

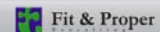


Banking Resolution Failure Seminar

Session III – Crisis management and exceptional measures

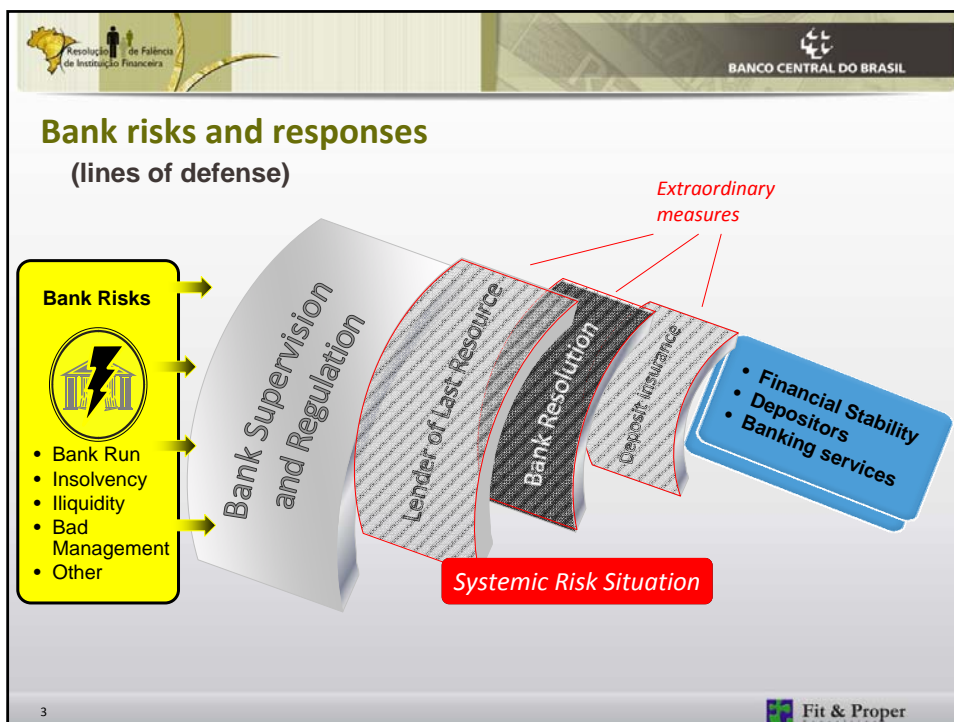
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Resolução de Falência de Instituição Financeira

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Bank Resolution

What is Bank Resolution?

A possible definition

- ➡ The procedures and measures taken by the **authorities to solve** the situation of an **unviable bank**
- ➡ The resolution of a bank implies a certain degree of **deposit payment** and typically leads to the **withdrawal of the bank's license** or **fundamental change in its ownership**

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- Bank Resolution**
- Most common resolution schemes (Basel definitions) -not mutually exclusive -
- 1 | Closure of the bank and payment of deposits
 - 2 | Open bank assistance (liquidity or capital)
 - 3 | Government intervention (take-over, nationalization)
 - 4 | Merger /Acquisition (induced by the authorities)
 - 5 | "Bridge Bank"
 - 6 | "Good Bank-Bad Bank" (or other Purchase-and-Assumption modalities)
 - 7 | F&H ("Forbearance and Hope")
- 6 Fit & Proper

Systemic Risk and Exceptional Measures

Definition of a systemic event

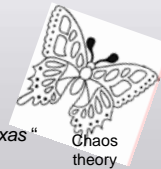
Situation where the closure of a bank threatens to generate negative externalities to other banks or to the economy

A specific legislation for systemic events is one option in the architecture the legal framework

Decision to be taken:

- » Conditions or issues that identify a “systemic event”
- » Who and when to declare “systemic event”
- » Whether “systemic events” are foreseen within the law

Edward Lorenz (1973) “The flap of a butterfly's wings in Brazil set off a tornado in Texas”



Chaos theory

Systemic Risk and Exceptional Measures

Key issues to consider an event as “systemic”

Size / Interconnection / Coverage / of the unviable (s) bank (s)


Financial sector situation


Economic situation of the country

Financial and Economic situation of the region or the world



A systemic bank requires exceptional measures?





