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**Authorities' Roles and Organizational Issues in Systemic Bank Restructuring**

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**Abstract**

Systemic bank restructuring must be the responsibility of one government authority only, with other authorities providing support and analytical help. The restructuring authority, whose tasks are enumerated and discussed, should preferably be a separate and temporary agency reporting to the finance ministry. Other solutions are possible but not recommended. Parliament should be involved in setting priorities and supervising the process, but political interference in restructuring operations should be avoided. Practical issues to consider include ensuring efficient cooperation between authorities; the arrangement of problem asset workout and recovery; and restructuring of politically sensitive enterprises.

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## SUMMARY

The systemic bank restructuring process should be the clear and unique responsibility of one authority only, which would ideally be backed by strong political consensus. Giving this responsibility to a new, temporary institution would avoid conflict in areas of responsibility normally belonging to jointly the finance ministry, the central bank, and the supervisory authorities. Once the acute stage of the systemic problem is resolved, the new authority should be dissolved.

The new authority should make every effort to establish good and full cooperation with the finance ministry, the monetary authority, and the banking supervision authorities. To this end, skilled staff from those permanent institutions could be seconded to the new authority, which, preferably, should report to the finance ministry, which carries responsibility for funding the restructuring program. This would also reduce potentially serious conflicts of interest. Subordinating the authority to the finance ministry would also reduce potentially serious conflicts of interest. Political input and control should be limited to decisions on formal proposals from the authority.

During restructuring, the permanent authorities should continue to fulfill their normal duties. The finance ministry should monitor and allocate funds for restructuring requiring normal preparation and documentation. The central bank could, at its discretion, provide liquidity support to banks under restructuring if normal conditions are met. Bank supervisors would monitor banks under restructuring according to normal requirements.

The restructuring authority should have responsibility for how the asset workout is organized. Credits to politically sensitive enterprises should be removed from bank balance sheets onto the government budget. For other assets, strictly commercial criteria should prevail. Asset workouts may be conducted either in a central unit, possibly owned by the government, or in bank-owned decentralized units, depending on, for instance, access to necessary personnel and the ease of achieving appropriate incentives.

## I. INTRODUCTION

Making sure that problems in a single bank are detected, monitored, and solved is, typically, one of the main duties of the banking supervision authority. However, when serious problems simultaneously surface in substantial parts of the banking system, or when corrective action is likely to have significant domino effects, the issues have immediate relevance for those authorities responsible for economic and monetary policy as well.

Throughout this paper it will be assumed that government must be actively involved in systemic bank restructuring. There are at least two reasons for assuming this to be necessary. **First**, avoidance of a possible systemic financial crisis as well as ensuring the efficiency of the payments system, are public goods, which the private sector typically cannot provide. For the government to do so, it needs to have a very clear and credible strategy, it must implement and communicate that strategy to the markets in a transparent manner, and it must maintain absolute public confidence in its commitments. **Second**, bank failures and their possible multiplier effects may have negative social and political consequences that various government authorities have been given the task of counteracting. To make certain that such consequences can be taken into account when problems in individual banks are addressed, the banking supervision authority should make sure that both the finance ministry and the central bank are fully informed of the situation both in individual banks and in the banking system, and of the supervisors' own view on the potential systemic consequences.

Issues which then surface are: (a) what should be the role of government and Parliament in the process; (b) which authorities should be responsible and involved, and in which way; (c) how should the necessary coordination between different authorities be arranged; and (d) how should workout operations be organized. Because these issues concern several often independent authorities, and because restructuring decisions have a substantial economic impact over a long time, there needs to be a large degree of consensus in both government and Parliament on the organizational setup of the restructuring effort.

This paper is mainly based on practical experiences in Nordic countries rather than on empirical or theoretical research. While this could reduce the universal validity of its conclusions, the issues raised have proven to be a practical problem in all countries dealing with systemic bank restructuring and the paper therefore adds to the awareness of the complexities involved.

