CHAPTER 6

Bank Liquidation Procedures

When a bank fails, the liquidating authority succeeds to the rights, powers, and privileges of the bank and its stockholders, officers, and directors. The liquidating authority can be a deposit insurance agency (DIA), a special-purpose agency (e.g., an asset management company—see Annex 6.1), or an administrator appointed by a commercial bankruptcy court. A bank liquidation office can be a stand-alone operation established in the failed bank's office, or consolidated within a DIA or other special-purpose agency, such as an asset management company. To facilitate the orderly solution of bank failures, standardized procedures and methods of dealing with failed banks and the liquidation of their assets should be developed and followed.

During a liquidation process, and even after a purchase and assumption (P&A) transaction, the liquidating authority will have assets to liquidate and administrative matters to address. This chapter provides detailed procedures regarding the effective liquidation operations, regardless of what entity bears responsibility. These bank liquidation procedures are equally applicable whether it is one bank, or a conglomeration of many failed banks.

Priorities of this approach include:

- Ensuring that all operations are consistent with proper governance, transparency, and accountability
- Maximizing the price of such sale or disposition of assets, consistent with the goal of protecting depositors and other creditors of the bank

- Ensuring fair competition among potential purchasers or merger partners
- Prohibiting any kind of discrimination in the solicitation and consideration of offers

A typical liquidation office structure can be divided into two functional departments: operations (the subject of this chapter); and asset management and disposition (discussed in Chapter 7). Annex 6.2 is an organizational chart that illustrates the functional structure of a liquidation office. Any liquidation office, from the smallest unconsolidated bank liquidation site to an entire national liquidation operation, can be structured similarly. The number of specialists and technicians shown under each department will vary according to the size of the operation. In fact, in smaller operations, one individual may be responsible for two or more functional areas. The notes that accompany Annex 6.1 define the functional areas and describe the areas of responsibility for each.

The guidelines in this chapter, along with Chapter 7, represent a compilation of standards that have proven successful in many bank liquidations. As applicable, they can form the basis for bank liquidation operational manuals. In that case, when changes are made to liquidation guidelines or asset disposition policies, appropriate directives or numbered memoranda should be distributed to all affected personnel (i.e., managers, liquidation committees, and account officers). On a regular basis, such memoranda can be directly incorporated into revised chapters of the manual, which will be updated and distributed, accompanied by a change notice.

Note that because job titles are subject to change and task assignments vary somewhat, the term “account officer” has been adopted for use in describing duties that may be performed by asset management specialists, claims specialists, technicians, and other specialists. In these bank liquidation discussions, an account officer is the individual responsible for performing the particular duty.

1 An earlier version of this chapter was published in David C. Parker, Liquidation Operations and Asset Disposition (U.S. Agency for International Development, Washington, 2000).
2 Along with Chapter 7, which addresses asset management and disposition. Taken together, this bank liquidation discussion provides basic standardized procedures for liquidation office operations and asset disposition. Although the aim is for a comprehensive guide regarding bank liquidation, it is virtually impossible to cover every aspect that may conceivably come up. However, the ideas contained here can aid in the approach to decision-making for situations that are not covered.
3 If bank liquidation is conducted through commercial bankruptcy court, the supervisory authority or DIA may be able to provide similar guidelines to the bankruptcy administrator to help ensure more efficient operations, which would ultimately result in greater recovery for the depositors and creditors of the bankruptcy estate.

4 Although specific situations may present opportunities for alternative approaches, these guidelines should be followed to the extent feasible and in accordance with good business judgment and legal constraints.
Closing a Failed Bank: Resolution Practices and Procedures

**Box 6.1. Example of Bankruptcy Claims Priorities**

1. Claims by secured creditors, up to the value of their security.
2. Employee compensation, taxes, and social contributions.¹
3. Receivership operational expenses and administrative costs (all costs pertaining to the liquidation process), including other obligations created during conservatorship or liquidation.
4. Claims by insured depositors, or the subrogated claims of a deposit insurance agency (in cases where a deposit insurance scheme exists).
5. Claims by uninsured depositors² and other creditors.
6. Claims by subordinated debt holders.
7. Claims by shareholders.

¹ In some jurisdictions.
² Note that some jurisdictions, with or without a deposit insurance agency, may have depositor preference; that is, all depositors’ claims (even uninsured, as applicable) have a higher claim priority than any other creditor.

