CLEARING THE DECKS

EXPERIENCES IN BANKING RESOLUTION

--ARISTOBULO DE JUAN--

(A. de Juan y Asociados, S.L.)

Spain

CLEARING THE DECKS

TABLE OF CONTENTS

I. INTRODUCTION

I. The author was asked to write a "how to" paper for a World Bank conference. That is why I spell out a set of principles, rules of thumb and "do´s and don'ts" from different perspectives, on how to deal with the different aspects of banking crises. The result may be somewhat dense, as it may sound too assertive. But I do not mean to be dogmatic.

II. The numerous areas that had to be covered in this paper and their complexity have led me to give priority to concepts rather than to specific country cases. Although each concept I describe is backed up by one or more country cases, I have limited the number of examples I used because too many references would have made the paper confusing. Indeed, I made just a few references to the experiences of specific countries.

III. As used in this paper, the term banking crises assumes that they always involve deep insolvency, be they single bank failures, widespread crises or systemic ones. These are the reasons why the term crises and insolvency are often used as equivalents. So are the terms bank restructuring (to include bank closures), crises resolution and deck clearing.

IV. The doctrine about these concepts is growing deeper and richer, thanks to the international experience gained because of the crises occurred since 1980 on. My contribution is not that of a professor or an economist. Rather, it is that of a practitioner, who sees things from a micro perspective, has worked in bank pathology in a variety of countries over a number of years and has seen some resolutions succeed and many fail. This has led him to express concepts and refer to some successful cases that were contrary to conventional wisdom - sometimes even if only for the sake of debate.

II. LET US WELCOME FINANCIAL CRISES

BANKING CRISES AS A TRIGGER FOR AWARENESS AND REFORM

1. Countries "need a good banking crises" to ignite the engine and undertake serious banking reforms. This may sound like black humor, but, in fact, it is only when a country has a serious crisis that its government reacts thoroughly and addresses such key areas as bank restructuring and crises resolution. So, let us welcome financial crises, particularly if they are systemic.

- The soundness of a banking system is of paramount importance -not only for the payment system, but also for macroeconomic stability and growth-. The latter implication is a recent discovery for many. If the banking system suffers, a fiscal and monetary sacrifice may have to be made, as a trade-off.

- Systemic banking crises are generally triggered by macro upheavals, but they usually include many banks that, because of poor managerial practices, were previously insolvent. Insolvency may be blamed on macro mismanagement, but, to the extent the insolvency is timely identified, they should be given a rigorous case-by-case treatment, in order to avoid bankers bailout.

- Private sector solutions have their own merits. But, in actual fact, a realistic and effective resolution of banking crises require primarily government intervention and funding, in order to force banks to close or to restructure them for sale to or merger with sound investors. We live in a second-best world. Avoidance of macroeconomic instability requires a trade-off.

- Prudential regulation and supervision are necessary to prevent crises from happening, but they do not solve past crises and may prove of little use if no restructuring legislation and institutions are in place, even if on a stand-by basis.

- Excess borrowing often leads to illiquidity, through the relaxation of sound lending and recovery policies. Which, in turn, leads to insolvency and, then, to illiquidity. While insolvency and illiquidity grow deeper and deeper, they may remain hidden for a few years, due to poor supervision, cosmetic accounting and expensive fund-taking. At the end of the process, illiquidity ultimately comes to surface and you discover that the bank had been deeply insolvent long before. This illiquidity, in turn, makes insolvency deeper.

- If a crisis is really deep in terms of solvency, a wrong diagnosis of the size of the "black hole" will lead to inadequate treatment and to a waste of money and efforts. Actually, if crises are treated half-way, they are likely to repeat themselves, perhaps just a few years later.

- The later a crisis is thoroughly addressed, the more costly its solution will be. Losses will grow, sometimes even in spiral. And, ultimately, the government's vaults and the economy of the country in general will end up taking the bulk of the hit.

BANK RESTRUCTURING, THE POOR RELATIVE

2. The concept and techniques of bank restructuring, which has been advocated, alongside with regulation and supervision, have met special reluctance. It is taking a long time for them to be accepted and implemented in a realistic and effective manner. The idea that capital losses should be refilled with real money, at a cost for the government if need be, was a very difficult pill to swallow. And still is. Opponents of bank restructuring often used a magnified and sometimes unfocused concept of moral hazard, as a theoretical approach. Also lobbies oppose restructuring, because, if properly implemented, owners and managers would lose their investment and their jobs.

Many countries have undergone a serious financial crisis. Then, and only then, have they put in place –even if reluctantly- restructuring operations. All countries boast that they have restructured their banks, but this does not mean much. The key questions are: Were you successful? And, which restructuring operations worked satisfactory and which ones did not? Unfortunately, if we study international experience, we observe that many restructuring operations did not work: Restructured banks continue to be capital-insolvent and results-insolvent, even if capital improved to a certain but limited extent. Many operations lead to a stage of "muddling through", in the hope that the economy will grow and the financial system will grow out of the crises. Sometimes this may come true, but only when insolvency is shallow and economic growth is very quick and sustainable -not when insolvency is deep and the banks' capital has been lost several times, as is often the case. If so, the losses grow more rapidly than the economy. In the meantime, the danger of a liquidity crisis and a credit crunch will hang over the system.

The fact is that bank restructuring is "the poor relative" of banking reform. Many writings from academia and M.F.O.'s about the soundness of financial systems or banking reform practically ignore the concept and mechanisms of bank restructuring or water it down with a whole barrier of reservations. Also, much banking legislation do not cover bank restructuring at all, under the assumption that insolvency of individual banks does not require special treatment and that systemic crises should be treated by special emergency laws. In other instances, legislation addresses insolvency by way of just private sector mechanisms, namely recapitalization by the previous owners and through creditors' committees. But these mechanisms only operate satisfactorily if and when capital erosion is unveiled very promptly, thanks to strong supervision -not if insolvency is unveiled when it is already deep-. If such approach is applied to countries with weak regulation and poor supervision, the solution to insolvency and crises is most likely to be improvised, in a haphazard way, too late and sometimes through amateurish institutional and financial arrangements.

III. WE ALL DREAM OF SYSTEMS WITH LITTLE GOVERNMENT AND NO DECKS TO CLEAR

3. The market is supposed to operate efficiently by itself through tough competition; moderate spreads; good governance; good internal controls; transparency to the public; assistance from external auditors and rating agencies to that effect; rigorous interbank markets and self-regulation, as mechanisms for prompt exit, recapitalization of banks by the previous or by new shareholders and, in case of insolvency, closure of banks through bankruptcy or similar procedures.

4. But with some rare exceptions, life is not quite like that -definitely not when supervision is weak, insolvency is widespread, and political will to achieve a sound banking system is not strong and sustained over time. Let us not forget that policies that are good in times of prosperity may prove harmful in times of crisis or depression. Some reflections:

   - Good governance is always necessary, but if just good governance was applied to deep insolvency or illiquidity, it would be of no use.
   - Market discipline and rating agencies are also necessary. But, what happens if they are based on non-transparent information provided by problem banks in self-defense? Market discipline should work just as a supplement to prudential regulation and supervision. Not as a substitute.
   - Transparency is a clear objective, but what would happen if governments or banks, all of a sudden, publicized the deep insolvency of many of them? You would probably have to wait until the storm has cleared. In the meantime, transparency should be reinforced, but in a gradual manner.
   - Enhancing competition through licensing numerous banks is welcome as a concept, but is it wise to do so in times of crises? Shouldn't you establish a licensing moratorium? Also, what if most of the new licensees are businessmen whose ultimate objective may be taking deposits for self-lending? ¿Will real competition be fostered?

- Self-regulation is an ideal approach in theory. But, what if there is no transparency? What if this concept degenerates in a collective exercise of mutual protection against government intervention?
- Shareholders are responsible for filling in the capital gap. It goes without saying. But will they do so, if capital has been depleted several times? What to do then?
- Closing insolvent banks is a healthy and consistent approach, but is it the best recipe, if financial, social or political implications are likely to trigger off a general crisis of confidence?

5. The conclusion is that, in times of deep insolvency, the contribution of private sector to prevent and solve the core problems may be useful but, in fact, proves rather limited. Governments have to step in and -indeed- to clear the decks. It is only then that creditors' committees and private institutions specialized in mergers and acquisitions or asset disposal, etc., may prove a good supplement to achieve effective restructuring operations.

IV. OBSTACLES TO DECK CLEARING

FISCAL DISCIPLINE

6. When a bank is insolvent, the previous owner or new partners are supposed to recapitalize it. Otherwise, it should be closed, unless the government considers it is viable or its closure is expected to trigger a widespread crisis. There are also cases when governments adopt the general policy of never closing any bank. They may be utterly wrong, but they do adopt the policy anyway. So, let us suppose that the insolvent bank is not closed, for whatever reasons. Then, guidelines for alternative action should be in place.

   Rather than theorizing, let us mimic a typical dialogue between a government (G) and an advisor (A), which has been almost "transcribed" from real life by the author.

“(A) In case of restructuring, the name of the game is real capital. It is not a matter of loans, under any modality: last resort, refinancing, subordinated debt, etc. It is not a matter of debt equity swaps, financial engineering, etc. either”.

“(G) I understand that, but, mind you, the previous owners will always refuse to put good money after bad money.”

“(A) I suppose so. Close the bank then. Or, if you can not afford to close it, for serious reasons, recapitalize it with public funds. Then, make sure you write-off the previous capital first, in order to eliminate the previous managers and owners and thus avoid moral hazard. And, lastly, sell it to a sound institution.”

“(G) Great, but where do we get the capital to protect depositors (in case of closure) or to thoroughly recapitalize the bank (in case of restructuring)? There are no budget funds available and departure from fiscal discipline is a no-no. International organization would kill us. So, let us wait until illiquidity appears and, then, we can use the Central Bank’s last-resort facilities. Repeated rollover of short-term facilities may save us. They might even be repaid, sooner or later. Who knows? But never mind. Some experts or politicians do not worry about lending of last resort. They do not want to recognize that those loans may become a quasi-fiscal or even fiscal loss and mistake them for recapitalization funds.”

“(A) Sorry. Let me tell you that when illiquidity appears and stays on for longer than a few weeks, insolvency has probably been there for quite some time, is probably very deep and grows deeper and deeper. Lending of last resort is no solution. Neither is imaginative accounting or financial engineering. Please, do not use gimmicks. We are talking about real capital -be it injected as equity or via purchase of bad assets with loss assumption by a third party, usually by the government; be it by using cash or government securities-. Of course, we are talking about capital in adequate proportions in order to produce real profits and real positive flows”.

“(G) This is impossible. I said that printing money or increasing the fiscal deficit has to be ruled out. Having the Central Bank lending or incurring losses for these purposes is a deadly sin. There is only one way around the problem: You consider that insolvency is shallow by way of an upside-down approach. In other words, you may decide that the sum of estimated losses "cannot" be higher than the sum of funds you can make available for restructuring. Let us suppose they are equal. Then, you make some form of soft loans and put some nominal recapitalization funds into the bank, perhaps borrowed from M.F.O.'s. And, of course, you announce publicly -even abroad- that the problem is solved. This move will restore confidence, obtain foreign financial support and buy time -perhaps until the new elections bring in a new government-."

"(A) Then you are lost. Do not forget that, while insolvent banks hide their situation and remain artificially liquid, hidden insolvency grows in spiral, exponentially, with very detrimental effects: a credit squeeze, misallocation of resources, growth of the final bill to be paid by the government and moral hazard.

"(G) So, you think we are really lost? Or will economic growth solve things? This is what we believe. And, if so, the obvious recipe is to buy time. Our successors will know how to solve the problems."

