This note provides basic guidance for senior managers of supervisory agencies in making contingency plans to deal with banking or financial system distress and crises. For this purpose systemic distress and crises are taken to be those situations where the solvency and/or liquidity of many or most banks have suffered shocks that have shaken public confidence. Systemic distress and crises usually emerge suddenly and the authorities quickly can find themselves reacting to events. Engaging in contingency planning prior to a crisis will help the supervisory authorities to identify the types of actions that may have to be taken during a crisis, as well as the skills, policies and processes that would be required to support these actions. Contingency planning can lead to more prompt and comprehensive action to resolve crises and can lower the costs of doing so. Contingency planning may also help reduce the likelihood that a crisis will occur or reduce the amount of damage it may cause.

There are several objectives for resolving crises that can serve to guide contingency planning efforts. One is to protect the interests of depositors (especially small depositors). Many national authorities believe it is important to protect depositors’ interests in order to prevent serious damage to the ability of the banking system to

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1 This note was originally prepared for distribution to the Associates of the Toronto International Leadership Centre for Financial Sector Supervision, a non-profit executive development institute for supervisors of the banking, securities and insurance industries.

2 This note will address contingency planning for banking crises, though many of the elements apply equally to the securities and insurance industries.
mobilize savings and contribute to the functioning of the economy. Another objective is to protect the interests of the state (taxpayers) in order to avoid incurring unnecessarily large costs in the process of resolving the crisis and to minimize the future burden on taxpayers. Often private individuals and firms will take advantage of a crisis to gain financially from the authorities’ actions or to escape their responsibilities. The authorities must act in a way that avoids inappropriately benefiting private parties at the expense of the state. In other words, the authorities can and must act in a way that attempts to minimize the costs to the state of resolving systemic distress.

A critical objective is to promptly restore the solvency, liquidity and profitability of the banking system. Only in this way will it again begin to function in a manner supportive of the economy, especially providing credit to firms and consumers.

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

- safety nets (providing liquidity, guaranteeing deposits)
- determining the condition of banks
- strengthening capital-deficient banks
- resolving insolvent banks
- managing and disposing of banks and assets that fall temporarily into state hands
- institutional arrangements

**Safety Nets**

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3 In this view, the utility of a financial system to a country and its citizens is in part dependent on its ability to mobilize the nation’s savings.

4 Financial crises usually result in large fiscal costs that lead to increases in taxes or reductions in other expenditures.

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

6 Systemic distress and crisis often lead to a so-called “credit-crunch” that can contribute to economic recession that will exacerbate the crisis.
The events surrounding a crisis quickly put to the test the official safety nets that support the banking system. This includes the central bank’s role as lender of last resort, and in many countries the official or quasi-official deposit protection arrangements.

**Lender of last resort**

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

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

As part of the routine supervision and regulatory function, bank managers should be required to have in place their own contingency funding plans which define the manner in which they will maintain liquidity in times of distress. Although borrowing from the central bank should be seen as a last resort, banks should ensure that the assets and documentation required to support collateralized borrowing from the central bank are in good order. The supervisory authorities can reevaluate their supervisory policies and processes in this regard, and similarly can reevaluate regulations applicable to maintenance of liquidity.
The supervisory authorities’ contingency plans for a crisis situation should involve several additional elements, some of which are discussed in more detail in subsequent sections of this note. The supervisors should be prepared to solicit from the banks, perhaps even on a daily basis, detailed liquidity reports depicting banks’ funding situation. These reports can be designed in advance, and bank managers can be instructed in their use. In addition, the supervisors will need the capacity to send staff and/or auditors into banks. The purposes may be to evaluate the accuracy of liquidity reporting and the banks’ funding situation, to diagnosis banks’ overall financial condition and operational situation, and to detect potential looting or other misuse of liquidity by bank insiders. Procedures for this work can be defined in advance. Supervisory enforcement actions\(^7\) can also be used to mitigate against the potential misuse of liquidity. Finally, the supervisory authorities need to be able to contribute to government’s capacity to effectively resolve insolvent or capital-deficient banks so as to preclude a situation where the central banks and/or government is forced to provide liquidity to a bank for lack of a viable alternative.

