Critical Issues in Financial Stability: Preventing and Confronting Bank Insolvency

BANK RESTRUCTURING AND RESOLUTION

Some well applied experiences

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The World Bank - IMF - US Federal Reserve Board

Contents

Introduction

In past years bibliography on Banking Supervision puts:

- A lot of emphasis on how to supervise a bank
- Some emphasis on how to open a bank
- Not so much emphasis on how to close a bank

Introduction

Fortunately, Bank Restructuring and Resolution has gained attention in the last years

Why Bank Restructuring matters ?

- A mismanaged bank closure may provoke systemic effects.
- It is at this moment when incentives are set
- How the bank is closed impacts on the total cost of resolution
- This is when judgment about supervisor is made

Schemes applied

Alternatives used in many countries to deal with bank insolvency :

A. Plain payment of Deposits

B. Merger with other banks (encouraged by authorities)

C. Government intervention

A) Plain payment of Deposit Insurance

The bank is closed and the deposit insurance is paid. The bank is later liquidated.

Disadvantages:

- **Very costly**
- **Loss of banking service and jobs**
- **Deterioration of assets due to the judicial liquidation process**

B) Acquisition by other banks (encouraged)

The bank is absorbed by another bank

Disadvantages:

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

C) Government intervention

The Central Bank (or other institution) replaces the bank´s authorities and takes over the bank

Disadvantages:

- **May cause greater monetary and fiscal impact**
- **Increase State Owned Banks share (proven to be less efficient)**
- **Moral hazard**

What can be done …???

Apply the resolution process based on

"good bank" - "bad bank" separation scheme

This was the scheme applied in Argentina and some other countries, since the mid 90's.

"Good Bank"- " Bad Bank" scheme

How it works…

1. **Separate the bank in two** → **Good bank** / **Bad bank**

2. **Transfer the "good bank" to one or more solvent banks willing to acquire it**

3. **Leave the "bad bank" to its owners.**

"Good Bank"- " Bad Bank" scheme

Good bank:

- **Liabilities:** Deposits and Labor claims
- **Assets:** the best assets; must equal the amount of liabilities

Bad bank:

- **Rest of liabilities and remaining assets**

The most efficient way of transferring assets is through a trust

"Good Bank"- " Bad Bank" scheme

What happens if the "good assets" are not enough to cover deposits (*good bank* with negative net-worth) ?

Who is the natural candidate to lose ?

•Deposits Insurance Agency (up to the cost of paying the insurance)

•Big depositors, (LR)

A practical example

Troubled Bank balance sheet

Assets 70		Liabilities 100	
Cash	10	Deposits	80
Loans	30	Labor	10
Bad Loans	20	Other	10
Fixed Assets	10		
		Net Worth	-30

GOOD BANK

Assets		Liabilities	
Cash	10	Deposits	80
Loans	30	Labor	10
Bad Loans	10		
Fixed Assets	5		
Total	55	Total	90
		Net Worth	-35
		Deposit Ins. A.	35

BAD BANK

Assets		Liabilities	
Cash	0	Deposits	0
Loans	0	Others	10
Bad Loans	10	Dep. I. A.	35
Fixed Assets	5		
Total	15	Total	45
		Net Worth	-30

"Good Bank"- " Bad Bank" scheme

Some advantages

- It provides rapid resolution
- Minimizes contagion risk
- Minimizes impact on clients and employees
- Eliminates legal contingencies for buyer (all hidden claims remain with the bad bank)
- Minimizes Costs:
  - No further deterioration of assets
  - Stops operating and financial losses

  In the case of Argentina the fiscal cost = 0

Applied Experience –Argentine case (90´s)

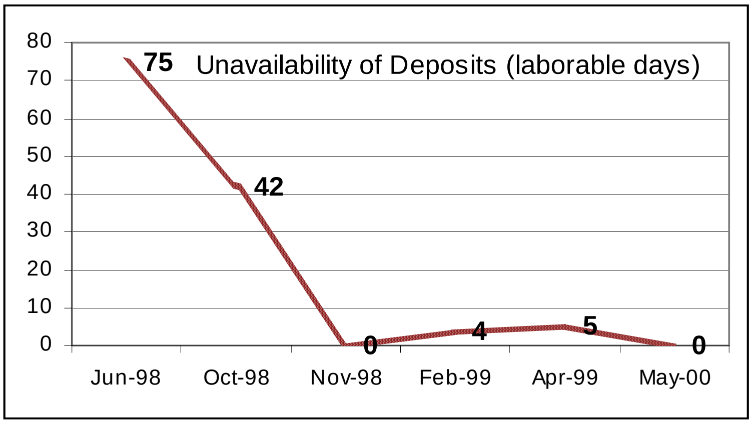
Banks resolved in Argentina (97-00)

Date	Bank	Total Deposits (millions)	Paid Deposits (millions)	% of Paid Deposits	SEDESA (millions)
31-Mar-97	Coopesur CL	101	101	100%	40
30-Abr-97	Banco Unión Comercial e Industrial SA	296	296	100%	118
08-May-97	Nuevo Banco de Azul SA	23	23	100%	9
12-Dic-97	Banco Argencoop	184	184	100%	60
18-Dic-97	Banco Crédito Provincial SA (3)	340	251	74%	87
30-Abr-98	Banco Platense SA (4)	45	24	54%	18
04-Jun-98	Banco Patricios SA	331	331	100%	121
25-Jun-98	Banco Medefin UNB SA	106	106	100%	
30-Oct-98	Banco Mayo CL	708	708	100%	350
27-Nov-98	Banco Almafuerte CL	171	171	100%	60
12-Feb-99	Banco Israelita de Córdoba	168	168	100%	60
16-Abr-99	Banco Mendoza SA	456	456	100%	100
26-May-00	Compañía Financiera Luján Williams SA	10	10	100%	3
	TOTAL	2939	2829	94%	1026

Applied Experience –Argentine case (´90s)

- **With GB-BB schemes , 97% of deposits were recovered**
- **In 17 of the 19 restructured banks, depositors recovered 100% of their deposits**
- **The last failed bank before the introduction of GB-BB scheme had only recovered 8% of total deposits**

Bank Restructuring – Learning Curve



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

Applied Experience –Argentine case (´90s)

GB-BB scheme in Argentine experience

- **Very efficient bank restructuring scheme, applied prior to a bank´s failure**
- **Implies minimum fiscal and financial system costs**
- **It does not affect other banks by contagion or cost generalization**
- **Minimizes moral hazard, especially for bankers**

Applied Experience –Argentine case (´90s)

- This scheme is only a part of a whole system involving aspects of banking regulation and supervision
- It requires a set of adequate prudential regulations, and an independent banking supervision authority, with the resources to enforce it

Applied Experience –Argentine case (´90s)

Although this resolution scheme has proved to be very efficient and there is consensus about its convenience, it is not widely applied

WHY ?

- Natural fear to apply new procedures and schemes
- Requires a prompt action
- Other alternatives appear easier and less painful

"Good Bank"- " Bad Bank" scheme

Preconditions to apply "Good Bank - Bad Bank scheme" :

- Adequate legal and regulatory framework
- Technical capabilities
- Minimum enhanced supervision
- Political will

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Challenges

Challenge faced by supervisor:

Adopt, *timely*, a resolution scheme that, providing reasonable protection to depositors, minimizes :

- **resolution cost**
- **systemic impact**

The scheme described fulfills these conditions

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Thank you !

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