Improving Transparency in Asian Banking Systems

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There is a perception that credit ratings are driven by financial accounting inputs and that ratings map into well established ratios or other performance measures. This may hold to a certain extent in the US or other developed countries with advanced reporting and regulatory controls. However, where transparency is weak, rating analysts must rely on soft data sources. Indeed, the lack of transparency in many parts of the world forces analysts to base opinions on criteria obtained through indirect means.

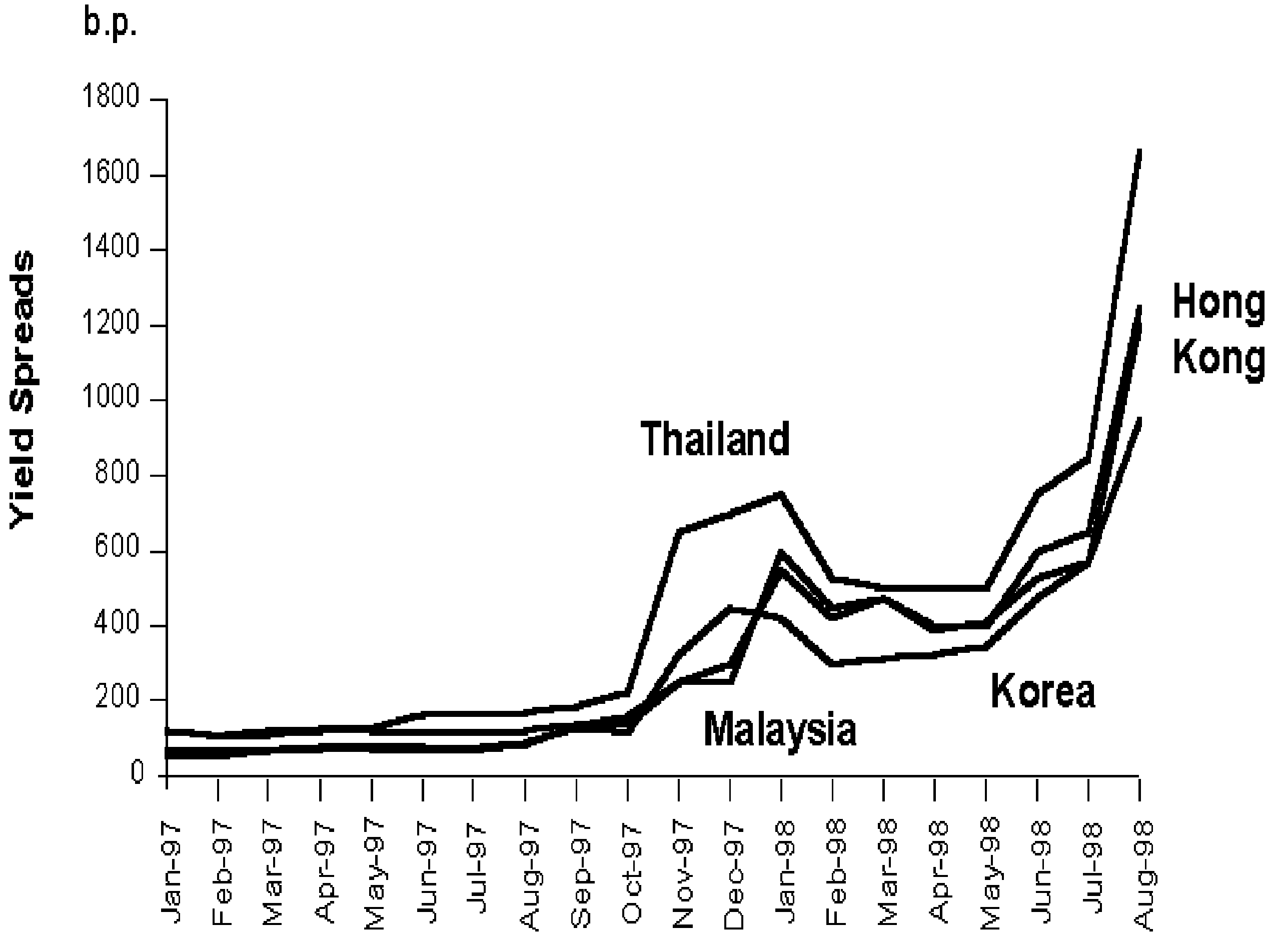
Subjective data are typically much more scarce and costly to acquire. Moreover, it is natural, under certain circumstances, to interpret vague assurances, or a "trust us" attitude with a grain of salt. Where transparency is lacking, our experience has taught us to favor a conservative view of the situation. We are willing to trust the source of soft data as long as the data is confirmed by other sources or subsequent developments. But if we feel misled or lied to, that trust is broken and credibility may be damaged for a very long time.

