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Bank Resolution Conceptual Issues

Overview of Financial Sector Issues and Analysis Workshop

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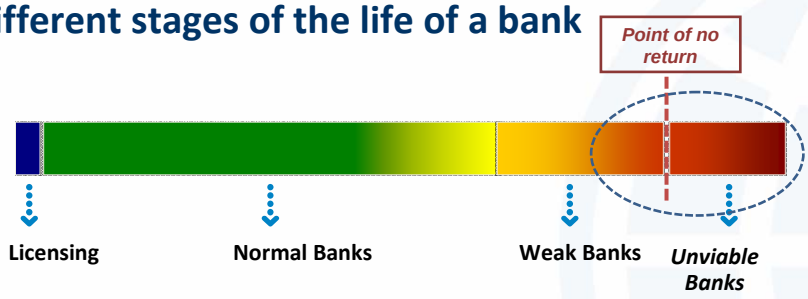
Content

Conceptual Issues

Exercise

I. Introduction to Bank Resolution

Different stages of the life of a bank



Measures	Standard Supervision [preventive]	Intensive Supervision	Resolution Process

I. Introduction to Bank Resolution (cont.)

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**

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I. Introduction to Bank Resolution (cont.)

Why is Bank Resolution of great importance?

- It could lead to negative **systemic effects** 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 situations could impact the **dynamics and the solution to the crisis**

*And… It affects **depositors´ resources***

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II. Alternative 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")*

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II. Alternative Resolution Schemes (cont.)

Resolution schemes and Implications

		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)	Medium/ 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	Medium/ Low	Low	Low

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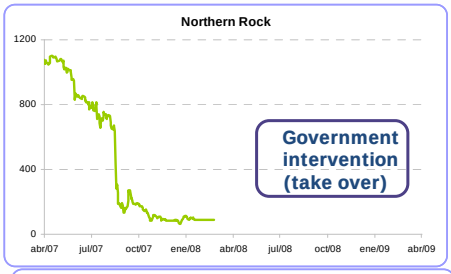
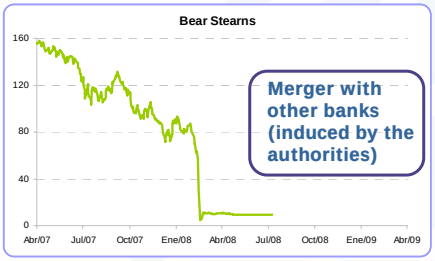
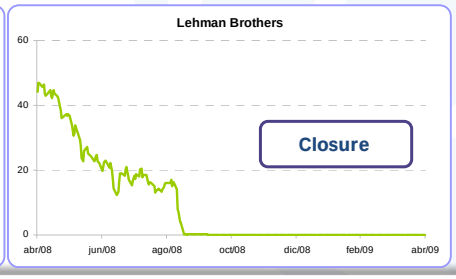
Resolution schemes in practice







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"Good Bank" - "Bad Bank" Scheme

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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 starts the liquidation process (typically ends in bankruptcy)

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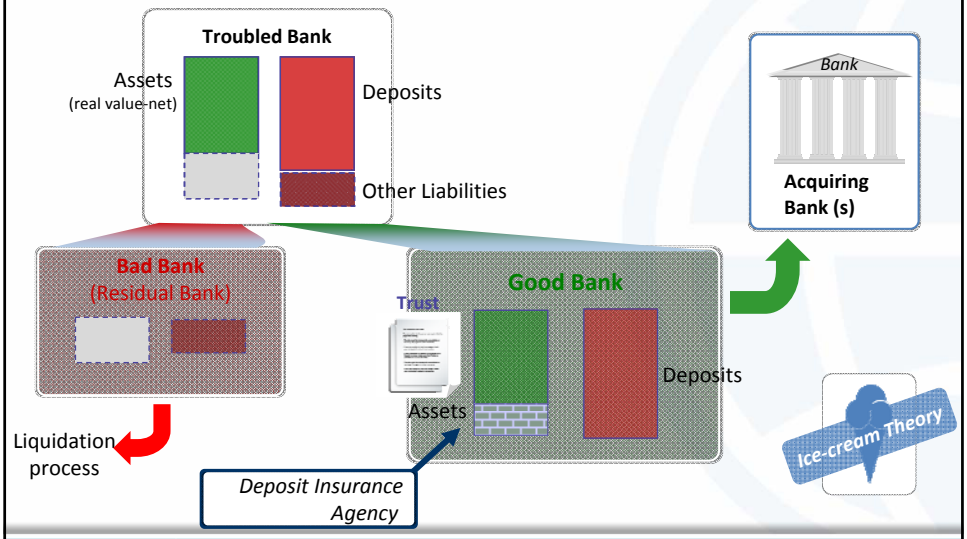
III. "Good Bank- Bad Bank" (cont.)



