



## Bank Resolution Conceptual Issues

### Overview of Financial Sector Issues and Analysis Workshop

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## Content

### Conceptual Issues

- I. Introduction to Bank Resolution
- II. Alternative Resolution Schemes
- III. "Good Bank- Bad Bank"
- IV. Bank Resolution Pillars & Criteria
- V. "Experiences with Good Bank- Bad Bank"
- VI. Bank resolution and contagion Risk

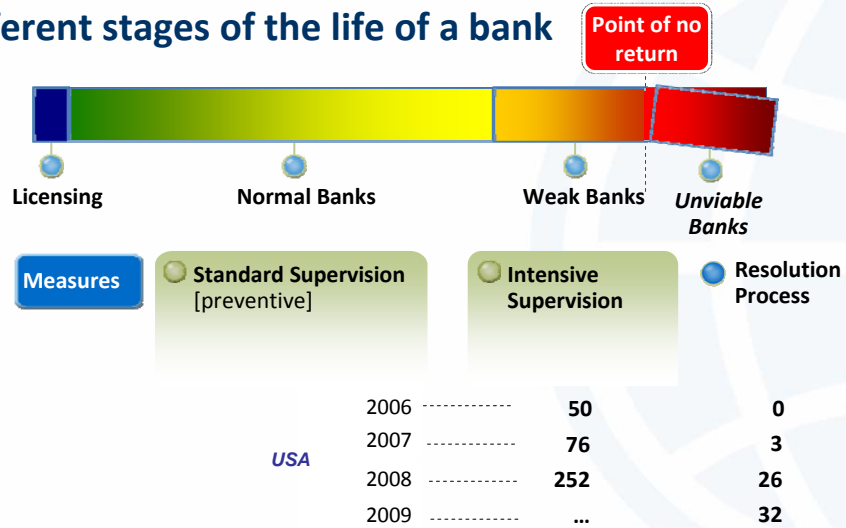
### Exercise

### Analysis of Real Cases

- I. Northern Rock
- II. Bear Stearns
- III. Lehman
- IV. Citigroup

I. Introduction to Bank Resolution

## Different stages of the life of a bank



I. Introduction to 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**

## I. Introduction to Bank Resolution

### 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 (moral hazard )
- ➔ It could lead to **large total costs**, depending on the modus operandi through which the bank is closed
- ➔ In systemic situation could impact the **dynamic and the solution to the crisis**

*And... It affects **depositors' resources***

## II. Alternatives Resolution Schemes

### 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)
- F& H ("Forbearance and Hope")

## II. Alternatives Resolution Schemes

### Most common resolution schemes (Basel definitions) -

not mutually exclusive

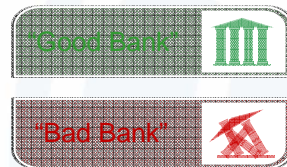
		Moral Hazard	Fiscal/ Private Cost	Systemic Impact	Bank services deterioration
1	Closure of the bank and payment of deposits	Low	High	Medium/ High	High
2	Open bank assistance (liquidity or capital)	High	unknown	Low	Low
3	Government intervention (take-over)	High	unknown	Low	Low
4	Merger / Acquisition (induced by the authorities)	Medium	None	Low/ High	Low
5	"Bridge Bank"	Medium	Medium	Low	Low
6	"Good Bank-Bad Bank" (or other Purchase-and-Assumption modalities)	Low	Low	Low	Low

