Financial Infrastructure

Issues for Developing Countries

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Financial infrastructure is an underrated aspect of financial and industrial sector development. Financial infrastructure includes: prudential regulation and supervision of financial institutions; accounting and financial information disclosure policies required of financial institutions; framework of laws governing financial transactions and the legal procedures to enforce them; and dissemination of financial and legal information. The purpose of this paper is to highlight the major issues on fronting developing countries in the development of their financial infrastructure. Although this paper focuses primarily on financial infrastructure as it relates to depository institutions, financial infrastructure is equally important for the non-bank sector. With this in mind, a brief section will discuss its relevance beyond the banking sector.
Contents

Foreword vi

I. Introduction 1

II. Prudential Regulations and Supervision for Banks 1
    Thailand: highlight on prudential supervision 5
    India and Malaysia: a comparison of recent regulatory changes 6
    Yugoslavia: starting from scratch 7

III. Accounting Policies and Disclosure 10
    South Korea: facing up to bad debts 12
    Yugoslavia: progress made 12
    Indonesia: preliminary reforms 13

IV. Legal Framework and Procedures 13

V. Information Dissemination 15

VI. Financial Infrastructure for the Nonbank Sector 16

VII. Role of Multilateral Institutions 17

References 18
Foreword

The industrial sector program of EDI's Finance, Industry and Energy Division focuses on the process of industrial change (adjustment, restructuring) and its role in economic development. The training curriculum is presented within a framework that allows discussion of the role of the state in facilitating this change, and organizes the subject matter into modules which can then be grouped according to the needs of the participants. The modules review the effect on industrial performance of financial, fiscal, trade, regulatory, and specific industrial policies; how changes in the global economy can affect sector or subsector performance and how a country may in turn adapt its policies; the required institutional framework and infrastructure, including supporting infrastructure such as entrepreneurship, management capabilities and technology; and the social dimensions of industrial change. Specialized training activities draw from the framework and include the role of the financial sector in facilitating industrial change, subsector and enterprise restructuring, public enterprise reform, privatization, industrial pollution, and the effect of market structure on competition and small enterprise development.

The program is articulated around cycles of regional and worldwide roundtables and seminars. Policymakers, mid-level civil servants, CEOs and trainers are brought together to discuss agendas of specific issues and problems, often identified beforehand by the participants themselves. The papers circulated at these seminars are published in the EDI Working Papers series, to make them available to a broader audience than is possible within the context of the seminars themselves.

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Financial Infrastructure:
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I. Introduction

Financial infrastructure includes: prudential regulation and supervision of financial institutions; accounting policies and financial information disclosure required of financial institutions; framework of laws governing financial transactions and the legal procedures to enforce them; and dissemination of financial and legal information. The purpose of this paper is to highlight the major issues confronting developing countries in the development of their financial infrastructure. Although this paper focuses primarily on financial infrastructure as it relates to depository institutions, financial infrastructure is equally important for the non-bank sector. With this in mind, a brief section will discuss its relevance beyond the banking sector.

Financial infrastructure is an underrated aspect of financial and industrial sector development. Poorly functioning and underdeveloped infrastructure impedes efficient intermediation and private sector growth by adding to the risk and cost of transactions. Good prudential regulations and supervision, accounting policies, and laws and legal procedures greatly increase the likelihood of a sound financial system and efficient financial intermediation. Borrowers and lenders can rely on financial information, lenders can rely on foreclosure for loan recovery and depositors can rely on the soundness of depository institutions. These infrastructure developments facilitate market based development, allowing private agents to transact business easily. Developing countries are at different stages of financial infrastructure development depending on their history and approach to economic development. Ex-colonial countries inherited a variety of systems, which some have modernized. Countries that adopted a socialist approach to development did not feel the same need for financial infrastructure as countries that adopted a private sector or mixed sector approach. In socialist countries, because the state controlled everything, there appeared to be less need for financial infrastructure.

Section II of this paper examines issues relating to prudential regulations and supervision for banks, while Section III reviews accounting policies and disclosure issues. In Section IV, the legal framework and procedures are addressed; and Section V focuses on information dissemination. Financial infrastructure for the nonbank sector is briefly reviewed in Section VI, and the paper concludes with the role of multilateral institutions in Section VII.

II. Prudential Regulations and Supervision for Banks

Banks' liabilities are special. Banks play a pivotal role as depositories and often provide the main financial instrument for household wealth in developing countries. They are responsible for maintaining the payments system and are still the major financial intermediaries in developing countries. They are also used as vehicles for
implementing monetary and fiscal policies. Maintaining confidence in the banking system is of paramount importance for avoiding a disruption of the financial system, money supply and, consequently, production and distribution in a country. Prudential regulations and supervision by a government agency are essential safeguards to ensure continued confidence in the financial system. In what follows, we list the essential regulations and supervisory practices that conform to international norms and published commentaries of experts.  

Prudential regulations should:

- Include criteria for entry. Professional qualifications, experience, financial backing and sound ethical standards should be required to obtain a banking licence.
- Define the scope of permissible banking activities as clearly as possible. For historical reasons, countries have adopted different divisions between financing (banking, securities underwriting, real estate, insurance, leasing, etc.) and investment (equity in other banks, financial and non-financial companies) activities. The recent trend is to categorize activities by function rather than institutions. A holding company concept with subsidiaries organized by function would facilitate regulation and supervision.
- Maintain capital adequacy standards of not less than 5 to 8 percent of assets for well-managed banks—more for most other banks—with adjustment for risk profiles and off-balance sheet risks. Where accounting systems are well developed, a risk-based capital adequacy standard by function might be appropriate. Capital should be carefully defined. The preference is to limit the definition to equity and retained earnings although subordinated debt is sometimes included. It is important, however, to exclude revaluation reserves and other specific reserves, e.g., for bad debts.
- Diversify assets adequately to avoid undue concentration of risk. Lending risk should be limited to 15 percent to 25 percent of capital to any one borrower or group of borrowers. India has a high limit of 50 percent which is justified on the basis of low bank capitalization, but this is in fact a double danger. Insider lending should be strictly limited. It is the most frequent cause of bank failures in many countries, including the current crisis in the U.S. and the problems in Kenya a few years ago. Off-balance sheet activity and international lending and transactions risks should be considered.
- Clarify stringent asset classification and provisioning guidelines. Countries should require: classification of assets by quality (e.g., current, substandard, doubtful and bad); definition of non-performing assets (e.g., arrears of 90-180 days); suspension of interest as income on non-performing assets; and mandate minimum provisions for possible losses based on asset classification (e.g., current, 2-10 percent; substandard, 25 percent; doubtful, 50 percent; and bad, 100 percent).
- Consider provision of deposit insurance. These schemes are designed to protect individual depositors and preserve the integrity of the financial system. The protection is really for unsophisticated savers who are unable to assess the financial risks themselves. Insurance reduces the incentive for sudden withdrawals and lowers the risk of general banking panics that undermine financial system stability. Thus, insurance can minimize the social cost of bank failures. Deposit insurance can also contribute to market
efficiency by levelling the playing field for smaller depositories. However, deposit protection can make depositors indifferent to the risk profile of the depository and encourage management to take risks—a moral hazard problem. This problem can be overcome by risk-based premiums or by limiting coverage to small savings by individuals (US coverage of $100,000 is considered too high). Risk-based premiums, however, have the disadvantage of signalling a weak institution which might lead to deposit withdrawals and further weakening, and requiring full information disclosure about risk of banks' asset portfolio.

- Spell out remedial actions and punitive sanctions that supervisors can use to handle troubled and insolvent institutions. A formal mandate lends credibility to supervisory authorities and is necessary to ensure against claims that intervention has gone beyond the scope of supervisory powers.

Prudential supervision should:
- Be regular and frequent. India requires an inspection every 4 years, which is too infrequent. An annual or biannual inspection is usually recommended depending on the general state of the financial system and the health of financial institutions. Inspections should use the CAMEL system developed in the U.S.: capital adequacy; asset quality; earnings trends and quality; and liquidity, asset and liability management.
- Supplement on-site inspections with off-site tracking by analyzing data on liquidity, asset quality, earnings, and solvency regularly. This is an important early warning system which can prevent major problems if action is taken in time.
- Establish minimum requirements for disclosure of financial information. Disclosure requirements should weigh maintaining confidence in the system with providing enough information to depositors and others to allow informed judgement about the institution.
- Carry out effective and prompt enforcement of remedial actions and punitive sanctions—levy fines and penalties, remove management, restrict dividends, withhold branch and other corporate approvals, issue cease and desist orders, and revoke licenses. Exercise of these enforcement powers is a necessary supplement to the regular monitoring process to prevent problems from getting out of hand and discrediting regulations and supervision.
- Ensure and carefully define stringent liquidity and solvency standards. Supervisors should further have the power to declare banks insolvent, close them, and place them in receivership outside the normal corporate bankruptcy process. In Kenya, the normal legal process took about two years, allowing enough time for the owners to remove a substantial portion of the institution's assets. Supervision should be sufficiently effective so that troubled institutions can be identified sooner and put on a course of treatment before it is too late to save them. Quick action is important because delay increases the cost of rescue.

In many developing countries the banking system has been used to achieve social objectives. India, for example, has required banks to direct a substantial amount of their credit to priority sectors at below-market interest rates. This practice has resulted in a large amount of bad debts and poor bank performance due to politicization of lending and high quantity targets that have resulted in adverse
selection. On top of this, bank regulations and supervision standards pertaining to capital, liquidity and solvency have been lowered to accommodate poor bank performance. Bank regulators and supervisors are compromised in the process and the financial system suffers. The day of reckoning is delayed but the cost of restoring the system to a healthy state increases substantially. It is preferable to maintain high prudential and supervision standards to minimize any deterioration in the financial system and to resolve failures quickly.

In the past decade there has been considerable deregulation of the financial system worldwide. The role of prudential regulations and supervision in this context has, however, been misunderstood. While economic deregulation usually leads to greater efficiency and is desirable, it should be accompanied by increased prudential regulation to ensure the continued safety and soundness of the financial system. During the financial deregulation in the U.S. in the early 1980s, the capital adequacy standards for savings and loan institutions (S&L) were lowered and the number of examiners were reduced—just the opposite of what should have occurred. Economic deregulation of the financial sector, therefore, should be accompanied by higher prudential safeguards which should be implemented gradually, with adequate flexibility to accommodate changing economic circumstances. The line between economic and prudential regulation is thin, however. Any specific aspect of regulation may—and most do—have components of both. But the focus is different between using regulation to control credit allocation and pricing and using regulation to maintain a healthy and efficient financial system. In many developing countries, it is not a matter of completely reorientating both, but rather giving greater emphasis to prudential regulation.

A survey of some World Bank financial sector reports indicates that the Philippines, Thailand, and Malaysia have adequate prudential regulation and supervision systems that need only minor improvements. Enforcement is another matter, as illustrated by developments in the Philippines in the late '70s and early '80s. India has a nearly complete system but the standards required are inadequate. The Indonesian and Kenyan systems are weak but are being upgraded, and many Eastern European countries are just developing their systems afresh. To better illustrate some countries' experience with prudential regulation and supervision of banks, four country cases will be briefly reviewed: Thailand, India, Malaysia, and Yugoslavia.

