
Economic Development Institute of The World Bank

From Good Bankers to Bad Bankers

*Ineffective Supervision and Management Deterioration
as Major Elements in Banking Crises*

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FINANCE, INDUSTRY, AND ENERGY DIVISION

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Abstract

This working Paper stresses the role of bank management as a major element in all banking crises. Even when the crisis has its roots in macroeconomic conditions or in unexpected changes in government economic policy, and not initially in poor management, good bankers, when in trouble, often become bad bankers through a series of deteriorating attitudes. The paper analyzes the causes and consequences of the mechanisms at work and presents the remedies which can be applied to stop and reverse the deterioration of financial institutions of systems in distress.

The views presented in this paper, however, are entirely those of the author and do not necessarily reflect those of The World Bank

INTRODUCTION

This paper is not intended to be a rigid manual or pass any ethical judgement on Bankers' behavior. Rather, it is a model made up of *features that repeat themselves historically* around the world, both in developing countries and *in developed ones*.

Contrary to the theory that financial crises are only due to macroeconomic factors, this paper stresses the role of bank *management as a major element in all banking crises*, as a potential originator or as a multiplier of losses and economic distortions. It also stresses the fact that good bankers, when in trouble, often become bad bankers, through a sequence of deteriorating attitudes.

Poor management and ineffective supervision are relevant not only to the crisis of single institutions or to widespread crisis affecting a significant proportion of a banking system, as would appear obvious. They are also a major element in *general financial crises* that affect the whole system. Those crises may be caused by economic upheavals, inappropriate monetary or exchange rate policies and/or abrupt deregulation. In those cases, both *good banks and bad banks can be found*, depending on the quality of their management. In fact, good management may enable banks to survive and be reasonably healthy. On the other hand, bad management will lead to a deeper crisis, through compounding losses, misallocating resources and contributing to inflation through high interest rates. Therefore, applying only macroeconomic remedial action to general financial crises, without simultaneously *addressing the institutional side* of them, may prove ineffective or even counterproductive.

Banking Supervision is shown as a key element *to prevent or limit* the damages of poor management. The concept of supervision is used here to cover regulation, supervision proper and remedial action (from conventional enforcement to restructuring of institutions). If good regulation, supervision and remedial mechanisms are in place, bad management is less likely to exist. And if it exists, it is less likely to last. *Remedies can be put to work* to stop and reverse deterioration. And because of the acceleration potential of deterioration, *the sooner, the better*.

The features of the model described in this paper, as well as the lessons to be learned are expressed in a sketchy way, for the sake of simplicity.

AN ATTEMPT TO TYPIFY MANAGEMENT

The above assertions would make it important to analyze the managerial problems that lead banks to failure and what regulations and supervision could do to prevent or remedy them.

Regulators in the USA have a system to rate banks according to the quality of Capital, Assets, Management, Earnings and Liquidity. They call it the CAMEL System, after the initials of those items. Each particular institution is given periodical marks by the supervisors, according to the performance in a series of aspects that make up each of those areas. Averages for each area and for the whole exercise lead to rating banks from 1 to 5, from very good to failing banks. The elements used as a basis to rate bank's Management are:

- ↗competence
- ↗leadership
- ↗compliance with regulations
- ↗ability to plan
- ↗ability to react to changes in the environment
- ↗quality of policies and ability to control that they are applied
- ↗quality of management team and potential succession
- ↗risk of insider dealings
- ↗succession prospect

A satisfactory response to those concepts can be a good definition of *good management*. If all banks were well managed, the only reasons for failure would be those due to the economic or political background. Even in those cases, the need for regulation and supervision would exist, in a similar way that traffic laws and policemen would be necessary even in a country of good drivers. Both banking and driving are risky activities for third parties.

Let us draw a picture of things that could certainly happen in the context of nonexistent or ineffective regulation and supervision. Types of mismanagement can be grouped in four categories: (a) technical mismanagement; (b) "cosmetic mismanagement"; (c) "desperate management" ("La fuite en avant"); and (d) fraud. They do not have to occur in a sequential manner. But when technical mismanagement leads to losses or to the need for a dividend reduction, it frequently unleashes "cosmetic" and "desperate" management.