**BANK LIQUIDATION OPERATIONS**

A bank liquidation operations division deals with matters that support but are not necessarily directly involved in asset liquidation. The areas that are discussed in this chapter are depositors and creditors claims, settlements, administration, facilities, personnel, contracting, legal, management information systems, and auditing.

**Depositor and Creditor Claims**

Prompt payment of a failed bank’s deposits according to legal priority can help maintain confidence in the banking system (Box 6.1). Depending on the legal framework, claims responsibility may be split. For example, in jurisdictions with a narrow-mandate (paybox) deposit insurance agency (DIA), insured depositor claims will be handled by the DIA and all other claims by a receiver or through bankruptcy court. In jurisdictions with a broad-mandate DIA (i.e., the DIA has bank resolution and liquidation powers), the DIA is responsible for everything. In jurisdictions with no DIA, the bankruptcy court is responsible for everything. This chapter assumes a broad-mandate DIA and refers to this function as the claims department. In this context, the claims department is responsible for processing general creditor and other claims against the bank receivership, as well as determining funds available for dividend distribution.

As noted in Chapter 3, before a bank closing, the claims department should collect necessary information about the bank’s depositors and creditors. Ideally, information regarding the size of the bank (number of depositors and dollar amount of deposits), secured deposits, workspace facilities, and bank personnel should be readily available from the bank examiners. Potential claims, including number, type, and amount of projected deposits, should be obtained. Other critical information includes the sophistication of the bank’s data processing system, types of contracts and leases, and any other special situations or deposit accounts.

The claims department will coordinate with other members of the closing team in gathering and determining the appropriate resources for the bank closing. This would include the number of personnel required to fulfill the functions, an adequate amount of supplies and equipment, and assurances of obtaining the necessary deposit reports.

During a closing, the claims department will continue coordination with other members of the closing team in performing the assigned function. To begin the process of paying off insured deposits, several tasks must be accomplished. These include, but are not limited to:

- Collecting required documentation
- Establishing a filing system
- Initiating a tickler system
- Arranging for handling any credit card deposit accounts
- Arranging for processing any electronic deposits.

The claims department will arrange for any required legal notice to depositors and creditors to be published in local newspapers and filed with the court. The claims department will begin processing any general creditor claims. Also, any items affecting any deposit balances through an ATM must be addressed. Of course, all actions taken should be completely documented. Files must be established for each claimant that should contain, at a minimum:

- Documentation supporting the claim (e.g., proof of ownership of a deposit account, signed invoice for services performed or goods received)
- Proof of identity of claimant
- All correspondence and memoranda regarding the claim
- Ultimate disposition of the claim.

After the closing, the claims department shifts into more of an administration mode, with duties to assure that liability accounts of the closed bank are properly reconciled, and that all claims are properly tracked. The payment of deposit accounts will continue by legal priority, as will those of general creditors, depending on the availability of funds.

**Settlements**³

Whenever a bank has gone through a P&A transaction there will be a need for a settlement function. Variations of this type

³ Portions of this section have been excerpted from Federal Deposit Insurance Corporation, Closing Manual (Washington, 2006).
of transaction are discussed at length in Chapter 5. Duties of settlement personnel include adjusting for purchase prices of assets, arranging appraisals for purchase of fixed assets, and correcting any errors and omissions of the closing process, as further described below.

The settlement unit is responsible for administering the terms of the P&A transaction with a purchasing bank. This includes monitoring the agreement to ensure compliance by both the purchasing bank and the receiver. The settlement function allows for finalizing and making adjustments compelled by the transfer of liabilities and the purchase of assets from the liquidating authority to the purchasing bank. Additionally, this unit scrutinizes and processes the various options available to the purchasing bank according to the terms of the P&A agreement.

By definition, the settlement function exists only when there is a P&A transaction with an assuming bank. The standard settlement period continues for 180 days from the date of the bank failure and usually provides for various events and functions to be performed within a certain time frame. During this period, the settlement agent oversees the transfer of the failed bank's assets and liabilities in accordance with the terms of the agreement, and the correction of any discrepancies related to the asset or liabilities balances purchased by or transferred to the assuming bank.

However, it is important to note that each closing is unique, and therefore the exact roles and responsibilities of the settlement personnel may vary according to the agreement and other factors associated with the particular closing. The following list is a typical representation:

- Assists the assuming institution, as required, in understanding its roles and responsibilities during the settlement period
- Communicates the P&A agreement's critical dates to the appropriate parties and monitors to ensure compliance
- Facilitates the purchase of assets under option in the P&A agreement
- Negotiates with the assuming bank to pay bills on behalf of the receiver
- Accumulates information for costs to be split between the receiver and the assuming bank
- Prepares appropriate documentation and secures the appropriate approvals for each financial adjustment
- Directs interim and final settlement funding between the receivership and the assuming bank in accordance with the P&A agreement.