"(A) Kidding oneself and doing nothing is the worst policy you can adopt. If insolvency is deep, the losses run like a rabbit. Simultaneously, economic growth may run like a tortoise. Improving the borrowers' repayment capacity takes a long time. In the meantime, I said already what happens. Do you not realize that the loss is already in the system? Actually, you are supplying a lot of capital under different forms: last-resort lending, refinancing of loans that were allocated to State owned companies, subsidies to the banks or to bank's borrowers. Why do not you form a package with all these forms of support and put it to a better and organized use to start with? Right now, you are having the cost, but not the benefit."

"(G) We disagree entirely. What you want is to bankrupt our financial system."

"(A) Wait a minute and listen, please. I am not bankrupting your system. Your system is already bankrupt, whether I say it or not. And whether you recognize it or not. What is at stake, among other things, is macroeconomic stability and growth, as well as the proper functioning of the payment system. And the later you act, the more costly it will be. All this is very important. “You can not make an omelet without breaking eggs”.

Maintaining macro-economic stability and protecting depositors (who, by the way, have being neglected by your poor supervision) has a price. There is no magic solution.

I invite you to do 3 things: First, FIGHT CONVENTIONAL WISDOM, in the fiscal and monetary areas. Second, use your IMAGINATION to mitigate, share and/or compensate –avoidance is probably impossible- the fiscal and monetary impact. And third, design INSTITUTIONAL CHANNELS that may ensure an effective restructuring operation.

POOR INSTITUTIONAL ARRANGEMENTS AND POOR COORDINATION AMONG PLAYERS.

7. When addressing a restructuring operation for the first time, the right institutions may not be in place and there may be strong hesitations about whether to act and about who should do what. These limitations may be due to conceptual question marks or to gaps in the regulatory framework. Generally, there are different institutions concerned: the Treasury, the Central Bank and the Superintendency of Banks. In addition, one or several specialized institutions are often established to deal with failure resolution. Lack of effective and expeditious coordination between all the above institutions is very frequent and constitutes an obstacle to address a restructuring operation and, needless to say, to good decision making. Sometimes, there are turf fights. Frequently, on the contrary, everyone wants to pass the buck, until the Central Bank is left holding the “baby”, who happens not to have any father. The topic of institutional arrangements will be revisited later in this paper.

LACK OF LEGAL SECURITY

8. Closing banks and recapitalizing insolvent banks with government funds implies having bank owners loose their investment and voting rights and having bank managers loose their positions. Sometimes, they may also be taken to court. Their interests and those of delinquent borrowers and a part of the staff are damaged. The defense of some of those interests often lead to legal action against the authorities,

be it civil or criminal, on alleged grounds of confiscation, inadequate asset valuation, discriminatory treatment, corruption, etc. The authorities need legal security by way of clear laws that provide solid ground for them to undertake the different measures that are involved in crises resolution, particularly in systemic crises resolution. Lacking of such legal security, the authorities may hesitate to take any action at all or may feel encouraged to avoid this obstacle by turning problems around. Among other things, the legal framework should allow for severance of owners and managers, for acquisition and sale of the bank shares and assets, for their pricing and disposal, etc…. Judicial procedures also need to be reliable and expeditious.

It goes without saying that the previous bankers should have adequate rights to protect themselves -preferably "post facto", because, otherwise, closing or failure resolution could be delayed, while more and more losses and disruptions occur-. In support of this statement, it can be said that the error of closing or restructuring banks due to a pessimistic diagnosis is most rare. Actually, in twenty years of hands-on experience in this area, the author has known of none. On the contrary, the error of leaving insolvent banks in operation occurs very frequently.

BANKRUPTCY AND FORECLOSURE PROCEDURES

9. Laws as well as judicial procedures in the areas covered in this paper are old-fashioned in many countries and not well-adapted to the specific nature of bankruptcy of financial institutions. Creditors may not be given the right priority or may not be well protected. Liquidation procedures may prove bureaucratic, extremely lengthy and make assets lose a considerable part of their value. Also, foreclosure on collaterals, a procedure that is supposed to protect the lender against delinquent borrowers is also cumbersome, protracted, leads to poor recovery and is sometimes subject to corruption. Bankruptcy and foreclosure procedures become serious obstacles to effective bank restructuring. New laws have to be put in place to radically reform the above norms and procedures. Judicial reforms are also strongly needed in many countries. However, this paper will not dwell on these matters, because they require a very long and complex coverage and would be out of proportion here.

V. SOME QUALIFICATIONS ON MORAL HAZARD

10. In many aspects of life, moral hazard is a very important concept. It forms part of human nature. It basically means that, if given the wrong incentives, people do the wrong things. When talking about financial systems, regulators should do their best to avoid moral hazard or limit it to a minimum. Moral hazard may derive from many aspects of a variety of government policies. But, sometimes, warnings about the risk of moral hazard in the financial system are unfocused or unrealistic, seen as a concept that indiscriminately haunts a number of aspects of bank regulation and restructuring. Qualifying this topic may clarify when moral hazard is a real danger and when it is not. This is very important, because when decisions on banking crisis have to be made in a government's board room at 3 a.m., stemming "the bleeding" becomes a first and foremost objective. Under those circumstances, avoiding moral hazard tends to be a second priority. To understand moral hazard, we first must distinguish among several kinds of moral hazard -bankers', depositors', creditors', borrowers', supervisors'. I will comment briefly on the elements that leads these players to moral hazard and which ones do not.

<u>BANKERS' MORAL HAZARD</u>

11. Bad bankers can be led to make risky placements or risky off-balance sheet operations, to incur fraudulent practices or to remain artificially liquid by paying high interest rates on their liabilities. This is particularly true if they are in trouble and want to gamble for survival or resurrection, which will happen if they are aware that the regulatory framework is poor and they have nothing to fear. But this will not happen if they feel a credible threat of government intervention, through which they may lose their investment, their financial instrument, their social pre-eminence, and may even be taken to court. Whether depositors lose their deposits or not is of secondary importance to bad bankers, unless it causes legal problems to them.

- <u>Poor regulation and supervision</u> make it possible for bank insolvency, insider lending and fraud to go unnoticed. And the damage will not be undone by severe remedial action, including fines, dividend suspension, mandatory capital write-offs, mandatory capital increases, closure of banks, etc., if these measures are untimely. To this effect, poor regulation and supervision do foster moral hazard.

But if, on the contrary, the regulatory framework is strong, it will be possible to identify and unveil problems promptly, to impose gradual provisioning and effective remedial action, make transparency possible, close banks, write off capital and force the owners and managers to leave the bank. If this is the case, moral hazard will certainly play no role.

- Deposit Insurance. Full deposit protection may certainly lead to moral hazard, especially if it is explicit. Ironically, this may also be the case when there is no deposit insurance at all, because such a situation often leads to full implicit protection. Be it explicit or implicit, full protection makes it difficult for regulators to close banks. It is too costly. In fact, in a number of countries with full insurance there is a tradition that banks are never closed. As stated before, bad bankers do not care too much about depositors, but about staying in place and be legally safe. But, being aware that their bank is very unlikely to be closed, they will be tempted to embark on risky practices.

  On the contrary, limited and explicit deposit insurance is no panacea, but it does protect modest depositors, who would have never been in a position to tell a good bank from a bad bank. It also limits the risk and the size of deposit runs. In the author's opinion, this kind of protection does not foster bankers' moral hazard because it makes bank closure easy. The threat of government intervention as described above, becomes more credible to bad bankers.

- Bank restructuring. Does it foster moral hazard? If restructuring consists of just recapitalization, while the old owners and managers are left in place, it certainly fosters bankers' moral hazard. If recapitalization is delayed, more or less indefinitely, for lack of funds or faulty institutional arrangements, moral hazard will also exist. But if restructuring is timely and capital write-off and removal of boards and managers go hand-in-hand with it, discipline will be reinforced and bankers will be very careful about the way they run their bank. There will be no moral hazard. The threat of Government intervention, here again, becomes more credible. The paper tiger becomes a real tiger.

- Last resort lending. If it is short term and moderate in size -just enough to cover occasional liquidity gaps which are normal in any banking system- there is no moral hazard in last resort lending. However, if the size of the support grows indefinitely and the maturity of the loans is indefinitely rolled over, there will be bankers' moral hazard. The bad banker knows that the Central Bank becomes more and more committed to bail him out, and his bargaining position becomes stronger. "Come on. It is too late", he may think. "Close the bank now, if you dare". The bad bankers and or their subordinates may even be tempted to use those funds for their personal interests. This may happen in any kind of crisis.

DEPOSITORS' MORAL HAZARD

12. If regulation and supervision are not capable of unveiling problems promptly, if deposit protection covers 100 percent of deposits and if governments never close banks, depositors will be led to place their money in those banks that pay the highest interest, with no further investigation. These are normally the worst banks. They pay high rates, because the deposits they take make it possible for them to survive and keep lending, by remaining "physically" liquid, while hiding their technical illiquidity and their insolvency. This is moral hazard.

    But, if regulation and supervision unveils insolvency promptly, if deposit insurance is limited to modest depositors and if insolvency leads to either bank closure or bank restructuring, decided on a case-by-case basis without a pre-established policy, there will be no moral hazard. There is one exception: Protected depositors may be led to make placements in risky banks up to the protected limit. But this is probably a lesser evil.

    What about depositors protection in case of bank restructuring, through the continuity of the bank or a purchase and assumption operation? There might be some moral hazard, but, here again, if restructuring is decided on a case-by-case consideration and closure remains a possibility every time insolvency is identified, moral hazard will be mitigated, because uninsured depositors are still at risk. At any rate, if restructuring operations are considered to be necessary -if compared with their alternatives- this kind of moral hazard may also be the lesser of two evils.

    Are depositors, with poor and unreliable information, ever in a position to tell a good bank from a bad bank? If we take into consideration that rating agencies, investment bankers, M.F.O.s and even supervisors, who have access to tons of information, also make serious diagnosis mistakes, how can we expect depositors to make the right decision?

CREDITORS' MORAL HAZARD

13. What is said about uninsured depositors is also valid for creditors in case of closure, when the creditors are protected through modalities of bank restructuring that allow for the continuity of banks. But if creditors are required to write off all or a part of their subordinated debt or their credits as part of the restructuring package, or swap them for longer-term debt or capital, creditors' moral hazard will be mitigated.

14. In systemic crises, particularly in large economies or in regions, lending of last resort also may foster moral hazard for creditors, if given in large amounts and very long term. Creditors will probably end up recovering their loans with their high-risk premium and assume that next time the same mechanism will apply. They will keep making risky loans to risky borrowers in the hope that the risk premium will cover the risk. But they should not forget that, quite often, operations with high-risk premiums may make the lender lose the premium, the standard interest and often the capital. In a few words, there is moral hazard. Eliminating the moral hazard here seems very difficult. But some suggestions to limit it could be: Make it clear that things may be different next time; try to make creditors take a certain hit; and close banks, when you conclude that they are not viable even if they received last resort lasting assistance. Additionally, if there is evidence of fraud, the fraudulent bankers should be sued.

BORROWERS' MORAL HAZARD

15. A good regulatory framework will lead banks to properly classify and duly provision bad debts. This will force them, in turn, to stop lending to bad borrowers and reinforce recovery, which will constitute a moral hazard deterrent for borrowers. Limited deposit insurance, which facilitates bank closure, as well as judicial recovery or liquidation of bad assets, may also be a deterrent. Restructuring, will also deter borrowers' moral hazard, if assets recovery and

liquidation is left with the restructured bank under new and strong management or if left with a specialized, efficient and strong recovery institution. Be it private or governmental.

But if the provisioning and income recognition requirements are soft, there will be borrowers' moral hazard. If asset recovery is left with previous bankers, with the Central Bank (which never recovers well) or even with a specialized institution with no proper staffing and incentives to recover, then, there will also be moral hazard for the borrowers. They will ask for more and more loans, even beyond their commercial or investment needs. At any lending rates. They are probably aware that they will never have to pay their facilities back. Borrowers' moral hazard also occurs when political interference puts pressure on banks to be lax on recovery of certain loans, which happens very frequently -but not only- with state-owned banks or state-owned enterprises, or where cronyism prevails.

