

**IADI**

*International Association of Deposit Insurers*

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# **General Guidance for the Resolution of Bank Failures**

Prepared by the Research and Guidance Committee  
International Association of Deposit Insurers

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# **I. Executive Summary**

Since its establishment in 2002, the mission of the International Association of Deposit Insurers (IADI) has been to “contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation.” As part of its mission, IADI undertakes research projects to provide guidance on deposit insurance issues.

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 failing or failed banks. Although the responsibilities of deposit insurers for various aspects of the resolution framework vary from country to country, the manner in which failed banks are resolved has a major impact on all deposit insurers.

The objective of this paper is to develop general guidance for deposit insurers and other safety net participants interested in establishing or enhancing their mechanisms for the resolution of failed or failing banks. It was prepared by the IADI Sub-committee on Developing Guidance for the Resolution of Bank Failures and is designed to take into account different country circumstances, settings and structures.

The guidance developed is based on the judgment of IADI’s members and the experiences of deposit insurers involved in the resolution of bank failures. Key sources of information used were the responses from a survey questionnaire distributed by the sub-committee in June 2004. The paper also draws on relevant reports and other literature available on the subject.

## **Key guidance points**

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

### **A. General Issues**

1. 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 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 paybox mandate.

2. Effective bank failure resolution requires an operationally independent and accountable deposit insurer, with a clear mandate and that is insulated from undue political and industry influence.
3. The failure resolution powers granted to a deposit insurer should be consistent with its public policy objectives and mandate.
4. The legal system should support the timely and effective resolution of bank failures including situations which pose a systemic risk to the financial system.
5. The use of temporary blanket guarantees and reliance on public funds may be appropriate in certain circumstances.

## **B. Interrelationship and Cross-border issues**

1. 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.
2. An explicit statutory mechanism should be set up for dealing with systemic crises and when dealing with "Too big To fail" issues.
3. With the increasing growth in international banking activities there is a need for greater information sharing and coordination between deposit insurers and supervisory authorities dealing with failures across international borders.

## **C. Statutory powers accorded to the deposit insurer**

1. Deposit insurers should have access all necessary funding in order to fulfill their mandates.
2. A deposit insurer should have the authority to accept or reject new members and terminate the insurance status of a member bank and coordinate on the timing of termination with the supervisory agency prior to bank closure. Or at least a DI should participate in the decision process.
3. A deposit insurer should have the authority to conduct on-site reviews, perform due diligence and have access to depositor records before bank closure.
4. Those working for a deposit insurer and other safety net participants should have appropriate legal protection while discharging their mandates, and afterwards.
5. 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.

## **D. Operational and Administrative Issues**

1. Deposit insurers should have appropriate policies and standard operational procedures (SOPs) for all their bank resolution processes.
2. 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.
3. Deposit insurers should undertake an appropriate valuation and follow transparent sales processes for the resolution of failed banks.
4. 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.
5. A code of conduct for employees of a deposit insurer should be in place.

6. A deposit insurer should be provided with the power to investigate, and if necessary, litigate against those parties at fault in a bank failure.

## **E. Resolution of Failing or Failed Banks**

1. It is important to have in place a rule-based or statutory trigger mechanism for early intervention into the affairs of a troubled bank and for determining whether a bank has failed.
2. 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.
3. In order to be efficient, reliable and credible in handling individual bank failures, the deposit insurer should establish effective resolution policies and procedures.
4. 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 the upside.
5. The rules for managing the liquidation process, reporting duties of the liquidator, legal deadlines and distributions to creditors should be well defined and documented.

## II. Introduction

Since its establishment in 2002, IADI has been committed to sharing deposit insurance information and experiences with the international community. The mission of IADI is to “contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation”. As part of its mission, IADI undertakes research projects to provide guidance on deposit insurance issues.

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 failing or failed banks.<sup>1</sup> Establishing an appropriate resolution framework and clarifying the roles and responsibilities of the financial safety-net participants within it are central issues and are highly dependent on a country’s political, cultural, financial, economic, legal and supervisory circumstances.<sup>2</sup>

The responsibilities of deposit insurers for various aspects of the resolution framework are also country-specific and reflect national public policy objectives and mandates. However, regardless of the specific responsibilities of the deposit insurer, the manner in which failed banks are resolved is of crucial importance for all deposit insurers and other financial safety net participants.

The objective of this paper is to develop general guidance for deposit insurers and other safety net participants interested in establishing or enhancing their mechanisms for dealing with bank failures.<sup>3</sup> It was prepared by the IADI Sub-committee on Developing Guidance for the Resolution of Bank Failures and is designed to take into account different country circumstances, settings and structures.

The paper is based on the judgment of IADI’s members and the experiences of various countries involved in the resolution of bank failures. Key sources of information used in the paper were the

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<sup>1</sup> In this paper the term “bank” is used to describe all financial institutions which accept deposits from the public.

<sup>2</sup> The financial system safety net typically comprises the functions of financial sector supervision and regulation, deposit protection, a lender of last resort facility and often includes a role for the government treasury department or ministry.

<sup>3</sup> The Sub-Committee on Developing General Guidance for the Resolution of Bank Failures was made up of members from 13 countries: Taiwan (Chair), Canada, France, Japan, Jordan, Hungary, Kazakhstan, Korea, Mexico, Nigeria, Philippines, Russia, and USA.

responses from a survey questionnaire distributed by the sub-committee in June 2004.<sup>4</sup> The paper also draws on relevant reports and other literature available on the subject.

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<sup>4</sup> The questionnaire entitled "Resolution of Bank Failures" was distributed on 3 June 2004 to 76 institutions including both IADI and non-IADI members. The number of questionnaires returned was 34, which represented a 45% response rate.



### **III. Resolution of Failed Banks: Issues and Survey Results**

In order to assist in the development of guidance on the subject of the resolution of failing or failed banks, the Research and Guidance committee of IADI prepared a detailed survey questionnaire. The survey collected information from a wide range of countries and different types of deposit insurers and financial system safety net arrangements.<sup>5</sup>

The deposit insurers who responded ranged from those which could be classified as primarily paybox types (with a mandate focused on paying out depositors claims when a bank fails) to "risk minimizers" or non-paybox type deposit insurers with wider mandates providing them with the means to better control the risks they face.

For the purposes of this paper the term "resolution" is defined as a disposition plan for a failed or failing bank, which is directed by the responsible safety-net authority, and is generally designed to fully reimburse or protect insured deposits while minimizing costs to the deposit insurer. Typically, resolutions involve costs to the insurer because the insurer's obligation to insured deposits exceeds net recoveries on the institution's assets.

Some of the key areas addressed in the survey included: the incidence and costs of bank failures and systemic crises; the factors responsible for failures; the roles and responsibilities of deposit insurers and other safety net participants in resolutions; the pros and cons of various resolution methods and approaches to asset disposition for failed banks; information sharing and coordination mechanisms; and valuable insights from the actual experiences of deposit insurers in handling resolutions and asset dispositions.

The following section of the paper sets out the detailed survey findings and the sub-committee's analysis and evaluation of the results.

#### **General Observations**

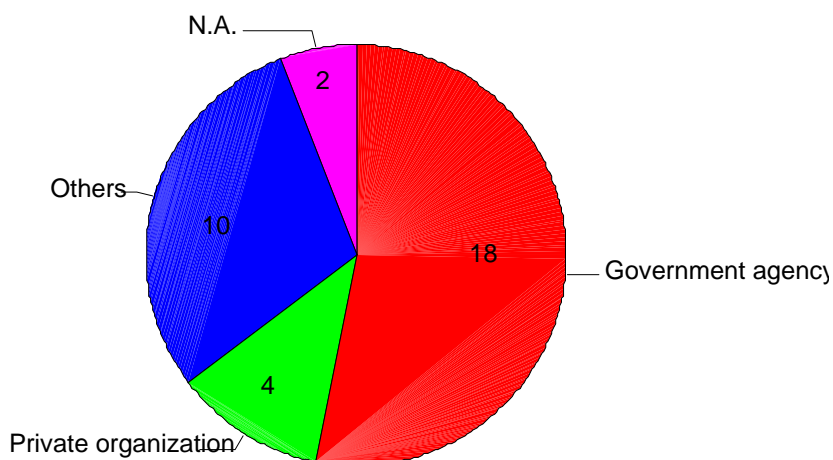
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<sup>5</sup> A total of 76 questionnaires were distributed on 3 June 2004, of which 34 were circulated to IADI members and 42 were circulated to Non-IADI members. Thirty four responses were received representing a 45% response rate. Among the 34 respondents, 15 deposit insurers could be classified as primarily pay-box types and 19 deposit insurers were classified as primarily non-pay-box type deposit insurers or risk minimizers. The collected questionnaires were reviewed for completeness and logic and were processed by SPSS statistical software.

In general, the survey results confirmed the prevalence of consolidation and conglomeration trends in banking through both internal expansion and mergers and acquisitions. Banking industry concentration continues to increase in most countries. According to the questionnaire responses among 34 countries, five countries had a concentration ratio of 93% of assets for their top five largest banks while the average concentration ratio in 25 countries was more than 30%.

Another finding of the survey was that banking crises have been quite common. Twenty four out of the 34 respondents indicated they had had some form of banking crisis or major failures during the last ten years. It also appears that the trend to increasing concentration in banking is raising the risk exposure of deposit insurers and other safety net participants to individual bank failures and potential systemic crises. Thus, when dealing with bank failures it is important for safety net participants to understand the issues of both individual bank failures and failures which could result in systemic crises.

Figure 1: Organization of DI



In dealing with systemic banking crisis, the role and responsibility of every financial safety net participant, including the deposit insurer, supervisor and central bank is very important. Based on the responses to the questionnaire, most deposit insurer (DI) respondents were administered by a government or a public agency. Only four deposit insurers were privately administered. The insurers in ten countries could

not be characterized as primarily government or private, but shared characteristics of both systems (Figure 1).

## **A. Countries confronting a banking crisis or individual bank failure**

Except for Portugal and Cyprus, most countries surveyed had confronted a banking crisis or individual bank failures. Over the last ten years, nineteen countries had suffered from a banking crisis. The earliest and latest crises among the sample countries occurred in 1990 and 2003 respectively.

### **1. Net resolution cost**

Among 19 countries which responded to questions on resolution costs, the minimum resolution cost was US\$709,000 and the maximum was US\$162 billion with an average of US\$20 billion. As to resolution costs as a percentage of one year's GDP for a country, the lowest ratio was 0.002% for Hungary and the largest was 35.8% for Jamaica, with an average of 5.5%. For those countries with high net resolution costs<sup>6</sup>, the costs to the economy and financial stability were extremely high. This illustrates the importance of strengthening the effectiveness and efficiency of banking supervision, regulation and the resolution of bank failures.

