BANK RESTRUCTURING & RESOLUTION

COMPARATIVE EXPERIENCES

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Preventing and Confronting Banking Crisis

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INTRODUCTION

1. This Seminar covers a series of critical issues for Financial Systems and focuses on Preventing and Confronting Bank Insolvency. This happens in the context of a joint effort by the W.B., the IMF and the FED, to create a consensus on these issues, in order to inspire governments on effective mechanisms to prevent, deal with and solve insolvency problems in a way that strengthens their systems, rather than weakening them.

2. It is true that the decade of the `90s was one of o tremendous progress in Banking Regulation around the world, spurred by the multilateral institutions. Also, the Scandinavian, Latin American and Asian crises lead to significant and more realistic progress in the area of Bank Resolution. But it is also true that the current international economic crisis is leading to a strong pressure by borrowers and banks for governments to step back on both areas and adopt lax policies. The result is that quite a number of governments are now applying forbearance on Regulation or its application. They are treating insolvency with just liquidity support. Both policyties are adopted in order to postpone the formal urge for realistic solutions. They forget that the postponement derived from forbearance practices and survival through liquidity make problems deeper, incentive "moral hazard" and make ultimate solutions much more costly. That is why the current international effort to create a body of doctrine on bank insolvency is particularly praiseworthy and timely

3. In this context, I feel my contribution to this Seminar should not be a scientific region-by-region comparison, but a comparison between resolution systems that work successfully and those that lead to weaker banks or weaker financial sectors. With strong emphasis on the latter. This comparison will be based on the author's hands-on international experience on this topic in over 30 countries, as seen from a practitioner viewpoint.

4. Many Governments boast: "Yes, we had our banking crisis, but we enacted proper legislation, developed special mechanisms and solved problems very nicely". But this is far from being the case. Actually, if we take a glance at the banking systems where restructuring and resolution was applied in the last, say, 15 years, I can hardly think of more than 10 countries that proved successful and had no recidives in their systems. In fact, in a majority of countries, a number of supposedly "resolved" banks continue to have negative capital, negative results, poor governance and poor internal controls. Some still have owners and managers who are far from being fit and proper and make good governance an illusion. Of course, there are also countries where a number of insolvent banks have never been addressed. As a result, in both situations, lack of transparency is a common feature. And talking about market discipline and market solutions in a context of no transparency sounds somewhat out of place. Worse, this scenario happens with the "de facto" complicity of the supervisors. Therefore, identifying and emphasizing the main features that make solutions to insolvency unsuccessful seems rather relevant.

NO ACTION AND CAUSES OF NO ACTION

5. The worst solution to bank insolvency is no action at all. In fact, the error of closing or restructuring banks, based on a pessimistic diagnosis is most rare, if it is ever made. On the contrary, the error of leaving insolvent banks in operation occurs very frequently. The major reasons for no action may be one or several of those described below, from point 6 to point 12:

6. <u>Poor diagnosis.</u>

Insolvency is seldom identified as such by Supervisors. Also, insolvency is often mistaken for a slight undercapitalization or capital erosion. This situation, in its turn, may be due to:

- Regulatory forbearance, particularly in the areas of capital and provisioning

- Poor banking regulations, particularity in the areas of capital requirements and in the areas of risk asset valuation, provisioning and income recognition.

- Poor examination practices, including long time gaps between consecutive examinations of each bank.

- Poor examination teams, with little experience or little ability to convincingly present their findings to the insolvent bankers, who are always unwilling to recognize their situation.

7. Lack of political will, derived from a variety of reasons, as follows:

- Poor diagnosis, for the reasons described above

- Political or social reasons. Bank resolution makes governments and regulators unpopular and thus subject to political or social ram. An interesting example: hardly any energetic action is taken by governments or regulators when their tenure is close to an end. Pressure from lobbies is not unrelated to this deterring element.

- Fear of legal implications that may be prompted by those whose interests would be hurt in a potential resolution process. These implications may include civil or criminal suits against the supervisors and/or blackmailing practices.

