Problem Bank Resolution Methodology

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Bank Has Inadequate Capital

0 < capital < CAR

• Take supervisory action to increase capital
  – Require owners to put in more capital
  – Require owners to sell bank or give up share of bank to new investors

↓

• Facilitate a merger with well capitalized bank with no use of public funds
Insolvent Bank Resolution

Guiding Principles

• Shareholders take the first loss.
• Subordinated creditors take the next loss.
• General creditors, including depositors take the last loss.
  – If deposit insurance exists, deposit insurer bears the loss instead of insured depositors.
• Secured creditors get paid first up to collateral.
Insolvent Bank Resolution

Choice of Resolution Strategy Should

• Enhance public confidence
• Avoid disruption to payment system
• Minimize losses to depositors, government, or deposit insurance fund
• Minimize adverse macroeconomic effects
Insolvent Bank Resolution

Key Elements

• Speed of funds availability for depositors
• Minimize loss of available banking services
• Need to rapidly address credits
• Transparency
Praying for redemption is not a legitimate bank resolution technique.
Resolution Techniques

Straight Liquidation

• Bank is closed and placed in liquidation.

• As assets are sold, creditors receive distributions from recoveries on assets.
Straight Liquidation

With deposit insurance

- Insured depositors are paid out their funds shortly after the closing.
- D I Fund takes the place of insured depositors as general creditor in liquidation.
Straight Liquidation/deposit insurance payout

**Pros**
- Shareholders lose all unless other creditors receive full recovery.
- Increases market discipline since depositors suffer losses.
- [small depositors protected, rest suffer losses]

**Cons**
- Delays in paying depositors undermines public confidence.
- Liquidation of assets can stretch out for many years (often more than 10 years.)
- Borrowers lose lending relationship with potential macroeconomic impact.
- [Payout maximizes fiscal outlay at time of closing.]
Resolution Techniques

Nationalize Bank

- Bank is declared insolvent and shareholders are wiped out.
- State recapitalizes bank by putting in sufficient cash/gov’t paper to fill hole and bring bank up to CAR.
- Government has 100% ownership and management control of bank.
Nationalize Bank

Pros

• Speedy resolution.
• Protects all creditors of bank.
• Maintains lending relationships.
• No potential disruption to payment system.
• Potentially minimizes fiscal outlay (size of hole plus additional capital).

Cons

• Erodes market discipline.
• Perpetuates inefficient bank.
• Competitive advantage over other banks due to perceived Gov’t. guarantee.
• Gov’t. ownership invites political interference in bank.
Resolution Techniques

Purchase and Assumption Agreement (P&A)

• Acquiring bank purchases the good assets of the failed bank and assumes the depositor liabilities.
• Deposit insurer or government puts in cash/paper for the difference. They seek to recover funds from recoveries on “bad” assets.
• Acquirer chosen based on highest premium.
# Sample P & A Transaction

## Failed Bank

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; Sec</td>
<td>10</td>
</tr>
<tr>
<td>Perf. Loans</td>
<td>50</td>
</tr>
<tr>
<td>NPLs</td>
<td>50</td>
</tr>
<tr>
<td>-Provisions</td>
<td>20</td>
</tr>
<tr>
<td>Total Assets</td>
<td>90</td>
</tr>
</tbody>
</table>

- Total Liabilities: 100
- Total Equity: -10

## Acquirer

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; Sec</td>
<td>10</td>
</tr>
<tr>
<td>Perf. Loans</td>
<td>50</td>
</tr>
<tr>
<td>Cash &amp; Sec fr Govt</td>
<td>38</td>
</tr>
<tr>
<td>Cash &amp; Sec fr Buyer</td>
<td>2</td>
</tr>
<tr>
<td>Cash &amp; Sec for Cap</td>
<td>5</td>
</tr>
<tr>
<td>Total Assets</td>
<td>105</td>
</tr>
</tbody>
</table>

- Total Liab: 100
- Total Equity: 5

## Liquidation

<table>
<thead>
<tr>
<th>Assets</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPLs</td>
<td>50</td>
</tr>
<tr>
<td>-Provisions</td>
<td>20</td>
</tr>
<tr>
<td>Total Assets</td>
<td>30</td>
</tr>
</tbody>
</table>

