

Pitfalls in Managing Closures of Financial Institutions

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I. INTRODUCTION AND BACKGROUND

Closure of a financial institution is essential when it is no longer viable. Unviable financial institutions lead to accrual of losses that eventually will have to be borne by various stakeholders. If allowed to operate, they undermine healthy market competition and create moral hazard by giving owners and managers incentives to gamble for recovery and opportunities for asset looting and criminal “end games.” Their continued presence may over time undermine the soundness of an entire financial system. Owners and managers of financial institutions are typically required by law to close an institution once it becomes insolvent. But numbers can be manipulated and closures or other forms of market exit tend to be delayed and take place only at supervisors’ insistence.

Closures of financial institutions are seldom the routine supervisory actions they should be. Closing individual institutions in an otherwise healthy financial system should be considered a routine matter similar to that of new entry. Closure should be part of supervisors’ “toolbox” of corrective measures and the ultimate sanction for breaching their licensing agreements and prudential rules. Reasons for closures could be a lack of financial viability; breaches of prudential requirements, licensing agreements or corrective action plans; or criminal activity, fraud and gross malfeasance. Except in cases of fraud, closure is typically preceded by other corrective supervisory actions. Clean closures causing little disturbances to the financial system should be viewed as a sign of effective supervision.

Closures are often delayed by supervisors, who are reluctant to take actions that may be seen by the public and politicians as a failure of supervision rather than a failure of the

institutions' owners and managers. As a result, closures, and especially closures of banks, often come too late and after problems already have accumulated, and may set in motion contagion dynamics that affect the entire financial system and the economy at large. As a result, systemic risks are too often invoked as reasons for not closing financial institutions, especially deposit-taking institutions, sometimes with references to well publicized cases of botched closings elsewhere in the world.

Closure of a financial institution is a process, not an event. Although a closure could be viewed as an event, such as, for example, the moment of termination of an institutions life as a legal entity or even the moment of physical closing of its doors for business, this paper views closure as a process starting with planning, followed by implementation and ending with the institutions liquidation and disappearance. The process may be quick but often takes months or years to be completed.

Closure is one of the most important ways of keeping a financial system competitive, efficient and sound. Closures remove unviable institutions and excess capacity from the system. They force owners, managers, creditors and other stakeholders to take responsibility for accumulated losses. In many countries, only closures trigger the legal mechanisms that allow the distribution of losses. Closures must be executed in a clean and efficient way so to maintain a level competitive playing field and minimize damaging market disturbances. The strategic, administrative, political and legal complexities of closing financial institutions can be overcome with proper consideration and management of the different steps and constraints involved. That requires careful planning, implementation and downstream follow-up.

This paper explores the various pitfalls in the process of closing financial institutions and how to deal with them. It covers closure both at the level of individual institutions and on a systemic scale. The paper focuses on banks, which in most countries constitute the core of the financial system. It also focuses on public and prudential policy issues rather than corporate policy issues. The paper is based on the experiences of the author derived from dealing first hand with many of the world's banking problems and closure over the last decade. After a brief discussion in section 2 of some definitions of terms commonly used in bank closing and resolution, the paper will discuss ten different areas of pitfalls that official decision makers will need to be aware of in managing the process of closing banks. The paper will end with a concluding summary of the pitfalls.

II. TERMS AND DEFINITIONS

A closure typically means the end of a financial institution as a legal entity. A closure is typically accompanied by a withdrawal of an institution's operating license but there are legal frameworks that allow the suspension of operations without revoking a license, which may be withdrawn at some later point. A closure can be an up front action followed by a resolution and liquidation process, or part of or even the end result of an intervention and resolution process. The closure process seeks to bring assets, liabilities and any remaining business franchise of an intervened or closed institution back into the market under new ownership. It seeks to do so with minimum market disruption and loss of asset values. It can take months or years for this process to be completed and all assets

and liabilities have found final owners and all losses have been distributed among stakeholders.¹

Intervention means takeover of management and ownership control of an institution by its official supervisor, possibly leading to some type of reorganization or to closure and liquidation. An intervention gives the authorities an opportunity to review an institution from the inside and time to make more informed decisions about an optimal resolution strategy, which may include closure. Interventions must be short, if the authorities are to avoid becoming co-responsible for the problems of the intervened institution. In cases where there is urgency to prevent liquidity support or asset looting but the necessary legal and strategic decisions cannot yet be made, operations may be suspended or frozen. While such an action will give some needed respite for consultations with the lender of last resort (LOLR) and other supervisors it may also unleash dangerous contagion dynamics for the entire system.

Intervention is followed by resolution. Resolution implies a reorganization of an institution's operations, assets and liabilities in a variety of forms that typically include ownership changes. Resolution options include legal closure. Other options include mergers, partial sales, purchase and assumption (P&A) operations, liquidation, establishment of bridge banks or reorganizations. A *merger or acquisition* (or sale) of an institution means that all the assets and liabilities of a failing firm are transferred to and

¹ The report of a recent Basel Committee Task Force on Dealing with Weak Bank distinguishes between legal and economic closures; it concludes that closure should achieve the former and avoid the latter, i.e., the financial intermediary should be closed without closing or destroying the economic transactions that it intermediates; see Basel (2002). The report provides comprehensive guidance on identification of weak banks, on the range of corrective actions that supervisors employ prior to closure, as well as on closures and other options for exit and resolution.

absorbed into another institution. In a *P&A operation*, another financial institution purchases a portion or a portion of the assets of a failing one together with part or all of its liabilities; the purchase includes the failing institution's customer base and goodwill but not its license or charter. P&A transactions typically require withdrawal of license and the initiation of a liquidation process. Partial sales or P&A operations may or may not involve government financial support. In a government-supported merger or P&A operation, a government entity or deposit insurer will pay the purchasing institution, typically in securities, for the difference between the value of the assets and liabilities.

Liquidation is the legal process under which the assets of an institution are sold and proceeds used to settle its liabilities in full or in part. Liquidation brings finality to the legal closure of a financial institution. A liquidation can be voluntary or forced, be within or outside general bankruptcy procedures, and may involve courts to varying degrees. Proceeds from the sale of assets are used to pay off the creditors in the order or seniority prescribed by law. Liquidation could involve the transfer or sale of all or part of an institution's assets and liabilities to other institutions through an administrative process, possibly leaving a rump of bad or complex assets to be liquidated through a judicial process. If several institutions are to be closed and liquidated simultaneously, special procedures and institutions for asset workouts and liquidations may be needed.

An unviable bank may be closed and some or all of its assets and liabilities transferred to a temporary bridge bank. This will allow continued operations and bridge the time until a permanent resolution option can be found. A bridge bank has its own limited license and may manage assets or absorb the operations of one or more

closed banks. A bridge bank would need to be separately capitalized, normally by the government.