- A certain concept of fiscal and monetary discipline, short term, when governments do not bear in mind that the name of the game is real capital and that both kinds of discipline will have to suffer, sooner or later, if an effective solution is to be put in place. And that the later the more costly.

- The wish to buy time in the hope that "the economy will recover and will solve up problems in the financial system". This assumption often proves wrong, because, when insolvency is deep, the expected recovery is comparatively slow, insufficient

or late. And because poor management, which often continues to be in place, is as important a cause of growing insolvency as the economy.

8. No legal security.

The authorities need legal security by way of clear laws that provide solid ground for them to undertake the different measures that are required in crises resolution, particularly in systemic crises resolution. Lacking of such legal security, the authorities may hesitate to take any action at all or may feel encouraged to avoid this obstacle by turning problems around, through "ersatz" solutions. Among other things, the legal framework should allow for safe sources of funding, for severance of owners and managers, for acquisition and sale of the bank shares and assets, for their pricing and disposal, for effective bankruptcy procedures, etc.... Judicial procedures also need to be reliable and expeditious.

9. Lack of proper institutional arrangements.

When having to address a restructuring operation, the right institutions may not be in place and there may be strong hesitations about whether to act and about who should do what. These limitations may be due to conceptual question marks or to gaps in the regulatory framework. Generally, there are different institutions concerned with the soundness of financial systems: the Treasury, the Central Bank and the Superintendency of Banks. In addition, one or several specialized institutions are often established to deal specifically with failure resolution. Additional to legal lack of clear allocation of functions, lack of effective and expeditious coordination between the above players is very frequent and constitutes an obstacle to good decision making and to promptly address restructuring operations. Frequently, there are turf fights or, on the contrary, everyone wants to pass the buck.

10. A misperception of moral hazard.

When talking about financial systems, regulators should do their best to avoid moral hazard or limit it to a minimum. And moral hazard may derive from a variety of government policies. Agreed. But, overemphasizing the risk of moral hazard in the financial system proves wrong. Qualifying this topic may clarify when moral hazard is a real danger and when it is not. An example: some governments do not have deposit insurance or restructuring mechanisms inbuilt in their legislation for fear of bankers moral hazard. But, where is banker's moral hazard if proper mechanisms ensure their leaving the insolvent bank when expeditiously closed or restructured? In actual fact, the worst moral hazard leading bankers to risky of fraudulent practices is keeping insolvent banks alive. Be it due to poor Supervision or to the absence or delayed application of Resolution mechanisms. As for depositors, resolution mechanisms may in fact involve a certain element of moral hazard, but this is a lesser evil, if compared with the harm that is caused by no action. Including vulnerability to systemic crisis. Anyhow, depositors' moral hazard can be corrected by later strengthening bank Supervision. An additional rationale, decisions on banking crisis have often to be made overnight. Then, "stemming the bleeding" becomes a first and foremost objective. Under those circumstances, avoiding moral hazard 100% should to be a second priority.

SUCCESSFUL VRS. UNSUCCESSFUL BANKING RESOLUTION

General

11. There is a series of principles which are now shared, as such, by academia, multilateral institutions, experienced supervisors and practitioners. Almost two decades of banking crises have made everybody learn numerous lessons and depart from the classical "motto" that prevailed until the mid `80s among a number of economists: "if you have to face the problem of insolvent banks, mergers are just the solution". No more or less than that. Things have improved and there is consensus on some key topics, as follows:

    - Strong Supervisory and Resolution mechanisms should be in place "ex ante" or be put in place when crises happen.
    - A safe legal framework is indispensable for timely and effective action.
    - Closure is the best option, unless alternative resolution mechanisms directly or indirectly, prove less costly and better avoid contagion.
    - The cost of resolution should be minimized and shared by different players.
    - An explicit and limited deposit insurance mechanism contributes to financial stability if banks are to be closed.
    - Mergers are a solution to explore, provided merging banks are well capitalized.

