



Safeguarding deposits:

Learning from experience

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PREFACE

Saving is a fundamental human activity and savings can take many forms. This publication, however, is concerned only with money deposited for the joint purposes of earning a return and security.

Individuals and societies vary in the extent to which they save in the form of money. They differ as well in the basic motivation for the saving process. Motives, in general, are composite and include: saving as a store of value, saving for future contingencies and saving in the sense of accumulation for future investment. When saving deposits are made, then the savings instrument itself is also viewed as an income-generating investment. Different individuals vary as to which motive or mix of motives is applicable.

Despite differences in the motivations of savers, one expectation is common to all. The issue of the safety of the deposits is vital.

This book addresses some of the issues involved in ensuring that the savings deposits of the public are secure. It highlights the key roles played by an appropriate regulatory environment, by depositor education and, above all, by sound management of financial intermediaries. In addition, it outlines the points for and against risk management mechanisms such as deposit insurance and also outlines rehabilitation measures which can be taken following a bank crisis.

The intended readership includes the managements and staff of banks, especially those operating in rural areas of developing countries. It is also addressed to policy makers and others who are concerned with measures to ensure the well-being of rural populations as regards their access to secure deposit facilities.

Hartwig de Haën

Assistant Director-General Agriculture Department

INTRODUCTION

Encouraging rural people to deposit funds fulfils two major functions. Firstly it fosters investment. Secondly, it builds a linkage between the immediate institution and the depositor. This linkage, which has aspects of responsibility and belonging, has been shown to be particularly effective as the basis for successful financial intermediation. But these beneficial aspects only apply when the deposits are secure. Serious consequences follow any loss.

Loss of deposits hurts. The affected saver's distress is obvious, particularly if there is no safety net which would provide reimbursement. Equally, losses of this type mean that the deposit-taking institution must have been in trouble. This is a matter of no little importance, especially in developing situations where sound institutional formation is such a vital part of the development process; weakening of any such institution means that provision of financial services will be adversely affected. If the losses are significant then each such event strikes a blow at the stability of the banking system.

There are a variety of reasons why financial stability is high on the list of economic priorities. From a public policy perspective, the government's goal to ensure the stability of the financial system should be of paramount importance. The failure of any bank, no matter how small, may lead to loss of confidence in the system, unless the government can demonstrate its ability to handle bank crises in an orderly and systematic fashion.

From the point of view of the saver, stability of financial markets is equally important. While a stable banking system provides the saver with a safe financial asset (bank deposits), increasing instability threatens this safety. With bank failures, the danger of losing at least a part of savings balances becomes a real one.

Despite past efforts to promote banking stability, the banking systems of many industrialized and developing countries have experienced serious distress during the past decade. Financial institutions have suffered large losses, many are insolvent, and some have actually failed. In the 1980s, more than 25 governments in developing countries have intervened to help distressed financial institutions in situations where the possibility of widespread bank runs and the collapse of the banking system has been apparent. These include countries from Africa and Latin America, as well as from Asia. Institutions involved have been from all sub-sectors of the financial market: formal, semi-formal and informal.

The position of savers in banking crises in developing countries is vulnerable compared to the situation in industrialized economies. The safety net for deposits tends to be much less comprehensive. While governments have, in most crises, stepped in to rescue savers, the financial resources made available for these operations have not always been adequate to provide full compensation, even to small depositors. In semi-formal and informal sector failures, relative losses to the savers have been even higher.

The aim of this document is to present evidence on different aspects of banking instability in various countries, on measures to rehabilitate ailing financial institutions and on the safety of deposits in times of financial crisis. While bank rehabilitation techniques and deposit insurance schemes are fairly widely covered in the document, the main thrust is on methods and systems that are considered relevant for preventing financial institution instability in developing countries. This emphasis on methods to prevent bank insolvency is justified because of the finding that the most important factor in safeguarding savings deposits in developing countries is the quality and character of management within the banks themselves, and not for instance, the availability or otherwise of deposit insurance.

The safeguarding of savings can relate to either the real value of savings or to their nominal value. When the real value of savings is being considered, the main issue is inflation, its impact on the real value of deposits and on the propensity to save in financial institutions. Literature on this subject is abundant. This publication, however, deals with the safeguarding of the nominal value of savings. The safety of the nominal value of deposits depends on such factors as efficient and prudent management of savings institutions; availability of adequate risk-bearing resources; efficiency of regulation and supervision of the institutions; and availability of a formal guarantee of all or part of the funds deposited with the institutions. The key test for the standard of this protection is how the savers' rights are honoured during a banking crisis. As financial instability became an increasingly frequent phenomena during the past decade, the safety aspects of saving have attained ever greater urgency and importance.

The document is organised as follows. In Chapter 1, the role of savings in economic development is discussed and the different types of institutions taking deposits in lesser developed countries (LDCs) are introduced. The subject of Chapter 2 is the increasing instability of the financial market, which presents an increasing threat to the safety of savings. The next three chapters provide information on banking crises in various environments and on the methods used to safeguard savings in different circumstances. Chapter 3 deals with the crises and relevant facts in three European countries (Finland, Italy and Hungary), and

assesses the lessons for LDCs that can be learnt from these country cases. Chapter 4 presents two cases from the semi-formal cooperative sector, one from Malaysia and one from Kenya. In Chapter 5, the strengths and weaknesses of the informal sector are approached from the point of view of the depositor. Chapters 5, 6 and 7 aim at drawing the key lessons from the existing evidence for banking in the LDC environment. They deal with the key policies in preventing instability in financial institutions, with the principal elements of the safety net and with methods to protect the safety of savings when financial institutions become insolvent.

Whilst intended initially to stand alone, *Safeguarding Deposits: Learning from Experience* is seen as the basis for further products in this technical area, particularly products geared to providing direct training of bank managements and staff in developing for their own use the general principles outlined in this book.

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SUMMARY

There are a variety of reasons why financial stability is high on the list of economic priorities. From a public policy perspective, the government's goal to ensure the stability of the financial system should be of paramount importance. The failure of any bank, no matter how small, may lead to loss of confidence in the system, unless the government can demonstrate its ability to handle bank crises in an orderly and systematic fashion.

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The aim of this document is to present evidence on different aspects of the safety of deposits in times of financial crisis and on measures to rehabilitate ailing financial institutions. Whilst intended to stand alone, *Safeguarding Deposits: Learning from Experience* is seen as the basis for further products in this technical area, particularly products geared to providing direct training of bank managements and staff in developing for their own use the general principles outlined in this book.

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1. FINANCIAL INTERMEDIATION AND SAVINGS MOBILISATION

SUMMARY

This chapter:

- Reviews the role of savings in economic development and the need for an effective financial system to increase the mobilisation of savings.
- Outlines the classification of financial intermediaries into formal, semi-formal and informal suppliers and explains the strongly dualistic structure that prevails in many developing countries.
- Briefly describes institutions that can be found in the formal and semi-formal sectors and some forms of informal financial arrangements.
- Identifies the new emphasis on deposit collection in developing countries and the potential benefits of this approach.
- Notes the weakness of many financial systems and consequent risk to the safety of deposits.

1.1 The Role of Savings in Economic Development

1 A common feature of economic growth theories is the premise that capital accumulation is a prerequisite of economic growth and the savings of individuals and households are an essential part of the process of capital accumulation. Savings determine, to a large extent, the rate at which productive capacity and income grow. On average, rapidly growing countries have higher saving rates than slower-growing countries.¹ These rates are influenced by many factors: the level of income per capita, the rate of income growth, the age composition of the population and attitudes toward thrift. Macroeconomic and political stability affect expectations and thus, also the saving rate. The services provided by government, such as social security, can affect saving, as well as the availability and quality of financial services. Government financial policy also has an impact, and higher real interest rates lead to financial deepening as savers are encouraged to switch their savings from real to financial assets.

2 Until the 1980s, however, most developing countries relied heavily on external funding to finance their development and did little to promote domestic savings. Then the flow of external resources, consisting of foreign private investment, official grant aid, public and private borrowing, radically decreased and government efforts to mobilize local resources intensified. Now an adequate domestic savings rate is considered to be essential for the attainment of sustainable economic growth in developing countries.

3 Savings rates achieved in various developing countries have, in fact, challenged the premise that such countries have a low or non-existent savings capacity. A recent World Bank study analysed the average savings and investment rates for fourteen developing countries in the 1970s and 1980s.² The results showed that, on average, households saved 13 percent of Gross National Product (GNP) and invested 6 percent, which left them with a savings surplus of 7 percent of GNP. Businesses saved almost 9 percent of GNP but invested over 15 percent of GNP, illustrating their need for resources. The foreign sector was generally a net lender and governments net borrowers. Country-by-country sectoral balances varied considerably. For instance, the savings surplus of the household sector ranged from 1.5 percent in Cote d'Ivoire to nearly 17 percent in Malaysia. Overall, however, households as a group financed all their investment from savings, while businesses used borrowed funds to finance 45 percent of their investments.

4 A system of financial intermediation is necessary to channel the flow of funds from suppliers to users of funds. An effective and smoothly functioning financial system will increase the mobilization of savings, lower transaction costs, disperse risks and direct the allocation of resources to the most productive uses. Financial intermediation generally involves a diversity of institutions, instruments and markets. The particular structure existing in a country reflects the history, circumstances and policies that have influenced economic development there. When analysing the role of the saver in financial operations in developing countries, it is relevant to examine how the structure of the financial systems in these countries differs from the systems functioning in industrialized countries.

1.2 Financial Intermediation in Developing Countries

1.2.1 Development of Financial Systems

1 The suppliers of financial intermediation services and products can be broadly classified into three groups: formal, semi-formal and informal. The formal group is comprised of organisations specifically chartered by the government as financial institutions and subject to banking regulations and supervision. Semi-formal suppliers fall outside the regulation of the banking authorities but are usually licensed and supervised by other government agencies. Informal financial intermediaries operate outside the structure of government regulation and supervision. Table 1.1 indicates the wide range of operators that can be found in each group. The dividing lines are not absolute - regulatory structures vary and credit unions, for example, may fall in the formal sector in one country and the semi-formal sector in another country.

Table 1.1 *Suppliers of Financial Intermediation Services*

FORMAL SECTOR	SEMI-FORMAL SECTOR	INFORMAL SECTOR
Central Bank	Savings and credit cooperatives	Savings associations
Commercial banks	Multi-purpose cooperatives	Combined savings and credit associations - "Roscas" and variants
Merchant banks		
Savings banks	Credit unions	Informal financial firms
Rural banks		
Postal savings banks	Cooperative quasi-banks	- indigenous bankers
Labour banks		
Cooperative banks	Employee savings funds	- finance companies
Development banks - State-owned - Private	Banques Populaires	- investment companies
	Village banks	Non-registered self-help groups
Building societies	Development projects	Individual moneylenders
Credit Unions	Registered self-help groups and savings clubs	- commercial
		- non-commercial (friends, neighbours, relatives)
Social security institutions		Traders and shop-keepers
Contractual savings institutions		
- Pension funds		
- Insurance companies		
Other non-bank institutions		
- Finance companies		
- Term-lending institutions		
Markets		
- Stocks and bonds		

2 Depending on historical factors and the level of economic development, various combinations - and not necessarily all - of these types of intermediaries are present in the financial systems of developing countries. In Africa, for example, although many countries enjoyed relative financial stability under colonial rule, their financial systems suffered from neglect and stagnation during this period. The formal and semi-formal sectors consisted of a few foreign commercial banks, post office services and some cooperative societies and they were oriented toward serving expatriate communities and the import / export trade. These intermediaries provided little service to the indigenous populations, whose needs were met mainly by the informal sector. The formal financial sector remained undeveloped in Africa until countries gained their independence. In Asia, financial systems were more advanced. Foreign banks were more active in financing internal trade and most Asian countries also had a fairly well-developed indigenous financial system with commercial banks, large financial

service cooperatives and informal bankers and moneylenders. Latin America, politically independent since the early 19th century, did not suffer from colonial repression but financial instability prevented the evolution of mature financial systems in many countries.

3 As a result of the environment in which the financial markets evolved in developing countries, they are usually characterised by a strongly dualistic structure. Thus, in addition to the formal providers of financial services, the semi-formal and informal operators continue to play a highly significant role in financial intermediation in most developing countries. It is generally assumed that the organised, formal institutions are urban-oriented and serve the monetised, modern sectors of economies, while the semi-formal and informal operators serve the traditional, rural, subsistence parts of the economies. Research, however, is increasingly showing that reality is more complex and the dividing lines less clear and, in many economies, there are substantial flows of funds between the different sub-sectors of the financial market.

4 Two explanations are usually put forward for the continuing existence of major informal financial sectors in developing economies.³ The first suggests the informal sector is a response to the shortcomings and excessive regulation of the formal financial sector. Thus formal operators have proved to be too bureaucratic, too urban, too regulated and too rigid to provide the savings and credit facilities which a large part of population needs and seeks. According to the second explanation, the existence and dynamism of the informal sector are more related to the intrinsic dualism of economic and social structures in developing countries and the rural population's attachment to traditional values and customs of family, village or tribal solidarity, than to the inefficiency of the formal operators. This explanation for the existence of financial dualism stresses the importance of cultural and socio-political factors, along with economic and financial ones, to account for the resilience and vitality of the informal sector.⁴

5 Furthermore, financial and monetary policies pursued by many developing countries have been inappropriate and even fuelled dualism. In some countries, dualism has been driven by the formal sector institutions' repression of financial markets. Repressive practices include placing interest rate ceilings on savings deposit accounts, which reduces the cost of funds to the banking sector below market-clearing rates, and specifying collateral and documentation requirements for loans which limit credit access to large, formal sector enterprises. By these means, the political and economic elites which control the banking and business sectors in many developing countries are able to obtain relatively "cheap" credit to finance their operations, while the majority of the population has to accept low yields on savings and pay higher than market-clearing interest rates for loans. Consequently, financial markets have remained fragmented and informal operators have continued to operate with success in many countries.

1.2.2 The Formal Financial Sector

1 As shown in Table 1.1, the formal financial sector, which includes both bank and non-bank intermediaries, covers a wide range of institutions, most of which operate under central bank and treasury regulations. While the central banks themselves do not accept deposits from the public, they usually act as bankers to the government and other banks and in this capacity are estimated to hold some 20 percent of the financial sector's assets in developing countries.⁵

2 Banks in developing countries hold a larger share of all formal sector financial assets (48 percent) than they do in industrialised countries (37 percent). Commercial banks are the oldest and most dominant form of banking in developing countries. Initially often foreign owned and urban-oriented, many have come under government pressure to expand their operations to rural areas. Currently they hold a major share of formal sector rural deposits in many developing countries. Merchant banks concentrate in most countries on corporate and inter-bank deposits. Post offices, with their wide branch networks, collect a significant share of rural and small depositors' funds but seldom grant loans to private customers.

3 Labour banks exist in many Latin American countries to provide small consumer loans and, occasionally, mortgage loans to employees in the formal sector. In this regard they function much like employee credit unions in industrialised countries with savings and loan payments processed through payroll deductions. Participation may or may not be mandatory. The labour banks may be associated with trade union organisations.

4 Cooperative banks still exist in some developing countries, although many have failed. They differ from other cooperatives in that they are usually permitted to offer their financial services to non-members. These banks may have more limited product offerings than other chartered banks. Their purpose is generally to mobilise retail deposits and other liabilities to fund wholesale loans to their member-owner cooperatives.

5 Building societies, also known as mutual savings and loan associations in some parts of South America, have traditionally offered savings and mortgage loan services to retail clientele. They may be chartered under specific laws separate from bank acts and may have their own regulatory agencies. Building societies often have their own central banking institutions, in the same way as cooperative societies and unions.

6 Registered finance companies are the most common form of non-bank financial institution found in the formal sector of developing countries. They usually operate with a small organisational structure and raise deposits from the public and other financial institutions to invest mainly in the business and real estate sectors. While functioning under central bank regulations, they have frequently been able to attract substantial deposits by

offering interest rates slightly higher than those of the commercial banks. On the other hand, their generally weak capital structures and adventurous investment policies often reduce the stability of these institutions.

1.2.3 The Semi-formal Financial Sector

1 Intermediaries in the semi-formal financial sector are not chartered financial institutions but they are empowered or permitted to provide financial services and products. These arrangements generally fall outside the regulation of the banking authorities but operators are usually licensed and supervised by other government agencies, such as the Cooperative Registrar. They regularly have written by-laws, statutes, constitutions or rules of operation. In many countries these financial intermediaries receive donor and government support and subsidies for their operations.

2 Credit unions and savings and credit cooperatives are cooperative, voluntary financial organizations owned and operated by members. Their purpose is to encourage savings by creating local deposit facilities and then using the pooled funds to make loans for productive, consumer or social purposes to their members. They may also provide other financial services, e.g., loan protection insurance. Cooperatives and credit unions may be rural-based or urban-based. Rural cooperatives operate as farmers' grassroots organizations, aimed usually at meeting the seasonal financial needs of their members which banks do not satisfy. Urban cooperatives are in most cases centered around a firm or profession, but can be community-based, and they exist primarily to cover the short-term credit needs of their members.

3 Credit unions and savings and credit cooperatives are generally limited by law to providing services only to their members. Nevertheless they have captured a small but significant share of the savings markets in many developing countries. Credit union savings, as a percentage of the private sector savings market, ranged from 6.2 percent in the Caribbean, to 4.3 percent in Africa, 1.2 percent in Latin America and 0.8 percent in Asia.⁶ The credit union movement's savings market share in the U.S.A. is only 6.9 percent after 80 years of development. Primary level credit unions and savings and credit cooperatives are usually member-owners of vertically integrated secondary cooperatives which provide them with central banking, trade association and business support services. In some developing countries these secondary institutions are regulated as formal financial sector entities.⁷ In fact there are examples of new, general, financial institution laws in some countries (Bolivia, Ecuador) which now include credit unions and specialised savings and credit cooperatives as regulated participants in the formal financial sector. Most credit unions and savings and credit cooperatives, however, remain part of the semi-formal financial sector, governed by credit union laws and supervised by specialised regulatory agencies independent of the banking authorities.⁸

4 Cooperative quasi-banks have appeared in a number of developing countries, e.g., Peru, Colombia, Bolivia. These are typically entities, registered under cooperative law, which have adopted names and/or operating methods which liken them to retail commercial banks, although they are not chartered nor regulated as such. Some of these institutions have failed with considerable loss of savings; some continue to operate as quasi-banks and others have converted to bank charters.

5 Employee savings funds are operated by employers in some developing countries (Costa Rica, Guatemala) as a benefit of employment. These funds may be managed by the employer or jointly with an employee association. Severance or other benefit payments by the employer may be paid into the fund and matched with employees' payroll deductions. The funds may make loans to employees or invest in commercial activities and financial assets.

6 Village banks, like the ones operating in Mali, The Gambia and Burkina Faso, are institutions organized to collect deposits and issue loans at the village level. They fall in the semi-formal category because, unlike unit rural banks, they are not formally regulated and supervised by banking authorities.

7 In many developing countries, deposit-collecting, self-help groups and savings clubs can be classified as semi-formal because they are registered and have often linked themselves with formal sector institutions. Many intermediaries of this type also receive donor and government support and function under the supervision of some organization or authority.

1.2.4 The Informal Financial Sector

1 The informal financial sector involves a heterogeneous set of individuals and groups who provide financial services and products. They function outside central bank and government regulation and supervision and may have no legal standing. Some of these arrangements have a long operational history and continue to thrive even when the formal system develops and expands. Others emerge as a reaction to the repression of the formal system, and may lose their importance with liberalization of the financial market. There is little information about the scale of activities in the informal sector - written records are not passed on to any central authority.

2 Two forms of informal financial arrangements are of special interest with regard to deposit taking. The first is the most wide-spread informal savings method which exists or has existed in almost all developing countries, i.e., rotating savings and credit associations (commonly known as ROSCAs). In this type of association, each member contributes a given amount at a fixed interval and the total amount collected is distributed to members in rotation. The system is strictly reciprocal and, in most cases, members enjoy the same or similar status and income. In many countries, there is also another type of informal savings and credit group in operation in which funds are not rotated but built up. These funds are either kept in cash in safe custody, deposited in an account in a bank or distributed as loans to members. It is quite common for rotating and non-rotating practices to be part of the operations of the same group.

3 The other important type of operator collecting deposits in the informal sector are finance companies. In Asia the development of these firms has been a response to both financial regulation and economic opportunities. Despite their names (companies and corporations), their often bank-like offices and their various links to formal sector financial firms, these intermediaries are considered part of the informal sector. By filling a gap left unserved by formal banking institutions and operating outside the central bank regulations, informal financial companies have managed to capture a significant share of the deposit market in many countries. Their higher than average interest rates, innovative ways of operating and low transaction costs have been a key to success, especially when operating in remote rural areas. In many cases, however, a fast growth period in this type of activity has been followed by bankruptcy, with savers suffering major losses. Such problems were experienced in Pakistan and Egypt during the 1980s and in Costa Rica, the failure of seven finance companies after the stock market crash in 1987, provoked runs on banks and savings and credit cooperatives, leading to three cooperatives suspending payments.

1.3 The Drive to Increase Deposit Collection in Developing Countries

1 In the 1960s and 1970s, providing credit at low rates of interest was widely believed to be the only essential function of financial intermediaries in the rural areas of developing countries. However, the widespread failure of subsidized and heavily regulated credit programmes to achieve the goals of increased production and more equitable income distribution have been considered lately to reflect the basic weaknesses of the credit-centered approach to development finance in developing countries. This has led to an increased emphasis on savings mobilization, "the forgotten half of rural finance", and during the past decade there has been an upsurge in policies and programmes aimed at increasing deposit collection by financial intermediaries in developing countries.⁹ Savings mobilization is considered now to be a crucial factor in the development of sound financial markets. There

are a growing number of successful savings mobilization programmes in developing countries and governments and international agencies have recently become much more interested in such activities. Rural and non-wealthy households in particular have become the focus of policies to promote saving, as the myths that the poor have no margin over consumption for saving and do not respond to economic incentives are increasingly being questioned. Evidence of the capacity of small farmers to make deposits is shown in the case studies highlighted in Box 1.1.

Box 1.1 *Evidence of Small Farmer Savings Capacity in Taiwan and Korea*

In the 1960s, both Taiwan and the Republic of Korea started to promote rural savings mobilization, instead of relying solely on subsidized credit. The potential for savings mobilization was enhanced by complementary reforms that significantly raised interest rates on both loans and deposits. As a result, in Taiwan, the supply of agricultural credit increased from US\$ 30 million in 1956 to US\$ 400 million in 1971. A substantial part of this expanded lending fund was derived from deposits collected through rural cooperatives. Attractive interest rates on deposits, coupled with high rates of return to on-farm investments, played a key role in inducing the increase in deposits and their mobilization in rural areas.

Studies in the Republic of Korea during the same period show similar evidence of significant savings capacity in rural areas. In the mid-1960s, after years of supporting only subsidized credit programmes, the Government implemented two new, related policies: higher interest rates and a national drive to promote rural savings through cooperatives. The results were dramatic. Farm household surveys showed an increase in saving from 12 percent of household income in 1963 to 33 percent in 1974. Motivated by the more attractive rates of interest on deposits and the ability of rural cooperatives to provide a secure, convenient and inexpensive way to save, even the smallest farms and households with the lowest incomes deposited significant amounts of money. The examples suggest that savings capacity exists in developing countries, even among the poorer farmers.

Source: Agency for International Development; *Mobilizing Savings and Rural Finance: the AID Experience*, Washington, D.C., 1991.

2 Credit unions and savings and credit cooperatives have been particularly active in promoting savings, since members' deposits are their principal source of loanable funds. Key features of successful savings mobilization programmes implemented by organisations affiliated with the World Council of Credit Unions include:

- pricing of savings accounts at positive real interest rates
- active promotion and advertising, aimed particularly at holders of small accounts
- expanded office hours and better service to savers
- wider range of savings account products
- computerisation of teller operations
- improvements in office facilities to enhance public image.

As a result there has been significant real growth in the savings market share of credit unions and cooperatives in Africa, Asia and Latin America, despite inflation and other economic difficulties.¹⁰

3 So there are now a number of examples showing that poor households benefit from the improved deposit opportunities provided by safe, liquid, interest-bearing savings products. These allow households to earn a positive return on their deposits and to avoid, at least in part, the erosion of these balances by inflation. Deposits help people to accumulate funds, which are then available for investments in physical capital and to assist the cash flows associated with consumption. Increased use of the financial system also generates social efficiencies through the pooling of risks and through information economies in the allocation of funds for investment. In addition to these considerations, the use of savings as a hedge against low and uncertain future incomes is, in many cases, a prime motive for the accumulation of assets, especially for the non-wealthy households in developing countries.¹¹

4 However, while the increasing emphasis on domestic deposit mobilisation has been a step in the right direction, the financial policies implemented in most developing countries have not created robust financial systems. With the rate of inflation often well above the rates of interest on deposits, most domestic savings have not been made in this form. Financial systems have remained small in terms of assets and undeveloped in terms of institutions and financial instruments. Furthermore, the macroeconomic environment has often discouraged the deepening of financial systems. For example, a number of developing countries have suffered or are still experiencing serious political unrest, war or civil conflict. Obviously, in these circumstances, the disruption of economic activities and uncertainties about the future affect decisions and abilities to save and, in general, undermine confidence in the banking system. In the 1980s, the weaknesses of many financial systems became apparent and banking instability emerged as a major problem not only in developing countries but also in many industrialised countries. This raised questions about the safety of deposits in financial institutions and the rights of savers in times of banking crisis.

