IV Bank Restructuring

Overview of Strategy

The main objective of the restructuring strategy is to restore individual banks and the system to profitability and solvency. The strategy entails strengthening viable banks, improving the operating environment for all banks, and resolving those banks that are insolvent or nonviable. Bank restructuring is a multiyear process, requiring the establishment or revision of laws and institutions; the development of strategies to liquidate, merge, or recapitalize banks; the restructuring and recovery of bank assets; and the establishment of positive cash flows. Systemic bank restructuring can lead to major downsizing of and ownership changes in the system.

Legal and Institutional Framework[25]

The establishment of a single high-level authority, charged with ensuring consistency among government agencies, will strengthen the restructuring strategy. This authority should be composed of cabinet-level officials and senior staff of financial sector oversight agencies and, to be effective, should have strong political commitment. Experience has shown that consistent implementation of a complex restructuring process is difficult in the absence of a single authority with a clear mandate. This authority should delegate most implementation issues to appropriate agencies.

If feasible, existing agencies with established credibility may be given responsibly for implementing the restructuring strategy. Such agencies, including the central bank, the supervisory agency, the ministry of finance, and the deposit insurance agency, have the necessary staff, organization, and infrastructure. Given the need to act quickly, it may be cost effective to rely on these existing institutions. Establishment of new, specialized bodies in charge of implementing systemic bank restructuring can be distracting and time consuming.

If existing agencies have limited credibility or lack specialized skills, specialized institutions may need to be established. Examples include the creation of a bank-restructuring agency, when the government must take over and temporarily run and restructure intervened banks, or a centralized asset management company (see Appendix II). In this case, the specialized agencies must be given a clear mandate and may be given a limited life. Care must be taken to ensure that the new agencies have full political support, adequate staff, and a sufficient budget to carry out their responsibilities.

Legal frameworks for bank intervention and resolution should be reviewed and, where necessary, amended—possibly through emergency legislation. Changes to laws and regulations may be needed, so as to

- facilitate intervention in weak banks and write down shareholder capital;[26]
- regulate asset valuation and transfers of property and creditor rights in support of the bank restructuring strategy;
- update accounting and auditing rules, and loan and collateral valuation rules; and
- ensure the fitness and propriety of owners and managers of banks, the eligibility of foreign investors, the entry criteria for new banks, and limitations on foreign exchange exposures, connected lending, and loan concentration.

[25]Legal issues in bank restructuring are extremely complex and depend to a considerable degree on the legal and institutional framework in each country. This topic is too broad to be covered adequately in this paper. The International Monetary Fund and World Bank staff are writing jointly a report on the legal and institutional framework for bank restructuring.

[26]In some countries, supervisors have been unable to take over insolvent banks because shareholders have been able to impede loss recognition and capital dilution, thus stalling the restructuring process. The process can be hindered by any combination of issues, including lack of authority to intervene banks, deficient operational definitions of insolvency, a judicial stay on interventions, or a lack of protection for supervisors from personal lawsuits.

Other legal or regulatory reforms might be required to

- improve loan recovery powers of banks;
- facilitate the transfer of assets between institutions;
- facilitate debt-equity swaps;
- strengthen bankruptcy laws, including improving the balance between debtor and creditor rights;
- strengthen rules and procedures for foreclosure of collateral; and
- strengthen legislation on contracts, property, and companies.

Given that many such reforms are potentially very extensive and time consuming, reforms during the crisis should focus on crucial aspects only.

The judiciary may need to be strengthened if it does not have the experience or capacity to address adequately the bank restructuring process. To ensure speed and quality of bank restructuring, many countries have set up specialized courts to deal with bank and corporate restructuring. There may also be a need to set up arbitration panels and other facilities for extrajudicial settlement of financial disputes.

