Basel Committee
on Banking Supervision

Supervisory Guidance on Dealing with Weak Banks

Report of the Task Force on Dealing with Weak Banks

March 2002

BANK FOR INTERNATIONAL SETTLEMENTS

Table of Contents

Executive Summary

i. Weak banks are a worldwide phenomenon. Supervisors should be ready to deal with them. This report provides a toolkit offering practical guidance in the areas of problem identification, corrective action, resolution techniques and exit strategies. The intended target audience of this report is the banking supervisory community worldwide, including international financial institutions advising supervisors.

ii. A weak bank can be variously defined. In this report, it is "one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management". In such cases, and given the need to maintain confidence in the financial system, a supervisor should try to preserve the value of the bank's assets with minimal disruption to its operations, subject to minimising resolution costs. It may well be that the bank as a legal entity ceases to exist.

iii. For supervision to operate effectively, the proper regulatory, accounting and legal framework, as set out in the Basel Core Principles for Effective Banking Supervision, must be in place. A supervisor must distinguish clearly between symptoms and causes of bank problems. The report analyses these. A supervisor must also identify and tackle problems at an early stage before they become acute. The report considers the relevant sources of information and the avenues available for supervisors.

iv. While supervisors have a range of corrective action tools at their disposal, primary responsibility for addressing weakness and problems rests with the Board and management of the bank. Supervisory measures have to be proportionate. Corrective action should fit the scale of the problem and be set within a clear time frame. A balance has to be struck between rigid prompt corrective action regimes and general, less binding frameworks. One effective combination would include "automatic" rules for pre-agreed acceptable supervisory actions plus room for flexibility in particular circumstances. A balance has also to be struck between informal methods, normally where the bank's problems are less serious and bank management is co-operative, and more formal actions that are binding on the bank, with penalties for non-compliance. Closure of the bank and revocation of the licence remain the ultimate sanction.

v. Corrective action plans must be detailed and specific, showing how the bank's financial position will be restored. A supervisor must be able to assess if there is satisfactory progress or if additional actions are necessary. A supervisor should also have agreed upon mechanisms in place for consulting or informing the government, central bank and other regulatory agencies, domestic and foreign. In particular, the supervisor and the central bank usually have common interests that require consultation before taking actions against a weak bank. Disclosure is another critical area. The overriding consideration must be whether the disclosure contributes to the supervisor's objective in resolving the weak bank.

vi. If the prospect of insolvency is imminent, alternatives are necessary. They include a merger with or acquisition by a healthy bank; a purchase and assumption transaction; and open bank assistance and bridge bank techniques. These are outlined in the report. If no investor is willing to step in or if the reimbursement of depositors is less costly than other options, repayment of depositors (in full or in part) and liquidation are unavoidable.

vii. Public funds may be used to provide liquidity support, or in exceptional circumstances, solvency support. On a case by case basis, the central bank may consider the discretionary provision of emergency liquidity assistance, in addition to its normal facilities, to illiquid but presumed solvent banks. Solvency support, on the other hand, will involve taxpayers' money and the decision should always be taken and funded by the government and the legislative body, and not the central bank. However, close cooperation and sharing of information between the central bank and government is necessary. Liquidity and solvency support should always be linked to other more permanent corrective measures.

viii. In some cases, a supervisor will have to consider additional issues where the bank is part of a larger group or it is a foreign bank. The relevant factors and possible options, such as ring-fencing, are examined. Special considerations, both political and financial, can also apply to state-owned banks where the timescale for resolving problems may need to be longer.

Part I. General issues, Preconditions, Identification

1. Introduction and background

1. Weak banks are a worldwide phenomenon.[1] They pose a continuing challenge for bank supervisors in all countries, irrespective of the political structure, financial system and level of economic and technical development. All bank supervisors have to be prepared to minimise their incidence and deal with them if they occur.

2. Weak banks have common problems and there are lessons to be drawn by pooling the experience of supervisors, especially the specific actions that have or have not worked in given circumstances. In the past, the lack of contingency arrangements and understanding of the tools available for dealing with weak banks have sometimes resulted in unnecessary delays in supervisory actions. They have been key factors in the high costs of resolving banking problems. Appropriate guidance could reduce the costs and spillover effects of these problems.

3. At its meeting in April 2001, the Financial Stability Forum (FSF) discussed the feasibility of developing guidance on dealing with weak banks and systemic banking crises. In the discussion, members emphasised the importance of developing guidance on dealing with weak banks on an individual basis, which was considered to be primarily a supervisory issue. The Basel Committee on Banking Supervision agreed that the development of international supervisory guidance on dealing with weak banks would be helpful. To this end, the Basel Committee, in co-operation with its Core Principles Liaison Group (CPLG), set up a Task Force in July 2001 to report on the treatment of weak banks, based on the experiences of different countries and in different circumstances.[2]

4. The Task Force held four meetings between July 2001 and January 2002.

1.1 Mandate

5. The mandate of the Task Force (Annex 2) was to produce a "tool-kit" containing guidance for supervisors when dealing with weak banks. The report examines a wide variety of bank problems, their background and causes, and assesses the pros and cons of various methods of dealing with them. These include preventive measures, early identification, corrective actions, resolution issues and exit strategies. The report is not intended to be prescriptive - rather it identifies good practice which has already been tried. The intention is to offer practical guidance which can be adapted to the specific circumstances of each case.

6. The target audience of this report is the banking supervisory community worldwide, including the international financial institutions which advise supervisors. For this reason, the Task Force has not focused on any specific category of countries or banking systems. The tool-kit should be relevant irrespective of whether the institution is a small local bank or a large international banking group; whether it is a public or privately owned bank; or whether it is a universal bank or financial group. Supervisors can use the toolkit either as a reference in

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[1] In more than 50 countries, one or more banks were formally closed in the last five years. Source: World Bank.

[2] 16 countries were represented on the Task Force. In addition, the World Bank, the IMF, the European Commission and the BIS Financial Stability Institute participated. Please see Annex 1 for a listing of members.

a particular problem case, or as a guide for preparing the authorities in a particular country to deal with the problems caused by weak banks.

1.2 Related work in other fora

7. This report focuses on dealing with individual weak banks. There has been much work done on related issues. Examples are the World Bank/IMF (legal aspects of insolvency and liquidation of banks), IMF (framework for managing systemic banking crises), APEC (policy lessons on bank failure management), the Groupe de Contact (causes of banking difficulties) and the OECD (experiences with resolution with weak financial institutions). The Task Force has tried to minimise overlaps. Where relevant, the report makes references to published reports. Existing international standards, such as the Basel Committee's Core Principles for Effective Banking Supervision[3], are also relevant and these have been cross-referenced where appropriate. A Reference List is in Annex 3.

