



World Bank



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Consulting



## Bank Resolution Conceptual Issues

### Overview of Financial Sector Issues and Analysis Workshop

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## Content

### Conceptual Issues

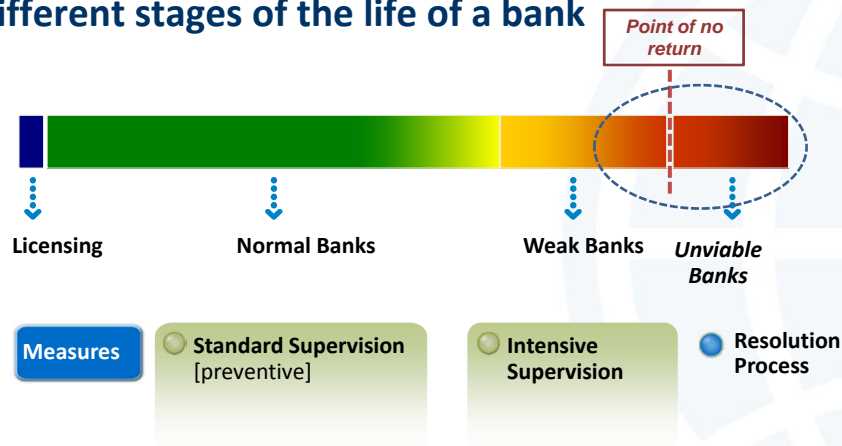
- I. Introduction to Bank Resolution
- II. Alternative Resolution Schemes
- III. "Good Bank- Bad Bank"
- IV. Bank Resolution Pillars & Criteria
- V. Experiences with "Good Bank- Bad Bank"
- VI. Bank Resolution in the United States
- VII. Systemic and Non-systemic situations

### Exercise



## I. Introduction to Bank Resolution

### Different stages of the life of a bank



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## 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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## II. Alternative Resolution Schemes

## Resolution alternatives in systemic situations

Non - systemic



Systemic

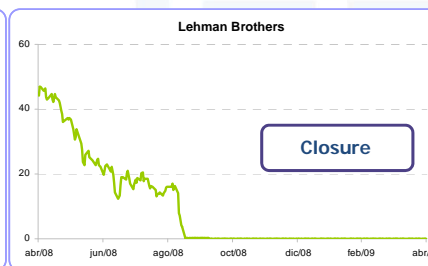
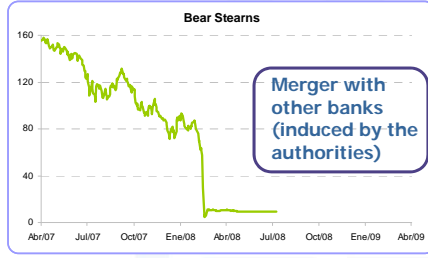
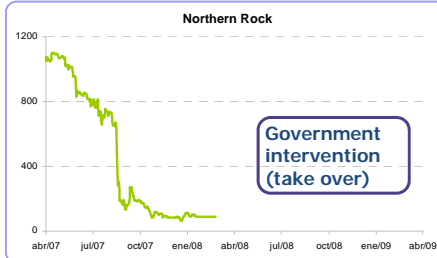
- 1 Closure of the bank and payment of deposits
- 2 Open bank assistance
- 3 Government intervention
- 4 Merger /Acquisition
- 5 "Bridge Bank"
- 6 "Good Bank-Bad Bank"

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## Resolution schemes in practice

Stock price in us dollars



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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

"Good Bank" 