### "Good Bank" - "Bad Bank" Scheme

### III. "Good Bank- Bad Bank"

#### How it works: it ...

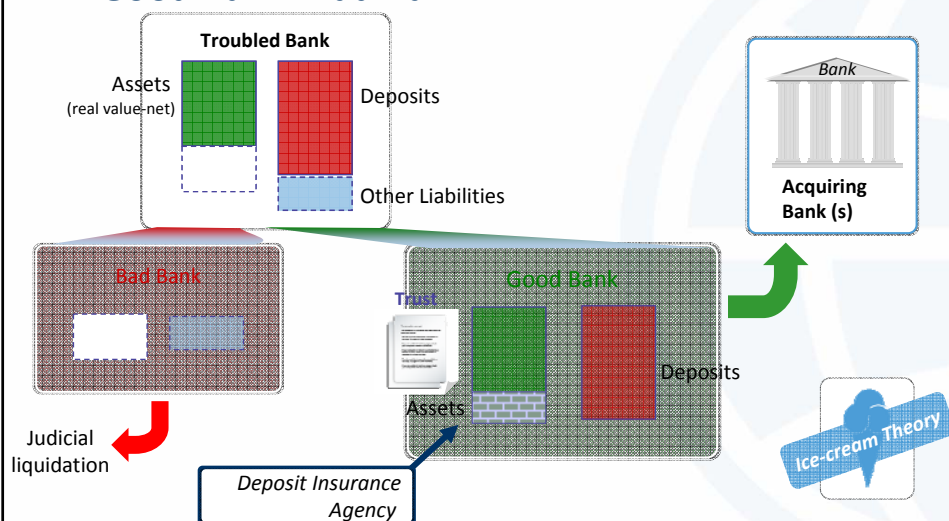
Separates the failed bank into



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

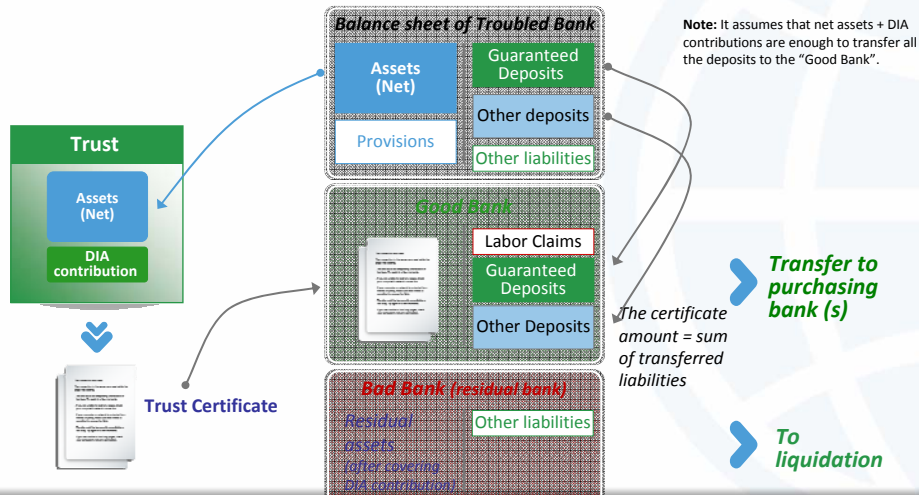
Leaves the "bad bank" to its owners and start the liquidation process (typically ends in bankruptcy)

### III. "Good Bank- Bad Bank"



### III. "Good Bank- Bad Bank" (cont.)

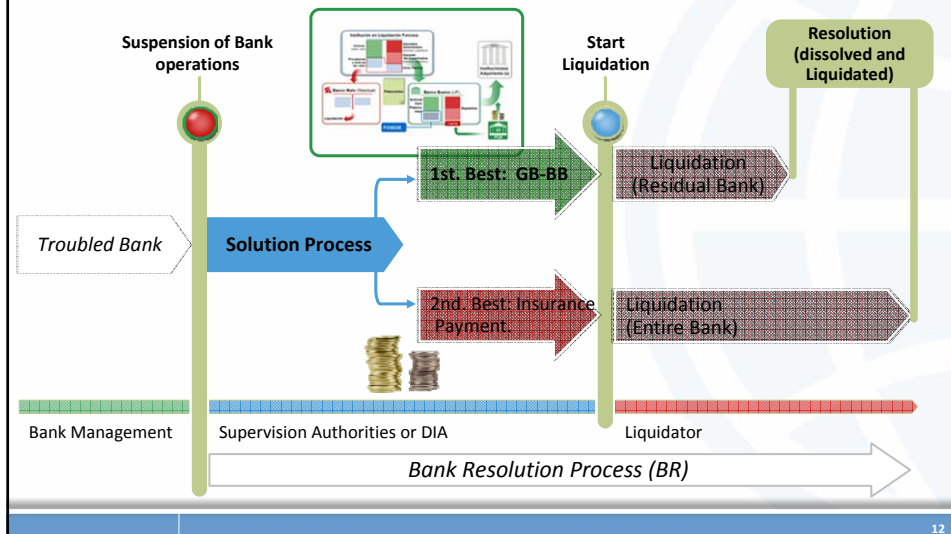
#### Details:



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### III. "Good Bank- Bad Bank"

#### Possible resolution outcomes:

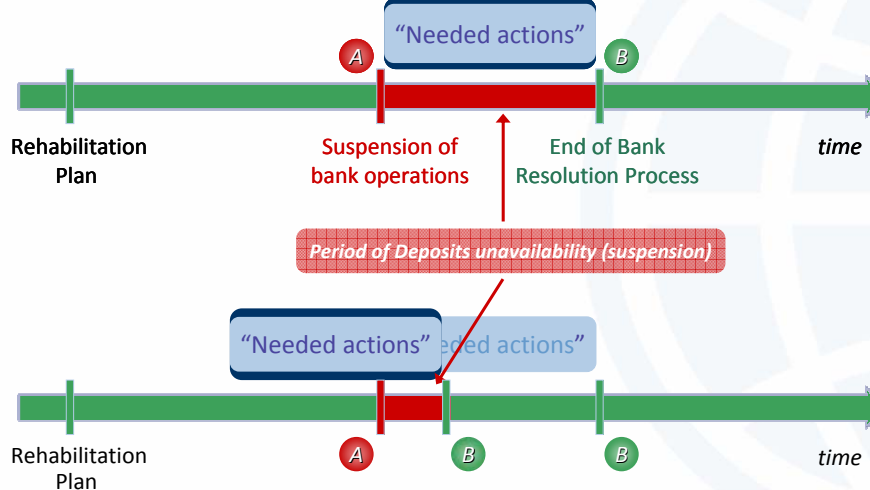


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## III. "Good Bank- Bad Bank"

## Reducing length of resolution period...



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## III. "Good Bank- Bad Bank"

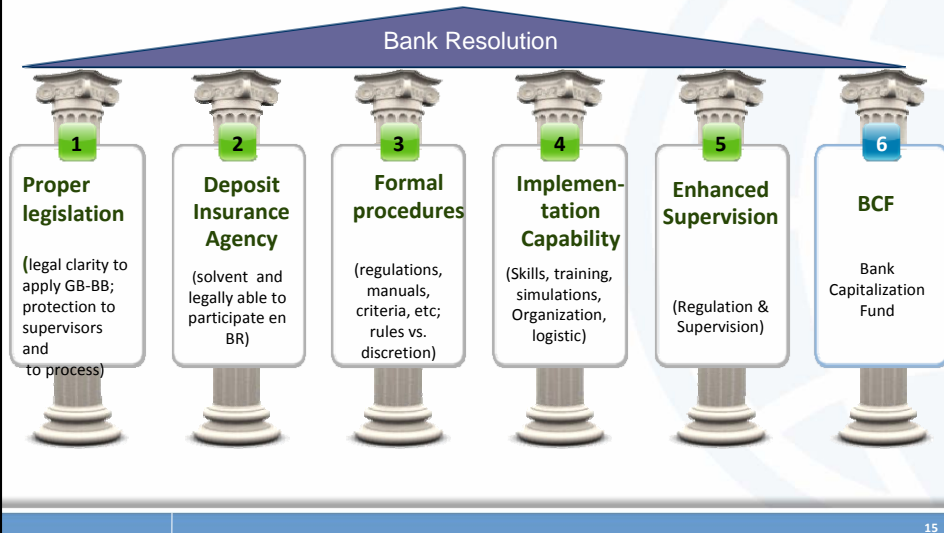
## Some advantages of the Good Bank-Bad Bank scheme

- + **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)

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#### IV. Bank Resolution Pillars

### Bank Resolution Pillars



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#### IV. Bank Resolution "criteria"

- Minimization of direct 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. World Bank, Policy Research Working Paper, WPS 4389

