World Bank

Conceptual Issues Related to Bank Resolution

Javier Bolzico
Jbolzico@fitproper.com

Yira Mascaró
Ymascaro@worldbank.org

Fit & Proper

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Introduction:

Different stages of the life of a bank

Status	Licensing	Normal Operations	Some weaknesses	*Unviable Bank*
		Standard Supervision (Camels 1-3)	Intensive Supervision (Camels 4)	Resolution Process
Measures		•Prompt Corrective Actions	•Regularization Plan	•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**

Why is Bank Resolution of great importance?

- It could lead to negative **systemic effects** **(i.e., contagion risk)** if a bank closure is mismanaged
- It **sets incentives** for the remaining part of the system
- It could lead to **large total costs**, depending on the modus operandi through which the bank is closed
- It is at this point that bank **supervision is really tested**

And… It affects depositors´ resources

Most common resolution schemes (Basel definitions) - not mutually exclusive

1. Closure of the bank and payment of deposits
2. Open bank assistance
3. Government intervention (take-over)
4. Merger with other banks (induced by the authorities)
5. "Bridge Bank"
6. Purchase-and-Assumption (P&A) → "Good Bank-Bad Bank"

F & H ("Forbearance and Hope")

1 Closure of the bank and payment of deposits

The troubled bank is closed and deposits are paid (total or partially). The bank is later liquidated

Advantages

- The problem is solved
- Little *moral hazard* – market discipline

Disadvantages

- Very costly
- Loss of banking services and jobs
- Deterioration of assets due to the judicial liquidation process
- Possible systemic impact

2 Open bank assistance

The government keeps the troubled bank open by providing solvency and/or liquidity support

Disadvantages

- Very costly - fiscal & monetary impact
- Does not attack the root of the problem
- May increase the final cost of resolution
- Moral hazard

- Preserves Bank operations
- Avoids -- temporarily -- the cost of bank closure

Advantages

3 Government Intervention

The Central Bank (or any other public institution) takes over the management and shareholders of the troubled bank and runs the business

Disadvantages

- Very costly - Fiscal & monetary impact
- Does not attack the root of the problem
- May increase the final cost of resolution
- Moral hazard

- Preserves bank operations
- Avoids - temporarily- the cost of bank closure

Advantages

4 Merger with other banks (induced by the authorities)

The troubled bank is absorbed by another (solvent) bank. The authorities may use "persuasion"

Disadvantages

- May cause problems to acquiring bank
- May discourage private investment
- Moral hazard

- Preserves bank operations

Advantages

5 "Bridge Bank"

The authorities close the troubled bank and, at the same time, create a new bank ("bridge bank") with some, or all, of the original assets and liabilities.
A designated "liquidator" runs the bank until its shares are sold to the market.

Disadvantages

- The bridge could "become a road"
- May require capital and liquidity support from the government
- May increase the final cost of resolution
- Interferes with the Market
- Moral hazard

- Preserves bank operations & buys some time

Advantages

6 Purchase-and-Assumption (P&A) transactions

In a P&A, one o more healthy banks (or investors) purchase some, or all of the assets and assume liabilities.
The process is conducted by the authorities and implies the withdrawal of the bank´s license.
The original shareholders and managers can be removed in the process.

The P&A transaction may be structured in many different ways:

Here we will refer to a specific type of P&A transaction

Good Bank - Bad Bank scheme

6 Purchase-and-Assumption (P&A) transactions (cont.)

What makes the "Good bank-Bad bank" scheme different among P&A transactions?

The legal unity is split into two

Thus, a large portion of the assets avoids being eroded through a judicial liquidation process

6 Purchase-and-Assumption (P&A) transactions (cont)

If it is well applied it:

- Minimizes the cost of resolution (preserves the value of assets)
- Has a very small impact on bank operations
- Is market friendly
- Minimizes moral hazard

Advantages

Challenges /Disadv.

