

# **Commentary on Banking Reform and Bank Restructuring** \*

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I would like to thank the Syrian National Committee of the ICC for inviting me to participate in this Forum and to speak in this session on banking and financial services development.

## **A) Introduction:**

During the past two years, Syria enacted three banking legislations, the first involved allowing the establishment of private banks, the second guaranteed banking secrecy, and the third amended the 1954 Money and Central Bank Law. These new banking laws are the first steps towards building an efficient and modern banking system in Syria and preparing the ground for introducing monetary policy into the Syrian economy. But Syria still has to cope with the various aspects of implementing the new laws, as well with the problem of rehabilitating/restructuring its existing public banks, and upgrading the capacity of its central banking institutions.

My presentation this morning will make certain observations on bank reform and bank restructuring based on collective bank reform experiences pursued elsewhere over the past two decades.

## **B) Why Bank Reform**

The first question I would like to pose is why banking reform?

Some think of banking reform merely as a necessary measure to provide financing to an emerging private sector, but the significant of banking reform goes well beyond that. Bank reform is intended for the following purposes:

- to help mobilize domestic savings
- to deepen and broaden intermediation between savers and investors.
- to strengthen the capacity of the financial system to allocate capital on a commercial basis.
- to help Improve the allocation of resources in the national economy.
- to help mobilize foreign savings and attract foreign capital inflow, and to help integrate the domestic economy in the regional and global economies.

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All above objectives eventually help enhance growth, move a country up the technology ladder, and create employment opportunities. A sound banking system allocates resources to enterprises with high expected returns, and denies resources to enterprises that are losing money, either because of poor management or because of declining business. Also deepening (increasing the ratio of financial assets to GDP) and broadening (introducing a variety of instruments into the financial sector) of financial intermediation in national economies has proven to be a major factor in enhancing economic growth.

### **C) How to Undertake Bank Reform and Restructuring**

The second question I would like to pose is how to undertake bank reform and restructuring and what instruments to use.

The immediate answer is that bank reform and restructuring should be pursued in a comprehensive and systematic way. The instruments of this comprehensive approach are the following:

1. Clearing arrears

Existing arrears by public and private borrowers could lead to illiquidity as well as insolvency of banks. Thus elimination of arrears is major component of any bank reform. This has often been done - successfully through removing non-performing loans from the balance sheets of banks and transferring them to a separate loan recovery agency.

2. Recapitalization of banks

Another component is recapitalization of banks. Some Governments resort to recapitalization to avoid having to face the difficult problem of clearing arrears (non performance loans), but recapitalization of banks without settlement of arrears would not be sufficient. It will be certain to call for further recapitalization a few years later.

3. Operational Restructuring

The third component is operational restructuring. This includes such measures as downsizing (staff cut), introducing new lending rules, management change, extending credit on the basis of performance, subjecting banks to private external audits etc.... Settlement of arrears and capitalization both falling under “financial restructuring” and intended to solve a “stock” solvency problem), will not be sufficient unless accompanied by operational restructuring a process intended to solve a “flow” profitability problem. Experience has shown that countries that do not carry out operational restructuring will experience recurring banking crisis.

#### 4. Supervisory and Regulatory System

The fourth component is putting an efficient supervisory and regulatory system in place as soon as bank liberalization starts. The system should guard against internal problems arising from within the banking system and external shocks arising from the real economy.

It is critical to have prudential regulations in place and to have technically competent staff at the central bank to implement them earliest in the process. But two problems, arise, the first relating to finding the skilled and experienced staff to carry out this function effectively and the second, relating to the political ability of the monetary authorities (the central bank and the monetary boards) to enforce critical technical decisions, such as the possible closure of a financial institution.

Nevertheless, prudential supervisory and regulations system is the most important of the above components, and should be given the highest priority of all. Countries who introduced financial liberalization before having an effective prudential regulatory system in place faced banking crises.

#### 5. Independent Monetary Institutions and Policies

For banking reform and restructuring to be complete and sustainable, there should be independent monetary institutions that are able to design and implement monetary policy. This includes adoption of flexible interest rate policies and the carrying out of open market operations (OMO), if treasury bills exist in the economy.