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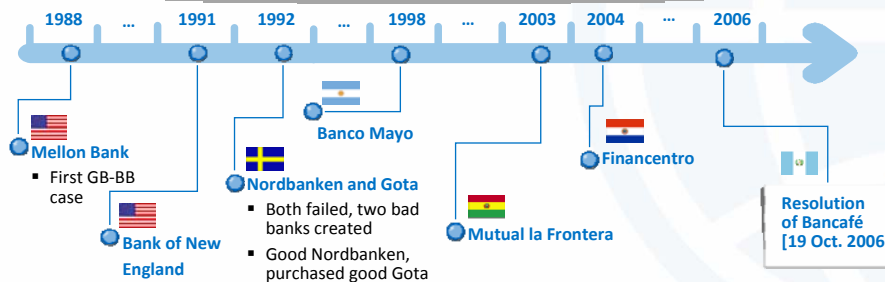
## Experience with Good Bank-Bad Bank scheme

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### V. "Experiences with Good Bank- Bad Bank"

International evidence points to a number of successful GB-BB cases

- (i) Resolved at minimum cost
- (ii) Covering most deposits
- (iii) Preserving majority of bank employment

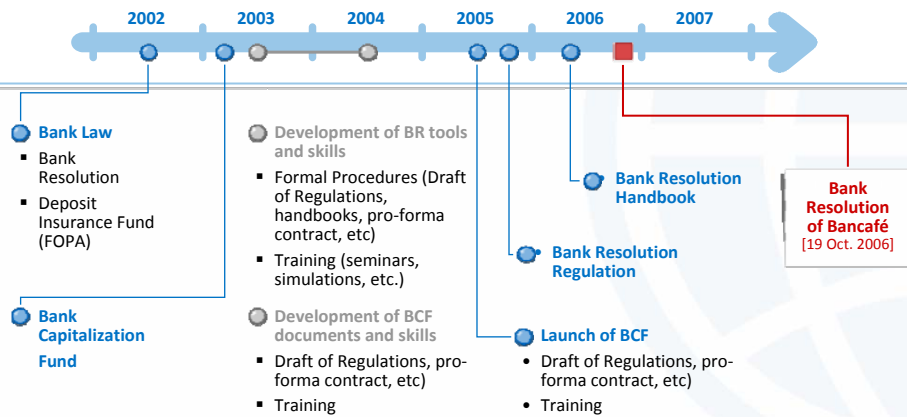


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V. "Experiences with Good Bank- Bad Bank"