A most dangerous way to borrowers' moral hazard occurs when governments impose mandatory write-offs or moratoria on banks vis-a-vis their borrowers' debts, across-the-board, or when governments bail out bankers with banks. A number of borrowers may feel morally freed from their commitments to the bank. "If the government solves the bankers' problems, rather than ours", they may say, Why should I repay?"

SUPERVISORS' MORAL HAZARD

16. There is no reason for supervisors' moral hazard, in a context where regulation is strong, analysts and inspectors are skilled and sufficient in number, enforcement action is effective and exit policies are realistic, based on proper institutional arrangements, and politically supported. But if there is no legal safety, no political will or no proper policies, funding or institutions to "clean up the decks", no matter how good the rest of the regulatory and supervisory framework may be, supervisors will have negative incentives to identify problem banks or insolvency situations. Because, if they do, "the baby" will remain in their lap with no solution ahead, and they will run very serious risks, including legal ones.

17. There is also supervisors' moral hazard when they are associated with the problems. Actually, when their previous action was lax or wrong, they will be reluctant to unveil problems that make their mistakes apparent.

VI. ALL RIGHT, LET US CLEAR THE DECKS

NO EXACT SCIENCE BUT COMMON OBJECTIVES

18. By now, we assume that self-regulation and the mere use of market procedures do not provide effective solutions to insolvency, be it individual, widespread or systemic. We also assume that the obstacles described in this paper can and should be removed and that it is generally accepted that ineffective resolution or no resolution at all lead to growing hidden and compound insolvency and to compound costs. We also assume that the authorities will not be able to honor the implicit contract they have with taxpayers and insured depositors to control the risk exposure of financial institutions, foster “good governance”, and prevent the undesirable externalities associated with systemic instability or crises. Therefore, decks should be cleared.

19. “Clearing the decks”, bank restructuring or banking crises resolution are no exact science. These names can be applied to closure, liquidation and rehabilitation. This kind of “business” is not made for perfectionists. A lot of “nasty” things have to be done, in order to complete successful operations. But they are less “nasty" than their alternatives.

20. There are two main objectives that are pursued by “deck clearing”: achieving soundness and avoiding damage.

    - The main positive goal is to build, at a minimum cost for taxpayers, a sound, competitive and well managed banking system, where only viable banks and good bankers stay in business. In other words: to be able to forget about the problem in the future.

    - The main damage to be avoided is:
        - Disruptions of the payment system
        - General loss of confidence, as a result of losses for depositors and creditors.
        - Misallocation of resources in favor of the worst borrowers or worst segments of the economy and crowding out of the most promising ones.
        - Increasing fiscal and monetary damage.

- Macroeconomic instability.

DIFFERENT TREATMENT FOR DIFFERENT SCOPE & DEPTH

21. As mentioned before, crises can be divided into those affecting isolated individual banks, those that are widespread in a system and those that affect the whole system, called systemic crises. In all three categories, deep insolvency and underlying illiquidity is considered to be a common feature. For the purpose of this paper, the concept of deep insolvency is construed as the loss of capital several times, as well as the existence of negative cash flows, whose mere financing at market conditions make insolvency deeper and deeper. If the owners or the market are not prepared to refill the stock of losses and reconstruct the flows, the underlying illiquidity comes to surface. Something urgent has to be done about the institutions concerned. The different kinds of crises will probably need different kinds of treatment, even if they have a number of features in common and if their borders are often blurry. Case-by-case treatment, across the board measures or a combination of both will be the basic choices.

22. Single bank failures. Closure is a generally accepted solution for single bank failures, unless the size of the bank involves the risk of contagion. If such a risk exists, rather than being closed, the bank is likely to be restructured on a case-by-case basis, through special institutional, financial and operational mechanisms. This is generally the case for large institutions which are considered to be "too big to fail" or "too big to be closed". But, even if the risk of contagion is not apparent to the public, governments may be aware that, there is wider underlying insolvency in the banking system and may avoid bank closure. Also, some governments may have a predetermined policy not to close any bank, in any case. Even if this policy is wrong, banks that failed in isolation will not be closed, but rehabilitated by means of special mechanisms. Those mechanisms should therefore be built in the legal framework, in order to enable quick and effective action, rather than leaving things to amateurish improvisation and poor coordination on the part of the government players.

23. Widespread insolvency. Here, a considerable proportion of a system –not all of it- is insolvent. Perhaps 20-50 percent in terms of the number of existing banks or 10-30 percent, in terms of total assets of the system. Widespread insolvency is not necessarily apparent, because losses may remain undisclosed for a long period of

time. Illiquidity may not be apparent either, because the actual negative flows are indefinitely funded with expensive short-term resources. One day, supervisors disclose insolvency in a bank or in a few banks, only when illiquidity appears and as a result of it. If the supervisor is aware that insolvency is widespread, while not apparent, closing those banks will not be the most frequent choice, except perhaps for small banks which are clearly non-viable. The risk for crises to become systemic crises if banks are closed is as serious as that triggered by the closure of big banks.

24. Although it is true that the later you treat a crises, the more costly it will be, it is not always possible to act early. Why? Because doing so would imply the treatment of all banks simultaneously, without necessarily having the necessary resources and expertise. Therefore, a clean-up operation over a period of perhaps 3-5 years is more likely. Is it more costly than one-shot operation for all the sick banks? On paper, probably so. But the one-shot approach, which is generally advocated by the author for each particular bank, may lead to many errors and higher cost, if simultaneously applied system-wide, due to lack of experience and proper institutional and financial arrangements.

25. Systemic crises. This is a serious problem nowadays. Systemic crises affect most of the institutions in a system. They prevent the system from performing its basic functions, because of the breakdown of payment systems, withdrawals of deposits and credit crunches. As noted before, the line between a single bank's insolvency and widespread insolvency is sometimes blurry, as is the line between widespread insolvency and systemic crisis. While deep insolvency is present in all three categories of crises, illiquiditiy affecting most of the banks is the special feature of systemic crises. Therefore, special mechanisms should be put in place to satisfy the liquidity needs and rein in "the wild horse". Additionally, other series of measures should be taken across-the-board, in order to improve the general flotation line of the sinking boat, i.e., the financial system at large. Of course, macroeconomic recovery is also necessary to solve systemic crises.

VII. ACROSS-THE-BOARD RESTRUCTURING FOR WIDESPREAD INSOLVENCY OR SYSTEMIC CRISES

A SUGGESTED MIX AND SEQUENCING

26. It is important to point out that, when you apply support measures to all banks, good and bad, you are being unfair and may be giving perverse incentives to bad bankers for wrongdoing. What's more, such support will become very costly. This is why, even in systemic crises, a case-by-case approach for diagnosis of individual banks -even if imperfect- should be a prerequisite for action and it is also why a many of the support measures themselves should be case-by-case oriented.

In this regard, I suggest the following approaches and sequencing:

- Try to build enough political consensus and announce some of the key policies you are going to apply in order to restore a certain degree of confidence. To this effect, information on an initial diagnosis is necessary. But, be aware that, in dramatic situations, excess information may trigger panic. And available loss figures initially will have to be multiplied by two, three or four to reach the real ones. Also avoid announcing policies and committing yourself prematurely to take measures that you may be unable to implement.
- Prepare and "sell" special emergency legislation to address the situation.
- First close or restructure the worst banks, which were already insolvent before the macro-upheaval occurred. Do not let bad bankers protect themselves and be bailed out on the claim that it was all the government's fault. Be aware that in most bank failures, poor management is a major cause.
- Apply last-resort lending to those banks that, in an initial approach, are not candidates for closure.
- Apply a combination of the across-the-board measures that this paper will suggest later.
- For banks that were not brought back to health by the general measures, but are viable nonetheless, follow the checklist of case-by-case arrangements that can

solve their individual problem. This will probably be done over a period of time, as losses of each particular bank are gradually unveiled.

27. Because of the blurry lines between individual and widespread insolvency and between widespread insolvency and systemic crises, both widespread insolvency and systemic crises will have to be treated not only with a mix of measures across the board, but also with many of the instruments and procedures described later in this paper for case-by-case resolution. Neither of the two packages should be considered without a cross reference to the other..

LENDING OF LAST RESORT

28. It is internationally accepted that one of the main central banks' functions is lending of last resort to temporarily illiquid banks. Textbooks say that this lending should be:
    - At higher than market rate, as a penalty to poor management and as a deterrent to moral hazard.
    - Short-term -ideally overnight money. Rollovers may be allowed, but up to a limit. Not more than 30 days? Up to 60 or 90 days, in exceptional cases? Some flexibility is recommended, but not too much.
    - Properly secured, through rediscount or collateralization of assets, which should be as liquid as possible.
    - Replaced as soon as possible by recapitalization funds, if the illiquid bank proves to be insolvent and a decision is made to recapitalize it, rather than to close it.

29. In systemic crises, this kind of support will have to be huge and be supplied directly by the Central Bank or by other sources. It may not necessarily meet the conditions that are mentioned above.

30. There are countries that recently have gone as far as to prohibit last-resort lending by the Central Bank. Other countries do not have such a legal constraint, but are just unwilling or unable to lend the huge amounts and at the terms that are required in a systemic crisis, without entirely disrupting monetary objectives short-term. In both cases, the need for foreign assistance, both public and private, may be unavoidable. Foreign lines of credit or special debt issues to be financed by

M.F.O., or foreign banks have been used as a solution by several countries in the past few years. Special domestic debt can also be used. These arrangements can prove effective to buy time, but one should not boast that the government is not providing such last-resort financing or is not suffering any monetary or fiscal damage. In other words: who is committed to repay the last resort funds ? Who is responsible for such contingent liabilities?

31. As indicated above, lending of last resort is applied to individual insolvent banks, to widespread insolvency and to systemic crises. Ideally, only to those banks that are not going to be closed. The problem is that in all these types of insolvency, supervisors do not always know from the beginning whether particular banks should be closed. Initial diagnosis are most often very poor and you can not wait until real losses are accurately identified. Loss discovery is a gradual and difficult process. Therefore, chances are that governments may be supplying last-resort money to banks that ultimately will be closed and those funds -or a part of them- may become a loss.

32. Another risk is that last resort support may “have to be” rolled over for longer periods and for increasing amounts. Then, governments may not dare to close the banks involved, lest they have to turn the loans in their Central Bank’s books into losses. Then, in order to remain legal, last-resort lending may be converted in another longer-term modality of lending, perhaps through refinancing of bad loans to state-owned borrowers or through subordinated debt. Or just, having the Central Bank’s support being replaced by loans from State-owned development banks, without due transparence. In those cases, long term -actually termless- lending may be mistaken for real recapitalization and the problem may be wrongly considered as closed. It will spring up again.

33. Let us consider cases when last resort money is lent beyond ordinary bounds to illiquid banks, and then a decision is made to restructure those banks. In such cases, the government should do its best to recover such moneys. Unfortunately, this is not always the case and those loans are partially or entirely lost. Three formulas applied by central banks in different countries to recover those loans are mentioned below:

- Swap them for capital and sell that capital later, once the bank has been restructured (as occurred in Chile)

- Swap them for subordinated debt, that will be reimbursed once the bank is restructured. If convertible, the debt can be swapped for capital and then sold. In the meantime, as in the previous case, that capital can be used by the government as a means of exercising influence on or control of the illiquid bank. (This was the case in Mexico).
- Make reimbursement of those loans a requirement for the future buyers to meet, as a part of the bidding that will conclude the restructuring process. (Spain's approach).