Burden Sharing and Loss Allocation

Once a bank has been intervened by the government, the burden sharing issues move to the asset side of its balance sheet. The government now has responsibility for the bank and its assets and must use different resolution or liquidation options to protect asset values and minimize losses. The bank may be kept open in full or in part under new management or liquidated. Regardless of the resolution pursued, burden sharing becomes an issue between government and private bank borrowers. Accordingly, banks' credit and other asset portfolios must be managed as efficiently as possible.

New private investors brought in to recapitalize weak banks cannot be expected to absorb existing losses. In a systemic crisis, banks seldom have much franchise value, and new private investors are unlikely to assume the losses of insolvent banks. Moreover, most banks face major uncertainties regarding their own viability. Existing losses must, therefore, be assumed by existing private stakeholders up to their legal liability limits, and the remainder by the government. Allocation of losses arising from future valuation changes of existing assets is often negotiated between the new investor and the government before acquisition.

Bank Restructuring Options

Diagnosing Banks

The bank restructuring strategy begins with a diagnosis of the financial condition of individual banks. The first task is to identify the size and distribution of bank losses. As supervisory data may be outdated and may not reflect the full economic impact of the crisis, supervisors may attempt to update available information based on uniform valuation criteria. The supervisors will also examine information on banks' ownership structures—public or private, foreign or domestic, concentrated or dispersed—to help determine the scope for upfront support from existing or potential new private owners.

As quickly as possible, banks should be classified using uniform indicators. A frequently used measure of solvency is the risk-weighted Basel capital adequacy ratio (CAR). In a crisis, however, the accurate measurement of capital is usually limited by problems with loan valuation and classification, and weak provisioning rules. International accounting or prudential rules provide little operational guidance. Other indicators may be used, including gearing ratios or banks' reliance on central bank credit.

When data limitations delay bank evaluation, supervisors have to develop the needed information to determine bank viability (Box 7). As described earlier, a bank is viable if it can remain profitable and earn a competitive return on equity over the medium term, and if the shareholders are committed and able to support the bank. Supervisors may require banks to produce forward-looking business plans based on common assumptions and worse case–scenario analyses. Viability may need to be confirmed with simple stress testing of banks' loan portfolios and balance sheets under different exchange rate, interest rate, and economic growth assumptions; and with simulations of banks' core profitability after excluding credit and other losses directly related to the crisis. Supervisors will also have to examine the viability of individual banks in the context of expected future volume of activity that the overall economy can absorb.

Supervisors may use special audits by independent external auditors to ensure uniformity and impartiality. Such audits may be warranted where insider lending or government-directed lending has been prevalent or when the supervisors cannot meet the sudden demand for on-site inspections. Clear and uniform guidelines are needed to protect the auditing process from excessive bias toward caution because auditors tend to use "liquidation" rather than "going concern" values in order to protect their own reputations. Special audits are more useful later on than earlier in a

Box 7. Difficulties in the Identification of Bank Solvency

- **Identifying the size and distribution of bank losses is critical for developing a crisis response** and a bank restructuring strategy. A banking crisis involves losses and erosion of capital for individual banks. The identification of bank losses is extremely difficult, especially early on in a crisis because valuation procedures may be weak, and bankers may have strong incentives to cover up losses.
- **Bank liabilities are normally relatively easy to value.** But there may be liabilities held off banks' balance sheets and liabilities of branches or subsidiaries at home and abroad that may have to be included. There may also be liabilities that are unrecorded.
- **The valuation of loan portfolios is particularly difficult.** There are no market prices for loans, especially for nonperforming loans. Loan valuation is typically based on loan classification and provisioning rules, which tend to capture values with a lag—there is no true value of a nonperforming loan.
- **Loan classification and provisioning rules often are inadequate and need to be reformed.** But reforms will take time to become effective because the data is collected by banks, which will need time to change their accounting and internal controls systems.
- **There is typically widespread denial of the severity of the situation.** It is difficult for bankers and officials alike to accept the full scope and speed of deterioration in a banking crisis because everyone involved first assumes that the problems are temporary. This leads to underprovisioning.
- **The value of a bank and its capital adequacy are difficult to establish.** Lags in the valuation of banks' loan portfolios as underlying economic conditions deteriorate lead to overvaluation of capital. Low-quality assets and creative accounting may further inflate capital numbers and adequacy ratios.
- **Policy decisions typically have to be based on whatever data are available to supervisors.** The supervisors are typically the only ones with data on individual banks and an overall view of the financial condition of the system.
- **Bankers and external auditors may have strong incentives to obscure and delay the process:** bankers, because they may lose their bank and have irregularities to conceal, and external auditors, because their analysis is based on historical data and they may be defensive of numbers that they have certified.

