

Contingency Planning for Bank Resolution and Financial Crises

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Introduction¹

This note provides basic guidance for senior managers of supervisory agencies in making contingency plans to deal with banking or financial system distress and crisis. For this purpose, systemic distress and crises are taken to be those situations where the solvency and/or liquidity of many or most banks have suffered shocks that have shaken public confidence. This note will address contingency planning for bank resolutions and banking crises, though many of the elements apply equally to the securities and insurance industries.

Systemic distress and crises usually emerge suddenly, and the authorities quickly can find themselves reacting to events. Engaging in contingency planning prior to a crisis will help the supervisory authorities to identify the types of actions that may have to be taken during a crisis, as well as the skills, policies and processes that would be required to support these actions. Contingency planning can lead to more prompt and comprehensive action to resolve crises and can lower the costs of doing so. Contingency planning may also help reduce the likelihood that a crisis will occur, or reduce the amount of damage it may cause.

This note addresses contingency planning in the context of the following:

- Creating safety nets
- Determining the conditions of banks
- Strengthening undercapitalized banks
- Resolving insolvent banks
- Managing and reprivatizing banks under temporary state ownership
- Establishing a crisis management unit

Objectives of Crisis Resolution

The objectives of crisis resolution are to:

- **Protect the interests of depositors (especially small depositors):** It is important to protect depositors' interests in order to prevent serious damage to the ability of the banking system to mobilize savings and contribute to the functioning of the economy. The utility of a financial system to a country and its citizens is in part dependent on its ability to mobilize the nation's savings.
- **Protect the interests of the state (taxpayers):** The interests of the state must be protected in order to avoid incurring unnecessarily large costs in the process of resolving the crisis and to minimize the future burden on taxpayers. Financial crises can result in large fiscal costs that lead to increases in taxes or reductions in other expenditures. Often, private individuals and firms will take advantage of a crisis to gain financially from the authorities' actions or to escape their responsibilities. The authorities must act in a way that avoids inappropriately benefiting private parties at the expense of the state. In other words, the authorities can and must act in a way that attempts to minimize the costs to the state of resolving systemic distress.²

¹ This note was prepared by David Scott on behalf of Toronto Centre.

² Resolving a crisis involves complex trade-offs in terms of up-front and long run costs, the speed with which reforms are implemented, and the rates of economic growth and unemployment, among other matters, that are beyond the scope of this note.

- **Promptly restore the solvency, liquidity and profitability of the banking system:** Systemic distress and crisis often lead to a so-called “credit crunch” that can contribute to economic recession and exacerbate the crisis. Only by promptly restoring the solvency, liquidity and profitability of the banking system can it again begin to function in a manner supportive of the economy, especially providing credit to firms and consumers.

Creating Safety Nets

The events surrounding a crisis quickly put to the test the official safety nets that support the banking system. These include the central bank’s role as lender of last resort and, in many countries, the official or quasi-official deposit protection arrangements.

A crisis likely will involve a sudden increase in demand for liquidity by banks. Shaken depositor confidence leads to deposit outflows. The interbank market may be sharply curtailed as well, limiting the role of the system itself in providing liquidity to needy banks.

On the one hand, liquidity should be provided to the system to help banks meet deposit withdrawal demands and deter a widespread loss of confidence; on the other hand, provision of liquidity can prove costly because it can keep nonviable loss-making banks in operation, finance capital flight and result in inflation. The challenge is therefore to meet legitimate needs for liquidity while avoiding the provision of liquidity to banks with no prospects of recovery and/or the expropriation by bank insiders of the liquidity provided. While the senior managers of supervisory agencies will not have primary responsibility for lender-of-last resort decisions and actions, they will have to play a complementary role in providing accurate information and informed judgements to the responsible authorities.

As part of the routine supervision and regulatory function, bank managers should be required to have in place their own contingency funding plans which define the manner in which they will maintain liquidity in times of distress. For banks required to prepare formal recovery plans, contingency funding plans would be part of the recovery plan. Although borrowing from the central bank should be seen as a last resort, banks should ensure that the assets and documentation required to support collateralized borrowing from the central bank are in good order. The supervisory authorities can reevaluate their supervisory policies and processes in this regard, and similarly can reevaluate regulations applicable to maintenance of liquidity.

