Banking Sector Governance: General Principles and Best Practices

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Governmental Responsibilities for the Banking System as Related to Bank Insolvency

Generally Accepted

Controlling price levels
Managing systemic risk
Smoothing the business cycle
Enforcing fiduciary duties of managers
Provision of liquidity to solvent institutions facing temporary cash shortfall
Monitoring and analyzing economic activity
Resolving failed institutions

Generally accepted with qualifications

Protecting savings of depositors
Influencing credit allocation in periods of financial distress

Less widely accepted

Owning and/or managing commercial banks after (or before) insolvency
Lending to the government to fund bailouts
Preventing failure of individual institutions where systematic risk is absent

Agencies with Potential Responsibility for Bank Insolvency

Type of Agency

Central bank
Finance ministry/treasury department
Specialized financial regulator
Specialized deposit insurer
Public Prosecutor

Level of Government

National
State/provincial
Local
Self-regulatory organization (clearing house)

Best Practices for Managing Bank Insolvency: General Regulatory Considerations

Best Practice: *Bank regulators should avoid pro-cyclical responses to problems in the banking sector.*

Best Practice: *Bank regulators should, to the extent consistent with the preservation of the safety and soundness of banks, allow banks to undertake reasonable business risks*.

Best Practice: *Bank regulators should insist that commercial banks maintain appropriate levels of capital, as defined by transparent internationally recognized standards.*

Best Practice: *Bank regulators should, to the extent feasible, require banks to implement internal risk-management controls and protocols, subject to review and approval by the regulators.*

Best Practice: *Bank regulators should impose and enforce limits on insider lending and other self-dealing activities where the terms of the transactions are more favorable to the insider than would be obtainable in an arm's-length market transaction.*

Best Practice: *Bank regulators should seek to avoid excessive concentration of ownership of banking assets.*

Best Practice: *Bank regulators should seek to avoid excessive dispersion of ownership through geographical or other regulations.*

Best Practice: *Bank regulators should, where appropriate, utilize the private sector to obtain information about bank solvency and to discipline bank managers*.

Best Practice: *Deposit insurance programs should be administered in such a way as to minimize moral hazard, consistent with the objectives of preventing instability in the banking sector and safeguarding small deposits.*

Best Practice: *The relevant banking agencies should engage in advance planning to develop cooperative emergency responses to severe financial system instability.*

Best Practice: *In order to cope with cross-border contagion risk, the relevant banking agencies should develop bilateral or multilateral relationships with banking regulators in nations with linked economies as well as with international banking agencies and institutions.*

Best Practices for Managing Bank Insolvency: Issues Related to Management of Individual Failures

Best Practice: *Bank regulators should intervene promptly to resolve problems prior to or at the point of economic insolvency.*

Best Practice: *Bank regulators should seek to maintain continuity of banking services when resolving a failed institution.*

Best Practice: *Bank regulators should, consistently with the need for prompt resolution, seek to achieve an orderly and efficient auction for the failed institution's assets.*

Best Practice: *Claims of small depositors should be given priority as a matter of law over other unsecured debt of a failed bank.*

Best Practice: *In other respects, bank regulators should maintain contractual priority of claims during the resolution process.*

Best Practice: *Bank regulators should not rescue failed banks when the insolvency does not threaten systematic stability.*

Best Practice: *Bank regulators should generally remove incumbent managers after a bank has failed, unless the failure is due to exogenous factors and the incumbent managers are deemed to be competent.*

Best Practice: *Where failure of an institution threatens financial system stability, the decision to rescue the institution should be made after high-level consultation among responsible government agencies.*

Best Practice: *The government should acquire ownership in failed institutions or their assets only when the ordinary processes for orderly private disposition of assets are found to be ineffective*.

Best Practice: *To the extent feasible, state-owned banks should be subject to the same general safety and soundness requirements as private institutions.*

Best Practice: *The finances of state-owned banks should be accounted for in a transparent fashion, and their true condition should be fairly and realistically disclosed absent persuasive reasons for maintaining confidentiality.*

Best Practice: *If found to be insolvent, state-owned banks should be placed in reorganization as promptly as possible consistent with the need to maintain the stability of the financial system.*

Best Practices for Managing Bank Insolvency: Issues Related to Central Banks

Best practice: *The central bank should seek to maintain reasonably stable prices in order (among other things) to reduce the threat of bank insolvency.*

Best practice: *In order to achieve stable prices, the CB should have a reasonably high level of independence from political influence.*

Best practice: *A reasonably high level of independence of the CB should be explicitly protected by law.*

Best Practice: *The CB should maintain a professional staff of the highest quality, including research and legal departments with direct access to the Board.*

Best Practice: *The allocation of responsibility for managing bank insolvency as between the CB and other agencies is a matter to be determined with reference to the facts, circumstances, and history of a given political jurisdiction.*

Best Practice: *Relevant (but not exclusive) considerations in allocating regulatory responsibility for bank insolvency include the following:*

- *(a) History of regulation.*
- *(b) Fragility of the banking system.*
- *(c) Nature of deposit insurance program (if any).*
- *(d) Structure of the banking industry.*
- *(e) Presence and market share of government-owned banks.*
- *(f) Integration of commercial banking with other financial activities (e.g., securities, insurance, fund management, and investment advice).*
- *(g) Strength and independence of the judiciary.*
- *(h) Relative reputations, expertise, and capacities of the CB as compared with other existing or potential regulators.*
- *(i) Degree of legal independence of the CB.*
- *(j) Political realities.*

Managing Bank Insolvency: Some Regulatory Alternatives

Narrow Banks. Commercial banks would be required to hold 100% reserves against deposits.

Government Demand Debt. For countries with fragile banking systems, the government would issue book-entry, variable rate debt instruments payable on demand either to the investor or a third party, with accounts maintained by the commercial banking sector. Banks would be precluded from issuing very short-term debt, but could issue term debt and could earn fees for managing the government accounts.

Assessable Stock. After failure, holders of a bank's stock would be assessed to pay creditor claims up to some multiple of their holdings.

Clearinghouses as self-regulatory organizations. After failure, private sector institutions would organize a resolution of the insolvency either independently or under government supervision.