COMPARISON OF PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN THE SEACEN COUNTRIES

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FOREWORD

The Asian crisis episode taught us that a banking crisis resolution is very costly, painful and complicated. However, it also inspires us that well-managed financial institutions – especially banks – and effective banking supervision are essential to maintain financial system stability. A sound, efficient and competitive banking system is crucial to ensure sustained economic growth. To this end, a well designed and effective regulatory framework is essential.

Most of research and literature on problem bank resolution were mainly focus on the causes of the crises and resolution of systemic crisis. There were few studies on problem bank identification, intervention and resolution. To fill this gap, The SEACEN Centre initiated a research project entitled "Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries".

This study is organised in two parts. Part I, the overview, provides an informative and balanced summary of the current status of problem bank identification, intervention and resolution mechanisms in the SEACEN countries. It also provides a set of important policy lessons and implications based upon the regional experience throughout the 1997 financial crisis. Part II consists of seven country papers which outline the legal and regulatory frameworks on problem bank identification, intervention and resolution in each country.

The SEACEN Centre gratefully acknowledges the contribution of the Project Leader Mr. Sukarela Batunanggar (Bank Indonesia) and country researcher: Mr. Steven Avel (Bank of Papua New Guinea), Mr. Bisma Raj Dhungana (Nepal Rastra Bank), Mr. Harrison S.W Ku (Central Bank of the Republic of China (Taiwan)), Ms. Uma Rajoo (Bank Negara Malaysia), P.W.D.N.R. Rodrigo (Central Bank of Sri Lanka), and Mr. Rath Sovannorak (National Bank of Cambodia). The Centre and the Project Leader would also like to thank Mr. Conrado A. Reyno (Bangko Sentral ng Pilipinas) and staffs as well as Mrs.Tongurai Limpiti (Bank of Thailand) and staffs who kindly provided information for the survey. Last but not least, The Centre and the Project Leader would also like to express gratitude to Prof. Joon-Ho Hahm (Yonsei University South Korea) and Dr. David Scott (World Bank) for their insightful comments and suggestions. Certainly the views expressed in the paper are those of the authors and do not necessarily reflect those of The SEACEN Centre or its member central banks.

We hope that this study will be valuable reference for supervisory authorities and policy makers in dealing with problem banks.

Dr. A.G. Karunasena
Executive Director
The SEACEN Centre

July 2008

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by Harrison S.W. Ku

Effective problem bank identification and resolution is crucial to ensure not only the soundness of a bank, but also the resilience of the financial system as a whole – since banks are dominant players in the financial system. Successful problem bank management will reduce the potential of both individual bank failures and banking crisis as well as minimise resolution costs. Hence, a comprehensive, clear framework and guidelines for dealing with problem banks is crucial.

This study aims at two main objectives: (i) to analyse the framework and process of problem bank identification, intervention and resolution in the SEACEN countries; and (ii) to identify key issues and lessons learned for an effective problem bank management.

In general, bank supervisors in nine SEACEN countries surveyed have a clear legal and prudential framework in dealing with problem banks. However, the level of progress diverges from country to country depending on their legal and political settings as well as economic development. Crisis hit countries (Indonesia, Malaysia and Thailand), and countries experiencing banking system distresses (Philippines and Republic of China, Taiwan) appear to have a more developed framework, particularly on crisis management. Supervisory authorities in the crisis-affected countries have enhanced the effectiveness of their banking supervision along with the post-crisis bank restructuring program. However, non crisis-affected hit countries (Cambodia, Nepal, Papua New Guinea and Sri Lanka) have a relatively less comprehensive framework. Non-crisis countries mostly are yet to have an explicit deposit insurance scheme and develop a crisis management framework.

Among key challenges for bank supervisors is to ensure both macro and micro supervisory objectives – to maintain financial stability and ensure depositor protection – are effectively attained. In practice, it often is difficult to identify and measure as well as manage systemic risk which requires different skills and methodologies. Therefore, it is imperative to perform and enhance the efficacy of macro-prudential surveillance to identify, monitor and mitigate the risks to the financial system.

For countries which are yet to have a crisis management framework it is important to develop comprehensive financial safety nets, consisting of: (i) an explicit and limited deposit insurance scheme; (ii) a well-defined and transparent LLR both in normal times and during systemic crises; and (iii) a clear crisis management framework. Deposit insurance and LLR can be important tools for crisis management, but they are not sufficient to prevent banking crises. They should be used along with measures such as market discipline and prudential banking supervision. A well-devised framework is essential, but effective implementation is much more important. It is necessary to perform a crisis simulation regularly in order to increase readiness in managing crisis Therefore, capacity building is indispensable.

INTEGRATIVE REPORT
PART I

COMPARISON OF PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN THE SEACEN COUNTRIES

by Sukarela Batunanggar[1]

1. Introduction

Effective banking supervision is the basic element of safety nets aiming at creating and promoting financial system stability. Banks, for the most part, are the dominant financial system component in the economy. Banks carry numerous risks inherent with the business, and thus need to be regulated, supervised and managed in a healthy manner. Bank defaults – especially with systemic effect – can endanger the stability of the financial system and the economy. Hence, the ultimate objective of bank supervision is to promote and maintain the soundness of financial institutions via regulation, which includes off-site analysis and on-site examination of risk management, financial conditions, and compliance with laws and regulations.

The lack of supervisory capability is often cited as one of the reasons for financial system weaknesses [Mayes, Halme dan Liuksila (2001), Batunanggar (2002 and 2004)]. As Mishkin (2001) argued, asymmetric information leads to adverse selection and moral-hazard problems that have an important impact on financial systems and justifies the need for prudential supervision.

The origin of the Asian financial crisis was financial and corporate sectors weaknesses combined with macroeconomic vulnerabilities. Weaknesses in bank and corporate governance and the lack of market discipline allowed excessive risk taking, as prudential regulations were weak or poorly enforced. Close relationship between governments, financial institutions, and borrowers worsened the problem particularly in Indonesia and Korea [Lindgren et al. (1999)]. In a similar vein, Nasution (2000) and Batunanggar (2002 and 2004) argued that drawbacks in risk management and bank governance as well as weak banking supervision were among the main contributory factors exacerbating the financial crisis in Indonesia in 1997-1998. Because of a combination of domestic and foreign factors, the crisis was particularly severe in Indonesia, Korea and Thailand. Malaysia and Philippines also experienced some effects of the financial crisis and adopted measures to deal with the turmoil and strengthen their financial systems.

The cost of a banking crisis is significantly large. Hoggarth, Reis and Sapporta (2001) found that the cumulative output losses incurred during crisis periods were large, estimated

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in the order of 15-20 percent, on average, of annual GDP[2]. The case-study evidence suggests that prompt intervention reduces the costs of intervention and promotes efficiency [OECD (2002a)]. Conversely, the inability to take fast and decisive actions in restructuring the banking system, when combined with political intervention, make the resolution of the banking crisis ineffective and costlier [De Luna-Martinez (2000), Batunanggar (2002 and 2004)]. Failure to gauge the magnitude of the problems or delays in its resolution invariably compounds the problems and costs involved (Sheng, 1992). Furthermore, in the case of Indonesia, Batunanggar (2002 and 2004) found that the absence of financial safety nets and a crisis-management framework and guidelines as well as political intervention were among the culprits behind the ineffective, prolonged, and costly resolution of its banking crisis.

The central banks and supervisory authorities especially in crisis-affected countries are committed to enhance the effectiveness of their bank supervision along with their post-crisis bank restructuring programme. The main characteristic of a systemic crisis is that the financial condition of a bank will rapidly deteriorate as a result of an adverse economy and/or a widespread bank-run. Pre-crisis, the focus of the supervisor is to assess the condition of the banks to determine quickly which of the banks have a better probability of surviving from those which are likely to fail if a crisis occurs.

Hence, a clear and comprehensive framework and guidelines as well as methods for dealing with problem banks are crucial. The problem banks identified should be managed rapidly, objectively, transparently, and consistently in order to restore the health of the financial system and the economy.

1.1 Objectives of the Study

Most of the researches and literatures on problem banks focused on the resolution of systemic crisis with less attention given to the management of problem banks. Therefore, this project aims to analyse problem bank identification, intervention, and resolution in nine SEACEN countries[3] and to identify the key issues as well as derive lessons learned for the effective management of problem banks.

This chapter compares the approach and framework for problem bank identification, intervention and resolution in the SEACEN countries. Furthermore, it draws key lessons learned and recommendations for more effective bank problem identification and resolution for the SEACEN countries in particular and for other countries in general.

The individual country papers identify the key issues – strengths, drawbacks and challenges – and propose policy recommendations in dealing with problem banks identification, identification and resolution in each country.

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2 They provided a cross-country study on the measurement of the losses incurred during periods of banking crises. In contrast to previous research, they also found that the output losses incurred during crises in the developed countries are as high, or higher, on average, than those in the emerging-market economies and also those of neighbouring countries that did not at the time experience severe banking problems. In the emerging-market economies, banking crises appear to be costly only when accompanied by a currency crisis. These results seem robust in allowing for macroeconomic conditions at the outset of crisis – in particular low and declining output growth – that have also contributed to future output losses during crises episodes.

3 Cambodia, Indonesia, Malaysia, Nepal, Papua New Guinea, Philippines, Republic of China (Taiwan), Sri Lanka, and Thailand. Philippines and Thailand completed the survey but did not contribute their country papers.

1.2 Data and Methodology

This study covers nine SEACEN member countries, namely, Cambodia, Indonesia, Malaysia, Nepal, Papua New Guinea, Philippines, Republic of China (Taiwan), Sri Lanka, and Thailand. Philippines and Thailand participated in the survey but did not contribute their country papers.

The research project was based on literature review and survey. The data and information collected for the research project include: (i) the legal framework for bank supervision based on the prevailing laws or acts, regulations, supervisory guidelines or manuals, in particular with regard to problem bank supervision and resolution; (ii) data and information covering the relevant issues concerning problem bank identification, intervention and resolution which are presented in the Appendix (Table 1-26); and (iii) other data and information from published documents.

2. General Framework

The framework for problem bank identification, intervention and resolution differs from country to country. It is shaped by several factors such as political, economic and legal setting. An appropriate framework for dealing with weak and failing banks is necessary in order to provide a clear and sensible guideline for supervisors. Where bank supervision is separated from the central bank and a deposit insurance company exists, a mechanism for coordination between the related agencies is a crucial requirement.

The Basel Committee on Banking Supervision (BCBS) issued a document, "Supervisory Guidance on Dealing with Weak Banks," which provides a comprehensive and useful guideline for dealing with problem banks. As formulated by the Basel Committee, the three key tasks of the supervisor in dealing with problem banks are to identify the problems early, ensure preventive or corrective measures are adopted, and have a resolution strategy in place should the remedial action fail[4].

A weak bank is one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management[5].

The guiding principles for supervisors when dealing with weak banks include speed, cost-efficiency, flexibility, consistency, avoidance of moral hazard, and transparency and and cooperation[6]. Figure 1 provides a brief summary of the guiding principles.

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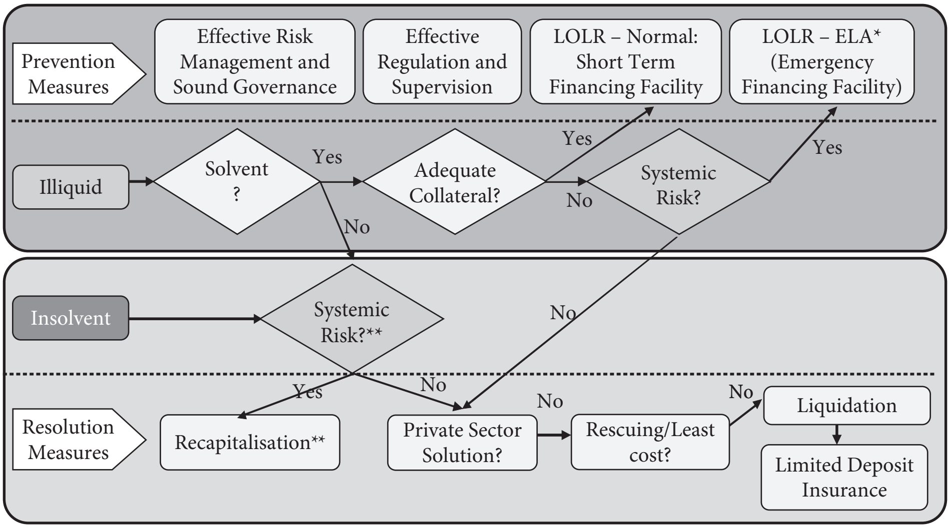
4 Supervisory Guidance on Dealing with Weak Banks, BCBS, BIS, March 2002.
5 ibid.
6 ibid.

Figure 1: The Guiding Principles for Dealing with Weak Banks
• **Speed.** Supervisors should act promptly. Experience from many countries shows that regulatory and supervisory forbearance has exacerbated the problems of a weak bank. By not dealing with the problems promptly, they have grown rapidly making the eventual resolution efforts more difficult and more expensive, with the possibility of becoming more widespread and systemic. • **Cost-efficiency.** A least cost criterion should guide the supervisor when making choices between alternative actions consistent with achieving the supervisory objectives. It is important that the supervisor considers all costs, including exogenous costs such as instability of the financial system, in deciding on a course of action. • **Flexibility.** Legislation frequently adopts a rules-based approach. However, it is also helpful if the legislation permits the supervisor to exercise discretion in the deployment and timing of supervisory tools. Supervisors should be prepared to act flexibly by considering the full range of powers available when faced with a weak bank. • **Consistency.** Consistent and well-understood supervisory actions will not distort the competitive environment. Such an approach will also minimise confusion and uncertainty in times of crisis. Similar problems in different banks, large or small, private or state-owned should receive similar treatment. • **Avoiding moral hazard.** Supervisory action should not create incentives for banks to act in a manner that incurs costs which they do not have to bear entirely. Shareholders should not be compensated for losses when a bank gets into difficulty; otherwise it will encourage other banks to behave less prudently on the expectation that they will receive a similar bailout if problems occur. Equally, supervisory action should not protect the interest of the bank's corporate officers. • **Transparency and cooperation.** Inadequate or incorrect information from the bank increases uncertainty for everyone involved. It can lead to misplaced supervisory action and add to the costs of solving the problems. The bank and the relevant authorities should aim for a high degree of information sharing and transparency about their intended actions. Decisions on disclosures, or not, to the general public are more difficult and must depend on the specific situation - whether it contributes to the supervisor's objective in resolving the weak bank and maintaining broader systemic stability. Source: Supervisory Guidance on Dealing with Weak Banks, BCBS, BIS, March 2002.

The general framework in dealing with weak banks is presented in Figure 2 below. A detailed framework for dealing with a problem bank and a flow chart for assisting the resolution of a failing bank facing solvency and systemic issues are provided in the Appendix – in Figures 16 and 17. In actuality the frameworks and mechanisms in dealing with problem banks vary from country to country due to differences in their legal, economic and political settings.

Figure 2
General Framework in Dealing with Problem Bank



3. Managing Problem Banks in SEACEN Countries

This section compares and interprets the information from the Survey Tables collected from the nine SEACEN countries. It is useful to identify the general framework and process across countries for managing problem banks. However, we are mindful of the differences in policies and in the activities listed as well as in the tools deployed.

3.1 Legal Framework for Bank Regulation and Supervision

Generally, all the countries have clearly established legal frameworks for supervising banks in general and for dealing with problem banks in particular. Principally, the banking supervision in the SEACEN member countries consists of the regulation of capital and other general prudential regulations for the banks to adhere as well as provisions for the examination of the banks' compliance with the regulations. In all the countries, except the Republic of China (Taiwan), the regulation and supervision of banks come under the authority of the central bank. For the non-bank financial institutions, some of them are under the supervision of the central bank while others come under the purview of the Ministry of Finance or is shared between the two.

3.2 Prudential Requirements

The prudential requirements emphasize the obligation of banks to hold adequate capital as a buffer to cover the inherent business risks and provide adequate risk management and control systems to mitigate the risks.

The prudential standards were formulated and published by the Basel Committee in a document, "The 25 Core Principles for Effective Banking Supervision," issued in September 1997. Bank supervisors must ensure that banks have adequate policies, procedures, and practices associated with: (i) management information system; (ii) risk management process;

(iii) internal controls; (iv) country risk and transfer risk; (v) market risk; (iv) legal lending limits to related companies and individuals; (vii) asset quality; (viii) loan and investment; (ix) know your customer; and (x) minimum capital adequacy. The prudential requirements are also well-known as capital, asset quality, management, earnings, liquidity and sensitivity to risks or "CAMELS".

Even though varying in practice, all the countries basically apply the same prudential standards for ensuring the soundness of banks. All the countries require their banks to maintain the minimum capital-adequacy ratio of eight percent as set by the Basle Capital Accord. In Cambodia, Papua New Guinea, Philippines, Nepal and Sri Lanka the capital requirement well exceeded the minimum standard. It is often argued that the Basle risk-weighted standards, developed for industrial countries, may not be completely suitable for banks in many emerging countries. The overall minimum ratio of eight percent may be too low for banks operating in a much more volatile macro-economic environment[7]. The revised Basel Capital Accord (Basel-II) framework which is more comprehensive and risk sensitive will address this problem.

In addition, most of the countries also apply liquidity ratios such as loan to deposit ratio and reserve ratio.

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7 See Goldstein and Turner (1996).

Figure 3
Prudential Ratios

Country	Capital adequacy ratio*	Minimum capital	Liquidity ratio	Required reserve ratio
Cambodia	15%	KHR 50 bn	≥50%	8% of total deposits
Indonesia	8%	Rp3000 bn	LDR <110%	3% of total IDR deposits 5% of total FX deposits
Malaysia	8%	Capital of domestic banking grp RM2b	Not prescribed	Statutory Reserve Ratio of 4%
Nepal	11%	Paid up capital should be at least Rs. 2 billion	Commercial banks are free to manage on their own.	- CRR 5% [1] - No CRR requirements on FX deposits
Papua New Guinea	12%	PGK15 m	15% for good banks 35% for a worst bank	3% of total deposits
Philippines	10%	Pesos 4,950 (Universal bnk) Pesos 2,400 (commercial bnk)	LDR <80%	10% (universal & commercial bank)
Sri Lanka [2]	10%	Rs.2.500 mn (commercial bank) Rs. 1500 mn (specialized bank)	20% of liabilities	10% on all rupee deposits
Rep of China (Taiwan) [3]	8%	NT10 bn	LDR < 7%(NT)	• 4%-10.75% of NT deposits. • 15.125% of Trust funds. • 5% of FX deposits.
Thailand	8.5%	Baht 5,000 Mn.	6% of total deposit, total short term foreign borrowing and total borrowing with embedded financial derivatives.	

* Percentage to risk weighted assets
1) Of total deposits monitored on weekly basis (Balance with NRB/ Total deposits in Rs.)
2) 20 percent of total liabilities less liabilities due to the central bank and shareholders, to the holders of non redeemable debt instruments and its liabilities on repos in relation to treasury bills or securities issued or guaranteed by the Government
3) LDR = Actual liquid reserves/Total reservable liabilities; (10.75 percent of checking accounts, 9.775 percent of passbook deposits, 5.5 percent of savings passbook deposits, 4 percent of savings time deposits, 5 percent of time deposits)

"Connected lending" – the extension of loans to bank owners and management as well as to related companies – is a key corporate governance problem that contributed to the banking problem particularly in Indonesia, Thailand and Korea. High loan concentration to a single or group of borrowers and excessive exposure to certain economic sectors is also a source of vulnerability that contributed to the fragility of the banking sector.

All the countries have prudential limits regulating bank exposures to related parties, single borrowers and corporate groups (Figure 4). Sri Lanka set the highest limit of 30 percent for a single borrower. Malaysia and Papua New Guinea prohibit loan extension to related parties. Republic of China (Taiwan) and Thailand set the loan exposure limits based on total equity instead of on the bank's capital.

Figure 4
Loan Exposure Limits

Country	Related parties (% to capital)	Single borrowers (% to capital)	Sectors
Cambodia	10	20	No
Indonesia	10	20	Loans for land prohibited 1997
Malaysia	25% of capital base	25% of capital base	Loans to Broad Property sector 1)
Nepal	25% of Core capital	25% of core capital	2)
Papua New Guinea	25	25	None
Philippines	100	25 3)	
Sri Lanka	Maximum lending to a director or his close relations is restricted to Rs. 500,000	30% for single 33% for aggregate	None
Rep of China (Taiwan)	40 (% to total equity)	3% of equity for individual 15% of equity for single legal entity	20% 4)
Thailand	5 % of tier 1 capital 50% of equity of related parties 25% of total liabilities of related parties (whichever is lower)	25% of tier 1 capital fund	

1) Outstanding loans and advances extended to the BPS (real estate and construction sectors) in any calendar quarter shall not exceed 20 percent of the total outstanding loans in the previous quarter. Private debt securities and commercial papers issued to finance property development purchased by banking institutions in the primary market in any calendar quarter shall not exceed 20 percent of the total PDS and CPs purchased in the primary market in the previous quarter.
2) Sectoral exposure ≤ 100% is reviewed by the management of the bank itself and > 100% should be reviewed by the BOD of the commercial bank and report to NRB
3) Since 5 June 1997, the BSP tightened the regulation on real estate lending. The prescribed ceiling on commercial bank's loan to the real estate sector is 20 percent of a bank's total loan portfolio, exclusive of loans to finance the acquisition or improvement of residential units amounting to not more than P3.5 million. Inclusive of these loans, however, aggregate real estate loans should not exceed 30 percent of the bank's total loan portfolio.
4) Loans for residential construction and business purposes shall not exceed 30% of the aggregate of bank's deposits and bank debentures issued at the time such loans is extended.

Prudential limits on foreign exchange exposures are also applied in all the countries (Figure 5). In some countries, Thailand for example, these limits are quite detailed, while in other countries, Malaysia for example, formal prudential rules on foreign exchange exposures are not specified. However, banks are required to set their own individual foreign exposure limits.

To mitigate the liquidity risk from increasing maturity mismatch, some countries (Indonesia, Malaysia, Papua New Guinea) also require their banks to manage their maturity mismatch.

Figure 5
Foreign Exchange and Maturity Limits

Country	Foreign currency exposure	Maturity mismatch
Cambodia	≤15% of aggregate of all currencies	No guideline
Indonesia	Maximum net OP 20% of K	Maturity mismatch considered adequate performance should be at least
Malaysia	n/a (each bank has individual net OP limit)	No formal guidelines
Nepal	Maximum of 30% of core capital	Formal guidelines to review, monitor and submitting returns to NRB on gap analysis, maturity profile and monitoring of liquidity and interest rate risk etc.
Papua New Guinea	10% of Capital Base- Single Currency 15% of Capital Base - Overall (all currencies)	Banks are required to square their positions at the end of each day. This is done through inter-bank borrowing and use of the ESA.
Philippines	Maximum net OP 20% of K or US$50 million	No formal guidelines
Sri Lanka	Positive maximum NOP limit is 20% capital funds. Limits on negative positions are set by individual banks	No formal guidelines
Rep of China (Taiwan)	Approval of individual bank's application (According to bank's overall condition) No formal guidelines	No formal guidelines
Thailand 1)	**Individual limit :** 15% or USD 5mn whichever is the greater. **Aggregated limit :** 20% or USD 10 mn, whichever is the greater.	No formal guidelines

OP = open position; fx = foreign exchange; K = capital

1) **Individual limit :** At the end of each day financial institutions shall maintain a net open position in each currency in proportion to its capital at a rate not exceeding 15 percent or USD 5 million, whichever is the greater.

Aggregated limit : At the end of each day financial institutions shall maintain an aggregate position in proportion to its capital at a rate not exceeding 20 percent or USD 10 million, whichever is the greater.

Generally, all the countries adopt a "best practice" loan classification, which is similar: one to three months for "special mention", three to six months for "substandard", four to nine months "doubtful", and six to twelve months for "Loss" category. Papua New Guinea and Republic of China (Taiwan) apply a more lenient standard which is six to twelve months for doubtful and over twelve months for loss (Figure 6).

Figure 6
Period Overdue for Interest Suspension and Loan Classification

Country	Period overdue for interest suspension	Substandard	Doubtful	Loss
Cambodia	3 M	3 M	6 M	12 M
Indonesia	3 M	3 M	6 M	9 M
Malaysia	3 M			
Nepal	3 M	6 M	9 M	12 M
Papua New Guinea	I M – 3 M	3 M – 6 M	6 M - 12 M	Over 12 M
Philippines	1 M	3 M	4 to 5 M	6 M
Sri Lanka	3 M	6 M	9 M	12 M
Rep of China (Taiwan) 1)	1 M -3 M* 1 M -12 M**	3 M -6 M* Over 12 M **	6 M-12 M*	Over 12 M*
Thailand 2)	3 M	3 M	6 M	12 M

M = month (s) 1) *without collateral; ** *with collateral
2) Asset is classified into six categories: Pass (1 M.), Special Mention (2 M.), Substandard (3 M.), Doubtful (6 M.), Doubtful Loss (12 M.), and Loss (write-off).

The same condition applies to loan provisioning requirement which is one percent for performing loans, 2 to 5 percent for special mention, 15 to 25 percent for substandard (except Thailand which requires 100 percent), 50 percent for doubtful and 100 percent for loss (Figure 7). Differently, Cambodia requires a lower loan loss provisioning and only for substandard, doubtful and loss loans.

Figure 7
Loan Provisioning Requirements
(As a percentage of original loan value)

Country	Performing (Standard)	Special mentioned	Substandard	Doubtful	Loss
Cambodia	–	–	10	30	100
Indonesia	1	5	15	50	100
Malaysia	1.5 (general provision)	N/A	20	50	100
Nepal	1	N/A	25	50	100
Papua New Guinea	1	5	25	50	100
Philippines	1 regular 5 restructured	5	10 regular 25 unsecured	50	100
Sri Lanka 1)	1		20	50	100
Rep of China (Taiwan)	0	2	10	50	100
Thailand 2)	1	2	100	100	100

1) The provisioning is based on the outstanding loan value minus value of securities
2) 1 percent and 2 percent of net value between outstanding loan and collateral. BOT applies IAS 39, therefore FIs have to set 100 percent provision of the difference between outstanding debt and present value of estimated future cash flows from debtors or estimated future cash flows from sales of collaterals.

3.3 Problem Bank Identification

All the countries except Papua New Guinea adopt a risk-based framework in supervising banks. All the countries also implement early warning systems and risk assessment systems in identifying bank problems. In some of the countries, supervisory risk assessment (bank rating) and early warning systems have been adopted since early 1990s in Indonesia and Sri Lanka and in the Philippines in 1998. In most of the countries the same were adopted since 2003 up to the present (Figure 8). All the countries, except Malaysia, adopt a similar CAMELS rating system to assess banks' risks. Thailand, in particular, uses much more indicators in applying a risk-based supervisory system.

Figure 8
Indicator/Risk Categories and Ratios Used in Supervisory Risk Assessment and Early Warning Systems - Supervisory Bank Rating Systems

Country	System	Indicator & ratios used	Asset quality	Solven -cy	Profit -ability	Liquid -ity	Market Risk	Management & control	Eco -nomic
Cambodia	CAMELS	5	1	1	1	1	–	–	
Indonesia 1)	CAMELS	6	1	1	1	1	1	1	
Malaysia	n/a	–	–	–	–	–	–	–	–
Nepal	CALES	5	1	1	1	1	1		
Papua New Guinea	CAMELS	6	1	1	1	1	1	1	–
Philippines	CAMELS	6	1	1	1	1	1	–	–
Sri Lanka 2)	n/a	–	–	–	–	–	–	–	–
Rep of China (Taiwan) 3)	CARSEL	6	1 (C)	1 (A)	1 (R)	1 (S)	1 (E)	1 (L)	
Thailand 4)	Risk-based Supervision	41	13	2	5	11	10	*	–

1) Also uses qualitative assessment on good governance and strategic risk.
2) When bank supervisor conclude the final composite rating as supervisory rating, he or she should consider external factors influencing bank operations such as macroeconomic and banking industry as well as bank sensitivity to risk factors.
3) C-Capital Adequacy, A- Asset Quality, R- Regulations' compliance, S- Strategies and Stability, E- Earnings, L- Liquidity.
4) *Includes qualitative assessment.

Besides the supervisory bank-rating systems, most of the countries also apply financial ratios and peer group analysis as part of their supervisory risk assessment and early warning systems.

Identifying and measuring banks' problems and risks are challenging in line with the constantly changing business and external environment, particularly financial globalization. Consequently, the conventional tools for identifying banks' risks, such as financial ratios, while they are still useful, are no longer sufficient. These challenges require bank supervisors to develop and apply a more risk-based and forward-looking tools to identify and measure banks' risks not only stemming from internal factors but also external factors, such as shocks from both financial and real sectors, both domestic or international finance. Corresponding to the challenges, all the countries also use other early warning tools in addition to CAMELS.

Four countries (Indonesia, Malaysia, Republic of China (Taiwan), and Thailand) apply stress test to measure banks' sensitivity to risks. Indonesia, Philippines and Thailand have developed econometric models to predict bank failures.

With respect to off-site surveillance, all the countries put significant efforts on on-site examination to identify banks' problems and assess their risks. Varying in their stages of development, all the countries except Papua New Guinea adopt a risk-based approach in examination which is more risk focused and forward looking.

Proper supervisory strategy and tools are essential for ensuring accurate and timely problem bank identification. However, much will depend on the quality of the banks' information management systems, governance and control systems. Experience shows that there are four main factors causing a banking crisis or individual bank failure, namely, unsound banking practices, poor risk management, bad corporate governance and fraud. The first three causes were occurrences in all the countries, while fraud also occurred in most of the countries except Sri Lanka and Republic of China (Taiwan) (Figure 9).

Figure 9
Micro Factors Causing Banking Crisis or Individual Banking Failure

Country	Unsound practices	Poor risk management	Bad corporate governance	Fraud	Others
Cambodia					
Indonesia	✓	✓	✓	✓	
Malaysia					
Nepal	✓	✓	✓	✓	1)
Papua New Guinea	✓	✓	✓	✓	
Philippines	✓	✓	✓	✓	
Sri Lanka	✓	✓	✓		
Rep of China (Taiwan)	✓	✓	✓		
Thailand	✓	✓	✓	✓	

1) Weakness in internal controls, governance, risk management skills, low capital base in the commercial banks.

Therefore, bank supervisors should encourage the practice of more effective risk management and control, transparency and good governance which function as the first line of defence against bank problems and risks.

In addition to the micro factors, bank supervisors also must be aware of the macro factors causing a banking crisis or individual bank failure, namely, economic recession, weak supervision system, and political intervention (Figure 10). In the case of Indonesia and Thailand, premature financial deregulation was also observed to be a culprit behind banking crisis or individual bank failure. Consequently, as mentioned in the previous section, there is a greater use of environmental analysis and stress testing to measure the impact of external shocks to the individual bank and the banking system. Particularly in the post-Asian crisis, the authorities lay considerable stress to ensure independence and effectiveness of banking supervision.

Figure 10
Macro Factors Causing Banking Crisis or Individual Banking Failure

Country	Economic Recession	Premature Financial Deregulation	Weak Supervision System	Political intervention	Others
Cambodia	–	–	–	–	1)
Indonesia	✓	✓	✓	✓	
Malaysia					2)
Nepal	✓		✓	✓	3)
Papua New Guinea	–	–	–	✓	–
Philippines	✓				
Sri Lanka	✓			✓	
Rep of China (Taiwan)					
Thailand	✓	✓	✓	✓	

1) Increase of capital requirement.
2) Currency crisis in the region led to massive outflow of funds from the regional economies and distressed corporations.
3) Especially weakness in internal controls, governance, risk management skills, low capital base in the commercial banks.

Some of the key issues and challenges related to problem bank identification in the SEACEN countries are as follows: first, compliance-based supervision and historical bank-performance analysis using backward-looking indicators are not effective in identifying banks' problems early and accurately. This is mainly due to limited information available to the bank supervisor and lag in bank reporting. The situation is made worse when the banks' information systems, internal controls and corporate governance are weak. Problem banks in the SEACEN countries are generally caused by unsound banking practices, poor risk management, bad governance and fraud. Usually the problem banks disguise their fundamental problems that can only be detected by on-site work. On-site analysis is useful to uncover the root causes of the weaknesses. However, the identification of the banks' problems based the on-site examination results are usually delayed so that the corrective actions cannot be taken promptly. Therefore, a risk-based supervisory strategy which is more focused towards banks' high risk areas should be adopted and developed. More forward-looking indicators and analyses as well as other tools such as stress testing are required to complement a conventional historical-trend analysis of banks' performance.

Second, in line with the implementation of risk-based supervision, the adoption of a more comprehensive bank risk management must be promoted to ensure that the banks' risks are properly managed. Early introduction of the new initiatives will allow a better understanding of the concepts and their merits as well as facilitate preparation for gradual implementation. The response of banks' management to the adoption of risk management differs depending on their knowledge, skill and experience. The larger and better managed banks are usually more proactive compared to the smaller banks.

Third, developing the new supervisory framework and tools are less demanding as compared to their implementation. The effective application of the new framework and tools requires not only enhanced business processes and systems, but more importantly, a paradigm shift for the bank supervisors. It is important to note that the adoption of a risk-based supervision and risk management requires consistent change management. To make it work, strong leadership and commitment from top management as well as human resource development are essential to facilitate the process. In addition, there should be appropriate incentive systems both for the bank supervisor and for the banks' management to develop their skills and migrate from a compliance-based and backward-looking approach toward a forward-looking approach and to use their judgment.

3.4 Problem Bank Intervention

All the countries have clear grounds for receivership and early resolution of bank insolvency, and they adopt rule-based criteria for intervention. Most of the countries use both capital inadequacy or critical undercapitalisation and liquidity inadequacy as criteria for intervention in a problem bank (Figure 11). The Philippines uses only liquidity inadequacy, while Indonesia uses only capital-inadequacy criteria.

Some of the countries structure their early intervention framework into three categories: undercapitalised, significantly undercapitalised, and critically undercapitalised while others arrange it only into two categories. The minimum threshold set by the authorities varies among countries ranging from below 4 percent to 6 percent (Figure 11). For the Philippines, its early intervention framework is structured differently into four categories: up to 40 percent undercapitalised, up to 60 percent undercapitalised, up to 80 percent undercapitalised, and more than 80 percent undercapitalised from the minimum statutory capital of 10 percent.

When CAR falls below the minimum statutory level and/or there is non-compliance with the law, rules and regulations which jeopardize the condition of the bank, the supervisory authority has the discretionary authority to intervene. The intervention measures include dismissal of the bank's management and appointment of a temporary management, order for the bank to submit a capital-restoration plan, issuance of a cease and decease order, and closure if the intervention fails.

Bank intervention is a complex process which requires focus and careful attention. Two countries (Philippines and Nepal) have a special unit charged with the responsibility of supervising problem banks which are in critical condition.

Figure 11
Explicit Structured Early Intervention Framework

Country	Capital Level Trigger for Mandatory and Discretionary Actions		
	Undercapitalised	Significantly Undercapitalised	Critically Undercapitalised
Cambodia	10% < CAR <15%	5% < CAR <10%	CAR <5%
Indonesia	6% < CAR < 8%	CAR ≤ 6%	n/a
Malaysia [1)]			
Nepal	8% < CAR < 11%	5% < CAR < 8%	0% < CAR < 5%
Papua New Guinea	CAR < 12% or Tier I <8% Leverage <6%	CAR < 8% or Tier I <4% Leverage <4%	CAR & Tier I irrelevant Leverage <2%
Philippines [2)]			
Sri Lanka	No specific measure		
Rep of China (Taiwan)	5% <CAR ≤ 8%	CAR < 6%	n/a
Thailand	CAR <8.5%	CAR <8.5% or Tier I <4.25%	n/a

1) Supervisory has discretionary powers to take appropriate measures
2) Categorised differently into four types: up to 40 percent undercapitalised, up to 60 percent undercapitalised, up to 80 percent undercapitalised, and more than 80 percent undercapitalised from the minimum statutory capital of 10 percent.

Bank intervention should be based on a comprehensive analysis of the symptoms and causes of the deficiencies of problem banks. The realization of the supervisory objectives of financial stability and depositor protection must also be kept in view. Once the bank supervisors identify the problems and the causes of a weak bank, timely and appropriate corrective actions – based on the condition and scale of the problem – are required to deal with the deficiencies and the behavioral change of the bank.

However, the corrective action is mainly based on a lagging indicator of a bank's financial health. Intervention in problem banks is likely to be triggered only after they have been identified by the examiners, who rely on far more information than capital ratio. Therefore, in addition to quantitative criteria such as capital-adequacy ratio, non-performing loans or liquidity ratio, it is necessary to define and build into the trigger mechanism for problem bank intervention some qualitative criteria.

The above-mentioned problem is related to the rules-versus-discretion issue. Correcting a bank's problems should be done in timely manner and based on sound judgment which requires some latitude of discretion, particularly in the case where contagion or systemic risks are evident. However, too much discretion creates a lack of transparency, erodes accountability, and has moral-hazard potential. Therefore, the challenge is striking a right balance. A bank's problems and corrective action plans may not always conform to the detailed procedures stated in the exit-policy guideline. Consequently, it behooves the supervisor to make prompt and appropriate decisions to ensure that the bank's problems are properly treated and in a timely manner.

The other challenge is gaining the bank management's commitment to adhere to the action plans in order to restore the bank's health. Experience shows that the causes of problem banks are often rooted in mismanagement, poor governance, and fraud. In such cases, it is difficult to expect the bank management to commit to the corrective action plans. The supervisor may ask the bank's controlling shareholders to appoint a caretaker or to change the bank's management. However, in practice this can be quite difficult. Another related issue is the legal power of the bank supervisors in exercising the letter of comfort issued by the problem bank's controlling shareholders. In some cases, the bank supervisors face difficulty enforcing the bank's controlling shareholders to take the agreed-upon actions. The supervisors may also be constrained by a weak legal system for them to take legal action against bad bankers and this gives rise to moral hazard which hinders market discipline. The experience shows that the cases of successful bank intervention are supported by a combination of factors including: (i) early identification of both the symptoms and causes of the bank's problems; (ii) prompt and timely corrective actions by the bank supervisors; and (ii) the bank's owner and management's commitment to turn around the bank.

3.5 Problem Bank Resolution

A coordination mechanism linking up the related authorities is crucial for the effective management of problem banks. All the countries, except Sri Lanka, have clear coordination mechanisms for dealing with bank failures, which are formulated in a memorandum of understanding with other regulators,

The supervisory authorities or deposit insurance companies in the SEACEN countries use a variety of resolution methods for dealing with problem banks, including deposit payoffs, purchase and assumption transactions, open-bank assistance, good bank versus bad bank, and bridge banks, publicly-assisted bank restructuring, and temporary nationalisation. In general, a country uses more than one method of resolution, but the best practices vary among the countries (Figure 12). Lindgren et al. (1999) identify that the techniques commonly used in most countries for the consolidation of the financial sectors. They include closures, mergers, purchase and assumption operations, and bridge banks.

In all the countries, except the Republic of China (Taiwan), the central bank as a bank supervisor has the power to declare bank failure. In most of the countries, the power to determine the appropriate bank resolution method to adopt is reserved by the central bank (Malaysia, Nepal, Papua New Guinea, Sri Lanka, and Thailand). In Indonesia it is solely determined by the deposit insurance company, while in Malaysia the central bank and the deposit insurance company jointly decide it. In the Philippines and Thailand, besides the central bank, the court system also has power to determine the bank resolution method. In Nepal, Papua New Guinea, and Sri Lanka, besides the banking supervisory authority, certified public accountants can also be appointed to assess the value of the failing banks.

Figure 12
Resolution Methods

Country	Deposit payoff	Purchase & assumptions	Open bank assistance	Bridge banks	Asset purchase	Publicly assisted bank restructuring
Cambodia	✓	–	–	–	–	–
Indonesia	✓	–	✓	✓	–	–
Malaysia	✓	–	–	–	–	–
Nepal	n/a 1)	–	–	–	–	–
Papua New Guinea	✓	✓	✓	–	✓	✓
Philippines	✓	–	–	–	–	–
Sri Lanka 1)						✓
Rep of China (Taiwan)	✓	✓	✓ 2)	✓	–	–
Thailand	✓	–	✓	–	–	✓

1) The methods are not specified. The one selected represents an actual case.
2) Restricted the bank failure in the event that there is any potential that will significantly endanger credit order and financial stability.

Basically, there are three sets of criteria used to determine bank failure: (i) examination criteria based on the on-site examination result; (ii) liquidation criteria based on the liquidators' appraisal; and (iii) market-value criteria. All the countries adopt the examination criteria to determine a failed bank. In addition to the examination criteria, the Philippines and Republic of China (Taiwan) also adopt the liquidation criteria.

The main objective of a bank restructuring programme is to overhaul the banking system and enable banks to function as financial intermediaries as efficiently and as quickly as possible. The process of resolving financial crises typically involves three major steps: (i) diagnostic review; (ii) resolution of the non-viable institutions and recapitalisation of the viable ones; and (iii) resolution of the non-performing loans.

Essentially, a bank restructuring programme consists of two main elements: (i) financial restructuring, including capital injection and loan restructuring; and (ii) operational restructuring entailing the improvement of a bank's internal organisation, such as its operational efficiency, governance, risk management and control. Generally, the approaches adopted in Korea, Thailand, Indonesia and Malaysia are similar. Financial restructuring focused on the closure of adversely insolvent financial institutions, takeovers, carving out and transferring bad assets to a central agency, and capital injection from private and public sources. During the 1997/1998 Asian crisis, the crisis-affected countries (Indonesia, Malaysia and Thailand) carried out mergers, closures and state intervention in the distressed banks. There are several instruments used to recapitalize and purchase non-performing loans (NPL), such as bonds (Indonesia and Philippines).

In response to the banking crisis or individual bank failures, all the countries took measures to improve their banking regulation and supervision and encourage banks to adopt the best practices, including risk management, corporate governance, and internal control (Figure 13). Most of the countries also improved the resolution methods for their implementation effectiveness.

Figure 13
Improvement Made after Banking Crisis or Individual Banking Failure

Country	Bank regulation and supervision	Banking practices *	Resolution method	Asset management company	Financial safety nets**	Crisis manage-ment
Cambodia	✓	✓	✓	–	–	–
Indonesia	✓	✓	✓	✓	✓	✓
Malaysia	✓	✓		✓	✓	
Nepal	✓	✓	✓			
Papua New Guinea	✓	✓	–	–	–	–
Philippines	✓	✓	–	–	✓	–
Sri Lanka	✓	✓				✓
Rep of China (Taiwan)	✓	✓	✓	✓	✓	✓
Thailand	✓	✓	✓	✓	✓	✓

* Risk management, corporate governance, internal control, etc
** Including lender of last resort for emergency situation, deposit insurance

Thailand, which was first hit by the Asian crisis in mid-1997, merged 12 finance companies and one commercial bank, closed 59 finance and securities companies and two commercial banks, as well as took over and recapitalised six commercial banks and 12 finance and securities companies. Indonesia was most severely impacted by the Asian crisis. Since the creation of the Indonesian Banking Restructuring Agency (IBRA) in January 1998, the government of Indonesia initiated a bank restructuring programme as part of a broad resolution programme, which included takeovers, mergers and recapitalisation. Bank Indonesia and the IBRA enforced the closure of 64 medium and small private commercial banks, took over and recapitalised 14 commercial banks and 12 regional banks, merged and recapitalised seven taken-over private commercial banks into one bank as well as merged three state-owned banks into a new established bank[8]. Compared to other crisis-affected countries, Malaysia proved to be more resilient and effective in surmounting the crisis. Only four banks were taken over which were merged into two banks, with no closures.

Bank closures in the non-crisis-affected countries were less frequent as compared to the crisis-affected countries. The situation in the non-crisis-affected countries was characterised by the absence of deposit insurance systems, less developed systems for problem bank resolution and crisis management, and the adoption of open-bank resolution as the most visible option for bank supervisors in dealing with failing banks. This situation was quite similar to the conditions prevailing in pre-crisis Indonesia and Thailand in 1997/98 where open-bank resolution was preferred over closure. However, the experience shows that open-bank resolution is ineffective and induces moral hazard. This issue is also related with the difficulties faced by bank supervisors to take strong enforcement against bad behavior of bank management and owners, which hinder market discipline.

To be effective, the resolution process for problem banks has to be speedy, objective, transparent, and consistent in order to restore the health of the financial system and the economy.

[8] See Batunanggar (2002 and 2005) for detailed information and analysis.

3.6 Safety Nets and Crisis Management

Financial safety nets are vital for ensuring financial system stability. Comprehensive safety nets cover lenders of last resort (both for normal condition and systemic crisis), deposit insurance schemes, and crisis management. Most of the countries, particularly Indonesia, Malaysia, Philippines, Sri Lanka, Republic of China (Taiwan) and Thailand, improved their financial safety nets and crisis management in order to strengthen the resilience of their financial systems (see Figure 13).

Crisis-affected countries have clear crisis-management frameworks in place, including policies in dealing with systemic banking crisis, roles and responsibilities, coordination mechanisms linking relevant agencies in dealing with systemic crisis, and provision of liquidity assistance for banks in emergency condition. Non-crisis-affected countries, such as Cambodia, Papua New Guinea, Nepal, and Sri Lanka, evidenced less developed financial systems and are yet without crisis-management frameworks. However, Nepal is reported to have a coordination mechanism for dealing with systemic crises, but it is still under development.

3.6.1 Lender of Last Resort (LLR)

Walter Bagehot (1873), the founding father of modern LLR, stated the three principles of LLR: (i) provision for lending against sufficient collaterals (for solvent banks only); (ii) provision for lending with penalty rate (for liquid banks only); (iii) announcement of the commitment to lend without limit (to ensure credibility)[9].

The historical experience suggests that successful lender-of-last-resort actions have prevented panics on numerous occasions (Bordo, 2002). According to Mishkin (2001), central banks can encourage the recovery of financial crisis by providing loans as lender of last resort. Although there may well be good reasons for maintaining ambiguity over the criteria for providing liquidity assistance, He (2000) argued that properly designed lending procedures, clearly laid-out authority and accountability, as well as disclosure rules, will promote financial stability, reduce moral hazard, and protect the lender of last resort from undue political pressure.

While individual frameworks differ from country to country, there is a broad consensus on the key considerations for emergency lending during normal and crisis periods. LLR for normal times which is also known as normal or "secured" lending, basically follows the Bagehot rules. While LLR for systemic crisis, sometimes called "unsecured" lending, is provided based on certain exceptions such as: (i) measures aimed at containing the crisis, with the decisions jointly made by the monetary, supervisory, and fiscal authorities; and (ii) relaxation of repayment terms to accommodate the implementation of a systemic bank-restructuring strategy. [10] However, as argued by Sinclair (2000) and Goodhart (2002), within the time scale allowed, it is often difficult, if not impossible, for the central banks to distinguish between a solvency and a liquidity problem.

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9 The LLR concept was born in the19th century by Henry Thornton (1802) who explicated the fundamental elements of good central banking practice in the light of emergency lending. Walter Bagehot (1873) developed the concept of Thornton (even though he did not mention his name).

10 See Dong He (2000), for detailed guiding principles of LLR for normal times and systemic crisis.

In line with the common practice, all the countries provide direct lending to individual illiquid banks as part of their role as lenders of last resort. Interestingly, Papua New Guinea and Nepal also provide direct lending to individual insolvent banks. However, none of the countries provide direct lending to individual, insolvent non-depository institutions. In the Republic of China (Taiwan), both the central bank and the deposit insurance company are responsible for providing emergency liquidity assistance (joint decision).

It is important to note the Indonesian experience in providing emergency liquidity assistance during the 1997/98 crisis. Bank Indonesia provided around Rp170 trillion to banks facing serious liquidity problem after they were hurt by systemic bank-runs. The large budgetary cost that this entailed created tension and distrust between Bank Indonesia and the Government, particularly over the accountability and integrity of Bank Indonesia in providing the emergency liquidity support. The problem arose from unclear criteria for distinguishing good from bad banks and the absence of LLR guidelines and procedures to ensure accountability. In addition, there was also a lack of coordination between the agencies in managing the crisis.

3.6.2 Deposit Insurance

The experience shows that deposit insurance scheme is one of the important elements for maintaining financial system stability. In general, deposit insurance is aimed at three interrelated aspects: (i) protection of deposits, particularly small deposits; (ii) maintenance of public confidence in the financial system, especially the banking system; and (iii) maintenance of financial system stability.

Essentially, the main objective of deposit insurance is to avoid bank-runs. According to the Diamond-Dybvig model (1983), bank runs are indicated by "self-fulfilling prophecy" where the deterioration of depositors' confidence can lead to banking crisis. The problem is caused by two factors: (i) there is asymmetric information between depositors and bank management; and (ii) generally, the incapability of depositors to assess a bank's soundness. In addition, banks are also vulnerable to the event since their liquid assets are usually less than their liquid liabilities.

Prior to the 1997 crisis, none of the East Asian crisis-affected countries, except the Philippines –which was least affected by the crisis – and the Republic of China (Taiwan), had explicit deposit insurance schemes. A limited deposit guarantee in Indonesia was first applied when the authorities closed down Bank Summa at the beginning of the 1990s, which was considered unsuccessful. Subsequently, there were no further bank closures until the authorities closed down 16 banks in November 1997, and introduced a limited guarantee. However, this failed to prevent systemic bank-runs. Batunanggar (2002 and 2004) argued that a very limited deposit-insurance scheme was not effective in preventing bank-runs during the 1997 crisis in Indonesia[11]. Therefore, if a blanket guarantee had been introduced earlier at the outset of the crisis, the systemic runs might have been reduced.

[11] Deposits denominated of more than Rp20 millions – the uninsured component – accounted for about 80 percent of total deposits.

Figure 14
Deposit Protection Schemes

Country	Institution	Year Established	Coverage	Limit	Funding
Cambodia	NA				
Indonesia	Indonesian Deposit Insurance Corporation	2004	Bank deposits	Rp100 million per customer per bank	• Initial contribution from banks • Fees from banks (insurance premium) 0.002 p.a. of total deposit.
Malaysia	Malaysian Deposit Insurance Corporation	2005	Bank deposits	RM60,000 per depositor	• Fees from banks (insurance premium) 0.002 p.a. of total deposits • 2008 onwards - differentiated premium scale
Nepal	None, Act is being prepared.				
Papua New Guinea	There are no deposit protection schemes.				
Philippines	PDIC	1963	Bank deposit	P250,000 per depositor per bank	Insurance assessment – 1/5 of 1% of assessed deposits
Sri Lanka	Voluntary deposit insurance scheme	1987	Licensed Banks and registered cooperative societies	Rs. 100,000	Premiums + Central bank initial contribution + income
Rep of China (Taiwan)	Central Deposit Insurance Corporation	1985	Bank deposits 1)	NT1,500,000 per customer per bank	1. Initially established by CBC and MOF 2. Fees from banks (Different insurance premium - 0.05%, 0.055%, 0.06%. of insured deposit).
Thailand	FIDF *	1985	Fin. Institution deposits	Blanket (1997 – present)	• Allocation from BOT. • Fee from Financial Institutions • Others.

1) Rep of China (Taiwan): Include: checking deposits, demand deposits, time deposits, and other deposits that the competent authority has approved as insurable. Exclude deposits in foreign currency, Negotiable Certificate of Deposits, amounts due to all levels of government agencies, amounts due to the Central Bank; amounts due to banks, postal institutions handling postal savings and remittance businesses, credit cooperatives, farmer's and fishermen's associations with credit departments, and the Agricultural Bank of Taiwan; and other deposits that approved by the competent authority has approved as uninsurable.
* Financial Institutions Development Fund.

To strengthen the resilience of their financial systems, some ASEAN countries began to develop their deposit insurance schemes and established independent agencies to insure deposits. Indonesia, for example, enacted its Deposit Insurance Law[12] in September, 2004 and established the Indonesian Deposit Insurance Corporation a year later. Following Indonesia, Malaysia established its Malaysian Deposit Insurance Corporation in 2005. Efforts are also underway in Thailand and Nepal to establish their deposit insurance agencies. Sri Lanka still adopts a voluntary deposit insurance scheme which was operational in 1987, while Papua New Guinea is yet without a deposit protection scheme.

[12] Law number 24 on September 22, 2004.

3.6.3 Crisis Management

Crisis management is aimed at minimizing the impact of financial distress. It is a plan for restoring financial stability quickly and cost-effectively should a major crisis occur. Usually it is detailed in a protocol for deployment by a crisis management team and it clearly defines the roles and responsibilities of the related parties in the resolution of a financial crisis.

Basically, a comprehensive crisis-management framework should clearly define some criteria for systemic risk, roles and responsibilities as well as a coordination mechanism linking the relevant agencies in dealing with systemic crisis, and provide instruments for dealing with systemic crisis. Some countries (Indonesia, Malaysia, Philippines, Republic of China (Taiwan) and Thailand) already possess explicit crisis-management policies or frameworks. Whereas in others (Nepal and Papua New Guinea), the crisis-management policies are less explicit and comprehensive, while in Cambodia and Sri Lanka they are still unavailable.

Similar with Indonesia's case, when there is a systemic crisis and Republic of China, Taiwan's CDIC is unable to resolve the problem banks' purchase and assumption transactions, the CDIC may set up a bridge bank to assume all or part of the business, assets and liabilities of the banks. Republic of China, Taiwan established the Financial Restructuring Fund[13].

Indonesia, in particular, after learning tough lessons from the 1997/98 crisis, is earnest in its commitment to improve its financial safety nets which cover LLR for systemic crisis, deposit insurance scheme, and crisis management[14]. Bank Indonesia and the Ministry of Finance have developed a financial safety-net framework and enacted regulations and procedures for an Emergency Financing Facility. To ensure effective coordination between Bank Indonesia, the Indonesian Deposit Insurance Corporation, and the Ministry of Finance in maintaining financial system stability, the Coordinating Committee and Financial System Stability Forum was established. Furthermore, a Task Force under the Financial System Stability Forum finalised the draft of the Indonesian Financial Safety Net Law and is currently developing a crisis-management protocol for Indonesia.

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[13] See Ku (2008) for more detailed information.

[14] See Batunanggar (2002, 2003 and 2006) for Indonesian financial safety nets and crisis management.

Figure 15
Summary of Measures to Address the Financial System Instability

Measures	Cambodia	Indonesia	Malaysia	Nepal	Papua New Guinea	Philippines	Rep of China (Taiwan)	Sri Lanka	Thailand
Emergency measures									
Liquidity support	–	✓	✓	✓	✓	✓	✓	✓	✓
Introduction of a blanket guarantee	–	✓	–	–	–	–	✓	–	✓
Institutional measures	–	✓	–	–	–	–	–	–	✓
Establishment of an overarching restructuring authority	–	✓	–	✓1)	✓	–	–	–	✓
Establishment of a separate bank restructuring authority	–	✓	–	–	–	–	✓	–	✓
Establishment of a centralized asset management company	–	✓	✓	–	–	–	✓2)	–	✓
Adoption of a special corporate debt restructuring framework	–	✓	✓	✓3)	–	–	–	–	✓
Operational autonomy or restructuring agency	–	Ltd	–	–	–	–	–	✓	Ltd
Restructuring measures									
Intervention of financial institutions that were weak or insolvent	✓	✓	–	✓	✓	✓	✓	–	✓
• Merger of weak institutions	–	✓	–	✓	✓	✓	✓	✓	✓
• Closure of insolvent institutions	✓	✓	–	–	✓	✓	–	✓	✓
Use of public funds to purchase non performing assets	–	✓	–	–	–	–	–	✓	✓
Use of public funds to recapitalize institutions, including state intervention in banks	–	✓	✓	✓	✓	–	–	–	✓
Elimination or dilution of current shareholders stakes of insolvent banks	–	✓	✓	✓	✓	–	✓	–	✓
New direct foreign investment	–	✓	–	–	✓	–	✓	–	✓
Other measures 4)									
Measures to encourage corporate restructuring	✓	✓	–	✓	✓	–	✓	–	✓
Steps to improve prudential supervision and regulation	✓	✓	–	✓	✓	–	✓	✓	✓

✓ : Yes; – : No; Ltd : limited
1) Introduction of FSRP high level committee.
2) Establishment of asset management companies to buy bank NPLs.
3) Grievances Hearing Cell in NRB
4) Other measures in Nepal including establishment of DRT, operation of High level co-ordination Committee for FSRP, strengthening of credit information Bureau and Legislative reforms.

4. Conclusions and Policy Recommendations

The Asian crisis taught us an expensive lesson that resolution of banking crises is exceedingly costly, painful and complicated. However, it also left us with a deep impression that well-managed banking systems and effective banking supervision are essential for maintaining the stability of financial systems.

Effective problem bank identification and resolution are crucial in ensuring not only the soundness of a bank, but also the resilience of the financial system as a whole – since banks are dominant players in the financial system. They will reduce the potential of individual bank failures and banking crisis as well as minimise their resolution costs. Hence, a clear and comprehensive framework and guidelines for dealing with problem banks are vital.

In general, the bank supervisors in the nine SEACEN countries surveyed have established clear legal and prudential frameworks in their financial systems for dealing with problem banks. However, the stage of development of their crisis-management frameworks varies between the countries, depending on their legal and political settings as well as on their economic development. The non-crisis-affected countries (Cambodia, Nepal, Papua New Guinea and Sri Lanka) have less comprehensive frameworks. Whereas the crisis-affected countries (Indonesia, Malaysia and Thailand), and the countries which experienced banking system distress (Philippines and Republic of China, Taiwan), appear to have more developed frameworks particularly for crisis management. The supervisory authorities in the crisis-affected countries have enhanced the effectiveness of their banking supervision along with their post-crisis banking restructuring program.

Problem banks in the SEACEN countries are generally caused by unsound banking practices, poor risk management, bad governance, and fraud. The following are some of the key issues and challenges related to the identification of problem banks: First, compliance-based supervision and historical bank-performance analysis using backward-looking indicators are not effective in identifying the banks' problems. This is mainly due to the limited information available to the bank supervisors and a time lag in the bank reports. The condition is made worse when the banks' information systems, internal controls and corporate governance are weak. Usually the problem banks disguise their fundamental problems which can only be detected by on-site work. However, the on-site examination results are usually delayed so that the corrective actions cannot be performed promptly. Therefore, a risk-based supervisory strategy which is focused toward banks' high-risk areas should be adopted and developed. Besides, forward-looking indicators and analysis as well as other tools such as stress testing are required to complement a conventional historical-trend analysis of banks' performance. Second, in line with the implementation of risk-based supervision, the adoption of comprehensive bank-risk management must be promoted to ensure that the banks' risks are properly managed. It is wise to introduce the new initiatives early to allow time for people to gain understanding and facilitate preparation for their gradual implementation. Third, developing the new supervisory frameworks and tools is much easier than their implementation. The adoption of risk-based supervision and risk management require rigorous and consistent change-management. Effective application of the new frameworks and tools requires not only enhanced business processes and systems but, more importantly, a paradigm shifting for bank supervisors. There should be incentive systems both for the bank supervisors and for the banks' management in developing their analytical skills and using their judgment. To make risk-based supervision and risk management work, strong leadership, top-management commitment, and human resource development are necessary to drive and facilitate the process.

We learn from experience that successful bank interventions are supported by a combination of factors, including: (i) early identification of both the symptoms and causes of the banks' problems; (ii) timely and appropriate corrective actions by the bank supervisors;

and (iii) the bank owners' and management's commitment to turn around the banks. Bank supervisors face at least three key challenges: First is performing a comprehensive analysis of the causes and symptoms of the weaknesses of problem banks. Once the bank supervisor identifies the problems of a weak bank, then timely and appropriate corrective actions – based on the condition and scale of the problem – are required to deal with the deficiencies and behavioural change of the bank. However, the prompt corrective actions is mainly based on a lagging indicator of a bank's financial health. Intervention in problem banks is likely to be triggered only after they have been identified by examiners, who rely on far more information than the capital ratio. Therefore, in addition to quantitative criteria such as capital-adequacy ratio, non-performing loans or liquidity ratio, it is necessary to include qualitative criteria as part of trigger mechanism for problem bank intervention.

The second is related to the rules-versus-discretion issue. Correcting the bank's problems should be timely and based on sound judgment. This requires some latitude of discretion, particularly in the case where contagion or systemic risk is evident. However, too much discretion creates a lack of transparency, erodes accountability, and has moral-hazard potential. Therefore, the challenge is striking a right balance. The bank's problem and corrective action plans may not always correspond to the detailed procedures stipulated in the exit policy guideline. Consequently, the supervisor is called to respond and take quick action to ensure that the bank's problems are handled properly and in a timely manner.

