THE FINANCING OF PROBLEM BANKS

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WORLD BANK

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THE SOURCES FOR PROBLEM BANKS FINANCING

1) **Bank's internal resources**

2) **Central Bank's resources**

3) **Resolution funds**

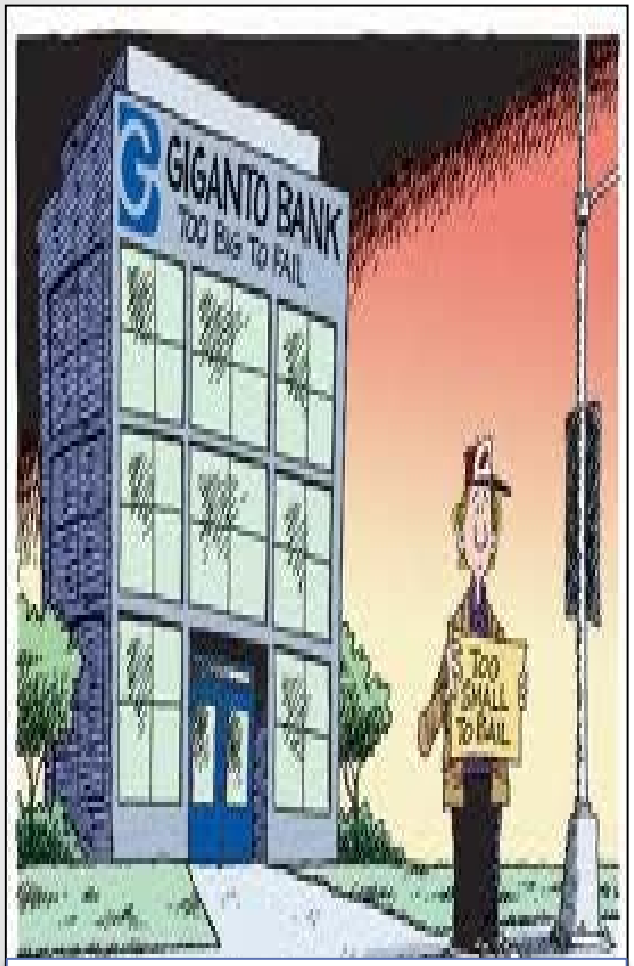
4) **Deposit Guarantee Schemes**

5) **Public funds**

BANK'S INTERNAL RESOURCES: BAIL-IN TOOL

- **Bail-in** is the **most effective resolution tool**.
- It provides **new value to the institution** in crisis by **eliminating** (or **reducing**) **shareholders' and creditors' rights**.
- The **write-down** of capital instruments and liabilities and/or their **conversion into equity** can be seen as the **provision of new value in terms of less debts to repay** (Bodellini 2018).
- It has been described as a **'third way'** between the provision of liquidity by central banks to illiquid banks and the winding down of insolvent institutions (Ringe 2016).
- Its main **objective** is to **maintain the fundamental operations** of a failing bank working (Armour 2015), **without using taxpayers' money** (Bates and Gleeson 2011).

THE CRITICALITIES OF BAIL-IN



- The most critical aspect of bail-in is that **it does not provide fresh money**.
- If the bank in crisis is not only insolvent but also illiquid (which is often the case), with bail-in **the insolvency problem can be solved**—provided that there are enough bail-inable liabilities in relation to the losses—**but the liquidity problem cannot**.
- In the event of liquidity shortage, therefore, some forms of external financing and/or public intervention seem to be necessary.
- Additionally, an **excessive use of bail-in can produce financial instability and systemic risk**.
- This can happen when a significant amount of bail-inable liabilities is held by other banks and financial institutions. **By writing them down, the insolvency problems of the failing bank are likely to be transmitted** to the creditor banks and financial firms thereby **creating the domino effect** (Bodellini 2018).
- In these cases, **resolution authorities have** been given **the power to exempt some liabilities from the application of bail-in** (Bodellini 2017).