- Its implementation requires skills, expertise, political will and guidelines
- Requires the voluntary participation of private banks
- It may not be so attractive from the political point of view

"Good Bank" - "Bad Bank" Scheme

How it works: it …

Separates the failed bank into

- "Good bank"
- "Bad bank"

Transfers the "good bank" to one or more solvent banks willing to acquire it

Leaves the "bad bank" to its owners and start the liquidation process (typically ends in bankruptcy)

What are the elements of each component…

"Good bank"

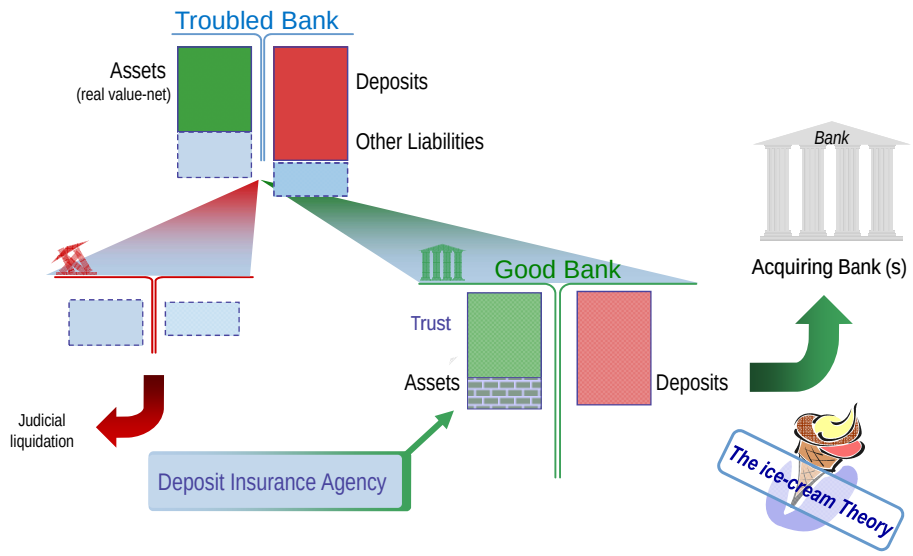
- **Liabilities:** Deposits and Labor claims
- **Assets:** the good assets + contribution from deposit insurance agency; not greater than liabilities

"Bad bank"

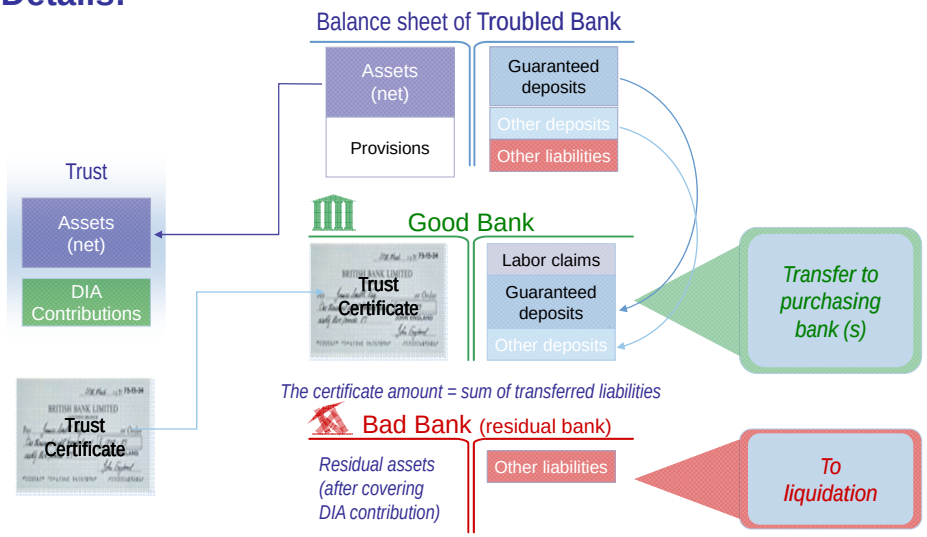
- Rest of liabilities and remaining (bad) assets

An efficient way to transfer assets is through a Trust

Let's see in more details how it works...