The third is gaining the bank's management commitment to implement the action plans for restoring the bank's health. In general, the causes of problem banks in the SEACEN countries are rooted in mismanagement, poor governance, and fraud. In such cases, it is unrealistic to expect the bank management's commitment to adhere to the action plans. The supervisor may ask the bank's controlling shareholders to appoint a caretaker or to change the bank's management. However, in practice this can be difficult. Also, in a country where the legal system is weak, instituting criminal action against frauds committed by bad bankers to minimise moral hazard is a huge challenge.

The resolution process has to be speedy, objective, transparent, and consistent if it is to be effective in restoring the health of the financial system and the economy. The crisis-management frameworks for dealing with problem banks have been significantly improved in the crisis-affected countries as part of their post-crisis restructuring programme. However, non-crisis countries tend to have a less comprehensive problem bank resolution framework. They mostly do not yet have an explicit deposit insurance scheme and develop a crisis management framework. These conditions correspond to less frequent individual bank closures which are probably due to adoption of open bank resolution and/or non-existence of systemic bank failure in those countries. However, open bank resolution is ineffective and induces moral hazard.

The other challenge for bank supervisors engaged in the resolution of problem banks is ensuring both the macro and micro supervisory objectives – maintenance of financial stability and depositor protection – are effectively attained. In practice, it is often difficult for the supervisors to identify and measure as well as manage the systemic risks which require different skills and methodologies. The Asian financial crisis and crises in other countries show that effective micro-prudential supervision which is aimed at ensuring the soundness of individual banks, must be combined with macro-prudential surveillance to ensure the stability of the financial system. Therefore it is imperative to perform – and enhance the efficacy of – macro-prudential surveillance to identify, monitor, and mitigate the risks to the financial system.

For countries which do not yet have a crisis-management framework it is important to develop comprehensive financial safety nets, consisting of: (i) explicit and limited deposit insurance schemes; (ii) a well-defined and transparent LLR both in normal times and during systemic crises; and (iii) clear crisis-management frameworks. Deposit insurances and LLR can be important tools for crisis management, but they are not sufficient to prevent banking crises. They should be deployed along with other financial stability tools such as market discipline and prudential banking supervision.

Finally, history teaches us that financial crises are often repeated, though no two crises are alike. They are also difficult to predict and, thus, to avoid. Hence, both crisis prevention and crisis resolution are crucial for ensuring the resilience of the financial system. The key is to 'be well prepared' – to always expect the unexpected. A well devised crisis-management framework is essential, but its effective implementation is even more important. Therefore, capacity building is indispensable.

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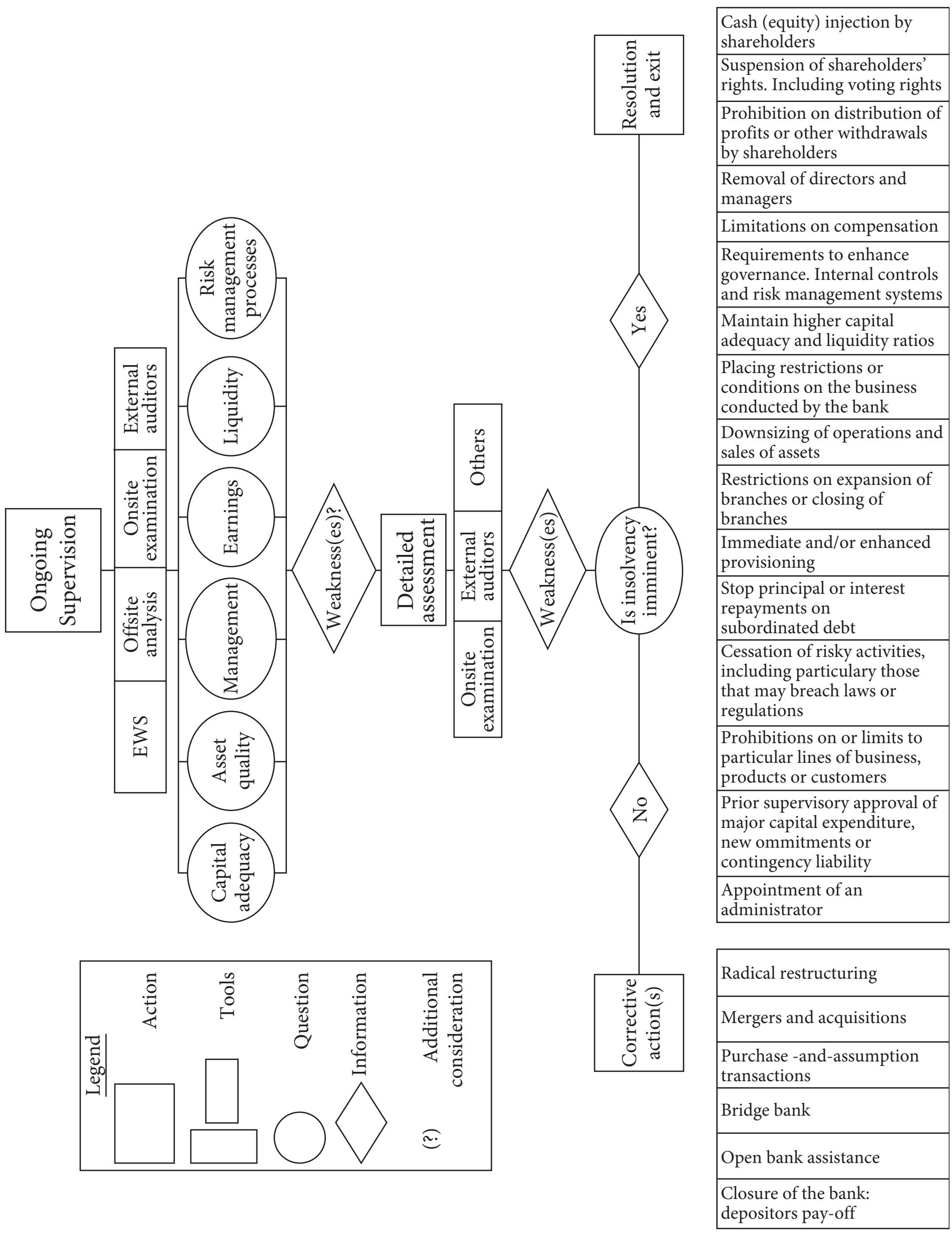
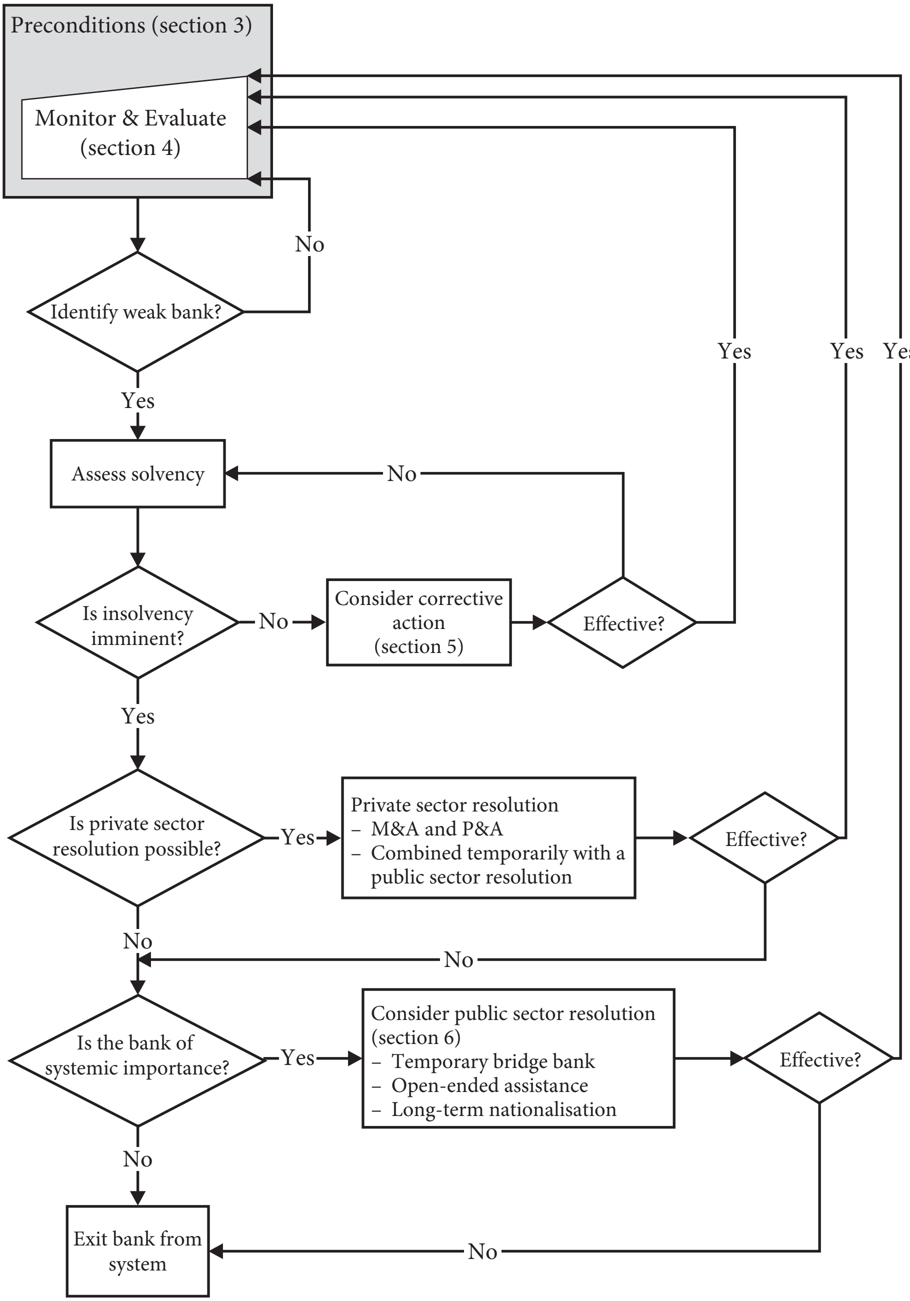
Appendix

Figure 16
Detailed Framework in Dealing with Problem Banks



Source: Supervisory Guidance on Dealing with Weak Banks, BCBS, BIS, March 2002

Figure 17
Flow Chart to Assist Resolution of Weak Banks
Focus on Solvency and Systemic Issues



Source: Supervisory Guidance on Dealing with Weak Banks, BCBS, BIS, March 2002

Table 1. Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries

Functions/ Activities	Descriptions	Cambodia	Indonesia	Malaysia	Nepal	Papua New Guinea	Philippines	Rep of China (Taiwan)	Sri Lanka	Thailand
Legal Framework for Bank Regulation and Supervision										
Bank Regulation	Who writes capital and other general prudential regulations that banks (and other deposit-taking institutions) must adhere to? (Central Bank/Supervisory authority/Ministry of Finance)	CB	CB	CB	CB*	CB	CB	SA	CB	CB
Bank Supervision	Who examines banks to ensure compliance with regulation? (Central Bank/Supervisory authority/Ministry of Finance)	CB	CB	CB	CB	CB	CB	SA	CB	CB
Non-bank financial regulation	Who writes capital and other general prudential regulations that non-bank financial must adhere to: (Central Bank/Supervisory authority/Ministry of Finance)	MF	MF	SA	CB*	MoF/ RoC	CB	SA	CB SEC IBSL	MF/ CB
Non-bank financial Supervision	Who examines non-bank financial to ensure compliance with regulation? (Central Bank/Supervisory authority/Ministry of Finance)	MF	MF	SA	CB*	MoF/ RoC	CB	SA	CB SEC IBSL	CB
Problem Bank Identification										
Supervisory Strategy	Supervises bank under a risk-based supervisory framework	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Supervisory Tools	Using an early warning systems	Yes	Yes	Yes	Yes #	Yes	Yes	Yes	Yes	Yes
	Using indicators or red flags, such as rapid lending growth	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Using stress test to measure bank's sensitivity to risks	No	Yes	Yes	No	No	Yes	Yes	Yes	Yes
	Using an econometric model to predict bank's default	No	Yes	No	No	No	-	No	No	Yes
Problem Bank Intervention and Resolution Management										
Grounds for Receivership and Early Resolution	Criteria for the intervention of insolvent banks: • Rules based:									
	✓ capital inadequacy or critically under capitalized	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
	✓ liquidity inadequacy	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	✓ others (e.g. violation to laws and regulations)	No	No	Yes	Yes	Yes	No	Yes	Yes	No
	• Discretional	No	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Supervision of Failing Banks	Special unit supervises the critically problem banks.	No	No	No	Yes	No	Yes	No	No	No
Coordination	Coordination mechanism in dealing with bank failure, e.g. formulated in a memorandum of understanding.	Yes	Yes	Yes	Yes**	Yes	Yes	Yes	No	Yes
Honest brokering	Facilitating or organizing private sectors to problem banks	Yes	Yes	No	Yes*	Yes	No	Yes	Yes	Yes

Table 1. Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries

Functions/ Activities	Descriptions	Cambodia	Indonesia	Malaysia	Nepal	Papua New Guinea	Philippines	Rep of China (Taiwan)	Sri Lanka	Thailand
Resolution	Conducts, authorizes or supervises sales of assets and other transactions in resolving failed institutions	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
Legal	Resolves conflicting legal claims among creditors to failed institutions	No	No	No	No	No	No	No	Yes	No
Resolution Methods	• deposit payoff	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
	• purchase and assumptions transactions	No	No	Yes	No	Yes	No	Yes	No	No
	• open bank assistance	No	Yes	Yes	Yes	Yes	No	Yes	No	Yes
	• good bank versus bad bank and bridge banks	No	Yes	Yes	No	No	No	Yes	Yes	Yes
	• publicly assisted bank restructuring	No	Yes	Yes	Part	Yes	No	Yes	Yes	Yes
	• temporary nationalization	No	Yes	Yes	No	No	No	Yes	Yes	Yes
Safety Nets and Crisis Management										
Crisis Management Framework	Legal framework for crisis management including:									
	• definition and criteria of systemic risk	No	Yes	No	Part^	No	Yes	Yes	N/a	Yes
	• clear roles and responsibilities as well as coordination mechanism of relevant agencies in dealing with systemic crisis	No	Yes	No	Part	Yes	Yes	Yes	N/a	Yes
	• instruments for dealing with systemic crisis	No	Yes	Yes	Part	Yes	Yes	Yes	n/a	Yes
Emergency liquidity assistance	Provision of liquidity to the money markets during crisis	No	Yes	Yes	Yes	No	No	Yes	Yes	Yes
	Direct lending to individual illiquid banks or depositories	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Direct lending to individual insolvent banks or depositories	No	No	No	Yes	Yes	No	No	No	No
	Direct lending to individual illiquid non-depositories institutions	No	No	No	Yes	No	No	No	No	No
	Direct lending to individual insolvent non-depositories institutions	No	No	No	No	No	No	No	No	No
Deposit Insurer	Insures deposit or other house hold financial assets	No	Yes	Yes	Yes	No	Yes	Yes	No	Yes

CB=Central Bank; SA=Supervisory Authority; MF=Ministry of Finance =Yes X = No.
*Nepal Rastra Bank supervises banks and financial institutions licensed by NRB, which does not covers insurance companies, employees provident fund and Citizen Investment Trust-, those collecting contractual deposits.
EWS is applied through off-site and on-site report implementations.
** There is a high level co-ordination committee chaired by the finance minister to oversee the policy matters within financial sector reform program. This is one time basis and there is not a permanent MOU between the government and NRB to deal with bank failure with systemic crisis.
PNG: RoC=Registrar of Companies
^However there is no separate documented policy and law but it has been exercised on ad hoc basis

Table 2. Period Overdue for Interest Suspension and Loan Classification

Country	Period overdue for interest suspension	Substandard	Doubtful	Loss
Cambodia	3 M	3 M	6 M	12 M
Indonesia	3 M	3 M	6 M	9 M
Malaysia	3 M	-	-	-
Nepal	≤3M	≤6M	≤12M	>12M
Papua New Guinea	>30days<90 days	>90days<180days	>180days<360days	>360days
Philippines	1 M	3 M	4 to 5 M	6 M
Sri Lanka	3M	6M	9M	12M
Rep of China (Taiwan)	1 M -3 M (No Collateral) 1M -12 M(With Enough Collateral)	3 M -6 M (No Collateral) Over 12 M (With Enough Collateral)	6 M-12 M (No Collateral)	Over 12 M (No Collateral)
Thailand 1)	3 M	3 M	6 M	12 M

M = month (s)

1) all assets are classified into one of 6 categories – Pass (1 M.), Special Mention (2 M.), Substandard (3 M.), Doubtful (6 M.), Doubtful Loss (12 M.), and Loss (write-off).

Table 3. Loan Provisioning Requirements
(As a percentage of original loan value)

Country	Performing (Standard)	Special mentioned	Substandard	Doubtful	Loss
Cambodia	-	-	10	30	100
Indonesia	1	5	15	50	100
Malaysia	1.5 (general provision)	N/A	20	50	100
Nepal	1	NA	25	50	100
Papua New Guinea	1	5	25	50	100
Philippines	1 regular 5 restructured	5	10 regular 25 unsecured	50	100
Sri Lanka 1)	1		20	50	100
Rep of China (Taiwan)	0	2	10	50	100
Thailand 2)	1	2	100	100	100

1) The provisioning is based on the outstanding loan value minus value of securities

2) 1% and 2% of net value between outstanding loan and collateralBOT applies IAS 39, therefore FIs have to set 100% provision of the difference between outstanding debt and present value of estimated future cash flows from debtors or estimated future cash flows from sales of collaterals.

Table 4.1. Supervisory Risk Assessment and Early Warning Systems

Country/Sup. Authority	System	Year implemented	System type
Cambodia National Bank of Cambodia	CAMELS	2003	Newly introduced Cambodia Off-site Bank Report for prompt corrective action (not yet fully implemented)
Indonesia Bank Indonesia	CAMELS	1991 2004 (imprvd)	Off-site supervisory bank rating system
	Risk Matrix	2003	Off-site supervisory tools to measure the level and trend of bank's risks: credit, liquidity, interest rate, forex, operational, compliance, legal and strategic risk and to determine supervisory plan and risk-focused examination.
	Stress Test	2003	Sensitivity analysis tools at to measure the impact of certain changes in macroeconomic variables to the bank's earning and capital. Macro stress test is also used as financial system stability surveillance tool.
	Bank Failure Model	2005	Early warning model - failure and timing to failure prediction. It is used as financial system stability surveillance tool.
Malaysia Bank Negara Malaysia	Risk Based Supervision Framework	2007	Continuous surveillance aimed at assessing significant activities that affect the stability and soundness of individual FI and its Group.
	Macro-prudential Surveillance		To identify domestic inter-linkages between different sectors within the economy and their implications on banking sector stability e.g. corporate sector, household sector and financial markets
	Enhancement to Stress Test Framework	2007	To better assess the areas of vulnerability and resilience level of individual banking institutions and the system as a whole to exceptional but plausible adverse events
Nepal Nepal Rastra Bank	CAMELS	2003	On-site supervisory bank rating system
	CALES	2004 Jan	off-site bank rating system
	EWS	Drafted	Under discussion
	PCA	July 2008	Circular issued on 16 August 2007 (under Basel II framework)
Papua New Guinea Bank of PNG	CAMELS	2003	Off-Site Supervisory internal banking rating system
Philippines Bangko Sentral ng Pilipinas	CAMELS	1998	Off-site supervisory bank rating system
	Risk Assessment System	1998	Off-site supervisory tools to measure and assess eight categories of risk (credit, market, interest rate, foreign exchange, liquidity, operations, legal and compliance) in terms of quantity of risks, quality of risks, aggregate risk and direction of risk
	Risk Management, Operational Control, Compliance and Asset Quality (ROCA)	2004	Rating system used in supervising branches of foreign banks
	Bank Performance Report (BPR) and Bank Folder	1998	Supervisory tool used in monitoring the financial performance of supervised entities in between on-site examinations. The BPR contains, in one compact report, key performance indicators that support CAMELS soundness analysis. Current performance levels are related to historical trends and relative performance vis-à-vis peer group.
	Top Corporate Borrower Reports		Tool used to measure and monitor the total exposures of the banking system to a particular borrower, family, and/or business group, as well as any developments in the loan-beneficiary industries which could affect the status of such exposures.
	Early Warning System (EWS)		Statistical model that generates one-year ahead forecasts of key bank performance variables, especially solvency and asset quality. This is used to help prioritize on-site examinations.
Sri Lanka Central Bank of Sri Lanka	CAMELS	1990 2005	Off-site supervisory bank rating system Uses sensitivity analysis to assess the impact on capital.

Rep of China (Taiwan)	CARSEL (CBC)	1991 2006 (imprv'd)	Off-site supervisory bank rating system
	Stress Test (CBC)	Since 2006	Under development and used as financial system stability surveillance tool
	CAMELS (CDIC)	1994	Off-site supervisory bank rating system
Thailand Bank of Thailand	CAMELS	Prior to 2003	Supervisory bank rating system
	Financial ratios based on risk-based supervision	2003- present	
	Early Warning System of Individual bank 1)	2006-present	Off-site supervisory tools to assess the level and trend of bank's risks.
	Early Warning Model of Banking Distress 2)		Analytical tools used for financial system stability surveillance and risks assessing of banking system distress.
	Stress test	2007	Sensitivity analysis tool aimed to measure the impact of change in macroeconomic variables to the bank's earning and capital.

1) EWS is conducted in 3 approaches, namely Supervisory Standard, Off-trend Deviation, and Peer Comparison. All approaches are employed with the same 14 financial ratios of each individual bank, representing solvency, profitability, asset quality, market risk, and liquidity risk. Trigger points are divided into 3 levels, namely green, yellow, and red in order to create early warning zone for examiners to closely monitor vulnerabilities of financial institutions.

2) Using combination of various methods, e.g. trigger points, trends, econometrics model, together with expert judgment, and indicators, including systemic financial variables and macroeconomic variables.

Table 4.2. Indicator/Risk Categories and Ratios Used in Supervisory Risk Assessment and Early Warning Systems - Financial Ratio and Peer Group Analysis Systems

Country	System	Indicator categories & ratios used	Asset quality	Solvency	Profit-ability	Liquidity	Market Risk	Manage -ment and control	Economic	Others
Cambodia	Bank performance report	43	16	9	13	5				
Indonesia	BPeR 1)	18	3	6	3	4	-	-	-	2
Malaysia	n/a									
Nepal	Bank monitoring	25	7	**2	8	3	5			
Papua New Guinea	CAMELS	14	4	3	2	3	2	-	-	-
Philippines	n/a									
Sri Lanka	-	19	4	3	9	2	1	-	-	-
Rep of China (Taiwan)	Bank Monitoring System	101	14 (C)	10 (A)	29 (R)	29 (S)	12 (E)	7 (L)		
Thailand	EWS of Individual bank	14	6	2	4	1	1	-	-	-
	EWS Model of Banking Distress	6	1	1	1	1	-	-	2	-

1)Bank Performance Evaluation Report is used as supporting tools for bank supervisor as part of core knowledge of risk-based supervision.
2)Capital market monitoring ratios relating to trading activity.

Table 5. Explicit Structured Early Intervention Framework

<table>
<tr><td>Country</td><td colspan="3">Capital Level Trigger/
Mandatory and Discretionary Actions</td></tr>
<tr><td rowspan="2">Cambodia</td><td>**Undercapitalised**</td><td>**Significantly Undercapitalised**</td><td>**Critically Undercapitalised**</td></tr>
<tr><td>**CAR >10% but <15%**</td><td>**CAR >5% but <10%**</td><td>**CAR <5%**</td></tr>
<tr><td rowspan="3">Indonesia</td><td>**Trigger Ratio**</td><td colspan="2">**Measures *)**</td></tr>
<tr><td colspan="3">**6% < CAR < 8%**
• Bank is obliged to submit capital restoration plan
• Prohibition of the Bank from paying out any distribution of capital
• Prohibition of the Bank from conducting any transactions with a related party and or any other parties
• Imposition of restriction on the Bank to carrying out business expansion plan or new business activities that have never been performed before
• Imposition of restriction on the Bank pertaining to payment salaries, compensation or any other form of similar payment to the management of the Bank, and or compensation for related parties
• Prohibition for the bank from executing payment on subordinated loan
• Mandatory reporting by the bank for any change in share ownership in any amount less than 10%
• Submit a detailed daily report concerning liquidity schedule
• Submit the realization of capital restoration plan monthly</td></tr>
<tr><td colspan="3">**CAR ≤ 6%**
• Bank is obliged to submit capital restoration plan
• Prohibition of the Bank from paying out any distribution of capital
• Prohibition of the Bank from conducting any transactions with a related party and or any other parties
• Imposition of restriction on the Bank to asset growth
• Imposition of restriction on the Bank to carrying out business expansion plan or new business activities that have never been performed before
• Imposition of restriction on the Bank pertaining to payment salaries, compensation or any other form of similar payment to the management of the Bank, and or compensation for related parties
• Prohibition for the bank from executing payment on subordinated loan
• Mandatory reporting by the bank for any change in share ownership in any amount less than 10%
• Submit a detailed daily report concerning liquidity schedule
• Submit the realization of capital restoration plan monthly
• Bank is prohibited from selling or reducing the amount of its assets or strengthening its commitment and contingencies without supervisor's permission
• Bank must submit some relevant information monitored closely by bank supervisors</td></tr>
<tr><td>Malaysia</td><td colspan="3">Supervisory has discretionary powers to take appropriate measures.</td></tr>
<tr><td>Nepal</td><td>**CAR < 10% and ≥ 9%**
-Prohibition from establishing new branches.
-Prohibition from declaring dividends.
-Submit a capital plan for recapitalization of the bank.
-Interaction with the senior management on corrective course of action.</td><td>**CAR < 9% and ≥ 6%**
-Action required under category 1.
- Suspension of lending, investment, and credit extension activities
-Prior approval of NRB for acquiring, through purchase or lease, additional fixed assets;
-Prior approval of NRB for establishing new business lines
-Other actions under NRB Act 2058 and BAFIA 2063.

CAR < 6% and ≥ 3%
- Action required under category 2.
- Restriction on deposit mobilization
- Prohibition from acquiring, through purchase or lease, additional fixed assets;
- Restrictions on paying incentives, severance packages, management fees or other discretionary compensation to directors or officers without prior approval of NRB.
- Restriction on SLF.
- Other actions under NRB Act 2058 and BAFIA 2063.</td><td>**CAR <3% and ≥ 1%**
-Action required under category 3.
-Restrictions on salary increments, recruitments and promotions.
-Action to directors and chief executive if capital position doesn't improve in 6 months after initiating action under this category.
-Other actions under NRB Act 2058 and BAFIA 2063.

CAR< 1%
- Action required under category 4.
-Declare the bank as problem bank and initiate actions under Section 86 of NRB Act.
-Suspend existing board of directors and chief executive of the bank and bring in new board and management.
-Initiate steps to dilute the ownership of the existing shareholders.
-Other actions under NRB Act 2058 and BAFIA 2063.</td></tr>
</table>

Country	Capital Level Trigger/ Mandatory and Discretionary Actions		
Papua New Guinea	**CAR <12% or Tier 1 <8%** Leverage <6% • Bank to provide detailed plan for increasing capital • No dividends of any kind shall be declared or paid • No new business activities may be entered into or undertaken • No new branches may be opened • No new loans	**CAR <8% or Tier 1<4%** **Leverage <4%** • Urgent need for capital injection • Appointment of Statutory Manager to run the affairs of the bank	**CAR & Tier 1 no longer relevant.** **Leverage <2%** • Based on the Statutory Manager, recommendations for receivership and liquidation process
Philippines	See Table 8.1		
Sri Lanka	Supervisory has discretionary powers to take appropriate measures. No specific measures under each scenario is given		
Rep of China (Taiwan)	**8% >CAR>=6%** • Cannot make any cash distribution and pay the compensation, bonuses, and other similar allowances given by the bank to directors and supervisors. • May order the bank to submit a time-limited improvement plan for capital increase or reduction of total risk assets. • May restrict risk-based assets increase or take other necessary measures.	**CAR <6%** • May dismiss the directors and supervisors. of the bank. • May order the bank disposal specific assets. • May restrict or ban the credit or other similar transactions with related parties. • May restrict equity investments. • May order the bank to dismiss some of its branch organizations within a certain period of time. • May take conservatorship or other necessary measures.	-
Thailand	**Prior to CAR< 8.5%** (In case the condition or operation of a financial institution is such that serious damage may be caused to the public interest.)		
	• Must submit capital strengthening plan • Recommend such financial institution to delay or postpone their distributions of dividends and/or bonus payoffs. • Recommend such financial institution to decelerate an expansion on risk assets and avoid taking deposit by providing abnormal high rate of interest. • Sanction in various forms.		
	Undercapitalised (CAR < 8.5 %) or (Tier 1 < 4.25%)		
	• Must submit capital resolution plan • Order to decrease/increase capital funds • Prohibit from distributing or disposing of the whole of any part of profits and bonus • Prohibit from expanding risk assets • Prohibit from taking deposit by providing abnormal high interest rate and borrowing funds with abnormal high cost • Impose restriction on management fees • Impose restriction on certain transactions with affiliated companies or related person or management. • Remove management • Take over the control • Must be placed on conservatorship • Revoke the banking license		

CAR = capital adequacy ratio

Indonesia: * For all banks having CAR <8%: Bank supervisor order: (i) Capital Restoration Plan; (ii) Mandatory Supervisory Action; (iii) Certain Actions, such as change Board of Directors and senior management, write-off bad loan, conduct merger with other bank(s), sell the bank, delegate the management of part or all of the bank to another party, sell part or all of assets and liabilities, suspend certain business activities.

Table 6. Explicit Structured Early Intervention Framework in the Philippines

Capital Level Trigger/ Mandatory and Discretionary Action			
Up to 40% Undercapitalised	Up to 60% Undercapitalised	Up to 80% Undercapitalised	More than 80% Undercapitalised
- Suspension of authority to invest in non-allied undertakings (for UBs only) - Suspension of authority to invest in allied undertakings UBs/ RBs/ - Suspension of securities and dealership functions (for UBs only) - Restrictions on lending to affiliates - Suspension of branching privileges - Suspension of declaration of cash dividends - Restrictions on overall loan growth/investments (new loans to the extent of collections only) - Denial of access to BSP rediscounting facilities - Suspension of authority to accept or create demand deposits or operate NOW accounts - Suspension of authority to accept or handle government deposits	- Suspension of authority to invest in non-allied undertakings (for UBs only) - Suspension of authority to invest in allied undertaking -Suspension of securities and dealership functions (for UBs only) -Suspension of branching privileges - Suspension of declaration of cash dividends - Restrictions on overall loan growth/ investments (new loans to the extent of collections only) - Restrictions on lending to affiliates - Denial of access to rediscounting facilities - Suspension of authority to accept or handle government deposits - Suspension of authority to engage in quasi-banking activities - Suspension of authority to engage in derivatives activities - Suspension of FCDU activities - Suspension of trust operations - Suspension of authority to accept or create demand deposits or operate NOW accounts	- Suspension of authority to invest in non-allied undertakings (for UBs only) - Suspension of authority to invest in allied undertakings - Suspension of securities and dealership functions (for UBs only) - Suspension of branching privileges - Suspension of declaration of cash dividends - Denial of access to BSP rediscounting facilities - Suspension of authority to accept or create demand deposits or operate NOW accounts - Suspension of authority to accept or handle government deposits - Suspension of authority to engage in quasi-banking activities - Suspension of authority to engage in derivatives activities - Suspension of FCDU activities - Suspension of trust operations - Suspension of international banking activities - Suspension of lending activities - Suspension of issuance of domestic L/Cs	- Suspension of clearing privileges - Suspension of granting of bonuses/profit-sharing not covered by existing contracts or By-Laws

Table 7. Discretionary Policies of Intervention

Country	Situations Allowing Authorities to Act	Measures
Cambodia	CAR <15%	Formal meeting for resolution or require to top up capital
Indonesia	CAR falls below the minimum (in practice Bank Indonesia sets an informal trigger ratio above the statutory minimum capital ratio) and the Bank has been imposed administrative sanctions by bank supervisor due to its violation of Banking Act.	Dismissing the Bank management and then appointing a temporary substitute of the management until the General Meeting of Shareholders or the Meeting of Cooperative Members appoints the permanent substitute with the approval of Bank Supervisor.
Malaysia	Non compliances to law, rules and regulations and taking into account the gravity of the concerns and the overall state of the bank	To take any step/action, or not to do any act or action; prohibit bank from extending further credit facility; remove any officer of the bank; or appoint a person to advise the bank; assume control;
Nepal	Non-compliance to law, rules, regulation and directives of NRB.	NRB can take control over the bank and appoint a management committee (MC) to operate it, then corrective or restructuring actions are initiated by the MC
Papua New Guinea	Situations which may prompt the Central Bank to act will include amongst other things are: • Financial and operational weaknesses or non-compliance with banking laws and prudential standards. This may include capital ratios falling below 12%, 8% & 6%; • High or increasing NPLs • Inadequate provisioning of loans • Continuous breaching of limits set by the CB;	The CB will discuss with the Board corrective measures or remedial actions. It will also issue directives relating to the issues discussed. It will issue additional conditions on a bank's license. In worst case scenarios, it will remove the Board of the bank and place a Statutory Manager to manage the affairs of the entity and put it back to a sound footing. In the event that the entity cannot be resurrected, it will be placed under liquidation.
Philippines	(a) Illiquid but not insolvent; granted emergency loans (b) 1. unable to pay its liabilities as they become due in the ordinary course of business 2. insufficient realizable assets to meet liabilities 3. cannot continue in business without involving probable losses to its depositors and creditors 4. declared a bank holiday 5. suspended payment of deposit liabilities for more than 30 days	Comptrollership Receivership/Closure
Sri Lanka	CAR fall below the minimum	Communicating with the banks, asset freeze, suspension of dividend payment, capital injection plans
Rep of China (Taiwan)	n/a	n/a
Thailand	In practice, CAR falls below the internal used trigger ratio above the statutory minimum capital ratio	BOT orders such financial institution to submit capital strengthening plan. In case-by case basis, BOT may request such banks to delay or postpone their distributions of dividends and/or bonus payoffs. Moreover, BOT may also request such banks to decelerate an expansion on risk assets and avoid taking deposit by providing abnormal high rate of interest. BOT may sanction in various forms.

Table 8. Restructuring Methods

Country	Government capital injection	Asset management corporation (s)	Domestic bank merger	Foreign bank take over
Cambodia	✓	✓	✓	✓
Indonesia	✓	✓	✓	
Malaysia	✓	✓	✓	
Nepal 1)	n/a	n/a	✓	✓
Papua New Guinea	✓	✓	✓	✓
Philippines	✓	✓	✓	
Sri Lanka 2)	✓		✓	✓
Rep of China (Taiwan)	n/a	✓	✓	✓
Thailand	✓	✓	✓	✓

1) Based on legal provision
2) These methods may not be applicable to all types of banks

Table 9. Bankruptcy Procedures

Country	Trial length of time	Priority of banks' secured loans	Priority of banks' unsecured loans
Cambodia	-	n.a.	n.a.
Indonesia	-	High	n.a.
Malaysia	-	High (Company's Act 1967)	-
Nepal	-	Extremely High (section 6 NRB Act)	High (Section 77f B&FIA)
Papua New Guinea	This is dealt with under the Bankruptcy Act. However, high priority is still given to secured loans. All loans given are fully secured.		
Philippines		High	n.a.
Sri Lanka			
Rep of China (Taiwan)	-	High	n.a.
Thailand	Depends on a case-by-case basis.	High Because bankruptcy law allows SC to be outside the priority of claims in bankruptcy liquidation procedures.	Low Because BF, T and W take precedence over unsecured claims in the priority of claims under bankruptcy procedures.

BF = bankruptcy fees, W= wages, T = taxes, SC = secured claims

Table 10. Examples of Good Bank/Bad Bank

Country	Year	Troubled bank	Good bank	Bad bank
Cambodia	n/a	n/a	n/a	n/a
Indonesia	1999	1. Bank Danamon 2. Bank PDFCI **4 state-owned banks:** 3. Bank BNI 4. Bank BBD 5. Bank BDN 6. Bank Exim	Bank Danamon (surviving banks) 4 state owned banks are recapitalized and consolidated to be Bank Mandiri	IBRA
	2000	1. Bank Duta 2. Bank Rama 3. Bank TAMARA 4. Bank Tiara Asia 5. Bank Nusa 6. Bank POS 7. Bank JAYA 8. Bank Risyad Salim	Bank Danamon those 8 troubled banks were merged with Bank Danamon.	IBRA
Malaysia	n/a	n/a	n/a	n/a
Nepal	2001 & 2006	Nepal Bank Limited & Nepal Bangladesh Bank Ltd	Standard Chartered Bank Nepal Ltd.	NA
Papua New Guinea	1997-2001	PNG Banking Corporation	Bank of South Pacific	PNG Banking Corporation
Philippines	n/a			
Sri Lanka	2005	Merc Bank	… Bank infused capital and restructured	Prumaka Bank
Rep of China (Taiwan)	2003	Kaohsiung Business Bank	Sold to E. Sun Bank (domestic bank)	Lone Star Asia-Pacific, Ltd
Thailand	1998 - 1999	- The Laem Thong Bank - The Union Bank of Bangkok - The Bangkok of Bank of Commerce - First Bangkok City Bank - Siam City Bank - Bangkok Metropolitan Bank - Nakornthon Bank	- Siam City Bank - Radanasin Bank	AMCs such as state-owned AMCs (BAM, SAM and TAMC) and other private AMCs

Table 11. Mergers, Closures, State Intervention, and Resolution Costs (1997 – 2007)

Country	Mergers	Closures	State intervention	Resolution Costs*
Cambodia	No	16 commercial Banks 1)	No	n/a
Indonesia 1997-2000 2001 - 2007	4 of 7 state commercial banks were merged into a single commercial bank (54%) 5 commercial banks	64 commercial banks (18%) 9 commercial banks, 4 of them were self liquidated (.. %)	12 commercial banks (20%) -	51
Malaysia	assumed control over 4 BIs and merged 2 commercial banks. 15 mergers (6%), finance companies and commercial bank)	None	1 merchant bank and 2 finance companies under the central bank control (3%)	-
Nepal	HISEF with Laxmi Bank	None	2 Banks, RBB &NBL	GDP Rs. 558 billion cost for Bank reform (NBL&RBB) Rs. 5.27 billion.(0.94% of GDP)
Papua New Guinea	2 of the 6 commercial banks were acquired.	Licenses were revoked with assets and liabilities transferred to new entities or the purchasing commercial banks.	-	-
Philippines	46	Comm. Bank : 2 Thrift Bank : 20	-	-
Sri Lanka	-	-	2 state banks were recapitalized twice amounting to Rs. 35 billion through the issue of restructuring bonds in 1993 and 1996	Around 4% in 1996 GDP
Rep of China (Taiwan)	* 4 state banks were merged into 2 state banks. (5 state banks in total) * 12 private banks were merged into 7 private banks. (34 private banks in total)	n/a	Financial Restructuring Fund take conservatorship over 8 banks.	1.4
Thailand 1997	-	44 finance and securities companies 15 finance companies	-	n/a
1998	-	2 commercial banks	6 commercial banks 4 finance and securities companies 8 finance companies	n/a
1999	12 finance companies and 1 commercial bank	-	-	n/a
2002	2 commercial banks	-	-	n/a
2004	2 commercial banks and 1 finance company	-	-	n/a
2005	4 commercial banks	-	-	n/a
2007	2 commercial banks	-	-	n/a

*Percentage of GDP 1) as a requirement of bank capital increase)

Table 12. Instruments Used to Recapitalise and Purchase NPLs

Country	Instrument	Received	Description
Cambodia	n/a	n/a	
Indonesia	Bonds	Equity	Variable and fixed coupon bonds. Owner under the private bank scheme may purchase back shares after three years; tradable.
Malaysia	Bonds	Equity	Under Danamodal
Nepal	n/a	n/a	In 1990s, government issued bond to recapitalize NBL &RBB under CBPASS Program. Now is not applicable.
Papua New Guinea	n/a	Equity	Although this has never happened in the history of banks in PNG, purchasing of NPLs is and can be allowed.
Philippines	n/a	n/a	-
Sri Lanka	Restructuring bonds	Equity Fixed coupons	-
Rep of China (Taiwan)	Set up asset management company to buy financial institution's NPLs	n/a	The losses from sale of NPLs by a financial institution to an asset management company may be carried forward over five years.
Thailand	- P/N (Purchase NPL) - Cash (Recapitalise) - Debt to equity swap	Equity	P/N with interest rate linked to deposit rate, aval by FIDF. FIDF took the shares to be a majority shareholder. After restructuring the banks, FIDF will divest the shares to the market. The former owners are not allowed to purchase the shares back.

Table 13. Institution Responsible for Assessing the Value of Failing Bank

Country	Banking Supervisory Authority	Certified Public Accountant	Deposit Insurance	Others
Cambodia	-	-	-	Liquidator
Indonesia	-	-	✓	-
Malaysia	✓	-	✓	-
Nepal		✓ 1)	-	Liquidator
Papua New Guinea	✓	✓	-	-
Philippines	✓		✓	-
Sri Lanka	✓	✓		-
Rep of China (Taiwan)	-	-	✓ 2)	-
Thailand	-	-	-	✓ 3)

1) Under Insolvency Act, it is done by the liquidator appointed by the Court from the approved list.
2) Coordinating committee appointed by MF
3) CDIC outsource the assessment of the failing bank's value to accounting firms or appraiser.

Table 14. Criteria used to Determine Failed Bank

Country	Examination criteria*	Liquidation criteria**	Market value criteria	Others
Cambodia	-	✓	-	-
Indonesia	✓	-	-	-
Malaysia	No failed banks	-	-	-
Nepal	1)	-	-	-
Papua New Guinea	✓	-	-	-
Philippines	✓	✓	✓	-
Sri Lanka	✓	-	-	-
Rep of China (Taiwan)	✓	✓	-	-
Thailand	✓	-	-	-

*based on on-site examination result **based on liquidators' appraisal
1) No failed banks, but failed bank is that which is not able to discharge its liabilities (based on NRB's appraisal and auditors report)

Table 15. Institution with Power to Declare Bank Failure

Country	Central bank	Supervisory authority	Deposit insurance company	Others , e.g. Court system
Cambodia	✓	None	-	-
Indonesia	✓	None	-	-
Malaysia	✓	None	-	-
Nepal	✓	None	-	-
Papua New Guinea	✓	None	-	-
Philippines	✓	None	-	-
Sri Lanka	✓	None	-	-
Rep of China (Taiwan)	-	✓	-	-
Thailand	✓	None	-	-

Table 16. Institution with the Power to Determine Bank Resolution Method

Country	Central bank	Supervisory authority	Deposit insurance company	Others , e.g. Court system
Cambodia	✓			
Indonesia			✓ 1)	
Malaysia	✓		✓	
Nepal	✓			
Papua New Guinea	✓			
Philippines	✓	✓		✓
Sri Lanka	✓			✓
Rep of China (Taiwan)		✓		
Thailand	✓ 2)			

1) In case of failed bank with of systemic risk, the decision is made by Coordinating Committee, consisting of Finance Minister, Governor of Bank Indonesia, and Chief of Board Commissioner of Indonesian Deposit Insurance Corporation.
2) In case of failed bank with of systemic risk, the decision is made by the Financial Institutions Policy Committee (FIPC), consisting of Governor of the Bank of Thailand, Director General of Ministry of Finance, Secretary General of Securities and Exchange Commission, Director General of Ministry of Commerce, Secretary General of Agricultural and Futures Trading Commission.

Table 17. Institution Responsible for Providing Emergency Liquidity Assistance

Country	Central bank	Supervisory authority	Deposit insurance company	Others
Cambodia	✓	-	-	-
Indonesia	✓	-	-	-
Malaysia	✓	-	-	-
Nepal	✓	-	-	-
Papua New Guinea	✓	-	-	-
Philippines	✓	-	-	-
Sri Lanka	✓	-	-	-
Rep of China (Taiwan)	✓	-	✓	-
Thailand	✓	-	-	-

Table 18. Major Actions Taken within Six Months Prior to Bank Closure

Country	Ask recapitalization plan	Appraisal of assets and liabilities	Conservatorship	Others
Cambodia	✓	-	-	-
Indonesia	✓	✓	✓	
Malaysia	No bank closure	-	-	-
Nepal	No bank closure	-	-	-
Papua New Guinea	✓	-	-	-
Philippines	✓	-	-	
Sri Lanka	✓	✓	-	✓
Rep of China (Taiwan)	✓	✓	✓	-
Thailand	✓	✓	✓	-

Table 19. Deposit Insurance has the Power to Terminate the Insured Status

Country	Yes	Yes, but prior to approval	No	n.a.
Cambodia	No 1)-	-	-	✓
Indonesia	-	-	✓	-
Malaysia	✓	-	-	-
Nepal	No 1)-	-	-	✓
Papua New Guinea	No 1)	-	-	-
Philippines	-	-	✓	-
Sri Lanka	No 1)	-	-	-
Rep of China (Taiwan)	✓	-	-	-
Thailand	-	-	✓	-

1) There is no deposit insurance agency.

Table 20. Time to Gain Access to Deposit Records

Country	Before bank failure	At the time bank failure	After bank failure
Cambodia	✓	-	-
Indonesia	✓	-	-
Malaysia	-	✓	-
Nepal	-	✓	-
Papua New Guinea 1)	-	-	-
Philippines	-	-	✓
Sri Lanka	✓	-	-
Rep of China (Taiwan)	✓	-	-
Thailand	-	✓	-

1)There is no bank failure yet

Table 21. Statutory Time Limit of Reimbursement

Country	Within 1 week	1 week to 1 month	1 to 3 months	3 to 6 months	Over 6 months	n.a.
Cambodia	-	-	-	-	-	✓
Indonesia	-	-	✓	-	-	-
Malaysia	-	-	-	-	-	✓
Nepal	-	-	-	-	-	✓
Papua New Guinea 1)	-	-	-	-	-	-
Philippines	-	-	✓	-	-	-
Sri Lanka	-	-	-	-	-	✓
Rep of China (Taiwan)	-	-	-	-	-	✓1)
Thailand	-	-	-	-	-	✓

2) No prescribed deadline and will disclose in the announcement of reimbursement details (case by case).

Table 22. Actual Average Period of Reimbursement

Country	Within 1 week	1 week to 1 month	1 to 3 months	3 to 6 months	Over 6 months	n.a.
Cambodia	-	-	-	-	-	✓
Indonesia	-	-	✓	-	-	
Malaysia	-	-	-	-	-	✓
Nepal	-	-	-	-	-	✓
Papua New Guinea	-	-	-	-	-	✓
Philippines	-	-	✓	-	-	
Sri Lanka	-	-		-	-	✓
Rep of China (Taiwan)	-	-	-	-	-	✓1)
Thailand	-	✓	-	-	-	

1) Never happened.

Table 23. Average Failure Resolution Cases in the Past 10 Years

Country	Deposit payoff	Purchase and assumptions	Open bank assistance	Bridge banks
Cambodia	17 banks	-	-	-
Indonesia	70 banks	-	-	4 banks
Malaysia	-	-	-	-
Nepal	NA	NA	NA	NA
Papua New Guinea	-	1		
Philippines	176	-	-	-
Sri Lanka	-	-	1	-
Rep of China (Taiwan)	-	5 banks	-	-
Thailand	63 fis.	3 banks, 12 fis.	4 banks 2 fis.	-

Table 24. Average Duration of Each Resolution in the Past 10 Years (in months)

Country	Deposit payoff	Purchase and assumptions	Open bank assistance	Bridge banks
Cambodia	-	-	-	-
Indonesia	-	-	-	24
Malaysia	-	-	-	-
Nepal	-	-	-	-
Papua New Guinea	-	36	-	-
Philippines	-	-	-	-
Sri Lanka	-	-	-	-
Rep of China (Taiwan)	-	12	-	-
Thailand	1	4	18	-

Table 25. Funding Sources for Systemic Banking Crisis

Country	Government special budget	Issuing bond	Central bank	IMF, World Bank	Others
Cambodia	-	-	-	-	-
Indonesia	-	✓	✓	-	-
Malaysia	-	-	-		Untested
Nepal	✓	-	-	✓	DFID grant
Papua New Guinea 1)	-	-	-	-	-
Philippines	-	-	✓	-	-
Sri Lanka	-	✓		-	✓
Rep of China (Taiwan)	✓		✓	-	-
Thailand	-	✓	✓	-	✓ 2)

1) The Central Bank would be expected to step in to correct any crisis (PNG)
2) Such as R/P market, Interbank market.

Table 26. Special Regulations for Deposit Insurer in Handling Systemic Banking Crisis

Country	Exempt from resolution cost restriction	Providing blanket guarantee	Unlimited funding support	Assess special premium	Others or n/a
Cambodia*	-	-	-	-	-
Indonesia	✓	-	-	-	-
Malaysia	-	-	-	-	-
Nepal	-	-	-	-	✓
Papua New Guinea*	-	-	-	-	-
Philippines	-	-	-	-	-
Sri Lanka	-	-	-	-	-
Rep of China (Taiwan)	✓	-	-	✓	-
Thailand	✓	✓	-	✓	-

* deposit insurance is not available

COUNTRY CHAPTERS

PART II

PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN CAMBODIA

by Rath Sovannorak[1]

1. Introduction

In most developing economies, including throughout Asia, the banking sector plays a crucial role in financial resource allocation and savings in the economy. The health of an economy depends on the degree of safety and stability of its banking system. A sound, stable and robust banking system is a pre-requisite for the economic development and well being of a country. Unsafe banks can lead to systemic financial crisis, economic collapse and massive permanent economic losses, as in the Asian financial crises in 1997-1998 The National Bank of Cambodia (NBC) is the authority responsible for ensuring the stability and soundness of the banking system. In the absence of a capital market, Cambodia's banking sector plays a key role in the country's economic development. Under the restructuring of the banking sector in the year 2000, banks were required to increase their individual minimum paid-up capital up to about USD13 million. Sixteen commercial banks were closed and the remaining banks committed more capital, with the result that the banking sector as a whole was strengthened. Thus, a system for problem bank resolution and prevention of insolvent bank deserve attention in Cambodia before any future bank failure takes place. The NBC, as the supervisory authority, continues to promulgate the laws and regulations in accordance with the Basle core principles and other best practices for effective banking supervision, to strengthen the banking system.

The objectives of this paper are to focus on the overall policy and framework for the identification, intervention, and resolution of problem banks. and to highlight for consideration some of the issues concerning the establishment of additional guidelines, policy, and institutions for solving banking problems and for bank restructuring. The paper is divided into five parts. The First Part is the introduction. The Second Part presents the legal framework in dealing with problem bank. The Third Part deals with problem bank identification, while problem bank intervention and resolution are covered in the Fourth Part. The paper ends with conclusion and consideration for establishing necessary framework and institution to detect any bank problem.

2. Legal Framework in Dealing with Problem Banks

2.1 Legal Framework

The current legislative framework has largely been developed in the second half of the 1990s in response to a shift from a centrally planned to an open-market economy. The financial reforms have focused largely on the re-regulation of the banking system that had earlier suffered from excessive liberalisation. The main elements of the new legal framework are:

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The Law on the Organisation and Conduct of the National Bank of Cambodia, promulgated in January 1996, replaced the 1992 law. Under this new law, the NBC is accorded legal authority and autonomy to license, de-license, regulate and supervise banks and financial institutions and other relevant establishments, such as auditors and liquidators, and also to participate in the formation and supervision of the money and financial markets. The NBC is empowered to:

a) issue such decisions, regulations, and other directives;
b) appoint its officers or any other qualified person to regularly inspect any bank or financial institution;
c) require an officer or employee of a bank or financial institution to furnish to the Central Bank any information as may be required for the purpose of supervision and regulation; and,
d) in accordance with the existing laws take action or sanction against any official or employee of a bank or financial institution who is found guilty of contravening a provision of the existing laws or regulations of the NBC.

The Law on Banking and Financial Institutions was enacted in November 1999 and a number of subsequent regulations (*prakas*) issued by the NBC. Until now the focus of the financial reform was on the building up of public confidence in the banking sector, chiefly through strengthening the regulatory system and prudential supervision. The Law on Banking and Financial Institutions represents a step forward towards promoting more orderly financial markets by providing the legal framework for the licensing, organisation, operation, and supervision of a broad range of financial service companies. Under the provision of Article 40) of this law, the Central Bank supervises the banking system and its related activities, such as the money market, the inter-bank settlement system, and the financial intermediation. The Central Bank has the authority to:

a. issue licences and define the licensing process;
b. issue regulations for the implementation of this law;
c. supervise the banking system through permanent off-site monitoring and periodic on-site examinations of each institution; and should the need arises, extend on-site examinations to its subsidiary or to any other related entities, including shareholders;
d. and, in accordance with the provisions of Articles 52 to 54 of this law, take disciplinary action.

   As mentioned in Article 41 specifies the duties of the supervisory which include:
   a. licensing a banking institution to carry out financial and banking operations in Cambodia,
   b. defining and enforcing prudential rules that a banking institution must abide by,
   c. supervising, permanently but after the fact, through both off-site and on-site examinations, the financial position and functioning of a banking institution,
   d. imposing disciplinary sanctions against a banking institution for failing to comply with law and regulations,
   e. referring to the courts if failure to observe laws and regulations undermines the public interest.

Managers and shareholders of the banking institutions are accountable for mismanagement, and for deficiencies in internal control, in accordance with the provisions of Articles 14, 19, 27 and 30 of this law.

If a banking institution contravenes a provision of the laws or regulations governing its activities, and fails to heed a warning or fails to comply with an injunction, the supervisory authority may impose the disciplinary sanctions (Art 52).

Some other regulations issued by the NBC deal with problem bank, namely, Prakas on Standardised Procedure for Prompt Corrective Action for Banking and Financial Institutions, solvency ratio, liquidity ratio, large exposure, etc.

In addition to the above-mentioned laws and regulations, the NBC set up Prakas on the appointment of the Consultative Committee for Banking Supervision. The Committee's duties are as follow:

- plan for banking supervision strategy
- approve the annual report on Banking Supervision
- recommend one of the following sanctions against the institutions that are in
- breach of laws and regulations, or have failed to heed a warning or to comply with an injunction:
    - caution
    - reprimand
    - prohibition from performing certain operations, and any other limitations on the carrying on of business;
    - temporary suspension or compulsory resignation of one or more of executives, with or without appointment of a provisional administrator;
    - appointing a provisional administrator;
    - withdrawal of the licence and liquidation;
- Recommend granting licence.
- Recommend new regulations relating to the banking business.

2.2 Roles and Responsibilities of NBC and of Administrator or Liquidator

2.2.1 Role and Responsibility of NBC

As the supervisory authority, the NBC performs its function to ensure the safety and soundness of the banking system by conducting off-site surveillance and on-site examination to identify bank problem as early as possible in order to detect, put some prompt corrective actions, and find resolution. The NBC is empowered to appoint a provisional administrator or a liquidator as an urgent administrative and protective measure. The banking institution concerned must be given notice of the measure, which is enforceable immediately (Article 53). The supervisory authority decides as a last resort jurisdiction in the case of the other disciplinary sanctions, which are of a moral or a financial nature. These decisions are enforceable immediately, but may be appealed to the highest administrative jurisdiction on the grounds of legal flaw or irregularity (Article 54). If a serious and confirmed threat is weighing on the solvency of a banking institution and if appeals for reconstitution of own funds, as provided for in Articles 14, 19, 27 and 30, remain without effect, the supervisory authority may, on its own initiative or at request from the executives or shareholders, appoint, at the banking institution's expense, a provisional administrator for an initial period not exceeding 3 months. If circumstances so warrant, the provisional administrator's appointment can be extended for another period of 3 months (Article 57).

2.2.2 Administrator or Liquidator

A "provisional administrator" is a person appointed by the National Bank of Cambodia under Article. 57 of the Law on Banking and Financial Institutions (LBFI) to manage, direct and represent the financial institution. His duty (Article 59 of LBFI) is to make an assessment whether or not the banking institution is solvent, and to administer the current activities in order to preserve as far as possible the banking institution's solvency and maintain the rights of depositors and creditors. As in Article 67, if a provisional administrator or a liquidator is in some ways hindered from performing his duty by the concerned entity, he may refer the matter to the court.

3. Problem Bank Identification

3.1 Supervisory Strategies and Methods and Early Warning System

One of the tasks of the NBC as the supervisory authority is to create a regulatory framework that provides a level playing field for ensuring fair competition between financial institutions and reflecting the level of risk undertaken by a specific organization (depending on size, funding sources, governance structure, operations, growth, etc.). As based on both the off-and on-site manuals, the NBC's supervisory strategies and methods in identifying problem bank lie in the conduct of off-site and on-site supervision.

For off-site supervision, the NBC recently introduced a guideline for the off-site surveillance system (OSS). The objectives of this guideline are to spot potential difficulties of banks, identify risks that threaten the banking system, keep the management informed on banks' financial condition, check compliance with laws and regulations, prepare on-site inspections, follow up on the inspectors' findings, and prepare the enforcement measures, i.e. the prompt corrective action, and sanctions. The OSS consists of three tools, namely, an analytical tool, the Bank Performance Report (BPR), a database on prudential ratios and other regulatory aspects (Regulations), and a reporting tool, the Cambodian Off-site Bank Report for prompt corrective Action (COBRA). All banks' report are analysed and reported at least on a quarterly basis. Banks identified as weak and under alert are subject to monthly reporting under COBRA format. The assessment criteria on banks' condition are based on the CAMEL rating system This uniform rating system is designed to provide an early warning on the banks' condition. It assigns a bank a composite rating from 1 (low risk) to 5 (high risk):

Rating 1: Standard risk; prescribed action: standard supervision
Rating 2: Special mention; prescribed action: early warning, close supervision
Rating 3: High risk: prescribed action: official warning
Rating 4: Situation deteriorated, breach of the regulation; prescribed action: injunction, sanction

Rating 5: Critical situation; prescribed action:bank under administration, restructuring

The on-site inspections allow the NBC to go on location to investigate beyond the figures and written reports. Inspectors assess how the institution is actually managed and how its day-to-day practices comply with the stated policies and regulatory requirements. On-site inspections complements off-site supervision. The banking and financial institutions are normally inspected every twelve to eighteen months. The assessment of the on-site inspector is based on six key areas of banking risk, specificialy, capital adequacy, assets quality, management, earnings, liquidity, and sensitivity to market risk (based on the CAMELS rating system). Each of the key areas is assigned an individual rating from 1 (strong) to 5 (poor) as follows:

Rating 1: Strong
Rating 2: Satisfactory
Rating 3: Fair
Rating 4: Unsatisfactory
Rating 5: Poor

Supervision will only work when the banking and financial institutions are certain that non-compliance with the regulations and supervisory requirements of the Central Bank will result in Corrective Measures being imposed by the Central Bank. To be effective, the corrective measures taken by the supervisor need to be adequate, appropriate, and timely. This means that the supervisory system should be able to detect early warning signs of bank distress, so that the Central Bank can take quick and appropriate counter-measures to maintain stability of the system.

3.2 Problem Bank Identification

Based on the off-site and on-site examination reports, the examiners can identify the weaknesses and problems of banks and take appropriate measures to deal with the situation The following are the major causal factors of weak banks:

a. Bank experiencing rapid growth:
   - Capital levels are declining rapidly.
   - Funding sources are unstable or short-term.
   - Growth varies significantly from the bank's budget
   - New products and activities are being pursued with little or no expertise or with inadequate risk- management controls.

b. Management Deficiencies
   - Non-responsive management
   - Increasing non-compliance with laws, regulations and internal policies and procedures
   - Insufficient planning and response to risks.

c. Poor Asset Quality
- loan growth increase
- increase in NPLs
- changes in loans loss reserve
- loan concentration

d. Off-balance sheet exposures
- inadequate oversight mechanism
- high levels of activity relative to size and risk profile
- accounting errors

e. Poor risk management
- policies (loan policy was not well defined)
- personnel (staff policy, inefficient staff)
- controls (audit, MIS)

f. Fraud and insider abuse
- excessive salaries and bonuses
- higher rates paid on insider deposits
- extension of credit granted on favorable terms
- irregularity of transaction between insiders and bank's clients

3.3 Communications

One of the examiners' duties is to communicate with bank management. Effective, accurate, and frequent communication with the bank board and management is very important in problem bank identification and resolution. The examiners must communicate with the board and management in a firm, timely and non-threatening way in order to avoid compromising future cooperation and communication.

3.3.1 The Off-site and On-site Examination Reports

On completion of the off-site and on-site examinations, the supervisors prepare the examination reports on the findings, conclusions and recommendations, and communicate formally to the concerned banks. The reports must highlight the deficiencies and non-compliances, and proritise the areas of weaknesses, and bank prior commitments. The root causes of problems must be addressed for prompt corrective action and resolution.

