
ARTICLES

A primer on Open Bank Resolution

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The Reserve Bank supervises registered banks with the objective of promoting the maintenance of a sound and efficient financial system and avoiding significant damage to the financial system from the failure of a bank. While the Reserve Bank designs its prudential supervision to reduce the risk of banking failure, bank failures remain possible. It is therefore essential that there are robust processes in place to manage bank failures to minimise the costs and disruption to the financial system and the wider economy, whilst minimising the cost to the taxpayer of doing so. This article outlines the work that the Reserve Bank has been doing to implement its Open Bank Resolution (OBR) policy to meet these objectives, and explains how the policy would affect different parties were it necessary to use it in practice.

1 Introduction

The global financial crisis has highlighted the enormous fiscal cost governments can incur in providing financial support for troubled banks. A major challenge for policy-makers is how to limit the disruption of a bank failure on the economy whilst minimising the overall cost to the taxpayer. At the same time, it is important that resolution options do not erode market disciplines on bank creditors to act prudently in their dealings with the bank. The Reserve Bank first began considering options for responding to a bank failure following the 1997 Asian financial crisis. This work led to the development of the Open Bank Resolution (OBR) and other supporting policies.² OBR is a tool that would enable the failure of a large bank to be managed without many of the disruptions and stresses to the banking system and economy that would be caused by allowing conventional failure regimes (ie, liquidation) to operate.

This article provides an outline of the OBR policy and its implications for stakeholders.

2 Implications of a bank failure

Businesses can fail for a variety of reasons. Indeed, in a well-functioning economy, normal competitive pressures will lead to the demise of less efficient or effective firms over time. While the failure of any firm will be disruptive for its direct

stakeholders, in most instances it does not create significant problems for the wider economy, with the failed firm simply passing into liquidation or being acquired by a stronger rival.

However, a bank failure can have more wide-reaching implications for the economy than the failure of most other firms, particularly if the bank is large. In any modern economy, banks are a conduit for numerous financial contracts that must be honoured and renewed over time to enable the economy to function properly. A bank failure can cause major upheaval for significant numbers of individuals and businesses if they suddenly find themselves unable to access their funds, make payments, or draw on their existing credit lines. In the event that the bank was subject to a standard liquidation process, it could be many months or years before any remaining value in the business could be released to depositors and other creditors. In the interim, the bank's closure would most likely be extremely disruptive for the economy.

In principle, liquidation of a major bank could be avoided if the failing bank was acquired by a rival institution or new entrant. Whilst there have been examples of large financial institutions acquiring rivals, one large bank may be unable or unwilling to rescue another without public support, particularly given that a failure is more likely to occur during times of wider market distress. Acquisition may be particularly problematic in the case of New Zealand, where the banking sector is dominated by a small number of relatively large institutions.

The primary objective of OBR is to ensure the continuation of the core banking functions of the distressed bank – in a

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² The OBR (then referred to as Bank Creditor Recapitalisation) was described in detail in a paper by Harrison *et al* (2007).

manner that limits the cost to the taxpayer – until its future can be resolved. In the absence of viable alternative solutions there will be strong pressure on governments to provide ‘bail-outs’ to distressed banks, which can result in large fiscal costs and can create an expectation of public support. The resulting ‘moral hazard’ can damage incentives on bank management to operate in a prudent manner, and reduce the incentive for creditors and depositors to scrutinise their bank’s affairs. OBR helps to address these concerns in that it improves the ‘resolvability’ of banks, making it possible to impose losses on owners and creditors. Furthermore, it is consistent with wider international efforts to develop effective failure resolution frameworks.³

3 The OBR policy

The Reserve Bank’s OBR policy is an important part of the toolkit for responding to a bank failure in New Zealand. It is designed to allow a distressed bank to be open for business on the day after the bank is placed under statutory management. Compared to other failure resolution processes, this has the advantage of allowing customers to gain access to most of their account balances and to other banking services without material disruption. It would also have the benefit of enabling the bank to continue to operate while an appropriate long-term solution is identified. This, in turn, would help to preserve the remaining value of the bank relative to a situation where it was forced to close its doors (as may be expected in a liquidation or receivership).