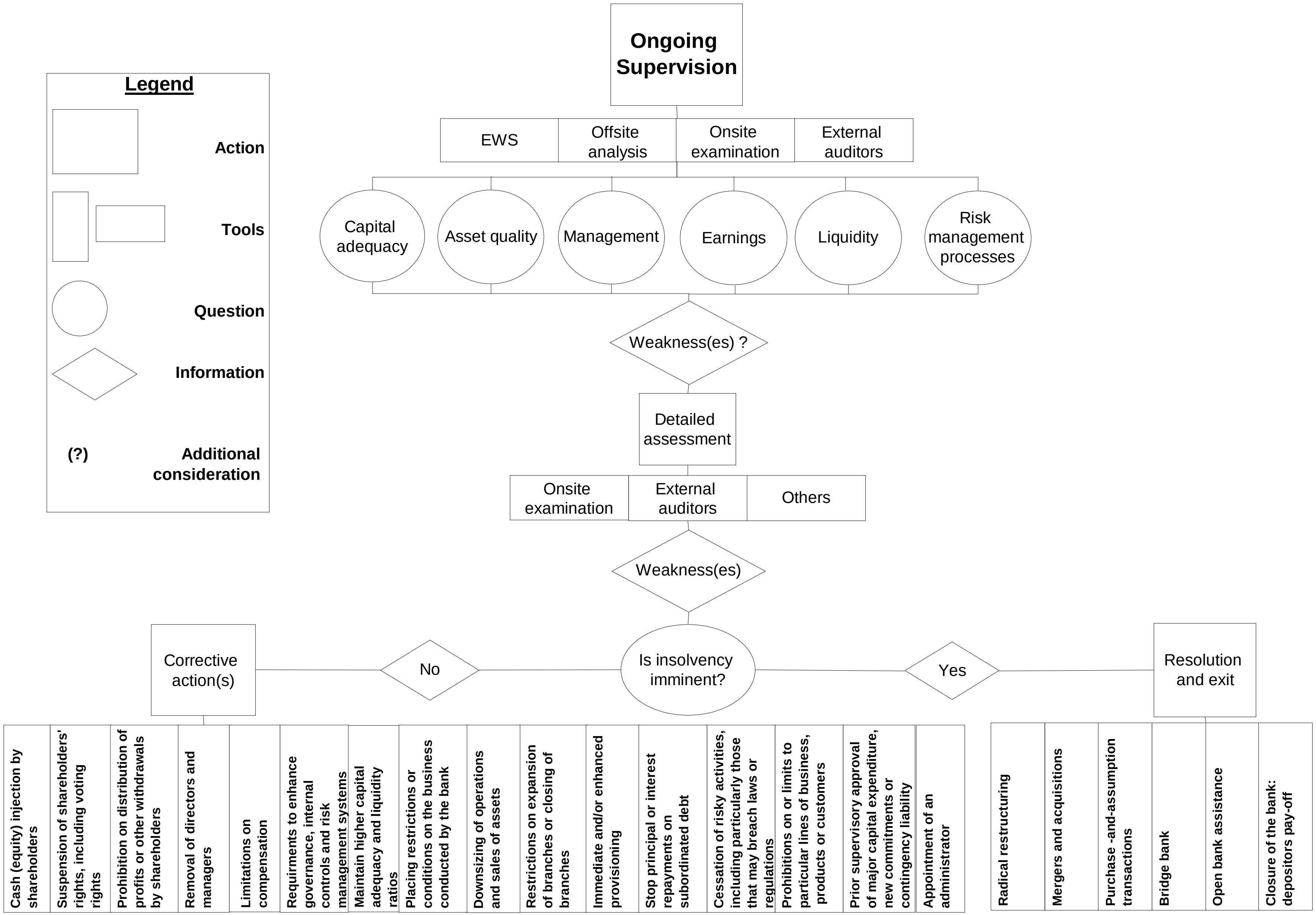
1.3 Structure of this report

8. Weaknesses in a bank may occur at various points in time. The bank, together with the supervisor, must work continuously on steps to prevent problems and, if weaknesses develop, identify and remedy them promptly. The structure of the report reflects these different stages. Part I discusses general issues, the underlying supervisory preconditions for dealing with weak banks and techniques for supervision that will allow the supervisor to identify problems. Part II deals with the corrective measures to turn around a weak bank and resolution and exit strategies for failing or failed banks.

9. A pictorial overview of the structure of this report is provided in Figure 1.

[3] Basel Committee on Banking Supervision (1997), *Core Principles for Effective Banking Supervision*, Basel, September.

Figure 1: Overview of the structure of the report



2. General issues and concepts

2.1 Definition of a "weak bank"

10. This report uses the following definition:

> A weak bank is one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management.

11. The definition focuses on a bank where there are potential or immediate threats to liquidity and solvency, rather than one with observable weaknesses that are isolated or temporary and which can normally be corrected by appropriate remedial action. Of course, all weaknesses, whatever their magnitude and character, must be addressed by the bank. The problems in a weak bank are more fundamental. They include, but are not limited to, poor management; inadequate financial resources; absence of a long-term sustainable business strategy; weak asset quality; and poor systems and controls. Weak banks do not occur overnight. Problems that seem to emerge rapidly are often the sign of financial or managerial weaknesses that have been allowed to persist for some time. These problems can rapidly become a major concern to a supervisor if minimum prudential requirements are not met and viability is threatened. The task of the supervisor is to identify these problems early, ensure preventive or corrective measures are adopted, and have a resolution strategy in place should preventive action fail.

2.2 Principles for dealing with weak banks

12. As part of the background to the work, the Task Force considered why it is necessary and desirable to deal with weak banks. The answer is related to the fundamental objectives of banking supervision. These, of course, vary somewhat from country to country – and in some cases, are expressly stated in law. As a general proposition, however, a central objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors. Dealing effectively with weak banks fits neatly into this wider objective.

13. In dealing with weak banks, this objective translates into supervisory actions aimed at preserving the value of the bank's assets with minimal disruption to its operations (i.e. maintaining the *economic* entity), subject to minimising any resolution costs. In certain cases, it may well be that the bank as a *legal* entity should cease to exist.

14. The guiding principles for a supervisor when dealing with weak banks include:

- *Speed*. Supervisors should act promptly. Experience from many countries shows that regulatory and supervisory forbearance has exacerbated the problems of a weak bank. By not dealing with the problems promptly, they have grown rapidly making the eventual resolution efforts more difficult and more expensive, with the possibility of becoming more widespread and systemic.
- *Cost-efficiency*. A least cost criterion should guide the supervisor when making choices between alternative actions consistent with achieving the supervisory objectives. It is important that the supervisor considers all costs, including exogenous costs such as instability of the financial system, in deciding on a course of action.
- *Flexibility*. Legislation frequently adopts a rules-based approach. However, it is also helpful if the legislation permits the supervisor to exercise discretion in the deployment and timing of supervisory tools. It is outside the scope of this Task

Force to prescribe the nature of any one country's legislative framework – suffice it to say that supervisors should be prepared to act flexibly by considering the full range of powers available when faced with a weak bank.

- *Consistency*. Consistent and well-understood supervisory actions will not distort the competitive environment. Such an approach will also minimise confusion and uncertainty in times of crisis. Similar problems in different banks, large or small, private or state-owned,[4] should receive similar treatment.
- *Avoiding moral hazard*. Supervisory action should not create incentives for banks to act in a manner that incurs costs which they do not have to bear entirely. Shareholders should not be compensated for losses when a bank gets into difficulty; otherwise it will encourage other banks to behave less prudently on the expectation that they will receive a similar bailout if problems occur. Equally, supervisory action should not protect the interest of the bank's corporate officers. As Bagehot wrote: "[A]ny aid to a present bad Bank is the surest mode of preventing the establishment of a future good Bank"[5].
- *Transparency and cooperation*. Inadequate or incorrect information from the bank increases uncertainty for everyone involved. It can lead to misplaced supervisory action and add to the costs of solving the problems. The bank and the relevant authorities should aim for a high degree of information sharing and transparency about their intended actions. Decisions on disclosures – or not - to the wider financial community and the general public are more difficult and must depend on the specific situation. These will generally need to be carefully assessed in each particular case. The overriding consideration must be whether the disclosure contributes to the supervisor's objective in resolving the weak bank and maintaining broader systemic stability.

2.2.1 Impact

15. In order to avoid distorting competition in the financial sector, small and large banks should be subject to the same supervisory and regulatory framework. This applies in normal times as well as in times of problems. There can, however, be good reasons for treating large banks differently in some explicitly defined situations. Large banks have bigger interbank linkages and carry out a wider range of activities, often including cross-border operations, and so a large bank failure will create greater spillover effects. But potentially systemic problems do not arise only with large banks. They may arise when a number of small banks fail simultaneously or where a small bank has a critical position in a particular market segment. Equally the failure of a large bank may not be systemic if the economic background is very strong.

16. In potentially systemic cases, there may sometimes be additional resolution measures available, such as lender of last resort liquidity from the central bank and solvency support from the government. Nonetheless, there is no reason why the banks concerned should be immune to drastic reorganisation or being wound down, if warranted.

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[4] The treatment of public sector banks is discussed in more detail in section 7.3.

[5] Bagehot, W (1873), *Lombard Street,* Henry S. King and Co.

2.3 Symptoms and causes of bank problems

17. It is important to distinguish between the symptoms and causes of bank problems. The symptoms of weak banks are usually *poor asset quality*, *lack of profitability*, *losses of capital, reputation* problems, and/or *liquidity* problems.

18. The different symptoms often emerge together. Experiences from several countries indicate that liquidity problems have seldom occurred alone and their emergence has generally been one aspect of broader difficulties.

19. While banking difficulties usually result from a combination of factors, they have become evident as credit problems in the majority of cases[6]. This should not be surprising given that lending has been and still is the mainstay of banking business. More often than not, credit losses stem from weaknesses in management control and credit risk management systems.

20. In particular, it is often true that management and control processes have not been sufficiently robust to prevent:

- *Poor lending practices,* such as poor underwriting skills or an overly aggressive loan expansion programme, coupled with an absence of incentives to identify problem loans at an early stage and to take corrective actions.
- *Excessive loan concentrations.* Concentration of lending to one geographic area or industrial sector has been the cause of problems for many banks. Unless a bank maintains a diversified loan portfolio, it is exposed to the risk that loans to any particular area, or related group of companies, could become impaired at the same time.
- *Excessive risk taking.* One reason for this is that bank management may have incentives to assume a higher risk profile in lending activities so as to benefit from short term increases in either the bank's profits or share price.
- *Overrides of existing policies and procedures,* such as limits on concentration or connected lending. Strong individuals within the bank, by force of personality, dominant ownership or executive position, may override policies and procedures. In state-owned banks, this can come through political interference.
- *Fraud or criminal activities and self-dealing* by one or more individuals.