3.3.2 Potential or Significant Problems

On identification of potential problems and issues, the examiners must keep the management and board regularly informed of the preliminary findings. This is to update the management on the condition of the bank to facilitate the resolution process, and thus prevent "surprises" when the preliminary ratings are disclosed during the wrap-up meeting. When the examiners make an observation about an issue which is not a problem, but could be a potential problem, the examiners may choose to apply moral suasion for management to make the improvement.

3.3.3 Wrap-up Meetings

After finishing their examination, the supervisors conduct a wrap-up meeting with senior bank management and board to summarise the findings, conclusions, recommendation, corrective actions, and follow-up activity. Sometimes, the supervisory senior management may attend the meeting to convince, recommend, and add emphasis on problem bank and resolution. During the meeting the supervisors shall prioritise the problems in order help the bank management to understand the risks and gain the management commitment to implement the corrective actions within the specified time period.

4. Problem Bank Resolution and Intervention

4.1 History of Bank Closure

4.1.1 Bank Restructuring

In the year 2000, with the implementation of the Law on Banking and Financial Institutions, many essential regulations were issued with the intention of restructuring the banking system through the re-licensing mechanism. The National Bank of Cambodia issued action plans with deadlines for the submission by the banking and financial institutions for evaluation of their licensing applications.

The first step in the re-licensing process was to diagnose banks based on the capital adequacy rules and other prudential ratios and measure the extent of the problems faced by individual banks. The measurements were based on the following three elements:

1. The rating based on CAMELS methodology and the information submitted in the bank's business plans;
2. Whether the new capital requirement of 50 billion riels ($13 million) has been met; and
3. Whether corrective measures (prudential) are needed.

As a result, banks were classified into three categories:

- 4 viable and fully capitalised banks,
- 15 potentially viable banks that needed to increase capital and take other corrective measures,
- 16 non-viable banks, of which 11 voluntarily liquidated. Of the banks which liquidated voluntarily, five were insolvent.
- There is no deposit guarantee scheme for depositors.

The viable and fully capitalised banks were re-licensed for three years, and the potentially viable banks were required to sign Memorandum of Understandings (MOUs) with the NBC to commit additional capital and correct any errors found during critical diagnosis. The MOUs contained schedules for the banks to complete. The NBC required banks to arrange for a voluntary liquidation when they were not viable. The NBC then arranged a purchase transaction in which a sound second bank would pay a small amount to assume some combination of assets and deposits from the non-viable banks. This would avoid losses for depositors and create a more favorable climate for liquidation. However, such purchased transaction was not carried out. The re-licensing process resulted in a significant reduction in the number of banks in the system and ensuring that those that remain are strong enough to make a meaningful contribution to the development of the economy. After the restructuring process, the licensed banks were required to implement the uniform Chart of Accounts (COA).

4.1.2 Reimbursement of Depositors' Money

The Law on Banking and Financial Institutions clearly defined the priority for the reimbursement of depositors' money when bank liquidations occurred. Reimbursement to depositors is ranked fourth in the priority of claims after tax expenses, employees' salaries and other preferential shares.

1. A fixed method where each depositor shall receive an equal amount up to two million riels (US$500 equivalent), and
2. Remaining assets shall be disbursed proportionally according to international practice. All claims were settled in accordance to the priority provided under Article 64 of the Law on Banking and Financial Institutions,. Of the five insolvent banks, only one had sufficient funds to reimburse its depositors.

4.2 Prompt Corrective Actions (PCA)

The supervisory process is to find and identify problems as early as possible in order to take remedial action that can protect serious bank deterioration. If problems are detected, the examiners determine the extent of the deficiencies as well as the timing and form of the corrective action required. Prompt corrective actions range from informal advice and moral suasion to formal enforcement actions, such as ceasure, fine, and provisional administration. The corrective measures prescribed would be appropriate to the problem and would be designed to correct and improve the condition of the bank. If a serious and confirmed threat is weighing on the solvency of a banking institution and if appeals for reconstitution of own funds, as provided for under Articles 14, 19, 27 and 30 remain without effect, the supervisory authority may, on its own initiative or at request from the executives or shareholders, appoint, at the banking institution's expense, a provisional administrator for an initial period not exceeding three months. If the circumstance so warrant, the provisional administrator's appointment can be extended for another period of three months.

The NBC has issued and implemented a formal procedure for prompt corrective action (PCA) of banks and financial institutions licensed by the NBC. Prompt corrective action is a prescribed set of disciplinary sanctions and limitations applicable to the financial institutions in accordance with the Law on Banking and Financial Institutions. Capital Restoration Plan is a formal plan signed by a financial institution's Board of Directors and submitted to the National Bank of Cambodia. Such a plan details the actions, strategies and commitments the Board will undertake to attain capital adequacy as defined by the solvency ratio. Such a plan includes numerical financial goals and stipulates timetables and deadlines for attaining said the benchmarks. The following are the main components of this Prakas:

a. Prompt Corrective Action: a set of disciplinary sanctions and limitations applicable to financial institutions
b. Capital Restoration Plan: a formal plan signed by the board and submitted to the NBC
c. Provisional Administrator: a person appointed by the NBC to manage, direct and represent the financial institution.
d. Capital Call Meeting: a formal meeting called by the NBC, where financial institution's directors are notified of a capital deficiency and are given a specified time period to provide a specific capital injunction amount.
   - Under the PCA procedures, the financial institutions will be categorised based on their solvency ratio.
     - well-capitalised, solvency ratio ≥ 20%
     - adequately capitalszed, solvency ratio ≥ 15% but <20%
     - undercapitalszed, solvency ratio ≥ 10% but <15%
     - significantly undercapitalised, solvency ratio ≥ 5% but <10%
     - critically undercapitalised, solvency ratio < 5%
   - When FI becomes undercapitalised, it must prepare and submit a Capital Restoration Plan (CRP) to the NBC within 30 days. The NBC will notify the FI in writing of the CRP's acceptability within 30 days of receipt or any delay and reason.
   - An acceptable of CRP must indicate the possibility of capital restoration and must include:
     - current balance sheets and budgets, strategic plan, market analysis and other relevant information
     - means to raise capital must address
e. Steps to become adequately capitalised
f. Levels of capital to be attained during each quarter of the year
g. Types and levels of activities in which the FI will engage
h. Any other information that the NBC may require
   - Influential shareholders must submit a written guarantee that the FI will comply with the CRP that the owner will take action required by CRP, ensure the selection of new management, discontinue any risky activities
   - Undercapitalised FI that fails to submit or implement an acceptable CRP, the FI shall face the following sanctions:
     - ask prior approval from the NBC before paying any bonus or increase compensation to senior executive officer
     - injunction to recapitalise through sanctions and fines
     - restriction transaction with affiliates
     - other disciplinary measures may also be decided by the NBC
     - restriction on asset growth, restriction on activities
     - resignation of one or more executives
     - injunction to hire qualified senior executives
     - injunction to stop taking deposits from correspondent FIs
     - injunction for divesting subsidiaries
     - appointment of a provisional administrator
   - Critical undercapitalised FI; a capital call meeting shall be called and the FI shall be ordered not to:
     - sell significant assets

- extend new credits to customers
- change accounting methods, unless existing ones break the law
- pay compensation and bonus
- pay interest on liabilities above prevailing market rates

A provisional administrator shall be appointed within 180 days notifying capital call meeting.

5. Conclusion

Apart from the closure of 16 banks resulting from the requirement of an increase in the minimum paid-up capital of banks to about USD13 million, Cambodia has not experienced any bank insolvency. Though some banks incurred losses and erosion of capital which resulted from poor asset quality, poor management and governance, they were prompt in taking corrective action, with improvement in their financial performance. Thus, a system for problem bank resolution and insolvency prevention is essential in Cambodia to pre-empt the occurrence of bank crisis leading to bank failure.)

There is no unique solution for problem banks. There is a broad variety of measures that may be taken to deal with problem banks, depending on the severity of their deficiencies, including market-based solutions (shareholders' capitalisation and agreement with creditors, acquisitions and mergers) and government-based solutions, (lender of last resort, intervention, provisional administration, capitalisation with public funds, and bank closure). Cambodia should explore and be guided by international experience regarding the legal, institutional, and regulatory frameworks for dealing with insolvent banks in developing an appropriate system to address problem bank resolution and insolvency. An effective strategy for the resolution of problem banks rests on two pillars. One is having a strong institutional framework in place that will reduce the risk exposures of banks leading to bank failures as well as the costs of bank failures. The components of a strong institutional framework consist of sound macroeconomic policies, sound banking supervision and regulation, good corporate governance and a well-functioning court system. The other pillar is having a supervisory authority that has full legal authority and autonomy to enforce sound and comprehensive laws, regulations, and policies. It is difficult to predict which banks are likely to fail especially in a systemic crisis. Thus, there is a need to provide sufficient financial resources to cover their operations, and specialists in bank restructuring and resolution to identify root causes and take timely action. The followings can be considered:

- Diagnose problems and initiate some prompt corrective actions
    - based on off-site and on-site supervision, supervisors can detect some signs of problem banks through financial ratios and other indicators.
    - supervisors can evaluate the extent of the problem and carry out resolution of problem bank speedily where a bank has been identified as problematic) how depth the problem is and find the resolution timely, if problem banks have been identified.
    - a system for surveillance of the banking sector must be in place in order to detect and identify problem banks for initiation of prompt corrective action.

- Law, regulations, and intervention
    - banking law and regulations should have clear rules governing the role in bank restructuring, without adversely affecting market-based solution and forced liquidation.
    - banking regulation should encourage capitalisation of the problem banks by others or mergers.
    - The supervisory authority's staff who are responsible for bank restructuring and resolution shall be protected by law and regulation. Lack of legal protection may impair banking resolution efforts.
    - In implementating bank restructuring and resolution measures for banks that are critically undercapitalised, illiquid or are in contravention of the applicable laws and regulations, the NBC has the responsibility to ensure the safety and soundness of the banking system, the restoration of credibility, and the building up of the public confidence. Resolution strategy should enhance public confidence, avoid disruption to payment system, minimise losses to depositors and government, ans well as minimise adverse macroeconomic effects.
    - banking law and regulations shall explicitly mention the roles and the procedure for the operation of lender of last resort, avoiding moral hazard especially for a country with highly dollarised economies. If the Central Bank does not have sufficient international reserves, liquidity support under dollarised economies may result in a reduction of net international reserves. Thus, the intervention should target problem banks that result from mismanagement and under-capitalisation.
    - the legal system should support timely and effective resolution of bank failures in order to prevent systemic crisis to the financial system. The legal framework should include clear guidelines and policies for dealing with problem banks, prompt corrective action, depositor payoff, etc. A well developed legal system will reduce the costs associated with problem bank resolution and create for effective governance, if the bank management, including officers, managers, directors, internal and external auditors of a failed bank, are liable to prosecution under the law.
    - with the increasing financial system integration, the coordination between home-host supervisory authorities and deposit insurers plays a significant role in dealing with cross-border banks failures by sharing information and action plan for resolution.
    - all concerned government agencies and the Central Bank must work closely with one another in order to carry out the resolution of failed banks with the least cost.

Appendix 1

Unofficial Translation

B7.02- 203 Prokor

PRAKAS
on
Standardized Procedure for
Prompt Corrective Action for Banking and Financial Institutions

The Governor of the National Bank of Cambodia

- With reference to the Constitution of the Kingdom of Cambodia
- With reference to the Royal Kram NS/RKM/0196/27, dated January 26, 1996 promulgating the Law on the Organization and Functioning of the National Bank of Cambodia
- With reference to the Royal Kram NS/RKM/1199/13 of November 18, 1999 promulgating the Law on Banking and Financial Institutions
- With reference to the Royal Decree NS/RKT/0202/039 of February 16, 2002 on the reappointment of His Excellency Chea Chanto as Governor General of the National Bank of Cambodia
- Pursuant to the agreement of the senior officer meeting of the National Bank of Cambodia on September 09, 2002.

DECIDES

Article 1

To issue formal procedure for prompt corrective action (PCA) of the banking and financial institutions licensed by the National Bank of Cambodia, hereafter referred to as financial institutions by pre-establishing practice formalities of financial institutions and to implement oversights with uniformity and fairness.

Article 2

1. "Prompt corrective action" is a prescribed set of disciplinary sanctions and limitations applicable to financial institutions in accordance to the Law on Banking and Financial Institutions.

2. "Solvency ratio" refers to the calculation of capital adequacy stipulated in Prakas B7.00-46 relating to the Banks' Solvency ratio.

3. "Capital Restoration Plan" is a formal plan signed by a financial institution's Board of Directors and submitted to the National Bank of Cambodia. Such a plan details the actions, strategies and commitments the Board will undertake to attain capital adequacy as defined by the solvency ratio. Such a plan includes numerical financial goals and stipulates timetables and deadlines for attaining said benchmarks.

4. “Provisional Administrator” is a person appointed by the National Bank of Cambodia following art. 57 of the law on banking and financial institutions (LBFI) to manage direct and represent the financial institution. His duty (art. 59 of LBFI) is to assess the financial situation and administer the current activities in order to preserve as far as possible the covered entity’s solvency and maintain the rights of depositors and creditors.

5. “Capital Call Meeting” is a formal meeting called by NBC, where financial institution directors are notified of a material capital deficiency at their financial institution and given a specified time period to provide a specific capital Injection amount.

Article 3

Under the prompt corrective action procedures, the financial institutions will be categorized based on their solvency ratio, as previously defined in Prakas on Solvency ratio of Banks. A financial institution is classified as:

a. Well-Capitalized when its solvency ratio equals or exceeds 25 per cent.

b. Adequately Capitalized when its solvency ratio equals or exceeds 20 per cent, but is less than 25 per cent

c. Undercapitalized when its solvency ratio equals or exceeds 15 per cent, but is less than 20 per cent

d. Significantly Undercapitalized when its solvency ratio equals or exceeds 5 per cent., but is less than 15 per cent.

e. Critically Undercapitalized when its solvency ratio is less than 5 per cent.

Article 4

When a financial institution becomes undercapitalized, it must prepare and submit a Capital Restoration Plan (CRP) to the NBC within 30 days after it became undercapitalized. The NBC will notify the financial institution in writing of the CRP’s acceptability within 30 days of receipt or any delay and the reason for the delay.

Article 5.

An acceptable CRP must indicate the possibility of capital restoration and must include the following:

a. Current balance sheets and budgets, long-term budgets, a strategic plan, market analysis based on realistic assumptions, and any other relevant information.
b. Means to raise capital that must address:
   - The steps the financial institution will take to become adequately capitalized.
   - The levels of capital to be attained during each quarter of each year of the plan.

- The types and levels of activities in which the financial institution will engage.
- Any other information the NBC may require.

Article 6

In addition to the preparation and submission of the CRP to the NBC, the influential shareholders must submit a written guarantee that the financial institution will comply with the CRP. The guarantee must include the financial commitment of the influential shareholders in the implementation of the CRP. In addition, the guarantee must include the assurances that the owner will:

a. Take actions required by the CRP.
b. Ensure the selection of new competent management.
c. Restrict transactions between the financial institution and the owner.
d. Discontinue any risky or inappropriate activities.

Depending on the company involved, the guarantee may also include a promissory note, a pledge of assets, appropriate assurances from company counsel, a company board of directors' resolution, and other supervisory actions deemed necessary to ensure performance.

Article 7

Undercapitalized financial institutions that fail to submit or implement an acceptable CRP and significantly undercapitalised financial institutions shall face the following sanctions:

a. NBC approval before paying any bonus or increasing compensation to a senior executive officer.
b. Injunction to recapitalise
c. Restrictions on transactions with affiliates.
d. Restrictions on interest rates on deposits.

Other discretionary measures may also be decided, at NBC's sole decision:

a. Restrictions on asset growth or reduction of assets.
b. Restriction on activities.
c. Resignation of one or more executives
d. Injunction to hire new qualified senior executive officers
e. Injunction to stop taking deposits from correspondent financial institutions.
f. Injunction of divesting subsidiaries that may cause a significant risk to the financial institution
g. Appointment of a provisional administrator

Article 8

As soon as a financial institution is known to have become critically undercapitalized, a capital call meeting shall be called. The financial institution shall be ordered not to:

a. Sell significant assets or waiver customers guarantees
b. Extend new credits to customers
c. Change accounting methods, unless existing ones break the law
d. Pay compensation or bonuses.
e. Pay interest on liabilities above prevailing market rates.

A provisional administrator shall be appointed within 180 days of notifying capital call meeting.

Article 9

The General Direction, the General Secretariat, the General Cashier, the General Inspection, all Departments of the National Bank of Cambodia, and all Banking and Financial Institutions under the NBC's supervisory authority shall implement this Prakas.

Article 10

This Prakas shall have effect from the signing date.

Phnom Penh, October 17, 2002
The Governor
Signed and Sealed: Chea Chanto

cc:
- The Members of the Board of Directors
- The parties concerned as stated in Article 9
- File
- CM "for info"
- Administration of CM
  "for publication in the National Gazette"

Appendix 2
<u>*Unofficial Translation*</u>
B7.05-212 Prokor

PRAKAS
on
Amendment of Prakas

Standardized Procedures for Prompt Corrective Action for Banking and Financial Institutions

The Governor of the National Bank of Cambodia

- With reference to the Constitution of the Kingdom of Cambodia;
- With reference to the Royal Kram NS/RKM/0196/27, dated January 26, 1996 promulgating the Law on the Organization and conduct of the National Bank of Cambodia;
- With reference to the Royal Kram NS/RKM/1199/13 of November 18, 1999 promulgating the Law on Banking and Financial Institutions;
- With reference to the Royal Decree NS/0904/244 of 7 September 2004 on the appointment of His Excellency Chea Chanto as Governor of the National Bank of Cambodia;
- Pursuant to the request of the banking supervision department;

DECIDES

Article 1.

Article 3 of Prakas No. B7-02-203 dated 17 October, 2002 relating to the standardized procedures for prompt corrective action for banking and financial institutions is amended as following:

Under the prompt corrective action procedures, the banks and financial institutions will be categorized based on their solvency ratio, as previously defined in the amendment of Prakas on Solvency Ratio of Banks. A bank and financial institution is classified as:

a. Well-Capitalized when its solvency ratio equals or exceeds 20 percent.
b. Adequately Capitalized when its solvency ratio equals or exceeds 15 per cent, but is less than 20 percent
c. Undercapitalized when its solvency ratio equals or exceeds 10 percent, but is less than 15 percent
d. Significantly Undercapitalized when its solvency ratio equals or exceeds 5 percent, but is less than 10 percent.
e. Critically Undercapitalized when its solvency ratio is less than 5 percent.

Article 2.

The General Direction, the General Secretariat, the General Inspection, the General Cashier, all Departments of the National Bank of Cambodia, and all Banking and Financial Institutions under the National Bank of Cambodia's supervisory authority shall strictly implement this Prakas.

Article 3.

This Prakas shall have effect from the signing date.

Phnom Penh, 29 November, 2005
The Governor
Signed and sealed: Chea Chanto

cc:
- The Members of the Board of Directors
- The parties concerned as stated in Article 2
- File
- CM "for info"
- Administration of CM "for publication in the National Gazette"

PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN INDONESIA

by Sukarela Batunanggar[1] and Bambang W. Budiawan[2]

1. Introduction

The Indonesian banking system has experienced structural developments[3]. Following the implementation of extensive bank reforms in October 1988, the banking industry grew rapidly in terms of the number of banks as well as total assets[4]. However, a lack of effective supervision resulted in imprudent behaviour by the banking industry. In February 1991, prudential banking principles were introduced, and banks were urged to merge or consolidate. Furthermore, in the mid-1990s self-regulatory measures, including the improvement of internal controls as well as information technology and systems were introduced to strengthen the banks' soundness. Unfortunately, the wide-scale banking consolidation and the improvement of bank control systems never took place prior to the recent crisis. This was due to a lack of commitment by the owners of banks to strengthen their organisations and weak law enforcement from Bank Indonesia (BI) as the supervisory authority. Under the old law of 1968, Bank Indonesia lacked independence and, to a large extent, was unable to apply tough measures on well-politically connected banks[5].

During the pre-crisis period, besides having poor governance and control, the banking industry also suffered from fundamental liquidity management weaknesses as indicated by: (i) large volatile deposits in the composition of banks' funds (ii) a high loan to deposit ratio and exposure to foreign exchange risk[6]. As the currency crisis spread in mid-1997, this generated other risks. Firstly, there was an increase of liquidity risk due to a huge maturity mismatch of assets and liabilities[7]. Secondly, credit risk increased due to the inability of debtors to repay their foreign currency loans as the rupiah depreciated sharply.

Indonesia's banking crisis of 1997/98 was the most severe in East Asia and one of the most costly crises of the last quarter of the twentieth century. The fiscal costs of resolving the Indonesian banking crisis amounted to Rp654 trillion or 51 percent of its annual GDP[8]. It was the second highest in the world during the last quarter of the century after Argentina's 55.1 percent of GDP during its 1980–1982 crisis. The experience of the 1997/98 crisis in

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3 Under the Banking Act, 1992, banks are categorised into commercial banks and rural banks. However, the analysis in this paper only focuses on commercial banks. Before the 1997/98 crisis, the Indonesian banking system evolved in five stages: (i) the rehabilitation period (1967-1973) to restore the economy from high inflation; (ii) the ceiling period (1974–1983) where the interest rate ceilings were applied; (iii) the growth period (1983–1988), following the banking deregulation of June 1983, removed the interest rate ceilings; (iv) the acceleration period (1988–1991) following the impact of extensive bank reforms in October 1988; and (v) the consolidation (1991–1997) in which prudential banking principles and self-regulatory measures were introduced including capital adequacy, bank ratings and internal controls. See Batunanggar (2002 and 2004) and Djiwandono (1997) for more detailed discussions.

4 Within two years, Bank Indonesia granted licenses for 73 new commercial banks and 301 commercial bank branches.

5 See Cole and Slade, (1998).

6 Foreign exchange risk was reflected in the increasing ratio of foreign currency liabilities to assets and the significance of foreign currency loans in banks' portfolios.

7 As short-term foreign currencies borrowings were replaced by medium-term and long-term rupiah loans.

8 This compares with Thailand 32.8 percent, South Korea 26.5 percent, Japan 20 percent, Malaysia 16.4 percent, and Philippine: 0.5 percent (1998); 13.2 percent (1983 – 1987), see Honohan and Klingebiel (2000).

Indonesia showed that excessive risk-taking combined with poor risk management and bad governance contributed mostly to the banking crisis. Batunanggar (2002 and 2004) argued that Indonesia's crisis resolution suffered from two main problems: (i) a lack of understanding on the part of the International Monetary Fund (IMF) and of the authorities handling the crisis which resulted in inappropriate strategies both at the macro- and micro-level; and (ii) a lack of government commitment to take consistent and objective measures. The intense political intervention also worsened the situation. In addition, the absence of a clear mechanism of the crisis resolution has created costly Bank Indonesia Liquidity Support (BLBI) during the 1997 crisis, which in turn created a painful and very controversial case.

In line with the banking restructuring programme agreed with the IMF on July 1999, Bank Indonesia attempted to enhance the effectiveness of banking supervision to meet international standards, particularly the Basel Committee's Core Principles for Effective Banking Supervision. Essentially, the plan covers improvement of bank entry and exit policies, adoption of risk-based supervision and consolidated supervision, incorporation of market risk in the capital adequacy, and improving market discipline by enhancing banks' transparency. Bank Indonesia continues to improve the effectiveness of its banking supervision as part of the Indonesian Banking Architecture (API) which is aimed at a strong and resilient banking system capable of supporting economic growth[9].

During the past six years, there was voluminous research on the cause and experience of Asian crises, including that of Indonesia's. However, the previous studies on the Asian and, especially, the Indonesian banking crisis were primarily aimed at the origin of crises. They outlined causes as well as lessons learned, but there was less attention given to the issues of problem bank management. This study aims to describe and analyse a framework and process for dealing with problem banks in Indonesia.

This paper is organised in six main parts. Following this introduction, the Indonesian legal framework in dealing with problem banks is presented in Part 2. Part 3 outlines the development of the banking regulation and supervision of the Indonesian banking system during the pre- and post-crisis period of 1997/98. Then, the supervisory tools are presented in the following order: problem bank identification (Part 4), problem bank intervention (Part 5), and problem bank resolution, including a range of remedial measures to resolve the deficiencies of a problem bank and to resolve a failed bank (Part 6). Part 7 provides an outline of the crisis-management framework and policies adopted. Finally, Part 8 concludes with the lessons learned and proposes the policy recommendations for more effective problem-bank management in Indonesia.

2. Legal Framework in Dealing with Problem Bank

A comprehensive legal framework - which provides for and clearly defines the objectives, roles, responsibilities, powers, independence, and legal protection of supervisors - is essential for effective banking supervision. The provision of autonomy, accountability and legal protection of bank supervisors requires three components to be in place. First, operational independence to pursue the objectives set by legislation. Second, adequate

9 The API is BI's comprehensive programme for the period of 2004-2010 for the development of a strong and resilient banking system capable of supporting economic growth. Among the key elements of API is the creation of effective banking supervision in line with international standards.

resources to meet the objectives of banking law and provide the framework for setting the minimum standards that the banks must meet as well as to allow supervisors sufficient flexibility to set the prudential rules and to accord them legal protection from personal and institutional liability for supervisory actions taken in good faith in the course of performing their supervisory duties. Third, is the provision of a mechanism for inter-agency cooperation and sharing of the relevant information among the various official agencies.

2.1 Legal and Institutional Framework

Financial safety-net players in Indonesia involve three authorities, namely, Bank Indonesia as the bank supervisor and lender of last resort, the Indonesian Deposit Insurance Corporation (IDIC) responsible for insuring bank deposits as well as resolving failed banks, and the government who provide funds for emergency liquidity assistance and systemic bank resolution.

2.1.1 Bank Indonesia

Bank Indonesia obtains its legal and operational independence with the ratification of its new act in 1999[10]. Bank Indonesia is accountable to the parliament in carrying out its duties and authorities. To ensure transparency and accountability, Bank Indonesia should disclose information of its performance and plans to the public through the mass media at the beginning of every fiscal year[11].

One of Bank Indonesia's core functions is to ensure a safe and sound banking system through the regulation and supervision of individual banks. Bank Indonesia also plays an important role in maintaining financial system stability through its role as lender of last resort and surveillance of systemic risks that may affect the entire financial sector.

As the bank supervisor, Bank Indonesia prescribes regulations, grants and revokes bank license, supervises banks and imposes sanctions on a bank in accordance with the prevailing regulations. Bank Indonesia has a range of mandatory and discretionary tools to address problem banks. These tools can impact on bank's shareholders, management and bank operation.

There is a plan to transfer bank supervision from Bank Indonesia to a new agency, the Financial Supervisory Authority (FSA) to be established by the end of 2010. As promulgated in Article 34 of the Bank Indonesia's Act, the FSA will act as a "mega regulator" and supervise all the financial institutions (excluding rural banks) and financial markets[12]. Three critical issues on the creation of Indonesia's FSA are: (i) it status may not be fully independent since it is under the President; (ii) budget constraints since it will be solely funded by supervision

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[10] Bank Indonesia's Act No. 23 Year 1999, which replace Act No.13 Year 1968, where Bank Indonesia's Governor is a member of Monetary Board, chaired by Finance Minister.

[11] The information contains its performance on monetary policies of the previous year, a proposal of monetary policy strategies for the following year as well as the developments in the economic and financial sectors, including bank supervision reports. Bank Indonesia should also submit a report on the implementation of its tasks to the House of Representatives quarterly.

[12] Initially, as promulgated in BI's Act No.23 of 1999, the transfer should be carried out by December 2002. However, due to inadequate preparation and differences in viewpoints between Bank Indonesia and the government as well among the politicians in the parliament, the transfer date has been shifted to December 2010, as provided under the amended BI's Act No.3 of 2004.

levies from the financial industry; and (iii) risks and implications to banks and banking system stability. These issues accordingly require careful consideration by the authorities[13].

2.1.2 Indonesia Deposit Insurance Corporation (IDIC)

Indonesia Deposit Insurance Corporation was established in September 2005 under Act Number 24 of 2004[14]. The IDIC is an independent institution accountable to the President. To ensure its effective governance and the coordination of the IDIC with Bank Indonesia and the Ministry of Finance, high-level officials from Bank Indonesia and the Ministry of Finance are represented (as ex-officio) in its Board of Commissioners.

The major functions of the IDIC are to insure customers' deposits and to resolve failed banks. The IDIC is responsible for the overall management and implementation of the deposit insurance program. Operationally, it covers three main tasks: (i) to determine deposit insurance policies; (ii) to determine and implement the resolution policy for failing banks that do not have a systemic effect; and (iii) to handle a failing bank[15] that has a systemic effect.

To ensure effective resolution of failing banks, the IDIC is empowered to: (i) take over control of the failing bank and exercise all the rights and powers of the shareholders; (ii) possess and manage the assets and liabilities of the bank; (iii) review, annul, terminate and/or alter any contracts between the bank and third parties; and (iv) sell and transfer the failing bank's assets and liabilities without debtor or creditor consent.

Legal protection for the regulator and supervisor is provided under the Central Bank act. Bank Indonesia's officials are protected against prosecution, if they act in a good faith. Therefore, Bank Indonesia is insulated against unnecessary legal suits from third parties when its officials exercise their duties and responsibilities appropriately.

The challenge is ensuring the consistency of practicing those laws and regulations. This is crucial since the bank supervisor is required to make an objective assessment based not only on quantitative measures, but also on qualitative criteria or judgment.

2.1.3 The Government

The government, which is represented by the Ministry of Finance, is responsible for providing the legal framework for the financial sector and public funds for systemic-emergency-liquidity assistance and banking crisis resolution.

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13 Abram and Taylor (2000), and Goodhart (2001) provide excellent discussions on the issues in the unification of financial sector supervision. Goodhart argues that banking supervision in less developed countries is better to be retained within the central bank because it will be better funded, is more independent and will be performed with greater expertise and reliability. Currently, discussions are on-going among high-level officials from Bank Indonesia and the Ministry of Finance to change the plan – for bank supervision is to be retained by BI and for an independent agency to supervise non-bank financial institutions and capital market to be established. In addition, the establishment of the Financial System Stability Forum (consisting of high-level officials from the Ministry of Finance, BI and the IDIC) will facilitate effective coordination and regulatory harmonisation among the institutions involved in dealing with systemic issues. However, a formal decision regarding this issue remains to be taken.

14 Bank Indonesia was actively involved in the establishment of the IDIC, including the preparation of the IDIC Act, organisation and regulations as well as the assignment of several of its personnel to the IDIC.

15 As stipulated in the IDIC Act, a failing bank is a bank that experiences financial difficulties and endangers the continuation of its business, and is declared by Bank Indonesia as beyond rescue.

2.2 Coordination and Information Sharing

The maintenance of financial system stability is a public policy which involves BI, the IDIC and the Ministry of Finance. Therefore, sound coordination and cooperation among these authorities is a necessity. The coordination and cooperation will usually consist of information-sharing, harmonisation of policy issues, and prompt strategic response to potential instability and systemic crises[16].

With the establishment of the IDIC, coordination between Bank Indonesia and the IDIC is vital to ensure effective problem bank resolution. Bank Indonesia and the IDIC signed a Memorandum of Understanding (MoU) in 2006 which covers regular information-sharing for normal and problem banks as well as cooperation in the closing of insolvent banks.

Basically, there are three possibilities for Bank Indonesia regarding the resolution of problem banks:

(1) In the case of failing banks without systemic effect, Bank Indonesia will transfer the bank to the IDIC for resolution. Prior to the transfer, Bank Indonesia will inform and discuss with the IDIC the bank's problem and condition.

(2) If Bank Indonesia identifies that the problem bank is beset with a liquidity problem which carries a contagion risk, it will convene a meeting with the Finance Minister to decide on the extension of emergency liquidity assistance.

(3) In case where the problem bank is insolvent with a systemic effect, Bank Indonesia will convene a meting with the Coordinating Committee to determine the resolution measures for the failing bank. As provided under the IDIC Law, the Coordinating Committee consists of the Finance Minister, the Governor of Bank Indonesia and the Chief Commissioner of the IDIC.

A joint task force from the Ministry of Finance, Bank Indonesia and the IDIC has drafted the Indonesian Financial Safety Net (FSN) Act. The FSN purposes to establish a strong legal framework providing the policies and coordination mechanisms to facilitate the work of the authorities responsible for maintaining financial system stability, including crisis management.

There are, at least, two issues emerging from this new regulatory framework. First, the bank supervisor is challenged to be more transparent and effective in performing its job. Once a bank becomes problematic, the supervisor should share the relevant data and information on the bank's problems with the IDIC. Second, differences in perception and perspective arising on certain issues between the two institutions could hinder the effectiveness of coordination. Therefore, the two institutions should foster the culture of cooperation and mutual understanding through open dialogues. So far, the coordination and cooperation between Bank Indonesia and the IDIC has been effective. A regular staff-exchange programme is one of the good ways to enhance the working relationship of the two institutions.

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[16] Santoso, Wimboh and S. Batunanggar (2007).

3. Prudential Banking Regulation and Supervision

3.1 Pre-Crisis (1991 to 1997)

Banking regulatory and supervisory framework, strategies and process adopted by Bank Indonesia have also undergone significant improvement corresponding with the development of the banking system (See Figure 1).

In response to the swift development of the banking industry following the post-banking deregulation of October 1988, Bank Indonesia initiated prudential regulatory and supervisory reforms in 1991. An early warning system (EWS) was also developed as a tool to assist bank supervisors in assessing and monitoring the condition of the banking institutions. Self-regulatory measures comprising the improvement of internal controls and technology & information systems were also introduced to strengthen the soundness of the banks.

In general, the progress of the regulatory and supervisory improvement initiatives taken in the pre-crisis period was very slow. The long-term plan and detailed action plans which had been clearly and comprehensively formulated in the BI's Strategic Plan were not executed consistently[17]. Therefore, the weaknesses of banking supervision persisted due to the poor development of organisational capabilities (including of human resources) and weak law enforcement in the banking industry. Central to this issue was active political intervention and a lack of strong and visionary leadership[18].

Figure 1
Regulatory and Supervisory Reforms Pre-Crisis (1991 - 1997)

Period	Initiative	Key Measures
Pre-Crisis (1991 - 1997)		
1991	"February Package"	• Introduction of prudential regulations in line with international standards – capital adequacy requirement, asset quality classification and provision for classified assets. • Adoption of CAMEL rating.
1991/92	Improvement in the Effectiveness of Banking Supervision	• Development of technical guidelines for on-site examination. • Development of database ("Sistem Data Dasar/SDD") and early warning system ("Sistem Pemantauan Dini Bank Indonesia/ SPDBI") as a tool for bank supervisors in assessing and monitoring the condition of banks. • Decentralisation of supervision of bank with headquarters in branch office's area.
1992/93	"Self Regulatory Banking"	• Improvement of internal controls and technology & information systems to strengthen banks' soundness.
1994	Reorganisation of the Banking Supervision Units	• Reorganisation of the banking supervision structure into a "dedicated team" by merging the on-site and off-site supervision units. • Capacity building for the bank supervisor, including the development of specialist bank examiners, e.g. IT examiners.
Source: Bank Indonesia (various reports) and Batunanggar (1996)		

17 In its Strategic Plan of 1994 to 2004, BI declared its vision as a centre of excellence in its core functions (monetary policy, banking supervision and payment system) and a role model in its supporting function. The Strategic Plan clearly outlined sound strategies called "strategic thrusts" for each area. See Batunanggar (1996) for a critical analysis of Bank Indonesia's strategic management framework and process.

18 See Batunanggar (1996 and 2002) for a detailed analysis on these issues.

3.2 Post-Crisis (1998 to Present)

As part of the policy for the restructuring of the banking sector, Bank Indonesia introduced a number of programmes to enhance the effectiveness of banking supervision (see Figure 2). The improvement of banking supervision is intended to meet the following objectives: (i) provide flexible and responsive supervision; (ii) foster consistency, coordination, and communication among bank supervisors; (iii) provide comprehensive and objective assessment of the bank's risks and performance; and (iv) promote the safety and soundness of the banking industry.

To meet the above objectives, Bank Indonesia carried several initiatives, including the adoption of a risk-based supervisory approach and prudential regulations that encourage banks to enhance their risk management practices; development of risk assessment system to encourage judgment and analytical thinking as well as provide consistent results; and the introduction of a framework to assess financial system stability. The new risk-based framework focuses on supervisory activities to assess the adequacy of banks' risk management – in identifying, measuring, monitoring and controlling risks – particularly in respect of the high risk areas in the bank operations.

Since July 2000, Bank Indonesia carried out intensive surveillance of the major banks by placing an on-site supervision team in each of the banks to ensure that they were well managed and did not pose a high risk to the stability of the banking system. The "on-site presence" teams apply a risk-based approach in analysing and monitoring the banks' condition[19].

Effective risk management has always been central to the conduct of safe and sound banking activities. It becomes even more important as product innovation, and the size and complexities of financial transactions transform the financial landscape and the nature of banking markets. The regulation and guidelines for commercial banks on risk management were issued in mid-2003 to improve the effectiveness of bank's risk management and to ensure that bank's business is conducted in a safe and sound manner. The introduction of the risk management initiative is in line with the implementation of the new Basel Accord.

To integrate and reinforce the various regulatory and supervisory improvement initiatives, Bank Indonesia developed the Indonesian Banking Architecture (IBA) in 2004. The IBA is a comprehensive framework for the Indonesian banking system which sets direction and structures for the banking industry over the next five to ten years. The IBA's action plans include the improvement of bank's risk management, infrastructure and customer education as well as improvement of banking supervision (see Figure 20 in the Appendices).

The risk-based supervision guidelines for bank supervisors were also issued in mid-2003. The guidelines are aimed at assisting bank supervisors in applying the new approach, especially in planning and scoping the examination according to the size, risks and complexities of bank's activities as well as in focusing attention and resources on the higher risk areas of the bank's operations. Furthermore, a risk assessment system was developed in

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[19] See Batunanggar, et al (2001) for detailed information on "On-site Supervisory Presence".

December 2003. Central to this new approach is changing the bank supervisors' paradigm and behavior from a compliance-based approach toward a risk-focused approach.

Figure 2
Regulatory and Supervisory Reforms Post-Crisis (1998 - Present)

Period	Initiative	Key Measures
Post-Crisis 1998 - present		
1998	Reorganisation of Banking Supervision Units	• Reorganisation of the banking supervision units from "dedicated teams" to a separate structure of on-site and off-site supervision units. The rationale of this change was a belief, under the previous structure, the bank supervisor was too close to the bank, that it could create moral hazard.
1999-2000	Bank Restructuring	• Bank restructuring programme, including closure of unviable insolvent banks and recapitalisation of "systemically important" and viable insolvent banks.
2000-present	Prudential Regulations	• Introduction of prudential measures included bank business plan, fit and proper test for bank's management and controlling shareholders, improvement of bank's asset quality classifications and provisioning, financial disclosures, legal lending limit,capital adequacy requirement, and bank exit policy.
2000	Intensive Surveillance on Major Banks	• Intensive surveillance on major or "systemically" important banks by placing On-site Supervisory Presence Team at each bank to assess and monitor bank's risks as part of the efforts in maintaining banking system stability.
2003	Risk Management	• Introduction of risk management for banks to ensure that bank's business is conducted in a safe and sound manner.
	Risk-based Supervision (RBS)	• Development of RBS framework, risk assessment system and guidelines. • Improvement of supervisory CAMELS rating.
	Capacity Building for Bank Managers and Supervisors	• Introduction of a compulsory risk-management-certification programme for bank's managers and supervisors. • Training and certification programme for bank supervisors and bank researchers.
2004-present	Indonesian Banking Architecture (IBA)	• Set direction and framework for the banking industry over the next five to ten years. It is aimed in building a sound and efficient banking system to create financial system stability for the promotion of national economic growth.
2005-present	Preparation of Basel-II Implementation	• Development of implementation plan, consultative papers and regulations, performing Quantitative Impact Studies, and formation of Working Groups with banks. Gradual implementation by all banks, starting 2008 with the simplest methods.
2006	Investigation Unit	• Establishment of Investigation and Mediation Directorate responsible for investigating indication bank's criminal cases, e.g. fraud.
2006	Reorganisation of Banking Supervision Units	• The separate on-site teams and off-site teams were integrated back into "dedicated teams" to improve coordination, resource allocation and supervisors' understanding of bank. • A group of Specialist Bank Supervisors responsible for examining specific areas, such as market risk, credit risk, and IT.
Source: Bank Indonesia (various reports) and Batunanggar (1996) for pre-crisis period.		

3.3 Organisational Structure of Banking Supervision

A proper organisational structure is necessary to support an effective banking supervision. Therefore, it is useful to survey the development of the organisational structure of banking supervision in Bank Indonesia. In 1994, Bank Indonesia reorganised the structure of its banking supervision units into a "dedicated structure" which integrated on-site and off-site supervision units. Central to the integrated structure was the importance of capacity building for bank supervisors, including the development of specialist bank examiners, e.g. IT examiners.

The integrated structure was changed in 1998 on the belief that, under this structure, bank supervisors became too close their banks with the consequent loss of objectivity. However, the separate structure has inherent fundamental weaknesses, including ineffective coordination of off-site units with on-site units – which were coordinated under different Deputy Governors – and inefficient human resource allocation. This condition hinders bank supervisor to know their bank better since the number of bank supervisors was limited compared to number of banks.

Recently, after careful reconsideration of the strengths and weaknesses of the supervisory approaches, Bank Indonesia reorganised its the bank supervision structure and brought back the integrated model to improve the efficiency and effectiveness of coordination and human resource allocation as well as facilitate the bank supervisors' understanding of the condition and problems of the banks under their supervision. A group of Specialist Supervisors responsible for examining specific areas, such as market risk, credit risk, and information technology, was also created. It remains to be seen whether the close proximity to the banks would re-emerge as a problem. This potential problem could be alleviated by more frequent staff rotation and establishment of an independent review function.

However, the reorganisation still taps only the structure (the "hard" elements) while other important other elements, namely, staff, skills, styles and culture not yet developed. To be effective, the "soft" elements of the organization, including organisational culture and incentive systems, should be developed through a comprehensive and consistent change management.

4. Problem Banks Identification

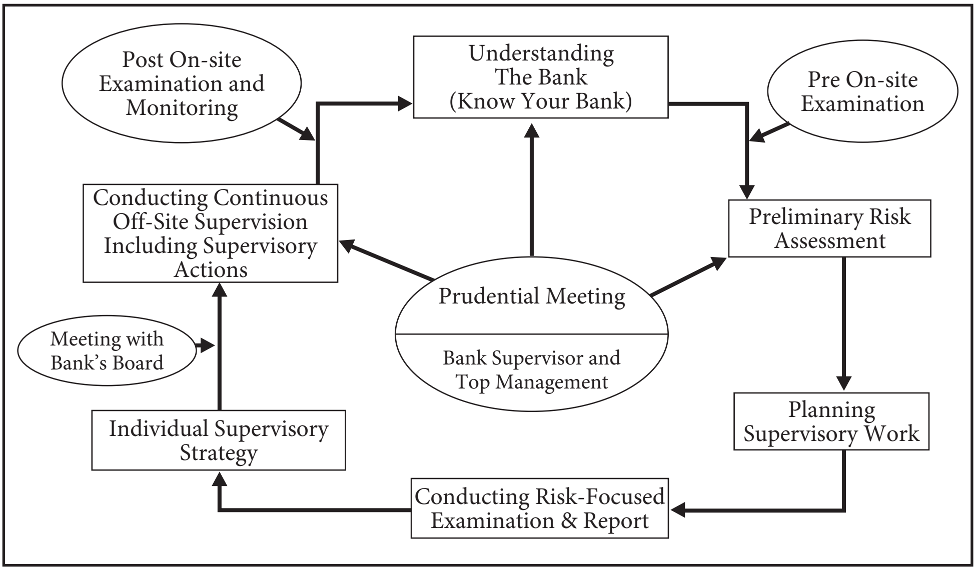
One of the most challenging tasks of the bank supervisor is identifying and responding rapidly to the symptoms and root-causes of problems that may not yet be obvious to the bank management. As part of its on-going supervisory strategy, Bank Indonesia adopted several instruments, including off-site analysis, on-site examination, early warning systems (EWS) and external auditors, for the purpose. However, the EWS was developed later in 1991, while the external auditors mainly functioned only after the crisis.

4.1 Supervisory Risk Assessment Systems

The framework for risk-focused supervision contains a series of supervisory activities that center on the supervisor's understanding of the bank and dialogue with the bank's management. The key activities are illustrated in Figure 3.

At any stage of the supervisory cycle, the bank supervisor can initiate prompt corrective action, especially if they should find the existence of potential problems endangering the viability of the bank.

Figure 3
The Risk-based Supervisory Cycle



Bank Indonesia utilises two complementary supervisory rating systems to assess the overall health of the individual banks, and the quality of their risk management practices. These rating systems are CAMELS and Risk Assessment System outlined below.

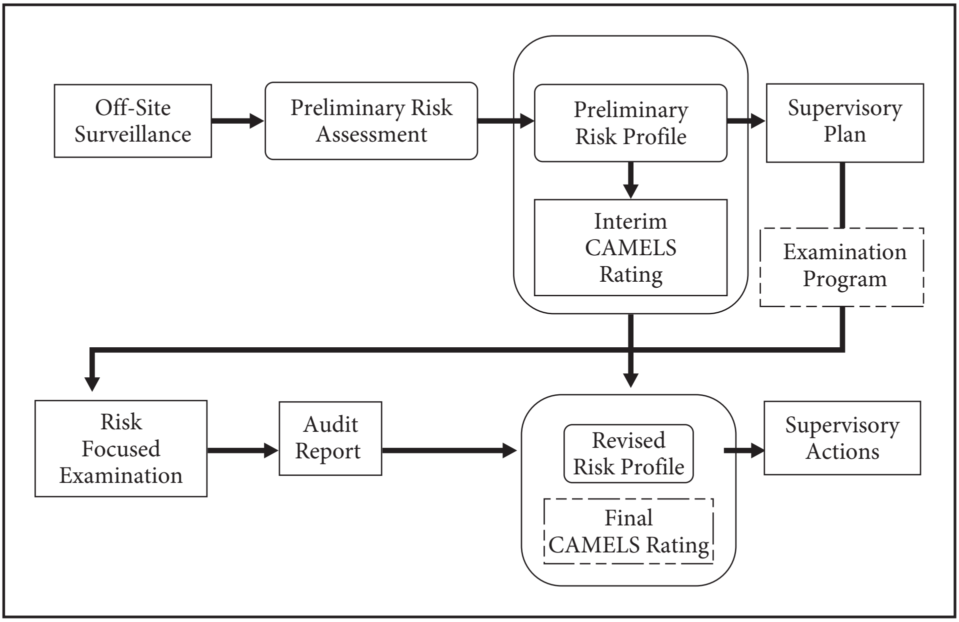
4.1.1 CAMELS Rating System

CAMELS – stands for Capital, Assets Quality, Management, Earnings, Liquidity, and Sensitivity – is a uniform rating system commonly used by bank supervisors. This rating system provides an overall composite rating score for a bank as well as separate rating scores for each of the six areas of assessment on a scale of 1 (best) to 5 (worst). These indicators provide the bank supervisors a set of standard criteria with which to conduct bank examination and to categorise banks and diagnose their weaknesses on the basis of the assessment.

Bank Indonesia adopted the CAMEL rating system in 1991, and subsequently upgraded the rating system to CAMELS in 2004, adding sensitivity to market risk. The CAMELS rating framework is illustrated in Figure 4.

The CAMELS rating is normally performed annually since a bank is generally examined once a year. In the case of problem banks, i.e. banks with CAMELS ratings of 4 or 5, their ratings may be assessed more frequently, as these banks are subject to more frequent on-site examinations. However, the CAMELS rating tends to be prescriptive and sets the boundaries for risk analysis. In addition, it is often based on off-site supervisory information which usually has a time lag and its accuracy is highly dependent on the integrity of the bank's data and management information system. Thus, the challenge is developing a system which provides both structure and consistency, while allowing room for flexibility, judgment and analytical thinking.

Figure 4
CAMELS Rating Framework



4.1.2 Risk Assessment System

In line with the implementation of risk management for commercial banks in 2003, Bank Indonesia developed a Risk Assessment System (RAS) as an integral part of a risk-based supervision cycle. The RAS provides an enhanced method of identifying, measuring and communicating the degree of bank's risks (low, moderate, high), the quality of risk management (weak, acceptable, strong) as well as the direction of risks (decrease, stable, increase). The RAS encourages bank supervisor's judgment. It is a forward-looking tool which provides not only the bank's current risk profile, but also the direction of the bank risks that is valuable in developing supervisory plans for problem banks.

There are some interesting issues regarding the application of CAMELS rating and the RAS by bank supervisors. First, at the outset of its implementation, the bank supervisor tended to use the quantitative measures and avoid making judgments. This was mainly due to the lack of knowledge and skills as well as information on the bank's condition. Consequently, efforts have been made to enhance the bank supervisors' capability in performing qualitative analysis and making judgment by improving their capability and supervisory core processes, including the reorganisation of the banking supervision unit which integrated off-site with on-site examination in 2006. However, there are still flaws in the current CAMELS rating and the RAS. As mentioned above, CAMELS tends to be prescriptive and information delayed. The RAS, on the other hand, is too focused on quantitative indicators, and tends to be mechanistic. In addition, both systems are repetitive which result in inefficient use of resources and a potential cause of confusion.

Bank Indonesia has reviewed its risk-based supervision and developed plans to enhance its risk-based supervisory framework and process, including measures to consolidate the CAMELS and RAS, develop and equip supervisors with the skills and expertise to conduct risk assessment, create a more robust infrastructure to support supervisory process, reduce redundant and burdensome administrative supervisory tasks, and improve the training and development programme for bank supervisors.

4.2 Early Warning Systems and Other Indicators

The use of early warning systems and other indicators are essential in bank supervision. The early warning systems assist supervisors to monitor trends that may signal problems and trigger plan and target supervisory activities.

The bank supervisors have been using early warning signals and other monitoring tools since 2002. Bank performance analysis and stress testing of the bank's business plan are the predictive tools used for assessing the implication of bank loan growth on bank solvency. Bank Indonesia is currently developing a model for projecting bank performance to identify potential problem banks.

4.3 Macro-Prudential Surveillance

To complement its supervisory approach to individual banks (micro-prudential supervision) since 2002, Bank Indonesia has also developed a framework to assess risks of the overall financial system (macro-prudential surveillance). Micro-prudential analysis focuses on the individual banks, promoting their soundness and protecting depositors, whilst macro-prudential analysis focuses on the systemic risks bearing on the financial system as a whole. The macro-prudential framework will be described in greater detail in Section 6.

Surveillance is part of the financial stability unit's task aiming at measuring the potential threats and vulnerabilities to the financial system. This will enable the appropriate actions and policies to be taken timely to minimise their negative impact on the financial system as a whole[20].

The analysis and assessment are carried out based on the series of aggregate financial and economic data gathered from various sources, both internally and externally. The tools applied consist of the Financial Soundness Indicators (see Figure 5), stress tests, and econometric model, which are more forward-looking. The threats to financial system stability is analysed focusing on the risk factors originating from inside and from outside the financial system.

Stress testing is used to analyse the potential impact of adverse macroeconomic shocks on financial stability by examining the tolerance levels of financial institutions under various economic scenarios. The methods are being refined and improved continuously in relation to developments in the domestic condition, policies and regulations, to ensure better outcomes[21].

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[20] Batunanggar (2002).

[21] See Santoso, Wimboh and S. Batunanggar (2007), for more detailed analysis.

Figure 5
Financial Soundness Indicators

Aggregated Micro-prudential Indicators	Macroeconomic Indicators
Capital Adequacy ✓ Aggregated capital ratio; Freq. distribution of CAR **Asset Quality** *Lending institution* ✓ Sectoral credit concentration ✓ Foreign currency-denominated lending ✓ Connected lending; NPL and provision; etc. *Borrowing entity* ✓ Debt-equity ratios; Corporate profitability; etc. **Management** Growth in the number of financial institutions; etc. **Earnings** ✓ RoA, RoE, Income and Expense ratios, etc. **Liquidity** ✓ Central bank credit to fin institutions; LDR; maturity structure of assets and liabilities; **Sensitivity to market risk** ✓ FX risk; interest rate risk; equity price risk; etc. **Market-based indicators** ✓ Market prices of financial instruments; credit ratings, sovereign yield spread; et. (Evans et.al, "Macroprudential Indicators of Financial System Soundness", IMF Occasional Paper No. 192, 2000.)	**Economic Growth** ✓ Aggregated growth rate ✓ Sectoral slumps **Balance of Payment** ✓ Current account deficit ✓ FX reserve adequacy ✓ External debt (incl. maturity structure) ✓ Terms of trade ✓ Composition and maturity of capital flows **Inflation** ✓ Volatility in inflation **Interest and exchange rates** ✓ Volatility of interest and exchange rates ✓ Level of domestic interest rates ✓ Exchange rate sustainability ✓ Exchange rate guarantees **Contagion effect** ✓ Trade spillovers ✓ Financiall market correlation **Other Factors** ✓ Directed lending and investment ✓ Government resource to banking system ✓ Arrears in the economy

4.4 Communicating Concerns

Communication between the bank supervisor and the bank's management is very important in problem bank supervision. An effective and frequent communication will facilitate an open and positive dialogue on bank's problems and condition, thus encourage common understanding of the bank's problems and how to solve them properly and in timely manner.

The bank supervisor can, at any time, if necessary, conduct prudential meetings with the bank senior management. The bank appoints central points of contact, who are usually the compliance senior officer, chief risk officer and internal auditor. The frequency of the meetings increases when the bank's condition gets worse, depending upon the result of the monitoring and on-site examination.

5. Problem Bank Intervention

The problem bank intervention is based on the development of a specific and viable plan for corrective actions of the problem bank and on subsequent monitoring to ensure the bank's adherence to the plan. If the corrective actions are successful, the bank returns to sound condition. If the circumstance of the bank worsens, the situation requires resolution.

Under Bank Indonesia Regulation concerning the subsequent action for supervision and designation of bank's status under the framework of risk-based supervision, Bank Indonesia classifies the supervision status of the banks in three levels, depending on a bank's risk profile and other indicators.

5.1 Normal Supervision

Bank Indonesia exercises normal supervisory oversight for all banks that are rated sound, or are well capitalised with effective risk management. Currently, the vast majority of banks in Indonesia fall under normal supervision. The framework for normal supervision is illustrated in Figure 4.

Bank Indonesia has also conducted CAMELS ratings quarterly, and as of December 2006, around 7 percent of commercial banks are categorised as poor and unsound, as illustrated in Figure 7. Banks with composite ratings of 4 (poor) and 5 (unsound) must prepare and implement action plans to improve their performance.

Figure 6
Banks' Risk Profile, December 2006

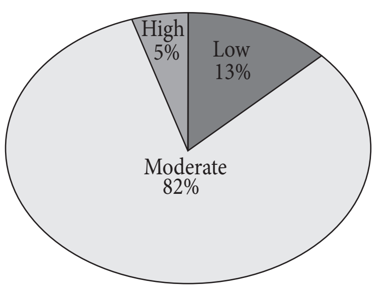
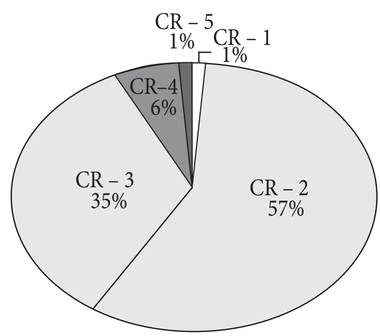


Figure 7
CAMELS Rating, December 2006



Source: Banking Supervision Report (2006), Bank Indonesia

5.2 Intensive Supervision

Bank Indonesia will apply intensive supervisory measures for banks that are deemed to have potential difficulties endangering their business operations, for instance, if there is any significant deterioration of performing loans. Banks falling into this category meet one or more of the following criteria:

(a) have net non-performing loans in excess of 5 percent of total credit;
(b) are rated poor (composite rating of 4) or unsound (composite rating of 5);
(c) are in breach of the legal lending limit and the bank's action plan is unfeasible;
(d) violate the net open position and the bank's action plan is unacceptable;
(e) suffer from structural liquidity problem; and
(f) fundamental profitability problem.

In addition, major banks with total assets above IDR10 billion are also under intensive supervision considering their significance to the financial system stability.

From a total of 130 commercial banks, including three shariah banks, there are 16 banks (13 percent) classified as under intensive supervision. Two of these banks are state-owned with net non-performing loans above 5 percent, but the trend is improving. At the end of 2007, the NPLs of the two state-owned banks are projected at below 5 percent.

5.3 Special Surveillance

Bank Indonesia conducts special surveillance of banks that are facing difficulties endangering the continuity of their business. A bank will also fall into special surveillance under the following conditions: if it does not show improvement post intensive supervision; the bank's financial conditions deteriorate; the management is incapable of turning the bank around; and, most importantly, when the bank has difficulties endangering the continuity of its business.

Based on Article 37, paragraph (1) of Banking Act: "The term bank condition deemed to have potential difficulties endangering its continued operation if based on Bank Indonesia assessment, the bank's conditions become worst such as decreasing of capital, asset quality, liquidity and profitability, and also the management of bank will not meet basic safety and soundness principles of a healthy bank". This paragraph lays the legal basis for designating banks as having difficulties endangering their existence.

Bank Indonesia has the power to place banks under special surveillance. It will designate a problem bank for special surveillance if, in its assessment, the condition of the bank is deteriorating and the sustainability of the bank's business is at risk. Bank Indonesia could use both rule-based and discretion criteria for bank intervention. However, in practice, the bank supervisors often use rule-based criteria to avoid challenge and appeal by bank's owners and management.

Banks designated for special surveillance fall under one or more of these criteria. First, if there is an insolvency problem where its capital adequacy ratio is persistently less than 8 percent. Second, the bank has fundamental and persistent liquidity problems jeopardising its operations with an indication of a worsening condition in the near future, or is considered by bank supervisor as undergoing a fundamental liquidity problem.

Banks under special surveillance are mandated by BI to undertake prompt corrective action (PCA), which includes: (i) submission of a Capital Restoration Plan (CRP) by the bank and/or the shareholders of the bank; (ii) compliance with its Mandatory Supervisory Actions (MSA); and (iii) performance of certain actions by the bank and/or the bank shareholders, such as:

(a) changing the board of commissioners and/or the board of directors;
(b) writing off credit and calculate Bank loss with the Bank capital;
(c) conducting a merger or consolidating with other bank(s);
(d) selling the bank to investors willing to take over all liabilities of the bank;
(e) delegating the management of part or all of the bank's activities to a third party;
(f) selling part or all of the assets and liabilities of the bank to other bank (s) or other investors; and/or
(g) suspending certain business activities of the bank.

Bank Indonesia will also exercise cease-and-desist order (CDO), like for instance, issuing a prohibition to the problem bank from distributing any dividend, or from conducting any transactions with a related party, and imposing restrictions on bank asset growth, and on the payment of salary, compensation, or any other form of similar payment to the management of the bank, and/or compensation for related parties.

Under the CDO, Bank Indonesia has also legal authority to forbid the bank from undertaking any change in ownership. Shareholders that retain shares equal to, or greater than, 10 percent, and controlling shareholders, including the controlling parties of the bank, cannot sell their stakes until they obtain the prior approval of Bank Indonesia. If Bank Indonesia considers the failing bank as facing serious difficulties jeopardising its business and/or posing threats to the stability of the financial system, or endangering the economy, Bank Indonesia can revoke the bank's operating license.

With the implementation of this exit policy, ten commercial banks were designated for special surveillance. Based upon their progress, six of the banks were closed due to insolvency problems, while other banks were rescued with capital injection by shareholders and change of new management.