**Bancaf  [mid-2006]**

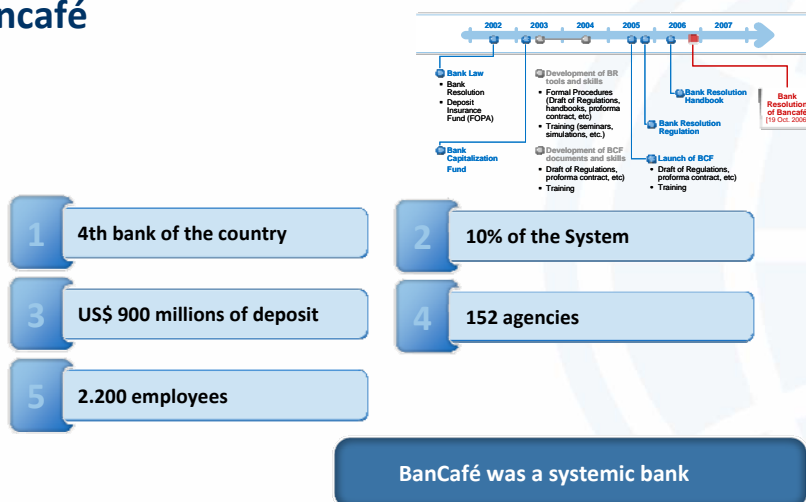
Guatemala readiness before Bancaf  Bank



V. "Experiences with Good Bank- Bad Bank"

**Bancaf **

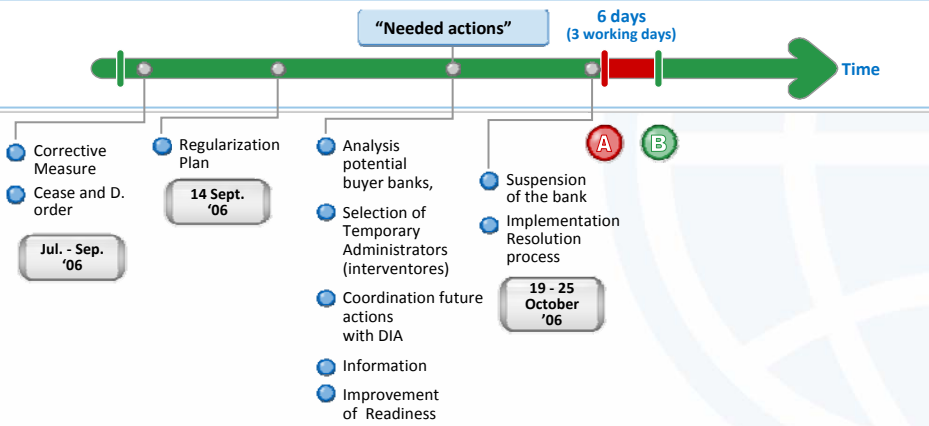
Guatemala readiness before Bancaf  Bank



V. "Experiences with Good Bank- Bad Bank" (cont.)

**BanCafé (mid-2006)**

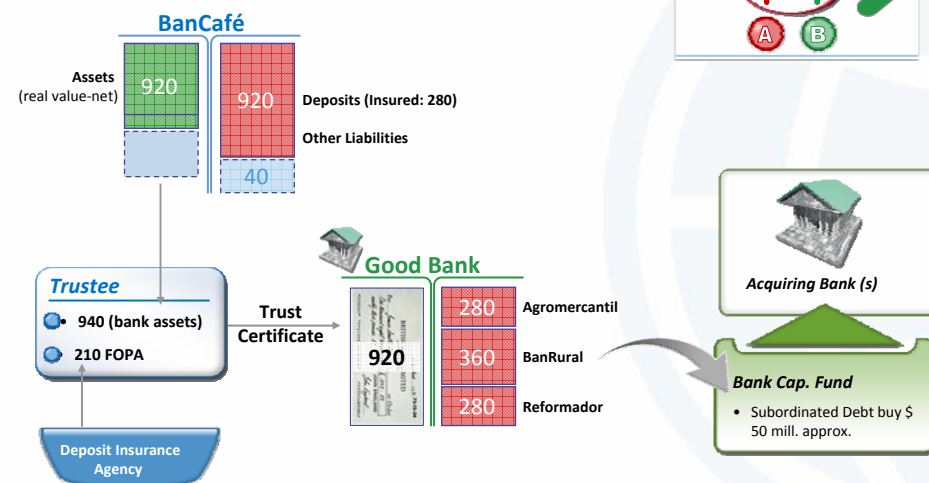
The resolution process



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V. "Experiences with Good Bank- Bad Bank" (cont.)

**BanCafé**



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## Bank Resolution and Contagion Risk: A Digression

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### VI. Bank Resolution and Contagion Risk

#### **“Total” Contagion Risk (TCR):**

A bank failure raises the probability of a run on the deposits of other banks

$$TCR = \text{direct risk (DCR)} + \text{indirect risk (ICR)}$$

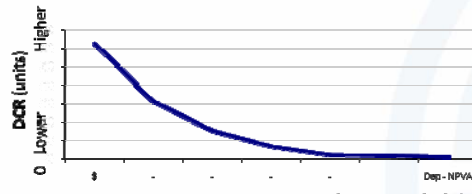
- ➔ The **Direct** risk emerges when the depositors of a failed bank do not have access to all or part of their deposits, or perceive they will have permanent losses
- ➔ The **Indirect** risk emerges from negative externalities of a bank failure over: the economy, the fiscal stance, or the solvency of the DIA

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VI. Bank Resolution and Contagion Risk

**Digression (cont.) Minimizing TCR-illustration**

**Direct**  
Contagion  
Risk (DCR)



**Indirect**  
Contagion  
Risk (ICR)