# 3 FRAMEWORK FOR PROBLEM BANK MANAGEMENT

Although various countries have developed financial safety nets (FSN) as a key building block of financial system stability, especially in the wake of the 1997 East Asian financial crisis, the 2007 financial crisis serves as a timely reminder of the need and continuous refinement of FSN in response to the dynamics of financial system stability. An FSN framework generally consist of 4 major components: a deposit protection scheme, lender of last resort facility, an effective and orderly resolution / exit framework for problem banks, and an effective mechanism for coordination among related agencies for preventing and managing systemic problems in the banking sector. Access to a well established FSN framework is even more important for the domestic banking sector given that the local private banks hold 74.6 percent of the total assets of the banking system.[1]

Banking crises are costly; they are known to entail output losses in the range of 15 to 20 percent of annual GDP.[2] The early identification of problems and prompt intervention helps in averting system wide crisis while reducing the cost of crisis when they occur, and promotes efficiency in the banking system. An effective framework for problem bank management is one of the key components of FSN, and is primarily aimed at dealing with problem banks with minimal disruption to normal banking operations, while minimizing the cost of intervention. It is worth noting that SBP has effectively dealt with a number of problem banks in the past.

The State Bank of Pakistan has prepared a comprehensive framework named "Problem Bank Management and Contingency Plan" (PBM&CP) for implementing timely and effective resolution of problems faced by individual banks. This document replaces the existing "Problem Bank Management Manual" for internal SBP guidance. The new framework aims to manage weak banks in an objective, transparent and cost-effective manner so as to ensure stability in the banking system. The new framework spells out detailed policies and procedures for problem bank identification, intervention and timely resolution in a cost effective manner.

With this background, this chapter briefly reviews the key components of SBP's framework for problem bank management.

## 3.1 Problem Bank

How does one define a problem bank? SBP follows guidelines set forth by the Basel Committee of Banking Supervision (BCBS) for defining a problem bank as "one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and /or quality of management".[3] This implies that banks which are facing threats to their liquidity or solvency position will be categorized as problem or weak banks. Notably, such weaknesses in banks do not emerge suddenly. International experience suggests that "poor management, inadequate financial resources, absence of long-term sustainable business strategy, weak asset quality, and poor systems and controls"[4] are some of major characteristics of weak banks. Most of these problems have their roots in managerial weaknesses, which allow these problems to persist for some time. The underlying reasons

[1] As at June CY09.
[2] Batunanggar, Sukarela (2008), "Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries", The South East Asian Central Banks (SEACEN).
[3] "Supervisory Guidelines on Dealing with Banks", Page 6 of BCBS, BIS, March 2002.
[4] "Supervisory Guidelines on Dealing with Banks", Page 6 of BCBS, BIS, March 2002.

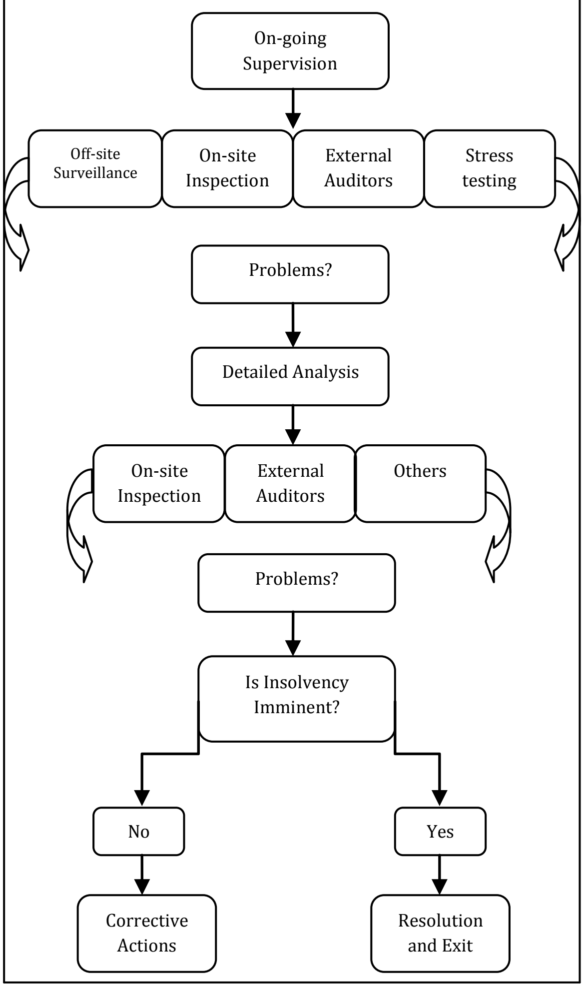
and the presence of weak banks in the system are of great concern for regulators and supervisors of any banking system.

