VI

Exceptional Financial Support to Insolvent Banks

As treated here, exceptional financial support is provided to a bank only when it is insolvent. It should be distinguished from liquidity support provided to banks by a central bank as lender of last resort.[185]

Typically, exceptional financial support, or "open bank assistance" as it is sometimes called, is provided to a bank in financial distress in order to rescue the bank or to prepare it for a merger with another financial institution, when its failure is judged to have serious consequences for the banking system, for instance, because the bank is too big to fail, or when such assistance is required in the context of a systemic banking crisis. Usually, exceptional financial support is corrective in the sense that it provides remedial assistance aimed at preserving the bank's franchise in one form or another. A fundamental objective of exceptional financial support is that the bank receiving support continues to operate as a legally independent corporation. Therefore, as discussed here, exceptional financial support is provided to the bank in distress and does not include official financial support that is extended to another institution to facilitate a sale, merger, or purchase and assumption transaction whereby the bank is transferred to that institution.[186]

The justification for providing exceptional financial support to insolvent banks must be sought in the systemic consequences of with-

[185] See Chapter I, Section 5, above. In theory, exceptional financial support may also be required in cases where a bank is solvent but is unable to meet the collateral requirements for central bank credit; as such cases are relatively rare, they are ignored in this discussion.

[186] See Chapter XI, below, for a discussion of official financial support provided in the context of bank resolution procedures involving transfers of banks in distress.

holding it. Therefore, the decision to provide exceptional financial support will depend on several factors. One is whether household deposits are protected by deposit insurance. In many countries, the monetary authorities will be more inclined to extend financial assistance when there is no deposit insurance than when there is, although, in others, there may be some pressure to provide assistance in order to protect the deposit insurance fund. Another factor is whether failure of the bank would have unacceptable consequences for the banking system as a whole, either because failure of the bank would cause serious difficulties for other banks that are creditors of the failing bank (e.g., because its size or the nature of its operations does not permit an orderly resolution) or because failure of the bank is expected to lead to a dangerous loss of public confidence in the banking system. Large size is not the only criterion. As is illustrated by the small-bank crisis in England in the early 1990s, the failure of a significant number of small banks can endanger the banking system if it is not contained (which it was). Also, the failure of a medium-sized bank can seriously tarnish the international reputation of a major financial center (London or New York). A subsidiary consideration may well be that no other institution can be found that is prepared to take over the bank on reasonable terms. A third factor is the seriousness and permanence of the immediate causes leading to the bank's liquidity shortfall. If the causes are systemic, for instance where they are related to the failure of other financial institutions, the authorities may step in aggressively with liquid resources to combat the spreading of contagion. If, however, the bank is in trouble because its access to the interbank market has been cut by other banks based on its weak financial condition, the authorities may be more reluctant to ride to the rescue. A fourth factor to be considered by the monetary authorities of a country is that a bank failure may adversely affect international transactions using the country's payment and securities transfer systems and the international reputation of its financial markets.

Exceptional financial support to an insolvent bank may take several forms. It may come as a loan from the central bank, the state, the deposit insurance agency, or commercial sources, as a guarantee for loans provided by others, as a bond swap, or as an equity contribution.

Although, normally, the central bank may extend financial assistance only to solvent institutions, the central bank may nevertheless be authorized to grant exceptional short-term funding to an insolvent bank so as to permit the bank to continue to meet its liabilities, sometimes collateralized by assets that normally are not eligible to be used as security for central bank credit. The state treasury may provide financing directly, or

through an intermediary such as the central bank. Alternatively, the deposit insurance agency may provide financial assistance, although the funds available to it to engage in large-scale support would often be inadequate, requiring additional funding from the state treasury.[187] Or the monetary authorities may try to organize funding from commercial sources; however, due to the weak financial condition of the bank, such support will generally not be available without considerable pressure from the authorities or at least their implicit debt-service guarantee.[188]

Bond swaps can be used to exchange central bank or state treasury bonds for nonperforming loans of a bank in distress. Removing nonperforming loan assets from a bank's balance sheet in exchange for central bank or government securities not only strengthens the bank's financial condition, but also frees the bank from the administrative burden of debt collection and thereby helps the bank to focus on the rehabilitation of its core activities. The nonperforming loans may be transferred to a state agency, such as the deposit insurance agency or an asset management corporation, for collection or for a loan workout. In recent years, the bond swap has been among the most frequently used methods in bank restructuring packages.[189]

Special financial assistance may also come in the form of an equity participation by the state in the bank, either directly or indirectly through a financial intermediary that may have been established specifically for that purpose;[190] such equity stakes are often preferred shares in the bank's capital in amounts and on terms that give the state or its agent effective control of the bank and that sufficiently dilute the value of existing equity capital. In some countries, the law authorizes the deposit insurance agency to provide equity funding or an equity funding guarantee.[191] If restructuring of the bank is successful, the

[187] E.g., *Norway*: Section 2–12(1) of the Law on Guarantee Schemes for Banks of 1996; *United States*: 12 U.S.C. § 1823(c).