## II. THE ROLE OF POLITICAL INSTITUTIONS

The exact role of government and Parliament in the process will depend on what proves necessary to ensure prompt and sufficient action to avoid severe financial dislocations in the economy. Nevertheless, it is important that political decision makers realize the economic and

political dangers inherent in their taking either too active or too passive a role in the systemic restructuring process. In particular, politicians should avoid trying to guide authorities' proposals on the handling of individual banks, because this is likely to compromise the credibility and efficiency of the whole restructuring process. The proper input of political institutions comes in the decision phase, when proposals on the broad strategy have to be accepted, rejected or modified.

Political decisions on issues of distribution of costs, organization, and monitoring are both inescapable and useful. Wide political consensus should be sought at an early stage, at least on (a) the general goals and constraints of the systemic bank restructuring exercise;<sup>2</sup> (b) the principles on how to allocate costs between different groups and sectors of the economy, including how owners and depositors should be treated; (c) the assignment of responsibilities for restructuring among various authorities; (d) the enactment of necessary new laws and regulations to streamline information exchange and decision making among the authorities; (e) a "vision" of how the future financial system should look; and (f) how political decision makers should monitor the process while limiting their direct involvement.

One important precondition for timely political action is the availability of basic information issues, such as: what is and should be the role of banking in the economy; what financial and structural constraints or goals must be taken into account; and which alternative solutions are available in reality. Such information should, accordingly, be produced by the authorities in good time **before** politicians are forced to face such issues.

Once political decisions have been taken on these issues, responsibility for the restructuring process should be lodged with designated restructuring authority. Government and Parliament should monitor the activities of the designated restructuring authority, make sure that agreed general principles and constraints are observed, and provide public political support for the restructuring effort. However, there may not always be sufficient time or consensus to design such principles and constraints in sufficient detail to provide the restructuring authority with guidelines covering all possible issues and situations. In this case it may be useful to have the government make the final decision also on how each individual bank is to be treated, on the basis of a specific proposal from the restructuring authority consistent with its overall strategy.

Such government participation in the decision making process must remain restrained, systematic and transparent. This is particularly true if government or Parliament decides on special treatment for "politically sensitive" banks or enterprises, which the government may allow to continue to operate at a loss. Such institutions should be funded through the budget

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<sup>2</sup>Such issues are likely to differ somewhat between countries, but could include the maximum total amount of government support to banks, the role of foreign ownership, identification of any "politically sensitive" bank or enterprise to be excluded from the regular restructuring exercise, and the speed of privatization or reprivatization when relevant.

of some ministry, and should be removed from the restructuring exercise. The authority responsible for restructuring should be asked to accept responsibility only for banks and enterprises whose problems are to be solved using strictly commercial criteria.<sup>3</sup> It should be stressed that the government must speak with one voice when it takes decisions in these matters, because disagreement creates confusion and loss of confidence in the financial markets.

Government deliberations must always be swift and secret in order to avoid creating liquidity problems for the banks concerned, culminating in clear and publicly announced decisions. The secrecy requirement is relevant only for the financial situation of, and restructuring proposals for, individual banks before decisions are taken. Once restructuring programs have been decided upon, the general principles should be made public. Preferably, leaders of the political opposition should be included in the deliberations to create as wide a political consensus as possible.

### III. ALTERNATIVE INSTITUTIONAL STRUCTURES

#### A. General Issues

Restructuring has important consequences in the areas of responsibility of several, often independent authorities (see Appendix). Each authority is, furthermore, likely to have superior insight and skills regarding certain issues relevant to restructuring decisions. Accordingly, there will be an early need to decide to: (a) assign primary responsibility for restructuring to one authority, including the option of creating a new temporary restructuring authority for that purpose; (b) determine the role of the other authorities during the restructuring effort; and © make sure that all available relevant expertise, as a top national priority, can be utilized in the restructuring process.