34. "Ersatz" formulas for last-resort lending have been used as an initial step to provide liquidity to the banks. One such formula is "directed" or "induced" loans made by sounder banks to illiquid ones, presumably with some kind of support or guarantee by the Central Bank. The rationale for this is that these sounder banks could have been the beneficiaries of "flight to quality" from the worst to the best banks and it is fair to have them return the flows. Another formula has been "directed" or "induced" purchase of illiquid assets by sounder banks, which has provided some liquidity to "dry" banks. Sometimes, though, it is at a cost: The price of such assets has been established by the buyer, who was a very strong bargaining position. These formulas do provide liquidity, but perhaps at an additional loss for the weak bank.

OTHER MEASURES ACROSS-THE-BOARD

35. Across-the-board measures -other than last-resort funding- can be chosen from among those listed below. They are just briefly described here, but could be the subject of a separate paper.

36. Lower reserve requirements and/or remunerate them. Lifting the government's tax -which is involved in freezing deposits to meet those requirements- is of help as a supplement of liquidity support and as a way to diminish current losses.

37. Withhold dividend payments for all banks. If most of them are loss makers, allowing dividend payments will further decapitalize them. And what you need is to see them recapitalized.

38. Block delinquent borrowers' deposits, if there are any left, at the time the crisis occurs.

39. Recapitalize state-owned-enterprises, to allow them to repay their debt to banks, fund bad loans made by banks to state-owned enterprises -not always voluntarily- and write off any previous refinancing against the loans that were made to those enterprises.

40. Arrange for roll-over of short-term foreign credit facilities

41. Provide foreign currency for banks to repay their foreign-currency borrowing, entirely or up to a certain limit, when lack of foreign currency was among the macro causes of the crises.

42. Carve out bad assets across the board as a proportion of each bank's capital. You can do it once or gradually, as the depth of systemic insolvency is identified. Some repurchase agreements could be established between the government and the banks, as an incentive for good management and recovery and for reduction of the cost to the tax payer. But the conditions should not be very strict in terms of proportions, price, and timing, in order to avoid perpetuation of problems and to allow for real rehabilitation. Strike a balance.

43. Reduce forced credit to economic segments that are otherwise unable to borrow. This is another partial way to stop the bleeding of liquidity and capital. Authorizing market rates for this kind of lending -rather than mandatory preferential rates- could also help banks diminish their current losses.

44. What about phasing-out requirements on capital, provisions, and income recognition? This is a deadly sin and could not be recommended at all. Particularly, in situations where the bank's or the system's predicament -i.e. its losses- is growing intrinsically worse, such policy is probably suicidal. But if governments, faced with a general upheaval, yield to the temptation to have recourse to phasing out those requirements, then, as a last line of resistance, a fundamental rule of thumb should be followed: There should be no free lunch, as explained below.

45. Governments should not give any assistance or allow for any forbearance to any bank, even across the board, without strictly requiring from them a full turnaround plan, in order to help control the damage the bank suffers. Such a turnaround plan should also be comprehensive and should include surgery measures in all key

areas: management, accounting, personnel, administrative expenditure, lending policies, recovery, pricing, etc.…The owners and the supervisors should watch over their design, their implementation and their effectiveness.

VIII. CASE-BY-CASE ACTION

CHOICE 1: NO ACTION

46. This can happen just by omission on the part of the government or by announcing explicitly that the government will take no action and will let the private sector sort things out. Sooner or later, the government will have to gear reverse and take some action.

47. Taking no action is the worst choice, but there are many reasons why this course may be taken.

    - Uncertainty as to the size of the losses and willingness to have a full and thorough diagnosis first. This is a rational approach, but may lead to an "analysis-paralysis" syndrome. An initial diagnosis is never thorough.
    - A fear to close banks as long as they remain "physically" liquid, because of the social and political implications of such measures.
    - An unwillingness to see the loss taken by depositors and creditors because of the risk of systemic contagion, and because of the underlying complicity of the governments in the lack of transparency to depositors and creditors.
    - An unwillingness or a lack of budget funds to take the loss derived from closure or rehabilitation. M.F.O.'s surveillance function supports full protection of government's budgets. This policy is rational and sound in itself, but may prove unrealistic and even counterproductive, if no exceptions are allowed for extraordinary crises.
    - An unwillingness to stop receiving taxes (and dividends in case of state-owned-banks) from insolvent banks that kept declaring profits.

- A poor regulatory framework, which may fail to typify the grounds and tools for enforcement of remedial action, including closure and forced restructuring.
- Poor supervisory mechanisms or staff, which may be incapable of identifying insolvency early, accurately or at all. This will certainly happen when bank examination does not work.
- Lack of political will, sometimes derived from the pressure of individual bankers or their lobbies. "Rather than addressing insolvency by having capital injected", they will say "let us just forbear on provisions and adjustments, while waiting for the economy to recover. Time will solve things up".

48. The implications of no action are very harmful. Here are some of them:

- Lack of transparency by way of widespread cosmetics, which is fostered by the government through poor supervision.
- Poor allocation of resources to the worst borrowers and segments in the economy -often "the old borrowers"- and crowding out of the best ones.
- Risky and speculative placements, as a common rule.
- Frequent corruption and fraud.
- An increase in the stock of losses due merely to financing of the current stock of losses.
- Increasing fiscal distortions, because the Treasury and/or the Central Bank will end up incurring losses. Do not forget that loans to insolvent banks on the C. B.'s balance sheet often result in actual losses.
- Lastly, serious monetary distortions will occur: Interest rates will get out of control, when bankers gamble for survival or resurrection and systemic crisis will bring about inflation, which is a burden for the society.
- Widespread Supervisors moral hazard and complicity in cosmetics.

CHOICE 2: BANK CLOSURE AND DEPOSIT INSURANCE

WHEN TO CLOSE

49. Closing Banks is the right thing to do. Shareholders, depositors, and creditors played a market game and lost. The survival of the fittest will be strong in the long

run. The problem is that the long run is made of a sequence of short terms. And short-term implications of banks closures may be very detrimental for the system and make the long-run horizon never materialize or delay it significantly. This may happen when the size of the bank is likely to produce contagion and a loss of confidence in the rest of the system. This may also happen in systems where banks are licensed to have industrial subsidiaries or when lending is heavily concentrated in industrial borrowers. Deciding whether contagion is likely to occur should be based on the information available, but also on judgment, because the available information is not necessarily reliable. Turning off the tap may also trigger serious labor and social problems. Another problem, as mentioned before, is that some governments -for good or bad reasons- may simply decide that they will not close any bank, whatever its size.

50. In spite of the above considerations, one should recommend that non-viable banks -no matter how blurry this concept may be in practice- and banks which do not render a necessary service to a given community or economic segment, should be closed. This is particularly true if they are small and the risk of contagion is not significant. Medium-sized banks should also be closed, as a matter of principle, but a decision may be made not to close them if, after a case-by-case consideration, a risk of contagion is found. Big banks, however, are special animals and killing them may have dangerous implications. Generally speaking, they will not be closed. That is why they are called “too big to fail”. Rather, they will be the subject of a restructuring operation, along the lines described in this paper for case-by-case treatment.

51. It is worth commenting on the concept of the “least cost”, as the criterion to decide whether an insolvent bank should be closed or restructured. The conventional rule of thumb says - for good reason- that the choice between the two options should favor the least costly one. But, what is the real cost of each option?. It is certainly not the difference between the market value of assets and liabilities in the books at the time of closure, minus uninsured deposits and credits. Why? In case of liquidation, assets loose their market value in high proportions. In case of closure, the cost of externalities –both quantitative and qualitative- may be very significant. Think of interbank deposits, domino effects, social implications... Also, governments may feel obliged to pay-off uninsured liabilities. And, in case of closure of universal banks, what will happen to their non-financial subsidiaries?.

Here again, the use of good judgement and a degree of discretion are necessary to reach a good decision.

DEPOSIT INSURANCE

52. Explicit deposit insurance, limited to deposits up to a certain sum, is a common feature in many banking systems. This is a way to protect small depositors, limit the risk of contagion, encourage closure of insolvent banks, make the threat of closure more credible to bad bankers and, thus, deter moral hazard. A growing number of countries have introduced this concept in their banking systems. The European Union has gone as far as to make it a mandatory mechanism for its member countries and also mandatory for all banking institutions in each country. No moral hazard seems to have ensued. Actually, mandatory membership is becoming a common feature of deposit insurance.

53. Deposit insurance mechanisms are financed by private financial institutions in most systems, which is a type of self-insurance. But when this funding proves insufficient, governments may have to join in and co-finance deposit protection through or outside this institutional channel.([1]) Financing is generally provided as a periodic contribution, annual or more frequent, by each institution, as a part of its overhead. In some countries, it is only provided as needed, not “ex–ante”. The periodic contributions vary for each country and for each particular situation and are frequently established as a proportion of deposits. The range may go from 0.05% to 0.3%. A range between 0.1 percent to 0.2 percent is more frequent. It can be lowered or raised over time, as needed.

54. Academics and government officials have widely debated whether the size of premiums should be risk-based -and therefore be different for each bank- as an incentive for good management. But very few countries have yet introduced this

2. [1] In 1977, Spain because Deposit Insurance was incepted in the midst of a crisis, it was decided that the Central Bank should initially share 50% of the financing, in order to avoid a further weakening of the system. Recently in the 90’s, the Central Bank discontinued financing the insurance mechanism, because the crises was over and the ordinary financing by the private institutions was expected to suffice to solve future problems. A new law was enacted to this effect, following a European directive.

concept, for a variety of reasons. Two of them can be mentioned here: First, lack of strong supervision and the difficulties of having a permanent, simultaneous and realistic diagnosis of the risk involved in the different banks may lead to unfair treatment, with a lot of potential implications, including legal ones. Second, the establishment of different risk based premiums implies publicity recognizing the existence of risky banks. When no proper resolution mechanisms are in place, such publicity may trigger a loss of confidence and make the situation worse. However, as a concept, risk-based premiums are generally accepted and are likely to be gradually established internationally, as the supervisory systems become stronger.

55. The deposit insurance mechanism may adopt several institutional modalities: First, just a Fund, normally with the Central Bank, which receives financing from member banks and pays-off the insured deposits. Second, a public legal person, governed by public or by private law. No matter who finances the insurance scheme, the responsability for establishing the premiums and managing the scheme lies with the government, most frequently with the Central Bank or the supervisory institution if it is separate from the Central Bank. After all, deposit insurance is inherent to the good functioning of the financial system. Management is ensured through a Board whose membership may vary. Government representatives are always present and should have the deciding power. Private bankers and other professionals may also be represented on the board.

56. Deposits are protected up to a limit, which may be established as a multiple of the minimum wage (generally 5-15 times), as a proportion of the total sum of deposits to be protected in the system, based on stratified statistics for different levels of individual deposits, or just as a lump sum. The European Union standard is now € 100.000.-, as a result of the current international crisis. Creditors, holders of hybrid debt and investors and managers involved in the bank deterioration are generally excluded from protection. Some countries also exclude term deposits and those deposits with a remuneration that is 2 percent or more above the average remuneration of deposits in the system.

57. A very important question, however, is what to do when the funds accumulated in the insurance institution are insufficient to pay off insured deposits of banks to be closed. The worst thing to do would be delaying closure. We all know by now the implications of no action. Better alternative options, of uneven merits, are:

- Increasing the periodic contributions of the member banks.
- Assessing a special levy from member banks, as an advance to the institution or as a loss.
- Have the institution issue debt to be covered by the public or, more likely, by all its members or by a number of them.
- Lending by the Central Bank to the deposit insurance mechanism, no matter how heretic it may sound. It would not be the first time this procedure has operated successfully in the past, particularly when the insurance scheme was instituted after the accident -the crisis- has blown up.
- Last but not least, particularly if the government decided to protect uninsured depositors, making exceptional budget appropriations might have to be considered. It would not be the first time this was done, either.