This paper examines the role that poor transparency has played in the East Asian financial crisis. Our focus is on the banking systems of the affected countries. We argue that weak transparency increases funding costs, especially in times of financial distress. Yet transparency can only help prevent a financial crisis and should not be seen as a cure for systems already under stress. Poor transparency is typically found in societies characterized by unchecked economic power or those with corrupt business practices. Deep-seated cultural differences suggest that it may be many years before changes in transparency can occur.

The East Asian Crisis

The meltdown in currency, bond and equity markets, over the past year or more has contributed to massive credit rationing for East Asia, particularly by foreign creditor banks. (Figure 1.) A permanent solution to the East Asian financial crisis will require a restoration of interbank confidence in the region's banks, which, in turn, will require credible transparency, massive restructuring and state-financed recapitalization. Vague, or unrealistically broad guarantees, half-hearted support measures and minor improvements in transparency will not be enough to induce interbank creditors to reopen credit lines voluntarily; there will be too much uncertainty. Interbank creditors will demand solvency and transparency.

The roadblock in the way of such measures is that transparency is revealing insolvency, further shaking creditor confidence, wiping out existing shareholder claims and endangering nondepository creditors (e.g., subordinated bondholders). Since some of these banks have undergone recent capital-raising operations, foreign investors have been further injured and credibility has taken another major blow. On top of this, revelation of insolvency is likely to bring to light managerial corruption and incompetence, requiring the dismissal of the existing managers, if not their arrest and trial. This is a powerful disincentive for bank management to come clean about asset quality.



The best way that credible transparency can be achieved is if arms-length bank examination and loan classification policies are adopted and conducted by independent and incorruptible bureaucrats. This is a part of the various IMF plans, but very difficult to actually achieve in societies without a tradition of independent, authoritative and incorruptible civil servants. Consequently, it seems very unlikely to us that transparency and solvency can be achieved in the near term and, therefore, it will be a challenge to restore interbank confidence within the next few years.

A critical factor here is the central role of banks in the financial equation: the debtor banks who act as the countries' principal credit-takers, and the creditor banks who act as the countries' principal credit providers. *The restoration of credit availability will be decided not by the debtor countries, the IMF or creditor governments, but rather as a result of private, autonomous decisions made by individual bank credit departments about other bank obligors.*

Transparency Defined

The dictionary provides several definitions of transparency, most having to do with light. Definitions applicable to a financial context include: easily understood or detected; obvious; guileless (free of deceit, cunning or craftiness); candid; open. In other words, fully revealing the true financial picture of a bank or firm. Transparency insures that reported financial data reflects reality. If there is a change in the financial status of a reporting entity, full transparency requires that that change be reflected accordingly and instantaneously to all concerned.

Transparency is not about cultural differences. Yet it is clear that certain cultures naturally resist attempts to improve transparency. Or worse, they wait until there is a crisis to make the change. At times, this exacerbates the problem and causes the crisis to deepen. As we argue below, transparency fosters confidence and trust as well as better economic decision making. Confidence and trust reap benefits of lower overall funding costs and higher profits.

As banks push beyond the basic, sound banking practice of engaging in short-term, self-liquidating lending, the need for transparency increases. Balance sheets stacked with long-term commitments, margin lending and direct equity investments are most vulnerable to economic disruptions. The weaker the transparency for such banks, the greater the likelihood that they may be trying to hide bad news and the larger the premium they must pay to attract funds. Where local laws permit poor transparency, managers of these institutions intuitively weigh the costs of improved transparency against the benefits of reduced funding costs.

Examples of Poor Transparency

We have encountered many examples of poor transparency throughout the world. The list below, while not exhaustive, provides a flavor of the issues faced by analysts trying to uncover the true financial status of debtors.