The supervisory authorities’ contingency plans for a crisis situation should involve several additional elements, some of which are discussed in more detail in subsequent sections of this note. The supervisors should be prepared to solicit from banks, perhaps on a daily basis, detailed liquidity reports depicting the banks’ funding situation. These reports can be designed in advance and bank managers can be instructed in their use. In addition, the supervisors will need the capacity to send staff and/or auditors or other agents into banks. The purposes may be to evaluate the accuracy of liquidity reporting and the bank’s funding situation, to diagnose the bank’s overall financial condition and operational situation, and to detect potential looting or other misuse of liquidity of bank insiders. Procedures for this work can be defined in advance. Supervisory enforcement actions, such as legally-binding agreements between the supervisory authorities and the senior managers and/or directors of banks, can also be used to mitigate the potential misuse of liquidity. Finally, the supervisory authorities need to be able to contribute to government’s capacity to effectively resolve insolvent or capital-deficient banks so as to preclude a situation where the central banks and/or government is forced to provide liquidity to a bank for lack of a viable resolution alternative.

A common reaction of governments to the loss of confidence during a crisis is to publicly commit to guarantee all deposits in banks. In systems that do not have pre-existing deposit protection arrangements,



the authorities introduce them; in systems with limited deposit protection, the limits of coverage are increased. In some countries even claims on nonbank financial institutions have been covered by such guarantees.

In a severe crisis, the government may appropriately decide it has few alternatives other than to provide some form of blanket protection for depositors. In doing so, it must be aware it is both creating a claim on the state and putting its credibility on the line. The guarantee must be honored – and therefore financed – or the government’s credibility will suffer damage that will impair its ability to achieve the objectives of crisis resolution.

As with lender-of-last-resort decisions, the supervisory authorities will likely play only a complementary role in decisions and actions relating to deposit protection arrangements during a crisis. For example, they may have a role to play in the procedures for vetting claims and ensuring prompt payout of protected deposits.

In some instances, weaknesses in the supervision of bank disclosures to customers can impair the government’s ability to minimize the extent of state protection. Many governments that have encountered a crisis have been forced to guarantee non-deposit claims on banks at significant cost to the state. Such claims have included pooled investment instruments (mutual funds or unit investment trusts) and claims on specific assets, such as in fiduciary (trust) accounts. The problem faced by these governments has been that banks sold or created such instruments on the basis of an explicit or implicit guarantee of principle and, in many cases, specific rates of return. This imprudent activity may have been overlooked, ignored or condoned by the supervisory authorities. Customers may believe (or at least argue) that their instrument is effectively a deposit, and the authorities will come under political pressure to provide a guarantee.

Contingency planning by supervisory authorities should therefore involve reexamining bank’s practices in making disclosures to customers regarding different types of instruments, especially investments and trust accounts. Steps should be taken to ensure that customers and the general public can readily distinguish between those instruments that are general obligations of the bank (including deposits that are protected in some manner by the depositor insurer or state) and those that are solely at the risk of the customer. One way to do this is to publish widely the terms and limits of deposit protection schemes.

Determining the Condition of Banks

In a crisis, it will be important to be able to differentiate between banks that are winners and banks that are losers. The winners are the banks that, in relative terms, have the best management, finances and operations. The losers are the banks that have become insolvent, have weak operations, and/or have poor, reckless or criminal managers. The winners will be the foundations of the post-crisis banking system; the losers need to be carefully monitored and resolved. Shareholders, managers, other insiders and debtors of “loser” banks may be those most likely to engage in activities designed to enrich themselves at the expense of depositors and taxpayers.

If the supervisory agency is doing its job well, it will already know which banks have good managers and which do not. It may also have a sense of which banks have strong operational franchises; and, it should have knowledge of the financial condition of the banks.

In a crisis, the financial condition of banks can change rapidly. Prior information may be of limited value and a reassessment is often required. It is important that supervisory authorities have a contingency plan for rapidly and accurately determining the evolving condition of banks in a crisis situation, especially the larger banks whose failure could have systemic implications. This task – a challenge in the best of circumstances – can be greatly complicated if the books and records of banks are in poor condition. Only

the best supervisory agencies will have the capacity to quickly diagnose the condition of a bank in these circumstances, and as an element of contingency planning, the senior managers of the agency need to be skeptical regarding this capacity. Of course, the supervisory authorities can undertake institutional strengthening that improves their capacity in this respect. This work may take several years and is outside the scope of the contingency planning to which this note addresses itself.

Supervisory authorities can use local external auditors to bolster their capacity in times of need. Local auditors bring the benefit of knowledge of the local market. On the other hand, they may not be well-placed to perform the type of work required because they may have an auditing perspective and insufficient asset valuation skills. They may also have conflicts of interest arising both from their role in auditing banks and their relationship with the individuals controlling banks.