Types of Settlement Transactions

Settlement transactions vary according to the unique nature and complexity of the failed bank. However, this section summarizes the most common activities.

**Pro forma adjustments.** These typically include adjustments from book value to market value, correction of errors/omissions detected after the pro forma balances were posted, and reallocation of assets/liabilities. Only those adjustments that affect both the receiver and assuming bank may be settlement items. For example, errors may have been made in balancing general ledger accounts. To the extent that these accounts transferred to the purchasing bank, plus or minus adjustments may be necessary.

**Discovered assets and liabilities.** Further analysis of the failed bank may reveal new or “discovered” assets or liabilities not identified during the initial pro forma. Discovered assets and liabilities are settlement items only to the extent that they affect both the receiver and the assuming bank.

“Cherry picks” and put-backs. In order to divest as many assets as possible, a P&A agreement may provide an opportunity for a purchasing bank to “cherry pick” (a fully discretionary purchase) good assets (usually loans), or “put back” lower quality assets (usually loans) to the receiver. In a put-back transaction, the assuming bank may return an asset to the receiver as described in the P&A agreement.

In a repurchase, the receiver may determine if it is in the best interest of the receivership to own the asset.

**Post-closing expenses.** Certain expenses such as post-closing wages for temporary employees may be paid by the assuming bank on behalf of the receiver and if so, are reimbursed to the assuming bank via settlement. Additionally, the cost of appraisals on bank premises to determine fair market value is typically shared equally by the receiver and the assuming bank. These amounts are also paid via a settlement.

**Purchase of premises, furniture, fixtures and equipment, or prepaid contracts.** The P&A agreement may provide an option for the assuming bank to purchase these assets. Typically, appraisal costs are included as settlement items, as are asset-related rent amounts and asset purchase amounts. Moreover, the P&A agreement may allow for purchase of an exclusive 90-day option to purchase the bank premises (and branches, if applicable). During this period, the settlement unit must coordinate the selection of appraisers and schedule any required appraisals with the purchasing bank. Often the P&A agreement grants the purchasing bank an option to assume various contracts and leases. Notification of the exercise of such options is usually required within 30 days.

**Other typical adjustments.** Net wire interest; securities valuations/purchases; premises leases/assignments/quit claim deeds/bills of sale; and correspondent bank account reconciling items; expense adjustments (i.e., broker/appraiser fees, telephone bills, data processing fees).

Administration

An effective administration unit of a liquidation office will promote the smooth and efficient operation of the

---

6 A P&A agreement will usually provide for various events and functions to be performed within a certain time frame. For example, the “put-back” provision for lower-quality assets must generally be accomplished within 60 days.
organization. The primary responsibilities of an administration unit include facilities, personnel, and contracting.

**Facilities**

Attention to detail in the facilities area will ensure that account officers are free to perform their assigned functions without needlessly worrying about the smaller things that make an office function properly. These matters include:

- Obtaining and maintaining adequate office space
- Obtaining and maintaining adequate office equipment (e.g., telephones, copying machines, computers, printers, etc.)
- Obtaining and maintaining adequate office supplies (paper, toner, pads, pens, etc.)
- Providing for efficient shipping services, and mail receipt and delivery
- Negotiating and monitoring administrative contracts (e.g., leases, maintenance agreements, etc.)
- Any other administrative duty that may be required to facilitate the efficient operation of the office.

**Personnel**

An administration unit should also follow all applicable policies and procedures regarding the employees of the failed bank. Based on the asset size of the bank in liquidation, and the relative sizes of the various types of asset portfolios, adequate staff should be retained to aggressively pursue asset disposition and administer operational functions. Comparing the guidelines itemized in Chapter 7 to the portfolios of assets acquired will provide a benchmark for the level of staffing required, ensuring optimum asset collection efforts.

Training is another matter that falls within the responsibility of the personnel unit. Sufficient resources should be devoted to ensuring that employees are adequately grounded in the knowledge required to perform their duties. This would include instructions on subjects as diverse as timesheets, claims administration, asset disposition, and delegation of authority.