- **Thailand: highlight on prudential supervision**

Among the three countries examined here, Thailand is considered to have instituted the most effective prudential banking regulations and enforced them with relatively competent supervision. No new banks have been established within the last quarter century, but bank branching has grown along with the rest of the financial system spurred by Thailand's high rates of economic growth. Although banking regulations are extensive and as mentioned before need only minor adjustments, Thailand has done very well with regard to its supervisory practices. There is still, of course, scope for improvement. We choose, therefore, to focus the remainder of this review on prudential supervision of Thai banks.

In response to the financial crisis that persisted from the late 1970s to the mid-1980s, the Commercial Banking Act and the Bank of Thailand Act were amended in
1985 to bolster supervisors' power to restructure failing institutions. Strengthened and broader powers required an upgrading of the supervisory framework that, when combined with relatively well-trained staff, has resulted in a supervisory capacity currently deemed as "highly satisfactory." Domestic and foreign banks in Thailand are supervised separately from non-bank financial institutions by the Department of Bank Supervision and Examination under the Bank of Thailand (BOT). Approximately 350 people are employed in the tasks of on and off-site examinations, the research of new supervisory methods, and computer auditing. On-site examinations of all bank headquarters and selected branches are performed annually by more than 200 examiners. Use of the CAMEL system allows a thorough diagnosis of the overall health of the bank and special priority is placed on higher-risk activities. Off-site examination is a continuous monitoring process performed throughout the year requiring banks to periodically submit statements on assets and liabilities, income, expenditure, deposits, profits, losses, major debtors and their contingent liabilities, overdue debts, sector concentrations, and inter-bank transactions among other things. Analysis of this data is sophisticated relative to other developing countries, involving trend and inter-bank comparisons and computer modeling to isolate current and potential troubles and prepare them for follow-up.

The evolution of Thai banking supervision has not been totally able to keep pace with the needs of a growing and increasingly sophisticated banking system, but the record so far indicates that the government is headed in the right direction. Initially, on-site examinations attempted mainly to enforce compliance with laws and procedures. Its orientation then expanded to stress performance evaluation according to solvency criteria. It is clear from the on and off-site examination processes that supervisors currently have the capacity to competently carry out portfolio assessment and identify problem areas. The next step would be to enhance their capability to isolate the sources of risk/systems mismanagement behind these problems and systematically assist banks in averting future distress. In this way supervisors would assume a more proactive function: to avert distress ex ante in the hopes that fewer problems will have to be managed ex post.

- India and Malaysia: a comparison of recent regulatory changes

During the 1980s, both India and Malaysia established a series of prudential banking regulations that currently cover most of the essential issues listed previously in this section. In Malaysia, they were prompted by the 1985-86 recession, and were implemented concomitantly with macro-economic adjustment measures. Malaysia's banking regulations, which need only minor adjustment, correspond more closely to international norms than those in India, where they are still too lax to be very effective. We compare below how some critical areas of prudential regulation have been addressed in the two countries and reiterate the recommendation that India could follow the lead of countries like Malaysia in tightening their regulations.

- Capital adequacy: India, as in the cases of Malaysia and Thailand, needs to formulate risk-based capital adequacy standards, not just for core capital but also for other items such as off-balance sheet activities,
asset growth, and problem assets along the lines proposed by the Basle Committee. In the absence of weighted standards, the capital base of banks does not accurately reflect the riskiness of their portfolios and cannot adequately safeguard against potential losses. Furthermore, the efficacy of any standard will be reduced if, as in the case of Thailand, exemptions are permitted (for agricultural credit) and used as an instrument of directed credit.

ii) Exposure limits: In India and Malaysia exposure limits to a single borrower or group were established. However, in the case of India, it was set too high at 50 percent, and in Malaysia, set slightly over a prudent limit at 30 percent. More conservative countries have settled on a maximum limit of 25 percent, and some as low as 10 percent or 15 percent.

iii) Asset classification and provisioning: Both countries introduced an asset classification code comparable to international standards. The classification of actual or potential loss-making assets is an important aid to banks and supervisors alike in prioritizing problem areas, but is especially useful when determining provisions to be made against losses. Currently, only India and Malaysia make specific provisions for the worst classes—doubtful and bad assets. Not only should provision be made for substandard assets—those assets that are better secured but whose primary sources of repayment are insufficient—but a general reserve should be made against the balance of all assets according to the loan performance record of the bank, the riskiness of its overall portfolio, trends in loan growth and the larger economy, and loan policy changes.

iv) Interest suspension: A standard recommendation that India has not yet met is that banks should not be allowed to accrue interest as income on loans that are in arrears of more than 180 days, as is the case in Malaysia. A limit of 90 days—which is the standard in the U.S. and many other countries—could be imposed if extra prudence is desired.

v) Information disclosure: Policies in India are too lax regarding the disclosure of information in India. Banks should be required to publish information such as the amounts of loan loss provisions, non-performing or renegotiated assets, or depreciation of investment portfolios.

vi) Deposit Insurance: Following a series of sporadic bank runs during the recession of the mid-1980s, Bank Negara, Malaysia's central bank, considered establishing deposit insurance to cover small deposits. However, Bank Negara decided against it, at least for the time being, for two reasons. First, it felt that premiums would unfairly burden smaller and weaker institutions and second, because of the moral hazard problem mentioned above. In India, the Deposit Insurance Corporation (DIC) was founded in 1962 and is owned by the Reserve Bank of India (RBI), which makes almost all of its decisions. Membership is compulsory for all commercial and rural banks as well as many cooperatives. During the 1980s, about 70 percent of all deposits were covered, save those of foreign, central, and state governments, and other kinds of banks. The DIC is financed by RBI, which provides all the paid-up capital, and bank premiums set at .05 percent of covered deposits.
Although deposit insurance in India qualifies as an explicit system, it has not yet been used to its full potential—deposits of state-owned banks comprise 95 percent of all deposits and the government has preferred to use other means of supporting its banks. In 1978, the DIC was merged with the Credit Guarantee Corporation of India (CGC). The CGC went into deficit last year and had to borrow from the DIC, prompting a rise in premiums for loan insurance and a three-year moratorium on new claims. To mitigate the loss in bank's earnings and public maintain confidence in the banking system, the government would have to replenish the CGC quickly.