Notes:

1. The World Bank, *Financial Systems and Development*, Policy and Research Series 15, The World Bank, Washington, D.C., 1990, p. 9, Table 2.1.
2. *Ibid.*, p. 11. The countries included in the study were Cameroon, China, Colombia, Cote d'Ivoire, Ecuador, India, Republic of Korea, Malaysia, The Philippines, Portugal, Thailand, Tunisia, Turkey and Yugoslavia.
3. For a recent, comprehensive study on financial dualism in developing countries, see Germidis, D., Kessler, D. and Meghir, R., *Financial Systems: What role for the Formal and Informal Financial Sectors?*, OECD Development Centre Studies, Paris, 1991.
4. *Ibid.*, pp. 53 - 54.
5. The World Bank, *op.cit.*, p.21.
6. Marion, P., *Credit Union Achievements in Developing Countries*, in Yearbook of Cooperative Enterprise 1990, Plunkett Foundation, London, 1990.
7. Marion, P., *Building Successful Financial Systems: The Role of Credit Unions in Financial Sector Development*, Technical paper, Workshop on Rural Finance and Financial Sector Development, U.S. Agency for International Development, Washington D.C., 1987.
8. World Council of Credit Unions, *International Digest of Laws Governing Credit Unions* (English edition), Madison, 1993.
9. For studies on the problems of the credit-centered approach in developing countries, see von Pischke, J.D., *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, EDI Development Studies, The World Bank, Washington D.C., 1991, and Vogel, R.C., "Savings Mobilization: The Forgotten Half of Rural Finance", in Adams, D., Graham, D. and von Pischke, J.D., (eds), *Undermining Rural Development with Cheap Credit*, Westview Press, Boulder Colorado, 1982.
10. See case studies from World Council of Credit Unions and the World Bank "Credit Union Development Seminar", Madison, 1990, viz., Ghana (Ito, L.), Togo (Akemakou, K.), The Philippines (Cowell, R.), Africa (Magers, D.), Cameroon (Mahon, D. and Bettinger, J.), Malawi (Jerving, J.), Niger (Ito, L.) and Togo (Aeschliman, C.); and World Council of Credit Unions, *Mid-term Evaluation Report Cooperative Sector Low-cost Housing Project in Ecuador*, Project Report, 1993; and Marion, P., Almeyda, G. and Magers, D., *Credit Unions as Cooperatives: Experience and Potential*, Technical paper, World Bank Seminar on Donor Support for the Promotion of Rural Cooperatives in Developing Countries, The World Bank, Washington D.C., 1990.
11. Vogel, R.C. and Burkett, P., *Mobilizing Small-Scale Savings: Approaches, Costs and Benefits*, Industry and Finance Series Vol. 15, The World Bank, Washington D.C., 1986.

2. THE CAUSES AND CONSEQUENCES OF FINANCIAL INSTABILITY

SUMMARY

This chapter:

- Explains the importance of stability in financial markets.
- Identifies the main causes of banking failures in industrialised countries in the 1980s.
- Tells the story of the crisis which destroyed many Savings and Loan Associations in the USA, following the liberalisation of the financial markets.
- Notes that depositors in industrialised countries have been largely protected by government intervention when banks fail.
- Identifies the additional problems facing financial institutions in developing countries, particularly the weakness of financial management and the lack of supervision.
- Notes that depositors in developing countries are more vulnerable to losses, as the resources available for rescue are limited.

2.1 The Importance of Financial Stability

1 Ensuring the stability of the financial system is usually high on the list of any government's economic priorities.¹² The failure of a large bank or multiple bank failures in a country may force a sudden contraction of the money supply or a failure of the payment system and can result in severe dislocation of the economy with real or implicit obligations being placed on the government. The failure of any bank, no matter how small, may lead to a contagious loss of confidence in the system, unless the government in question can demonstrate its ability to handle a bank crisis in an orderly and systematic fashion.

2 From the point of view of depositors, the stability of financial markets is equally important. A stable banking system provides the saver with the option of a safe financial asset in the form of bank deposits, but instability threatens this safety. When a bank fails, the danger of depositors losing at least part of their savings balances increases.

3 Despite efforts to promote financial stability, the banking systems of many industrialised and developing countries experienced serious distress during the 1980s. Many financial institutions suffered large losses, some became insolvent and some failed. Bank insolvency as such was nothing new, but the scale of the problem - the number of insolvent institutions and the number of countries affected - was without precedent. Furthermore, in many countries of the developing world, banking crises were really systemic, since a significant proportion of the insolvencies in their banking systems had been caused, at least partially, by macro-economic (system-wide) events.

2.2 Financial Instability in Industrialised Countries

1 In industrialised countries, recent banking crises have been closely related to the extensive deregulation which took place in financial markets in the late 1970s and during the 1980s. Country after country eliminated or relaxed credit and interest rate controls and removed or softened restrictions on market entry and diversification. Even though most governments introduced new and more comprehensive prudential and other regulations at the same time, the liberalisation of the financial market proved to be a difficult process to control. In a number of countries, the result was a very rapid credit expansion and the overheating of stock and real estate markets. When recession set in, real estate and / or stock prices collapsed. As a result many banks found themselves in financial crisis. In most industrialised countries, governments stepped in to rescue ailing financial institutions and losses experienced by depositors have been limited. The costs of these salvage operations to the state and the taxpayers, however, were often extremely high.

2 The first major banking crisis in the industrialised world in the 1980s was the failure of hundreds of Savings and Loan Associations in the USA. A brief review of this story is worth repeating here, as it reveals many of the basic problems that emerged in subsequent banking crises in other industrialised and developing countries.¹³ Until the late 1970s, the Savings and Loan Associations in the USA were a group of sleepy, prosperous and safe financial institutions. These Associations, often known as "thrifts", were a vital part of the housing finance system in the country and were confined mainly to issuing home mortgage loans. The structure of their operations had one basic flaw: they borrowed short (passbook accounts), and lent long (typically, thirty year fixed interest rate loans). Consequently, when the rate of interest rose sharply, their profitability was automatically reduced. This situation of sharply rising interest rates hit the thrifts first in 1965-66. The Congressional solution for this minor crisis was to extend the system of interest ceilings on deposits (known as 'Regulation Q') to the thrifts. This solution worked for the next decade as depositors had few suitable alternatives and market interest rates did not rise far above the ceilings.

3 In the late 1970s and early 1980s, however, interest rates again rose sharply, at a time when there were numerous alternative channels for deposits (mainly money market mutual funds). As a result, many of the thrifts incurred massive losses in 1980-82. On this occasion the Congressional response was to introduce deregulation. The thrifts were allowed to offer adjustable rate mortgages; they could make commercial real estate loans, unsecured commercial loans and consumer loans; they could participate in projects as owners; the Regulation Q on interest rates was phased out; and the maximum deposit insurance cover was raised from US\$ 40,000 to US\$ 100,000. These types of changes became the standard ones to be repeated in one form or another in financial liberalisation actions throughout the world. There was a related problem which was also to become a standard feature in other countries:

the moves were not accompanied by adequate regulatory and supervision systems to safeguard the evolution to a more liberal environment.

4 While many of the Savings and Loan Associations remained conservative in their policies, hundreds of them did quickly take advantage of the new environment and attempt to cover their previous losses with the aggressive expansion of activities. Study of a group of 637 thrifts that failed between 1986 and 1989, showed that their growth during 1983-85 led to a doubling of their sizes; and a subsample of 74 in this group grew by 400 percent or more during the same period.¹⁴ The phasing out of Regulation Q made it possible for the thrifts to actively campaign for deposits and pay market interest rates (or even above market rates). With the increase in the deposit insurance cover, funds could also be gathered in larger amounts. A large proportion of the collected funds was invested in the new, non-traditional assets that the deregulation actions of 1980-82 had made possible. These new investments were often over optimistic and poorly researched; in some cases, they were also fraudulent.

5 While the above problems alone could have led to the collapse of affected thrifts, the situation was made worse by two exogenous events: firstly, the decline in oil prices during the 1980s and secondly, changes in the U.S. tax laws which gave real estate loans less favourable treatment than before. The combined effects of all these events resulted in massive losses for some thrifts, especially in the Southwestern states. As property values in real estate markets began to slide downwards, insolvency among the thrifts became more and more common from 1986 onwards.

6 As the seriousness of the situation became known, the US government tightened the prudential and investment rules of the thrifts, but a great deal of damage was already done. By the end of 1989, 637 thrifts had been either liquidated or placed with receivers. Many more were merged with each other to create viable financial institutions. During the following years, still more thrifts collapsed and were either liquidated or merged with other financial institutions. Total losses of the thrift debacle have been estimated at US\$ 100 billion, equivalent to two percent of GDP. The main losers were the shareholders and taxpayers since the government funded the compensation payments to the savers in the insolvent associations.

7 The experience of the Savings and Loan Associations in the USA illustrates the potential dangers of uncontrolled liberalisation of financial markets and the high costs of salvage operations for the state and taxpayers. Similar crises emerged in the late 1980s and early 1990s in other industrialised countries. Deregulation of financial markets took place in Scandinavia in the mid 1980s and some of the largest rescue operations, relative to the size of their economies, were required there, first in Norway, then in Sweden and Finland. Symptoms of financial instability of the same type can be found in almost all developed countries including Switzerland and Japan. It should be noted, however, that liberalisation *per se* was

not the cause of the financial instability. In fact, the causes of instability in the form of non-performing loans, mis-matched assets and liabilities, excessive operating costs, etc., already existed in the financial structure of the deregulated institutions and liberalisation simply revealed the technical insolvencies and other problems that had been "hidden" under prior regulations. In many cases, these "revealed" problems were exacerbated by government policies that increased the risk to taxpayers by simultaneously increasing government-backed deposit insurance schemes and reducing prudential supervision. Depositors in industrialised countries, however, have generally been fortunate that the governments have come to the rescue and, in most cases, compensated them in full when banks have failed.

2.3 Financial Instability in Developing Countries

1 While many of the causes of financial crisis in developing countries are similar to those observed in industrialised countries, the situation is more complex. Problems can be found at the macroeconomic, sectoral and institutional level. In the 1950s, the financial systems in most developing countries were dominated by foreign-owned banks, providing mainly short-term trade finance for exports. During the 1960s, the governments generally did not find these existing financial institutions suitable to finance their development plans. So, in order to realise their development objectives, major changes were introduced in financial markets. In Africa and in many countries in Asia, the common policy was to nationalise the largest banks. Substantial segments of their financial systems became state-controlled. Financial institutions were directed to lend to state enterprises and priority sectors at below-market interest rates. These loans were not channelled to projects with the highest returns but to those the governments considered socially desirable. A large share of non-performing "assets" in developing countries are found among these directed loans. In addition, interest rate spreads were often too small to cover the banks' costs and the profitability of the financial institutions decreased or disappeared.

2 The problems of the banks in developing countries were not so apparent in the 1970s when the access to foreign funds was easy. However, overseas borrowing became much more difficult after the 1982 debt crisis, as foreign commercial banks ceased their voluntary lending to developing countries. Governments and state enterprises started to borrow more from the domestic markets, which crowded out the private sector and in many countries caused inflationary pressures. To earn foreign exchange, many countries devalued their currencies and lowered their tariffs and other trade barriers. As a consequence local firms had to face abrupt changes in relative prices, often alongside recession at home. In these circumstances many businesses became unprofitable and were unable to repay loans.

3 The problems related to economic policies were compounded by institutional shortcomings. Many banks and other financial institutions were badly managed. Loan appraisals and loan follow-up were weak; loan concentration and lending to associated firms was excessive and lending often continued as a client's position deteriorated. Banks commonly had mismatched portfolios; some lacked proper internal controls; many had excessively high operating costs due to overstaffing and too many branches. The policies adopted by institutions facing difficulties frequently increased the seriousness of the crises. A normal practice was to roll over doubtful loans to hide the weaknesses of the portfolio. As the crisis deepened, some bankers engaged in speculative real estate or foreign exchange dealings, while others paid above-market interest rates to acquire funds to cover losses. Outright fraud was involved in some cases of bank failure in developing countries.

4 The instability of the financial institutions in developing countries should have been controlled by financial regulation and bank supervision. In many countries, however, the banking laws and regulations did not keep up with the developments in financial services and became outdated. Bank supervision was often subjected to political pressure by the powerful interest groups controlling the banking and formal business sectors. All over Latin America, Asia and Africa, bank supervision was unable to keep on top of the situation in the ailing banks, allowing major crises to develop. In the semi-formal sector, control by ministries was even weaker and crises in the cooperative financial sector (e.g., in Asia) were allowed to develop into disasters from the depositors' point of view, practically without any action by the authorities. It is apparent that in some cases this inaction benefited the formal financial sector by decreasing public trust in non-bank financial intermediaries.

5 Reliable information on the depth of the financial crisis in developing countries is difficult to obtain. While the cases of major institutional failures are known, much financial distress remains hidden. Many banks have rolled over unpaid debts and capitalised unpaid interest, so their insolvency is often not readily apparent from their accounts. Furthermore, if a bank is highly geared, it can remain liquid and continue to operate long after becoming insolvent. When proper audits have been made of financial intermediaries in developing countries, non-performing loans have almost always proved to be substantial and well above the reported level.

6 However, it is known that during the 1980s, more than 25 governments in developing countries intervened to help distressed financial institutions in situations where the possibility of widespread bank runs and the collapse of the banking system was apparent. Countries from Africa, Latin America and Asia were involved. The institutions assisted came from all sectors of the financial market: formal, semi-formal and informal. In Latin America alone, Argentina, Bolivia, Chile, Uruguay, Ecuador, Colombia and Mexico have experienced significant banking crises of a systemic nature. The main causes of these crises were:

- (i) macroeconomic instability, derived in most cases from incorrect economic and financial policies;
- (ii) mismanagement of banks;
- (iii) fraud; and
- (iv) banking failures in other countries which affected local banks.¹⁵

7 Credit unions and savings and credit cooperatives have also had problems in developing countries. The tolerance members show of low profitability, because of their concern to assure themselves of access to credit, and the tendency of leaders to show forbearance in loan collection, coupled with relatively unsophisticated financial management skills, are factors which add to the potential for financial distress in these institutions. A study in Guatemala identified the common features found in credit unions in which the depositors funds were in jeopardy.¹⁶ These are summarised in Box 2.1.

Box 2.1 *Features Characteristic of Credit Unions / Cooperatives in Financial Difficulty in Guatemala*

The following features were found to characterise credit unions in Guatemala whose viability as independent financial institutions was questionable and in which depositors funds were at risk:	
1. Borrowing	Soft foreign loans
2. Loan interest rates	Lower than banking rates
3. Loan amount	According to amount of shares (2:1 to 5:1)
4. Loan security	Fiduciary or none
5. Delinquency rate	High (measured by overdue payments as share of portfolio balance)
6. Deposit savings yield	Lower than banking sector and discouraging to savers
7. Share savings yield	Very low to 0 %
8. Loan loss provision	Fixed percentage, without considering delinquency
9. Bad loan write-off	Non-existent or only when all hope of collection was exhausted
10. Earnings distribution	To members after creating minimum reserves
11. Type of member	Poor people in rural areas, social welfare mentality
12. Employees	Low salaries
Source:	World Council of Credit Unions; <i>Credit Union Financial Stabilization</i> , Santo Domingo, February 1992.

8 Depositors in developing countries are more vulnerable in a banking crisis than their counterparts in industrialised countries. The safety net for savers tends to be much less comprehensive. While the governments have stepped in to rescue depositors in most crises, the funds made available for these operations have rarely been adequate to provide full compensation even to small depositors. When intermediaries in the semi-formal and informal sectors have failed, depositors losses have generally been even higher. In order to consider

ways of helping developing countries to avoid these problems in the future, the following chapters examine the experience of selected countries in dealing with banking crises and the methods used to safeguard deposits in their different circumstances.

Notes:

12. The vital importance to public policy of ensuring the stability of the financial system is pointed out by Polizatto, V., in "Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks", in Callier, P. (ed), *Financial Systems and Development in Africa*, EDI Seminar Series, The World Bank, Washington D.C., 1991.
13. Reviews of the Savings and Loan Association experience can be found in: White, L.J., "The United States Savings and Loans Debacle: Some Lessons for the Regulation of Financial Institutions", in Vittas, D. (ed), *Financial Regulation: Changing the Rules of the Game*, EDI Development Studies, The World Bank, Washington D.C., 1992 and in Callier, P., *op cit*, pp. 241-242.
14. White, L.J., *op cit*, p. 274.
15. Morris, F., *Latin America's Banking Systems in the 1980s*, World Bank Discussion Papers 81, The World Bank, Washington D.C., 1990.
16. World Council of Credit Unions, *Credit Union Financial Stabilisation*, Santo Domingo, 1992.

3. BANKING CRISES AND INSTITUTIONAL REHABILITATION IN EUROPE

This chapter takes the form of three case studies, examining the circumstances which led to banking crises in Finland, Hungary and Italy and the methods of rescue and deposit protection employed in each case.

FINLAND

This case study illustrates the potential for bank instability following financial deregulation and the subsequent high cost to government of preventing institutional collapse and safeguarding depositors. Finnish banks had predictable profit margins and negligible loan losses until the mid 1980s. Between 1982 and 1989, a major deregulation of financial markets took place and banks, unused to recognising, evaluating and controlling risks inherent in unregulated markets, continued to operate on outdated principles, leading to a rapid credit expansion. This, coupled with recession and disruption of export markets, eventually led to a banking crisis. The commitment of the government to financial stability and unlimited deposit insurance cover, forced them into costly salvage operations, including taking control of banks, supporting mergers, providing capital injections and creation of a guarantee fund. Government support of banks represented 7% of GDP in 1992.

HUNGARY

This case study highlights the problems that result from a lack of trained and experienced personnel in financial institutions. Hungary was a centrally planned economy until steps were taken in the mid-1980s to increase the role of market forces. The reforms led to massive upheavals in the economy, exacerbated by the collapse of the Soviet Union export market. Against this background newly structured commercial banks and the savings cooperatives had to adjust to much riskier business lending with very inexperienced staff. The commercial banks had also inherited weak portfolios from the pre-reform period and the savings cooperatives could no longer rely on recovery of housing loans from wage deductions. As some banks and cooperatives failed, the government introduced new financial regulations and a loan consolidation scheme for banks. A security fund set up by the Central Association of Savings Cooperatives kept many cooperatives in business. Household depositors were protected from losses by a government guarantee scheme and this was replaced by a modernised deposit insurance system in 1993. The challenge, however, remained the need to improve banking skills in the country.

ITALY

This case study describes a country with long established procedures for the rescue of ailing banks and a recent move to lessen the costs of such actions to the state by establishing a private sector security fund. Despite a well regulated financial system from the mid 1930s, there had been instances of bank failure and the central bank can initiate procedures which protect depositors, usually by arranging for new owners or a sound bank to takeover. These salvage operations were encouraged by the provision of highly subsidised loans to the intervening parties and were thus costly to the taxpayers. In 1987 a new Interbank Deposit Fund was set up to increase private sector participation in supporting ailing banks and to provide a deposit insurance scheme. By 1994, this fund had successfully intervened in three bank crises. However, if the scale of bank instability grows following financial deregulation, the fund would be too small and deposit protection would still depend on state intervention.

3.1 Finland: The High Cost of Deregulation

3.1.1 The Financial System in Finland

1 Up to the 1990s the banking system in Finland consisted of five major bank groups and some smaller commercial banks. In addition to these institutions, depositors were also served by small banks, belonging to either the cooperative or savings bank groups. In many respects these two groups functioned as one entity. In 1992, there were 310 cooperative banks and 41 savings banks in operation. All the major banking groups provided services in all parts of the country and to all sectors of the economy.

2 The role of deposit banks is very important in Finland. About two thirds of the borrowing by households and enterprises is from these banks. In addition to this, Finnish banks operate a universal system and, thus, possess large share-holdings in non-financial companies and undertake investment bank activities. They hold a strong controlling position in the Finnish enterprise sector.

3.1.2 The Growth of Financial Crisis

1 Finnish banks operated in a highly regulated environment up to the mid-1980s. It was a stable industry characterised by capital controls, interest rate regulations and predictable profit margins. Loan losses were negligible. Competition between the banks took the form of investment in new banking technologies and creating extensive branch networks. The result was a technically advanced network with high operating costs by international standards.

2 Between 1982 and 1989, a major deregulation took place in Finnish financial markets. This included the following changes in banking practice:

- foreign banks were allowed to operate in Finland;
- banks were allowed to determine interest rates on loans freely;
- foreign borrowing by companies was not restricted;
- direct investment abroad was unrestricted;
- a real money market was established;
- floating rates were allowed on loans;
- the Central Bank discontinued its periodical guidelines and lending and borrowing decisions were largely left to market participants.

These major deregulatory measures were not accompanied by other reforms which could have dampened the expansionary effects. Fiscal policies encouraged borrowing by businesses and households and consequently, in a more liberal market where credit was easily available, households and companies started to borrow as never before. In 1988, for instance, bank lending grew by no less than 30 percent.

3 All participants in the financial markets - the regulators, banks and customers, were slow to comprehend the full implications of the more liberal financial environment. This was due in part to the exceptional period of high growth enjoyed by the Finnish economy in the 1980s. External terms of trade improved significantly after 1986 and unemployment was low. In fact industrial areas in the south of the country suffered from labour shortages rather than unemployment. The overall result was a highly optimistic atmosphere in the country and this encouraged borrowers to underestimate the risks associated with increasing indebtedness, floating interest rates and foreign currency loans. By 1989, most indicators showed a serious overheating of the Finnish economy. Stock prices and real estate values soared. Credit expansion was record-high. Although some investments were used to increase the production capacity of the country, much more was invested in the closed sectors of the economy - housing, recreation and the retail trade. With low unemployment, labour costs accelerated, eroding external competitiveness.

4 The banks themselves contributed to the developing crisis. A paper prepared by the Bank of Finland in 1993 noted:

"Banks, unused to recognizing, evaluating and controlling risks inherent in unregulated markets, continued to operate on the basis of partly outdated principles. Competition for market shares was the dominant objective and led to a lowering in banks' credit standards. Insufficient attention was given to the value and quality of collateral, trust being put in the historical unlikelihood of falling asset values. Credit risk was not correctly priced. Likewise, interest rate risks attracted too little attention."¹⁷

5 The economic situation in 1989 prompted the Bank of Finland to start tightening monetary policy. At the same time, servicing the newly-raised debts took an increasing share of the incomes of both households and enterprises and domestic demand started to weaken. Stock and real estate values declined rapidly. On the external front, export performance weakened and markets were lost due to the lack of price competitiveness. A special shock came with the collapse of the important Soviet market. Finnish companies and banks suffered losses from Soviet export credits and only a small proportion of the exports could be switched to other markets due to differences in commodity composition between eastern and western markets.

6 Rising interest rates and the devaluation of the currency in 1991, further reduced the capacity of households and enterprises to service their debts. The number of bankruptcies in the business sector started to accelerate and a steadily increasing share of the banks' portfolios had to be listed as non-performing loans. For the first time in decades, the aggregate profit of the Finnish banks became negative. In 1992 the problems deepened to a serious crisis. GDP fell by 3.5 percent and business failures reached 700 per month. The value of non-performing loans held by the banks increased from approximately FIM 42 billion to FIM 77 billion and some FIM 22 billion (4.8 percent of total lending) was recorded as bad debt. Reflecting the way the money was used during the boom, most of the non-performing loans were related to construction, real estate and trade. Manufacturing accounted for only 8 percent of the problem assets. It was clear by this time that some banks would not survive without government support.

3.1.3 Intervention Mechanisms to Support Banks

1 Given the stable nature of the banking industry in Finland until the mid-1980s, the public safety net designed for the financial sector at that time was geared to tackling problems of only limited size. The Banking Supervision Office focused on the legal aspects of their supervisory functions and relatively little was done in the field of quantitative risk analysis. The Bank of Finland failed to perceive at an early stage the full consequences of the credit boom and no major tightening of the money market was carried out at first. When warnings did come from the Central Bank and the bank supervisors at the end of the 1980s, they were too late to save the banking sector from major crisis.

2 The first bank to get into serious difficulties was Skopbank, the commercial bank that acted as a central bank for the savings bank sector. Following deregulation, this bank had pursued an aggressive, expansionary lending policy but the quality of its expanded loan portfolio was poor. From 1989 Skopbank was put under special surveillance by the Bank of Finland and the Banking Supervision office. A restructuring programme was prepared for the bank and its owners, the savings banks, were required to provide FIM 1.8 billion to finance part of this rescue programme. This programme proved to be too limited to salvage Skopbank and in 1991, the bank was faced with an acute liquidity crisis. So the Bank of Finland took control of the bank in order to retain confidence in the Finnish financial system. Skopbank continued to function under the Central Bank's ownership with a new management.