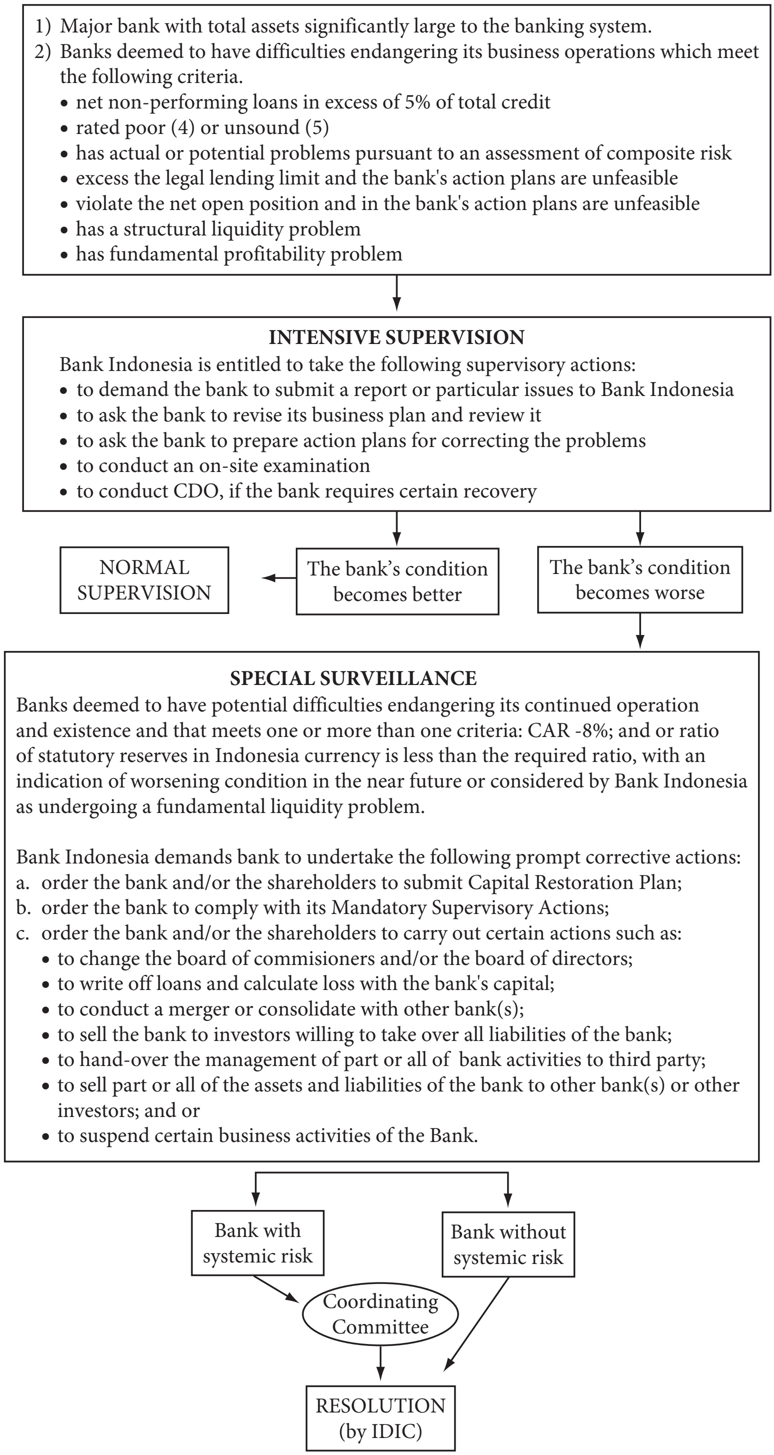
The bank's problem and corrective action plans may not always conform to the detailed procedures stipulated in the exit policy guideline. Consequently, the supervisor must make speedy decisions to ensure that the bank's problems are handled appropriately and in a timely manner. Nevertheless, there have been instances when the bank supervisors have been brought to court for closing the bank before the deadline for corrective action.

In some cases, the bank supervisors encounter difficulty in enforcing the controlling shareholders of the problem bank to carry out the agreed actions. This is mainly due to the issue of legal authority of the bank supervisor to exercise the letter of comfort issued by the controlling shareholders of the problem.

In addition, the bank supervisors face a significant challenge of law enforcement to minimise moral hazard by bad bankers. Bank Indonesia has established a dedicated unit to investigate the signs and symptoms of criminal acts, such fraud and other violations against the law. The investigation is conducted in cooperation with the Police Department and the Office of the Attorney General. However, given the prevailing weaknesses of the legal and criminal justice system and law enforcement, many of the criminal and bank fraud cases are not followed up consistently.

Figure 8 illustrates Bank Indonesia's intervention process for weak banks.

Figure 8
The Intervention Process of Weak Banks



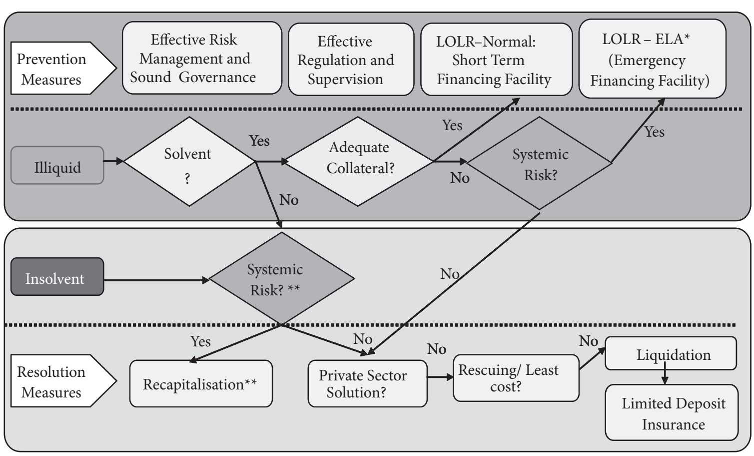
6. Problem Bank Resolution

Prior to the 1997 crisis, Bank Indonesia adopted an open-bank-resolution strategy in solving bank problems through the provision of emergency loans for both liquidity and capital purposes. It was premised on the belief that bank closure would reduce public confidence in the banking system, cause bank runs, and endanger financial system stability. Due to the weaknesses of enforcement and bank supervision, this strategy proved ineffective and created moral hazard problems. The relaxed policy on bank entry since 1988 and the absence of a bank exit policy, combined with weak banking regulation and supervision, increased the fragility of the banking system[22].

Bank Summa was the only unsound commercial bank actually liquidated in 1992 - two decades prior to the 1997 crisis. At the time, Bank Indonesia provided a limited ad-hoc deposit guarantee of Rp20 million (US$8,000), while the bank's owners shared the resolution costs. The liquidation process of Bank Summa was protracted. It reflected the inadequacies of the procedures and powers at the disposal of Bank Indonesia for dealing with a failed bank. This experience reinforced Bank Indonesia's view that bank closures should be avoided at all costs[23].

Since 2005, the resolution of failing banks is managed by the IDIC. The resolution of failing banks is classified in two categories: failing bank without systemic effect or risk, and one with systemic effect. The resolution measures for failing bank without systemic effect is determined and carried out by the IDIC under the least-cost method. The resolution for failing bank with systemic effect is determined by the Coordinating Committee. The problem bank resolution framework in Indonesia is illustrated in the Figure 9.

Figure 9
Problem Bank Resolution



* Joint Decision by Bank Indonesia and Ministry of Finance
**Decided by Coordinating Committee (Bank Indonesia, Ministry of Finance, and IDIC)

Source: Batunanggar (2007)

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22 Batunanggar (2002 and 2004).
23 See Batunanggar (2002 and 2004) and Santoso (2000).

Subsequently, the resolution of a failing bank without a systemic effect is carried out, with or without rescue, based on least cost method. Whereas the resolution of a failing bank with systemic effect is carried out by rescuing the failing bank, with or without the participation of the existing shareholders.

6.1 Resolution of Failing Banks without Systemic Risks

When a bank without systemic risk is considered insolvent – its capital adequacy ratio is less than minimum requirement (8 percent) – and the corrective actions fail, Bank Indonesia will transfer the bank to the IDIC to be resolved on the basis of the least-cost method. The IDIC may take over control of the bank, or may allow the bank's shareholders and management to execute a restructuring program, or will close the unviable bank. However, the bank closure is carried out carefully to ensure it does not affect public confidence in the banking system. The IDIC and Bank Indonesia cooperate closely prior to and following the closure to minimise the negative impact of the closure on financial systemic stability.

6.1.1 Rescuing a Failing Bank

The decision whether or not to rescue a failing bank is determined by the IDIC, weighing, at a minimum, the estimated costs of rescuing and the costs of not rescuing a failing bank. The estimated costs of rescuing a bank include the capital injections required to return the bank to solvency and restore its liquidity, while the estimated cost of not rescuing include the cost of payment of the insured deposits, advances for employee remuneration, advances for employee severance, and the projected recovery from the sale of the failed bank's assets.

The decision of the IDIC to rescue a failing bank that does not have a systemic risk is determined by the following parameters. First, the estimated cost of rescuing the bank is significantly lower than the estimated cost of not rescuing the aforementioned bank. Second, after the rescue, the bank should exhibit good business prospects. Finally, there is a statement from the General Shareholders Meeting (GSM) of the bank that, minimally, exhibits agreement to: (i) surrender the rights and powers of the GSM to the IDIC; (ii) surrender the management of the bank to the IDIC; and (iii) not to press charges against the IDIC or other parties appointed by the IDIC, if the rescue process is not successful, as long as the IDIC or any of the other parties appointed by the IDIC carry out their duties in due faith.

Then, the bank provides the IDIC with the documents pertaining to the utilisation of the funding facilities from Bank Indonesia, the financial data of debtors, the capital structure and composition of shareholders for the past three years, and other relevant information that is related to the assets and liabilities, including bank capital. After all the requirements are fulfilled, the GSM hands over all its rights and powers to the IDIC.

The IDIC then initiates the following course of action. The IDIC will occupy, manage and foreclose the assets that belong to, or become the subjective rights and/ or liabilities of the bank; make temporary capital placements; and sell and/or transfer the assets of the failing bank, without debtor consent, and/or the bank's liabilities without creditor consent. Additionally, the IDIC will hand over the management of the bank to other parties; merge or consolidate with other banks; transfer the bank's ownership; and review, annul, terminate, and/or alter any contracts between the failed bank and third parties that are burdensome to the bank.

Further, all funds injected by the IDIC to rescue the bank will become the IDIC's temporary capital placement in the bank. If, at the time of surrender to the IDIC, the bank's equity is positive, the IDIC and the former shareholders will sign an agreement that governs the proceedings of the sale of the rescued bank's shares. If the bank's equity is zero or negative at the time of surrender to the IDIC, the former shareholders' have no rights upon the sale of the rescued bank's shares. Its agreement determines the use of the proceeds from the sale of the rescued bank's shares.

6.1.2 Closure a Failing Bank

In the event the bank fails to meet the agreed terms and conditions, or if the IDIC decides not to continue with the bank rescue, the IDIC will request Bank Indonesia to revoke the licence of the bank in accordance with the prevailing laws and regulations. Hence, the IDIC will pay the insurance claim to the depositors of the bank whose licence was revoked.

6.2 Resolution of Failing Banks with Systemic Risks

6.2.1 With Capital Injection by the Shareholders

The IDIC handles a failing bank with systemic risk by involving the shareholders participation (open-bank assistance). This measure may only be implemented if the shareholders of the failing bank injects a minimum of 20 percent capital of the estimated handling cost, and provides a GSM agreement to surrender to the IDIC the rights and powers of the GSM and the management of the bank, and not to press charges against the IDIC or any other parties appointed by the IDIC in the event the resolution is unsuccessful, as long as the IDIC and any of the other parties appointed by the IDIC have performed their duties in good faith.

In the event that a bank's equity is positive, after the former shareholders inject temporary capital, the IDIC and the former shareholders will sign an agreement to govern the proceeds of sale of the bank's shares. Meanwhile, in the event that the bank's equity is zero or negative after the former shareholders inject capital, the former shareholders have no rights upon the sale of the bank's shares.

6.2.2 Without Capital Injection by the Shareholders

If the failing bank on its own is unable to achieve a turnaround to recover its position, the IDIC will intervene without the shareholders' participation. It will take over all the rights and powers of the GSM, the title of ownership, management, and/or other interests on the bank. The IDIC, or any other parties appointed by the IDIC for the rescue operation, are accorded protection under the law from any legal suits by the shareholders and the bank management in the event of unsuccessful resolution, as long as the IDIC and the other parties appointed by the IDIC have carried out their duties in good faith.

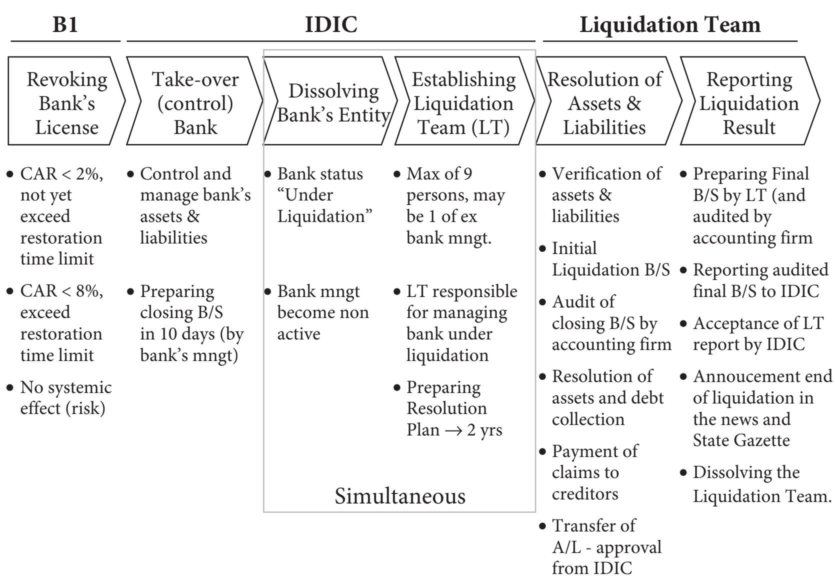
After the IDIC has taken over all the rights and power of the GSM, the title of ownership, management, and/or other interest on the bank, it can carry out the resolution actions. Further, all the funds injected by the IDIC to handle the failing bank will become the IDIC's temporary capital placement in the bank.

6.3 Liquidation of Failing Banks

The primary objectives of bank liquidation are to ensure the maintenance of financial system stability, the preservation and optimal collection of the liquidated bank's assets, and recovery by creditors of as much of their investments or deposits as possible. A clear legal framework and procedures are required for effective bank liquidation. The absence of an effective legal framework could cause disorderly closure and increase the risk of contagion with systemic implications.

As illustrated in Figure 10, in liquidating a failed bank whose license has been revoked, the IDIC will undertake the following course of action, including the provision of advance payment for the accrued and unpaid staff remuneration and separation pay, initiation of the necessary actions in order to preserve the asset of the bank prior to the liquidation process, decision to dissolve the bank's legal entity, appointment of a liquidation team, and announcement of the bank's status as under liquidation. The IDIC must dispose of banks' shares within a period of two years for a bank that is not systemically important and three years for problem bank with systemic risk. It could be renewed for no more than two additional years.

Figure 10
Bank Liquidation Process in Indonesia



Source: Batunanggar (2007)

7. Crisis Management[24]

The experience of Indonesia in problem bank resolution and crisis management can be studied through three periods. First, was the period prior to the 1997 crisis, where open bank resolution and emergency liquidity facility assistance were practiced. Second, was the period during the 1997 crisis, in which there was system-wide banking restructuring. Third, is the current period since 2004, with the introduction and development of financial safety nets and crisis management. The key measures taken during those periods are summarised in Figure 11.

7.1 Financial Safety Nets Prior to 1997-1998 Crisis

Prior to the 1997 crisis, Bank Indonesia adopted an open-bank-resolution strategy in solving bank problems through providing emergency loans both for liquidity and capital support. The support was not based on any pre-existing formal guarantee mechanism, but rather on a belief that some of the banks that needed support were too big to fail, or the failure of a bank could cause contagion[25]. However, the open bank resolution strategy proved ineffective and created moral hazard problems. The absence of a clear bank exit policy, combined with weak law enforcement and banking supervision, increased the fragility of the banking system.

7.1.1 Deposit Insurance

The plan for establishing a deposit insurance scheme was discussed quite intensively since the early 1990s. However, the authorities declined the proposal because they considered that it would create moral hazard. A limited deposit guarantee in Indonesia was first applied when the authorities closed down Bank Summa at the beginning of the 1990s. The case was considered unsuccessful[26].

7.1.2 Lender of Last Resort

Under its old Law of 1968, Bank Indonesia was authorised to provide emergency loans to banks facing critical liquidity problems[27]. However, there were no well-defined rules and procedures to regulate the operation of this function.

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[24] This section is drawn largely from Batunanggar (2002, 2003, 2004 and 2006)

[25] Before the 1997 crisis, none of the East Asian crisis countries except the Philippines, which was least affected by the crisis, had an explicit deposit insurance scheme

[26] The plan for establishing a deposit insurance scheme has been discussed quite intensively since the early 1990s. However, the authorities declined the proposal because they considered that it would create moral hazard.

[27] The previous BI's Law (1967) set BI's status as a "dependent" agency providing assistance ot the Government in carrying out monetary, banking and payment system policies. The current BI's Law (1999) establishes its independence from political intervention.

Figure 11
Problem Bank Resolution and Crisis Management in Indonesia

Period and Measures	Features
Prior to the 1997 crisis • Open Bank Resolution • Liquidity and Solvency Support	• Bank Indonesia (BI) supported either illiquid or insolvent banks to avoid bank closure • BI encouraged banks to consolidate and or merge
During the 1997 crisis • First Round Closures of 16 Small Banks • Establishment the Restructuring Agency • Blanket Guarantee • Special Surveillance of 54 banks • First round take over of 7 banks and round closure of 7 banks • Third Round closure of 3 banks formerly taken-over • Second Round Taken Over of Bank Central Asia (BCA) • Due Diligence of 119 banks • Mega Merger 4 state-owned banks • Recapitalisation Programme	• Government, including BI provided limited deposit guarantees • The closure criteria and the process was not communicated well to the public • Indonesian Banking Restructuring Agency (IBRA) is established to restructure problem banks and to act as an assets management company • IBRA took over 54 problem banks • IBRA suspended shareholders' rights and changed their management • The operations of these banks were frozen while their deposits transferred to selected state-owned banks • IBRA frozen three banks taken over while their deposits transferred to selected state-owned banks • BCA, the largest domestic private bank, was taken over by IBRA • IBRA suspended shareholders' rights and changed their management • Diagnostic review of bank's condition; banks are categorised by their capital adequacy ratio to be Bank "A", "B", "C". • Bank Mandiri was established as result of merger BBD, BNI, Bank Exim and BAPINDO • Business Plan Preparation and Business Plan Review • Fit and Proper Tests
2004 - present • Exit Policy • Financial Safety Nets and Crisis Management	• Lender of the last resort, for normal times and systemic risk • Establishment of IDIC and adoption of limited insurance scheme • Exit policy for unfeasible failing bank • Interagency Coordination (Coordinating Committee and Financial Stability Forum: Bank Indonesia, MoF, IDIC).

Source: Batunanggar (2007)

7.2 Crisis Management during the Banking Crisis

7.2.1 Emergency Liquidity Support

During the 1997 crisis, Bank Indonesia provided liquidity support to problem banks in order to prevent the collapse of the banking system and to maintain the payments system. The deterioration of confidence in the banking system, coupled with political uncertainties and social unrest, caused severe bank runs with the contagion spreading from perceived unsound banks to sound ones. As the crisis intensified, the amount of overdraft facilities increased from Rp31 trillion in December 1997 to Rp170 trillion in December 1998. The large budgetary cost that this entailed created tension and distrust between Bank Indonesia and the government, particularly over the accountability of Bank Indonesia in providing the emergency liquidity support.

7.2.2 Bank Closures and Deposit Guarantee

With the closing of Bank Summa in 1992, there were no bank closures until the authorities closed down 16 banks in November 1997 and introduced a limited guarantee. The initial bank closures, unlike in Korea and Thailand, failed to regain confidence in the government and the banking sector and even prompted a more intensive bank-run.

To maintain public confidence in the banking system, the government issued a blanket guarantee on 27 January. It covered all commercial banks' liabilities (rupiah and foreign currency), including both depositors and creditors.

Several observers [Nasution (1999), Radelet and Sachs (1999), Batunanggar (2002 and 2004)] argued that the first bank closure was poorly managed, and thus, failed. They argued that the bank closures should not have been made in the middle of a panic without a detailed plan for restructuring the financial system. The IMF's initial programme failed to include provisions for deposits insurance, management of the performing and non-performing assets of these banks, or measures for securing and strengthening the rest of the banking system. This was apparently admitted later by the IMF in an internal document[28].

From November 1997–2000, there were six major rounds of intervention taken by the authorities, including both "open bank" resolutions and bank closures: (i) the closure of 16 small banks in November 1997; (ii) intervention into 54 banks in February 1998; (iii) the take over of 7 banks and closure of another 7 in April 1998; (iv) the closure of four banks previously taken over in April 1998 and August 1998; and (v) the closure of 38 banks together with a take over of 7 banks and joint recapitalisation of 7 banks in March 1999; and (vi) a recapitalisation of six state-owned banks and 12 regional banks during 1999 – 2000[29].

7.2.3 The Bank Restructuring Programme

The main objective of the bank restructuring programme was to overhaul the banking system and enable the financial intermediation of banks to function as efficiently and quickly as possible. The resolution of financial crises is typically carried out in three sequential steps: (i) a diagnostic review; (ii) a resolution of non-viable institutions and recapitalisation of viable ones; and (iii) a resolution of non-performing loans.

Essentially, bank restructuring consists of two elements: (i) financial restructuring, including capital injection and loan restructuring; and (ii) operational restructuring comprising the improvement of a bank's internal organization, such as its operational efficiency, governance, risk management and control. Generally, the approaches adopted in Korea, Thailand, Indonesia (Figure 13), and Malaysia are similar.

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28 "IMF Now Admits Tactics in Indonesia Deepened the Crisis", New York Times, 14 January 1998.

29 See Batunanggar (2002 and 2004) for detailed information and analysis.

Figure 12: Diagnostic Review - Good Bank, Bad Bank
As an initial step in the bank restructuring programme, Bank Indonesia, assisted by international auditors, performed due diligence (a financial review) on all Indonesian-owned banks in order to determine the solvency and the costs of recapitalisation. It was started in August 1998 and completed in December 1998. An examination of all foreign-exchange commercial banks including state-owned banks was performed by international auditors, while the non-foreign exchange banks were examined by Bank Indonesia's supervisors. These assessments focused on the banks' portfolio to determine solvent (good) and insolvent (bad) banks, based on strict loan quality assessment and provisioning. It was followed by a discussion with the banks' directors and commissioners in order to communicate the findings as well as the banks' status and follow-up actions that the banks should be take in line with the recapitalisation programme. The due diligence exercise categorised banks into three groups, according to their capital-adequacy ratio (CAR): (i) solvent "A" banks with CARs of 4 percent or more; (ii) insolvent "B" banks with CARs from -25 percent up to less than 4 percent; and (iii) highly insolvent "C" bank with CAR less than -25 percent. The B and C banks were required to prepare and submit business plans to Bank Indonesia as part of a joint recapitalisation programme. In addition, their shareholders were also required to inject a minimum of 20 percent of required capital to meet CARs of 4 percent. While the "A" banks could operate normally, they were required to prepare a business plan in order to improve their performance. The viability of a bank for a joint recapitalization programme was determined by committees with representative members from Bank Indonesia, IBRA and the Ministry of Finance.

The Result of Due Diligence on Commercial Banks (13 March 1999)

Group of Banks	A Category CAR > 4%	B Category -25% < CAR < 4%	C Category CAR < -25%	Total
State-owned banks	–	–	7	7
Regional Development Banks	15	8	4	27
National Private Banks	74	16	38	128
Joint-venture Banks	30	–	2	32
Total	119	24	51	194

Source: Batunanggar (2002 and 2004)

As part of the bank restructuring programme, the government announced a bank recapitalisation programme. There were two types of bank recapitalisation: self-recapitalisation carried out by the bank owners alone or with new strategic investors; and joint recapitalisation between the bank owners, investors and the government. The latter required some criteria that must be met by the banks, including the obligation to inject additional capital (minimum of 20 percent of required capital to meet capital-adequacy ratio (CAR) of 4 percent), a viable business plan, and fitness and probity of the banks' controlling shareholders and management (Figure 13).

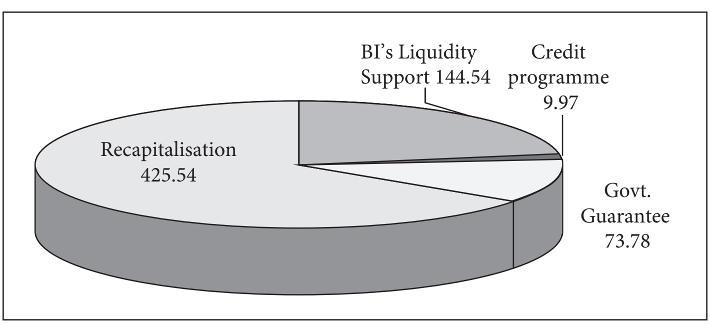
Further, if an insolvent bank was considered to have a significant role in the economy[30] it was taken over by the government (IBRA), and/or merged with another bank. The objectivity of this additional criterion in practice, however, is debatable. Insolvent banks that failed to meet these criteria were frozen and then later liquidated. Then, the government announced the results of the due diligence review and assessment on the viability of banks to be included in the joint recapitalisation programme.

[30] Mainly based on the number of deposit accounts.

Figure 13: The Criteria of Recapitalisation Programme
The eligibility of a bank for joint recapitalisation was primarily based on two main aspects: (1) the viability of a bank's business plan; and (2) the fitness and probity of bank's management and controlling shareholders. The assessment was conducted by several committees (Technical Committee, Evaluation Committee, and Policy Committee) representing Bank Indonesia, Ministry of Finance and IBRA. To ensure transparency and objectivity, independent observers representing the IMF, World Bank, and the ADB were invited to the meeting, but without any rights over the decision-making process. **I. Business Plan Review** **a. Main criteria**, included: • ability of bank's shareholders and/or new investors to inject minimum of 20 percent funds to meet a 4 percent CAR, • compliance with the existing regulations (legal lending limit, net open position, etc.), • bank's viability to meet CAR of 8 percent at end of 2001, based on a stress test model. **b. Additional criteria**, included: • asset rehabilitation plan, business development plan, franchise values (networks, IT/IS) and significance to the economy, projected ROE 15 percent at the end of 2001. • A bank will pass the business plan review if it meets at least all these main criteria. **II. Fit and Proper Test** The fit and proper test was conducted on the banks' controlling shareholders (owners of more than 25 percent of the shares), board of commissioners, and board of directors. The fit and proper test consists of: • Fitness Test – the competence and independence of bank's board of commissioners and directors. • Propriety Test – integrity, fulfillment of commitment to BI, enlistment of bad debts and/or other imprudent fraudulent actions committed by the bank's management and controlling shareholders.
Source: Batunanggar (2002 and 2004)

Indonesia's banking crisis was the most severe in East Asia and one of the costliest of the last quarter of the twentieth century. Figure 14 shows that the fiscal costs amounted to Rp654 trillion or 51 percent of GDP to rehabilitate Indonesia's banking system.

Figure 14
Indonesia's Fiscal Cost of Banking Crisis Resolution
(in trillion rupiah)



Source: Batunanggar (2002 and 2004), Bank Indonesia

Batunanggar (2002 and 2004) argued that the crisis resolution suffered from two main problems: (i) a lack of understanding on the part of the IMF and on the part of the authorities in handling the crisis, which resulted in the adoption of inappropriate strategies both at the macro and micro level; and (ii) a lack of government commitment to take consistent and objective measures. To be effective, the resolution process should be carried out in an objective, transparent, and consistent manner in order to restore the health of the financial system and of the economy. Batunanggar derived ten key lessons learned from Indonesia's banking crisis. They are summarised in Figure 15.

Figure 15: Key Lessons Learned from Indonesia's Banking Crisis Resolution

(1) Open bank resolution strategy and implicit guarantees (are not effective measures for bank resolution.

(2) Political intervention and a lack of commitment to resolve the crisis disrupts the resolution process and aggravates the situation, where inconsistent policies and a reluctance to address the core problems and take tough decisions hinder the effectiveness of crisis resolution.

(3) Bank closure should be executed rapidly but with a well-devised strategy, including a contingency plan consisting of a worst-case scenario and risk-mitigation strategy to prevent and/or to resolve the problems.

(4) Bank restructuring policies should be transparent, uniform and implemented consistently.

(5) A blanket guarantee is important, but should only be used as temporary measure in crisis resolution.

(6) A transparent and clearly defined lender-of-last-resort (LLR) policy and procedures are required for crisis management, in particular, in a systemic crisis environment.

(7) A combination of micro and macroeconomic policies is required for an effective crisis management, in particular, if the currency crisis and banking crisis occur simultaneously.

(8) Effective cooperation between the related institutions is necessary for effective crisis prevention and resolution.

(9) Institutional capacity is an important aspect of crisis management. The ability to acknowledge the extent of a crisis early and to devise proper resolution strategies is essential.

(10) Prudential banking regulation and supervision is a principal element in creating and maintaining financial system stability.

Source: Batunanggar S. (2002 and 2004)

7.3 Banking Crisis Management in the Post Crisis

Based on the Central Bank Act, Bank Indonesia is permitted to perform only a very limited role as lender of last resort. Bank Indonesia can only provide limited LLR in normal times to banks (for a maximum of 90 days) that have high quality and liquid collateral. The collateral could be securities, or claims issued by the Government, or other highly-rated legal entities, which can be readily sold in the market. In practice, government recapitalisation bonds and Bank Indonesia Certificates (SBIs) are the only eligible assets currently available to banks. The facility serves like a discount window, which the central bank routinely opens at all times to handle normal day-to-day operational mismatches which might be experienced by a bank. However, the facility does not constitute a LLR function typically used to provide emergency liquidity support to the financial system during crisis periods (i.e. when banks usually do not have high quality collateral).

Two strategic measures have been adopted as part of a comprehensive crisis management strategy. The government blanket guarantee is replaced with an explicit deposit insurance scheme, and the lender of last resort (LLR) facility redesigned.

7.3.1 Explicit and Limited and Deposit Insurance Scheme

The government blanket guarantee programme, which came into effect because of the crisis, has indeed been successful in recovering public confidence in the banking sector. However, research shows that the blanket guarantee has contributed to moral hazard by bank managers and customers, and has the potential to create crises in the long-run.

In order to prevent any negative impact on financial stability, the implementation of the deposit insurance scheme was made in stages. The entire liabilities of banks were guaranteed by the IDIC up to March 2005. Then, starting from March 2007, the deposit insurance was limited to up to Rp100 million per customer per bank. In the event of bank failure, the IDIC will insure customer deposits up to a certain amount, while non-insured deposits will be resolved through the bank liquidation process. The IDIC is expected to preserve public confidence in the Indonesian banking industry.

A Memorandum of Understanding between Bank Indonesia and IDIC is being prepared to facilitate effective coordination and information exchange between the two organizations. As mentioned earlier, deposit insurance is one element of financial safety nets. For it to be implemented effectively, it must be supported by other nets, especially effective banking supervision.

7.3.2 Emergency Liquidity Assistance for Systemic Crisis

Bank Indonesia (BI) in its capacity as lender of the last resort may provide a loan to a bank to resolve a short-term funding difficulty. The lender-of-last resort policy is part of the financial safety net essential to financial system stability. As a lender of last resort, Bank Indonesia may give loans to commercial banks for both normal times and systemic crises, in order to solve liquidity problems. In principle, liquidity facility could only be provided to solvent banks.

There are two types of lender-of-last resort facilities extended by BI to commercial banks. First, is the Short-Term Funding Facility (FPJP), which is extended to banks experiencing liquidity difficulties at end of the day (overnight) to resolve liquidity difficulty under normal conditions. Provision of the FPJP must be backed by provision of liquid, high value collateral by the bank to Bank Indonesia. Second, is the Emergency Financing Facility (EFF) for a problem bank that is facing liquidity difficulty that has systemic impact, but still meeting the level of solvency prescribed by Bank Indonesia.

The EFF is a facility for addressing systemic impact or risk in an emergency in order to prevent and resolve a crisis. The extension of this facility is jointly decided by the Minister of Finance and the Governor Bank Indonesia, and is funded at the expense of the government. The decision to extend the EFF shall be based on the assessment of the potential threat of systemic risk to financial system stability and the negative impact on the economy, if the EFF is not extended to the bank. The funding for the EFF is charged to the state budget through the issuance of government securities. However, the requirements on solvency and collaterals, with several exceptions, are still applicable.

A Memorandum of Understanding between the Minister of Finance and the Governor of Bank Indonesia has been signed spelling out the stipulations and procedures for decision making in the handling of problem bank that has systemic impact, provision of the emergency financing facility, and for the financing source from the state budget. In implementing the guidelines, the Ministry of Finance and BI issued regulations governing the extension of the EFF for commercial banks that was incorporated into the Minister of Finance Decree and BI regulation.

The key challenge relating to the extension of EFF is ensuring consensus that Bank Indonesia and the Ministry of Finance reach agreement about the systemic risks and the prompt and appropriate action to take.

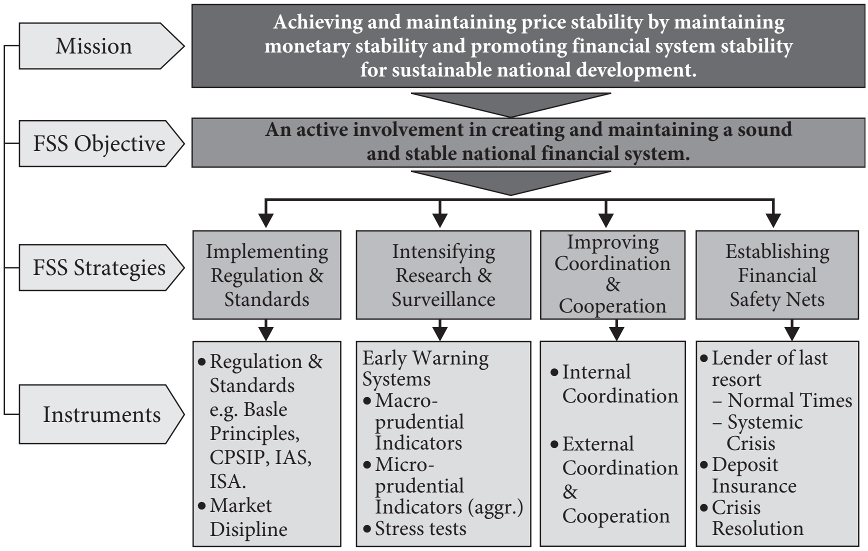
7.3.3 Strengthening the Financial System Stability

Maintaining the stability of the financial system requires concerted efforts from the various authorities. Therefore, effective coordination and cooperation is urgently required in response to potential instability and systemic crises that frequently require mutual policy-making and harmonisation of policy issues.

In line with its mission of maintaining monetary stability, Bank Indonesia plays an active role in maintaining financial system stability. In maintaining financial system stability, Bank Indonesia adopts four major strategies (i) implementing regulations and standards, including the fostering of market discipline; (ii) intensifying research and surveillance on the financial system; (iii) improving effective coordination and cooperation between the relevant institutions; and iv) establishing financial safety nets, including lender of last resort, both for normal times and systemic crisis, explicit and limited deposit insurance scheme, and crisis management. (See Figure 16)

To bolster financial system stability, the government and Bank Indonesia have prepared a comprehensive Financial Safety Net (FSN) framework. The FSN framework clearly defines the objectives and elements of the FSN, roles and responsibilities of the relevant authorities, and a coordination mechanism linking the authorities. The FSN has four elements: (i) effective supervision and regulation; (ii) lender of last resort; (iii) deposit insurance; and (iv) effective crisis management. Currently, a task force comprising the staff members of the Ministry of Finance, Bank Indonesia, and the IDIC, is drafting the FSN Law. The law will provide a solid legal framework empowering the respective authorities to perform crisis management to preserve financial stability.

Figure 16
Bank Indonesia's Financial System Stability Framework



On 30 December 2005, the Minister of Finance, the Governor of Bank Indonesia, and the Chairman of the DIC signed a joint decree to establish the Financial System Stability Forum (FSSF), a vehicle for the coordination and sharing of information among the authorities. The FSSF is expected to improve coordination between the authorities and, consequently, bolster efforts to preserve financial system stability.

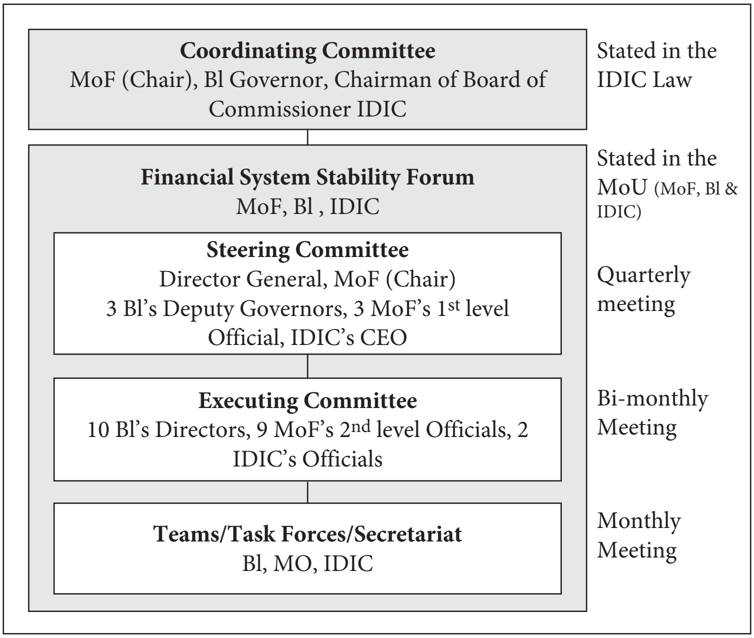
The main responsibility of the FSSF is to provide recommendations to the Coordinating Committee – consisting of the Finance Minister, the Governor of Bank Indonesia and the Chairman of IDIC – who is responsible for determining the resolution measures for failing bank with systemic risk[31].

The FSSF has four main functions: (i) support the responsibilities of the joint committee in the decision-making process for failing banks that has systemic risk; (ii) coordinate and share information to synchronise the prudential rules and regulations in the financial sector; (iii) discuss the problems of financial institutions that have systemic risk, based on the information from the supervisory authority; and (iv) coordinate the implementation initiatives in the financial sector, for instance, the Indonesian Financial Sector Architecture (IFSA) and the Financial Sector Assessment Program (FSAP).

The FSSF consists of three tiers: the Steering Forum, the Executive Forum and the Working Group (Figure 17).

[31] According to **The Deposit Insurance Company, No. 24 of 2004**.

Figure 17
Financial System Stability Forum



8. Conclusions and Policy Recommendations

8.1 Conclusions

The twin "banking and currency" crisis, which struck Indonesia severely in 1997/98, was a very costly and painful experience. The crisis episode has taught us hard but very important lessons. It has also brought about the awareness of the importance of effective risk management and good governance as well as effective banking supervision and financial system stability.

Learning from the crisis experience, Bank Indonesia and the government have taken measures to reform the banking system, including banking restructuring and improving the effectiveness of banking supervision. Significant progress has been achieved through the execution of various initiatives to improve the banking supervision framework, including problem bank management.

The resolution of problem banks has been enhanced with the establishment of the IDIC and the gradual introduction of an explicit and limited deposit insurance scheme. Furthermore, Indonesia has developed a framework of financial safety nets and procedures for dealing effectively with crisis prevention and resolution. Among the key measures introduced are emergency liquidity assistance to contain systemic liquidity risk and development of a crisis management policy and protocol. In addition, the coordination and cooperation among the financial safety net players – Bank Indonesia, the IDIC and Ministry of Finance – have been improved with the establishment of the Coordinating Committee and Financial System Stability Committee.

To enhance the resilience of the financial system, Bank Indonesia performs macro-prudential surveillance to assess and monitor developments and risks to the financial system as a whole. The Financial Stability Review is published regularly to foster understanding and stimulate discussions among the stakeholders on issues related to financial stability.

However, there are still some key issues and flaws in Bank Indonesia's current problem bank management, including: (i) CAMELS supervisory rating and risk assessment systems are redundant and markedly quantitative. These limitations hinder analytical thinking and supervisory judgment affecting the quality of the supervision work; (ii) the need for bank supervisors to improve their skills in line with the implementation of risk-based supervisory framework and risk management; (iii) there is still redundancy in the bank supervision process deterring the efficiency of bank supervisors and limiting their time and attention to strategic issues of problem bank management; and (iv) the need for strong enforcement action against weak banks to be executed promptly in order to foster good corporate governance and market discipline in the banking industry.

In addition, under the current human resource management system, there is no incentive for bank supervisors to enhance their capability and improve their performance. The main culprit behind this issue is the adoption of a standard or "one-size-fits-all" performance appraisal system. There are no specific job values and career development plan for employees, particularly for bank supervisors which require specialisation. Currently, a job value system, which assigns different values for different jobs, according to the complexity and risks of the work performed, has been developed and is being discussed at the top level.

The adoption of risk-based rules set expectations for the banking industry and provides a frame of reference for the supervisor. This approach will foster more transparent and prudent behavior on the part of the bank owner and management and will promote awareness of the importance of risk management and good governance, which is the first line of defense in the banking system.

8.2 Policy Recommendations

Various tools are needed for problem bank resolution, including a strong legal framework that contains a combination of rules versus discretion to allow for flexible and speedy decisions. This new approach should be supported by the development of flexible risk-assessment methodologies for individual banks and for the banking system as a whole. It is recommended that Bank Indonesia should improve its risk assessment systems.

The following are among the priority initiatives: First, is the need to improve the risk-based supervisory framework and systems. One obvious step is to integrate the CAMELS supervisory rating system and the risk assessment system (RAS) – since they overlap and result in some duplication of work effort, and to improve its methodology in order to promote bank supervisor's analytical thinking and judgment.

Second, is to enhance the capability of bank supervisors consistently and continuously. With the implementation of Basel II starting 2008, bank supervisors are required not only to assess the adequacy of the bank's risk management in general, but also the feasibility of the bank's internal model for calculating capital charge. This is a new area which requires advance knowledge, skills and experience. Therefore, bank supervisors should be provided training and development to enhance their capability and motivation to gear them up for the more challenging supervisory tasks they have to perform.

Third, in line with global financial integration and a rapidly changing financial landscape, the bank supervisor has to be able to effectively measure both the endogenous and exogenous risks to the individual banks and the banking system. The current information technology and information systems for bank supervisors need further improvement.

Fourth, the bank supervisory process should be reviewed and streamlined to eliminate administrative overlaps, remove work duplication and reduce the number of unnecessary reports. Improvement in the efficiency of the work process will allow bank supervisors to focus more on risk analysis and follow-up on banks' problems.

Fifth, is the need to carry out comprehensive organisational development, with particular attention to integrating the "soft" elements, namely, the skills, styles and culture for meeting the challenging and growing complexity of banking supervision. This initiative should be driven by consistent change management, including the development of leadership. To be effective, the organisational development should be supported by the appropriate training and development, human performance appraisal, and incentive systems.

Sixth, a strong and comprehensive legal framework is essential to confer the necessary legal powers as well as legal protection for supervisors in carrying out bank supervision under a risk-based and judgmental supervisory regime.

The swift development of banking business and financial globalization bring higher and more complex risks to the banks, which require the bank supervisor to be more hands-on and pro-active. Therefore, the key words in view for the bank are: effective risk management and stronger capital. For the bank supervisor, they are effective risk-based supervision and proficient human capital.

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Figure 18: Bank Restructuring Process in Indonesia

❑ **Performing a Diagnostic Review**

As an initial step, a financial review ("due diligence") was carried out by the BI supervisors and international auditors to determine the banks' solvency and the recapitalisation costs, based on stricter criteria of asset classification and loan loss provisioning. Based on the result of this due diligence, banks were categorised into three categories according to their capital adequacy ratio (CAR): "A" banks with CAR of 4 percent or more, "B" banks with CAR from –25 percent up to less than 4 percent, and "C" banks with CAR less than –25 percent.

The "A" banks were not required to adopt the recapitalisation programme. However, they had to prepare business and action plans to improve their performance. While the "B" bank had to increase their capital to meet a CAR of at least 4 percent either by self-recapitalisation or by applying for joint-governmental recapitalisation.

❑ **Recapitalisation Programme**

The eligibility of a bank for the joint recapitalisation programme was primarily based on two aspects: (1) the viability of a banks' business plan; and (2) the fitness, and probity of banks' management and controlling shareholders. The assessment was conducted by several committees (Technical Committee, Evaluation Committee, and Policy Committee) representing Bank Indonesia, Ministry of Finance and IBRA). To ensure transparency and objectivity, independent observers representing the IMF, the World Bank, and the ADB were invited to the meeting, but without any rights in the decision making process.

❑ **Business Plan Preparation**

Viability for the joint-recapitalisation programme was based on two main criteria: (1) the business prospect measured by the viability of the bank's business plan, and (2) the fitness and propriety of management and owners. Other criteria were the bank's contribution to the economy measured by networks and number of depositors. In particular, "C" category banks had to increase their capital to the minimum level of "B" banks in 30 days in order to be considered for the recapitalisation programme. The bank's business plan comprised:

a. *Current condition* - identification of a bank's core problems and areas for improvement
b. *Economic assumptions* used for the projections
c. *Asset Rehabilitation Plan* - action plans to reduce non-performing loans (NPLs)
d. *Compliance Plan* with the regulations - action plans to settle Legal Lending Limit (LLL) and net open position (NOP) violations, and to improve the loan quality to affiliated debtors
e. *Business Development Plan* - bank strategies to improve performance and soundness comprising risk management, governance, operational efficiency.
f. *Settlement plan* of Bank Indonesia Liquidity Support (BLBI)
g. *Divestment Plan* of government shares within three years
h. *Financial Projections* - detailed financial projections including financial targets: CAR of minimum 8 percent and RoE minimum 15 percent by 31 December 2001.

❑ **Reviewing the Business Plan**

a. *Main criteria*, included:
- capability of shareholders and/or new investors to inject min. 20 percent funds to meet a 4 percent CAR,
- compliance with the existing regulations (legal lending limit, net open position, etc.),
- bank's viability to meet CAR of 8 percent by the end of 2001. The bank's projected CAR in December 2001 was based on a stress test model developed by international consultants.

b. *Additional criteria*, included:
- asset rehabilitation plan, business development plan, franchise values (networks, IT/IS) and significance to the economy, projected RoE 15 percent by the end of 2001.

A bank would pass the business plan review if it met at least all the main criteria.

❑ **Performing a Fit and Proper Test**

The fit and proper test was conducted on a bank's shareholders (those owning more than 25 percent shares or the controlling shareholders), board of commissioners, and board of directors. The fit and proper test consisted of:

a. *Fitness Test* - assessment of the competence and independence of bank's board of commissioners and directors.
b. *Propriety Test* - assessment of integrity fulfillment of commitment to BI, enlistment of bad debts and or delinquent people in the banking sector, other imprudent and fraudulent actions.

❑ **Recapitalisation**

The recapitalisation process involved several key steps including:

- Transferring a bank's bad loans to IBRA;
- Signing the recapitalisation agreement (contract) between the government, BI and the bank's management.
- Injecting additional capital by bank owners (fresh fund) and the government (government bonds).

Source: Batunanggar (2002 and 2004)

<table>
<tr><th colspan="4">Figure 19: List of Liquidated Banks, Banks Taken Over (BTO),
Frozen Banks (BBO) and Recapitalised Banks</th></tr>
<tr><th colspan="2">1st Round Closures - Liquidated Banks (16):
1 November 1997</th><th>2nd Round Closures -
(10) Frozen Banks</th><th>1st Round Taken-
over (8)</th></tr>
<tr>
<td>1. Bank Andromeda
2. Bank Anrico
3. Bank Astria Raya
4. Bank Harapan Sentosa
5. Bank Citrahasta
6. Bank Dwipa Semesta
7. Bank Guna Int'l
8. Bank Industri</td>
<td>9. Bank Majapahit
10. Bank Mataram
11. Bank Jakarta
12. Bank Kosagraha
13. Bank Pacific
14. Bank Pinaesaan
15. Bank SEAB
16. Bank SBU</td>
<td>4 April 1998
1. Bank Centris
2. Bank Deka
3. Bank Hokkindo
4. Bank Istimarat
5. Bank Pelita
6. Bank Subentra
7. Bank Surya
21 August 1998
8. Bank Umum Nasional*
9. Bank Dagang Nasional Ind.*
10. Bank Modern*</td>
<td>4 April 1998
1. Bank Danamon
2. Bank FDFCI
3. Bank Tiara
4. Bank Umum Nasional*
5. Bank Dagang Nasional Ind.*
6. Bank Modern*
7. Bank Ekspor Impor Ind
29 May 1998
8. Bank Central Asia</td>
</tr>
<tr><th colspan="3">3rd Round Closure - Frozen Banks (38):
13 March 1999</th><th>2nd and 3rd Round
Taken-over (9)</th></tr>
<tr>
<td>1. Bank Sewu
2. Bank Papan Sejatera
3. Bank Indonesia Raya
4. Bank Ficorinvest
5. Bank Central Dagang
6. Bank Dharmala
7. Bank Ciputra
8. Bank Sembada Artanugroho
9. Bank Aken
10. Bank Intan
11. Bank Alfa
12. Bank Dewa Rutji
13. Bank Kharisma</td>
<td>14. Bank Umum Servetia
15. Bank Arya Panduarta
16. Bank Sino
17. Bank Danahutama
18. Bank Budi Internasional
19. Bank Orient
20. Bank Sahid Gajah Perkasa
21. Bank Dana Asia
22. Bank Yakin Makmur
23. Bank Asia Pacific
24. Bank Putra Surya Perkasa
25. Bank Pesona Kriyadana
26. Bank Bepede Indonesia</td>
<td>27. Bank Mashil Utama
28. Bank Dagang Industri
29. Bank Indotrade
30. Bank Bumiraya Utama
31. Bank Baja
32. Bank Tata
33. Bank Lautan Berlian
34. Bank Uppindo
35. Bank Metropolitan Raya
36. Bank Hastin Int'l.
37. Bank Namura Internusa
38. Bank Bahari</td>
<td>2nd Round
March 13, 1999
1. Bank Duta
2. Bank Nusa Nasional
3. Bank Pos Nusantara
4. Bank Jaya
5. Bank Tamara,
6. Bank Rama
7. Bank Risyad Salim Int'l
3rd Round
21 April 1999
8. Bank Niaga
23 July 1999
9. Bank Bali</td>
</tr>
<tr><th colspan="2">Recapitalisation of
Private Banks</th><th colspan="2">Recapitalisation of Regional Development
and State-owned Banks</th></tr>
<tr>
<td>1st Round (7)
21 April 1999
1. Bank Lippo, Tbk.
2. Bank Int'l Indonesia
3. Bank Bukopin
4. Bank Universal
5. Bank Prima Ekspress
6. Bank Artamedia
7. Bank Patriot</td>
<td>4th Round (3)
March 2000
1. Bank Danamon, Merged with 7 BTOs
• Bank Duta
• Bank Nusa Nasional
• Bank Pos Nusantara
• Bank Jaya
• Bank Tamara,
• Bank Rama
• Bank Risyad Salim Int'l
June 2000
1. Bank Bali
2. Bank Niaga</td>
<td>2nd Round (12)
28 May 1999
Regional development banks
1. BPD DI Aceh
2. Bengkulu
3. BPD Sumatera Utara
4. BPD Lampung
5. BPD DKI Jakarta
6. BPD Jawa Tengah
7. BPD Jawa Timur
8. BPD NTB
9. BPD NTT
10. BPD Kalimantan Barat
11. BPD Sulawesi Utara
12. BPD Maluku</td>
<td>3rd Round (4)
(March - July 2000)
State-owned banks
1. Bank Mandiri*
2. Bank BNI
3. Bank BRI
4. Bank BTN

*a new established bank, merger of 4 state-owned banks:
• Bank Ekspor Impor Indonesia
• Bank Bumi Daya,
• Bank Dagang Negara
• Bank Pembangunan Indonesia</td>
</tr>
<tr><td colspan="4">Source: Batunanggar (2002 and 2004)</td></tr>
</table>

Figure 20: The IDIC Authorities and Responsibilities

In performing its duties, the IDIC is authorised to determine and collect insurance premiums, as well as to determine and collect contributions from banks' upon becoming a member of the IDIC and to manage the IDIC assets and liabilities.

In line with its mandate, the IDIC has legal authority:

(1) to obtain customers' deposit data, the bank's soundness report, the bank's financial statement, and the bank examination report, as long as it does not violate the bank's secrecy;

(2) perform reconciliation, verification and/or confirmation on those data;

(3) determine the terms and conditions, procedures, and requirements on claim payments;

(4) appoint, delegate, and/or assign other parties to act in the interest and/or on behalf of the IDIC, to perform tasks; and

(5) carry out public awareness programs among the banks and the general public on deposit insurance as well as impose administrative sanctions.

With regard to the resolution and handling of failing bank, the IDIC has legal authority to:

(1) take over and exercise all the rights and powers of the shareholders, including the rights and powers of the general shareholder meeting;

(2) possess and manage assets and liabilities of the failing bank that is rescued;

(3) review and terminate and/or alter any contracts between the failing bank that is rescued and other parties that are burdensome to the bank; and

(4) sell and or transfer failing bank assets without debtor permission and/or failing bank liabilities without creditor permission.

In the meantime, when a bank is predicted to be a failing bank, the IDIC is responsible to do the following:

(1) estimate the cost of closed bank where the cost of resolution is the least;

(2) to provide recommendations for the rescuing or closing of non-systemic effect bank, appoint an intervention manager;

(3) appoint a rescue bank manager or to form a liquidation team; and

(4) plan and organise intervention arrangements on top of implementing intervention, including redeeming deposits, or assuming the business' of the failing bank.

Source: The IDIC Law No.24 of 2004

PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN MALAYSIA

by Uma Rajoo[1]

1. Introduction

Bank Negara Malaysia - the Central Bank of Malaysia - has the primary responsibility for maintaining the stability of the Malaysian financial system and for supervising financial institutions licensed under the Banking and Financial Institutions Act 1989 (BAFIA) as well as Islamic banks licensed under the Islamic Banking Act 1983 (IBA). Globalisation and liberalisation as well as financial innovation and technological advances have resulted in a fast changing financial landscape leading to a significant transformation of the operating environment. Managing the risks emanating from these changes is a key supervisory challenge. Supervisors are left with the imperative of designing a suitable regulatory and supervisory framework which will allow the supervisor to pursue developmental objectives, encouraging greater efficiency and competition in the financial system, and to ensure the attainment of the financial stability objectives at the same time.

Malaysia, like many other South-East Asian countries, went through a process of financial liberalisation after the Asian financial crisis of 1997. Although Malaysia had embarked on financial as well as prudential reforms since the early 1990's, the Asian crisis quickened the pace for the implementation of various measures for addressing the vulnerabilities that had manifested in the banking system at that time. The crisis heightened the need for building a financial sector that would be resilient, efficient and responsive to the changing economic structure. The Financial Sector Master Plan (FSMP) formulated by Bank Negara Malaysia in early 2001 outlined the medium and longer-term strategies for the development of the financial sector, including conventional, Islamic and investment banking.

Bank Negara Malaysia's regulatory philosophy remains unchanged as it seeks to maintain a balance between fostering efficiency and promoting innovation whilst preserving financial stability through, amongst others, the promotion of sound risk management practices. The role of the bank supervisor is to ensure that banks have risk management systems in place and hold adequate capital that commensurate with their risk profile, with the supervisor having authority to review and intervene when necessary. The supervisory regime is required to be supported by a comprehensive set of regulatory and supervisory powers, enacted by legislation and combined with effective enforcement of the appropriate legislation. The institutional framework includes having strong and effective banking supervision and regulation with sufficient authority to enforce prompt corrective action measures to contain banking crises and avoid contagion, a structured intervention approach, and an effective judicial system for failed bank resolution processes.

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2. Legal and Institutional Framework

Bank Negara Malaysia was established under the Central Bank of Malaysia Act, 1958 (CBA) which, among other things, provided for the licensing and regulation of the banking business. The Banking and Financial Institutions Act (BAFIA), introduced in 1989, extended the powers of Bank Negara Malaysia for the supervision and regulation of the institutions engaged in deposit-taking and extension of finance and credit facilities. The BAFIA repealed the Finance Companies Act, 1969 and the Banking Act, 1973 which only granted the Bank supervisory and regulatory powers over deposit-taking institutions. While the Minister of Finance retains the authority for licensing of financial institutions, Bank Negara Malaysia recommends the entry criteria for licensed institutions. Under BAFIA, the Bank is able to prescribe comprehensive protective regulations to protect depositors' and creditors' interests. The supervisors are conferred legal authority to institute investigations and prosecution of illegal deposit-taking activities, and they are accorded legal protection from prosecution in the course of carrying out their supervisory activities.

Currently, the three main regulators of the Malaysian financial system are: (1) Bank Negara Malaysia, which as the central bank, regulates the banking institutions, insurance companies and selected development financial institutions; (2) The Securities Commission of Malaysia (SC) which regulates the capital markets; and (3) The Labuan Offshore Financial Services Authority (LOFSA) which regulates the offshore financial services.

Additionally, the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia or PIDM), was established in 2005 with the enactment of the Malaysia Deposit Insurance Act 2005, to provide least-cost resolution options when dealing with problem banks. Deposit insurance represents an added safety net for the promotion of financial stability. However, Bank Negara Malaysia remains the principal regulator, having the sole authority to declare whether a bank has failed and transfer the bank to PIDM for determining the appropriate resolution method. This clear legal division of duties and responsibilities is important for all the financial safety-net participants in the crisis-resolution framework as it serves to minimise the regulatory burden of dual reporting on the banks as well as prevent premature intervention.

3. Communication and Coordination of Activities

Effective communication and coordination between the stakeholders is also crucial. A formal division of duties and responsibilities can be reached by legal arrangement or administrative regulation. Bank Negara Malaysia has in place a Memorandum of Understanding with the SC and LOFSA which allows it to address the supervision of all entities as part of its consolidated supervision. With the PIDM, Bank Negara Malaysia has entered into a Strategic Alliance Agreement to facilitate cooperation between both parties. These agreements provide for a structured collaboration between the Bank and the other agencies to share information on key issues and developments to facilitate the surveillance operations. Both formal and informal information-exchange mechanisms have been put in place to facilitate timely data and information exchanges that can be leveraged upon to support and enable the other agencies to fulfil their mandated roles. This has proven particularly successful as it has enabled all the parties to identify overlaps and duplication of efforts, rescinded unnecessary formalities and harmonised the surveillance function over institutions.

4. Prudential Regulation and Supervision

Bank Negara Malaysia is empowered to issue regulations as provided for under Section 126 of BAFIA,[2] thus making them legally enforceable. Regulations need to be reviewed to ensure they remain effective, i.e. they accord banks sufficient flexibility to operate and yet ensure the banking system remains resilient and sound. The banking reformation measures put in place throughout the last decade have created larger entities through mergers and consolidation of the banks. The regulatory and supervisory framework should provide sufficient incentives for greater market discipline, stakeholder activism, and accountability amongst the board of directors, senior management and shareholders of financial institutions, depositors and other market participants. With a continuously evolving operating environment, it is essential that liberalisation and deregulation initiatives are accompanied by appropriate measures to strengthen the capacity and capabilities of the banks.

Bank Negara Malaysia introduced prudential and regulatory reforms progressively, which included regulations on risk-management capabilities, governance standards and transparency, to further enhance the strength of the banking system. This was in tandem with developments in the international scene, which saw a shift in regulatory focus trending away from rule-based regulation to principle-based regulation, and placing greater reliance on a bank's internal controls and risk-management systems.

4.1 Problem Bank Identification - Supervisory Regime and Rating Framework

The regulatory framework needs to be supported by an effective supervisory framework which will include the evaluation of the overall performance and financial condition of each player in the banking system. The supervisory approach must be dynamic to allow for the early detection of weaknesses or deficiencies that could potentially destabilise the financial system. As the rapid changes taking place in the banking system saw the emergence of larger entities, more complex operating structures and products, the approach for monitoring the safety and soundness of banks also evolved as Bank Negara Malaysia opted for a enhanced risk-based approach in 2007.

4.1.1 Risk-based Approach Using CAMELS[3] Framework

Prior to 2007, Bank Negara Malaysia adopted the CAMELS framework which focused on key risks of the banks portfolio which would threaten the safety and soundness of banking institutions which included a forward-looking approach in assessing the banks' risk profile and risk-management systems. Under this approach, the Bank accorded greater supervisory focus in evaluating the banking institutions' credit, market and operational risks.

Structure-wise, this approach consists of two functions for monitoring banks, an off-site and on-site function.

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2 Section 126 of the BAFIA reads: "The Bank or the Minister may generally in respect of this Act, or in respect of any particular provision of this Act, or generally in respect of all or any of the licensed or scheduled businesses, issue such guidelines, circulars or notes as the Bank or the Minister may consider desirable."