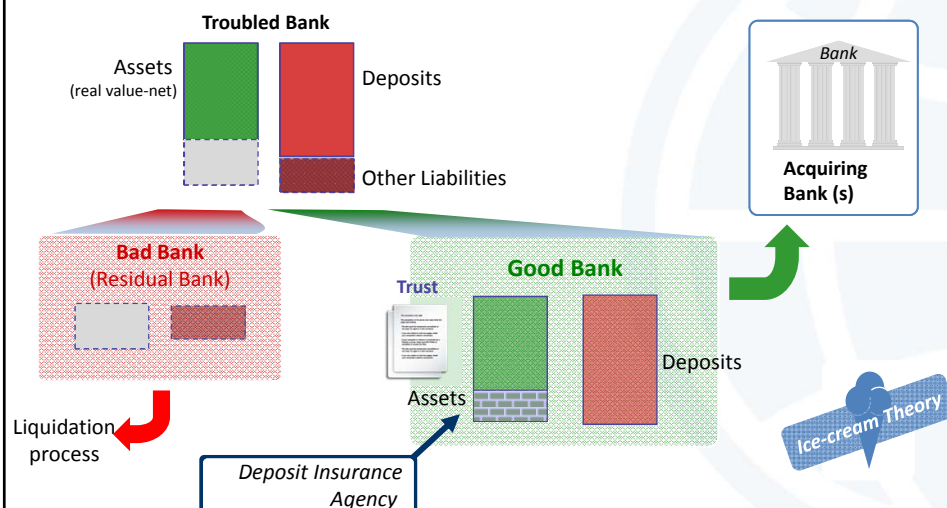
"Bad Bank" 

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

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

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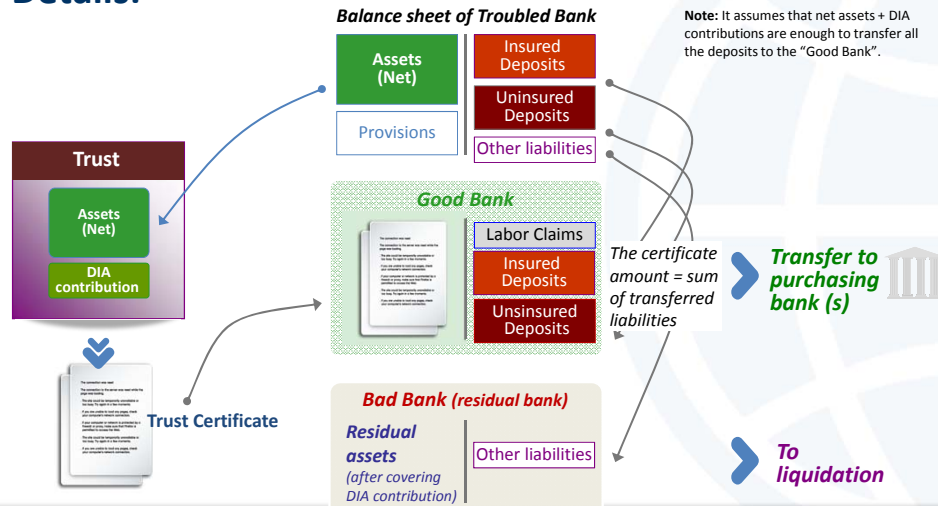
### III. "Good Bank- Bad Bank" (cont.)



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

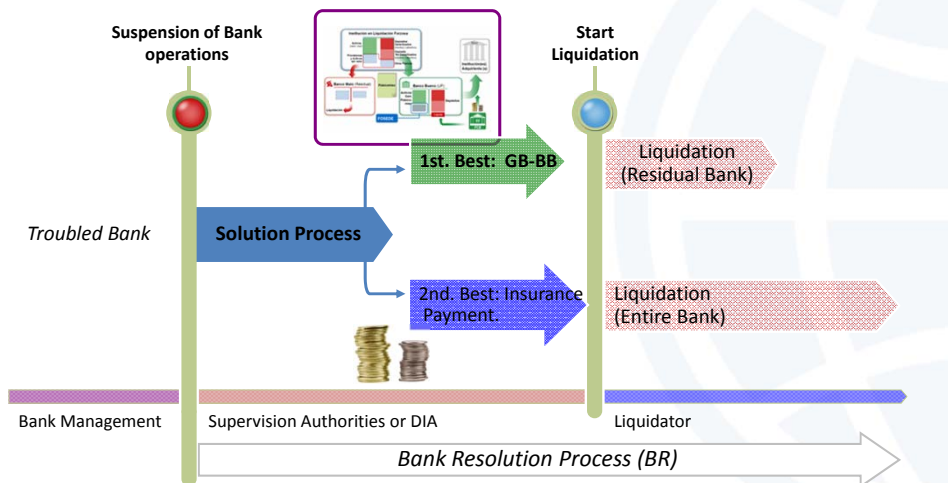
#### Details:



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

#### Possible resolution outcomes:

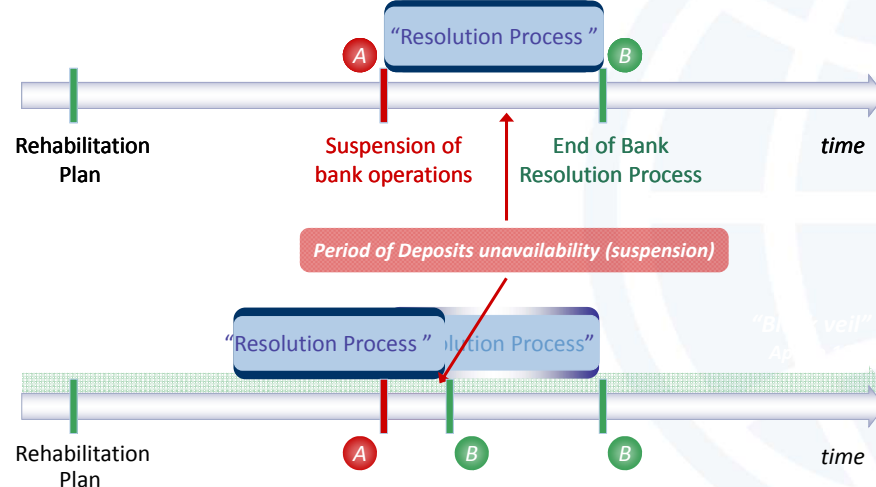


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## III. "Good Bank- Bad Bank" (cont.)

## 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)

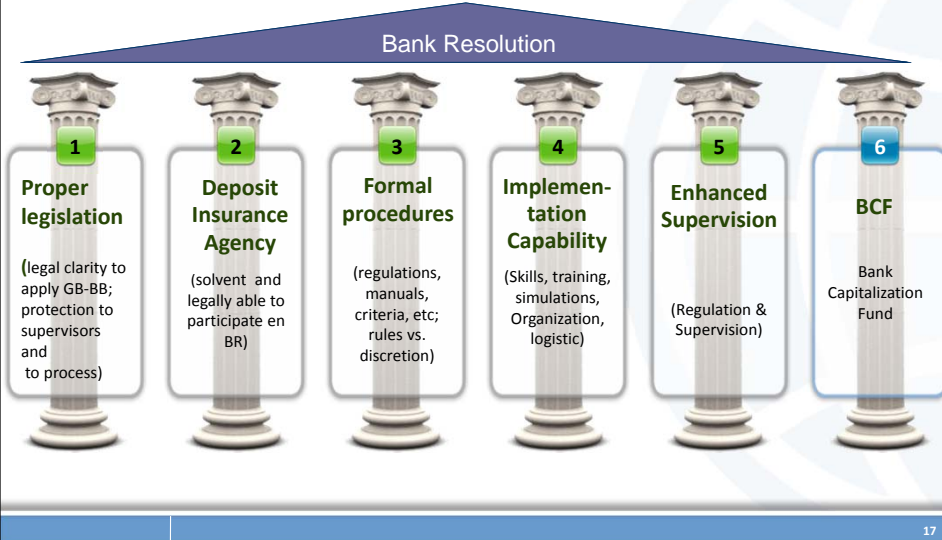
..but it needs a  
buyer and a  
strong legal  
framework

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#### IV. Bank Resolution Pillars & Criteria

### Bank Resolution Pillars



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#### 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 protection to small depositor ("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

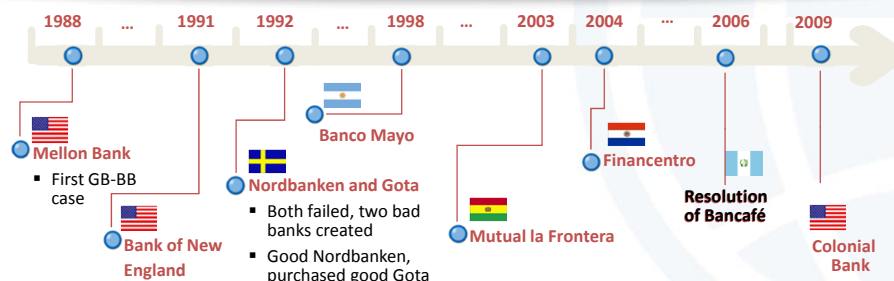
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### V. Experiences with “Good Bank- Bad Bank”

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” (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