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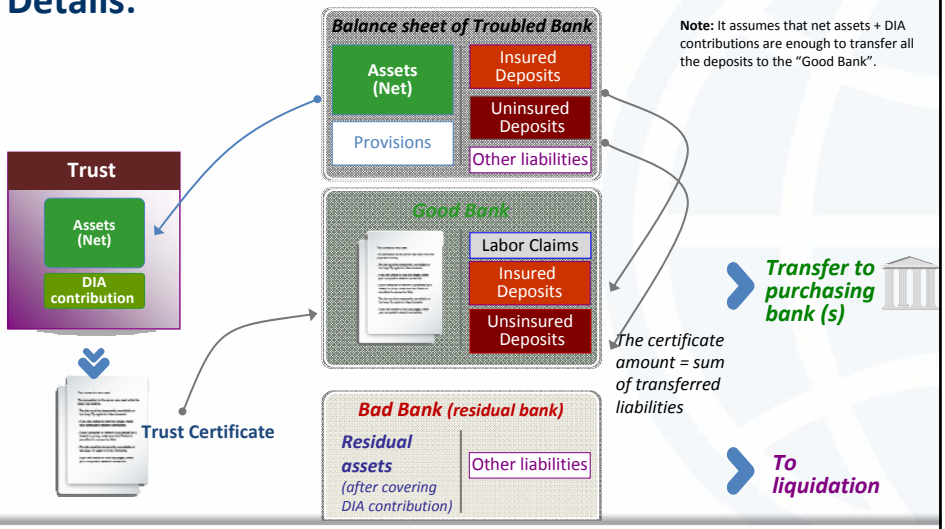
III. "Good Bank- Bad Bank" (cont.)

Details:



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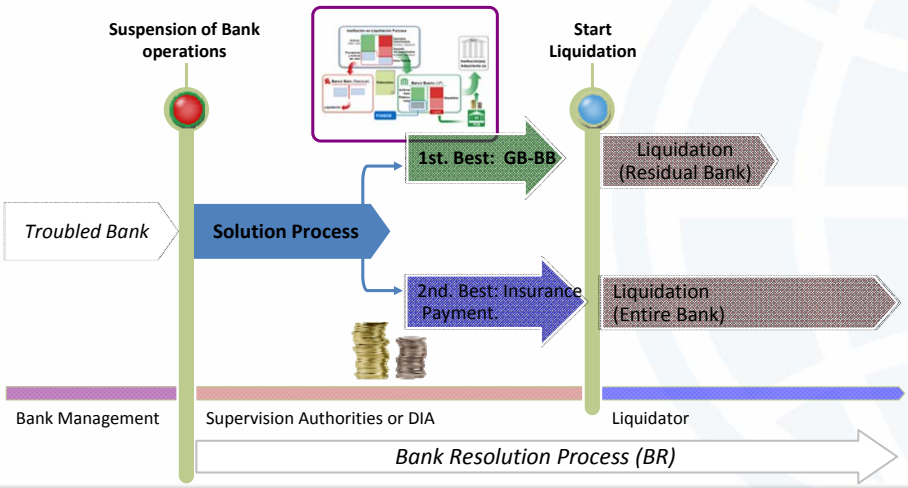
III. "Good Bank- Bad Bank" (cont.)