21. Apart from credit risk, a bank's weakness may also stem from other risks, including interest rate risk, market risk, operational risk and strategic risk. These risks are not new, although historically they have been less important in accounting for bank failures than credit risk. Some of these risks may become more important for banks. For example, operational risk will come into greater focus as banks make use of more sophisticated systems, new delivery channels and outsourcing arrangements that increase the bank's reliance and exposure to third parties. At the same time, the increase in one type of risk is often compensated by a reduction in another type of risk - securitisation of assets, for example, increases operational and legal risks but reduces credit risk. Banks should also benefit from

6 See for example the Groupe de Contact paper, The Causes of Banking Difficulties in the EEA 1988-1998. The Groupe's analysis "revealed that while banking difficulties usually resulted from a combination of contributing factors, the majority of cases manifested themselves as credit problems. Market risk was not a significant contributor in the vast majority of cases examined, although operational risk did emerge as a notable factor in a number of cases." (page 1)

improved techniques and instruments for risk reduction. The balance has to be carefully managed in all banks.

22. Weak banks have, in the past, contributed to or exacerbated financial crises. Equally, external factors such as negative macroeconomic shocks (including a currency crisis, a weak “real” sector; inadequate preparation for financial sector liberalisation, etc.) may also lead to problems for banks. External factors may not overwhelm a well-managed and financially sound bank but will certainly expose deficiencies in management and control in weaker banks.

3. Preconditions

23. The Basel Core Principles for Effective Banking Supervision and its Methodology[7] set out the necessary foundations of a sound supervisory system. They are also crucial in preventing and dealing with weak banks. In essence and to be effective, laws must provide for or supervisors must be given powers to set and/or require:

- Comprehensive rules for the licensing of banks, for permitting new major activities, acquisitions or investments by banks and for ownership changes in banks.
- Prudential rules or guidelines for banks, such as norms and limits on capital, liquidity, connected lending and loan concentrations, and powers to enforce a range of penalties when prudential requirements are not met.
- Requirements for internal controls and risk management systems in banks consistent with the strategy, complexity and scale of the business. This includes policies and procedures for the identification, reporting, monitoring and managing of all the various risks inherent in banking activities.
- Requirements for effective corporate governance in banks. Good governance can be further enhanced by appropriate incentives for managers to maintain good credit and risk management practices and internal control procedures and systems, and by market discipline, facilitated by greater disclosure.
- Requirements for periodic reporting by banks and the means to conduct onsite examinations, so that problems can be detected in a timely manner.
- Timely corrective measures to overcome difficulties. There should be a wide range of instruments available to the supervisor so as to permit a graduated and flexible response to different problems. In extreme cases, the supervisor should be able to revoke the licence.
- Accounting standards based on conventions and rules that are internationally accepted and relevant for banks. In particular, there must be rules or guidance that require asset impairment to be recognised on a timely basis so that unrealisable values do not remain on a bank's books.[8]

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[7] Basel Committee on Banking Supervision (1999), *Core Principles Methodology*, Basel, October.

[8] The guidance for loan classification and provisioning are often set by supervisors. Some examples are: (i) loan loss recognition should be realistic and supported by a thorough evaluation of the risks inherent in individual credits and the loan portfolio; (ii) impaired loans should not be classified as performing if additional money is being lent to the borrower (so called evergreening); (iii) loan classification should depend not only on the payment status, but also on an evaluation of the borrower's creditworthiness; (iv) the valuation of not readily marketable assets should be conservative; and (v) uncollectible loans should be charged off.

- The scope and standards to be achieved in audits of banks. There should be penalties for auditors in the event of non-compliance, including supervisory power to dismiss auditors that have violated rules or otherwise proved themselves unsuitable. There should be a legal basis for the auditor to report its findings directly to the supervisor.[9]

24. The other main institutional pre-conditions for dealing effectively with weak banks are:

- Laws providing that the bank supervisory authority has operational independence and access to adequate resources to conduct effective supervision.
- Laws providing appropriate legal protection for supervisory authorities and individual supervisors for actions taken in good faith in the course of performing supervisory duties.
- A legal and judicial environment, including an adequate insolvency regime[10], which allows an efficient resolution of banks, expeditious liquidation of assets and fair and equal treatment of creditors.[11]
- Neutral tax rules that allow asset transfers and other transactions in a bank resolution without distorting or offsetting the corrective nature of such measures.
- A system of inter-agency cooperation and information-sharing among official agencies, both domestic and foreign, responsible for the safety and soundness of the financial system.
- A well functioning safety net that enhances the general public's trust in the banking system. Important features of a safety net are a lender of last resort facility with the central bank and deposit protection arrangements.

4. Identification of weak banks

25. If undetected, weaknesses in banks tend to grow over time. The supervisor's challenge is to identify weaknesses before they become irreparable.

26. Successful identification of weak banks depends on the information collected by the supervisor from a wide variety of sources. A range of channels and methods is typically used. It is important that the information is timely, relevant and of good quality. Having good sources of information, though, will rarely be sufficient on its own; supervisory judgement will

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[9] The role of auditors in banks and banking supervision differ somewhat in different countries. In some countries, the supervisors require external auditors to (i) confirm the adequacy of provisions or allowances made by banks for bad and impaired debts and diminution in the value of assets; (ii) verify compliance with regulatory requirements on prudential norms (e.g. liquidity requirements, concentration limits) and the bank's assessment of its capital adequacy ratio; (iii) give a report on the quality of the internal control and risk management procedures; and (iv) report to the supervisor immediately serious violations of banking or any other regulations, criminal offences involving fraud or dishonesty, issues that prejudice the interest of depositors, or any fact that may result in material weaknesses in a bank.

[10] In addition, there needs also to be an efficient insolvency regime for corporations and individuals.

[11] Details of an inadequate insolvency regime for banking institutions will be discussed in documents to be produced by the Bank Insolvency Initiative of the World Bank and IMF.

almost always be called for in interpreting information and assessing the financial health of a bank.

4.1 Methods employing mainly quantitative financial information

4.1.1 Financial statements analyses

27. The supervisor can use a bank's financial information to produce a wide array of financial ratios to assess the performance and financial condition of the bank. The analysis involves:

- comparison of the financial indicators of an individual bank to a peer group; and
- examining the trend in an indicator.

28. The potential gaps and shortcomings in this monitoring tool are that:

- the relevance of the analysis is critically dependent on the quality of the information received from the bank. This is why many supervisors look for independent testing of the accuracy of a bank's returns;
- the ratios only portray the position at a particular point in time;
- financial indicators tend to be lagging indicators of weakness; and
- it should not be used in isolation without considering qualitative aspects. The bank's corporate governance and risk management practices have a bearing on both the accuracy of the data and the likelihood that problems will in fact materialise.

4.1.2 Early warning systems

29. Based in large part upon the regulatory reports submitted by banks, some supervisors have developed or are developing statistically based early warning systems (EWS). These models attempt to estimate the likelihood of failure or financial distress over a fixed time horizon. Alternatively, some EWS aim at predicting future insolvency by estimating potential future losses.

30. The inputs into the statistical models are mainly financial indicators - these can be objectively measured. Efforts to capture qualitative factors in models, such as the quality of management, internal controls, and overall risk management practices are difficult as they can only be represented, albeit imperfectly, by some proxy indicator. It is also not easy to incorporate competitive and environmental factors. These are the drawbacks of EWS.

31. EWS will normally not provide firm evidence of weaknesses but will give indications for further investigations by the bank and by the supervisor. Using EWS is particularly important for helping supervisors to direct limited supervisory resources towards banks or activities where weaknesses are most likely to be found.

4.2 Supervisory assessments

4.2.1 Supervisory rating systems

32. Many supervisors use a rating system to draw together assessments of the various components of a bank's condition. Although supervisors may take into account different components and name their systems differently, there are many common factors in the rating

process. They include capital, asset quality, management, earnings, liquidity, sensitivity to market risk and operational risk.

33. A major benefit of a supervisory rating system (SRS) is that it provides a structured and comprehensive framework. Quantitative and qualitative information are collected and analysed on a consistent basis and supervision is focused on deviations from the "normal". Applying the framework should lead to a closer co-operation between offsite and onsite supervision. Onsite examiners should be promptly informed of indications of weaknesses in specific banks; and onsite examiners should alert the offsite function to look for specific areas/banks/activities where they suspect that weaknesses may exist. An SRS does not of course preclude decisions to collect and analyse specific data – outside the usual framework - on an ad hoc basis.