Systemic problems are common when dealing with closures. This paper recognizes such problems but does not seek to define them very precisely. Systemic problems are often used as excuses for inaction or inappropriate policies, which may include government guarantees. But the reality is that closure of one or more financial institutions under certain circumstances may threaten the stability of an entire financial system and negatively affect a country's macroeconomic performance. As discussed in this paper, systemic threats need to be analyzed in the context of structural weaknesses in a financial system and the macroeconomic situation at any given time.

III. TEN MAJOR PITFALLS

The sections that follow discuss ten areas that constitute pitfalls in the closing of banks. Their delineation is somewhat arbitrary, as they all are closely interrelated. The order in which they appear does not reflect their importance, priority or sequence. The ten areas are:

1. Perennial measurement problems
2. Problem identification: Is it systemic?
3. Lack of clear intervention triggers
4. Forbearance and liquidity support
5. Loss sharing

6. Limit contagion
7. Protect asset values—seek least cost resolution
8. Linkages with macroeconomy
9. Legal framework
10. Institutional and political framework

A. Perennial Measurement Problems

Reliable information on weak financial institutions is available the least when needed the most. Information on financial institutions, especially those in trouble, is notoriously insufficient and unreliable. In periods of economic deterioration, accounting losses always lag behind underlying economic losses, especially for loans, which account for the bulk of assets in many institutions. Loan valuation, and especially valuation of problem loans, is a largely subjective exercise in which bank managers, external auditors and supervisors come up with their best estimates using various methodologies. Valuation of government securities and other claims on government may also become highly arbitrary, especially in cases of financial stress or debt default in the public sector.² In periods of economic turmoil, all asset valuation become extremely uncertain, as values shift continuously in response to underlying economic, market, legal and political

² The present situation in Argentina shows how the valuation of government securities becomes highly arbitrary in periods of extreme market volatility and the possibility “haircuts” in the context of a public debt restructuring.

circumstances. Few countries have meaningful market pricing mechanisms for distressed financial assets. In the absence of reliable data intervention or closure becomes difficult.

Capital adequacy ratios (CARs) are often poor measures of the solvency and financial viability of financial institutions. CARs for problem institutions are often inflated, as asset values are overestimated and the institutions' financial losses underestimated. Although economic losses already have occurred, it will take time for them to show up in the CARs. Without adequate and objective accounting and valuation, it will be easy for owners and managers to conceal problems and difficult for supervisors to determine a firm basis for closure. At the same time, firm data and criteria will be needed to legally justify an intervention or closing of an institution and to stand up to possible court challenges.

The data will become less reliable as market conditions deteriorate. Asset valuation may be relatively easy, if the problems affect only an individual institution under relatively normal circumstances, stable asset values and predictable economic conditions. As more institutions are affected, the valuation problems become more complex, as market conditions and asset values may become adversely affected by the resolution process itself. Far more complexity is added in an environment of systemic banking sector weaknesses, contagion, dramatic declines in asset values and major macroeconomic disruptions. Accounting data reported to supervisors will always reflect underlying asset deterioration with a lag, at least until an institution is intervened or closed, when due diligence or liquidation analysis will give provide more realistic information.

When to intervene when available data indicate problems but give no firm basis for intervention or closure is always a judgment call. Loan and other asset valuation rules and procedures must be enforced on a uniform basis to counter incentives of bankers and external auditors to obscure and delay the value discovery process. Despite poor data, uniformity of criteria will help identify weaknesses and the worst performers. But this process may be too slow and supervisors often have to intervene in or suspend operations of an institution based on partial indicators and get a proper valuation from the inside. They may need to wait with closures until they have prepared a better data base. If an intervention were to bring out data to show that an institution is viable after all, it can always be returned to its owners. But such a scenario is rare--typically interventions confirm the financial problems and produce evidence to support intervention and/or closure. Given that interventions and closures may be challenged long afterwards, all data, assumptions and criteria should be properly safeguarded to provide evidence later on, if needed.

The liability side of an institution's balance sheet may include surprises. The valuation of the liability side of an institution's balance sheet is normally relatively easy--provided that all liabilities and contingencies are included. It is not uncommon to discover liabilities that have been excluded from institutions' accounts and concealed from auditors and supervisors, possibly for years. Irregular liabilities could include deposits accumulated using all the trappings of legitimate operations and then diverted to the personal use of owners or managers; they could be gathered domestically or through foreign or offshore affiliates. Like pyramid schemes, clandestine deposit-taking operations can go on as long as they can stay liquid. Their size could exceed those on the

balance sheet.³ Once identified, a decision will have to be made whether or not to include such liabilities in an institution's liquidation balance sheet. Governments often feel compelled to do so in order to maintain confidence in the rest of the system, especially if depositors have dealt in good faith with an officially licensed and supervised institution.

External auditors are of little use when better data is needed quickly. The results of regular external audits are typically already available to supervisors but may be unreliable and outdated. Special audits by institutions' regular auditors or outside independent auditors may be useful, if based on detailed additional criteria. But such audits tend to take too much time, so institutions may have to be intervened first and only then subjected to audits and decisions on closure. Independent external audits are suitable to ensure uniformity of criteria and impartiality in cases where the competence or integrity of the bankers or supervisors are in doubt, or where insider or government directed lending is prevalent.

If external audits are called for, extreme care needs to be taken so as not to single out any particular institution or group of institutions. An audit can seldom be kept secret. Government owned or intervened banks can be subjected to special audits without too much market repercussions. But singling out any private bank or group of banks for audits may well doom them to failure. An audit may have to be done on a system-wide basis even if one or only a few banks or institutions are the targets. But this may be worthwhile, as case by case diagnosis will be needed even if the problems were to

³ The most recent cases of such schemes have been in some banks in Turkey and the Dominican Republic, where the size of the illegitimate transactions have exceeded the size of their entire balance sheet.

become systemic. Clear guidelines are needed to prevent both over- and undervaluation of bank assets. Auditors may wish to protect their own reputations and be excessively cautious, and use “liquidation” values rather than higher “going concern” values. To increase their credibility, special audits can be verified through second opinions and ultimately by the supervisory authority—although supervisors at the same time must be careful not to undo the results of the audits. Special audits must be part of a broader strategy to strengthen confidence in a financial system.

B. Problem Identification: Is It Systemic?

It is essential to assess the distribution of problems and their likely broader systemic impact in parallel with estimations of the magnitude of financial problems. It is important to establish whether problems are confined to a single financial institution or affect several institutions or groups of institutions, whether they are part of financial conglomerates or broader corporate “groups” and their importance in the financial system as a whole and the payments system. Dealing with problems in the core banking system or a single dominant bank rather than smaller banks or subgroups of near-banks or other financial institutions may require very different closure decisions. The ownership structure of intervention and closure candidates also needs to be determined in order to fully ascertain the potential impact of different closure strategies.