### **2. Macro & non-macro factors causing a banking crisis or individual bank failure**

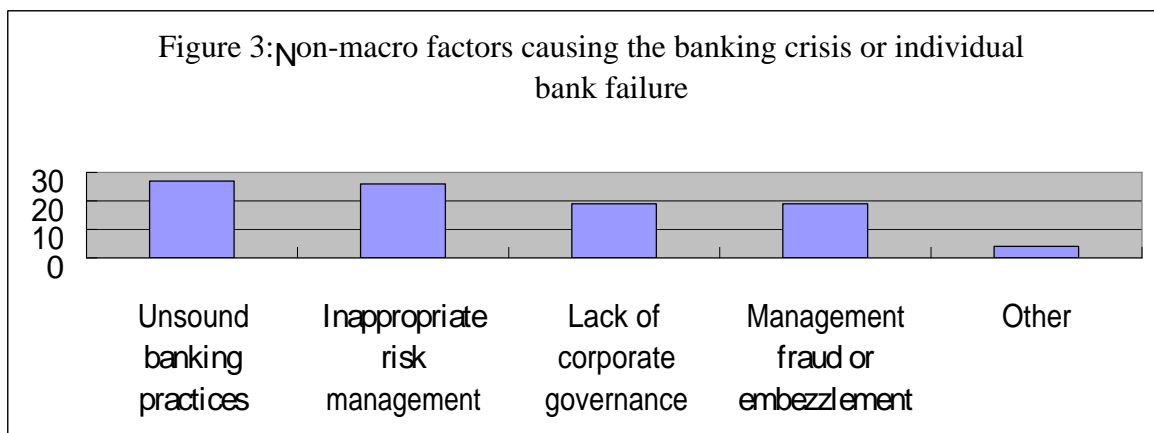
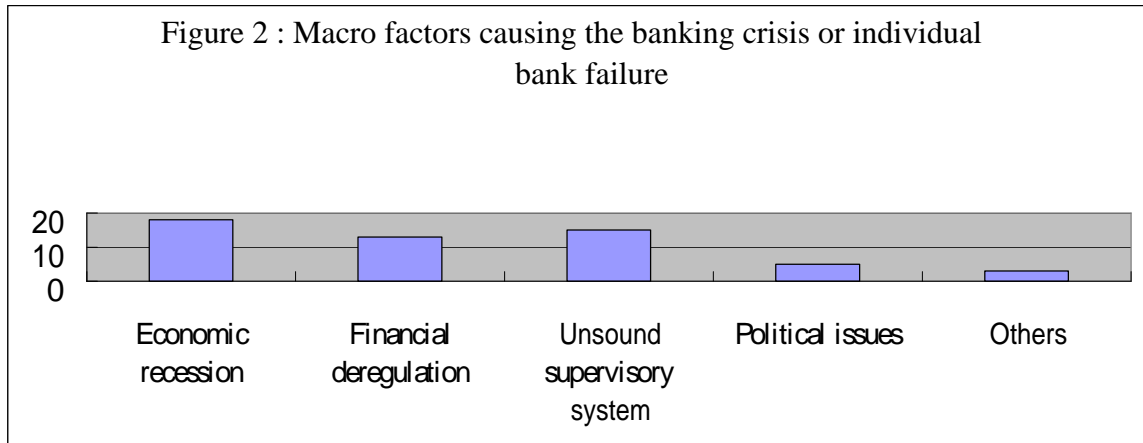
Referring to the macro factors<sup>7</sup> causing a banking crisis or individual bank failures, economic recession was the most common reason cited (18 countries), followed by the presence of an unsound financial regulatory/supervisory system (15 countries), financial deregulation (13 countries), and political issues (5 countries). As for bank failure specific non-macro factors<sup>8</sup>, the reasons cited were in order: unsound banking practices, inappropriate risk management, poor corporate governance and management fraud or embezzlement<sup>9</sup> (Figure 2,3).

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<sup>6</sup> Regarding denominator GDP, some countries use the certain year GDP and The Philippines uses the 5-year average GDP.

<sup>7</sup> and <sup>8</sup> The answer to the question was a multiple-choice.

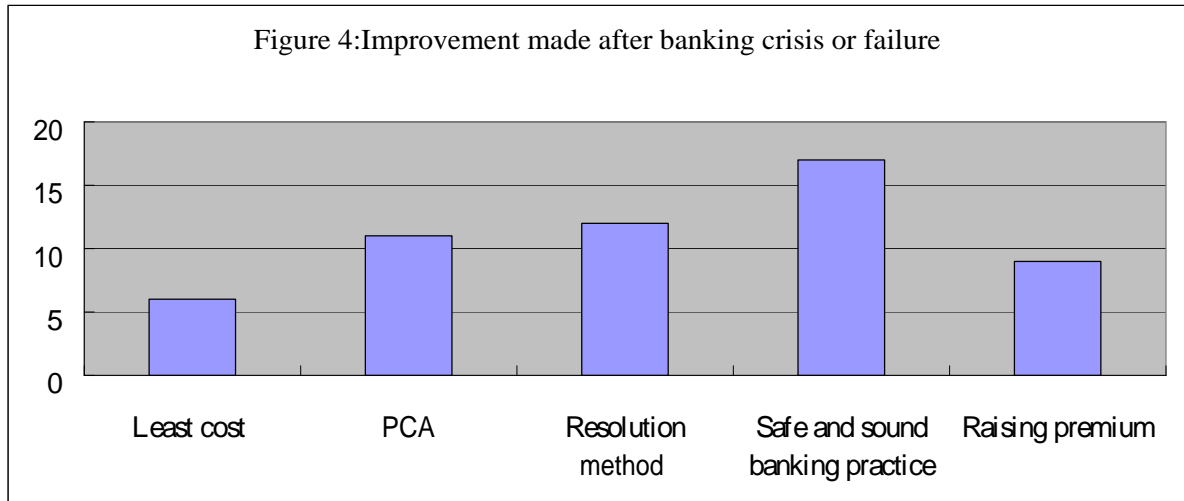
<sup>9</sup> If we need to define the relations among: "unsound banking practices", "inappropriate risk management" and "Poor corporate governance", one could say that "inappropriate risk management" & "poor governance" are the forms of "unsound banking practices".



### 3. Improvements made after the banking crisis or the bank failure

The improvements made<sup>10</sup> by governments in 34 countries after a banking crisis or bank failures were in top down order: the introduction of safe and sound banking practices, improved bank resolution methods, prompt corrective action (PCA), raising deposit insurance premiums and/or adopting differential premium systems, and the introduction of least cost resolution practices (Figure 4).

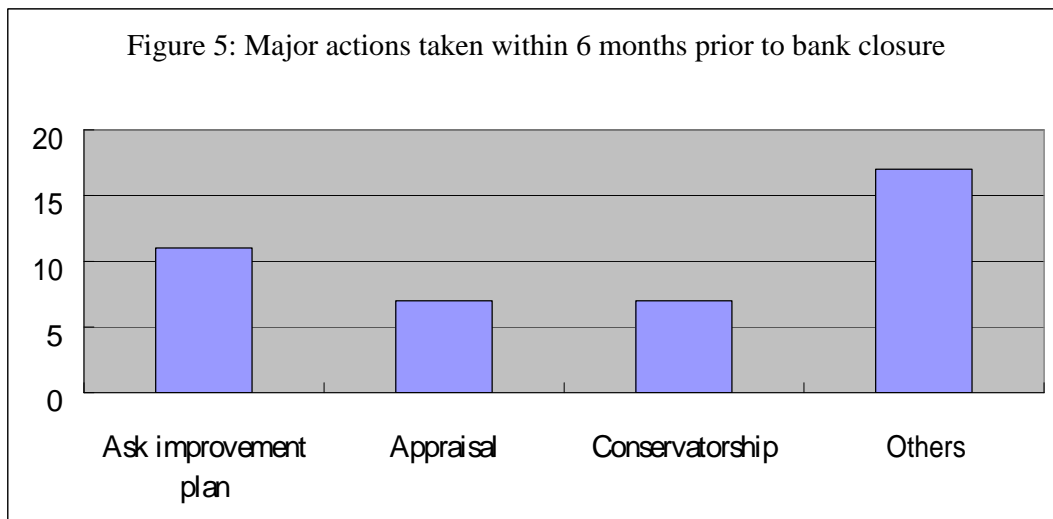
<sup>10</sup> The answer to the question was a multiple-choice.



## B. Resolution powers and mandates in dealing with individual bank failures

### 1. Major actions taken within six months prior to bank closure

According to the survey results, the deposit insurer or supervisory agency can take the following major actions within 6 months prior to a bank closure<sup>11</sup> (Figure 5):



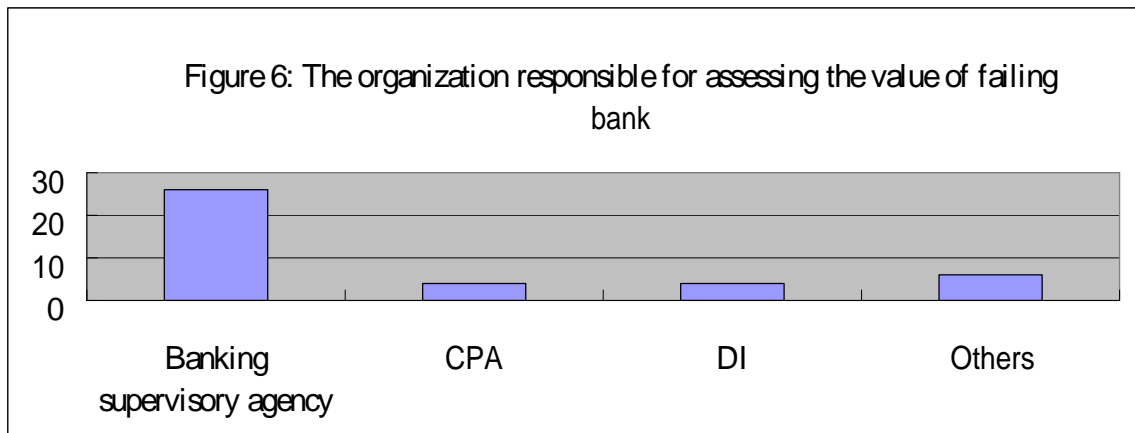
(1) Request the failing bank to submit a recapitalization or improvement plan (11 countries).

<sup>11</sup> The answer to the question was a multiple-choice.

- (2) Arrange for the appraisal of assets and liabilities of the failing bank (7 countries).
- (3) Place the failing bank into conservatorship (7 countries).
- (4) Others: Some countries responded that the deposit insurer or supervisory agency should first make sure that the bank is insolvent and then properly arrange for the appraisal of the failing bank's assets and liabilities (e.g. such as in the Philippines and Cyprus). In other countries the deposit insurer or supervisory agency can take actions when allowed/empowered by their central bank such as in the Netherlands and France.

**2. Prompt corrective action (PCA) and the legal authority to declare bank failure**

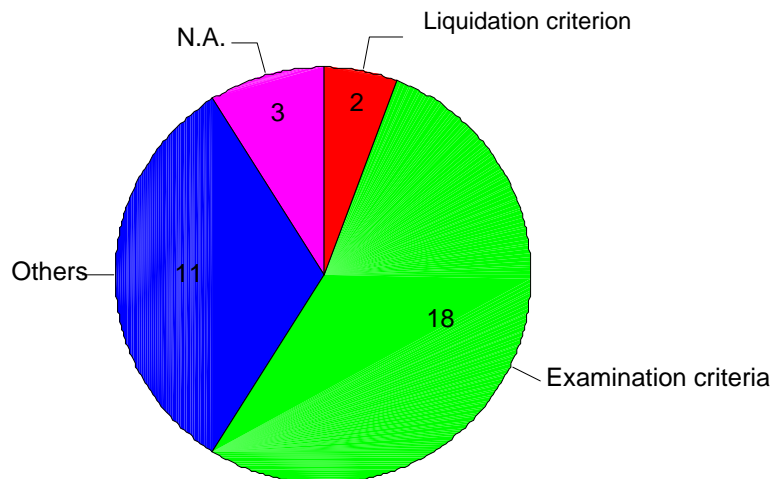
- (1) PCA: There were 15 countries surveyed which had a rule-based or statutory approach for early intervention and resolution (e.g. PCA).
- (2) Assessing viability: Responsibility for assessing the true value of a failing bank (e.g. its net worth or financial viability) was given to the supervisory agency in 26 countries, accounting firms (i.e. CPA) in 4 countries, and the deposit insurer in 4 countries.