58. In some countries, as will be mentioned when dealing with case-by-case restructuring, this institution, other that just a deposit-protection function, accumulates one or more of the following responsibilities:
    a) bank restructuring, including capital injection, clean-up and disposal of bad assets;
    b) arranging for the sale or merger of insolvent banks;
    c) ensure “bridge” management and ownership until a sound new owner is found and an acquisition is arranged.

    This approach has proved effective in a variety of countries, because funding and decision-making mechanisms are common. In such cases, government funding becomes practically unavoidable. In the author’s view, the deposit insurance institution even if combined with a restructuring function, should never have a last-resort lending function, so that illiquidity and solvency funding have very a clear border-line, both conceptually and institutionally.

59. Another remark: except for the American F.D.I.C. deposit insurance institutions should not have a supervisory function in order to avoid confusion and poor coordination with other supervisory bodies. In fact, the supervisory function should always remain with the supervision authority -before, during, and after restructuring operations, including those of state-owned banks. Also, state-owned banks do not have to form part of deposit insurance mechanisms, because the banks’ depositors are explicitly or implicitly protected by their owner, i.e. the state.

60. As mentioned in Section IV, full deposit protection is by no means recommended. Neither is lack of any deposit protection, which often leads to full implicit protection. Both foster moral hazard all-around, as they make bank closure or restructuring more unlikely. This does not mean that, when full protection exists, it should be suppressed overnight, especially when the system is shaky. That could prove to be a shock to confidence. Rather, it should be phased out over a few years and be replaced gradually by a limited and explicit deposit protection.

CHOICE THREE: BANK RESTRUCTURING

THE R.O.M. PRINCIPLE

61. Bank restructuring is an alternative when failing banks are not closed and their assets are not liquidated after bankruptcy or similar condition. It can be addressed by a variety of procedures and institutions. But successful restructuring requires the application of what we can call the R.O.M. principle: R for Recapitalization; O for ownership; and M for Management.
    - **R**ecapitalization of the bank, or compensation for the difference between assets and liabilities, occurs when new owners are expected to buy the bank or its balance sheet.
    - **O**wnership means the exit of previous owners and entry of sound new ones. Systems and even individual banks could be bailed out, but bankers should not be.
    - Changing **M**anagement should ensure good governance the previous board and managers leave the bank and the new owners name replacements.

    The recapitalization should take care of the past problems, while the new ownership and management are expected to avoid future ones: Ensure good governance, make good profits -and end up paying good taxes-. It is not always easy to treat those three areas of bank restructuring thoroughly and simultaneously, but if there is political will and realism, a satisfactory level of efficiency could be reached.

TWO TYPICAL MODELS: A SUMMARY

62. The above objectives can be reached through different arrangements. The most relevant ones can be briefly described as follows.

- GOOD BANK/BAD BANK. The legal shell, -i.e. the shares of the insolvent bank- keep its assets and liabilities, as well as its staff. The equity capital is written off and an adequate level of capital is injected by a special restructuring mechanism. The capital write-off is supposed to deprive previous investors from ownership and control. As a result, the bank's management will also be removed. But, when insolvency is deep, huge losses still remain in the bank after the write-off, both in terms of stock and flows. Thus, in order to complete the recapitalization, the restructuring mechanism will have to carve out the bad assets and even assume other remaining losses to the extent necessary to make the capital true and make the bank profitable, as well. The bad assets and the package of potential losses constitute the so-called BAD BANK. The Bank that has been cleaned up becomes the so-called GOOD BANK.

- The BAD BANK will have to be subject to strong recovery action, which can be taken by a government restructuring institution, by a private assets management corporation, by the GOOD BANK itself (if commissioned to perform the recovery task), or by specialized private agents operating in the market
- A modality of BAD BANK takes place, just organization-wise, when bad assets are not carved out of the bank. They remain within the bank, and form a special "Work-out Department", with separate management. Also with separate financial statements, for monitoring and analytical purposes. But, under this arrangement, the loss problem is not solved, as it remains within the bank and will have to be balanced with new capital.

- The government has to put the GOOD BANK up for sale or merger as early as possible, ideally, through auctions or tenders. More flexible procedures can also be used to effect the sale, as long as they ensure sufficient publicity, competition, and neutrality. If this process takes long, some institutional "bridge" arrangements will have to be made to ensure temporary ownership and to monitor the bank management, while a new owner takes over. "Bridge" arrangements will be covered later in Sections VIII and IX of this paper. Because of the blurred lines between individual and widespread insolvency, and between widespread insolvency and systemic crises, both widespread insolvency and systemic crises will have to be treated not only with a mix of across-the-board measures, but also with many of the instruments and procedures described later in this paper for case-by-case resolution.

- PURCHASE AND ASSUMPTION. This formula presupposes that the shares of the failing bank are under the government control. We may be talking about:
  a. a State-owned bank,
  b. a previously insolvent bank, whose ownership has been taken over by the government through a special restructuring institution, or
  c. a bank, whose ownership rights have been legally frozen and whose balance sheet has been passed to a restructuring agency for receivership and liquidation.

  Whatever the form of control of the bank, sale of ownership of the shares to new institutions or to the public does not occur, although the bank's assets can be purchased and the matching liabilities assumed by a private institution. The assets purchase may cover only the good assets with matching liabilities. It may also cover all the assets, good or bad. If the latter is the case, the loss contained in the bad assets should be compensated by the restructuring mechanism. Otherwise, the buyer could not meet the liabilities assumed without incurring a loss.

- The purchase and assumption arrangement is easier to implement in developed countries. In less-developed ones, agreeing expeditiously on the market value of the assets or relying on independent market appraisers may prove risky or just impossible.

RECAPITALIZATION: OBJECTIVES AND INITIAL ATTEMPTS

63. The objective of recapitalization is twofold: First, the new capital in the books should become real (i.e. not eroded by hidden losses) and reach an adequate level as a proportion of risk assets. Second, profits and flows should become positive and real -i.e. not the result of fictitious accruals-. This requires a thorough identification of the real losses, both stock and flows. This task is not easy to achieve from outside the bank through external audits or initial examinations and

may prove to be a gradual and time-consuming discovery process. It only becomes an easier task once the previous bankers have gone or as a result of the bank's liquidation.

64. The owners of an insolvent bank are primarily responsible for its recapitalization. New solvent partners can also do it instead, provided they are screened by the government, as fit and proper. This could happen when supervision is strong, capital erosion is identified at an early stage and mandatory corrective action can be imposed gradually ([2]). This includes recapitalization of small capital "holes".

65. But experience says that, most of the times, the flaws in supervision do not make it possible to identify insolvency at an early stage, but only when illiquidity or fraud appear and the reality can not be hidden any longer. By then, the equity capital has been depleted several times. If so, the previous owners will hardly be able or willing to fill in the gap and also, no desirable new partner (strategic or otherwise) or potential acquirer will be willing to inject new capital or acquire the bank, without a previous clean-up of the losses. This is where recapitalization through special mechanisms becomes a must. Before or simultaneously, governments must try other procedures:

66. Stopping decapitalization must be the initial recapitalization measure. To that effect, transparent accounting should lead the bank to discontinue payment of dividends and taxes. Loss-making entities should not pay them. Loss-making bankers should leave, and conservative ones should be appointed to take their place.

67. Freezing or netting bad borrowers deposits, against part of their bad loans may also help. Of course, this measure can only be taken if there are any such deposits left in the bank at the time failure is identified.

68. Having uninsured depositors or investors take a part of the hit or swap their short term deposits for longer term ones is possible but not necessarily recommended. It would certainly diminish the direct cost of a particular restructuring operation in the short term, but it may also trigger detrimental consequences system-wide, such

[2] This is the objective pursued in the United States in the '90s by the Federal Deposit Insurance Corporation Improvement Act, which, if successful, would reduce the number of failures and the cost of their resolution.

as demonetization and capital flight. It may all depend on the size of the bank. And kill the future market of those products.

69. Creditors can take a part of the hit, through partial write-offs or swaps of short-term for longer term debt or for capital. The former will help diminish the losses. The second will reduce short-term liquidity needs. The latter will reduce both the loss and the liquidity needs. But there are concerns with this measure, too, especially as regards creditors'reaction for the future. This is one of the numerous reasons why it is so important to differentiate the treatment of shallow insolvency from that of deep insolvency.

CAPITAL INJECTION BY GOVERNMENT INSTITUTIONS

70. This is essential to any satisfactory solution to banking crises, if the previous attempts fail. Illiquidity may be reined in with last-resort lending. You may even put in place another kind of longer term lending. But, if insolvency is deep, the answer to a real capital loss is a real capital injection and/or removal of the loss. Capital injection should normally be done through a capital increase. Priority should be given to Tier I capital. In case of insolvency, subordinated debt is not a good replacement for capital, because, in fact, it is a loan. Even if convertible, until such a time it is converted into capital, it is still a loan. And, in any case, it always carries an interest rate, probably a high one. Removal of the loss from the bank happens when a restructuring mechanism purchases the bad assets and assumes their losses. The bad assets issue will be dealt with later in this paper.

71. When efforts to make the owners or new partners recapitalize the bank have been exhausted, the government should first attempt to obtain from the owners collateralization for the bad assets and thus reduce the losses it will have to incur. But if the bank has not yet been taken over, there is a risk that ultimately the collateral obtained will be financed by the bank, while still under the owner's control. It is important here to avoid protracted negotiations or there may be deposit runs and last-minute fraud that may further weaken the bank.

72. If restructuring is addressed as a GOOD BANK-BAD BANK operation, an initial step to be taken is to have the equity capital written off. This will eliminate the previous owners'economic and political rights. Their control on the bank will disappear. They should be the obvious candidates to take the hit, other than the

government. In addition to having the banker exit the bank, this measure will also write off the equivalent amount of losses. If this is not sufficient to solve the capital erosion, further recapitalization through assets clean-up will have to be done. At any rate, after the write-off, the bank's capital should be increased and replenished. The write-off followed by a capital increase is what many call an "accordion" or "concertino" operation, for obvious reasons.

73. How do you write off the equity capital? A strong and clear-cut legal mechanism, which authorizes the government to order the write-off or freeze the political rights of the owners, is a prerequisite. Otherwise, this formula may prove vulnerable. For lack of such legislation, several alternative procedures can be followed. Some of them proved effective in some countries in the past, but they are time-consuming and may prove legally vulnerable. ([3])

74. Who should inject the new capital? The alternative to recapitalization by the owner or by a new solvent partner is recapitalization by a government institution. It goes without saying that, when the state owns a bank, the capital injection should be

---

[3] As it shows several of the alternatives used in practice, the mechanisms used in Spain in its crisis of the '80s and in the case of Banesto, in 1994, are described here:

- For smaller banks, where one or a few investors had the majority control through the ownership of a large package of shares, the Restructuring Agency (Fondo de Garantía de Depósitos) negotiated with those investors. The objective was to have them sell their shares at a nominal price of PTAs. 1 per share. Negotiations were always harsh. Investors normally claimed that their bank was not insolvent and that the government's figures were utterly wrong. Faced with the evidence of hard figures, they ended up accepting the transaction. The growing illiquidity and headlines full of bad news, which began to leak, softened the investor's position. Once the Restructuring Agency owned the control shares, a small board and new management were appointed. The bank was then run by common commercial law, and the capital was written off.
- When ownership was widespread and acquisition of a smaller package of shares could not give the majority in shareholders meetings, the Central Bank would remove the board of directors and appoint other bankers as new board members. A move for which the law had given it clear power. The new board, in coordination with the Central Bank, would then convene a shareholders' meeting, explain the real situation of the bank and obtain approval for the capital write-off, followed by a capital increase, to which the previous owners would have limited or no access. Because it was rather hard to ask the minority shareholders to vote for an action in which they would lose their capital entirely, some kind of "sweetener" had to be found –namely reducing the value of each share, not to zero, but to a fraction of its par value. This, plus announcing the restructuring plans and inviting the shareholders to participate in a more promising future than closing the bank, worked the miracle. The proportion of the original shareholder's stake in the bank capital would suffer an overwhelming dilution.

done by the Treasury, whether insolvency is shallow or deep. The Treasury should also clean up any additional losses that may remain in the bank after the write-off, before privatization follows.