Closure policy has to be consistent across categories of financial institutions and over time. The sooner the scope and nature of problem institutions and categories can be identified the better. Available data, even if deficient, needs to be simulated with changing interest, exchange and economic growth rate assumptions to make sure that a

seemingly limited problem does not evolve into a systemic one under various plausible scenarios. As far as possible, an intervention and closure strategy should be chosen that need not be changed, unless circumstances would change in a fundamental and unpredictable way. To the extent problems are considered systemic and of macroeconomic significance, the closure strategy will need to become an integral part of broader macroeconomic policies and considerations.

There are no quantitative ratios or rules of thumb for when a problem is to be considered systemic. It depends on the size and structure of each system and the macroeconomic environment at any given time—for example, a problem may be viewed quite differently in an economic upturn than in a downturn. The relative size of one or more financial institutions in the financial system as well as the relative size of a system in the economy also matters. The larger the relative size of the system the more it matters in the economy; a system with assets representing the equivalent of, say, 200 percent of GDP is clearly more important for the economy than one representing, say, 20 percent of GDP. A bank with a market share of 20 percent in the former system will represent 40 percent of GDP, while it would represent only 4 percent in the latter case. So the systemic and macroeconomic effects of closing a major bank would have to be considered.

It also makes a difference whether the institution subject to potential closure is a large bank at the core of the financial and payments systems or one or more smaller banks or other financial institutions--except, of course, in cases where smaller institutions' problems directly affect a core institution. Individual institutions and especially core banks may be so important to the financial and payments systems that they are considered “too big to fail.” But the reality that a bank is “too big to be closed”

must not mean that is too big to be intervened (owners and managers removed), resolved and possibly even closed and reorganized as quite a different institution.⁴

In case of a single bank that is unviable, intervention or closure must take place as soon as possible, while making sure that legal and institutional requirements and constraints are being met. Closure of a larger rather than smaller number of institutions may increase confidence in remaining institutions. However, every intervention and closure sets a precedent for future similar actions. Therefore, as discussed above, if the problems are believed to be widespread, there is a need to have a good understanding of the size and nature of the problem and the required overall strategy before any closures take effect. This is particularly important the strategy involves loss sharing, as discussed below. In cases of fraud, criminality or sudden and extreme illiquidity, there may be no choice but to go for immediate suspension or closure.

In case of a systemic problem situation, the closure strategy will be different depending on whether or not a blanket guarantee is used. If a government blanket guarantee for depositors and creditors is used, there is a need to decide up front whether or not it will be applied to all institutions, including those to be closed, or only to those that will remain in operation. Once a credible blanket guarantee is in place, closures can take place in an orderly way without fear of contagion. The impact of burden sharing decisions on closures and the effects of a blanket guarantee are discussed further below.

⁴ For a broader discussion of these issues, see Andrews and Josefsson (2003).

C. Lack of Clear Intervention Triggers

Experience in all countries has shown that it is cheaper to intervene in and resolve problem banks early. The earlier the intervention, the lower the cost for all stakeholders, because losses are likely to be smaller and would not yet have been accumulated. Resolution will be easier because asset prices early on are more stable and more investors (banks and non-banks) are likely to be interested in buying distressed assets, as less such assets are on the market. The more the situation deteriorates, the more asset prices will fall and investor interest dry up—and resolution costs increase. In addition, as losses build up the likelihood of severe market distortions and broader systemic weakening will increase and may ultimately have huge cost implications that will complicate resolution.

Intervention and closure of a bank or other financial institution must be based on certain legal and regulatory criteria. Such criteria could be insolvency, illiquidity, gross breaches of prudential ratios and regulations, management misconduct or fraud and criminality. However, such criteria need to be translated into operational definitions and quantitative ratios or limits, which, when reached or breached, will “trigger” the intervention and closure of an institution. Even in countries where the authorities have wide discretionary powers to intervene, defining such criteria is useful. Intervention “triggers” must be transparent and uniformly applied. There must always be a demonstrable objective and legal basis for any intervention and closure.

Capital adequacy ratios (CARs) are the most common intervention triggers but are often useless for operational purposes, given the asset valuation problems discussed

above. Since the FDICIA introduced mandatory Prompt Corrective Action (PCA) in the United States in 1991 some [40] countries have introduced similar regimes. PCA implies mandatory takeover of a bank when its weighted CAR falls below a certain level, say, 2 percent, which in most cases implies negative net worth once proper valuations have been performed. CARs are excellent intervention triggers in relatively normal times, when they reflect banks' net worth reasonably well. But PCA has severe practical limitations in a rapidly deteriorating economic environment where accounting values for financial assets and CARs become inflated and start to lag behind economic realities. They may even be counterproductive, if a slavish focus on CARs results in delayed interventions and closures.

When solvency triggers do not work, quantitative liquidity triggers often take over.

Problem institutions can stay liquid even as their profitability and solvency is eroded. Competitors are often aware of such problems and require premiums in the domestic money market and eventually close them out of the market altogether. The central bank/LOLR often becomes the only provider of liquidity. Banks with liquidity problems are likely to also have solvency problems. Given that illiquidity quickly can make undercapitalized institutions severely insolvent, the LOLR has to make a decision as to how much liquidity support to provide, as discussed further below. LOLR liquidity support expressed on a bank-by-bank basis, say, as a multiple of a bank's capital or net worth, can be used as a trigger. Once the liquidity support reaches the trigger level, the institution is intervened. Liquidity indicators typically show problems long before CARs.

Additional triggers or corroborating evidence can be useful. Qualitative conditions like incompliance with certain prudential rules, breach of licensing or (re)capitalization

agreements, evidence of fraudulent activity, etc. can support liquidity triggers or be intervention triggers on their own. All triggers must be designed to hold up legally, because closures will destroy and redistribute private property and wealth and therefore have a high likelihood of being challenged in courts. Owners of intervened or closed banks may show documents, certified by their external auditors that prove their institution to have been solvent when it was taken over or closed. Therefore, there is need for supervisors to clearly define the criteria for interventions and closures and be prepared to defend them in court, if challenged.

D. Forbearance and Liquidity Support

Forbearance or allowing loss-making institutions to remain in operation despite signs of severe problems or outright breaches of prudential rules will allow losses to accumulate. As discussed above, the authorities may not be fully aware of the extent of the deterioration or not have a clear legal basis or operational triggers for intervention or closure decisions. However, there may be breaches of prudential rules and market information that indicate severe problems and a need for immediate corrective actions. In such a situation the supervisory authorities may choose not to pursue such indicators further or simply to ignore them. Allowing financial institutions to continue operations as if everything were normal is referred to as forbearance; it makes the government co-responsible for the accumulation of losses and invariably complicates closing and other resolution options later on.