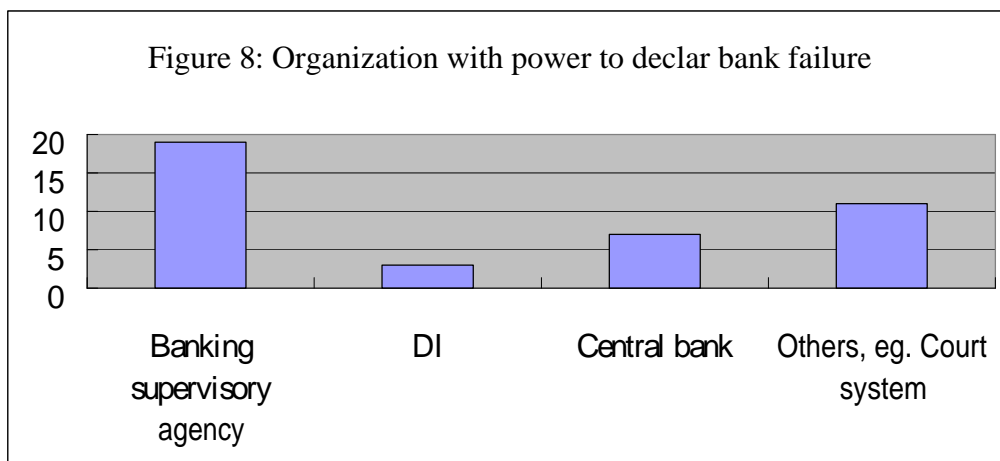
- (3) Criteria used to determine whether a bank has failed: 18 countries have adopted the supervisory on-site examination<sup>12</sup> criteria and 2 countries use a liquidation criterion to determine whether a bank has failed. However, no country which responded to the survey had adopted market value criteria for valuation. (Figure 7)

<sup>12</sup> The supervisory on-site examination criteria refer to the general appraisal methodology used by supervisory agency when conducting the on-site examination towards financial institutions. Liquidation criterion refers to the appraisal methodology used by liquidators to access the recovery value of a financial institution on a liquidation basis.

Figure 7 :Criteria used to determine whether a bank has failed

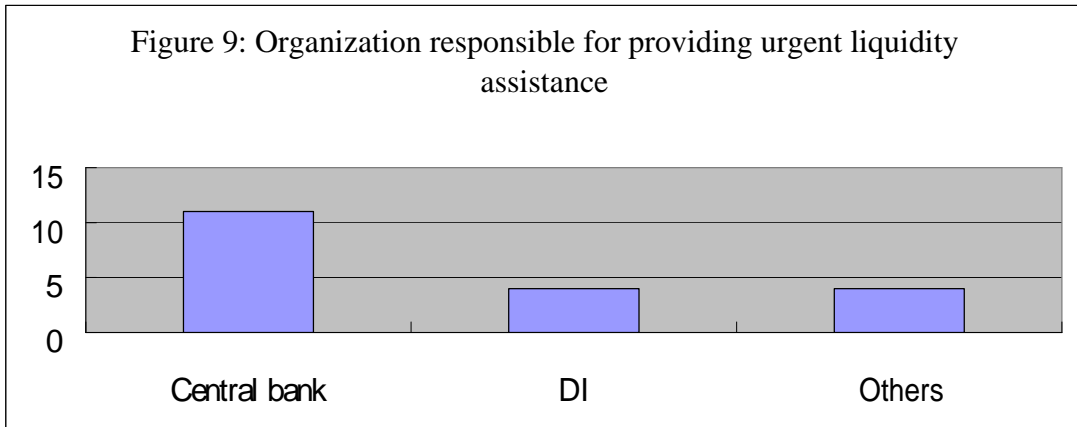


(4) Declaration of bank failure: the banking supervisory agency in 19 countries was responsible for the declaration of a bank failure. The central bank in seven countries; and the deposit insurer in three countries were granted the legal power to declare whether a bank has failed or is insolvent. The remaining countries responded that these powers reside in their court system. (Figure 8)



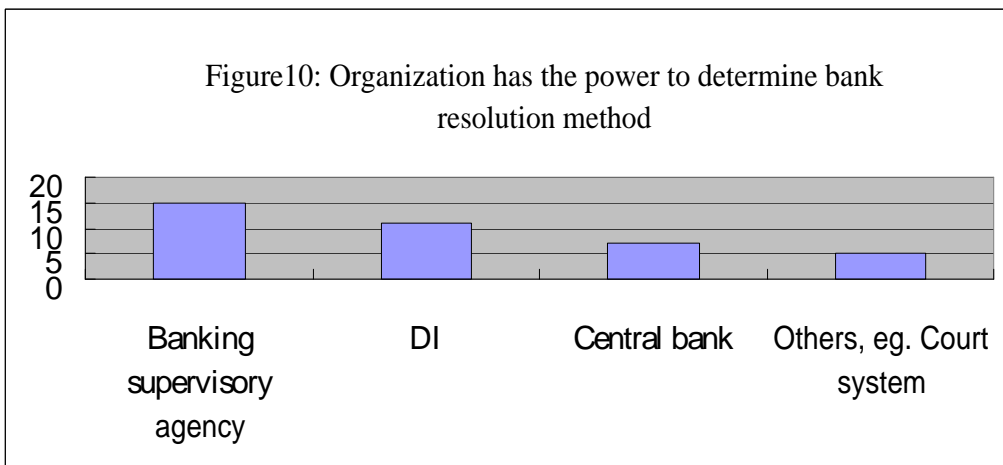
(5) Liquidity assistance: In the case of bank runs or a liquidity crisis, the central bank is responsible for providing urgent liquidity assistance to failing banks in 12 countries surveyed. In four countries both the central bank and deposit insurer are responsible for providing urgent

liquidity assistance to failing banks. (Figure 9)



### 3. The power to determine bank resolution methods

(1)The determination of resolution methods: Responsibility for this function lies with the banking supervisory agency in 15 countries, the deposit insurer in 11 countries, and the central bank in seven countries. The remaining countries responded that it was their court system which was granted this power. (Figure 10)



(2)On-site appraisal: In only 13 countries the deposit insurer has the authority to conduct on-site appraisal or due diligence for a failing/problem bank in connection with determining resolution options before a bank is closed.

(3)Major source of resolution: While in the process of handling a bank failure resolution, the major source of liquidity for paybox type deposit insurers are their deposit insurance funds. For non-paybox

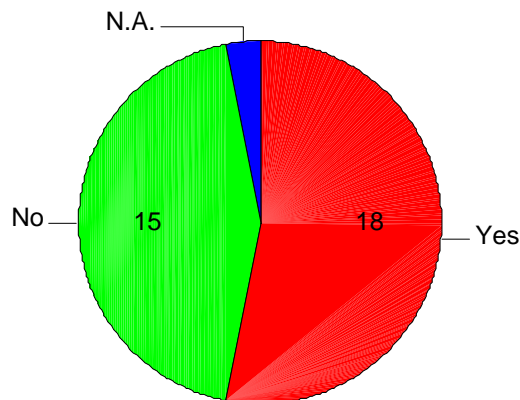


insurers the sources of liquidity support were generally more diversified.

#### 4. Formal coordination mechanism

In dealing with bank failures, 18 countries have a formal coordination mechanism by law, contract or agreement among financial safety net participants (including the deposit insurer), while 15 countries have no formal mechanisms. (Figure 11).

Figure 11: Having coordination mechanism  
in dealing with bank failures



#### 5. Financial holding companies and their responsibilities for their bank subsidiaries

Financial holding companies (FHC), or financial institutions acting as a subsidiary of a financial conglomerate, were allowed in 24 countries surveyed. However, there were only seven countries where the parent company was required to guarantee the liabilities of a failed bank subsidiary by statute, contract or agreement. In 20 countries, the resolution mechanism for the failed bank subsidiary of a FHC or a financial conglomerate was the same as that for a non-FHC individual bank failure.

#### 6. The termination of the insured status of a member bank

Only in seven countries did the deposit insurer have the authority to

terminate the insured status (i.e. membership) of a failing bank before closure (Figure 12). In these cases, the deposit insurer was required to publish a notice of termination of a bank's membership. After terminating the insured status of a member bank, the insurer in 12 countries continued to provide protection to depositors within a period of time ranging from one year (Taiwan) to two years (Canada: Autorité des marchés financiers, Québec). (Figure 13)

Figure 12:DI has the authority to terminate the insured status

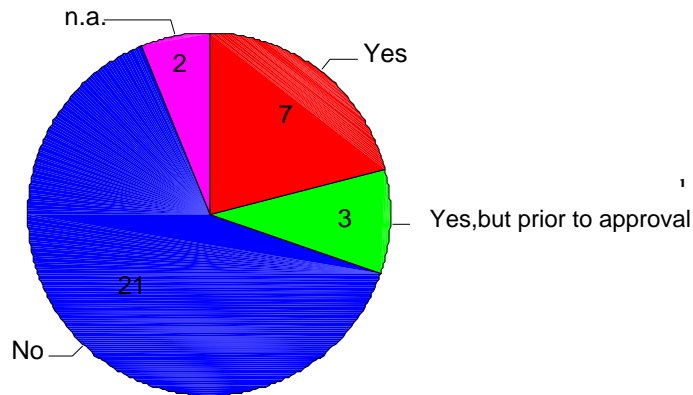
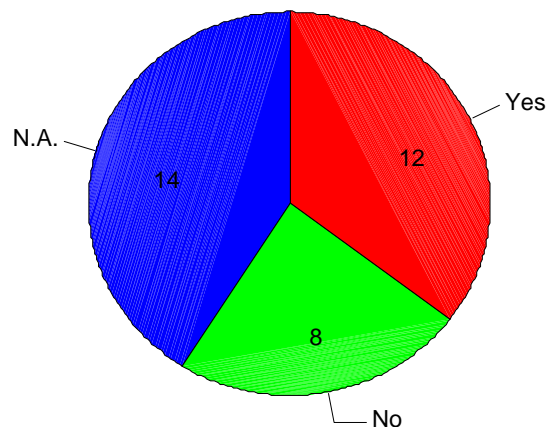
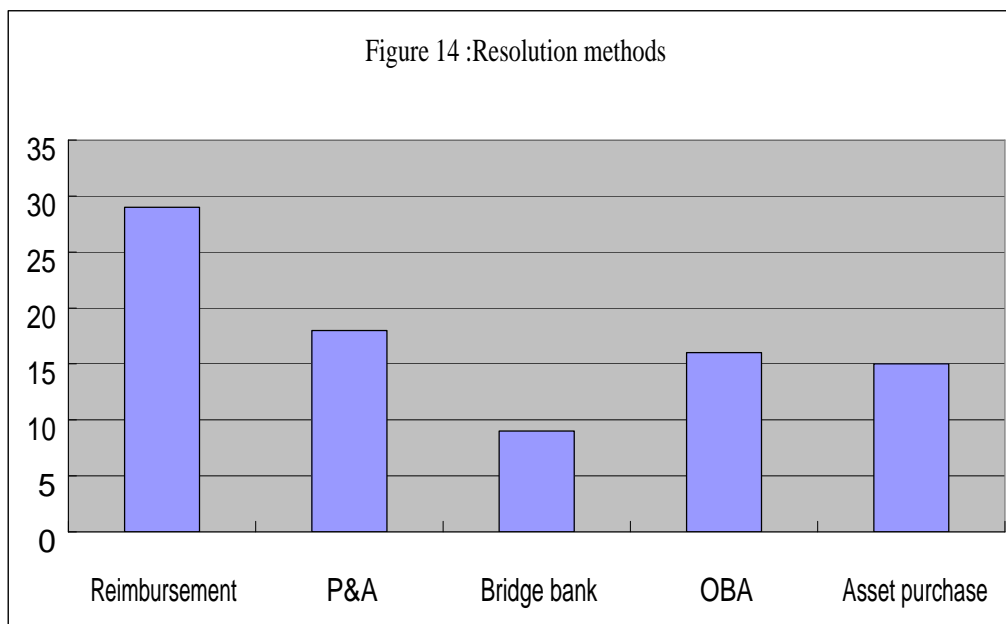


Figure 13:DI provides protection after termination of the deposit insurance



## C. Resolution Options for Bank Failures

The major resolution method used for paybox type deposit insurers in resolving failed banks was the reimbursement of insured depositors. Deposit insurers with a loss minimization mandate were generally required to adopt some form of least-cost resolution principle and they may decide on the appropriate resolution method. The resolution methods<sup>13</sup> available for deposit insurers in resolving failed banks were as follows (Figure 14):



### 1. Reimbursement (payout) of insured depositors

A depositor reimbursement or payout resolution may be accomplished by the deposit insurer directly paying depositors their insured balances or by transferring the accounts to another bank that makes the insured balances available to the depositors. The bank is often closed (license or charter extinguished) and the assets and uninsured claims are transferred to a receiver for liquidation and settlement.