12. In spite of the above, there are still a series of principles, policies and practices, where consensus is only reached by having the parties adhere to common denominators that often prove "light" or far from ensuring effective resolutions. On the other hand, experience allows to better identify components of resolution formulas that are likely to lead to reasonable success or to inescapable failure. Experience also allows identifying some modalities of sound formulas that can turn resolutions into failures. And, for sure, experience allows differentiating a "quick fix" from a real and lasting solution. This experience can be a good contribution by practitioners to the debate and consensus building

Areas where some standard resolution formulas do not work

13. Explicit and limited deposit insurance.

This mechanisms is now preached as a basic element for financial stability. Be it as an instrument to just guarantee modest depositors when banks are closed or as a twofold instrument for bank restructuring. All right. It should be financed by banks by way of annual contributions or premia, the doctrine goes. But, if single banks suffer from deep insolvency or if insolvency is widespread, deposit insurance mechanisms, can not only be financed by banks. It would prove ineffective and even counterproductive. Why? Because bank assessments

should not be raised to reach too high levels, if governments wish to avoid the risk of suffocation. This source of financing will prove highly insufficient to pay protected deposits in case of closure or to recapitalise banks in case of restructuring. Therefore, governments will have to supplement the funding of resolutions. Otherwise the following may occur:

- The regulator will feel inhibited to address problems
- If insolvency is addressed through closure of a number of banks, particularly medium sized or big ones, the protected limit is likely to be exceeded and covered with government funds, anyway.
- If, on the contrary, insolvency resolution is addressed by way of recapitalization, the banks ordinary funding will not allow for real reconstruction of capital and results. The most likely implications would be leaving a still insolvent bank operate on the market or selling the still insolvent bank to a third bank, with the heritage of its black hole, which may cause a serious harm to the latter and to the system.

14. Massive liquidity support.

In case of systemic crisis, massive liquidity support, beyond the normal terms of last resort lending may prove a must. This support is provided by governments on their own and/or with funds provided basically by multilateral institutions. The liquidity is generally provided across the board, both to sound and unsound banks, as an emergency measure, which makes discrimination difficult. To many, this kind of support is just the solution to the problem. But, as a whole, it is not. This type of liquidity may prove a solution for sound banks, which suffer temporally from illiquidity because of macro economic problems. But when systemic crises happen in a country, a high number of banks were insolvent beforehand. That is one of the reasons why those systems, in general, were so vulnerable to systemic problems. Those banks' insolvency should have been addressed before by their government, but was not. For them, liquidity is a way to keep surviving. But loans will have to be reimbursed to the lender and interest on them will have to be served. Capital, not loans, is the answer to insolvency, a concept that means loss of capital, precisely. If treated with loans, insolvency continues to be there and to grow deeper and deeper. For those banks, massive liquidity support may prove a precondition for a final solution: stemming their bedding or that of the system. The real solution will come when their insolvency is addressed through resolution formulas, mainly closure or restructuring. Ideally, that approach should have been taken beforehand, as a part of ordinary supervisory systems. Or, at least identified and treated when the crisis blows out. Their systems would have been more resistant to crises and a lot of liquidity support would have been saved. When early resolution was not the case, their later closure or restructuring, after dealing with illiquidity, becomes an additional must.

15. Restructuring.

If a bank is deeply insolvent, the shareholders do not recapitalized it and the government decides not to close it, it should be thoroughly restructured, through three basic measures:

recapitalization by other players, change of management and new ownership. If one of them is not applied, the other two measures are likely to prove useless.

16. Recapitalization.

This is normally done through capital injection and/or carving out of bad assets. Ant it should be full, so as to cover the stock of losses and generate positive flows. Do we all agree? Probably not. Actually experience shows that some of the recapitalization practices that form part of the conventional wisdom are doomed to failure. Let us elaborate briefly on the following resolution systems:

- Real but little capital.