crisis because the audits ensure uniformity and impartially but not timely information. Ideally, they should be verified through second opinions.

The appropriate valuation of government bonds held by banks has become an important element in assessing the financial conditions of banks. Banks in emerging market countries often hold significant amounts of government bonds. As the financial condition of the government deteriorates, the market value of the bonds may also deteriorate. When government bonds sell at deep discounts in the market, marking to market such bonds could make the banking system insolvent and recapitalization costly. The private sector may not have sufficient resources to offset the value loss from the deterioration in the value of government bonds. On the other hand, government finances may not be able to support the issuance of additional bonds for bank recapitalization.

The alternatives are not attractive. A significant portion of the banking system could be closed and liquidated. Alternatively, government bonds could be placed in the investment account of the banks and held at face value. A third option might be to distinguish between existing bond holdings, which could be marked to market, and new bonds issued to recapitalize banks to be held at face value. Finally, the requirement to mark to market securities could be phased in over a long period (e.g., five years) to allow shareholders time to recapitalize their bank. Whatever the solution, the valuation of government bonds should be uniform and transparent.

Once the diagnosis is complete, banks can be classified into three main categories based on their CARs, their viability, or their liquidity shortfalls as well as other supervisory data. The three categories of banks are typically viable and meeting their legal CAR and other regulatory requirements, nonviable and insolvent, and viable but undercapitalized. In the latter classification, an additional assessment will be needed on the ability of the existing shareholders to recapitalize their bank within an acceptable period or, alternatively, whether public funding should be considered. This classification is highly sensitive and should not be announced to the public but rather used by the supervisory authorities in designing restructuring options (Box 8).

Dealing with Viable but Undercapitalized Banks

All solvent but undercapitalized banks should be required to present time-bound restructuring plans—showing how they intend to remain profitable and solvent—and should be subject to intensive report-

Box 8. How to Assess the Financial Condition of Banks: The Case of Turkey

In Turkey, assessment of the capital needs of private banks was done by external auditors and linked to their audited financial statements as of end-December 2001. While potential conflict of interest was an issue, the banks' own external auditors were considered the best suited because of their in-depth knowledge of the respective banks and their ability to carry out the assessments more quickly and at a lower cost than new, outside auditors.

The banking supervisory agency issued detailed instructions on supplementary reporting requirements to be prepared by bank management and certified by the auditors. The supplementary reporting requirements focused on the following four areas:

Capital adequacy: Detailed information was requested about all components of assets and risk weightings that had been applied, including any recent injection of liquid capital.

Credits and other receivables: Since this constituted the single greatest risk for most of the banks, extensive disclosure of information had been required on both an individual and a group loan basis such as: borrowers' performance; ability and willingness to pay; risk classification (five categories) and provisions made; and auditors' verification that the credit risks had been assessed in either 75 percent of the loan portfolio or the 200 largest exposures, whichever was the highest.

Exposures to related parties: Banks were required to disclose all related party balances and transactions of entities and individuals both onshore and offshore. Auditors were required to confirm completeness and to review the pricing and economic substance of all such transactions.