### 3.2 Framework for Managing Problem Banks

Given the importance of a framework for effective problem bank management, SBP in its capacity as a regulator and supervisor of the banking system has developed a coherent strategy for problem bank management. The guiding principles include early identification of the problems, prompt corrective actions, cost-efficiency, objectivity and consistency of criteria, avoidance of moral hazard, and transparency and cooperation. These guiding principles are in conformity with the best international practices as discussed in the BCBS report on Supervisory Guidance on Dealing with Weak Banks. It is important to note that these guiding principles are used for managing all weak banks irrespective of their size and ownership structure. Although large banks are more important due to their greater impact on the system because of their substantial inter-bank linkages and wide range of activities, the simultaneous failure of a few small banks may also lead to potential systemic problems. This consistency serves to provide a level playing field for banks and aligns competitive forces in the banking system.

**Figure 3.1** explains the major process followed by the SBP. The flow chart indicates that SBP makes use of supervisory assessment along with other sources of information to identify weak banks in the system. The early indications of weaknesses are further analyzed in the second step to find out potential sources and nature of the emerging problems. This process is followed by the quantification of financial problems and their impact on the solvency position of the bank. If there is no threat of immediate insolvency, corrective actions are taken to resolve these weaknesses. On the other hand, if insolvency is imminent, SBP resorts to its resolution mechanism. The SBP has already successfully managed a number of weak banks in the past, where some of the resolutions culminated into mergers and acquisitions of the weak banks. The key stages of problem bank management are briefly reviewed in the following section.

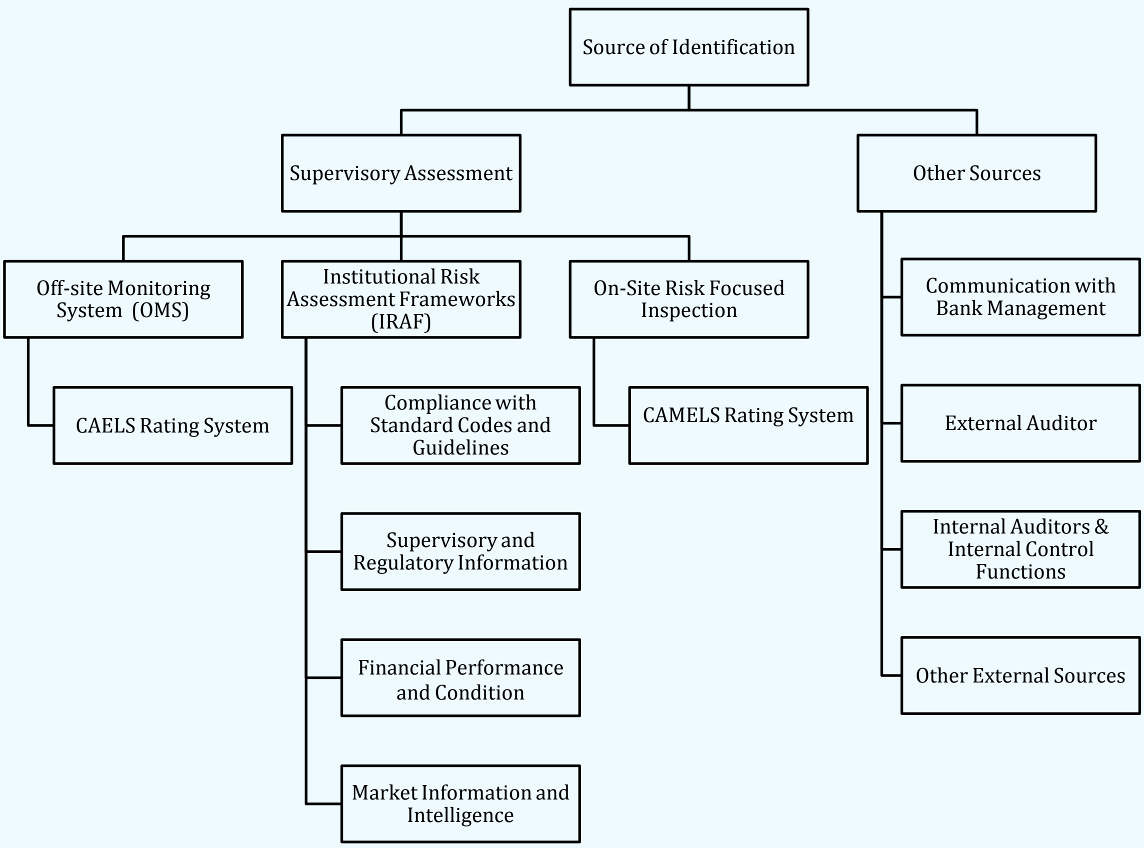
**Figure 3.1: General Framework for Problem Bank**