CENTRAL BANK'S RESOURCES: LENDER OF LAST RESORT

- **'Lending of last resort' (LOLR),** also known as 'Emergency Liquidity Assistance' **(ELA)**, is the **supply of liquidity by central banks to individual banks.**

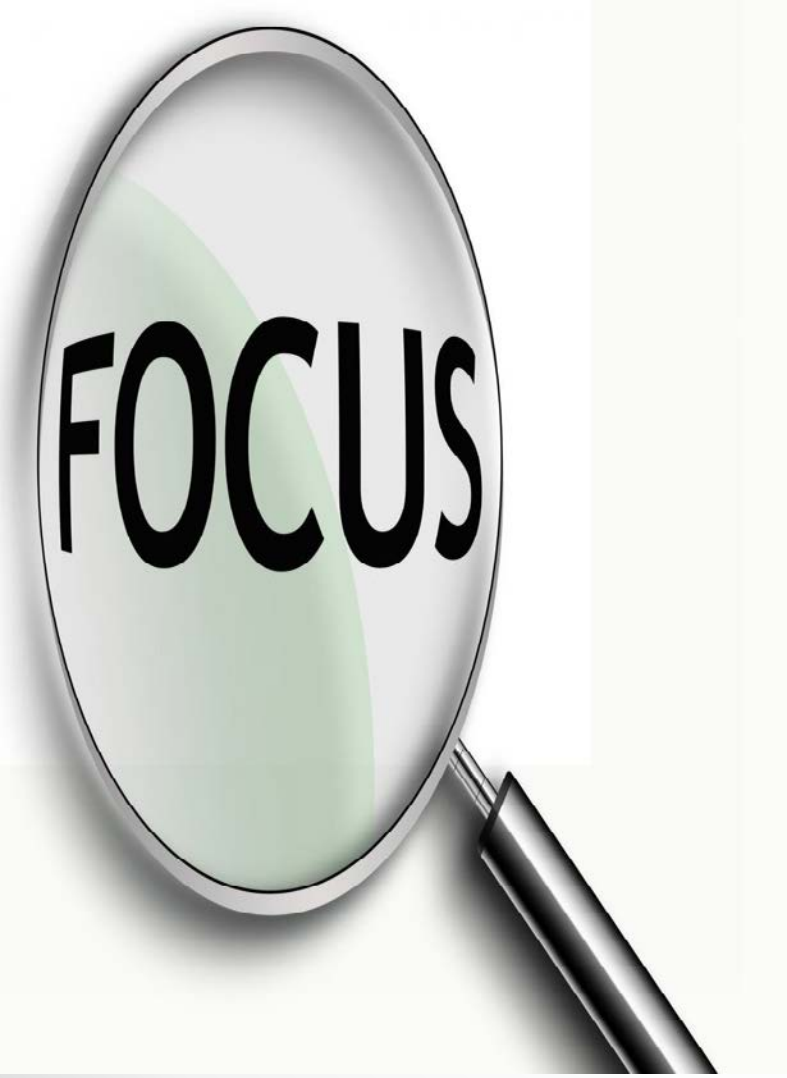
- It is **one of the most important tools** in fighting liquidity shortage and emergency situations and was **extensively used in Europe** during the global financial crisis, mainly **in order to keep financial stability.**

- It constitutes a lending function of central banks in cases where institutions cannot get funds any more on the markets. **Therefore it is the first line of defence in a crisis**.

- **Liquidity assistance is granted to specific, individual and solvent institutions**.

- In addition, lending can only take place against **good collateral** and at a relatively **high penalty interest rate**.

THE IMPORTANCE OF ELA



- Even if, in theory, illiquidity and insolvency are different concepts, **in practice, often, a bank that is illiquid sooner or later might end up being even insolvent**.

- This can happen due to the fact that **a bank that needs to meet significant deposit withdrawals might decide to fire-sell its assets**, thereby suffering proportional losses. Such losses can in turn cause it to become insolvent.

- That is the reason why **ELA is so important to prevent banks from fire-selling their assets** and central banks play a relevant role in keeping solvent but illiquid banks alive.