#### (1)The reasons for adopting reimbursement

According to the survey responses, the main reasons for adopting reimbursement (payout) in 29 countries were:

- (a) The prompt and timely reimbursement of insured depositors can help prevent a contingent systemic crisis.

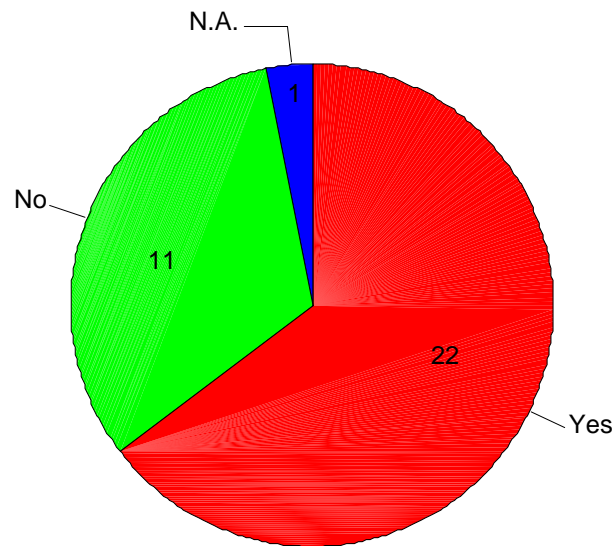
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<sup>13</sup> The answer to the question was a multiple-choice.

- (b) The court’s decision on forcible bank liquidation, or a wind-up order has been made.
- (c) To incur a least cost resolution as well as less confusion associated with a failure compared with other alternatives.
- (d) The payout method was preferred over other resolution methods after considering the impact of other resolution options on the deposit insurance fund and the stability of the financial system.
- (e) No other option: There is no franchise value of the failing bank.

**(2)The characteristics of the reimbursement**

Figure 15 :Having SOP for reimbursement



The characteristics of the reimbursement process in 29 countries were as follows:

- (a) Most countries (22 countries) have a standard operational procedure (SOP) for the reimbursement of insured depositors (Figure 15).
- (b) According to statute, contract or agreement, the time limit from the date of the bank closure to actual reimbursement was usually not over six months, and the shortest time limit was one week in the U.S. (Figure 16). But, according to actual experiences the average period from the date of bank closure to depositor payout was over six months in four countries surveyed (figure 17). This indicates that the actual reimbursement period can be longer than the legal statute.

Figure 16 :Statutory time limit of reimbursement

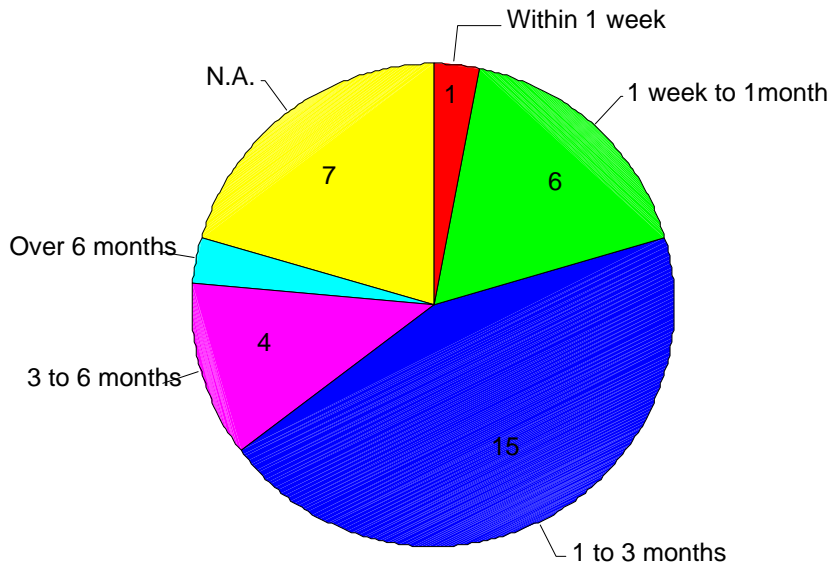
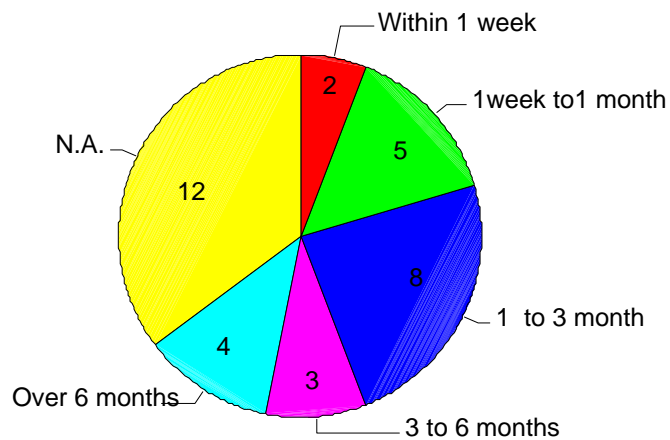
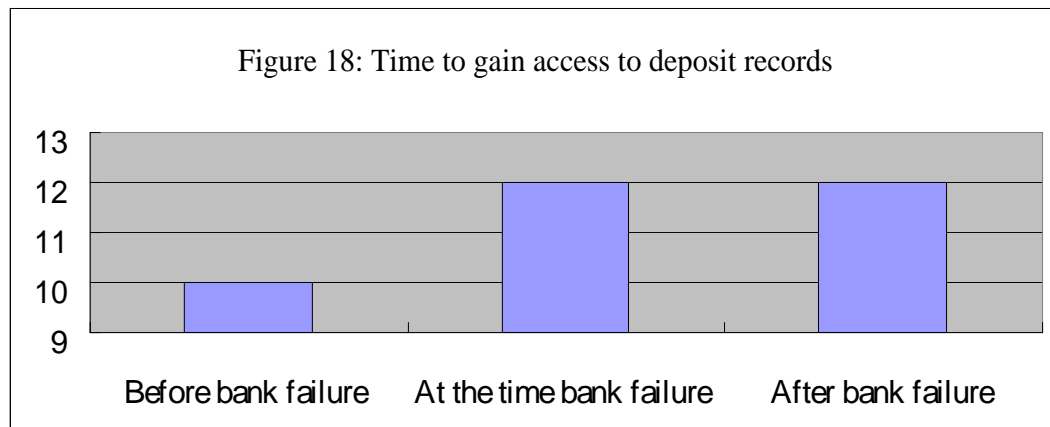


Figure 17 :Actual average period of reimbursement



- (c) According to the survey responses, deposit insurers in ten countries can gain access to the deposit records of failed banks before bank closure. In 12 countries access can only be obtained at the time of bank closure and in the remaining 12 countries only after bank closure. This suggests that if a deposit insurer can gain access early to depositor records, it may have greater influence on the

expedition of the actual reimbursement process (Figure 18).



- (d) In cases where the insured depositors are in need of urgent liquidity (i.e. their funds) before the completion of the actual reimbursement, ten countries provided their deposit insurers with the option of making advance payments.

## 2. Purchase and Assumption (P&A)

A purchase and assumption transaction or resolution is one in which a healthy bank or group of investors assume some or all of the obligations, and purchase some or all of the assets, of the failed or failing bank. Some of the key findings of the survey on P&A resolutions were:

### (1) Reasons for adopting P&A

According to the response, the main reasons for adopting a P&A resolution in 18 countries are as follows:

- (a) When the cost for adopting P&A is less than the estimated loss arising from a payout.
- (b) P&A is considered to be less disruptive compared to a payout.
- (c) P&A is considered to be in the best interests of the bank's depositors and would aid in the reconstruction of the bank or the disposition of its assets in an expeditious manner.

### (2) Characteristics of the P&A

The characteristics of the P&A in 18 countries are as follows:

- (a) Most countries still do not have a standard operational procedure (SOP) for P&A transactions.
- (b) Most countries adopt a whole bank P&A or a P&A with optional asset

pools when handling failed banks.

### **3. Bridge Banks**

The term bridge bank refers to a temporary bank established and operated by the deposit insurer to acquire the assets and assume the liabilities of a failed bank until a final resolution can be accomplished. Some of the key findings of the survey on bridge bank resolutions were:

#### **(1) Reasons for adopting a bridge bank**

According to the responses, the main reasons for adopting bridge bank in nine countries are as follows:

- (a) Bank with an attractive franchise is in danger of failing before acquirers can be found.
- (b) To maintain daily operations of a failed bank.
- (c) In cases where liquidator is reluctant to proceed with the formal liquidation because either the failed bank is too large (so no adequate funds are available for reimbursement) or there is not enough time to market the bank's assets to potential acquirers.
- (d) When the number of failed financial institutions is very large and the failures have occurred during a short period of time.

#### **(2) Characteristics of bridge banks**

The characteristics of the bridge bank in nine countries are as follows:

- (a) Only three countries have standard operational procedure (SOP) for bridge bank transaction.
- (b) There is a capital requirement for a bridge bank in some countries, like Colombia and Japan<sup>14</sup>, while there is no capital requirement in the U.S. and Korea.
- (c) For three out of six responding countries, the bridge bank continued to be a member of the deposit insurance system.

### **4. Open-Bank Assistance (OBA)**

The term Open Bank Assistance (OBA) refers to a resolution method in which an insured bank in danger of failing receives assistance in the form of a direct loan, an assisted merger, or a purchase of assets. Some of the key findings of the survey on OBA resolutions were:

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<sup>14</sup> In Japan, a bridge bank's capital requirement is stipulated in the banking law, ¥1 billion capital at minimum to every bank.