Possible resolution outcomes:



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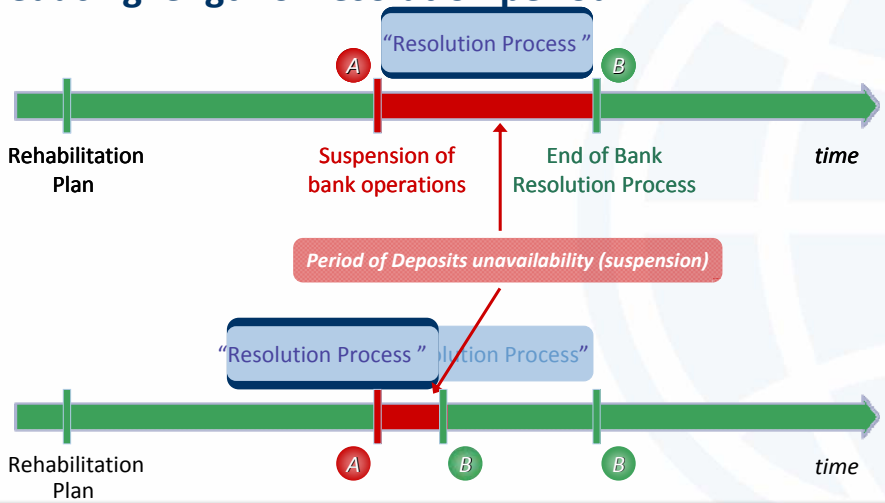
III. "Good Bank- Bad Bank" (cont.)

Reducing length of resolution period...



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

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)

..but it needs a buyer and a strong legal framework

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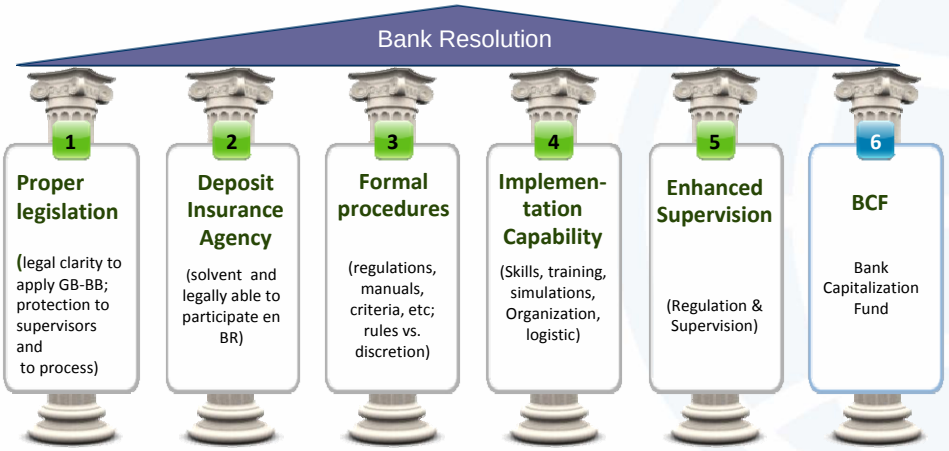
IV. Bank Resolution Pillars & Criteria

Bank Resolution Pillars



IV. Bank Resolution Pillars & Criteria (cont.)

Bank Resolution criteria (principles). *When is a BR Good?*

- 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 Efective Bank Resolution” – Bolzico, Mascaró and Granata, 2007. *Word Bank, Policy Research Working Paper, WPS 4389*

Experience with Good Bank-Bad Bank scheme

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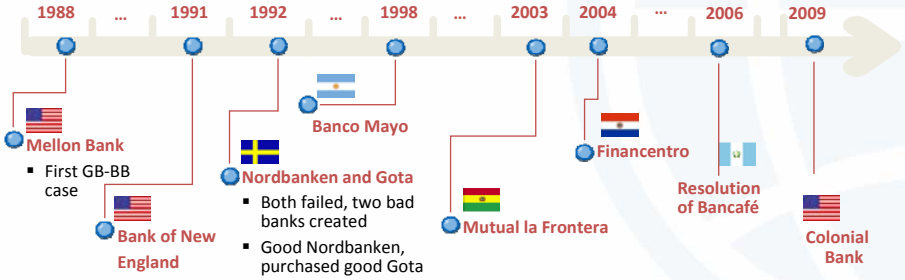
V. Experiences with "Good Bank- Bad Bank"

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" (cont.)