**Deposit Protection Arrangements**

A common reaction by governments to the loss of confidence during a crisis is to publicly commit to guarantee all deposits in banks. In systems that do not have a pre-existing deposit protection arrangements, the authorities introduce them. In systems with limited deposit protection, the limits of coverage are increased.\(^8\)

In a severe crisis the government may appropriately decide it has few alternatives other than to provide some form of blanket protection for depositors. In doing so it must be aware it is both creating a claim on the state and putting its credibility on the line. The

\(^7\) Legally-binding agreements between the supervisory authorities and the senior managers and/or directors of banks.

\(^8\) In some countries even claims on non-bank financial institutions have been covered by such guarantees.
guarantee must either be honored, and therefore financed, or the government’s credibility will suffer damage that will impair its ability to achieve the objectives of crisis resolution.

As with lender of last resort decisions, the supervisory authorities will likely play only a complementary role in decisions and actions relating to deposit protection arrangements during a crisis. For example, they may have a role to play in the procedures for vetting claims and ensuring prompt pay-out of deposits. At the same time, past supervisory actions with respect to disclosures by banks of the status of liabilities can have negative implications for the government’s ability to minimize the extent of state protection.

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

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

**Determining the Condition of Banks**
In a crisis it will be important to be able to differentiate between banks that are winners and those that are losers. The winners are those banks that, in relative terms, have the best management, finances and operations. The losers are banks that have become insolvent, have weak operations, and/or have poor, reckless or criminal managers. The winners will be the foundations of the post-crisis banking system. The losers need to be carefully monitored and resolved.\(^9\)

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

In a crisis, the financial condition of banks can change rapidly. Prior information may be of limited value and a reassessment is often required. It is important that supervisory authorities have a contingency plan for rapidly and accurately determining the evolving condition of banks in a crisis situation, especially the larger banks. This task, a challenge in the best of circumstances, can be greatly complicated if the books and records of banks are in poor condition. Only the best supervisory agencies will have the capacity to quickly diagnosis the condition of a bank in these circumstances, and as an element of contingency planning the senior managers of the agency need to be skeptical regarding this capacity.\(^10\)

One alternative is to use local external auditors to bolster the capacity of the supervisory agency. Local auditors bring the benefit of knowledge of the local market. On the other hand they may not be well-placed to perform the type of work required because they have an auditing perspective and insufficient asset valuation skills. They may also have

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\(^9\) Shareholders, managers, other insiders and debtors of “loser” banks may be those most likely to engage in activities designed to enrich themselves at the expense of depositors or taxpayers.

\(^10\) Of course the supervisory authorities can undertake institutional strengthening that improves the capacity of the supervisory agency in this respect. This work may take several years and is outside the scope of the contingency planning to which this note addresses itself.
conflicts of interest arising both from their role in auditing banks and their relationship with the individuals controlling banks. One way to overcome these potential weaknesses is to require that the process be managed by local audit firms’ international partners skilled in bank valuation and liquidation. The authorities can prepare for this in advance by identifying appropriate firms (local and international) that can perform such diagnostic work, developing basic terms of reference and draft contracts, understanding the contracting process and ensuring there are no legal impediments to contracting with the firms or to the firms performing their work.

This work will yield a first-cut assessment that can be useful in establishing supervisory priorities, supporting decisions by the central bank in providing liquidity, triggering actions to gain control over banks that are in the worst condition or that are being looted, and estimating the overall size of the losses in the system and the potential amount of financing the authorities may need to raise. However, these assessments should not be the basis for determining the capital needs of banks in the context of using public funds to support recapitalization. Diagnostics of that nature are discussed in the context of the following sections.

**Strengthening Under-Capitalized Banks**

In a crisis a significant portion of the banking system may be revealed to be undercapitalized. To achieve the objectives of crisis resolution the government will need to take action to promote the recapitalization of such banks. This involves maximizing the amount of new capital invested by the private sector, a task that in the first instance falls to the supervisory agency.

