BANK RESTRUCTURING STRATEGIES

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June 30, 2021

AGENDA

I. TERMINOLOGY

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VII. KEY TAKEAWAYS

I. TERMINOLOGY

Weak but viable bank → Non-viable bank → Insolvent bank

Early Intervention → Resolution → Resolution followed by liquidation

BANK RESTRUCTURING

I. TERMINOLOGY

- **Non viability** is generally the trigger for resolution and is a financial state in which a bank is significantly below its required capital ratio, cannot restore itself to financial soundness and is no longer able to perform its critical financial services in a manner consistent with the protection of its customers and the stability of the financial system. Resolution should be triggered before balance sheet insolvency.

- **Early intervention measures**: are designed to prompt banks to address their weaknesses in a timely way. These regimes are normally authorized under regular supervisory powers which allow for a significant amount of discretion and scope for supervisory judgement. More formal "Prompt Corrective Action" regimes also exist.

- **Bank resolution:** refers to the restructuring of a non-viable bank in an orderly manner without severe systemic disruption or exposing tax payers to the risk of loss. This is achieved by protecting the functions of the bank that are critical to the financial market or the real economy and by ensuring that losses are borne by shareholders and creditors of the failing bank, as they would be in insolvency.

- **Bank liquidation:** refers to the orderly winding-up through liquidation and payment of creditor claims, generally following the pay-out of insured depositors by the deposit protection scheme. Liquidation of a bank may occur as part of the resolution or may apply only to the residual assets and liabilities after resolution has been completed.

- **Bank restructuring** generally refers to specific actions by the supervisor to remedy weak banks that might not yet be breaching prudential requirements but have marginal capital and profitability and whose viability might come under threat unless they are restructured – e.g. through a merger with larger banks.

II. EARLY INTERVENTION

"Early": Escalating supervisory response usually starts before prudential indicators are breached.

Main differences in existing regimes relate to:

- Formality
- The triggers (forward looking vs backward looking)
- The range of powers
- The degree of discretion when the regime gets activated
- Transparency

Examples: US: PCA regime, EU: EIM regime, PCA in the Philippines,…

Source: Basel Core Principles for Effective Banking Supervision (2012), Basel Committee on Banking Supervision
Guidelines for identifying and dealing with weak banks (2015), Basel Committee on Banking Supervision
Frameworks for early supervisory intervention (2018), Basel Committee on Banking Supervision

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II. EARLY INTERVENTION

Early intervention powers with impact on governance *

- Enhance governance, internal controls and risk management
- Replace individual managers and board members
- Submit a plan to restore compliance with supervisory requirements
- Implement recovery plans
- Restrict compensation to directors and senior executive officers or limit it to a percentage of net revenues including consideration of possible claw-backs
- Require prior supervisory approval for major capital expenditure, material commitment or contingent liability
- Change legal structure

Source: Basel Committee Guidelines for identifying and dealing with weak banks, July 2015

II. EARLY INTERVENTION

Early intervention powers with impact on operations and expansion

- Enhance/change capital and/or liquidity and strategic planning
- Impose specific liquidity requirements (such as restrictions on mismatches)
- Require additional/more frequent reporting requirements
- Impose additional disclosures
- Restrict or limit any (or all) activities
- Downsize operations and/or asset classes including closure of domestic/foreign branches
- Require immediate/enhanced provisioning for assets of doubtful quality.

II. EARLY INTERVENTION

Early intervention powers with impact on shareholders' rights & cash availability

Shareholders' rights

- Suspend particular or all shareholders' rights
- Prohibit or restrict the distribution of dividends
- Appoint an administrator or conservator
- Impose mergers and acquisitions

Cash availability

- Hold capital and/or liquidity in excess of the minimum requirements
- Require new borrowings/ bond issuance and/or rollover of liabilities/secure line of credit to address liquidity and maturity transformation issues)

III. BANK RESOLUTION

Key attributes for effective resolution regimes (Financial Stability Board, 2014)

Objectives of bank resolution:

- In resolving a bank, the main objectives will usually be to:
- Maintain continuity of critical functions of the failing bank, such as deposit-taking, lending under committed facilities, payment and settlement, and risk hedging – especially if the bank is systemically important
- Maintain stability of the financial system
- Minimize disruption to, and adverse effects on, the wider economy
- Minimize government funding and risk absorption, and associated moral hazard
- Protect insured depositors

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III. BANK RESOLUTION

Key elements of a bank resolution regime

- Well-defined resolution objectives, and where appropriate, the priorities with these objectives
- Clear and comprehensive legal powers
- Well-defined triggers for resolution and the exercise of particular powers
- A resolution authority with clear responsibility, capacity, operational independence and accountability for resolution
- Recovery plans to enable banks to restore themselves to financial soundness
- A menu of resolution options for dealing with each kind of situation and guidance on when and how to use each option

III. BANK RESOLUTION

Key elements of bank resolution

- Appropriate pre-positioning in banks for different resolution options – through resolution plans for individual banks
- A dedicated source of funding for resolution
- Legal safeguards against abuse of resolution powers and to ensure that no party is left worse off than they would have been under conventional winding up
- Court powers limited to ex-post compensation
- Robust arrangements for domestic and cross border cooperation

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III. BANK RESOLUTION

Resolution tools

The tool used will depend on the scope and scale of the financial crisis and the systemic importance of the failing bank(s):

For systemic banks and banks with critical functions:

Transfer assets & liabilities of the failing bank to:

- Another bank
- A bridge bank

Bail in creditors

Last resort: temporary public ownership

For other banks: generally, but not always, liquidation and deposit insurance

MAIN TYPES OF BANK RESOLUTION

Resolution option	Type of situation in which it might be used
Closure and transfer of insured deposits and viable assets to another bank	Individual small bank where other banks are willing and able (prudentially and operationally) to absorb the insured deposits and viable assets
Closure and payout of insured deposits	Individual small bank where no other banks are willing or able to assume the insured deposits. Payout occurs via a paying agent, the deposit insurer or the failed bank
Merger of a failing bank into a larger, healthy bank, via sale of equity of the failed bank to the acquiring bank	Small to medium-sized bank, where an acquiring bank has the prudential capacity to acquire it, and market concentration issues do not arise. Generally only used if the failing bank has positive equity, unless supplemental funding is provided
Transfer of critical functions and services to a healthy bank	Medium-sized bank, where an acquiring bank has the prudential and operational capacity to absorb the business and market concentration issues do not present problems
Transfer of critical functions and services to a bridge bank	Medium to large bank, where market concentration issues prevent merger into another bank, and the failing bank is operationally unsound
Recapitalization via bail-in	Medium to large bank, where there is a substantial tranche of debt amenable to contractual or statutory bail-in, contagion risk is low, and the bank is operationally sound if recapitalized
Recapitalization via combination of bail-in and bail-out using resolution funds or government funding	Systemic bank, where there is a substantial tranche of debt amenable to contractual or statutory bail-in, and contagion risk is low, but where bail-in is not sufficient to fully restore capital to the target level, and the bank is operationally sound once recapitalized
Recapitalization via resolution funds or government funding	Systemic bank, where there is no capacity for bail-in or where bail-in would lead to severe contagion risk, and the bank is operationally sound once recapitalized

III. BANK RESOLUTION

Deposit insurance payout mechanisms

- Payout of the deposit up to the deposit insurance cap (calculated on a Single Customer View), where payout is generally made within 30 days of the closure of the bank. Payout is normally made either via a pre-identified agency bank or by the deposit insurer directly, using funds accumulated in the deposit insurance fund.

- Transfer of insured deposit accounts to a recipient bank via a purchase and assumption transaction, whereby the acquirer bank is pre-identified by the deposit insurer through a tender process.

- Sale of the bank (minus non-critical functions) to another bank, using the funds of the deposit insurer, leaving the rest of the failed bank to be wound up.

- Enabling insured depositors to access their funds via the failed bank for a temporary period under the control of the deposit insurer - e.g. the bank's normal deposit access channels.