- Delays in financial reporting or the absence of quarterly and semi-annual updates;
- Lax accounting practices, especially those relating to loss and impairment definitions of financial assets;
- No consolidation of the financial results of related companies, and conversely, the lack of separate corporate entity financial statements;
- Complex corporate structures, lack of clear ownership interests and hidden related party lending;
- Continuing accrual of interest for problem loans;
- Undisclosed derivatives activity, such as forward contracts; likewise, missing footnotes;
- Lack of independent outside auditors and audit committees;
- Lack of timely information about material events when they occur and/or the poor distribution of information that is made public; and
- Restrictions on the freedom of independent third parties to voice opinions of financial issues.

Transparency In Banking Systems

Accounting transparency is vital to the health of a banking system. Without transparency, diseased banks which are insolvent in an economic sense are certified healthy in an accounting sense and are therefore allowed to survive and risk contaminating the entire banking system. With transparency, the diseased banks are naturally cut out of the system, reducing capacity and allowing the remaining banks to operate profitably. But if diseased banks are kept alive because of opaque accounting methods or regulatory forbearance, the strong banks will often grow weak.

When otherwise healthy banks become infected due to delays in resolving sick banks, the costs of returning the system to health inevitably rise. If the disease has spread throughout the banking system, the direct costs of restoring individual banks to health may be only a small part of the total bill. As diseased banks are recognized by market participants, despite the efforts of officials to hide the problems, the entire banking system can be penalized through increased funding costs or outright credit rationing. The banks, infected or otherwise, will face pressures to restrict growth or even shrink lending operations. Asset prices may decline, liquidity may dry up and loan quality at all banks may suffer, depending on the perceived difficulties facing the banking system. Moreover, business activity will likely stall and unemployment could rise. The bailout costs in such a situation may become a significant portion of the country's wealth.

At least until recently, it is our opinion that most Asian banks have played lip service to accounting transparency. Although many banks provide negligible detail and wholly implausible "headline" financial results, many have gone through the motions of providing excruciating detail about all of their activities. This might be referred to as nominal accounting transparency. While the banks may have followed the letter of the regulations when it came to classifying problem loans, they did not fulfill the spirit of the regulations. For example, many banks book additional loans to weak borrowers as current and performing. In a strict accounting sense, the loans *are* performing. Yet, because these loans have been made to borrowers who have already defaulted, and are therefore weak, in an economic sense, the loans should be classified as being of doubtful quality.

This is one of the key lessons being learned today in Asia as those countries try to restore international confidence to banking systems badly shaken by massive bad debt problems incurred as a result of asset bubbles and poor underwriting practices. The true extent of problem loans at many Asian banks is still not officially recognized. The risk now is that the situation has been made worse by banks who grew their loan books by extending new loans to insolvent borrowers in order to help them make payments on their existing loans.

To a certain extent, inaction on the part of authorities to deal with the banking mess in Asia reflects an unwillingness to see firms fail. There appears to be a cultural bias against failure, contrary to the capitalist model practiced in the West. Our textbooks tell us that the deliberate restraint of the invisible hand will lead to a misallocation of scarce resources. Inefficiencies will be allowed to persist and growth is stifled. In Asian banking systems there are no winners and no losers. Management is not held accountable for mistakes and misdeeds go unpunished.

Asia's banking system problems have in turn contributed to a sustained regional decline in asset prices, particularly real estate and commodities, which despite low interest rates in some countries, continue to weaken. Other fallout from the ongoing banking crisis are falling currencies, depressed equity prices, a flight to financial asset quality, stagnant economies and rising unemployment, all of which serve to lengthen the period before recovery can occur.