Valuation issues: The instructions required an extensive listing of transactions and testing of rates, prices, and legal documents to assess the economic substance and legal form of transactions. Standards were given to identify and correct accidental or deliberate off-market pricing, such as for the valuation of securities and foreign exchange accounts. The auditors were also told to be on the lookout for window dressing and fictitious transactions.

To monitor the assessments of the external auditors, the supervisory agency appointed independent reviewers who were asked to verify that the banks and the external auditors had carried out the assessments according to the above regulations and guidelines.

ing and monitoring.[27] If bankers are not able to present such plans, if they fail to comply with them, or if the bank becomes insolvent, it should be intervened. While all banks should be required to meet prudential requirements, shareholders may not be able to recapitalize their bank immediately. In this case, the recapitalization schedule could be phased in.[28] Banks operating in this fashion should be required to suspend dividend and profit distributions until the required level of capital has been restored.

Private banks should be required to recapitalize from private sources according to uniform rules. Prudential rules could call either for gradual implementation of loan loss provisions or a temporary acceptance of reduced capital ratios.[29] Phasing in capital allows for a more transparent and public evaluation of the banking system. Rules on recapitalization should also identify acceptable instruments of capital, eligible investors, and the timetable for the contributions. The recapitalization timetable must consider the reality that a very limited pool of capital may be immediately available for equity investment. Whether the authorities opt to phase in capital or provisioning requirements, the policies must be fully transparent and announced to the market.

Dealing with Insolvent and Nonviable Banks

All insolvent and nonviable banks should be intervened and resolved as soon as possible to stop their losses. If insolvent banks stay open without financial and operational restructuring, losses are likely to grow. Allowing insolvent banks to continue operations can distort competition, result in perverse incentives for other banks, and increase the eventual cost of restructuring.

Intervened banks should be passed to the agency responsible for bank resolution, which will decide on resolution options. Options include determining whether to close a bank or to keep it open. If the bank is closed, decisions need to be made on how to manage or sell assets and liabilities. If the bank is kept open, the restructuring agency must decide on a range of alternatives, including whether to recapital-

[27]Undercapitalized banks are those operating below the legal minimum CAR. Insolvency is often defined as operating with a CAR of zero or less. In some countries with prompt corrective action regimes, the law may oblige supervisors to intervene in a bank when its CAR falls below a certain threshold (2 percent in some countries).

[28]This gradual but monitored approach is not forbearance. Forbearance is defined as permitting banks to operate below prudential norms without a plan or without close monitoring.

[29]The former method was used in Thailand, the latter in Indonesia and Korea.

ize the bank with public funds; to offer it for immediate sale as is, possibly with government guarantees on certain assets values; or to merge it with another sound public bank.

The choice of resolution options will depend in part on the availability of resources and should be guided by least-cost criteria for the economy. The government should assess the likely costs of different options and choose the combination of options with the lowest present value costs. Cost estimates, however, should be evaluated in a medium-term perspective and include an estimate of the impact of any government-financed efforts on the sustainability of government debt. The appropriate level of publicly financed recapitalization will have to be evaluated in the context of the country's sustainable level of public debt.

Intervened banks may be subject to operational restructuring to reduce their expenses and losses. The authorities must recognize that intervening in a bank will not stop losses, so any intervention must be accompanied by measures to control the loss-making activities.

Management and senior staff may have to be changed, risk management systems improved, branches closed, specialized functions and subsidiaries spun off, and staff size substantially reduced. At the same time, bank assets must be managed as efficiently as possible so as to minimize credit losses; for this, the best staff must be retained and, if needed, new specialist staff hired. The aim should be to bring the bank back to profitability as soon as possible.

Deposits in closed banks should be transferred to remaining sound banks (public or private). Even if a blanket guarantee is in place, depositor payout could be limited so that depositors suffer little, if any, disruption of their financial services. Transferred liabilities should be accompanied by assets of equivalent value, often government bonds, given the likely shortfall of good quality bank assets relative to deposits. The assets also need to generate sufficient yield to enable an acquiring bank to make interest payments on the transferred deposits.

