Crisis Management and Bank Resolution – Practical issues and new developments

Seminar for Senior Bank Supervisors from Emerging Economies

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Disclaimer

The views expressed in this material are those of the author and do not necessarily represent those of the IMF or IMF policy.

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Agenda

- Management of systemic banking crises
- Financial Stability Board Key Attributes of Effective Resolution Regimes
- Total Loss Absorbing Capacity (TLAC)
After the Global Financial Crisis, a lot of effort went into strengthening the toolkit for managing banking crises.

So, what is new about it?

Not much (at first glance)...

- Principles and best practices derived from experience of authorities around the globe
- Essential techniques well tested but not consistently used

More money has been lost because of four words than at the point of a gun. Those four words are ‘This time is different’. Reinhart and Rogoff, 2009
Costs of bank rescues led to renewed emphasis on credible alternatives

- Special resolution regimes
- Financial sector levies
- “Living wills” to facilitate orderly wind-ups

Some statistics (Advanced G20 countries)
- Net fiscal cost 2.8 percent of GDP (average)
- Debt projected to increase by 40 percent of GDP
- Cumulative output loss 26 percent of GDP (estimate)
Lessons from the Global Financial Crisis

- Many countries lacked important legal powers to resolve financial institutions in distress

- Challenges even where resolution regime was deemed to be robust (e.g. US)
  - cross-border issues
  - complexities in group structures
Lessons from the Global Financial Crisis – EU

- Lack of options to allow banks to continue to provide essential functions in insolvency
  - Bail-outs amounting to about 13 percent of GDP

- Lack of authority to impose resolutions
  - Litigation over transactions initiated to stabilize failing banks (Hypo Real Estate, Fortis, SNS)

- No tools to take control prior to insolvency
  - Northern Rock proposed dividend while receiving extraordinary Bank of England support
Management of systemic banking crises

- Four phases
  - 1. Contain crisis
  - 2. Restructure banks
  - 3. Restructure bank assets – loans
  - 4. Exit from Crisis Mode
PHASE 1 – CONTAIN CRISIS
How to contain a systemic banking crisis
Irrespective of origin, crises typically emerge as a liquidity problem in one, or some, or all banks.

Liquidity problems and deposit withdrawals are symptoms of underlying problems.

Liquidity is rarely the driving factor.
Argentina
Panic must be stopped...

- policies cannot be implemented in midst of a financial collapse
Containment measures

- Designed to support the overall strategy
- Credible policies should be announced and enacted
- Measures are temporary – they cannot last forever
Containment measures – cont’d

• Options available:
  – Emergency liquidity assistance
  – Blanket guarantees
  – Bank intervention

• If containment measures prove to be ineffective, the adoption of administrative measures may become inevitable
Emergency Liquidity Assistance

• Objective: restore depositor and creditor confidence

• Gives rise to various risks
  – Increases monetary aggregates
  – Losses to the central bank
  – Moral hazard
  – Authorities may end up supporting insolvent banks
  – Prone to abuse
  – Dollarized/ Euro-ized economies
Emergency Liquidity Assistance—cont’d

- Policy options
  - Sterilize liquidity injections
  - Introduce liquidity triggers
  - Enhanced supervision of recipient banks
  - Measures for dollarized economies
Blanket Guarantees

- Objective: stop bank runs caused by loss of depositor confidence
- Deployed by many countries facing systemic distress, but with mixed results

- Policy considerations
  - Typically ineffective if used in isolation – prone to abuse, fosters complacency, increases moral hazard
  - Fiscal costs can be substantial
  - Exit to be carefully managed
Administrative measures

• Objective and assumptions
  
  – Contain the collapse of a banking system due to deposit runs and financial outflows

  – Loss of confidence in the authorities’ ability to manage the crisis de facto limits effectiveness of blanket guarantees

  – Ability to introduce and enforce financial sector regulations and capital controls
Administrative measures

• Key steps for the adoption of restrictions
  
  – Preparation of relevant law(s), regulations and implementation modalities in secret.
  