**Contracting**

Contracting for goods and services should be competitively bid to the extent possible. Relationships can be established with local vendors for small and/or regular purchases of goods (e.g., office supplies, cleaning services, etc.); however, for larger, more specialized services, comprehensive procedures need to be developed on a standardized basis and closely followed. Additionally, a contractor oversight unit should be instituted with responsibility to ensure compliance with contractual agreements.

**Legal**

Many of the duties and responsibilities of liquidation activities require the professional services of attorneys. From the initial drafting of a sales agreement to monitoring the performance of a purchasing bank and providing legal expertise to assist in the collection of assets, a liquidation office cannot do without legal representation. Legal work can encompass a broad range of areas such as foreclosure, loan workouts, bankruptcy of debtors, contract disputes, asset sales, collecting on notes and guarantees, tax issues, pension funds, and shareholder suits. The duties can also include investigations to determine whether directors, officers, or other professionals caused harm to the failed bank.

Depending on the situation, a legal adviser could be an employee of the supervisory authority, the DIA, or an asset management company, or be an independent contractor. Regardless of status, the legal adviser’s duties will generally be the same in each situation. The size and complexity of the bank’s organization and the asset structure will determine the extent of the duties and the duration of the assignment. The legal adviser will work closely with the receiver and provide, on an as-needed basis, advice and assistance on all legal questions and matters that arise. Also, the legal adviser will be involved in various employee issues.

It is critical to the success of an organization that its personnel view their relationship with the legal department as a partnership. Initiation and management of litigation involve both legal and business decisions. Additionally, decisions regarding litigation usually involve the exercise of joint delegation of authority to the legal department and the liquidation office.

Put simply, an attorney from the legal department is responsible for decisions concerning legal issues, while the account officer is responsible for making the business decisions related to the case. Coordination between the account officer and the attorney within the structure of the attorney-client relationship is paramount to achieving successful results. Litigation should be initiated or settled only under joint delegation of authority from the agency.

In jurisdictions with special bank insolvency regimes, the receiver is usually imbued with special powers, as briefly mentioned in Chapter 1. Some of those powers include:

- **Contract repudiation.** A receiver may repudiate any contract within a “reasonable time” of appointment if the receiver (1) deems it burdensome, and (2) finds that repudiation would promote the orderly administration of the estate. This repudiation power ends any future obligations imposed by the contract. Any damages resulting from contract repudiation are limited to actual direct compensatory damages.

- **Stay of litigation.** A receiver is substituted as a party for litigation pending against the failed bank. Because the receiver may need time to assess each case to determine whether and how to proceed, the law permits the receiver to request a stay of legal proceedings of up to 90 days. This power also extends to litigation filed after the bank’s failure. The receiver must formally request the stay; however, a court cannot decline to issue the stay.
• **Avoidance powers.** A receiver has the power to avoid certain fraudulent conveyances. A receiver may avoid a security interest in a property, even if perfected, if the security interest was taken in contemplation of the bank’s insolvency, or with the intent to hinder, delay, or defraud the bank or its creditors. The receiver may avoid any transfers made by obligors within five years of the receiver’s appointment. These rights are superior to any rights of a trustee or any other party.

• **Special defenses.** A receiver has certain “special defenses” that it can use to defeat the defenses of obligors of a failed bank. For example, improperly documented agreements are not binding on the receiver. The receiver must be able to rely upon the books and records of the failed bank to evaluate its assets and liabilities accurately. Critical to effective resolution transactions, asset sales, and debt collection. Courts may not enjoin the receiver. Courts cannot prevent the receiver from conducting foreclosures or asset sales, nor can they attach or execute upon any assets the receiver possesses. (These statutory provisions do not bar the recovery of monetary damages, however.)

### Management Information Systems

Taken together, the areas of accounting and information processing comprise a management information system (MIS). A sound MIS is a key component of management effectiveness and decision-making processes. Management is responsible for developing and implementing an information system that facilitates managerial activities. An MIS is considered a feedback device and as such is a method for managing risks. Senior management determines what information is needed for them to make informed decisions and monitor activities of the establishment. Staff correspondingly develops the systems to ensure that the desired information is available and usable for performance measurement.

The financial records should be kept in accordance with the accounting standards of the International Accounting Standards Board; however, liquidation accounting is generally on a cash rather than accrual basis. To ensure financial integrity, an organization must have an effective accounting and information processing system that provides for general and subsidiary ledgers. The organization’s general ledger system is its official financial system of record. The general ledger exhibits the financial condition of the organization and is used by the government and the public to monitor the financial operations of the organization. To ensure financial integrity, subsidiary records must be reconciled on a timely basis and kept in balance with general ledger control figures.