Supervisors typically employ a string of corrective measures to give a problem institution a chance to improve before being intervened or closed. Only in cases of

extremely rapid financial deterioration or discovery of criminal wrongdoing do supervisors intervene without giving the institution a chance to survive through recapitalization or other forms of financial or operational restructuring. However, such corrective measures are often forbearance in disguise as they do little to correct the situation. Recapitalization and restructuring plans may be unrealistic and loosely enforced. Supervisors often accept vague promises of recapitalization from phantom investors.⁵ Supervisors may also wishfully expect economic conditions to improve and that the problems of the institutions under their supervision will go away—something that seldom happens. The end result of forbearance is an accumulation of losses and erosion of net worth that may become widespread and lead to a severe systemic problem.

It is often the central bank/LOLR that uses liquidity triggers to intervene or close an institution. Banks and near-banks may have exhausted their capacity to get attracts deposits or credit at home or abroad and can only rely on the LOLR for liquidity support. They may be highly vulnerable to liquidity shocks, and their demand for LOLR support may rapidly increase to levels that jeopardize monetary stability. The LOLR must stop the “bleeding” of liquidity but cannot do so without the banks’ operations being suspended or closed. This is when liquidity triggers will be essential. When supervisors are forbearing banks and possibly other financial institutions it is typically monetary management considerations that will bring about supervisory intervention or closure.

⁵ In this context it should be noted that new private investors cannot be expected to absorb existing losses, except perhaps in cases where the losses would have tax carry-over value for another profitable bank. Only when existing losses have been fully recognized can new private investors, domestic and foreign, be expected to have interest in injecting additional capital.

Forbearance facilitated by LOLR liquidity support complicates subsequent interventions and closures. The combination of forbearance and liquidity support makes the monetary and supervisory authorities (often combined in a central bank) accomplices in an arrangement that may be expedient in the short run but in the end will undermine long-term financial stability and complicate future resolution options. By effectively financing a buildup of losses in problem institutions, the LOLR is in effect allowing existing owners and managers to stay in control, loot assets and honor liabilities selectively, which will make matters worse for other creditors and depositors in the end. In most countries the LOLR is a most privileged creditor, which means that other creditors will be squeezed out as a result of the LOLR's actions, while the LOLR itself will carry little risk for its destructive policies. To prevent such abuse by the LOLR, the US FDICIA outlawed LOLR support to institutions believed to be insolvent

There is a tradeoff between denying LOLR support and possibly causing wider systemic problems on the one hand and providing such support and preventing systemic problems on the other hand. LOLR support is supposed to be provided only to solvent institutions facing temporary illiquidity. But temporary illiquidity is hard to establish—permanent illiquidity starts as being temporary. Most illiquid banks have some solvency problems, albeit not necessarily insurmountable ones. It is extremely difficult to determine whether early liquidity support will help institutions recover and thus reduce eventual losses or just help finance additional losses that never can be recovered. This is where the supervisors' intimate knowledge of financial institutions is

crucial. Considerations will change depending where on the timeline toward systemic crisis a financial system is located.⁶

Denying liquidity support may lead to disruptions in the payments system.

Interruptions to the payments system are bound to trigger panic and runs on other banks. A decision to cease liquidity support therefore cannot be made independent of intervention or closure decisions. Smaller banks or financial institutions may be closed without affecting the normal operations of the rest of the system. But if the problem lies with a large bank at the core of the payments system, liquidity support can seldom be stopped. Instead, such a bank may be intervened (its owners and managers removed) and kept in operation while its liquidity is stabilized and a resolution strategy implemented.

A common fallacy is to assume that losses or the need for liquidity support will stop once a bank is intervened or closed. There may be further “flow” losses deriving from costs of financing, managing bank assets (staffing costs, management fees to other institutions) and liquidators and “stock” losses from declining asset values. Depending on resolution options, such losses may continue in the institution or may shift elsewhere, for example, to a deposit insurer, to liability holders or to the government. These, in turn, may need liquidity support. If a government guarantee is used, an intervention or closure will not stop losses and resolutions costs from accruing to the government and may not immediately stop deposit withdrawals. Only if a closure involves the transfer of all losses to other private stakeholders may claims on LOLR liquidity support stop.

⁶ For an illustrative practitioner’s view of this dilemma and other issues surrounding closure and resolution of banks, see De Juan (1999).

The more government is involved in forbearance and liquidity support, the more it will be held responsible. It may erode market confidence in the government's competence and integrity. The public is likely to consider the government co-responsible and will demand it to assume part or all of the resolution costs. Pressure will mount for a blanket guarantee, even when a case for such a guarantee may not have been there had decisive intervention or closure decisions been taken only a few months or even weeks before. Due diligence valuations following interventions or closures will gradually reveal the full extent of accumulated losses and the extent of the forbearance. That may further undermine confidence and lead to more interventions and closures.

E. Loss Sharing

The most difficult decisions in managing closures relate to burden sharing. It is normally defined in law how losses are to be distributed: owners absorb losses first, holders of subordinated debt next, etc. As losses often exceed the stakes of owners and subordinated debt holders, losses will have to be covered by other creditors and depositors in accordance with their legally established rankings, which tend to differ from country to country.⁷ Liquidators, the central bank, tax authorities and bank personnel often are most preferred creditors. Depositors may rank above other creditors; small depositors above large depositors. Classes of claims typically are to be honored from the institutions assets in the pre-established legal order and for remaining claimants on a *pari passu* basis. If there is deposit insurance scheme, it initially absorbs losses up to its legally stipulated limits and then seeks reimbursement depending on its priority in the

⁷ Losses are allocated in accordance with the legal rankings or preferences stipulated in banking, bankruptcy, deposit insurance and other laws, as may be the case.

creditor queue. In case of a government blanket guarantee of depositors and/or creditors, all losses after those absorbed by share- and subordinated debt holders and certain excluded categories will fall on the government.

Loss sharing with existing owners and managers should be pursued as far as possible. Getting shareholders to accept losses may require closure but in many countries this can be done with supervisory intervention and identification of the losses.⁸ Losses of private owners are typically limited to the amount of their shareholdings under company law.⁹ The prospects are slim to impose more losses on existing owners than their share capital, except in cases where they have acted illegally, for example, borrowed from the institution in violation of connected lending limits or been involved in fraudulent or criminal activities may be subject to unlimited liability. Dividends deemed excessive may be reversed. To the extent managers can be held similarly accountable they should also share in losses to the extent of their financial capabilities.¹⁰

In some jurisdictions, losses cannot be imposed on creditors or depositors, including holders of subordinated debt, unless an institution is closed. Creditors and depositors would then be compensated up to the value of remaining assets in the legally established order of priorities. Compensation is often done in installments based on proceeds from

⁸ In some countries shareholders can be wiped out without closure. Supervisors determine asset values, net worth and the size of losses to be written off against accumulated reserves and paid up capital. If the shareholder assembly does not endorse a proposed write-off, the institution may be intervened or closed immediately.

⁹ There may also be loss-sharing issues among groups of shareholders, for example between minority and majority shareholders.

¹⁰ Managers and owners also should be prosecuted to the full extent of the law in cases of fraud and criminality.

asset recovery. Some countries require the entire liquidation process to be completed before anyone is compensated.