One way to overcome these potential weaknesses is to require that the process be managed by local audit firms' international partners skilled in bank valuation and liquidation. The authorities can prepare for this in advance by:

- Identifying appropriate firms (local and international) that can perform such diagnostic work, though firms that have audited the bank during any of the past several years should be excluded from consideration;
- Developing basic terms of reference and draft contracts; and
- Understanding the contracting process and ensuring there are no legal impediments to contracting with the firms or to the firms performing their work.

This work will yield a first-cut assessment that can be useful in:

- Establishing supervisory priorities;
- Supporting decisions by the central bank in providing liquidity;
- Triggering actions to gain control over banks that are in the worst condition or that are being looted; and
- Estimating the overall size of the losses in the system and the potential amount of financing the authorities may need to raise, keeping in mind that the experience in virtually all countries that have faced crises is that estimates of losses in the early stages of a crisis are understated, often significantly.

These assessments should not be the basis for determining the capital needs of banks in the context of using public funds to support recapitalization. Diagnostics of that nature are discussed in the context of the following sections.

Strengthening Undercapitalized Banks

Bank managers and boards of directors are responsible for ensuring the adequacy of bank capital and for having recovery or contingency plans in place to assure that capital adequacy can be quickly restored in times of stress. In a crisis, a significant portion of the banking system may be revealed to be undercapitalized. To achieve the objectives of crisis resolution, the government will need to take action to promote the recapitalization of such banks, especially those whose failure could have systemic implications. This involves maximizing the amount of new capital invested by the existing shareholders and/or by other private sector sources, a task that in the first instance falls to the supervisory agency.

It follows then that contingency plans by the supervisory authorities should ensure that adequate processes and incentives are in place to motivate existing shareholders to recapitalize their bank. The routine bank supervision process should assess banks' capital planning processes and promote recovery and contingency planning on the part of senior bank management and the board for raising capital in times of distress. Additional incentives can be created by having the following in place:

- A supervisory or other diagnostic process that is seen by bank managers, directors and major shareholders as able to accurately assess the condition of the bank;
- A supervisory enforcement process that will progressively raise the stakes for managers, directors and major shareholders who fail to raise adequate capital within a reasonable period of time, including the removal of top management;
- A prompt and effective process for placing banks into resolution that is seen by managers, directors and shareholders as likely to be triggered should the bank be determined to be insolvent, nonviable or unable to restore capital in a reasonable period of time; and
- A referral process that can be expected to submit any suspected improper or illegal activities for review and possible prosecution by the relevant authorities.

By taking advance action to put in place and strengthen these elements, the supervisory authorities will be able to create the credible threat that should shareholders not recapitalize their bank, their ownership interests will be substantially reduced or lost altogether.

Resolving Insolvent Banks

In a crisis, a number of banks may become insolvent or nonviable. Since the incentives facing senior managers of such banks can lead to excessive risk-taking and higher losses, it is important that the government has the means to promptly take control of and resolve them. Moreover, supervisory authorities need to be assured of their capacity to reign-in instances of excessive risk-taking or looting by the managers of troubled banks. Supervisory authorities should promote and assist in contingency planning by the relevant resolution authorities to ensure that the necessary policies, procedures, legal framework and financing will be in place. The actual role of the supervisory agency will vary according to the specific circumstances of individual countries.

Insolvent banks can either be wound-up, resolved in whole or in part as a going concern, or taken over by the state. Winding-up can involve placing the bank in liquidation and promptly paying out protected deposits. A better option in most cases is an assisted acquisition, whereby protected deposits, and perhaps certain other liabilities as well as some or all assets, are acquired by a healthy bank, perhaps with financial assistance from the deposit insurer and/or government. The remaining (not acquired) part of the bank is put into liquidation.

Some banks may need to be resolved by other means. This can be the case with banks whose failure could have systemic repercussions and which cannot practically be put into liquidation, and for which there are no potential immediate acquirers for at least their systemically important businesses. Resolving banks of this nature can present special challenges due to their size, complexity and interconnectedness with the financial system. Resolution of such banks can involve creation by government of a bridge bank into which the systemically important operations are transferred, and/or, to the extent possible, creditor financed recapitalization (so-called bail-in). As a last resort such banks might have be temporarily taken over by the government.