An accounting and management information system should assure that the organization has the capability to account for its cost and expenses related to each bank. The system should have the capacity to calculate, track, and record each bank’s collections and expenditures. It is very important to be able to allocate these items for each bank. By accounting for each bank in this manner, the organization can determine the expenditures per bank versus any income (collections or sale) the bank generates. Documenting operational losses related to the management of assets can help an organization decide whether to close out a liquidation.

The organization may want to establish a management committee for the finance and data processing functions. The MIS, finance area, and senior management of the asset disposition departments should have representatives on the management committee. The committee should ensure that the services of the data processing and finance departments are geared toward supporting the effective management of the asset portfolio. To that end, the management committee should develop a comprehensive policy regarding both data processing and accounting. This should address standardized reporting requirements, daily operational procedures, and internal controls.

One of the first responsibilities of the MIS and accounting unit is preparing a final pro forma statement of condition at the time of a bank closing. This requires balancing all the accounts of the failed bank. Going forward, the accounting unit is responsible for maintaining accurate financial records for all liquidation, or receiverships under its responsibility.

Each failed bank’s accounting records should be maintained separately. Other important aspects of a standardized accounting system include:

- Having a general and subsidiary ledger
- Ensuring that all accounts are balanced and reconciled on a daily basis
- Having a system to control disbursements (including any payment orders or check stock)
- Establishing a payment-processing procedures (including mail control, place for payment, etc.)
- Developing expense submission procedures (required documentation, etc.)
- Cost accounting
- Asset valuation.

These components will support financial reporting, asset management, and asset management monitoring.

The design of the MIS should consider a system’s probable life cycle as well as allow for regular re-evaluation. A reliable information system should meet the following minimum requirements:

- Capability to handle the anticipated data volume
- Ease of use for sorting and updating
- Capability to integrate financial management system needs with overall MIS strategy.

Management should ensure that these objectives are realized while keeping in mind the competing points of development time versus lifetime of the mission. Senior management should devote considerable analysis to whether system

---

requirements are more efficiently developed in house or outsourced. Cost of purchased or contracted development of software must be weighed against the time needed to develop the system in house. Experience has shown, however, that developing data processing applications in house is generally more costly and time consuming than purchasing off the shelf systems or contracting with vendors to provide the service, especially when time frames are short.

There are five essential elements that must be addressed in the area of accounting and information processing:

1. Timeliness
2. Accuracy
3. Consistency
4. Completeness
5. Relevance.

Management decisions and strategies may be rendered invalid or even detrimental should any one of these components be compromised.

**Timeliness.** Information must be current and available to all appropriate users to facilitate timely decisions. This necessitates prompt collection and editing of data. Records should be updated daily, reflecting each day’s activities separately and distinctly from that of another day. The records should show the bank’s financial condition as of the given date.

**Accuracy.** A system of internal controls must be in place to ensure the accuracy of data. Information should be properly edited and reconciled, with the appropriate control mechanisms in place. A comprehensive internal and external audit program would greatly facilitate this endeavor.

An efficient operation cannot be conducted without a record-keeping system capable of generating a wide variety of internal information and reports. Such a system is necessary if a company’s board of directors is to be kept well-informed and maximum managerial effectiveness achieved. Subsidiary records should always be kept in balance with general ledger control figures.

The records and systems should be designed to enable the tracing of any given item as it passes through the company’s books as well as the creating of archives. The following recordkeeping deficiencies should be avoided:

- General ledger entries fail to contain an adequate description of the transaction.
- Reconciliation records of accounts are not kept current and/or fail to reflect the description and disposition of outstanding items.
- Details concerning debits and credits to accounts are inadequate.
- Accounts and records are not posted on a current basis.

A policy regarding segregation of duties should be implemented. The participation of two or more persons or departments in a transaction provides for dual control and allows the work of one to serve as proof of the accuracy of another. Additionally, when two or more persons are involved in a transaction, the possibility of fraud diminishes considerably. Ideally, duties should be arranged so that no one person dominates any transaction from inception to termination. For example:

- Those having authority to sign checks should not be assigned to reconcile bank accounts.
- Records should be reconciled to the general ledger by someone other than the one originating the entries.
- Personnel should not initiate transactions or correct data (on rare occasions when such activity is required to complete processing in a timely manner, transactions should be approved by appropriate levels of management in the data center and at the affected department).