  – Ascertain that the central bank has up-to-date information on liabilities, including those to nonresidents.
  
  – Develop a clear communication strategy to foster understanding of the measures.
Administrative measures – cont’d

• Administrative measures aim to...
  – ...stop liquidity outflows when confidence is not restored

• Type of measures
  – Deposit freezes
  – Deposit restructuring
  – Capital and exchange controls
Administrative measures – cont’d

• To be used with care as administrative measures are extremely disruptive to
  – Payment systems
  – Economic activity
  – Private sector confidence
  – Exemptions
  – Unwinding process

Must be viewed as a final, desperate measure to stop runs if all other tools have failed
PHASE 2 – BANK RESTRUCTURING
Now that the fire is contained...
Phase 2 – Bank Restructuring

- Guiding principles
- Evaluating options
- Key resolution tools
- Resolution triggers
- Funding arrangements
Guiding principles
Phase 2 – Bank Restructuring: principles

- Establishment of a single high-level authority
- High credibility agency, responsible for implementation of restructuring strategy
- Specialized skills
- Emergency legislation
Bank restructuring: principles

- Speed of intervention is essential.
- Protection of depositors facilitates the restructuring process.
- Process should fair and rules should be equally applied to all banks.
- State intervention in capitalization may be justified.
Bank restructuring: principles

- Diagnosis, focus on medium-term viability
- Recognize losses upfront
- Preserve viable, undercapitalized banks:
  - request time-bound recap/restructuring plans
  - close oversight and prompt corrective actions
- Resolve insolvent, unviable banks:
  - not all institutions to be rescued
  - close/merge and liquidate assets
Bank Restructuring: Diagnosis

Identifying insolvent banks

Resolving insolvent banks

Options
- Private sector: P&A
- Public sector: P&A, bridge bank, bank nationalization, etc
- Combination: joint recapitalization
- Burden sharing should be explicit (e.g. bail-in)

Diagnosis: Asset valuation is key but difficult

Risks: data limitations

“Solvency” and “viability” can be confused
Common Challenges

- Inability to write down shareholder capital
- Limited legal authority to facilitate bank sales
- Weak mandate to restructure banks
- Ineffective procedures to implement P & A transaction
- Insufficient knowledge of judges on banking matters
- Lack of legal protection to staff and board members
Key resolution tools
Bank Nationalization

- Direct bank recapitalization with public funds.
- Risks:
  - Significant state ownership of financial institutions
  - Political interference
  - Contingencies for fiscal
Bridge banks

- Establishment
  - Bridge assumes all or part of the assets and liabilities of the failed bank within a short period of time (i.e., 90 days or less).
  - excludes nonperforming assets, subsidiaries, assets in litigation or fraud-related and contingent liabilities.

- Operation
  - Regulators appoint new management and Board, who—together with existing employees—will continue operating the bank under a conservative approach.
  - The government may contribute additional resources to strengthen its balance sheet.

- Termination:
  - Disposal over 2-3 years
Bridge banks

- Key advantages
  - Stabilizes the institution (and thus maintains franchise value) while a thorough assessment is performed, and the bank is marketed to prospective buyers.
  - May facilitate the sale to a buyer that has done due diligence but is not interested in the entire failed institution.
  - Useful for large and small institutions, or when resolving several institutions at the same time.
  - It helps to leave in the bank under liquidation contingencies
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.
Bank Resolution: P&A

- **Bank Value < 0**

  Selling Bank

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<th>Assets</th>
<th>Liabilities</th>
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<td>Gap</td>
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  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

- Resolution via P&A has distinct advantages
  - helps preserve confidence in the banking sector
  - minimizes disruption to bank customers
  - preserves financial stability by minimizing likelihood of a bank run
- P&As provide depositors with prompt access to insured deposits, while ...
- ... maintaining the value of performing assets via the immediate transfer thereof to healthy bank
**Definition.** Statutory power to recapitalize a distressed SIFI by converting and/or writing down its unsecured debt while maintaining its legal entity.
Importance of bail-in for bank resolution