3 The next banks to collapse were the savings banks themselves. Again the reason was aggressive expansion of credit during the boom years, resulting in a very weak quality of loan portfolios. Some large loans had been issued, based on careless appraisals, and much of the lending to the domestic sector was denominated in foreign currency, which created repayment difficulties for borrowers after the devaluation of the markka. As the crisis in the savings banks deepened, the Government encouraged a merger of the distressed banks and provided capital support on condition that a restructuring programme was implemented. In practice, the Government became the controlling owner of the Savings Bank of Finland. By October 1993, this bank was considered incapable of existing as an independent banking unit. The viable parts of the bank were split into four by the government and sold to the other banking groups in Finland. Doubtful assets worth some FIM 40 billion remained in the control of the government and were handed over to a newly established asset management company.

4 Some commercial banks were also in difficulties. For example, a small commercial bank, STS-Bank Ltd, had lent extensively to real estate and construction companies and then faced a decline in the value of its loan collateral which precipitated a crisis. The Bank's attempts to diversify from the household sector to corporate lending were also a disaster and loan losses soared. By September 1992, a stage was reached in which STS-Bank was unable to continue to operate as an independent banking entity and it merged with one of the leading commercial banks, Kansallis-Osake-Pankki (KOP). The merger was negotiated in close cooperation with the state, who also took responsibility for FIM 3.4 billion of doubtful loans.

5 In the early stages of the banking crisis, ad hoc measures were used to maintain the stability of the financial market, such as the costly take-over of the Skopbank, for example. After this event and following the recommendation of a special working group, two major steps were taken to tackle the banking problems on a more systematic basis. The first element of the new approach was to make a general capital injection in to the sector to prevent a domestic credit crisis and to help banks avoid the need for further emergency support. A total of nearly FIM 8 billion of fresh capital was made available to all banking groups in the form of preferred capital certificates, bearing a slightly above market interest rate. These certificates could be converted into voting stock if either interest remained unpaid for three years in succession or the bank's solvency ratio fell below the required minimum. Failure by any bank in Finland to fulfil either of these two conditions would make the state a dominant shareholder in that bank. This threat of effective nationalisation proved to be a powerful incentive for the commercial banks to improve their performance and increase their capital base.

6 The second element of the salvage operation was the creation of the Government Guarantee Fund. This was established in April 1992 to help ensure the stability of the banking system and secure the claims of both domestic and foreign depositors. The Fund operates with a staff of some 20 persons who cooperate with the Bank of Finland and the Banking Supervision Office. Originally the Fund was authorized to grant bank support to a total limit of FIM 20 billion but this was soon raised to FIM 50 billion. Techniques used to support banking operations included acquisition of bank shares and provision of other types of equity capital, loans and guarantees. With this new institution handling the bank support, the Bank of Finland was able to concentrate on its conventional central bank tasks.

7 Between 1991 and 1993, about FIM 40 billion worth of state funds was spent to support banks. Appendix A shows the full details of this support. The mandatory security funds, originally created against the background of a stable, profitable banking sector, amounted to only FIM 300 million in 1990. This was clearly minimal in comparison to the losses the banks suffered in the early 1990s and made little contribution to the total salvage operation required. The amount of support in 1992 alone was equivalent to 18.6 percent of the whole Finnish state budget. The problem was still not over and further large amounts were expected to be needed to clear the banks' balance sheets of bad loans originating from the boom years of the 1980s. However, the intervention by the state meant that the overall confidence in the banking system did not collapse and there were no runs on the distressed banks.

8 By 1994 the banking crisis was clearly being brought under control. A large proportion of the bad debt had been written off; rationalisation measures, in the form of a reduced labour force and cuts in the number of branches, had created lower bank operational costs and the fast recovery of exports improved the debt servicing capacity of many customers. Two large commercial banks, responding to the threat of nationalisation inherent in large capital injections by the state, raised billions of FIM of fresh share capital from their owners and new private investors. These banks, Kansallis-Osake-Pankki and the Union Bank of Finland, expected to reach a profitable level of operation by 1995. This gave hope that the state might one day recover part of the funds it was forced to invest in bank salvage operations

3.1.4 The Safety of Deposits

1 The level of protection given to depositors in Finland is comprehensive. A compulsory deposit insurance system was introduced in 1969 and membership in a security fund became mandatory for all deposit-taking institutions. Prior to this, savings and cooperative banks had voluntarily operated their own security funds for decades and commercial banks had established such funds in 1966. The security funds are responsible for repaying depositors' claims, if payment cannot be effected out of a bank's own funds as a result of bankruptcy. The responsibility is unlimited, i.e., there is no ceiling per depositor or per account. The security funds may also grant subsidies and loans to member banks facing problems. The banks pay an annual flat-rate contribution to these funds.

2 Experience during the banking crises of the 1990s showed that the resources accumulated in these security funds were very small in relation to potential compensation liabilities. However, in the interest of financial stability, the government made it very clear that in all circumstances depositors would be fully compensated. In August 1992, the Finnish Government announced that the stability of the Finnish banking system would be maintained and to calm foreign investors, this commitment was confirmed by the Parliament. Its exceptionally strong resolution reads as follows:

"Parliament requires the state to guarantee that Finnish banks are able to meet their commitments on time under any circumstances. Whenever necessary, Parliament shall grant sufficient appropriations and powers to be used by the Government for meeting such commitments."

Both the success and the huge cost of this commitment have already been elaborated.

3.2 Hungary: Financial Reforms Highlight Shortage of Banking Skills

3.2.1 The Financial System in Hungary

1 Until the mid-1980s, the financial system in Hungary was organised to meet the requirements of a planned economy, characterized by centralised decision-making. The household and enterprise sectors were kept separate from each other and served by different financial institutions. The National Bank of Hungary (NBH) functioned as both the central bank and the only commercial bank for the enterprise sector. All deposit accounts of firms, public institutions and production cooperatives were kept in NBH, which also issued them with short and long term credit according to economic plans. The Foreign Trade Bank Ltd. handled the banking aspects of import and export trade. Other banks with limited activities in the public and enterprise sectors were the State Development Bank, the Central Bank of Exchange and Credit Ltd., the Central Corporation of Banking Companies and the General Banking and Trust Company Ltd.

2 The household sector was served by the National Savings Bank (NSB) and by savings cooperatives. NSB collected deposits through its wide branch network and through post offices all over the country. Loans issued by NSB were solely for housing purposes and to a lesser extent for local government use. Savings cooperatives provided similar services especially in rural areas. Deposits were used to make housing and consumption loans to members and excess funds were invested in NBH. Full employment guaranteed the repayment of loans and in cases of default, an effective system of deducting repayments direct from the defaulter's wages kept loan losses to a minimum. In this pre-reform financial system, the potential contribution of the private sector, that is, of household savings, to productive uses was limited by the institutional separation between the household and enterprise banking systems.

3 Reforms designed to increase the role of market forces in Hungary started in 1968. However, little changed in the 1970s and only by the mid-1980s was financial sector reform officially acknowledged as an essential component of the process. In January 1987, a two-tier banking system was established and the monopoly of the National Bank of Hungary, existing from 1949, was abolished. The credit functions of NBH were separated from its central banking operations. NBH itself continued as a conventional central bank which participates in formulating economic policy, enforces monetary aspects in macroeconomic planning and protects the value of the currency. The credit sections of NBH were converted into two new commercial banks - the Commercial and Credit Bank and the Hungarian Credit Bank. A third bank, the Budapest Bank, was formed at the same time, partly from the commercial wing of the State Development Bank. These three banks were allocated loan accounts from the NBH portfolio. The Foreign Trade Bank continued to function largely as before and the General Banking and Trust Company was authorised to become a full service commercial bank.

4 After an interim period of two years, an explicit process of integration of the enterprise and household banking sectors was begun. From 1989, commercial banks, the National Savings Bank and savings cooperatives were free to engage in financial transactions with both households and enterprises and clients were allowed to choose between banks. By mid-1993, a total of 43 commercial, investment and savings banks and financial institutions were operating in Hungary, 20 of them with foreign shareholding. The number of savings cooperatives was 256, with 1.8 million members and 1,800 branches. In addition to these, a Postal Savings and Commercial Bank commenced operation in 1988. The market share of household deposits held by the National Savings Bank remained high, exceeding 50 percent of the total. The savings cooperatives and the Postal Bank held another 10 percent of these deposits and the rest was held by various commercial and investment banking institutions. To supervise the operations of the financial institutions, the State Bank Supervision Agency was established and attached to the Ministry of Finance.

3.2.2 The Growth of Financial Crisis

1 Financial reform in Hungary took place in a complex and difficult macro environment. Apart from major internal changes in social and economic structure, they faced the loss of important markets in the neighbouring ex-socialist countries. Many of Hungary's industrial firms confronted either closure or complete reorientation. New limited liability companies, which increased in number from 4,800 in 1988 to 64,000 in 1992, were often under-capitalised and operated by inexperienced managers. The agricultural sector was paralysed by the collapse of the Soviet Union, which had been their main export market, and new private farming businesses were suffering the problems of incomplete land reform. Gross domestic product decreased in real terms every year from 1988. Unemployment increased from zero in 1987 to 12 percent in 1993. Production in most industries fell to between 50 and 80 percent of the levels in 1988. Housing construction fell from 90,000 units in 1980 to 25,000 in 1992. These changes obviously cut much deeper than those of the economic liberalisation and adjustment programmes implemented in other countries.

2 Against this complex background, financial reform was bound to experience problems. New institutions and systems require new management policies and procedures but old attitudes and policies take time to change. The rapid growth in number of financial institutions meant banking skills were spread very thinly across Hungary's financial sector. There simply were not the human and physical resources available to support an up-to-date efficient financial system. Furthermore, the new banks were handicapped by inheriting the weak portfolios of the pre-reform period.

3 The savings cooperatives ran into difficulties from 1989, when they were allowed to give loans to enterprises. Given the worsening economic conditions and the age structure of the enterprise sector, this was bound to increase risks. Adequate loan appraisal and follow-up were essential but skills in this area were severely lacking in the savings cooperatives, so that monitoring of loans started in most cases when the problems were already beyond remedy. Consequently, out of the Ft10 billion issued by cooperatives to the corporate sector, some 50 percent was lost or considered bad debt by 1993. Three cooperatives had collapsed by this time and 22 others were on the brink of collapse, mostly as a result of lending diversification.

4 The problems of the savings cooperatives were compounded by increasing difficulties in recovering housing loans. Unemployment and decreasing incomes were responsible for this and new laws made deductions directly from wages more difficult. In some agricultural regions badly hit by the reforms, collateral no longer covered loans as real estate prices declined. A third problem for the cooperatives was that new investment in interbank markets had not proved to be as safe as expected. Their ability to endure investment losses was limited as they were operating with very small amounts of their own capital and reserves. Twenty cooperatives were faced with large losses when the commercial Ybl Bank Ltd. collapsed and they were only saved from bankruptcy by government intervention to repay 80 percent of the lost deposits. Even the 25 percent of cooperative funds held in their own Bank of Savings Cooperatives was at risk, particularly as the cooperatives lost their representation on the Board of Directors, by virtue of the rule in the 1991 Banking Act which specified that an individual cooperative must own a minimum of five percent of shares to get a seat on the Board.

5 Many of the problems for Hungarian commercial banks in the early 1990s were legacies from the pre-reform period. In particular inherited loans to state enterprises threatened bank stability. These formed a major part of the stagnant (or lost) elements of loan portfolios held by the large commercial banks. However, credit continued to be extended to these unprofitable firms, because starting a massive winding up exercise, with debts written off, was expected to lead under the prevailing conditions to "the banking system and, in due course, the entire economy going down like ninepins".¹⁸ Another weakness in the banks' portfolios was the extent of loan concentration. Between 40 and 50 percent of the three largest banks' placements were with barely one percent of the clientele. This indicated a dangerous state of "creditor's dependence".

6 By the end of 1992, non-performing loans in the banking sector in Hungary amounted to one fifth of total lending. In the enterprise sector, the non-performing loans represented nearly 30 percent of the stock of claims towards enterprises. At the same time the deterioration of the banks' capital structure was reflected in the increasing gap between the required (Ft270 billion) and generated (Ft89 billion) risk reserves. In addition, most banks were unable to reach the 8 percent capital adequacy ratio stipulated by the law. Therefore, the accumulated own funds of banks could not substitute for the risk reserve shortfall in the banking sector. All this reduced the stability of the financial market.

7 Three bank failures occurred after the reforms started and formed the most visible part of the crisis in the commercial bank sector in Hungary. The first one took place in late 1991, when a specialised financial institution - the Inगतlanbank (Real Estate Bank) - became insolvent, following crippling losses suffered in speculative deals connected with the site of the 1996 World Expo in Budapest. Inगतlanbank's banking licence was withdrawn in May 1992. The failure of this bank did not have a major impact on the banking market but the collapse of two other banks, Ybl Bank and GBV, and the related Entrepreneurs' Savings Cooperative, were much more serious incidents, although even they represented less than 1 percent of total banking assets. Most of their depositors were state-owned enterprises, public institutions, banks and savings cooperatives.

8 In 19XX a group of entrepreneurs - known as the Hepta Group - gained control over Ybl Bank and GBV and used them to finance their business activities. The group's borrowing from the banks reportedly reached Ft 12bn by mid 1992. Reacting to the exceptionally large operations of these banks in the interbank money market, bank supervisors found that Ybl Bank had several undocumented loans. Funds had disappeared, possibly abroad, and securities held as collateral by GBV were not found. Ybl Bank reported a Ft 4 billion net loss in 1992. The State Banking Supervision took control of the banks in 1992 to minimise the damage to the banking system. Ybl Bank was declared insolvent and its liquidation ordered. GBV, however, survived since the Westdeutsche Landesbank - which already possessed a significant share portion - invested new funds in the bank and gained majority control.

9 The effect of these collapses was much greater than the banks' sizes may have suggested:

- they shook the confidence of depositors in the banking sector and foreigners, including potential bank owners, were alarmed by the bankruptcies;
- they caused a crisis of confidence in the domestic interbank market; and
- there was a run on deposits in small and medium-sized banks as depositors looked for safe investment opportunities in larger banks.

3.2.3 Intervention Mechanisms to Support Financial Institutions

1 Various actions have been taken in Hungary to increase stability in the financial sector and improve the safety of deposits. In 1991 new legislation was introduced to improve the regulations governing banks. The law closely followed the second EU Directive and Basle Committee Solvency Guidelines and provided a legally sound framework for banking operations. New regulations included the following:

- maximum equity holding per shareholder (including the state) limited to 25 percent;
- at least 90 percent of equity to be registered and not in bearer form;
- specified minimum levels of share capital for commercial banks and savings cooperatives;
- provision to be made for loan losses;
- risk-adjusted solvency ratio to be 8 percent;
- total exposure to a single borrower not to exceed 25 percent of a bank's adjusted capital;
- related companies to be treated as one borrower;
- banks not allowed to lend for the purpose of buying their own shares;
- loans limited to 50 percent of the market value of an equity type of security;
- restrictions on a bank granting credit to a company in which it owns more than 10 percent of the equity;
- loans to management and staff not to exceed 5 percent of bank's adjusted capital;
- loans to all connected parties to be kept below 10 percent of bank's adjusted capital;
- investment in real estate not to exceed 15 percent of adjusted capital;
- all equity investments of a bank not to exceed 60 percent of adjusted capital;
- equity participation in other companies limited to 51 percent, except for financial institutions and brokerage companies.

2 At the end of 1992, the government introduced a Loan Consolidation Scheme. Financial institutions were offered the opportunity to swap bad loans for state bonds with 20 years maturity. The swap price offered to the banks was 80 percent of the book value of the swapped loans. Fourteen banks and 69 cooperatives participated in the scheme, exchanging approximately Ft120 billion of bad debts (equivalent to 4.3% of GDP) for Ft93 billion worth of state bonds. This improved the balance sheets of these institutions and increased their capital adequacy ratios. However, the stock of bad loans continued to grow and the Ministry of Finance had to prepare another bank support scheme, this time involving direct capital injections. Participating banks had to issue new shares to be purchased by the state with 20 year interest bearing bonds. The intention was to bring their capital adequacy ratios nearer to the stipulated 8 percent level and increase their capacity to write off bad loans. To support this action, each bank was assisted with an individual development programme to help improve its standard of operation. The second phase of loan consolidation led in effect to the renationalisation of the banks involved and could discourage future foreign and local private investment in banks.

3 The State Banking Supervision office visited and reported on the performance of banks. However, their systems and procedures failed to provide any advance warning of the poor state of Ybl Bank and the other two related institutions. The standard monthly, quarterly and annual reports were too slow a system to enable corrective action to be taken in time and various key indicators, such as the lending concentration ratio, were not included in the reports. The SBS also had only five field inspectors which was quite inadequate for the fast growing banking sector in Hungary. Having failed to pre-empt the problems, the SBS had to take control of the collapsing Ybl and GBV Banks in order to minimise damage to financial stability. To improve future supervision, a process of identifying indicators which could warn of approaching difficulties, e.g., mismatch indicators, concentration ratios, etc., was instigated and faster reporting systems introduced. Increased cooperation with the central bank supervision department was expected to improve the efficiency of on-site inspections.

4 The problems of the savings cooperatives were first tackled by the Central Association of Savings Cooperatives, which represents the interests of the sector. This organisation introduced a security fund for its member cooperatives in 1991. The fund was accumulated through annual contributions which were equivalent to 1/1000 of the asset value of each member cooperative. Cooperatives facing losses were allowed to apply for a subsidy which would enable them to break-even in their accounts. These subsidies had to be paid back to the fund within three years once a cooperative returned to a profitable level of operation. In 1991, when the security fund was launched, assistance was given to seven cooperatives to the value of Ft30 million. The next year, 22 cooperatives were supported with Ft120 million and 20 more sought support in 1993, including a number of large units facing substantial losses. The obvious inadequacy of the security fund led to a petition from the cooperatives to the government for public funds to solve the crisis.

5 The Ministry of Finance agreed in principle to support the savings cooperatives but specified certain pre-conditions. It was very concerned about institutions providing full banking services with minimal capital reserves and without proper external supervision. So the savings cooperatives were asked to accept the following rules:

- membership of the central association would be mandatory, although cooperatives would remain independent units with their own balance sheets;
- cooperatives would accept uniform rules for their lending operations;
- the Bank of Savings Cooperatives would come under the direct control of the movement and the liquid funds of savings cooperatives would be invested solely in this bank;
- risk sharing would be encouraged by forming lending consortiums between cooperatives;
- a strong supervision unit would be established in the central association to carry out the external control functions in the movement;

These proposals were all supported by the Central Association of Savings Cooperatives. Once implemented, the government agreed it would inject capital into a new safety fund to be established in the Central Association. Assistance from this fund would be provided to ailing cooperatives both to cover losses and to support capital investments to strengthen the weak capital base of most Hungarian savings cooperatives.

6 The "integration" plan met resistance both from the movement itself and from the management of the Bank of Savings Cooperatives, as the independent status of individual institutions was seen to be put in jeopardy. However, implementation of the plan would address some of the problems of the savings cooperatives. In the longer-term, even closer cooperation between cooperatives could be needed. Most of them are small, under-capitalized and often unable to attract competent managers. They are vulnerable to errors of judgement in investment operations, especially in corporate lending. Additional failures would be costly to the state and to individuals with large deposits. The amalgamation of cooperatives to larger units would improve their chances of meeting the new equity capital requirements of the Banking Act and increase their capacity to recruit competent, professional managers. Increased cooperation with other financial institutions, e.g., the new rural bank, would also enable the cooperatives to concentrate on those areas of banking in which they have most experience and in which the risks are better controlled by the management.

7 One way in which the government in Hungary contributed to, rather than mitigated, financial instability was by allowing the commercial banking system to maintain unprofitable state enterprises. This policy had important social, political and economic reasons for existence but it forced the financial institutions to assume risks and costs which threatened their viability as safe and efficient intermediaries of scarce financial resources. Banks and cooperatives have been used in a similar way in developing countries to supply subsidised, directed credit to offset terms of trade and other economic problems of targeted population sectors.

3.2.4 The Safety of Deposits

1 Before the reforms took place in Hungary, the state guaranteed household savings without upper limit per deposit or per person. At this time the financial system was stable and losses were few. After the reforms started, however, both commercial banks and savings cooperatives faced crises which put savers' deposits in jeopardy. In the cooperative savings movement, the actions taken to prevent the collapse of member cooperatives by the Central Association, such as the establishment of the security fund, helped to protect depositors. In those cases in which bankruptcy occurred, the government guarantee scheme compensated the savers in full except in one cooperative where those who had invested Ft25 million in deposit certificates not covered by the guarantee scheme lost their savings. The long term

security of deposits in the savings cooperatives depends heavily on the success of the integration plans for the movement.

2 The treatment of depositors in those cases of commercial bank failure raised a heated debate in Hungary. Most of the deposits in the failed banks came from business enterprises, other banks, local governments and other public institutions. The few household depositors affected were fully compensated by the government guarantee scheme but this scheme did not cover the large deposits of firms, banks and other institutions. Within 24 hours of the collapse of Ybl Bank, the deposit holders had formed an 'account holders association' to act as a pressure group to safeguard their interest. Partly as a result of the work done by this association, the government eventually agreed to provide 100 percent compensation for all depositors in Ybl Bank Ltd. up to a limit of Ft5 million per account and 40 percent compensation for amounts exceeding this limit. Total losses suffered by depositors as a result of the commercial bank failures in the early 1990s were not published, but it has been estimated that as much as Ft5 billion of public and private investors funds were lost in these bank failures.

3 Apart from compensation in the case of bank failure, the state has taken action to intervene in three small commercial banks - Iparbank, Konzumbank and Dunabank - in order to protect their depositors from losses. The State Property Agency, which was in charge of privatisation, recapitalised the banks and installed a new management team in each of these institutions. As with the savings cooperatives, the long term safety of deposits in the commercial banks depends on the success of actions to maintain the stability and profitability of the sector. Thus the improvement of bank supervision, the loan consolidation scheme and the 1991 Act are all critical. However, the seeds of instability remain serious in a system where the main bank shareholders are also the main debtors and frequently turn out to be the non-creditworthy ones. Furthermore the consolidation plans appeared to increase the share of state ownership in banks rather than decrease it.

4 In 1993, the creation of a National Deposit Insurance Fund (NDIF) was approved by Parliament. The law was designed largely in accordance with the guidelines of the EC for a uniform deposit insurance system. The primary function of the NDIF was to provide compensation to depositors if their Forint or foreign exchange deposits were frozen due to bank failures. The NDIF would repay the principal and accrued interest of deposits from a failed financial institution, up to a limit of Ft1 million per bank and depositor. Deposits placed in foreign exchange would be repaid in foreign currency. All types of deposit accounts were included in the cover afforded by the NDIF. Thus this Act extended the scope of deposit insurance to firms, in contrast to the previous state guarantee system which only covered households. However, it also introduced an upper limit to the cover, which the old guarantee system did not have.

5 All financial institutions taking deposits from the public have to join the National Deposit Insurance Fund. The initial admission fee is 0.5 percent of the institution's subscribed capital. The annual insurance premium is normally a maximum of 0.2 percent of the insured deposits, but can be raised to 0.3 percent, if the operations of the financial institution are considered to be risky. If the pay out obligations are expected to exceed the accrued premium fund, the NDIF is allowed to borrow either from the open market or from the National Bank of Hungary. These loans may be guaranteed by the state, but the repayment has to be funded by extraordinary contributions from member institutions. The NDIF can be used to finance rescue operations, if such operations are recommended and supported by the State Banking Supervision office.

6 The new National Deposit Insurance Fund modernises the Hungarian system of deposit insurance. However, it should be seen only as the final stage of the safety net and the main effort in safeguarding deposits should be directed towards preventing bank failures through the proper management of institutions and effective supervision of their operations. When the two-tier banking system was established in 1987, the banking industry had 12,000 employees. Less than 10 percent of them were involved in "real" commercial banking operations in activities linked to foreign trade. Currently the sector employs over 40,000 people. Necessary skills are still scarce in areas such as credit evaluation, risk management and effective loan follow-up. This situation presents a great training and education challenge for the Hungarian banking sector.

3.3 Italy: Increasing Private Sector Role in Bank Support

3.3.1 *The Financial System in Italy*

1 The current structure of the banking sector in Italy is largely based on a series of laws enacted during the 1930s. Until then the financial sector had suffered from repeated crises. Many banks were of the universal type. They were major shareholders in large industrial firms and took part in their management. A large share of these investments were highly illiquid and maturity mismatching was common. Most bank liabilities were in the form of short-term deposits, while assets were dominated by long-term loans to large companies. This close relationship between banks and big, often weak, enterprises was a constant source of instability, but it was the collapse of a large bank in the early 1920s that finally led to financial reform. The authorities did not intervene in that major bank failure and thousands of small depositors lost the bulk of their savings. As a consequence, the banking system's share of savings declined for the next 20 years.¹⁹

2 The 1936 Banking Act and other related measures introduced major changes and created a banking system that remained essentially unchanged up to the late 1980s. Banks holding deposits were prohibited from owning shares in non-bank institutions. Banking institutions had to concentrate on either short-term or long-term operations and strictly observe maturity matching. IRI, a state-controlled financial holding, bought controlling stakes in three major commercial banks and took over the management of their industrial holdings. This left the banks free to concentrate on banking operations in the short-term market. IMI, another government-controlled body, dominated the medium and long-term market. Both direct and indirect state control over the financial sector increased. In addition, the Bank of Italy was given ample supervision powers.