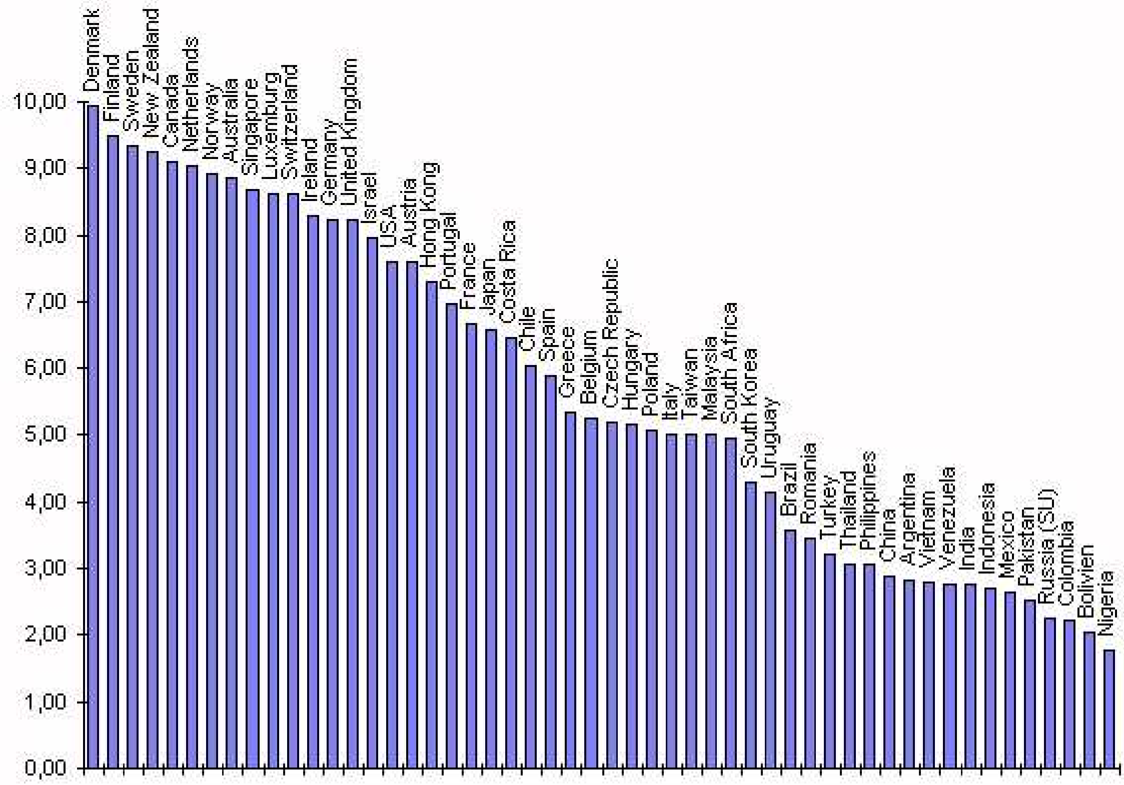
Transparency could also be said to be lacking when it comes to official policy regarding the protection of bank creditors. The deepening banking crisis in Japan, for example, has caused various officials to make vague or even conflicting statements about the treatment of different claims in the event of a bank closure. Lacking historical precedents, there is much uncertainty about how small depositors versus large depositors might fare. Or how authorities might treat foreign depositors, interbank claims, senior unsecured bond holders, subordinated bondholders or preferred stockholders. Mindful that each situation would likely be unique, a consistent, authoritative statement would go far in restoring confidence. Blanket guarantees, while perhaps helpful from a systemic risk perspective, can lead to moral hazard issues. Moreover, such guarantees could be seen as being insupportable in light of available resources.

How might one measure transparency?

Because there is no universally accepted definition of transparency and the concept itself remains somewhat subjective, a quantitative measure of a transparency is extremely difficult to prepare. We turn instead to the results of a readily-available survey which attempts to quantify the perceived degree of corruption in a large number of countries. The surveys are conducted by Göttingen University and Transparency International, a non-governmental organization whose mission is to curb corruption. The organization was founded in 1993 and is headquartered in Berlin. Each country is ranked, based only on the perceptions of business people that participated in the surveys, on a scale of one to ten. A perfect 10.00 would be a totally corruption-free country. There had to be at least four responses for a country to be included in the corruption index.

Why use a corruption index as a measure of transparency? Intuitively, there is a strong relationship between corruption within a country and the transparency of its bank accounting standards. Many social systems are characterized by economic power concentrated in the hands of government officials, the military or business interests. Lacking appropriate checks and balances, such power often begets corruption and/or political interference. Such practices provide very strong incentives to obfuscate the picture being presented to outside parties. Self-dealing, related party lending and questionable loans to politicians and friends are not the sort of laundry that banks want aired publicly. Thus, corrupt regimes are most likely to favor poor transparency.

Below is a ranking of 52 countries (or special regions) by their 1997 TI Score. The country having the lowest perceived corruption, with a corruption score of 9.94, is Denmark. Nigeria, with a perceived corruption score of 1.76, is seen as the most corrupt country on the list. In the appendix, we list each country and score alphabetically. Three East Asian names, Singapore, Hong Kong and Japan, rank above the median score as being regarded as having relatively low corruption. Conversely, Taiwan, Malaysia, South Korea, Thailand, the Philippines, China and Indonesia are well below the median.