Fraud may be a part of the process since the very beginning, but it is dealt with at the end, as a part of the dynamics that make good managers become bad managers. Illiquidity comes at the end of the process. In the meantime, the bank in question may have lost its capital several times.

Whereas nonfinancial institutions may experience illiquidity despite underlying solvency, a peculiarity of banking is that *insolvency invariably precedes illiquidity*. The dimension of portfolio, the leverage banks operate with and their ability to raise money from depositors are the key differences between financial and nonfinancial firms.

TECHNICAL MISMANAGEMENT

Technical mismanagement may occur; (a) *when* a new bank is set up and has, naturally, a new management; (b) *when* control of an existing bank is acquired by new owners; (c) *when* an existing bank that used to be well managed proves unable to plan ahead for changes or fails to acknowledge a deteriorating situation and remedy it.

Technical mismanagement may involve a whole variety of inadequate policies and practices. *The most relevant ones are:* overextension, poor lending, lack of internal controls and poor planning in the areas of business and management.

Overextension and *quick growth* are some of the major sources of failure. Overextension means lending sums of money that are not in proportion to the Bank's capital (as a cushion for potential losses), or diversifying activities to geographical or business areas the bank is not familiar with or is not well equipped to manage. Overextension is often connected with seeking *growth for the sake of growth*.

Poor lending policies are a key danger that may also prove fatal. The key element of bank management is making sure that deposits (which do not belong to the bank but to the depositors) are lent in such a manner so as to yield a proper remuneration and be reimbursed to the bank. Policies or practices to avoid are:

- (a) *Risk concentration.* This means making loans representing a high proportion of the bank's capital to one single borrower or group of borrowers or to a given sector or industry. This practice may be the result of the free will of the banker (who believes in the eternal health of a given borrower) or the result of irresistible borrowers pressure *vis-à-vis* the banker, when unable to service their debt or even pay their operational overhead. Risk concentration is frequently mixed with connected lending, as will be described below. Not all concentration lead to failure, but most banks failure are the result of serious loan concentration.
- (b) *Connected lending.* This means a situation where the bank lends money to companies owned (totally or partly) by the banker or by the bank. Since ownership, especially in the case of bankers, is frequently indirect (i.e., through other subsidiaries or through decision making relationship), the concept of connection is used rather than ownership, because of its wider connotation.

Lending to borrowers connected to the bankers, beyond certain limits, is frequently fraudulent, as will be explained later in this paper. In most cases, this kind of lending contains a high risk, because of the banker's tendency to use the bank as an instrument to finance his business, irrespective of their ability to repay, and concentrate large proportions of the bank lending on them. Concentration, default and permanent roll-over of loans are very common with connected lending. Most bank failures are also the result of connected lending.

Lending to borrowers owned by the banks is typical of development banks. It also happens with commercial banks in some very industrialized countries, like Germany and Japan. As a matter of principle, there is nothing wrong with this kind of lending, provided borrowers are treated as if they were ordinary third parties. Scattered ownership and proper internal control are significant elements to this effect.

However, in practice, the danger exists that: (i) the loans are made according to less rigorous criteria and concentrate a high proportion of capital, because of the parental relationship between the bank and the subsidiary; (ii) the managerial attitudes of the subsidiary management deteriorate because of their easy and systematic access to credit; (iii) the bank's representatives on the subsidiary's board develop a cozy relationship with the subsidiary and the people they are supposed to supervise; as a result, they become an obstacle to information and control rather, than a proper service for both; and (iv) the parent bank will seldom recognize a loan to a subsidiary as "overdue" or doubtful. Besides, in the case of state-owned development banks, short term social objectives and political pressure may lead to bad loans and losses, whether or not accounted for in the books.

- (c) *Mismatching*, or lending at terms out of proportion with those of deposits. Transforming terms forms part of the essence of banking, because money is fungible and deposits stay longer with the bank than their legal terms would permit. But, when the terms of lending are overstretched far beyond those of liabilities or became so because of forced rollovers, serious liquidity problems may arise. If the bank that mismatches its assets and liabilities is able to solve the liquidity situation, it may have had to pay excessive rates for its new funding. And, if it operates with fixed interest rates, it may incur losses in the transformation. That is a modality of what you call *interest risk*. A problem which is particularly serious may occur when the Bank operates in foreign currency, and where, besides the borrowers solvency, additional risks are involved, such as the transfer risks and the rate of exchange risk.