3 During the 1970s and the first half of the 1980s, further control and protection measures were imposed on the banking sector. Credit creation was limited through ceilings on expansion and strict regulations were placed on international capital movements. Branch expansion was controlled by the central bank. Various types of interest rate subsidies were introduced. Under the umbrella of these protective measures, banking was a generally safe and stable industry and large economic rents were earned, increasing the profitability of the sector. Furthermore, interest rate agreements between banks limited competition between them. There were, nevertheless, instances of bank failures. The Banca Privata Finanziaria was declared bankrupt in 1974 and had to be taken over by the Banco di Roma. In 1982, well documented problems and irregularities in the Banco Ambrosiano led to a savings run on the bank and, during that year, the bank's deposits dropped from Lit 3,600 billion to Lit 1,900 billion.

4 From the mid-1980s, following the worldwide trends and EC directives, a systematic dismantling of controls took place in Italy's banking sector. The process was in many ways similar to that described in the case of Finland. Limitations on capital movements were relaxed, interest rate controls were discontinued, credit ceilings were removed and the opening of new branches was made easier. In 1990 a law, the Legge Amato, encouraged bank mergers and the conversion of banks to limited liability companies. A new Banking Act in 1994 ended the market segmentation which obliged banks to concentrate on either long-term or short-term operations. This new Act and the implementation of EU Directive II reintroduced universal banking to Italy, including allowing shareholding by banks in industrial and other non-bank companies.

5 This deregulation programme and the 1994 Banking Act was expected to result in another major restructuring of the Italian financial market, both in terms of its institutions and banking practices. It was known that, in other countries, this process had led to increasing problems with banks' portfolios and increasing compensation demands from depositors. The question was whether in Italy, the effort to increase the role of the private sector in bank security funds would reduce the cost of bank salvage operations to the state and the taxpayers.

3.3.2 Intervention Mechanisms to Support Banks

1 In addition to such conventional stabilization methods as prudential regulations, lender-of-last-resort facilities and state bank supervision, Italy also has two procedures which are used to reorganize and redress ailing banks. These are known as the Extraordinary Administration and the Compulsory Administrative Liquidation procedures. Both procedures have to be ordered by the Treasury Minister, on the advice of the Bank of Italy. Which procedure is adopted depends on the gravity of the bank losses or violations.

2 The Extraordinary Administration procedure involves the temporary replacement of a bank's management by commissioners appointed by the Bank of Italy. Their task is to identify the causes and extent of the crisis, as well as the most appropriate ways of overcoming it. The most usual action is to seek fresh capital for the bank. This can involve a takeover of the institution by new owners or a merger with a sound bank. The Compulsory Administrative Liquidation procedure is put in place whenever the attempts to bring a bank back to a sound footing prove unsuccessful. The task of the commissioners, who act as liquidators in this case, is to protect depositors' interests and, if possible, safeguard the bank's operational structure. The liabilities are usually transferred immediately to a sound bank, which then subsequently acquires all or part of the assets placed in liquidation. This action, which has been applied to various cases in recent years, can enable both of the intended objectives to be achieved.

3 To encourage sound banks to become involved in these salvage takeover operations, a decree was issued in 1974 which authorised the Bank of Italy to grant advances to intervening banks at the highly subsidised interest rate of 1 percent. This facility was first used in 1974 when the Banco di Roma took over the assets and liabilities of the bankrupt Banca Privata Finanziaria and until 1987, it was the main tool used in solving crises in the Italian banking sector. It was particularly important in the salvage of the Banco Ambrosiano in 1982. The bank was saved by six other banks which bought the bank's assets and liabilities and formed the Nuovo Banco Ambrosiano. The Bank of Italy financed the deal with a large advance at 1 percent interest. The case of the Banco Ambrosiano started a heated debate about the high costs of solving banking crises in Italy. At the political level, it was felt that the 1 percent advance facility placed the sole burden of protecting the various interests involved in a bank crisis on the taxpayers. Many believed that the cost of deposit protection should be shared by all the participants in the banking system. These demands eventually led to a shift in the protection policy towards a system that relied more on private security funds than on direct central bank intervention.

4 In 1938, the Italian Savings Banks Association (ACRI) had established a security fund. This was initially called the Savings Banks Advances Fund and later, in 1946, the Solidarity and Development Fund. The aim of the fund was to:

- preserve the prestige of savings banks and develop their organisations
- contribute to solving temporary financial difficulties faced by savings banks
- cover certified losses.

Deposit cover was not included as one of the purposes of the fund. The fund has been little used over the years and its capital only amounted to Lit 100 billion.

5 Another security fund was established in 1978 - the Central Guarantee Fund of the Rural Banks. This was based on a voluntary agreement between the banks and at the end of 1992, 703 out of 713 rural banks were members of the fund. The banks initially contributed 1% of their total deposit balance to the fund, which is operated by their central institution (ICCREA). Since 1986, decreasing contribution percentages have been applied, related to the total deposits of the banks. In 1993, the size of the fund was Lit 175 billion and was expected to gradually reach Lit 300 billion. The fund pays a 5 percent interest rate on the banks' contributions.

6 The Central Guarantee Fund assists rural banks in two main ways. First, it can provide financial support to newly established rural banks. The fund can issue subsidized loans at 0.5 percent interest, up to a maximum Lit 1 billion per bank. Secondly, when a rural bank is facing a financial crisis, the fund will inspect the bank and estimate the volume and type of assistance required to rescue it. In most cases this takes the form of capital advances at 0 percent interest, backed by government bonds. The bank is given five years to repay

these loans. All the fund's interventions must be approved by the Board of ICCREA and authorised by the Central Bank.

7 While the operations of the above funds have been on a fairly minor scale, the creation of the Italian Interbank Deposit Fund (IIDF) in 1987 was a major effort to secure more private sector participation in bank salvage operations. This fund is a voluntary security scheme, functioning under the umbrella of the Italian Bank Association (IBA) but as a separate legal entity. Nearly all Italian banks have joined the new fund, with the exception of the rural banks who continue to participate in the Central Guarantee Fund.

8 The aims of the IIDF are to protect depositors through three different types of intervention:

- a. supporting banks subject to the Extraordinary Administration procedure by providing subsidized loans, share capital injections and guarantees;
- b. providing compensation to customers losing deposits, in those cases where a bank cannot be rescued and reaches a stage of liquidation; and
- c. funding the transfer of assets and liabilities from a failed bank to a sound one, provided that the cost incurred would be less than making direct payments to depositors.

The deposit cover provided per account is:

- up to Lit 200 million 100 %
- between Lit 200 million and 1 billion 75 %
- over Lit 1 billion 0 %.

The fund does not cover the deposits of managers or controlling shareholders, deposits with extraordinarily high interest rates, funds on nameless accounts or interbank deposits. On the other hand, there is no cover limit per customer, so by splitting savings into different accounts, a depositor can always reach a full 100 percent coverage.

9 The IIDF is financed by its member banks. The fund is essentially a stand-by facility and, in the balance sheets of individual banks, the commitments to the fund are shown as special provisions. In 1990, the total commitments of the banks to the fund were Lit 4,000 billion, approximately 0.5 percent of total deposits in the member banks. In the case of an actual rescue operation, each bank makes a disbursement to the fund and registers it as a credit in their accounts. If a rescue operation results in a loss, the member banks record their disbursements to the fund as a materialized loss. These losses can be deducted from taxable profits, which means that with Italy's company tax rate of some 50 percent, the state eventually pays about half of the losses incurred.

10 A unique feature of the IIDF is a provision in its Statutes under which member banks are required to supply to the fund, every six months, data on specified ratios related to its liquidity situation, solvency and operational efficiency. Member banks significantly diverging from the agreed levels of these ratios are given one year in which to return to an

acceptable level of operations. If this does not happen, they can be expelled from the fund, in which case the insurance cover for deposits will be terminated after six months from the day of expulsion.

11 While largely a private sector instrument, the IIDF functions in close cooperation with the state. Each of its interventions must be approved by the Bank of Italy and so must any change in the fund's statutes. Monetary authorities have representation on the Management Board and Supervisory Committee of the fund. However, it was hoped the private sector nature of the fund would make bank salvage operations more efficient than in the past and also that the costs of such operations would be shared on a more acceptable basis. The continuous monitoring of banks participating in the fund will provide early warning of problems and thus reduce the costs of salvage operations.

12 Since its inception in 1987, the IIDF has intervened in three banking crises. The first case concerned Cassa di Risparmio di Prato (C.R.Prato), a savings bank with 22 branches. Due to mismanagement and too much concentration of lending to the troubled textile industry, over 60 percent of the bank's loans became non-performing and 30 percent were eventually lost. The fund's first intervention was to provide two Lit 200 billion loans, one at the market interest rate, one at 0 percent. As this proved to be inadequate, the fund converted the loans to equity and injected another Lit 400 billion of share capital, while a new management team took control of the bank. Eventually, the fund's shares in C.R. Prato were sold to Monte dei Paschi di Siena, a large Italian bank. The fund's losses in this operation were over Lit 600 billion.

13 The second case involved Banco di Tricesimo, the smallest private bank in Italy. The bank's normal banking activities were sound but the owners used it as a front for risky junk bond operations. Risks involved in these deals led to a decision to liquidate the bank. The Fund reimbursed depositors according to the agreed limits. The third intervention by the fund involved Banca di Girgenti, a Sicilian bank. As a result of illegal activities by the owners-cum-managers of the bank, large amounts of both the bank's and its customers' bonds were found to be missing. As an immediate step, the fund granted an interest free loan of Lit 10 billion to the bank. Eventually the assets and liabilities were taken over by Credito Emiliano. Losses covered by the fund in this operation amounted to Lit 84 billion.

14 These examples show that the new Italian security fund can play a useful role in salvage operations relating to smaller banks. Also, being part of the industry itself, the IIDF has proved a useful instrument in negotiations with candidates for the take-over of assets and liabilities of ailing banks.

3.3.3 The Safety of Deposits

1 Depositors in Italy have always been at risk in times of bank crisis. The occasion in the 1920s when many small depositors lost their money following a major bank collapse, led to a loss of confidence for many years. The oldest security fund, the Common Guarantee Fund for Savings Banks, was established as long ago as 1927. Financed by contributions from savings banks, the express purpose of this fund was to compensate depositors in times of financial crisis. It has never been used for this purpose, however. The later fund, founded by the Italian Savings Banks Association, excluded deposit protection from its aims. The Central Guarantee Fund of the rural banks also excluded compensating depositors in the case of a bank liquidation from its activities.

2 Thus, when the Italian Interbank Deposit Fund was established in 1987, it was the first time that many banks had participated in any kind of deposit insurance scheme. The extent of cover provided per account was outlined in Section 3.3.2 and attention drawn to the fact that a customer could obtain complete protection by holding savings in different accounts to ensure the limit for 100 percent cover is not exceeded. However, there are still weaknesses in the system. All actions taken by the management of the fund are discretionary. There are no statutes stating that in a case of liquidation, action must be taken and deposits reimbursed up to the agreed limits. Whether the fund assists a bank or not, depends in each case on decisions made by the management of the fund. This of course radically weakens the protection afforded to depositors. Furthermore, the expulsion of the weakest banks from the fund does not necessarily lead to better protection of savers' deposits.

3 With regard to the size of the fund, out of the original Lit 4,000 billion reserved for the fund, Lit 3,200 billion was left in 1993. This is a small amount compared to potential compensation liabilities. One single major crisis in a medium-size or large bank could easily exhaust the whole amount. The system created to recapitalise the fund only adds Lit 400 billion to the capital of the fund annually. Thus, it is clear that the fund does not really provide a comprehensive deposit insurance cover for the customers of the member banks. In the case of a major crisis, the state would have to intervene directly as the fund would be inadequate for the task. As the process of deregulation continues and banks diversify into new sectors of the market, problems with bank stability are likely to increase. Thus the government could find the cost of bank support growing, despite the involvement of the private sector in the security fund.

Notes:

17. Nyberg, P. and Vihriala, V., *The Finnish Banking Crisis and Its Handling*, Bank of Finland Discussion Papers 8/93, Bank of Finland, Helsinki, 1993, pp. 12 - 13.
18. Speder, Z., *The Characteristic Behaviour of Hungarian Commercial Banks*, Acta Oeconomica 43, Budapest, 1991, p. 138.
19. Draghi, M., "The Case For and Against Financial Conglomerate Groups: The Italian Debate on the Eve of the European Banking Integration", in Vittas, D., (ed), *Financial Regulation: Changing the Rules of the Game*, EDI Development Studies, The World Bank, Washington D.C., 1992, p. 392.

4. FINANCIAL SERVICE COOPERATIVES IN DEVELOPING COUNTRIES: CRISES AND RESCUE PROGRAMMES

As noted in chapter 1, semi-formal and informal financial intermediation services play a major role in developing countries. Cooperatives in particular are important providers of deposit-taking and credit facilities and have often faced greater financial crises than the formal sector. This chapter examines the experiences of cooperatives involved in financial service provision in Malaysia, Kenya and Latin America.

MALAYSIA

In this case study the expansion of financial institutions, including deposit-taking cooperatives and a variety of unlicensed institutions, during a long period of sustained real economic growth is described. Prosperity encouraged borrowing and speculative investments. Then, in 1985-86, commodity prices collapsed and immediately precipitated crises in a number of financial institutions, particularly illegal ones and the poorly supervised deposit-taking cooperatives. The Malaysian government acted swiftly to restore confidence, including the introduction of an Emergency Act to give them additional powers of intervention. Their investigations revealed extensive mismanagement in the cooperative banking sector and a rescue programme was implemented which, as a result of take-overs, effectively destroyed the involvement of cooperatives in financial intermediation in Malaysia. Many depositors lost some or all of their savings despite the rescue efforts, highlighting again the implications of poor management of financial services.

KENYA

This case study assesses a financial system that has experienced widespread instability since the mid-1980s. The involvement of cooperatives in financial service provision in Kenya is considerable and the experiences of rural-based multi-purpose cooperative unions in banking and urban-based single-purpose savings and credit cooperatives are examined in detail. As in Malaysia and other countries, these cooperatives operate outside central bank supervision and regulation and the disadvantages of this are again identified. No deposit insurance fund is operated by the cooperatives and depositors lost all their savings when four rural banking sections collapsed. Government intervention and support has been limited and the licensing of financial institutions is generally thought to be too liberal. A Deposit Protection Fund Board has now been established for the formal sector.

LATIN AMERICA

Savings and credit cooperatives, based on the credit union model, were widely promoted in Latin America and form an important part of the financial system. The cooperatives operated outside the formal banking sector controls and were allowed to engage in non-financial business activities. By the 1980s, however, many were in financial difficulties largely as a result of poor financial management. In Honduras and Guatemala, the World Council of Credit Unions and USAID were involved in the implementation of financial stabilisation programmes for selected cooperatives and the background to the crises and rehabilitation efforts in these two countries are described in this section. Key features of the stabilisation programmes were staff training programmes and the provision of low or zero cost loans to the cooperatives, which were invested to generate income which was then used to write-off bad debts.

4.1 Malaysia: Expansion and Collapse of Cooperative Banking

4.1.1 The Financial System in Malaysia

1 Malaysia has a fairly sophisticated financial system for its stage of development.²⁰ At the end of the 1980s it had 39 commercial banks, 47 licensed financial companies, 12 merchant banks, 7 discount houses and a host of other specialized financial intermediaries. Foreign banks have a large presence in Malaysia, accounting for 16 of the licensed banks, one quarter of total loans and a fifth of total bank deposits. At the end of 1987, total assets in the financial system amounted to M\$ 140 billion, equivalent to 269.2 percent of GNP. The monetary and banking institutions, representing 70 percent of the total assets of the system, are under the direct supervision of the Central Bank (Bank Negara). The remaining financial institutions are under the supervision of other agencies. For example, deposit-taking cooperatives are supervised by the Ministry of National and Rural Development, while some development banks are supervised by the Ministry of Public Enterprises and others by the Ministry of Finance.

2 Deposit-taking cooperatives in Malaysia sprang from the relatively slow growing cooperative movement in the 1960s. They found deposit taking a golden way to diversify out of the traditional consumer financing and to expand their activities. Spearheaded by the Cooperative Central Bank, a group of 35 deposit-taking cooperatives built up a membership of over one million and had over 600 branches (in comparison to 860 commercial bank branches), with total deposits of over M\$ 4 billion in 19XX. There was minimal supervision over their lending and investment operations and, other than a simple demand that they should hold 25 percent of deposits in liquid form, there were no statutory reserve requirements for deposit-taking cooperatives nor lender of last resort facilities. The Department of Cooperative Development, which was charged with the supervision of all cooperatives in Malaysia, i.e., a total of nearly 3,000, was not equipped to deal with the rapidly expanding and complex operations of the deposit-taking group. The auditing of their accounts was often as much as two years behind time.

3 Apart from the deposit-taking cooperatives, there were some other financial intermediaries that emerged in the 1970s, ostensibly as part of the cooperative movement but in fact operating illegally. They were quasi-finance companies, e.g., pawnbrokers or credit and leasing companies, that collected deposits from the public to finance business activities. As they were operating without the licence required from the central bank for deposit taking, they avoided the constraints of supervision by the central bank and were directly contravening the law.

4.1.2 The Experience of Financial Crisis

1 The banking system in Malaysia experienced a period of continuous and rapid expansion from the early 1970s to the mid 1980s, as the nation enjoyed an unprecedented period of real growth. Favourable commodity prices and the exploitation of oil led to rising incomes and an increase in national savings, including deposits in the banking system. The growth in assets of the commercial banks accelerated from an annual average of 19.1 percent in the first half of the 1970s to 24.4 percent in the second half. There was also a rapid growth in lending, which increased at an average rate of 22.8 percent per annum in the decade from 1975-84. An increasing proportion of this bank credit was used to make investments in real estate and speculate in equities. Stock and real estate markets soared.

2 Against this background, the mid-1980s recession had a dramatic impact on financial institutions and led to the sharpest deflation in Malaysia since the post-Korean War recession of 1952-53. The gradual slide in commodity prices began to accelerate towards the end of 1986, total export income reducing by 2.6 percent in 1985 and 5.9 percent in 1986. Real GDP growth became negative in 1985 for the first time since 1975, while nominal gross national income declined by 2.9 percent in 1985 and 7.9 percent in 1986. Share prices fell by 59.8 percent from their peak in 1984 and total market capitalisation declined by 44 percent to M\$ 46.7 billion at its lowest point in April 1986. Growth of deposits in the banking system fell sharply from an annual rate of 20.3 percent in 1984 to 3.8 percent in 1986 and the rate of loan growth moderated to 6 percent at the end of 1986, compared with the figure of 36.5 percent in 1980.

3 To bank management and their borrowers, the traumatic events of 1985-86 were a shock. Throughout the previous two decades, the Malaysian banking system had enjoyed a period of rising profits. In a period of uninterrupted growth and rising property (and hence security) values, bad loans were negligible and, as late as 1983, specific and bad debt provisions averaged only 1 to 1.5 percent of total loans. Foreclosed property could easily be sold at values higher than the loans outstanding. However, with M\$ 37.3 billion wiped off the stock market capitalisation and property prices falling under selling pressure, the banks began to face the spectre of rising numbers of non-performing loans and bad and doubtful debts in 1985-86.

4 The first major sign of emerging financial distress was in September 1985 when one of the illegal deposit-taking institutions, Setia Timor (Eastern Trust), failed to honour its deposit withdrawals. Depositor nervousness spread and throughout 1986, the country experienced sporadic runs against the weaker financial institutions. Fortunately, most of the banks and finance companies had strong enough backing from their shareholders, but four medium-sized domestic commercial banks and four finance companies did run in to difficulties. Then in July, 1986, a large deposit-taking cooperative, Kosatu, with M\$156

million in deposits, 53,000 depositors and 67 branches, suspended payments. Contagion spread quickly from Kosatu to the other deposit-taking cooperatives and they rapidly ran out of funds to meet demands for withdrawals. By August of 1986, 24 deposit-taking cooperatives were in trouble and the danger of financial failure becoming systemic was a real possibility. Many more of the illegal deposit-taking institutions were also in difficulties and by 1987, 33 of them had failed, involving 8,000 depositors and total deposits of M\$49 million.

4.1.3 Intervention Mechanisms to Support Financial Institutions

1 The government was able to use conventional legal powers and administrative machinery to intervene and rescue the ailing commercial banks and finance companies. However, to cope with the Kosatu crisis, it had to introduce an Emergency Act in July, 1986, incorporating the Essential (Protection of Depositors) Regulations 1986, which empowered the central bank to freeze the assets of Kosatu and its principal officers, to impound their passports and to conduct an investigation. As the crisis spread in the deposit-taking cooperative sector, the government used these regulations to suspend and investigate the other 23 cooperatives in difficulties.

2 The investigations, which involved 17 accounting firms working in conjunction with central bank examination teams, revealed that the 24 cooperatives in distress had 522,000 members, 630 branches and total deposits of M\$1.5 billion. Twenty one of the cooperatives were found to be insolvent, with losses totalling an estimated M\$683 million or 38.8 percent of total assets. Many of them did not maintain the minimum liquidity ratio of 25 percent of deposits and were in no position to meet significant deposit withdrawals. The problems were compounded by gross mismanagement, including:

- over-investment in land and property,
- lack of control over loss-making subsidiaries,
- widespread speculation in shares,
- imprudent lending to directors and interested parties,
- fraudulent misappropriation of funds,
- criminal breach of trust and
- many conflict of interest situations.

Based upon the investigation results, the central bank reported nine cases of fraud and 21 cases of conflict of interest and technical offences to the police.

3 The investigations also revealed numerous instances of blatant disregard for rules and regulations. By opening branches freely (often without permission), offering high interest rates and attractive commission schemes for their branch staff to collect deposits, the cooperatives were engaged in a vicious circle of Ponzi financing, i.e., using new depositors' funds to meet deposit withdrawals and interest payments and to cover their mounting losses. Overall the fundamental structure of the cooperatives was flawed, with gross

undercapitalisation and over-commitment in long-term and speculative assets, funded by short-term deposits. Furthermore, the 24 deposit-taking cooperatives had invested nearly half their assets in connected lending or in their 106 subsidiaries and related companies, which ranged from a newspaper to a cosmetics distribution firm.

4 Following the suspension and investigation of the 24 ailing deposit-taking cooperatives, pressure began to mount for a quick rescue plan. Emotions became highly charged as over 522,000 depositors and approximately M\$1.5 billion in deposits were involved. The government appointed a special Action Committee on Cooperatives, chaired by the Central Bank and with representatives from the government and the private sector. Among the options considered was a plan which involved the refund of up to 25 percent of deposits in cash immediately, placing a further 25 percent in two-year deposits at a maximum of 6 percent per annum interest and converting the balance to equity. This scheme was designed as a general framework to restructure the cooperatives but was rejected when it was prematurely leaked to the press. Depositors expressed very strong views that their deposits should be guaranteed in full by the government as a matter of legal and moral responsibility. They also objected strongly to the conversion of their deposits into equity and demanded legal action against the staff responsible for the failure of the deposit-taking cooperatives.

5 The rescue package that was finally implemented was carried out in three stages. The first stage involved unfreezing the deposits of 11 cooperatives that had relatively small capital deficiencies. In January 1987, these cooperatives, each of which had nearly 100 percent net asset backing for deposits, received soft loans from the Central Bank and reached agreement with the banks or finance companies appointed to take over their assets and liabilities. All depositors in these 11 cooperatives would receive full refunds in cash over periods of up to five years but without interest.

6 Stage two of the rescue plan involved a group of 12 cooperatives with moderate to heavy losses. This scheme provided for a \$1 for \$1 return to all depositors through a combination of cash and equity, of which the cash component would be at least 50 percent, while the balance would be converted into equity in a licensed financial institution that would absorb all the assets and liabilities of the twelve cooperatives. The Central Bank acquired equity in a finance company and utilized it as a rescue instrument under a government-approved scheme for the depositors.

7 Stage three involved the largest of the deposit-taking cooperatives, KSM, which had deposits of M\$ 549 million and an asset backing of about 50 percent. The government accepted a proposal by Magnum Corporation Berhad (MCB), a large, public, listed company, and its licensed finance company subsidiary to take over the net assets and deposit liabilities of KSM. Depositors in KSM would be repaid in full on a 50:50 basis, with 50 percent paid in cash in stages from 1987 to 1989. The remaining 50 percent would be paid initially in the

form of irredeemable, convertible, unsecured loan stocks of MCB, at a price to be determined. The loan stock would be non-interest bearing for the first two years and would be convertible into MCB ordinary shares at a predetermined rate over the two years from 1989-91.

8 To make these rescue schemes work, the Central Bank had to provide a total of M\$ 720 million in soft loans at 1 percent per annum, plus M\$ 280 million in commercial loans at 4 percent per annum for a term of ten years, to the financial institutions taking over the failed cooperatives. Altogether, the rescue of 24 cooperatives, involving deposits of M\$ 1.5 billion, required M\$ 1 billion in loans from the Central Bank, as well as M\$ 23.4 million to cover professional fees incurred in the investigations and receiverships.