Recapitalization may prove insufficient for several reasons:

a) the size of capital or clean up injections does not suffice to make up for the past stock of losses and to bring results from the red into the black;

b) the volume of assets cleaned up is adequate, but they are bought by the government at less than face value, thus leaving the stock of losses, or part of it, within the bank;

c) the capital injected or the funding of the purchase of assets is done through government securities with a low interest rate, that does not allow for a spread that proves sufficient to generate positive flows. Both situations are very frequent.

If one or more of the above recapitalization procedures are applied, the bank will remain insolvent or strongly undercapitalized.

- Mergers of banks.

Mergers by the sake of mergers are certainly doomed to failure. In actual practice, mergers where the insolvent bank is not fully recapitalized and/or the merging partner does not have a strong capital base are no solution. They compound the problem. Another reason for failure: when one of the merging bank does not have a strong management team, with the necessary skills and depth to take over the other partner successfully, the problems existing in the insolvent bank prior to the merger will compound and will certainly have a contagious effect on the merged institution. Let alone the fact that mergers, even between well capitalized and well run banks, undergo a risky process of mutual adjustment and fight for power that affects the merged bank in the initial years. An exception to this rule may be mergers where one of the banks

is large and solvent and the other is insolvent but very small. In this case, the losses of the small bank may be diluted in the larger bank.

- Assets revaluation to build up new reserves.

In inflation times, banks are sometimes authorized to revalue their assets at market value and create the equivalent income and reserves, without any tax impact. This fiscal measure allows banks to increase their equity, accountingwise, but it avoids the formal need for real capital increases, commensurate with the growth of the balance sheet in inflationary terms. The problem is that, if a bank is deeply insolvent, this measure does not improve the bank's flows. Only real capital or replacement of bad assets with good performing assets do.

- Termless and growing liquidity support under any modality.

This is treating a solvency problem as if it were a liquidity problem. In cases of deep insolvency, only huge and disproportionate amounts of liquidity, if lent at a very low cost, would allow the insolvent bank to obtain enough yield to writeoff the past stock of losses and generate new profits. Since this proves impossible in practical terms, the lasting liquidity support will keep the bank afloat but the new liquidity will probably be used to cover financial and operational costs and the stock of losses will continue to accumulate. In the end, if the bank is closed, the liquidity support will have been lost by the lender. If the bank is to be restructured, new amounts of money will have to be injected in terms of capital. Additionally, the process of lasting liquidity support, often conveys "moral hazard", since the bad managers that are being supported are given a perverse incentive to continue the practices that lead to insolvency in the past and even incur fraudulent ones.

- Medium term lending by the Government.

In this respect, some governments purchase medium- term securities issued by the insolvent bank, as a way out of insolvency. The same comments as above can be applied here, since such purchase is also a loan, in substance. Recapitalizing insolvent banks with loans can only succeed if the net margin obtained by the new funds, during the term of the loans, can cover the stock of losses and later generate positive flows. This is hardly possible if, as is always the case, the size of this type of lending or its cost does not allow for a sufficient margin, if the term of the loans is shorter than necessary and/or if the bank has to allocate a part of the loans obtained to meet its liquidity needs, including the payment of operational costs.

- Callable capital

This financial device can be used as a guarantee by governments to increase the capital of an insolvent bank if necessary. Some governments decide to restructure one or several insolvent banks, but, because of lack of budget funds or political will, they do not do it fully or at all. They are however aware that the capital of those banks has been lost and they are technically bankrupt. Legal bankruptcy would be mandatory once the problems are unveiled. But, in order to avoid it, some governements, while wishfully waiting for new funds from whatever source to fully recapitalize the banks, issue a formal guarantee to eventually subscribe a real capital increase, if need be. They tend to content themselves with this measure and consider that the bank has actually been restructured financially. The truth is that the bank may have become legally solvent, but this type of guarantee has not improved its income or its flows at all. They remain negative, thus continuing to erode the bank's capital further.

- Debt rescheduling.