[188] To that end, the deposit insurance agency may be authorized by law to extend guarantees. See, e.g., *Norway*: Section 2–12(1)(b) of the Law on Guarantee Schemes for Banks of 1996; *United States*: 12 U.S.C. § 1823(c)(2)(A)(iii), but only to facilitate the merger or consolidation of the bank with, the sale of assets of the bank to, or the assumption of liabilities or the acquisition of control of the bank by, another institution.

[189] Claudia Dziobek, and Ceyla Pazarbaşioğlu, "Lessons from Systemic Bank Restructuring: A Survey of 24 Countries," IMF Working Paper 97/171 (Washington: International Monetary Fund), 1997, at pp. 15–16.

[190] An example of such intermediary is the Reconstruction Finance Corporation of the *United States*, which between 1933 and 1953 provided equity capital to many banks in distress.

[191] *Norway*: Section 2–12(1)(c) of the Law on Guarantee Schemes for Banks of 1996.

shares may be bought back by the bank or be converted into common stock and sold by the state to the public. An alternative to equity participations may be to provide credit financing in the form of quasi-equity where the ranking of the bank debt so created is contractually subordinated to all other debt of the bank.[192]

The law may require that several conditions must be met before public funding can be deemed justified. These may include that the bank receiving the loan must be threatened with the inability to pay its debts as they become due if the funds are not provided, that the loan is intended to lessen the effects of a systemic banking crisis, that the loan represents the least-cost solution for the regulatory agencies to the bank's problems, and that the bank's management has been competent and has complied with applicable law and regulations.[193] The requirement that open bank assistance, when compared with other bank resolution strategies, represents the least-cost solution means generally that it represents the least financial cost to the fiscal authorities. However, that solution need not be the optimal alternative when viewed from the perspective of the banking system. The solution that carries the least financial cost is not necessarily the solution with the lowest economic cost. Therefore, the law should provide for a safety valve permitting open bank assistance in cases where rescuing the bank is mandated by systemic considerations; the use of this exception may be limited and public accountability may be enhanced by prescribing a restrictive decision-making process involving a broad spectrum of the political establishment.[194]

An important objective in providing exceptional financial support to an insolvent bank is to ensure that, to the extent possible, the full costs of such support are borne by the bank's owners. In principle, special financial support should be provided on terms and conditions that reflect market cost. In practice, however, such terms might not be ascertainable as no financing from market sources would be available for an insolvent bank at any price, whereas financing, if it would be offered on such terms, would be too onerous to fit a restructuring plan.

[192] See Gillian Garcia, "Deposit Insurance and Crisis Management," IMF Working Paper 00/57 (Washington: International Monetary Fund), 2000, at pp. 51–52.

[193] *United States*: 12 U.S.C. § 1823(c).

[194] See for this approach the *United States*: 12 U.S.C. § 1823(c)(4)(G) requiring a decision of the Secretary of the Treasury (in consultation with the U.S. President) pursuant to a written recommendation adopted by a two-thirds majority of both the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System, for the adoption of a bank resolution strategy other than the least-cost solution.

Consequently, special financial support to an insolvent bank may have to be priced at subsidized levels; the difference between those terms and what is assumed to be a fair market price should be charged to the bank's owners.

More generally, the law should require that managers and owners of an insolvent bank suffer consequences of their failure to keep their bank safe and sound. Charging the costs of a bank's failure to the bank's owners, by suspending dividend payments or diluting their equity stake or imposing civil or criminal penalties, precludes the owners from benefiting from official assistance (free ridership) and tends to reduce the moral hazard that a rescue operation poses with respect to other banks. Bank managers guilty of negligence or worse should be removed and made to pay penalties in case of gross negligence or willful misconduct. However, imposing such sanctions on bank owners and managers would not be appropriate in cases where bank failures occur as a result of circumstances beyond their control, such as war or natural disaster. Otherwise, the provision of such disincentives for managers and owners has been identified as a key element of best practices in bank restructuring.[195]

[195] Dziobek, and Pazarbaşioğlu, "Lessons from Systemic Bank Restructuring," at p. 15. See also Garcia, "Deposit Insurance and Crisis Management," at p. 51.