ELA REQUIREMENTS IN A NUTSHELL: ‘BAGEHOT LOLR MODEL’

- **Solvent** (even though illiquid) **banks**.
- **Liquidity provided on a case by case basis** only to specific institutions.
- Assistance provided on a **temporary basis**.
- **Adequate collateral** offered by the (illiquid) bank.
- **Interest rates** (typically) **higher** than those of monetary policy operations.
- **Discretion of the central bank** in the decision.

THE CRITICALITIES OF CENTRAL BANK ELA

- Typically **ELA** is **reserved** for **solvent institutions**.
- **Potential restrictions in** providing ELA in the context of **resolution**.
- **Difficulties** in distinguishing between **illiquidity and insolvency** – thin dividing line.
- Some EU banks were benefiting from ELA just until when they were declared failing or likely to fail, *e.g.* **Banco Popular** and **ABLV Bank** (Lastra – Russo – Bodellini 2019).
- Within the Banking Union some have argued in favour of **centralising ELA at Euro Area level**, thereby empowering the ECB (Lastra 2015).

RESOLUTION FUNDS

- **Resolution funds** are '**filled**' **through mandatory contributions from banks**.
- They should **not** be **used** directly **to absorb the losses** of the institution under resolution **or to recapitalize** it.
- They may be **used** only to the extent necessary to ensure the effective application of the resolution tools, **for the following purposes**: (a) to **guarantee** the **assets** or the **liabilities**; (b) to **make loans**; (c) to **purchase assets**; (d) to **make contributions to a bridge institution** and an **asset management vehicle**; (e) to **pay compensation to shareholders or creditors**; (f) to **make a contribution to the institution under resolution in lieu of the write down or conversion of liabilities of certain creditors**, when the bail-in tool is applied and the resolution authority decides **to exclude certain creditors from the scope of bail-in**; (g) to **lend to other financing arrangements on a voluntary basis**; (h) to take **any combination** of the actions referred to in points (a) to (g).

THE SHORTCOMINGS OF RESOLUTION FUNDS

- The **use of resolution fund**'s resources is **subject to** some relevant **limitations** in the EU.
- They **can make a contribution to the institution under resolution if**: a) a **contribution to loss absorption and recapitalisation** equal to an amount **not less than 8% of the total liabilities** of the institution has been made; and b) their **contribution does not exceed 5% of the total liabilities** of the institution.
- These **limitations are coherent** with the general principles governing the new framework, according to which shareholders and creditors have to be the first and the second to bear losses. They should also **reduce moral hazard** due to the knowledge that external resources can be available only after the mandatory involvement of shareholders and creditors and up to a certain amount (Bodellini 2018).
- **However**, **in extremely serious situations it could be difficult to effectively resolve a bank by complying with such limitations**, particularly by providing such a limited amount of external resources. This can be the case when the losses are huge or when a significant amount of liabilities are exempted by the resolution authorities from the application of bail-in (Bodellini 2018).

DEPOSIT GUARANTEE SCHEMES

- In view of the costs of the failure of a credit institution to the economy as a whole and its **adverse impact on financial stability** and the confidence of depositors, it is **important to have mechanisms for reimbursing depositors in the event of bank crisis**, such as deposit guarantee schemes (**DGSs)**.

- **Each credit institution should be part of a DGS**, thereby ensuring a high level of depositor protection and a level playing field between credit institutions.

- **The key task of a DGS is to protect depositors against the consequences of the insolvency of a credit institution**. DGSs should primarily be used to repay depositors, the **'paybox' function**.

- In the EU the **coverage level is EUR 100.000 per depositor per bank**.

- **DGSs are funded by banks**, that are obliged to become members of a DGS.

THE INTERVENTION OF DGSs IN BANK CRISES

- **DGSs'** resources should be used **primarily to repay depositors** in the event of a bank crisis. After the payment, **DGSs should subrogate in the liquidation** proceeding and participate in the distribution of assets recovery.