If the bank solves the liquidity situation with more expensive funding within market standards and operates with variable rates, mismatching is not a serious problem. Still, the borrower may prove unable to pay high variable rates, especially in situations of high inflation.

If the funding to solve the liquidity crisis is obtained at rates high above the market, the variable rates related to market standards on the assets side will be of no help, and losses will be incurred.

In any case, if mismatching is the result of continuous roll-over or rescheduling, because of the borrowers inability to serve their debt, the financing of those non-performing loans may also cause losses.

- (d) *Ineffective recovery*. This frequently stems from conflict of interest between the bank and companies owned by the bank or the bankers, as well as from political pressure on bankers or potential labor problems.
- (e) *Overly optimistic assessment* of borrower's prospects, including failure to assess all possible risks for borrowers. This includes inadequate assessment of quality of management. Such loans may be made under political pressure.

Lack of internal controls may also happen in different areas, but the most dangerous ones are those affecting:

- ▣ *credit review procedures* which should be in place to avoid overly optimistic loans, excess risk concentration, plus inappropriate rescheduling; they should also prompt timely recovery action;
- ▣ *information systems*, which should enable management to promptly analyze the trends of its business, and flash red lights as a warning of illness or problems that can be addressed at an early stage; and
- ▣ *internal audits*, which should ensure that both regulations and internal policies are properly applied throughout the bank.

Poor Planning or considering that “nothing serious ever happens”. The ability to foresee is a very rare gift, which can be developed with adequate techniques. But poor planning is not only a matter of technique, but a matter of attitude. It has a close relationship with the age or interests of top management, with the *absence of teamwork*, and with the wishful thinking that *banking has always been a very safe business that needs no sophistication or adaptation to change*. “We have always done very well”, “Nothing serious ever happens,” and “Problems are solved by time,” are typical attitudes. In a context of economic upheaval, growing competition, financial “menageries,” etc. it is easy to understand the consequences of poor planning. On the contrary, if a bank follows its own trends closely, if it tries to capture what is ahead in the economy and on the markets, it can adapt its strategy so as to suffer limited damage and survive even in the midst of serious upheavals. Together with quick growth and bad lending policies, this aspect of mismanagement is the most frequent cause of bank deterioration.

THE CROSSROAD

As a result of technical mismanagement and/or other macro or micro factors, a bank may find itself in a situation where *equity is increasingly eroded* by hidden losses, *real profits decrease* (if not disappear) and *dividends, of course, are in danger*. This would be the typical situation where good supervision or a good board would have the bank declare the real situation, change management and inject new capital. But, lack of proper supervision and/or good boards lead to a very different situation. A drop in dividends is the key signal for the market that the bank is deteriorating and bankers will tend to do everything in their power to avoid lack of confidence and to keep control of ownership and management. *This is the key crossroad*. If the supervisor or the banker does not take the right road, the bank is doomed to engulf in “cosmetic management” and “desperate management”, either one after the other or simultaneously. Management will get worse and worse, the culture of the organization will deteriorate very quickly, the market will be distorted and a spiral of losses will soar. That is probably the point of no return. From then on, liquidation or restructuring is the only effective solution to a situation of insolvency that may grow in geometric progression.

COSMETIC MANAGEMENT

What can be called “*cosmetic management*” consists of hiding past and current losses so as to buy time and remain in control, while looking and/or waiting for solutions.

While there are almost infinite ways to hide the economic reality of your bank, some of them can be grouped in a model: the “*upside-down income statement*” technique. In a typical income statement, the first item is interest income and the last one is dividends, dividends being the result of additions and deductions of all the items in between. But when dividends are in danger, the banker may decide that they cannot be considered a variable, but a fixed element, that is taken as a basis to construct the remainder of the statement down the ladder, through manipulation of figures, no matter what the reality is. The “*upside-down income statement*” would therefore tend to read as model A, as against a standard one, as shown in model B.