### Stage 1: Identification

The first step in the process of problem bank management is the early identification of problems. SBP uses both the supervisory assessment and market information for this purpose. **Figure 3.2** shows that SBP has a well established supervisory assessment framework comprising of Off-site surveillance, On-site inspections and an overarching Institutional Risk Assessment Framework (IRAF) that embodies both the former tools and presents a comprehensive position of a bank after taking into account other information. The Off-site surveillance is carried out on quarterly basis by using CAELS Rating System. This system helps in identifying those banks which have witnessed noticeable changes in their financial condition. The system also helps in efficient use of scarce supervisory resources by providing information on potentially weak banks and their particular areas of concerns that require further assessment.

**Figure 3.2: Flow Chart of Problems Identification**




In the CAELS rating system, all the components namely capital adequacy, asset quality, earnings and profitability, liquidity and sensitivity to market risks, are rated on a scale from 1 to 5, with 1 being the strongest. Thresholds for each indicator are objectively pre-specified. Rating of individual components is used to derive a composite CALES rating for each bank. Banks with composite CALES rating of 4 or 5 are categorized as problem banks. It is important to note that this operational definition of a problem bank takes into account all the five components instead of just liquidity or solvency. The logic for using this broad definition at the operational level is simple, i.e. the interpretation of all components of the CALES rating system, instead of a narrow focus on just a few.

The past experience of problem banks in Pakistan indicates that these banks generally have poor lending practices, excessive credit concentration risk, weak compliance of policies and procedures, excessive risk taking and in some cases, conflict of interest and fraud or other criminal activities. Most of these factors are a reflection of poor bank management, which allows problems to persist for some time. Being cognizant of these issues, SBP uses another off-site monitoring tool named the Institutional Risk Assessment Framework (IRAF). This framework is designed to help ensure proactive and comprehensive monitoring of financial risks. The framework consists of 4 major components.

1. Compliance with Standards, Codes and Guidelines: Given the qualitative nature of this component, SBP has developed a detailed questionnaire to assess banks' compliance with SBP's regulatory and supervisory requirements, guidelines on risk management and codes of corporate governance. In addition to specific areas, the questionnaire is also designed to assess the level of compliance in each area. To ensure the adequacy of the information, the Board of Directors of each bank is required to endorse the assessment provided in the questionnaire. The assessment report is used to rank each bank at a scale 1 to 5 and a Compliance Risk Rating is derived for each bank. The final rating is assigned weightage of 15 percent in the overall IRAF rating of a bank.
2. Supervisory and Regulatory Information: This component takes into account information on management, and systems & controls. Specifically, it includes findings of the latest on-site inspection, information on fraud and forgeries, management letter from external auditors and status of compliance with SBP instructions. All this information is used to compile the Supervisory & Regulatory Risk Rating (SRRR) on a scale of 1 to 5. The final rating is assigned a weightage of 30 percent in the overall IRAF rating.
3. Financial Performance and Condition: This component includes information on CAMEL-S[5] rating of a bank from the latest on-site Inspection report, performance of the bank based on audited accounts, and the CALES rating of the bank. The combined information is assigned a weightage of 45 percent in overall rating.
4. Market Information and Intelligence: This component includes information on credit rating, number of complaints against the bank, and market reports (brokerage houses, print & electronic media etc.). This information has a weightage of 10 percent.