One single authority must, in any case, have the primary and sole responsibility for making proposals to the government on bank restructuring principles and measures. This is necessary for two reasons. **First**, the restructuring strategy must remain internally consistent to ensure credibility and transparency. It is important that the authorities speak with only one voice, because any divergent views are going to be seen in the markets as a change in policy. **Second**, the time available for discussions and deliberations is often limited, and someone

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<sup>3</sup>Such commercial considerations, however, must be modified by judgements on how solutions in individual cases are likely to affect financial stability. For instance, a nonviable bank may be merged rather than closed if closure is thought likely to cause a liquidity crisis; or a marginally viable bank may be closed rather than rehabilitated if financial markets appear to accept and expect such a decision. However, departure from commercial criteria should always be clearly argued and motivated to enable parliamentary investigators to assess the decision.

must decide when proposals have to be made and action taken. Other authorities should participate in the preparation of restructuring decisions, but should have no right of veto.

Because of this, the restructuring authority should make every effort to establish good and full cooperation at all stages of the restructuring process with the other authorities. In particular, preliminary views on possible constraints on individual restructuring decisions should be solicited as early as possible. Furthermore, there should be ways for other authorities to provide input in the planning and management process on a continuous basis as well.

Any authority responsible for bank restructuring, should be given adequate legal rights and political support to fulfill its duties. This should be done as early in the process as possible to ensure equal and fair treatment of all concerned parties. Restructuring will, in its work-out phase, always involve transfers of ownership, terminations of employment contracts, inexact pricing of assets and other activities which deeply and sometimes apparently unjustly will affect the fortunes of individuals. Because this may create demands for legal redress and damages, the legal position of both the authority and its staff should be made very clear.

Courts have only a limited role to play in the systemic bank restructuring exercise, although to the extent court proceedings are required by law in specific instances, courts should fulfill their normal duties. Courts have little or no expertise in many of the issues important for the systemic restructuring process. In some instances, courts may not even have achieved the quality or integrity necessary to successfully manage the restructuring of individual banks. Moreover, the sheer volume of legal activity related to a systemic bank restructuring might well overwhelm the capacity of even well-functioning court systems and unnecessarily delay the process. Therefore, systemic restructuring should not be a matter for the courts, and appropriate changes in law might be required to ensure this.

## **B. The Restructuring Authority**

### **Required skill profile**

The skills required of the restructuring authority largely depend on how active an operational role it has to play in the restructuring of individual banks. This, in turn, crucially depends on the quality of available candidates for management positions in banks under restructuring, as well as on the quality of operational staff in these banks. If good candidates and personnel are available, problem banks may need only general guidelines and monitoring from the restructuring authority. Otherwise, the authority will itself have to conduct a substantial part of the portfolio evaluation and work-out preparations, and will therefore need a much wider spectrum of skills and a larger staff.

Developing and transition economies seldom have sufficient numbers of qualified managers and staff used to operating in a market environment. Furthermore, asset markets are often still undeveloped or small, providing little guidance for market evaluation of bank portfolios. Therefore, it seems safe to assume that the restructuring authority in such economies is likely

to need access to a wide spectrum of bank restructuring skills. In such cases, the authorities should therefore consider recruiting temporary expertise from abroad for this purpose rather than accept insufficient qualifications or numbers of staff at the restructuring authority.

In this case, any restructuring authority in such economies will have responsibility for at least the following issues during the bank evaluation phase:

1. an audit of all banks considered for restructuring to determine exactly the legal liabilities and assets of each bank;
2. establishment of a uniform system of bank and asset evaluation, based on common aims and assumptions about real and financial developments in the economy as well as in its particular sectors;
3. valuation of assets, including: a valuation of collateral for loans (involving the valuation of individual pieces of or rights to real estate, guarantees and undertakings by third parties, as well as securities); an evaluation of debtors' ability to repay problem loans (involving an evaluation of enterprises' future economic prospects as well as of the bank's legal and real ability to ensure an improvement in them); and an evaluation of stock holdings (involving an evaluation of how the value of such stock should be maximized—by immediate sale, by restructuring the enterprise, or by writing off the stock);
4. a special audit of each bank to determine whether bank management or staff should be subject to criminal or civil suits; and
5. an evaluation of whether to rehabilitate, merge or liquidate each individual problem bank.

In addition, any restructuring authority will have to deal with at least the following issues during the bank restructuring phase:

1. establish, regulate, monitor, and possibly finance those work-out units which recover value from bank assets at government risk; and
2. handle the transfer or sale of good assets and liabilities from banks being liquidated.