Bancafé

1. 4th bank of the country
2. 10% of the System
3. US$ 900 millions of deposit
4. 152 agencies
5. 2.200 employees

BanCafé was a systemic bank

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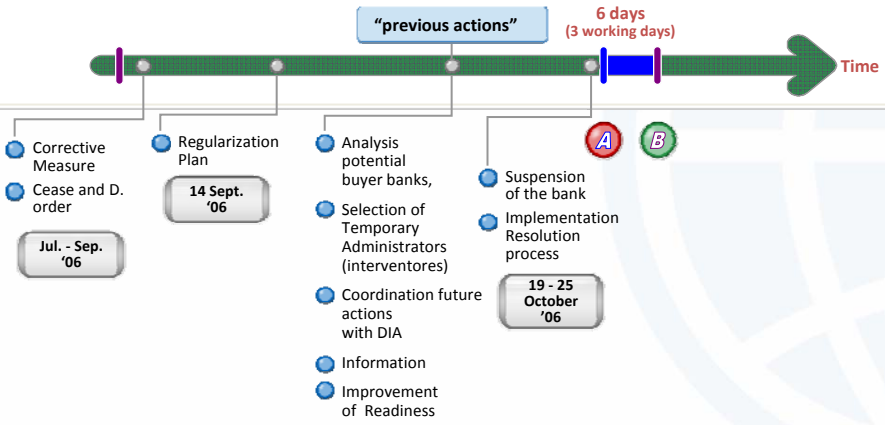
V. Experiences with "Good Bank- Bad Bank" (cont.)

BanCafé (mid-2006)

The resolution process



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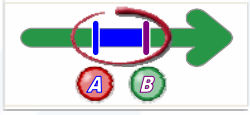
V. Experiences with "Good Bank- Bad Bank" (cont.)

BanCafé



Up to 2009, the Trust Certificate was fully paid and FOPA started to receive payment of its junior Certificate

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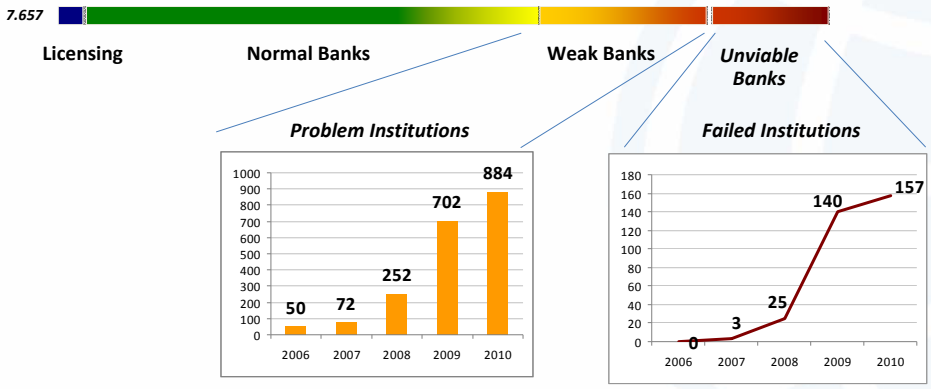
VI. Bank Resolution in Unites States

Problem Institutions and Failed Institutions



Source: FDIC

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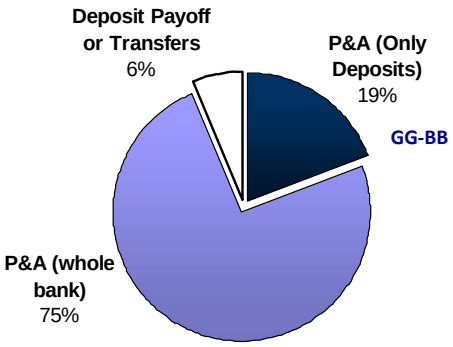
VI. Bank Resolution in Unites States (cont.)

FDIC – Bank Failure Resolution Type (2009)

140 cases



Source: FDIC

VI. Bank Resolution in Unites States (cont.)

FDIC Resources

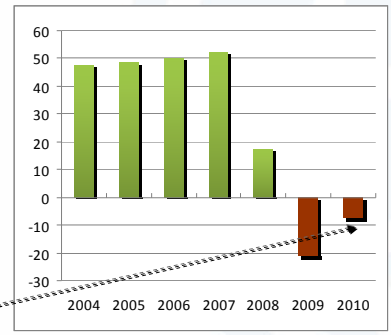
BALANCE SHEET - 2010

Cash	33.7
Investments	14.7
Receivable from resolutions	29.5
Other Receivable	2.7
Property	0.4
Total Assets	**81.1**

Prepaid assessments	30.1
Liabilities due to resolutions	30.5
Deferred revenues	9.1
Contingent: Future failures	17.7
Other	1.1
Total Assets	**88.4**

Fund Balance	**-7.4**

(Billons $)



Source: FDIC

Systemic and Non-Systemic situations

VII. Systemic and non-systemic situations

What is a systemic situation?

