Foro de Seguro de Depósitos de las Américas

Americas Deposit Insurance Forum

Session Four:

ESSENTIAL RESOLUTION TOOLKIT

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IPAB INSTITUTO PARA LA PROTECCIÓN AL AHORRO BANCARIO

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INTRODUCTION

- Defining Resolution
- Resolution Options: Closed Bank Versus Open Bank
- Introduction To Techniques For Bank Resolution
- Resolution Options: Techniques For Bank Resolution
- Role Of Deposit Insurance In Resolution

DEFINING RESOLUTION

- Resolution can be defined as a procedure that ensures the orderly closing of a bank and involves a series of measures used by the competent authorities as an alternative to bankruptcy proceedings
- It is aimed at preventing the failure of a given bank from evolving into a systemic banking crisis while minimizing the cost to taxpayers for supporting banks
- A systemic crisis can be defined as one in which even healthy banks begin to see depositors withdraw funds or lending between such institutions falters

DEFINING RESOLUTION (2)

- Maintaining the payment system is a key factor in the design of a bank resolution strategy and must be considered carefully when determining a resolution strategy for a particular bank
- The availability of alternative sources of payment services to the public (for example, direct deposit accounts or the deposit of the “float” for a mobile money operator) may have to be considered as part of both resolution planning and the implementation of an institution-specific resolution
- Intervention in an institution facing financial difficulties is most effective if it can be accomplished at a point at which there is still franchise value that can be utilized to lessen the cost

RESOLUTION OPTIONS: CLOSED BANK VERSUS OPEN BANK RESOLUTION

- Should resolution be done on an open bank basis or only after a bank is closed?

  - ✓ Closed bank resolution may provide greater certainty and protection against legal challenges
  - ✓ Resolution based on “lack of viability” without closure may allow for greater preservation of value for bank franchise
  - ✓ Open bank resolutions require the competent authority to have the power to impose losses on shareholders

RESOLUTION OPTIONS: INTRODUCTION TO TECHNIQUES FOR BANK RESOLUTION

- There are a number of techniques for resolving banks but each must be supported by the appropriate legal framework
- Some of the techniques discussed here may require amendments to the framework currently in place in your countries

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION

- Straight Liquidation
- Nationalization
- Purchase and Assumption (P&A) Transactions
- Variations On The P&A

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (2)

- Straight Liquidation:

✓ Comparable to the insolvency proceeding applied to companies
✓ The bank is closed, ceases to operate, and is placed into liquidation
✓ The Resolution Authority or its designate manages the liquidation process
✓ The manager of the liquidation process will sell or recover on the assets of the insolvent bank and creditors will receive periodic distributions in accordance with an established priority scheme

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (3)

Pros:

- ✓ Shareholders lose their investment unless the losses are so small that other creditors receive full recovery
- ✓ However, with deposit insurance in place small depositors receive all of their insured/protected funds
- ✓ The priority scheme in place determines whether uninsured depositors will receive any or most of their funds
- ✓ Liquidations can be relatively easy to manage for a small institution

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (4)

Cons:

- ✓ The disadvantage of a straight liquidation is that the liquidation of assets can take many years which delays the return of funds to creditors and creates significant expenses and loss of value for the liquidator
- ✓ Systemic parts of the institution cannot be preserved
- ✓ In a straight liquidation borrowers lose their relationship with a bank
- ✓ The fiscal outlays will also be greater under a straight liquidation because at the time of the liquidation the deposit insurer must pay out the full amount of covered deposits

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (5)

- **Nationalization** is an alternative to liquidation that allows a bank to remain open but with the replacement of the owners with the government

✓ The law must allow the government to wipe out the shareholders' interest; if not, there will have to be a negotiation with the shareholders to reduce their interest to zero which may be time-consuming

✓ The government must then recapitalize the bank to bring it into conformity with prudential requirements for capital and liquidity

✓ The recapitalization can be accomplished with infusions of cash, government paper or government guaranteed paper

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (6)

Pros:

- ✓ Nationalization of a bank protects all the creditors of the individual bank which can be a benefit in a time of stress on the banking system
- ✓ The bank continues to operate without disruption to sources of credit and the payment system
- ✓ The nationalization of one bank can be an alternative to the announcement of a blanket guarantee for all creditors of the entire banking system

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (7)

Cons:

- ✓ Nationalization can produce market distortions which may erode the competitiveness of private banks in the financial sector
- ✓ It can be difficult to exit from the ownership of the bank which can cause fiscal and operational strains on the government
- ✓ The existence of a government owned bank may encourage political interference in the bank's operations
- ✓ It can be expensive to operate a nationalized bank and difficult to find a private sector solution for the bank once it is in the government's control for more than a relatively short period of time

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (8)

- ✓ **Purchase and Assumption (P&A)Transactions** are an alternative to straight liquidations or nationalizations. These transactions require the existence of another bank (or investor interested in acquiring a bank license) willing to acquire all or part of the business of an insolvent bank
- ✓ The transfer of assets and liabilities should be able to be accomplished without the consent of shareholders or creditors under the governing legal framework
- ✓ The goal of a P&A is to have the insolvent bank cease to exist but avoid the disruption of a liquidation

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (9)

- ✓ The basic structure of a P&A is to have the acquiring bank purchase the good assets (often just cash and securities) of the failed bank and assume its deposit liabilities