34. In many countries, banks below a certain rating would automatically receive special supervisory attention. The SRS indicates which banks are more susceptible to future problems, so that further supervisory resources can focus on these banks.

4.2.2 Risk-based supervision

35. An increasing number of supervisors are moving to risk-based supervision. This is a forward looking approach where the supervisor assesses the various business areas of the bank and the associated quality of management and internal controls to identify the areas of greatest risk and concern. The supervisory focus is directed to these areas to allow the supervisor to identify problems at an early stage. Many banks have seen the advantages of a risk-based approach and adopted the methodology for their own internal audit work.

36. In practice this means identifying, often through the firm's own management accounts and internal audit function, the significant business units and those areas of inherently high business risk, such as a division of the bank that is consciously targeting riskier borrowers. The supervisor may concentrate his efforts on examining the robustness of the controls in these areas. Alternatively this approach may identify and focus on relatively weak controls, such as an understaffed internal audit function relative to the bank's peers. The supervisor's resources will be targeted at discovering more about, and probably implementing a remedial action plan for, the area of weakness.

4.2.3 Surveillance of the banking system

37. The surveillance of banks for supervisory purposes focuses mainly on the risks of failure of an *individual* bank. Surveillance of the banking system (and the financial system) as a whole can also provide early warning indicators of financial system problems which, in turn, may affect individual banks. Analysis of the state of the economy and credit conditions can help inform the supervisory approach to individual banks. For example, if economic surveillance suggests there is a significant risk of a decline in real estate values, the supervisor would be wise to monitor more closely those banks with particular exposure to the sector.

38. Surveillance of the banking system entails identification of potential external shocks to the domestic and international environment and an assessment of how the banking system will be affected by these shocks. Pertinent questions include how robust the banking sector is likely to be in absorbing these shocks? Could losses be spread through credit inter-linkages and/or some other form of contagion? How liquid are financial markets?

39. One approach in measuring credit risk[12] is to trace through, using a quantitative macroeconomic model or more qualitative analysis, the effects of an exogenous adverse event, such as an increase in interest rates or a marked slowdown in aggregate demand, and thus output growth. The impact on banks' household and corporate customers would depend on their own vulnerability at the time. This, in turn, is likely to depend on factors such as the level of and recent trend in income and capital gearing of the household and corporate sectors on average and across the distribution. The position of firms and households at the top end of the distribution of fragility indicators would be particularly important since these would be the ones most likely to default on their loan repayments.

40. In turn, the impact of deterioration in the corporate and household (and overseas) position on banks would depend on the composition of banks' exposures and the capital cushion available to withstand such losses.

41. Evidence from past episodes of bank weakness or failures may also be indicative of what macroeconomic factors could provide an early indication of bank risk. There is now a plethora of empirical studies on leading indicators of recent banking crises. Macroeconomic factors frequently cited in these studies are a marked slowdown in real output, asset price bubbles (e.g. in financial assets or real estate), increases in real interest rates and exchange rate depreciation, particularly when these negative shocks occur following a period of rapid credit growth and/or financial deregulation.[13]

42. Many central banks and supervisory authorities publish surveillance analysis of the banking system in their annual reports while a few publish standalone financial stability reports on a more frequent basis.

4.3 Channels for information about weaknesses

4.3.1 Communication with bank management

43. The quality of management is probably the single most important element in the successful operation of a financial institution. Frequent contact and dialogue with bank management and the Board of Directors[14] are important components of effective supervision.[15] To the extent practicable, the supervisor should have regular contact with the management of all banks and not only those in poor financial condition. Discussing strategies, plans, deviations from existing business plans or changes in management with the bank's executive management will allow supervisors to update and review the existing supervisory framework as necessary. The supervisor should also review with management their efforts to correct identified weaknesses in the previous onsite examination.

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[12] Similarly some guidance on the vulnerability of the banking system to *market* risk could be assessed by simulating the impact of a given exchange rate depreciation or increase in interest rates on a banks' on balance sheet position. However, how accurate a guide this would be to a bank's underlying risk would depend on the size and quality of any compensating off-balance-sheet hedging positions.

[13] See the article by Bell, J and Pain, D L (2000), "Leading indicator models of banking crises: a critical review", Bank of England, *Financial Stability Review*, December, pp 113-129, for a recent review of the literature on leading indicators of banking crises.

[14] The notions of the Board of Directors and senior management are used in this paper to label two decision-making functions within a bank. In some countries, the Board has the main function of supervising the executive body, and it is known as a Supervisory Board. In other countries, the Board has wider competence, including executive functions.

[15] Core Principle 17.

44. An official meeting with bank management and the Board of Directors should be held at the conclusion of each on-site examination. Depending on the type of supervisory system as well as the circumstances and condition of the bank, other meetings can be useful at least once before the next on-site examination. Frequent meetings can be useful for riskier or problem banks.

45. There may or may not be a statutory duty for the Board of Directors to report material weakness in the bank to the supervisor. In some countries, there is an audit committee within the Board of Directors, which is required to report, without delay, to the supervisor anything irregular in the management of the bank, or any violation of banking regulation. Even in the absence of statutory obligation, a culture or understanding between the bank management and supervisor should be established such that management knows it is better to go to the supervisor with a problem earlier rather than later.

46. Contacts between the supervisor and the bank management should not only be formal and top level, but there should be regular dialogue at different staff levels. A good practice is to meet with the banks on issues not related to the situation of the individual bank, for instance on future regulations or macroeconomic developments. By creating this regular dialogue, bank managers and directors should be more willing to inform the supervisor of emerging questions or problems.

4.3.2 Regulatory reporting and offsite review[16]

47. Banks are typically required to submit timely financial statements to the supervisor in the form of regulatory returns and other ad hoc financial reports. The frequency of reporting depends on the nature of the data. The quicker data become obsolete, such as market-based data, the more frequent the reporting. Quarterly reporting, as a minimum, would be appropriate for many types of prudential data such as loan classification and provisioning, risk concentration, insider lending and capital adequacy. Longer intervals could be accepted for slower changing data. Supervisors should have the legal power to require banks to report all data that are relevant for supervision with sanctions available to punish deficient, incorrect, or late submission of returns.

4.3.3 Onsite examinations

48. Effective banking supervision should consist of some form of both onsite and offsite supervision. If deterioration in the bank's condition is detected in the offsite review, onsite examination can be used to assess more precisely the nature, the breadth and depth of the problem.

49. Onsite examination provides both quantitative and qualitative analyses of the bank's financial condition, management, risk management and established internal control processes. The purpose is for the supervisor to determine if management has the ability to identify, measure, monitor and control the risks faced by the bank.

50. The breadth, depth and frequency of the on-site examination will be driven by the overall risk profile of the bank. See section 4.2.2 above on risk-based supervision. This can be determined by an assessment of the level and trend of risks in the bank, the adequacy of

[16] See the Core Principles Methodology document, in particular principles 16 to 18, for more on offsite reviews and onsite examinations.

the risk management systems that are in place (including reporting structure) and the financial strength of the bank in terms of earnings and capital. There can be general full scope examinations or specific examinations focusing on segments of operations or types of risk.

51. In many countries, examinations are typically conducted every 12 months. Exceptions to the examination cycle will depend on the risk profile of the institution. The cycle for small banks with low-risk and a stable financial position may be extended while those with weak or deteriorating financials should be examined more frequently. Examination reports should be prepared in a timely fashion, for example, it is the practice of many supervisors to finalise the report within one month of the conclusion of the examination. When there are significant weaknesses calling for immediate attention, supervisory action should be initiated before awaiting the finalisation of the formal examination report. All or parts of an examination (e.g. where special skills are needed) may be commissioned by supervisors but undertaken by external auditors or other “skilled persons”. Supervisory agencies should possess the legal power to order special examinations on individual banks or groups of banks at any time to follow up on suspected weaknesses.

4.3.4 External auditors

52. Cooperation between external auditors and supervisors is useful in identifying weak banks.[17] External auditors may identify weaknesses before a supervisor. This can happen during the statutory financial audit or in the course of executing an onsite examination on behalf of the supervisors. The cooperation may be based on periodic meetings between external auditors and supervisors.

53. The supervisor should regularly follow the auditor’s reports and letters to the bank and its Board of Directors, which are always available for the supervisor at the bank. The supervisor may wish to agree with the bank that the auditors are instructed to send a copy of all such reports directly to the supervisor. Following the auditor’s reports and letters will support the supervisor’s identification of control weaknesses or areas of high risk in the bank. In countries where the supervisors have access to the auditor’s work papers, a review of those is helpful to focus better the supervisor’s resources and avoid unnecessary duplication.