A bank may be placed into statutory management on the advice of the Minister of Finance following a recommendation of the Reserve Bank. This reflects the reality that placing a bank into statutory management deprives the owners of control of their business. Moreover, while the OBR is a Reserve Bank policy, bank failures often involve risk to the taxpayer and their resolution – of whatever shape or form – tends to take on a ‘whole-of-government’ dimension. The reasons for making such a recommendation are prescribed in the Reserve Bank of New Zealand Act and include a bank

being insolvent, or being operated in an imprudent manner, or that its circumstances pose a threat to the soundness of the system. Once the decision has been taken to put a bank into statutory management, the primary objectives of OBR are to:

- Ensure that, as far as possible, any losses are ultimately borne by the bank’s shareholders and creditors consistent with the legal obligations they entered into.
- Provide a mechanism to enable the bank’s customers (individuals and businesses) to continue to have access to most of their deposits (and to other banking facilities like transactions facilities) so as to reduce the disruption to the economy that would otherwise occur.
- Enable the core of the bank to be kept as intact as possible to minimise disruption to the payments system and wider banking system.
- Ensure that an urgent desire to avoid economic disruption does not dictate how the important matter of loss allocation is determined; ie, to ensure the government is not forced to bail out the bank simply because there are no acceptable alternatives.
- Preserve any remaining franchise value in the business to maximise the exit options.

Under OBR, shareholders are the first to bear the bank’s losses, followed by its subordinated debt holders. If there are any remaining losses, these are then allocated to the bank’s unsecured creditors, including its depositors. A proportion of each unsecured creditor’s funds would be frozen (and therefore inaccessible) based on a conservative assessment of the potential for losses by the failed bank. This estimate would include a suitable buffer to allow for the inevitable uncertainty around the final size of any loss. The frozen funds would be available to the statutory manager to apply against the bank’s losses. Once the initial frozen proportion had been determined, no further funds would be frozen even if the bank’s financial position was to deteriorate further.

An important advantage of OBR over some other resolution options is that customers would be able to access the unfrozen portion of their funds immediately after the bank

³ See, for example, the BIS report on ‘Resolution Policies and Frameworks’ www.bis.org/publ/bcbs200.htm The Reserve Bank’s OBR policy is broadly consistent with the recommendations contained in this report.

was placed in statutory management. In practical terms, the unfrozen funds would be available from the start of the following banking day. The unfrozen portion of funds would be supported by a government guarantee. This support would be expected to significantly reduce incentives on customers to withdraw all of their remaining funds, but there would be no restrictions on them doing so. The Reserve Bank would provide liquidity support to ensure that the affected bank could meet customer demands for funds.

In addition to gaining access to the unfrozen portion of their funds, the intention under OBR would be to ensure that existing customers continue to have access to other banking services, such as the ability to make payments. This might also include ongoing access to their existing credit facilities. However, the statutory manager (possibly on the direction of the Reserve Bank) would need to reach decisions about the terms and conditions under which new deposits would be accepted and any credit facilities were supplied. These decisions would take into account the likely impact on the economy, the effect on the bank's future prospects, and any additional fiscal risk for the Crown.

An essential requirement to be able to implement an OBR is that the banks' operating systems have the capability to freeze a portion of funds in customers' accounts whilst providing immediate (ie, next day) access to the remaining portion. The Reserve Bank is requiring all registered banks with retail funding of over \$1 billion to pre-position their internal systems to be able to give effect to the policy.⁴

Significant work has been undertaken in recent years to ensure that the structures of financial institutions in New Zealand and key payment systems are consistent with the implementation of OBR. Reserve Bank policies such as outsourcing, local incorporation and governance – while important in their own right – were designed to be consistent with the implementation of the OBR.⁵ In particular, these policies were designed to help ensure that the New Zealand subsidiary of an overseas parent bank would have the stand-

alone functional capability to remain open for business even if the parent itself was closed.

The key elements of the OBR process are presented in figure 1 in stylised form overleaf.