Consistent with the objectives of crisis resolution, a decision among payout/liquidation, assisted acquisition, resolution by other means, and takeover by the state should be based on an assessment of which is least-costly to the deposit insurer and state. Contingency planning should ensure that policies

and procedures for making a least-cost determination are in place, including ensuring that a full assessment of the potential future costs inherent in ownership by the state can be made. Putting these in place in advance should help to mitigate the risk that the supervisory and resolution authorities and government see takeover by the state as the least objectionable course of action in the near-term only to find it an expensive mistake in the long-run.

Contingency planning should ensure that the government is not forced to take over banks for lack of capacity to efficiently wind them up or otherwise resolve them. This requires that adequate legal foundations and well-defined policies and procedures are in place in advance. Contingency planning should ensure that legal powers, policies, procedures and financing would be in place so as to make winding-up a viable option.

In the case of payout and liquidation, it is important that the authorities have the capacity to rapidly pay, within a matter of days, protected deposits to prevent the erosion of public confidence that will arise if uncertainty about prompt payment is created. The supervisory and resolution authorities should work to ensure that such capacity exists, and be prepared to play their respective roles in the process.

Where banks are wound-up by means of an assisted acquisition, contingency planning should ensure that the deposit insurer or government has the capacity to transfer at least the protected deposits to a healthier bank within a short period of time. The supervisory agency needs to be prepared to fulfil its likely role in vetting the qualifications and condition of the acquiring bank. Under assisted acquisitions, deposits ideally would be transferred to a private bank. For this purpose, the deposit insurer and/or other resolution authorities can design bidding mechanisms, develop necessary contracts, and prepare step-by-step procedures for the tasks involved in transferring deposits. Lacking sufficient advance preparations they may be forced to transfer deposits to a bank already owned by the state.

Contingency planning by resolution authorities, supported by the supervisory authorities, is especially important to be prepared to resolve systemically important banks. This should take the form of detailed resolution plans that pick up where banks' own recovery plans left off, and which are routinely strengthened and updated. The ability to be able to resolve such institutions also requires having adequate legal powers in place to ensure the bank, or at least its systemically important businesses, is able to continue to operate will undergoing a restoration of capital, liquidity and profitability.

For the eventuality that a private sector solution cannot immediately achieved, the authorities should have basic policies in place for deploying and leveraging public funds. Contingency planning should include advance consideration and agreement among key government officials on the basic objectives and principles governing the use of public funds. These could include, for example, that:

- The amount of public funds used to effect bank recapitalization be held to a minimum and recovered to the maximum extent possible
- When public funds are used, there is a good probability that the recapitalized bank will quickly achieve sustainable profitability
- The public funds are used to maximum effect to attract strong management and governance expertise

While in practice these are complex issues and challenges, about which much can be written, in the simplest terms contingency plans should ensure that the government will be in a position to aggressively wield the powers it has at its disposal to achieve the objectives of crisis resolution. Governments should seek to leverage any use of public funds to attract new shareholders, especially strategic investors that bring needed expertise and substantial capital into the system.

When using public funds to support the restoration of capital, liquidity and profitability of a bank, it is essential that the government performs a “due diligence” exercise much as would a private sector investor contemplating an investment in a bank. Contingency planning should ensure this due diligence capacity can be promptly executed. Due diligence involves a more in-depth analysis than the assessment of banks’ condition discussed earlier, and will require additional skills and analyses. To support this work, it will be important that the government has complete access to information from the bank, and supervisors will have a role to play in ensuring access to and the accuracy of the information.

To be prepared for a decision to place a bank under temporary state ownership, contingency planning again should involve ensuring that adequate legal powers, policies and procedures are in place to execute the takeover. Contingency planning should also address how the government will leverage the takeover to help to restore confidence in the system while avoiding claiming that the bank has been fully recapitalized and restored to health at the time of the takeover. Making such a claim can complicate the process of privatizing the bank because the authorities will likely not know the capital needs of the bank or what actions are required to restore it to health at the time of the takeover. Subsequent recapitalizations, possibly in the context of privatization, can then prove politically difficult.

Managing and Reprivatizing Banks under Temporary State Ownership

In the course of resolving a crisis, the government may suddenly become the owner of banks – especially relatively large banks – that have become insolvent but will not be wound-up. The challenge facing the government and the supervisory authorities will be to avoid incurring new losses and to prepare the bank for resale. Depending upon the severity of the crisis, as well as other factors, the government may be the owner of the bank for a period of a year or more. To mitigate potential problems inherent in state ownership, the government needs to be prepared to exert sound governance over the institution and ensure effective management.