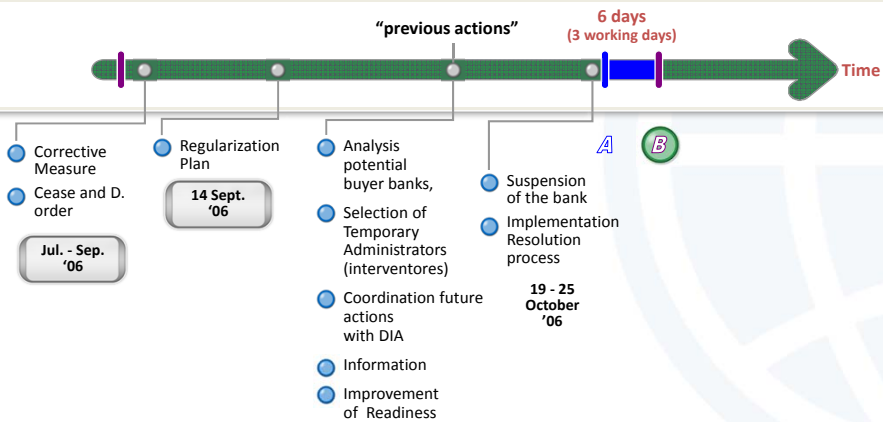
Bancafé was a systemic bank

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V. Experiences with “Good Bank- Bad Bank” (cont.)

**Bancafé (mid-2006)**

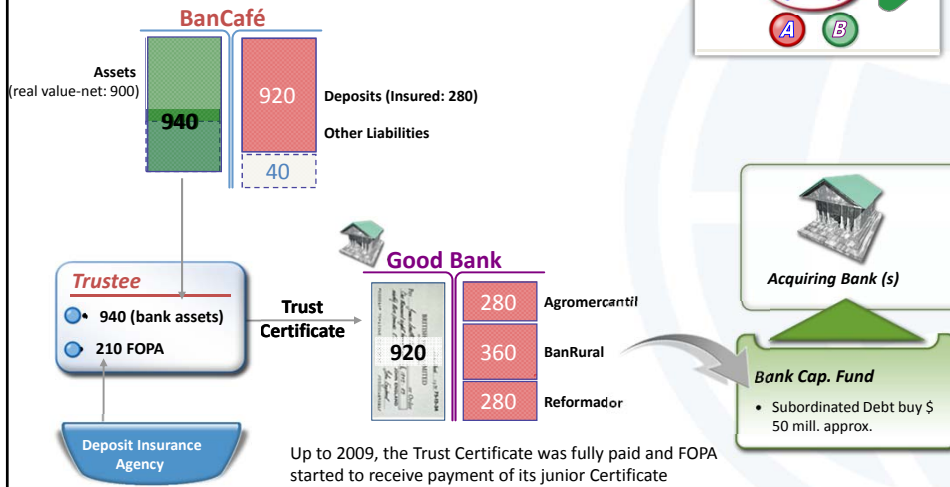
The resolution process



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

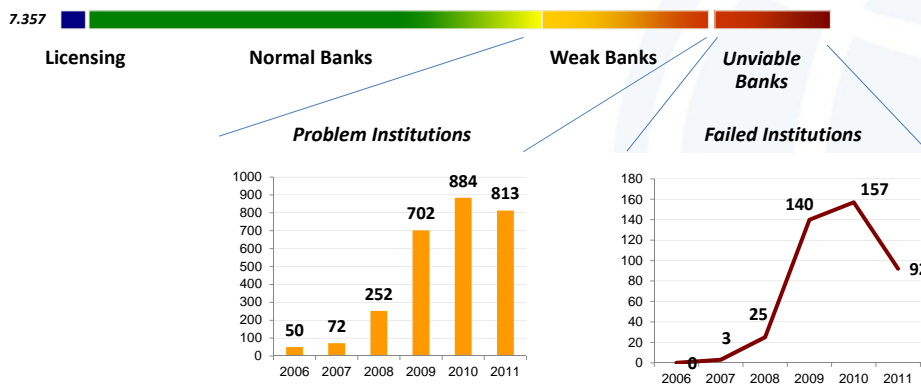
### BanCafé



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## VI. Bank Resolution in United States

### Problem Institutions and Failed Institutions



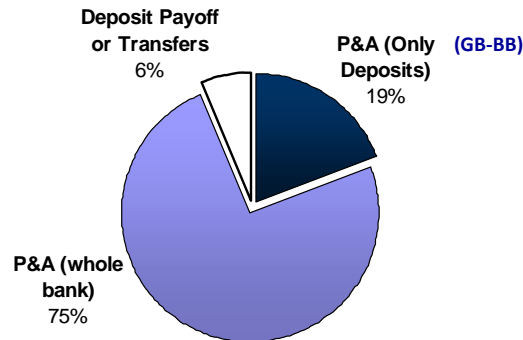
Source: FDIC (updated up to April 2012. Last data available Dec. 2011)

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VI. Bank Resolution in Unites States (cont.)