#### 6. A Healthy Economic Environment

A banking system cannot be healthy without a healthy economic environment: the macro-economic frame, the regulatory and institutional framework affecting the conduct of business, fiscal, monetary, trade and foreign exchanges policies, the roles of the public and private sectors, the tax regime and its administrations, and the judicial system, among other elements. Good economic environment can enhance bank reform and bank performance, and poor economic environment can precipitate a financial / banking crisis. In fact, crises normally originate either from the real economy (depreciation of the currency, budgetary deficit sudden capital outflow) or from the banking system itself (deficient bank management, lax banking practices, Poor operational control, shortcomings in regulations and accounting problems etc...).

#### 7. Economic Reform Program

Banking reform should be part of a sound, credible and well studied comprehensive economic reform program, with clear vision, priorities, policies and a time frame. This program should include reforming the existing regulatory, legislative and judicial framework and restructuring and upgrading production units in both the public and private sectors.

## **D) What is proposed for Syria**

The following is proposed:

- a. Syria should adopt a comprehensive approach to banking reform and restructuring, benefiting from the accumulated bank reform and restructuring experiences obtained elsewhere. Many countries in the world implemented bank reform but a limited number implemented comprehensive and systematic bank restructuring programs. There is no reason why Syria cannot be one of them.
- b. Successful bank restructuring in Syria also requires:
  - a strong commitment to a market economy
  - a strong political support and commitment at a high level.
  - broad political consensus on comprehensive restructuring, and
  - a comprehensive economic reform program. (In particular banking reform has to go hand in hand with fiscal reform and public enterprise reform).
- c. A special technical group should be created to implement bank restructuring, in order not to detract the budgetary, monetary, and supervisory authorities from their regular tasks.
- d. The technical group should start by conducting an independent diagnostic study to identify and establish the nature and the magnitude of the problem. Failure to diagnose problems correctly leads to a design of a restructuring program that is either inadequate or insufficient.
- e. A major emphasis should be placed on training in banking, finance, accounting, management, marketing and all other business related fields.
- f. Banks to be restructured should be transformed into joint stock companies, with the Ministry of Finance as the sole shareholder, and should be subject to legislation regarding their operations, separate from law No. 20 of 1994 which governs the functioning of public enterprises.
- g. The idea proposed by some for merging some existing public banks is not a solution for existing public banks, problems. Merging two or more existing banking institutions will only produce a giant weak banking institution. What is needed first is a major restructuring effort along the lines proposed above. Once restructuring has been carried out successfully, a merger could be considered.
- h. Concluding long term technical assistance contracts with reputable foreign banks should be considered
- i. The newly revived supreme monetary policy institution (the Money and Credit Council) should be given a true opportunity to carry out independent monetary policies, within the Government development objectives. It should also be allowed to take responsibility to act promptly whenever a crisis arises.
- j. Government development policies should put primary emphasis (in talk as well as in action) on promotion of non-oil exports, in preparation for the post-oil era. This is an extremely urgent matter for the long term development of the Syrian economy, especially that efforts to develop exports take a long time

to materialize. The stability of the Syrian pound in the long term will depend on economic fundamentals. If total exports lag behind total imports significantly (with no more oil to export), the pound will be subject to extreme pressure.

- k. Syria would improve its business environment by unifying its exchange rates, and easing its exchange control regime. It should continue its present currency pegged system after unification of rates, but should make exchange rate adjustments as necessary in response to market forces. The commercial Bank of Syria should also be allowed to sell foreign exchange for industrial and commercial purposes. Floating is out of the question at present because of the absence of the institutional capacity to manage such a system.
- l. Treasury bills should be introduced into Syria's public finance, as an efficient way to finance budget deficit, and to create instruments that enable the carrying out of open market operations (OMO), as part of its monetary policies.
- m. In the interest of both financial deepening and financial broadening, new banks and restructured banks should not be confined to traditional commercial banking and to modern retail services. They should be allowed to provide investment and merchant banking services and be involved in non-bank-financial instruments, provided the central bank is able to exercise effective supervision on these services. Also specialized financial institutions for providing one or more of these services (venture capital, mutual funds, pension funds mortgage finance etc.....) should be allowed to be established.
- n. Improving the soundness of the banking sector is a long term process and there is a need for a continuous monitoring of the bank restructuring policies.
- o. Finally, how urgent is bank reform? How urgent is bank restructuring? The answer is that it is most urgent, given all the reasons cited early in the paper for bank reform, and given the fact that reformed banks can play a crucial role in the upgrading of the private sector and the restructuring the public enterprise sector. Experience has shown that success in banking reform is positively correlated with prompt action. Therefore, the time for action is now.

Thank you  
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