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11 The firm that has audited the bank during any of the past several years should be excluded from consideration.

12 The experience in virtually all countries that have faced crises is that estimates of losses in the early stages of a crisis are understated, often significantly.

13 Insolvent banks (those with negative capital) will be discussed in the next section of this note.
If, after substantial and thorough effort by supervisors and other senior government officials, private sector alternatives have been exhausted, the government may need to consider using public funds as an inducement for the investment of capital by new investors in the system, especially by strategic investors who offer expertise in the management and governance of banks. As a last resort the government might consider the use of public funds as an inducement for new investment by existing shareholders, though only under exacting terms and conditions. In these activities the supervisory agency will likely play a supporting role.

It follows then that contingency plans by the supervisory authorities should ensure that adequate processes and incentives will be in place to motivate senior managers and existing shareholders to recapitalize their bank. The routine bank supervision process should assess banks’ capital planning processes and promote contingency planning on the part of senior bank management for raising capital in times of distress. Additional incentives encompass four elements: i) a supervisory or other diagnostic process that is seen by bank managers and shareholders as able to accurately assess the condition of the bank, ii) a supervisory enforcement process that will progressively raise the stakes for managers and shareholders who fail to raise adequate capital within a reasonable period of time, including the removal of top management, iii) a prompt and effective failure resolution process that is seen by managers and shareholders as likely to be triggered should the bank be determined to be insolvent or non-viable, and iv) a referral process that will submit any suspected improper or illegal activities for review and possible prosecution by the relevant authorities. By taking advance action to put in place and strengthen these elements, the supervisory authorities will be able to create the credible threat that should shareholders not recapitalize their bank, their ownership interests will be substantially reduced or lost altogether.

Where efforts to induce bank managers to raise capital from existing shareholders or new investors are not successful, the authorities may have to adopt policies for leveraging public funds as a means to create additional incentives. The senior management of the supervisory agency may have a role in formulating and executing such policies.
Contingency planning should include advance consideration and agreement among key government officials of the basic objectives and principles governing the use of public funds for this purpose. These could include for example that the amount of public funds used to effect bank recapitalization has to be held to a minimum and recovered to the maximum extent possible. They could include that when public funds are used, there is a good probability that the recapitalized bank will achieve sustainable profitability as soon as feasible, and that the public funds are used to maximum effect to attract strong management and governance expertise. While in practice these are complex issues and challenges about which much can be written, in the simplest terms contingency plans should ensure that the government will be in a position to aggressively wield the powers it has at its disposal to achieve the objectives of crisis resolution. This is especially important in the (what should be rare) case of providing incentives to existing shareholders. Governments may wish to be more generous with new shareholders, especially strategic investors that bring needed expertise and substantial capital into the system.

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

**Resolution of Insolvent and Non-viable Banks**

In a crisis a number of banks may become insolvent or non-viable. Since the incentives facing senior managers of such banks lead to excessive risk-taking and higher losses, it is...
important that the government has the means to take control of and resolve them.\[14\] Supervisory authorities should promote and assist in contingency planning by the relevant senior officials in government to ensure that the necessary policies, procedures, legal framework and financing will be in place. The actual role of the supervisory agency will vary according to the specific circumstances of individual countries.

Insolvent banks can either be wound-up or taken over by the state. Winding-up can take the form of either liquidation (along with the prompt pay-out of any protected deposits) or an assisted acquisition, whereby liabilities (and perhaps some or all assets) are acquired by a healthy bank with the financial assistance of the government. Consistent with the objectives of crisis resolution, a decision as between liquidation, assisted acquisition and take-over by the state should be based on an assessment of least-cost to the state. Contingency planning should ensure that policies and procedures for making a least-cost determination are in place, including ensuring that a full assessment of the potential future costs inherent in ownership by the state can be made. Putting these in place in advance should help to mitigate the risk that the supervisory authorities and government see take-over by the state as the least objectionable course of action in the near-term only to find it an expensive mistake in the long-run.