**FDIC – Bank Failure Resolution Type (2009)**

140 cases



Source: FDIC

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VI. Bank Resolution in Unites States (cont.)

**FDIC Resources**

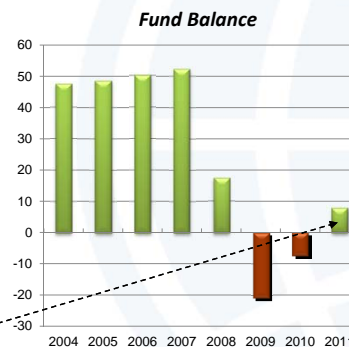
**BALANCE SHEET - 2011\***

Cash	17,3
Investments	27,5
Receivable from resolutions	29,3
Other Receivable	2,4
Property	0,4
Total Assets	77,0

Prepaid assessments	20,4
Liabilities due to resolutions	31,5
Deferred revenues	9,1
Contingent: Future failures	7,2
Other	1,0
Total Assets	69,2

<b>Fund Balance</b>	<b>7,8</b>
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(Billions \$) \* Data of September 2011 (last data available)



Source: FDIC

(updated up to April 2012. Last data available Dec. 2011 )

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## Systemic and Non-Systemic situations

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### VII. Systemic and non-systemic situations

#### What is a systemic situation?

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

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

**Key issues to consider an event as “systemic”**

Size / Interconnection / Coverage / of the unviable 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 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 special capacities once triggered by the systemic classification include:*

- No closure of failing banks
- Explicit Forbearance
- Liquidity provision from lender of last resort 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.)

**Having or not having systemic risk legislation?**

*Having a specific legislation for systemic situations has pros and cons:*

**Pros:**

- Higher readiness to deal with systemic situations
- Provide special instruments to deal with systemic situation
- Signal of strength
- Pre-defined set of exceptions to ordinary rules

**Cons:**

- Moral hazard
- Legislation may not fit the next crisis

*There is no single answer ...*

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

**Macro-prudential measures related to Bank Resolution**

- Basel Guidelines regarding macro-prudential policy recommendations include:

- 1 Living wills
- 2 Too big to fail
- 3 Subordinated debt

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

**Macro-prudential measures related to Bank Resolution****2 Too big to fail**

*Measures to address “too big to fail banks” during normal times include:*

- » Additional capital requirements
- » Restrictions on, or limitation of, activities
- » Living-wills (more comprehensive)

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

## Macro-prudential measures related to Bank Resolution

### 2 Too big to fail (cont.)

*Traditional measures to deal with the failure of “too big to fail banks”*

- Open banking assistance (liquidity or capital)
- Intervention
- Bridge Bank
- Merger (induced by authorities)

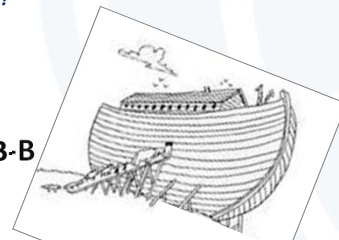
What do they have  
in common?