54. Conflicts of interest may limit the role a bank’s external auditor can play in identifying weaknesses. Conflicts of interest may for example arise when the external audit firm is providing consulting services to the bank that it audits. The external audit firm may have to evaluate the bank’s asset valuation model developed by the same firm’s consultants. In such cases, the external auditor may not have the right incentives to report everything amiss. It is important that supervisors are aware of these issues when they rely on the work of external auditors. Some supervisors may have the possibility to contract auditors or other experts to conduct fieldwork. To choose the bank’s external audit firm for such an assignment may appear useful as the firm is familiar with the bank’s operations, controls, etc, but the firm may nevertheless lack critical distance from the bank and may risk repeating mistakes made in the audit.

[17] See Basel Committee on Banking Supervision (2002), *The relationship between banking supervisors and banks’ external auditors*, Basel, January.

4.3.5 Information from bank internal control and internal auditors

55. Supervisors should have unfettered access to reports and all other documents issued by the internal control and audit functions. They should examine these on a regular basis, at a minimum during each onsite examination but preferably more frequently.

56. Typically, internal auditors report to the Board of Directors or a committee of the Board. There may be no formal channel of reporting from the internal auditors directly to the supervisor if they come across weakness in the bank or of internal controls. However, it should be both expected and a matter of course for the directors and management of the bank to relay to the supervisor any information on material weaknesses, which is received from the internal auditors.

4.3.6 Contacts with other supervisory and related authorities

57. Banking supervisors should maintain close communication on relevant issues with other domestic agencies that have an interest in the bank's financial condition. Interested parties normally include the Securities and Insurance supervisors, the central bank, the deposit insurer, the overseer of the payment systems, the Ministry of Finance and the government. In countries where the banking supervisory authority is outside the central bank, the supervisor should nevertheless communicate relevant information with the relevant functions of the central bank, such as those functions responsible for monetary and exchange rate policy, payment systems and financial stability. In the case of banks that have cross-border operations, there should also be communication with foreign supervisors.

58. In some countries, it would be normal practice for Memoranda of Understanding (MOUs) to be signed between the supervisors and these agencies, covering the types of information to be exchanged and the protection of information that is shared. This is especially important if there are agencies outside the usual supervisory circle, such as a private deposit insurance agency, where confidentiality of information may be an issue. The execution of a MOU should not be regarded as the only solution, provided there are practicable ways of exchanging information expediently.

59. Where a MOU is not a precondition for exchanging or sharing information between banking supervisors in two countries, there are differing views in the supervisory community as to whether a MOU is the best channel. MOUs take time to negotiate, and may end up being overly legalistic, impeding rather than facilitating the exchange of information. That said, many countries have found it useful to execute MOUs to set the framework for mutual cooperation. Whatever the form of arrangement chosen, it must be robust. It should ensure that the exchange of information may take place under difficult circumstances, such as at a time of severe bank problems.

4.3.7 Other external sources

60. Signals from the market, through information in the press, external credit ratings, or other means, are a valuable source of information about the condition of a bank and its possible direction. The supervisor should treat information from these sources carefully since it may be unreliable. Nevertheless, it may often be an indicator that warrants further investigation.

4.4 Contingency planning

61. Supervisors have a wide range of tools that can be used to identify and deal with weak banks and it is important that supervisors have a good understanding of them. These

tools include both the supervisor's statutory powers and its ability to exercise 'moral suasion'. The limits of these powers and their capacity to be challenged must be carefully understood. The supervisor needs to prepare detailed and comprehensive contingency plans for dealing with weak banks in order to respond promptly in a crisis.

62. A supervisor should prepare a documented contingency plan that will encompass a range of scenarios. This might range from a large, potentially systemically important, bank that collapses 'overnight', to a small, relatively unimportant, bank that is in decline but can be managed out of the industry with little disruption. At a high level, the plans should consider:

- mechanisms by which the supervisor will become aware of a weak bank;
- the authority to make decisions relating to the identification and assessment of a weak bank (i.e. at what point does a bank move from normal supervisory oversight to more intensive day-to-day supervision?);
- arrangements to discuss the problems at the bank with its Board and management without delay;
- arrangements to conduct an in-depth assessment, including the use of independent experts if necessary;
- arrangements for reporting the assessment's findings and who will be informed, inside and outside the supervisory agency;
- responsibilities for determining the supervisor's detailed course of action, including taking physical control of the banking facilities, and transferring or repaying deposits;
- the means of communicating and coordinating supervisory action with other relevant parties;
- arrangements for any public announcement where appropriate and subsequent management of public information;
- potential conflicts with the objectives of Government or other relevant agencies, and how these might be resolved; and
- mechanisms for monitoring the success or otherwise of supervisory actions, and adjusting these as necessary.

63. In addition to financial information, the supervisor must have rapid access to a wide range of relevant non-financial information about the bank. This includes organisational and legal structure, participation in payment systems, etc. (In some countries, it is known as a "fact book".) Some of this information should be kept by the supervisor and other (primarily operating data that is frequently changed) should be kept at the bank.

64. The supervisor should also ensure that banks have contingency plans in place to allow them to handle periods of unexpected financial weakness. These ought to include a liquidity and funding plan and a capital restoration plan. As a by-product of Y2000, many banks now have tried and tested business continuity plans in place for IT problems. It is important that supervisors encourage banks to give thought to the means by which broader financial difficulties would be handled.

65. Importantly, any sort of financial difficulties (particularly if these are known or suspected in the market) will require the bank to have adequate liquidity to enable it to meet its obligations while the weaknesses are being corrected or other action is taken. Hence, some form of planning for a liquidity crisis is necessary. Such a plan can (and probably should) be broader, but at a minimum should address how to resolve a liquidity crisis triggered by a loss of confidence in the bank itself. The plan should demonstrate, in the event

the bank is experiencing difficulties in rolling-over its liabilities, how it would be able to continue to meet its obligations for a reasonable period of time. Contingency plans to provide or activate new funding sources, and allow for capital to be raised in a short period of time, or for assets to be sold or securitised, should also be requested and regularly examined by the supervisor.

Part II. Corrective action, resolution and exit

5. Corrective actions

66. Corrective actions are those actions required to deal with deficiencies and change behaviour in a weak bank. They can be implemented voluntarily by the bank under the supervisor's informal oversight or, if necessary, via formal supervisory intervention. Resolution techniques, discussed in section 6, are those that are employed when failure is imminent and will typically involve stronger supervisory intervention and some change to the legal structure and ownership of the bank. A flowchart to assist the supervisor is provided in Annex 4.

67. Under normal circumstances, it is the responsibility of the Board of Directors and senior management of the bank, and not of the supervisor, to determine how the bank should solve its problems. However, should the bank engage in unsound banking practices or breach statutory or other key supervisory requirements, for example, capital adequacy and liquidity requirements, the supervisor should have powers to compel the bank to take necessary remedial action – and a statutory responsibility to ensure that the remedial action taken is appropriate. The role of the supervisor is to guide and steer the bank in its rehabilitation. This is consistent with the widely shared supervisory objectives of financial stability, minimum disruption to depositors and other bank counterparties and in many countries promoting economic activity. At the extreme, supervisors should have powers to close the bank.

5.1 General principles for corrective action

68. The principles for dealing with weak banks are set out in section 2.2. In essence, the following should guide supervisors in implementing corrective action:

- *The fulfilment of supervisory objectives*, including financial stability and depositor protection.
- *Corrective action should be timely*. The bank and the supervisor should take prompt action to prevent the problems from growing and exacerbating the financial weakness of the bank.
- *Management commitment*. The management of the bank must be committed to the action plan for corrective action. Otherwise, the replacement of management should be considered.
- *Proportionality.* Corrective actions should be appropriate to the circumstances and scale of the problem.
- *Comprehensiveness*. Both causes and symptoms of weakness must be addressed by the corrective programme.

5.2 Implementation of corrective action

5.2.1 Determining the nature and seriousness of the weakness

69. In order to formulate a plan of corrective action, there has to be an assessment of the nature and seriousness of the weakness. After a weakness is first detected, the supervisor has to decide on the following: Who is to do the in-depth assessment, and how

should it be done? What are the causes? What is the size and character of the problem; and are liquidity and solvency going to be an immediate concern?

70. The bank's Board of Directors, its management and the supervisor may have different views as to the nature and seriousness of the bank's weaknesses. An onsite assessment is usually the most efficient way of identifying the full extent and nature of the problems faced by a bank. Problem banks may mask their most significant troubles in a way that can only be detected by onsite work. An onsite examination also helps to uncover the underlying causes of a weakness rather than merely the symptoms. Depending on the circumstances, the supervisor may require the assistance of external auditors and other independent expert advisers.