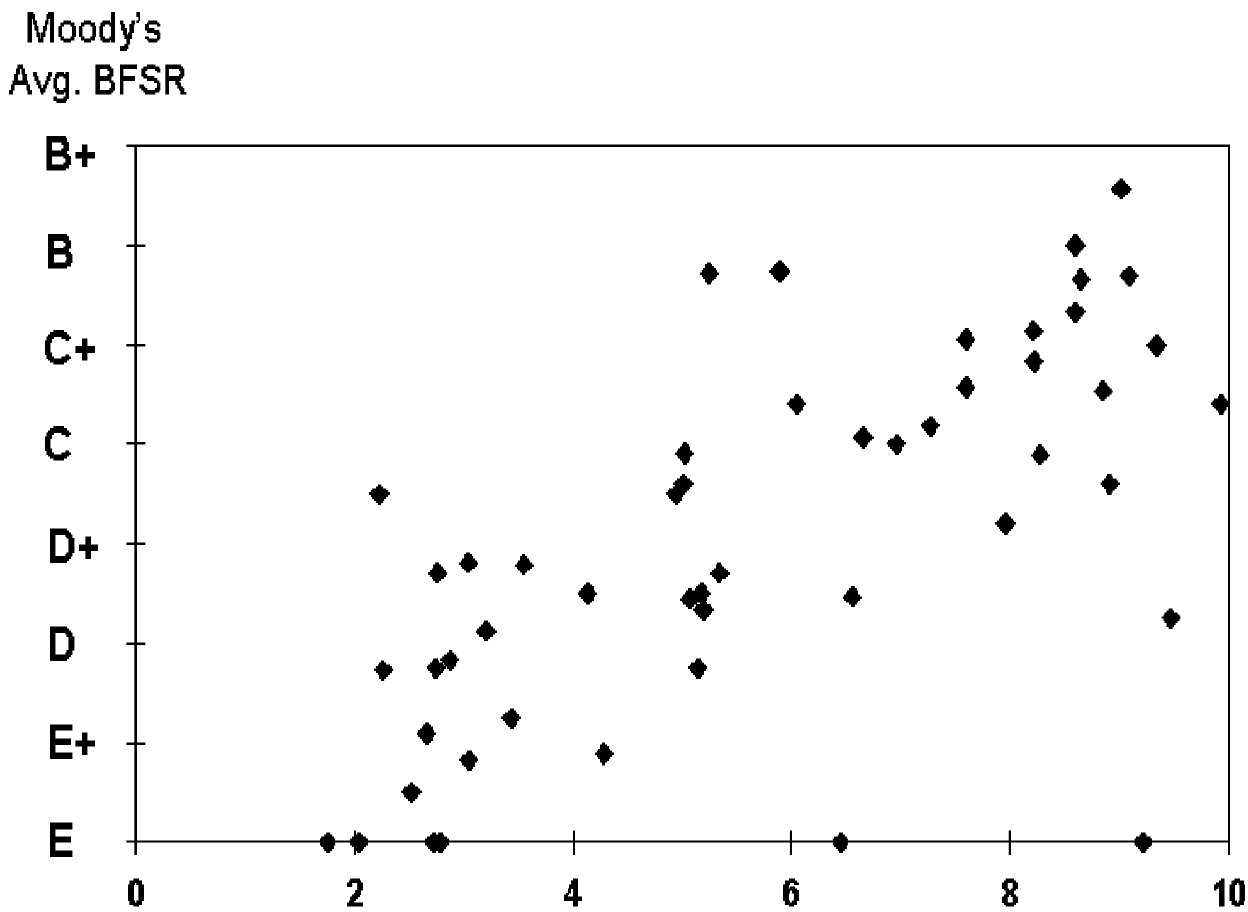


Moody's bank financial strength ratings (BFSRs) provide investors with an indication of a financial institution's ability to withstand stress. In nearly all of the countries now experiencing problems, average system-wide BFSRs have been among the lowest in the world. Moody's introduced its bank financial strength ratings in 1994 to serve the interbank deposit and lending market. Today, Moody's has over 854 BFSRs for banks in 63 countries. Our strategy has been to assign BFSRs to all banks holding a deposit rating. Multilateral and national development banks are current exceptions to this rule, however, because of their special role in facilitating economic growth.

BFSRs are intended to provide investors and cross-border interbank lenders with a measure of a bank's intrinsic safety and soundness on an entity-specific basis. Thus, unlike traditional bond or deposit ratings, BFSRs are assigned to issuers, not specific debt issues. Also unlike debt ratings, BFSRs are not intended to measure the risk of credit loss, or expected loss. Hence they do not replace bond and deposit ratings.

