



General Guidance for the Resolution of Bank Failures

Introduction

In order to deal in a timely and effective manner with the impact of individual bank failures or systemic banking crisis, many countries are seeking to enhance their mechanisms for dealing with problem institutions. Although the responsibilities of deposit insurers vary from country to country, the manner in which failed banks are resolved has a major impact on all deposit insurers.

This issue highlights the main issues articulated in the [General Guidance for the Resolution of Bank Failures \(Guidance Paper\)](#) issued by IADI in December 2005. The guidance developed is based on the judgment of IADI's members and the experiences of deposit insurers and will be of use to many similar organizations involved in the resolution of bank failures.

Key guidance points

The guidance is divided into five parts. The first part addresses general issues; the second section deals with interrelationships among safety net participants and cross-border issues; the third looks at the powers accorded to deposit insurers; the penultimate part addresses operational and administrative issues related to resolutions; and the final section deals with specific issues related to the resolution of failing or failed banks.

General Issues:

- A strong institutional framework reduces the risk of banking failures or crises and helps minimize the costs of bank failures. Thus, it is recommended that policymakers ensure that there is a strong institutional framework in place for the economy and financial system. This should include: sound macroeconomic policies, effective corporate governance, sound banking supervision and regulation (including prompt corrective action), an efficient and effective failure resolution processes and a well- developed judicial and criminal investigation system. Furthermore, strengthening the institutional framework for bank supervision is of particular importance for deposit insurers with a limited or "pay-box" type mandate.
- Effective bank failure resolution requires an operationally independent and accountable deposit insurer, with a clear mandate, and one that is insulated from undue political and industry influence.
- The failure resolution powers granted to a deposit insurer should be consistent with its public policy objectives and mandate.
- The legal system should support the timely and effective resolution of bank failures including situations which pose a systemic risk to the financial system.



- The use of temporary blanket guarantees –to fully protect all bank depositors during a financial crisis– and reliance on public funds may be appropriate in certain circumstances.

Interrelationship and Cross-border issues:

- The division of duties and responsibilities among safety net players should be clearly defined and information sharing and coordination mechanisms must be in place for all financial safety net participants.
- An explicit statutory mechanism should be set up for dealing with systemic crises and when dealing with “Too Big to Fail” issues.
- With the increasing growth in international banking activities there is a need for greater information sharing and coordination between deposit insurers, supervisory authorities and other safety net players when dealing with failures across international borders.

Statutory powers accorded to the deposit insurer:

- Deposit insurers should have access to all necessary funding in order to fulfil their mandates.
- A deposit insurer should have the authority to accept or reject new members and terminate the insurance status of a member institution and coordinate on the timing of termination with the supervisory agency prior to the closure of a bank. While this might create some issues it is recommended that the deposit insurer should at least participate in the decision-making process.
- A deposit insurer should have the authority to conduct on-site reviews, perform due diligence, and have access to depositor records before a bank is closed.
- Those working for a deposit insurer and other safety net participants should have appropriate legal protection while discharging their mandates, and afterwards.
- Clear legal authority should be in place to allow for the prosecution of the directors, officers, and auditors of failed banks when there is due cause.

Operational and Administrative Issues:

- Deposit insurers should have appropriate policies and standard operational procedures (SOPs) for all their bank resolution processes.
- Deposit insurers should have the authority to contract outsourcing services for specialized consultation, evaluation or appraisals, or Certified Public Accounting firms with the capability to assist in the carrying out an independent valuation of the failing/failed bank.



- Deposit insurers should undertake an appropriate valuation and follow transparent sales processes for the resolution of failed banks.
- A deposit insurer should have in place an effective public awareness and communication mechanism to enhance the confidence of the public in the deposit insurance system and the failure resolution process.
- A code of conduct for employees of a deposit insurer should be in place.
- A deposit insurer should be provided with powers to investigate and, if necessary, litigate against those parties at fault in a bank failure.

Resolution of Failing or Failed Banks:

- It is important to have in place a “rules-based” or statutory trigger mechanism for early intervention into the affairs of a troubled bank and for determining whether a bank has failed.
- A professional, experienced team composed of staff from the supervisor and/or deposit insurer (or outside experts) should assess the viability of a problem bank.
- In order to be efficient, reliable and credible in handling individual bank failures, the deposit insurer should establish effective resolution policies and procedures.
- Failure resolution strategies should try to maximize the recovery of the failed bank’s assets using a market approach including possible recovery mechanisms that will allow the deposit insurer to benefit from any upsides.
- The rules for managing the liquidation process, reporting duties of the liquidator, legal deadlines and distributions to creditors should be well defined and documented.

Where to get further information on the discussion paper?

The General Guidance for the Resolution of Bank Failures can be accessed on the IADI website: [Guidance Paper – Resolution of Bank Failures](#).



Question of the Month for Deposit Insurers

Do you have a method or system which helps deposit insurers identify the correctness of a bank's deposit records before the bank goes into a trouble? (If yes, please describe briefly how the method or system works.)

Determining who should be reimbursed and how much should be reimbursed to each depositor is critical to an effective reimbursement process. However, when the amount of deposits declared by a failed bank turns out to be different from the actual amount collected from the depositors, the deposit payout function will not work effectively. Hence, the FSF Guidance on deposit insurance pointed out that systems and procedures should be developed in order to help deposit insurers to get more reliable and correct deposit records of the failed bank.¹

This Research Letter was issued on **10 January 2007**. This month's question was asked by the Savings Deposit Insurance Fund of Turkey, a Member of IADI. The editor is looking forward to active participation on the "Question of the Month" from deposit insurers throughout the world and hopes to receive responses by **31 January 2007**. The results of the responses will be addressed in a Research Letter to be issued in February.

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

Layout & Design: Mark Lindsay E-mail: marklindsay@cdic.ca

¹ See page 34 of the Guidance for Developing Effective Deposit Insurance Systems (2001), the Financial Stability Forum (FSF) at the following website:
<http://www.iadi.org/html/App/SiteContent/FSF%20Final%20Report.pdf>