71. An essential part of the assessment is to determine the bank's present and expected liquidity and capital position and evaluate the bank's contingency plans.

72. In assessing the prospects of insolvency, there has to be an assessment of the fair value of the bank's net assets. In this regard, it is essential to measure correctly the quality of the loans, how many are impaired and whether collateral can be enforced; to determine the proper recognition of, and provisioning for, non-performing loans; and to assess the extent of insider and connected lending. On the liabilities side, there is a need to verify whether their recorded values are adequate; that all contingencies are recorded; and all off-balance sheet items are known and under control. In the assessment, the bank should take into account the effects of (close out) netting and possible setoffs.

73. Even if the value of the net assets is positive, solvency problems may arise in the near term due to expected losses. Equally, adequate profitability may compensate for a low value of net assets.

74. An accurate assessment of the fair value of the bank's net assets should indicate whether an internal solution is possible or whether an external solution needs to be sought, depending on the financial resources available to shareholders and management.

75. In assessing the liquidity position, there should be an analysis of the bank's cash flow, for a meaningful period ahead, to identify the real inflow and outflow of funds.

76. Where the supervisor forms the view that there is an immediate and significant threat of illiquidity or insolvency, immediate corrective action is essential. On the other hand, where the bank is exposed to financial strain or other form of weakness but the assessment is that these threats are real but not immediate, the supervisor's possible range of actions is broadened. Supervisors may exercise "close monitoring" in order to assess and prompt the bank to react effectively and adopt corrective measures.

5.2.2 Range of corrective actions

77. Supervisors are generally empowered with a range of tools for dealing with weak banks. These range from requirements on the bank to take specific action to mitigate the weakness to prohibiting activities that will aggravate the weakness. Supervisors should possess effective means to deal with management problems, including the power to have controlling owners, directors, and managers replaced or their powers restricted. Examples of the main corrective measures which supervisors need to have at their disposal follow. Section 5.3 discusses how they apply to particular problems.

Impact on shareholders

- Call for cash (equity) injection by shareholders

- Suspension of particular or all shareholders rights, including voting rights
- Prohibition on the distribution of profits or other withdrawals by shareholders

Impact on directors and managers

- Removal of directors and managers
- Limitations on compensation (including management fees and bonuses) to directors and senior executive officers

Impact on the bank

- Requiring the bank to enhance governance, internal controls and risk management systems
- Maintaining higher capital adequacy and liquidity ratios
- Placing restrictions or conditions on the business conducted by the bank
- Downsizing of operations and sales of assets
- Restricting expansion of branches or closing of branches at home or abroad
- Immediate or enhanced provisioning for those assets of doubtful quality and for those which are not represented in the accounts at fair value
- Banning principal or interest payments on subordinated debt
- Cessation of any practices that are harming the institution, such as irregularities and violation of laws or regulations governing the bank' s activity
- Prohibiting or limiting particular lines of business, products or customers (including concentration limits)
- Prior supervisory approval of any major capital expenditure, material commitment or contingent liability
- Appointing an administrator or conservator

5.2.3 Timely corrective action

78. When dealing with weak banks, timely corrective action is critical. International experience has shown that bank problems can worsen rapidly if not promptly addressed. In many cases, the bank's Board of Directors, management and shareholders as well as supervisors have tended to postpone taking timely and adequate corrective action.

79. The most basic cause for inaction is that these same parties may be reluctant – in good faith - to take the measures needed to remedy the situation in the hope that the problems will rectify themselves. In addition, the legislation may not be very explicit and the supervisor may want to avoid the risk of having its decision challenged in court. Finally, there may be explicit or implicit pressures on the supervisor from politicians or from lobby groups to postpone measures. In order to prevent undue forbearance, international standards (such as the Basel Core Principles) include recommendations that countries should have laws and regulations to ensure that supervisors act promptly and adequately in relation to the bank problems encountered.[18]

[18] Core Principle 22.

80. In most countries, unless specific supervisory thresholds are breached, there are no statutory provisions requiring mandatory corrective action for weak banks, i.e. obliging the supervisor to take specified actions according to some objective measure within a certain time. Generally, supervisors have the discretion to act pre-emptively, without waiting for a trigger to be breached. Supervisory measures have to be flexible and tailored to the specific situation. There is usually no pre-specified time limit within which the supervisor must act after identification of the problem. The absence of a clear legislative requirement, however, does not provide a reason for inaction; the best practice is normally to act as quickly as possible to prevent an escalation of the problem.

81. In many countries, the law itself provides against forbearance. Where legislation setting out the general rules for the supervisory authority prescribes that the supervisor must act with due promptness in all situations, failure to do so will make the supervisor liable to formal criticism or even financial responsibilities to the injured parties, such as depositors.

82. A balance has to be struck between rigid "prompt corrective action" regimes and general, less binding, frameworks. One effective combination would include "automatic" rules for pre-agreed acceptable supervisory actions - which protect the supervisor from undue interference in the decision process - plus room for flexibility in particular circumstances.

5.2.4 Degrees of corrective action

83. Corrective measures differ in the level of intrusiveness into a bank's management of its affairs. The specific measure(s) used by a supervisor will depend on the nature and seriousness of the difficulties encountered by a bank and how co-operative its management is.

84. Typically, supervisors are willing to use informal methods and less intrusive corrective action in cases where the bank's problems are less serious. It helps also if bank management is cooperative and moves promptly and vigorously to deal with its problems.

85. If the bank faces more serious problems, or in the absence of cooperation by the bank, the supervisor may have to take formal actions to ensure compliance with its recommendations. Formal actions are binding on the bank, with penalties for non-compliance. Depending on domestic regulations, this will involve the issue of some form of supervisory or enforcement notice outlining the actions the bank and management must take, and the time frame for acting. It could also involve "cease and desist orders" requiring the bank and/or management to stop engaging in a specified practice or violation. In some countries, such orders may also be issued to parties affiliated to the bank, such as the bank's accountants or auditors, to prevent or halt violations or unsafe or unsound practices.[19]

86. More severe corrective actions should be considered if there is an increased danger of insolvency. In such cases, the supervisor may impose a sale and payment prohibition on the bank to prevent or limit the dissipation of assets. To prevent new customers from being disadvantaged, the bank might be prohibited from accepting payments that are not intended for the redemption of debts to the bank, unless there is a deposit insurance scheme in place

[19] The prompt corrective action (PCA) framework, as used in the U.S., is a specific tool used to address critical situations. As a basis for PCA, insured depository institutions are divided into five capitalisation categories, ranging from well-capitalised to critically under-capitalised. Supervisory actions are required for those that are not adequately capitalised. It should be recognised that PCA is not an early intervention supervisory tool; typically supervisors actively use any number of informal and formal supervisory tools well before PCA is triggered. In fact, PCA is one of the last supervisory tools used when other measures have been exhausted.

which undertakes to satisfy the entitled parties in full. The appointment of an administrator may also be considered. Such drastic measures, mainly used for resolution, can lead to a further reduction in public confidence and must be considered and implemented in a careful manner.

87. The escalation in the corrective action would mean an increase in the intensity of supervision. There are resource and cost implications for the supervisor, which should be acknowledged and addressed. However, a lack of resources cannot be used as a justification for inaction. A supervisor should ensure, consistent with the Basel Core Principles, that its operational budget allows for the additional costs associated with corrective action, e.g. legal and consulting fees. It should also include in its contingency plans (section 4.4) how additional resources, both financial and staff, would be obtained if necessary.

5.2.5 Action plan

88. In formulating an "action plan" of corrective action, it makes sense to give priority to the more serious weaknesses. A coordinated plan that attempts to deal concurrently with the various weak areas may, however, be necessary because, quite often, the various issues are inter-related.

89. Any action plan, therefore, should comprise a package of corrective measures which, taken together, will not only resolve "symptoms" but also "causes". Given that poor management is usually a contributory factor, an assessment of management's ability should be included in the action plan.

90. As part of its action plan, the bank should be required to develop a detailed capital and operating plan, showing how the bank's financial health will be restored. The plan must show the bank's projections for its income, dividends, assets, liabilities, capital, non-performing assets and loan charge-offs, assessed in a conservative manner.

91. A key factor in determining whether the action plan will be successful is the commitment of the Board of Directors, and ultimately of the major shareholders of the bank. It is important for the supervisor to establish an open and frank dialogue with the Board, particularly the major shareholders, so as to secure their commitment to the bank, including the possibility of prompt injection of new capital or finding new shareholders.