BFSRs assess a bank's credit profile by excluding factors related to country risk concerns, regulatory support mechanisms, ownership, or membership in a banking group. Instead, they are opinions of the stand-alone risk of a bank enterprise and address aspects of risk familiar to regulatory examiners. In particular, we evaluate the bank's capital adequacy and quality. We also look at the quality of the bank's assets. Typically this would entail an estimate of the loss content of the loan portfolio or losses on equity shareholdings, if any. We try to assess the professionalism of management by asking questions about bank strategy and risk control mechanisms. We also look at the profitability of the bank and the strength of its franchise. And we consider the liquidity position of the bank by estimating its capacity to meet maturing obligations, as well as the bank's sensitivity to adverse interest rate or exchange rate movements.

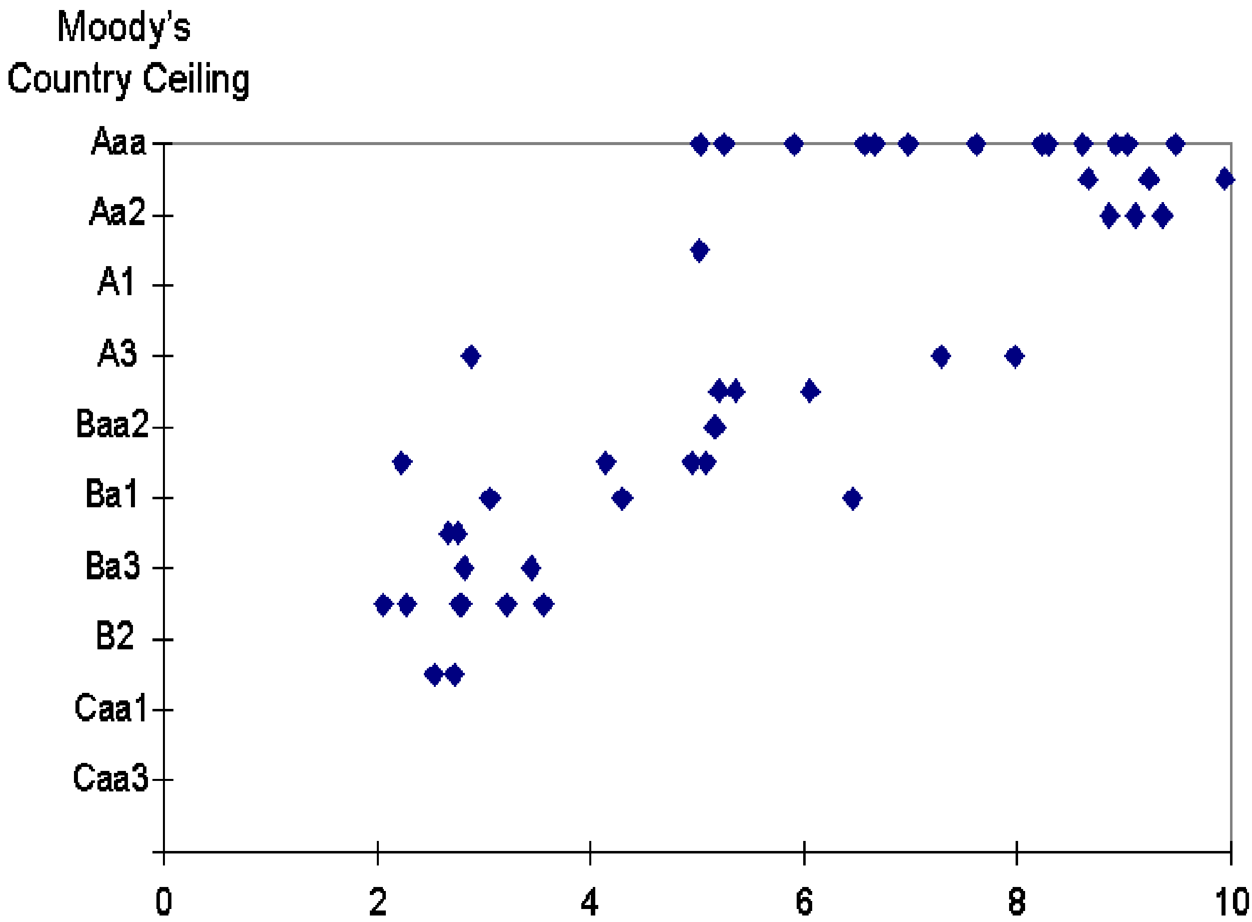
Also shown in the appendix, we matched the average financial strength rating across banks within each country to its corresponding corruption score. The ratings were those in effect as of August 3, 1998. Five countries of the 52 TI-rated countries did not have banks with Moody's-assigned financial strength ratings. For the remaining 47 countries, we construct below a scatterplot showing the corruption index (the horizontal axis) against Moody's average BFSR for that country.