- The crisis demonstrated the need to expand resolution powers and tools that permits expeditious action to preserve asset value and financial stability.
- There is increasing recognition that general corporate insolvency proceedings do not provide appropriate tools to manage the risks to financial stability, which can arise from the failure of a SIFI.
- SIFIs are too expensive to be saved with public funds.
Benefits of bail-in

- Mitigation of moral hazard.
- More speedy and efficient resolution mechanism for distressed SIFIs, while supporting continuation of business operations.
- Avoidance of complexities of transferring assets and liabilities (cross-border and between different legal entities)
- The intended outcome is that institutions would be incentivized to raise capital or restructured debt voluntarily before the triggering of the bail-in power.
Bail-in: Implementation issues

- **Legal.** It requires a solid and comprehensive legal framework as implies the modification of contractual rights without the consent of counterparties.

- **Resolution tool.** To be used under conservatorship or official administration or special resolution regimes.

- **Triggers.** There is need of clarity when and how the bail-in tool will be used. At early stage or relatively late stage of the financial downturn of a bank?
Bail-in: Implementation issue

- **Size of losses.** And capital needs must be validated by third party.
- **Contagion risks.**
- **Governance risk.** How to ensure former creditors behave as shareholders? What to do meanwhile the new shareholders get organized?
Funding arrangements
Funding arrangements

- They fulfill an essential. Resolution authorities will require funding at different stages in the resolution process.
- The banking industry, rather than the taxpayer, should, ultimately, shoulder the burden of resolution. This is a widely accepted among international standards setters and senior policy makers.
Funding arrangements

- Two options:
  - Ex-ante resolution funds. Financed via ex-ante contributions from the industry (similar to many DGS); and
  - Ex-post funding. Public resources are recovered through the industry’s contribution.

How effective these options could be?
Use of Public Money for Recap

- Last resort measure, only appropriate in systemic crises
- Often cited concerns
  - does not pass “least cost” test as loss estimations of problem banks are virtually always underestimated
  - greater temptation and opportunity for asset stripping
  - “pouring good money after bad”
  - moral hazard, “gambling for resurrection”
  - political pressure clouding good business decisions
  - psychological entrapment, increasingly difficult to say “no”
Use of Public Money for Recap

- Preferably, capital needs to be met via private resources
  - inability to attract fresh capital indicative of viability concerns?

- But...private solutions typically scarce during a systemic crisis
  - system-wide capital needs might simply be too large
  - (perceived) bank weaknesses reduce investors’ risk appetite; and
  - swift balance sheet adjustments unfeasible or detrimental to economic recovery
Use of Public Money for Recap

- Necessary safeguards:
  - Former shareholders to absorb first loss
  - Simultaneous injection of private capital to further reduce outlays for the taxpayer
  - Comprehensive restructuring plans, subject to strict oversight
  - Management changes appropriate (...also to “sell” the recipient’s new strategy to investors)
  - Ownership at arm’s length, no public involvement in day-to-day management
  - Exit scenario allowing for full repayment within reasonable timeframe
PHASE 3 – LOAN RESTRUCTURING
The banks are capitalized now, but...
Phase 3 – Loan Restructuring

- Resolution of debt overhang needed to restart supply and demand of credit
- Corporate and retail debt restructuring often neglected
- Issues in institutional framework
  - speed versus value
  - centralized versus decentralized
  - legal reforms (bankruptcy/foreclosure)
  - out-of-court debt restructuring (London approach)
State-funded AMCs