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IV. BANK RESTRUCTURING

Good practices for bank restructuring

- Supervisors can take actions pre-emptively to reduce the number of banks so as to avoid the risk of:
  - Multiple failures in the future
  - A moribund banking system, or segments of the banking system, with fragile margins and low level capital
- Clear policy objectives including trade-offs between efficiency, competition, contestability and stability are needed
- Well-considered set of criteria and triggers to determine the nature of the supervisory actions to achieve the objectives
- Criteria generally include capital ratios, sustainable profitability, liquidity and capacity to manage risks
- It is better to take a preemptive approach before the point of non-viability than to wait for banks to become non-viable and impose resolution.

IV. BANK RESTRUCTURING

Bank restructuring options

If the bank(s) comply with the licensing conditions:

- the supervisor can use moral suasion to encourage mergers (bank consolidation) or exit through individual discussions or public messaging
- the supervisor can require banks to identify a suitable merger partner in their recovery plans
- the supervisor can strengthen prudential standards beyond the capacity of these smaller banks, thus “forcing” them to exit, merge or broaden business models
- the supervisor can suspend or limit new licenses and raise the hurdle for licensing

If individual banks become weaker, binding early intervention measures can be imposed.

If the bank(s) become non-viable:

- Merge the viable assets and liabilities of the failing bank(s) with larger viable banks that are willing and able to absorb them (most common)
- Sell the equity in the failing bank(s) to larger viable banks that are willing and able to acquire them
- Close the failing bank(s) and transfer insured deposits and viable assets to another bank willing and able to absorb the business funded by deposit insurance as required, then liquidate the failing bank(s)
- Close the failing bank(s) and pay out insured deposits via deposit insurance, then liquidate the failing bank(s)

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V. BANK LIQUIDATION

Liquidation: Even the failure of small non-systemic banks can lead to financial stability concerns. Corporate insolvency regimes are not well suited for the specific characteristics of banks because:

- Banks are subject to deposit runs
- Even non systemic banks have a role in the real economy
- Depositors are not ordinary creditors

V. BANK LIQUIDATION

Bank specific insolvency procedures

Some countries have adopted bank-specific insolvency procedures

These include:

- The involvement of administrative authorities to reflect the complexity of banks' business models and the potential public interest concerns
- The limited role of creditors and the need for speedy procedures
- Earlier triggers for the initiation of insolvency proceedings
- The need for depositor protection and to maintain confidence in the banking system.

VI. NPL RESOLUTION AND AMC

NPL and AMC

- AMCs are common, can be public or private
- Asset purchasing AMC and resolution AMC
- Public if public funds at risk and systemic crisis
- Predictability of cash flows is very important
- Can be funded by issuing (state guaranteed) securities

Source: Public Asset Management Companies: A toolkit (2016), The World Bank

VI. NPL RESOLUTION AND AMC

Good practices for AMCs

Preconditions:

- Strong consensus and political with respect to the approach and a willingness to recognize losses
- Comprehensive and coordinated reform program to strengthen financial sector regulation and supervision, risk management, and legal and regulatory reforms to remove impediments to restructuring
- Solid diagnostic and critical mass of impaired assets
- Robust legal framework for bank resolution, debt recovery and creditors' rights

Legal and institutional framework

- Clearly focused and narrow mandate with necessary powers to accomplish tasks
- Use of special powers should be limited both in time and scope, and subject to oversight to limit abuse
- Strong governance, with frequent reporting including annual financial statements

Operational issues

- Move rapidly towards asset disposition
- Develop strategic plan as well as detailed business plans, with frequent reviews and corrective action plans when necessary
- Ensure strong internal controls to avoid misuse of funds

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VII. KEY TAKEAWAYS

Measures to manage contagion risk arising from bank failures:

- A well-structured resolution framework that enables resolutions to be initiated quickly and completed in an orderly and efficient manner in a short period of time
- A robust deposit insurance framework that the public understands and trusts
- The ability of the central bank to provide Emergency Liquidity Assistance to viable banks so that they and the financial system remains liquid through the bank resolution process
- The processes needed to restore weak banks to good financial health in a timely and credible manner through recovery and mergers.

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