RESOLVING SYSTEMICALLY IMPORTANT BANKS

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Reserve Bank of New Zealand

General failure management objectives

- Maintain public confidence in the operation of the financial system
- Minimise risk and/or cost to the Government
- Preserve incentives on stakeholders (banks, creditors, regulators)
- [Protect the innocent/needy/uninformed]

Too Big to Close

- Provide customer access to liquidity (deposits, normal credit facilities, payments functionality)
- Minimise market disruptions
- Minimise domino/contagion effects

Principal failure management options

1. Government bailout/nationalisation
2. Closure and conventional liquidation – pari passu payout with long delay
3. Deposit insurance – closure, immediate payout of insured deposits (less deductible)
4. “Prompt resolution” – 2 options:
   - Recapitalisation by insurer
   - Recapitalisation by creditors

Conventional deposit insurance

- Maximum amount covered
- Deductible/co-insurance
- Scope of “deposit” is limited
- Funded by levies – ex ante or ex post
- Resolution can be executed in a variety of ways:

Deposit insurance – resolution techniques

- Close bank, payout insured deposits, insurer assumes rights of insured creditors in liquidation
- Purchase and assumption of assets/liabilities
  - partial or whole-bank
  - financial contribution from insurer
  - liquidation of residual bank
- Bank kept open, with insurer control and assistance

Effectiveness of resolution techniques

- “Narrow” deposit insurance does not deal with TBTC:
  - the bank is closed
  - wholesale funding is not protected, and can “run” readily
  - normal credit facilities, payment functionality etc not maintained
- “Broader” approaches (“BIR”) can address TBTC partially or wholly

Recapitalisation by insurer (BIR)

- Insurance fund “fills the hole”
- Coverage effectively extended to uninsured deposits etc
- Insurer takes the bank over, or funds a “purchase and assumption” by another bank
- Bank effectively maintained as a going-concern
- Not necessarily least-cost resolution

Requirements to implement BIR

- Constituted Insurer, with authority to act and access to sufficient funding and liquidity
- Clear responsibilities for supervisor, insurer, central bank, (government)
- Prompt access to detailed financial data – assets, liabilities, market positions – to assess net asset deficiency
- Prompt access to the core functionality of the bank to enable continued operations

Recapitalisation by creditors (BCR)

- Stop the bank, “clear the pipelines”
- Initial haircut and partial release of core deposits
- Freeze on other obligations – pending haircut and release
- Re-open for limited business, under government guarantee if warranted
- Finalise haircut amount for pari passu application to all obligations
- Further release of core deposits, if warranted
- Payout on frozen obligations

Requirements to implement BCR

- Prompt access to detailed financial data – assets, liabilities, market positions – to assess net asset deficiency
- Clear rules and procedures for stopping the bank and "clearing the pipelines"
- Pre-positioning of the haircut software so that it can be executed quickly
- Prompt access to the core functionality of the bank to enable continued operations

BCR and BIR - similarities

- The bank remains open
- Core operations continue
- Immediate customer liquidity is provided through deposits and normal credit facilities (although deposits haircut in the BCR case)

BCR and BIR - differences

- Who pays?

BIR – surviving bank customers and shareholders (+ failed bank customers if ex ante levies significant, deductibles enforced)

BCR – failed bank customers

- Residual risks?

Probably lie with the Government in both cases, but greater under BIR

BCR and BIR - differences

BCR	Incentives and disciplines are largely preserved
BIR	Higher moral hazard Incentives on creditors weakened substantially Market discipline??

Funding an insurer

- Balance between ex ante and ex post levies
- Risk premiums
- Co-insurance
- Incentives on creditors and banks
- Tricky “level playing field” issues:

    Big banks subsidising small banks?

    Pricing the current implicit guarantee?

Exit strategies

- Choice of BCR or BIR does not restrict subsequent actions
- Both provide a platform for (eg)

  - Continued operation of the bank
  - Winding down the bank
  - Sale of the whole bank, or parts

“Recapitalisation”

- The immediate need is to “fill the hole” (restore “bare” solvency) so that the bank can continue to trade
- A subsequent need <u>may</u> be to provide fresh capital if the bank is to remain in full operation; this could come from different sources
- Issues that might need to be resolved in the particular circumstances are:
  - who now owns the bank?
  - what are the rights and status of the previous owners?

Pre-Commitment

Balance between:

- Certainty. Highly desirable that everyone knows in advance exactly what will happen so that they can manage their risks
- Flexibility. Desirable so that the response can be tailored to the particular circumstances. Constructive ambiguity?
- Credibility is key

Solution: Serious commitment to BCR as a workable option may be the best balance

Conclusion

- BCR probably lower operating cost than BIR
- BCR more effective than BIR in preserving incentives on banks, creditors and regulators
- BCR and BIR both involve significant operational risk – regular testing essential
- Appropriate exit strategies are an issue in both cases
- Credible positioning of the BCR option reduces the risk of less-attractive choices

Quotation from the research

We find a very strong and robust link between the generosity of the deposit insurance system and bank fragility….This result is consistent with the view that deposit insurance not only substantially aggravates moral hazard but also produces deleterious effects on bank fragility. The results, moreover, suggest that the adverse incentive effects from deposit insurance overwhelm any stabilizing effects."

J.R.Barth, G.Caprio and R.Levine, "Bank Regulation and Supervision: What Works Best?", World Bank, November 2001

Characteristics of some alternatives

Objective	Government rescue	Deposit insurance	BIR	BCR
Maintain public confidence in the operation of the financial system	Yes	No – if systemically important bank fails	Yes	Yes, provide wholesale deposits freed-up quickly
Minimise Government cost and risk	No – potentially high cost	Government may be explicit or implicit underwriter	Government may be explicit or implicit underwriter	Yes
Incentives on banks	High moral hazard	Medium moral hazard Market discipline depends on “who pays”: could be significant under “survivor pays”. Depends also on whether premiums are risk-based.	High moral hazard. Market discipline depends on “who pays”: could be very significant under “survivor pays”. Depends also on whether premiums are risk-based.	Low moral hazard, and market discipline preserved
Incentives on creditors	Weakened substantially	Weakened for insured depositors; OK for uninsured	Weakened substantially	Yes, if BCR perceived as credible
Incentives on regulators	Greater risk of forbearance?			Less risk of forbearance?
Customer access to liquidity	Yes	Only in respect of insured deposits; credit facilities and payments access not available	Yes	Yes
Market disruptions	Minimised	Could be large – wholesale depositors etc could be unsettled/disrupted	Low	Possible if wholesale payouts delayed or if creditors aggrieved
Domino/contagion effects	Minimised	Could be large – wholesale depositors etc could be unsettled/disrupted	Low	Possible if wholesale payouts delayed or if creditors aggrieved