92. Clearly, if management is to focus on turning around the bank it should have as few unnecessary distractions as possible, so it should shelve any plans for new branches, acquisitions or major new business initiatives in the interim. A voluntary undertaking of this nature can be incorporated into the action plan.

93. The action plan prepared by the bank should be approved by the Board of Directors and should give the supervisor reasonable assurance that the weaknesses will be satisfactorily addressed within an acceptable time-scale. In some cases, for example, where there have been breaches of statutory requirements, or where formal supervisory action has been taken against the bank, there may be statutory requirements requiring an action plan to be formally approved by the supervisor.

94. In some countries, the commitment by the Board of Directors to the action plan and the time frame is formalised in a written agreement signed between the supervisor and the bank, and the bank will be put under intensified supervision.

95. The Board of Directors and management, as well as the supervisor should carefully monitor the implementation of the action plan. Banks should be asked to provide the

supervisor with regular updates on the progress of the remedial programme against the action plan. In turn, the supervisor must be able to assess whether there is satisfactory progress, or whether additional corrective actions are necessary. Usually, this approach can resolve a large number of weak banks.

5.2.6 Enforcing compliance of corrective actions

96. The supervisor may have to consider the use of all available penalties and sanctions in order to enforce compliance with supervisory regulations and recommendations. These can range from warnings and fixed fines for minor violations to substantial fines of corporate officers for major violations. Corrective actions, such as dismissal of managers, directors or shareholders can also be used to enforce prior supervisory orders that have not been complied with. It is important that the penalties and sanctions can be applied to the bank itself or to the relevant individual persons. The ultimate sanction is the threat of bank closure or revocation of the bank licence.[20]

97. The decision to close a bank or revoke its licence should be done only when it is clear that the bank is not in a position to pay its present or future depositors and other creditors, or when the affairs of the company are being conducted in a manner detrimental to the interest of depositors or to the public interest. The sanction of revoking the licence is absolute and should be exercised with utmost care to avoid exacerbating the problems for the bank "stakeholders" and for the financial system. This does not mean that the revocation tool should not be used, only that the consequences of the action must be carefully considered and be prepared for[21]. In general, revocation of a banking licence should be accompanied by other resolution strategies (section 6).

98. Supervisors should stipulate a time frame within which banks should comply with the remedial action. This time frame should be related to the urgency and seriousness of the weakness, including the risk of contagion. If so provided in the banking legislation, supervisors could go to the courts to enforce their actions.[22]

99. Banks faced with orders from the supervisor may, depending on domestic law, appeal against the order. Given the importance of prompt compliance with corrective action, it is important that this is not delayed in the courts. Some countries have established arrangements whereby some decisions of the supervisor are immediately effective, even if the bank challenges them in the courts.

5.2.7 Consultation with other agencies

100. It is desirable for supervisors (including the deposit insurer) to be able to act independently of other government or judicial authorities in determining the actions needed to overcome banks' difficulties and to impose on banks the required corrective measures.[23]

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[20] There may be legal frameworks allowing other options for taking over the bank and eliminating its shareholders, or suspending its operations in full or part without necessarily revoking its licence.

[21] The issue of licence revocation and bank closures will be analysed in detail in the work of the World Bank and IMF on Legal Aspects of Bank Insolvency.

[22] In many cases, failure to comply with supervisory orders could result in civil money penalties or criminal fines. Supervisors should be able to work cooperatively with law enforcement officials in developing cases that may result in criminal prosecution.

[23] Core Principles 1 and 22 set out international standards for such powers.

Just as information exchange and sharing with other agencies are important in the identification of bank weaknesses, communication is even more important when it comes to dealing with a weak bank. In enforcing corrective action, the bank supervisor needs to consider whether to consult with or inform the Government, the central bank, and other regulatory agencies about the assessment and proposed course of action. The supervisor usually has an interest in reciprocal consultation with the central bank, as its action may have an impact on the central bank's dealings with the weak bank, and vice versa. For instance, the central bank might want to exclude a weak bank from its list of eligible counterparties to monetary policy operations. Conversely, a decision taken by the central bank to exclude a bank from the list of eligible counterparties to monetary policy operations or from major payment and settlement systems will limit the options available to the supervisor. The supervisor should also understand the circumstances in which it can involve the Government and other agencies into the supervisory action plan. This applies in particular to those having a direct interest in the soundness of the bank. Bilateral agreements, such as MOUs, with the various agencies (section 4.3.6) may be useful in problem bank situations, especially when there is need for rapid action.

101. In some countries, supervisors may need to consult with the Ministry of Finance or apply to the court for orders to revoke licences. There may also be special procedures involving the Ministry and the central bank when dealing with systemic crisis situations. The essential thing is that each supervisor knows the relevant procedures and can activate them in a hurry.

5.3 Dealing with different types of weaknesses

102. This section discusses how to deal with different types of weaknesses, but in practice of course, the individual weaknesses do not appear in isolation. A bank and its supervisor will have to deal with a range of different problems simultaneously. As noted above, the key to turning around a weak bank is to identify and quantify the problems and implement a comprehensive and credible corrective action plan. Depending on the circumstances, disclosure of the fact that the bank has embarked on such a plan may help in maintaining or restoring confidence in the bank.

5.3.1 Capital adequacy

103. Declines in capital ratios have different explanations. The most common include:

- a rapid increase in risk-weighted assets;
- a reduction in the absolute amount of capital, e.g. redemption of subordinated loans;
- overall losses in the bank operations; and
- adverse exchange rate movements, where there is a currency mismatch between risk-weighted assets and regulatory capital.

104. Improving the capital position addresses the symptom. The supervisor should also seek to understand in each instance why the capital ratio fell to determine if other measures are needed. In the first case of the instances listed above, the supervisor must assess whether the bank has the financial strength and the managerial and organisational capacity to handle the new risks. In the second case, the supervisor should determine if the reduction of capital is voluntary or involuntary, on the bank's part. In the third case, the underlying causes of the losses must be identified. A temporary loss, for example, emanating from unexpected market developments, calls for a different treatment from that of a bank that

consistently makes a loss. In the fourth case, the supervisor should assess the bank's management of its foreign exchange exposure.[24]

105. Where the bank's capital adequacy ratio has fallen below the supervisory and/or statutory minimum, the powers of the supervisor to take formal action against the bank to restore the ratio should be triggered

106. The supervisor's main consideration is whether, and how soon, the bank can restore its capital to an acceptable level. The bank should therefore be required to provide the supervisor with a clear commitment of how it proposes to restore the ratio and the timescale, with relevant milestones, for doing so.

107. It would be prudent for the supervisor to ask for assurances from the major shareholders of the bank that they continue to support the bank and are prepared to contribute to restoring the capital position by means of capital injection if the position of the bank deteriorates further.

108. If the existing shareholders are unable to provide the necessary capital injection, various other options can be considered, such as:

- selling or securitising assets, thereby reducing the capital needed to support the business;
- switching the portfolio from higher to lower risk weighted assets;
- cutting operating costs and capital expenditure, including bonuses to managers and directors;
- limiting or restricting the payment of dividends;
- restricting redemption of subordinated debt or other instruments; and
- bringing in a new shareholder who can contribute new capital.

109. A less obvious problem is where the bank's capital adequacy ratio falls significantly, for example, because the bank incurs a loss, to a level below what the market expects for the bank in question, but still remains above the supervisory and/or statutory minimum. This may affect confidence in the bank, particularly if there is an expectation that it may fall further in future.

110. In such circumstances a capital injection (perhaps restoring the capital adequacy ratio to the level before the loss was incurred) may also be appropriate, in order to reassure depositors and the market in general that the position of the bank will remain secure. In such cases, the supervisor will need to co-operate closely with bank management.

[24] If a bank's regulatory capital is denominated wholly in domestic currency and there are foreign currency assets, the capital adequacy ratio will change with the movements in the external value of the domestic currency. As a prudential requirement, and as part of their foreign exchange risk management, banks are expected to broadly match their foreign currency assets with their foreign currency liabilities, in order to protect the value of its capital from currency movements. With a matched position, the capital adequacy ratio will fall when the domestic currency depreciates. Banks should take into account this risk, but clearly, in case of a severe depreciation of the domestic currency, there will be cases when even prudent banks could see their capital adequacy ratio fall below the statutory minimum.

5.3.2 Asset quality

111. Asset quality problems can become "serious" in different ways. Provisions and write-offs can result in the bank incurring losses, leading to a reduction in its capital adequacy ratio. But even if the bank continues to make a profit, poor asset quality can still pose problems, for three main reasons:

- if the problem is not dealt with by proper problem loan management, the loan write-offs are likely to remain large or even escalate;
- problem loans in excess of the industry norm may indicate not only poor credit underwriting standards but in all likelihood poor management which may be a warning of incipient problems elsewhere; and
- public and market knowledge of the bank's relatively poor performance on asset quality may affect confidence in the bank, leading to deposit withdrawal or increased cost of funding.