The restructuring authority is unlikely to conduct the individual asset evaluations and workouts itself, but will be responsible for their correctness and completeness. For the practical work, which it will guide and supervise, it may use either the problem banks themselves (providing on-the-job training in the process), or separate workout units (see below).

### **Creation of a new temporary authority**

Operational restructuring decisions may, as indicated by the list of tasks above, require skills not necessarily found together in any of the existing authorities (for instance, auditing, financial engineering, business plan evaluation, credit risk evaluation). The skill profile of any existing authority given primary responsibility for restructuring may therefore need to be substantially widened. Furthermore, a very substantial part of the authority's management resources will, at least for some time, have to be expended on restructuring issues instead of on the issues which normally are the responsibility of that existing authority.

There are thus strong arguments for creating a special, but temporary, restructuring authority. This authority should have substantial autonomy, because: (a) proposals and decisions made by such an authority must be largely based on bank-, enterprise-, and instrument-specific considerations not readily usable by other authorities; (b) there may arise a need to weigh the differing views of other independent authorities; and © some conflicts of interest may otherwise be difficult to avoid.

The implications of this are that: (a) the restructuring authority should have a status specifically determined by law; (b) it should report to the government either directly or through the finance ministry, but have a legally guaranteed independent status; and © particular care should be taken to make the operations of the authority transparent to both other authorities and subsequent parliamentary scrutiny. At the same time, the role of other authorities in the restructuring process should be specified.

The existence of a new restructuring authority should not be allowed to affect the normal activities of the banking supervision agency, the finance ministry or the central bank. However, the new authority should maintain close liaison with these traditional authorities to ensure that all relevant authorities are as informed as possible about the implications of the restructuring process for their normal functions. Moreover, to minimize contradictory decisions, the restructuring authority might request other authorities to indicate appropriate (minimum) constraints on its decisions and activities. Ideally, such constraints should be the result of informal consensus among the authorities concerned.

As noted, banking supervision should supervise the banks under restructuring in a normal fashion. Therefore, unless banking supervision has given these banks special dispensations, specifically as part of the systemic restructuring strategy, they should fulfill all prudential and legal obligations required of any licensed bank. In fact, the systemic problems are by themselves a reason for increased supervisory vigilance. The finance ministry should monitor and allocate the use of public funds in its normal manner, requiring clear and adequate documentation as a precondition for their release. In addition, the ministry would be responsible for all aspects of the funding of systemic bank support. The central bank should avoid providing banks under restructuring with preferential funding, but could, if other prudential conditions are met, provide short-term liquidity support.

The temporary restructuring authority should be dissolved as soon as possible. Because it is a very specialized institution, there will be a rapidly declining need for its services once the acute stage of systemic instability has passed. This is likely to be the case when: (a) all problem banks have been subjected to evidently successful restructuring programs; (b) macroeconomic developments indicate that profitability and solvency in the banking sector as a whole is likely to remain sufficient; and © asset management units have proven able to function independently. The occasion may be used for improving the medium-term credibility of the banking system, for instance, by establishing a clearly limited deposit protection system reinforced by strict supervision, by introducing stronger disclosure obligations for external auditors, or by encouraging banks to qualify for ratings of international rating agencies.

### **Giving the responsibility to existing authorities**

In case a special temporary authority cannot be created, one of the permanent government authorities must be made responsible for making restructuring proposals and decisions. From the point of view of ability and resources, any of the authorities necessarily and intimately concerned with various aspects of bank restructuring—the finance ministry, the central bank and the banking supervision—can be made primarily responsible for the exercise.

Valid arguments can be made both for and against giving any of these three existing authorities primary responsibility for bank restructuring. Such arguments often relate to the fact that different authorities have unique responsibilities relating to banking and financial markets, including the required expertise.<sup>4</sup> The two essential issues are, however: (a) whether the authority in question can avoid conflicts of interest; and (b) the extent to which the authority's expertise corresponds to the practical demands put on the responsible restructuring authority.