- Yugoslavia: starting from scratch

As in other Eastern European countries currently in transition to more market-oriented economies, liberalization of the Yugoslav banking system was only one component on the agenda for an economy-wide overhaul. Until very recently, the nature of regulation and supervision of Yugoslav banks did not remotely qualify as prudential. The kinds of regulatory policies listed earlier in this section were virtually non-existent and the role of supervision had been essentially limited to ensuring that banks had been allocating credit according to the dictates of the National Bank of Yugoslavia (NBY). However, a major program for the development of a legal, regulatory, and supervisory framework has been underway since the end of 1989. Clearly the scope of financial sector reform in Yugoslavia must go beyond the development of prudential regulations and supervision; in fact, plans have been made to relicense, restructure, and recapitalize banks and to develop the securities industry. Moreover, financial sector reform must be coordinated with the broader tasks of economic restructuring, especially in the areas of macroeconomic stabilization and enterprise reform—again, these questions have been recently addressed.

For the purposes of this paper, Yugoslavia represents an interesting case and one distinct from those of Thailand and India because the source of its problems runs much deeper than a simple lack of political will to institute appropriate policies. The absence of prudential regulations and the special orientation of supervision has been symptomatic of a relatively underdeveloped financial system guided by the strong hand of government. As insolvent banks are restructured and new financial instruments are developed, the need for prudential policies becomes ever more acute. In essence, in order for prudential policies to be implemented, the government will first need to develop and empower an institutional capacity devoted fundamentally to maintaining the health of the banking system. Recent reforms addressed precisely this issue.

There is no generic rule that dictates exactly how the organization of this institutional capacity should be set up. However, despite the enormous task facing the government, critics have found it possible to provide some concrete suggestions by noting deficiencies in the existing structure of relevant institutions. The appeal of the strategy outlined below—and recent reforms indicate that the Yugoslav government is pursuing it in conjunction with the World Bank and IMF—is that it recognizes that transitory restructuring of the banking sector, i.e., the large-scale
salvaging and liquidation of insolvent banks, feeds directly into the development of a permanent supervisory capacity. This brings us back to an important point made before and one that the Yugoslav bank lobby has apparently been loathe to recognize: increased efforts to deregulate and decentralize decision-making in the banking sector should be accompanied by tightened prudential controls.9

The strategy proposed was as follows:

i) As an authentic central bank, NBY has the potential to be instrumental both in the transitory restructuring of the banking system and also as the overseer of the permanent supervisory process. Preliminary efforts should therefore be made toward restructuring NBY itself. Much of this involves financing the past losses of NBY and devising a more effective monetary policy—topics that are beyond the scope of this paper. However, more can be said about making NBY an effective force for change. The 1989 Banking Law gave NBY the power to issue and revoke banking licenses.10 But as of May, 1990, NBY had not yet received an explicit legislative mandate to function in the true capacity of an independent central bank, which in most countries governs the supervisory process. This important preliminary step must be made if NBY is to be charged with the design of prudential regulation and oversight of the supervisory process. Indeed, it is expected that amendments to the 1989 law to this effect are soon to be submitted to the Federal Assembly.

ii) As a precursor for bank restructuring, the government has already carried out comprehensive bank-by-bank portfolio evaluations. Special task forces included supervisors from NBY, auditors from the Social Accounting Service (SDK), and foreign audit firms. These diagnostic evaluations have been used to formulate restructuring and liquidation programs for individual banks. In December of 1989, the Bank Rehabilitation Agency (BRA) was mandated to implement these programs. With regard to prudential reform, however, these evaluations have laid the essential ground work for regulation in areas such as asset classification and provisioning guidelines, capital adequacy standards, and exposure limits. In addition, they have helped to determine the appropriate austerity of prudential regulations as well as the implications for additional financing banks may need to meet them in a timely manner. NBY is planning to issue prudential guidelines that will cover these important regulations.

iii) The 1989 banking law mandated NBY to guarantee local deposits. It is thus very much in the interest of NBY to ensure prudent bank operations and seems fitting that it oversee the supervisory process. Once armed with its legislative mandate, NBY could enact the kinds of prudential regulations discussed in this paper as soon as possible. Furthermore, NBY and the National Banks of the eight Republics and Autonomous Provinces are presently in the midst of reorganizing their on and off-site supervisory facilities. They will be responsible for performing the broad range of supervisory functions including licensing, continuous diagnostic evaluations, risk management, and regulatory enforcement. It has been recommended that to preserve their
independence, these facilities should not participate in the application of monetary policy.

iv) The role of these supervisory facilities will obviously be very different from what has been the norm in Yugoslavia—proper staffing will therefore be no easy task. Recruitment drives were initiated in 1990 and foreign technical assistance has been sought to meet the shortfall of necessary expertise. The more immediate duties of the facilities will be to develop examination methodologies and procedures, inspired by and building on those used in the diagnostic evaluations of paragraph ii. These will be used to guide and direct the on and off-site examination processes. The longer-range plan is to establish a Banking Development Institute which will provide technical training for banks, NBY, and BRA, and keep these institutions abreast of technical banking and management developments domestically and abroad. The credibility of the supervisory facilities, particularly that of NBY, can only be assured if it is granted the necessary enforcement powers. Given the enormous quantity of loan losses that will have to be managed, it may be years before the supervisory agency is able to move beyond crisis management. What is important is that it is readily developing the capacity to evolve according the needs of a more complex banking system—ensuring prudent behavior now will most certainly advance the long-term development of banks and of course, the budding private sector as well.