3 Capital adequacy, Asset quality, Management capability, Earnings performance, Liquidity and Sensitivity to market risk.

The off-site surveillance function served as a mechanism for early identification of problems in the banking institutions through the review of periodic reports and information submitted by the banking institutions. Off-site surveillance complemented the on-site examination function through routine of the financial health of banking institutions by means of rigorous financial analysis. Additionally, on-site examinations would be customised to suit the size, activities and risk profiles of the banking institutions. Based on their supervisory ratings, banks would be subjected to reviews within one to three-year cycles. More frequent visits would be imposed upon problematic institutions, whereas those with less supervisory concerns would be examined within the three year cycle.

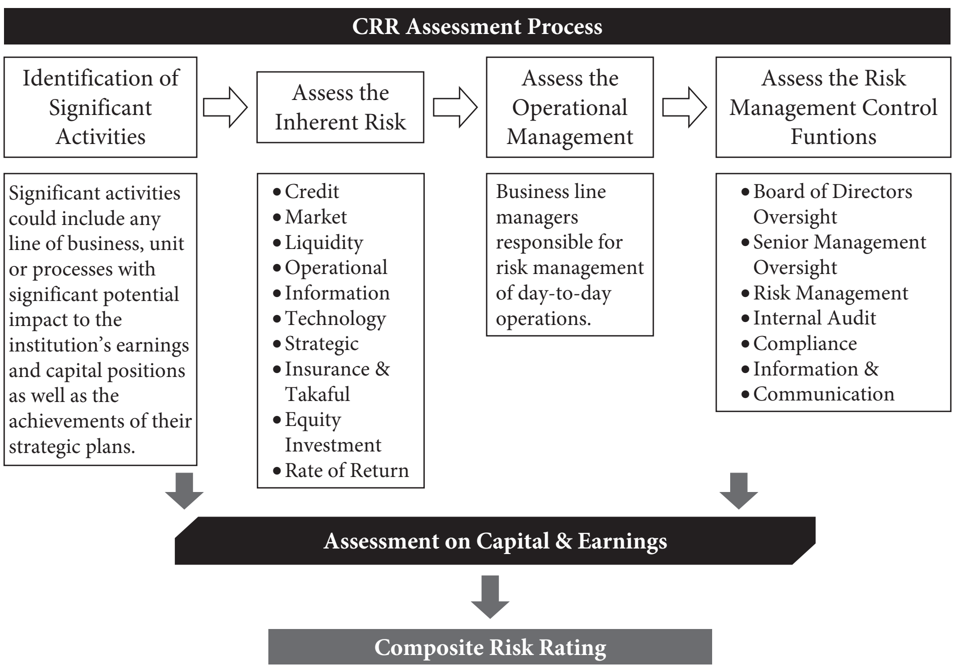
Bank Negara Malaysia used CAMELS as its supervisory-rating system to assess the financial soundness of the banking institutions. The rating derived from the CAMELS assessment would form the basis of how a bank would be supervised. The rating covers both the quantitative and qualitative aspects of the financial and operating conditions of the banking institutions and implicitly assesses the banking institutions' risk profile and adequacy of risk-management systems. Based on the assessment of the key risks encountered by the banking institutions and their capacity to manage these risks, a supervisory plan was formulated for each banking group so that the supervisory resources can be optimally allocated to areas of highest risk. The financial and operating conditions of all the entities within a banking group were also taken into account to ensure that these do not adversely affect the banking group or pose a systemic threat to the banking system as a whole.

However, with the increased complexity of products, IT systems and valuation models, the use of CAMELS rating systems for banks posed a challenge to supervisors. Firstly, although the rating system was premised on both quantitative and qualitative assessment factors, there was a tendency for it to be driven by mapping quantitative ratios to the rating. The higher the ratios, the better the rating accorded to the bank. Experience has shown that high ratios do not necessarily provide sufficient buffer in times of economic distress. Second, planning supervisory visits based on cycles left lengthy gaps in between on-site visits. With the financial landscape evolving and new developments forcing banks to compete at a higher level with more risk- taking activities, continuous engagement with the banks is necessary. The off-site function, while providing for the monitoring of key ratios, would not provide sufficient monitoring of the changes in governance and risk-management processes. Third, the operating structure to facilitate supervision and the conduct of separate on-site and off-site supervision, did not allow the business knowledge of the bank to be retained in one common repository. As the banks progressively enhanced their internal systems and employed more sophisticated risk-management systems, there was a greater need to understand the banks in order to anticipate changes in their risk profiles.

As the environment evolved and the complexities in banking activities increased through progressive liberalisation of prudential standards, direct regulation became increasingly difficult. The supervisory function needed to evolve to allow the regulators to shift emphasis to indirectly regulating banks by improving the banks' risk-management processes. Increasingly, the focus will be on assessment of methodologies and models used for estimating risks, and bank-specific stress tests conducted to adjudge the adequacy of capital. Given the complexity and rapidity of balance-sheet changes and the limited availability of regulatory resources, continuous surveillance of banks is a formidable undertaking. The need for market discipline is driven by the realisation that supervisors have limited time to devote to each bank, whereas effective market discipline requires continuous watch.

4.1.2 Enhanced Risk-based Supervisory Approach

Bank Negara Malaysia adopted an enhanced risk-based supervisory approach in early 2007 with the objective of providing a more systematic and effective process to assess the safety and soundness of the financial institutions. With the implementation of the new risk-based approach, Bank Negara Malaysia discontinued the use of the CAMELS rating system. Under the new supervisory approach, a bank is accorded a Composite Risk Rating (CRR) based on the assessment of the impact of the risks of the bank on its earnings and capital after taking into consideration the effectiveness of its operational management and risk management control functions in mitigating the inherent risks of the bank's significant activities.



The assessment of the risk begins with the identification of key activities that affect the stability and soundness of individual institution and its group. By assessing the core activities, the supervisor is able to obtain an understanding of how the activities are organised along its business lines, employing the level of granularity and generally following the lines of accountability and reporting within the institution to ensure that the information necessary for assessing the activity is readily available. Greater emphasis and responsibility is also placed on the institution to appropriately manage risks in line with the Bank's move towards principle-based regulations. As such, the oversight functions within the institution are assessed by the supervisor to determine the extent to which Bank Negara Malaysia can place reliance on those functions to ensure the appropriate risk management controls are in place within the institution. The overall net risk is then offset against the capital and earnings positions to arrive at the supervisory rating, the CRR.

The supervisory rating is subjected to review annually, but the rating can be changed at any time. The new framework recognises the increased complexities in the financial industry and the need for greater collaboration with the banks to provide assurance on the effectiveness of their risk management capabilities. The new framework provides greater clarity on the bank's significant activities, material-risk exposures and quality of risk management as well as emphasising the role of the bank's board of directors and senior management in managing its risks.

Under the new framework, supervisory teams would undertake a "relationship management" approach. Banks would be assigned a "relationship manager" (RM) who is responsible for keeping track of the current assessment of the institution and is the bank's main point of contact. Monitoring of the banks would be on a continuous basis, and with the supervisory rating subject to review at any point in time during the process. Relationship Managers would continuously engage the banks to monitor any change in their core activities as well as changes in its governance and risk-management functions. Any issues of supervisory concerns would be communicated immediately and the banks would have to implement the appropriate corrective action. The outcome of the implementation of the enhanced RBSF has translated into the supervision departments in Bank Negara Malaysia being restructured internally. Specialist risk units were also established to facilitate deeper assessment of the bank's more technical areas such as validation of risk models and information technology. Re-skilling of supervisors was also required as the new approach required supervisors to become more proactive in seeking out more detailed information from the banks and be more explicit in their assessment.

4.1.3 Surveillance Activities

A key precondition for effective identification of problem banks is obtaining sufficient information to formulate an assessment of the banks' soundness and identify areas of vulnerability. Both financial and non-financial data provide the key indicators not only for monitoring the banks' risk profiles but also for tracking the banks' rate of growth and concentration profiles, and will allow the supervisor to identify the risk areas early.

4.1.4 Statistical Data Submission

Under Bank Negara Malaysia's statistical reporting requirements, banks are expected to submit periodic returns through the Financial Institutions Statistical Systems to capture the major categories such as capital adequacy, profitability and liquidity ratios. The use of statistical data submissions through periodic returns provides comparative data for analysis. The foundation of the monitoring process is the regulatory database that has been developed from the series of regular statistical reports submitted to Bank Negara Malaysia by all institutions licensed under BAFIA. These institutions submit weekly, monthly, quarterly, and annual reports to the Statistical Services Department of Bank Negara Malaysia. The statistical database is also utilised by the banking supervision function to provide additional monitoring reports for the off-site surveillance of banks. A series of reports is generated monthly to provide comparative information to survey trends on an institution-by-institution basis and on an industry basis.

4.1.5 Macro-prudential Surveillance

The key to understanding the areas of vulnerability of banks is critical as threats can emanate from the inter-linkages between the financial system and the real sector, as well as from the increased integration with the external sectors either via trade or investment channels. Therefore, to complement bank-specific surveillance, the supervisors also need to be aware of external threats that could impact financial stability. Macro-surveillance aims at early identification of the potential risks and emerging vulnerabilities that could threaten financial stability and the smooth functioning of the financial sector. The 1997 crisis revealed that a clear correlation exists between the performance of banks and the economic conditions of the markets in which they operate. A negative shock that hits the balance sheets of corporate borrowers is also likely to hit a bank's capital. The financial accelerator effect working through the deterioration in the quality of the borrowers is likely to enlarge the negative effect on the bank's capital.

In Bank Negara Malaysia, macro-prudential surveillance is undertaken by a separate department from the supervision function. Bank Negara Malaysia has improved its methods of assessment and surveillance tools, and currently uses techniques that involve the analysis and assessment of both quantitative and qualitative information, using static and trend analyses, scenario and sensitivity analyses as well as forward-looking analytical tools such as stress testing. These tests are used to gauge and assess the capacity of the individual banking institutions and of the system as a whole to withstand the direct impact of adverse economic and financial shocks, e.g. property-market adjustment, changes in bond yields and prices, etc.

Additionally, the supervisors engage with the banks to obtain pertinent information on their risk profiles, business strategies and direction as well as their risk management control processes. Apart from both the financial and non-financial data submitted by the financial institutions to Bank Negara Malaysia, information is also obtained from the interactions and deliberations with economists, other regulators, market players, as well as from other sources of market intelligence and information service providers. This collection of information is used as part of the assessment and is translated into the supervisory rating.

4.2 Problem Bank Intervention

It is crucial for the regulators to have the authority to intervene and impose actions or assume control of the operations of problematic banking institutions before the situation deteriorates and thus affecting the stability of the banking system. Bank Negara Malaysia has broad supervisory powers to intervene and direct banks to take the necessary corrective action. The supervisory assessment process enables the Bank to identify problems early for pre-emptive action to prevent any deterioration in a problem bank's condition. The supervisory rating dictates the appropriate supervisory response. By linking the supervisory rating to the supervisory response, supervisors are able to focus resources on the problem banks. However, in some circumstances, there is a presumption for formal action, regardless of the bank's capital level and supervisory rating.

From the supervisory perspective, given the complexity and rapidity in which the financial position of a bank can change, the traditional capital standards are no longer adequate as a regulatory tool. Consequently, greater assessment is now needed on the risk-management processes and incentive mechanisms in place for risk taking. Although a "hardwire" approach makes intervention by banking supervisors more objective and less discretionary and minimises supervisory forbearance (delay or failure to take appropriate action against a problem bank) by imposing the mandatory provisions, this approach does not lend enough flexibility to the banks and to the regulator. The soft-trigger approach allows Bank Negara Malaysia to employ a selection of corrective measures specifically tailored to the bank to correct identified weaknesses, improve its overall condition, and return the bank to a safe and sound condition as quickly as possible. It grants regulators the discretion to devise the appropriate strategy to keep banks in business rather than imposing the mandatory provisions.

Formal enforcement actions are executed pursuant to Section 73 of the BAFIA. The BAFIA empowers the Bank to exercise formal enforcement actions over the bank, bank's directors, officers and related companies should the need arise. As formal actions are legally binding, non-compliance could result in penalties as provided under the specific provisions of the BAFIA. The ultimate sanction against an institution is revocation of the bank's licence and winding up of the bank. Depending on the circumstance, formal enforcement actions are normally initiated with the issuance of a written order outlining the actions to be taken by the bank and its management and the time frame for compliance.

These actions are intended to restore and strengthen the banking institution's financial and operating condition to return the bank to a safe and sound footing. In this regard, the bank may be required to dispose off certain assets or problem loans, remove a director or officer from office, employ qualified officers, or take any other action as deemed necessary by the Bank to correct the deficiencies. The Bank may also order a bank to cease from doing any act which is detrimental to the financial and operating condition of the bank. This includes restrictions on credit growth, borrowings by the bank and payment of dividends. If a bank's financial condition continues to deteriorate, the bank could be subjected to more intensified supervision. The measures include more frequent and detailed reviews, increased engagement with the management of the bank, obtaining commitment from the management and Board of Directors, submission of rehabilitation plans as well as other formal actions such as directives to cease certain activities and to increase the holding of additional capital.

The statutory powers accorded to Bank Negara Malaysia under BAFIA provide supervisors with the flexibility to take action in a wide range of circumstances where there is evidence that a bank is operating in a detrimental manner, is insolvent, or is in contravention of any legal provision. Under Section 73 of BAFIA, Bank Negara Malaysia can intervene if a bank informs Bank Negara Malaysia, or Bank Negara Malaysia finds a bank insolvent- that it is likely to be unable to meet its obligations or is likely to suspend payments. Bank Negara Malaysia may remove any officer, or director of the bank, appoint a director to the bank, take control of the bank's business, appoint a receiver or manager, or petition to wind up the bank. This is done with the prior approval from the Minister of Finance.

The statutory powers accorded to PIDM, allows it to to lend to its member institutions[5], guarantee deposits, loans or advances to a member institution enabling it to provide short-term liquidity support. It can borrow, acquire assets and non-performing loans from member institutions to avert risks to the financial system or a loss to PIDM (the powers of the PIDM are similar to the powers accorded to Danaharta during the crisis), and can override and prohibit caveats. The PIDM's full range of intervention and resolution powers will be invoked upon Bank Negara Malaysia notifying it that a member institution has ceased or is likely to cease to be viable. PIDM is charged with a "least cost" mandate when administering the deposit insurance system, i.e. to ensure the exit of banks that are not financially viable from the banking system is resolved with minimal disruption to the financial system. PIDM is solely responsible for the selection of options and is accountable for results of resolution process.

4.3 Problem Bank Resolution

If a bank's continued viability becomes doubtful, regulators must consider and prepare to implement bank-failure-contingency scenarios. As mentioned above, the supervisory duties for problem banks lie with Bank Negara Malaysia. The Bank is responsible for supervising the resolution of critical problem banks through rehabilitation or orderly resolution management. The on-going supervision of the problem bank will include increased monitoring and the regular review of the bank's financials for movements in the balance sheet or for further depletion of capital levels. On-site visits are increased while reporting from the bank is enhanced to monitor the development of on-going remedial plans and provide input into the development of various strategies for turning the bank around.

Bank Negara Malaysia has the responsibility and the authority to appoint a receiver and to place a bank into receivership before the bank becomes critically undercapitalised if one or more of the specified grounds under the relevant section of the BAFIA exists.

Critical to the resolution process is collaborating and coordinating the supervision activities to reduce the duplication of efforts and regulatory burden on the banks. This requires increased communication and coordination among both the primary and functional regulators to ensure an orderly resolution of the bank. Supervisors assigned to problem banks must communicate with the other regulators early in the resolution process. Consistent with their respective statutory mandates, the PIDM and Bank Negara Malaysia both have important roles in problem bank supervision and resolution. The deposit insurance legislation requires the Bank to notify PIDM when a member institution has ceased or, in the opinion of the Bank, is likely to cease to be viable in accordance with Section 73(1) of the BAFIA, 1989, or, in the case of Islamic Banks, Section 37(1) of the Islamic Banking Act, 1983. Bank Negara Malaysia has the ultimate discretion given the circumstances as to whether to pass on the resolution of a member institution to the PIDM.

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[5] Features of Deposit Institutions in Malaysia:
- Membership: All commercial banks, finance companies and Islamic banks; Mandatory by law
- Coverage of up to RM60,000 for all depositors.

Conventional and Islamic depositors (separate coverage).
Annual premiums assessed against member institutions. A flat premium rate for first two years; risk-based differential premium system from the third year onwards.

As mentioned above, The MDIC Act grants the PIDM enforcement authority over member institutions that are in an unsafe or unsound condition or otherwise pose a risk to the deposit insurance fund. Further, under the Act, PIDM has special examination authority over its member institutions and may cite such authorities to seek direct participation in Bank Negara Malaysia's examination activities of problem banks. PIDM's goal is to resolve an institution in a manner that avoids or minimises losses to the deposit insurance fund and ensuring that failing institutions are resolved at the least cost to the banking system. PIDM has extensive resolution powers which include asset-management powers allowing the institution to purchase NPLs, appoint receivers, or even assume control of the bank. Malaysia's experience in problem bank resolutions has largely been institutionalised with the establishment of PIDM. PIDM, a finite life agency, has been accorded the powers of the two special purpose vehicles established during the crisis of 1997, namely Pengurusan Danaharta Nasional Berhad (Danaharta) and Danamodal Nasional Berhad (Danamodal).

5. Crisis Management - The Malaysian Experience[6]

The 1997 crisis which began as a currency crisis eventually escalated into an economic crisis which adversely affected the domestic economy and consequently, the corporate sector. The ability of corporate sector to service their debt obligations was seriously impaired and this resulted in rising NPLs in the banking sector. The banking institutions became cautious in granting loans and began to focus on managing the increasing non-performing loans portfolio. There was a sharp decline in the annual growth of loans from nearly 30% in July 1997 to only 7.5% in August 1998. The deterioration in asset quality led to the weakening of the banks' balance-sheet positions and the threat of insolvency emerged.

Short-term measures were needed to ensure that the banking system continued to play its role in the smooth functioning of the intermediation process, while the long-term strategy to strengthen and consolidate the sector were initiated through the rationalisation, consolidation and reform of the financial and banking sector.

In July 1998, the government, through the National Economic Action Council (NEAC), announced a comprehensive National Economic Recovery Plan (NERP) to bring about stability and expedite economic recovery. The NERP stressed, among other things, the urgency of reforms within the corporate and banking sectors of the economy. The strategy involved the setting-up of an asset management company, Danaharta, the setting up of a special purpose vehicle, Danamodal, and the establishment of a joint public and private Committee, the Corporate Debt Restructuring Committee (CDRC), to restructure corporate debt.

5.1 Resolution of Non-Performing Loans (NPL)

Danaharta was established with the task of acquiring NPLs from banking institutions at discounted prices, financing them with zero-coupon bonds and managing these NPLs. This was to allow the banks to focus on lending activities to support economic growth. In establishing Danaharta, it was decided that an asset management company approach would be adopted. Danaharta would carve-out the NPLs in the banking system by making offers

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[6] Bank Negara Malaysia Annual Reports

to all financial institutions. However, only NPLs valued at RM5 million and above would be acquired. This addressed almost 70% of the total NPLs in the banking system. The number of accounts with loans exceeding RM5 million were relatively small, numbering between 2,000 to 3,000 accounts. This made it feasible to manage the NPLs in its portfolio on an account-by-account basis, thereby enabling Danaharta to choose the recovery strategy that would reap the best recovery value in each case. Under the Danaharta Act, Danaharta were accorded with three special powers to enable it to undertake its activities to meet its objectives expeditiously:

- The ability to buy assets through statutory vesting. This was essential to enable Danaharta to acquire assets with certainty of title and maximise value. Danaharta would have the same interest and priority as the selling financial institution, subject to registered interests and disclosed claims.
- The ability to appoint Special Administrators to manage the affairs of distressed companies. The Special Administrator would work with an independent Adviser to prepare a workout proposal and arrange for legal documentation and regulatory approval while helping to preserve the assets of the company, allowing it to remain as a going-concern. The appointment of the Special Administrators provided for the employment of skilled specialists to turn around distressed companies.
- The ability to sell foreclosed assets quickly without going through the court process (National Land Code was amended to facilitate the implementation of this act). The Act also allowed Danaharta to sell underlying collateral via private treaty, which was either by auction, tender or private contract. This provided the flexibility for Danaharta to enhance the sale of the foreclosed properties.

Other than the acquired NPLs, Danaharta were also to manage NPLs which were handed over by Bank Negara Malaysia. During the financial crisis, two large banking institutions, namely, Bank Bumiputra Malaysia Berhad and Sime Bank Berhad had experienced large losses resulting from the provisioning requirements for huge NPLs. The operations of these two banks were merged with two other stronger institutions. Bank Bumiputra Malaysia Berhad was absorbed by Bank of Commerce Malaysia Berhad while the operations of Sime Bank were taken over by RHB Bank Berhad. Danaharta Managers Sendirian Berhad and Danaharta Urus Sendirian Berhad (wholly owned subsidiaries of Danaharta) were established to manage the loans of Bank Bumiputra Malaysia Berhad and Sime Bank Berhad respectively.

Table 1
Results of Danaharta's Carve-out

RM billion	Acquired NPLs	Managed NPLs	Total Portfolio
By December 1998	8.11	11.62	19.73
By June 1998	17.79	21.54	39.33
30 June 2005	19.71	27.97	47.68

Source: Danaharta Final Report 2005.

By the end of June 2005, Danaharta had acquired and managed loans amounting to RM47.7 billion from the financial system, representing 2,902 loan accounts. As at 30 September 2005, Danaharta had achieved a recovery rate of 58%, managing to recover

RM30.35 billion of the RM52.42 billion NPLs (including interest accrued on these loans). The winding up of Danaharta in December 2005 marked the successful completion of the final chapter in the financial sector restructuring effort undertaken in the aftermath of the Asian financial crisis. In total, the cost incurred by the Government for the financial sector restructuring efforts through Danaharta and Danamodal accounted for 2.5% of the nation's GDP.

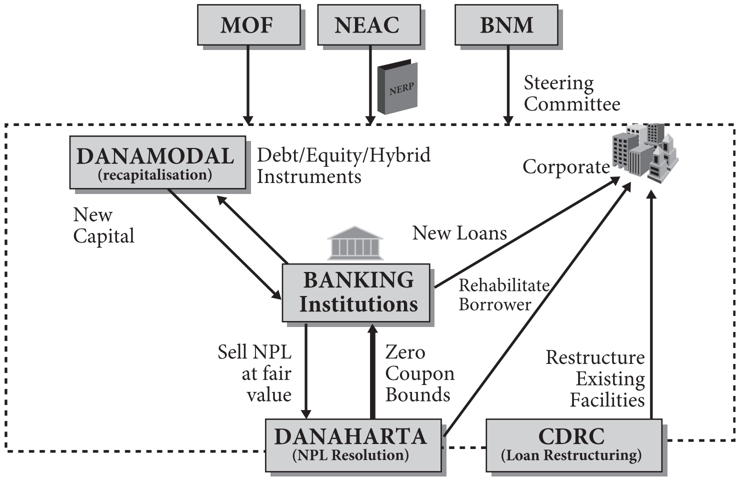
5.2 Recapitalisation of Banking Institutions

Danamodal, was set up to address capital erosion in the banking institutions by injecting capital into the institutions. Danamodal provided funds to the financial institutions which required additional capital to meet their capital-adequacy requirements, but were unable to raise them on their own given the drastic changes in market conditions and sentiment. Central to the recapitalisation and investment process were the negotiations with the stakeholders to arrive at the final terms and conditions of the contractual agreement between Danamodal and the shareholders of the banking institutions that received Danamodal's injection of capital. The Definitive Agreement (DA) spelt out in detail the structure of Danamodal's investment and various enabling provisions to allow Danamodal to achieve the above-mentioned objectives.

To achieve the immediate goals of strengthening the financial position and operations of the recapitalised banking institutions, Danamodal continuously monitored the banks' plans for corporate recovery and restructuring, and the effective implementation of such plans. Danamodal's exit strategies and plan are founded on the following basic principles:

- Danamodal seizes the earliest opportunity to exit.
- Danamodal exits after it is satisfied that it has achieved the objectives of recapitalisation, or if it is satisfied that its exit has enhanced the prospects of achieving the objectives.
- In exiting, Danamodal aims at full recovery of its investments with expected minimum return of 12 percent per annum on equity and 10 percent per annum on debt instruments.
- The economic recovery may help restore market-based solutions to solvency issues among the banking institutions, which may reduce the need for Danamodal's continued roles and accelerate its exit.

During its operations, Danamodal injected a total of RM7.6 billion into 10 banking institutions, which was much lower than the initial budget allocation of RM16 billion. Danamodal recovered RM6.6 billion of the capital investment, and prior to the winding-down in 2003, Danamodal had redeemed its entire RM11 billion 5-year zero-coupon unsecured redeemable bonds on 21 October 2003. The role of Danamodal in providing capital injections to weakened but still viable banking institutions was critical in ensuring that these institutions resume their lending activities. Danamodal's early action and strict adherence to the "first-loss" principle where the existing shareholders absorbed all the losses before the recapitalisation, kept the total cost of recapitalisation low, at approximately 0.2% of GDP.



5.3 Alleviating Debt Servicing Capacity of the Corporate Sector

The CDRC was established to address the weakening financial position of the corporate sector. As the health of the banking sector was also dependent on a strong and stable economic environment and, particularly, a viable corporate sector, it was important that both financial and corporate restructuring be implemented simultaneously. A committee under the auspices of Bank Negara Malaysia was formed in August 1998. The CDRC had no legal powers and was a voluntary workout mechanism. It served to facilitate discussions between borrowers and financial institutions to enable expeditious and voluntary restructuring of debts. A Steering Committee provided the oversight function while a Creditors' Committee led the restructuring process.

To be eligible to participate under the CDRC, a borrower would have to be a viable entity, with aggregate debts of RM50 million or more, and with more than three creditors. For the debt restructuring, the banks would initially attempt to restructure the NPLs on their own or through the CDRC. If a consensus could not be reached among the banks, Danaharta would assist by buying over the NPLs from the dissenting banks. Banks which did not sell to Danaharta would be required to write-down the loan to the collateral value and make adequate provisions.

In its four years of operations, CDRC successfully resolved 48 cases involving debts of RM52.6 billion. 32 of the 48 cases, with debts totaling RM36 billion, were fully restructured. The closure of the Corporate Debt Restructuring Committee (CDRC) on 15 August 2002 represented an important conclusion of the debt restructuring efforts undertaken since 1998.

5.4 The Bank Restructuring Programme

As part of the restructuring reforms introduced by Bank Negara Malaysia, consolidation was promoted to further strengthen the banking sector and address the highly fragmented domestic banking sector.

In January 1998, a merger programme for finance companies was announced to consolidate and strengthen the industry. This segment of the banking system was the most vulnerable to the adverse effects of the economic downturn with four main finance companies dominating 70 percent share of the sector. Additionally, a subsequent consolidation exercise was undertaken where 52 out of a total of 54 institutions were consolidated into ten banking groups. This was followed by the rationalisation of merchant banks, stock-broking companies and discount houses within the banking groups to create investment banks.

In November 2000, Bank Negara Malaysia announced the increase in the minimum amount of capital funds, unimpaired by losses, for banking institutions to take effect from 31 December 2001. The new minimum capital funds requirement were raised to RM2 billion for domestic-banking groups and RM300 million for the locally-incorporated foreign banks. The larger and stronger capital base is aimed at strengthening the resilience and the capital position of the banking institutions to absorb any destabilising effect of shocks to the system. To encourage the banking institutions to accelerate the consolidation process, various tax incentives were granted by the government, namely, exemption from stamp duty and real property gains tax and recognition of losses of the acquiree institutions for tax purposes. In 2008, the banking industry is dominated by 9 domestic banking groups, 13 foreign banks, 14 Islamic banks and 6 investment banks.

5.5 Key Lessons From the Crisis

The financial crisis challenged and stimulated the resilience of the financial landscape. It demanded immediate and prompt action by all the stakeholders, simultaneously requiring the actions taken to be effective and achieving the desired outcome of preserving financial stability. In retrospect, several key lessons can be drawn from this experience.

First is the need for comprehensive strategies in addressing the instability that was spreading across the financial system. In Malaysia's experience, complementing measures were introduced to stimulate the economy and create an environment conducive for the resumption of economic activities. Bank Negara Malaysia set up special funds to ensure continued access to financing by the small and medium-sized enterprises at reasonable rates. A merger and consolidation programme was introduced to improve the overall efficiency of the banking sector. The Financial Sector Master Plan (FSMP) launched in 2001 rolled out the programme for the reformation of the banking sector with detailed plans for strengthening domestic capacity, enhancing access to financing, and improving consumer activism, as well as maintaining financial stability.

Second, swift and timely response to a crisis is crucial. During the financial crisis, the Malaysian government put in place the institutional framework in less than six months. In addition, the Danaharta Act 1998 was passed within two months to facilitate the process. Although existing laws were sufficient, this would involve lengthy legal proceedings. For effective management of the increasing NPLs and the possibility of managing thousands of accounts, Danaharta needed to work quickly to relieve the banking system of NPLs and prevent a systemic failure. In the interest of time, it was decided that some of the crucial operational activities would be done outside of the court process.

And finally, the commitment by all the stakeholders, including the government and political masters, is important to ensure the expedient and effective implementation of proposed strategies so as to minimise the risks of a crisis from deepening and becoming prolonged. The government was committed to the financial restructuring programme as evidenced by the speed of the enactment of the Danaharta Act (within two months), provision of financial assistance in the form of the necessary funding for the institutional set-ups and tax incentives, as well as provision of the implicit guarantee on deposits of the banking sector. The banking institutions also supported the restructuring initiatives by committing their resources to implement the efforts.

6. Conclusions and Recommendations

The Malaysian economic and financial landscape has undergone significant transformation since the Asian financial crisis. A supervisory regime is vital in identifying problem banks. The supervisory process involves holistic diagnosis of the economic and environmental factors which could impact the financial industry and the individual banks. Based on the experience, actions and policies taken, it can be concluded that further measures need to be taken to be ready for the next crisis. Having gone through a financial crisis, supervisors and banks alike have learnt critical lessons concerning the importance of early detection of points of vulnerabilities. These lessons will be institutionalised and will translate into improved or enhanced policies and practices. However, implementing corrective measures for past mistakes does not prepare the supervisor or the banks for new emerging risks that will be brought about by innovation and the ever-changing financial landscape. Supervisors should focus on prevention, i.e. identifying and preventing banks from turning into problematic banks, rather than on crisis management.

The supervisory regime must be continuously reviewed to ensure that it remains effective in identifying and detecting the emerging risks. As Bank Negara Malaysia continues to liberalise the banking sector with the issuance of principle-based regulations, which would encourage a more competitive environment, banks that demonstrate the ability to manage risk well will be accorded greater flexibility to innovate. This differentiated-regulation approach provides an incentive for banks to continuously improve their risk management and controls. However, it is important that supervisors balance the liberalisation of rules with prudential re-regulation to ensure there is a mechanism to address new and emerging risks.

Greater collaboration and information exchange is needed among supervisors, especially in the case of complex banking groups and cross-border supervision. The increasing sophistication by which banks organise themselves in complex financial structures, with operations spread across various jurisdictions, has resulted in financial institutions looking to innovative ways to manage their operations. Therefore, there is a need for regulators of the home and of the host countries as well as for the regulators of the jurisdictions where the centralised functions reside to establish closer networking and ensure effective supervision of these institutions. With increasing inter-linkages between financial markets, banks are no longer insulated from the transmission of risk created in one industry. This heightens the need for close cooperation and coordination of the surveillance efforts to pre-empt emerging threats.

Finally, with the increasing complexity of the financial landscape and new and rapid developments unfolding in the market place, supervisors need to continuously hone their skills to stay a step ahead of the changes taking place. The risks arising from financially innovative products pose new challenges for supervisors to understand how risk is created and managed and how the adequacy of capital allocation is determined. In meeting these challenges, the skill sets of supervisors need to be enhanced and larger pools of specialists created. Developing supervisors with specialised skills, macro perspective, in-depth industry knowledge, sound judgment and experience in identifying and managing risk issues and in detecting emerging problems in a timely manner, is a must. It is also critical to develop supervisors who can think strategically and who possess effective communication skills and can play a pro-active role in shaping the banking environment.

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PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN NEPAL

by Bhisma Raj Dhungana[1]

1. Introduction

Many aspects should be considered together for the management of the banking system. Basically, the entry, operational and exit modalities are the major areas to be considered by the supervisory authorities. Hence, documented policies should be in place for the proper management of the banking system. The entry point of banks and financial institutions are managed and administered through the licensing policy. This is the first step whereby only the appropriate banks which pass through all the screening tests set by the supervisory authorities, are allowed to enter the system The second aspect is operational, which relates to the adequacy of prudential rules, regulations and the supervision system, whereby the sustainability and soundness of the banking institutions and their operations are assured at all times. When a bank is unable to function properly, or is illiquid, or its sustainability is in doubt, the intervention and resolution aspects come into view. Therefore, problem resolution is also one of the major areas to be considered by the supervisory authorities in the management of the banking system.

The Nepal Rastra Bank (NRB), as the central bank of Nepal, has sole responsibility for the regulation and supervision of the banking system. The NRB was established in 1956 under the Nepal Rastra Bank (NRB) Act, 1955. The NRB Act, 1955 has been replaced by the Nepal Rastra Bank Act, 2002. The NRB Act, 2002, accords legal authority to the NRB to deal with problem banks and to initiate corrective and resolution actions on problem banks in a timely manner.

1.1 Objectives of Nepal Rastra Bank

After the enactment of the NRB Act, 2002, the roles, responsibilities and objectives of the NRB have been redefined. The Act specifies the following:

1. Formulate monetary and foreign exchange policies in order to maintain the stability of price and balance of payments for sustainable development of the economy;
2. Promote stability and liquidity required in the banking and financial sector;
3. Develop a secure, healthy and efficient system of payment;
4. Regulate, inspect, supervise and monitor the banking and financial system; and
5. Promote the entire banking and financial system of Nepal and enhance its public credibility.

The Act clearly specifies that the NRB shall, without any prejudice to these objectives, extend co-operation in the implementation of the economic policies of the government.

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In order to meet its objectives, the NRB issues licences to banks and financial institutions, carries out inspection and supervision, initiates and takes over control of banking and financial institutions in the best interest of depositors and shareholders, if necessary. It has the power even to revoke a banking licence in the event of material non-compliance of various prudential norms and relevant laws and regulations, or to liquidate a loss-making bank.

1.2 Classification of Banks and Financial Institutions

The banks and financial institutions have been classified into four groups. The requirement of minimum paid-up capital differs as to the category of banks and financial institutions. The Figure 1 depicts the minimum capital requirements for banks and financial institutions to obtain a licence from the NRB and Figure 2 shows the categorisation of banks and financial institutions those are licensed by the NRB in Nepal.

Figure 1
Requirements of Minimum Paid-up Capital to Obtain Licence from NRB

Minimum Paid-up capital for obtaining licence for Banks and FIs (Rs. in billion)

Category	National Level (Rs.)	Regional Level (Rs.)	4-10 Districts (Rs.)	1-3 Districts (Rs.)
A (Commercial Banks)	2.0	–	–	–
B (Development Banks)	0.64	–	0.30 in case of leasing and 0.20 in other cases	0.30 incase of leasing and 0.10 in other cases
C (Finance Companies)	0.30 incase of leasing and 0.20 in other case	–	–	0.30 incase of leasing and 0.10 in other cases -
D (Micro Finance Development Banks)	0.10	0.06	0.02	0.01

Figure 2
Categorisation of Banks and Financial Institutions in Nepal

Bank and Financial Institution Act, 2006 (BAFIA) has categorised banks and financial institutions under four groups as follows:

Category	Description
A	This type of institution is known as Bank. They are given large access to undertake banking transactions and unlimited deposit collection and mobilisation of resources
B	This type of institution is known as Development Banks. Their scope and functions are as determined by BAFIA and NRB Act.
C	This type of institution is known as Non-Bank Financial Institutions popularly known as Finance Companies. Their scope and functions are as determined by the BAFIA and the NRB Acts.
D	This type of institution is known as Micro-Finance Institution. Their scope is Determined by the BAFIA and the NRB Acts. They are involved in micro-credit and group lending.

1.3 Banks and Financial Institutions under NRB's Jurisdiction

The total number of banks and financial institutions licensed by the NRB has stood at 208 in mid-July 2007. The classified details are given in the Figure 3 below:

Figure 3

Number of Banks and Financial Institutions Operating in Nepal as at 15 July 2007

Category	Number
Commercial Banks	20
Development Banks	38
Finance Companies	74
Micro Finance Development Banks	12
NGOs Licensed by NRB	47
Co-operatives (Licensed by NRB)	17

2. Legal Framework in Dealing with Problem Banks in Nepal

Principally, a problem bank is defined as the one whose liquidity or solvency is, or will be impaired, unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk-management capabilities and/or quality of management. This definition centers on a bank where there are potential or immediate threats to liquidity and solvency, rather than one with observable weaknesses that are isolated or temporary in nature, and which can normally be corrected by appropriate remedial action. However, all the weaknesses in a problem bank warrant due care for them to be sorted out as soon as possible.

The weaknesses of a problem bank include, but are not limited to, poor management, inadequate financial resources, absence of long-term sustainable business strategy, weak asset quality, poor internal-control system, and poor governance. A problem bank, at its initial stage is, principally, subject to the direct supervision of the NRB. If the deficiencies persist even after taking the necessary corrective steps under various modalities, the bank is subject to insolvency action and finally liquidated in accordance with the applicable laws.

The following Acts and Regulations deal with the remedial actions for the problematic banks:

- The Bank & Financial Institution Act, 2006
- The Nepal Rastra Bank Act, 2002
- The Company Act, 2006
- The Insolvency Act, 2006
- The Unified Directives, 2005 (the prudential norms and regulations issued by the NRB to banks)

The different acts contain various legal frameworks in relation to dealings with problematic companies, but the provisions of the NRB Act, 2002 and the BAFIA, 2006 supersede all the provisions over other laws in the case of banks and financial institutions. Exercising its supervisory intervention powers, the NRB can declare a bank as a problematic bank (Section 86B of the NRB Act), initiate restrictive and compelling actions (Section 86C), take control of the bank (Section 86D), initiate corrective measures (Section 86E), initiate curative measures (Section 86F), appeal for liquidation (Section 86G), reduce the level of capital to reflect the actual level (Section 86H), transfer the asset and liabilities of problem bank to other banks and financial institution (Sections 86J, 86K, & 86L).

2.1 Roles and Responsibilities of Different Agencies in the Resolution of Problem Banks

2.1.1 Role of Nepal Rastra Bank

The role of the NRB is to identify the problems early, ensure preventive or corrective measures are in place, and formulate the resolution strategy in the event the preventive actions fail. It is worthwhile to state here that there are some problem banks in Nepal which are undergoing rehabilitation and restructuring, but no banks and financial institutions have failed and are subjected to liquidation to date.

The BAFIA, 2006 and the Insolvency Act, 2006 incorporate the provisions for the liquidation action. Liquidation process cannot be initiated by a problem bank acting on its own. Only the sound banks can voluntarily initiate liquidation. Voluntary liquidation of a bank is not a practical option because the prior approval of the NRB is mandatory under the provision of the BAFIA for voluntary liquidation. Section 76 of BAFIA, 2006, states clearly that the NRB will issue the approval subject to some terms and conditions being fulfilled by the banking institution, and only after being assured of the financial capability of the bank in discharging all its liabilities. It follows only banks that are sound can opt for voluntarily liquidation not the problematic ones. It is observed that sound banks do not normally opt for liquidation.

In case of problem banks and financial institutions, when NRB initiates liquidation action by appealing in the court, the liquidation can be regarded as a mandatory

A banks can be forced into liquidation if, in the assessment of the NB, the financial position of the problem bank is irrecoverable and cannot be restored in any situation. This could arise where there have been significant and persistent non-compliances to the prudential norms and regulations, and the bank resulting from the liquidity crisis is incapable of discharging its obligations to its depositors and creditors, and its position cannot be improved or restructured even when the necessary steps are undertaken by the NRB. A bank, in this state, cannot be forced into liquidation straightaway. Proceedings have to be initiated to resolve the bank's problems through various corrective and restructuring processes. The NRB Act, 2002 has incorporated essential provisions in relation to the declaration of a bank as a problematic bank and the action steps that needed to be taken to protect the bank from being insolvent or from going into liquidation. All aspects of bank resolution fall under the jurisdiction of the NRB.

(i) Declaration as a Problem Bank

Under the provision of Section 86A of the NRB Act, if any banking and financial institution comes under the circumstance of insolvency or liquidation as per the prevailing laws, or is unable to discharge its payment obligations, or is materially incapable of meeting some or all of its liabilities, the banking institution shall report itself to the NRB within 15 days of such condition arising.

The Section 86B of the NRB Act, 2002, specifies the conditions for declaring a banking and financial institution as a problematic, and also provides the NRB with the legal authority to take control over such banking and financial institutions. Pursuant to the provision of this Act, upon the receipt of such report from the bank, as stated above, or if the NRB from the inspection reports or from any means is confident that the bank comes under the following condition, the NRB then can declare the bank as a problematic bank.

1. Not functioning in the interest of depositors, shareholders, creditors or general public.
2. Unable to make payments or unable to discharge its financial liability or possibility of being unable to discharge its financial liability.
3. Suffering from materially economic problem or being under the condition of insolvency.
4. Non-compliance to the relevant/prevailing laws, rules and directives, circulars or orders of the NRB and violation of the conditions as prescribed in the licence.
5. Submission of false or fraudulent documents and information during the course of obtaining a licence.
6. Unable to maintain minimum capital fund as prescribed by the NRB.
7. If the action has been initiated for liquidation or insolvency under the prevailing law.

8. Unreasonable delay in completing the voluntary liquidation process, if it has gone under the voluntary liquidation process.
9. If the foreign parent of the bank and financial institution goes into liquidation, is insolvent or is restricted to carry on transaction in their respective foreign countries.
10. If the NRB is confident that the bank and financial institution is unable to discharge its liabilities or is under such problem that it affects the discharging of the functions and responsibilities of the concerned bank.

Basically, the evaluation of the condition for declaration of a problem bank is based on the supervision reports and banks reports. For this purpose, the findings of the on-site inspection reports or the off-site supervision reports can be used. Banks are rated yearly under the CAMELS rating system and quarterly under the CAELS rating system.

(ii) Role of NRB in the Resolution of Problem Bank/Insolvent Bank

Corrective Action and Restructuring

The NRB can initiate a number of steps for the resolution of a problem bank. In general, the deficiencies of the banking institution are first uncovered through the regular off-site supervision and on-site inspections. Accordingly, the supervisory concerns in the reports are addressed. The corrective actions are prescribed and the bank is instructed to comply within the implementation timeframe of such reports. The bank is allowed sufficient time to take the corrective action with adequate plans and policies. In the meantime, the NRB conducts discussion with the Board of Directors of the bank.

If the measures fail, the NRB can, on its own, undertake various restructuring steps only after declaring the bank as a problematic bank (in order to save it from falling into insolvency and finally liquidation). When the NRB declares a banking institution as problematic, it can initiate two types of modalities for correction and one type of modality for liquidation:

1. Corrective Actions: The NRB initiates corrective actions for the banking and financial institution (pursuant to Section 86 (c) of the NRB Act, 2002).
2. Restructuring Actions: The NRB can initiate restructuring actions by taking over control of the bank on its own (as per Section 86 d & e).
3. Liquidation Action: If all the corrective / restructuring measures fail, the NRB can appeal in Appellate Court for liquidation. For this purpose, the NRB has to comply with some of the requirements as specified by the Act, which are elaborated below.

(iii) Corrective Action for Problem Bank

When the NRB declares a bank as a problematic bank in accordance with Section 86 (c) of the NRB Act, 2002, it can issue an order to the bank to carry out any or all of the following actions:

1. Increase the paid-up capital of the bank;
2. Cease the voting or other rights of the shareholders;
3. Restrict the dividend payments and other payments to shareholders;
4. Set limitations in the distribution of bonuses, remunerations, compensations to the board of directors and high official;
5. Put in place good governance, internal controls and risk management in the institution;
6. Restrict acceptance of deposits, credit lending, investments or set limits for it;
7. Compel to maintain the liquidity and capital adequacy at high level or restrict to do commercial transaction;
8. Limit the volume of transactions, sale of assets or branch expansion or instruct to close domestic/foreign branches;
9. Minimise the risks of less qualitative assets, inappropriately valued collaterals and other assets;
10. Stop the functions that incur a loss to the institution or stop unbeneficial activities;
11. Stop any permitted activities for a certain period;
12. Obtain prior approval from the NRB to purchase heavy capital assets or enter into commitments for such purchases or make expenses on existing contingent liabilities;
13. Order the removal one or more directors, managers or employees, and if bank fails to comply with the instruction, the NRB will take action on its own to remove them;
14. Suspend all the board of directors and appoint a new management team to run the bank;
15. Compel to de-list the shares in the stock exchange;
16. Restrict the payments on subordinated term debts; and
17. Initiate any appropriate actions as deemed necessary by the NRB.

(iv) Restructuring Actions under Section 86 (d & e) of the NRB Act, 2002.

The NRB will take over a problem bank as a last resort to save the failing bank. When NRB takes control of the bank, it appoints a management team comprising either its own staff or professionals from the market. The restructuring the NRB can undertake during the control period is clearly spelled out in the NRB Act. If the NRB takes control of the bank, the appointed officers can exercise all the powers of the shareholders, board of directors, and officials of the bank. They will have the functions and power of the annual general meetings (AGM) and special annual general meetings to carry on any activities. Within this situation the management team can perform the following functions:

- Suspend or cease any transactions operating in domestic or foreign market;
- Transfer the assets of the bank to other banking and financial institutions as per the prescribed guidelines of the NRB;
- Remove existing employees of the bank and appoint new personnel in their place;
- If deemed necessary, merge with other banking and financial institution or transfer any or all the assets and liabilities to other banking and financial institution;

- Under the prescribed standard of NRB, issue shares to new shareholders in order to reduce existing ownership structure or restructure through re-constituting the board of directors;
- Reduce capital or reduce the face value of share proportionately suitable to the existing capital of the bank. The process and modality are also specified in the Act;
- Initiate management restructuring and corporate restructuring of the bank; and
- Initiate other necessary measures as prescribed by the NRB.

Generally, the NRB can take over control of the management of a problematic bank initially for a maximum period of two years. But this period can be extended until the bank is restored to a stable and strong footing. If the NRB is be confident that the bank could be operated in a sound manner, the NRB can hand over the bank back the same board of directors (BOD) who were managing the bank before, or it may constitute a new BOD capable of operating the bank. In the Nepalese experience, some banks/financial institutions were controlled for a shorter period, while some are under control for a period of more than five years.

Figure 4
Takeover of Management of Problem Banks and Financial Institutions by the NRB

SN	Name of Bank & financial institution	Period	Reason	Progress
1.	Nepal Finance & Saving Co. Ltd	21 September 1993- 6 February, 1994	Conflicts in BOD, two parallel BOD to operate. Fail to protect the interest of depositors and investors	Initiated public issue of shares to introduce the general public in the management. New BOD was formed with the participation of public shareholders and handed over to it.
2.	Nepal Bank Limited	14 March, 2002 - to date	Violations of directives, mismanagement, dysfunctional due to resignation of all the members of BOD (except one),fail to protect the interest of depositors and investors	Foreign management placed for the restructuring of the bank. Loss position turned around to profitability, NPL begin to decrease, new policies and procedures on ALM, Credit, Human resource, Accounts, budgeting, audit, IT developed and implemented. The Bank is still under the control of the NRB.
3.	Lumbani Bank Limited	20 March, 2002- 24 December 2004	Conflicts in BOD, fail to protect the interest of depositors and investors	Initiated public issue of share. New BOD was formed with the participation of public shareholders and handed over to it.
4.	Nepal Bangladesh Bank Ltd	12 November, 2006 - to date	Violations of directives, mismanagement, poor governance, dysfunctional due to resignation of all the members of BOD (except two), fail to protect the interest of depositors and investors	Initially the NRB's own officials managed the Bank. After four months, Nepali management team from the market placed for the restructuring of the Bank. Loss position turned around to profitability, NPL begin to decrease, new policies and procedures are being developed and implemented. The good governance is being reinstalled. The Bank is still under the control of the NRB.

(v) Transfer of Assets and Liabilities

One of the restructuring steps undertaken by the NRB in order to protect the depositors from possible bankruptcy and liquidation is transferring any or all the assets and liabilities to another banking and financial institution within the prescribed framework. Such assets and liabilities can also be merged with another banking and financial institution accordingly. However, the transfer of assets and liabilities could not be initiated where:

- Such a transfer is against the interest of depositors, shareholders, creditors, or general public.
- If it appears that there will be a lack of proper management of assets and liabilities.
- If the banking and financial institution that is willing to take over the assets and liabilities disagrees to follow the guidelines as framed by the NRB to manage the assets and liabilities.

  The banking and financial institution or any other entity purchasing the assets and taking over the liabilities of a problematic bank would be entitled to exclusive rights over such assets and liabilities even though the title deed to the assets reside with the transferor bank.

Figure 5
Corrective and Restructuring Actions on Problem Banks in Nepal

Nepal Bank Limited (NBL): The NBL, founded on 15 November 1937, is the first commercial bank to be established in Nepal. This bank began to face operational, management, and financial problems following the financial liberalisation of the mid-1980s. The problems were first identified and corrective actions were taken during the CBPASS report implementation period in the 1990s. Again, several problems were identified in the KPMG report of 2000. The report pointed out several weaknesses: Several governance and management shortfalls, extremely poor information system, dysfunctional lending processes, poor strategic planning, business planning and budgeting, low moral of employees and numerous human resource issues, a negative net worth, and bank technically insolvent. Therefore, the bank required more surveillance and focused restructuring. This bank was among the two largest banks in Nepal operating a large branch network and undertaking government transactions in various districts of the country. The bank was taken over by the NRB on March 14, 2002. Subsequently from 22 July 2002, the bank was run by a foreign management team selected through a bidding process under the financial sector reform programme of the government. The bank is under a restructuring programme, with the bank management currently under the control of the NRB. Within a period of four years of restructuring, the bank achieved a turnaround. However, there remains a capital shortfall, but the shortfall has been reduced from Rs.13.09 billion as of July 2003 to Rs. 7.86 billion as of July 2006. The capital adequacy ratios are still negative. The cumulative loss has been reduced from 10.88 billion to Rs. 6.68 billion, with the Bank making profit regularly each year from 2004. The NPA level has been reduced from 60.47 percent to 14.60 percent. In July 2007, cash recovery from NPA accounted to 6.8 billion out of Rs. 10 billion NPLs. The staff head-count has been reduced from 5652 to 2960 during the restructuring period of four years. The salary structure of the Bank was revised upwards, and several manuals and bye-laws (e.g. budget, credit, IT, operation, treasury, strategic, employee bye-law, problem loan guide and loan write-off guidelines, etc.) have been documented and implemented. Although the bank succeeded in achieving a turnaround, the capital injection and completep rivatisation issues remain to be resolved.

Rastriya Banijya Bank Limited (RBBL): The RBBL, the second commercial bank in Nepal, was established as a fully-owned government bank on 23 January 1966. From its inception the RBBL functioned as the intermediary of the government to launch government programs in the rural and non-profit areas. The RBBL suffered from deficiencies in governance, regulatory compliance, capital adequacy, credit risk management since 1980s. During the CBPASS report implementation period in the early 1990s, the government injected some capital into the Bank, initiated recovery activities, installed a new management team, but it could not sustain the Bank over the long term. The bank was making loss continuously from 1990 to 1993. Thereafter, for two years the Bank operated in the black, but it again begun to incur losses. The annual losses were high from the year 2000, and the cumulative losses amounted to Rs. 24 billion in 2003. The RBBL is the largest bank in Nepal operating a wide branch network and providing extensive banking services to the rural and urban areas. It is imperative for the authorities to act and prevent the Bank from failing. A financial sector reform programme was launched by the government with the technical support of the World Bank. The programme not only covered the restructuring of the two big banks (NBL & RBBL), but it also addressed a comprehensive reform of the financial sector, including the strengthening of the Nepal Rastra Bank and capacity building of the financial system.

This bank remains fully owned by the government. It is still under restructuring by the NRB, the implementing authority for financial sector reform. The NRB emplaced a foreign management team in January 2003 in RBBL, adopting the international bidding process. Under restructuring, the Bank saw improvements in its financials, governance and operations. The staff head-count decreased from 5583 in 2002 to 3301 in 2006. The capital fund is still negative, but the level of negative capital has been reduced. The Bank reported profitability continuously from 2004 onwards. The annual audit of the Bank is being completed each year. Its systems and procedures are being improved. The bank has computerised its branch banking operations in 44 branches (out of 114), and the Bank introduced its ATM service in 2007. The level of NPLs has decreased from 60.15 percent as of July 2003 to 26.43 percent as of July 2007.

After a bank is taken over, the management committee appointed by the NRB is required to appoint an independent auditor to conduct a management and financial audit of the bank, and this report is to be disclosed publicly within one year from the date of the takeover. If the problems could not be resolved without ownership restructuring, such activities could also be initiated. For this purpose, the NRB should issue an order, by way of public notice, to arrange for the sale and transfer of the existing ownership.

Within this process, the NRB can instruct to sell the share of the existing shareholders at the price set by a professional committee, to any appropriate party approved by the NRB. Accordingly, the NRB can instruct to transfer or merge any or all of the assets and liabilities to any bank or financial institution or to other agency. The NRB can also initiate to incorporate a new bank or financial institution under government ownership in order to acquire the assets and liabilities of the problematic banks and financial institutions.

Figure 6
Corrective and Restructuring Actions on Problem Banks in Nepal

Nepal Bangladesh Bank Limited (NBBL): NBBL was suffering from deficiencies in governance, regulatory compliance, capital adequacy, credit risk management from the beginning of year 2000. There was conflict of interest in the Bank's lending. A large amount was disbursed to the promoters. The Bank was making losses and the NPA was increasing. Several initiatives were made by the NRB to correct the deficiencies, but the efforts were unsuccessful due to lack of timely fulfillment of the commitments made by the Bank's management. The Bank also obtained a Court stay-order to prevent intervention by the Central Bank. Immediately, the Bank encountered heavy withdrawals from its public depositors on 6-10 November, 2006, and faced a severe liquidity problem. Almost a quarter of its total deposit was withdrawn within three days, and long queues remained in front of the Bank to withdraw their money. Almost all the liquid assets of the Bank were liquidated to pay the depositors. This was the first bank-run in Nepalese banking history. The stay-order was subsequently lifted by the Court upon the request of the Bank management. This was followed by the resignation of almost the entire Board of Directors. To handle the situation, the NRB took over control of the Bank on 12 November, 2006. Within nine months of restructuring, the level of NPA was significantly reduced from 46 percent to 39 percent. The management and governance began to improve. The promoters began to make repayments on the outstanding loans which accounted to Rs.500 million. The management team has prepared a new capital plan. The Bank has restored public confidence and regained its profitability. The Bank remains under the control of the NRB, and is undergoing restructuring by the management team, appointed from the NRB. A separate desk has been created in the Bank Supervision Department of NRB to provide more focused surveillance to problem banks, as practiced in the prudent financial markets.

(vi) Appeal for Liquidation

If a problematic bank cannot be rescued, or if it is not in a position to discharge all its liabilities after all attempts to turn it round through corrective action or restructuring fail, the NRB can make a Court appeal for mandatory liquidation.

2.1.2 Role of the Ministry of Finance

The Ministry of Finance (MoF) plays a facilitating role to improve the overall soundness of the financial system. The Ministry is not required to be directly involved in the resolution or restructuring of individual problem banks in Nepal.

At the macro-level, its major role is supporting and helping to build and create a sound financial system in Nepal, notably, enacting banking laws, assisting in the establishment of supportive institutions in the financial system, and initiating financial sector reforms at its own cost. The government has formulated many policies and initiated actions to deal with the willful loan defaulters, too.

At the micro-level, the specific role of the MoF is towards improving the soundness and health of the problem banks which are owned and operated by the state.

The MoF has contributed significantly to the improvement of the overall financial system of Nepal from the beginning. In the early years, there were only two commercial banks in Nepal, which were both owned and operated by the government – The Nepal Bank Limited (NBL) and Rastriya Banijya Bank Limited (RBBL). From the mid-1980s, with the entry of private banks into the financial system, the role of the government-owned banks began to wane gradually. To date, both RBBL and NBL remain state-owned, with the RBBL being fully owned and the NBL, partially owned by the government. It is the responsibility of the Ministry of Finance to inject capital, establish good management and operate these two banks professionally. In order to improve the financial and operational health of these two banks and render them attractive for privatisation, both banks are being restructured under a comprehensive Financial Sector Reform Programme (FSRP), which was initiated in 2001. There are other financial institutions as well which are regulated by the government, such as the Citizen Investment Trust and the Employee Provident Fund.

Non-performing loans (NPLs) in the banking system was nearly 36 percent in 2000. The level of NPLs is around 10 percent as of July 2007. Poor governance, bad credit culture, and fraudulent lending contributed to this problem in the past. Therefore, to address the problems of the financial system, the MoF has taken various actions against willful defaulters, like seizure of passports and denying the willful defaulters use of certain state facilities.

2.1.3 Role of Deposit Insurance Agency

Nepal does not have any deposit insurance agency to date. However, the Nepal Rastra Bank, through the monetary policy for the fiscal year 2006-2007, has clearly announced its intention to insure deposits of small investors through the Deposit Insurance and Credit Guarantee Corporation (DICGC). The DICGC operates a credit guarantee scheme for directed lending, but it is not yet involved in providing deposit insurance.

2.1.4 Role of Assets Management Companies

Nepal does not have any Assets Management Companies (AMCs) at present, nor does it have related laws and regulations in this regard, though the NRB Act, 2002 provides for the transfer of assets to such companies. However, work for the formation of such laws and regulations have started. The NRB has been working with the government to create AMCs.

2.1.5 Role of Debt Recovery Tribunal

An institutional framework was introduced in 2002 to address the complex and lengthy legal processes in recovering the NPLs of banks and financial institutions. Under the FSRP, the government established a Debt Recovery Tribunal (DRT) to deal with the loan recovery cases. The DRT is empowered with the legal authority to acquire the borrowers'/ guarantors' additional assets which are not pledged to the concerned bank, and to dispose these acquired assets through auction in order to recover the bank's loan. Problem banks have brought many cases before the DRT and are seeing some results. The performance of the DRT as of July 2006 is shown in Figure 7.

The problem of NPLs can be resolved quickly if the courts can provide timely support to the banking and financial institutions. Unless and until the banks can recover their loans, their ability to meet the claims of their depositors will be impaired. In order to deal with the loan recovery cases, adequate and skillful commercial lawyers are needed to do litigation work. Moreover, there should be special courts to deal with commercial cases. The establishment of the Debt Recovery Tribunal in the financial system is a step in the right direction.

Figure 7
Performance of Debt Recovery Tribunal (DRT)

		Number	Amount Rs. in Million
1.	Total cases filed to DRT	1985	31623.6
2.	Cases Decided	333	4452.5
3.	Recovery of loans	113	211.2
4.	Recovery through mutual agreements		102.2

Source: Annual Report 2005/06, DRT

2.2 Mechanisms for Inter-agency Cooperation and Information Sharing Among Domestic as well as Foreign Official Agencies

With the enactment of the NRB Act, 2002, it has become possible for the NRB to share information with foreign central banks and supervisors in the areas of monitoring, inspection, and supervision of banking and financial institutions. The NRB has been sharing information with various foreign official agencies, like the Central Bank of Sri Lanka, Bank Negara Malaysia, Reserve Bank of India, SEACEN Centre, South East Asia New Zealand and Australia (SEANZA), Financial Stability Institute (FSI), International Monetary Fund, Asian Development Bank, and the World Bank.

The NRB has also constituted a high-level co-ordination committee to coordinate the sharing of information and solve the issues related to the scope and jurisdiction of the regulators of the system. The committee is headed by the Deputy Governor of the NRB and the membership includes the Registrar from Company Registrar Office, the Chairman of the Stock Exchange Board, and the Chairman of the Insurance Board.