- **Mandate:** narrow (min taxpayer losses), as supposed to broad (min fire sale effects).
- **Pricing:** current market value.
- **Legal backing:** strong legal basis needed for transfers of titles; adequate powers to maximize recoveries.
- **Funding:** adequate capitalization by treasury; consider joint ventures with private investors.
- **Governance:** independent board/private sector participation; disclosure; auditing; reports to parliament
Dealing with Impaired Assets

- Dilemma: Restructure NPLs inside or outside banks.
- In some cases size of impaired assets too great for AMC or other (single) state bailout. Burden sharing with creditors may be necessary (would also reduce moral hazard).
- Objectives of broad mandate AMCs, ambitious and long term—too early to reach final conclusions.
Dealing with Impaired Assets

- Some features of recent EU experience raise concerns:
  - Viability of participating banks if receive AMC bonds that are de-facto long maturity, illiquid, pay low interest rate, and carry non-credible state guarantee (even if ECB eligible).
  - Ownership and funding structures should not leave significant risk with participating bank groups, will not insulate banks from the problem assets (potentially defeating AMC aim)
  - While much good practice from previous crises learnt this time (transparency, good governance, fair value) more required on active restructuring and work out of loans
PHASE 4 – EXIT FROM CRISIS MODE
Phase 4 – Exit from Crisis Mode

- Exit from blanket guarantee if applied
- Exit from government ownership of banks
- Sale of assets taken over
- Overhaul of regulations to not repeat mistakes
- Continue corporate restructuring to avoid “second-wave crisis”
Lessons—Crisis Response

- Adopt comprehensive response
- Secure confidence of creditors/depositors
- Ensure upfront loss recognition
- Facilitate recapitalization
- Remove nonviable institutions
- Do not ignore debt restructuring
Lessons—Crisis Management

- Confront key questions early on
- Ensure adequate communication policy
- Garner political support
- Plan for uncertainty
- Prevent failure
Crisis management and resolution: a team work
Recent Developments

KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES
Key Attributes

- Financial Stability Board’s *Key Attributes of Effective Resolution Regimes for Financial Institutions*, November, 2011

- Twelve essential features that should be part of the resolution regime in all jurisdictions

- Assessment Methodology—consultative document August, 2013
  - Once complete, the Key Attributes will be included in the FSB’s Standards and Codes
Facilitate orderly resolution without taxpayer support
Focus on systemically important banks
…but proportional application benefits every jurisdiction
European Bank Recovery and Resolution Directive

- EU Bank Recovery and Resolution Directive (BRRD) adopted May 2014
  - To be reflected in national laws by end-2014
  - Relies on a network of national authorities and resolution funds to resolve banks

- National resolution authorities incompatible with a banking union
  - Single Resolution Mechanism (SRM), adopted July 2014
European Bank Recovery and Resolution Directive – cont’d

- Operationalizing the SRM
  - ECB initiates process ("failing or likely to fail")
  - 36 hour decision-making process envisioned to facilitate resolution over a weekend
  - Resolution scheme prepared by Single Resolution Board, to be amended in case of objection from EU Commission or Council
  - Scheme implemented by national authorities

- Cumbersome decision making process may not work as expected in a crisis
Looking ahead

- Reforms in train in many jurisdictions, but progress is slow
- Reduced “implicit support” assumptions used by rating agencies suggest that “too big to fail” (TBTF) is being addressed...
- ...but Fund analysis indicates that systemically important banks still enjoy sizable funding subsidies

“[The too-big-to-fail issue] is not solved and gone; it’s still here…it’s a real problem and needs to be addressed, if all possible.”

Ben S. Bernanke, March 2013
Recent Developments

TOTAL LOSS ABSORBING CAPACITY
New Normal - Gone Concern
Loss Absorbing Capacity

- The case of losses eroding a bank’s capital base can never be excluded.

- Preferred approach: creditor “Bail-in” instead of tax payer bail-out!