III. Accounting Policies and Disclosure

Finance is a very information intensive industry, making the quality and availability of financial information extremely important. Because of inadequate accounting policies, negative net worth and current losses sometimes do not show on banks' books. A president of a central bank of a major developing country said “most of our banks incur big losses but they all declare profits and pay taxes and dividends.” This occurs because many bankers want to hide their problems and poor accounting rules and practices allow it. Poor supervision by government agencies and unreliable external audits permit such inadequate disclosure. Sometimes governments, insolvent banks, and distressed borrowers become accomplices in the art of cover-up. Since banks play such a major role in maintaining confidence in the monetary system, there is considerable and widespread interest in their well-being. In particular, their solvency, liquidity, and the relative riskiness of their business (on or off their balance sheets). Thus, standardized financial information of high quality is essential.

Many countries do not have a developed accounting profession that adheres to Generally Accepted Accounting Principles (GAAP). Indonesia has accounting principles but not many professional accountants. In other cases where the profession is developed and GAAP exists, like India, there are no standard accounting policies and disclosure rules for banks. In some countries these rules are developed by the supervising authority and in others by the accounting profession. The International Accounting Standards Committee has just issued a standard on “Disclosures in the Financial Statements of Banks and Similar Financial Institutions” (IAS 30).
Most commentators in the field are of the opinion that accounting policies and disclosure requirements should be uniform for all financial intermediaries to facilitate comparison. The requirements should include:

**Policies:**
- Recognition of principal types of income (e.g., how interest on non-performing assets is treated).
- Determination of losses on loans and advances and for writing off uncollectible loans and advances (loan classification and provisioning).
- Valuation of assets (e.g., investment depreciation, capitalization of overdue interest).
- Distinction between transactions that affect the balance sheet and those that do not, but create contingencies.

**Income Statement:**
- The principal types of income and expense.
- Gains and losses on the main activities.

**Balance Sheet:**
- Classify assets and liabilities by type and maturity to facilitate analysis of maturity and interest mismatching and assessment of liquidity.

**Other:**
- Contingencies and commitments—guarantees (indebtedness, bank acceptances, standby letters of credit), performance bonds, bid bonds, warranties, swaps, options and futures etc.
- Concentration of assets.
- Significant net foreign currency exposure.

Implementing IAS 30 above would represent progress in most countries; but GAAP too has significant weaknesses. First, GAAP valuations are based on historical cost and therefore are slow to recognize changes in market value net worth. GAAP would be better suited to an economic environment in which prices and interest rates were more stable and transactions less complex. For example, the true S&L debacle in the U.S. occurred during 1983-85 but the insolvencies and closures began in 1986. Second, GAAP allows asset values to be overstated through "gains trading"—the only way for a bank to recognize value is to sell an appreciating asset. Conversely, it can avoid recognizing losses by holding on to a depreciating asset until maturity. GAAP also allows current income to be overstated at the expense of long-run asset value—banks make loans with large up-front fees and low interest charges. Third, intervention in failing institutions may be delayed because supervisory intervention or legal action is based on GAAP accounts, thus increasing the eventual losses. Fourth, the greater is a bank's net worth, the more protection it affords to the liability holders and deposit insurer. Because gains trading distorts true net worth in the ways mentioned above, deposit insurers may feel inclined to raise premiums in light of the perceived uncertainty.

Instead of relying on GAAP, countries with sophisticated accounting systems could move to market value or mark-to-market accounting, where assets are revalued according to current information. For example, changes in interest rates would change the value of fixed interest rate loans. Although the value of mark-to-market accounting has been contended, proponents claim that it gives a more accurate picture of a bank's net worth and enables supervisory authorities to intervene earlier.
and minimize losses. In addition, some simple simulations of future net worth with changes in interest rates, for instance, would also be valuable.

In order to highlight some of the accounting issues listed above, we now turn, as in the previous section, to a brief review of accounting practices and attempts to reform and enforce them in South Korea, Yugoslavia, and Indonesia.13

- **South Korea: facing up to bad debts**

South Korea's interventionist export promotion industrial policy of the 1960s and 1970s have been analyzed by many authors14 and continues to be of great interest to developing countries. Although the government has since eased off this hands-on approach and pursued increased liberalization of the financial system, it is only in the last few years that it has begun to face up to the morass of bad debts that have been one of the unfavorable legacies of this period. The government's primary instrument of export promotion was the extension of substantial amounts of soft loans to targeted industries. Some of these industries incurred heavy losses, particularly those of chemical and shipbuilding, their loans going from bad to worse without ever being conscientiously revealed or written off. Beginning in 1986, and particularly since 1989, regulators have taken a strong hand in forcing domestic banks to write off these debts and reimburse the central bank for their soft loans. It was only in 1989 that appeals in the legislature resulted in serious disclosure by the Bank of Korea concerning the extent of bad loans (except those of many specialized banking institutions) and the financial assistance it had lent to troubled banks over the last decade.