Contingency planning should involve identification of individuals or institutions that potentially can be called upon to manage banks under temporary state ownership. It should include consideration of the terms and condition of the contracts under which those individuals or institutions would be engaged on behalf of the government. Since ensuring that the bank is appropriately restructured can offer the best prospects of achieving the objectives of crisis resolution, these contracts should give managers incentives – financial and otherwise – to restructure the bank, reducing its cost base and building its profitability. This may involve key tasks such as shedding unprofitable businesses, closing unprofitable branches, reducing staffing and collecting and restructuring problem assets.

Establishing a Crisis Management Unit

If the scope of distress is limited, perhaps involving the insolvency of a small portion of the banking system, the supervisory and resolution authorities (the supervisory agency, the central bank and the deposit insurer) may be able to resolve the problem while keeping the finance ministry informed. At some point, however, the scope of the distress may overwhelm the normal capacity of the authorities. For example, taxpayer funds may be required or there may be the potential for banks to come under temporary state ownership. In such cases, the finance ministry must become more actively involved. Particularly if distress threatens to become systemic or reach crisis proportions, the top political authorities should operationalize or establish a crisis management unit (CMU), a special unit with responsibility for resolving the crisis and coordinating the activities of the permanent institutions of government. The CMU would report to the most senior levels of government (e.g. the President or the Prime Minister).

Governments should have contingency plans in place to operationalize a CMU because crisis resolution is in fact an extraordinary management challenge that can quickly overwhelm the capacities of the permanent institutions of government. Limits to their institutional capacity and weakness in coordination – sometimes including competition and rivalry – can undermine their effectiveness in dealing with a crisis and can prove costly. The CMU is a means to:

- Provide for full-time management of the crisis by an expert team;
- Coordinate the actions of the permanent institutions of government (supervisory and resolution authorities);
- Bolster their combined capacity by bringing to bear specialized skills. The specialized skills are similar to those required to deal with the bankruptcy of a large and complex private sector conglomerate, including managerial and leadership, corporate finance, and legal skills;
- Promote the ability of the government to speak with one voice on issues related to crisis resolution, which will be critical to its ability to establish credibility and restore confidence.

At a minimum, contingency planning should involve reviewing how the various permanent institutions exchange information and coordinate actions in the face of isolated problems. The authorities can further assess those mechanisms in the context of a simulation of the conditions likely to accompany a systemic crisis. The assessment should not be limited to formal information exchange and coordination mechanisms. In practice, much depends on the personal relationships among the heads of the agencies and the senior staffs, and the implications of these should be assessed as well.

Advance consideration should be given to the possible staffing and structure of a CMU. Appropriate staffing is critical. While the CMU would likely rely on senior staffs seconded from the permanent institutions of government, its top management team might well be drawn in part from the private sector. The CMU will have to deal with all the issues set out in this note, which in turn should influence considerations regarding appropriate structure in country-specific circumstances.

Finally, the authorities should make a determination of the nature of the events that would trigger the activation of a CMU. Governments must be prepared to avoid the trap of underestimating the dimensions of the problem and thus relying on the wrong institutional arrangements to deal with it.

Conclusions

To summarize, contingency planning should:

- Ensure that adequate legal powers, policies and processes are in place to deal with the failure of banks of all sizes
- Include advance consideration and agreement among key government officials on the basic objectives and principles governing any use of public funds for bank recapitalization;
- Ensure that policies and procedures for making a least-cost determination are in place, including ensuring that full assessment of the potential future costs inherent in ownership by the state can be made;
- Address how the government, as a last resort, will leverage a takeover to help to restore confidence in the system while avoiding claiming that the bank has been fully recapitalized and restored to health at the time of the takeover;
- Identify individuals or institutions that potentially can be called upon to manage banks under temporary state ownership;
- Include consideration of the terms and conditions of the contracts under which these individuals or institutions would be engaged on behalf of the resolution authority and government.

This note is intended to help the senior managers of supervisory and resolution agencies be better prepared to deal with widespread financial sector distress that might suddenly emerge in their markets. Equally important, a thorough assessment of crisis preparedness will likely reveal a number of steps that can be taken to actually mitigate the risks of crises. In implementing these steps, supervisory agency managers will have to mobilize the support of other key stakeholders to bring about the improvements being sought. The stakeholder analysis and change management tools of the Toronto Centre can be employed for this purpose.