The above information along with details on the prevailing macroeconomic environment and key financial sector developments are used to prepare an institutional profile of each bank, and a composite IRAF rating is derived for each bank. This rating is used to decide upon the future course of action for banks, as serious concerns may lead to specifying corrective actions for addressing the underlying weaknesses.

While this system helps in the proactive monitoring of financial risks in banks, the system also helps in identifying weak areas to be examined more carefully in the on-site inspection. The on-site inspection also helps in assessing risks in those areas which are almost impossible to analyze in off-site monitoring. Specifically, the on-site inspection focuses on details of the loan portfolio to determine the quality of the asset portfolio, assessment of internal control systems, effectiveness of internal audit, professional acumen of the management and other activities. Specifically, the on-site inspection focuses on each components of the CAMELS-S rating system. Finally, the bank is assigned a composite rating on a scale from 1 to 5. The scale has a similar interpretation as in case of off-site monitoring tools, i.e. a rating of 1 is an indication of strong performance. Specific interpretation of each rating is pre-specified in SBP's manuals for internal guidance.

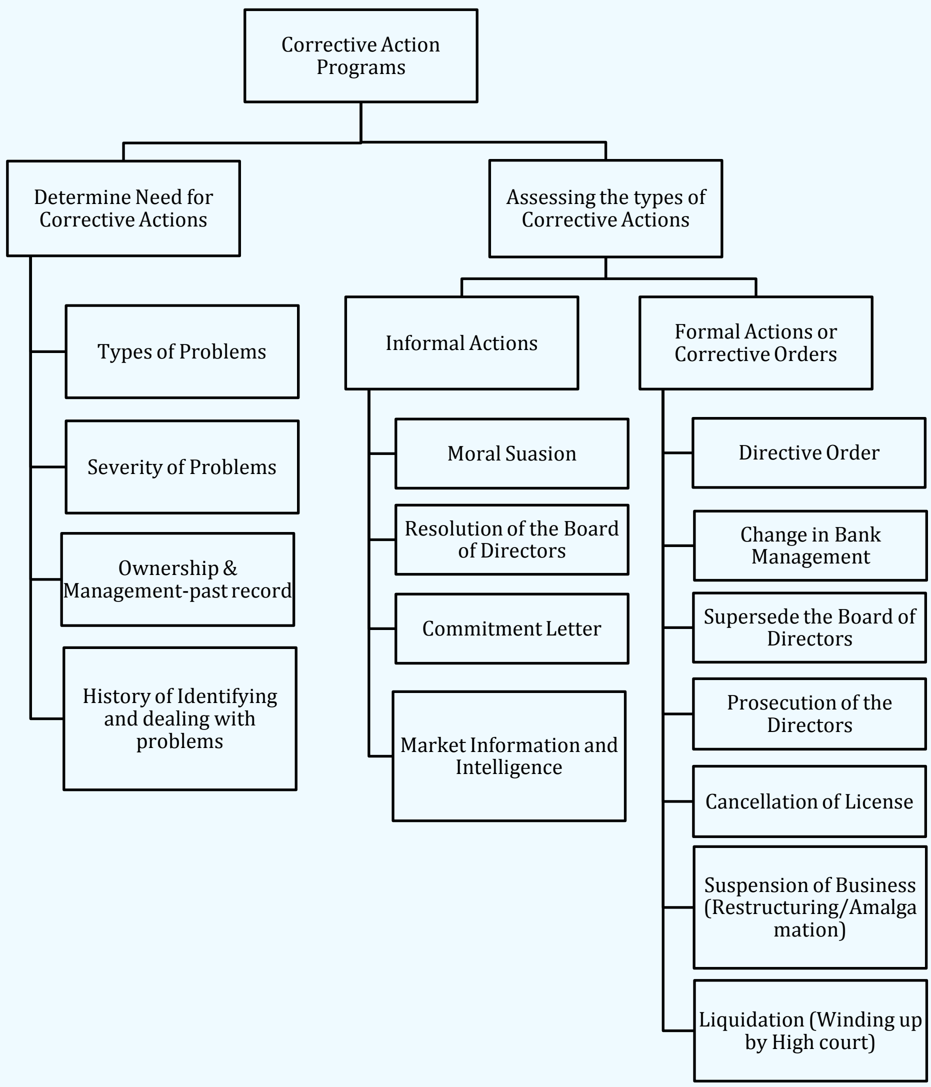
In sum, a brief review of off-site monitoring, on-site inspection and the IRAF help in the timely identification of problem banks as well as information on the major sources of problems. Previous experience of problem banks suggests that poor lending practices, credit concentration in the industrial sector and specific geographic areas, excessive risk-taking to benefit from short-term opportunities, conflict of interest, frauds and forgeries, and ultimately weak internal controls and systems are some of the general causes which give rise to weak and problem banks. It is important to note that most of these factors are ultimately rooted in poor management.