Between the end of 1987 and mid 1989, 17 domestic banks had formally written off 260 billion won worth of bad loans, or just under 10 percent of total bad loans.15 This helped to reduce the share of non-performing loans in total assets to 5.9 percent in 1989, down from 10.5 percent in 1986.16 Record high bank earnings over these years have made possible dramatic increases in loan loss provisions, and it seemed that unless this trend experienced a major reversal, the overhang of bad debts will be eliminated by 1992. The year 1992 will be important for financial markets in South Korea. First, foreigners will be allowed to make their first direct stock purchases there. Second, the government expects to make further progress in liberalizing interest rates and foreign exchange markets. Third, the Basle Committee's 8 percent risk-based capital adequacy standard will go into effect for the Group of Ten.17 If South Korean banks aspire to be competitive in the international market, they too will have to adhere to the new rule. Writing off bad debts now is an important move to ensure that Korean banks will be adequately capitalized in the future.

- **Yugoslavia: progress made**

In contrast to its performance in the areas of prudential regulation and supervision, an upgrading of the Yugoslav accounting system has been underway since 1987. In particular, the objectives of the 1989 Accounting Law were to "simplify the accounting system, close the gap between Yugoslav accounting and the GAAP, increase the meaningfulness of accounting information, and better serve the management community, external investors, creditors, and commercial partners."18
Many of the important reforms of the 1989 law and its amendments during the following year—as well as current proposals—are particular to enterprises and are not relevant for the purposes of this paper. However, some have also affected the banking system, such as the requirement that a detailed cash flow report and other financial and managerial information be provided along with the yearly income statement to facilitate independent audits. But the 1989 law falls short of its goal to make banking accounting practices more consistent with the GAAP in an important way. While it still preserves the past practice of prohibiting banks from deferring current foreign exchange losses, it continues to allow past losses to appear as assets in the balance sheets, thereby misrepresenting the bank's true financial profile. Instead of allowing banks to write these entries off gradually, as is presently the case, banks should be required to write off these losses in full as they occur and make the necessary adjustment in equity.

**Indonesia: preliminary reforms**

While Indonesia has made dramatic progress in deregulating its financial system, improvements in accounting standards and practices have not kept pace. Beyond the simple requirement that corporate entities keep accounting records, Indonesian company law is absent of any procedural guidance as to what kind of information should be recorded and how these records should be prepared, maintained, filed, or disclosed. This remains the most pressing reform to be undertaken. Second, it has further been proposed that an institutional capacity be developed to monitor accounting competency and maintain professional and ethical standards. Third, an incentive could be created to induce more entities to file financial statements according to the new accounting rules by assuring them that in so doing, they will be less likely to face fiscal investigations and tax penalties. Fourth, the liability status of entities needs to be clarified and accounting principles devised accordingly.

It should be noted that an effort has been initiated to improve government accounting practices which will eventually be extended to the private sector. In order to accelerate improvements in the private sector, the government has begun to promote professional accounting associations, in particular the Indonesian Institute of Accountants (IIA), to devise standardized accounting rules. It has been recommended that IIA be granted statutory power in this regard. It will also need additional financing and a more competent staff. Also on the current agenda is an effort to improve accounting education and on-the-job training. One way to accelerate this process and meet the short-term expertise shortfall would be to allow expatriate accountants to practice and participate in such programs.

**IV. Legal Framework and Procedures**

Clear legal rules concerning the rights and obligations of different agents and simple and fast enforcement procedures are essential for financial development. Clear rules and procedures would contribute to efficiency by reducing risk and transactions cost. A sound legal framework should encompass the following critical areas:
• **Contract law** should define the rights and obligations of the parties entering into contract and specify the procedures by which a breach of contract can be resolved. For example, when banks are not repaid according to the stipulations of a loan agreement, they should have access to timely foreclosure procedures if their portfolios are not to suffer and the amount of available credit to other more credit-worthy borrowers is not to be reduced. Otherwise there exists an implicit bias favoring distressed borrowers which raises the risks to lenders.

• The assignment and transferability of *property rights*, especially concerning *collateral*, is also important to facilitate financial intermediation. The use of collateral to secure credit implicitly raises the costs of breaching contracts and thus reduces the risks facing lenders. Debt collection should be legally enforceable within a reasonable time.

• Modern *company legislation* exists in many developing countries but may be worded vaguely. It should delineate how companies are to be organized. e.g., specify the number of directors, require annual meetings, etc. It should also grant companies effective control over their investments; the power to seek redress from managers who do not perform satisfactorily and from corporations they invest in that do not fulfill their obligations. In general then, company law should aim to protect the interests of shareholders, creditors, employees, and other interested parties by assigning rights and duties to them. Bankruptcy and reorganization procedures should also be clearly spelled out.

In countries such as South Korea, Singapore, and Taiwan, China, the development of an efficient private sector has been closely related to the early attention paid to developing a sound legal system. Korea enacted new codes based on German law in 1958 and 1962; Thailand adopted a civil and commercial code based on the French and German codes in 1923; and Japan had done the same in 1899.

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**Capitalist legal bedrock**

Several areas of law provide the bedrock of a capitalist market-oriented legal framework. Among them are: constitutional, real property, intellectual property, contract, company, foreign investment, bankruptcy and competition law. Constitutional law lays the groundwork, setting the general principles that guide the economy and define the roles of the public and private sectors. Property law (whether real, personal, or intellectual property) defines the universe of property rights, while contract law sets out the rules and mechanisms for exchanging them. Company and foreign investment laws determine how the main producers in the market are created, owned, and governed, and bankruptcy law defines how inviable producers exit. Finally, competition law (typically including both anti-monopoly and unfair competition components) ensures that the structure and behavior of economic actors (primarily companies) promote efficiency in the use of resources.

Many countries do not have comprehensive, modern laws and efficient procedures. Indonesia has parallel legal systems operating—customary adat law and the Indonesian civil and commercial codes, derived from the Dutch codes which date back to 1847 and remain outdated. Because adat law does not cover loan contracts or similar transactions, the commercial code is applied to companies and banks. Indonesia represents an interesting case because during the last decade, an intense program of economic deregulation has radically altered the efficiency and scope of private sector activity. It is only recently then that the economic landscape has been able to provide a compelling imperative for changes in commercial law, i.e., contract, credit, company, and capital market laws. Without these changes, the fundamental purpose of a commercial law framework—to create an environment of greater certainty, predictability, and confidence—has been largely unfulfilled. In contrast, some countries have only one legal system. In the case of India, it is obsolete and is an impediment to new kinds of transactions and new instruments.