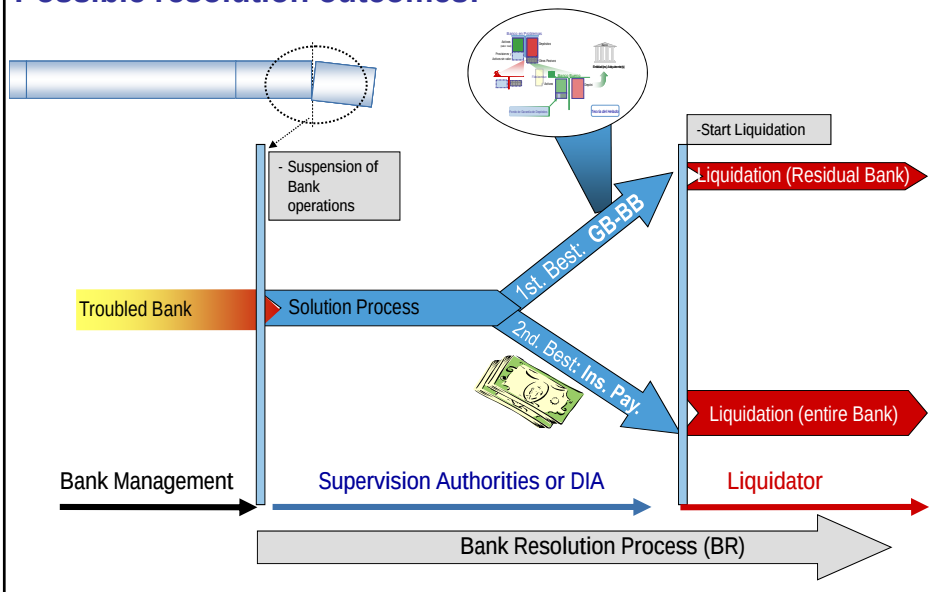


Details:



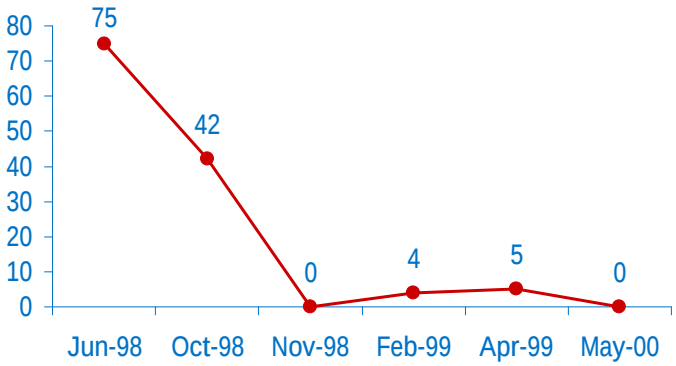
Note: It assumes that net assets + DIA contributions are enough to transfer all the deposits to the "Good Bank".

Possible resolution outcomes:



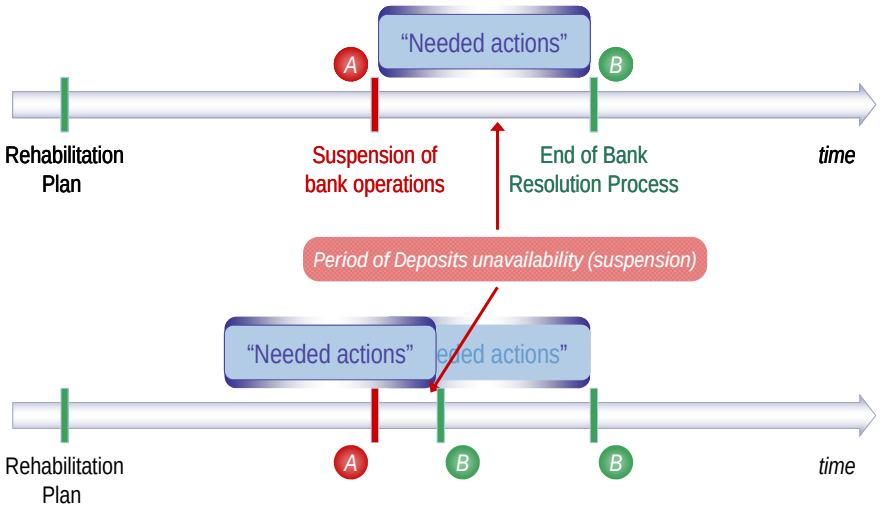
Handling Bank Resolution: Learning Curve (Argentina)