- Several conditions to be met in order to make bail-in work without risks for financial stability or the greater economy.
1. Initial situation

- A bank holds capital equal to 12 percent of risk weighted assets, 3 percentage points above minimum requirements.
- Excess capital is *going-concern* loss absorbing – it can be wiped out without need for recapitalization or intervention by authorities.
2. Losses materialize

- The bank experiences losses wiping out excess capital.
- Further losses would make the bank undercapitalized:
  - raise equity...
  - wind-down the bank.

Assets

Debt

Equity

Losses

Capital ratio just meeting the minimum
3. Further losses require action

- Critical functions must continue to operate
  - Payments, deposit access
- Requires capital gap to be filled
- Absent fresh private capital...
  - Liquidation => no option for systemic banks
  - Public ‘bail-out’ => not desirable
  - Private ‘bail-in’: conversion of existing debt claims

Resolution entails deep restructuring after initial recapitalization

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<th>Assets</th>
<th>Debt</th>
<th>Equity</th>
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Capital ratio violating regulatory minimum

More Losses
4. Bail-in to recapitalize

- Bail-in = recapitalization through debt-equity swap or write-down
- Conversion rebuilds minimum capital plus buffer
- Exposes debt to credit risk => “Gone-concern loss absorbency”
**Going-concern vs. gone-concern loss absorption**

### Going-concern capital buffers
- **Capital in excess of minimum requirements**
  - Can be “spent” by bank management
  - Bank remains under full control of owners and management
  - Generally more expensive

### Gone-concern loss absorption
- **Gone-concern loss absorbing capacity (bail-inable debt)**
  - Only available upon decision of resolution authority
  - Enable resolution powers, but NO technical liquidation or default
  - Lower cost than equity (but higher than non-GLAC debt)
What makes debt loss-absorbing?

- Feasibility: Ability to absorb losses outside of bankruptcy
  - Contractual regimes, e.g. low-triggering cocos
  - Statutory regimes, e.g. conversion upon decision of authorities
  - Structure of the bank, e.g. “structural subordination”

- Credibility: Probability that debt will be allowed to absorb losses in practice
  - Weighting against negative impact on bank and systemic level (financial stability, macro)
Feasibility ≠ credibility
Credibility depends on creditor
Post-mortem case studies of 2007/08 crisis on resources needed to absorb losses and complete necessary recapitalization

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<th>T1 % before support</th>
<th>Direct support in terms of</th>
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<tr>
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<td>RWA %</td>
<td>Total Assets %</td>
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<td>Citi</td>
<td>11.9</td>
<td>8.4</td>
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<td>Fortis (peak)</td>
<td>9.5</td>
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<tr>
<td>Average</td>
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Current proposal:

- **Quantity**: Pillar TLAC requirement of 16-18% RWA + Leverage Ratio backstop
- **Quality**: capital and “eligible liabilities”
Feasibility: ability to bail-in
- Countries are adopting the FSB resolution framework
- Many G-SIBs have sufficient GLAC if senior debt is included
- But lack of structural subordination might create problems in exercising bail-in

Action: implement FSB regime, (increase sub debt issuance, adjust bank structure)
Reality check: credibility – cont’d

- Credibility (continued)
  - No systematic knowledge of current creditors, claims migrate in run-up to crisis
  - Willingness to bail-in creditors will negatively correlate with size of systemic crisis
  - Resolution funds will not suffice in systemic crises

- Action: continuously monitor investor base, regulate holdings of “protected” and systemic investors

- Sufficient demand for € 6.7 trillion credible GLAC? Impact on funding cost?
Reality check: cross-border issues

- Action: intensify cross-border cooperation, require *internal* total loss absorbing capacity
Impact on Non G-SIBs?

- Current proposal discusses G-SIBs only.
  - 29 global banks designated by FSB
- All issues apply for
  - Domestically systemic banks (D-SIBs)
  - Non-systemic banks in systemic crisis ("systemic in a herd")
- Can increased TLAC help?
Macro-economic impact?

How can losses be diversified to minimize “second round” effects?
Thank you for your attention

Questions? Suggestions?
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