As the figure indicates, the two series are in fact significantly correlated. A regression of the corruption index on average BFSR yields an adjusted R^2 of 0.53. The sign of the relationship also conforms with intuition: countries perceived as being less corrupt have stronger banks, on average.

Moody's also provides country ceiling credit ratings for each country on the TI list except Nigeria. Also using the August 3, 1998 date, we show in the appendix the country ceiling long-term debt ratings for each country. These represent the highest foreign currency rating an issuer might receive where the obligor is subject to the sovereignty of a particular government. Such ratings are based upon the default risk for medium and/or long-term debt obligations issued by a national government (denominated in a foreign currency), either in its own name or with its guarantee. Put differently, it represents the "foreign currency transfer risk" associated with investing in a particular country. In cases where there is no particular debt obligation outstanding, a country ceiling rating could still be issued based on an assessment of risk posed by a national government if it were to issue a foreign currency obligation. We consider such obligations to represent the lowest foreign currency default risk within a country. The reason: a national government, through its ability to mobilize foreign currency assets within its own domain, has almost by definition the best ability to obtain foreign exchange of any issuer within the country. For instance, governments may, and often have, imposed foreign exchange controls.

We repeat the above exercise and plot below TI's corruption index against Moody's country ceiling ratings. The series do appear correlated, with higher-rated countries receiving better scores in the area of corruption. Regression results bear out this observation and indicate and even higher statistical relationship with an adjusted R^2 of 0.71.



These two comparisons help support the hypothesis that increased transparency, all else equal, will yield lower overall credit risk. Although we have admittedly used a very narrow definition of transparency, the relationship is strong enough to consider. The question then becomes: is the potential improvement in credit standing worth the risk of increased disclosure?

Why some banks (and even some regulators) may not want transparency

The positive aspects of transparency have been weighed against the costs throughout the history of banking. Debilitating panics and runs encouraged a form of secrecy surrounding financial condition fully sanctioned by regulators. Today there still persists an attitude among banks and their regulators that somehow the average citizen is incapable of acting rationally on sophisticated financial data. Even in developed countries, bank examination results (such as CAMEL ratings) are kept out of the public domain. Regulators may favor such secrecy to deflect public criticism arising from the failure to resolve or close a troubled bank. While improved transparency is advocated as a means of improving market discipline, regulators clearly fear the consequences.

There are several reasons why certain banks would favor poor transparency. Chiefly, it costs money to institute timely, accurate and detailed accounting systems. Resources that might be more profitably employed elsewhere are relegated to a reporting function. Statements must be formatted to international standards and outside auditors must be hired to opine on the quality of reporting. Many banks in developing countries are small and the costs of complying with transparent reporting practices may be significant.

Also of concern, transparency restricts management's ability to engage in self dealing. Loans to subsidiaries, politicians, family and friends may be interpreted in a harsh light when subject to international scrutiny. Lending of this type often finds its way into such speculative activities as stock market or real estate purchases. Such lending could also be used to prop up inefficient or corrupt business activities. In many cultures, it is expected that a loan officer would receive a "gift" for making a loan to certain borrowers. These activities may be difficult to hide under a fully transparent system of reporting. Banks have a large incentive not to reveal such activities as they may subject managers to civil or criminal legal action.

Fully transparent reporting may also reveal competitive strategies or vulnerabilities where a bank holds a large unhedged position in some asset or currency. State-owned banks may not want transparency to reveal policy lending or loans to finance a project considered to be a state secret. State-owned banks in many countries without well developed capital markets are used as instruments of economic policy. They direct funds to targeted industries in order to gain a foothold in international markets. Moreover, they can subsidize loss making entities or projects for broader political purposes.