- ✓ After a P&A the liquidator will dispose of the remaining assets for the benefit of all creditors of the failed bank in accordance with the governing priority scheme

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (10)

Pros:

- ✓ If there are potential acquirers a P&A transaction allows the resolution authority to capture the franchise or "good" value of the failed bank for the benefit of creditors
- ✓ Bank customers retain a banking relationship without interruption

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (11)

Variations On The P&A:

- ✓ The simplest P&A involves the transfer of cash and near-cash of the failed bank to an acquirer along with the insured deposit liabilities
- ✓ There must be a "true-up" process whereby any shortfall between the assumed assets (cash and near-cash) and deposit liabilities are matched by a payment from the government (or the deposit insurer)

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (12)

Variations On The P&A (2):

- ✓ A simple P&A can also be augmented by a process whereby the acquiring institution has the right of first refusal in the purchase of other assets from the failed institution
- ✓ Such a right can be exercised after a period of due diligence which allows the transaction to proceed without a lengthy period of review of loan files or other records related to other assets such as real estate

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (13)

Variations On The P&A (3):

- ✓ A “partial” P&A requires the acquirer to purchase the good assets of the failed bank (including performing loans) along with the deposits
- ✓ Depending on the legal framework in place the acquirer may be able to assume all the deposits or only the insured deposits
- ✓ If there is a “least cost test” in place for such transactions that may affect whether all deposits can be assumed

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (14)

Variations On The P&A (4):

- ✓ A "whole bank" P&A requires the acquirer to purchase all the assets of the failed bank (good and bad). This may require the resolution authority to provide certain loss protection to the acquirer on the bad assets
- ✓ This type of transaction would have to be valid under the legal framework in place

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (15)

Variations On The P&A (5):

- ✓ A "bridge bank" is a P&A to a newly-licensed bank owned by the resolution authority
- ✓ The bridge institution is authorized under the resolution framework as a temporary successor to a failing bank
- ✓ The bridge institution assumes the good assets and deposit liabilities (either all or just insured) of the insolvent bank

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (16)

Variations On The P&A (6):

- ✓ The bridge bank is a temporary solution that is usually limited to the resolution of a systemic bank
- ✓ Good practice dictates that a bridge transaction be utilized rarely and only as a short term measure to a pre-planned permanent solution for the troubled bank
- ✓ The legal framework in place would have to authorize the use of the bridge bank tool and specify its ownership structure and which prudential requirements would apply to it

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (17)

Variations On The P&A (7):

- ✓ The bridge bank differs from nationalization in that there is a process for leaving the problem assets and claims of owners in a "rump" institution
- ✓ The "cleansing" of the bank's balance sheet that takes place is designed to enhance the franchise value of the troubled bank and make it more attractive to the identified purchaser

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (18)

Temporary Administration/Conservatorship

- ✓ The use of a temporary administrator or conservator can be a useful tool in some (limited) circumstances
- ✓ This tool allows the operations of a bank to continue without suspending the activities of the bank
- ✓ However it requires the supervisory authority to be involved in the day-to-day operations of the bank without the power to completely eliminate the shareholders

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (19)

Temporary Administration/Conservatorship (2)

- ✓ The use of a temporary administrator may be appropriate when faced with management problems that manifest themselves with little notice (for example, the death of a key person or the discovery of a fraud)
- ✓ The use of this tool can however unnecessarily delay (and add to the cost of) the ultimate resolution of a bank
- ✓ It can also send a signal to the public that the bank is in trouble

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (20)

Role Of Deposit Insurance In Resolution (Financing)

- ✓ Loss absorber in the restructured balance-sheet on behalf of covered deposits
- ✓ Cost for the deposit insurer = payout amount for covered deposits – potential recoveries in the potential liquidation
- ✓ Contributes on a net basis to the resolution with funds (assets)
- ✓ Contribution based on a valuation procedure strictly defined in legislation

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (21)

Role Of Deposit Insurance In Resolution (Safeguards)

- ✓ No creditor worse off principle
- ✓ Some additional safeguards should be applied in order not to exhaust the deposit insurer’s funds in a resolution case and have no funds for a future potential pay-out (a cap on the maximum contribution to the resolution)
- ✓ Covered depositors continue to have access to their insured deposits in resolution in order for the deposit insurer’s funds to be used

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (22)

Role Of Deposit Insurance In Resolution (Safeguards 2)

- ✓ Deposit insurer provides opinion on the “least cost test” in resolution
- ✓ Deposit insurer authorizes the use of its own funds in resolution
- ✓ Deposit insurance funds are not used for recapitalization in resolution unless:

1. Shareholders’ interests are reduced to zero
2. Unsecured creditors have absorbed losses based on *pari passu* principle in accordance with the hierarchy of claims in liquidation

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (23)

Role Of Deposit Insurance In Resolution (Resolution Planning)

- ✓ The deposit insurer should cooperate with the Resolution Authority in the resolution planning process
- ✓ The deposit insurer has an interest in seeing a viable financial institution result from the resolution as that is crucial to the avoidance of the possibility that the deposit insurer will pay insured depositors twice if the new institution fails
- ✓ The exchange of information and the convergence of opinion between the deposit insurer and the Resolution Authority on the least cost resolution minimizes the possibility for such a double payment

RESOLUTION OPTIONS: TECHNIQUES FOR BANK RESOLUTION (24)

The critical element in undertaking resolution actions other than liquidation is:

Good Data and information about the failed bank

Thank you! Gracias!

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