Conflicts of interest should be minimized. The restructuring authority may be required to instruct banks on how various assets are to be valued and disposed of, and will have to decide on the extent and timing of recapitalization. Some of these decisions will, in time, have to be scrutinized by banking supervisors from both a legal and a prudential point of view. A substantial risk of conflicts of interest would therefore arise if the banking supervision authority were made primarily responsible for bank restructuring. Similarly, but possibly less seriously, the impartiality of the central bank may be called into question if it is responsible for

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<sup>4</sup>Because the division of responsibilities differs among countries, it is difficult to give generally valid reasons for or against choosing particular institutions to be responsible for bank restructuring. The more concentrated the responsibility for the banking sector in any one authority, the stronger would be the reasons to give that authority also responsibility for bank restructuring. However, such decisions should take into account that (a) the emergence of banking problems indicates that the authorities responsible may not have been doing their job well; and (b) there may be a risk of conflicts of interest involving those authorities' other responsibilities.

restoring profitability to some of the competitors in the interbank and currency markets which the central bank can influence. Possibly, the finance ministry could present the least risk of conflicts of interest. However, the finance ministry will be concerned about the budgetary implications of systemic bank restructuring. In practice the design of a restructuring program and its fiscal cost, of course, cannot be separated. Nevertheless, regardless of how the authority is assigned, the ministry should not delay taking action to resolve systemic banking problems because of the political sensitivity of budgetary issues.

If credible fire walls could be established within existing authorities, the problem of conflicts of interest could be reduced. This could tilt the selection of the proper authority if, as it is frequently the case in developing and transition countries, existing staff skills were substantially higher in the central bank or banking supervision authority than in the finance ministry. Even then, it could prove politically safer to transfer temporarily such resources as well as the restructuring responsibility to the finance ministry. This would, furthermore, reduce the possibility of conflicts arising from the fact that monetary management and banking supervision (typically combined in the central bank in most countries) should remain independent from the government in fulfilling their normal duties. However, if skilled staff cannot be seconded to the Ministry of Finance, responsibility for operational restructuring may have to be given to the central bank.

### C. Ensuring Sufficient Cooperation

As already indicated, the finance ministry, the monetary authority, and the banking supervision authority (particularly if independent) often have partially overlapping areas of responsibility. Even in normal times there are thus strong reasons to promote cooperation between them. When the economy experiences a systemic banking problem requiring comprehensive bank restructuring, cooperation becomes absolutely essential. This is because the designated authority, though responsible only for managing the bank restructuring process, must take into account how its activity affects overall financial stability, future competition in the banking market, the governance of banks, banking system liquidity as well as the fiscal costs of restructuring.

Both personal and institutional links between the restructuring authority and other important authorities must be strong from the beginning. Such links may be established in several different but complementary ways. **First**, the authorities concerned could be required to provide official opinions to the government on all proposals submitted by the restructuring authority. **Second**, qualified staff from other authorities could be seconded to the restructuring authority for the duration of the restructuring exercise. **Third**, senior staff from other authorities could be given explicit responsibility to support the restructuring effort in a number of ways (producing background or position papers, providing research support, conducting liaison for the timely exchange of information and views, and providing formal or informal advice on request and on their own initiative). **Fourth**, documentation prepared for restructuring proposals or decisions could be circulated for information and comments to

other authorities as soon as possible. **Fifth**, informal meetings between senior officials from different authorities on restructuring issues could be arranged on a regular basis. **Finally**, while the fiscal aspects and constraints of restructuring must remain the prerogative of the finance ministry alone, they should, nevertheless, be thoroughly explored together with other concerned authorities.

Once the restructuring process has begun, it must proceed decisively and transparently to a definite solution in order to minimize the risk of disturbances in the financial markets. If cooperation between authorities proves insufficient to ensure this, changes in procedures, responsibilities or personnel should be made. The government should in this case carefully assess the causes of such difficulties. Problems may arise because of an unclear division of responsibilities, but may also be caused by personality or attitude problems. In the latter cases, consideration should primarily be given to reassigning individuals to duties where their capacities and characteristics may be most appropriately utilized.