9 The prompt action taken by the Central Bank to step in and rescue the failed banks, financial companies and the 24 deposit-taking cooperatives, stabilised public confidence in the Malaysian financial system and prevented the contagion of financial crisis spreading, while the economy was in the trough of the recession. As it turned out, 1987 proved to be a year of strong recovery for the Malaysian economy, which increased the confidence of the public in the economy and the financial sector. While there remained pockets of unresolved problems in the financial institutions, the "Malaysian banking sector has regained health, and concern that the system would collapse has faded".²¹

10 For the cooperative banking movement in Malaysia, however, the 1985-86 crisis was a serious blow. Most of the deposit-taking cooperatives were taken over by other financial institutions and ceased to exist as independent economic units. As confidence was dramatically lost in the cooperative mode of organising banking services, it is difficult to see much future potential for large-scale cooperative banking operations in Malaysia. The scope for cooperative banking activities is also much more constrained by law than before. The government revised cooperative legislation to limit cooperatives to taking only specific deposits from their members, e.g., for housing and education, and not general savings and fixed deposits.

4.1.4 The Safety of Deposits

1 The Malaysian example illustrates how a financial system can evolve potentially out of control when an economy is growing fast. The growth of deposit-taking cooperatives took place with little supervision and a significant number of illegal deposit-taking institutions apparently were allowed to operate with impunity. It is clear, therefore, that the mere existence of regulations is not enough. Controls and penalties against breaches of law failed to deter insider trading, conflicts of interest, lending large sums to interested parties and other large-scale misuse of depositors' funds in the Malaysian banking cooperatives. It was equally clear that pressure from members and depositors was not able to ensure good quality management of these institutions.

2 While economic activity is thriving the risks inherent in uncontrolled lending, particularly for speculative and long-term assets, may be hidden. Recession, however, as in the European examples, quickly precipitates a crisis for under-capitalised financial institutions with weak loan portfolios, excessive connected lending, over-investment in land and property and other features of poor financial management. In Malaysia, this was proved by the collapse of deposit-taking cooperatives and illegal deposit-taking institutions in 1986. The total assets of these institutions altogether did not exceed M\$5 billion, i.e., 2.5 percent of the total assets of the financial system, but nevertheless involved over half a million depositors. Many of these depositors lost some or all of their savings as a result of the crisis and, as part of the cooperative rescue, were forced to accept delayed repayments without interest or conversion of their deposits into equity.

3 The prompt action of the Malaysian government to rescue those commercial banks that failed and to introduce legislation which enabled them to intervene in the cooperative crisis, prevented a widespread loss of public confidence in the financial system and this was clearly important in protecting the safety of other deposits. The rescue efforts were costly, however, and it would certainly be cheaper for the government to devote more resources to regular inspections and accurate monitoring of financial institutions than to fund further rescues. It is also important to ensure decisive action is taken to address the problems of ailing institutions once they are identified, as delays invariably compound the difficulties and costs involved. The fact that the financial crisis in Malaysia centred on the deposit-taking cooperatives that operated outside the supervisory structure of the central bank and the safety net designed for the banking sector, suggests that consideration should be given to widening the formal regulatory system to cover such semi-formal intermediaries, if the safety of deposits is to be increased. In the last analysis, though, the safety of deposits in Malaysia depends on the quality of the management of financial intermediation services.

4.2 Kenya: Experience Leads to Single-purpose Financial Service Cooperatives

4.2.1 *The Financial System in Kenya*

1 In the African context, Kenya's financial system is well developed with a large number of operators and widespread branch networks. By the 1980s the range of financial intermediaries included 30 commercial banks, more than 60 non-bank financial institutions and 10 building societies. There were also six development finance companies, the Kenyan Post Office Savings Bank with a large branch network and numerous cooperatives offering savings and credit services. The 30 commercial banks had between them more than 230 full branches, 80 sub-branches and 160 mobile units, i.e., over 470 banking outlets in all. Their total deposits amounted to Kshs 82 billion. The non-bank financial institutions offered practically the same services as the commercial banks, with the exception of foreign exchange business and cheque accounts services. Their total deposits amounted to approximately Kshs 40 billion. The Central Bank of Kenya performs the conventional functions of a central bank. They faced an increasingly complex task of supervision and control as the banking industry grew throughout the 1980s.

2 The involvement of cooperatives in financial service provision began in the 1960s. At that time cooperatives were seen as appropriate organisations to mobilise deposits from rural small-scale producers and urban salary earners. The pooled funds were to be used to issue loans to members, thus creating a source of credit for people who would not otherwise qualify for loans from commercial banks due to their lack of tangible securities. Over a 25 year period the cooperatives offering financial services grew to become important operators in Kenya's financial market, holding more than Ksh 15 billion in deposits by the mid 1980s. The organisations involved in the structure at this time were:

- (i) The Cooperative Bank of Kenya Ltd. - the central organization of the cooperative banking movement, with a nationwide network of 22 branches and total deposits of Kshs 2.6 billion;
- (ii) over 2000 urban based savings and credit cooperatives (urban SACCOs), with about 820,000 members and total deposits of Kshs 12 billion;
- (iii) 7 Union Banking Sections of rural multipurpose cooperative unions, with total deposits of Kshs 1 billion; and
- (iv) 30 producer based savings and credit cooperatives (rural SACCOs), with total deposits of Kshs 98 million.

These cooperatives, with billions of shillings in deposits, operate outside the prudential guidelines and controls of the central bank (just as deposit-taking cooperatives did in Malaysia). They function under the Cooperative Act and are controlled by the Ministry of Cooperative Development.

4.2.2 *The Growth of Financial Crisis*

3 From the mid-1980s, the financial sector in Kenya experienced a great many problems and almost continuous instability. Some commercial banks failed but it was among the non-bank financial institutions that the worst problems occurred. Various factors have been linked to the instabilities of Kenya's financial market. The persistent recession, combined with political instability and the related reduction in investment and donor fund inflows, created a difficult environment for the financial institutions' operations. Within the sector, there was evidence of serious mismatching, politically influenced credit distribution, systematic breaches of the Banking Act and a general lack of professional management of banking institutions. While there is adequate legislation for banking sector operations in Kenya, the Central Bank has been in practice a weak controller of financial institutions, which often have close connections with the political elite. A matter of concern for donors and other critics has been the ease of entry in to the financial market. Liberal licensing of financial institutions, which continued into the early 1990s, allowed too many 'spoilors' to enter the sector, with a disastrous impact on the management standard and the safety of investments in Kenya's financial sector.

2 During the banking crisis of 1985-86, several indigenous financial institutions collapsed. Weaknesses identified in these failed institutions included liquidity constraints, poor asset quality, weak internal controls and violations of the Banking Act. Furthermore, when rumours of a potential crisis in a financial institution start to circulate in Kenya, the standard response is a run on the institution which lasts until the bank offices are closed to further withdrawals. Evidence of continued instability came in 1993 when 15 financial institutions were put under the control of the Central Bank. Most of these were eventually closed down.

3 The rapid growth of cooperatives involved in financial service activities also brought problems. The legal framework and external control systems under which they operated were quickly outdated. The Cooperative Act concentrates on organisational issues and is weak on regulations and financial rules. The Ministry of Cooperative Development, which is the controlling organisation, does not have the resources to exercise active control over cooperatives involved in financial services. With weak external supervision, the safety of deposits in savings and credit cooperatives was solely dependent on the quality of management in each cooperative. The vulnerability of this situation became clear when several cooperatives lost large amounts of savers' funds in their investment activities and four rural banking cooperatives collapsed, causing substantial losses to their depositing members. The experience of the cooperative movement in financial service provision in Kenya is examined more closely in the following sections.

4.2.3 The Rural Cooperative Banking Sections

1 The large coffee-based cooperative unions in Kenya's Central Province were the first to introduce banking services to their members. These unions are registered as multipurpose secondary societies. Their main activities include processing and marketing of coffee and/or other cash crops, transport, farm input supply, book-keeping services, training and education. Banking services are set up as sections within the unions. A banking sub-committee, recruited from the union's management committee (the Board) handles the banking section's affairs, together with an employed banking secretary and staff. The main reasons for the multipurpose cooperative unions moving into financial service provision were:

- the unions covered a viable number of farmers through affiliated societies;
- the unions had a book-keeping pool;
- credit schemes had already been introduced through the unions;
- the unions had more qualified staff than the primary societies; and
- the unions had tangible collateral which could be utilized if external loan funds were needed to boost the banking section's lending operations.

2 As a result of marketing coffee and paying the proceeds direct to members' savings accounts in the banking sections, the volume of financial operations grew rapidly. By the early 1980s, the large coffee unions had become self-sufficient in funds and, after covering the seasonal and medium-term loan requirements of the farmers, had large amounts of liquid funds to invest in banks and financial companies. The profits from banking section operations in the coffee unions covered a major share of these unions' total overhead costs. Table 4.1 illustrates the growth of the union banking sections in Kenya and shows how successful they were in mobilising rural savings.

Table 4.1 *Union Banking Sections in Kenya*

	1980	1993
Number of Union Banking Sections	15	11*
Total members served	328,000	527,000
Total savings (Kshs Million)	277	1,060
Total loans (Kshs Million)	228	528

* Since 1980, four banking sections have collapsed.

3 The first major problems in union banking sections emerged in the mid-1980s, when a large number of Nairobi-based financial institutions collapsed. Attracted by higher than normal interest rate offers, various cooperative banking sections had invested their liquid funds in these backstreet banking organisations (a similar experience to that of the Hungarian cooperatives). They lost as much as Kshs 40 million. As it happened it was the better-off banking sections that lost these inter-bank deposits and they managed to cover the losses from their reserves. Thus, there were no direct losses for member depositors.

4 The financial crises suffered by a number of weaker union banking sections were more serious. Between 1987 and 1993, four banking sections collapsed due to a combination of factors, which included the use of members' savings to cover non-viable union activities, a lack of banking discipline and control and poor loan management. Details of the failures are given in Table 4.2.

Table 4.2 *Failed Union Banking Sections in Kenya, 1987-1993*

Union Banking Section	Year of Collapse	Savings Lost (Kshs Mill)	Member Loans (Kshs Mill)	Number of Members
Nyahururu	1987	4	0	7,000
Masaba	1987	3	2	25,000
Bungoma	1990	24	16	41,000
Machakos	1993	73	23	69,000
Total		104	41	142,000

5 Efforts to recover the outstanding loans from members of the unions in which the banking sections failed made little progress. This was a cause of major concern to the remaining union banking sections. A substantial part of their loan portfolios was also thought to be unrecoverable, possibly as much as 18-20 percent of the total loan amount of Kshs 500 million. No banking section had made adequate provision for bad debts; most had made no provision at all. The potential for crisis precipitated by non-performing loans was considerable.

4.2.4 *Urban Savings and Credit Societies*

1 The first urban savings and credit cooperatives (urban SACCOs) were registered in Kenya in 1964. The main objective of urban SACCOs is to mobilise the funds of their members, who normally have a common bond, e.g., all being employees of one company or ministry. Deposits are collected by direct deduction from members' salaries and loans are then made to members from the pooled funds. This type of cooperative banking, based on a credit union model, has proved to be a success in Kenya. In 1990 there were 1,580 urban SACCOs with 864,350 individual members and the equivalent of US\$ 320 million in total deposits.²²

2 The rapid growth of these institutions did not take place without problems. Although they were supported by detailed operational guidelines and manuals, the standard of management of the urban SACCOs varied considerably from one cooperative to another. A major area of concern was again the weakness of external supervision and control. No formal system of supervision was provided by the Ministry of Cooperative Development or the apex organization of urban SACCOs, the Kenya Union of Savings and Credit Cooperatives (KUSCO).

3 The system of direct deductions from salaries and members' deposit balances provide security against default in urban SACCOs' lending to members. The factors that led to increased instability in the Kenyan urban savings and credit societies were related to their other investment operations. First, as was the case with the rural banking sections, the urban SACCOs invested liquid funds in new financial institutions which offered higher interest rates than the Cooperative Bank or the large commercial banks. The failure of many of these finance companies in the mid-1980s caused large losses to the savings and credit societies and weakened the financial status of many of them. Second, the bigger, nationwide SACCOs, encouraged by their impressive growth performance in the 1980s, started to invest in real estate in Nairobi and other urban centres. The largest projects had budgets exceeding Kshs 500 million and the total value of these real estate investments amounted to approximately Kshs 5 billion. Some 20 percent of this money came from members' deposits and 80 percent was borrowed from the Cooperative Bank of Kenya.

4 The speculative investments in real estate were a clear deviation from the original objective of the savings and credit societies. To service their investment loans from the Cooperative Bank, several large SACCOs were obliged to postpone the issuing of new loans to members, even when a member had clearly qualified for a loan according to the SACCO rules regarding level of accumulated savings. Similarly, some SACCOs reduced or stopped the payment of interest on members' savings accounts because of the large commitment to real estate activities. While the final outcome of the real estate investments largely depends on the general development of the Kenyan real estate market, the speculative nature of the investments clearly increased instability in the cooperative savings and credit movement. A collapse in the Nairobi real estate market would pose an immediate threat to the survival of many of the largest savings and credit societies in Kenya and seriously endanger the safety of savings in this part of the Kenyan cooperative movement.

4.2.5 The Safety of Deposits

1 The rapid expansion of the number of commercial banks and branches in Kenya in the 1980s meant that the management skills in the banking industry were spread very thin. This increased the need for control and supervision by the Central Bank, which itself faced an increase in the volume and complexity of its operations as a result of the Structural Adjustment Programme adopted in the 1980s. Thus the supervision provided by the Central Bank has not been adequate to ensure the stability of all licensed financial institutions in Kenya and depositors' savings have been at risk.

2 In the wake of four bank failures in Kenya in 1985, the Deposit Protection Fund Board (DPFB) was created to protect depositors in the event that a bank is not able to meet all its obligations. The DPFB provides deposit insurance with a maximum cover of Kshs 100,000 per individual. It is also authorised to initiate pre-emptive action to reduce the risk of insolvency of a bank. Membership of the DPFB is compulsory for all licensed banks and financial institutions but not for cooperative unions and societies offering financial services. The Fund is financed by contributions from member organisations. The funds and manpower resources of the DPFB are fairly limited and its establishment has not reinstated the confidence of the public in the safety of saving deposits.

3 When the four rural cooperative banking sections failed, depositors lost a total of Kshs 104 million. There was no compensation of any kind available. Thus the safety of members deposits in these rural cooperative unions depended solely on the quality of the management. Furthermore the organisational structure of the banking sections had inherent weaknesses when it came to the safety of members' deposits. First, as the banking operations were carried out within the general framework of the union, the collapse of the union itself meant that the funds deposited in the banking section could be used to settle the claims of the union's creditors. Secondly, the deposited funds could be used to finance non-viable activities. There were several instances of the chairmen and general managers of unions using banking section funds to cover the losses of other union activities. This was done either through a formalised union overdraft or simply by withdrawing money from banking section accounts.

4 Both the above practices were against the rules approved by the Commissioner of Cooperatives but, even if the cases were well known, they seldom created any reaction from the Ministry of Cooperative Development. This highlights the third major weakness of the system which was the inability of the Ministry officials and the members to guarantee honest and professional management of depositors' funds. Problems existed both in the lending operations to members and in the investment of liquid funds in other financial institutions. Furthermore, the smaller unions tended to recruit their banking staff and union managers based on merits other than the professional skills required for the job.

5 As a result of these weaknesses, the Commissioner for Cooperative Development launched a new concept of autonomous, producer-based savings and credit cooperatives (rural SACCOs) in 1988. The strategy was to create single-purpose cooperatives which would facilitate professional specialisation and increase the safety of members' deposits. All new producer-based savings and credit activities were to adopt the rural SACCO concept and the surviving union banking sections have been gradually converted into independent rural SACCOs. Although the new format reduced the dangers of misuse of savers' funds for non-viable union activities, various problems remained. The issues of regulations, prudential

guidelines and adequate supervision remained unresolved. Rural banking supervision activities in the Ministry of Cooperative Development were strengthened with donor support but to prevent future crises, an alternative to the current ministry-based control model would be preferable.

6 The absence of adequate control and supervision was just as evident in the operations of the urban SACCOs. The only interventions by the Ministry of Cooperative Development had taken place in cases where the financial problems of the cooperatives had already reached crisis stage. Thus, even if the emphasis in savings protection is on preventive methods such as improved control, some type of a deposit insurance scheme needs to be introduced to compensate for at least the savings of the smaller rural and urban depositors in the event of future cooperative failures.

4.3 Latin America: Stabilising Savings and Credit Cooperatives

4.3.1 The Latin American Savings and Credit Cooperative System

1 Savings and credit cooperatives, based on the credit union model, were widely promoted in Latin America during the 1950s and 1960s. Cooperatives were organized in both work places and communities and by 1972 had accumulated nearly US\$160 million in members' savings. National federations had been organized in every country, providing trade association, development and, in some cases, central banking services. These federations established COLAC, the Latin American Confederation of Credit Unions, to represent them regionally and to provide technical and financial services across national boundaries. By 1992, 18 national movements were affiliated to COLAC, representing nearly 4.8 million individual members with US\$1.3 billion in savings invested in over 16,000 local cooperative institutions. Six national movements alone had total assets exceeding US\$100 million and region-wide assets totalled over US\$2.0 billion.

2 The savings and credit cooperatives established in Latin America were an amalgam of credit union and traditional agricultural and consumer cooperative features, a mixed identity which affected their stability during the 1970s and 1980s. From credit unions came a focus on financial services, including savings deposits received initially in the form of shares, and personal loans, issued primarily for consumer and small business or agricultural purposes. The cooperatives were organised around a common bond, typically a place of employment or a church parish. Pricing was based on the credit union model, with a 12% annual interest rate on loans (1% per month on the declining balance), 6% to cover projected operating expenses and reserve costs, leaving 6% for patronage refunds and dividends or interest payments.

3 Although organised like credit unions, the cooperatives were chartered under cooperative societies acts and were structured legally and financially more like agricultural and consumer cooperatives. This meant that shares were considered "risk capital", could not be easily withdrawn and earned only limited and rarely competitive returns. Capital reserves were based on net income and establishment of loan loss provisions or allowances was not required. Finally, the savings and credit cooperatives, unlike credit unions, were permitted and even encouraged to engage in non-financial business activities, thus diluting their capital and liquidity while expanding their risks and reducing interest earnings.

4 Although most of Latin America's savings and credit cooperatives were self-financing through saving mobilisation and, in aggregate, total savings exceeded total loans outstanding, external funding played a key role in the development of the movement's secondary (national federations) and tertiary (COLAC) organizations. This funding included both operating grants to support promotion and training and capital funds for on-lending to designated target

sectors, principally agriculture and small business. Capital funds were typically provided at subsidised interest rates and in some cases had ceilings on the maximum rates that could be charged to the end borrower. The purpose of the subsidised rates was two-fold: to stimulate borrowing and productive investment at the end borrower level and to provide earnings to the nascent federations and COLAC to cover their education and promotion expenses. While well intentioned, this funding strategy produced unfortunate, destabilizing results. It contributed to over-indebtedness and, hence, over-gearing of both individuals and institutions, insider lending, poor loan appraisal, increased delinquency, dependency on outside funding and, in some cases, to technical insolvency.

5 By the end of the 1980s, the Latin American savings and credit cooperative movement was facing a crisis. Although thousands of local cooperatives and offices still existed, many were operating at the margin of viability. Inflation and hyper-inflation had reduced the real value of members' savings, excessive loan delinquency and over-investment in non-financial assets had reduced earnings, real yields on savings were generally negative and capital ratios (excluding shares) had fallen to minimal levels. A minority of cooperatives had responded by offering market-rate deposit savings accounts and were improving services through computerisation and diversification of their product offerings but many societies were stagnant or declining. Only mobilisation of new deposit accounts, restrictions on the withdrawal of share savings and member loyalty prevented the outright failure of many cooperatives. Nonetheless, the widely publicised failure of two major cooperative quasi-banks in Peru and state intervention in the largest savings and credit cooperative in Ecuador demonstrated the extent of the crisis.

6 The problems faced by savings and credit cooperatives and their secondary and tertiary service organizations were quite similar throughout the region. Renewed economic growth and the reduction of inflation have helped some societies to stay in business but significant real savings growth and a return to financial stability have been achieved by relatively few movements. In Honduras and Guatemala, savings and credit cooperatives were the most widespread financial institutions directly serving the urban and rural, middle and lower income populations. As part of the cooperative movements in these countries, they were regulated by independent agencies which conducted audits but had little power or effectiveness when it came to the supervision of financial institutions. Furthermore, members' deposits and share savings were not protected by government guarantees or any other programmes. As grassroots organisations they were thought to be well placed to benefit from financial reform and increase the level of competition in the financial markets of these countries. So between 1984 and 1992, the World Council of Credit Unions, COLAC and others conducted analyses of these cooperatives and developed strategies to protect members' savings and rehabilitate the movements, which are described in the following sections.

4.3.2 Crisis in the Savings and Credit Cooperatives of Honduras and Guatemala

1 In Honduras the number of Savings and Credit Cooperatives grew continuously between 1972 and 1988, reaching a total of 83 individual societies, owned by over 57,000 members with some US\$50 million invested in share and deposit savings accounts (about 5.8% of the private savings market). The cooperatives were widely dispersed throughout the country and were highly active in real estate, small business and agricultural lending. Many, however, were technically insolvent, with loan delinquency averaging nearly 25% of the total loans outstanding, compared to loss provisions of just 3%. With an overall capital ratio (excluding shares) of only 2.7%, members stood to lose nearly 10% of their share savings accounts.

2 The Guatemalan savings and credit cooperatives also enjoyed constant growth during the 1970s and early 1980s, reaching totals of 77 cooperatives, over 87,000 members and nearly US\$17.5 million in savings by 1985. Unlike Honduras, however, the Guatemalan movement suffered severe financial problems as a result of the political instability and violence of the 1978-1983 period, economic recession and devaluations of the national currency. By 1988, the level of savings had fallen to US\$12.2 million and overall loan delinquency amounted to 30% of the total portfolio (measured by delinquent payments outstanding), compared with a loss provisions of about 5%. The overall capital ratio was less than 2% of assets. On a country-wide average basis, cooperative members would have lost up to 40% of the nominal value of their share savings accounts, were their cooperatives to have been liquidated.

3 Both countries had national federations to which the savings and credit cooperatives were affiliated. The services provided by these federations included central finance (wholesale savings and credit, like central banking), on-lending of international development funds, training and education of cooperative leaders and staff, group term life insurance on members' savings and loan account balances and representation of the movement when dealing with government and other entities. In addition, the National Federation of Honduras (FACACH) operated a variety of non-financial social and economic development programs funded by international donor agencies. During the 1980s, both federations were experiencing financial difficulties. By 1987 FACACH was insolvent due to the high delinquency in its externally funded development loan portfolio and repeated operating losses produced by its agricultural production, processing and marketing programmes.²³ Its failure would have doubled the potential losses of the cooperative members in Honduras and provoked runs on the cooperatives. The Guatemalan National Federation (FENACOAC) was solvent but heavily dependent on earnings from external development loan funds to subsidise its training and extension programme.²⁴

4.3.3 *Financial Stabilisation Programmes*

1 When it became evident, between 1984 and 1986, that many of the savings and credit cooperatives in Honduras and Guatemala faced severe solvency problems which were likely to have a detrimental effect on the development of the countries' rural financial markets, external assistance was sought. Financial support was obtained from the United States Agency for International Development and technical assistance from the World Council of Credit Unions and COLAC. Development projects were designed and implemented to address the two principal problems facing the cooperative movements: inadequate financial management skills and discipline, particularly in lending, and insufficient earnings, capital reserves and loss provisions to absorb the cooperatives' loan and other losses.

2 Based on the experience of the credit union movements in the United States and Canada, financial stabilisation programmes were developed to address the financial crises and institutional development programmes were developed to strengthen operations, primarily by staff training and education. Financial stabilisation programs were originally created by credit union movements to protect members' savings in the absence of deposit insurance. They were designed to ensure a public image of credit unions as sound financial intermediaries, despite their independence from the banking sector and its government guaranteed deposit insurance. In the United States and Canada, these programmes have now been replaced by deposit insurance.

3 The financial stabilisation programmes implemented in Honduras and Guatemala did not include deposit insurance, i.e., they did not offer an explicit guarantee to savers that their funds, either in their entirety or up to specified limits, would be repaid in the event of failure. Instead, they provided financial and technical assistance to the cooperatives as *preventive measures* to reduce the risk of failure, as was done in the United States and Canada in the years before deposit insurance. The key steps in the stabilisation process are summarised below:²⁵

- (i) completion of a diagnostic study of the cooperatives and federations, including a detailed financial analysis and assessment of their business and development potential;
- (ii) preparation of business development plans, including strategic mission statements, financial projections and key performance indicators to monitor during rehabilitation;
- (iii) selection of the participant organisations in the stabilisation programmes and agreements signed, specifying conditions for assistance and mutual obligations;
- (iv) implementation of the rehabilitation programme, comprising disbursement of stabilisation loans, adoption of new financial policies and controls, training, enhancement of office facilities and implementation of computerised information management systems;
- (v) periodic evaluation of participant performance against the standards set in the business development plans;
- (vi) renewal, modification or termination of the participation agreements depending on the achievement of performance indicators and implementation success.