## (1) Reasons for adopting OBA

According to the responses, the main reasons for adopting OBA in 16 countries were as follows:

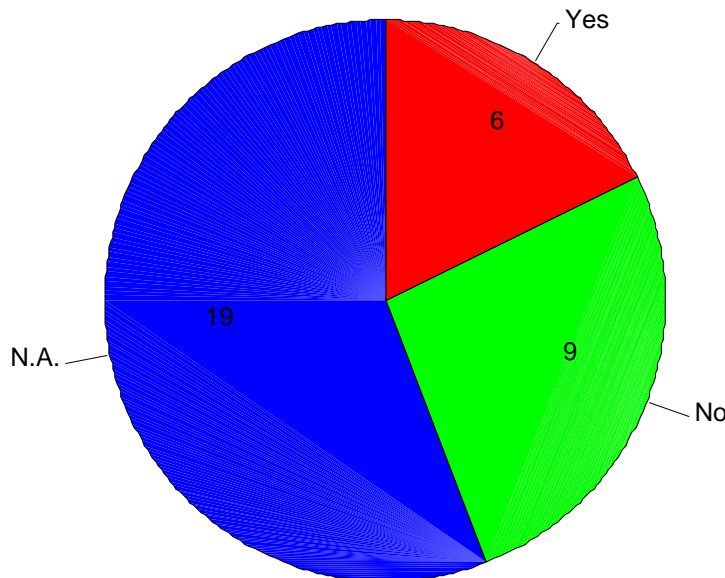
- (a) If the failure of a bank poses an extremely serious threat to the stability of the financial system and local and/or national economies.
- (b) The cost of providing OBA may be less than the potential losses arising from a deposit payout.

## (2) Characteristics of OBA

The characteristics of the OBA in 16 countries were as follows:

- (a) There is a standard operational procedure (SOP) for OBA in only six countries surveyed (Figure 19).

Figure 19: Having SOP for OBA



- (b) In nine countries, the deposit insurer or supervisory agency will dispatch a new management team or require a restructuring plan prior to providing OBA to a failing bank.
- (c) In some countries like Spain, Canada, Venezuela and Mexico, the failing bank is required to take a capital deduction (e.g. capital adjustments for large losses) prior to receiving OBA.
- (d) There did not appear to be any maximum duration requirement for OBA in some countries.

## 5. Asset Purchases



## **(1)The reasons for adopting asset purchases**

According to the responses received, the main reasons for adopting asset purchases in 15 countries were as follows:

- (a) As a way to minimize resolution costs by maximizing future recoveries.
- (b) As part of the financial restructuring of the failed bank.
- (c) A result of the reduction in the realizable value of assets resulting from a deterioration in asset quality or a situation where the receivables from asset sales are severely affected. Thus, it is essential to be able to provide for fresh earning assets, which can be source of income.

## **(2)The characteristics of Asset Purchases**

The characteristics of the assets purchased in 15 countries were as follows:

- (a) The deposit insurer or the supervisory agency was granted authority to purchase assets from failed banks in most countries.
- (b) The deposit insurer or the supervisory agency in most countries did not establish another subsidiary or joint asset management company to purchase the asset from the failed banks, except for Japan and Canada : Autorité des marchés financiers (Québec).

## **D. Actual experience in handling bank failures**

### **1. Actual experience**

#### **(1) Actual experiences in the past ten years for depositor reimbursement (payouts)**

According to the responses, these were the main findings regarding depositor reimbursement experiences:

- (a) Number of cases: in 16 countries surveyed the use of depositor reimbursement varied from 1 to 165, with an average of 19 instances (with the median of 4 instances).
- (b) Average asset size of failed banks: in 12 countries, it varied from US\$0 to US\$0.9 billion; the average asset size was about US\$0.2 billion (with the median of US\$34 million).
- (c) Average duration for each reimbursement: this varied from 1 to 120 months in 7 countries, the average was 40 months (with the median of 24 months).

#### **(2) Actual experiences in the past ten years in P&A**

- (a) Number of cases: in ten countries, it varied from one to 180, with an average of 30 (with the median of three).
- (b) Average asset size of failed banks: in six countries it varied from US\$0.2 to US\$11 billion with an average asset size of about US\$3 billion (with the median of US\$0.6 billion).
- (c) Average duration for P&A transactions varied from four to 24 months with an average of 14 months (the same for the median).

#### **(3) Actual experiences in the past ten years for bridge banks**

- (a) Number of cases: in two countries the cases varied from one to seven, with an average of four (the same for the median).
- (b) Average asset size of failed banks: in one country for US\$6 billion.
- (c) Average duration for each resolution: in one country for 48 months.

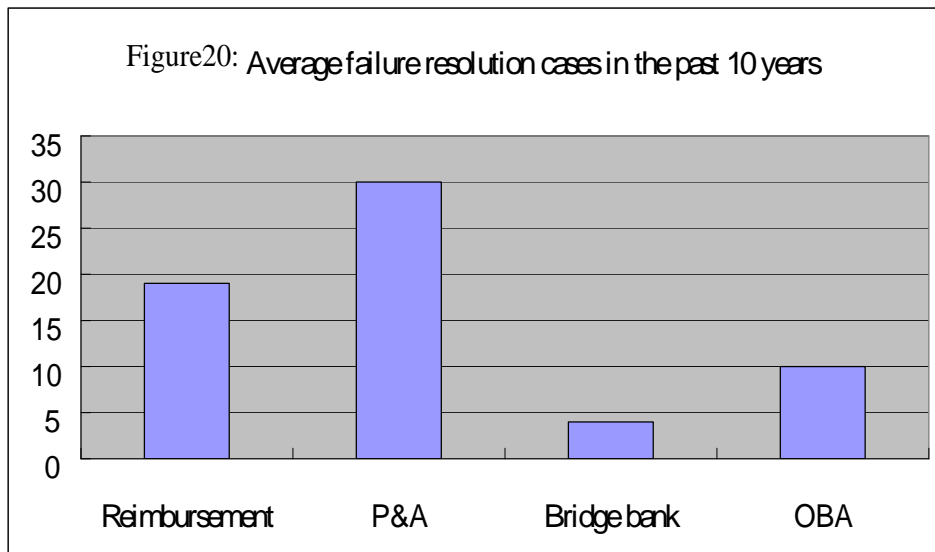
#### **(4) Actual experiences in the past ten years for OBA**

- (a) Number of cases: in nine countries this varied from one to 22, with an average of ten (with the median of 11).
- (b) The average asset size of failed banks: in four countries it varied from US\$1.2 billion to US\$37 billion with an average asset size of about US\$13 billion (with the median of US\$7 billion).

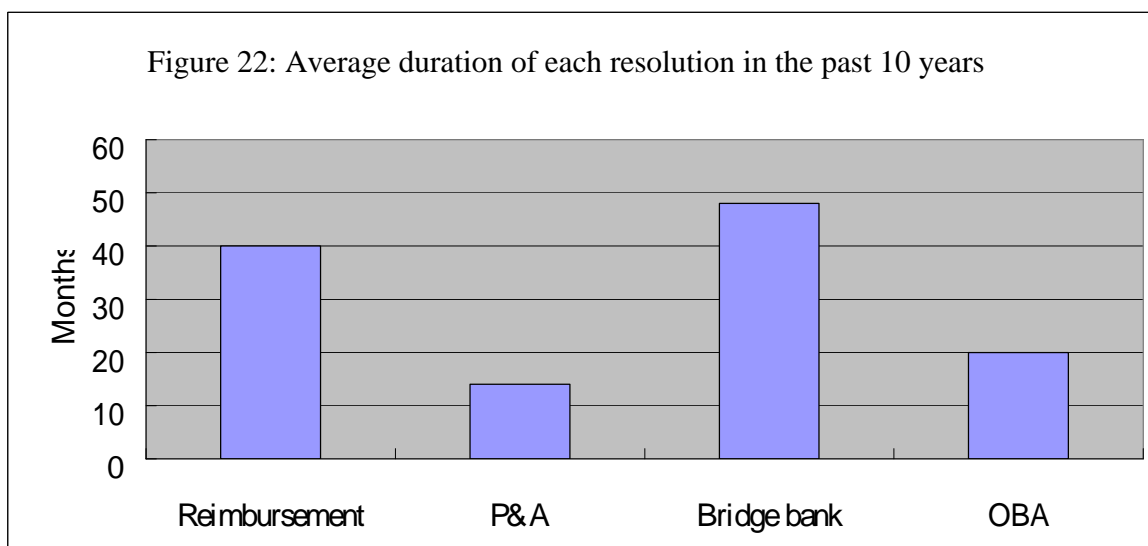
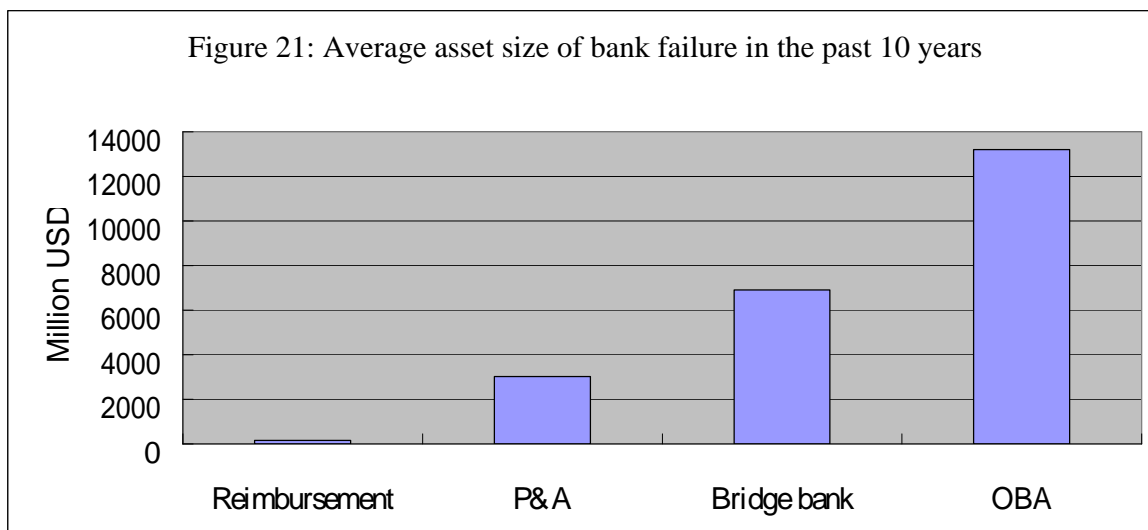
(c) Average duration for each instance of OBA: in three countries it varied from three to 48 months with an average of 20 months (with the median of 11 months).

### (5) Comparison among each resolution experience

The following chart compares the actual experiences with different types of resolutions during the past ten years. It indicates that P&A resolutions were adopted the most frequently followed by depositor reimbursement.



The average asset size in an OBA resolution was the largest followed by bridge banks. Bridge bank resolutions involved the longest average duration. From this analysis, most countries appear to have adopted P&A for larger bank failures and this method involved the shortest resolution time frame. The OBA resolution approach was generally used in very large bank failures and depositor reimbursement was utilized for relatively small bank failures. Therefore, the deposit insurer should have a clear-cut policy (including the time-span) in place in dealing with resolution methods to failing/failed bank. (Figure 21 and Figure 22)



## 2. Strengths and weaknesses of resolution options

According to the 34 countries' responses to actual experiences in handling bank failures, each resolution method had the following strengths and weaknesses:

### (1) Deposit reimbursement

#### (a) The strengths:

- (i) It can take care of depositor needs and help minimize the social and economic costs of bank failures.
- (ii) It guarantees the fair treatment of depositors and increases confidence in the banking system.

- (iii) It is especially effective in terms of weeding out “unwanted” banks in a system with “too many” non-viable banks.
- (iv) Depositors are compensated based on the amount of accumulated deposit contributions they have in banks (up to the coverage limit).