Model A (Upside Down)

Dividends
+ Undistributed Profits
+ Taxes
= Net Profits
+ Provisions
+ ___ Sundry Income/Expenditure
= ___ Operational Profit
+ Overhead
- Fees
= Spread
+ Financial Cost
= Interest Income

Model B (Classic)

Interest/Income
- Financial Cost
= Spread
+ Fees
- Overhead
= Operational Profit
± Sundry Income/Expenditure
- Provisions
= Net Profits
- Taxes
- Undistributed Profits
= Dividends

In Model A, once *dividends* have been *predetermined*, the first area a banker will touch upon in order to maintain the same dividends is *undistributed profits*. This is not yet an accounting gimmick, but the threshold to cosmetics. The bank is sacrificing its equity capital for the sake of a “good image” that no careful analyst should believe. Still, investors will receive the remuneration they were accustomed to.

Next problem arises when a further reduction in undistributed profits is no longer possible. Then, the banker will think of *manipulating the net profits* in order to increase them on paper, even if that means having to pay more taxes. How? The banker will have four main resources to achieve his purpose:

- (a) to provision less than required, through “evergreening” procedures, or collateralization
- (b) to consider uncollectable accruals as income
- (c) to revalue assets
- (d) to advance accrual of income and postpone accrual of expenditures.

“Evergreening”. The most serious problems of a bank are not in loans classified as overdue; they are smaller loans and are being dealt with. *The worst losses of a bank are hidden* in the portfolio that is classified by the banker as *current portfolio* or “good portfolio”. This means that when a banker wants to adapt provisions to a given level of profits and dividends, he will not classify a bad loan as overdue, doubtful or a write-off. Instead, he will automatically reschedule the loan over long periods of time, which will avoid classifying it as overdue. Interests will be refinanced. This is a snowball process that may lead to disaster because those loans become more and more difficult to collect and the borrower’s bargaining position is strengthened because of the bank’s failure to take effective recovery action. The culture of nonpayment develops. Those practices are very typical of loans to companies where the bank or the bankers have stock, or where the bank has concentrated disproportionate sums of money. A very significant example of the latter was that of banks substantially involved in foreign debt of LDCs during the ‘80s, when they kept rescheduling the debt over and over again without making the necessary provisions.

Another typical way of reducing the need for provisions is to make a bad loan look good by obtaining collateral, even if they are economically insufficient to cover the debt or are impossible to foreclose on. For instance, loans with prior mortgages, factories with ongoing business and labor problems, real estate with limited or no development potential. However, the banker will account for the collateral as being worth the principal plus the interest to be accrued over a period of time. The borrower will again be very happy about it.

In any case, the borrowers may still have negative equity, current losses or even negative cash flow, but the banker will argue to the effect that he does not have to provision those loans, and that time will solve the stressed situation of the borrower. He may even go as far as to say that he *“cannot make provisions”* for those and other bad loans, beyond the limits the tax laws consider as expenditure. “Therefore”, those loans are not bad.

The practices described above do not only lead the banker to provision less than he should, but will also lead him to capitalize interest, i.e. to account for *refinanced interest* (which in fact will be increased losses) as income. So, looking back to the income statement, the banker has achieved better “profits” not only because provisions are lower, but even more important, because interest accruals are artificial, thanks to procedures that make loans look like “evergreens”.

Suppose that “evergreening” is not enough to keep profits at the desired level. The banker still has a way out to revalue *fixed assets*, be they real estate or stock. Some legislation permits banks to periodically revalue their assets in time of inflation without additional tax implications. Some banks use this advantage to increase the book value of their assets beyond their economic value, thus creating artificial additional income (the difference between the previous book value and the new one) and reserves (as a counterpart of the asset revaluation).

Worst of all, some bankers may revalue their assets by selling them to companies that are connected with the bank, on credit, for a price above the book value, and account for the positive differences as income. The negative difference will not appear on the buyer’s balance sheet as it should. Another type of “revaluation”: banks may receive foreclosures that are insufficient to cover the loan in question but account for them at the loan value.