Loss-sharing procedures designed for individual banks in normal times but may not be suitable for systemic situations. Allocation of losses to creditors and depositors is extremely delicate measure, especially in a weak banking system or if applied to state-owned institutions.¹¹ Loss sharing may be politically unacceptable, as it may run counter to earlier policy assurances, implicit or explicit social contracts, or simply affect too many politically influential interests. But most importantly, loss sharing may cause flight to quality. Creditors and depositors in banks perceived to be weak will run to stronger banks or altogether away from the domestic banking system—a capital flight abroad. Given that it is the larger creditors and depositors that run first, limited deposit insurance for small depositors does not change these dynamics.

If there is risk of an indiscriminate systemic run, the government may decide to step in and introduce blanket guarantee and in effect assuming the responsibility for all losses after shareholders and subordinated debt holders have absorbed theirs. If subordinated debt is used as Tier 2 capital or as an instrument of market discipline, it is essential that the holders of such debt lose their stakes in full. A government guarantee is the observed preference of all governments that can afford it. This will be discussed further in the next section.

¹¹ The most famous case is probably the botched closure of 16 small Indonesian banks in late 1997; see Lindgren and others (1999).

There is a unique opportunity to impose losses on creditors and depositors of failing institutions before a blanket guarantee is introduced. A government may want to draw a line and inflict losses on creditors and depositors of failing institutions, while protecting creditors and depositors in remaining healthy institutions. This is politically difficult, however, as such a policy could be seen as arbitrary and biased, especially as the line between institutions that are to be closed and allowed to remain open may be very diffuse due to the measurement problems discussed above. It may be particularly difficult to show consistence of treatment over time, as additional institutions may have to be closed soon after. If such separation is needed, the bias should be in favor of intervention and closure of more rather than fewer institutions to give the authorities some respite.

Loss sharing arrangements are always extremely delicate and must be very carefully considered. They must not be changed on an ad hoc basis. It is essential for market confidence that all policies and rules with loss sharing implications be transparent and clearly explained and that they are implemented in as equitable a way as possible across similar types of institutions and over time. If a government decides to assume losses, it must be prepared do so even if the cost turns out to be substantially higher than originally estimates—which typically is the case. An unsustainable government guarantee can often complicate subsequent closure and resolution decisions.

F. Limit contagion

In closing of individual banks, care must be taken not to cause runs on other banks and undermine confidence and the financial strength of the rest of system. Any

major change in old policies and practices, and particularly regarding closures with losses inflicted on creditors and depositors can have devastating systemic effects. Losses in even a small bank may lead creditors and depositors in other banks to withdraw their funds from banks and other institutions they believed to be weak. Such withdrawals could be slow (a silent run) or reach panic proportions. The withdrawn funds maybe re-deposited in banks believed to be stronger, often state or foreign owned banks, but there could also be an indiscriminate run from all banks in the system regardless of their financial strength. This typically becomes part of capital flight and a run on the currency. Once monetary control has been lost, it is not easily regained and the macroeconomic costs can be massive.

Closure of banks with losses distributed to creditors and depositors is a high-wire act in an environment of weak financial institutions and economic prospects. Bank closures must be handled in such a way that they do not lead to expectations of further closings. If initial closings lead to such expectations, there is likely to be runs on banks, often in waves. Waves of bank closings may worsen expectations and cause monetary management to spin out of control. Any distribution of losses to stakeholders of institutions closed up front must be handled very carefully. If markets and the public can be convinced that initial closures have dealt with all major problems and the rest of the system is sound, the situation might be kept under control, especially if overall economic prospects are positive. In such a situation, closing as many weak or marginal institutions as possibly may help to support claims that remaining institutions are sound. But if economic and financial conditions are expected to deteriorate, such policies may not be credible.

A government blanket guarantee may be the only way to allow bank closures to proceed in an orderly manner. A blanket guarantee would typically guarantee payment of all bona fide claims of creditors and depositors in domestic currency on their maturity.¹² Such a guarantee is the observed preference of all governments in systemic situations, given that the potential cost of financial contagion and economic dislocations are viewed as being greater than the cost of a blanket guarantee.¹³ Once a credible blanket guarantee is in place and the government has assumed responsibility for the claims of depositors and creditors, they have no reason to run. Closures of banks and other financial institutions can then proceed in an orderly way without fear for contagion on the liability side of financial institutions' balance sheet. (Instead, the contagion risks move to the asset side, as discussed below.)

For a blanket guarantee to work it must be credible. The government must unambiguously back it politically and financially; it typically requires special legislation. For a guarantee to be credible, the government must be seen to have the financial capacity to honor it even in a worst case scenario. Distributing losses to creditors and depositors in initial closings may increase the credibility of the guarantee by improving the government's capacity to honor it. However, for any blanket guarantee to win full credibility it must be backed up with a comprehensive macroeconomic stabilization

¹² For a description of a proper design of a blanket guarantee and how to reduce moral hazard, see Hoelscher and others (2003)

¹³ While suspensions or closures of banks and other financial institutions were part of the initial measures to stabilize the banking systems in Indonesia, Korea and Thailand, only Thailand imposed losses on some creditors of the first group of 16 suspended finance companies (near-bank). In Indonesia, all creditors and depositors of the 16 banks closed initially were subsequently compensated in full.

package that ensures economic and fiscal sustainability. Transparency of rules as well as efficient and equitable implementation of a guarantee will further improve its credibility.

In cases where a blanket guarantee is not feasible, closure strategies will need to depend on circumstances. The government may not have the financial capacity to guarantee anything in a credible way. It may still seek to assume losses and share the cost through monetization over time. If contagion and capital flight is acute, some type of standstill or freeze on withdrawals of depositors and creditors may be used. Other scenarios could be forced reductions (haircuts) of outstanding balances, conversion of foreign currency obligations into domestic currency, lengthened maturities or debt renegotiation. Some of these scenarios may put bank closings on hold due to increased uncertainties but banks that clearly are unviable should still be intervened and/or closed even if their liquidation is process is less predictable.

Effective implementation of announced rules for honoring the claims of depositors and creditors will help increase confidence in the authorities' handling of the problems. Market confidence will give decision makers more flexibility. All rules need to be clearly disseminated and equitably and efficiently implemented. The legality of depositor and creditor claims need to be verified, especially in cases of deposit-taking outside balance sheets. All deposits, except those of insiders, should be honored. Excessive interest rates may be reduced. Deposits of non-performing borrowers may be netted against loan balances. To the extent possible, deposits and other liabilities should not be paid in cash but be transferred or sold to other financial institutions (with matching assets).

G. Protect Asset Values—Seek Least Cost Resolutions

The intervention or closure of an institution typically reduces the value of its assets.¹⁴ Values of assets decline as the relationships between an institution and its borrowers change. As they sever their on-going banking relationship, borrowers tend to become less able and/or willing to service their loans. The legal and political framework may facilitate or even encourage non-payment. If closures result in financial assets and particularly credits being unattended, values may deteriorate rapidly and losses increase. Loan delinquency is contagious. If allowed to spread, it could lead to the failure of other institutions that presently are sound.

