Bank Resolution Powers and Tools

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Overview

I. Resolution and financial stability

II. Guiding principles for effective bank resolution

III. Resolution tools and powers
I. Resolution and financial stability
Resolution fosters financial stability

- Fosters market discipline
- Reduces moral hazard
- Protects taxpayers from losses

Self-corrective mechanisms

- Promotes competition
- Avoids build-up of vulnerabilities
- Ensures continuity of financial services

Manage risks

- Removes weak banks from system
- Protects depositors and creditors
- Avoids contagion
- Maintains confidence

Efficient allocation of resources
Systemic risk matters for resolution

**High systemic risk:**
Problems centered on how the failure impacts the rest of the system / economy:

- Which functions should continue to minimize market disruption?
- How to avoid contagion / panic / bank runs?
- Which creditors should be protected?
- Is there a need for fiscal or central bank resources?

**Low systemic risk:**
Problems centered on the failing bank:

- What happens to insured deposits?
- Which banks can take them?
- What assets might be of interest to acquirers?
- How to obtain reliable valuations?
- Is there a need for using DIA resources?
The more systemic risk weighs in, the more...
- difficult the questions
- complicated the decisions
- uncertain the environment ... etc. etc.

Different approaches to resolution are needed while preserving fundamental principles:
- Insured depositors are protected
- Shareholders (and other creditors) take first losses
- Financial stability is maintained
## Closed vs. open Resolution

<table>
<thead>
<tr>
<th>Closed resolution strategy</th>
<th>Open resolution strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Close the failing bank and either pay out insured deposits or transfer them to another bank</td>
<td>Keep some or all of a bank’s business operating, either within the bank (once recapitalized), or transfer to another bank or in a bridge bank</td>
</tr>
<tr>
<td>Generally applied to small banks where the systemic and economic impact of closure is not significant</td>
<td>Reserved for situations where closing a financial institution would have significant adverse impact on financial stability and the economy</td>
</tr>
<tr>
<td>Attention! Failure to resolve orderly may result in contagion and systemic risk!</td>
<td></td>
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</table>
II. Guiding principles for effective bank resolution
How to be effective in resolution?

- **Strong legal framework:**
  - Clarity on legal authority, roles of different agencies
  - Operational independence
  - Adequate tools and powers, legal protections, safeguards
  - Sound governance and accountability

- **Operational preparedness:**
  - Menu of resolution options and guidance (when and how)
  - Appropriate pre-positioning for different resolution options

- **Robust cooperation**
  - Domestic and cross-border

- **Will to act**
  - Act decisively (delays inevitably exacerbate problems)
Lessons from the GFC

- Inadequate resolution powers and tools to orderly resolve a failing financial institution or group

- Inadequate mechanisms for loss allocation, including the ability to credibly subject bank creditors to loss in a bank failure without endangering financial stability

- Inadequate frameworks for cross-border enforcement of resolution measures and related cooperation.
FSB Key Attributes

• The FSB *Key Attributes of Effective Resolution for Financial Institutions* ("Key Attributes") provide the international standard for financial resolution

• Adopted in 2011 by the Financial Stability Board (FSB) to assist G20 jurisdictions to strengthen their resolution frameworks following the GFC

• A more stringent resolution framework for G-SIFIs, including well articulated cross-border cooperation
Overview of the Key Attributes

➤ Objectives:

✓ Resolve financial institutions in an orderly manner
✓ Minimize costs for taxpayers from rescues
✓ Maintain financial stability by ensuring continuity of critical economic functions
FSB Key Attributes – Pillars

– Scope
– Resolution authority
– Resolution powers
– Set-off, netting, collateral and segregation of client assets
– Safeguards in the use of resolution powers
– Resolution funding
– Legal framework for cross-border cooperation
– Crisis Management Groups
– Institution-specific cooperation agreements
– Resolvability assessments
– Recovery and resolution planning
– Access to information and information sharing
III. Resolution tools and powers
Resolution Powers

- Replace management
- Appoint an administrator to take control/manage the firm

Assume control

Tailor tools

Conserve value

- Override shareholders/creditors’ rights to approve merger, sale, capital injection, transfer of assets
- Transfer assets, liabilities to an existing entity, bridge bank, or asset management company (AMC)
- Bail-in creditors to recapitalize the failed firm or successor

- Suspend payments to unsecured creditors and stay creditor actions
- Temporarily stay early termination rights on financial contracts
- Oblige related group entities to continue to provide essential services
Resolution powers

• Resolution should be triggered reasonably early – before balance sheet insolvency and before all the equity has been fully wiped out ("point of non-viability"), e.g. bank:
  – is dependent to an excessive extent on loans, advances, guarantees or other financial assistance
  – has lost the confidence of depositors and the public
  – has a level of the regulatory capital which is or is about to become substantially deficient or
  – failed to pay any liability that become due and payable or will not be able to pay its liabilities as they become due and payable
Resolution safeguards

- The use of resolution powers can have major impacts on the rights and financial position of shareholders, creditors and others