Contingency planning should ensure that the government is not forced to take over banks for lack of the capacity to efficiently wind-up a bank. Both means of winding-up banks (liquidation and assisted acquisition) require adequate legal foundations and well-defined policies and procedures. Deposits payouts in a liquidation usually require financing in cash, whereas assisted acquisitions are usually financed by the issuance of state bonds or guarantees. Contingency planning should ensure that legal powers, policies, procedures and financing will be in place so as to make winding-up a viable option.

\[14\] Moreover, supervisory authorities need to be assured of their capacity to reign-in instances of excessive risk-taking or looting by the managers of troubled banks.
In the case of liquidation, it is important that the authorities have the capacity to rapidly pay-out protected deposits to prevent an erosion of public confidence that will arise if uncertainty is created about prompt payment. The supervisory authorities should work to ensure that such capacity exists, and be prepared to play their role in the process.

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

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

Management and Reprivatization of Banks Under Temporary State Ownership

In the course of resolving a crisis the government may suddenly become the owner of banks, especially relatively large banks, that have become insolvent but will not be
wound-up. The challenge facing the government and the supervisory authorities will be to avoid new losses being incurred and prepare the bank for resale. Depending on the severity of the crisis as well as other factors, the government may be the owner of the bank for a period of a year or more. To mitigate potential problems inherent in state ownership, the government needs to be prepared to exert sound governance over the institution and ensure effective management. While not the primary responsibility of the supervisory agency, the supervisory authorities can play a role in making preparations for adequate governance arrangements. The supervisory function can serve as a complement to these governance arrangements and a check on their implementation.

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

**Institutional Arrangements**

If the scope of distress is limited, perhaps involving the insolvency of a small portion of the banking system, the supervisory institutions (the supervisory agency, the central bank and the deposit protection agency) may be able to resolve the problem. At some point however the scope of the distress can overwhelm the capacity of the supervisory institutions. For example, if extraordinary financial resources are required or if there is the potential that banks will come under temporary state ownership, the finance ministry must become actively involved. By that point ad-hoc institutional arrangements should be in use to coordinate actions among the various government institutions. However, if
distress becomes systemic and reaches crisis proportions the top political authorities should establish a temporary single-purpose unit (a crisis management unit, or CMU) with responsibility for resolving the crisis and coordinating the activities of the permanent institutions of government. Such a CMU would report to the most senior levels of government (e.g. the President or Prime Minister).

Governments should establish a CMU because crisis resolution is in fact an extraordinary management challenge that can quickly overwhelm the capacities of the permanent institutions of government. Limits to their institutional capacity and weaknesses in coordination, sometimes including competition and rivalry, can undermine their effectiveness in dealing with a crisis and can prove costly. CMUs are a means to provide for full-time management of the crisis by an expert team, to coordinate the actions of the permanent institutions of government, and to bolster their combined capacity by bringing to bear specialized skills. They also are a means to promote the ability of the government to speak with one voice on issues related to crisis resolution, which will be critical to its ability to establish credibility and restore confidence.

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

Advance consideration should be given to the possible staffing and structure of a CMU. Appropriate staffing is critical. While the CMU would likely rely on senior staffs seconded from the permanent institutions of government, its top management team might

15 The specialized skills are similar to those required to deal with the bankruptcy of a large and complex private sector conglomerate, including managerial and leadership, corporate finance, and legal skills.
well be drawn in part from the private sector. The CMU will have to deal with all the issues set out in this note, which in turn should influence considerations regarding appropriate structure in country-specific circumstances.

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

Conclusions

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

Acknowledgements

The author would like to thank Robert Clarke, former U.S. Comptroller of the Currency, Ruth de Krivoy, former President, Central Bank of Venezuela, Michael Mackenzie, former Superintendent, Office of the Superintendent of Financial Institutions, Canada, Eigil Molgaard, former Chief Executive, Danish Supervisory Authority, Brian Quinn, former Deputy Governor, Bank of England, and Susan Marcus, The World Bank, for their contributions to this note.