When closing a financial institution, a resolution strategy already should be decided upon. Resolution starts the moment an institution is closed but should have been planned carefully in advance. A strategy may include options to deal with uncertainties depending on future market circumstances. When a closure is preceded by supervisory intervention, there is typically more time to explore various asset resolution options. A closure strategy should always include adequate arrangements for managing the assets of closed institutions; this could include strengthened legal and institutional infrastructures.

Resolutions should be guided by least cost (or least loss) criteria. This means that asset values be protected and resolutions costs minimized in order to restore maximum value to claim holders. In a resolution with loss-sharing, the recovery value is to be maximized for creditors and uninsured depositors. In resolution with a blanket guarantee,

¹⁴ Exceptions are those rare cases where the assets of an intervened or closed institution become subject to a different legal framework, which increases the recoverability of the assets (for example, Danaharta in Malaysia).

recovery value should be maximized—or losses or costs minimized—for the government. Least loss calculations need to be based on estimates of net present asset values under different recovery scenarios, including operational, recovery and financing costs. That is no easy task, especially in a period of macroeconomic uncertainty, when future prices and interest rates are difficult to predict.

Resolution of closed banks will involve decisions on whether to sell assets in blocks or individually, and whether to hold/rehabilitate or sell/liquidate assets.¹⁵ This involves the traditional dilemma of quick liquidation, possibly at low “fire-sale” prices on the one hand and holding on to assets and increasing their value through careful management on the other hand. Although time often should take priority over price in asset resolutions, this varies depending on circumstances. Quick sales may be more suitable for smaller problems and when markets are working, while “fire sales” in systemic situations may destroy asset values throughout the financial system and represent anything but a least-cost solution. Pricing is always the most difficult issue in asset resolution: sellers/liquidators want something approximating written down book values, while buyers want bargain prices—more so the more distressed market conditions are. There are also different ways to structure contingent prices, which, of course, may push any final liquidation far into the future.¹⁶

¹⁵ For a broader discussion of asset management issues in a systemic setting, see Lindgren and others (1999) and Hoelscher and others (2003).

¹⁶ There is often a mutual interest in having some type of conditional pricing—the seller wants to share in any possible “upside” and the buyer wants to reduce risk of additional losses. Various types of contingency pricing agreements and debt to equity transactions can be structured to bring assets under proper management as soon as possible to prevent further deterioration.

Active management of loan relationships and portfolios is essential in order to protect assets values. Loans are banks' and many other financial institutions' main assets. If loan files, collateral documentation or client relationships are allowed to be destroyed or abandoned, asset values can erode sharply. Borrower information must be protected and preserved for performing and nonperforming loans alike. This means protecting the integrity and documentation of loan files and making sure that relationships with borrowers continue to be actively managed. This process may best be managed by new owners of the assets but it may also require the involvement of the knowledge of key loan officers in the loan workout and liquidation even after an institution is intervened and/or closed.

Mergers and P&A transactions are ideal resolution techniques. Over-the-weekend absorption of assets by other banks or other financial institutions—government assisted or unassisted—are textbook examples of how to do efficient least cost closures. However, such operations typically work only in situations where problems not yet are widespread, there is a pool of interested buyers/investors and asset markets are working. Such operations seldom work when market conditions have been allowed to deteriorate, available asset values are highly questionable, financial weaknesses are believed to be widespread and growing, and the priority for other financial institutions is to stay alive, i.e., to preserve their capital and liquidity.

Mergers of two weak banks or sales of assets at inflated prices to weak banks are seldom permanent solutions. Such transactions may be orchestrated or under pressure from the government. It often involves state owned or controlled banks. While such transactions may provide a temporary relief for besieged supervisors, they typically only

lead to a larger problem later on. It is essential that only banks that have the managerial and financial capacity to absorb such assets be allowed to purchase them; needless to say, owners and managers of acquiring banks should also meet fit and proper criteria. Prudent mergers and asset transfers will reduce eventual resolution costs to private creditors and the government, as may be the case.

When distressed assets represent an important share in the financial system, special institutional arrangements may have to be relied upon. While decentralized and market based resolution options may be preferable in principle, they may simply not be available on the scale that is required. A bridge bank may be the preferred vehicle to receive and manage the good assets of one or several intervened or closed institutions. More commonly, the complexity and volume of the resolution may require specialized public resolution agencies. The least cost solution is typically a combination of different decentralized and centralized arrangements that rely on available private sector capabilities as much as possible.

Once a financial institution has been intervened or closed, the loss sharing problems (and moral hazard) move to the asset side of balance sheets. The liquidator or government will assume responsibility for banks and/or bank assets and must seek to manage them in such a way that asset values are protected and losses minimized. Management arrangements must be put in place to keep pressure on good borrowers to keep serving their loans and match repayment terms for nonperforming loans with delinquent borrowers' capacity to service loans. This may include loan restructuring. Claims on recalcitrant borrowers may be put into a judicial liquidation process. Burden sharing becomes a negotiating issue between creditors/the government on the one hand

and bank borrowers on the other hand.¹⁷ The balance is largely determined by the effectiveness of the political, legal and judicial systems to protect creditors. A loss of credit discipline is highly contagious and may lead to destruction of asset values throughout the financial system and the demise of other financial institutions.

H. Linkages with the Macroeconomy

Any closure strategy must take into account how it will affect the macroeconomic environment. Closing one or a few small banks or other financial institutions could be expected to have a limited effect. But closure of a significant part of the financial system may affect economic activity, as depositor and creditor balances may be temporarily unavailable or permanently lost, credit relationships broken and credit discipline eroded. Bank runs may affect monetary stability, lead to capital outflows and pressures on exchange and interest rates that may substantially affect economic activity. The most damaging scenario is closures leading to a system-wide freeze of depositor and creditor claims and an interruption of the payments system.

Fiscal costs must be minimized. Regardless of the government's financial situation there is a need to make sure that any closure strategy involves the least cost to the public sector. This may imply early closures, before losses have been allowed to accumulate due to lax regulations, forbearance and/or LOLR liquidity support. Losses absorbed by a

¹⁷ Borrowers have incentives not to give up control of their collateral or companies. They are prepared to go to great lengths to defend their property rights, including influencing legislation, courts, politicians and officials through legal and illegal means. Banks often end up being forced to give concessions asymmetrically, i.e., to share borrowers' losses up front without having a claim on potential future profits. To counter this, banks may try to get control of borrowers' businesses and future profits through debt to equity swaps and control of their cash flow.

funded deposit insurance scheme may reduce government outlays. The government may avoid fiscal costs by not introducing a blanket guarantee—although this may only seem so in the short run as the lack of a guarantee can cause contagion and lead to much larger costs later on. There may be resistance to closure or resolution because it would involve costs that the government “cannot afford.” That is never a valid argument because delaying action invariably makes the ultimate costs much larger.