Period of unavailability of deposits (working days)



"Close the bank on Friday, open it on Monday"

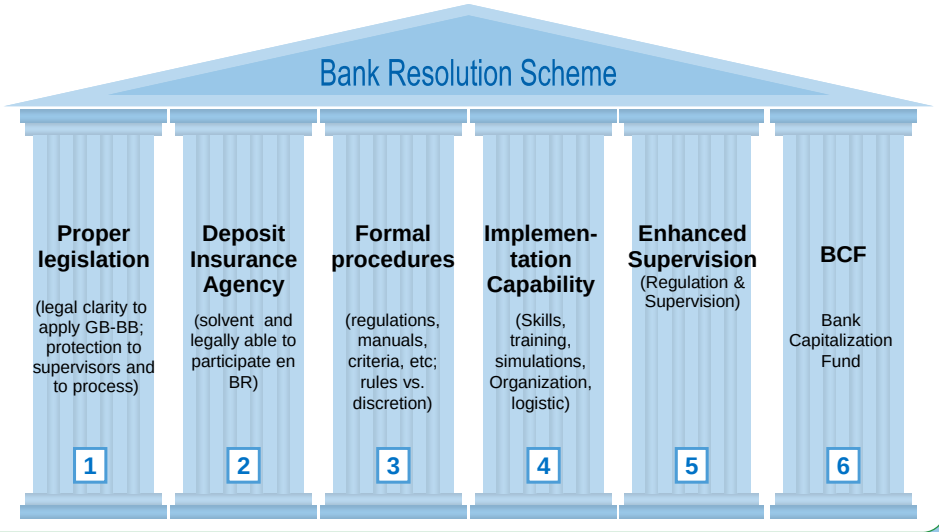
Reducing length of resolution period...



Some advantages of the Good Bank-Bad Bank scheme

- Minimizes contagion risk & is market friendly
- Minimizes costs:
  - No public funds (typically)
  - No further deterioration of assets
  - No further operating and financial losses
- Preserves banking services and jobs
- Eliminates legal contingencies for buyer (all hidden claims remain in the "bad bank")
- Minimizes moral hazard (shareholders of Troubled Bank face a bankruptcy process)

Pillars for a Good Bank Resolution Scheme



Experience with Good Bank-Bad Bank scheme

Selected **real cases** illustrate implementation of different BR approaches and some of the consequences:

- **Depositors lost** 75% of their deposits; it took several years to recover the remaining 25%
- Complex process ended in high Central Bank costs, **devaluation and inflation**. All liabilities covered
- **High quasi-fiscal cost**, even if failing bank was small; litigation processes ongoing after 3 years; high profile case (wide coverage in local press)
- **Nationalized. Higher costs**, because DIA first capitalized the Bank trying to "solve" the problem. As it failed anyways, DIA paid all deposits (**"paid twice"**)

Seeking for a more effective resolution alternative:
Evidence suggests that the implementation of GB-BB have led to important advantages in spite of…

Difficult environment at both the **national** and **international** level.

Different degree of development of the **pillars** for bank resolution and of **inherent difficulty of cases**.