**Legal reform in transitional socialist economies: Poland**

Over the past few years, Poland has been drafting laws and regulations to establish a legal framework for market activities. Although many Polish laws date from before World War II, most are flexible enough to permit a wide range of modern market activities. However, the generality of the laws leaves wide discretion for administrators and courts, and more time is needed to build up a body of cases and practice to further define the “rules of the new game.” Institutional reforms are also critical in terms of the court system, training of judges, lawyers, availability of receivers, and so on. The courts have little experience in economic matters. Property rights reform has in general lagged behind legal reform for general business activity. Amendments have been made to the Polish Constitution and Civil Code which have removed the former distinctions between social and private property. Compensation for prior expropriations, land registration, and underdeveloped court adjudication systems are problem areas. The current applicable company law is the Commercial Code of 1934, which was never formally abrogated and was recently revitalized. The new law on Foreign Investment of June 1991 is an improvement over the 1988 law in its contents over foreign ownership and repatriation of profits. Contract laws are in the process of being crafted based on the Civil Code of 1964. Many of the core rules of contracting, such as the rules of offer and acceptance, were fashioned in the 1933 Law of Obligations and remained in force throughout the period of central planning. The Bankruptcy Act of 1934 was never formally abolished, but was dormant until four years ago and has been used since then for closures of state enterprises. The law was most recently amended in 1990. The Polish Anti-Monopoly Act of 1990 provides for the regulation of both market structure and business conduct.

As stated above, governments need to provide for acceptable collateral and the assignment and transferability of property rights has to be clear and enforceable. In Kenya it is difficult to assign property rights because of communal ownership patterns. In China, farmers cannot own their land, but long-term land tenure has been restored and can be used as collateral. In Indonesia, the absence of sound credit laws and institutions has led to an excessive demand for collateral. Compounded with the difficulties of transferring property and the absence of a requirement that collateral be registered, frustrated borrowers have been known to pledge the same asset twice. In both India and the Philippines, legal procedures are cumbersome and slow—it can take many years to foreclose on collateral.

Legal enforcement procedures should be simple and quick. Otherwise, the credibility and influence of improved commercial and civil codes will mean little. In 1979, Pakistan established a system of special banking courts to expedite judgments for the recovery of bank loans. The general idea of special courts is a good one, but their potential to speed up the recovery process has not yet been realized. These courts were plagued by the same problems as the ordinary courts. To begin with, there were not enough special courts and the ones that existed were understaffed. Procedures were still lengthy and court rules were biased in favor of borrowers who used the rules to delay judgment. On top of this, once judgment was reached, claimants faced more lengthy proceedings needed to execute the decree. In 1989, it was reported that a back-log of 38,000 cases existed totaling around Rs. 5.5 billion (about US$ 300 million). In the same year, the government decided to undertake a program of financial sector reform, still underway, which includes a component to strengthen these special banking courts. Not only will more courts be established, but smaller cases are to be restricted from their rosters. Equally important, efforts will be made to eliminate the debtor bias by requiring the debtor to deposit the amount of the judgment in the appellate court if judgment has been pronounced and the debtor wishes to appeal. Sri Lanka too has established special courts for debt recovery and India and the Philippines are also considering specialized tribunals to expedite judgments. It is suggested that Indonesia follow their lead and in the meantime promote greater use of its current facilities for arbitration.

V. Information Dissemination

The absence of reliable information contributes to what is termed in academic circles as an adverse selection problem, whereby credit providers and equity investors are unable to distinguish good companies from bad. This implies that when scarce capital is made available, the result is often waste: capital granted to those that least deserve it.

Having financial information from banks and borrowing companies is a necessary step to disseminating it to users. In addition to the financial and business newspapers, periodicals, and journals that abound in developed countries, there are private firms that analyze the performance of banks and companies. In the U.S. for example, Moody's Investors Service provides in-depth financial and business profiles of 14,000 institutions including banks, savings and loans, investment trusts, and other companies and issues twice weekly reports. Moody's aggregates and
disseminates information on these institutions regarding their history and principal business activities, financial statements and statistics, and capital structure.

Some developing countries have started credit rating agencies, notably India, Malaysia, and Sri Lanka. In India, the agency was established in 1989 with the help of development banks in response to criticism of insufficient financial disclosure. Bank Indonesia has recently hired a consulting firm to help it establish a credit information system that will eventually provide credit histories of institutions and clients and records of financial transactions. By disseminating processed information widely, the agencies contribute to the efficiency of the financial system. In addition, there are also three financial dailies in India and several weekly business periodicals such as Business India. India, Pakistan, and Bangladesh all have regulatory agencies that periodically issue notifications or gazettes to the legal community that detail recent executive and tertiary-level orders. In addition, private enterprises have been licensed to publish parliamentary proceedings with court approval. Changes in land ownership require prior publication in newspapers. Similarly, changes in laws and court decisions have to be made available to the public. In Indonesia, there is no systematic information on laws, regulations and procedures, and court decisions are not always written and published. Because of this, inordinate delays in enforcement of contracts have led to unusually high costs and risks of financial transactions.