**(b) The weaknesses:**

- (i) All the functions of a failed bank must be given up; the failure of a particular bank is public knowledge which could lead to a crisis in confidence affecting all banks.
- (ii) It limits the discretionary power of the deposit insurer.
- (iii) It may take a long period of time to affect a reimbursement and there is the concomitant risk for employees of the deposit insurer (who may not receive legal protection) of being held personally liable for the losses of uninsured creditors.

**(2) P&A**

**(a) The strengths:**

- (i) It can preserve the functions of the failed bank and maintains the relationship of the depositor with the bank. Thus, it preserves confidence in the system.
- (ii) It often covers all depositors, the timing of cash obligations can be stretched out, and it may preserve some jobs of the failed bank.
- (iii) It is often the least expensive and disruptive resolution approach may not require any additional funds from government finances.
- (iv) It can minimize market disruptions since transference of assets can be executed in a very short period.
- (v) It allows customers access to their deposits and they do not suffer any shortcomings in service.

**(b) The weaknesses:**

- (i) It may be difficult to find an assuming financial institution when economic circumstances or the banking system is weak.
- (ii) It may increase a country’s costs of resolving failed banks and could reduce market discipline.
- (iii) If all depositors are covered, it may diminish the significance of deposit insurance limits and could lead to depositors negotiating coverage levels.
- (iv) Private investors are typically not interested in acquiring an insolvent bank; therefore in order to attract an acquirer new funding must be injected into the institution from either the government or the deposit insurer.
- (v) The insurer faces an arduous task of facilitating the early valuation of assets and liabilities of the failing institution as it endeavors to maintain secrecy. And, not all P&A transactions involve acquiring all

deposit liabilities so that not all (100%) of depositors are always fully protected.

### **(3) Bridge Bank**

(a) The strengths:

- (i) It is often better than a P&A in terms of timely resolution and the preservation of the functions of the failed bank.
- (ii) It can make depositors and creditors of financial institutions more confident.
- (iii) The establishment of a bridge bank can provide the insurer with more time to find the right acquirer and prospective acquirers to assess the value of the bank from which they can base their bids.

(b) The weaknesses:

- (i) It may increase costs incurred by the deposit insurer or the government. This is because the deposit insurer or the government becomes the owner of the failed or failing bank and later must sell it. Thus, incurring additional resolution expenses and administrative costs.
- (ii) It may be costly for the deposit insurer as it can require more time and effort to set up a bridge bank than other resolution options. In the absence of the right acquirer or in the absence of bidders, completing the resolution process may take longer than what would be ideally required.
- (iii) This method may be applied simply to "buy time" for the supervisory authority and could lead to lengthy delays and costs for the final resolution of the problem bank.

### **(4) OBA**

(a) The strengths:

- (i) It may resolve the liquidity problems of failed financial institutions, stabilize the confidence of depositors and financial conditions, and avoid a systemic banking crisis.
- (ii) Investors are required to bring in fresh capital to share in the costs of rehabilitating the failing institution.

(b) The weaknesses:

- (i) The insurance fund may be eroded more quickly and within a shorter time period than with other alternatives.
- (ii) It could induce "moral hazard" and possibly protect those private agents who contributed to the failure of the bank.
- (iii) It can reduce market discipline and may promote "Too big to fail" problems.

## **(5) Partial payment**

Partial payments are made to cover the immediate living costs and other expenses of depositors, etc., in a financial institution that has been subject to an insurable contingency, when it is anticipated that insurance payments or the reimbursement of insured deposits will not begin for a considerable length of time.

(a) The strengths:

- (i) Partial payment provides temporary relief to the distressed depositor. In the case of a depositor with unresolved issues, partial payment up to the resolved amount may mitigate the risk faced by the insured depositor.
- (ii) It forces depositors (small and large) to be more diligent when choosing a bank (all depositors are responsible for a part of their deposits).

(b) The weaknesses:

- (i) Depositors are not fully reimbursed at one time.
- (ii) It may create unnecessary excess burden on the Information Technology systems and thus delay the whole process, endangering the completion of the payment within statutory time frame.

## **(6) Advanced payment**

(a) The strengths:

Payment to uninsured depositors in advance, prior to liquidation of the failed institution, provides depositors immediate returns on the uninsured portion of their deposits.

(b) The weaknesses:

- (i) Advanced payment in itself is not a resolution method
- (ii) The amount of payment depends on the conservative valuation of the failed institution; the risk of overestimation is still present.

## **E. Gaps in current laws or practices dealing with individual bank failures**

The following suggestions are from the respondents of the questionnaire in order to improve the effectiveness of the resolution process:

### **1. Changes should be made in mandates and powers**

These are some suggestions from respondents for deposit insurers or

supervisory agencies to improve the resolution of failed banks:

- (1) the deposit insurer should have onsite supervisory powers.
- (2) the deposit insurer should have due diligence power (e.g. preparatory examination).
- (3) the deposit insurer should have the power to withdraw the insurance status of an institution (termination).
- (4) laws should be amended to strengthen the independence and the inspection power of the deposit insurer, and to establish a coordinating mechanism between the deposit insurer and the supervisory agency.
- (5) provisions regarding the resolution of insured depository institutions that were suspended from operations should be supplemented to accelerate the process of resolution.
- (6) the deposit insurer should have independence in determining its own administrative expenses budget.
- (7) The insurer needs more powers in the context of a prompt corrective action program in order to assess a failing bank's potential impact and take action to resolve the failed bank.

## **2. Changes should be made in funding and in the reimbursement of insured depositors**

- (1) Sufficient funds should be available for the deposit insurer to promptly deal with unsound (failed) financial institutions.
- (2) It would be helpful for a deposit insurer to have the legal capacity to effect deposit transfers between institutions for reimbursement purposes (i.e. arrange for institutions to make reimbursements to depositors and other bank creditors in the name of the deposit insurer, for the guaranteed obligations of another institution).
- (3) The period between revocation of the license and the initial date of reimbursement needs to be shortened.

## **3. Changes should be made if P&A, OBA, assets purchase and other methods adopted**

- (1) The deposit insurer should have disposal options related to P&A transactions, such as to sell assets in pools; to manage the failed bank's property; to credit a healthy bank which wishes buy-out or assume the business of the failed bank or part of its business.
- (2) The insurer or supervisory agency should have access to sufficient funding resources to provide OBA for a large bank confronted with a financial problem.
- (3) The deposit insurer should have mandates for direct asset management.
- (4) Proper guidelines need to be in place to ensure that the insurer



correctly determines who gets paid, how much and when, and that the partial payment of one party should not set a precedent that others may demand partial payment as well.

#### **4. Others suggestions**

- (1) The deposit insurer needs more discretionary powers in resolutions; for example, it should have the right to follow the least-cost method, OBA options etc.
- (2) There needs to be a clearer definition of “Too Big To Fail” and the specific procedures to follow in the case of such banking problems.
- (3) Deposit insurers have some legal constraints (regarding different options). Reaching a fair resolution must take the following issues into consideration: the minimization of total resolution costs, delays in reimbursements, and the maximization of asset recoveries. Some of the above components are tangible and others are intangible (for example: social costs), which means that a thorough cost-benefit analysis should be undertaken.
- (4) The insurer should be empowered to select the appropriate resolution method for any bank failure. This includes the right to undertake preventive measures and/or inspections in the bank prior to failing. These suggestions can result in decreased social costs associated with bank failures and increased public trust in the banking system.
- (5) The deposit insurer’s capital should be enhanced and deposit insurer should be more independent.

#### **F. The main differences between paybox type & non-paybox type of deposit insurance system with respect to resolutions**

According to the questionnaire results, there were 16 deposit insurers with a primarily paybox type mandate. There were 18 insurers with a non-paybox mandate which typically involved powers to control their insured risk exposure to some extent. This paper provides some comparisons between these two types of insurers and how they deal with failure resolutions.

1. After a banking crisis or a bank failure, those countries with primarily paybox type deposit insurers had to rely heavily on enhancements to the supervisory and regulatory system to promote safe and sound banking practices. However, those countries with non-paybox type deposit insurer were able to adopt more widespread improvements in their banking infrastructure and supervisory practices. For example, initiatives such as the adoption of safe and sound banking practices,

least cost resolutions, PCA, enhanced failed bank resolution methods, raising premiums or adopting differential premium system etc.

2. In actions taken by the deposit insurer within 6 months prior to bank closure, the non-paybox deposit insurers were able to take more actions towards addressing failing banks. For example, they were allowed to require a recapitalization or improvement plan, to arrange for appraisal of assets and liabilities, and to place failing banks into conservatorship.
3. PCA issues: only 2 countries with paybox-type insurers have a rules-based or statutory approach for early intervention and resolution (e.g. prompt corrective action). But, numerous non-paybox deposit insurers have such mechanisms in place.
4. On-site appraisal issues: only 2 countries with a paybox deposit insurer have the authority to conduct on-site appraisals or due diligence of the failing/problem banks in connection with resolutions. But, most countries with non-paybox deposit insurers have been granted this authority.
5. Sources of funding: While handling bank failures, paybox insurers generally utilize their own funds for liquidity purposes. However, non-paybox deposit insurers generally have access to more sources of liquidity such as their insurance fund, the central bank and other financial institutions etc.
6. Government as the guarantor of the deposit insurers borrowings for resolution purposes: only three countries with a paybox insurer had governments which acted as guarantors when their insurers issued bonds or borrowed money from the central bank or other financial institutions for resolutions. But, in most countries with non-paybox deposit insurers governments acted as guarantors when the insurer borrowed money for resolutions.
7. Termination power: only four paybox deposit insurers had the authority to terminate the insured status of a failing bank before bank closure. But, a number of non-paybox insurers were given the authority to terminate the insured status of their members when warranted.
8. Resolution methods: almost all the paybox deposit insurers made use of the reimbursement (payout) resolution method. But, non-paybox deposit insurers used other resolution methods in addition to payouts

such as purchase and assumption transactions, open-bank assistance, asset purchases, bridge banks, etc.

9. Resolution cost principle issues: For insurers with a paybox mandate the main objective is to minimize payout costs. However, for those with a non-paybox mandate more choices were available such as the use of least-cost resolution objectives and methods, the optimal cost method, straight payout cost approaches etc.
10. Timing of access to the deposit records: most paybox deposit insurers have access to the deposit records only after the banks are closed. But, for most non-paybox deposit insurers access to the records of depositors is granted before or at the time of banks closure or at the most a few days after closure.

## **G. Systemic banking crisis**

### **1. Resolution powers and mandates in dealing with systemic banking crises**

- (1) Statutory mechanism: Among 34 countries, only seven countries had statutory mechanisms for handling a systemic banking crisis.
- (2) The definition of a systemic banking crisis used by most respondents included reference to the bank in question having a large national or regional market share (e.g. exceeding 8%-10%) or having a major influence on the economy or a financial system or regional economy and financial system. Or, if the resolution of a failing bank were conducted on a least cost basis and this would cause serious adverse effects on economic conditions or financial stability then it would be considered a systemically important bank.
- (3) Authority to decide: In cases where a bank closure were deemed to have systemic implications, the central bank was provided with authority in 8 countries, the banking supervisory agency in 8 countries, and the deposit insurer in 2 countries.<sup>15</sup>
- (4) Funding source: The government and the central bank were the main funding sources for handling systemic banking crises.

### **2. Methods considered resolving a bank with systemic implications**

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<sup>15</sup> In U.S.A., the *Federal Deposit Insurance Corporation Improvement Act of 1991* requires the FDIC to resolve failed banks following the least cost principle. However, when a least-cost resolution would lead to systemic risk, an exception is stipulated in Section 13(c)(4)(G) of the *Federal Deposit Insurance Act*.