4 Some of the actions that the participating cooperatives agreed to undertake included cessation of non-financial business activities, repricing of services to market levels, creation of loan loss provisions, capitalisation of net earnings, improved collection of delinquent loans, write-off of bad debts and other non-performing assets and introduction of marketing programmes to increase growth rates and profitability. The stabilisation programmes provided zero or low cost loans to the participant cooperatives and federations which were invested in government bonds in Honduras and finance company debt instruments in Guatemala. The net interest earnings on these investments were then used to write-off the loss "assets" on the participants' books gradually over a five-year period, thus allowing the cooperatives to rebuild loss provisions and capital reserves from operating income. The capital funds lent to the participants were fully secured by the invested funds themselves. Upon conclusion of each individual stabilisation agreement, the principal was returned intact to the stabilisation fund to be used for stabilising other cooperatives. Recapitalisation of FACACH, the insolvent Honduran federation, was accomplished by direct deposits in the federation itself and by giving low-cost, secured loans to cooperatives to invest in new share accounts in the federation.

5 During the first five years of the stabilisation programmes, 49 cooperatives and the two federations were rehabilitated, protecting the savings of over 120,000 people in Honduras and Guatemala. A new, "safety-conscious" management mentality was developed in both participating and non-participating cooperatives. A new generation of leaders and managers incorporated sound business principles into their management strategies, replacing the previous perception of cooperatives as social organisations independent of financial market forces.²⁶ However, the technical assistance to the participants and operation of the stabilisation funds, continued to be externally subsidised and institutionalisation of the process in indigenous organisations was only just beginning. Many savings and credit cooperatives remained to be stabilised. Table 4.3 summarises the financial results of the stabilisation programmes in Honduras and Guatemala.

Table 4.3 *Cooperative Stabilisation Results*

Performance Variables	Honduras		Guatemala	
	1988	1992	1988	1992
SAVINGS (in millions)	Lempiras		Quetzales	
Nominal local currency	L/44.3	L/152.6	Q/24.9	Q/93.1
U.S. dollar equivalent	\$19.7	\$22.2	\$9.2	\$17.7
Constant 1985 local currency	L/39.6	L/69.2	Q/14.6	Q/23.7
Annual percentage growth rate in constant currency	14.9%		12.9%	
ASSET QUALITY				
Loan delinquency rate	23.3%	15.1%	14.9%	6.9%
CAPITAL ADEQUACY / PROTECTION				
Capital to assets ratio	2.7%	6.2%	5.5%	9.0%
Loss provisions to delinquent loans ratio	12.8%	14.5%	33.3%	57.8%
EARNINGS / PROFITABILITY				
Operating cost as percent of assets	7.7%	5.5%	6.4%	7.9%
Net income as percent of assets	(0.9)%	2.3%	2.4%	2.2%

Sources: **HONDURAS:**

USAID: *Sintesis Informativa del Sector Cooperativo de Ahorro y Credito de Honduras*, March 1993.

GUATEMALA:

World Council of Credit Unions: *Credit Unions Retooled: A Road Map for Financial Stabilization*, March 1993 and *The Impact of Credit Unions in Guatemalan Financial Markets*, November 1993.

BOTH COUNTRIES:

International Financial Statistics, International Monetary Fund, Washington, D.C., January 1994 (exchange rates and consumer price indices).

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26. See Lennon, B. and Richardson, C., *The Impact of Credit Unions in Guatemalan Financial Markets*, Project Report, WOCCU, 1993; Richardson, D., Lennon, B., Branch, B., *op cit* and Agency for International Development, *Sintesis Informativa del Sector Cooperativo de Ahorro y Credito de Honduras*, (Informational Summary of the Credit Union Sector of Honduras), Tegucigalpa, 1993.

5. SAFEGUARDING DEPOSITS IN THE INFORMAL SECTOR

SUMMARY

This chapter

- Identifies the importance and success of small informal savings and credit associations in developing countries.
- Describes the procedures that ensure strict financial discipline and deposit safety are maintained in both rotating and accumulating savings groups.
- Notes the significance of local knowledge and community pressure in achieving a high degree of loyalty from members and minimising default.
- Assesses the circumstances that encourage the growth of informal sector commercial finance companies in the deposit-taking market.
- Indicates the high level of risk to the safety of deposits in such companies.

5.1 Key Characteristics of Informal Sector Operations

1 The informal providers of financial intermediation services are critically important in many developing countries. Small savings and credit associations are often characterised by strict financial discipline and a high degree of safety for deposits. However, when the scale of operations increase, these informal organisations start to experience problems. There is evidence to show that saving in large, often unauthorised groups of this kind is very risky and some consider that they should be subject to more prudential regulation and public supervision.

2 The fact that financial leniency is much less common in small savings and credit associations is one of the most striking differences between the formal (or semi-formal) and informal sectors of financial markets in developing countries. There is so much evidence of formal or semi-formal operators granting loans to clients who are not creditworthy and of collusion between borrowers and loan officers to gain personal benefits. In the informal sector, however, where the source of funds is in most cases the people's own savings, the savings and credit association members have done everything possible to make sure their money will not be lost. If there is any doubt, people will not pool their funds and will generally look for other options for their savings.

3 The strategies used to preserve savings and avoid losses are as varied as the informal sector itself. They are usually a mixture of prudence, careful observation of the credibility and creditworthiness of partners, in-depth assessment of business opportunities and risks and steps of precaution and prevention. The sanctions employed in the informal sector in most cases effectively prevent people from acting dishonestly. It is revealing to talk to borrowers about their attitudes towards their obligations to different types of financial institution. Somebody taking a loan from a development bank or cooperative society may be quite prepared to default, whereas he would do everything possible to pay his savings contribution

and loan repayment on the stipulated day to an intermediary in the informal sector. In many cases, members of a savings association would be prepared to borrow money to maintain their savings contributions and repayments but they would be much less likely to do so in the case of a bank, project or cooperative loan.

5.2 Savings and Credit Associations

1 The most common form of informal savings and credit associations, rotating savings and credit associations (ROSCAs), together with the non-rotating kind, are found in most developing countries. A great deal has been written about their operation in these countries, covering even small localised versions. While few authors have systematically assessed the financial performance of the associations, most agree that compliance with the obligations to make savings contributions in time and to repay loans at the maturity date is very high.²⁷ In those cases where analysis has been undertaken, the results confirm these general indications. For example, one study of savings and credit associations or Bams among the Tiv in Nigeria, found repayment rates of 98 percent in the late 1960s²⁸ and a later study of the Bams identified a default rate of 1.3 percent and a similar low rate of 4.4 percent in the associations or Oja of the Igala people²⁹. Chit funds in India, operated by individuals rather than groups, are reported to have bad debts of no more than 7 percent of total transactions, while the proportion of bad debts in the "nidhi" (mutual benefit funds in South India) are zero.³⁰ In Thailand the proportion of ROSCAs that faced difficulties with default was just 0.5 percent on average.³¹

2 Various systems and procedures have contributed to this high level of savings and credit discipline in informal savings and credit associations. Every association starts its operations with the careful selection of co-members and co-savers. Whether an individual tries to get a new ROSCA started and wishes to select and convince others to join, or whether a potential member looks around for a suitable savings association, people invariably screen and assess each other thoroughly. In the rotating associations, each member is expected to have a source of revenue that will enable them to make payments as agreed. Where loans are granted, all the members must have a good reputation, credibility and creditworthiness. If these conditions cannot be met by a potential member, he or she usually refrains from joining such a group.

3 When a savings group starts operating, members usually select a chairperson, a treasurer and a secretary, thereby separating various roles and duties and in many cases creating a system of mutual control. The financial transactions are frequently carried out in public and not behind closed doors. When all members are present, the "four-eyes-principle" is firmly established and the risk of theft and cheating is reduced.³² In the 1990s almost all informal groups keep records.³³ They are a means of avoiding confusion, of ensuring transparency in dealings and enabling the accuracy of transactions handled by the

committee(s) to be checked. Where members are suspicious, they may demand that personal savings pass-books are issued, in which all savings contributions are recorded. In some cases, the positions of those handling cash are duplicated to reduce the probability of errors, mismanagement and embezzlement.

4 In ROSCAs, the rotation of the day's total collection is determined in many different ways but, invariably, only reputable members will be given an early position, while new members will be given later positions. A system of auctioning the hand-out is practised primarily in those groups where the credibility of all members is beyond doubt. In Thailand, for example, the organiser and money collector receive bids from among the members and allocate the total amount collected to the highest bidder. If any of the members default, the collector is held personally responsible and expected to make up for the defaulter. The reward or compensation for this risk is that he or she receives the first round without any surcharge.³⁴ Most informal groups have a limited life span, although members usually start a new round immediately after terminating one. When funds are accumulated, these are usually redistributed to the members at the end of a cycle. As a result of this practice, the amounts invested into one system are limited and the risk of loss is minimized. While this is advantageous from the point of security, it is a serious constraint to financial development as no reserves are built up and no loan fund is available at the beginning of a new round.

5 In those savings and credit associations where deposits are built up, the security of the funds is a major concern for the members. If the accumulated funds are not used to make loans, they are usually deposited with formal financial institutions, provided that the transaction costs are not prohibitive. However, most groups prefer to utilise their funds for granting loans to members and, in exceptional cases, to non-members. Loan and collateral conditions vary from place to place and are more varied and innovative than in the formal sector. Techniques used by groups prior to disbursement to reduce risks and make sure that funds are repaid commonly include:

- a) careful assessment of the creditworthiness of borrowers in terms of their total assets, honesty, performance in the group, previous track records of borrowing, financial obligations in the family, amount of other debts, regularity and amount of income, purpose of project, profitability of project to be financed;
- b) limitation of loans to productive purposes;
- c) presentation of one independent witness for the transactions;
- d) presentation of one or several guarantors from among the members, who may stand with their personal savings and their other total assets for the borrower;
- e) pledging of personal goods;
- f) reducing the amount agreed per borrower, thereby enabling more members to be served with smaller amounts rather than a few with large amounts; and
- g) deducting the interest from the loan amount before issue.

6 A very important aspect of ensuring the safety of funds in savings and credit associations is the enforcement of repayment. In sharp contrast to the leniency and lack of enforcement in the formal sector, there is an abundance of sanctions against defaulters in the informal sector. These sanctions are fine-tuned by the organisers and members of savings associations, in accordance with socio-cultural norms, local customs, patterns of behaviour and value systems. In most cases the sanctions are part of the customary law system, often proving that underneath the state laws, customary laws continue to exist and function, probably much more effectively than the state laws. In fact such traditional law systems in ethnic societies are not stagnant and rules and regulations develop over time.³⁵

7 In general, as in the formal sector, the steps undertaken to enforce payments are predetermined and prescribed and the pressure exerted is gradually increased. A typical series of steps might include:

- i. a reminder from the committee
- ii. a warning from the chairperson
- iii. an invitation to explain the reasons for defaulting to the committee/members
- iv. imposition of a fine
- v. a final warning
- vi. confiscation of savings
- vii. confiscation of the guarantor's savings
- viii. confiscation of other assets belonging to the borrower
- ix. the announcement of a date when these assets will be auctioned
- x. conduct of the auction.

8 In centralised societies, intervention by the higher ranks of the local socio-political strata is usually sufficient to make sure that defaulters look for some money to repay their debts. Direct pressure, the threat of being expelled or the news of their default being made public and the loss of deposit facilities and credibility are usually sufficient to exert adequate pressure on the defaulter. Customary law provides the framework for all this and the actions undertaken are usually familiar and widely accepted by everyone in the community. Thus there are seldom any arguments over the cases and the police and the courts are rarely requested to intervene. The few cases of legal recourse reported in the literature are insignificant and, in most of these cases, the village authorities have utilised their ties with the state to request assistance as a favour, not as a legal matter. Apart from direct sanctions against a defaulter, there are also sanctions operating within the wider community network. In hierarchical, centralised societies, the village authorities may prevent redistribution of goods to defaulters or ban a person from mutual help systems. In fragmented or decentralised societies, the interruption of reciprocity may play a more decisive role.

9 The remaining critical aspect for the safety of deposits in informal savings and credit associations is the physical preservation of cash. This issue is not relevant in the simple rotating savings associations but is of importance in all non-rotating groups in which funds are accumulated. Most groups try to reduce the amount of cash kept in the group funds by either granting loans to members or by depositing surplus funds in banks and other financial institutions. When groups deposit a part of their savings in a bank, they usually have one to three signatories for the account, with multiple signatures needed to withdraw money. The pass-book may be kept by a different committee member.

10 If groups are too remote from banks, or access to banks in cases of urgency is not assured, or people have no trust in the banks, or withdrawals are too bureaucratically regulated, accumulated funds may be stored by the groups themselves. These funds often remain with a respected chairperson or treasurer, frequently a female member of the group with whom funds are thought to be safer. Usually people make sure that such a person is rich enough to be able to resist misusing the group's funds. In some cases, groups put the cash into a secure box, lock it and hand the key and the cash box to different persons. If this is not enough in the eyes of the members, the chairperson may hand over the box and the key to different persons in turn, without making known to the ordinary members who actually has them at any one time. In all such cases, the cash to be stored is counted in public, the amount noted in the books by the secretary and the box then locked. At the next meeting, the box is opened in public, the amount counted and checked against the records of the secretary. In the "caisses villageoises" or village banks in Mali, Gambia and some other countries, a strong safe is one of the main incentives for members to join these organisations.

11 With systems and procedures of the types described, informal savings and credit associations usually follow a sound policy of risk avoidance and provide a safe deposit facility for small savers in developing countries. There have been suggestions that these associations should be registered and licenced to operate, becoming subject to written by-laws, prescriptions regarding minimum capital and limitations on contribution per member. However, experience with state involvement in formal and semi-formal financial institutions in developing countries, suggests that government intervention in the informal sector would be unlikely to improve the safety of savings in these groups. Furthermore, the informal savings and credit groups which have experienced most problems, have been those which were created through the initiative of government agencies or development projects. It appears that the success of indigenous savings and credit associations depends a great deal on spontaneity and the community ties of neighbourhood and workplace, which regulation from above would only stifle and erode. In contrast, semi-formal and formal institutions could learn a great deal from the discipline of informal groups. Indeed the increasing use of the group approach by formal financial institutions suggests they have already grasped the benefits of some of the informal group practices.

5.3 Informal Finance Companies

1 In complete contrast to the informal savings and credit associations with their enviable track record of safeguarding deposits, some countries have a different type of operator in their informal financial sector, one which poses a far greater risk to the safety of deposits. As mentioned in Chapter 1, these are commercial firms that set themselves up as finance companies and operate outside central bank regulations. They often fill a gap left unserved by the formal banking institutions and are a response to economic opportunities. In many cases a fast growth period, during which such companies may have captured a significant share of the deposit market, has been followed by an equally rapid decline as conditions change. An example of this series of events has already been described in Section 4.1, the case study of Malaysia, where illegal deposit-taking institutions flourished until the mid-1980s recession and then many collapsed causing widespread losses to depositors. Other countries to experience similar problems include Pakistan, India - in particular the state of Kerala - and Thailand. An example of an illegal deposit-taking scheme in Thailand is highlighted in Box 5.1 and the events leading to the closure of informal finance companies in Pakistan are outlined below to illustrate further the risks for savers in this type of operation.³⁶

2 Between 1977 and 1979, Pakistan witnessed a mushrooming of informal sector financial companies. They emerged at a time when nationalised formal institutions did not serve rural savers well, partly as a result of regulations on the pricing of financial services. There was also a considerable rise in peoples' capacity to save following the sixfold increase in labourers' remittances from the Middle East and a debate was in process on the establishment of an Islamic banking code that would have banned interest on capital and imposed religious taxes on savings. In this environment informal finance companies, using alternative approaches to savings mobilisation, proved to be a great success. At the peak of their financial activity in mid-1979, there were 80 companies in operation with combined deposits of almost half a billion rupees, representing 12 percent of formal sector deposits. They had 1,290 branches altogether with 13,867 employees.

3 A number of factors, in addition to slightly higher interest rates on deposits, explain the spectacular growth of these companies. Most of the deposits were relatively small and came from the rural areas, including remote villages where bank branches did not exist. Educated, unemployed youths, from influential families in particular, were hired and encouraged to use their influence to obtain deposits. The services offered were more flexible and personal than those provided by the banks and returns from invested funds were to be shared with depositors in lieu of interest, which appealed to religious sentiment in rural areas.

4 If these private companies experienced spectacular growth over a brief period, their collapse was equally spectacular. The earlier companies were mostly in capable hands and created considerable goodwill among savers. However, faced with unregulated entry and the absence of any sort of prudential control, anyone wishing to set up a company of this type was free to do so. Soon unscrupulous agents entered the market to take their share of the high profits. An increasing proportion of investments went into dubious ventures. When depositors who were not getting satisfactory returns attempted to withdraw their deposits and failed to get their money back, widespread complaints began to appear in the newspapers. In mid-1979 the owners of private finance companies petitioned the government requesting that they regulate and police them and recommending a comprehensive set of prudential requirements for their companies. Instead, the government undertook an inquiry into irregularities committed by a few of the companies and then declared that these companies could not maintain deposit accounts with the nationalized banks. This, together with the press stories, induced a run on deposits that the companies could not withstand. In October 1979, the government imposed a total ban on these companies, took over their assets and initiated an inquiry into depositors' claims. In this collapse, hundreds of thousands of relatively poor savers lost at least a part of their deposits.

Box 5.1 *Thailand: "The Oil Trucks" Story*

In informal financial institutions, the practice of using new liabilities to pay returns on existing claims has been a common one. This was happening in Thailand in the 1960s and 1970s with the so-called "oil-trucks" scheme. Agents of the companies involved looked around for investors or depositors who wanted high returns on their capital. For each "oil-truck" investment, valued at Baht 160,800, a monthly interest of 6.3% (minus 4% tax) was offered. The agents received commission on each "oil-truck" payment collected.

Later on, other operators modified the scheme by selling half "oil-trucks" or one "wheel", valued at Baht 10,100, to investors. Borrowing contracts or post-dated cheques were used as guarantee documents. Instead of calling these transactions "accepting money from the public", the activity was called "borrowing", which was not at that time regulated by the laws.

When the government became aware of the volume and speculative character of these operations and the misuse of savers' funds, the Emergency Decree on Fraudulent Borrowing against the Public B.E. 2527 (1983) Act was passed to prohibit these activities. The total losses of the 22,180 people who reported to the authorities (excluding obviously many others who did not report) amounted to Baht 6,048 million, equivalent to some US\$ 240 million and representing almost 6% of the total deposits at formal banking institutions at that time.

Source: Follet, K., *Unorganized Money Market in Thailand*, Bank of Thailand, Department of Financial Institution Supervision and Examination, Bangkok, 1987.

5 A number of lessons can be learnt from the experiences of the informal sector financial companies. It is clear that these firms can be extremely effective in mobilising savings. With their unconventional methods of operations, such as salary-cum-commission payments to employees and one man branch offices, they are able to tap savings even in remote villages. However, by functioning outside the regulatory framework, fast growth tends to lead to speculative investments, increasing misuse of funds and declining depositor security. To prevent the costly collapses of financial institutions of this type, regulation becomes a necessity when the scale of operation grows. The main challenge is to devise a pattern of regulation that preserves the essential flexibility and low transaction costs of these operators, while ensuring an acceptable degree of depositor security. In this respect, the situation relating to these private financial institutions is similar to that of cooperatives and other semi-formal organisations in developing countries.

Notes:

27. See work by the following authors on savings and credit associations:
 - Bouman, F., *The RoSCA: Financial Technology of an Informal Savings and Credit Institution in Developing Economies*, in *Savings and Development*, Vol. 3, 4, 1979, pp. 253 - 276;
 - Kropp, E., Marx, M., Pramod, P., Quinones, B. and Seibel, H., *Linking Self-Help Groups and Banks in Developing Countries*, TZ-Verlagsgesellschaft, Rossdorf, 1989, p 46;
 - Holst, J., "Le rôle des institutions financières informelles dans la mobilisation de l'épargne", in Kessler, D. and Ullmo, P.A. (eds), *Epargne et Développement*, Economica, Paris, 1985, pp. 121-154;
 - Adams, D. and Fitchett, D., "Introduction" in Adams, D. and Fitchett, D. (eds), *Informal Finance in Low-Income Countries*, Westview Press, Boulder, 1992, p. 13;
 - Schreider, G. and Cuevas, C., "Informal Financial Groups in Cameroon" in Adams, D. and Fitchett, D. (eds), *op cit*, p. 48;
 - Nayar, C., "Strengths of Informal Financial Institutions: Examples from India" in Adams, D. and Fitchett, D. (eds), *op cit*, p. 205;
 - Adams, D. and Canavesi, M., "Rotating Savings and Credit Associations in Bolivia" in Adams, D. and Fitchett, D. (eds), *op cit*, p. 320.
28. Morss, E.R., Hatch, J.K., Micklewait, D.R. & Sweet, C.F., *Strategies for small farmer development – an empirical study of rural development projects in Gambia, Ghana, Kenya, Lesotho, Nigeria, Bolivia, Colombia, Mexico, Paraguay and Peru*, Boulder, 1976.
29. Marx, M., *Gewohnheitsrecht als Entwicklungspotential. Selbsthilfeorganisationen in Nigeria*, Breitenbach Publishers, Saarbrücken and Fort Lauderdale, 1990.
30. Nayar, C., *op cit*.
31. Vongpradhip, D., *Urban Unorganised Money Markets in Thailand*, Bank of Thailand, Department of Economic Research, Bangkok, 1987.
32. Schreider, G. and Cuevas, C., *op cit*.
33. See Marx, M., *op cit*, and Schreider, G. and Cuevas, C., *op cit*.
34. Vongpradhip, D., *op cit*.
35. Marx, M., *op cit*.
36. The information on finance companies in Pakistan is taken from:
 - Asian Development Bank, *Informal Finance: Some Findings from Asia*, Economics and Development Research Centre, Asian Development Bank, 1990, Ch. 5 and 15; and
 - Vogel, R. and Wieland, R., "Regulatory Avoidance in Informal Financial Markets" in Adams, D. and Fitchett, D. (eds), *op cit*.

6. SAFEGUARDING DEPOSITS: PREVENTIVE MEASURES

SUMMARY

This chapter:

- Identifies the key factors that emerge from the various case studies as critical to the aim of safeguarding deposits.
- Makes recommendations for improving the management of financial intermediation in respect of loan appraisal, lending policies, loan recovery, investment of liquid funds, management systems and involvement in non-financial business activities.
- Makes recommendations for improving public policy in terms of the legal framework for financial activities, external supervision and non-intervention in lending policies.

6.1 Learning from Experience

1 One of the most striking points to emerge from the case studies of recent financial crises is the similarity of causes for financial instability both between countries and across sectors. Bankers and politicians often surrender to the temptation of assuming that macro-economic factors are the main cause of crises in financial institutions. While there is no doubt that serious recession is a substantial threat to the stability of financial markets and the effects can be exacerbated by inappropriate fiscal and monetary policies, especially during a period of market liberalisation, the evidence shows that bad management is the key contributor to the failure of financial institutions.

2 Mismanagement in financial institutions has involved inadequate and over-optimistic loan appraisal, lax loan recovery, high risk diversification of lending and investments, risk concentration, connected and insider lending, loan mismatching and, particularly in the case of cooperatives and credit unions, non-financial business activities. These weaknesses arise primarily as a result of inexperience and inadequate training but can also be due to corruption or political interference. Apart from these factors, there may be additional managerial deficiencies with regard to operational systems and procedures. Thus, there is great scope for improving the safety of deposits in financial institutions by up-grading the quality of management personnel.

3 At the level of public policy, the critical issues for prevention of financial crises concern prudential regulations and external supervision mechanisms. It was evident from the case studies that an absence of clear, easily monitored rules and appropriate enforcement contributed to financial market instability. In some countries, policies of market liberalisation and financial deregulation were not matched by improved supervision and resulted in uncontrolled expansion and diversification of financial institutions, followed by an increase in financial crises. In other countries crises were precipitated by the collapse of completely unregulated, sometimes illegal, deposit-taking institutions that had been allowed to grow unchecked. Cooperative organisations invariably operate outside central bank control and

regulation and without adequate alternative supervision, this has contributed to failure in this sector. In contrast to the problems caused by a lack of intervention, some government policies in developing countries regarding directed lending, "cheap" credit and the creation of government run non-viable financial institutions have added to financial market instability.

4 It is the intention in the remainder of this chapter to draw on the evidence and experience of so many countries to recommend actions which will help to promote financial stability in a range of institutions and thus help to safeguard savers' deposits. Attention will then be turned to the question of deposit insurance to protect savers from losses if collapse does occur and the variety of steps that can be taken to rescue financial institutions that are in crisis.

6.2 Recommendations for Improving the Management of Financial Institutions

6.2.1 Loan Appraisal

1 For the managers of financial institutions, the paramount task is to make sure that deposits are lent in such a manner as to yield an adequate remuneration and be repaid. Thus, the assessment of loan applications must involve a careful analysis of credit risk, i.e., the danger that the borrower will default. It was the systematic failure to assess credit risk that was behind the collapse of many financial institutions in the 1980s. The anxiety of institutions to increase their market share, e.g., during periods of fast economic growth and financial deregulation, led to a lowering of standards of credit review procedures and increasing levels of default. The literature on sound credit review procedures is abundant but their application remains inadequate in many instances. Given the nature of financial intermediation, credit risk can never be fully eliminated. However, a systematic application of correct loan appraisal techniques could help many institutions to build up a sound portfolio with healthy recovery rates.