Shareholders  
and/or investors  
bail out  
**MORAL HAZARD**

*A different approach to resolve big banks:*

**“Good Bank - Bridge” GB-B**

**“NOAH’S ARK”**



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

## Macro-prudential measures related to Bank Resolution

### 2 Too big to fail (cont.)

*How does the GB-B work?*

Separates  
the failed  
bank into

**“Good Bank”**



Bank License

Transfers the “good bank” to “bridge “  
vehicle (ark) owned by the government

- Personnel
- Depositors
- Payment system
- Banking services

**“Bad Bank”**



Leaves the “bad bank” to its owners  
and starts the liquidation process

- Shareholders
- Investors
- Other liabilities

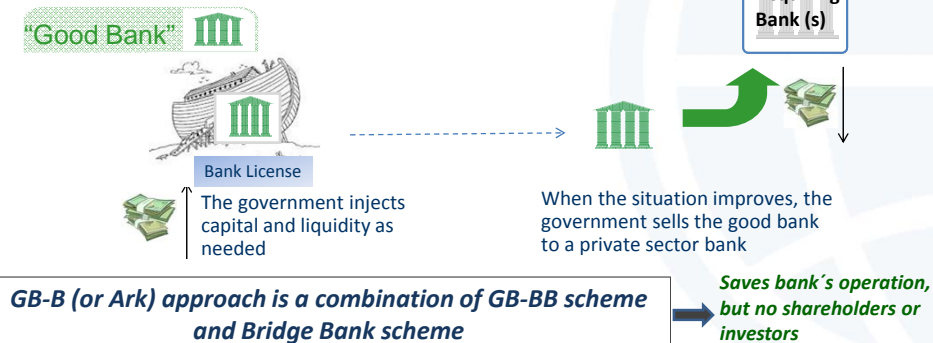
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## VII. Systemic and non-systemic situations (cont.)

### Macro-prudential measures related to Bank Resolution

#### 2 Too big to fail (cont.)

How does the GB-B works? (cont.)



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

not mutually exclusive

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## Bank Resolution

### Exercise [Part 1]

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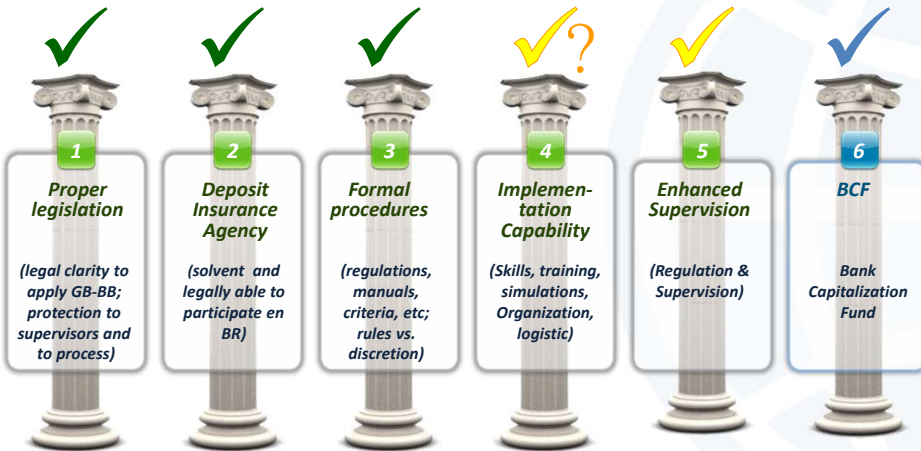
## Bank Resolution Exercise

- Presentation of the case:

*We are in a country named **Bankland***

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

## Pillars for Good Bank-Bad Bank Resolution in BankLand



EXERCISE

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

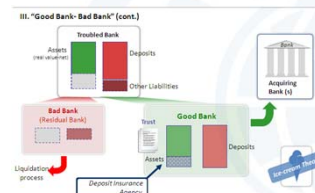


» Explicitly allows for Good Bank-Bad Bank scheme

» Explicitly protects supervisors and process

» Creditor's

- 1 Labor Claims
- 2 Deposits
- 3 Rest of deposits
- 4 Other liabilities



EXERCISE

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



» Deposit insurance : up to \$ 10,000

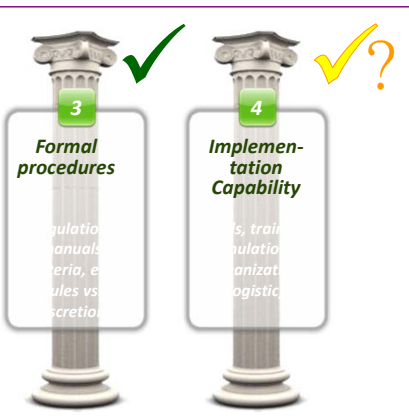
» DIA has the capability to participate in BR  
(Under the "lesser cost" criteria)

» DIA is solvent

EXERCISE

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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

EXERCISE

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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*

EXERCISE

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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

EXERCISE

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***You are the Superintendent of Banks....***