A systemic situation results when the failure (or potential failure) of one ore more banks creates negative externalities for the stability of the financial system and the economy as a whole

VII. Systemic and non-systemic situations (cont.)

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

Does a systemic bank require exceptional measures?

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VII. Systemic and non-systemic situations (cont.)

Effects of declaring a systemic risk situation

- Once a bank failure is declared as systemic it **enables the authorities:**

A) to follow actions and procedures that are not legally bound under "normal" circumstances.

B) not to comply with pre-defined rules.

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VII. Systemic and non-systemic situations (cont.)

Effects of declaring a systemic risk situation

Such especial capacities once triggered by the systemic classification include:

- No closure of failing banks
- Explicit Forbearance
- Liquidity provision from lender of last resource over the established limits or assistance to institutions other than banks
- Capitalization of banks using public funds or conversion to state-ownership
- Purchase of bank assets using public funds
- Extension of coverage of deposits guarantees to all deposits or to other type of liabilities
- Other

The authorities´ "fire fighting power" grows (also the potential "collateral damage")

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VII. Systemic and non-systemic situations (cont.)

Macro-prudential measures related to Bank Resolution

Too big to fail

Subordinated debt

Living Will

Contigency plan of authorities & cross border bank resolution

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VII. Systemic and non-systemic situations (cont.)

Macro-prudential measures related to Bank Resolution

Too big to fail:

-Additional capital requirements

-Restriction on /limitation of activities

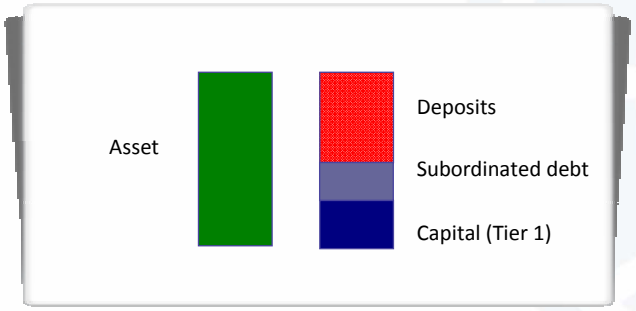
-Living-will

VII. Systemic and non-systemic situations (cont.)

Macro-prudential measures related to Bank Resolution

Subordinated debt

In case of deterioration of assets…:

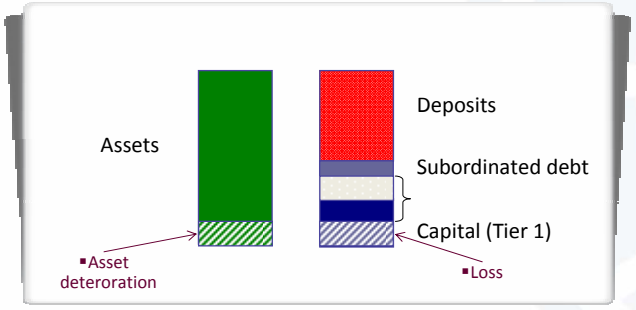


VII. Systemic and non-systemic situations (cont.)

Macro-prudential measures related to Bank Resolution

Subordinated debt (cont.)