- Safeguards are therefore essential to avoid abuse of powers and unfair outcomes

- Remedies under safeguards should be of an ex post nature, with no capacity to unwind a resolution once implemented
Resolution safeguards

- Resolution respects hierarchy of claims with flexibility to depart from *pari passu* treatment of creditors of same class
- No creditor (or shareholder) will be left worse off than had the bank or other entity been wound up under conventional insolvency law (“no creditor worse off than in liquidation”)
- Ex post monetary compensation for any party left worse off under the resolution
- Ex post rights of judicial review and compensation for misuse of powers
The “Intervention” Scale

Fiscal cost/ moral hazard

Size of firm/systemic risk

Liquidation

Official administration

AMCs

Bail-in

P&A

Nationalization
Transfer of Assets and Liabilities

Transfer assets and liabilities (Purchase and Assumption – P&A) of failed firm to healthy or bridge firm

- Without consent of shareholders/creditors
- May include systemic functions
- Remainder left in failed firm, and liquidated
- Shareholders/creditors of liquidated firm bear losses

Experience: successfully used many times in some countries but can be difficult to split large, complex, cross-border firms
Bank Resolution: P&A

Bank Value < 0

Selling Bank

Assets | Liabilities

Gap

Acquiring institution absorbs assets and liabilities, while gap is filled via support deposit guarantee scheme (which receives a claim on the residual entity)

Residual entity liquidated
P&A Benefits

- Prompt access to insured deposits
- Preserves confidence in the banking sector
- Minimizes disruption to bank customers
- Maintains the value of performing assets via the transfer to a healthy bank
- Preserves financial stability
• Temporary national banks established and operated to acquire the assets and liabilities of a failed bank to “bridge” the lapse between the failure and its final resolution.

• First introduced in the U.S. in 1987 following the failure of Continental Illinois in 1984—the largest commercial and industrial lender as of 1981. Due to its complexity, the FDIC could not find a buyer to implement a P&A.
Bridge Banks “Life Cycle”

- **Operation:**
  Licensed institution operated at arm’s length
  Subject to prudential requirements, notably capital and liquidity standards

- **Termination:**
  Charter typically granted for 2–3 years with limited renewable extensions (i.e., the U.S. up to three one year extensions, but in practice bridge bank runs for a few months; Taiwan, Japan, and Korea one extension of one year)
Bridge Banks Benefits

- Stabilizes the institution (and thus maintains franchise value) while the bank is marketed to prospective buyers
- May facilitate the sale to a buyer that is only interested in a partial acquisition
- Useful for large institutions, or when resolving several institutions at the same time
- Excludes nonperforming assets, assets in litigation or fraud-related and contingent liabilities
Bridge Banks Concerns

- Possible perception by other banks of unfair competition because of the state ownership
- Excessive time in the state hands and risk of political interference
- Cost overruns with respect to the original estimate
- Possible reduction of the deposit base leading to a potential loss in franchise value
Tools – Bail-in

Write down firm’s liabilities or convert them into equity

- No transfer to other entities
- Insured and secured claims excluded
- Without consent of shareholders/creditors
- Administrative procedure

Experience: relatively untested
Bail-in: a simple example

Table 1. Effects of Bail-in on Bank Balance Sheet: A Simple Example

<table>
<thead>
<tr>
<th>Bank balance sheet at the starting point (in billions of U.S. dollars)</th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>Asset</td>
<td>100</td>
<td>Liability</td>
</tr>
<tr>
<td>Cash &amp; other fixed assets</td>
<td>5</td>
<td>Deposits</td>
</tr>
<tr>
<td>Securities &amp; short-term investment</td>
<td>45</td>
<td>Repos &amp; other short-term borrowing</td>
</tr>
<tr>
<td>Loans &amp; other long-term investment</td>
<td>50</td>
<td>Long-term unsecured debt</td>
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<td></td>
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<td>Equity</td>
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<th>Bank balance sheet after a write-down of $10 billion in long-term assets</th>
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<tr>
<td>Asset</td>
<td>90</td>
<td>Liability</td>
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<th>Bank balance sheet after recapitalization under the bail-in power</th>
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Benefits of bail-in

- Too expensive to save SIFIs with public funds
- Mitigation of moral hazard
- Speedy and efficient resolution mechanism that allows for a continuation of business operations
- Avoidance of complexities of transferring assets and liabilities (cross-border & between legal entities)
Bail-in: Implementation issues

- Robust legal framework needed to guard against litigation relating to modifications of contractual rights without the counterparties’ consent

- Can impact the pricing and availability of bank funding

- How to ensure former creditors behave as shareholders?

- May have less relevance in deposit-funded markets
Tools - Asset Management Companies

Transfer non-performing assets from failing firms to AMCs

- Purpose to pool and collectively manage non-performing assets
- Assets transferred at market prices
- Frequently used in systemic crises

Experience: can be difficult to value assets; potentially high fiscal costs if state has to recapitalize participating firms
Questions?