Similarly, a policy regarding rotation of personnel should be adopted. Planned and unannounced rotation of duties is an important principle of internal control. The rotation should be of sufficient duration to be effective. Rotation of personnel is an effective internal check and can also be a valuable aid in the company’s overall training program.

**Consistency.** Without consistent information, strategies and decisions cannot be adequately monitored or measured. Variations in how data is collected or reported can distort analysis. Any change in collection or reporting procedures should be clearly defined, documented, and communicated to all users.

The uniform handling of like transactions is essential to the production of reliable reports. It is essential that instructions be established for processing routine transactions. The organization should develop and implement standardized accounting procedures (i.e., an accounting manual) in order to ensure consistency in operating procedures.

Where records are computer-generated there should be a user’s guide for each application readily available for reference by user departments. Manuals for each application should consist of a guide provided by the vendor and supplemented by procedures written by the user. Manuals should delineate preparation and control of source documents, routines pertaining to control over the movement of documents, the daily reconciliation of totals to general ledger, and changes to master files.

**Completeness.** Information provided by MIS mechanisms must be complete. The critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished, but the system that supplies it as well. An effective MIS is composed of information from a number of sources, and the information must serve a number of users, each having various needs. The MIS must selectively update information and coordinate it into meaningful and clear formats. Quality, quantity, and timeliness are factors that determine the effectiveness of management information systems.

**Relevance.** Decision-makers cannot fulfill their responsibilities unless all pertinent information is provided in a comprehensive yet concise format. Care should be taken to ensure that senior management receives relevant information.
in order to identify and measure potential risks. Unnecessary, inappropriate, or unsuitable details are of no value in effective decision-making.

Audit

The management of a liquidation office should create a policy to direct the office’s auditing goals. The policy should establish the:

- Authority of the internal auditor
- Scope and timing of audits
- Recognition and implementation of corrective actions.

The auditor must be independent of any other department, have no additional conflicting duties, and report directly to senior management.

The appointment of a professionally competent internal auditor responsible for the development and administration of an internal audit program is one of the most effective internal control procedures available. The basic purpose of internal auditing is the prevention and detection of loss. An effective program includes determination that controls and operational procedures are functioning in a manner that will minimize the possibility of losses due to inefficiencies, irregularities, and/or willful manipulation.

The auditor’s role is to help safeguard the organization’s assets by performing tests and procedures establishing the validity and reliability of operating systems, procedural controls, and resulting records. The internal audit program should:

- Be in written form
- Be approved by executive management
- Identify the scope of the program
- Be reviewed on a periodic basis
- Be revised when necessary.

Auditors must have complete independence in carrying out the audit program and should report their findings directly to executive management or a designated audit committee. It is imperative that internal auditors have sufficient authority and the degree of audit independence essential to exercise their responsibilities, and no other operational duties. Auditors should not audit accounts for which they have responsibility.

A comprehensive internal audit program should include the following elements.

1. A determination that the records are complete and adequate, and that transactions are promptly and properly recorded in the accounts.
2. A review of data processing controls that should include proof totals, batch totals, document counts, number of accounts, and any prenumbered documents that are used. The auditor should periodically sample the controls to ensure their accuracy. Sampling includes:
   - Spot-checking reconciliation procedures to ensure output totals agree with input totals
   - Reviewing the disposition of suspense items, determining why they are not processed, and assuring that they are properly corrected and reentered on a timely basis
   - Verifying selected master file information and reviewing exception reports to source documents.
3. A determination that assets are adequately safeguarded and properly presented in financial reports, and that liabilities are completely disclosed and accounted for.
4. An assurance that collateral and other nonledger items are properly recorded and protected by effective custodial controls.
5. A review for compliance with delegation of authority to be certain there are no departures from established policy.
6. A review for compliance with other policies set forth by management. This would also encompass such matters as review of information technology procedures and controls, as well as review of source documents to ensure that sensitive master file changes requests have supervisory approval.
7. An accounting for the receipt of income and review of expenses to determine that they are correct in amount and consistent with policy.
8. An appraisal of the performance of personnel in accomplishing assigned internal control functions and responsibilities. This would entail tracing transactions to final disposition to ensure there are adequate audit trails.
9. The preparation of a proper and complete set of working papers covering each audit.
10. The utilization of accepted verification and confirmation techniques.
11. The establishment and maintenance of an operating manual describing the specific procedures and techniques to be used by the auditor or auditing staff in performing the audit function.
ANNEX 6.1. ASSET MANAGEMENT COMPANIES

This annex describes the primary features that make an asset management company (AMC) effective. Many of these features can be equally applicable in operating bank liquidation within a deposit insurance agency or via commercial bankruptcy courts.