#### **IV. WORKOUT ISSUES**

##### **A. Determining Priorities**

The success of recovering value from the problem assets (the workout) primarily depends on speed and the recovery rate. This has two implications: (a) any general issues concerning the evaluation, classification, transfer and treatment of problem assets have to be resolved at an early stage so that operations are not delayed; and (b) the workout process itself should remain flexible and administratively uncomplicated.

When assigning tasks to workout units, there is often a trade-off between maximizing recovery on the one hand, and the implementation of other goals (structural, social or political) on the other. It seems reasonable, therefore, to assign regular workout units no other goals but to maximize the commercial return from problem assets. By contrast, assets that are politically or socially sensitive in some fashion, should not be transferred to regular workout units, but to a special quasi-government unit with a non-commercial mandate. Such transfers should be strict exceptions, however, because they tend to prolong the necessary enterprise restructuring, thus raising the total cost to government.

##### **B. Centralization Versus Decentralization**

A rehabilitated bank's nonperforming assets and acquired collateral that are not politically or socially sensitive are usually transferred to a regular workout unit. This specialized unit attempts to recover as much value from the problem assets as possible through, for instance, debt renegotiations, asset swaps, enterprise restructuring, liquidations, or sales of collateral. Some assets may need to be managed for an appreciable time before their value can be realized. A workout unit could, in principle, be either common to all problem banks, in which

case it could be owned by the banks themselves or by the government, or there could be one unit for each bank. The latter type of unit could be a separate company or even be part of the rehabilitated bank itself in this case, a separate management structure should be created, and the impaired assets that remain in the bank are compensated for an capital is not decreased.

Arguments sometimes advanced in favor of a single workout unit for all banks include: cost savings through economies of scale; avoidance of competitive asset price dumping; improved prospects for orderly sectoral restructuring in the real economy; uniform workout practices; efficient utilization of scarce expertise; and easier government monitoring and supervision of workout practices.

The main problem with a single workout unit, particularly in developing and transition economies, may be that of inappropriate incentive design. The single unit might be fairly large in relation to the banking system, implying that it must be an independent company owned by the government or by a number of banks. This could easily cause problems of inefficient governance. Such a unit can offer staff the prospect of short-term employment only, being liquidated as soon as the portfolio of problem assets is rapidly disposed of. This may be a particularly severe problem in countries where qualified staff are scarce. Therefore, recovery costs are likely to rise gradually as efficient staff leave or their remuneration is raised toward the end of the unit's life cycle. Alternatively, recovery efforts may falter as staff try to prolong their employment. However, even when the operating costs of such a unit are high, if the unit is efficient, it will save the government many times its cost in terms of improved recovery proceeds.

Other potential problems of a single workout unit will arise from its status as a quasi-government agency and include: a dominant position as supplier in some asset markets; difficulty of convincing the owners, and particularly the government, of the necessity to provide staff with adequate remuneration; and greater susceptibility to political pressure. A single work-out unit should not be privately owned because a systemic bank restructuring exercise will necessarily require substantial financial support from the government. Conflicts of interest between private owners and the government are bound to emerge.

Despite these problems, there may be limited alternatives to a centralized agency. **First**, if problem enterprises have liabilities to numerous banks in roughly equal proportions, it may prove difficult for the concerned banks to agree on which bank should be responsible for each individual workout. **Second**, banks may have personnel resources for a limited amount of individual workouts only. In such cases, the responsibility for both the workout and finance of some enterprises could be transferred to a central agency. The net liabilities of this agency should, of course, be treated as a liability of the owners themselves.

At the same time, under appropriate circumstances, a decentralized asset work-out could prove an attractive alternative to a centralized process. To maximize incentives, each rehabilitated bank could be financially responsible for its own workout unit. This could be

achieved either by creating a separate unit within the bank itself, or by creating a wholly-owned subsidiary. Such a solution would provide workout staff with more certain employment prospects, would internalize the remuneration issues, reduce problems of pricing asset transfers, and avoid some governance problems. Also, the existence of several bank-specific work-out units would avoid the risk that the a single workout unit would have a dominant market position, thus reducing the scope for distortions in asset prices. Furthermore, the susceptibility of workout units to political influence would likely be reduced.