75. In privately owned banks, an initial alternative to consider is a deposit-insurance mechanism, funded by the private sector, when given additional responsibility for recapitalization of banks. Its funds would then be used to pay off insured depositors in case of closure or to inject capital in insolvent banks when rehabilitation is considered to be a better choice. The Treasury, however, would keep a subsidiary funding role, when a decision is made to protect uninsured depositors of closed banks, as a lesser evil, or when funding from the private sector proves insufficient to pay off depositors or undertake restructuring.
When this mechanism does not apply, but governements have to step in as a second-best alternative, the Treasury has to be the primary source of funds, both for the capital injection and for the assets clean up. Then, the funds should come out of the budget, in a transparent manner.
Sometimes in the past, no matter how heretical it may sound, the capital was injected by the central bank directly or through a restructuring institution. This formula was successfully in a number of cases ([4]), and if applied again, it may be done as a bridge to the budget.

76. There are however ways to have the loss shared by other players. Some of them have already been described and will just be enumerated now:

- First and foremost, the owners will have to loose their investment. In addition, they should be required to offer collateral of their own to reduce the loss derived from bad assets.
- Some uninsured depositors and creditors might on occasions take a partial hit.
- Delinquent borrowers will have to reimburse their borrowings to a larger extent than they expected, if proper assets-recovery mechanisms are established.

77. <u>What to do, when there are no funds available</u> ?. Although the best ways to share the loss will have to be sought, the problem will still be so serious that governments should address it head-on and use special budget appropriations. Bridge loans from MFO, foreign government, foreign banks, the Central Bank, etc,

[4] Spain applied this formula and went as far as to have the loss taken by the central bank. Of course, the Treasury ultimately took the loss from the central bank, by way of lower dividends.

could also be considered, because prompt funding of the restructuring operation becomes a must. Some reflections in this respect were made in Section III, as a part of the dialogue between a government and an adviser, but are recapitulated here in a more structured manner:

- The loss is already in the system.
- If the government does not want to pay the bill today, it will end up paying a much more expensive bill in the future. The losses of insolvent banks keep growing, sometimes in spiral, even if only by the refinancing of the previous stock of losses.
- While reluctant to recapitalize banks, many governments keep indefinitely incurring losses to help out problem banks through subsidies, liquidity support, guarantees, hidden funding by official development banks, refinancing of bad debts to state-owned companies, etc. If such assistance is quantified, isolated, and put to better use for specific and well-organized restructuring operations, a part of the problem could be resolved. Otherwise, governments have the cost but not the benefit. Any loss is a good loss –if it is the final loss.
- A certain proportion of the losses incurred in successful bank restructuring by government will later be recovered if the banks return to soundness and start paying taxes.

78. How will the capital be paid for? Special care should be taken to limit fiscal and monetary disruptions.([5]) The most typical way to do so is to pay with government securities, so that those disruptions are limited to the interest payments, during the

[5] There are countries where, contrary to this statement, the recapitalization of failing banks that were not closed, including the assets clean-up, was paid in cash, through a restructuring agency. This was the procedure applied in Spain to solve its banking crisis of the '80s, as well of that of Banesto, the fourth largest Spanish bank, in 1994. Because of its fiscal and monetary implication, this procedure is not to be recommended, unless other measures are simultaneously taken to spread it over time and compensate inflationary effects. Such measures were taken in Spain. The restructuring funds were available on D-Day, in cash, but the fiscal loss was spread over a number of years and inflation diminished. How?. The restructuring agency was funded 50/50, by annual contributions paid by the banking system and the C.B., plus loans from the C.B. But these loans were fully reimbursed by the agency with the proceeds of assets recovery and with the surplus produced by annual contributions, after the crisis was over. The C.B. losses, then, materialized in its annual contributions over a period of 13 years. As for the monetary implications, while large sums of last resort and restructuring funds were poured in the market (from 1978 through 1985), inflation went down from 25% to 9%. An effective open market operation mopped up excess liquidity on the market and a tax reform and better collection procedures were put in place, which increased considerably tax income for the Treasury. Also, budget adjustments and a rise of reserve requirements, except for banks under restructuring, helped.

securities term. The redemption of the principal will have an additional impact on maturity. If maturity of the whole principal is left for the end of the term, the impact will be one-shot and could be difficult to take. If the size of the impact is large, governments may be tempted to extend the maturity period and even convert the securities into perpetual debt. Therefore, gradual redemption is advised, so that the hit is taken evenly over a long period of time. Perhaps 10 to 20 years.

79. Ideally, the government securities should be <u>tradable</u> -at any time or over a previously established time schedule. The government may prefer not to have a diversified base of claimants upon maturity. But it should be recalled that insolvent banks are also illiquid and they need liquid assets to recover their lending capacity. Once the restructured banks have been sold to sound investors, trading the securities for cash on the market does not seem to involve a special risk, but provides the Bank with liquidity to resume normal lending.

80. Precisely, because of the bank's need for liquidity, zero-coupon bonds are not effective instruments for bank restructuring. Also, holding payment of interest on those bonds until maturity of the principal may make the temptation to postpone the maturity date longer. Therefore, interest rates should be paid in cash, periodically, one or more times per year.

81. Insolvent banks not only have a stock of losses, but also current losses. Therefore, interest rates should not be lower than market rates. If governments really want to have the banks and the banking system come back to soundness and be able to forget about those problems for good they should not be shortsighted. These interest rates can have a variety of parameters:

- Same interest rate as the average deposits should be ruled out, because there would be no margin between those assets and the average liabilities.

- Treasury Bills rates is a very common standard and is conceptually correct. However one has to consider if the margin above the average cost of funding may be low or even negative -i.e. insufficient to turn the red figures into black. It is all a matter of proper financial analysis.

- Average lending rates applied to ordinary borrowers would definitely favor reasonable margins and would be consistent with the purpose of bringing the formerly failing banks back to normal. Of course, those rates could be slightly lower, because the government securities do not involve the same risk as ordinary borrowers.

The higher the rates, of course, the higher the fiscal and monetary impact. But, economies should be considered in a long-term perspective.

CARVING OUT AND DISPOSAL OF BAD ASSETS.

82. Removing bad assets from the bank is, in fact, the key tool for recapitalization, because ordinary capital injection will seldom be sufficient to wipe out the stock of losses and make the bank profitable. Later disposal should follow, with one objective: To minimize the cost of the restructuring operation. Both functions are normally performed by special restructuring institutions.

83. Which assets should be purchased? Priority should be given to the largest and worst assets. By doing this, a large proportion of the loss will be removed and the recovery institution can be better focussed than if assets are small and very diversified. Assets of any kind could be bought: loans, investments, fixed assets, foreclosures and, for universal banks, even subsidiary companies. Responsibility for guarantees and lawsuits may also have to be assumed. Historically, real estate is, by far, the main bad asset to carve out and liquidate.

84. Three models have been successfully applied in a variety of countries for assets clean-up:

- Bad assets are bought at book value or rather, at book value minus existing provisions. Therefore, the price of the assets to be carved out is always higher than the remaining losses, because not all of those assets are a 100 percent loss. The unprovisioned loss hiding in those assets will have been removed. The law governing the restructuring institutions should make it clear that they are allowed to assume losses. Actually they would not operate effectively if it did not make losses. That is what those institutions are there for. Otherwise, the losses would be left with the bank. Then, they should be unveiled and the capital gap should be immediately covered with new capital injections. Of course, these losses should later have to be minimized through effective recovery and liquidation.

- Bad assets are bought out of the insolvent bank at market value by the restructuring institution, be it official or private, with the purpose to sell them at the best possible market price and try to make a profit ([6]). By buying the bad assets at market value, the losses are left with the bank. Then, as a part of the same package, another government arm, probably the Treasury, through special budget appropriations, will fill in the gap with capital. This formula mimics market mechanisms and has worked well in some developed countries. But, if applied in less mature societies, with weaker institutional frameworks, the establishment of a market value and the necessary due-diligence to be performed later could give rise to litigations with the previous owners, the potential postponement of urgent action, and even judicial decisions that may even block the restructuring process.

- There are cases where bad assets, with their hidden losses, were bought directly by the Central Bank at book value, against special government securities ([7]). This is a very debatable procedure, because Central Banks are supposed to stay away from financing restructuring operations. However, this move stemmed the bleeding of the system and, while not without problems, made the banks' recovery possible. The bad assets were taken directly by the Central Bank, but their recovery was left to the cleaned-up banks. And a condition was set: No such bank could pay any dividend until it had repurchased the unrecovered bad assets from the central bank out of its profits.

85. Who should pay for the assets clean-up and how? All that was said about capital injection applies here.

86. Institutional arrangements. This function is usually carried out by the same institution that handles asset disposal. A brief description of the most common alternatives follows:

- The deposit insurance institution is one choice, when it given additional responsibility for bank restructuring, including capital injection, clean-up and

[6] This is the Scandinavian model.
[7] This happened in Chile in the mid '80s.

disposal of assets (see Section VII, choice 2,). To avoid repetition, this arrangement is just enunciated here, but has worked satisfactorily in a number of countries.

- Another special restructuring agency, separate from the deposit insurance institution, may be set up to carry out one or two of the following functions:

- To inject capital and also to buy and dispose of bad assets. This model tends to be embodied in government institutions. Because decision-making and the source of funding are common, bad assets should be bought at book value minus reserves, in order to limit capital injection to a commensurate capital adequacy level.

- Just to purchase and dispose of bad assets, but not to inject capital. Asset purchase and disposal can then be done by either a government institution (such as the RTC in the United States) or by private asset-management corporations, supervised by the government. In the latter case, assets are bought and disposed of at market prices. The staff is given incentives for successful recovery and these companies are liquidated when they complete their task.

- A Special private company may be set up by a bank or a group of banks, to locate their bad assets in its balance sheet. Such company is actually a subsidiary of those banks. Its purpose is to segregate those bad assets from their own balance sheets, have a specialized recovery function isolated from their ordinary banking activities and perhaps facilitate the follow up of the financial performance of this function. So far, so good. But to the extent that those bad assets in the new company are financed by the mother bank(s) from their own resources (through capital and/or loans), the loss is not carved out of those banks and financial restructuring is not achieved. Actually it should be consolidated in their parent banks' accounts.

87. Assets disposal, other than by a special agency, can also be performed by:

- The insolvent bank, when the bad assets remain in its portfolio and the loss is made up for by the government with just capital injection.
- The insolvent bank, when commissioned by the restructuring institutions, for reasons of effectiveness and against an incentive.

- Market players -specialized investment bankers and recovery institutions- that may have bought the bad assets from other players or may have been commissioned by them to perform that task.

88. Principles on assets disposal. Effective asset disposal is a very important part of bank rehabilitation, in order to minimize its cost. Here are some principles:

- Doing it from an institution that stays away from the bank and is staffed with skilled recoverers will make it easier to resist borrowers' pressure for further lending and soft debt rescheduling. This formula will also allow the new management to concentrate his staff and managerial time on the future.

- Conventional bankers or easy-going lawyers and mere administrators are not necessarily good recoverers or liquidators.