The OBR itself does not resolve the future of the bank or allocate final losses. Rather, it is a mechanism that ensures ongoing liquidity for creditors whilst the government determines the appropriate exit strategy. In this regard, it is likely to be materially less disruptive than liquidation or receivership would be. Furthermore, the process of freezing and releasing portions of creditors' claims has no impact on the ranking of creditors that would apply in a conventional liquidation. The impact on each class of creditor is discussed in detail below.

4 The OBR and stakeholders

This section discusses the implications for various groups of stakeholders once a bank that is subject to the OBR process reopens for business. Figure 2, overleaf, provides a stylised representation of the bank's balance sheet after the initial assessment of losses has been undertaken and a proportion of creditors' claims have been frozen.

The following sections provide more detail on the impact on each stakeholder and an explanation for the reasons for their respective treatments.

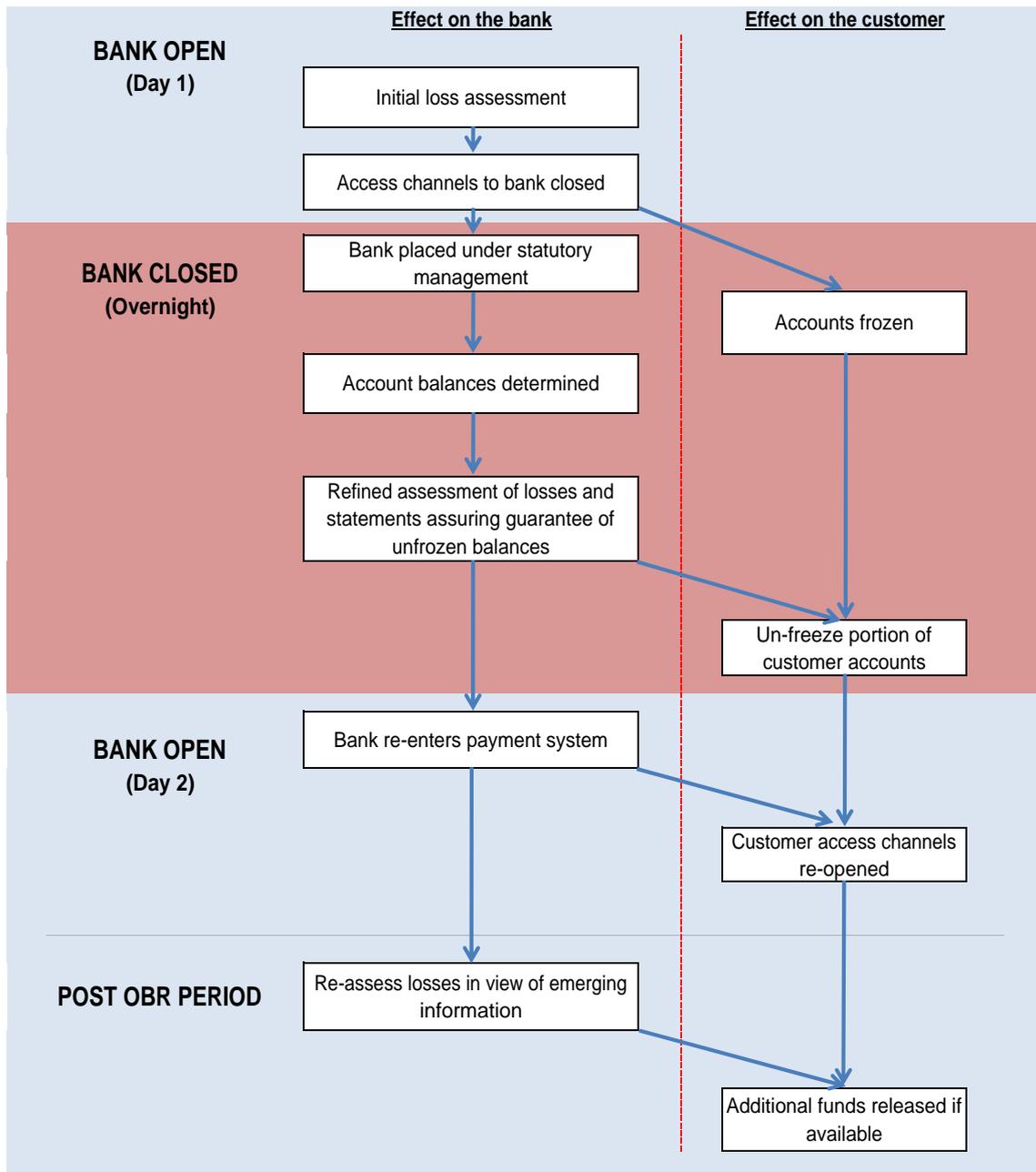
Bank owners and shareholders

One of the advantages of the OBR is that it reduces the moral hazard that is created when there is an implicit assumption that public support will be provided to troubled banks. This can mean that the owners, shareholders (and creditors) enjoy the full benefits of good performance, while not necessarily bearing the full consequences of poor performance. As a result, it can generate incentives for excessive risk taking, with negative consequences for the financial stability of the wider economy, especially where shareholders assume or believe that should things go wrong public funds will be used to 'bail them out'. This is sometimes referred to as 'privatising the gains and socialising the losses'.