The main initial constraint on this solution may be the availability of qualified workout staff. If so, on-site training by outside consultants should be considered at a very early stage. Because a workout function is an essential part of any viable bank, lack of trained staff in this area is an indication of nonviability of the bank itself. Therefore, if sufficient training cannot be provided in time, it may be an indication that too many banks are being rehabilitated rather than merged or closed.

For the decentralized alternative to work, it is essential that problem assets at each bank are valued as close to market prices as possible prior to recapitalization of the bank. Unless this is done, the workout may prove to be either a windfall or an insurmountable loss to the banks. As a consequence, workout efforts by the banks may in both cases be less intense than hoped for. A decentralized approach is therefore more likely to succeed if it is supported by a well-functioning regulatory framework with strong monitoring and enforcement by the supervisory agency.

Once banks have been made solvent and profitable they should be required to conduct the workout of their own assets without further government intervention. Different workout units and banks should be able legally to trade assets with each other. At this stage, it is vital that banks' governance, and the professional skills and incentives of their staff are adequate.

### **C. Restructuring Politically Sensitive Enterprises**

The government may decide that some enterprises with financial difficulties should remain unstructured at least for some time. This means that they would be able to receive market-based financing only if fully guaranteed by the government. However, because these enterprises will operate financially like quasi-government agencies, their debt to banks should be moved off bank balance sheets and their financial deficits should be covered by current transfers from the budget to make the costs of their continued operations transparent. When their debt to banks is removed from the banks' balance sheets, banks should be compensated with the nominal value of the enterprises' debt to banks.

When the government has decided to delay restructuring of enterprises with financial difficulties (for instance, to avoid employment problems), government guarantees should be

given to banks for credits provided such enterprises.<sup>5</sup> Such guarantees would increase the total amount of debt owed by the government, thus reducing the amount available for other restructuring efforts. This may eventually prove to be more expensive for the government and the economy as a whole than the alternative of an early restructuring of these enterprises.

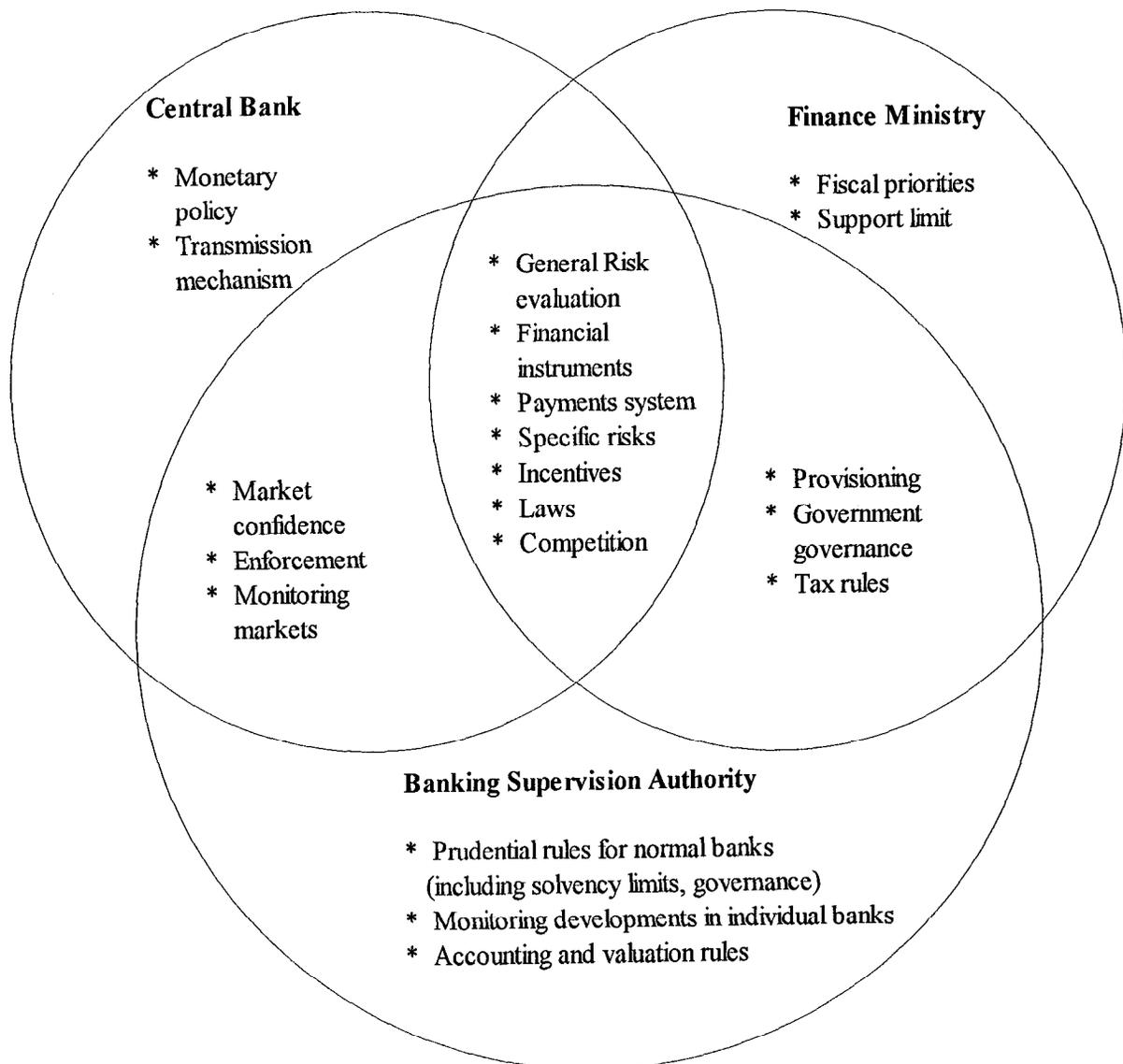
Politically sensitive enterprises are often subject to little restructuring but much financing at government risk in many developing and especially in transition economies. The rationale for such cost-increasing policies may be the high local or short-term cost associated with reductions or closure of operations. However, rather than support nonviable enterprises, the government workout agency should salvage their viable parts, which subsequently could get commercial finance.