Debt rescheduling postpones maturity and foreclosure. The liquidity situation of the borrower is thus improved, but it does not improve its solvency situation by itself. This will only happen if the creditor bank and/or other creditors, such as suppliers, the Government, etc, write off a part of their claims and/or the borrower undergoes a serious process of restructuring. If restructuring is not applied to the borrower, the bank will not improve its liquidity situation or its solvency problems. It may even see itself forced to extend new loan facilities. In spite of this, some governments allow for reversal of provisions, on the wrong assumption that the borrower's solvency has automatically been improved by debt rescheduling. Worse, some governments make it mandatory for banks to reschedule their loans to all borrowers across the board, with a long grace period. Here again, if this bail out of the borrowers is not accompanied by any restructuring, it does not improve insolvency of the creditor banks.

- Zero coupon securities.

Banks are sometimes recapitalized through capital increases or purchase of assets that are subscribed by governments with zero coupon bonds or other securities. These securities, upon maturity, accumulate interest payment so as to cover the book value of the assets bought. This formula allows for a postponement of the monetary out flows on the part of the government, but, the bank's cash-flows remain negative in real terms during the maturity period. Also, zero coupon securities could only improve the solvency situation of a bank at maturity, if and when the value

of the bonds on maturity covers the previously existing losses, plus those that have accumulated during the maturity period. Under the assumption that the bank has not become illiquid in the meantime.

- Debt - equity swaps.

Those who advocate for this arrangement as a modality of financial restructuring argue that the bank improves its solvency situation since it exchanges a bad loan for ownership rights. They also claim that the bank can thus participate in the restructuring of the borrower, as a co-owner, thus improving the quality of its asset. These arguments do not necessarily prove true. Actually, if the borrower is in trouble, the bank's assets related to that borrower, be them loans or shares, have the same quality and should be provisioned for to the same extent. As to the banks' role in the borrowers restructuring, international experience says that most of the times, bankers do not necessarily prove to be good entrepreneurs or good managers of industrial or service concerns. Also, when a banker has a participation in the capital of a borrower company, it will find itself under strong pressure to increase the volume of loans to that borrower, even if the situation of the latter remains difficult or worse than before.

17. Management change.

If the government recapitalizes a bank, even fully, but leaves in place the same management that caused the bank's insolvency, problems are very likely to repeat themselves: the bad borrowers are likely to get further loans, the recovery policy will remain ineffective, operational costs will remain uncut and internal controls will be as unreliable as before. Even worse: there will be "moral hard", i.e. a perverse incentive for poor management, since the poorer it is, the bigger the losses and therefore the bigger the volume of recapitalization funds it can expect to be provided by the government. Fraud may also be fostered.

18. Institutional strengthening may prove useless if it is applied to insolvent banks without undertaking recapitalization action. The best managers in the world would be overcome by insolvency, which keeps growing when not treated financially. And the best systems or computer technology will prove useless to reconstruct the bank's solvency.

19. New ownership.

In dealing with insolvency, the primary objective should be to allow governments to be able to forget about the insolvent banks for ever. And, to that effect, attract a strong institutional investor to buy the formerly insolvent bank or its assets. Any mechanism to be applied by governments should first be tested against this key objective, in order for them to make sure that they are not in conflict with it, but, on the contrary, facilitate its

achievement. This issue, which is key to the success of failure of bank restructuring, comes at the end of this paper, as a strong concluding requisite. This objective also justifies flexibility on the application of certain principles, from a broader and longer term perspective. In fact, principles in this experimental business should not be considered as carved in stone, but subject to practical considerations to ensure successful resolutions. This may particularly apply to principles such as:

- Minimizing costs.

Some governments or theoreticians believe that bank restructuring can be performed at no cost or even with a profit. But this approach is not realistic at all, since deep insolvency usually conveys the loss of the equity, several times. If so, "someone" has ultimately to take the loss that goes beyond the capital write-off. So, if the "minimum cost" approach is applied with no qualifications, the insolvent bank will remain a problem, no sound institution will ever buy it and the ultimate cost will obviously be higher. "Optimazing costs", rather than minimizing them, would sound like a more sensible policy.