Another type of maneuver to hide losses is to *advance accrual of income and postpone accrual of expenditures*. Let us mention a couple of examples. Fees should normally be spread over the operation term. However, bankers in trouble will account for them the very day the fee is received. On the expenditures side, the banker may postpone accounting for commitments (for example, the payment of the price of a purchase) to the time of actual payment, instead of making the entry on the day the contract is signed.

DESPERATE MANAGEMENT

“*Desperate management*” is an expression that means to describe a situation where bankers see themselves in danger of “having to declare” a capital loss or having to pay fewer or no dividends. At that stage, the banker, besides indulging in cosmetics, will also look for business which may permit them to buy time, and if lucky, make up for the previous deterioration. The main practices followed under these attitudes are (a) speculation, (b) paying rates above market rates for deposits, and (c) charging high interest rates to borrowers.

When a distressed economic environment, bitter competition, and/or technical mismanagement leads you to have current losses and a high proportion of non-performing assets, the banker will look for alternative sources of income, most of the time, *speculative activities*. A few typical examples; buying or financing real estate in times of inflation, in the hope that prices will keep increasing forever and a profit will be made when the property is sold; buying land as a basis for real estate development through loans from the bank; buying stock under the assumption that you are making a short-term profit. Frequently, profit does not materialize because of a change in the market trends or because of inaccurate estimates. Think of a situation where a tight monetary policy brings in deflation and adjustment, the market becomes narrower and the value of real estate drops dramatically.

What happens through the whole process is that the bank's proportion of non-performing assets becomes higher and higher, and the yield (that is supposed to be the income to cover deposit, interest rates, overhead and profits) continues to diminish. No matter how the cosmetics are applied, the *problem is now the real cash flow*, which suffers damage, and the bank begins to experience liquidity difficulties.

When in *liquidity difficulties*, the banker will go out to the market and offer *very high interest rates to potential depositors*. He needs to maintain an image of growth, he hopes that he can charge similarly high interest rates to borrowers and have growth absorb its problems; and above all, he is just *in need of cash*. What for?. In order to cover interest to his depositors and even be able to physically pay the payroll and other fixed expenditures. Their deposit principals may no longer be entirely allocated to making new loans but to pay staff or suppliers. At this stage, the banker is taking deposits knowing they are unlikely to be repaid to depositors.

To the extent that the banker can still make new loans with a part of his deposits increase, he will try to make up for the high remuneration he pays to the depositors *by charging interest rates to this borrowers that are beyond the market price*. What happens is that he is now involved in a perverse process, because the quality of borrowers that can accept high interest rates is not likely to be the best. They are, typically, cases of stressed borrowers or of borrowers connected to the bank or the bankers, who hope they will not have to serve their debt. The borrowers have negative equity. The connected borrowers have connections. Through this practice, the banker may have *high spreads* on its income statements, but only *on paper*.

FRAUD

Fraud may have been one of the causes of losses for a bank at an earlier stage. That is frequently the case when a bank is set up or acquired by speculators or businessmen having their own business interests. Also, *fraud* is involved in “cosmetic” management, to the extent it is a way of hiding the truth to the public, in a business that is based on confidence. However, *fraud* is dealt with at the end of the process, in order to suggest that a former good manager may become a fraudulent manager, through a deterioration process, such as the one described in this paper. In fact, when illiquidity approaches and the banker feels the end may be near, he may feel the temptation to divert money out of the bank. The most typical channel is *self-lending*, i.e. lending to companies that are owned by or connected with the banker. This may be done through special formal procedures that would make it very difficult for the bank to foreclose on him when he is no longer there. Another fraud which is typical of his last minute situation is “*swinging ownership*” of companies that are owned by the bank or the banker; if the company is prosperous, the banker may buy it from the bank at a low price. If the company is in poor shape, the banker will have the bank buy it from him at a high price. Of course, all those operations are “properly” materialized through fiduciaries, paper companies, and other similar methods, so as to escape supervision. After all, he is in charge and “it is all the Government’s fault”.

