

How to Manage Troubled Banks? A Practitioner's Approach

Introduction

The **South East Asian Central Banks (SEACEN) Centre** held its 9th Conference of Directors of Supervision of Asia-Pacific Economies in Singapore on 9 July 2007, with the theme of "Building Intervention and Resolution Framework for Problem Banks." The Conference provided a needed forum for the heads of supervision departments of central banks/monetary authorities in the Asia-Pacific region to exchange views and share experiences on topical issues pertaining to banking supervision.

Among the distinguished speakers, Jean Pierre Sabourin, Chair of the Executive Council and President of the **International Association of Deposit Insurers (IADI)**, delivered a presentation on "Management of Troubled Banks: A Practitioner's Approach" based on his experience in leading the Canada Deposit Insurance Corporation and now the head of the Malaysia Deposit Insurance Corporation. This Research Letter issue highlights Mr. Sabourin's views on the issues related to problem bank resolution.

What were the main issues addressed during the presentation?

In his remarks, Mr. Sabourin attempted to identify the following issues: 1) guiding principles in effectively managing troubled banks; 2) the role of different players in a financial system; 3) the roles and responsibilities of safety net players in dealing with troubled banks; 4) issues in selecting an appropriate resolution method; and 5) challenges and practical considerations for deposit insurers.

Guiding principles for effectively managing troubled banks

In the first part of the presentation, Mr. Sabourin noted five guiding principles which he thinks are most useful and effective in building a sound and robust banking system:

- Safety and soundness, performance and ongoing viability are the direct responsibility of the bank's board of directors and not that of regulators or supervisors.
- Given the critical role of banks in the economy, sound and effective regulatory, supervisory and deposit insurance regimes are essential.
- Regulatory forbearance is all too often a sin with expensive consequences.
- Effective resolution of troubled banks is optimal when there is a private sector solution without financial assistance being provided by the safety net players.
- When a bank's capital dips below minimum regulatory requirements, intervention by the supervisor should immediately follow, based on clear intervention guidelines.

Mr. Sabourin noted that "The failure of a bank would have severe economic, social and political consequences since it affects a large number of the population, is disruptive and is therefore to be avoided. Hence banks are regulated and supervised extensively to ensure they remain financially safe and sound." He added that regulations must keep in concert with international best practices and fit a country's current financial system development.

The role of different players in a financial system

Attention then moved to the roles and responsibilities of different players in a financial system. As Mr. Sabourin mentioned, the basis of a safe and sound banking system relies on a number of key players, such as the board of directors, managers and supervisors. Hence, it is important for each of the players to understand their roles and responsibilities for supporting a sound and solid banking system.

First of all, he mentioned the important role of the board of directors, which is to set the strategic direction and the tone for establishing and complying with sound risk management policies based on the understanding of the risk inherent in their business. He then noted the role of bank managers, which is primarily to implement the business plan approved by the board of directors and manage the business and affairs of the bank according to board approved controls and limits.

Regarding the relationship between the board of directors and bank management, he said, "When management takes inappropriate risks and exposes the bank to large financial losses, the board must act to either eliminate that risk and/or change management. It is sound governance to separate the role of the Chairman of the Board and that of the CEO. The separation of duties and responsibilities of the Board and Management reinforces that the board delegates its responsibilities to the CEO and the CEO takes instructions from the board."

While addressing the responsibilities of supervisors to ensure that banks are well governed and well managed, Mr. Sabourin also pointed to recent changes in the supervisory environment – supervisors are increasingly undertaking risk-based examinations and should more and more rely on the work undertaken by the banks' internal and external auditors.

The roles and responsibilities of safety net players in dealing with troubled banks

In this section, Mr. Sabourin raised two key questions and answered them from the deposit insurance practitioner's perspective.