2.3 Mechanisms to Ensure Autonomy of Bank Authorities and Legal Protection to the Regulators

The NRB Act, 2002 establishes the autonomy of the central bank and defines its responsibilities and areas of jurisdiction. One of the objectives of the NRB is to monitor, supervise and inspect banking and financial institutions licensed by the NRB. The NRB believes that this objective can be fulfilled only if full authority and autonomy are granted to the supervisors. The NRB Act enacts various provisions in this regard, some of which can be summarised as follows:

a) Provisions for inspection, supervision and monitoring of banking and financial institutions.
b) Authority to issue necessary directives, guidelines, circulars and orders to banking and financial institutions and ensure they are complied with.
c) Requirement for banking and financial institutions to provide information regarding banking transactions as deemed necessary by the NRB.
d) Power to dissolve the management of the banking and financial institution and take over the management.
e) Prior permission of the NRB required for banking and financial institutions to raise capital and subordinated term debt and issue bonds.
f) Requirement for banking and financial institutions to provide written information in relation to their banking transactions.
g) Provision for issuance of directives and orders by inspectors during the course of on-site inspection of banking and financial institutions.
h) Authority to take stringent and stern actions (which can also include imprisonment and monetary penalty) against the banking and financial institutions and their employees for failure on their part to comply with the NRB directives and applicable rules and regulations, and for carrying out any transaction which is detrimental to the interest of depositors, shareholders, creditors and the general public.

2.3.1 Legal Protection to the Regulators/Supervisors

The Nepal Rastra Bank Act, 2002 accords legal authority to the NRB to regulate the functions and activities of commercial banks and financial institutions. The NRB may frame rules and by-laws and issue orders, directives and circulars as deemed appropriate, for the NRB to carry out its regulatory and supervisory work. It shall be the duty of the banking and financials institution to abide by such orders, rules, by-laws, directives, and circulars. In case of voluntary as well as compulsory liquidation of the banking and financial institution, the concerned banking and financial institution is required to obtain the prior approval of the NRB.

Section 107 the NRB Act, 2002 stipulates that the "governor, deputy governor, director or any official or employee of NRB shall not be personally or collectively liable for any act done in good faith under the NRB act and under the regulations or bye-law or under an order or directives issued there under." In such cases the bank shall bear all the expenses, in case of a lawsuit. Therefore, there is some kind of protection to the supervisors.

2.3.2 Mechanisms to Ensure Accountability of Bank Authorities and Judicial Review

As mentioned above, the NRB has exclusive authority to issue directives to banking and financial institutions operating in Nepal and it shall be the duty of the officials of the concerned institutions to comply with such directives. In the case of non-compliance, the NRB Act and the Bank and Financial Institution Act, 2006 further empowers the NRB to initiate necessary actions against such banking and financial institutions. Actions in this regard can be a written warning, prohibition on providing remuneration, imprisonment and a penalty that can extend up to the amount related to such violations. The NRB also reserves the right to remove an official or management personnel from the bank if the NRB has good ground to believe that such official has been involved in fraudulent practice.

3. Problem Bank Identification

3.1 Supervisory Strategy

The NRB has prepared and enforced a supervision bye-law under which the on-site supervision manual (2003) and off-site supervision manual (14 Jan 2004) have been prepared and implemented. These manuals are based on a risk-based supervision framework. NRB has implemented Basel-II framework (simplified standardized approach) from year 2007. Under this framework, Basel I-and Basel-II are being implemented in parallel for year 2007/08. For the year 2007, banks are required to implement the reporting format as prescribed by the new capital-adequacy framework, but they will be monitored for compliance under Basel-I framework.

3.2 Prudential Requirements

To date, the NRB has issued 17 directives, 2 guidelines and various circulars to the banking and financial institutions. All these directives are required to be complied by the banks and financial institutions at all times.

The NRB, as the central bank, has the important task of regulating and supervising the banking system of Nepal. In order to discharge this role, the NRB assesses the overall strength of the banking system as well as the safety and soundness of the individual banking and financial institutions. The NRB uses a uniform rating system, known as "CAMELS," whereby supervisors in doing the assessment assign individual numerical ratings to the key areas of Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk (CAMELS) as well as assign an overall composite rating to each banking institution. In this way, the banking and financial institutions are categorised into groups based on their overall strength, quality and operating soundness. By the rating system, problem banks that are in need of increased supervision are identified.

In the CAMELS rating system each bank is assigned two sets of ratings:

1. Performance Ratings, which comprise six individual ratings that address each of the CAMELS components; and
2. An overall Composite Rating, a single rating that is based on a comprehensive assessment of the overall condition of the bank.

Both the ratings are scored on a numerical scale of "1" to "5" in ascending order of supervisory concern. That is, "1" represents the best rating, while "5" indicates the worst rating.

The following is the description of the rating scores for the each of the six components:

Rating 1 - indicates very strong performance
Rating 2 - indicates above-average performance that adequately provides for the safe and sound operation of the banks and financial institution.
Rating 3 - indicates performance that is flawed to some degree.
Rating 4 - indicates unsatisfactory performance. If left unchecked, such performance could threaten the solvency of the banking and financial institution.
Rating 5 - indicates very unsatisfactory performance in need immediate remedial attention for the sake of the banking and financial institution's survival.

3.3 Early Warning Systems, Other Indicators and Risk Assessment

To date, the early warning signals are observed and monitored from through on-site inspections based on the CAMELS ratings and through off-site supervision based on the CAELS ratings. However, a draft of the enforcement actions to be taken in response to the Early Warning Signals is under preparation and will be implemented.

3.4 Communicating Concerns

Concerns on problems are communicated to the banking and financial institutions in various ways:

1. During the inspection: The significant issues are put in front of the management during the inspection period. These issued are verified and suggested to the management immediately. The concerns which can be resolved during the inspection are not mentioned in the inspection report and those which cannot be resolved during the period of inspection are incorporated in the report for the bank to comply in the future.
2. During the course of finalising of the inspection report: After the completion of the inspection, the draft inspection report is discussed with the management of the bank and it is forwarded to the management for formal comments.
3. Report implementation: After completion of the inspection and having obtained the comments of the bank management on the report, the report is forwarded to the management of the bank again along with the recommendations and instructions provided by the Board of Directors of the NRB.

4. Special Meetings with the Management: There is a system used by the NRB to monitor the quarterly progress of the bank on the report implementation.

If there is multi-disciplinary issue that involves various regulatory authorities, the issue is resolved through the high-level co-ordination committee (HLCC). The HLCC does not deliberate on implementation issues raised by the inspection report, but only resolves specific issues of the related to the financial system that bear on the Financial Sector Reform Programme.

The consolidated Annual Report of Inspection and Supervision is prepared by the Supervision Department and posted on the web site of the NRB for the information of the general public. The NRB also puts the executive summary of the inspection reports of the individual banks on the web-site for the information of the general public.

4. Main Problems in the Banking System

About one third of all the commercial banks continue to encounter various deficiencies in their operations. The problematic areas fall under these main categories:

- Inadequate working capital
- High levels of NPL
- Poor governance and internal controls
- Poor information technology and MIS in the bank
- Poor credit, human resource and asset/liability management capabilities
- Improper planning and business strategy

5. Causes of Problems in the Banking System

The Nepalese banking system suffers from various deficiencies in credit management governance, IT, account/audit and so forth. The problem of non-performing loans is a burning issue in the financial system. Some of the obstacles are beyond credit management, contributing to a higher level of NPL. However, the level of NPLs in the banking system has been reduced from around 29 percent in 2003 to 10 percent in July 2007 (Annex 1).

For the purpose of analysis, the factors contributing to high NPLs can be classified into two groups. The first group of causal factors is internal factors, mainly weaknesses of the individual banks in credit management and deficiencies in oversight. Preventive measures have been taken at the institutional level to reduce the level of NPLs, The problems of NPLs are also being resolved by the banks themselves to some extent. The next group of causal factors are external in nature which are essentially beyond the control of the banking and financial institutions. The causes behind the alarming NPL level in the banking system are due to some of these factors:

5.1 Internal Factors

A. Risk management deficiencies within the banking and financial institutions: These comprise poor internal-control systems, operating procedures and credit culture, which are being improved.

B. Management oversight deficiencies at the policy level: Along with the adoption of rapid and aggressive growth strategies is a corresponding lack of competencies at the level of the Board of Directors in monitoring these strategies.

C. Limited supervision by the NRB itself in the past and weak internal controls within the commercial banks: these comprise weak supervision and monitoring, inadequate system of reward and sanction, and poor Management Information System (MIS) to monitor, manage and control the risks within the banking and financial institutions themselves.

D. Significant off-balance sheet exposure ultimately giving rise to problematic on-balance sheet exposure.

E. Insider abuse and fraud.

F. Poor efforts in recovery even when the loans have been categorised as bad.

G. Significant NPLs in the system due to a few major banks which have been poorly managed.

5.2 External Factors

A. Weak legislative regime in the past, especially the legal framework governing the financial system and its poor implementation.

B. Lack of supportive institutions that can help to reduce the NPL: Lack of effective and professional Notary public services in eliminating problems associated with cheques, bills purchased and discounted, lack of secured transaction office to register moveable properties, lack of credit-rating agencies facilitating to rate the risk grades, lack of asset management corporation assisting the financial institutions to manage the distressed loans, lack of proper training facilities and academic institutions for enhancing the skills and knowledge of the personnel of banking and financial institutions.

C. Political instability, deterioration in economic growth rates and business activities over the last few years.

D. Poor regulatory and supervisory capacity of the central bank in the past.

E. Security and conflict situation at present.

F. Other systemic problems that are being faced by all the financial institutions equally.

The two big banks of Nepal, which are still state-owned, lack adequate capital to operate. If we analyse the information provided in the Annex 2, the overall capital of the financial system appears negative (due to negative reserve and surpluses). This is only because of the heavy cumulative losses of the above-mentioned two big banks. Therefore, there is a need to re-capitalise these banks and improve the level of governance and professionalism in the system. Most of the private banks are operating prudently and the banking system (excluding these problem banks) is heading towards achieving macro-economic sustainability in the economy.

6. Problem Bank Intervention

6.1 Prompt Corrective Actions

Based the CAMELS rating system, if the ratings of a bank should indicate that the bank has a problem in one or more of the key areas, the matter is addressed in the inspection report and taken up and discussed with the management. Management is requested to submit a plan of action to resolve the issues. If the corrective action is carried out in accordance with the plan, the NRB will not initiate the process to take over control of the bank.

Section 100 of the NRB Act specifies the punishment for the violation of bank regulations. This section stipulates that in the event that any licensed commercial bank or financial institution violates an order or directives issued by the NRB or is in breach of the regulation or bye-laws formed there under, the NRB may impose one or more of the following penalties on the banking and financial institution.

(a) Issuance of reprimand or written warning;
(b) Securing an undertaking from the board of directors to adopt reformative measures;
(c) Issuance of written order to cease or abstain from such violation and to adopt reformative measures;
(d) Suspension or termination of the services provided by the NRB;
(e) Prohibition imposed on the commercial bank or financial institution from distributing dividend to its shareholders;
(f) Prohibition from accepting deposits or granting loan and advances
(g) Imposition of full or partial restriction on transaction of business by the banking and financial institution.
(h) Suspension or revocation of licence of the banking and financial institution.

In the event that any official violates the rules and regulations of the NRB, the NRB may impose a monetary penalty on the person of up to Rupees 500,000 or the NRB could issue an order to terminate the employment of the official.

In this way the management is compel to recover the problem bank as per instructions and order of the NRB.

The corrective measures implemented by the banks are assessed by the board of directors of the NRB, and further instructions are provided formally by letter issued through the concerned supervision department, if required.

Besides this, Basel-II capital adequacy framework will be implemented in full phase from July 2008, for which a directive has already been issued to the commercial banks. Within this framework, the prompt-corrective-action (PCA) rule has been prescribed on the basis of minimum capital-adequacy ratio (CAR). The minimum capital-adequacy ratio is prescribed at 10 percent. The nature of the enforcement action will largely depend on degree of the capital adequacy of the bank. The trigger points and the prescribed action have been determined as follows:

1. CAR below 10 percent and equal or above 9 percent
   - Prohibition from establishing new branches.
   - Prohibition from declaring dividends.
   - Submission of a capital plan for recapitalization of the bank.
   - Interaction with the senior management on course of corrective action.

2. CAR below 9 percent and equal or above 6 percent
   - Action required under Category 1.
   - Suspension of lending, investment, and credit extension activities.

- Prior approval of the NRB for acquiring, through purchase or lease, additional fixed assets.
- Prior approval of NRB for establishing new business lines
- Other actions under the Nepal Rastra Bank Act, 2002 and the Bank and Financial Institution Act, 2006.

3. CAR below 6 percent and equal or above 3 percent
    - Action required under Category 2.
    - Restriction on deposit mobilization
    - Prohibition from acquiring, through purchase or lease, additional fixed assets;
    - Restrictions on payment of incentives, severance packages, management fees or other discretionary compensation to directors or officers without prior approval of the NRB.
    - Restriction on Standby Liquidity Facility (SLF).
    - Other actions under Nepal Rastra Bank Act, 2002 and the Bank and Financial Institution Act, 2006.

4. CAR below 3 percent and equal or above 1 percent
    - Action required under Category 3.
    - Restrictions on salary increments, recruitments and promotions.
    - Action to directors and chief executive if capital position of the institution does not improve in six months after initiating action under this Category.
    - Other actions under Nepal Rastra Bank Act 2002 and Bank and Financial Institution Act 2006.

5. CAR below 1 percent
    - Action required under Category 4.
    - Declare the bank as problem bank and initiate actions under Section 86 of NRB Act.
    - Suspend existing board of directors and chief executive of the bank and bring in new board and management.
    - Initiate steps to dilute the ownership of the existing shareholders.
    - Other actions under Nepal Rastra Bank Act, 2002.

The trigger points and stipulated actions will be applied uniformly to all banks under this framework. However, the NRB may allow certain exceptions in the following cases:

1. Branch expansion which is targeted in the rural parts of the country where the banking facility is not available in a competitive manner.
2. Banks that are already under the restructuring process.
3. Banks whose management and operation are under the direct control of the Nepal Rastra Bank.
4. Banks that are too big to fail in the national context.

6.2 Resolving Liquidity Problems

Commercial banks are required to maintain CRR (cash reserve ratio) at 5 percent of total deposits. If they fail to maintain the prescribed ratio, they are enalized at the bank rate, i.e., 6.25 percent for the first time in the fiscal year, the rate would double on the second time, and triple from the third time onwards.

The CRR is monitored weekly and the liquidity profile is monitored on a quarterly basis by the NRB. As the liquidity component is one of the major components of CAMELS-based supervision system, the NRB evaluates all aspect of the liquidity management of the bank. The Directive No. 5 of the NRB deals with the liquidity risk management. The NRB collects the profile on maturity, liquidity, maturity mismatch, and gap-analysis information from the banks on a quarterly basis. On the basis of these quarterly financials and information, the liquidity risk of the bank is evaluated, causes of liquidity problems are uncovered and communicated to the bank for timely rectification and some times with instruction for the submission of contingency plans for resolving the liquidity problems.

In the event that banks have a liquidity problem, there are two types of modalities to support the problem banks.

General window: If a problem bank has adequate government securities in its investment portfolio, it can obtain assistance from the general window of the NRB. Each and every commercial bank can enjoy standby liquidity facility (SLF) to get out from temporary liquidity problem. Under this scheme, 50 percent of the value of treasury bills can be withdrawn for a short period of 7 days at the prevailing average discount rate of treasury bills.

Lender of last resort: The Board of the NRB has the discretion to decide whether or not to support the problem bank. In general, banks which are solvent are supported through this window if they have a liquidity problem. The lender-of-last-resort facility was once provided to a problem bank, which was taken over by the NRB. In this particular case, the collateral value of its good loans, based on the loan documentation, was assessed in determining the solvency of the bank. There is a need for policy guidelines to specify the circumstance by which a bank can obtain lender-of-last-resort assistance from the NRB, along with the prescribed process and the required documents to obtain such assistance.

Commercial banks can also avail for refinancing under various schemes. These schemes are provided to facilitate lending in the desired sectors, such as towards micro-credit lending, lending for foreign exports and for rehabilitation of sick industries.

Section 49 of the NRB Act incorporates a provision for refinancing to any banking and financial institution for a maximum period of six months. In order to obtain refinance, the bank should have collateral, such as internationally negotiable instruments, gold or precious metals, government bonds or other securities, as prescribed by the NRB. This is a general method to provide liquidity for making additional lending in the sectors as prescribed by the NRB.

6.3 Resolving Credit and Capital Impairment Problem

6.3.1 Resolving Credit Problems

Credit usually represents the bulk of a banking institution's assets and interest on the credit represents the major source of income. A bank needs to have a quality credit portfolio.

Therefore, the credit operations are reviewed carefully during on-site inspection. The banking and financial institutions are to have documented credit policies in place. The institution's credit appraisal system, credit approval system, documentation, credit authority, security, credit supervision and credit recovery and restructuring aspects are examined during the on-site supervision. If any type of credit problem is identified, this is communicated to the management for further improvement.

The problem of the Nepalese Banking system is high NPLs, but the level is gradually decreasing. It is mandatory for a banking and financial institution to check the credit profile of a borrower from the Credit Information Bureau (CIB) for loan disbursements of above Rs.2.5 million. The CIB also maintains a list of defaulted borrowers and the list is updated when a borrower is black-listed by the banking institution. Blacklisted borrowers are barred from applying for any additional loans and facilities from any banking and financial institutions until they settle their outstanding liabilities and have their names deleted from the blacklist.

The banking and financial institutions are required to maintain their NPL level at the prudent level of below five percent. If their levels exceed the limit, they will not be allowed to undertake branch expansion. Recently, the government has made it a policy that state-owned agencies and organizations are not allowed to keep their deposits in the banking and institutions whose NPL levels are 10 percent or more.

In order to reduce the level of NPLs, the banking and financial institutions can initiate auctions to dispose of the collaterals pledged with them and to recover the outstanding loan amounts from the proceeds. Where a loan has been categorised as bad and the collateral is inadequate to cover the loan, and if the borrower has additional property not pledged with the bank, the bank can appeal to the Debt Recovery Tribunal to recovery the loan from those un-pledged securities. The DRT initiates the legal action to seize the additional property of the borrower, and to auction it and recover the proceeds for the bank.

6.3.2 Resolving Capital Impairment Problem

The banking and financial institutions are required to maintain a minimum capital adequacy ratio (CAR) at all the times. As of July 2008, banks are required to maintain 5.5 percent core capital and 11 percent capital fund to total risk- weighted assets. Capital adequacy is monitored on a quarterly basis by the NRB. Any banking and financial institution that is not able to maintain its capital adequacy ratios in any quarter, must report to the NRB within 15 days, stating the causes for its capital inadequacy, plan and programme to meet the requirement. The bank will not be allowed to declare dividends and distribute bonus shares unless and until it maintains the adequacy ratios. In addition, the bank will not be allowed to open new branches and will be prohibited from obtaining refinance from the NRB. The bank may be restricted from lending and accepting new deposits, and the NRB can initiate any action, as provided under Section 100 of NRB Act, 2002.

The capital of commercial banks and financial institutions is also prescribed in the form of paid-up capital. The minimum paid-up capital of a commercial bank is Rs.2 billion. The banking and financial institutions that fall short of the prescribed level are required to meet the requirement by the year 2013. For this purpose, the bank has to formulate a capital plan and increase the paid-up capital proportionally within the plan period. Almost all the commercial banks are presently strengthening their capital base by issuing right shares and bonus shares.

The banking and financial institutions that do not meet their capital requirements are deemed to be in breach of the regulations and are punishable under the provisions of the NRB Act, 2002.

6.4 Removing Bank Management and Ownership

This issue has been addressed in Section 86 of the NRB Act 2002. After declaring a bank/financial institution as a problem bank/financial institution, the NRB can remove the management and restructure the ownership itself.

There have been a few instances where NRB intervened, removed the board of directors, and assumed control of the bank. The examples are: NEFINCO, Nepal Bank Limited, Lumbini Bank Ltd. and Nepal Bangladesh Bank Ltd. The main reason behind the NRB's intervention was non-compliance to its directives, failure on the part of these banks to abide by the principles of corporate governance, like insider lending to family members, relatives, firms and companies where the promoters, directors and Chief Executive Officer of the bank had an interest. The NRB in these cases declared the banks as problematic banks and took over the management. The NRB has still retains control of the Nepal Bangladesh Bank Ltd. In the case of the Lumbani bank, the NRB has constituted a new board of directors from its owners and the management has been handed over to them.

The Nepal Rastra Bank Act, 2002 empowers the NRB to forfeit the rights attached with any class of shares if it believes that such forfeiture would avoid certain group of shareholders from influencing the management. The Act has also allowed the NRB to direct these shareholders to transfer these shares to certain groups as approved by the NRB.

6.5 Role of the Courts in Bank Intervention

The NRB Act, 2002 provides full authority to NRB to intervene in a bank. The NRB is not required to initiate court proceedings to intervene, but it has to inform the government after taking over control of the management of any bank. Voluntary liquidation also requires the NRB's prior approval before a bank obtains a court order. Liquidation is administered by the court according to the provisions of the Insolvency Act, 2006, whether it is appealed by the NRB or is under the bank's voluntary arrangement.

7. Resolution Management

Some banks are experiencing losses and erosion of capital in the Nepalese financial system. These losses have been due to poor asset quality, poor management, and poor corporate governance. High risk concentration resulting from the exposure of banks in related companies and increase in the value of collateral which gives banks a false sense of security, have contributed to the failure of banks in most of the countries, including Nepal.

Banks restructuring is generally a management tool that is deployed to improve the bank's profitability, quality of assets and corporate governance. However, in practice, while the banking law confers legal authority to the bank regulator to take over control and restructure a problem bank, the actions of the regulator may be subject to judicial review. Restructuring a bank begins with the corrective measures ordered by the Court or by the bank's regulator as soon as the bank shows significant signs of non-compliance with the prudential requirements. Non-compliance with the prudential requirements can include failure on the part of the bank to maintain the minimum capital-adequacy norms, non-compliance by the bank with the provisions of a single-obligor limit, and the provision of loan loss. Prudential non-compliance can jeopardize public deposits and the interest of the stockholders of the bank. All these issues should be addressed in time and corrective actions should be initiated. If such actions fail, resolution seems inevitable in the system.

7.1 Resolution under Insolvency Act, 2006

The Insolvency Act, 2006, provides that insolvency action can be initiated for any company (including banking and financial institutions) in any of the following ways to apply to the Court for insolvency proceedings:

a) Company itself
b) At least 5 percent of the total creditors of the company.
c) At least 5 percent of the shareholders of the company.
d) At least 5 percent of the debenture holders of the company.
e) Liquidator of the company.

The prior approval of the Nepal Rastra Bank and of the relevant regulatory authorities is required to obtained, respectively, by banking and financial institutions and by other specific companies, before a court application can be made.

A person (who is enlisted in the business of liquidation) is selected and appointed by the Court as a liquidator. On the appointment of the liquidator, the board of directors, management and employees are removed from the service of the company. The liquidator also takes over the books of accounts of the company.

7.2 Official Administration of Insolvent Banks

To date, Nepal has not experienced any bank insolvency. However, the NRB has declared a number of banking and financial institutions as problematic. Reform actions and plans have been taken by the NRB to protect the banks from falling into insolvency. The measures include extending refinancing assistance to the banks to help them maintain their liquidity position and sustain their restructuring.

There are two methods of liquidation: The first is voluntary liquidation. If a bank or financial institution is sound enough to pay up all its liabilities and the NRB grants its approval, which may be subject to some terms and conditions, the voluntary liquidation may proceed. Second, if any bank or financial institution that could not be recovered through corrective and restructuring efforts, then the NRB can appeal in court to liquidate the bank. The liquidation process and procedures are not specified in both the BAFIA 2006 and the

NRB Act, 2002. Therefore, after submitting the application in the court, the provisions of Insolvency Act, 2006 will prevail for completing the liquidation.

Under the Insolvency Act 2006, the court can appoint an investigating officer to initiate the insolvency process. The investigating officer will investigate the financial and other position of the company and prepare a report, convene a meeting of the creditors, and submit the resolutions of the meetings to the court. With these documents, the court can issue an order to do any of the following:

1. Initiate liquidation immediately.
2. Implement restructuring program.
3. Wait for some time to recover the bank (if possible), instead of carrying out the liquidation.
4. Provide additional time for insolvency process in order to conduct additional investigation
5. Cancel the order to initiate the process of insolvency

7.3 Initiation of Bank Insolvency Proceedings

The Insolvency Act 2006 stipulates that the legal proceedings for bank insolvency will have to meet all the requirements defined in the Banks and Financial Institutions Act, 2006, the Nepal Rastra Bank Act, 2002 and the Companies Act, 2006. The Insolvency Act, 2006 also requires the prior approval of the NRB to liquidate banks and financial institutions. There are two types of liquidation in Nepal, namely, voluntary liquidation (including liquidation by the Company Registrar) and compulsory liquidation (by the court upon the request of the regulators or creditors).

A company is presumed to be insolvent when eligible persons (5 percent share holders or 10 percent creditors or debenture holders), or the company itself, or the liquidator, or regulator make an application for insolvency proceedings. For applications by companies, a special resolution is passed by the BOD and the application is given to the court. If creditors make the appeal for insolvency, they have to complete a 35-day period from the date of notice directing the company to payoff its debts. If waiting period is completed, than the court can initiate the investigation for insolvency. A liquidator is appointed and the liquidation process is initiated thereafter.

7.4 Some of the Important Roles and Responsibilities of the Liquidator in Insolvency Act and Companies Act

a) File a case on behalf of the company.
b) Hire employees for the purpose of expediting the work of liquidation.
c) Recover 'calls in arrears' on shares from the shareholders.
d) Use company's official seal.
e) Take a loan secured by assets of the company.
f) Sell the assets in the best interest of the company and discharge liabilities of the company.
g) Amicably solve the issue of payment of dues with the creditors of the company.

h) Sell the assets and settle the liabilities
i) Initiate all the activities to liquidate the company.
j) On appointment of a liquidator, all the powers and duties of BOD, management and other employees will rest on the liquidator.
k) BOD, management, and employees of the bank will be barred from taking part in the management and operation of the bank and they shall be removed from their respective positions, unless and until the liquidator gives them an order to stay.
l) Take over the assets, accounts and other necessary documents of the bank.
m) Submit statement of performance to the Registrar every 6 months after the start of liquidation proceedings.
n) Submit statement of affairs to the shareholders every 6 months after the start of liquidation proceedings.
o) Realization of assets and discharge of liabilities.
p) Call general meeting of the shareholders or creditors to discuss the proceedings of liquidation.

7.5 Restructuring Programs under Insolvency Act 2006

The Insolvency Act, 2006 defines restructuring as a process under which a restructuring program is launched under this Act for any type of company (including a bank) which is facing the financial crisis, and, if it is not addressed in time, would result in the company falling into possible bankruptcy or insolvency. Under Section 22 (2) of the Insolvency Act, 2006, the liquidator, manager or the official is ordered to complete the restructuring activities within the prescribed timeframe. The restructuring manager has to prepare a restructuring plan incorporating the following matters:

a) Plan to change the capital structure by capitalising the debt
b) Payment of dues to the creditors by realisation of some of the assets of the company.
c) Issue of securities in lieu of outstanding obligations to the creditors.
d) Conversion of the claims of creditors into capital
e) Merger of the company with another company.
f) Change in the management of the company.
g) Any other restructuring programs as directed by the Court.

The person appointed as a restructuring manager will have exclusive power to manage the company undertaking the restructuring.

7.6 Treatment of Bank Deposits and Other Claims

The provisions for the priority of claim settlement differ between the different Acts. But in the case of banking and financial institutions, the claims should be settled in accordance with the provisions of the NRB Act and the Bank and Financial Institution Act, 2006. Upon realisation of the asset value, the claims are settled by the liquidator in the following order:

a) Liquidation expenses.
b) Payments to saving depositors.
c) Payments to fixed depositors.
d) Payment to other depositors.

e) Payment of taxes and other similar fees & duties.
f) Payment of loan taken from the NRB.
g) Payment of outstanding salaries, allowances, gratuity and provident fund.
h) Payment of other loans and advances.
i) Payment to shareholders.

8. Crisis Management

8.1 Issues Related to Systemic Banking Crisis

The risks emerging from the system as a whole, arising from any internal or external shocks, could have systemic effects on to the financial system. So far the issues relating to systemic crisis in Nepal, are not related to the external shocks as experienced in the South-east Asian nations, but have to do with the internal weaknesses of the system. Poor financial legislation, poor institutional infrastructure, poor regulatory and supervisory capabilities, poor risk management and operational skill in the banking and financial institution, low level of capital structure, and so forth, were the main causes in the past, which distorted the credit culture, corporate culture and governance and generating high levels of NPLs and huge losses in the financial system. To resolve such systemic problems, Nepal had launched a comprehensive Financial Sector Reform Program in 2001. Nepal today is in the process of building a strong financial architecture to enhance the soundness of its financial system. Under FSRP, the two dominant state-owned banks are being restructured, and the NRB has launched a re-engineering programme to modernise its operation and build up its capacity. Similarly, to remove the weaknesses of the financial system as a whole, a capacity-building programme is also being launched. Most of the points of weaknesses in the financial system are being addressed and are being resolved with minimal cost and burden to the public.

8.2 Institutional Arrangements to Deal with Systemic Crisis

The authorities have to play an active role to prevent systemic crisis. The government of Nepal is discharging its role in various forms. The FSRP has been introduced as a programme by the government to address this issue, and the Nepal Rastra Bank is an implementing agency. The reform program has been launched with the financial assistance of the International Development Association (IDA) of the World Bank group. The first phase of Financial Sector Technical Assistance Project (FSTAP) credit agreement was signed on 30th April 2003 with a closing date of 30 June 2007. The cost of the project is US$ 30.1 million. The sources of the funding are from the following: IDA Credit: US$16 Million, DFID Grant: US$10 Million and HMG/N Grant: US$ 4.1 Million.

Similarly, the second phase of the FSTAP, credit agreement was signed on 10 June 2004 with a closing date of 29 April 2009. The cost of the second phase is US$75.5 million. The sources of funding are from the following: IDA Credit: US$68.5 Million, Grant: US$7.0 Million. Therefore, all together around US$105.6 million is going to expending in this program.

9. Conclusion and Recommendations

The objectives of the NRB are to promote stability, develop a secure, healthy and efficient banking system. In addition, as the primary concern of depositors is the safety of their money, NRB also aims to enhance the credibility of the banking system. To benefit the overall economy, funds that are placed in the banking and financial institutions should be channeled to the productive sectors. However, it was discovered in several instances that the funds collected from the public have been diverted by the promoters, directors, and members of the senior management of the banks for their private use. The NRB views these matters as serious non-compliance to its directives on corporate governance and has acted against the perpetrators. In this regard, the NRB has been working to prevent insider lending in the banking and financial institutions and to enhance corporate governance in the system. Another major weakness is the disbursement of loans and advances by senior managers of the bank to related companies of the promoters. The weaknesses in poor corporate governance and weak internal control have been commonly found in almost all the problem banks taken over by the NRB. It is also found that poor governance has led to imprudent lending, which in turn led to increase in the level of NPLs and losses, and brought on many other complications to the institutions.

The NRB Act, 2002 and the Bank & Financial Institution Act, 2006 have empowered the NRB to intervene and resolve a problem bank by initiating corrective action or by restructuring. Deficiencies in a bank are identified through several ways, such as notification of the bank itself, or on the basis of reports like the auditors' reports, on-site and off-site inspection reports. Among these, the most effective and comprehensive way to identify the problem areas is through the on-site inspection reports. As the increasing severity of the problems could lead to insolvency of the bank, intervention and resolution modalities, which have been discussed under Section 6 and Section 7 above, must be in place to prevent the bank from falling into insolvency and from facing possible liquidation.

In Nepal, the banking and financial institutions cannot on their own initiate insolvency proceedings to resolve their problematic position. Voluntary liquidation is possible if a bank is solvent and has the prior approval of the NRB, otherwise a problem bank must first be taken over by the NRB and subjected to corrective action or restructuring. If the problem bank cannot or does not seem to not be able to be rehabilitated, then the NRB can appeal to the court for liquidation. On obtaining the court order, the liquidation is carried out in accordance with the provisions of the Insolvency Act.

In order to prevent systemic crisis, the government has been undertaking comprehensive financial reforms that encompass preventive as well as corrective actions in the financial system. One of the best examples is the Comprehensive Financial Sector Reform Program, which uses the public funds as well as donor's technical assistance.

In general, risks of bank failure should be viewed as part of a competitive environment. Regulators cannot and should not guarantee that there will not be any bank failure in the system. Fortunately, Nepal has not experienced any bank liquidation in its history. Even though there are a few problem banks in its financial system, they have been making steady progress under restructuring.

It is noted that while the resolution and exit policies are already in place, sometimes actions are taken based on discretion. Therefore, to make the system more transparent, a clear prompt corrective actions (CPA) policy and programme has been formulated and is being implemented.

To refine the resolution and exit policies, well-defined criteria are being framed for determining when a bank requires intervention or closure. The regulators should take prompt action whenever such criteria are met. In the resolution of problem banks, private sector solutions should be considered best. It allows the takeover of the problem bank by a healthy institution that finds ownership of the problem bank attractive. The regulators need to encourage such private-sector solutions, and apply the least-cost criterion when initiating the resolution and exit of problem banks.

The challenge of supervisors of the financial system is to resolve problem banks in time. The rehabilitation of a problem bank should be quick to minimise the eventual cost to depositors, creditors and taxpayers.

It is observed that a resolution strategy sometimes may not be on a competitive basis. This is the case with the large state-owned banks when they get into trouble, although the NRB may have the view that the resolution or exit techniques should be done on a competitive basis. While implementing any strategy on bank resolution, initiatives to resolve a problem bank should not distort competition and penalise the efficient banks. The choice of resolution measures and the choice between resolution and closure should be made with the aim of minimising market disruptions.

Deficiencies in the banking and financial institutions can be resolved more easily if they are identified early. The CAMELS rating system is an effective mechanism to identify problems at the early stage. It also facilitates timely intervention by the supervisors.

Insolvent banks should be allowed to close. On the other hand, problem banks, which are in a tight liquidity situation and which are recoverable, should be rehabilitated and restructured. To provide the financial safety nets in the Nepalese financial system, a deposit insurance company should be established. In addition, lender of last resort and other policy to deal with systemic crisis should be put in place.

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Annex 1

Status of Non-Performing Loans in the Nepalese Banking System

Banks	Mid-July 2003			Mid-July 2004			Mid-July 2005			Mid-July 2006			Mid-July 2007		
	Total Gross Loan (In Million Rs)	NPL (In Million Rs)	**NPL to Total Gross Loan (%)**	Total Gross Loan (In Million Rs)	NPL In Million Rs)	**NPL to Total Gross Loan (%)**	Total Gross Loan (In Million Rs)	NPL (In Million Rs)	**NPL to Total Gross Loan (%)**	Total Gross Loan (In Million Rs)	NPL (In Million Rs)	**NPL to Total Gross Loan (In%)**	Total Gross Loan (In Million Rs)	NPL (In Million Rs)	**NPL to Total Gross Loan (In%)**
1. Nepal Bank Limited	18132.33	10964.91	**60.47**	17937.66	9640.08	**53.74**	16866.55	8372.11	**49.64**	12879.22	3233.90	**25.11**	13750.70	2007.50	**14.60**
2. Rastriya Banijya Bank	26608.83	16005.32	**60.15**	25105.68	14470.52	**57.64**	25835.20	13689.34	**52.99**	27158.89	12313.84	**45.34**	25422.60	6719.30	**26.43**
3. NABIL Bank Limited	8113.68	449.63	**5.54**	8548.66	286.68	**3.35**	10946.74	144.51	**1.32**	13278.78	165.98	**1.25**	15903.00	178.30	**1.12**
4. Nepal Investment Bank Limited	5921.79	117.09	**1.98**	7338.57	181.44	**2.47**	10453.16	280.87	**2.69**	13171.54	302.94	**2.30**	17769.00	376.10	**2.12**
5. Standard Chartered Bank Nepal Ltd	6000.16	247.95	**4.13**	6693.86	252.20	**3.77**	8420.87	226.31	**2.69**	9206.28	195.17	**2.12**	10789.90	197.10	**1.83**
6. Himalayan Bank Limited	10844.60	1092.84	**10.08**	12919.63	1147.46	**8.88**	13451.17	1001.35	**7.44**	15939.63	978.69	**6.14**	17841.60	629.80	**3.53**
7. Nepal SBI Bank Limited	4795.84	561.67	**11.71**	5531.83	345.82	**6.25**	6739.35	441.02	**6.54**	8232.11	520.26	**6.32**	10065.00	45.80	**0.46**
8. Nepal Bangladesh Bank Limited	7961.51	1013.28	**12.73**	9644.70	1042.18	**10.81**	9626.91	1832.94	**19.04**	8478.77	1040.34	**12.27**	9159.10	3217.50	**35.13**
9. Everest Bank Limited	5049.58	111.19	**2.20**	6095.84	104.76	**1.72**	7900.09	128.81	**1.63**	10154.86	121.85	**1.20**	14099.90	107.00	**0.76**
10. Bank of Kathmandu Limited	4856.03	420.87	**8.67**	6008.31	399.94	**6.66**	6182.05	308.51	**4.99**	7542.75	190.17	**2.52**	9722.10	214.00	**2.20**
11. Nepal Credit and Commerce Bank	3396.41	700.83	**20.63**	4717.30	600.05	**12.72**	6011.90	519.26	**8.64**	5914.44	655.91	**11.09**	5122.20	1568.70	**30.63**
12. Lumbini Bank Limited	2618.55	302.96	**11.57**	3222.75	237.30	**7.36**	3685.13	561.13	**15.23**	4384.00	1401.58	**31.97**	4944.60	981.40	**19.85**
13. Nepal Industrial & Commercial Bank	2562.86	170.69	**6.66**	3743.09	146.59	**3.92**	4909.36	185.43	**3.78**	6657.38	173.09	**2.60**	9128.70	100.30	**1.10**
14. Machhapuchhre Bank Limited	1495.86	31.10	**2.08**	2540.79	24.98	**0.98**	5130.22	19.86	**0.39**	6068.90	16.99	**0.28**	7326.20	82.20	**1.12**
15. Kumari Bank Limited	2137.59	36.32	**1.70**	3697.99	28.19	**0.76**	5681.01	53.99	**0.95**	6010.19	54.09	**0.90**	9062.50	66.20	**0.73**
16. Laxmi Bank Limited	775.94	0.00	**0.00**	1750.93	0.00	**0.00**	2726.14	44.49	**1.63**	4274.56	27.78	**0.65**	6529.20	23.10	**0.35**
17. Siddhartha Bank Limited	629.03	0.00	**0.00**	1567.83	25.22	**1.61**	2634.93	67.93	**2.58**	3869.28	51.84	**1.34**	6319.90	21.50	**0.34**
18. Global Bank Ltd													2601.70	0.00	**0.00**
19. Agriculture Development Bank Ltd.										25087.23	5326.00	**21.23**	34225.00	5647.10	**16.50**
Total	111900.59	32226.66	**28.80**	127065.40	28933.41	**22.77**	147200.78	27877.84	**18.94**	188308.81	26770.42	**14.22**	229782.90	22182.90	**9.65**

Note: Global bank is a newly established commercial bank and Agriculture Development Bank is upgraded to commercial bank in 2006.

Annex 2

Consolidated Financials of the Banking System

(Rs. in Thousands)

Capital and Liabilities	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
Share Capital	6,552,005	7,777,400	8,350,651	11,101,522	16,849,764
Reserves and Surplus	(26,283,085)	(30,721,880)	(28,048,813)	(32,823,223)	(31,828,256)
Debenture & Bond	–	–	–	–	1,810,000
Loans & Borrowing	3,185,487	3,194,132	3,382,377	11,973,882	9,208,426
Deposit	165,498,736	181,292,438	206,678,378	253,257,333	291,985,286
Bills Payable	444,058	587,940	697,395	970,678	807,968
Proposed & Payable dividend	805,171	857,131	1,094,685	1,179,337	1,609,093
Tax Liabilities	19,643	24,156	13,267	285,998	808,696
Other Liabilities	41,129,546	44,141,996	47,654,017	36,580,209	20,871,465
Total Liabilities	**191,351,561**	**207,153,313**	**239,821,957**	**282,525,736**	**312,122,442**
Cash Balance	5,259,939	5,135,942	4,968,201	6,373,971	7,081,487
Balance with NRB	11,555,520	11,724,238	18,231,216	17,720,459	21,132,454
Balance with Banks	4,748,461	3,306,346	3,164,030	3,630,679	3,949,261
Money At call	4,613,331	4,055,096	5,983,939	5,565,173	7,259,539
Investment	45,525,708	55,654,713	59,969,477	70,819,520	88,349,123
Loan and Advances	75,553,458	82,097,416	97,501,323	139,950,468	160,778,434
Fixed Assets	1,890,132	2,159,452	2,419,531	3,362,069	3,731,586
Non- Banking Assets	665,382	1,120,994	574,480	681,020	521,164
Other Assets	41,539,630	41,899,116	47,009,760	34,422,377	19,319,394
Total Assets	**191,351,561**	**207,153,313**	**239,821,957**	**282,525,736**	**312,122,442**
Interest Income	10,087,205	11,859,588	12,869,658	18,151,359	20,094,407
Interest Expenses	7,670,628	7,258,737	6,462,165	7,375,780	8,330,177
Net Interest Income	**2,416,577**	**4,600,851**	**6,407,493**	**10,775,580**	**11,764,233**
Commission and discount	1,129,721	1,329,385	1,468,980	1,485,104	1,617,899
Other Operating Income	311,349	302,092	508,707	920,936	830,899
Exchange Income	1,055,026	793,942	972,853	964,506	1,334,356
Total Operating Income	**4,912,673**	**7,026,270**	**9,358,033**	**14,146,123**	**15,547,386**
Employees Expenses	2,672,978	5,653,345	3,707,020	3,876,093	4,952,269
Other Operating Expenses	1,444,883	1,846,542	2,022,798	2,654,530	2,852,566
Exchange Loss	–	26	–	18,600	–
Operating Profit Before Provision	**794,812**	**(473,643)**	**3,628,215**	**7,596,900**	**7,742,550**
Provisions for possible losses	9,402,317	2,443,882	1,348,335	4,185,046	5,655,923
Operating Profit	**(8,607,505)**	**(2,917,525)**	**2,279,880**	**3,411,855**	**2,086,630**
Non-Operating Income/Expenses	118,400	220,657	903,345	1,641,625	157,038
Return From Loan Loss Provision	295,504	577,814	2,127,177	1,465,367	4,583,133
Profit From Ordinary activities	**(8,193,601)**	**(2,119,054)**	**5,310,402**	**6,518,846**	**6,826,802**
Extra ordinary Income/Expenses	(469,104)	(51,574)	(81,821)	(644,344)	(948,303)
Net Profit including all activities	**(8,662,705)**	**(2,170,628)**	**5,228,581**	**5,874,502**	**5,878,497**
Provision For Staff Bonus	199,548	287,248	492,773	393,596	638,081
Provision For Income Tax	566,631	859,371	1,028,329	1,081,489	1,477,922
-This Year	–	–	–	257,769	1,601,979
-Up to Last Year	–	–	–	–	404,317
Net Profit/Loss	**(9,428,884)**	**(3,317,247)**	**3,707,479**	**4,389,103**	**3,234,122**

PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN PAPUA NEW GUINEA

by Steven Avel[1]

1. Introduction

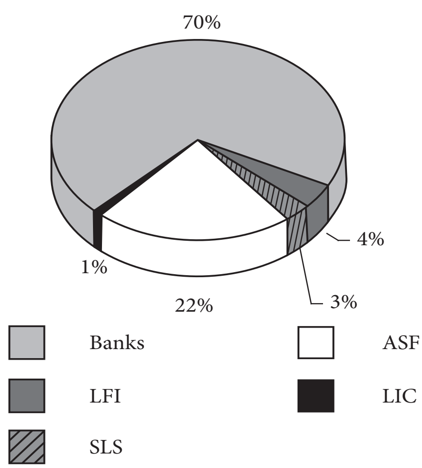
The object of this paper is to present the regulatory and supervisory framework of Papua New Guinea (PNG) and analyse the process of problem bank identification, intervention and resolution in PNG. A former state-owned bank, the Papua New Guinea Banking Corporation (PNGBC), is used as the example to present how the Bank of Papua New Guinea (BPNG) undertakes the processes involved in problem bank identification, intervention and resolution. Details on the PNGBC are attached in Appendices 1a and 1b.

The total assets of PNG's financial system ("system") is valued at K13,754.40 million or US$4,524.47 million (K3.04:$US1) as at 30 June 2007. The system comprises 4 commercial banks with total assets of K9,544.50 million or US$3,139.64 million, 11 licensed financial institutions (K488.20m/US$160.59m), 21 savings and loan societies (K441.6m/US$145.26m), 7 authorised superannuation funds (K3,089.60m/US$1,016.32m), 5 life insurance companies[2] (K190.50m/US$62.66m), 2 investment managers, 5 fund administrators and 3 life insurance brokers.

The banking sector is the critical sector as it holds 69.4 per cent of the system's total assets and the rest by other authorised financial institutions.

Figure 1 below shows the spread of the assets in the financial system.

Figure 1
Financial System's Total Assets as at June 2007



Source: Bank of PNG

[1] Manager, Financial System Supervision Department, Bank of Papua New Guinea
[2] Excludes general insurance companies and brokers which are supervised by the Insurance Commissioner's Office. The National Development Bank and Unit Trusts are not supervised by BPNG.

The distribution above shows that the soundness and stability of the banking sector is crucial in ensuring stability in PNG's financial system. As part of the BPNG's responsibilities, the key aim is to identify and prevent vulnerabilities in the financial system and take appropriate mitigating actions to prevent systemic consequences.

2. Legal Framework for Regulation and Supervision of Financial System

2.1 Legal Framework

Besides the other core responsibilities of formulating and implementing monetary policy and ensuring an efficient payment system, the BPNG is responsible for regulating and supervising all banks and licensed financial institutions operating in PNG. Legislations that mandate the BPNG to perform its functions and responsibilities are the *Central Bank Act, 2000 (CBA) and the Banks and Financial Institutions Act, 2000 (BFIA)*. The BPNG is also responsible for the regulation and supervision of savings and loan societies under the *Savings and Loan Societies (Amendment) Act, 1995 (SLSA)*, authorised superannuation funds under the *Superannuation (General Provision) Act, 2000 (SA)* and life insurance companies under the *Life Insurance, Act 2000 (LIA)*.

2.2 Coordination and Information Sharing

Under the above laws, the BPNG, in dealing with problem banks and all other financial institutions for which the BPNG is responsible, can solicit the assistance of other agencies, such as the Financial Intelligence Unit (attached to Fraud Squad), Police Department, Registrar of Companies and the CPA PNG Limited (Institute of Accountants). The BPNG takes responsibility for the overall co-ordination of activities.

Although the sharing of information between these agencies is limited, given that the legislations covering the agencies do not allow for sharing of information unless required by a court order, a few government agencies, including the Internal Revenue Commission (IRC) and the Investment Promotion Authority (IPA), have acknowledged the importance of information sharing with the Central Bank and have each signed a Memorandum of Understanding (MOU) with the BPNG.

2.3 Issues on Autonomy, Accountability and Legal Protection of Bank Supervisors

As a result of the reform of the financial system in 2000, bank supervisors have a greater degree of independence in performing their roles and responsibilities without influence or interference from the government or other external agencies. Bank supervisors are also protected under the above five (5) Acts that the BPNG administers. However, there is a greater accountability required of bank supervisors – accountability to the public and to the BPNG in ensuring effective performance of its objectives and functions.

3. Problem Bank Identification

3.1 Supervisory Strategy

Supervision is a preventative and collaborative practice, intended to be flexible and designed to identify and assess risks. The BPNG's approach to supervision is focused on the bank's systems, policies and internal controls. This helps the BPNG to ensure that appropriate procedures are in place to contain risks and, importantly, that the bank's management adheres to them. The objective is to ensure public confidence and a sound and stable financial system.

The supervisory approach used by the BPNG in monitoring the condition of authorised banks is twofold:

i) *On-site examinations or reviews* – which involve the physical presence of the BPNG examiners on a bank's premises to assess a range of activities including: a) the adequacy of management's risk and internal control procedures; b) the bank's systems and processes with regard to the overall operations and condition; c) key ratios, factors and conditions affecting capital; d) the interrelationships between capital and other components of CAMELS[3]; and e) the bank's adherence to laws and regulations and to the terms stipulated in the banking licence.

ii) *Off-site surveillance* – which involve collecting, reviewing and analysing reports and statistical returns. Information used for the analyses are collected through standardized Call Reports submitted to the Financial System Supervision Department (FSSD) on a quarterly basis, monthly reports to Monetary Policy Unit (MPU) and daily market reports to Financial Market Department (FMD). Other sources of information used for off-site monitoring are annual accounts, correspondences and any other publicly-available information provided by the market. Call Reports are also used to check adherence to prudential requirements.

Off-site monitoring is often used to identify potential problems, particularly in the intervals between on-site visits, thereby providing early detection and prompting corrective actions before problems become serious.

From on-site examinations and quarterly off-site reviews, a rating is given to a bank using the CAMELS rating system. Under CAMELS, a bank is assigned a composite rating between 1 and 5 on a numerical scale based on the evaluation and rating of six essential components of an institution's financial condition and operations.

The BPNG also uses CAMELS to categorise institutions with deficiencies in a particular component and to identify problematic financial institutions. In order to do that, the BPNG has set prudential requirements for all components under CAMELS.

[3] CAMELS - The component factors address the adequacy of Capital, the quality of Assets, the capability of Management, the quality and level of Earnings, the adequacy of Liquidity, and Sensitivity to market risk. It is a rating system used by the BPNG to evaluate the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

3.2 Prudential Requirements

In line with international practices, the BPNG as the regulator and supervisor has implemented all of the 25 basic principles of the Basel Committee on effective banking supervision. These principles provide the basis for the BPNG to strengthen its current supervisory regime.

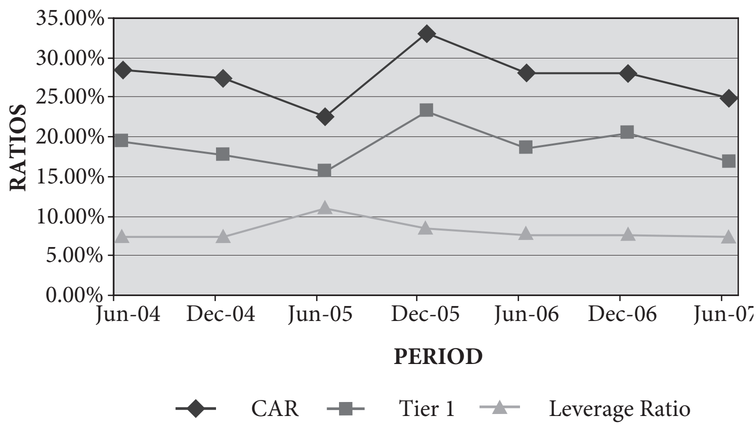
The Financial Sector Reforms adopted in 2000 played a major role in enhancing the performance of banks and financial institutions in PNG. Legislative amendments were made to a number of statutes including the BFIA, setting the framework under which banks and other institutions are supervised. The BPNG has the prudential powers under the BFIA to implement the principles, including setting prudential standards and requirements for banks.

The prudential guidelines include requirements on: (i) minimum capital (CAR 12 percent, Tier 1 Ratio 8 percent, Leverage Ratio 6 percent); (ii) asset classification and provisioning; (iii) limits on Inter-Bank Placements; (iv) limits on foreign currency exposures; and (v) limits on loans to related parties. With the responsibility entrusted to the bank boards to perform and ensure sound operations, the BPNG also put in place requirements to assess the fit and properness of persons holding or intending to hold management positions. Similarly, key performance indicators on earnings are used to monitor performance, while the banks are expected to maintain adequate liquidity for their operations.

These prudential requirements are essential for prudent supervision without which supervision would be difficult to perform. They can also have some positive impact in the growth of bank assets through sound management and adequate risk- management systems to mitigate risks.

Overall, banks have continued to maintain adequate capital relative to risks within the banking sector. Figure 2 below shows the movements in the capital ratios since 2004.

Figure 2
Capital Ratios of Banks since June 2004



Source: Bank of PNG

3.3 Early Warning Systems, Other Indicators and Risk Assessments

Early warning systems and monitoring tools are essential in bank supervision. The BPNG uses CAMELS as an internal supervisory tool for evaluating the soundness of financial institutions and for identifying those institutions requiring special supervisory attention. Non-compliance with the prudential requirements is a cause for concern. Supervisors also use quarterly and annual reports to identify trends in banks that may signal a potential problem.

Information from these reports helps the BPNG monitor activities and trends in key indicators and plan future examination activities and the scope of those activities. Red flags in problem banks take many forms, and BPNG would consider a number of factors before determining the most appropriate supervisory response. The BPNG recognises as red flags in the early detection of potential problems with a particular bank the following:

a) *Asset Quality Deterioration* – is the most common financial risk in nearly all problem banks. This can be caused by economic factors, poor management, anxiety for earnings, insider abuse and other factors.

b) *Adverse Effects of Rapid Growth*
- Capital levels declining rapidly
- Growth varies significantly from the bank's budget or strategic plan
- New products and activities are being pursued with no expertise or inadequate risk-management controls

c) *Management Oversight Deficiencies*
- Non-responsive management
- Passive or uniform board of directors
- On-going noncompliance with regulatory requirements, laws or internal standards
- Insufficient planning and response to risks
- Inadequate talent and experience at the CEO and management levels

d) *Inappropriate Limits on Access to Bank Staff and Documents*
- Refusal to provide information within a reasonable time period
- Blocking access to relevant third-party records
- Providing incomplete and inaccurate information

e) *Risk Management Deficiencies (Policies, Processes, Personnel, Controls)*
- Sound risk-management systems to mitigate risk assumed by a bank.

f) *Strained Liquidity*
- Low liquidity levels
- Decline in deposit levels
- Funding mismatches
- Higher cost of funds relative to market

g) *Insider Abuse and Fraud*

- Extension of credit granted on a more favorable term
- Excessive salaries, bonuses and fees relative to the size of the bank
- Fees paid for services not yet received
- Dishonest or fraudulent act
- Profiting from insider knowledge, etc.

The above can be assessed off-site using the data provided in the Call Reports and during on-site examinations. Indicators from off-site assessment are increasing levels of past due loans and Non-Performing Loans as a percentage of total loans and significant changes in provisions for loan losses. Figure 3 is an example of the type of analysis supervisors performed on reports submitted to the BPNG. These ratios are compared against the benchmarks in place to determine the quality of the loan portfolio.

Figure 3
Asset Quality - Banking Sector

	Jun-07	Dec-06	Jun-06	Dec-05	Jun-05	Dec-04	Jun-04
NPL/Total Loans	2.3%	2.5%	2.6%	3.8%	4.4%	4.1%	5.4%
Provisions/Total Loans	2.6%	2.9%	2.8%	3.5%	4.7%	5.0%	4.2%
Provisions/NPLs	111.2%	115.0%	110.5%	91.4%	106.9%	111.5%	77.8%

Source: Bank of PNG

Deteriorating asset quality is caused by a combination of factors including high loan concentrations, in adequate management information system (MIS), large volume of loans with structural weaknesses and large volume of unsecured lending.

3.4 Communication Concerns

The BPNG recognises that effective, accurate and frequent communication with the board and management is extremely important in problem-bank supervision. It also recognises the value in communicating concerns with other regulators on matters concerning problem banks. The manner in which concerns are communicated to the bank should be clearly defined, and reflect the severity of the given situation. The commonly used methods of communicating concerns to problem banks are:

- discuss the matter over the phone followed by a letter or email confirming the matters discussed;
- conduct exit meetings at the conclusion of an examination or review with senior management and, in some cases, with directors, to summarize the conclusions, required corrective actions and plan for follow-up actions by the BPNG, including formal enforcement actions, if any;
- communicate through the ROE – this is a formal communication of supervisory concerns to a bank;
- conduct meetings with the board whenever there is material information to convey; and
- communicate the concerns to other regulators, e.g. IRC, Insurance Commissioner, Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC).

3.5 Problem Bank Identification: The Case of PNGBC

The process taken to identify the PNGBC as a problem bank is summarised in Appendix 1a and discussed in detail in Appendix 1b.

4. Problem Bank Intervention

4.1 Prompt Corrective Actions

In determining the appropriate corrective actions, the BPNG takes into consideration the severity of the problem and the most appropriate supervisory and enforcement action to take. The type of action chosen depended also on the bank's current condition with consideration given to the cooperation, responsiveness, and capability of the board and management.

Supervisory and enforcement actions that BPNG may take on a problem bank include: (i) issue letter of commitment; (ii) impose additional conditions on a bank's licence; (iii) signing of MOU; (iv) removal of board and or management; (v) sanctions on certain business activities; and (vi) instituting a statutory manager to run the affairs of the bank.

4.2 Resolving Liquidity Problems

Liquidity levels with banks in PNG continue to be high. However, the BPNG requires all banks to have a policy detailing what, how and where to obtain cash for operations at a reasonable cost when needed. It must also have effective processes in place to monitor and react to the contraction of deposits and other funding.

A prudential standard on minimum liquidity will soon be released, outlining the prudential liquidity requirements for all banks. The standard prescribes the level of liquidity a bank should have based on its capital and the quality of assets. This standard will also replace the Minimum Liquid Asset Ratio (MLAR) which is used as a monetary policy instrument.

4.3 Resolving Credit and Capital Impairment Problems

Lending activity is predominately the source of income and financial risk to banks. Thus, the potential for loss in the event of default is imminent. Banks classify and make provisions on all loans under the following categories: Pass (0 – 30 days) – 1 percent, Special Mention (31 – 90 days) – 5 percent, Substandard (91 – 180 days) – 25 percent, Doubtful (181 – 360 days) – 50 percent and Loss (> 360 days) – 100 per cent. These provisions are prescribed in the standard on asset classification and provisioning. During reviews, bank supervisors check to ensure that correct and adequate provisioning is made for loans.

In a situation where a bank experiences capital impairment, the BPNG can impose sanctions such as no dividend payment to shareholders, no major capital expenditures and selling of assets. The BPNG can ask the bank to raise additional capital through injection by the bank holding company or shareholders or through new share issues to the public.

BPNG has set minimum capital requirements of CAR at 12 percent, Tier 1 Ratio 8 percent and Leverage Ratio 6 percent. However, it also has the authority to require more capital in a bank with significant risk.

4.4 Removing Bank Management and Ownership Issues

If the problem relates to mismanagement, then necessary steps can be taken to replace management. For ownership issues, divestment of shares is one option a bank could take to dilute majority shareholding.

4.5 Role of the Courts in Bank Intervention

When all avenues have been exhausted and the aggrieved party is not satisfied with the actions taken, the matter can be put before the courts to decide. The BPNG does not have an in-house legal counsel; therefore, it uses private law firms to take up any litigation cases in the courts on its behalf.

4.6 Problem Bank Intervention: The Case of PNGBC

Following the identification of the PNGBC's problems, the BPNG intervened to save the bank from total collapse and possible disruptions to the financial system. Details of the BPNG's intervention process are shown in Appendix 1a and discussed in Appendix 1b.

5. Problem Bank Resolution

5.1 Grounds for Receivership and Early Resolution

The BPNG has the power and responsibility to appoint a receiver for a problem bank. Under Section 36 of the BFIA, the BPNG may take control of the business of an Authorised Institution (AI) or appoint an Administrator to take over control of the business of an AI where:

(a) the AI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment; or
(b) the BPNG considers that the AI is likely to become unable to meet its obligations or is about to suspend payment; or
(c) the AI becomes unable to meet its obligations or suspends payment; or
(d) the AI fails to implement or observe, or is breach of, a prudential standard or a condition imposed on its licence such that, in the opinion of BPNG, the interests of the depositors of the AI are materially threatened.

Section 37 of BFIA makes provisions for the basis of terminating control where it empowers the BPNG or the appointed Administrator to take control of the business of an AI until:

(i) the deposits of the AI have been repaid or the BPNG is satisfied that suitable provision has been made for their repayment; or
(ii) the BPNG considers that it is no longer necessary for it or the appointed Administrator to remain in control of the business of the AI.

5.2 Supervisory Responsibilities for Failing Banks

The BPNG does not have a specific office or unit responsible for supervising the resolution of critical problem banks. Institutions experiencing significant problems are handled by assigned analysts who are also desk officers and an assigned senior analyst as overseer. Together with the manager responsible, they will plan supervisory activities, including the development of an on-going strategy, off-site reviews, and prepare various enforcement actions.

Depending on the action to be taken, a legal counsel can be engaged to assist with the matter. The supervision of a problem bank is a time-intensive process, and often in PNG it can take long to resolve. The problem bank is placed under on-going supervision, which includes liquidity monitoring and regular review of the bank's financial movements in the balance sheet or of further depletion of capital levels.