- In the context of **liquidation DGSs** are allowed to use their **resources to let depositors continue to access their deposits**, for example by **financing the transfer** of assets and liabilities of the insolvent bank to another bank. However, this type of intervention must comply with the **'least cost principle'**, *i.e.* the costs borne in so doing by the DGS **cannot exceed the amount that it would have had to pay to compensate the covered depositors** of the insolvent bank.

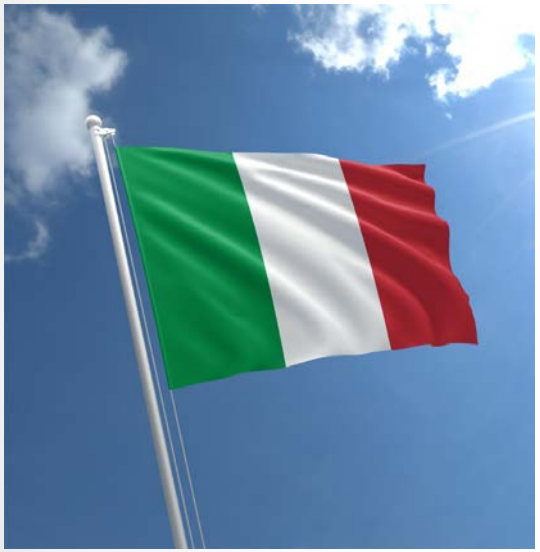
- In the context of **resolution**, **DGSs** are liable for the **amount by which covered deposits would have been affected in the event of liquidation under insolvency proceeding**. This has to be linked now with the **'depositor preference'**, and as consequence depositors will be affected only when losses are huge. Therefore there is not much space to manoeuvre.

ALTERNATIVE MEASURES TO PREVENT A BANK FAILURE

- DGSs can also use their resources for **alternative measures aimed at preventing the failure** of a banking institution, *e.g.* by financing the transfer of assets and liabilities of a bank in crisis to another bank, thereby taking on the inherent imbalance.

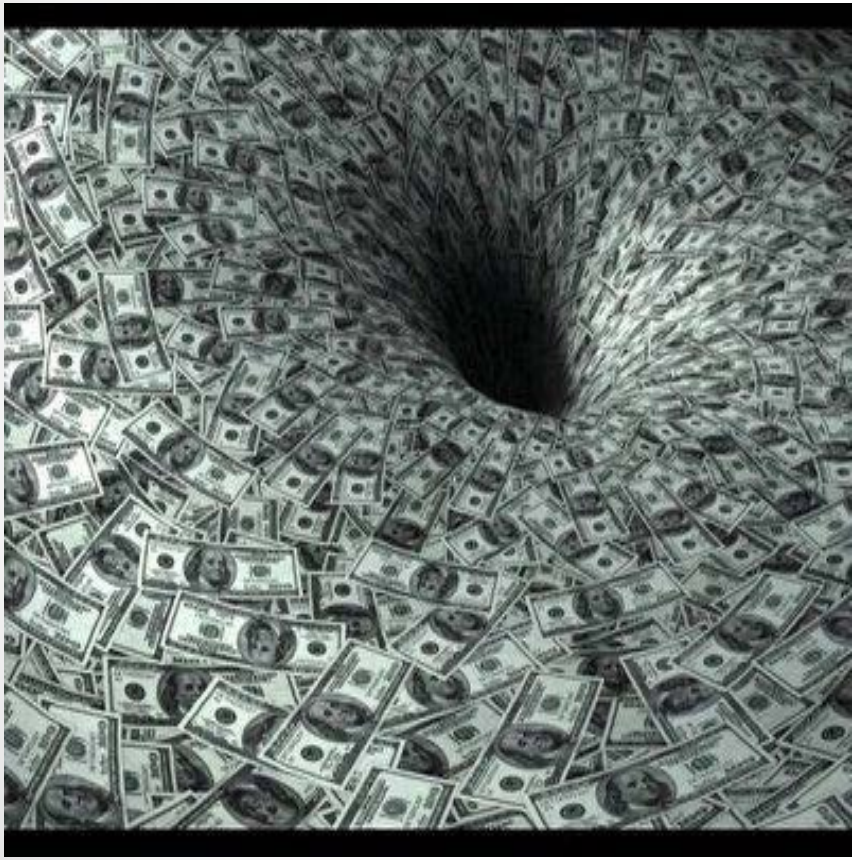
- In these cases, **a number of conditions have to be met**: a) the resolution authority has **not** taken any **resolution** action; b) the DGS has **appropriate systems and procedures in place for selecting and implementing alternative measures** and monitoring affiliated risks; c) the **costs of the measures do not exceed the costs** of fulfilling the statutory or contractual **mandate** of the DGS; d) the use of alternative measures by the DGS is linked to **conditions imposed on the credit institution** that is being supported, involving at least more stringent risk monitoring and greater verification rights for the DGS; e) the use of alternative measures by the DGS is linked to commitments by the credit institution being supported with a **view to securing access to covered deposits**; f) the ability of the affiliated credit institutions to pay the extraordinary contributions is **confirmed** in the **assessment of the competent authority**.