Recapitalization of Banks with Public Funds

Public capital support of private banks may be justified in some situations. While public capital, in principle, should not be used to support private banks, the authorities may help private owners achieve a least-cost resolution. In this case, injection of new funds by the shareholders could be supplemented with public funds. Public participation in the recapitalization may be justified in cases where the worst private banks already have been intervened and the remaining system does not have access to sufficient capital. Under these circumstances, the shareholders and managers must be fit and proper, and not the cause of the banking problems. Public funds may also be justified when the public sector causes the banking problems through policies directly affecting the bank, such as sovereign debt restructuring or imposition of contract modifications. In this case, the issuance of bonds to compensate banks for their losses could be considered.

A successful public solvency support scheme should be uniform and transparent. Such a scheme should not be considered early in the restructuring process but, rather, as a last resort when it becomes clear that restoration of confidence and viability in the banking system will not be achieved without such support from the government or across-the-board nationalization.

A public solvency support scheme should be available to all banks and should be designed to provide bank owners with incentives to raise private capital before turning to government funds. Government equity could be contingent on such factors as new private equity in a set proportion; the government's having preferential shares; the government's having representation on banks' boards; government approval of bank's management; and government veto rights on certain decisions. Such schemes have been successful in Thailand in mid-1998 and in Turkey in early 2002. Examples of safeguards used in Turkey are provided in Box 9.

Once a decision is made to recapitalize a bank with public funds, the appropriate instruments must be designed. An increase in paid-in capital (Tier I capital) is preferred because it both improves capital ratios and provides income. The government may not wish to have an ownership stake in the banks, however, and may opt to inject Tier II capital or purchase subordinated debt of the bank.[30] If the government does not take an ownership share in the bank, however, it should hold shares that convert to ownership if the bank fails to implement its restructuring plan or if the bank's financial position sharply deteriorates.

Returning the Banking System to Normal

Once the banking system has stabilized and both corporate restructuring and asset resolution are under way, the authorities must turn to strengthening the financial system and increasing financial intermediation. Returning levels of financial intermedia-

[30]For a detailed discussion of recapitalization instruments see Enoch, Garcia, and Sundararajan (2002) and Dziobek (1998).

Box 9. Elements of the Public Recapitalization Program in Turkey

Public sector recapitalization programs must be designed in light of specific circumstances and government policies. Not all programs will be alike. The availability of shareholder resources, the extent of recapitalization needed, and the legal structure will all affect program design. In 2001, Turkey initiated a public sector recapitalization program with the following criteria and conditions:

Last resort: A public solvency support scheme should be viewed as a last option when there are no other alternatives available.

Private participation: For a bank to be eligible for public support, existing shareholders or new private investors must be willing to inject at least half of the Tier 1 capital needed.

Operational restructuring: To qualify for support, banks must present an acceptable operational restructuring plan, including measures to strengthen internal control, enhance risk management, increase revenues, cut costs, and deal with nonperforming loans.

No bailout of existing shareholders: Capital needs in banks must be thoroughly assessed, and all losses must be imposed on existing shareholders before public funds are injected. The assessment of capital needs should be verified by a third party. Preferably, the shares held by the government should have preferred status to shares held by the old shareholders. Thus, if there are additional losses over a given period of time, say six months, those losses should be absorbed by the old shareholders.

Positive net worth: To be eligible for support, a bank must have a positive net worth. If not, existing owners or new private investors must bring the CAR to above zero before a bank is eligible for public support.

Shareholders' rights: The government should have the right to appoint at least one board member, irrespective of its capital contribution. Such board member(s), who should have documented experience in banking, should have veto powers on matters material to the soundness of the bank.

Price: The government should pay net book value for the shares.

Buy backs: When the government wants to sell its shares, existing shareholders should have the right of first refusal for a given period, say, two years. The price should be whichever is the highest of the government's investment cost (principal and interest), net book value, or market price (including third party offers).