- Liab to Govt: 38

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Sample P & A Transaction
P&A Transaction

- **Advantages**
  - Can be executed quickly
  - Retains banking services
  - Captures premium for franchise value, if any
  - Avoids disruption to depositors, current borrowers, and payment system
  - Shareholders wiped out and inefficient bank leaves system

- **Disadvantages**
  - Large depositors protected, eroding market discipline.
  - If bank is in bad shape, may require significant contribution from government/deposit insurer to fill gap between deposits and assets purchased.
Variations on P&A

Insured Deposit Transfer

• Similar to P&A except only insured deposits are assumed by the acquiring bank.

• This limits the cost to deposit insurer and should result in least cost resolution since premium is received for franchise.
Variations on P&A

De Novo Bank P&A

• New bank is created and it assumes liabilities and acquires assets.
• New bank can be privately owned or the government can create the bank.

Advantage:
  – Avoid losing a bank (protect jobs and banking services to community)
Variations on P&A

**Whole Bank Transaction**

- Same as P&A, except all assets are purchased.
- Good assets are purchased at book value or market (if one exists) and bad assets are priced on a bid basis (what is offered).
- Selection of winning bid based on price offered for assets.
- Government or deposit insurer fills in the difference.
Whole Bank Transaction

Pros
• There is no need for a protracted liquidation of the assets by the gov’t. or deposit insurer.
• Borrowers have chance to maintain banking relationship.
• Minimizes fiscal outlay for closing.

Cons
• If acquiring bank does not have the management expertise to handle the “bad assets” it’s condition may deteriorate, creating a new problem bank.
• Requires sufficient lead time for due diligence.
• Requires cooperation of failing bank’s mgt.
• May yield large haircut.
Resolution Techniques

Good Bank – Bad Bank

- Two banks created from the failed bank. One with the good assets and the other with the bad ones.
- This can be used with a nationalized bank or when a bank is purchased.
- It allows the bad assets to be separated from the bank while funding them with deposits or government paper.
Techniques in Bank Resolution

Conservatorship

• In some countries, a conservator is appointed to determine if the bank is insolvent and whether it can be rehabilitated.

• Conservator takes over the management and voting rights of shareholders but not their economic rights.
### Conservatorship

<table>
<thead>
<tr>
<th><strong>Pros</strong></th>
<th><strong>Cons</strong></th>
</tr>
</thead>
</table>
| - Form of intervention to deal with management problems.  
  - Useful when $0 < \text{capital} < \text{CAR}$.  
  - Can be used to take control of bank while arranging resolution. | - Can unnecessarily delay bank resolution.  
  - Increases public’s uncertainty and can trigger runs.  
  - Shareholders may still attempt to interfere. |
State Banks

- State banks should be supervised as are all other banks.
- Resolution will require the government to recapitalize the bank (unless it is willing to sell it).
- Unless problem loan and operational issues are dealt with the bank will continue to be a problem.
- Governance issues must be addressed!!!
Asset Management Companies

Their Role in Resolving Problem Banks
AMCs

Proper management and disposition of nonperforming assets is a critical element of bank resolution.

• Implications for cost of bank resolution.
• Depending on size of NPLs, can have systemic implications.
• Vehicle to promote corporate restructuring.
Types of AMCs

- Bank AMCs
- Private third party AMCs
- Centralized government owned AMCs
- Deposit insurers
- “Bad Bank” in good bank – bad bank resolution
Centralized AMCs have been set up for a number of reasons:

• The resolution of insolvent and nonviable financial institutions.
• The restructuring of distressed but viable institutions.
• The privatization of government owned or intervened banks.
Operational Goals for AMCs

• Rapid disposition of assets acquired by the government.
  – Rapid sale of assets to private sector
  – Rapid disposition to avoid further deterioration in value.

• Focus on restructuring NPLs and recovery efforts.
Its all about public confidence

• Firm supervision, consistently applied.
• Supportive legal structure.
• Transparency in dealing with problem banks.