⁴ See <http://www.rbnz.govt.nz/finstab/banking/4335146.pdf>

⁵ See Chetwin (2006) 'The Reserve Bank's local incorporation policy', 69(4) *Reserve Bank of New Zealand Bulletin*, and RBNZ 'Outsourcing policy' <http://www.rbnz.govt.nz/finstab/banking/regulation/bs11.pdf>

Figure 1
Stylised example of the OBR



The OBR is designed to ensure that owners and shareholders bear the first loss in the event that the bank fails. There will have been opportunities for the existing owners and shareholders to provide additional capital or other support to the bank before the decision is taken to activate the OBR policy. In effect, the activation of OBR means that the existing owners of the bank have become unwilling or unable to support the bank themselves, or obtain support from a third party without public assistance. Without such assistance, the bank could be expected to fail. As a result,

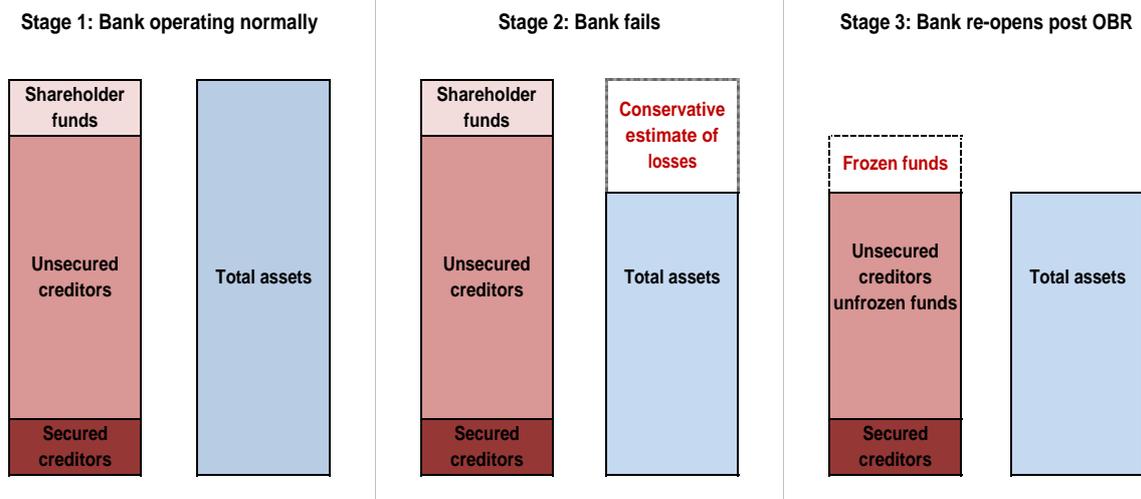
it is expected that their economic interest in the institution is fully extinguished at the point the bank enters the OBR process.

Subordinated creditors

OBR is not intended to alter the ranking of stakeholders relative to a conventional liquidation. Accordingly, any creditors of the bank that are legally subordinated (ie, a claim that ranks after all other claims in the event the bank fails) should expect to have their claim extinguished before

Figure 2

Initial impact of OBR process



any losses are incurred by the rest of the bank's creditors. Subordinated creditors would retain a residual interest only in the event other creditors were able to be fully repaid with a surplus available.