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Systemic Risk and Exceptional Measures

Effects of declaring events as “Systemic” —→ Excepcional mesures


» Declaring an event as systemic **allows authorities not to comply certain obligations, limits and restrictions** valid for normal periods (and even to break certain principles) and to have **extraordinary powers**.

Examples:


- » Not to close unviable banks
- » Forbearance
- » Lender of last resource assistance over the established limits
- » Capitalization / Nationalization of financial institutions
- » Buy assets with public funds
- » Extension of guarantees to all deposits and other liabilities
- » Other

The authorities’ “fire power” grows (also the potential “collateral damage”)

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Systemic Risk and Exceptional Measures

“Dangers” of applying systemic solutions


Bank Risks



- » “Saving” bankers and investors with money from “carpenters and plumbers”
- » Public money and private management
- » Financing banking imbalances
- » Perverse incentives (moral hazard)
- » Inflation
- » Fiscal deficit

Challenge: To have a scheme that allows a proper response to systemic events minimizing its “dangers”

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Bank Resolution Principles BRP (criteria)

- Minimization financial and economic costs.
- Minimization of contagion risk.
- Ensure a minimum level of protection to “widows and orphans”.
- No bail out for shareholders.
- No bail out for investors
- Adequate transparency..
- Timely response and resolution.

(*)“Practical Guidelines for Effective Bank Resolution” – Bolzico, Mascaró and Granata, 2007.
Word Bank, Policy Research Working Paper, WPS 4389

Bank Resolution Principles BRP (criteria)

- **Minimization financial and economic costs.**

BR processes have costs. Authorities should try to achieve the least possible costs and to allocated them properly .

Losses allocation (“the proper ranking”):

1. **Stockholders,**
2. Investors, Big depositors
3. Deposit insurance agency
4. State (if systemic)

- **Minimization of contagion risk.**

The question is not only to “resolve the bank”, it had to be done:

*- **Timely** and with **reasonable amount of resource***

Bank Resolution Principles BRP (criteria)

- **Ensure a minimum level of protection to “widows and orphans”.**

General consensus that small depositor should be protected

- **No bail out for shareholders or investors**

The BR losses must be borne first by shareholders and in the second place by sophisticated investors .

External resources to aid the process should not benefit shareholders or investors. Failure to do so will likely increase the total cost of resolution and create perverse incentives (i.e. moral hazard)

Bank Resolution Principles BRP (criteria)

- **Adequate transparency.**

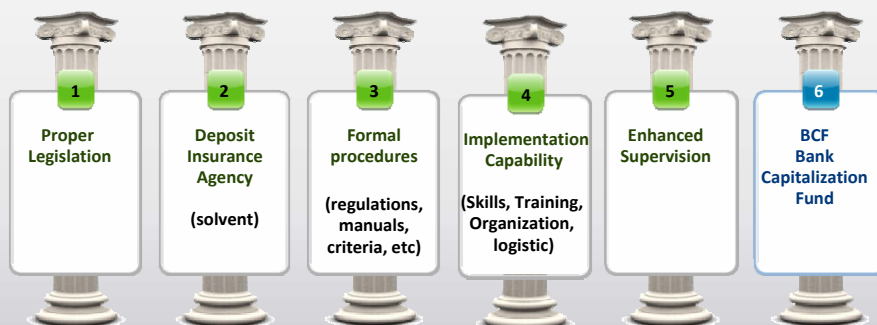
Transparency is needed to avoid hampering the credibility of the authorities during the resolution process and to ensure a positive perception of the process by market participants. The procedure should be perceived to be fair and in compliance with the BRP

- **Timely response and resolution.**

The supervisor needs to start the process as soon as problems are identified, following triggers and actions that should be clearly defined ex-ante. Failure to do so will increase problems and costs

Pillars for a Good Bank Resolution Scheme

Pillars for a Good Bank Resolution Scheme



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Challenges for policy makers

To achieve a bank resolution and crisis management scheme that:

✓ provides an effective response to banking problems, *and at the same time...*

✓ fulfills the bank resolution principles, BRP

In systemic events authorities might decide not to follow some of the BRP (but, be careful)

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