Once a government has introduced a blanket guarantee and taken responsibility for the liabilities of financial institutions it has to bear the losses that ensue. Losses can be minimized through a well managed resolution process, including closures, which will preserve financial asset values and reduce ultimate losses—i.e., a least cost resolution. A government also can help keep down ultimate fiscal costs by not allowing leniency or subsidies for borrowers. Governments normally have to issue debt to pay for such losses and may choose to distribute the burden of such debt over time through monetization (inflation). To the extent the government’s capacity to issue new debt is limited, the only options available may be a freeze on depositors and creditors and a public debt default.

Closures could lead to a credit crunch and affect economic activity. Broken credit relationships of borrowers in certain subsectors or regions can be hard to replace and can lead to unnecessary financial hardships, bankruptcies and closures of companies. Companies owned by universal banks or part of financial or non-financial groups or conglomerates that include closed banks may be forced unnecessarily into bankruptcy. As solvency comes under pressure system-wide (perhaps as a result of initial closures) financial institutions may become more interested in securing their own solvency and survival than extending new loans. If credit discipline is deteriorating, perhaps as a result

of dynamics unleashed by the resolution of closed institutions, new credit may dry up altogether. Such a credit crunch often reflects the necessary down-sizing of a financial system after a credit bubble. But it still needs to be considered in the overall closure strategy and also needs to be explained to politicians and the public alike.

Any closure of financial institutions that may have a systemic impact must take above and other macroeconomic linkages into consideration. This does not mean that closures decisions be delayed or avoided, only that they take place after a proper analysis of the two-way linkages between different closure and macroeconomic scenarios. The intent should be to strengthen confidence and avoid, as far as possible, any major changes in the strategy and in loss sharing arrangements. If this is not done, the result could be reversal of closure or burden sharing decisions, which could have devastating effects on market confidence and efforts to normalize the system.

I. Legal Framework

A clear and transparent legal framework for intervention and/or closure of financial institutions is essential.¹⁸ As mentioned above, closures (with or without loss sharing) redistributes wealth and is therefore likely to be strongly contested. Close attention therefore needs to be paid to the legal backing of every aspect of the closure process, including criteria and triggers for closures, dilution and write-off of shareholder rights, loss sharing among classes of stakeholders, etc. Failure to pay attention to what may seem like legal details may result in legal hurdles that may slow down or even bring the entire closure process to a halt.

There may be a need to clarify existing legislation with new regulations and directives, always with the objective of bringing transparency and uniformity to the legal framework. At the same time, there may be political forces working against such transparency, as dealing with institutions on an opaque case-by-case basis gives more opportunities for special favors and different forms of financial bail-outs. Transparent laws and regulations will strengthen the willingness of supervisors and other officials to take decisive action. Work on such clarifications must take place in parallel with preparations for interventions and/or closures.

If problems are systemic, the situation may require a new legal framework if the existing legislation is designed to deal only with individual institutions in normal times. It may be necessary to provide additional intervention powers to the supervisory authority, prescribe new loss sharing arrangements and introduce new summary closure procedures. If a blanket guarantee is used, it normally must be backed by law to gain full credibility.

New laws may be required for the management of closure, restructuring and asset resolution, especially when the volume of assets to be resolved is large. Slow and cumbersome judicial procedures may have to be replaced with summary administrative procedures to allow faster and more efficient resolutions. Laws may have to be introduced or amended to give flexibility for assets transfers and sales, remove tax and other hurdles in the resolution process and guide the establishment of private resolution

¹⁸ For broader discussion see Asser (2002).

vehicles. Foreclosure and bankruptcy laws and procedures may have to be strengthened and streamlined to handle a high volume of cases.

A key legal issue in closures and subsequent resolution of financial institutions is to make sure that supervisors and other key officials are protected under the law for actions taken in pursuit of their legally mandated tasks. Officials involved in the closure and resolution process are often open to intimidation and interference every step of the closure and resolution process. If officials do not feel protected, they will not make decisions in the public interest. The law has to ensure that officials need not fear legal harassment, frivolous law suits and high costs of defending themselves for actions taken in good faith in the conduct of their official duties. The law must seek to give officials the right incentives for making decisions based on what is best for the financial system and the economy.

The judicial system must be in tune with the authorities' closure strategy. The judicial system must be expeditious and predictable. Unnecessarily cumbersome judicial procedures and delays can derail a closure strategy. This may be due to a lack of capacity of the judiciary to handle complex cases. It may also reflect efforts of owners of institutions to be closed or already closed to sabotage the process, perhaps by creating endless delays and by using their political and financial resources to influence the courts. Courts may hear appeals but should not be allowed to stop interventions or closures. If courts become overburdened, budget resources may be required to increase their capacity. In case of systemic crisis, special courts and an additional infrastructure may have to be introduced to facilitate a speedy processing.

J. Institutional and political framework

A common problem in managing closures of financial institutions is a lack of political support. Often politicians are unable to deal with the range of uncertainties that officials face in closures: for example, why data are not firm, losses cannot be precisely established, no one told them before, the extent of possible contagion is not known--just to mention a few. They may lack the will to do anything due to fears of macro-economic consequences or affecting powerful supporters. Ideally, politicians should leave closure decisions to supervisors and other officials, especially when dealing with closures of institutions without systemic importance. But there are also key decisions, like loss sharing with uninsured creditors and depositors, and legal amendments, which are eminently political.

Politically well connected shareholders will try to sabotage closures. They will often try to stop intervention and closure, and delay dilution or loss of their shares. They will fight to preserve control of their institution using all means at their disposal, including corruption and intimidation of government, supervisory and judicial officials. They will seek to maintain some ownership control as well as options to buy back their institution or assets at bargain prices after creditors and government have absorbed losses. A closure decision that is capriciously held up or reversed by a court or government body or cannot be implemented for lack of police or other enforcement support may not only expose institutions or assets to major losses but also broadly damage supervisory authority and discipline in the financial system.

After interventions or closures, politically well connected borrowers will try to avoid servicing their loans. Pressures will mount for lenient application of loan classification and provisioning rules, government imposed debt moratoria, unilateral debt relief by banks, direct subsidies, etc. Politicians will be scared with economic disaster scenarios. Pressures will also be put on the judiciary. Such efforts may be driven by the borrowers with the least capacity to honor their contracts or most political influence, or both. Borrowers with capacity to pay will join the bandwagon. The end result may be a generalized breakdown of credit discipline that could become extremely expensive to the government, make the financial system insolvent and severely limit its intermediary role. Breakdowns in credit discipline are almost always caused by political decisions.