Successful GB-BB cases …

… i.e., resolved at minimum cost, preserving banking business, covering most deposits, preserving majority of bank employment

Selected cases from LAC:

- Argentina -Banco Mayo 1998
- Bolivia - Mutual la Frontera 2003
- Paraguay –Financentro 2004

Bolivia-Mutual La Frontera (mid-2003)
Environment at national and International level

1. Difficult political/macro environment– recurring bank runs
2. Persistent decline of bank assets; lack of interest of existing international banks; system vulnerability
3. History of long and costly processes (borne mostly by Government) with long and unnecessary legal suits
4. Explicit regulatory forbearance for all *Mutuales* since '93
5. Solid legislation and regulation in place
6. Manuals and procedures completed; simulations, BRU
7. Supporting instruments available: DIA (solvent)

Bolivia- Mutual La Frontera (cont.)
Institution's characteristics; implications of process

1. Small -1 branch; negative capital since Dec. '96; New deadline May '04 (three other inst. with negative capital)
2. Only entity providing financial services in a remote area
3. Rapid resolution ("weekend") in May '03 -Mutual Paitití, (previous resolution processes 2-19 years)
4. No contagion; Extensive use of cash for the transaction
5. In 2004, " forbearance" was eliminated for 3 remaining inst. with negative capital, successfully resolved with "GB-BB"

Summary of coverage and instruments:

	Argentinean	Bolivian	Paraguayan
	BCRA	Superintendencia de Bancos y Entidades Financieras Bolivia	BCP Banco Central del Paraguay
Trust	✓	✓	—
Deposits	100 %	100 %	< 100%
DIA	Legal maximum	Legal maximum	50% of legal maximum
Bank Capitalization Fund	✓	Created afterwards	Does not exist

Bank Resolution and Contagion Risk: A Digression

"Total" Contagion Risk (TCR): A bank failure raises the probability of a run on the deposits of other banks.

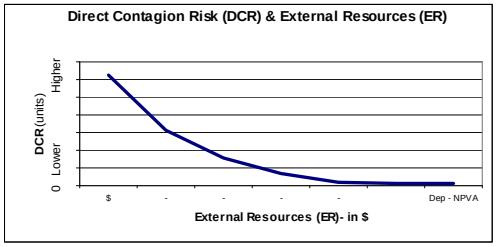
TCR = direct** risk **(DCR)+ indirect** risk **(ICR)

The **Direct** risk emerges when the depositors of a failed bank do not have access to all or part of their deposits, or perceive they will have permanent losses

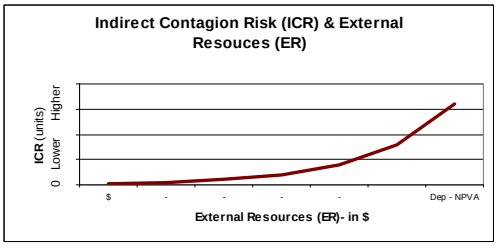
The **Indirect** risk emerges from negative externalities of a bank failure over: the economy, the fiscal stance, or the solvency of the DIA

Digression (cont.) Minimizing TCR-illustration

Direct Contagion Risk (DCR)



Indirect Contagion Risk (ICR)



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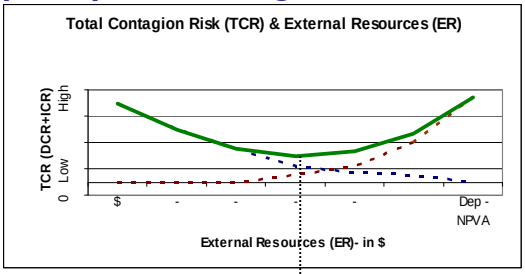
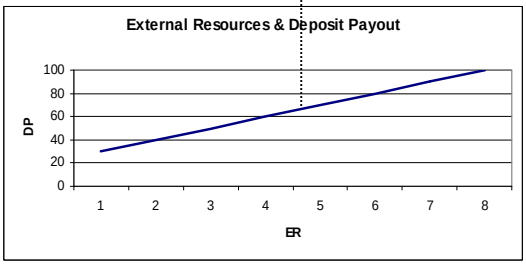
Digression (cont.) Minimizing TCR-illustration

Total Contagion Risk (TCR)



External Resources and Deposit Payout (in min TCR)



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Thank you!