5.3 Asset Quality and Financial Review Process

The PNGBC was the only problem bank that experienced deteriorating asset quality as a result of poor management of its loan portfolio. The quality of assets was critical enough to deplete the bank's capital as shown in Figure 4.

Figure 4
Capital of the Problem Bank

	Jun-01	Dec-00	Jun-00	Dec-99	Jun-99	Dec-98	Jun-98	Dec-97	Jun-97
Minimum Req'ment	10.0%	10.0%	10.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
CAR	5.98%	5.04%	8.01%	15.93%	14.50%	8.7%	4.86%	7.89%	12.40%

Source: Bank of PNG

Further, there were records of significant write-offs and inadequate provisioning or allowance for loans and leases.

Figure 5 below indicates that non-performing loans ranged from 18 percent o 25 percent of total loans. This is considered very high indicating poor credit management.

Figure 5
Asset Quality of PNGBC

	Jun-01	Dec-00	Jun-00	Dec-99	Jun-99	Dec-98	Jun-98
NPL/Total Loans	21%	23%	22%	23%	18%	25%	24%
Prov/NPL	79%	70%	49%	80%	104%	79%	78%

Source: Bank of PNG

5.4 Bank Closing Process

By the late 1990s, the PNGBC was undercapitalised and it was evident that the safety of depositors' funds was at stake. As the largest bank with a total asset base at K1 billion (US$320m), it was evident that any closure would affect other institutions, thus, creating a systemic risk to the whole financial system.

The decision to sell the bank was made by the government of PNG as part of its privatisation program. The process to expedite the sale was a detailed one, with all parties involved. The PNGBC was successfully sold off in 2002.

5.5 Resolution Methods

There are several methods for resolving failing banks: (i) closure of the bank: deposit payoff; (ii) purchase and assumptions transactions; (iii) open bank assistance; (iv) public/radical restructuring and (v) mergers and acquisitions.

5.6 Problem Bank Resolution: The Case of the PNGBC

The problems of the PNGBC were resolved through a successful merger and acquisition as illustrated in Appendix 1a and further explained in Appendix 1b.

6. Crisis Management

6.1 Key Policies in Dealing with Systemic Banking Crisis

The BPNG did not have at the time of the PNGBC crisis any documented policies detailing how to deal with a bank in crisis. Despite this, the BPNG has a very good working relationship with other relevant agencies that could assist the BPNG to institute legal action against institutions who fail to comply with the BFIA and the licensing requirements.

The BPNG, as the Central Bank, is also the lender of last resort. This lending facility is provided for banks that are solvent but may have been faced with a critical liquidity problem. So far, BPNG has not directly used this facility to assist a problem bank because PNG has yet to experience a bank failure. However, where there is a critical problem with a particular bank, BPNG would work very closely with the concerned bank to resolve the matter, in order to prevent a systemic crisis.

6.2 Institutional Arrangements for Systemic Banking Crisis

As much as possible the BPNG sees to it that there is a continuous dialogue between the problem bank's board and management to ensure that minimal disruption is caused on its normal operation and there is no systemic risk. In the supervision history of the BPNG, it has been successful in preventing a systemic banking crisis. Nevertheless, with increased reliance on the banking sector for all financial needs, arrangements amongst institutions, particularly the regulated institutions and other regulators, need to be instituted to prevent bank crisis or failures.

6.3 Key Issues in Crisis Management

All banks are required to plan for any "worse case scenario" and have in place a contingency plan. A business continuity plan should be also put in place to ensure its banking business is not disrupted. Bank management must understand the seriousness of the need to plan for future problems.

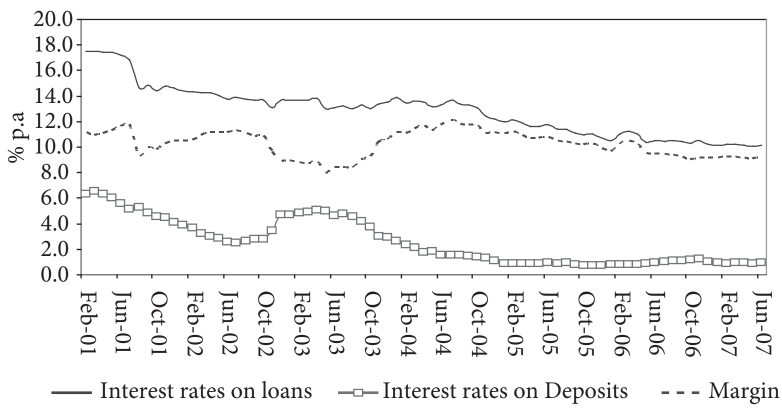
All banks should review and assess the sources of risks in their own business and conduct an audit of areas or provide contingency plans for possible events that can lead to a crisis. In this way, institutions could determine which potential crisis can be avoided by planning for appropriate measures to take and determining the resources to allocate to these areas.

7. Prospects and Future Outlook for PNG's Financial Sector

The financial sector reforms which commenced in 2000 and other structural reforms contributed to the country's favourable economic conditions since 2002. Economic activity continues to grow with renewed confidence by the business community in the government's macroeconomic management. All the major macroeconomic indicators show this positive outlook. These include rising employment levels, increased exports, higher credit growth in the banking system, and prudent fiscal management. These developments have created an enabling environment for the BPNG to conduct monetary policy and achieve price stability. The BPNG has achieved and maintained low inflation, a stable exchange rate and low interest rates. Foreign reserves reached a historic level of US$2,117.50 million (equal to approx. K5,890.20 million) as at 26 November 2007.

Figure 6 below shows a five-year monthly weighted average lending and deposits rates and the margins of commercial banks up to June 2007.

Figure 6
Monthly Weighted Average Lending and Deposits Rates and Margin (spread)



Source: Bank of PNG

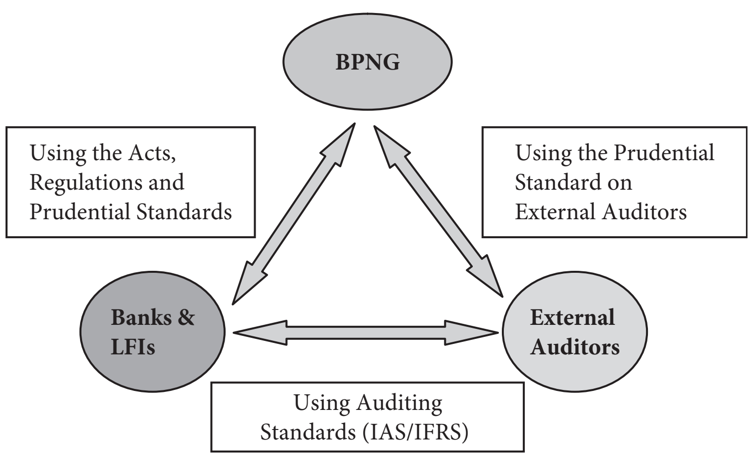
Although PNG's financial sector is strengthened by these favourable economic conditions, the BPNG has to be vigilant in its supervisory responsibilities to ensure the stability of the system and the soundness of the institutions that it regulates and supervises.

It is prudent for the BPNG to be aware of the strengths as well as perceived weaknesses, threats and challenges that may undermine continued growth and sustainability of the financial sector.

7.1 Strengths and Perceived Vulnerabilities of the Financial Sector

The government's decision to reform the financial sector was the significant factor that laid the foundation in building the strength of PNG's financial sector. The passing of the CBA and BFIA gave the Central Bank a focused set of objectives, increased its independence and improved regulation and supervision of the financial system. The CBA also limited the government's access to Central Bank financing and introduced a new Board with wider community representation. Stringent 'fit and proper' criteria were introduced in the BFIA for managers and directors of banks and financial institutions. Strong supervision by the BPNG and the external auditors provided the impetus to growth and strengthen the tripartite partnership in the supervision process.

Figure 7
Tripartite Supervisory Process



A variant structure, but with the similar approach/methodology of regulation and supervision, also applies to the superannuation and life insurance industries following the passing of the SA and LIA in late 2000.

There are perceived vulnerabilities or weaknesses that the BPNG must address which include:

- lack of competition due to few major banks and limited licensed financial institutions;
- limited domestic investment options to invest liquid funds;

- lack of or inadequate prosecution powers of BPNG in the current Acts; and
- penalties in the current Acts are not prescriptive

Weaknesses in FSSD include:

- Department is relatively too large
- High staff turnover
- Department needs to build its staff capacity to strengthen technical expertise in banking, superannuation and insurance; and
- Ineffective enforcement due to inadequate prosecution powers of the BPNG.

7.2 Threats and Challenges to Growth and Sustainability of the Financial Sector

Financial sector growth and sustainability cannot be achieved alone by the government undertaking major legislative reforms or the Central Bank formulating and implementing sound monetary policy and carrying out an effective supervision of the financial system.

Threats and challenges for the BPNG are many. Among them and equally important is the need to adopt and implement good governance in the financial sector. Good corporate governance is important to enhancing strong reporting system, efficient internal controls and risk-management systems.

PNG has an open economy and events and developments elsewhere in the world have a direct impact on the domestic economy and, hence, on its financial sector due to its reliance on the export of its many natural resources. The current favourable economic condition is, to a greater extent, due to the high world prices of these resources, particularly oil and other mineral resources. Significant threats and challenges will come when the opposite scenario becomes a reality for PNG to face. This will present a much greater challenge for the BPNG in its supervisory responsibilities.

7.3 Future Plans

The immediate plan for the BPNG is the restructure of FSSD. The restructure is expected to result in having two Departments reporting to the Deputy Governor, Policy and Regulations. Based on grouping by related industries, the two new Departments would be the Banking Supervision Department (BSD) and the Superannuation and Insurance Supervision Department (SISD). This change is necessary in view of: (i) the FSSD taking on additional responsibilities; (ii) the possibility that the BPNG will regulate and supervise the general insurance industry; and (iii) ensuring greater focus on the industries that are currently paying or prepared to pay the cost of supervision.

For the longer term, the BPNG will review the current legislations to tighten up any loop holes and make adequate provisions for issues, such as penalties for breaches, prosecution powers, cross-border supervision, cost of supervision and a review of the current 'fit and proper' requirements to include minority shareholders.

8. Conclusion

The effectiveness of a Central Bank in dealing with a problem bank is determined by a number of critical factors. These include having an effective legal framework that empowers a Central Bank to carry out its core functions and responsibilities without undue influence or interference from the government, other institutions of government and external agencies. In PNG, the financial sector reforms undertaken in 2000 had paved the way for the BPNG to ensure banks comply with the prudential requirements introduced as part of the reform process. The BPNG also sought external assistance from the IMF and APRA to carry out the reform.

Further, a number of financial institutions, savings and loan societies, superannuation funds and life insurance companies have had to introduce major changes in their structure and business operations to comply with the prudential requirements. These changes, which conform to the Basel Core Principles of Effective Banking Supervision, have realised significant benefits for these institutions and their members/policy holders.

Although these positive developments are continuing, the BPNG will continue to be vigilant in overseeing the performance of all banks, licensed financial institutions, savings and loan societies, superannuation funds, life insurance companies and the general insurance companies in the future. The BPNG is now in the initial stages of restructuring the FSSD as part of its continuing efforts to strengthen its supervisory role and to ensure the financial system remains stable and strong. This calls for equally greater responsibility on the managers and directors of all licensed financial institutions to prudently manage these institutions and to avoid the problems experienced by the PNGBC – the problem bank used in our case study.

The PNGBC, the largest commercial bank owned by the government with an extensive network in PNG and significant market share, and whose profitability was on the decline as a result of its inefficiencies in managing its loan book and bad management practices, was sold to another commercial bank. Although profitability of the bank improved in 1998, this was not sufficient to resurrect the troubled bank as the government had made a decision to privatise it.

As the PNGBC was a wholly state-owned bank, political pressures for loan approvals marred the bank's lending processes. Loan proposals were pushed from two fronts - pressure from national leaders and from the PNGBC CEO level. At the operational level of the PNGBC, loan officers tended to support or favour loan proposals from relatives and business associates. The end result was deterioration in the quality of loans resulting in high non-performing loans and poor earnings. Continuing losses diminished capital; thereby breaching the prudential limits.

The BPNG took corrective actions to rehabilitate the problem bank, and the best option acceptable to all parties was for the sale of the PNGBC to the BSP in 2002.

9. Recommendations

There are many supervisory issues and challenges that the BPNG is faced with. Some of these are discussed in this report. A number of these issues and challenges have been addressed. However, the following recommendations require immediate attention and action to enhance capacity-building and to lift supervision of the LFIs to another level higher:

(i) Following the restructure of the FSSD, which will commence in the first quarter of 2008, the proposed two Departments, namely, the Banking Supervision Department and the Superannuation & Insurance Supervision Department, should start the process to shift away from the current approach, which is based largely on CAMELS, to a more dynamic, forward-looking risk-based supervision approach.

(ii) While a review of the SLSA is underway, a review of the BFIA and LIA should be considered necessary in view of the need to address a number of emerging issues confronting the BPNG, including:
- enforcement and compliance issues;
- prescriptive powers of the BPNG;
- penalties for breaches;
- fit and propriety of shareholders;
- cost of supervision;
- user-pay policy;
- consolidated supervision;
- cross-border supervision; and
- possible inclusion of the general insurance sector under the supervision of the Central Bank.

(iii) There is a need to develop a structured and coordinated approach to ensuring continuous application of knowledge, skills and information received from international training, such as from SEACEN, APRA, PFTAC, etc., to improve the effectiveness of supervision.

(iv) Given that supervisory issues, threats and challenges of SEACEN member countries are not necessarily the same in nature and magnitude, a forum or a similar avenue should be created for the member countries to share information whereby bank problems and solutions can be shared electronically on a web-page or as an agenda on annual meetings of heads of supervisors.

Abbreviations

APRA	Australian Prudential Regulation Authority
ASF	Authorised Superannuation Funds
ASIC	Australian Securities and Investments Commission
BFIA	Banks and Financial Institutions Act, 2000
BPNG	Bank of Papua New Guinea
BSP	Bank South Pacific Limited
CAR	Capital Adequacy Ratio
CBA	Central Banking Act, 2000
FMD	Financial Markets Department
FPG	Financial Pacific Group
FSSD	Financial System Supervision Department
GoPNG	Government of Papua New Guinea
IMF	International Monetary Fund
IPA	Investment Promotion Authority
IRC	Internal Revenue Commission
LFI	Licensed Financial Institution
LIA	Life Insurance Act, 2000
LIC	Life Insurance Companies
MLAR	Minimum Liquid Asset Ratio
MVIL	Motor Vehicle Insurance Limited
NFL	Nambawan Finance Limited
PFTAC	Pacific Financial Technical Assistance Centre
PNGBC	Papua New Guinea Banking Corporation
PwC	Price WaterHouse Coopers
ROE	Report of Examination
SA	Superannuation (General Provisions) Act, 2000
SEACEN	South East Asian Central Banks
SLS	Savings and Loan Societies
SLSA	Savings & Loan Societies (Amendment) Act, 1995

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Appendix 1a

Problem Bank Identification, Intervention and Resolution in Papua New Guinea

(Based on PNG's experience with Papua New Guinea Banking Corporation)

Identification

- **On-site Examination**
- **Independent Review-PWC**

- Rapid loan growth
- Lending concentration and asset quality deterioration
- Large exposure limits exceeded
- Asset impairement
- Capital deficiencies
- Weak Internal controls
- Management oversight deficiencies
- Poor business strategy
- Larger surplus cash held by branches
- Risk management deficiencies
- Inappropriate limits on access to bank staff and documents

Intervention

- **Supervisory Responses or Actions**
  - Report of Examination (ROE)
  - Exit meetings
  - Communication with other regulators
  - Commiting to a signed MOU
- **Enforcement Actions**
  - Remedial Actions in accordance with the Act and upon Minister's approval
  - Removal of the Board of PNGBC
  - Appointment of a Caretaker Board

Resolution

- **Sale of PNGBC to BSP**
- **Revocation of PNGBC's license**

- a successful sale of PNGBC through competitive bidding
- a successful merger and aquisition of the problem bank

Appendix 1b

PROBLEM BANK: PAPUA NEW GUINEA BANKING CORPORATION (PNGBC)

1. Problem Bank Identification: The Case of PNGBC

Due to resource constraints and lack of supervisory oversight by the Banking Supervision Department (BSD) at the time, the BPNG requested Price Waterhouse Coopers (PwC), an accounting & auditing firm to assist with an examination to review the loan portfolio and internal control systems of PNGBC in 1998 and again in 2000.

Similarly, the Finance Pacific Group (FPG) which is the holding company of PNGBC, requested PwC to undertake a diagnostic review on PNGBC and its wholly owned subsidiary, Nambawan Finance Limited in March 2000. The review was aimed at identifying areas for improvement, which might enhance the value of the divestment given the Government's stated intention to privatise PNGBC and its subsidiaries. Although the review was requested by the FPG, a copy of the review report was made available to BPNG. Both reviews uncovered many problems with varying degrees of severity that were critical to the viability of the bank and the financial system as a whole. This was because PNGBC was the largest bank with an extensive branching network in PNG and total market share of K1,355.14 million as at December 2001.

Below is a brief account of some of the problems uncovered during the review and actions taken by BPNG and the Government to resolve the problems and privatize the bank.

a. Rapid Loan Growth

Significant growth in assets was reported. PNGBC was increasing its lending at an unsustainable and alarming rate over the six months from January to June 1998 by about 30% against the market trend. This includes an exposure of K50 million to its subsidiary company, the PNGBC Holding No.1 Pty Ltd. When lending is higher than the general level of economic activity, this could be expected to increase the level of risk in the loan portfolio, particularly given the sharp increases in interest rates at the time.

b. Lending Concentration & Asset Quality Deterioration

(i) The quality of the assets deteriorated and was of great concern. The bank's strong orientation towards the financial needs of the average population (asset side) was not reflected on the credit side. It was more focused on sectors such as agriculture, fishing, forestry and logging which were riskier requiring high provisioning for bad debts. The industry concentrations were not closely monitored by PNGBC and contributed to the poor performance.

(ii) As at December 1997, exposures to 23 customers amounted to K396 million, representing 66.4 per cent of the total portfolio of K596 million. These large loans performed so poorly that they threatened the bank's liquidity and solvency.

(iii) As at December 1998, only 1.7 per cent of the bank's loan portfolio comprised personal loans, with a maximum credit size of K10,000. PNGBC's experience is even more limited regarding the credit business with small and medium enterprises. As at December 1997, PNGBC had about 400 outstanding loans in this market segment with an estimated loan default rate of more than 40 percent.

c. *Large Exposures*

As at 31 December 1999, there were 5 non-group exposures, which exceeded PNGBC's prudential limits (plus 2 borderline exposures). Intra-group exposures to Motor Vehicle Insurance Limited (MVIL) and Nambawan Finance Limited (NFL) were in excess of prudential large exposure limits for individual and aggregate connected parties.

PNGBC had inadequate processes in place to assess large exposures, including lack of rigorous measures to prevent future overexposures and to contain existing large exposures.

d. *Asset Impairment*

Even with the high rate of non-performing assets, the bank failed to apply its policy with respect to the treatment of impaired assets. Concerns were also raised about the recoverability of certain claims made against the Government of Papua New Guinea.

e. *Capital Deficiencies*

While PNGBC's capital as at December 1997 was 7.89%, it was grossly insolvent as adjustments to capital were not considered by the bank. As at 31 December 1998 the bank's capital marginally increased above 8%. Again, as the adjustments were not considered, the ratios given in the table below do not accurately reflect the extent of deterioration in PNGBC's capital.

	Jun-01	Dec-00	Jun-00	Dec-99	Jun-99	Dec-98	Jun-98	Dec-97	Jun-97
Minimum Requirement	10.0%	10.0%	10.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
CAR	5.98%	5.04%	8.01%	15.93%	14.50%	8.70%	4.86%	7.89%	12.40%

After 1998, there were discussions and attempts within the BPNG to increase the capital requirements and CAR. The PwC review found that with increases in both kina amount (from K5 m to K15 m) and capital ratio (from 8% to 10%); PNGBC would still suffer a significant short fall. Note also that during 1999, the Government, being the shareholder of the bank, made a decision to amalgamate the PNGBC's holding companies with the problem bank to create a single entity. As a result, CAR of the bank had increased significantly in 1999.

As the regulator, BPNG had great concern about the amalgamation. There were relatively low levels of capital in PNGBC as well as the FPG companies, particularly MVIL which presented a potential contagion risk to PNGBC. MVIL had a number of subsidiary companies, most of which were non-performing or not operating. Thus, the review by PwC recommended to the board of PNGBC to consider isolating the bank and its subsidiaries from that risk by separating MVIL from the FPG. The recommendation was accepted by the board of PNGBC and implemented in 2000.

f. Internal Controls

There were substantial weaknesses in almost all aspects of the internal control systems of the bank, particularly in the lending, treasury and foreign exchange operations. The weaknesses included outdated or no manuals for some activities, an inadequate information system and inappropriate procedures regarding the origins of transactions, accounting and recording, monitoring and review and reporting of transactions.

g. Management Oversight Deficiencies

Within the bank's organizational structure, responsibilities and reporting lines were not clearly defined resulting in overlaps and inefficiencies. The deficiencies include:

- overlap in the roles of the Executive Chairman, Managing Director and General Manager – Banking;
- potential for a flatter structure with more direct reporting channels; and
- no appropriate representation at Executive Committee level for certain key operational divisional heads.

The Head Office and Support Function of PNGBC had a support role of other companies within the FPG. The review recommended that a decision be made separating the activities for PNGBC and those for FPG.

h. Business Strategy

The review identified that the strategy document was not wholly complete or integrated with various other divisional business plans. There was no comprehensive strategic plan prepared at the Board level to provide direction and guidance to all business units within PNGBC.

PNGBC had not adopted a specific strategic approach in developing particular markets, customers, products or services. Instead, it relied on its traditional banking businesses and placed a lot of emphasis on expansion and customer-outreach at the expense of profitability as the bank was expected to deliver banking services as part of its social obligation to the communities. This caused some branches, sub-branches and agencies to be unable to sustain operations and forced closures.

i. Surplus cash held by branches

High levels of currency notes were being held at branches. Cash holdings at branches should have been reduced to a more appropriate level to preclude exposures to crime and to re-deploy to earning assets.

j. Risk Management Deficiencies

i) *Risk Management Framework* - PNGBC failed to develop a risk management framework to be used in identifying, measuring and monitoring risks on a bank-wide basis. It also had fundamental weaknesses in its procedures and risk controls. The Board and management's lax attitude towards putting in place systems and processes to mitigate risks led to more serious problems. The bank's appetite and tolerance levels for risk were not clearly stated. A risk appetite and attitude should have been developed to drive the establishment of various risk limits for the Treasury and International Departments and other business units of the bank.

ii) *Policies & Procedure* - PNGBC failed to have adequate and appropriate policies in place. Furthermore, existing policies were not updated to reflect the changes taking place within the organization.

iii) *Human Resource/Personnel* – PNGBC's personnel cost ratios were one-and-half times more compared to the other banks. It had the highest number of staff per branch and the lowest level of assets per branch.

Political interference with the operations of the bank resulted in the promotion of inexperienced managers and loan officers. The loan book continued to deteriorate in the process. Also, with the political appointment of the CEOs, a lack of continuity in key positions within the bank created uncertainties.

iv) *Management Information System* - The Integrated Banking System (IBS) had weaknesses that impeded on proper controls of the lending function. Lack of improvement or enhancement in the system led to it being deficient in:

- loan grading by asset quality;
- flagging the expiry of security documentation;
- improvements in loan arrears reporting;
- identification of related group of borrowers;
- accurate assessment of concentration risk within the loan portfolio; and
- historical provisioning levels.

k. Communicating Concerns

Effective, accurate and frequent communication is extremely important in problem banks and it was no different with PNGBC. Hence, BPNG was careful in how to address the issues. This is because the troubled bank was a large bank and its closure could have significantly affected confidence in the banking industry and have destabilizing effects on the financial system and the overall economy. In the resolution process, there was ongoing communication between BPNG, PNGBC and the Minister for Treasury and Finance.

2. Problem Bank Intervention: The Case of PNGBC

In the process of rehabilitating the troubled bank, BPNG took certain corrective actions and ensured subsequent monitoring for adherence to those supervisory enforcement actions. Detailed below were some of the rehabilitation actions.

a) ***Informal Supervisory Responses or Actions***

i) *Communication through the Report of Examination (ROE)* - From the reviews conducted by PwC and the Bank and as part of the examination process, a ROE discussing potential and significant problems affecting the bank were communicated to the Board with recommendations for corrective actions.

ii) *Meetings and Consultations* - Exit meetings were held after the examinations/ reviews to discuss the issues identified during the examinations. Many other meetings and consultations were convened during the whole process as problems were identified with the management and the Board.

iii) *Communication with other Regulators* – the only other financial supervisor with interest in the FPG was the Insurance Commissioner. Continuous dialogue between the Bank and the Commissioner took place due to the fact that MVIL, a subsidiary is involved with insurance.

iv) *Memorandum of Understanding (MOU)* – was also used where all stakeholders involved had to provide their undertaking in resolving the issues.

b) ***Formal Enforcement Actions***

i) BPNG, with the approval of the Minister for Treasury and in accordance with Sec. 18(2)(a) and (b) of BFIA, had directed the bank to refrain from extending any further loan commitments to any clients while at the same time endeavor to recall any existing commitments where commercially and legally feasible, until such time as the capital adequacy ratio has been restored and all other prudential concerns have been rectified.

ii) BPNG, using powers under the BFIA, removed the Board of PNGBC and replaced it with independent directors who had demonstrated integrity.

3. Problem Bank Resolution: The Case of PNGBC

(a) Sale of Problem Bank

In line with the Government's policy to privatize the government owned institutions, including the troubled bank, PNGBC was prepared for sale. This was despite the significant improvement in the financial position of the troubled bank following BPNG's intervention Within the GoPNG's short time-frame for the privatization of PNGBC, considerable efforts were made to enhance the value of the bank to bring to the point of sale.

During the whole process, issues prevalent in a normal sale were discussed at great lengths and resolved before the necessary agreements were signed. This included issues on shareholding (controlling interest at 51% or more), bad debts, safety of depositor's funds of both banks, future dividend payments by the acquiring bank, capital requirements of the acquirer and other related issues. The bids to acquire the trouble bank were issued in late 2001. The successful bidder was a local privately-owned bank, Bank South Pacific Limited.

At the time of sale, prudential regulation and supervision under the new regime has improved considerably. Therefore, care was taken to ensure that the acquiring bank complied with all the prudential requirements and regulations imposed by the relevant authorities before the acquisition and amalgamation took place. Some issues remained unresolved but with the understanding that these matters would be resolved in the normal course of supervision, and acting within the privatization time-frame to sell the bank, BPNG approved the sale to BSP in April 2002. Additional conditions were imposed on the acquirer's license regarding the unresolved matters.

(b) Revocation of PNGBC's License

BPNG also consented to surrender the license of the troubled bank to take effect on the date of the acquisition. However, this did not eventuate due to certain unresolved issues. The revocation of the license of PNGBC was eventually done in July 2002.

PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN SRI LANKA

by P.W.D.N.R. Rodrigo[1]

1. Introduction

The banking sector dominates the financial system in Sri Lanka, accounting for about 60% of the total financial sector assets. Therefore, the soundness and the resilience of the banking sector is crucial in the maintenance of financial system stability, which is one of the core objectives of the Central Bank.

Sri Lanka has a multi regulatory system for the regulation and supervision of the financial sector, consisting of the Central Bank of Sri Lanka (CBSL), the Securities and Exchange Commission (SEC), and Insurance Board of Sri Lanka (IBSL). In addition, the Registrar of Companies (ROC), Sri Lanka Accounting and Auditing Monitoring Board (SLAAMB) and the Colombo Stock Exchange (CSE) also perform some regulatory functions relating to the financial sector. However, the share of assets and deposits of entities coming under the supervision of the CBSL, is by far, the largest share as shown in the Table 1. There are two types of banks identified under the Banking Act (BA), i.e., Licensed Commercial Banks (LCBs) and Licensed Specialized Banks (LSBs). The main differences between these two types of banks are that LSBs cannot accept demand deposits and deal in foreign exchange transactions. There are 23 LCBs consisting of 2 state banks, 8 domestic private banks and 12 branches of foreign banks. There are 14 LSBs bringing the total number of banks in the country to 37.

[1] Author is Deputy Director of the Bank Supervision Department of Central Bank of Sri Lanka.

Table 1
Assets and Deposit Liabilities of the Main Financial Institution in the Financial System

	2006 (a)		2007 (b)	
	Rs. bn	% Share of Total	Rs. bn	% Share of Total
Banking Sector	**2,635.0**	**70.6**	**3,068.5**	**71.0**
Central Bank	492.8	13.2	561.9	13.0
Licensed Commercial Banks (c)	1,786.9	47.9	2,100.0	48.6
Licensed Specialised Banks	355.3	9.5	406.6	9.4
Other Deposit Taking Financial Institutions	**140.9**	**3.8**	**177.1**	**4.1**
Registered Finance Companies	108.2	2.9	142.5	3.3
Co-operative Rural Banks	27.8	0.7	28.7	0.7
Thrift and Credit Co-op. Societies	4.9	0.1	5.9	0.1
Other Specialised Financial Institutions	**170.8**	**4.6**	**192.9**	**4.5**
Specialised Leasing Companies	78.0	2.1	96.0	2.2
Primary Dealers	49.9	1.3	54.2	1.3
Merchant Banks	30.5	0.8	31.4	0.7
Stock Broking Companies	5.7	0.2	3.8	0.1
Unit Trusts	5.4	0.1	6.3	0.1
Venture Capital Companies	1.3	0.0	1.1	0.0
Credit Rating Agencies	0.1	0.0	0.1	0.0
Contractual Savings Institutions	**786.8**	**21.1**	**884.6**	**20.5**
Insurance Companies	117.0	3.1	133.1	3.1
Employees' Provident Fund	492.1	13.2	560.0	13.0
Employees' Trust Fund	67.0	1.8	78.8	1.8
Private Provident Funds	95.8	2.6	96.2	2.2
Public Service Provident Fund	15.0	0.4	16.5	0.4
Total	**3,733.5**	**100.0**	**4,323.0**	**100.0**

(a) Revised
(b) Provisional
(c) Consolidated assets of both DBUs and OBUs of LCBs

Source: Central Bank of Sri Lanka

2. Legal Framework in Dealing with Problem Bank

2.1 Legal Framework

The regulation and supervision of licensed banks are governed mainly under the Monetary Law Act (MLA) No. 50 of 1949, the Banking Act No. 30 of 1988 and the Exchange Control Act (ECA).The CBSL is the regulatory authority for the banking sector and the regulatory authorities designated under these legislations are the Monetary Board (MB), the Governor, Director of Bank Supervision and the Controller of Exchange. The Bank Supervision Department of the CBSL carries out the supervisory functions relating to banks. There is no mandatory deposit insurance scheme although there is a voluntary deposit insurance scheme in which none of the licensed are registered.

The MLA has some general provisions with respect to the supervision of banks. It includes provisions for the following:

- The objectives of the CBSL are "economic and price stability and financial system stability with a view to encouraging and promoting the development of the productive resources of Sri Lanka.
- The establishment of the department of bank supervision and its functions
- Power of the MB to suspend or restrict business of a bank
- Winding up of a bank

The BA clearly defines the CBSL's functions regarding the supervision of banks. BA and the regulations made under it by the CBSL provide the framework of prudential regulations that banks must meet. The BA contains detailed provisions relating to the procedures to be followed with respect to problem banks. The MB is the ultimate authority for major supervisory decisions. However, the Director of Bank Supervision (DBS) too has power under the BA to issue cease and desist orders, approve fitness and propriety of bank directors, and act as the liquidator of banks under the BA.

Where the Director of Bank Supervision (DBS) is satisfied that a licensed bank is found to have encountered problems and if those problems cannot be resolved through the formal communication with the management of the respective bank, there are several resolution measures available to the regulator in terms of the legal provisions.

In addition to the entities mentioned above, Courts intervene in the case of liquidation and examination of executive powers of the regulator. Furthermore, the concurrence of the Minister of Finance is required for licensing of banks.

Several issues have been raised by concerned parties on the fact that legal powers for supervision are contained in both the MLA and BA. Although there does not seem to be serious legal conflicts, it is desirable to have a consolidated banking law to clarify the powers of the MB and banks' obligations. Accordingly, a new banking law has been drafted. It is also argued that licensing power should be fully ascribed to the MB without requiring the need for the Minister's concurrence or approval.

2.2 Coordination and Information Sharing

Information sharing among regulators is affected by the secrecy provision in the MLA (Section 45) Accordingly, except in the performance of his/ her duties under the Act, no officer should communicate information to anyone other than those authorized. Similar provisions are found in legislations governing other regulators such as SEC and IBSL.

However, this has not become a major issue due to the fact that banks, which come under the purview of the CBSL for supervisory purpose, are dominant in the financial sector. Furthermore, the risks are limited mainly because there are limits on the extent to which banks may invest in subsidiaries and there are also limits on the size of shareholding in banks. Risks, if any, are mitigated due to the following administrative arrangements in place to improve information sharing among regulators:

- A Deputy Governor of the CBSL is represented in the Boards of SEC and IBSL.
- Establishment of an Inter Regulatory Institutions Council (IRIC) – This Committee, chaired by the Governor of the CBSL, discuss on a regular basis, common issues faced by the financial sector.
- Working Group on Financial Conglomerates – This functions as the research arm of the IRIC to examine issues assigned to it by the IRIC. Issues relating to information sharing is discussed at this Committee.
- Memorandum of Understanding (MOUs) with regulators: MOUs have been signed with the IBSL and SEC. However, these are again subject to the legal provisions on secrecy. On a cross broader basis, an MOU has been signed with Pakistan and discussions are underway to sign MOUs with few other countries.

However, it is possible that the linkages between financial institutions may become complex and less transparent. It is therefore, necessary, that exceptions to the barriers of information sharing be put in place to meet future needs.

2.3 Issues on Autonomy, Accountability and Legal Protection of Bank Supervisor

The banking regulator, i.e. the CBSL, has the operational independence without government or industry interference. The Monetary Board (MB) which is the governing body of the CBSL, consists of the Governor, the Secretary to the Ministry of Finance (MOF) and three members appointed by the President on the recommendation of the MOF with the concurrence of the Constitution Council. The Governor is appointed for a fixed term of 6 years and cannot be removed without cause (MLA Section 13).

The CBSL has budgetary autonomy (MLA Section 6) and is able to attract and retain qualified staff by offering relatively high levels of remuneration. The CBSL has a substantial training program for its staff. Supervisory decisions are generally taken by the MB while the concurrence of the Minister of Finance is required for some decisions.

The CBSL is required under the MLA (Section 35) to produce an annual report for the Minster who should present it before the Parliament for discussion by the Committee on Public Enterprises (COPE). The financial statements of the CBSL are audited by the Auditor General (AG) who report the findings to the Parliament. The AG also has the right to determine whether the CBSL is providing value for money.

An issue that has been raised with regard to the autonomy of the CBSL is the presence of the Minster's representative in the MB. This is questioned on the grounds that the two state banks (which accounts for about 46% of the LCB's assets) are owned by the government and that the representative of the Minister responsible for these banks sitting in the MB, supervises them as well. This is alleged to compromise the MB's independence and could inhibit the CBSL from enforcing good standards of corporate governance for banks. For example, members of the bank boards are expected to take no part in approving transactions with parties with which they may be involved. An example suggested is the inability of the CBSL to rectify long standing breaches of prudential requirements by state banks.

The counter arguments put forward in defense of the presence of the Minister's representative on the MB is that drafters of the MLA (John Exter, a Federal Reserve Bank officer from the USA) intended a closer cooperation and coordination between the Minster of Finance and the CBSL, given the fact that Sri Lanka is a developing country and that his presence on the MB does not imply a lack of independence. The CBSL has treated all banks alike despite its ownership differences. Bank supervisors are given legal protection for the activities done in good faith.

3. Problem Bank Identification

3.1 Supervisory Strategy (Risk-based Supervision Framework)

Of late, the Bank Supervision Department (BSD) shifted to a risk based supervision from a compliance based supervision where supervision is focused on identification of evolving trends in risks of banks, and capacity of banks to effectively face potential sources of risks. The operational manuals and internal directions and regulations issued to banks provides the methodology for determining and assessing the nature, importance and scope of the risks to which individual and banking groups are exposed. Whenever necessary, contacts are made with the non–bank supervisor.

Banks are expected to notify any substantive changes in their activities and report adverse developments to the supervisor. Banks are examined on-site once in every two years with the scope and duration of the examinations depending on the size of the bank. A CAMELS approach is used for the purpose of examinations. Continuous examination is carried out by identifying evolving risks to the soundness of each bank. In addition, spot examinations are conducted as and when required, to examine specific issues in depth. A web based on-line reporting system is used for continuous surveillance to facilitate processing, monitoring and analysis of prudential information.

Further improvement to supervisory methodology, including a forward looking view on the risk profile of banks, are being developed. Stress testing techniques and integrated risk management are being developed to proactively address any serious threat to the stability of the banking system from currency or emerging risks.

3.2 Prudential Requirements

The law provides for the issue of directions by the MB to banks on a broad number of banking activities (BA, Section 46).

Capital Adequacy: The current capital adequacy is 10% of the risk weighted assets for both types of banks, with Tier 1 capital adequacy being 5%. The Basel I supervisory framework is adopted with the focus on credit and market risks. Dividends cannot be declared when a bank is not in a position to meet the minimum capital adequacy requirements. Basel II will be effective from January 2008 with the standardized approach for credit and market risks and the basic indicator approach for operational risk. The minimum initial capital requirement was increased to Rs. 2.5 billion and Rs.1.5 billion respectively for LCBs and LSBs in 2005.

Asset Quality: There are directions on classification of loans, advances, investments, valuation of securities, provisioning and income recognition, single borrower limit, related party transactions. With the implementation of the International Accounting Standards in 2008, concepts of fair value options and impairment test may be used for the purpose of loan classification.

A time bound classification method is adopted for non-performing advances with the transfer of advances to NPA category after interest or installment in arrears for more than 3 months. NPAs are grouped into 4 depending on the time elapsed after being classified, i.e. overdue, substandard, doubtful and loss. Provisions are made at 20%, 30% and 100% respectively, net of the value of collateral on NPAs. Recognition of income has to be stopped when the advance is in arrears for 3 months or more.

Management: A fit and proper test is used with respect to directors and employees of banks. The criteria include qualifications in relevant fields, commission of any act which involves fraud, deceit, dishonesty or any other improper conduct, investigations into such acts, conviction by courts, insolvency and so on, provisioning both specific and general, etc. With a view to improving the risk management in banks and prevent conflicts of interests, a mandatory code of corporate governance will come into effect from January 2008.

Earnings: There are directions on income recognition dividends and maintenance of specific reserves. No bank can declare dividends until all its capitalized expenses, initial expenses or any other expenses not represented by tangible assets, have been completely written off.

Liquidity: The current liquidity ratio is 20% of the total liabilities minus liabilities to the CBSL and shareholders. A list of permitted assets for this purpose has been issued.

3.3 Early Warning Systems, Other Indicators and Risk Assessment

The off-site or continuous examination is used as an early warning system to identify potential sources of risks. For each bank, a report is prepared based on the information provided by banks on-line together with information collected from other sources such as news reports, rating agencies, auditors' reports and examination reports. The information collected from these sources and the trends in main prudential indicators are used as an early warning system, although currently, there are no specific quantitative early warning models.

3.4 Communicating Concerns

Several methods are used in communicating concerns identified in the course of examinations. These include meeting with boards and management during on-site examinations. During and after on-site examinations, issues identified are discussed with the management and relevant officers of banks by the Governor, MB and the DBS. After the examination, meetings are held to provide information to banks to rectify and take necessary actions for errors and omissions identified. The examination report of the banks is sent to the Board for their information and action. The respective officers of the banks are identified in the examination reports for taking corrective actions.

Meetings are held with banks' management as and when required, on information collected from on-going examinations and other sources, and remedial actions are prescribed if required.

An on-line early warning system is being designed to provide information to the banks' management on a real time basis. Supervisory concerns, if any, are not generally communicated to other regulators due to secrecy restrictions. Sharing of such information may be possible with the development of the financial sector and the establishment of proper procedures for preserving the confidentiality of such information.

4. Problem Bank Intervention

4.1 Prompt Corrective Actions

Banks' management is called for meetings with the MB and/or DBS to discuss issues requiring immediate action depending on the severity of the issues. When the DBS is certain that a licensed bank is found to have encountered problems and those problems cannot be resolved through the formal communication with the management of the bank, there are several measures available to the regulator in terms of the legal provisions.

If the DBS is convinced that the bank

- Is engaged in unsafe and unsound practices which is likely to jeopardize its obligations to its depositor;
- Has failed to or contravened to comply with the provisions of the BA or any regulations issued under the BA or failed to comply with any written law which related to banking or finance;

the DBS may issue an order directing the bank ;

- To cease and desist from any such practices or;
- Failure to comply with the provisions of the BA or directions or any other written laws;
- To take necessary actions to correct the conditions resulting from unsound practices or failure within such period as specified in the order;
- Cancellation of license issued to a bank (BA Section 9 and 10).

An order for cancellation is issued if the bank has:

- Failed to pay any debts incurred by it on such debt becoming due or;
- Had a petition or action for relief against such bank and has had appointed with respect to such bank under any bankruptcy law or any other law which provides for relief of debtors or which related to debtors, a liquidation or receiver;
- Contravention of any provisions of the BA or regulations;
- Furnished false, misleading or inaccurate information to the MB;
- Carried on or is carrying on its business in a manner likely to be detrimental to the interest of its depositors.

The bank aggrieved by this order can appeal to the MB within 30 days of the order

However, the MB can specify other steps without canceling the license (BA Section 11). The order made by the MB can include any of the following:

- Directing the bank to suspend its business;
- Requiring the bank to forthwith take or refrain from taking any actions (freeze on deposits, granting loans, impose restrictions on other risky business);
- Appointing a fit and proper person to advise such bank with regard to the proper conduct of the business;
- Restraining any director, manager or controller of the bank from carrying out any functions and appointing a fit and proper person to carry out such functions;
- Assumption of control of, and for the carrying on of the business of the bank by the MB or delegating the control so assumed to another person in order to carry on the business of the bank;
- Re-organising the bank by arranging for the increase of its capital or reconstitution of its board or both;
- Providing the necessary for the amalgamation of the bank with any other bank that consent to such amalgamation;
- Vesting the business of the bank in another bank which consent to it;
- Cancel the license when the MB, after taking the above actions, is of the opinion that it is in the interest of the banking system to do so.

The bank can appeal to the decision of the MB under Article 136 of the Constitution. The license of a smaller private specialised banks was canceled in 2002 due to serious loss in capital resulting from high non-performing loans. However, on appeal to the Supreme Court by the bank, the order was revoked and the supervisor was ordered to explore other methods to revive and restructure the bank. However, since no viable restructuring proposal was received from interested parties, the license was cancelled again. With the court case dragging on, the government decided to vest the assets of the bank into a newly created state owned bank, the operations of which are expected to commence in 2008. A scheme for the repayment of deposits of the failed bank has been published.

4.2 Resolving Liquidity Problems

Any indications of serious liquidity problems are examined to identify the causes and a proposal for the cause of action for the resolution of such problems is made. In addition to the liquid asset ratio, gap analysis, frequent resort to reverse repo window of the CBSL, high and consistent call money borrowings are used to identify emerging liquidity problems in banks. Banks facing liquidity issues are called for meetings where the causes and remedial actions are discussed. A spot examination is carried out if required. A lender of last resort facility is available for illiquid but solvent banks at the terms and conditions specified by the MB. However, there are no procedural guidelines for the provision of lender of last resort facility.

4.3 Resolving Credit and Capital Impairment Problems

According to the current regulations, a bank cannot reduce its capital without the approval of the MB and it should at all times maintain its minimum capital adequacy ratio. Any variation in the capital adequacy ratio is communicated to banks by the MB. The following actions can be taken to address such issues:

- Grant of a reasonable period of time by the MB for rectification when equity capital or capital funds of a bank have become deficient. The bank should submit a plan for the infusion of fresh capital;
- Imposition of restrictions on the capital deficient bank such as suspension of payment of dividends, etc.

4.4 Removing Bank Management and Ownership Issues

Without canceling the license, one of the other methods available for the MB is to change or remove the bank management. Accordingly, it can remove or restrict functions of any director, manager or controller of a bank if it is of the opinion that problems encountered are of such a nature that cannot be resolved through formal communication with the bank's management.

The current regulations limit the amount of share ownership in a bank to a person or group directly or acting in concert to 10% of the issued capital, carrying voting rights of a bank. The MB can permit shareholdings up to 15% of the issued capital. However, these provisions do not apply to the government. The share ownership limits is not a barrier to the restructuring of the problem bank since the MB can permit share ownership in excess of these limits only for the purpose of restructuring problem banks.

4.5 Role of the Courts in Bank Intervention

Under Section 176 of the Constitution, a bank can appeal to the Appeal Court in the event of the cancellation of its license by the MB. An application needs to be submitted to the district court in the case of bank liquidations.

A bank whose license was cancelled by the MB appealed to the Appeal Court to quash the decision. The liquidation proceedings have been protracted over a long period of time and are still pending since 2002. The government passed amendments in the BA to vest the problem bank's assets in a new government owned bank in 2006. The new bank has been established and is in the process of starting its operations. A repayment scheme has been published for the depositors and other creditors of the bank.

5. Resolution Management

5.1 Grounds for Receivership and Early Resolution

The following are the grounds for cancellation of license issued to a bank (BA Section 9 and 10). If the bank does not appeal to the MB or to the courts within 30 days of the order, the DBS can make an application to the district court for compulsory liquidation of the bank.

- The bank has failed to pay any debts incurred by it on such debt becoming due or;
- There has been a petition or action for relief against the bank and has appointed with regard to such bank under any bankruptcy law or any other law which provides for relief of debtors or which related to debtors, a liquidation or receiver;
- Contravention of any provisions of the BA or regulations;
- Furnished false, misleading or inaccurate information to the MB;
- Carried on or is carrying on its business in a manner likely to be detrimental to the interest of its depositors.

It can be deduced from the grounds listed above, that the adequacy of capital is the main basis for the liquidation of a bank.

5.2 Supervisory Responsibilities for Failing Banks

Although there are no permanent institutional arrangement for dealing with problem banks, special units can be created when such banks are identified as was the case with regard to the failed bank referred to above. A strategic enterprise management agency (SEMA) was established in 2004 to advise and monitor the affairs of selected state enterprises including banks. Plan for infusion of capital for a one state commercial bank with deficient capital has been prepared by the SEMA. Accordingly, an ADB line of credit has been obtained subject to the meeting of specified performance criteria by the bank.

5.3 Asset Quality and Financial Review Process

If statutory examinations carried out indicate that the bank is insolvent or illiquid and has become unable to meet the demands of its depositors and creditors or that its continuance in business is likely to involve losses to its depositors or creditors, the MB can suspend the operations of the bank. Pursuant to the suspension, special examinations can be carried out by auditors to determine the level of capital and quality of assets. Depending on the results of such audits, either a restructuring or cancellation of the operation can be initiated by the MB.

5.4 Bank Closing Process

The DBS becomes the liquidator of a bank with regard to both voluntary and compulsory liquidations. Liquidation of any company including a bank is carried out by a court of law. Voluntary liquidations cannot be effected without the authorization of the MB. The approval is given only if the bank is solvent, has sufficient liquid assets to repay its depositors and a majority of shareholders have approved such a liquidation.

When approval is granted, the bank should cease to carry on business and repay depositors and creditors. In the case of a compulsory liquidation consequent to the cancellation of a bank, the DBS as liquidator has following powers:

- To wind up its operations by institution of liquidation proceedings in Court;
- To stop or limit the payments of it obligations;
- To execute any instrument in the name of the bank;
- To initiate, defend and conduct in its name any action or proceedings to which the bank may be a party;
- To terminate any contract of employment entered with such bank.

The DBS should issue a statement of the nature and the amount for which their claim is shown in the bank's books to all depositors and other creditors. A three month period is given to such parties to file objections regarding the claims.

Liquidation expenses, wages and salaries of employees, taxes, fees due to the CBSL, deposits, creditors and shareholders, get priority of claims respectively, under the BA. When all assets have been distributed an audited account is submitted to the Courts to terminate the liquidation. The DBS then should proceed to terminate the judicial existence of the bank in accordance with the provisions of the Companies Act.

5.5 Resolution Methods

In terms of the law, a problem bank can be revived through change of ownership, amalgamation with another bank and liquidation. In addition, the operations of the bank can be vested in a state owned bank as was practiced recently in case of a problem bank. However, this method can be used only with regard to the failure of a specialized bank.

5.6 Cost of Resolution

There have not been bank failures except for a private specialized bank mentioned above. In this case, while government funds have not been used, the deposits of government agencies will be converted to capital for the bank. In the past, there have been two instances where the government has recapitalized two state owned commercial banks.

6. Crisis Management

6.1 Key Policies in Dealing with Systemic Banking Crisis

There have not been a systemic banking crises in the country except problems with state owned banks. The law does not provide for definitions or criteria for systemic risks and other matters related thereto. It is therefore essential to examine the need for such a legal or administrative framework for handling systemic crises.

A lender of last resort (LOR) facility is available under the MLA to provide emergency liquidity assistance. However, except for the terms and conditions, the law does not lay down the criteria for the provision of such facility to a problem bank. Therefore, the formulation of guidelines for the use of the LOR must be formulated clearly and transparently.

6.2 Institutional Arrangements for Systemic Banking Crisis

These areas are not specified in the relevant laws. The institutions that may be involved in such a situation would be the same institutions such as the CBSL, Ministry of Finance and other regulators in the financial sector.

6.3 Key Issues in Crisis Management

In view of the above, there are several issues with regard to problem bank resolution and crises management. These include gaps in the existing legal framework covering problem banks in areas such as information sharing, lack of definitions for problem bank identification and systemic crises, issues relating to the need for a deposit insurance scheme and the provision of lender of last resort facility.

However, it should be noted that there are no clear cut answers or definitions with respect to some of these issues because of various country specific factors. In the area of problem bank resolution and crises management, relevant legislations could be amended to facilitate proactive role by regulators. Furthermore, it may be necessary to streamline the process of liquidation and winding up process. For example, special tribunals or similar legal process could be set up to deal with bank liquidation.

A systemic crisis could be described as a crises affecting the entire or a significant part of the financial system impacting the real economy. However, the problem with a systemic crises is that it is often difficult to identify early, whether a particular problem would have a systemic impact or not. Therefore, many countries do not try to define or set clear cut guidelines on certain areas such as the provision of lender of last facility. This has been clearly evident in the responses of some central banks to the recent sub-prime turmoil in the western countries.

7. Conclusions

Though the existing legal and regulatory framework covering bank supervision in general and handling of problem banks in particular, is fairly adequate and satisfies internationally accepted principles, improvements could be made to areas identified through the introduction of required changes to the law as a forward looking measure to mitigate risks to financial system stability in the future. Some of the main issues associated with problem bank resolution such as information sharing, deposit insurance and legal amendments are currently under consideration.

PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN REPUBLIC OF CHINA (TAIWAN)

by Harrison S.W. Ku[1]

1. Introduction

Problem banks occur in a multitude of different forms. Banking systems can be continuously weak, reflecting unsafe and unsound banking practices, or they can be the result of structural weaknesses in the institutional framework of a country. Widespread banking problems can emerge because of external shocks or economic slowdowns affecting the economy as a whole or some sectors of an economy. Under these circumstances, the government's goal is to re-establish macroeconomic stability and financial intermediation using a combination of macroeconomic and microeconomic tools.

Over the last decade, Republic of China (Taiwan) [hereafter referred to as ROC (Taiwan)] has steadily introduced phased innovations and reforms to its handling of problem financial institutions. The changes since 1999 saw a shift in Taiwan's deposit insurance system from voluntary to mandatory participation, the establishment of a new mechanism for handling problem financial institutions, as well as the implementation of a risk-based premium system. In 2001, the ROC (Taiwan) government set up the Financial Restructuring Fund and appropriated a total of US$ 7 billion to dispose of problem insured institutions. A temporary blanket guarantee was provided by the Fund over a period of four years. The revised Deposit Insurance Act of January, 2007 established a mechanism for handling systemic crises, including exemption from the minimum resolution cost restriction and adoption of a bridge-bank mechanism to deal with the systemic crises. Such efforts have earned ROC (Taiwan) widespread recognition for its contribution to bringing about major improvements to the overall operational status of the financial institutions, protecting the interests of depositors, and enhancing public confidence in the financial system.

2. Legal Framework in Dealing with Problem Banks

2.1 Legal Framework

Financial Supervisory Commission (FSC)

Established on 1st July 2004, the FSC was set up to be the single statutory financial supervisor in ROC (Taiwan). The newly established Commission, with the same standing as a ministry, is responsible for the prudential supervision of all financial institutions, including banks, security firms and insurance companies. The goals of the FSC are to promote sound business management of financial institutions, maintain financial stability, and promote the development of financial markets.

The FSC is in charge of the following matters:

(1) Financial systems and supervisory policies;

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(2) Proposal, amendment and repeal of financial laws and regulations;
(3) Monitoring and regulation of the following in connection with financial institutions: the establishment, termination, revocation, change, merger, business suspension, dissolution, and approval of business;
(4) Development, monitoring, and regulation of financial markets;
(5) Examination of financial institutions;
(6) Examination of matters relating to public companies and securities markets;
(7) International financial matters;
(8) Consumer's protection on financial matters;
(9) Enforcement of financial laws and regulations, punishment of violators and handling of matters related thereto;
(10) Collection, processing and analysis of statistical information relating to financial monitoring, regulation and examination; and
(11) Other matters relating to financial monitoring, regulation and examination.

Central Bank of the Republic of China (Taiwan) (CBC)

From 1st July 2004, the CBC no longer conducts regular full-scope on-site examinations on individual financial institutions. The CBC, serving as the lender of last resort, still holds the responsibility for the stability of the financial system as a whole. Therefore, it retains the authority to examine financial institutions on issues with regard to the execution and implementation of monetary, credit and foreign exchange policies. The CBC's legal responsibility is to promote financial stability, guide sound banking operations, maintain the stability of the internal and external value of the currency, and foster economic development within the scope of the above objectives.

The CBC conducts the following main operations:

(1) Monetary Management
The Bank uses various policy instruments to regulate financial conditions and achieve monetary policy objectives, including open market operations, discounts and temporary accommodations, required reserve ratios, re-deposits of financial institutions, etc.

(2) Foreign Exchange Management
Taiwanese residents can freely hold and use foreign exchange export proceeds and also make foreign exchange import payments without restrictions. Only certain regulations imposed on remittances related to capital account transactions are retained for the purpose of financial stability. The CBC adopts a managed exchange rate system, meaning that the New Taiwan dollar exchange rate is determined by market demand and supply. However, when there is a large fluctuation in the exchange rate, the CBC is likely to step in.

(3) Clearing and Settlement Services
The CBC is the major operator of the payments system in Taiwan, providing services for payments among banks. The CBC is also responsible for promoting the efficiency and security of the payments system, as well as for supervising clearing houses regarding cheque clearing and settlements among the banks involved.

(4) Currency Issuance

The CBC is responsible for designing, planning, producing bank notes and coins, and destroying old notes, which are no longer fit to use. The Bank of Taiwan, a state-owned commercial bank, is authorised to distribute notes and coins and sort out returned notes.

(5) Treasury Agency Functions

As the fiscal agency, the Bank handles receipts and disbursements of funds and properties for the central government and its agencies. It also handles the issuance, redemption and interest payment of central government securities.

(6) Bank Examination

Based on the Central Bank of China Act, the CBC also has the responsibility to examine the operations of all financial institutions under the operational objectives of promoting financial stability and guiding sound banking operations. Following the establishment of the FSC, the CBC retains the power to conduct target examinations and maintains the off-site monitoring system to make sure that the operations of banks will be consistent with the monetary and exchange rate policies as well as the stability of the financial system.

(7) Statistics and Research

The CBC compiles data on financial statistics, flow of funds, and balance of payments, and publishes these statistics in the Financial Statistics Monthly, Flow of Funds Annual, and Balance of Payments Quarterly. The Bank's Annual Report and Quarterly Review are also published. The Bank's publications are sent to domestic and international institutions. The CBC also conducts studies on the economic and financial conditions of major countries as well as the impact arising from innovations in global financial markets.

Central Deposit Insurance Corporation (CDIC)

The government-owned CDIC was established on September, 1985, with capital jointly invested by the Ministry of Finance and the Central Bank of China. The CDIC, which is supervised by the FSC, is the only institution in Taiwan exclusively in charge of managing the deposit insurance system, and serves as an integral part of the country's financial safety net.

The main objectives of the CDIC are:

(1) Protect the rights and interests of depositors in financial institutions.
(2) Maintain credit order.
(3) Enhance sound development of financial businesses.

If a problem bank occurs, the FSC determines the need for corrective action, assesses the types of remedial measures, adopts the appropriate process and corrective action plan. The CDIC is usually appointed by the FSC to deal with problem banks.

When a bank has emergency funding requirement caused by unusual depositor withdrawals, the bank may submit a letter of explanation to the CBC, along with the approved collateral, to apply to the CBC for discounting of secured loans. The CBC may also provide special accommodation to the CDIC when it is handling problem banks.

In order to maintain financial stability, the Deposit Insurance Act was amended (effective January 18, 2007). The major amendments to the Act include moves to strengthen the financial safety net centered on the depository insurance mechanism, bolster the risk management mechanism and solvency of the CDIC, and replenish the insurance reserve fund. The amendment will ensure that problem banks are dealt with promptly and effectively.

2.2 Coordination and Information Sharing

The Standing Committee of Financial Supervisors (SCFS) was established to facilitate the coordination and sharing of information among the FSC, CBC, CDIC, or any other government agencies on matters pertaining to the monitoring, regulation, or examination of banking and financial institutions. The Standing Committee functions as a communication operation platform. Senior executives of the CBC, FSC and CDIC meet periodically, or they may meet at any time, if necessary, to consult and cooperate on the above or major financial supervisory concerns, including handling failed banks, funding and liquidity of problem banks, and matters concerning foreign bank operation, etc.

Regarding the connection with foreign official agencies, the FSC enters into bilateral surveillance MOUs with overseas financial supervisory authorities and strengthens information exchange and cooperation on financial supervisory issues, so as to facilitate the efforts of Taiwan's more competitive financial institutions to become more international and implement strategies for regional deployment.

2.3 Issues on Autonomy, Accountability and Legal Protection of Bank Supervisor

The Organic Act Governing the Establishment of the Financial Supervisory Commission, Executive Yuan 2003 (AEFSC) has promulgated the FSC as the competent authority for the development, monitoring, regulation, and examination of financial markets and financial service enterprises in Taiwan. The FSC shall exercise its authority of office independently in accordance with the prevailing laws. The Commissioners of the FSC shall act in a non-partisan manner, and shall not take part in the activities of any political parties during their tenure as commissioners.

The FSC may, at any time, appoint a designee, entrust an appropriate institution, or direct a local competent authority to appoint a designee to examine the business, financial affairs and other relevant affairs of a bank or related parties, or direct a bank or related parties to prepare and submit, within a prescribed period of time, balance sheets, property inventories, or other relevant documents for examination.

The FSC may, when necessary, appoint professionals to verify statements, materials or affairs that are subject to examination, and such professionals shall, in turn, present a report to the FSC. Any fees arising there from shall be borne by the relevant bank(s).

The responsible person(s) or staff member(s) of a bank, or other concerned persons, found guilty of committing any of the following acts when the competent authority dispatches officials, or mandates appropriate institutions, or orders local competent authorities to dispatch officials, or designates professional and technical persons to check the business, financial condition and other related matters, or orders the bank or other concerned persons to submit financial reports, property inventories, or other related documents and reports, in accordance with Article 45 of The Banking Act of The Republic of China, shall be punished by an administrative fine of not less than NT$2,000,000, and not more than NT$10,000,000:

(1) Refusing to be investigated, or refusing to open the vault, or other storage facilities.
(2) Concealing or damaging books and documents related to business or financial conditions.
(3) Refusing to reply, or misrepresenting responses to inquiries of the investigator without justifiable reasons.
(4) Failure to timely, honestly or completely provide financial reports, property inventories or other related data or reports, or to pay investigation fees within the specified period(s) of time.