Coordination among different authorities is essential in managing an effective least cost closure and resolution process.¹⁹ Authorities and official entities often operate at cross-purposes. Recognizing that different official authorities have different roles to play in the intervention and closure process, there is a need to share information and coordinate objectives, decisions and implementation. The more complex and widespread the context of bank closings, the more necessary will be formal institutional arrangements for coordinating decision-making. Supervisors are formally in charge of interventions and closures—even if decisions de facto may have been made by another government body. The central bank is the monetary manager and LOLR and needs to coordinate closely with supervisors. The government may be involved as owner of state banks, guarantor of depositors or a deposit insurance scheme, and as the ultimate provider of solvency support for the system. Close policy coordination will help in managing

¹⁹ For a broader discussion see Nyberg (1997).

interventions and closures, containing systemic problems and reducing ultimate resolution costs.

A deposit insurance scheme may be very helpful in managing closures. Explicit insurance of small depositors is likely to make closures of individual banks politically easier, even in cases where large depositors and creditors incur losses. The law of a deposit insurance agency may help clarify intervention and closure procedures. A deposit insurance agency may by law have specific responsibilities for closing and resolving banks and other deposit-taking institutions. It may also have specialized staff and other infrastructure ready to deal with closures and resolutions. A deposit insurance agency will maintain contacts with and will be able to draw on the experiences of similar agencies in other countries.

Staffing may be a key constraint for effective resolutions and closures. If several institutions with branch networks are intervened and closed at once, hundreds or even thousands of staff and security personnel may need to be involved. This may have to be done in the face of militant resistance from the intervened/closed institutions' personnel or labor union. Needless to say, this will require careful planning and preparation. Intervention teams need to be trained in key actions such as to secure premises, protect assets and files, immobilize correspondent accounts, etc.²⁰ At the same time, every effort must be made to keep attention focused on the soundness of remaining institutions, and especially on the core banking system.

²⁰ For a description of such specific actions, see FDIC Closure Manual; FDIC (1998).

Closures and resolutions will require highly skilled staff. Lawyers, bankers, forensic accountants, loan workout specialists, etc. with experience in closures will be needed. To the extent such expertise, including retirees with relevant past closure experiences, is not available locally it will need to be brought in from abroad. Such expertise is often expensive--but that cannot be allowed to be a constraint, because not dealing with losses in a speedy manner is bound to be much more expensive. Local professionals may have to get crash courses in the various operational intricacies and pitfalls of resolutions and closures.

Lack of information and transparency will hamper the closure process make it more difficult to maintaining systemic stability. Too much information at the wrong time, of course, may also hurt the process. As discussed above, closures--and especially closures with loss-sharing--can easily create panic and contagion. Effective information and communications are crucial but often neglected aspects of closure, intervention, resolution and liquidation. An information strategy must make the public aware of the reasons for closures, the broader context, the treatment of different categories of stakeholders, any loss sharing requirements, the broad restructuring strategy, supportive macroeconomic policies and the role of the government and its agencies. A well crafted information campaign can reduce uncertainty and facilitate the resolution and closure process.

Consistency of information is also important. Politicians should seek avoid making statements and interpretations of the rules, because every exception becomes the new rule with unpredictable consequences. Clear and consistent information will help prevent rumors and misinformation as well as erosion of private sector confidence. When

information is not communicate properly or, worse, when different authorities give conflicting messages, confidence is eroded, possibly to the point where the closure and restructuring process is severely derailed. Regardless of the institutional set-up, it is therefore essential to have a single official spokesman for all aspects of an intervention and resolution process, especially the details about closures and loss-sharing. The strategy must be explained in a transparent manner and in sufficient detail for different audiences, including assurances of equitable treatment of similar types of institutions and stakeholders over time. Although hard to estimate, the cost of information lapses can be very high and typically end up being borne by the government.

IV. SUMMARY AND CONCLUSIONS

Closures of unviable financial institutions are essential for keeping a financial system sound. Closure is not an event but part of a complex process to distribute losses and bring bank assets and liabilities back into the market under new ownership with as little market disruption and loss of value as possible. Closing financial institutions is a process fraught with problems, constraints and pitfalls—and it becomes more complex the more widespread or systemic the problems are.

This paper has discussed issues and pitfalls in managing closures of financial institutions. The issues were organized under ten headings. The topics covered are present in different form and with different intensity in every closure case and country.

In managing closures of financial institutions there are always formidable information and measurement problem, which typically make it difficult to meet legal prerequisites for closures. And there are no shortcuts to get the information, as values will become

firmer only over time as institutions are intervened and due diligence and assets sales processes get started. Beyond measurement problems, any closure strategy requires a good understanding of size and ownership distributions of the problem institution(s) within a system. A strategy will be easier for one or a few small institutions than for a large bank at the core of the system not to talk about problems on a systemic scale. Early intervention is desirable but requires legal basis to do so. Closure may have to be preceded by supervisory intervention to establish such a basis. Solvency indicators (and PCA regimes) are often useless as they capture underlying deterioration with too long lags. Liquidity triggers and other intervention criteria may have to be used instead. Supervisory forbearance is often facilitated by liquidity support from the LOLR. The longer this is allowed to continue, the more difficult it will be to stop without systemic problems. Stopping LOLR support to unviable institutions without disrupting the payments system and causing systemic contagion typically cannot be done without closure or intervention.

The most critical issue in managing closures is loss sharing. While owners normally can be assumed to lose their stakes without too much problems, assigning losses to creditors and depositors is a delicate balance between allowing market discipline to work on the one hand and unleashing widespread creditor and depositor runs on the other hand. Contagion can best avoided by introducing a blanket government guarantee, which--if it is credible--will calm creditors and depositors and allow closures to proceed in an orderly manner without market disturbances. However, a blanket guarantee creates a huge moral hazard on the asset side of the financial system as the government will be responsible for all losses. Efficient arrangements for management of the asset of intervened and closed

institutions therefore become priorities and should be ready to be implemented as soon as the intervention or closure takes effect. An inappropriate institutional and legal structure will result in reduced asset values and may lead to a severe erosion of credit discipline with major fiscal and other macroeconomic effects.

Any closure strategy must consider the effects it may have on the macroeconomy as well as effects that different macroeconomic stress scenarios in turn may have on that strategy. Fiscal sustainability and other macroeconomic constraints must also be considered in the design of closure strategies. Closures must scrupulously follow the law as legal hurdles may well bring the process to a halt. If the law is insufficient, it should be amended or complemented. If the judicial system is weak, it may have to be strengthened with budget support to help the closure strategy. It is particularly important to ensure legal protection of supervisors and other official involved in a closure or resolution process. The political process must be made to support intervention and closures, despite likely efforts by politically forceful owners and borrowers to get relief. Coordination between official authorities is essential and if the problem is severe, one or a new authority may have to be put in charge. A deposit insurance agency may greatly facilitate closures. Lack of skilled staff is often a bottleneck so access to local and foreign expertise becomes crucial. Finally, without transparency and an effective information campaign the efforts to strengthen confidence and normalize the system may not be effective.

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