[5] Capital adequacy, asset quality, earnings and profitability, liquidity and system and controls.

**Step 2: Intervention or Corrective Actions**

Timely identification of problem banks is followed by regulatory intervention to deal with the underlying causes of problems. The nature of intervention or corrective actions primarily depends on the types and severity of problems, behavior and ability of the bank management and owners to fix the problem, and the previous record of dealing with deficiencies (if any) (**Figure 3.3**). Moreover, any difference in opinion between the SBP and the bank management is generally discussed before deciding the nature of intervention. Sometimes, special on-site inspection is also carried out to determine the severity of the problem. It is ensured that corrective actions are effective, timely, comprehensive and in line with regulatory and supervisory objectives. Efforts are also made to determine the impact of these corrective actions on future liquidity and the solvency position of the problem bank.

**Figure3.3: Flow Chart of Corrective Actions**




Depending on the nature and severity of problems, SBP chooses from a wide range of corrective actions at its disposal. These corrective actions range from simple informal actions to rigorous formal actions (**Figure 3.3**). Informal supervisory and regulatory enforcement actions generally include Board Resolution, Commitment Letter and Memorandum of Understanding or Written Agreement. SBP has developed an application criteria for using these enforcement actions depending on the composite rating of a bank.

- In case of Board Resolution, SBP suggests specific actions to be taken by the board of directors and the bank management to deal with deficiencies identified in the first stage. However, all board members are required to officially adopt and sign the suggested plan for actions.
- Commitment Letter from SBP is a formal letter in response to deficiencies or weaknesses identified in the Inspection report. The letter recommends specific corrective actions to deal with identified weaknesses. The board of directors accepts and signs this letter to indicate their commitment for resolving the underlying weaknesses.
- Memorandum of Understanding (MOU) is for relatively severe action as compared to the Board Resolution and the Commitment letter. The MOU is generally prepared by the SBP to specify corrective actions according to the severity of the problem. The suggested action is to be mandatorily implemented by the bank management and the board of directors. Failure to do so may lead to the pursuit of formal actions by the SBP.
- In case of Written Agreement, the underlying document for corrective measures is generally the same as in case of the MOU. However, its appearance is relatively formal and it is considered to be a formal agreement between SBP and the Board of directors of the bank.

The banks' failure to implement corrective actions under the informal supervisory enforcement actions and the existence of significant problems in a bank (generally with a composite rating of 5 or downgraded from 4 to 5) may lead to formal actions by the SBP. Formal actions are also referred to as corrective orders. In enforcing formal actions, SBP unilaterally enforces its plan on the board of directors to deal with underlying weaknesses in the banks. The board of directors is required to acknowledge that they have received, read and understood the plan enjoined by the SBP. Corrective orders generally comprise of the following directives.