When confronted with unusual or questionable activity on a bank's part, market discipline can be swift and potentially disruptive to the entire banking system of a country. Indeed there may develop a Catch 22 situation when trying to introduce transparency to previously closed systems. First, assume that banks operating in a system of poor transparency have been poorly managed and have hidden fundamental problems in their loan portfolio. As long as the region or economy seemingly prospers, the market (i.e., investors and interbank lending officers) will not mind the poor transparency. Once problems surface, however, investors may begin to lose confidence. They may suspect that there are bigger problems lurking beneath the surface but they don't know.

While officials may encourage increased transparency as a means of easing the banking system's ensuing credit crunch, increased transparency would instead reveal the true state of the banks and/or the inadequacy of regulator's plans to deal with the banking crisis. Investor fears may be confirmed and confidence may fall further. The credit crunch could deepen and the economy, along with the quality of bank assets, would be further compromised. A vicious cycle might develop until the entire system has virtually collapsed. The irony is that efforts to improve transparency in fact worsen the situation.

Transparency is a preventive measure which must be introduced when confidence is rising and market reaction is likely to be benign. Just as one would not prescribe physical exercise to a patient in an intensive care ward - however proper such advise may be for a healthy person - transparency can only be introduced when a banking system is free from stress.

Conclusion

We have argued that poor transparency has played a key role in the East Asian financial crisis. We discussed examples of poor transparency, and noted a correlation between credit risk and a quantitative measure of corruption. We suggest that weak transparency increases funding costs, especially in times of financial distress, but note that transparency can only help prevent a financial crisis and should not be seen as a cure for systems already under stress. Poor transparency has been associated with societies characterized by unchecked economic power or those with corrupt business practices. Cultural and other barriers suggest that it may be many years before changes in transparency can occur.

Appendix

As of 8/3/98	**TI Corruption**	**Moody's**	**Moody's**	**Moody's**
Country	**Perception Index**	**Avg BFSR**	**Avg BFSR**	**Sov. LT Rating**
Argentina	2.81	2.44	D	Ba3
Australia	8.86	4.54	C+	Aa2
Austria	7.61	4.57	C+	Aaa
Belgium	5.25	5.71	B	Aaa
Bolivia	2.05	NA	NA	B1
Brazil	3.56	2.79	D+	B1
Canada	9.1	5.70	B	Aa2
Chile	6.05	4.40	C	Baa1
China	2.88	1.83	D	A3
Colombia	2.23	3.50	C	Baa3
Costa Rica	6.45	NA	NA	Ba1
Czech Republic	5.2	2.33	D	Baa1
Denmark	9.94	4.40	C	Aa1
Finland	9.48	2.25	D	Aaa
France	6.66	4.07	C	Aaa
Germany	8.23	4.84	C+	Aaa
Greece	5.35	2.71	D+	Baa1
Hong Kong	7.28	4.18	C	A3
Hungary	5.18	2.50	D+	Baa2
India	2.75	1.75	D	Ba2
Indonesia	2.72	0.00	E	B3
Ireland	8.28	3.90	C	Aaa
Israel	7.97	3.20	D+	A3
Italy	5.03	3.92	C	Aaa
Japan	6.57	2.47	D	Aaa
Luxembourg	8.61	5.33	C+	Aaa
Malaysia	5.15	1.75	D	Baa2
Mexico	2.66	1.10	E+	Ba2
Netherlands	9.03	6.57	B+	Aaa
New Zealand	9.23	NA	NA	Aa1
Nigeria	1.76	NA	NA	NA
Norway	8.92	3.60	C	Aaa
Pakistan	2.53	0.50	E+	B3

Philippines	3.05	2.82	D+	Ba1
Poland	5.08	2.44	D	Baa3
Portugal	6.97	4.00	C	Aaa
Romania	3.44	1.25	E+	Ba3
Russia	2.27	1.73	D	B1
Singapore	8.66	5.67	B	Aa1
South Africa	4.95	3.50	C	Baa3
South Korea	4.29	0.89	E+	Ba1
Spain	5.9	5.74	B	Aaa
Sweden	9.35	5.00	C+	Aa2
Switzerland	8.61	6.00	B	Aaa
Taiwan	5.02	3.60	C	Aa3
Thailand	3.06	0.82	E+	Ba1
Turkey	3.21	2.13	D	B1
United Kingdom	8.22	5.15	C+	Aaa
Uruguay	4.14	2.50	D+	Baa3
United States	7.61	5.05	C+	Aaa
Venezuela	2.77	2.71	D+	B1
Vietnam	2.79	NA	NA	B1