There are alternative strategies for managing and disposing of impaired assets, depending on factors such as the type of asset, size and distribution, structure of the banking system, and available management capacity in the banks and in the public sector. There is no single optimal solution. There are, however, common factors that contribute to the success of AMCs. These include a supportive legal and regulatory environment, strong leadership, operational independence, appropriately structured incentives, and a commercial orientation.

Probably the most important purpose of having AMCs is the managerial factor. The handling of bad loans and assets requires other skills beyond those normally available in a bank. Real estate specialists, liquidation experts, and specialists on various industrial sectors may be needed. In addition, managing the bad assets would interfere with the daily running of the bank. Importantly, both the good bank and the AMC could be given independent and transparent profit goals if separated. That would provide incentives for managers and staff.

An effective AMC must have clearly defined goals and a governance structure that is both supportive of these goals and assures that management meets the goals. In some countries AMCs have operated with a focus on disposing of the assets. These AMCs have functioned as rapid disposition vehicles, quickly selling assets to the private sector. In all cases the goal was to dispose of the asset as quickly as possible so as to avoid further deterioration in value and to minimize the carrying cost of the government. It should be recognized that rapid disposition requires the AMC to have good information about the assets it is attempting to dispose of and that a market for these assets exists.

AMC operations should be guided ultimately by the objective of profit maximization or loss minimization, taking into full account market conditions as well as the funding cost to the AMC. Experience has shown that AMCs with clearly defined, focused, and consistent goals are more likely to be effective.

Various approaches to the structure and organization of AMCs can be adopted to achieve the authorities’ objectives. In terms of ownership, AMCs can be either public or private, and within these there are alternative structures. When a substantial amount of bad loans and assets has to be transferred to an AMC over a short period of time, it is often difficult to find a private investor willing to own such an AMC without asking for far-reaching government guarantees covering the future value of the asset portfolio. In this situation, the government is in a more favorable position owning the AMC itself rather than providing guarantees, since it might then benefit from any future upward price movements of the AMC’s assets. In addition, it is difficult to formulate guarantees that would give a private owner strong incentives to sell the assets at the best prices. This could lead to further losses for the state.

Public AMCs can be freestanding entities or may be a responsibility of an existing public agency, such as the ministry of finance or the deposit insurer. It is preferable, however, that AMCs not be set up as a unit within the central bank, or as its subsidiary, since the central bank’s primary responsibility is to achieve and maintain price stability, and its balance sheet should not be made unwieldy by taking on large amounts of nonperforming assets of the banking system.

An important issue in setting up AMCs concerns their legal powers. The legal basis of the AMC should provide for clean transfers of titles (and the associated priority) in all of its asset transactions. Similarly, legal obstacles for the transfer of assets, such as the requirement that permission of the debtors be obtained before the transfer of loans can be effected, should be removed. The legal basis should ensure that the AMC “stands in the shoes” of the former bank at least in the eyes of the law. In addition, asset disposition by public AMCs could be delayed by perceived potential legal liabilities accruing to the AMC management. In this situation, legal protection for the employees of the AMCs in the execution of their responsibilities in good faith should be considered.

Effective asset management and disposition require the support of an effective legal system. Such a system should clearly define the rights of ownership as well as the legal obligations between debtors and creditors and provide for the orderly resolution of disputed claims, including debt recovery and realization of collateral for unpaid debt. Such a system should also balance the protection of creditors and that of debtors. However, when the existing legal system is not equipped to deal with the magnitude of the nonperforming assets (e.g., when the court system is inexperienced and does not have enough resources), or when endeavors to reform the system are excessively time consuming, there may be a case to grant special legal powers to AMCs to facilitate asset recovery and restructuring.

Good governance is necessary to assure the effective operation of an AMC. Especially in the case of a government-owned AMC, governance issues are critical because the AMC is, on the one hand, subject to potential political pressure and, on the other, accountable to the public for its actions and performance. Therefore, it is essential that an AMC be both independent and

---

transparent with regard to its operations. Its stakeholders—the public, government, and shareholders—must be able to evaluate its performance.

The very nature of the asset management process invites political interference. If delinquent borrowers feel they may get more favorable treatment by contacting their elected officials, it is likely that they will do so. One must also expect elected representatives to make inquiries on behalf of their constituents. The critical balance is to assure that the AMC does not take inappropriate actions as a result of pressure, but at the same time is responsive to the public.