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<sup>5</sup>This assumes that the government always and unquestionably honors both its guarantees and other liabilities on time. This is an absolutely vital cornerstone of any well-functioning financial market, and is a **precondition** for any government restructuring policy to work.

### DIVISION OF LABOR AMONG AUTHORITIES IN SYSTEMIC RESTRUCTURING

The diagram below indicates the areas of responsibility relevant to systemic restructuring of the central bank, the finance ministry, and the banking supervision authority, respectively. If decisions on banking supervision issues are taken by one of the other authorities, the outline for that authority would be appropriately enlarged or reduced.



All authorities are concerned with the effect of specific risks on the economic situation of individual banks, the incentives within the banks and workout units, the adequacy of existing laws when decisions on restructuring have to be made, and the effects of restructuring on competition in the banking sector.

The finance ministry and the banking supervision authority have a common interest in how banks make provisions for problem loans, since it may affect both bank solvency and tax revenues and create future expenditure. Also government behavior in its role as a possible owner of one or several banks is of interest to both, since it may affect both restructuring costs and prudential behavior.

The finance ministry and the central bank share concern over evaluating the general economic risks to which the banking system under restructuring may be subjected, because they may both reduce the creditworthiness of banks and increase their need for support. The financial instruments used by the finance ministry for recapitalizing banks are of interest to the central bank, since they may have an impact on the development of the securities and money markets.

Finally, the central bank and the banking supervision authority share concern over how market confidence in the banks develop during the restructuring process, since this affects their liquidity and, indirectly, their solvency. Both authorities also wield some power of enforcement to support restructuring decisions, the supervisors on the basis of laws and the central bankers because of their status as lenders to the banks. They also share the concern that restructuring should proceed in a manner which does not disturb the financial markets or make them less transparent.

However, the general responsibilities given these authorities do not include responsibility for some of the main functions necessary for the restructuring exercise:

1. evaluation of individual bank assets (enterprises);
2. supervision of asset workouts in banks or special units; and
3. implementation of bank or enterprise workouts which remain the responsibility of the government.