- Contrary to the doctrine whereby insolvent banks should keep the bad loans and swap them against the borrowers' capital, as a way to be active or even lead the borrowers restructuring and thus diminish the bank risks, let banks be just banks. Actually, experience says that: a) the borrowers' capital is not necessarily a lower risk than its ordinary debt, because, by itself, the swap does not improve the borrowers' operational health; b) being a participant in the borrowers' s capital and in its board may lead to a higher risk, because the bank "gets involved" and is likely to be tempted or pressed to extend new lending facilities in order to avoid further "difficulties" on the part of the borrower; and c) bankers are not necessarily the best industrial managers or supervisors and may prove poor restructurers.

- Avoid to the maximum extent possible new financial facilities by governmental restructuring institutions to enhance the bad assets. Those institutions are there to achieve recovery and make bad assets liquid, within as short a period of time as possible, not to embark on entrepreneurial activities. This may lead to incur further risks. The case may be different for private restructuring companies, if they can find proper private funding.

- Give priority to time over price for disposal purpose. If they are in conflict, give consideration to the compound cost of financing frozen assets for a long period of time. Projections on the potential favorable evolution of prices, unless short-term and done very well, are just projections. And avoidance of lowering market prices by dumping a mass of given assets -real estate for instance- is not the problem of the restructuring agency.

- Debt rescheduling should be aimed at improving the recovery prospects, not at just kicking the problem forward. Therefore, it should be conditioned to: a) simultaneous payment of a part of the debt, b) reinforcement of guarantees, and c) corporate restructuring on the part of the borrower.

- Commissioning recovery of bad assets to the bank where they were purchased from can be a satisfactory exception to the principle of carrying out assets disposal away from the bank. In this case, give incentives to the bank for effective recovery. This exception can be applied in the following cases: when the restructuring agency is not strong enough and the new owner is properly staffed and managed; when assets are very small and diversified and recovery by a branch network may prove more effective; and when the former relationship between the borrower and the bank was not “cozy”, but strictly business-like.

- If there are competent investment banks or other specialized private institutions on the market that can assist in the disposal process, seek their assistance. They can play a role through well-restructured work-out plans, careful monitoring, assets securitization and handling of liquidation. But contractual conditions should watch over the assets owner’s interests in an effective manner.

- Maximizing recovery is a basic goal, but one should have no illusions about quick and profitable disposal of bad assets, except for the best ones. As a rule, they are of poor quality and have serious documentation problems that delay liquidation considerably.

- The government should not make write-offs mandatory, be it for specific borrowers or across the board, for given economic segments or types of borrowers. Mandatory write-offs involve “moral hazard”, both for the borrowers that profit by it directly and for other present and future borrowers. They are given a perverse incentive to borrow more money than they need and not to repay it. Write-offs, should be left to the good business judgement of the recoverer, to the extent they make recovery of the remaining debt easier.

IX. NEW MANAGEMENT: A KEY ELEMENT FOR GOOD GOVERNANCE

89. If a government really means to reconstruct the soundness of a bank or of its banking system, recapitalization should go hand in hand with change of management. This will have be done for the sake of justice, to avoid repetition of the past bad practices, to ensure good governance in the future and to avoid moral hazard in the restructured bank and in the system overall. Change of ownership (see Section IX) is a very frequent prerequisite for new management, except in state-owned-banks. As was said before, recapitalization will take care of the past. Change of management and ownership will take care of the future.

INITIAL AND FINAL NEW MANAGEMENT

90. A lot of changes may have to take place as soon as the insolvent bank is taken over. Starting in the key positions: The board and the chief executive officer are the top priority. If the new ones are good, the rest of the required changes will probably follow, although other changes -in such positions as internal controller, chief accountant, chief lending officer, and chief recovery officer- also should be given priority.

91. What kind of new managers are best for the initial stage? Except for short-term tasks, avoid inspectors, interveners, or conservators. They may be good administrators, but they are no real managers and might freeze the banks. Focus instead on professional managers, but not on conventional bankers. Rather, the new managers should be "war generals", oriented toward restructuring, because there is a lot of internal "surgery" to be done. And special courage is needed. Disclosing the real losses, strong recovery, branch closing, discontinuing unprofitable products, laying off personnel, reducing other operational costs, changing interest-rates strategy, etc.-all require a special personality.

92. Only after these measures have been successfully applied, can you aim at ordinary good governance to be applied by “peace generals” -i.e. conventional managers.

93. Final new management is to be ensured by the acquirer or strategic partner of the GOOD BANK, in a restructuring operation or by the acquirer of assets and liabilities in a purchase and assumption one. When a state owned bank is privatized to the public, the government should make sure that good management has been put in place before and has proved to be stable for a reasonable period of time.

WHERE TO FIND NEW MANAGEMENT?

94. In countries where banking is a mature sector and there is a good and deep banking managerial class, new managers can easily be found on the banking market. But when the professionals available on the market are scarce, there is a problem. If so, recourse to a variety of solutions is needed, in isolation or as a combination. Remember, though: There are always some good bank managers on the market. These are some categories in which to look:

- Expatriates or just foreign bank managers.
- Managers from the industries or service companies or even from the government, to a limited extent.
- Middle managers up from the ranks from the very restructured banks.
- Individual acquired through management contracts or twinning arrangements with sound banks. This has been tried in former socialist countries in Europe. These arrangements can be offered to good banks, against a fee and against the chance to observe the bank, the financial system and the economy before they get more involved. The results have been uneven.

The real way to implant good management is to sell the recapitalized bank to a sound investor -if possible, to a bank. A sound new owner will be very keen on appointing good management, in self-interest.

BRIDGE CARETAKING

95. Other than final management, initial new management, as described above, may also be ensured by an acquirer of a GOOD BANK or by that of assets and liabilities, when the take-over operation takes place shortly after insolvency is addressed by the government. But, most frequently, there is a time lag until new

owners come in. This interim situation may “freeze” the bank and cause serious damage to its assets value and to its future commercial development, if reactivated. Putting in place interim arrangements to ensure bridge caretaking and, thus, good management becomes a must.

96. Let us briefly describe a variety of arrangements and pass judgement on them:

- <u>Keep previous managers, but send inspectors with veto powers</u>. Physical presence and veto powers involve a very serious responsibility, but they can not avoid wrongdoing by the previous owners, even if they sit next door to inspectors. It is also obvious that this arrangement does not involve recapitalization by itself.

- <u>Have interveners or conservators replace former management</u>. They may help set accounts and internal controls in order and even administrate the banks. But appointment of interveners and conservators should not be considered as a solution in itself. First, they are not managers and should only be in place for a short time. Otherwise, after a while, the bank may deteriorate further. Also, this measure, by itself, does not involve recapitalization either.

- <u>Temporary nationalization</u>. This measure is included under the “bridge caretaking” concept, because it has been used by some countries in the past as a lesser evil to address insolvency temporarily. But this measure does not necessarily bring about effective management results and goes against sound competition and modern banking. If nationalization were to occur at all, it should last for a very short period of time. Actually, holding ownership of banks might prove an attractive situation for some governments and some ministers. It means power and may prove enjoyable -like having a toy-([8]). That is why reprivatization should be addressed as soon as possible.

- <u>Have new board members and managers appointed and supervised by the government</u>. This is probably the best solution. In theory, the appointment may

[8] In Spain, the Rumasa Holding company owned by a single family, owned 20 banks that went insolvent. Because the usual restructuring procedures could not be applied to the holding company or to 20 banks, one by one, the Government decided to nationalize the holding company. By that doing, it took over the whole banking group plus the holding company’s more than 200 non-financial subsidiaries. A special emergency Law was required to permit this move. This Law also required that the nationalized entities would have to be privatized in a short period of time. Actually, privatization of all banks took place a year and a half after the date of nationalization.

be made by either the Ministry of Finance, the Central Bank, the Bank Superintendency or the Restructuring Agency, as may be established by law. If the new management is strong and reliable, just some remote-control and normal banking supervision are required. But some qualifications should be made about the different government institutions that can perform it.

- The Ministry of Finance should appoint boards and managers only in state-owned banks. But Ministries of Finance are not necessarily good management monitors. Additionally, they may also feel the temptation to assume a supervisory function while, on the contrary, prudential supervision should be applied to these banks by the supervisory institutions.
- The Central Bank may have legal powers to appoint new board members and managers in private problem banks. But central bankers are not necessarily good at bank management. They may not even be supervisors. And, as a matter of principle, Central Banks should better stay away from involvement in bank management.
- The Superintendency of Banks, be it located within or outside the Central Bank, could also be responsible and capable of appointing new boards and managers. They are not managers but they can do some reasonable monitoring work. There may be conflict of interest between appointing management and controlling their performance from a supervisor's perspective. This is a constraint, but not necessarily and impediment, for lack of alternative arrangements.
- The Restructuring Agency, including the deposit Insurance institution, when given restructuring powers, proves a good choice, when they assume temporary ownership of the problem bank through capital injection. Handling ownership and management together makes sense. Also, this kind of institutions have more flexibility to be staffed with bankers. If so, they could monitor the banks' management properly. They could also ensure that uniform "surgery" measures and best practices are applied to the different banks under restructuring.([9])

[9] This is the formula that was applied in Spain in the '80s to ensure effective management of the 49 banks that were taken over and restructured until they were sold. It was called the "bank hospital" by the Press.

X.- NEW OWNERSHIP

EXIT OF FORMER OWNERS

97. As has just been said, the key to lasting new management and good governance is change of ownership. Anyway, the first thing to do -before recapitalization by government institutions- is to have the former owners exit the bank, which is always a difficult task. The ideal model is writing off the capital based on proper legal grounds. This can be achieved:
    - By mandatory instructions from the government.
    - By approval of the shareholders meeting. The former owners are unlikely to convene such a meeting. This will probably have to be done by an interim board appointed by the government.
    - By freezing the owners' rights, while the banks are being liquidated or sold to new owners.

98. Other models are also applied, for practical reasons, if legal or factual difficulties for a write-off operation can not be overcome. But, in a way, they are shareholders-friendly and should not be given priority. Here are some of them:

    - Capital dilution is a scheme by which capital is not written off, but a large capital increase is approved, at government initiative, and the previous owners are not allowed to participate. The previous owners keep their previous shares, but the value of their investment and the proportion of their voting rights drop sharply. They loose control of the bank.

    - Acquisitions of insolvent banks by solvent ones, before restructuring can also be an effective way to see the former owners exit and loose control. If the bank is insolvent, the price should be negative, but in order to see the operation materialize and see the bad banker exit, a nominal price may have to be agreed to by the buyer. What about good will? Loss-making banks are not supposed to have any good will. Anyway, these acquisitions should be monitored and authorized by the supervisory authority. The acquirer bank should inject new capital into the acquired bank, but the government should clean up the bad assets to avoid serious problems for the sound bank. An exception to full clean-up, as a prerequisite, could be considered when the buyer bank is sound and large and the acquired insolvent bank is very small.

- Mergers before restructuring can be another way to see the former owners of insolvent banks lose control, provided that the other merging bank is larger and solvent and that proper management agreements are reached between the two partners. If realistic terms for the exchange of shares are established, the former owners of an insolvent bank should loose a considerable part of their investment share. This is a further reason why these agreements should also be monitored and authorized by the government. Recapitalization -including assets clean-up- should also go hand-in-hand with any merger where one or two of the players are insolvent, along the lines that have been mentioned for acquisitions. Otherwise, a bigger problem will be created.

ENTRY OF NEW OWNERS TO REPLACE THE PREVIOUS ONES.

99. The ideal candidates for entry should be institutions, ideally banks. Insurance companies can also be considered. Non-financial concerns are not the best choice, because of potential conflicts of interest, which, particularly in the decline of economic cycles, may lead to loan concentration, lending to related parties and, often, to solvency problems. As the outcome of a restructuring operation, the new investors will normally come into the picture through mergers or acquisitions managed by the owner institution and monitored by the supervisory authority. But being a bank is not enough to be a good candidate. The good candidate should be large enough, fully solvent and well managed. It is only when these features are in place that the acquirer will be able to introduce synergies, change the bad business culture, and solve financial, legal, labor, and other problems that always remain in the failing bank, even if well recapitalized. Therefore, it is important to make a proper selection.