VI. Financial Infrastructure for the Nonbank Sector

Although the major part of this paper has been devoted to describing financial infrastructure for the banking sector, a few words can be said about its importance for the non-bank sector, namely, for non-bank financial institutions (NBFIs) and securities markets. Recent literature has both questioned and espoused the value of the more sophisticated financial institutions and instruments emerging in developing countries. Our intention here is not to join this debate; rather, we would simply like to note that many of the reasons why financial infrastructure is so important for banks can also be extended to the support of the non-bank sector. To repeat the idea yet a third time but in a new context, if NBFIs and securities markets are to be deregulated, if new instruments are to be made available to the public and private sectors, and if technology is to increase the speed of transactions, then the need for financial infrastructure—an appropriate legal, regulatory, accounting, and information framework—becomes increasingly acute.

So long as the development of new and innovative financial institutions and instruments is on the national agenda, governments will have to play a continuous role in assuring efficient and ethical market transactions. Legal and regulatory foundations have to be laid and improved. In general, they should include conduct codes and strong securities laws to curtail fraud and insider trading and spell out transparent trading and underwriting procedures. This will entail a rewriting of commercial and company law and possibly banking legislation. More specifically, rules will have to be laid particular to the variety of institutions and instruments—e.g., amending asset concentration limits for bank lending, imposing minimum capital requirements for brokers, and designing venture capital procedures. The new laws and regulations should confer powers to supervisory agencies, auditors,
securities exchange boards, and judicial institutions to monitor and enforce compliance with laws and regulations, impose sanctions, license and supervise market intermediaries, require financial information reporting, appraise the creditworthiness of new securities issuers, and settle disputes. The government can further improve information by promoting automated trading systems, monitoring the accuracy of prospectuses, imposing general disclosure requirements, and possibly building databases on transactions and securities companies for the purpose of encouraging risk assessment by brokers and investors. Improved accounting policies are important, among other reasons, to ensure the quality of companies releasing early issues in a budding capital market. All of these infrastructural components, therefore, are designed to build investor confidence by protecting interested parties, prevent financial distress, and enhance market efficiency.

Of course, financial infrastructure alone will not be sufficient to promote active securities markets. Some are of the view that infrastructural developments of the kind listed above would be of little consequence so long as prevailing interest rate and tax policies and the absence of appropriate fiscal incentives discourage private securities issues, and more basically, in countries where the rudiments of private enterprise culture do not exist. However, the absence of active securities markets notwithstanding, the proliferation of NBFIs in many countries warrants more effort directed towards developing a supportive infrastructural framework—one that would supersede the regulatory tangle that has often emerged ad hoc in response to failures and fraud but has also served to limit competition and efficiency.

VII. Role of Multilateral Institutions

The World Bank has surveyed financial infrastructure in financial sector reports for many countries. While the concentration has been on prudential regulations and supervision, accounting, law, and information dissemination have begun to receive relatively more attention than before. The Bank has made many financial sector loans and is developing others that support changes in prudential regulations and supervision among other reforms. Again, there has been increasing emphasis on other aspects of financial infrastructure. Indonesia is a country that has received a loan to develop its accounting profession along the lines described in section III. Ghana has received funding for its Institute of Chartered Accountants Assistance Program. A recent Financial Systems Modernization Project has been proposed for Hungary and Yugoslavia's Financial Sector Adjustment Loan is under review. Both plans would pursue efforts to bring these countries' accounting policies more in line with international norms and strengthen their accounting professions and legal foundations. The Lao P.D.R. has received technical assistance to develop its legal system and profession. China's Technical Assistance Loan also has an accounting component. It is apparent from these programs and proposals that a more coordinated effort on all levels of financial infrastructure is gaining greater support.
Endnotes

1. A broader definition of financial infrastructure would include, among other things, institutions for the development of necessary skills, such as handling corporate finance business and structuring project finance packages.

2. Specifically, they follow closely the proposals found in Bank Supervision: Suggested Guidelines, a collaborative product of World Bank staff to provide general guidance on the development of a strong prudential framework.


4. In addition to arrears, rollovers and reschedulings should also be examined because many bad loans are current—management can collude with borrowers to disguise bad assets.

5. The recommendations for reform have been selected and condensed primarily from the most recent World Bank financial sector reports on these countries, with the exception of Malaysia. The discussion on Yugoslavia refers to developments in the country prior to the civil strife in 1991.

6. Higher-risk activities include loans and advances, foreign exchange, speculative activities, and insider transactions.

7. Core capital refers to paid-up capital, share premiums, retained earnings, and statutory reserves.

8. Explicit deposit insurance is in contrast to an implicit insurance system, which is in operation in Thailand. An implicit system refers to a set of impromptu policy remedies usually applied to imminent bank failures. These remedies often correspond to those employed by a more formal system but are by nature discretionary.

9. The reference to the bank lobby was made by participants of the World Bank/EDI seminar, Financial Sector Reform in Transitional Socialist Economies, held in Paris in September 1990.

10. As of January 1990, 60 banks had been relicensed and 11 new banks licensed.

11. See de Juan, A., p. 310.

12. This delay can be avoided if, as is often the case, regulators put together their own financial statement based on a private assessment of a bank’s financial condition and performance, e.g., classification of assets and provisioning.

13. For Yugoslavia and Indonesia, we have once again relied on the most recent World Bank financial sector reports.


17. Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.


20. In 1977, Indonesia established an arbitration board, and Indonesian law allows any commercial dispute to be submitted for arbitration, including those involving government agencies and state-run enterprises. However, as of 1990 only 5-10 cases were handled by the board, and thus the potential for this alternative method of settling disputes has not been adequately explored.
22. NBFIs are finance companies, development finance institutions, stock exchanges, brokerage houses, venture capital companies, insurance companies, investment funds, and private pension funds, just to name a few. Securities markets include money markets, where instruments such as treasury bills, certificates of deposit, and commercial paper are traded, and capital markets, which provide debt and equity finance.
References


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