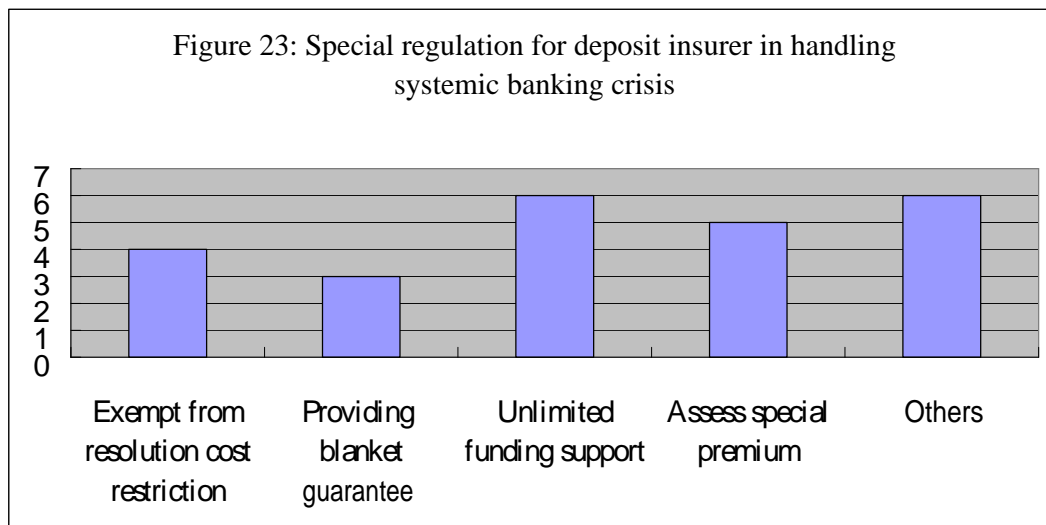
The following are the methods considered by the respondents' government or deposit insurer to resolve a bank with systemic implications:

- (1) Bridge bank transactions.
- (2) P&A or bridge bank method, instead of direct payout.
- (3) Financial assistance.
- (4) Set up a fund to solve the banking crisis and individual bank failures.
- (5) The adoption of special legislation.

### 3. Special regulations for a deposit insurer

According to the respondents here is a list of special regulations for the deposit insurer in handling a systemic banking crisis:

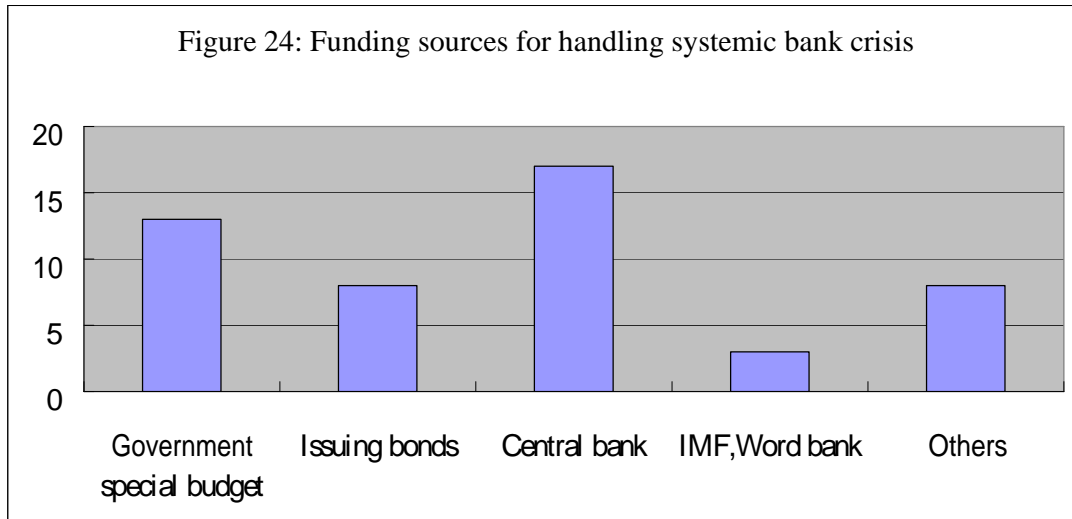
- (1) Four countries were exempted from resolution cost restrictions.
- (2) Three countries provided a blanket guarantee.
- (3) Six countries had unlimited funding support from the government or central bank.
- (4) Five countries assessed special premiums after a banking crisis.
- (5) Six countries responded to "others": no special regulation.



### 4. Funding sources for handling systemic bank crises

According to the responses, the funding sources for handling systemic bank crises were as following:

- (1) Government special budget appropriations: 13 countries.
- (2) Issuing bonds: 8 countries.
- (3) Central bank: 17 countries.
- (4) IMF, World Bank: 3 countries.
- (5) Others: 8 countries.



## 5. Gaps in the current law or practice in dealing with systemic banking crises

These were some suggestions from respondents to improve effectiveness when dealing with systemic banking crises:

- (1) The government or its authorities should be well empowered, with respect to regulatory powers, to promptly issue the necessary measures to contain a banking crisis.
- (2) In order to avoid a financial crisis and to maintain an orderly payment system, there should be recognition that in some situations rules of least cost in resolving a failing bank to be removed or suspended to deal with these types of systemic situations.

## H. Cross-border issues

According to the survey, there were nine countries that had confronted the case of cross-border insolvency of a deposit-taking international institution. Only three countries responded to having relevant substantive laws to deal with such a cross-border insolvency issue.

## **IV. Guidance for the Resolution of Failed Banks**

The following guidance on the resolution of bank failures was developed after careful analyses of the results of the survey questionnaire and the experience and judgment of IADI Members. Not all deposit insurers have a failure resolution as part of their mandates. However, for those insurers with a responsibility for failure resolution the following guidance is aimed at enhancing their mechanism for the resolution of failed banks and provides a better mechanism for checks and balances among financial safety net participants. The guidance is divided into five parts. The first part addresses general issues; the second part deals with interrelationships among safety net participants and cross-border issues; the third part looks at the powers accorded to the deposit insurer; part four addresses operational and administrative issues related to resolutions; and the last part deals with specific issues related to the resolution of failing or failed banks.

### **A. General Issues**

This section sets out guidance on general issues related to building a strong institutional framework for the deposit insurance system to function within. A suitable framework includes sound corporate governance, an effective supervisory, regulatory, accounting and transparency regime, and a well-developed legal system. All of these features have a major influence on the environment in which the deposit insurance system functions and help to control the risk exposure of the deposit insurer.

#### **1. A strong institutional framework reduces the risk of banking failures or crises.**

The responses to the survey indicated that in addition to economic downturns and other external shocks, some of the most important factors responsible for banking failures and crises were: unsound financial regulation/supervision and unsound banking practices, inappropriate risk management at banks, poor corporate governance and a weak legal framework. Thus, it is recommended that governments should ensure there is a strong institutional framework in place for the economy and banking system. This should include sound macroeconomic policies, an effective corporate governance regime, strong and effective banking supervision and regulation (including a prompt corrective action approach to intervention), reliance on market discipline, efficient failed bank resolution processes, and an effective judicial and criminal investigation system.

Strengthening the effectiveness of bank supervision is particularly important for deposit insurers who are limited to a paybox mandate.

**2. An effective deposit insurance system requires sound corporate governance.**

The sound governance of the deposit insurance organization strengthens the financial system's architecture and contributes directly to system stability. The four major elements comprising sound governance of organizations are: independence, accountability, transparency and integrity. All are equally important and reinforce each other in supporting good governance practices. The sound governance of the deposit insurer can be enhanced by regular internal and external reviews of its governance practices.

**3. Independence helps a deposit insurer avoid unwarranted political and industry interference and forbearance.**

Effective bank failure resolution requires an operationally independent and accountable deposit insurer, with a clear mandate and that is insulated from undue political and industry influence. This provides a high level of integrity, credibility and legitimacy and reduces the incidence of political interference and forbearance in resolutions.

**4. The mandate, responsibilities and the failure resolution powers granted to a deposit insurer should all be aligned.**

The powers granted to a deposit insurer should be consistent with its public policy objectives and mandate. If a deposit insurer is given a mandate to deal with the resolution of failed banks in a least cost manner, it should be provided with the necessary powers and authorities to do so. This includes the power to decide upon the appropriate resolution approach, the ability to undertake preventive measures (such as inspections) before a bank fails in order to control its risk exposure.

**5. The legal framework should support the timely and effective resolution of bank failures including situations which may pose a systemic risk to the financial system.**

An appropriate legal framework should be in place to support the

resolution of failed banks and to provide authority to the deposit insurer and supervisory authorities to minimize or mitigate damage to the financial system from a systemic crisis. This should include prompt corrective action measures to contain banking crises and avoid contagion; as well as in some cases to provide exceptions to least cost resolution requirements when dealing with banks representing systemic risk or involving the use of public funds.

**6. The use of temporary blanket guarantees and reliance on public funds may be appropriate in certain exceptional circumstances.**

Provision of blanket guarantee and the injection of public funds may be necessary if the deposit insurers funding resources are insufficient to handle a large bank failure or a systemic crisis has occurred. However, moral hazard and market discipline problems should be considered when using blanket guarantees and public funds. Therefore, their use should be restricted to exceptional circumstances (a clear and explicit definition should be in place) and be provided on a temporary basis (e.g. use of explicit dates of expiration). If public funds are to be used then it is important that the shareholders of the failing/failed bank should bear losses.

**7. Financial stability and social order are important goals.**

The confidence of the public in the financial system is an important objective for an effective deposit insurance system. Deposit insurers and other financial safety net participants should always consider the need to maintain financial system stability and confidence when dealing with the resolution of failed banks. A top priority for deposit insurers should be to focus on protecting the interests of insured depositors via efficient and effective resolution of failed banks.



## **B. Interrelationship and Cross-border issues**

This section sets out guidance on interrelationship management and cross-border issues when dealing with the division of duties and responsibilities among financial safety net participants in failing/failed bank resolution.

### **1. The division of duties and responsibilities among safety net players in a failing/ failed bank resolution should be clearly defined.**

Clear accountability and the division of duties and responsibilities among financial safety net participants are necessary in order to effectively handle failing/failed banks. A formal division of duties and responsibilities can be reached by legal arrangement, contracts or administrative regulation. The clear legal division of duties and powers to declare whether a bank has failed and determine the bank resolution method is important for all financial safety net participants involved in resolutions.

### **2. Information sharing and coordination mechanisms must be in place for all financial safety net participants.**

Formal information sharing and coordination mechanisms or arrangements need to be in place between the deposit insurer and the other safety net participants for handling failing/failed banks – and especially in cases involving a systemic crisis. If prompt corrective action triggers are a part of the intervention process then the deposit insurer should be given access to information to quickly assess the potential impact of the bank failure on its fund.

### **3. An explicit statutory mechanism should be set up for dealing with systemic crises.**

No financial safety net player by itself can deal effectively with a systemic banking crisis. An explicit statutory mechanism needs to be in place to allow the financial safety net participants to work together in handling a systemic banking crisis. This should include a clear division of work and duties, rules defining what is and is not a systemic crisis and a clear intervention framework for dealing with bank failures and resolutions.

### **4. Clear statutory mechanisms for dealing with “Too Big To Fail” issues should be established.**

A clear statutory mechanism for dealing with " Too big to fail (TBTF)" issues is very important when determining resolution principles and procedures. An explicit statutory mechanism should include a definition of TBTF and provide guidance on the resolution cost implications of various options. The resolution of failures involving financial holding companies should also be included in the TBTF framework.