THE ITALIAN EXPERIENCE



- The **Italian Deposit Guarantee Scheme** for long time operated with a view to **preventing its members' failure**.
- This way of working was based on **intervening before** the submission of a bank in crisis to **liquidation** with the aim of avoiding such result.
- In practice, instead of paying out the amount of insured deposits in the event of liquidation, the **DGS** used to **finance in several ways its member in crisis** to prevent its liquidation, *e.g.* by financing its acquisition by another bank, by providing guarantees, by purchasing shares, by taking on the mismatch between liabilities and assets to be transferred.
- The DGS informed its decisions on a **preventive assessment of both the potential success of the restructuring and the cost of its intervention *vis-à-vis* the amount it should have paid to insured depositors** should the bank have been submitted to liquidation (**'least cost principle')**.
- The Italian DGS used to operate in this way until 2014, when the European Commission in the **TERCAS case** ruled that this kind of intervention did not comply with the State aid framework.
- However, with a decision adopted on **19 March 2019**, the **Court of Justice of the European Union annulled the decision** of the Commission, arguing that the Italian DGS intervention did not violate the State aid framework.

PUBLIC FUNDS



- Even though the new resolution framework should effectively work without recurring to taxpayers' money, there are **still a number of cases in which public funds can be employed**.
- In these cases, nevertheless, **in the EU State aid rules apply as well.**
- **In** the context of **resolution**, public funds can be used through the so-called **'Government Financial Stabilisation tools'**, namely: a) the **public equity support tool** and b) the **temporary public ownership tool.**
- **When the institution is still solvent**, even though **in need to be recapitalised**, public funds can be used through the so-called **precautionary recapitalisation** (Bodellini 2017).
- **In** the context of **liquidation**, **public money can be used to orderly manage the proceeding (**Lastra – Russo – Bodellini 2019).

GOVERNMENT FINANCIAL STABILISATION TOOLS

- With the **public equity support** tool, the **State** can participate in the **recapitalisation** of an institution **by providing capital** in exchange for Common Equity Tier 1 instruments, Additional Tier 1 instruments or Tier 2 instruments.
- With the **temporary public ownership** tool, the **State** may **take an institution into temporary public ownership**, by making share transfer orders in which the transferee is either a State's nominee or a company wholly owned by the State
- Both instruments can only be used as a **last resort measure**—after the other resolution tools have been applied—with a view to **transferring the holding** in the resolved institution to the private sector **as soon as possible**.
- Additionally, before their use, it is required that: a) a **contribution** to **loss absorption and recapitalisation** equal to an amount not less than **8%** of total liabilities including own funds of the institution under resolution has been made by shareholders and creditors through write down, conversion or otherwise; and (b) the **Commission has authorised** the public intervention according to the Union State aid framework.

CONCLUDING REMARKS

No **financing tool** is effective in every case.

Each of them has **pros and cons** and their effective use mainly depends upon the characteristics of a **given case**.

Nevertheless, an **efficient legal framework** is one that provides the authorities (and the Government) with a **large toolkit**, allowing them to pick the **right instrument after a case-by-case assessment**.

To do so, both authorities and the Government need to be given **some discretion in their choices**.