2 In savings and credit cooperatives and credit unions in many developing countries, there has often been an almost automatic "entitlement" to borrow a given amount based on a multiple of the member's savings account balance, e.g., 2:1, 3:1 or 5:1. Minimal effort is made under these circumstances to appraise the borrower's repayment capacity and set the loan amount accordingly. This practice tends to increase loan delinquency, since some borrowers only repay the net amount which they received over and above their savings. The cooperative can use the savings account to write-off the remaining loan balance, but may lose income in the form of uncollected interest on the outstanding loan balance.³⁷ To improve loan appraisal, The World Council of Credit Unions recommended the following strategies to savings and credit cooperatives and credit unions:

- i. Grant loans only to members.
- ii. Base loan approval on the member's actual cash repayment capacity, not some arbitrary multiple of savings or percentage of collateral value.
- iii. Determine specific debt ratios (payments divided by cash income) for each type of loan and activity financed.
- iv. Set the loan amount based on the amount of the periodic payment, loan term and interest rate.

Appraising loan repayment capacity depends on the purpose of the loan and available sources of income. Consumer loans are repaid from salaries, wages or business income; production loans should be repaid from the sale of goods or services produced; investment loans should be repaid from net operating profits and depreciation.

3 One major risk area in terms of loan appraisal involves moving into new and untried markets. Diversification, according to economic theory, reduces the risk of concentrating on one segment of the market. The reality for financial institutions, however, has been a dangerous step into the unknown, such as previously untried corporate finance or real estate business. Lacking the necessary skills of project appraisal, collateral evaluation and supervision, inexperienced financial operators in these markets soon ran into difficulties. Diversification should not, therefore, be undertaken without appropriate expertise being available. Badly managed diversification inevitably puts savers deposits at risk.

6.2.2 Lending Policies

1 *Risk concentration.* A number of bank failures have been, at least partly, the result of situations in which a high proportion of the institution's capital was lent to one single borrower or confined to a small group of borrowers or one sector of industry. These situations may have been caused by political pressure, as was the case with many banks in Hungary, or they may have been the result of voluntary decisions by the management of the institutions, as was the case with cooperatives in Malaysia and some of the failed banks in Italy and Hungary, for example. Serious risk concentration can be a real danger for the whole financial system. In Ghana, portfolio concentration led to the technical insolvency of several major banks, with a radical decline in the overall safety of saving.³⁸ In many cases, risk concentration is mixed with connected lending.

2 *Connected lending.* In developing countries it is common for financial institutions to lend a large proportion of their capital to parties directly or indirectly connected to them. In many cases, lending of this type involves a high risk. Concentration, default and the permanent roll-over of loans are common features of connected lending. De Juan³⁹ points out four specific dangers related to connected lending:

- i. the loans are made according to less rigorous criteria than normally applied by the bank;
- ii. the managerial attitudes of the subsidiary management deteriorate because of their easy and systematic access to credit;
- iii. the bank's representatives develop a cosy relationship with the subsidiary and people they are supposed to supervise; as a result, they become an obstacle to information and control rather than an instrument of both; and
- iv. the parent bank will seldom recognise a loan to a subsidiary as 'overdue' or doubtful.

Furthermore connected lending is frequently fraudulent as was shown to be the case with some financial operators in Malaysia, Hungary and Italy.

3 *Insider lending.* Insider lending involves making loans to elected officials, staff and their family members and business associates of the financial institution, frequently on a preferential basis. Often there are no serious loan recovery efforts when repayment is due. In cooperatives, access to credit is sometimes considered to be one of the advantages of accepting an otherwise onerous position as a volunteer elected official. Many cooperatives have failed or stagnated when elected officials took and then failed to repay their loans, setting a bad example for others. Lack of adequate external regulatory supervision, collusion among leadership groups or committees and favouritism in loans to the general membership can all combine to facilitate insider lending and cause the loss of savings. Cooperative literature is replete with such cases.

4 *Mismatching.* In nearly all recent cases of financial institution failure in developing countries, one of the causes has been lending at terms out of proportion with those of deposits. Commonly mismatching leads to liquidity crises and to solve these the organisation may have to pay excessive rates for its new funding. When mismatching becomes serious, liquidity crises may increase and lead to runs. As the case of Kenya showed, runs in developing countries often lead to the closure of financial institutions and frequently to the loss of depositors's funds. Mismatching in savings and credit cooperatives has in some cases been the result of mortgage lending for members' homes and has typically produced liquidity shortages which are remedied through reductions in loan disbursements.

5 Cooperatives and credit unions in developing countries often have a reverse mismatch compared to banks and other profit-oriented financial institutions, i.e., the mismatch is between long-term share savings and short-term consumer loans. Although this protects liquidity, it also produces low earnings, insufficient dividend rates to attract new share savings and inadequate accumulation of institutional capital (retained earnings and capital reserves) to protect the nominal value of savings. Further, cooperative managements may become accustomed to the stability of share savings and liquidity, and begin to increase loan terms, e.g., for home loans. If they then "discover" a liquidity problem and this is addressed by borrowing externally or offering market rate deposit accounts which may cost more than

the yield on the long-term and possibly delinquency-plagued loan portfolio, the cooperative can find itself facing the more typical mismatch of short-term savings against fixed rate, long-term loans. This may be combined with a negative spread, insufficient institutional capital and loss provisions to write off its bad debts or write down its current, below-market rate loans to their market value. Typically, these losses will not have full impact due to member loyalty and the inherent difficulty of withdrawing their share savings. Instead, the cooperative may stagnate and members may be reluctant to invest new savings.

6 Obviously to maintain stability, financial institutions need clear policies which limit or prevent excessive loan concentration, connected or insider lending and mismatching. Effective monitoring procedures also need to be established to ensure policies are adhered to. For example, major actions which can be taken to restrict insider abuse include strict external audit and examination requirements, enforcing personal liability for abuses, prosecuting criminal abuses, enacting codes of ethical conduct and requiring the disclosure of all insider loans and business relationships.

6.2.3 *Loan Recovery*

1 Apart from problems created by weaknesses in loan appraisal, a large proportion of non-performing assets in the portfolios of financial institutions in developing countries result from a failure to press for repayments. Many financial intermediaries lack systematic procedures for ageing and classifying loans, collecting overdue loans and making realistic reserves for bad debts. Instead, a range of different practices have been used to hide the lack of success in loan recovery. Non-performing loans are rolled over, interest is accrued whether it has actually been received or not and new loans are provided to cover unpaid debts. While many factors external to the banks, e.g., government pressure, poor enforcement systems or politics, may have increased the volume of non-performing loans, a large share of the problem can be related to weak internal policies and indifferent attitudes towards loan recovery on the part of the financial institutions themselves.

2 According to a recent OECD study⁴⁰, 20 percent or more of total loans in developing countries are non-performing. Losses of this magnitude are difficult to cover out of the spreads, even if the spreads in developing countries are generally higher than those in industrialized countries. This means that intermediaries will remain financially weak and potentially unsafe for depositors, until higher levels of recovery are achieved. As far as savings and credit cooperatives and credit unions are concerned, loan delinquency is the single greatest risk to the safety of deposits and the following steps have been recommended to improve loan recovery rates in such organisations.⁴¹

- i. Measure delinquency at least monthly, if possible daily.⁴²
- ii. Implement a sound collection policy, including procedures which ensure rapid identification of delinquent loans, immediate contact with the borrower and continual follow-up until a loan is recovered.
- iii. Create and maintain loan loss provisions to cover all probable loan losses, based on monthly analysis of the portfolio and classification of delinquent loans by ageing categories.
- iv. Provide basic education in borrowing rights and repayment obligations to new cooperative members and others lacking experience in institutional credit.
- v. Do not accrue interest on delinquent loans and never refinance a loan simply to reduce the delinquency rate.
- vi. Do not permit elected officials to be delinquent and remain in office.
- vii. Charge all non-recoverable loans against the loan loss provision on a regular basis.

6.2.4 *Non-Financial Business Activities*

1 A problem in many savings and credit cooperatives in developing countries is investment in and operation of non-financial businesses. Typical activities include consumer stores, medical and dental services, pharmacies, schools and recreational facilities. The risks of such businesses are usually underwritten by the share capital supplied by savers and the institutional capital generated from the net earnings of savings and credit operations. These businesses are sometimes offered as a "service" to members instead of dividends or interest on their savings accounts, in accordance with the cooperative principle of limited returns on capital. In fact, they reduce liquidity and earnings and can contribute to instability and savings loss. Guidelines may need to be developed to ensure cooperatives considering such ventures apply appropriate caution and appraisal techniques.

2 The problem at primary cooperative level can be worsened by non-financial investment at the secondary or federation level. In these cases, cooperatives invest some of their members' savings in the federation which then re-invests in non-financial businesses such as agricultural production, processing and marketing facilities, real estate and a wide variety of other cooperatives and businesses. Cooperative savers are thus forced to assume non-financial risks at both the primary and secondary levels of the system and cooperative borrowers must pay for non-financial operating costs through higher interest rates on their loans. Many of the financial crises faced by cooperatives and federations have been caused by poor performance and losses associated with their non-financial businesses. Examples can be found in many countries, including Liberia, Kenya, Lesotho, Bolivia, Paraguay, Peru, Honduras, Jamaica and the Philippines.

6.2.5 *Inter-Bank Investments*

1 In addition to losses related to poor lending practices, risk taking in inter-bank investments has led to large losses of depositors' funds. Savings cooperatives in Kenya and Hungary are examples of institutions which, in search of higher-than-normal interest rates, invested substantial amounts of their funds in backstreet financial institutions. When these financial institutions collapsed, the losses to the cooperatives were in most cases total (inter-bank deposits of this kind are generally excluded from any deposit insurance schemes). In a number of cases, subsequent investigations revealed that some managers of the cooperatives had received personal benefits when directing the cooperative's liquid funds to a particular financial institution. Skills need to be developed in appraising the risk of investment strategies.

2 Successful investment strategies now being employed in savings and cooperative movements in developing countries are based on the "S-L-Y" guidelines developed in the credit union movements of the industrialised nations.⁴³ These guidelines are based on the premise that a cooperative or credit union should not seek risk and, thus, high yield, in its liquidity investment decisions. To protect savings, such investments must be made according to the following criteria:

- | | | |
|---------|-----|--|
| First: | "S" | <i>Safety</i> of principal and earnings; |
| Second: | "L" | <i>Liquidity</i> - the ability to recover funds rapidly without significant penalties; |
| Third: | "Y" | <i>Yield</i> - the return on investment. |

3 Since cooperatives in developing countries are only rarely required to maintain required reserves in central banks, they should ideally establish voluntary reserve systems. The reserves may be kept in the cooperative movement in centrally operated finance facilities or in banks or other low risk institutions.

6.2.6 *Management Systems*

1 In addition to sound policies relating to lending and investments, the existing evidence shows that to avoid insolvency and the loss of depositors' funds, various management practices and systems should be upgraded in financial institutions in developing countries. As Polizzato notes:

“The primary line of defence against insolvency and financial system distress is neither banking supervision nor prudential regulation. It is the quality and character of management within the banks themselves. Therefore, efforts to strengthen the financial system must also focus on strengthening management and management systems through a process of institutional development.”⁴⁴

2 When the volume of business in a financial institution exceeds the savings club size level, the main task of the elected boards or management committees is to recruit competent chief executives for the institutions. These people then take care of the day-to-day affairs of the institution, implement the policies established by the board and employ and educate the staff. To do this satisfactorily, a variety of management procedures are important as part of a total management system. These are identified by Polizatto as follows:⁴⁵

- (i) *Written policies and procedures.* To ensure that management executes business plans and controls risks appropriately, written policies should be formulated for each major business activity or function the intermediary is engaged in.
- (ii) *Internal controls.* A strong system of accounting and administrative controls is necessary to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency and encourage adherence to established policies.
- (iii) *Compliance.* Compliance systems are necessary to ensure that the institution is operating within the constraints of law.
- (iv) *Planning.* Planning is fundamental for effective management as it is the only way to cope with changes in competitive conditions, volatility in financial markets, technological advances and deregulation.
- (v) *Internal audit.* Traditionally, the primary objectives of the internal audit function have been the detection of irregularities and the determination of adherence to the institution's policies and procedures. However, in recent years, the responsibilities of internal auditors have been expanded to include such important functions as the appraisal of accounting, operating and administrative controls.
- (vi) *Management information systems.* In addition to monthly balance sheets and profit and loss statements, the management needs timely, accurate, and relevant information concerning the institution's loan portfolio, funding sources, foreign exchange risks, off-balance sheet contingencies, interest rates and so on.

3 Due to technical mismanagement and a lack of sound systems, intermediaries in all sub-sectors of the financial markets of developing countries frequently find themselves in a position in which the financial viability of the institution is being eroded. Faced with such a situation, a good board or management committee, or an external supervisor, should require the institution to recognise the problems and take appropriate action. However, good boards and effective supervisors are in short supply in many developing countries. As a result deteriorating banks are often allowed to continue to operate even after technical insolvency is apparent.

4 A good description of potential phases of mismanagement is provided by De Juan.⁴⁶ The first phase, which could be called "cosmetic management", consists of hiding past and current losses in order to buy time and remain in control, while looking or waiting for solutions. Banks can manipulate their income statements to show profits. They can reduce provisions, consider uncollected accruals as income and revalue assets. In the next phase, "desperate management", directors and managers see themselves in danger of having to declare a capital loss or having to pay lower dividends. This commonly leads them to become involved in speculative activities, e.g., real estate deals in times of inflation or short term stock purchases; or to decisions to offer exceptionally high interest rates to depositors or to charge interest to borrowers that is above the market price. In the last stage of the process, when a liquidity crisis approaches and the managers feel the end may be near, the temptation increases to divert money out of the institution. This may be done, for example, by fraudulent deals in connected lending or by "swinging ownership" of companies connected to the bank.

5 Many of these mismanagement practices were evident in the cases studies of financial crises and institutional failure described in earlier chapters of this document and their prevalence can largely be attributed to the lack of management systems and the weaknesses in management culture. Furthermore, the lack of adequate regulation and supervision of financial institutions in many developing countries provides an ideal ground for malpractices to persist for a long time.

6 Savings and credit cooperatives and credit unions in developing countries share many of the same problems as banking institutions in terms of management systems. However, cooperatives are in general much smaller than banks and provide different services, e.g., savings accounts rather than cheque accounts, small consumer and business loans based on repayment capacity rather than large commercial loans based on collateral. Cooperative management is usually less sophisticated and so are the management systems. Because of their small size, cooperatives typically join together in federations to get economies of scale and obtain important management support and other services which they cannot afford individually. An outline of the minimum management capabilities, systems, policies and external (federation) support services, which cooperatives need to protect their members' savings and grow is provided in Appendix B.

6.3 Recommendations for Public Policy

1 Financial instability can have adverse effects on a nation's economy and inflict serious harm on depositors, particularly small scale savers. Therefore most governments have established a variety of institutional arrangements, designed to preserve stability in financial markets. These arrangements typically include:

- banking laws and regulations that set the ground rules for bank operations and attempt to constrain undue bank risk-taking;
- the supervision and examination of financial institutions to assure compliance with laws and regulations and to prevent banks from engaging in unsafe and unsound banking practices; and
- lender of last resort facilities designed to prevent temporary bank liquidity problems from turning into bank runs and insolvencies.⁴⁷

6.3.1 Legal Framework

1 An appropriate legal framework for financial operations is a significant contributor to preventing or minimising financial sector problems. Evidence shows that the absence of prudential regulations in some key areas can lead to bank failures and systemic instability, while establishing sound, clear and easily monitored rules for financial activities both encourages managers to run their institutions better and facilitates the work of supervisors.

2 Up to the early 1980s, prudential regulations were inadequate in most developing countries. During the 1980s and early 1990s, major steps were then taken to establish a sound legal framework for banking operations in these countries, often as an integral part of structural adjustment programmes. The upgrading of the prudential regulatory framework involves stipulating a wide range of requirements. These should include legislation and rules to cover the following areas:⁴⁸

- (i) *Criteria for entry.* Most small banks collapse because of bad management and a weak capital base, so the initial decision to grant a licence is an important one and should be in accordance with clearly established criteria. This is an area where developing countries often fail and licences are granted based on political loyalties, patronage or bribes. Where this has occurred (as in Kenya), difficulties and bank insolvencies invariably follow.
- (ii) *Ownership.* Restrictions regarding the share of ownership that can be held by one person or family, relatives or connected parties may be established.
- (iii) *Capital adequacy ratios.* These stipulate the capital required as a percentage of risk assets to provide a cushion against unexpected losses and reduce the potential for institution failure.

- (iv) *Loan diversification.* Concentration of loan assets in certain geographic areas, industries or firms may be regulated to limit bank exposure to risk. On the other hand, rules may prevent institutions from expanding into areas in which they do not have adequate capabilities to operate.
- (v) *Single borrower credit limits.* These can prevent the concentration of the institution's capital into the hands of only a few individuals or group borrowers.
- (vi) *Liquidity ratios.* These are essential criteria for monitoring the long-term and short-term liquidity of the financial institutions.
- (vii) *Large loans.* Limits may be stipulated that ensure the aggregate amount of large loans does not exceed a designated portion of the institution's capital funds.
- (viii) *Loans to management and shareholders.* Rules can ensure that the same terms and credit limits applied to outside borrowers are also applied to managers and shareholders.
- (ix) *Loan classification and bad debt provision.* Rules may be established for classifying loans according to their actual and potential risk and for providing a basis for realistic bad debt provision.
- (x) *Accounting and audit.* Banking laws can require financial institutions to provide financial statements that conform to international standards. In addition, rules relating to the audit function are particularly important for protecting depositors. A lack of adherence to appropriate audit standards has allowed the crisis in many financial institutions in developing countries to continue and deepen without the knowledge of the owners or the supervising authorities.
- (xi) *Enforcement and sanctions.* The authority of bank supervisors to enforce regulations or impose sanctions to ensure compliance with banking laws and regulations must be specified.

3 In addition to banking laws, various other laws can have an impact on the operation of financial institutions. These include company laws, securities laws, debt recovery laws and laws on liquidation and bankruptcy. However, as identified in all the developing country case studies, a major weakness of many financial systems is the fact that various financial institutions, especially cooperatives and intermediaries in rural areas, operate completely outside prudential regulations. The general cooperative societies acts which govern the business operations of agricultural, commercial and industrial cooperatives are usually inadequate for those specialising in the provision of financial services. Thus there is an urgent need to extend the legal and regulatory protections accorded to bank customers to the members and customers of currently unregulated institutions, including savings and credit cooperatives and credit unions.

4 When regulations are being extended to intermediaries in the semi-formal and formal sectors, the rules must be flexible enough to allow for the different environments in which the intermediaries operate, the different market niches they serve, the differences in institutional design and in scales of operation and risk-taking. Thus, regulations emphasising the importance of the ownership function and the adequacy of capital are often difficult to apply to many cooperatives and non-government organisations. In the case of small informal savings groups, the safety of deposits is generally good and interference or regulation by authorities might only complicate the operations of these micro-institutions. So the diversity of small operators in the financial markets of developing countries makes it difficult to provide one recipe for appropriate regulations.

5 Some countries, such as Niger, Poland and Ukraine, are enacting specific enabling laws for credit unions and savings and credit cooperatives, based in part on credit union legislation in industrialised nations. This provides for access by the unions to the central banking system and prudential standards appropriate to their nature as non-profit, cooperative financial intermediaries. Other countries, such as Bolivia and Hungary, are enacting banking laws which include the financial functions of cooperatives and credit unions. Since most savings cooperatives in Hungary are much smaller than the banks, the new Hungarian Banking Act allows for variation in scales of operation by, for example, stipulating lower ceilings for share capital in savings cooperatives. A flexible approach of this type might be suitable for developing countries when attempting to bring semi-formal institutions under their prudential guidelines.

6.3.2 External Supervision

1 While regulatory legislation provides the foundation for sound banking practices, a supervisory system enforces and reinforces the basic elements of good banking and the safety of savings. A strong supervisory capability should be used to spot problems in bank management and loan portfolios well before insolvency occurs and to compel banks to take corrective action. However, in most developing countries, weak supervision of financial institutions has enabled many to ignore losses and continue with business as usual until eventually they have failed. As Long and Vittas note:

“In most developing countries bank supervision has focused on the implementation of economic directives, such as credit allocation, to be certain bank lending was in compliance with government directives. Very little attention has been paid to the quality of the loan portfolios, the adequacy of capital, and the soundness of bank management. The huge losses now found in the banks' portfolios in many developing countries are testimony to the poor quality of this oversight function.”⁴⁹

The weaknesses of bank supervision in Latin America are highlighted in Box 6.1.

Box 6.1 *Latin America: The Weaknesses of Bank Supervision*

- 1 Although the importance of an autonomous bank supervisor is widely recognized, in Latin America very few supervisors are autonomous.
- 2 Banking supervision is usually carried out by a department of the Central Bank or the Ministry of Finance and, thus, the objectives of banking supervision are often mixed up with other objectives.
- 3 In those countries in which regulation and supervision is generally weak, it has been found that supervision of non-commercial banks is even weaker. In most Latin American countries only commercial banks are under the purview of the Superintendent of Banks. Development banks, Savings and Loan Associations, leasing companies, credit unions, etc., are excluded.
- 4 In many Latin American countries, federal or provincial public banks have more political clout than the bank supervisor and as a result ignore most of the regulations. Argentina and Brazil provide examples of this situation.
- 5 Finally, the bank supervisors in Latin America have traditionally concentrated on compliance with Central Bank rules on reserve requirements and interest rates, while analysis of loan portfolio quality and operating efficiency has largely been overlooked. This has limited the superintendent's capacity to take timely action to stop unsound financial practices.

Source: Morris, F., *Latin America's Banking Systems in the 1980s*, World Bank Discussion Papers 81, the World Bank, Washington, D.C., 1990.

2 To improve the standard of bank supervision, several basic conditions have to be fulfilled. These include:

- providing an adequate overall regulatory framework;
- guaranteeing supervisors sufficient autonomy from political interference;
- ensuring supervisors have adequate resources to hire, train and retain competent personnel, and acquire appropriate technology;
- ensuring supervisors have sufficient authority to enforce its decisions without having to resort to the extreme action of recalling a bank's charter to operate.⁵⁰

3 An adequate system of bank supervision should balance off-site supervision and on-site inspection. The purpose of off-site supervision is to analyse reports of financial institutions, to identify problem areas and to propose remedies. The objective of on-site inspection is to ascertain whether the bank is operating in a sound manner, to determine the accuracy of financial reports that have been submitted to the regulator and the public and to check compliance with the law and regulations. Inspections can either be routine or special in-depth investigations to uncover fraud and risk exposure.⁵¹

4 Since the late 1970s various developing countries have made efforts to strengthen their banking supervision, often with technical assistance from abroad. Nevertheless, as the case studies in previous chapters showed, many countries still have major deficiencies in the way bank supervisors carry out their function. As a result of a lack of resources and/or unclear mandates, financial analyses of banks are commonly inadequate, examinations are infrequent and ineffective and demands for corrective action either come too late or are ignored by banks, often with the assistance of their supporters in the establishment.

5 While it is obvious that the bank supervision system in many developing countries needs a complete reorganization, some more limited suggestions can be made to improve their efficiency. The following recommendations could improve off-site supervision:

- (i) Prudential reports, which form the basis of off-site supervision, should be designed on a uniform basis for all financial intermediaries by the supervisors. The design should facilitate checking and lead to meaningful analysis and early warnings about the potential problems.
- (ii) Adequate periodicity and prompt returns should be encouraged.
- (iii) Prudential reports should not be limited to figures concerning liquidity, reserve requirement computations and credit guidelines. For the system to be effective, the reports must contain information that permit the measurement of risk, e.g., data relating to the bank's portfolio, including delinquencies and problem assets, and off-balance sheet commitments, as well as the usual balance sheet and profit and loss statements.⁵²
- (iv) An appropriate rating system should be developed and used, e.g., United States regulators use the "CAMEL" rating system. The CAMEL acronym stands for Capital adequacy, Asset quality, Management, Earnings and Liquidity. Ratings are prepared on each of these aspects, plus an overall rating, and they are compared with those of similar financial institutions. A modified system more suited to Latin America is outlined in Box 6.2

6 Recommendations which would improve on-site supervision are:

- (i) Supervisors should move away from checking compliance with laws to assessing risk and assisting institutions to manage risk.
- (ii) A top down approach should be embraced which places emphasis on the direction and policies formulated by the board of directors and executive management.⁵³
- (iii) Inspections should focus on verification of the quality and real value of assets, since accuracy of reporting is seldom a rule in developing countries. This should involve physical examination of the portfolio, investment and fixed asset files.
- (iv) Asset classification, provision for loan losses, suspension of interest and other adjustments should assist the supervisor make a correct diagnosis and enforce action.⁵⁴

Box 6.2 *Latin America: The PERLAS Rating System for Credit Unions*

To measure the financial soundness of Latin American credit unions, the PERLAS rating system has been developed. It is a modification of the CAMEL system commonly used in the USA, with inappropriate indices excluded and others, considered critical in the Latin American context, included. In the PERLAS system, each letter represents an important area of measurement as follows:

- P. represents PROTECTION and measures the coverage of provisions against delinquency and non-producing assets.
- E. represents FINANCIAL STRUCTURE ("estructura financiera") and measures the significant changes in the financial statement.
- R. represents YIELD ("rendimientos") and measures the yield on assets, liabilities and equity.
- L. represents LIQUIDITY and measures the degree of the credit union's liquid assets.
- A. represents NON-PRODUCING ASSETS ("activos improductivos") and measures the percentage of delinquency and other assets that do not generate income for the credit union.
- S. represents SIGNS OF EXPANSION and measures the percentage of growth in the main accounts of credit union assets, liabilities and equity.