**5. Cross-border coordination mechanisms should be established among international financial safety net players.**

With the increasing growth in international banking activities there is a need for greater information sharing and coordination among international deposit insurers and supervisory authorities dealing with failures across international borders. Cross-border mechanisms can be established by formal contracts, agreements or arrangement within international organizations.

## **C. Statutory powers accorded to the deposit insurer**

The statutory powers in this section could be shared between the different authorities of a country according to the regulation applicable in each country.

### **1. Deposit insurers should have a deposit insurance fund and a statutory target for the fund.**

In order to maintain financial stability and enhance public confidence, the deposit insurer should have access to necessary funding which may include a fund and a statutory target ratio for the fund. There should also be a clear timetable for the deposit insurer to achieve its funding goals.

### **2. The Deposit Insurer should have the statutory authority to accept or reject new members and terminate the insurance status of a member bank and coordinate on the timing of termination with the supervisory agency prior to bank closure.**

In order to control its risk exposure and control moral hazard, the deposit insurer should have the authority to accept or reject new members and terminate the insured status of a member institution if, prior to closure, it is engaged in unsafe and unsound banking practices, severe management problems or fraud. When deciding to terminate the insured status of a bank, the deposit insurer should coordinate its activities with the supervisory agency. So as not to have adverse implication on the banking system.

### **3. The deposit insurer should have the authority to conduct on-site reviews, perform due diligence and have access to the records of depositors before bank closure.**

In order to effectively execute a smooth resolution, a DI should have the authority to conduct on-site appraisals, conduct due diligence on the assets and liabilities of failing bank, or have access to the records of depositors in a bank prior to bank closure.

### **4. A deposit insurer should have a statutory mechanism in place for dealing with a systemic banking crisis.**

In order to cooperate with other financial safety net participants in

dealing with a systemic banking crisis, consideration should be given to introducing an emergency statutory rule that would allow for the introduction of a temporary blanket guarantee and/or suspension of least cost resolution requirements involving the use of public funds.

**5. A deposit insurer's employees should have appropriate legal protection when dealing with bank resolutions.**

Those working for a deposit insurer and other safety net participants should have appropriate legal protection while discharging their mandates. Specific provisions in legal protection should include granting statutory immunity to individuals from civil and criminal liability for their decisions, actions or omissions taken in good faith, except in case of gross misconduct, in the normal discharge of their legal responsibilities, as well as covering legal costs for those indemnified under appropriate circumstances.

**6. 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.**

There should be a clear and explicit legal system in place for the prosecution of officers, directors, managers and internal or external auditors of a failed bank when there is due cause. Such mechanisms can lower the costs associated with resolutions and create incentives for the better governance of banks.

## **D. Operational and Administrative Issues**

This section sets out guidance on operational and administrative issues for deposit insurers or other financial safety net participants involved in handling bank failures.

### **1. Appropriate policies and standard operational procedures for resolutions should be introduced.**

Deposit insurers should have appropriate policies and standard operational procedures (SOPs) for their bank resolution procedures. This should include reimbursement of depositors, purchase & assumption transactions, open bank assistance, and use of bridge banks etc. All SOPs should be reviewed periodically in order to update and revise them in tune with changing circumstances.

### **2. Use of outsourcing by the deposit insurance system in situations where internal resources are insufficient.**

Deposit insurers should have the authority to contract outsourcing services for specialized consultation, valuation or appraisals (or CPA firms with the capability to assist) in carrying out the independent valuation and sales of assets and liabilities of the failing/failed bank or payment processes. The process of selecting outsourcing vendors should be transparent and well managed.

### **3. Undertake appropriate valuation and follow transparent sales process for the resolution of failed banks.**

A deposit insurer should undertake an appropriate process for the appraisal of the value of a failed bank and follow an open and transparent process for the disposition of assets of a failed bank.

### **4. A deposit insurer should have in place an effective public awareness and communication mechanism to enhance the confidence of the public in the resolution process.**

A deposit insurer should, on a regular basis, communicate to the public the terms and conditions of deposit insurance coverage and the approach it takes to the resolution of failed banks.

### **5. A code of conduct for employees of a deposit insurer should be in place.**

Employees of the deposit insurer or other safety-net participants should follow an appropriate code of conduct and confidentiality provisions with respect to failed bank resolution. Good codes of conduct include prevention of conflict of interest pertaining to the discharge of their duties and the responsibilities of the employees.

**6. A deposit insurer should be provided with the power to investigate and if necessary litigate against those parties at fault in a bank failure.**

The power of investigation into alleged officers, directors, managers, auditors and related parties of the failing/failed bank can help improve recoveries for an insurer and can mitigate moral hazard problems by providing strong incentives against malfeasance.

## **E. Resolution of Failing or Failed Banks issues**

This section sets out guidance on resolution methods for failing or failed banks.

### **1. Have in place a rule-based or statutory trigger criterion for intervening in the affairs of a problem bank.**

It is important for the deposit insurer or other financial safety net participants to set up a rule-based or statutory trigger mechanism for early intervention into the affairs of a troubled bank and for determining whether a bank has failed. The trigger criteria should involve either quantitative or qualitative measures. The quantitative ratios should include measures such as regulatory capital and asset quality. Qualitative indexes should include measures of management quality and any material breaches of standards of sound business and financial practices, violations of regulatory requirements, or the inability of a bank to fulfill its obligations resulting from the claims of depositors.

### **2. A professional evaluation team should assess the financial viability of a failing bank.**

A professional, experienced team composed of staff from the supervisor and/or deposit insurer or outside experts should be created to assess the viability of a problem bank. The evaluation criteria should be based on criteria such as market value. If workout plans with a specific timetable are required by supervisors, the plans submitted by the failing bank should be well designed, approved and followed up by the financial supervisory agency and/or deposit insurer.

### **3. Effective resolution policy and emergency mechanisms to handle individual bank failures should be established.**

In order to be efficient, reliable and credible in handling individual bank failures, the deposit insurer should set up effective resolution policies and procedures. These should include how to apply least cost resolution methods, how to handle the systemic repercussions of the failure of large bank, how to avoid the disruption of banking services in a particular market or region, and what kind of emergency alternatives should be used if conditions deteriorate more quickly than expected.

#### **4. Try to maximize the recovery of the failed bank's assets using a market approach.**

The deposit insurer is typically the largest creditor in a failure after subrogation. Therefore, it should try to maximize its recoveries through tight control mechanism (e.g. Board of Creditors) posed on liquidator of failed bank, or by selling the assets of the failed banks through appropriate legal means and the use of real estate agents and other market mechanisms including possible recovery mechanisms that will allow the deposit insurer to benefit from the upside.

#### **5. Market principles and mechanisms should be relied upon as much as possible in resolution transactions.**

It is a good practice for the deposit insurer to resolve failed banks using market mechanisms and principles. This can include approaches which:

- Obtain support or assistance (e.g. risk sharing) from other financial safety net participants before commencing a resolution process.
- Build in a transparent approach to resolutions which encourages all potential purchasers to participate.
- Ensure high standards in the internal and external auditing associated with the resolution process.
- Where possible, employ mark-to-market approaches in the appraisal process.
- Use experienced professionals to expedite deal related transactions efficiently.
- Resolution approaches should be both effective and efficient (i.e. cost-effective) rather than relying solely on seeking the lowest cost method.

#### **6. Set up incentives for facilitating market mechanisms in resolution.**

If market-based processes are likely to be successful there needs to be system-wide statutory incentives for their use. Some examples are:

- Tax incentives: To facilitate mergers & acquisitions and bad debt write-offs.
- Administrative incentives: To reduce compliance costs, enhance debt recovery or insolvency registration.



## **7. Ensure efficient and effective insured depositor reimbursement.**

A top priority for deposit insurers is that there be focus on protecting the interests of insured depositors via efficient and effective reimbursement processes. Examples of efficient and effective depositor reimbursement procedures are:

- Shorten as much as possible the period between the revocation of a bank's license and the actual reimbursement process.
- Continuous disclosure of information to the public during the reimbursement process and liquidation. This should include keeping depositors informed about the details and timeframe of their reimbursement.
- The deposit insurer should be able to audit the data-processing systems used to assess deposit records and gain access to the failed bank's depositor records before bank closure to speed up the reimbursement process.
- The legal rules regarding objects and items to be withheld and set-off, as well as guiding subrogation should be well defined.
- The deposit insurer should set up partial payment procedures in cases where insured depositors are in need of their funds urgently before the actual reimbursement.

## **8. Guiding rules of liquidations should be well defined.**

The rules for the liquidation process, reporting duties of the liquidator, legal deadlines and distributions to creditors should be well defined and documented. Other factors influencing the recovery in liquidation should also be well controlled and managed, including the depositor's priority ranking, legal deadlines, set-off rules, the collateralization of claims and the litigation exposure of the deposit insurer during liquidation procedures. Furthermore, the guiding subrogation rules of the deposit insurer should be well defined.

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## Appendix 1: Net resolution cost<sup>1</sup> in past ten years

Countries	Net resolution cost in past 10 years(USD) <sup>2</sup>	Percentage of GDP <sup>3</sup>	Base of GDP <sup>4</sup>	Main resolution method
Colombia	2,810,000,000	4.00%	2002 GDP	Reimbursement, Bridge bank, OBA
El Salvador	68,000,000	0.50%	-	-
Hungary	709,000	0.00%	2000 GDP	Reimbursement
Czech Republic	2,430,800	0.50%	-	Reimbursement
Russia	3,100,000,000	0.18%	1999 GDP	-
Brazil	20,400,000,000	2.70%	1995,1996,1997,3-year average GDP	-
Japan	162,000,000,000	3.60%	2003 GDP	P&A
Canada	3,500,000,000	0.40%	-	Reimbursement, P&A
France	15,800,200	1.00%	-	Reimbursement,
Taiwan	2,640,000,000	0.93%	2001 GDP	P&A
Estonia	4,010,820	0.07%	1998 GDP	Reimbursement, P&A
Mexico	57,300,000,000	13.60%	1998 GDP	Reimbursement, OBA
Philippine	923,000,000	0.25%	1997~2001, 5-year average GDP	Reimbursement, P&A,OBA
Jamaica	2,630,000,000	35.80%	-	-
Korea	82,300,000,000	13.59%	2003 GDP	-
Venezuela	4,690,000,000	11.00%	-	Reimbursement, P&A,OBA

<sup>1</sup> The estimated net resolution cost including costs borne by the deposit insurer, government, or others, minus proceeds received from asset disposition.

<sup>2</sup> The related currency was exchanged to USD at the rate of September 16, 2004.

<sup>3</sup> The percentage of GDP was calculated and provided by questionnaire respondents, real GDP figure of each country was not provided.

<sup>4</sup> The base of GDP was provided by questionnaire respondents, some countries used 3 or 5 years average GDP, most countries used specific one year GDP.

## Appendix 2

### Number of Countries Responding to Questionnaire

#### **Members**

1. Brazil
2. Bulgaria
3. Canada: CDIC
4. Canada: Autorité des marchés financiers (Québec)
5. Colombia
6. Czech Republic
7. El Salvador
8. Finland
9. France
10. Hungary
11. Jamaica
12. Japan
13. Jordan
13. Kazakhstan
14. Kenya
15. Korea
16. Mexico
17. Philippines
18. Russia
19. Sweden
20. Taiwan
21. Tanzania
22. U.S.A.
23. Venezuela
24. Vietnam

#### **Non-Members**

1. Chile
2. Cyprus
3. Finland
4. Estonia
5. Lithuania
6. Netherlands
7. Portugal
8. Slovenia
9. Spain
10. U.K.