Along with independence, however, come transparency and accountability. Transparency with respect to all of its operations and its performance is critical for the AMC’s political independence. It is also key to maintaining public confidence that the liquidation process is being carried out in a fair and objective fashion. Transparency promotes accountability of the managers and the board vis-à-vis the public and reduces the perception of, and possibly tendencies for, corruption.

To assure transparency, AMCs should be required to publish regular reports describing their performance in pursuing their goals. The financial statements should be prepared in accordance with accepted liquidation and fund accounting practices. In addition to making detailed financial information public, the AMCs should be audited regularly to assure that their financial statements are accurate, that representations as to the value of assets are reasonable, and that the AMC has proper internal controls in place to safeguard the assets under its management. Independent auditors chosen by the government should undertake such audits.

To help strengthen the independence of a government-owned AMC, it should be governed by a board of directors and, following principles of corporate governance, the majority should be outside independent directors. These directors should be sufficiently independent so as to be able to assist the AMC in resisting pressure from borrowers and prospective purchasers of assets seeking preferential treatment. The board should have a clearly defined mandate and be responsible for assuring that the AMC carries out its mission and meets performance goals. The board should have the flexibility to establish all policies and procedures for the AMC, including policies for staff compensation, asset disposition strategies, credit and restructuring, budgets, and financial reporting.

AMCs face an inherent incentive problem. Most commercial operations assure their continued existence by being successful. However, asset management operations are in the business of going out of business. If they are successful, they will liquidate the assets under their management through restructuring and disposition and cease to exist. Consequently, it is important to design AMCs so that they do not become “warehouses” of nonperforming loans. There is a need for a structure of incentives that are designed to ensure effective and efficient asset management and disposition. These incentives need to address both the issues of the limited life of the entity and the performance of the staff. (See also Box 7.3 for more details on liquidation goals.)

One approach to the problem of the AMC being a self-liquidating entity is to develop incentives for the board members to counterbalance the motivations of the staff to prolong the life of the AMC unnecessarily. These incentives can take the form of political rewards, such as higher office or public recognition of a job well done, or financial incentives to the directors. Another option that has been successful in several countries is to limit the life of the AMC at the time it is created. This approach worked well and contributed to the success of the Resolution Trust Corporation in the United States and some of the private AMCs established by acquiring banks to manage assets for the receiver. If the AMC is a public entity, it helps to have senior career managers but rely on employees on term appointments that are tied to the expected life of the work. The use of term employees helps to alleviate political pressure to keep the AMC going in order to protect the jobs of its employees.

The other critical incentive issue is how to motivate employees and managers to maximize outcomes consistent with goals. One option is to have two components in the compensation package: salary and performance-based bonuses. A risk is that assets will be disposed of regardless of price just so employees can get a quick bonus. However, this can be mitigated by having proper approval procedures and establishing appropriate goals for individual assets.
ANNEX 6.2. STRUCTURE EXAMPLE: DIVISION OF LIQUIDATION OFFICE

Notes:

Accounting: Responsible for preparing a final pro forma balance sheet for the failed bank and providing accurate accounting services for the receivership(s).

Administration: Provides administrative services (personnel, facilities, contracts, etc.) during bank closing, and subsequently for receivership(s).

Asset marketing: Responsible for identifying similar types of assets to pool and sell as a package (bulk sale).

Claims: Responsible for administering and processing depositor and creditor claims.

Information technology: Responsible for all computer hardware, software, conversions and processing, both as liaison with failed bank’s system, and for subsequent needs of the receivership(s).

Investigations: Responsible for researching bank records and interviewing employees to determine criminal or civil liability in conjunction with the failure of the bank.

Loans: Responsible for inventory, control, and collection of all loans (installment, mortgage, commercial, etc.).

Other real estate owned (OREO): Responsible for marketing and sale of other real estate owned.

Other assets: Responsible for the liquidation or sale of other assets (reposessed collateral, prepaid expenses, etc.).

Settlement: Responsible for administering the terms of the transaction agreement with an assuming bank (e.g., adjustments to asset purchase prices, errors and omissions on pro forma balance sheet, etc.).

The following functional areas are not contained within the structure of a liquidation office, but contribute to the operations:

Internal review: Responsible for auditing the office’s operations.

Legal: Provides legal advice and support for bank closings and receivership operations.

Ombudsman: Provides a vehicle to facilitate media, governmental, and customer relations.