The PERLAS system has proved useful in South and Central America to analyse and compare the financial state of credit unions and to assess whether financial stabilisation efforts have had a positive and ongoing impact on unions participating in recovery programmes.

Source: World Council of Credit Unions; *Credit Union Financial Stabilization*, Santo Domingo, February 1992.

7 Another common weakness in the supervisory process in developing countries is a failure to follow up problems and to enforce action. This may be due to political influence, a lack of appropriate legislation to support enforcement, organisational weaknesses or weak leadership. However, as Polizatto⁵⁵ notes, it also occurs because the results of inspections and the type of corrective action needed are not adequately communicated to the boards of directors and senior management of banks.

8 In the same way that semi-formal financial institutions are not normally covered by prudential regulations, they are also rarely covered by the bank supervision system. If they are supervised at all, it is by a department in a ministry or in some other authority. Evidence from various countries, e.g., Malaysia, Kenya, Hungary, the Philippines, indicates that supervision organized in this manner tends to be ineffective. Therefore, at least for larger credit unions, savings and credit cooperatives and cooperative banks, it may be advisable for external supervision to be implemented under the authority of the state agency responsible for supervision of financial institutions.

9 In some countries, the supervision of financial service cooperatives is implemented as a collaborative arrangement between the bank supervision authority and the apex organization of the cooperatives. In other countries, however, supervision by government is necessary. The important thing is that the skills and authority of the state regulator of financial institutions should be involved, to guarantee that the function of external supervision is taken seriously and conducted professionally, without political interference. There may be merit in having a specialised agency to supervise credit unions and cooperatives, whose operations are closely coordinated with the various organisations of the wider cooperative movement. Such a regulatory agency could be financed by the cooperative institutions it supervises, thus, assuring that both the regulator and the regulated share the common objective of promoting safe and sound growth.

6.3.3 Directed Lending

1 Governments in both developing and industrialised countries have frequently employed the financial sector as agents of government policy. In particular, the "cheap credit" strategy of economic development, which included the creation of non-viable institutions, setting sectoral, directed credit quotas and interest rate ceilings, has been widely used in developing countries. As noted in Chapter 2, whatever conclusion is drawn concerning the impact of directed credit on growth and the distribution of income, it is obvious that it has had a damaging impact on financial systems in the countries concerned and there seems little to commend it. The ability to borrow cheap encouraged less productive investments and those who borrowed for projects with low financial returns could not repay the loans. This has eroded the financial viability of many deposit-taking institutions which were used as channels for directed credit.

2 Another related negative effect has been the impact of cheap "government" credit on financial discipline in general. The common understanding among borrowers that there are no sanctions for non-repayment in government-funded or donor-sponsored schemes has adversely affected the performance of loans financed from depositors' savings. The effect has been especially detrimental if the same window has been used for disbursements of both government-funded and deposit-funded loans. An example of this can be found in Western Kenya, where government schemes eroded the repayment discipline in cooperative lending activities funded from savings. In this case, cheap directed loans were eventually partly responsible for the collapse of the cooperative savings operations in the area. Cooperatives have frequently participated willingly in subsidised and directed credit programmes and their member-savers have invariably paid a high price for this access. Problems which have resulted from the policies include insufficient interest margins to cover normal operating costs, increased costs associated with the management and monitoring of targeted programmes, perverse incentives for insider dealing and inadequate loan appraisal and irrational price competition which depresses the market interest rate paid on savings.

Notes:

37. Agency for International Development, *Sintesis Informativa del Sector Cooperativo de Ahorro y Credito de Honduras*, (Informational Summary of the Credit Union Sector of Honduras), Tegucigalpa, 1993.
38. World Bank, *Financial Systems and Development*, Policy and Research Series 15, The World Bank, Washington DC, 1990.
39. de Juan, A., *From Good Bankers to Bad Bankers*, mimeo., World Bank, Washington DC, 1987.
40. Germidis, D., Kessler, D. and Meghir, R., *Financial Systems: What role for the Formal and Informal Financial Sectors?*, OECD Development Centre Studies, Paris, 1991.
41. Marion, P., *Seguridad y Solidez de las Cooperativas: Mecanismos de Proteccion del Ahorro*, (Cooperative Safety and Soundness: Savings Protection Mechanisms), COLAC, Panama City, 1990, FENACREP, Lima, 1992, WOCCU, Madison, 1992.
42. Delinquency should be measured by dividing the total principal of all loans with one or more delinquent payments by the total of all outstanding loans. It should *not* be measured by the ratio of delinquent payments to total outstanding loans, as many banks and cooperatives in developing countries still do.
43. Marion, P., *op cit.*
44. Polizatto, V., "Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks", in Callier, P. (ed), *Financial Systems and Development in Africa*, EDI Seminar Series, The World Bank, Washington D.C., 1991, pp. 313 - 314.
45. *Ibid.*
46. de Juan, A., *op cit.*
47. Talley, S. and Mas, I., "The Role of Deposit Insurance", in Vittas, D. (ed), *Financial Regulation: Changing the Rules of the Game*, EDI Development Studies, The World Bank, Washington D.C., 1992, p. 321.
48. The literature relating to prudential guidelines is extensive. Principal sources used were: World Bank, *Handbook on Financial Sector Operations*, Operations Policy Department, the World Bank, Washington DC., 1993, Ch. 3; de Juan, A., "Does Bank Insolvency Matter? And What to DO About It?", in Callier, P. (ed), *op cit.*; and Polizatto, V., *op cit.*
49. Long, M. and Vittas, D., "Changing the Rules of the Game", in Vittas, D. (ed), *op cit.*
50. Morris, F., *Latin America's Banking Systems in the 1980s*, World Bank Discussion Papers 81, The World Bank, Washington DC, 1990, p. 54.

51. Various recent articles discuss bank supervision in detail, e.g., Sheng, A., "Bank Supervision: Principles and Practices" in Callier, P., (ed), *op cit*; and Polizatto, V., and de Juan, A., in Callier, P. (ed), *op cit*.
52. Polizatto, V., *op cit*.
53. Ibid.
54. de Juan, A., in Callier, P. (ed), *op cit*.
55. Polizatto, V., *op cit*.

7. SAFEGUARDING DEPOSITS: RESCUE MEASURES

SUMMARY

This chapter:

- Examines the role of deposit insurance and some of its advantages and disadvantages.
- Outlines the circumstances under which deposit insurance will be most effective.
- Summarises the key features of financial stabilisation programmes for credit unions, which emphasise improved management and establishment of a stabilisation fund.
- Briefly contrasts alternative rescue measures for financial institutions, ranging from recapitalisation and a change of management to takeover or liquidation.

7.1 Deposit Insurance

1 The best and least costly way to protect the safety of deposits is to prevent the failure of financial institutions by sound management, supported by adequate prudential regulation and supervision. When a financial institution does become insolvent, the key question is who should bear the loss. According to conventional western thinking, the losses in banking should be borne, in broad descending order, by borrowers, shareholders, fellow bankers, other creditors or employees (in situations of liquidation) and, lastly, by the depositors.⁵⁶ While this is normally the situation in industrialised economies, various studies suggest that the situation is much less clear in developing countries. Authorities have sometimes passed losses on to depositors, especially in those cases where the institutions that failed were not large commercial banks or state-controlled financial institutions but semi-formal deposit takers such as cooperatives (see the examples of Malaysia, Kenya and Thailand).

2 However, to protect savers' rights and general financial stability when bank insolvencies do occur, most industrialised countries, and an increasing number of developing countries, have established deposit insurance schemes. Such schemes normally guarantee the nominal value and liquidity of deposits up to a certain amount. The insuring institution is usually government-controlled and has often been established specifically for the purpose. In most cases at least part of the insurer's funds comes in the form of premiums from institutions whose deposits are insured. In addition to explicit deposit insurance schemes, some level of implicit deposit insurance appears to exist in many countries, with the governments intervening to protect depositors even in the absence of insurance schemes.

3 Three main reasons are usually given to support the establishment of deposit insurance schemes:

- (i) they strengthen confidence in the banking system and help to promote savings in the form of deposits;
- (ii) they provide the government with a formal mechanism for dealing with failing banks;
- (iii) they ensure that small depositors are protected in the event of a bank failure.

4 Two main disadvantages of deposit insurance schemes have been identified. First, deposit insurance can suffer from the risk of moral hazard. Secondly, with deposit insurance, savers have less incentive to select only stable financial institutions and the institutions have less incentive to abide by the discipline of the market. It has been argued that by reducing the significance of market control, deposit insurance places a bigger responsibility on government to see that financial institutions behave prudently. The behaviour of Savings and Loan Associations in the U.S.A. after the insurance cover was increased in the early 1980s is often referred to as an example of a situation in which deposit insurance encouraged risky banking practices (see Chapter 2).

5 In developing countries the ability of a deposit insurance system to absorb losses when banks fail is usually questionable. Talley and Mas found that deposit insurance can only be considered to provide adequate protection in those countries that:

- (i) have a fairly stable banking system;
- (ii) have an effective prudential regulation and bank supervision system; and
- (iii) exhibit a willingness to adequately fund a deposit insurance system and give it the necessary government backup support that may be required to get the system through a period of stress.⁵⁷

There are probably very few developing countries that currently meet these conditions. In practice, developing countries tend to set up deposit insurance systems that have relatively little capital and lack strong state support. As a result, most of the schemes in these countries have no credibility. For example, when the Kenyan system was established in 1985, it was not provided with any initial capital. In the Nigerian system, which was set up in 1988, the initial capital was about one thousandth of the total assets of the banking system, even though several banks were already virtually insolvent.⁵⁸ Therefore, in those countries in which the security provided by deposit insurance is obviously very weak, the stress should be on efforts to get the whole financial system under proper control and supervision.

6 The strongest argument for the establishment of deposit insurance schemes in developing countries is related to the need to protect the depositors of small financial institutions. If a small institution fails, governments may not see the need to intervene and compensate savers because the failure may not be considered a threat to general financial stability. An explicit deposit insurance scheme can be effective in protecting depositors in these circumstances because it is designed specifically for the purpose and its actions should

not, therefore, be discretionary and ad hoc (although, as was evident in the case of the Italian Bank Fund, the rules can leave a great deal of room for discretion).

7 To encourage the mobilisation of savings and to support the status of bank deposits as a safe form of investment, deposit insurance schemes should cover all deposit taking institutions. This includes cooperatives and other semi-formal institutions, especially when they expand their operations from club-size to commercial activities. Talley and Mas⁵⁹ give two other reasons for including all types of deposit-taking institutions in the system. First, if some institutions are not insured and they are subjected to runs, these runs may spill over to affect insured institutions. The reason for this is that, during a panic, depositors are unlikely to distinguish between insured and uninsured intermediaries. Secondly, differential access to deposit insurance could confer advantages on certain types of financial institution, thereby introducing distortions into the financial sector.

6 It may not be appropriate, however, to have a single insurance fund to cover all types of institution. Experience in the United States suggests that separate deposit insurance funds for each major type of financial institution diversifies risk and insulates sound sub-sectors from unsound ones. Thus, widespread failure of the Savings and Loan Associations did not affect either the bank or credit union deposit insurance funds. If all three types of institution had been covered by one fund, saver confidence in the national financial system might have been fatally undermined. In addition, the fund operators would have found it expedient to raise premiums for all institutions, thus forcing the conservative savers and borrowers of banks and credit unions to subsidise the risk-taking customers of the Savings and Loan Associations.

7 According to Vittas, deposit insurance remains one of the most controversial elements of the prudential regulatory framework for financial institutions.⁶⁰ Deposit insurance schemes are relatively complex mechanisms and need to be properly designed for each country, if they are to perform in an effective way. Evidence so far collected indicates that schemes will function best if:

- (i) the system is public and the finances transparently clear;
- (ii) membership of the system is compulsory and includes all deposit taking institutions (with the possible exception of small, semi-formal club-size organisations);
- (iii) the deposit guarantee is only partial, in order to maintain a certain degree of market discipline; emphasis should be on the protection of small depositors;
- (iv) the private sector participates in the decision-making and management of the schemes;
- (v) the system is adequately funded and has some form of government back-up support in crises; and
- (vi) the insurer can resolve failing bank situations in a variety of ways.⁶¹

7.2 Financial Stabilisation

1 Financial stabilisation is a set of financial management tools and procedures which enable cooperatives and credit unions to build the institutional capital base required to ensure their continued existence in the face of changing economic and financial conditions. Financial stabilisation includes both internal managerial and policy tools as well as external regulatory requirements and financial resources. If wisely combined, these mechanisms can assist cooperatives and credit unions to overcome their problems and prevent the loss of members' savings. As a policy vehicle, financial stabilisation occupies a middle ground between deposit insurance on the one hand and completely unprotected savings on the other. It is particularly important in developing countries where legal and regulatory systems for cooperatives and credit unions are not developed sufficiently to support formal deposit guarantee mechanisms nor are adequate funds available to absorb the costs of a major liquidation.⁶²

2 Because of their non-profit nature, cooperatives and credit unions find it difficult to build institutional capital and thus protect their members' savings. This is because members tend to seek short-term benefits from below-market loan interest rates and/or above-market savings interest rates, rather than allowing the institution which they democratically control to retain net earnings in the form of capital reserves and loss provisions. Creating an acceptance of the need for net earnings to assure long-term viability, even at the cost of higher loan or lower savings interest rates, is the first step in stabilising a movement. This builds financial strength within individual institutions, thereby reducing the amount of external funds which they may require to cover potential losses. The second step is to establish an institutional capability to pool a portion of these increased, retained earnings (capital reserves) into a centralised fund which can then be used to resolve the problems of cooperatives or credit unions whose reserves and provisions are insufficient to cover their losses.⁶³

3 Operation of the stabilisation programme involves establishing basic financial procedures, ensuring their implementation through training, monitoring, examination and enforcement and, when necessary, providing financial resources from the stabilisation fund to institutions in difficulty. In extreme cases, the stabilisation programme operators may assume managerial control of a distressed cooperative or credit union, merge it with another or even liquidate it. While great care must be taken to protect the assets of the stabilisation fund itself, the primary concern is to ensure that the receiving cooperative does not fail and cause members to lose their savings involuntarily. In cases where the losses are too great to be remedied by improved management and stabilisation assistance alone, members may be required to accept a voluntary, partial write-down in the value of their savings accounts.

4 Like under-funded deposit insurance schemes, stabilisation programmes may sometimes be largely cosmetic. That is, they give an image of savings protection without

having the financial, legal or technical capability to prevent or withstand a major failure. In such a situation, the fund may avoid strict enforcement action and thereby allow insolvencies to worsen. Fortunately, a stabilisation fund has no direct liability to individual savers, so that a loss which leads to liquidation need not jeopardise the continuity of the fund. This contrasts with normal deposit insurance funds, where insolvency can easily induce runs on supposedly insured financial institutions.

5 The principal advantages of initiating formal savings protection mechanisms for cooperatives and credit unions in developing countries through stabilisation funds rather than deposit insurance programmes may be summarised as follows:

- (i) there is no direct liability to savers;
- (ii) the funds rely on cooperation and self-discipline among the cooperatives themselves, rather than on government funding and control;
- (iii) they may begin small, serving the soundest institutions, rather than needing to cover the risks of unsound institutions.

The major disadvantage is primarily a marketing problem. If banks or other institutions are covered by a deposit insurance programme and cooperatives and credit unions are not, the latter may find it difficult or excessively expensive to compete with the banks for savings. The success to date of stabilisation funds in some developing countries suggests that they may offer an important opportunity to protect savings through *loss prevention* methods rather than the more expensive loss reimbursement methods of deposit insurance.

7.3 Rescue and Rehabilitation Programmes

1 Which techniques should be favoured when rescuing distressed financial institutions? Among the many instruments that can be considered, the following were used during the 1980s crises:

- (i) change of management;
- (ii) recapitalisation either with government loans or equity capital or by new or existing shareholders;
- (iii) the purchase of non-performing loans by the central bank, with or without a subsequent repurchase required of shareholders;
- (iv) merger with, or absorption by, stronger financial institutions;
- (v) creation of a new umbrella organisation in which the failed institutions were grouped together; and
- (vi) liquidation.

Existing evidence indicates that market-based solutions appear to be most efficient and least costly to the taxpayers. If private sector buyers cannot be found for failed banks, liquidations tend to be cheaper than keeping insolvent banks open.⁶⁴ In several cases of bank crisis, the threat that large scale government intervention would permanently dilute the owners' position in the institution, has increased the shareholders' willingness to support rescue operations with fresh injections of share capital.

2 From the depositors' point of view, liquidations are hazardous in developing countries. With the poor coverage and weak funding of deposit insurance schemes, compensation to savers tends to be limited and there are frequently long delays in payment. A better solution is for a stronger financial institution to takeover the assets and liabilities of the failed institution. This approach has been widely used in the U.K., Italy and other European countries and it normally provides full cover for depositors' funds. The problem for many developing countries is that takeovers of this type require a great deal of subsidised backup finance from the government to get the private sector operators attracted to such deals. As many governments may not be prepared to provide this type of capital in adequate amounts, solutions of the type used in the Malaysian cooperative crisis may become more common in the future. These included partial compensation for savers in cash (in Malaysia it was 50 percent of the nominal value of the deposits) over a period of time, at a positive but low interest rate, and conversion of the rest into equity in the company which absorbed the failed financial institution.

3 When the rehabilitation of a distressed institution is achieved by recapitalisation and a clean-up of bad assets, it is generally agreed that unless major changes are introduced in the management of the institution, the problems that caused the bank to fail will soon repeat themselves. Under these circumstances depositors funds remain at risk. Evidence presented by De Juan⁶⁵ indicates that even if the original managers were competent and honest, it is very difficult for them to implement the policies that rehabilitation requires. They tend to adhere to old procedures and may be obstacles to proper disclosure in the new stage. Furthermore, other senior members of the staff would be given the wrong message if the old, unsuccessful top managers were left to run institutions that have been recapitalised. The need to change the whole management culture is one of the reasons why mergers are advocated as a solution to bank crisis.

4 The problem of how to renew the management of financial institutions is particularly difficult under the cooperative ownership mode. Cooperatives in many developing countries have shown a marked tendency to let their problems continue for long periods without a change in management. In Africa especially, the management committee members, who are elected representatives of local communities, are active participants in the day-to-day management of the cooperatives. In addition the committees tend to select general managers and other senior staff from among loyal supporters of the leading group in the management

committee. Evidence from Kenya shows that in many cases in which the members of management committees have been dismissed from their posts due to fraudulent behaviour, they have been returned to their offices in the next cooperative elections.⁶⁶ In contrast, change of elected officials and paid staff has been a common element in Latin American cooperative and credit union stabilisation programmes. Frequently these changes have been effected by the membership on learning of the causes and magnitude of the financial problems.⁶⁷ In Hungary, the proposed solution for problems of this type is to merge ailing medium-size savings cooperatives to form larger units, which would be subject to tighter regulation and supervision, and in which the separation of the ownership function from the management function could be more effectively implemented.

5 The recovery processes of cooperatives can be made still more complex as a result of a situation in which some of the owners may find it privately profitable to ensure the organisation does not maximise profits. This would apply to net borrowers whose payoff from reduced organisational profits would come at the expense of net savers. The diffused ownership structure and the potential rivalry among owners increases the risk of disintegration of the organisation and creates increased opportunities for management to pursue its own interest. In this way, as Chaves and Gonzales-Vega state, client-owned financial intermediaries may be inherently more unstable and may suffer from larger and longer-lasting principal-agent problems than other intermediaries in similar conditions.⁶⁸

Notes:

56. Sheng, A., "The Art of Bank Restructuring: Issues and Techniques", in Callier, P. (ed), *Financial Systems and Development in Africa*, EDI Seminar Series, The World Bank, Washington D.C., 1991, p. 231.
57. Talley, S. and Mas, I., "The Role of Deposit Insurance", in Vittas, D. (ed), *Financial Regulation: Changing the Rules of the Game*, EDI Development Studies, The World Bank, Washington D.C., 1992, p. 334.
58. Talley, S. and Mas, I., *Deposit Insurance in Developing Countries*, Policy, Research and External Affairs Working Papers, The World Bank, Washington, DC, 1990, p. 22.
59. *Ibid.*
60. Vittas, D. (ed), *Financial Regulation: Changing the Rules of the Game*, EDI Development Studies, The World Bank, Washington D.C., 1992.
61. Based on research data, Mas, I., *Deposit Insurance and Crisis*, a World Bank Mimeo Draft, Washington, DC, 1989, and Talley, S. and Mas, I., *op cit*, 1990, p.70.
62. Marion, P., *Financial Stabilisation*, Technical Paper, Symposium on Capital Markets and the Cooperative Sector, Tegucigalpa, 1988.
63. Marion, P., *Credit Union System Capitalisation and Development*, Technical Paper, Open Forum Meeting of COPAC on Revitalising Cooperatives in Developing and Transitional Economies: The Role of Members' Capital, Rome, 1993.
64. Sheng, A., *op cit*, 1991.
65. de Juan, A., "Does Bank Insolvency Matter? And What to Do About It?", in Callier, P. (ed), *op cit*.
66. Ruotsi, J., *Industrialisation, Ownership and Economic Performance: Two Agro-Processing Industries in Kenya*, Unpublished thesis, University of Sussex, IDS, 1991.
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68. Chaves, R.A. and Gonzales-Vega, C., *Principles of Regulation and Prudential Supervision: Should They Be Different for Microenterprise Finance Organisations?*, Occasional Paper No. 1979, Economics and Sociology, the Ohio State University, 1992

APPENDIX A

BANK SUPPORT IN FINLAND 1991-93 (FIM million)

Year	Bank	Bank of Finland	Council of State				Government Guarantee Fund				Total
			General Capital	Preferred capital certificates	Share capital	Guarantees	Loans	Subordinated loans	Preferred capital certificates	Share capital	
1991	SKOP	4,330 ¹									4,330
1992	SKOP	10,044 ²	580					1,500	1,000		13,124
	Savings Bank of Finland		1,094				1,400	7,100	2,900		12,494
	Other Savings Banks		160								160
	Savings Banks Security Fund					500					500
	OKO		422								422
	Cooperative Banks		1,108								1,108
	PSP		903								903
	SYP		1,749								1,749
	KOP		1,726								1,726
STS		170								170	
1993	SKOP	-2,822 ³		350		(300)		1,200			-1,272
	STS		-170 ³					3,036			2,866
	Savings Bank of Finland			750	250			950	150		2,100
	Sale of the Savings Bank of Finland		-1,094	-750				-3,756			-5,600
	KOP					(1,800) ⁴					(1,800)
	SYP					(1,000) ⁴					(1,000)
	Cooperative Banks Security Fund					(900) ⁵					(900)
	Arsenal						3,442			1,558	5,000
	Savings Banks Security Fund							-345			-345
Transferred										-357 ⁶	
TOTAL		11,552	6,648	350	3,692	(4,000)	155	1,400	10,030	5,608	39,078

1 Capital injection in SKOP of FIM 2,000 mill., composition of FIM 1,900 mill., own funds of the Holding Companies FIM 400 mill. and other items FIM 30mill.

2 Risks transferred to Holding Companies FIM 9,752 mill., loan to SKOP FIM 1,500 mill. minus repayments FIM 1,808 mill.

3 Repayments 4 Decisions in principle

5 Guarantee for interest payments

6 Security Fund of the Commercial Banks transfer to GGF.

APPENDIX B

Principles and Procedures for Effective Credit Union Management

General management

- Qualified, full-time personnel
- Written operating plans
- Written policies for:
Liquidity; Credit; Investments; Savings; Borrowing; Capitalisation; Pricing.
- Written operating procedures
- Compliance with laws, regulations, accounting standards
- Documented internal controls

Financial management

- Current accounting records
- Current delinquency controls
- Written budget
- Internal and external audits
- Financial performance and condition rating

Savings mobilisation

- Accept deposits from members only
- Concentrate on mobilising consumer and family savings
- Carefully match and manage large accounts

Earnings

- Set loan interest rates in accord with market rates and high enough to pay positive real or market rates on savings
- Implement a pricing methodology to cover all operating and loan loss costs, transfers to capital reserves and the cost of savings
- Disclose true interest rates on savings and loans

Institutional Capitalization

- Establish a minimum target capital ratio, such as 10% of total assets
- Establish a minimum transfer rate from gross income to capital reserves, such as 10% of gross income until reserves equal 10% of assets, then maintain the ratio

Liquidity

- Obtain external lines of credit to assure adequate liquidity on a standby basis
- Maintain liquid reserves of 10% of deposits, borrowings and shares

Federation/secondary business support services

- Insurance, including fidelity bonding, casualty, group credit and savings life coverage
- Auditing

Federation/secondary financial services

- Central finance facility to pool wholesale liquidity deposits and investments from cooperatives for lending to other cooperatives or re-investment in the financial market
- Stabilization fund to pool capital resources to assist with the rehabilitation of problem cooperatives

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