A FEW LINES ON CULTURE DETERIORATION

Deterioration of the management culture is one of the consequences of keeping problems unsolved as well as a source of the long lasting problem. The attitude and the example of top management permeate middle management and other organizational layers. A bad management culture is very difficult to change. Changing a deteriorated culture may take a new management as long as it took the culture to deteriorate, unless several layers of management are changed. This is one of the reasons why mergers are advocated as a solution to crises. Some features of a deteriorated management culture are:

- ◆ Paper is mistaken for facts. Figures are mistaken for money.
- ◆ Hiding and cheating become normal. Even “ethical”.
- ◆ Speculators become the ideal kind of managers, since speculation becomes the ideal business, as one of the few hopes for recovery.
- ◆ Promotion of managers is based on loyalty, not on competence.
- ◆ Management information and teamwork disappear gradually.
- ◆ Internal audit activities are cut or confined to investigation of minor problems in branch offices.
- ◆ Branch managers become “one-legged professionals”. They receive instructions from their superiors to concentrate on the collection of deposits and stop lending, since the whole lending gradually concentrates in the bank’s headquarters and main branch office.
- ◆ The fact that money is the raw material of the bank and the “need for prestige” lead to inflation in staff, salaries and overhead. Luxury premises become a rule.
- ◆ As a counterpart of the culture of nonpayment among borrowers of banks in distress, the bankers develop the culture of non-recovery.

THE ROLE OF BANKING SUPERVISION

The series of practices described under “cosmetic management”, “desperate management” and fraud may be simultaneous or sequential. They can take place quite easily in countries where there is no proper *regulation* that makes them illegal or subject to remedy. But even if regulation is there, lack of *adequate* supervision may provide an ideal ground for them to take place and persist for a long time. This paper is not going to elaborate on the rationale for banking regulation and supervision as a whole or on the key topics and activities involved in those concepts. But a few examples will be given below, regarding mismanagement aspects that could be prevented, limited, or remedied.

- ➔ If entry on the market is regulated and supervised, that is to say, if a supervisory institution (the Central Bank or Superintendency of Banks) is able to control how to become a banker (setting up a new bank or buying control of an existing one), the danger for bank mismanagement may be considerably reduced.
- ➔ If a bank is required to send adequate periodic and detailed information to the supervisory authority on their balance sheet and income statement, analysis of that information would permit them to identify the trends and the problems and take remedial action at an early stage, whenever necessary.
- ➔ If banks are required to disclose publicly their accounts in a reasonable desegregated form, stockholders and the public would press the management for remedial action, without the need for any public intervention.
- ➔ If the bank's accounts and assets are required to be audited by external auditors and their report is required to be sent to the supervisor and even published, this kind of verification would make hiding more difficult.
- ➔ If the legislation establishes rules that limit loan concentration, as well as connected lending, to a given proportion of capital, and if compliance is properly verified by the supervisor, the major risk of insolvency would be barred.
- ➔ If a minimum level of real equity capital versus assets is set, over extension and protracted undercapitalization would be limited risks.
- ➔ If rules are set for the bank to properly classify its assets as good or bad, and provision and accrual requirements are met, again with adequate verification, the state of health of the bank can be closely followed up and remedial action can be taken in due time.
- ➔ If proper penalties are established for mismanagement, lack of compliance of regulations or fraud, such as fines, replacement of management or legal actions, the room for mismanagement would again be limited.
- ➔ Last but not least, if proper mechanisms were in place to facilitate bank closure and restructuring, the deteriorating situations could be stopped in time and avoid spirals of market distortions and losses, that, in the end, would have to be covered by someone, most probably by the State.

LESSONS TO BE LEARNED

Many of them are expressed or implicit in the foregoing text, but the risk of repetition is worth running for the sake of synthesis. So, a brief summary can be established below.

Regulation and supervision are not panacea, but they are necessary pillars to have a strong financial system and limit damages caused by mismanagement and make macro policies effective.

Good regulation and supervision may prove no good if there are no mechanisms in place to solve insolvency cases. This situation may even lead to the corruption of the supervisor, who, for lack of remedies, may find himself forced to tolerate hiding.

Bad management is an essential ingredient of all banking crisis. Only in cases of complex economic upheaval can a good management be overwhelmed by the context; but even in this case, there are good managers and bad managers. Good managers can limit the damages to a considerable extent.