Pledge: To protect the public investment, majority shareholders in the bank should be required to pledge as collateral to the government shares held in the bank equal to the government's capital contribution. The shares can be used as collateral in the event the government faces losses when it sells its shares in the bank.

Payment: The government should pay for the shares in tradable government bonds issued on market terms.

Convertibility: If the government provides Tier 2 capital, this should automatically be converted into Tier 1 capital if the CAR falls below a certain ratio, say 8 percent, and if the private shareholders do not immediately bring it up to above 8 percent.

tion to historic levels has proved difficult in many postcrisis economies. Banks are often risk-averse and are seeking to rebuild depleted reserves. Often banks must implement costly restructuring programs. Efforts to enhance intermediation may require reinforcing prudential and regulatory oversight and improving transparency. Market discipline will need to be strengthened because the safeguards put in place at the height of the crisis must be phased out at a safe but meaningful pace. Exit rules for failing banks will have to be enforced and legal, judicial, and institutional structures strengthened to promote an effective and competitive banking system.

Key measures will have to be implemented to ensure a stable macroeconomic framework. Maintaining such a framework is essential for restructuring the banking system. Market forces operate most efficiently under stable macroeconomic conditions. Successful asset sales, recovery of financial intermediation, and economic growth depend on comprehensive and coherent monetary and fiscal policies.

Reforms will be needed to refocus the function and activities of institutions and to strengthen the prudential and supervisory structure. The roles of institutions change during a crisis, as bank and asset resolution become of critical importance. As the crisis subsides, institutions must be refocused to return to their traditional functions. If new institutions have been created, they must be either phased out or refocused. Similarly, banking regulation and supervision and exit procedures should be strengthened. Regulatory and supervisory arrangements can now be brought into line with good international practices. Formal forbearance can be ended with normal prudential regulations phased in over a specified period. Accounting, auditing, and disclosure procedures that strengthen market discipline can be implemented.

Restoring market liquidity is also key to increasing the resilience of the banking system after a crisis because the liquidity properties of assets and liabilities ultimately depend on the country's liquidity infrastructure and the resulting systemic liquidity. Pre-

vailing monetary arrangements, design aspects of central bank instruments, and arrangements for payments and money market operations bear directly on banks' abilities to manage short-term liquidity. Moreover, if special-purpose government bonds have been issued to recapitalize banks, the liquidity of these bonds also influences banks' ability to trade them efficiently in the market. High transaction costs resulting from rigid instrument design and trading rules can discourage trades and contribute to price volatility.

If a blanket guarantee is in place, it can be replaced with limited deposit insurance and strict exit rules. The blanket guarantee may be removed as soon as banks have been restructured to soundness, and the guarantee can be lifted without causing deposit shifts. As discussed previously, the blanket guarantee may be lifted in stages, removing protection first from deposits of the most sophisticated creditors. At the same time, the market should be given advance notice, possibly 6–12 months so that everyone is fully aware of the process. A new deposit insurance system, which may require new legislation, should be designed on the basis of good practices as to coverage, funding, and administration.[31] After a deposit insurance system has been introduced, strict exit rules should apply to any failing bank and losses distributed to creditors and depositors as called for under the deposit insurance system. Accordingly, the blanket guarantee must not be lifted until all banks are out of imminent danger.

Difficult decisions must be made concerning the treatment of government-owned banks. Privatization of banks and bank assets should take place according to a carefully developed strategy. The government will have to analyze the pace of divestment that maximizes recovery value. Rapid asset sales may yield less than sales later in the process. Similarly, the government will have to determine how best to increase competition and reduce the risk of mismanagement. Privatization of small banks may increase competition in the market, but it may be difficult to find sufficient buyers. Mergers or privatization of a single large institution may be easier, at the cost of reduced competition in the market. The role of foreign investors must also be defined.

[31]Garcia (2000b).