- Strict loss sharing.

This is easier said than done. As a matter of principle, having depositors and creditors share the loss with the owners and the rest of the banking system is a sound approach. But confidence in the future of the bank or the system is very likely to suffer if significant write-off of deposits is made compulsory. The experience of the "corralito" in Argentina speaks by itself. The potential interest of sound acquirers of formerly insolvent banks will also suffer.

- No Government funding for bank resolution.

Again, a sound principle in theory. But, as explained above, it is not a realistic policy, if banks are to be deeply restructured and soundly sold. The financing of such operations by just the banking systems will never suffice to bring a deeply insolvent banks to health and make it attractive to potential sound buyers. Government financing is inevitable.

- Above all, no Central Bank Funds.

We all agree on this, as a principle. But a number of the few success stories in the history of bank resolution included Central Bank financing. Addressing flagrant cases of bank insolvency require prompt action and government funds to prevent further deterioration and higher costs. And, if budgetary funds can not be appropriated expeditiously and in a flexible or gradual manner, Central Bank financing may prove most effective, no matter how heterodox. At least, as bridge financing, until the Treasury is in a position to reimburse the Central Bank ex -post. Otherwise, the damage to the banks will keep growing and full recapitalization will

become more and more difficult, thus impairing the possibility to ultimately find sound acquires.

- Avoid moral hazard.

Obviously. But let us repeat that poor Supervision and delayed Resolution are the worst causes of bankers' moral hazard. On the contrary, timely closure and sound restructuring expel the bad bankers from the system. If they know that there is a real threat, their behavior will be more rather than less disciplined. As for depositors' moral hazard, that is a lesser evil that can be corrected at a later stage. In any case, if it did exist, it is due to lack of transparency in the system. Whose fault is it? The bankers', of course. But also the Supervisors'. And again, if a magnified concept of moral leads to poor, delayed or no restructuring of insolvent banks, how can sound owners, i.e. a final solution, be found?

20. As to the choice of acquirers, it is strongly recommended for governments to make it very selective choice. Be it acquirers of previously insolvent banks or their assets. Candidates should be strongly capitalized, will managed and stable. Which we insist, can only be achieved when the previously insolvent bank has been restructured by way of full recapitalization, i.e. to the real reconstruction of capital and results. Otherwise, only unsound, small or insolvent institutional candidates will show up. They would not care as much about the solvency of the bank to buy, because they will end up getting their investment's yield or their money back through dividends based on cosmetic accounting or through self-lending. Also, their objective may be doing a favor to the authorities, for them to feel inhibited to take any corrective action against them.

Here are some rules of thumb to have sound ownership and management on board:

- Chose institutions, rather than a diversified initial ownership. The latter may not ensure strong management. Worse, it sometimes maintains the previous one.

- Chose financial institutions, particularly banks, and avoid industrial groups that are likely to use -and abuse- the banks to serve their own interests. Also avoid speculation oriented financial institutions. Their main interest may not be to own a strong bank, but to make short term profits out of it at any cost, including reselling the bank.

- Choose institutional buyers that are bigger than the bank to be sold. Smaller banks may not have sufficient management depth or capabilities to run a bigger creature and may suffer from indigestion.

21. Some remarks on Privatization as an ownership change.

A special case of ownership change is privatization. If the bank to be privatized was insolvent, the same concepts mentioned in this paper, as to recapitalization, change of management and new ownership, would apply. There is at least an aspect to be stressed

again, since it is never overemphasized. Governments, with the assistance of investment bankers, some times sell their banks to the public at large, with no strategic partner and without a strong and steady management put in place in advance. Such approach may have even been induced by the previous management, which proved to be less than perfect, in order to remain at the helm. Another risk: any surprise can emerge, in terms of the bank's control by undesirable groups of shareholders and, as a result, undesirable managers.

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