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
• Bank Resolutions Schemes applied more frequently
• The proposed Bank Resolution scheme
• A practical example of how it works
• Argentine experience during ’90
• Preconditions
• Challenges faced by supervisors
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

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

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*

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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 10</td>
<td>Deposits 80</td>
</tr>
<tr>
<td>Loans 30</td>
<td>Labor 10</td>
</tr>
<tr>
<td>Bad Loans 20</td>
<td>Other 10</td>
</tr>
<tr>
<td>Fixed Assets 10</td>
<td></td>
</tr>
</tbody>
</table>

### GOOD BANK

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 10</td>
<td>Deposits 80</td>
</tr>
<tr>
<td>Loans 30</td>
<td>Labor 10</td>
</tr>
<tr>
<td>Bad Loans 10</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets 5</td>
<td></td>
</tr>
</tbody>
</table>

Net Worth: -35

Deposit Ins. A. 35

### BAD BANK

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 0</td>
<td>Deposits 0</td>
</tr>
<tr>
<td>Loans 0</td>
<td>Others 10</td>
</tr>
<tr>
<td>Bad Loans 10</td>
<td>Dep. I. A. 35</td>
</tr>
<tr>
<td>Fixed Assets 5</td>
<td></td>
</tr>
</tbody>
</table>

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)

<table>
<thead>
<tr>
<th>Date</th>
<th>Bank</th>
<th>Total Deposits (millions)</th>
<th>Paid Deposits (millions)</th>
<th>% of Paid Deposits</th>
<th>SEDESA (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-Mar-97</td>
<td>Coopesur CL</td>
<td>101</td>
<td>101</td>
<td>100%</td>
<td>40</td>
</tr>
<tr>
<td>30-Abr-97</td>
<td>Banco Unión Comercial e Industrial SA</td>
<td>296</td>
<td>296</td>
<td>100%</td>
<td>118</td>
</tr>
<tr>
<td>08-May-97</td>
<td>Nuevo Banco de Azul SA</td>
<td>23</td>
<td>23</td>
<td>100%</td>
<td>9</td>
</tr>
<tr>
<td>12-Dic-97</td>
<td>Banco Argencoop</td>
<td>184</td>
<td>184</td>
<td>100%</td>
<td>60</td>
</tr>
<tr>
<td>18-Dic-97</td>
<td>Banco Crédito Provincial SA (3)</td>
<td>340</td>
<td>251</td>
<td>74%</td>
<td>87</td>
</tr>
<tr>
<td>30-Abr-98</td>
<td>Banco Plattense SA (4)</td>
<td>45</td>
<td>24</td>
<td>54%</td>
<td>18</td>
</tr>
<tr>
<td>04-Jun-98</td>
<td>Banco Patricios SA</td>
<td>331</td>
<td>331</td>
<td>100%</td>
<td>121</td>
</tr>
<tr>
<td>25-Jun-98</td>
<td>Banco Medefin UNB SA</td>
<td>106</td>
<td>106</td>
<td>100%</td>
<td>100</td>
</tr>
<tr>
<td>30-Oct-98</td>
<td>Banco Mayo CL</td>
<td>708</td>
<td>708</td>
<td>100%</td>
<td>350</td>
</tr>
<tr>
<td>27-Nov-98</td>
<td>Banco Almafuerte CL</td>
<td>171</td>
<td>171</td>
<td>100%</td>
<td>60</td>
</tr>
<tr>
<td>12-Feb-99</td>
<td>Banco Israelita de Córdoba</td>
<td>168</td>
<td>168</td>
<td>100%</td>
<td>60</td>
</tr>
<tr>
<td>16-Abr-99</td>
<td>Banco Mendoza SA</td>
<td>456</td>
<td>456</td>
<td>100%</td>
<td>100</td>
</tr>
<tr>
<td>26-May-00</td>
<td>Compañía Financiera Luján Williams SA</td>
<td>10</td>
<td>10</td>
<td>100%</td>
<td>3</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>2639</td>
<td>2639</td>
<td>94%</td>
<td>1026</td>
</tr>
</tbody>
</table>

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”

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
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.

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

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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