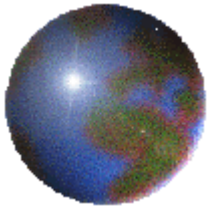


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*Comments on:
“Pitfalls in Managing Closures
of Financial Institutions”
by Carl-Johan Lindgren*

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Overview

- ✚ **Great paper—lucid, balanced, useful, permeated by hands-on knowledge and flashes of wisdom**
 - ✚ **Links to macro issues – a major plus**
- ✚ **The 10 areas of pitfalls are “on the money” and inter-linkages are well developed but there is lack of sufficient prioritization**
- ✚ **Focus of comments (Latin American centered):**
 - ✚ **Legal issues**
 - ✚ **Pitfalls of intervention**
 - ✚ **Open-bank resolution vs. closed-bank resolution**
 - ✚ **Liquidation: entire vs. residual balance sheet**

Ten Areas of Pitfalls

- 1. Valuation problems**
- 2. Identification problem – is it systemic?**
- 3. Intervention triggers**
- 4. Forbearance and liquidity support**
- 5. Loss sharing**
- 6. Contagion potential**
- 7. Asset value protection and least cost solutions**
- 8. Links to the macro economy**
- 9. Legal framework**
- 10. Institutional and political framework**

Legal Issues

- + Weak legal grounds and instruments – a common source of delays and even paralysis**
 - * Still dominated by corporate bankruptcy model (liquidation of entire balance sheet, see below)**
 - * Inadequate protection of the process – reversals of interventions/liquidations by court decisions**
 - * Deficient protection of supervisory and monetary authorities – cases abound in the region**

- + Beyond the legal framework – the judiciary!**
 - * Lack of expertise**
 - * Capture**

Pitfalls with Intervention

- ✚ **Risks for authorities in intervening to administer a bank that they do not own**
 - ✚ **Co-administration – liability for “running the bank into the ground”**
 - ✚ **Inherent instability (vulnerability to runs) if intervention is seen as two way street**
 - ✚ **Common corner solutions – first step towards inexorable liquidation or nationalization**

- ✚ **Understandable trend in LAC**
 - ✚ **Intervention as first step in resolution**
 - ✚ **Improved design of “regularization plans” (PCA)**

Closed-Bank vs. Open-Bank Resolution

Open-bank resolution

- ✱ The accordion technique (Spanish FOGADE; Colombian FOGAFIN) to gain ownership control
- ✱ All bank creditors are made whole – moral hazard
- ✱ Flexibility for “too-big-to-close” – restructuring (“carve-outs”, “spin-offs”) before re-privatization
- ✱ May become default route if rules of engagement not well designed (who decides; who pays)

Closed-bank resolution

- ✱ Best way to stop “bleeding” and limit moral hazard
- ✱ But technology is of the essence –over the weekend resolutions– to enhance authorities’ willingness

Liquidation: Entire vs. Residual Balance Sheet

+ Two distinct approaches

- ✳ Improve liquidation proceedings (extra-judicial?)
- ✳ Improve pre-liquidation resolution technology

+ Two key considerations (emphasis on function)

- ✳ “Hostages” – must disable authorities’ fear of depositor behavior while keeping bank owners’ fear
- ✳ “Refrigeration” – maintain assets in private hands

+ Tropicalization of P&As (residual balance sheet)

- ✳ Deposit transfer backed by senior participations in a privately managed asset asset trust
- ✳ Asset trust “enhanced” by deposit insurance with less cost rule
- ✳ Liquidation of residual balance sheet w/o license
- ✳ Consistent with “bridge bank” option