Who should be involved in dealing with troubled banks and at what point? Although in many jurisdictions only the supervisor and the central bank are vested with the authority to handle closure policy and resolution methods for troubled banks, he empathized that a deposit insurer also should be involved at an early stage when a bank becomes troubled since the deposit insurer bears the financial risk of all entrants to the banking system and the risk of the supervisor's inability and lack of will to act to resolve a troubled institution efficiently without regulatory forbearance.

Who should lead the bank failure resolution process? Taking Malaysia's case as an example, Mr. Sabourin stated that "It is vitally important that each safety net player's mandate is fully defined in law. In some jurisdictions, the supervisor has a mandate which includes the power to rehabilitate a troubled bank. However, it increases moral hazard by creating a perception that the supervisor stands ready to guarantee the rehabilitation and hence this may create more losses to deposit insurer. The difference in Malaysia's approach to bank resolution is the supervisor-deposit insurer partnership."



Attention then focused on the areas of cooperation for supervisors and deposit insurers in managing troubled banks. Mr. Sabourin briefly explored the Malaysian case where there is a Strategic Alliance Agreement (SAA) between the Malaysia Deposit Insurance Corporation (MDIC) and the Bank Negara Malaysia (BNM).¹

Issues and challenges in selecting an appropriate resolution method

Considering the importance of implementing appropriate prompt corrective action, he addressed some issues and challenges relevant to supervisors and other financial safety net players in selecting an appropriate resolution method.

He first pointed out that a bank's liquidity situation often masks other problems, and it is often the case that management will only recognize non-performing loans (NPLs) and record appropriate provisions if their balance sheet can absorb them. He said, "As a result, one only sees the tip of the NPL iceberg while much of the problem is hidden from view, only to appear later."

Mr. Sabourin then turned to the appropriate timing of supervisory intervention in dealing with a problem bank. While he believes a private sector solution by recapitalizing the bank or finding a purchaser or merger partner is the optimal option for a problem bank, he added, "If the bank's capital is below regulatory requirements and a recapitalization is not expected, then the supervisors must trigger an intervention in the best interest of the financial system."

Before selecting a failure resolution method, it is very important for the relevant players (the supervisor or the deposit insurer) to adequately assess the extent of the risks and exposures in the troubled bank, ensuring that the valuation assumptions are valid and include all in costs at net present values, and hence the available resolution options could be compared each other. He then looked at some useful criteria that a deposit insurer should set out when it considers providing financial assistance to a troubled bank for reducing total resolution costs ultimately.

Challenges and practical considerations for deposit insurers

In the final section, Mr. Sabourin focused on the challenges and concerns that deposit insurers are facing. He empathized three key challenges for deposit insurers which have a least cost mandate for bank resolution: 1) the lack of information in respect of the assets and liabilities of the troubled bank; 2) the lack of a well-functioning securitization market, particularly in most Asian countries; and 3) the lack of appropriate skilled personnel needed for asset management or claims-and-recoveries activities.

He ended with a remark on organisational effectiveness of the safety net players responsible for troubled bank management. "I see the bank resolution process as a team effort. The combined strength of each safety net player is needed to steer financial stability and each has a role to play. The real measure of our individual effectiveness is when the total financial system effectiveness is greater than the sum of our individual contributions."

¹ For further information on the SAA between MDIC and BNM, please see the linked IADI Research Letter Vol. 1 Issue 8 (12 October 2006): http://www.iadi.org/Research%20Letters/IADI_ResearchLetter_Vol1_Iss8.pdf.



Where to get further information on the Presentation?

For more information, please find the full text of Mr. Sabourin's presentation paper at the following linked website: [Management of Troubled Banks: A Practitioner's Approach](#).

This Research Letter was issued on 25 July 2007.

Editor: Gye Hwang Cho
Visiting Researcher
International Association of Deposit Insurers
Tel: +41 (61) 280 92 54 (Basel, Switzerland)
Fax: +41 (61) 280 95 54
E-mail GyeHwang.Cho@iadi.org www.iadi.org