100. In order to attract sound investors, the government should make sure that the former insolvent bank is really clean. Affluence is not required, but capital should be adequate and real, with a high Tier I proportion. And results and flows should really be in the black. Further improvement through synergies and good governance should come from the new investor. By contrast, if restructuring does not achieve an adequate level of real capital and positive flows, no sound investors will be attracted to buy an insolvent bank. Candidates for acquisition most probably will be undesirable bankers. Setting a very high price for the sale may also attract those undesirable investors. If the bank was expensive and not profitable, such new owners could obtain a "return on investment" through dividends based on cosmetic accounting and, most probably, through self-lending. The old problems may repeat themselves and even compound. Let's not forget that the objective to sell banks under government control is to forget about the problem -in other words, to ensure the prosperous future of what used to be a problem bank or a problem system. It is not an expenditure, but an investment.

101. The above hypothesis can easily be applied if the market is large and there are plenty of sound banks. But what if there are few candidates to buy the failed banks ? Actually, when the market of buyer banks is limited, you may have serious difficulties.

- The search for good acquirers will be time-consuming and the insolvent bank may deteriorate while waiting. Between takeover and sale, you need "bridge" management arrangements, as was described in Section VIII. But the government will have to undertake a very thorough case-by-case approach. Sometimes, once you manage to sell the first one or two banks, there is a demonstration effect and other potential acquirers become gradually interested in similar operations. In view of the difficulties, institutions other than banks, particularly financial institutions, as well as individual investors will have to be considered as candidate buyers. But, generally speaking, foreign banks will probably have to play a significant role. They should of course undergo the same tests for size, soundness and fit-and-proper management. But foreign banks should be welcome, because, more often than not, they improve competition, have better internal controls, good technology and good products and they may set an example for good governance. Now, what is the right proportion of foreign banks within a banking system? There are not set rules. Some government will accept just a few foreign banks. Other governments, for lack of domestic solutions to solve their failures, will accept a higher number of foreign banks, but they will consider that ownership of the largest banks is a matter of national sovereignty. Still other governments may bend to the harsh reality and accept participation of foreign banks even in the largest financial institutions.

102. What about individuals? In the author's view, individual investors can be considered as a second best solution. But, what kind of individuals?

- Employees are not very good candidates to acquire a restructured bank. Elimination of staff redundancies is probably one of the pending action the new owners will have to undertake. If the new owners are the bank's staff, few if any redundancies will be eliminated. Access to ownership could, however, be given to employees, if in a limited proportion and if the controlling shares are given to a strong investor.
- Industrialists or businessmen are not very promising candidates. Actually, international experience shows a high number of cases where excessive lending to the owners of their companies was the reason for serious problems for the banks.
- What about the public at large? This is a typical alternative in privatization of state-owned banks. It can also be considered for the sale of insolvent banks after government intervention, for lack of better alternatives. The public could be a candidate, but the government should make sure first that a strong management has been in place for some time and ensures stability. Otherwise, there may be worrisome situations, such as the emergence of the former "wrongdoers" or businessmen as core investors, or no-man's-land situations, where any management team, good or bad, may take full control of the bank. Even the previous team, that led the bank to insolvency, may emerge again. However, if the public shares ownership with a good bank, which controls management and plays the role of a strong strategic partner, this can be a satisfactory solution.
- Offering free shares is not a good solution. If you do not pay, you do not care. Actually, when shares are offered to employees or to the public for nothing or with privileged fiscal or credit facilities, the buyers are not very likely to care about the bank's governance or may sell their shares on the market and cause serious disruptions.

BRIDGE OWNERSHIP

As was said in the section on new management, the entry of new owners of the banks or of their assets and liabilities is likely to lag behind government intervention, if the buyers market is not large. In case of purchase of assets and assumption of liabilities, because the previous owners maintain ownership of the legal shell, only bridge management will be needed, as described in Section VIII. When restructuring conveys the transfer of the shares' ownership, there is need for a bridge ownership arrangement. This role of bridge owner is, logically, played by the institution that injects new capital in the bank. As has been explained before, the two main recapitalizers are the Treasury, directly, or a government restructuring institution, be it, a deposit insurance agency or a separate agency. But bridge ownership should be as brief as possible in order to avoid commercial damage to the bank. Some laws establish a limit of one or two years to put the bank up for sale. Of course, these sales should be supervised by the regulator to make sure that prices are adequate and that the final owners ensure fit and proper governance.

XI. OTHER AREAS TO BE COVERED

103. This paper does not attempt to cover all possible topics related to crises resolution. Indeed there are other areas to be covered. Among others:

- How do you restore confidence?
- How to build political consensus?
- Should you wait until the economy has recovered from depression before restructuring banks?
- Should you redesign the size and structure of the banking system or restructure the banks first?
- What should be the role of banking supervision before, during and after restructuring operations?
- When general bank insolvency is interlinked with general enterprise insolvency, which of the two areas should be addressed first, and how?

A full answer to each of these question marks may deserve other papers.

XII. SUMMARY PRINCIPLES AND GUIDELINES

104. Because there is always a “next time”, governments should make sure that prudential regulation and supervision reduce the risk and the size of potential banking crises in the future. But proper legislation should be in place to deal with banking crises resolution. Otherwise, prudential regulation and supervision, no matter how strong they are, serve little purpose. They would be discredited and problems would grow more and more serious.

105. Deep insolvency is the key problem when individual banks have a crises (as well as in widespread and systemic ones). Systemic ones have an added element: deep illiquidity. The line between the different kinds of crises is often blurry and their treatment will have to contemplate a proper mix of across-the-board and case-to-case measures.

106. Insolvency of individual banks should be treated case-by-case. But, because the line is blurry, both across-the-board and case-by-case measures will have to be applied to both widespread and systemic crises. This should be done in a proper sequencing, possibly along the following lines: First, build political consensus. Second, close the worst banks, particularly those that were already insolvent before the macro-upheaval occurred. Third, apply last resort lending to the rest of the banks that are illiquid. Fourth, apply other measures across the board to them, among those listed in this paper. And fifth, apply case-by-case treatment, as legal evidence of individual insolvency becomes apparent.

107. Primary responsibility for reconstructing an individual bank, as well as for recapitalization and change of management, lies with its owners. But, if the owners do not take these measures, the government will have to close the bank or step in instead for restructuring purposes.

108. When the previous owners and creditors fail to recapitalize the bank, bank closure is the first option. When banks are closed, an explicit deposit insurance scheme that would protect depositors up to a limited amount may prove very useful to limit the danger of contagion and encourage bank closure and, thus, the exit of bad bankers. Full deposit protection -whether implicit or explicit- should be avoided, since it does bring about moral hazard all around, i.e. for bankers, depositors, creditors, borrowers and supervisors. If it is in place, it should be phased-out over a few years and changed into an explicit and limited system. Let us bear in mind that, in practice, no deposit protection at all usually leads to full protection.

109. In actual fact, only small banks and sometimes medium-sized banks are closed. Large banks are very rarely closed. The alternative to closure is restructuring. Therefore, governments should be prepared to face it in terms of ordinary laws and regulations. Systemic crisis may require special laws.

110. The three legs of the stool in restructuring deeply insolvent banks by the government -other than last resort lending whenever needed- are **R**ecapitalization, **O**wnership change and **M**anagement change. If one of them is not applied, the others will probably fail. Recapitalizing a bank by the government, while leaving the same ownership and management in place, may lead to the perpetuation of the same problems and to moral hazard. On the contrary, if recapitalization goes hand-in-hand with the exit of the previous bankers, there are no reasons for moral hazard. When few alternatives exist on the market to find fit and proper investors and managers, a variety of solutions will have to be sought, including foreign banks and bridge ownership and management, until a final solution is arranged.

111. Recapitalization requires a good diagnosis of the stock and flow of losses. A poor diagnosis may lead to no action when there is need for action. It may also lead to treating systemic crises as if were no individual failures, and widespread insolvency as if it was only a problem of just a few isolated cases. Worse, it may lead governments to try to solve insolvency with ineffective instruments. Identification of the real losses may take time; it is a gradual process. An initial effort should be made to have a basically accurate picture as soon as possible, but you should avoid initial “analysis-paralysis”.

112. Effective recapitalization of deeply insolvent banks requires a third party to inject capital and purchase of assets. Lending operations, subordinate debt, and debt-equity swaps, are unlikely to fill in the gap. Real capital is what is needed, and it is needed to the extent necessary to reconstruct the equity capital and turn the profits and flows from red into black. Profits and flows are more important than equity. If results and flows keep decreasing, the capital would be further eroded and restructuring would be a failure. In such cases no phase-out of rules on capital, provisions and income-recognition should ever be accepted.

113. Reducing redundant labor and operational costs to a proportion that is in line with the bank's size and makes profits possible must be considered as a key part of the recapitalization package. Good governance overall is expected to be brought in by new institutional owners, if properly selected, which is basic to successful restructuring.

114. Capital injection and purchase of assets can be funded by the financial system through a restructuring institution, including a deposit insurance institution, when given the responsibility for the recapitalization function. If the financing by the banking system does not suffice or if such private arrangement does not exist, the Treasury will have to take the hit in a way or another, be it directly or through special government or mixed restructuring institutions.

115. The fiscal and monetary impact should be minimized, but not at the cost of half-way restructuring and subsequent "muddling through". Remember the old saying: "Bread for today but hunger for tomorrow". They should also be spread over a number of years, but the recapitalization funds must be supplied on D-Day, probably at the time the previous bankers exit the bank. The spreading is most frequently achieved by the issuance of government securities. Reduction of other government expenditure, a good functioning of the open market, a proper handling of reserve requirements and serious tax reform, including improvement in tax collection, may also mitigate or compensate for those distortions. A thorough restructuring would also require the securities to be gradually redeemable or tradable and the interests paid in cash at market rates.

116. Provided effective alternatives can be used, asset disposal should take place as far away from the bank as possible, so that the new bankers can concentrate on the future, rather than on the past. In mature societies, this function can be carried out

by private companies, according to market principles. But, more often, it is carried out by a government institution or even by the restructured banks, when they have strong management and are commissioned by the government to do so. If disposal is a government function, good rules of thumb could be: Do your best not to put new money on the bad assets, with a view to obtain a better price; just try to recover or liquidate as much as you can, from the state at which the assets are. For disposal purposes, give priority to early realization over expected price, if they are in conflict.

117. If, other than the banking sector, the government has to incur losses, they should be shared with other players, primarily the previous owners. Bad borrowers as a whole should also share the loss. Uninsured depositors and creditors may also be considered as candidates for loss-sharing, but due attention should be paid to the risk of contagion.

118. Sound investors should be given priority as potential new owners or partners, over less sound ones, even if the latter offer a higher price. What matters is the future soundness of the system. Its future potential to pay taxes should also count, as a return on the investment that was made by the government with taxpayer funds.

119. For lack of well established legal mechanisms, improvisation, imperfections and "groping in the dark" for solutions are frequent features at an initial stage. That is why bank restructuring needs strong and well coordinated institutions. A lot of money can be saved. The institutional framework would perform a variety of activities, such as deposit insurance, recapitalization, assets clean-up, temporary ownership and management, handling of sales or mergers and assets disposal. This can be done through different and separate institutional arrangements, as described in this paper. But good coordination and economy of efforts make unification of those functions in a simple institution worth considering.

120. Remember:

The business of bank restructuring is not made for perfectionists. In actual fact, many "nasty" things have to be done to achieve effective solutions. But they are certainly "less nasty" than their alternatives.

Any loss is a good loss, if it is the last loss.