In case of deterioration of assets…:



VII. Systemic and non-systemic situations (cont.)

Macro-prudential measures related to Bank Resolution

Living Will:

"guide for the undertaker to handle the deceased in a way that will avoid any contagious "

VII. Systemic and non-systemic situations (cont.)

Macro-prudential measures related to Bank Resolution

Contingency plan of authorities & cross border bank resolution

"guide for the undertaker to handle the deceased in a way that will avoid any contagion "

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Bank Resolution

Exercise [Part 1]

Washington DC, May 2011

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Bank Resolution Exercise

- **Presentation of the case:**

We are in a country named Bankland

***YOU** are in charge of the Bank Supervision Authority (Superintendent of Banks)*

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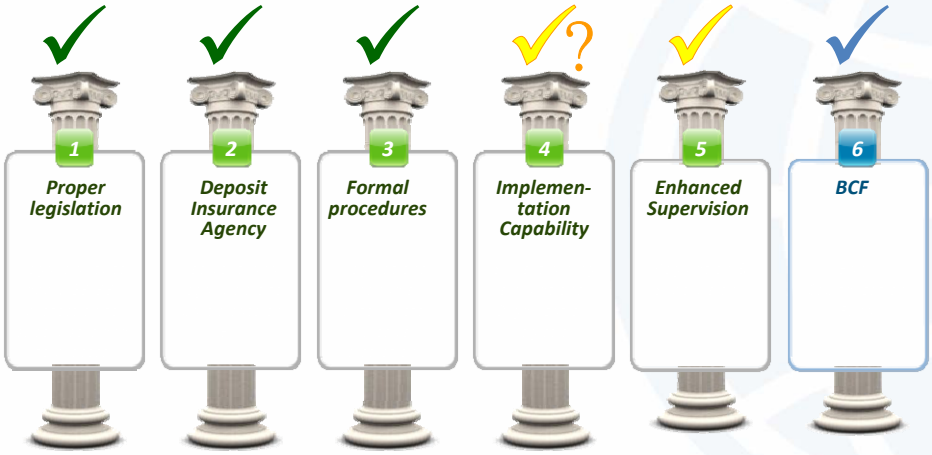
Pillars for Good Bank-Bad Bank Resolution in BankLand



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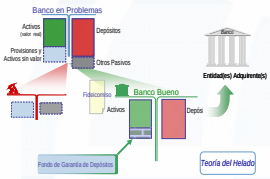
Pillars for Good Bank-Bad Bank Resolution (cont.)

- *Explicitly allows for Good Bank-Bad Bank scheme*
- *Explicitly protects supervisors and process*
- *Creditor's*
  1. *Labor Claims*
  2. *Deposits*
  3. *Rest of deposits*
  4. *Other liabilities*



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Pillars for Good Bank-Bad Bank Resolution (cont.)

- *Deposit insurance : up to $ 10,000*
- *DIA has the capability to participate in BR (Under the "lesser cost" criteria)*
- *DIA is solvent*

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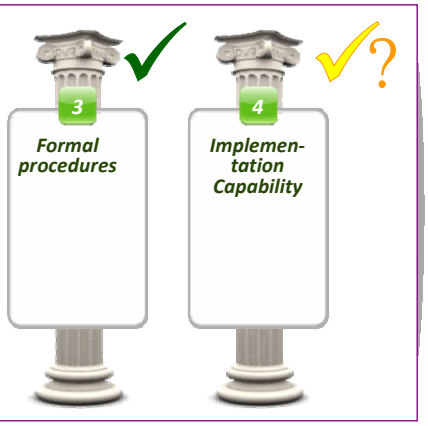
Pillars for Good Bank-Bad Bank Resolution (cont.)



- *There are BR Manuals & Procedures; Balances "rules versus discretion"*
- *The staff has received training and engaged in simulations of BR process*
- *BR Legislation and procedures have not been put in practice*

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Pillars for Good Bank-Bad Bank Resolution (cont.)

- *Regulation: Authorities are improving prudential regulations (50% done)*
- *Supervision: Supervision department is training its staff to apply risk-based supervision (50% of planned target accomplished)*
- *Capital adequacy ratio (CAR): 10% of risk assets*

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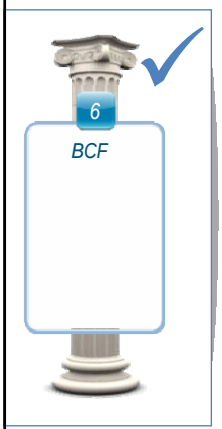
Pillars for Good Bank-Bad Bank Resolution (cont.)



- *Financial assistance for purchasing bank:*
  1. *Up to 10 % of assets of Good Bank*
  2. *Long-term and subordinated*
  3. *Relatively low interest rate*

You are the Superintendent of Banks….