3. Problem Bank Identification

3.1 Supervisory Strategy

(1) On-site examinations
The authority directly dispatches personnel, or acts in coordination with other regulatory agencies to dispatch personnel, to conduct on-site examinations.
A. All-scope examinations
These are risk-focused examinations focusing primarily on the examinee's financial, operational, and overall business status.
We are now applying the top-down approach on field examination of head office. The examiners should evaluate the management function, including the determination and evaluation of operation policies, board of directors' function, internal control system and audit system, coordination among different management departments, the reporting system, the risk management system, and head office management of its branches, etc. Each bank must undergo a full-scope examination, so that FSC can understand its operations and detect any major irregularities.
B. Targeted examinations
Targeted examinations focus on particular aspects of the examinee's business.

(2) Off-site monitoring
The supervisors review relevant statements, minutes of important meetings and other information or reports submitted by the banks in order to understand each bank's operations and determine the bank's compliance with laws and regulations and government policies. Where significant irregularities are discovered, these should immediately be reported to the higher authorities so that further examination can take place.

(3) Business interviews
The authority invites the responsible persons or supervisory officers of the banks to provide reports and express opinions on specific matters.

3.2 Prudential Requirements

The ratio between the equity capital and risk assets of a bank shall not be less than 8 percent. When necessary, the FSC may, based on international standards, increase the ratio. For banks that are required to produce consolidated financial statements, such ratio shall also be met on consolidated basis. If the actual ratio of a bank is lower than the required ratio, the FSC may prohibit the bank from paying dividends and/or take other necessary actions.

The banks may extend medium- or long-term loans for the purchase or construction of residential buildings or buildings for business purposes. However, the term of such loans may not exceed 30 years. The total amount of loans extended for residential construction and construction for business purposes by a commercial bank shall not exceed 30 percent of the aggregate of such commercial bank's deposits and bank debentures issued at the time such loans are extended. The total amount of medium-term loans extended by a commercial bank shall not exceed the balance of its time deposits received.

No unsecured credit shall be extended by a bank to enterprises in which the bank holds three percent or more of the total paid-in capital, to its staff members, to its major shareholders, to any interested party of its own responsible person or of a staff member in charge of credit extensions. However, the foregoing prohibition on unsecured credit shall not apply to consumer loans and loans extended to the government.

For any secured credit extended by a bank to enterprises in which the bank holds at least five percent of the total paid-in capital of the said enterprises, to its own responsible person, to its staff members, to its major shareholders, to any interested party of its own responsible person or of a staff member in charge of credit extensions, the terms of such extended credit shall not be more favorable than those terms offered to other same customer categories. If the credit amount to be extended by a bank exceeds the amount prescribed by the FSC, the bank is required to obtain the concurrence of at least three-quarters of all of such bank's directors present at a meeting attended by at least two-thirds of the directors, to extend such credit.

Acquisitions of real estate and stocks by a commercial bank through the foreclosure of mortgages or pledges shall be disposed of within four years from the date of acquisition.

A Bank shall establish an internal control system and audit system; regulations governing the objectives, principles, policies, operating procedures, qualifications and conditions for internal auditors, scope of internal control audits that a certified public accountant shall be engaged to undertake, and other matters requiring compliance, shall be prescribed by the FSC.

A bank shall establish an internal processing system and procedures with respect to the evaluation of asset quality, the creation of loan loss provision, the clearing of and writing off of non-performing and non-accrual loans. Applicable regulations with respect to the above system and procedures shall be prescribed by the FSC.

A bank, at the time of distributing its earnings for each fiscal year, shall set aside 30 percent of its after-tax earnings as a legal reserve. However, unless and until the accumulated legal reserve equals the bank's paid-in capital, the maximum cash profits, which may be distributed, shall not exceed 15 percent of the bank's paid-in capital. In the event that the accumulated legal reserve equals, or exceeds a bank's paid-in capital, the foregoing provision shall not apply.

In order to assure that a bank maintains adequate liquidity, the CBC, after consultation with the FSC, may from time to time prescribe a minimum ratio between the current assets of the bank and the bank's various liabilities. Upon a bank's failure to comply with the said minimum ratio, the FSC shall notify the bank to make due adjustment within a specified period of time.

3.3 Early Warning Systems

The CBC, while retaining the power to carry out targeted examinations, requires banks to file non-performing loan reports on a monthly basis. To enhance the liquidity management of banks, the CBC also requires banks to report the term structure of fund inflows and outflows denominated in local currency on a quarterly basis. The CBC also collects other call reports, such as banks' loan-loss reserve provisions, credit card and cash card business, country risk exposures, financial derivative products, etc. These data, together with systematic analysis and evaluation of banks' business, financial conditions and compliance with regulations, aids the CBC in maintaining the off-site monitoring system to detect banking problems.

The CBC's off-site monitoring system for banks is called CARSEL.

(1) Methodology
The methodology of the CARSEL involves:

A. Establishing a set of guidelines or benchmark ratios, which are considered to be norms.
B. Utilising statistical model for screening the financial ratios and figures. (winsorized mean)
C. Accumulating points into "score pool" when financial ratios or figures exceed the benchmark or minimum requirements on each factor.
D. Allocating weight to each component and factor.
E. Calculating weighted mean of each component.
F. Grading component scores into 1 to 5, as follows:
1 – strong
2 – satisfactory
3 – fair (watch category)
4 – marginal (watch category)
5 – unsatisfactory (watch category)
G Calculating composite score of individual system
Ratings are assigned for each component in addition to the overall rating of a bank's financial condition. The ratings are also scored on a scale from 1 to 5. Banks with ratings of 1 or 2 are considered to present few, if any, supervisory concerns, while banks with ratings of 3, 4, or 5 present moderate to extreme degrees of supervisory concern.

(2) Components

–C: Capital adequacy

Main factors are Tier 1 capital and total risk- based capital, Adjusted net-worth to adjusted assets, Adequacy of allowances for loan and other assets, the quality and strength of earnings to the capital.

–A: Asset quality

Main factors are the level, distribution, severity, and trend of classified assets, non-accrual and restructured loans, delinquent loans and non-performing assets, the exposure to off-balance sheet transactions, the extent of securities underwriting activities and exposure to counter parties.–R: Regulation compliance.

Main factors are compliance with applicable laws and regulations such as single lending limit, the volume, diversification of the loan and investment portfolios, the volume of lending to connected persons, the volume of real estate investment.

–S: Strategies and Stability

The main factors are the sensitivity of the net earnings to changes in interest rates, the concentration of loan by industries, the concentration of collaterals from credit extension, the growth rate of loan, deposit, and major business activities.

–E: Earnings

The main factors are the level of earnings, including trends and stability, the sources of earnings including interest revenues, commissions and service fees, the adequacy of the allowance for loan losses and other valuation allowance accounts, the exposure to market risks such as interest rate, foreign exchange, and price risks.

–L: Liquidity

The main factors are the adequacy of liquidity sources compared to present and future needs, compliance with laws and regulations, the availability of assets readily convertible to cash without undue loss, and the trend and stability of deposits.

(3) Application

A. Completing warning signal analysis reports(A) To gauge the soundness, financial and operational weaknesses, or adverse trends of banks for the CBC and related authorities.
   (B) To assess the liquidity issues, problems or deteriorating conditions of banks.

B. Publishing the statistical reports
   (A) Business Overview of Financial Institutions in Taiwan, annual report (Chinese version).
   (B) Major Business Statistics of Financial Institutions in Taiwan, annual report (Chinese version).
   (C) Condition and Performance of Domestic Banks, ROC, quarterly report (Chinese & English version).C. Providing information for business approval or reference
      (A) Deciding the line of foreign currency call loan for banks.
      (B) Deciding the line of foreign currency deposit for banks.
      (C) Providing comments for the FSC on applying to establish overseas subsidiaries or branches of domestic banks.
      (D) Providing comments for the CBC on applying to operate new business related to foreign currency from financial institutions.

(E) Providing reference for the CBC on applying to operate treasury agency from domestic banks.
(F) Providing reference for CBC on applying to be a dealer of central government bond from financial institutions.

C. Providing analysis data for particular issues, such as
   (A) NPL's problem of banking institutions.
   (B) Credit card and cash card's delinquent issues.
   (C) The valuation and resolution of problem institutions.

3.4 Communicating Concerns

Frequent and effective communication with the board and management and other regulators is extremely important in problem bank supervision. Examiners should communicate in an appropriate manner according to the severity of a given situation.

When examiners identify significant problems that affect the bank adversely, they must discuss with the management and the board as soon as possible. During the discussion meetings, the bank management must be allowed to clarify legitimate misunderstandings and commit to corrective action.

Based on an examination or review, an exit meeting should be held with the senior bank management or directors to conclude the findings and agree upon the required corrective action and the planned FSC follow-up, including the enforcement action, if necessary.

The examiner should prioritise the issues during the exit meeting to aid the management and directors in understanding the associated risks. In the exit meeting, the FSC should seek and obtain the commitment of the bank to carry out the corrective action, including adherence to the time frames.

Meetings with the board of directors of a problem bank should be convened whenever there is material information to convey. Common topics include examination conclusions, future supervisory plans, corrective action updates, and presentation of enforcement actions.

The report of problem banks often deals with complex issues that must be understood by the board. It must also be persuasive to encourage corrective action. The report will also provide the essential foundation for any enforcement action that may be required. Therefore, the amount of detail and the necessity for precise wording is especially important.

To insure its clarity and effectiveness, the examination report should:

(1) Reflect the bank's problems, their relative severity, and effect on the bank if left uncorrected.
(2) Disclose the stage of the bank's rehabilitation process and the management's competency/ability to correct the noted deficiencies.
(3) Highlight the uncorrected deficiencies from prior examinations, or other areas needing corrective action.
(4) Contain sufficient documentation and information to support any informal or formal enforcement action, including receivership where appropriate.

On-going communication with other regulators is necessary to ensure the smooth resolution of a problem bank. Communicating concerns to other regulators should take place well before the resolution management stage, but will likely intensify as the bank conditions worsen. Where the FSC's monitoring, regulation or examination of bank operations are connected with the operations of the CBC or any other government agencies, the FSC shall promulgate rules to govern the implementation of the operations thereof, such as requests for the examination reports of both institutions to be shared immediately, and the conservatorship or receivership of a bank should be discussed and communicated in advance to ensure the above action can be carried out smoothly and effectively.

4. Problem Bank Intervention

4.1 Prompt Corrective Action

If there is a possibility that a bank has violated the laws and regulations, or is in breach of its articles of incorporation, or has disturbed the sound operation of the financial system, the FSC may, depending on the situation, take any of the following actions, in addition to ordering correction or improvement by the Bank within a specified period of time:

(1) Revoke the resolutions of statutory meetings;
(2) Suspend part of the bank's business;
(3) Order the bank to discharge its managers or staff members;
(4) Discharge the bank's directors and supervisors or suspend them from performance of their duties for a specified period of time; and
(5) Take any other necessary measures.

If a bank, due to obvious adverse changes in its business or financial status, fails to pay its liabilities when due, or risks damage to depositors' interests, the FSC should:

(1) Order the bank to suspend its business and undergo rehabilitation within a certain time limit.
(2 Suspend part of the bank's business.
(3) Assign officials to take conservatorship or receivership over its operations.
(4) Take other necessary actions, including a request to the relevant authorities to restrict the departure from the country of the responsible person of the bank.
(5) Assign officials to take conservatorship or receivership over the bank, the FSC may suspend all or part of the rights and functions of the shareholders' meetings, the board of directors or supervisors.

If the actual ratio between equity capital and risk assets of a bank is lower than the required ratio (eight percent), the FSC may prohibit the bank from paying dividends and/or take other necessary actions.

If the losses of a bank exceed one third of the bank's capital, the bank's directors or supervisors shall immediately report the matter to the FSC. In this eventuality, the FSC may require the bank to correct such deficit of capital within a prescribed period of time. If the bank fails to do so within the prescribed time period, it shall be ordered to suspend its business.

The FSC's corrective action policy combines individual judgment with a framework to ensure consistency of application. The potential corrective actions range from informal advice and moral suasion to formal enforcement actions, such as cease-and-desist orders, capital directive (under draft) , and safety-and-soundness orders.

The following table summarises the various types of the FSC's informal and formal supervisory and enforcement actions:

Table 1
Informal and Formal Supervisory and Enforcement Actions

Type of Corrective Action	Description of Action
Informal Actions: FSC-Required Board Resolution	Bank-generated document designed to address one or more specific concerns identified by the FSC. It is not a binding legal document.
Commitment Letter	Document is signed by the bank's representatives, reflecting specific written commitments to take corrective action in response to the concerns identified by the FSC. It is not a binding legal document.
Corporate Leverage	An action by the FSC to withhold (or grant conditional approvals) or condition approvals as part of the corporate approval process.
Formal Actions: Formal Written Agreements	A document signed by the bank's board and approved by the FSC. Its provisions are set out in an article-by-article form to prescribe the necessary corrective action. Violation of a formal agreement can provide the legal basis for more serious proceedings (e.g., cease and desist).
Capital Directive (Under Draft)	An order designed for establishing and enforcing capital levels and for taking capital-related action.
Civil Money Penalties	Authorised civil money penalties levied for: violations of law, formal written agreements, final orders, and conditions imposed in writing; certain unsafe and unsound banking practices; and breach of fiduciary duty.
Conservatorship	Places the rights to control or dispose of the bank in the hands of an FSC-appointed conservator.
Orders Enforcing Safety and Soundness Standards	For the bank fail to comply with established safety and soundness standards, related agency notification of a deficiency, the bank may be directed to submit a compliance plan. If the bank fails to submit a timely, acceptable plan, or fails to adhere to an accepted plan, the (FSC) FRS may issue an order requiring the bank to take corrective action.

The FSC is currently drawing up the types of adoption measures of a bank based on the individual ratio between equity capital and risk assets. The draft of the adoption measures according to the capital-based ratio is as follows:

Table 2
Adoption Measures According to Capital-based Ratio
(Under Draft)

Capital Category	RBC	Description of Adoption Measures
Adequately Capitalised	>= 8%	-
Under-capitalised	6%<=RBC < 8%	1. Cannot make any cash distribution and pay out compensation, bonuses, and other similar allowances given by the bank to directors and supervisors. 2. May order the bank and directors to submit a time-limited improvement plan for capital increase or for reduction of total risk assets. 3. May restrict risk-based assets increase, or take other necessary measures.
Significantly Under-capitalised	2%<=RBC < 6%	1. Apply the above measures. 2. May dismiss the directors and supervisors of the bank and notify the company chartering agency (Ministry of Economic Affairs-re p20) Ministry of Economic Affairs to register the dismissal. 3. May ask the bank to acquire or dispose specific assets. 4. May order the bank to dispose of specific assets. 5. May restrict or ban the credit or other similar transactions with related parties. 6. May restrict equity investments, part of business operation or dismiss some of the bank's branch organisations within a certain period of time. 7. May restrict the bank's deposit interest rates relative to the rates of other banks or kind of similar deposit. 8. May restrict the payment of reward to the directors to an amount not higher than the amount represented by the latest 12 month average paid to them when the bank became significantly under-capitalised. 9. May take conservatorship, or other necessary measures.
Critically Under-capitalised	2%>RBC or Equity/Assets < 2%	Must place a bank in receivership or conservatorship within 90 days of notifying the bank that it is critically under-capitalised, unless the approval of the FSC to restore the bank's capital or under merger process.

4.2 Resolving Liquidity Problems

The examiners should be prepared to deal with the wide-ranging liquidity events caused by actual or perceived problems in any area of the bank. Relating to bank capital insolvency, the measures to prevent liquidity insolvency may include a combination of both discretionary and mandatory supervisory actions.

The examiners must consider the effect of the relevant statutes in assessing liquidity risk. In certain cases, these provisions will eliminate the eligible funding sources for the banks. These statutory restrictions are triggered by declines in regulatory capital. This serves to strengthen the correlation between asset quality problems and liquidity problems.

For banks experiencing significant liquidity problems, the examiners, in conjunction with the bank management, should:

(1) Assess the severity of an identified liquidity problem and determine an appropriate regulatory response.
(2) Determine the cause of the liquidity problem, the likely public perception, and the bank's ability to respond.
(3) Organise management to centralise coordination of liquidity throughout the company.
(4) Evaluate the feasibility and desirability of the bank liquidity source from financial markets. This will provide a troubled bank with funds to broadcast to the money markets and possibly keep the major fund providers from cashing in as they view support. Distinctions should be made between those institutions willing to provide support on a short-term unsecured basis and those requiring collateral.
(5) Analyse the bank's trading and off-balance-sheet commitments and identify counterparties. Prompt action will minimise contagion spreading to other financial markets.
(6) Assess the cash available at all drawing locations. The bank management will need to implement systems capable of identifying the needs accurately in terms of volume, currency types, and timing. Efficiency here is essential to neutralise public concerns and prevent panic among the insured depositors.

The banks and their examiners can typically use two distinct discretionary tools in the management of liquidity —fund-flow analysis and a contingency funding plan. Although these tools should be included in any effective liquidity risk management system during normal times, they are critically important during a crisis. The fund-flow analysis depicts a bank's historical sources and uses of funds and provides a general sense of funding activity and trends. The contingency funding plan is a forward-looking document that projects the sources and uses of funds under alternative scenarios, when adverse circumstances exist for both the bank as well as the capital markets.

The monitoring of the FSC and the CBC can be effective in detecting potential bank liquidity insolvency. The level and frequency of monitoring depend on the severity of a bank's liquidity position. The examiners should make and update assessments of an institution's level of liquidity risk and quality of risk management as conditions change. Changes in the assessments should be communicated to the senior management as they occur. If the bank's management is not responding adequately to the bank's liquidity situation, appropriate supervisory action should be taken. It may be necessary to impose formal enforcement action.

Liquidity problems may require close coordination with other regulators. The examiners should:

(1) Inform other regulatory agencies of a potential liquidity crisis, as appropriate. The FSC or CBC management should also communicate with the relevant foreign central banks where the affected Taiwanese institutions are based. The subsequent regulatory efforts should be coordinated closely and synchronised sensibly.
(2) Work with the CDIC in evaluating the bank, including the value and marketability of its assets. This may involve discussions with the CDIC agents and potential acquirers.
(3) Have the FSC and the CBC jointly discuss bank contingency funding plans, including the nature of bank assets pledged for any discount window borrowing.

In order to assure that a bank maintains adequate liquidity, the CBC, after consultation with the FSC, may from time to time prescribe a minimum ratio between the current assets of the bank and the bank's various liabilities. Upon a bank's failure to comply with the said minimum ratio, the FSC shall notify the bank to make due adjustment within a specified period of time.

The CBC has prescribed, "The Directions for the Central Bank of the Republic of China (Taiwan) Accommodations to Banks," for the processing of various accommodation operations to banks, such as qualified bills rediscount, accommodations without collateral, and accommodations with collateral, pursuant to the provision of Article 19 of the Central Bank of the Republic of China (Taiwan) Act.

For emergency funding requirements caused by the following conditions, banks may submit a letter of explanation to the CBC, along with the CBC-approved securities or reserve accounts as collateral, to apply to the CBC for discount of secured loans:

(1) Occurrence of unusual depositor withdrawals.
(2) Occurrence of unusual depositor withdrawals at banks responding to the need to remit deposit reserves to the said bank, when the said bank undertakes emergency funding accommodations according to the procedures.

In deciding whether to approve or reject the applications for various types of accommodations, the CBC may refer to the applicant bank's credit rating, the effectiveness of the client's credit background checks, the bank's general reserve position, the purpose of the accommodation, cooperation with the central bank's monetary policy, and any major violations, or bad records in the past year.

4.3 Resolving Credit and Capital Impairment Problems

Problem loans are classified based on the examiner's best judgment of probability of default and the likelihood of orderly liquidation. Bank problem loan review and classification are defined as follows:

(1) Special Mention

Loans falling in this category are loans that have potential weaknesses that deserve management's close attention. If left uncorrected, the potential weaknesses may result in the deterioration of the repayment prospects for the loan, or in the bank's credit position at some future date. Special-mention loans are required to appropriate 2 percent allowance for doubtful accounts. The overdue duration of a special-mention loan in Taiwan is: fully collateralised and overdue for one to twelve months; or unsecured and overdue for one to three months.

(2) Sub-standard

Loans that are inadequately protected by the current sound worth and paying capacity of the obligor, or by any collateral pledged. Loans so classified must have a well-defined weakness or weaknesses that jeopardise the liquidation of the debt, and are characterised by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Sub-standard loans are required to appropriate 10 percent for allowance for doubtful accounts. The overdue duration of a sub-standard loan in Taiwan is: fully collateralised and overdue for more than twelve months; or unsecured and overdue for three to six months.

(3) Doubtful

Loans that have all the weaknesses inherent in those loans classified as sub-standard, with the added characteristic that the existing facts, conditions, and values make collection or liquidation in full, highly improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until a more exact status may be determined. Pending factors include merger, acquisition, liquidation procedures, capital injection, additional collateral, new financing sources, or additional guarantors. Doubtful loans are required to appropriate 50 percent for allowance for doubtful accounts. The overdue duration of a doubtful loan in Taiwan is: unsecured and overdue for six to twelve months.

(4) Loss

Loans that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. Such loans should be charged off in the period in which they are deemed uncollectible. The overdue duration of Doubtful in Taiwan is Unsecured and overdue for more than 12 months.

The examiners must also ensure that banks have an adequate allowance for loan losses. The allowance for loan losses is a valuation reserve established and maintained by charges against the bank's operating income. As a valuation reserve, it is an estimate of the uncollectible amounts that is used to reduce the book value of loans to the amount that is expected to be collected. The allowance for loan losses must be maintained at a level adequate to address the estimated inherent losses in the loan portfolio as of the evaluation date.

A bank experiencing problems should recognise the need to raise additional capital before it falls to the under-capitalised level, as defined in the Domestic Bank Capital Mandate, or when its risk-based capital ratios fall below the regulatory minimums. If a bank does not undertake a capital-raising effort independently, the FSC may legally require the bank to develop and implement a plan to increase its capital.

4.4 Removing Bank Management and Ownership Issues

If there is a possibility that a bank has violated laws and regulations, or is in breach of its articles of incorporation, or has disturbed the sound operation of the financial system, the FSC may, depending on the situation, take any of the following actions, in addition to ordering correction or improvement by the bank within a specified period of time:

(1) Revoke the resolutions of statutory meetings;
(2) Suspend part of the bank's business;
(3) Order the bank to discharge its managers or staff members;
(4) Discharge the bank's directors and supervisors, or suspend them from performance of their duties for a specified period of time; and/or
(5) Take any other necessary measures.

In the event that a bank's directors or supervisors are discharged in accordance with the preceding four scenarios, the FSC shall notify the Ministry of Economic Affairs to cancel the registration of such directors or supervisors.

If business assistance is needed in order to improve a bank's operation defects, the FSC may designate institutions to provide such assistance.

If a bank, due to obvious adverse changes in its business or financial status, fails to pay its liabilities when due or risks damage to depositors' interests, the FSC may assign officials to take conservatorship or receivership over its operations or may take other necessary actions, including a request to the relevant authorities to restrict the departure from the country of the responsible person of the bank.

When assigning officials to take conservatorship or receivership over a bank, the FSC may suspend all or part of the rights and functions of the shareholders' meetings, the board of directors or supervisors.

When the FSC orders a bank to suspend business and undergo rehabilitation within a certain time limit, or sends officials to take conservatorship or receivership over a bank, the provisions of the Company Act concerning temporary managers, inspectors, and reorganisation shall not apply.

4.5 Role of Courts in Bank Intervention

The CDIC is the legal receiver of a failed bank in ROC (Taiwan). It carries out the resolution of failed banks, and is a legally-constituted entity, delegated by a government agency to exercise governmental power with respect to certain specifically designated matters under Article 16 of the Administrative Procedure Act. The CDIC is empowered to perform administrative acts and assume the right to manage and dispose of property of the resolved bank as a receiver. The supervisors acting in a resolution procedure are delegated by an administrative agency. The Courts decide the disputes in the administrative procedure. A deposit insurance contract exists between the CDIC and the resolved banks before resolution. The CDIC pays the depositors when the insured banks are resolved. The persons who are legally in charge of the banks are responsible for non-performance of obligation and tort.

5. Resolution Management

5.1 Grounds for Receivership and Early Resolution

The FSC has authority and responsibility to appoint a receiver for a bank (which will be the CDIC, if the bank is insured) for a number of grounds, discussed below. The Financial Restructuring Fund Statute also accords the FSC the authority to require the sale or merger of a bank in certain circumstances. The agency's goal is to resolve an institution in a manner that avoids or minimises losses to the deposit insurance funds.

The most commonly used grounds for receivership have been:

(1) Adjusted net worth is negative after the examination by the FSC, or after certificated auditing by Accountant.
(2) Failure to repay its debts.
(3) Significant deterioration in businesses or financial status. As stipulated in paragraph 1 of Article 62 of the *Banking Law*, failure to repay its debts, risking damaging the benefits of depositors, or, pursuant to Article 64, losses exceeding one third its capital and failure to improve within a prescribed timeline, and being determined by the FSC and the Management Committee of the Financial Restructuring Fund to be incapable of continuing operations.

The FSC also has the authority to place a bank into receivership before the bank comes under the above situations, if one or more of the specified grounds exist. Such action may help resolve a problem bank at the least long-term cost to the deposit insurance funds. Early resolution can reduce or limit losses that might otherwise result if the bank is allowed to remain open until its capital has dropped below 2 percent. Early resolution can be considered, for example, when a bank is: losing capital, has no realistic prospects for recapitalisation, or is engaging in practices likely to increase losses in the future. Moreover, even in situations where the bank is adequately capitalised, receivership may be appropriate if there are substantial unsafe and unsound practices the bank is not addressing, or there are other significant failings identified in the receivership statutes.

There are grounds based on violations of law or unsafe or unsound practices that have had, or are likely to have, a substantial negative effect on the bank:

(1) There is substantial dissipation of assets or earnings due to any violation of statute or regulation or any unsafe or unsound practice.
(2) There is a violation of law or regulation, or an unsafe or unsound practice or condition, that is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the institution's condition, or otherwise seriously prejudice the interests of the bank's depositors or the deposit insurance fund.
(3) The bank is in an unsafe or unsound condition to transact business.

There are grounds based on a variety of critical management failures of the bank:

(1) The bank's board of directors are controlled and manipulated by a few family or interest-group members.

(2) There is a willful violation of a cease-and-desist order that has become final.
(3) There is concealment of the bank's books, papers, records, or assets, or refusal to submit the bank's books, papers, records, or affairs for inspection to any examiner or to any lawful agent of the government.
(4) The bank, by resolution of its board of directors or its shareholders, consents to the appointment.
(5) The bank ceases to be an insured institution.
(6) The Attorney General notifies the FSC in writing that the bank has been found guilty of a criminal money laundering offense.

When a bank becomes undercapitalised, or when a bank begins to show the substantial safety and soundness or other failings indicated in the receivership grounds, but is not yet critically undercapitalised, the supervisory officers should consider whether an early resolution contingency plan involving the sale/merger or receivership, would be appropriate. Once a decision is made to adopt an early resolution approach, the FSC's resources should be focused on the best available option at the least cost to the deposit insurance funds. The facts and reasons on which the receivership grounds are based must be well supported and documented. In most instances, prior enforcement or action would have addressed these matters at an earlier stage before they became more severe (e.g., when the bank first became undercapitalised, or when the bank was required to remedy unsafe and unsound practices in an enforcement action). The record prepared for those actions will later be a part in documenting the receivership grounds.

Additional documentation of the continuation and worsening of the problems, and, for some grounds, documentation of the substantial negative impact on the bank's assets, earnings, and/or ability to conduct business, will be needed. All the FSC offices involved in early resolution planning (e.g., appropriate bank supervision, corporate licensing, and legal offices) should be informed of the possible need to take steps to support early resolution. The examiners should consult with these agencies regarding the options available and what records will be needed to support them.

5.2 Supervisory Responsibilities for Failing Banks

The FSC established the Special Inspections Unit to review major cases of suspected crime, and to conduct targeted examinations to promptly collect evidence to be referred to the prosecutors. The FSC also supervise closely about the resolution of critical problem banks through rehabilitation or orderly resolution management. On-going supervision can include daily liquidity monitoring and the regular review of a bank's financials for movements in the balance sheet or further depletion of capital levels. The field examiners assigned to problem banks could also be responsible for the development of on-going strategy, off-site reviews, and input into the development of various enforcement actions.

Consistent with their respective statutory mandates, the CBC and the CDIC both have important roles to play in problem bank supervision.

The CBC's supervisory interest in problem banks is premised on its role as lender of last resort. The CBC's maximum term of short-term accommodations to bank shall not exceed ten days. The following types are provided:

(1) Short-term accommodations with eligible collateral.
(2) Short-term accommodations without eligible collateral.
(3) Intra-day overdrafts.

The CBC's refinancing of secured loans to banks shall be limited to the following:

(1) Undertaking government-approved lending which the CBC also approves.
(2) Lending undertaken compatible with the Bank's monetary policy.
(3) Emergency funding requirements as approved by the CBC.

The maximum term of the CBC's discount of secured loans shall not exceed 360 days.

In any action taken by the CDIC, pursuant to Article 28 to Article 30, and Paragraph 2 Article 41 of the Deposit Insurance Act, the CDIC may ask the FSC, to negotiate with the CBC so as to receive its approval and obtain accommodation. The CDIC shall weigh and consider its own funding situation and the actual funding requirements of individual cases when submitting requests to the FSC to arrange for approval of the amount of accommodation from the CBC. The CDIC shall submit requests to the FSC to arrange for the CBC's approval of the term of accommodation based on the progress of each individual case. The CDIC may provide government bonds, certificates of deposit of the CBC and other eligible collaterals to apply for accommodation from the CBC. If the aforesaid accommodation exceeds the amount of collateral provided by the CDIC, the FSC shall, together with the Ministry of Finance and the CBC, submit to the Executive Yuan for National Treasury guarantee. After its approval, the National Treasury shall guarantee the accommodation.

The CDIC, as insurer and receiver, has numerous responsibilities for failing and failed banks. If a bank violates the laws, regulations or deposit insurance agreements, or engages in unsound business operations, the CDIC may give a warning notice of termination of the deposit insurance agreement and require rectification within a stipulated timeframe.

The CDIC shall notify the FSC and terminate its deposit insurance agreement and make announcements with respect thereof, in the event any one of the following occurs to a bank:

(1) Failure to take corrective actions within the stipulated time-frame after the CDIC gives a warning notice of termination of the deposit insurance agreement.
(2) Failure to make improvements upon being ordered by the FSC, or to undertake recapitalisation or make improvements in financial condition and business operations within a certain time-frame, or being assessed as being unable to make improvements by the FSC or the FDIC, prior to the deadline.
(3) Occurrence of a major fraud or other illegal activities with the potential to increase deposit insurance payouts.

Also, the CDIC should establish the coordination mechanisms with the FSC and the CBC for the purpose of handling business crises of banks, or any major event affecting financial order.

5.3 Asset Quality and Financial Review Process

Loan and other asset write-ups that provide support for the required charge-offs and allowances for loan provisions are essential in establishing the accuracy of the bank's capital levels, and thus determining whether grounds for closing the bank are present. A line-review process validates these examination findings by ensuring that the asset classifications and the approach and methodology used to arrive at the required provision balance are consistent with the FSC's policies and procedures.

The decision to write up an asset depends on:

(1) Bank management's concurrence with the classification.
(2) Whether an insider loan is involved.
(3) The size of the asset being classified relative to the total assets of the bank.
(4) The dollar amount of the classification.
(5) Complexity of the asset.

Since accurate classification of assets is critical to the bank's survival, a financial review process exists to verify the identified losses independently. It also serves as a quality assurance process in that other examiners not involved in the examination validate and review the examination findings. This process ensures that the decisions made during the on-site examination are not arbitrary, inconsistent with the FSC examination policies and procedures, or based on the opinion or decision of one person. The financial review consists of the work papers and write-ups used to document the information concerning the assets reviewed during the examination, especially those classified sub-standard, doubtful, or loss. The participants in the financial review will be experienced examiners, who have not been involved directly in the current bank examination.

Since capital-based closings are tied to the level of equity capital, the review to validate the results of the allowance for loans analysis is critical. The allowance for loans methodology, with supporting documentation, should be submitted for review, along with the recommended allowance for loans balance and provision. If the participants in the financial review are unable to reach agreement on the classification of specific assets or the allowance for loans provision, other senior examiners will decide the issue.

5.4 Bank Closing Process

Where the FSC has assigned officials to take receivership over a bank, the bank's operations and property management shall be handled by a receiver. Upon the bank receiving a letter ordering receivership, the responsible person(s) and staff members of the bank shall deliver all books, documents, chops and properties, together with an inventory thereof to the receiver; disclose all necessary matters concerning the assets and liabilities of the bank to the receiver; and take other necessary actions to permit such receivership. The bank's responsible person(s) or staff members shall not refuse to answer relevant inquiries, or falsely respond thereto. A bank which is placed under the conservatorship of officials dispatched by the FSC shall be subject to the preceding mandate.

The following actions by a receiver with respect to a bank under receivership, shall require preparation of a feasibility report and approval from the FSC:

(1) Mandating other banks, financial institutions, or the CDIC to operate all or part of the business;
(2) Increasing capital, reducing capital, or increasing capital after reducing capital;
(3) Sale of all or part of the business, assets or liabilities;
(4) Merger with another bank; and/or
(5) Other important actions, as determined by the FSC.

Since its establishment, the CDIC has been entrusted with the tasks of assisting problem banks or of providing assistance jointly with the central and local competent authorities to stabilise the operations of the problem banks as well as prevent moral hazard. The assistance includes primarily the dispatching of personnel to attend important meetings of the board of directors or of the resident directors of the problem banks, or to attend the assistance meetings held by the competent authority, and cooperate closely with the said authority to strengthen the assistance of the problem banks; prompting the problem banks with major flaws in financial and business status to correct their management deficiencies as soon as possible in collaboration with the relevant authority; and dispatching of personnel to reside in the problem banks with higher management risk to render assistance as required to effectively control insurance risk, and make timely recommendations to the competent authority regarding any other necessary measures, as ma be required by law to safeguard the depositors' benefits.

Pursuant to the Financial Restructuring Fund (FRF) Statute, the FRF shall entrust the CDIC with the full amount required to settle the deposit-related and non-deposit-related claims on the problem banks with unsound operations. The FRF shall, in its own name, take over the assets of the problem banks, and shall dispose of them by offering them for sale by tender, auction or other method. Any proceeds from the disposal shall be included in the Restructuring Fund. The CDIC shall, as entrusted by the FRF, continue to settle the liabilities and deal with the assets of the problem banks that listed and scheduled prior to the Fund's expiration date on July 10, 2005, as well as other unfinished matters related to the Fund.

In the event that a bank shall have been closed by the FSC, the CDIC should, in order to maintain an orderly credit system and protect the interests of that bank's depositors, fulfill its responsibility as a deposit insurer by means of any one of the following methods:

(1) Directly making payout refunding the principal amount from its insured deposits in accordance with the failed bank's own accounting records, or based on the evidence of outstanding amounts provided by the depositors.
(2) Holding consultations with other insured institutions that are in close proximity to the failed bank, and transferring the deposit accounts of the depositors in the failed bank to those institutions so that the claims of depositors can be met.
(3) Extending financial assistance to other insured institutions, or financial holding companies, through the provision of funds, loans, deposits or guarantee, or purchase of subordinated debts issued by them, in order to facilitate the sound institutions to merge with the closed bank, or else to assume its operations, assets and liabilities either in whole or in part.

It needs to be noted, however, that the cost to CDIC of proceeding with any one of the last two methods needs to be less than the losses that would arise from directly making a pay-off on the basis of the first method.

Upon the closing of a failed bank, the CDIC, in addition to performing the insurance obligation, shall be appointed by the FSC as the receiver to commence the winding up of the closed bank. The CDIC may, in order to meet the liquidity needs of the creditors of the closed bank, without increasing the costs incurred by the CDIC and after having calculated the value of the closed bank's assets, make advance payment against claims filed by the depositors beyond the maximum insurance coverage and non-depositors based on the anticipated reimbursement ratio. Such amounts may first be deducted from the total sum of money finally realised from the liquidation and repaid to the CDIC.

The proceeds resulting from the sale of the assets of the banks taken over by the FRF through tender, auction, or other means shall be deposited into the account of the Fund. For the assets assumed by the FRF arising from the FRF's management and disposal of the failed banks, the FRF may entrust the CDIC to perform the tasks of collection, debts rating, packaging and combination, public sale by tender, (or?) and securitisation.

Banks are typically closed at the end of the normal business day on Friday, with a CDIC representative in each branch office. If a bank comes under new ownership, the bank normally reopens the following Monday to ensure continuity of operations and access to customer deposits. Actually, failed bank close practice never happened in Taiwan.

When there is a systemic crisis and the CDIC is unable to resolve the problem banks a P&A transaction, the CDIC may set up a bridge bank to assume all or part of the businesses, assets and liabilities of the said banks. A bridge bank is deemed as an insured institution without capital, but the CDIC could provide it with working capital, if necessary. The duration of a bridge bank is limited to two years, which can be extended for one more year after the approval by the FSC. A bridge bank may be exempted from some regulations of the Banking Act, when it continues operation within the scope of assumption of the business, assets and liabilities of a closed insured bank.

Through July 2001 to August 2007, the resolution cost of failed depository institutions is NT$ 172 billion and the fiscal cost to GDP is 1.5 percent.

6. Crisis Management

A systemic crisis is identified by its threat to the stability of the banking system. Systemic crises are sufficiently severe to affect adversely the payments system and, in consequence, the real economy through reductions in credit flows, or the destruction of asset values. A typical feature of a systemic crisis is the difficulty in distinguishing between solvent and insolvent banks. A systemic crisis must be resolved by close coordination and cooperation of all financial safety net participants.

At the outset of a crisis, macroeconomic policies will need to be adjusted to restore confidence in the currency and the banking system. Systemic financial crises affect most sectors of the economy and require macroeconomic policy adjustments. The appropriate policy mix will depend on the nature of macroeconomic imbalances and the state of the banking system.

A systemic crisis can be referred as「In the event that there is any potential that will significantly endanger credit order and financial stability」.When there is an impending systemic crisis, the CDIC may be exempted from the restriction of least cost resolution after obtaining the consent of the FSC in consultation with the Ministry of Finance and the Central Bank, and with the final approval of the Executive Yuan (Cabinet).

The Financial Restructuring Fund (FRF) Statute was promulgated and implemented on July 2001. On June 2005, it was revised to reflect changes in the domestic financial environment. As of the end of August 2007, a total of 49 unsound financial institutions have been withdrawn from the market under the Fund, helping to reduce the average non-performing loan ratio across all financial institutions from 8.16 percent at the end of December 2001 to 2.45 percent at the end of August 2007. In addition to reducing the excess number of financial institutions in ROC (Taiwan), the withdrawal of problem institutions has resulted in a clear improvement in the overall asset quality of the financial institutions, as well as the creation of a sound economic environment. The initial period of the FRF's establishment was a time marked by the spread of the Asian financial crisis. In this regard, when undertaking a large scale disposition of problem institutions, it is crucial for the government to tread carefully avoiding the occurrence of a systemic financial crisis and social unrest.

To make use of the limited financial restructuring fund, the FSC requires problem banks to submit a self-rescue plan, including a timetable for capital injection and/or merger, and to fulfill the plan under supervision. In order to protect depositors and maintain financial stability, the problem banks that fail to complete the plans will be taken over by the government and made to exit from the market.

In dealing with systemic banking crisis, the role and responsibilities of the relevant supervisory agencies are stipulated as follows (in draft stage)

(1) The Financial Supervisory Commission (FSC)
   A. Implementation of the relevant policy decision.
   B. Contact and assist local competent agency or relevant authority to exercise related matters.
   C. Coordinate funding or accommodation related matters.
   D. Publish press announcement in unity.
   E. Exercise targeted examinations, if necessary.
   F. Take any necessary administrative or corrective action, if involving suspected financial crime, and present the facts of the case to a prosecutor or the court of jurisdiction to inspect.

(2) The Central Bank of China (CBC)
   A. Give necessary accommodation pursuant to the regulation.
   B. Smoothen and regulate the operation of the payment system, and the clearance and settlement of accounts among banks.

(3) The Central Deposit Insurance Corporation (CDIC)
  A. Dispatch personnel to assist problem bank in dealing with contingent matters depending on containment condition.
  B. Take administrative measures pursuant to the Deposit Insurance Act.

(4) The Ministry of Finance (MoF)

The CDIC may ask the FSC to negotiate with the CBC to receive its approval and obtain special financial accommodation within the amount of the collaterals provided by the CDIC. The Ministry of Finance shall guarantee that aforesaid financial accommodation, which exceeds the collateral provided by the CDIC.

The bank restructuring strategy begins with a diagnosis of the financial condition of the individual banks. The size and distribution of bank losses must be identified. As supervisory data may be outdated and not reflect the full economic impact of the crisis, the supervisors may attempt to update the available information based on uniform valuation criteria. The supervisors will also examine information on the banks' ownership structures to help determine the scope for up-front support from existing or potential new private owners.

The diagnosis of banking sector conditions in a crisis is typically hampered by data limitations. A frequently used measure of solvency is the risk-weighted Basel capital assets ratio (CAR). However, when data limitations delay the evaluation of banks' capital levels, the supervisors may need to rely on other sources of information to determine bank viability. Independent auditors have been useful in developing an impartial view of the current conditions of the bank, based on uniform criteria.

Banks determined to be non-viable and insolvent must be removed from the system. Depositor protection will facilitate this clean up, as banks can be closed without the fear causing of contagion. Many countries have been able to move aggressively in removing failed banks, once the blanket guarantee is in place.

The supervisors classify the remaining banks in the system and develop the appropriate resolution strategies. Typically, the supervisors would differentiate between banks that are (1) viable and meeting their legal CAR and other regulatory requirements; and (2) viable but undercapitalised. In the latter classification, an additional assessment will be needed to determine whether the existing shareholders can recapitalise their bank within an acceptable period, or if the use of public funding should be considered. The shareholders of undercapitalised banks must agree to a monitored recapitalisation and restructuring plan with time-bound targets. Failure to meet the targets would be cause for intervention and resolution of the bank. The plan should also include sufficient restrictions on bank operations as to establish incentives for the shareholders to over-perform in their restructuring.

Asset management and corporate debt restructuring are the final components of crisis management. A key aspect of this process is the orderly transfer of ownership and management of problem assets. The strengthening of this process may include both legal and institutional reforms. The resolution of the banking system issues is ideally carried out in conjunction with the resolution of the corporate sector issues.

There are a number of institutional options for managing impaired assets. Banks can manage them directly, or sell them to a specialised asset management company (AMC), either privately or publicly owned. Specialised institutions are necessary when managing NPLs interferes with the daily running of the bank, or when specialised skills are needed. While each institutional set-up has advantages and disadvantages, the experience suggests that privately-owned AMCs can respond quickly and efficiently, while government-owned centralised AMCs may be relatively more efficient when the size of the problem is large, special powers for asset resolution are needed, or the required skills are scarce.

7. Conclusion

The management of problem bank is accompanied with difficulties and potential setbacks. The tools for crisis containment and bank restructuring are powerful but, when misused, can set back the process of re-establishing financial sector stability. Accordingly, both the benefits and potential pitfalls of crisis management tools must be well understood and carefully adapted to local condition.

Bank resolution should be as efficient as possible. Bank resolution strategies should be comprehensive and complete. Moreover, the faster the recognition and resolution of banking distress, the less costly will be the resolution. Strong political support is necessary to ensure the full implementation of the strategies designed. Particular efforts should be made to ensure that the legal system is adequate for the strategy adopted. The experience suggests that the biggest threats to successful restructuring of the banking system include failure to complete the restructuring, excessive forbearance, failure to ensure loss-sharing of shareholders, inconsistent treatment of banks, and lack of political support for the process.

Appendix 1

Summary of the CDIC Supervision and Conservatorship of Problem Banks 1996~2006

Name of Bank	Date of Supervision/ Conservatorship	Reason of Supervision/ Conservatorship	Handling
Taichung Commercial Bank	1998.11.25 Supervision	Its Chairman forced the deal of making illegal big loans extended by its Taipei branch to **its** affiliated businesses Large-scale bank run was triggered resulting from illegal transactions of the shares of its listed company. The Ministry of Finance appointed the CDIC to station on site personnel for supervision after determining that its board of directors had serious problems of mal-function.	The Ministry of Finance terminated the CDIC's supervisory task on May 24, 1999 after new members of board of directors and supervisors were elected successfully and most businesses had been in normal operations.
Chung Hsing Bank	2000.4.28 Supervision for half year 2000.10.28 Supervision extended for half year 2001.4.28 Supervision extended for half year 2001.10.25 Conservatorship temporarily for five months 2002.3.25 Conservatorship for half year 2002.10.5 Conservatorship by Land Bank 2003.8.4 Conservatorship by CDIC again and entrusted Land Bank to manage its businesses and property	According to the media, illegal loan was made to Typhone Group. Abnormal withdrawals by depositors occurred on April 27, 2000. The Ministry of Finance appointed the CDIC to station personel on site for supervision and later for conservatorship to stabilise its business operation and maintain financial order.	Assumed by the Union Bank of Taiwan on March 19, 2005
Taiwan Development and Trust Corporation (TDTC)	2000.5.13 Supervision for half year 2000.11.13 Supervision extended for half year	The media reported the controversies over the land of Far Eastern Silo and Shipping (FESS) it had bought and the disputed earnings figures. Withdrawal of trust funds took place from May 12 to May 17, 2000 The Ministry of Finance appointed the CDIC to station personnel on site to assist resolving operation problems.	On May 11, 2001 the Ministry of Finance released the CDIC of its the supervisory task, but still appointed the CDIC to provide assistance. On January 27, 2005, the TDTC sold its trust department to the Jih Sun International Bank. The assumption was completed on August 6, 2005
Kaohsiung Business Bank	2002.1.28 Conservatorship for five months 2002.6.28 Conservatorship extended for half year 2002.12.28 Conservatorship extended for half year 2003.6.28 Conservatorship extended for half year 2003.12.28 Conservatorship extended for half year	Asset quality continued to deteriorate and failed to increase capital by cash injection . The Ministry of Finance appointed the CDIC to station personnel on site for conservatorship.	Assumed by E.Sun Bank on September 4, 2004

Appendix 2

Auctioning Off of the Non-performing Loans of Chung Hsing Bank and Koahsiung Business Bank

Unit: NT$ million

Financial Institution	Non-Performing Loans		Auction Date	Book Value	Bid Value	Awarded Bidder
Chung Hsing Bank	First block	Enterprises	2003.12.15	17,175	4,028	Lone Star Asia Pacific, Ltd.
		Individuals	2003.12.15	11,605	4,190	Alliance of Lehman Brothers Commercial Corporation Asia, Ltd. and TAMCO
	Second block	Combination 1	2004.03.29	12,446	3,824	Lone Star Asia Pacific, Ltd.
		Combination 2	2004.03.29	10,029	2,843	GE Capital
		Combination 3	2004.03.29	18,233	3,089	Taiwan Asset Management Corporation (TAMCO)
	Non-NPL assets/liabilities and business (excluding interbank deposite and call loans)		2004.12.09	3,123	7,108	Union Bank of Taiwan
Kaohsiung Business Bank	Enterprises		2003.06.24	8,370	2,980	Lone Star Asia Pacific, Ltd.
	Individuals		2003.06.24	13,350	5,250	Lone Star Asia Pacific, Ltd.
	Non-NPL assets/liabilities and business (excluding trust business)		2004.05.31	-17,073	13,368	E.Sun Bank

Appendix 3

The Financial Restructuring Fund (FRF)

Introduction

Since the 1990's, ROC (Taiwan) had been suffering from the burst of the economic bubble, with the real estate market mired in recession. The situations were exacerbated by the Asian financial crisis of 1997 and the September 21 earthquake in 1999. Many businesses started to experience financial crises. As a result, the business operations of ROC (Taiwan)'s financial institutions were fast deteriorating with bad loans continuing to soar. The market was awash with negative news and impacted the financial industry with detrimental effect. Rumors were rampant that systemic financial risk would be triggered. To facilitate the withdrawal of ailing financial institutions from the market smoothly and as soon as possible, and to preempt the occurrence of financial turmoil, the government utilised public funds to quickly resolve the financial crises of the business sector and safeguard depositors' benefits. The Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund was promulgated, and the Financial Restructuring Fund was set up and operative for a period of three years. However, it was extended for one further year on the approval of the Parliament. In 2004, the Parliament extended its validity by one year to July 10, 2005. Within this period of time, the Financial Restructuring Fund shall provide a transitional blank guarantee to all depositors and other creditors of the problem financial institutions to avert chain risk of financial crises. The revised Executive Yuan's Financial Restructuring Fund Establishment and Management Statute was approved by the Legislative Yuan on May 31, 2005 and promulgated by the President on June 22 the same year.

Competent Authority

The Financial Restructuring Fund's competent authority is the competent authority provided under the Banking Law. At the present time, this is the Financial Supervisory Commission.

Governing Body

The Financial Restructuring Fund's governing body is the Financial Restructuring Fund's Management Committee, which is responsible for deliberating the uses and operations of the Fund, approving the Fund's receipts and expenditures custodianship plans, reviewing the Fund's financial reports and cash-flow arrangements, and the appraisal of other issues concerned with the management, implementation and public disclosure in relation to the Fund. The Committee consists of nine to thirteen members, including one Committee Chairman and one Committee Vice-Chairman, who according to the Financial Restructuring Fund Statute, serve concurrently as the Head and Deputy Head of the competent authority, respectively. In addition, there are four Committee members, who serve concurrently as the Deputy Governor of the Central Bank of China, the Deputy Chairman of the Council of Agriculture, Executive Yuan, the Deputy Director of the Directorate-General of Budget, Accounting and Statistics, Executive Yuan, the Chairman of the Central Deposit Insurance Corporation. As for the remaining Committee members who are appointed, they serve on the basis of the professional knowledge and experience that they have in law, economics, finance and other fields that are relevant to the Committee. Such Committee members associated with the same party should not exceed one half of the total number of Committee members, in order that the Committee's decision-making process can be more independent. In addition to the Fund Management Committee, an Evaluation Sub-committee shall be established under the Fund. The functions of the Sub-committee are to identify unsound institutions, determine the priority and manner of disposition work and amount of compensation, and submit such findings to the Management Committee for its resolution.

Executive Body

The passing of resolutions by the FSC may be, pursuant to Article 10 of the Financial Restructuring Fund Statute, entrusted to the CDIC for implementation. The results of the implementation are then reported to the FSC for ratification, in order to achieve the division of duties objective.

Financial Resources and Funding Accommodation

The Fund's resources include government financial-business-tax revenue and deposit-insurance-premium income received from the financial sector. The former includes financial-business-tax-revenue covering the years 2002-2005, and it is estimated to be about NT$120 billion. The latter comprises the CDIC's incremental insurance-premium income covering a ten-year period from January 2002 onwards that arose as a result of the increase in the insurance assessment rate which took effect on January 1, 2000, and which is expected to amount to approximately NT$20 billion. The revised Statute stipulates that business-tax revenue from the financial industry for the five-year period from January 1, 2006, to the end of 2010 should be included in the financial source of the Restructuring Fund, up to a maximum of NT$110 billion. The surplus over this amount shall be appropriated to the deposit insurance fund. In the event that the revenues from the above financial sources are not realised, the CDIC may apply to the Central Bank of China for accommodation, borrow from other financial institutions, or else issue bank debentures, in order to meet the needs of the Fund's operations, and shall repay any such amounts from the above financial resources.

Applicable Financial Institutions

(1) The financial institution's adjusted net worth is negative.
(2) The financial institution is unable to pay its debts
(3) The financial institution's financial situation is deteriorating, and the competent authority maintains that it cannot continue to operate.

Of all the financial institutions, the community financial institutions, because of structurally derived problems, are in a relatively serious situation. Accordingly, the Fund stipulates that priority shall be given to the handling of community financial institutions. Twenty percent of the additional financial sources stipulated under the revised Statute shall be used for compensation in the disposition of the credit departments of farmers' and fishermen's associations, not subject to the expiration date of the Fund establishment.

Handling Problem Financial Institutions

Compensation for the non-deposit liabilities incurred by unsound financial institutions before promulgation of the revised Statute shall still be guaranteed under the principles of non-retroactive and legitimate expectation. No compensation will be provided for such liabilities incurred after the revised Statute came into force. As to the way in which the financial institutions are handled, this will be in line with the relevant regulations at the present time, such as the Banking Law, the Financial Institutions' Merger Law, and the Deposit Insurance Act, including:

(1) Settling the liabilities and taking over the assets that not settling by tender.
(2) The difference by which the liabilities to be settled exceed the assets.

Custody of the Fund

The funds of the FRF, apart from being used to handle problem financial institutions with unsound operations, shall be deposited in the form of cash in creditworthy financial institutions, used to purchase government bonds, bank debentures, and negotiable certificates of deposit issued by banks, or else maintained by other means, in accordance with regulations prescribed by the competent authority.

The Handling of Acquired Assets

Pursuant to the Financial Restructuring Fund Statute, the Restructuring Fund shall entrust the CDIC with the full amount required to settle the deposit-related and non-deposit-related claims on problem financial institutions with unsound operations. The Restructuring Fund shall, in its own name, take over the assets of the aforementioned financial institutions, and shall dispose of them by offering them for sale by tender, auction or other method. Any proceeds from the disposal shall be included in the Restructuring Fund.

Accounting Treatment

When handling accounting and auditing matters, the Fund shall conform to generally accepted accounting principles and auditing standards, and shall establish an accounting system which conforms to such principles and standards.

Legal Prosecution

The government established the Financial Restructuring Fund to dispose of problem financial institutions. Prosecuting personnel whose illegal actions create losses at a financial institution, to hold them accountable for their misconduct, could safeguard the rights and interests of the Fund and uphold social justice. The CDIC, therefore, actively pursues civil and criminal action against illegal acts by the responsible parties and employees of financial institutions, in accordance with the FRF Statute and the resolutions of the Fund Management Committee. As of the end of 2006, the CDIC had submitted 179 cases of malfeasance to the prosecution agencies for handling, and civil compensation has already been sought in 106 civil cases.

Fund Payments

Between July 2001 and the end of 2006, the Financial Restructuring Fund disposed of 48 unsound financial institutions, with the paid-out claims amounting to NT$165.1 billion according to law. The disposed institutions included 36 community financial institutions in 2001, eight community financial institutions in 2002, the Fongshan Credit Cooperative and Kaohsiung Business Bank in 2004, and the credit department of the Sinpi Township Farmers' Association and the Chung Shing Bank in 2005. As of December 31, 2006, the fund had handled claims for 37 credit departments of farmers' and fishermen's associations, with total payments of NT$49.4 billion, or 29.9 percent of the total; nine credit cooperatives, with total payments of about NT$43.3 billion, or 26.2 percent of the total; and two banks, with total payments of about NT$72.4 billion, or 43.9 percent of the total.

Appendix 4

Fact Sheet on Taiwan Deposit Insurance System

Launched	September 1985
Administered by	• Central Deposit Insurance Corporation (CDIC)
Participating Institutions	• Domestic Banks (including trust and investment companies and postal savings bank) • Credit cooperatives • Credit departments of farmers' and fishermen's associations • Foreign bank branches in Taiwan (Foreign bank branches whose deposits are protected in their home countries may not participate.) • Agricultural Bank of Taiwan
Premiums	• Paid by member institutions
Premium Rates	• Risk-based rate system and five rates instituted: 1. For domestic banks, local branches of foreign banks and credit cooperatives, they are 0.03 percent, 0.04 percent, 0.05 percent, 0.06 percent, and 0.07 percent of covered deposits. Insured deposits in excess of maximum coverage applied to the flat rate of 0.0025 percent. From Jan. 1, 2010, the flat rate changes to 0.005 percent. 2. For credit departments of farmers and fishermen's associations, they are 0.02 percent, 0.03 percent, 0.04 percent, 0.05 percent, and 0.06 percent of covered deposits. Insured deposits in excess of maximum coverage to the flat rate of 0.0025 percent.
Coverage	• Apply automatically to all eligible deposits; depositors do not need to apply for deposit insurance.
Maximum Coverage	• NT$1.5 million limited to deposit principal per depositor per insured institution
Types of Depositor Covered	• All depositors including resident/ non - resident individuals and organizations
Insured Deposits	• Checking accounts • Passbook deposits • Time deposits • Other deposits which the Financial Supervisory Commission has approved as insurable (The above-said deposits are restricted to those dominated in New Taiwan Dollars)
Uninsured Deposits	• Deposits in foreign currency • Negotiable certificates of deposit • Deposits from government agencies • Deposits from the Central Bank • Deposits from banks, postal savings bank (Taiwan Post Company), credit cooperatives, Agricultural Bank of Taiwan and credit departments of farmers' and fishermen's association • Deposit exceeding the per-institution maximum insurance coverage established for each depositor • Other deposits which the Financial Supervisory Commision has approved as non-insurable (e.g. structured deposits)

Appendix 5

Additional Information on Problem Bank Management in ROC (Taiwan)

Strengths and Weaknesses

Strengths – 1. Adequate capitalisation to absorb moderate industry risks
2. Ample liquidity
3. Government commitment to system stability

Weaknesses – 1. Fragmented industry structure and highly competitive operating environment
2. Low profitability
3. Over reliance on interest-sensitive income
4. Occasional political pressure that could disrupt financial reform

Future Initiatives for Improving Problem Bank Management Supervision

The Taiwan government will continue providing strong support to large, systemically important banks in the event of an unexpected shock that threatens the stability of the banking sector, with the aim of maintaining public confidence in the operation of the financial system.

The future initiatives for improving problem bank management supervision are:

1. Stabilising the financial environment
Stabilising prices and financial markets by adopting appropriate monetary policies tailored to meet prevailing macroeconomic conditions; proceeding with unifying supervision of the banking industry, and strengthening the oversight and early-warning mechanisms.
2. Building up an integrated and orderly financial market
Measures include strengthening corporate governance, improving the code of ethics of financial markets, setting up a sound mechanism to deal with disputes over financial transactions, enhancing financial examinations and cooperation with the justice agencies, as well as enhancing cross-border financial cooperation.
3. Completing the market exit mechanism for failed banks
Measures include utilising the Financial Restructuring Fund and the deposit insurance reserves together in order to increase the flexibility of the failed bank exit mechanism, adding the provisions of prompt corrective actions in the Banking Act to improve the efficiency of the market exit mechanism.
4. Assisting in establishing a sound social system
Measures include encouraging the protection-type and annuity-type of insurance products to cope with an aging society, continuing the promotion of small-and-medium enterprise loans, pressing on in preventing financial frauds and nominee bank accounts, and strengthening financial education.

Policy Recommendations

1. A uniform, accountable authority can facilitate problem bank management. Strong leadership is needed to deal with vested interests, determine issues affecting wealth and income distribution, and shepherd the restructuring program through the legislative process. This authority should clearly communicate the strategy and decisions to the public.
2. Speed of intervention is crucial.
   Delays in resolving a problem bank may result in larger losses for the public fund. Decisive steps need to be taken in the initial stages to stop creditor and depositor withdrawals. The faster the recognition and resolution of problem bank, the less costly will be the resolution.
3. Bank should be allowed to fail
   Bank failure can be a positive force for banking system stability. The presumption should not be that all banks must be protected. In any decision to use public money to support a bank, the benefits of keeping a bank open must be judged explicitly against the costs to the public sector and to the banking system of maintaining a weak bank.
4. Resolution should be guided by least cost (or least loss) criteria
   In a resolution with loss sharing, the recovery value is to be maximised for creditors and uninsured depositors. In resolution with a blanket guarantee, recovery value should be maximised (losses/costs minimised) for the government. Least loss calculations need to be based on estimated of net present asset values under different recovery scenarios, including estimates for operational, recovery and financing costs.
5. The bank resolution strategy should include a thorough diagnosis and bank resolution plan A process of bank separation should be carried out. Non-viable banks should be liquidated or merged with viable banks, and adjustment periods could be provided for viable but undercapitalised banks.
6. Bank resolution should follow a principle of equity and fair treatment.
   Restructuring policies should be applied to all banks on a uniform basis, which is independent of their ownership or type.
7. Corporate restructuring should accompany bank restructuring
   Without corporate restructuring, problem bank will deteriorate further, and may fall into the failed category. Corporate debt restructuring should be based on market principles and reinforce payment discipline.
8. Legal action must be taken against bank officials responsible for banking failure
   The prosecution of managers and directors responsible for wrongdoing in banks is the best recipe to impose market discipline. In cases when legal action has been taken, the remaining actors in the market understand that the authorities are determined to have a sound and safe banking system. In the absence of such resolve, similar illegal events will be repeated in the future.
9. Enhanced cooperation and coordination among different authorities
   The design and implementation of supervision policy, with close cooperation and coordination among the different authorities, including policy harmonisation and mutual recognition, is essential in the resolution of problem banks.