Unsecured creditors

Unsecured creditors include a wide range of individuals and entities. At one end of the spectrum, there are large international financial institutions that invest in debt issued by the bank (commonly referred to as wholesale funding). At the other end of the spectrum, are customers with cheque and savings accounts, and term deposits.

Whilst there are differences between different classes of unsecured creditors, they all have the same legal claim on the bank. Each has freely invested in a private institution and has enjoyed a return on that investment whilst accepting the risks associated with the investment. Under the OBR, it is expected that all unsecured creditors would be treated equally with the same proportion of claims remaining frozen for all depositors and creditors. The only difference in treatment will be the speed with which each class of investor is able to access the unfrozen portion of their claim.

The pre-positioning of customer accounts (such as transaction and savings accounts) means that they would have access to a significant proportion of their funds the day after the bank fails. This, in turn, would reduce the social and economic costs of failure. Holders of term deposits would be expected to have access to the unfrozen portion

of their funds upon maturity.

It is important to note that while the OBR has not been designed to pre-position the same functionality for wholesale funding, holders of the bank's unsecured wholesale debt will face the same proportion of losses as other customers. Wholesale investors are usually large institutions, and can generally be considered to be much better placed than retail customers to manage a delay in accessing the good portion of their claim, and as such the costs of requiring pre-positioning for these investors are not considered to be justified.

Secured and preferred creditors

Secured creditors include those with a legal priority over the bank's assets. The OBR process should have no impact on the ranking of creditors. Secured creditors would look to their security in the first instance to meet their claims on the bank.

Government and taxpayers

The OBR is designed to ensure that depositors have on-going access to banking services and as much of their cash as possible. For this objective to be met, other parties in the financial system must be able to transact with the bank with confidence upon its reopening. To ensure that this confidence is maintained, it is essential that the assessed good portion of all funds, and any new obligations entered

into by the statutory manager, are backed by a government guarantee for the period in which the bank remains under statutory management.

These factors combined mean that the government (and by extension taxpayers), are bearing the risk that the initial assessment of losses is not sufficiently conservative. Public funding would therefore be required to make up any shortfall in meeting the guaranteed portion of depositors' funds. For this reason, the initial assessment of the proportion of funds that needs to be frozen to cover losses will be conservative to give comfort that there is sufficient headroom over estimated losses.

Exiting OBR

OBR is not designed to determine how the bank failure should ultimately be resolved, but to create time for a full analysis of the appropriate course of action to be determined. While the initial portion of the creditors' claims that are frozen puts a ceiling on their final losses, their actual losses may be less than this if it turns out that the estimate of the losses was too conservative. Once the affairs of the bank have become more certain, the statutory manager has the capacity to return a portion of the frozen monies to depositors. Therefore, creditors could well regain access to much of their frozen funds once the bank's losses are determined.

Ultimately, the resolution of the bank will fund the unfrozen liabilities. This may be achieved through a number of means, including:

- liquidation and sale of assets;
- takeover by another bank or repurchase by parent group; or
- restructure for continued operation as a stand-alone bank.

The final exit strategy would be determined on a number of factors, with market conditions, the viability of the entity, and other commercial factors playing an important role in the final decision.

5 Conclusion

While rare, bank failures can happen, and can be enormously costly and disruptive. The global financial crisis has renewed the focus on finding resolution mechanisms to deal with failed banks that do not involve heavy recourse to the taxpayer (ie, taxpayer-funded bail-outs). The OBR policy is an important component in the toolkit of resolution options, and one that is in keeping with international developments.

The OBR has several noteworthy features, including:

- facilitating the resolution of the bank without material recourse to the taxpayer;
- strengthening incentives on bank management and creditors to operate in a prudent manner, thereby reducing the probability of failure;
- providing a way to minimise the disruption that would occur to customers and the wider economy from the closure of a bank; and
- providing customers with continued access to most of their funds (the unfrozen portion), supported by a government guarantee.

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