Such discretion needs in turn to be **counterbalanced with proportional accountability**.

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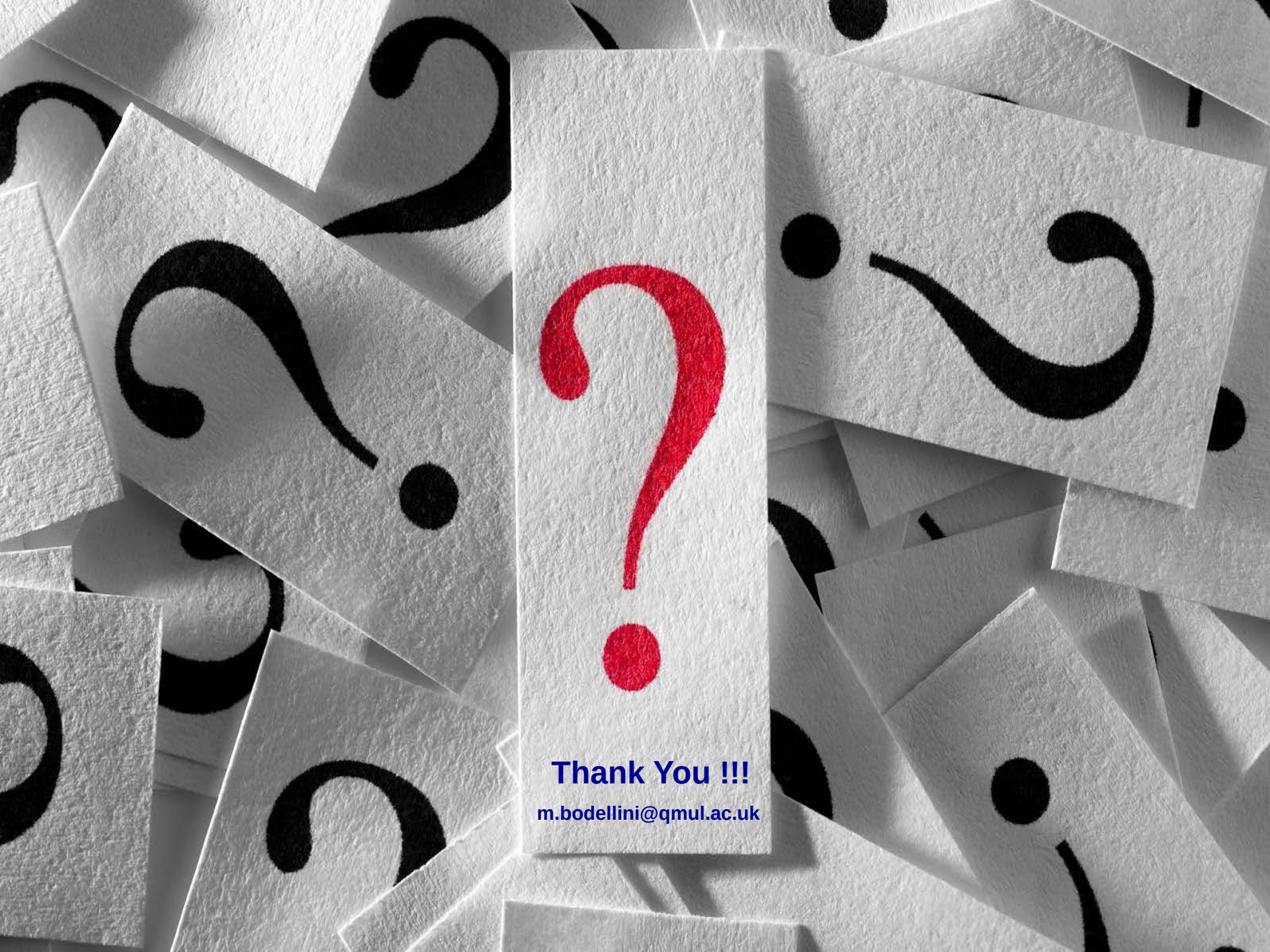

Thank You !!!

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