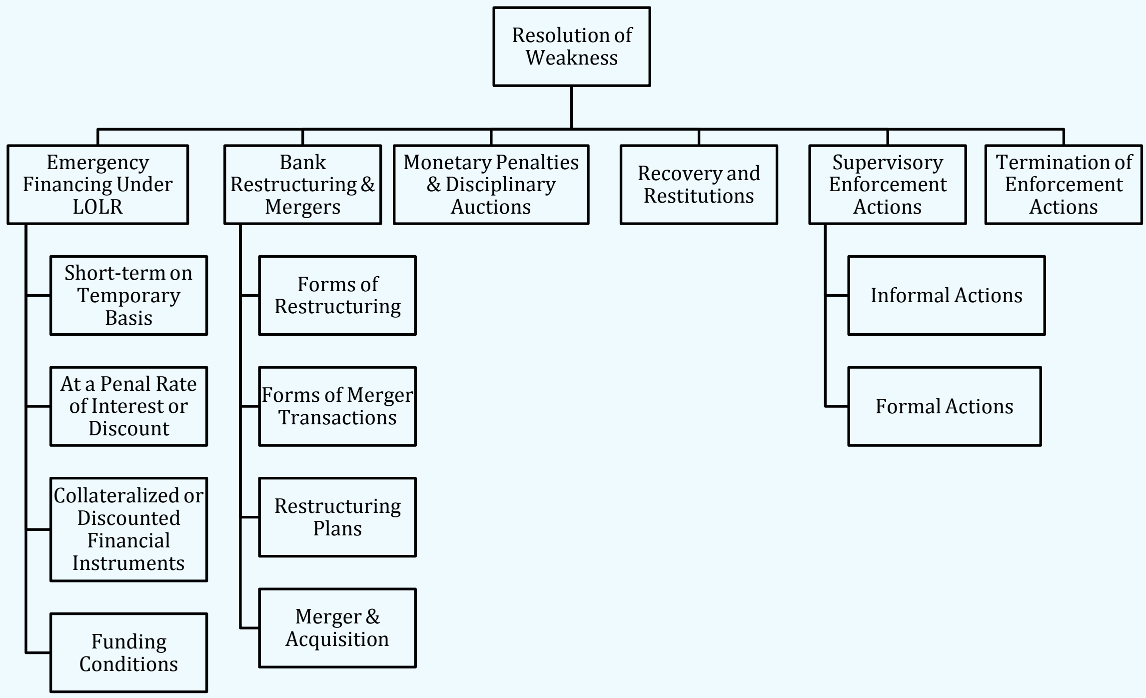
- Issuance of Directive Orders: In directive orders, SBP specifies weaknesses in a bank, and time bound requirements to be met by the bank management and board of directors. The directive orders generally include requirements for additional capital, directions for improving operating policies and procedures (lending practices, recovery of non-performing loans, correction of legal and regulatory violations etc.). Moreover, SBP is authorized to issue directives in the larger interest of the public and depositors.
- Depending on the nature of the problem, SBP may remove the bank management and the board of directors. For an interim period, it may appoint another chairperson, director or chief executive, and draft a scheme for the merger of the problem bank.

In addition to above formal actions, the SBP may also cancel the license, and formal actions may liquidation of the bank.

**Step 3: Resolution and Lender of Last Resort Function**

Given the nature of weaknesses in banks, SBP decides on the appropriate measures from a wide range of corrective actions discussed in step 2. **Figure 3.4** shows the resolution process generally adopted by the SBP. Being the lender of last resort, SBP has also developed mechanism for Emergency Financing Facility (EFF) for banks which face temporary liquidity shortages. The facility is primarily aimed at minimizing threats to overall financial stability by ensuring smooth functioning of the payment system, minimizing likelihood of runs on banks, preventing disorderly insolvency of banks, and supporting the transmission mechanism of monetary policy. SBP has also developed a detailed eligibility criteria and funding conditions for internal guidance. These help to ensure transparency and maintain consistency in implementing this financing facility.

**Figure 3.4: Flow Chart of Resolution Process**




Another key component of corrective actions is banks' restructuring and mergers. In this case, the problem bank may apply for urgent liquidity/financial assistance along with a proposal for restructuring or merger with another bank. SBP evaluates the application based on the criteria set forth for awarding a new banking license, i.e. compliance with the provisions of Banking Companies Ordinance 1962 and associated regulations for restructuring and mergers. In some instances, the government may also be involved as SBP's liquidity support is only available on a fully secured basis. Therefore, in certain cases there may be need for government guarantee for providing financial assistance to the bank. Moreover, the guiding principles of problem bank management are followed to decide upon the typical form of restructuring, types of merger transactions and restructuring plans.

### 3.3 Termination of Enforcement Actions

The final step in managing problem banks is the termination of enforcement actions, for which SBP has also developed a formal mechanism. For example, a formal outstanding enforcement order against a problem bank may be terminated if the bank receives a satisfactory rating in subsequent supervisory assessment.

## References

Batunanggar, Sukarela (2008), "Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries", The South East Asian Central Banks (SEACEN).

Bank of International Settlements, Basel Committee on Banking Supervision (2002), "Supervisory Guidelines on Dealing with Banks", Page 6 of, March 2002.