112. For asset quality problems, onsite examinations are usually the most useful way of evaluating the extent of the problem. The examination should focus on whether problem loans are being identified promptly; whether the bank has a dedicated problem loan management/recovery unit, and whether this is operating effectively; whether problem loans are being classified correctly; and whether adequate provisions are being set aside. While the maintenance of adequate provisions is, in the first instance, primarily a matter for the bank and its auditors, the supervisor has a major role to play in determining whether the provisioning policy is prudent and is being applied effectively. If provisions are not adequate, the bank's capital adequacy ratio will be overstated.

113. The supervisor is likely to be able to make use of (1) peer group comparison (e.g. experience from other onsite examinations) and (2) stress-testing to gauge the scale of the problem and the particular areas of concern. Supervisors are increasingly requiring banks to do stress-testing as a routine management practice.

114. The bank with asset quality problems should be expected to devise an appropriate remedial action plan. This may include:

- negotiating new agreements with its viable but weak debtors (through loan maturity extension, interest rate reductions, partial debt forgiveness, debt to equity swaps, etc.);
- taking possession of loan collateral or other assets of the debtor;
- writing off long-term problem loans; and
- selling assets or transferring assets to a special purpose debt management vehicle (although the supervisor should determine that such transactions are not designed only as a form of regulatory arbitrage).

115. In practice, however, whatever approach the bank takes, there are certain principles that apply. First, the bank needs to try to arrive at a realistic assessment of its current asset quality, and not be tempted to hide the problem by entering into "cosmetic" restructurings with insolvent debtors. Second, it needs to put resources into strengthening its problem loan management unit so that it can boost recoveries. Third, it needs to be prepared to "bite the bullet" on provisioning. Asset quality problems that drag on cast a shadow over the bank for many years. To be effective, provisions must be determined on the basis of the short-term realisable value for collateral, or a conservative present value estimate of the borrower's likely repayments, not on longer-term, potentially optimistic, projections of future value. If the bank has the resources or can secure additional resources, for example, by capital injection,

it is preferable to try to "clean up the balance sheet" as expeditiously as possible. This may, however, result in the bank taking a big hit to profitability and capital.

116. The supervisor will almost certainly expect the bank to set targets in terms of reduction of problem loans to a certain level by a particular time and will want to monitor the progress the bank is making by means of onsite visits or reports by the bank's external or internal auditors. It should ensure that all restructured debt is classified as non-performing and is provisioned until the bank demonstrates that the debtor has regained its capacity to repay its loan in full.

117. Beyond dealing with the immediate problem, the supervisor should also ensure that the bank fully reviews its credit assessment, credit approval and credit monitoring processes. Weaknesses in these will almost certainly have played a large part in the general asset quality problem.

5.3.3 Management

118. Poor management is likely to be a problem in most weak banks. While it is not the supervisor's role to select senior management for banks, supervisors have the responsibility to evaluate proposed directors and senior management as to expertise and integrity (fit and proper test) and to prevent or discourage appointments deemed detrimental to the interests of depositors. Supervisors should also evaluate directors and senior managers as part of the regular supervision of the bank.

119. Unless there is evidence of fraud or massive incompetence – for example, if the supervisor feels that an individual is just not up to the job, as indicated by the bank's performance - it may be difficult to request formally the removal of unsuitable persons. In such situations it may be more effective for the supervisor to discuss the future of the management with the Board of Directors or the major shareholders of the bank and to seek their commitment, voluntarily, to strengthen the management. The emphasis should be on bringing in strong individuals with the skills the bank needs, for example CEO, Financial Controller, a Head of Credit or "consultants" to boost the existing team.

120. As a last resort, if the law permits, a supervisor may appoint an individual to run the affairs of the bank temporarily for the purpose of seeking solutions to the difficulties encountered. The appointment should be conducted in such a manner that does not give the impression that responsibility for bank management has shifted to the supervisor.

5.3.4 Earnings

121. Declining bank earnings may have different causes. These include:

- unprofitable investments in new activities or in branches, subsidiaries or overseas operations;
- insufficient diversification and unsustainable income streams;
- unreliability of non-core income items;
- poor cost control; and
- increased competition in core activities, leading to net interest margin compression.

122. Deteriorating earnings will lead directly to reduced liquidity and weaker solvency, so these problems must be addressed. Banks must be required to reduce or restructure unprofitable activities (e.g. close branches) and to reduce costs (e.g. cut bonuses and

salaries and/or the number of employees). If the problems are severe, a significant reorganisation of the bank may be necessary. In parallel, relevant measures such as changes to the bank's strategic business directions and operating plans to turn around its earnings must be taken.

5.3.5 Liquidity

123. Liquidity can be a problem when a bank's holdings of cash and marketable assets provide little margin for comfort above the level necessary for business, and thus little scope for manoeuvre in times of stress.

124. It is possible that liquidity may be a problem in and of itself in the scenario where the bank expands its loan book more quickly than it can secure adequate, reliable funding. However liquidity problems are more often than not a symptom of other problems. A lack of confidence in the bank is, for example, demonstrated by customers withdrawing deposits and other banks cutting interbank lines. Problem banks typically become insolvent far before they become illiquid.

125. Supervisors have different requirements on how minimum levels of liquidity are expressed. If a bank's liquidity falls below the required minimum, this will normally trigger a series of actions by the supervisor, such as requiring the bank to indicate how, and how soon, it plans to restore its liquidity to an acceptable level.

126. If the bank is unable to restore its liquidity position, or the position shows signs of weakening further, prompt action is critical. To facilitate this, the supervisor should require the bank to prepare detailed cash flow projections, for example, for the next five working days. The five-day period will allow the bank at least to continue to the end of the business week and the supervisor can then decide whether the bank should reopen in the following week. Stress tests should be carried out on the basis of these projections, so as to give a better idea of how long the bank's liquidity can last if the situation worsens (i.e. if there is no let-up, or an acceleration, in the loss of liquidity). The bank's cash flow projections should take into account, among other things, premature withdrawals and offsetting of the bank's placements against the liabilities owed by the bank on a global basis.

127. There are a number of actions that the bank can take to improve the position. First, as regards withdrawals, it can issue statements to reassure the public and may wish to speak to large depositors directly. This of course depends on the bank's underlying position being healthy. Second, as regards its liquidity stock, it can try to secure lines from friendly banks, or to sell or repurchase assets so as to boost liquidity. It can also seek liquidity support from its major shareholders.

128. The question of central bank liquidity support is also likely to arise. The central bank may be able to assist a solvent bank in acquiring liquidity, within its normal loan facilities, such as the discount window, on market terms and against acceptable collateral. This may be quicker than the bank going to the market and more discreet.

129. On a case by case basis, the central bank may consider the discretionary provision of emergency liquidity assistance in addition to its normal standing facilities, to illiquid but presumed solvent banks. Private sector mechanisms should usually have been exhausted before emergency liquidity assistance is considered, partly to reduce moral hazard and partly to minimise the risk of possible losses of public monies. Where possible, collateral should be required to reduce the risk of losses. Depending on the circumstances, the central bank may wish to restore confidence by issuing a statement clarifying the position and perhaps confirming that it stands ready to provide liquidity support in the current case and to any other illiquid but solvent bank.

5.3.6 Risk management processes

130. Risk management processes may be inadequate for the size and nature of the activities of the bank and its risk profile. It is important these processes address adequately all the risks that the bank is facing. The following paragraphs deal with two examples.

131. As financial intermediaries, banks cannot avoid market risk. Bank management is primarily responsible for monitoring and controlling market risk. It has a duty to establish prudent risk limits in relation to its financial strength and risk management capabilities. These limits must be carefully and routinely monitored by management and if the risk becomes excessive and threatens the financial condition of the bank, prompt action must be taken to correct this condition. If however, management is unable to reduce excessive market risk, supervisory action may be required. This may be directed not only at excessive exposures but the weak risk management and lax controls that permitted excessive risk taking to develop.

132. There is growing awareness of operational risk, especially given the increasing reliance by banks on technology. For instance, breakdowns of IT-systems may lead to large losses and a loss of public confidence. Other system-related and operational deficiencies in banks may translate into losses, possibly leading to insolvency. The supervisor has to require the bank to address the explicit systemic/operational deficiency promptly, and in many cases urgently because it (e.g. a non-functioning IT system) may threaten the ongoing operations of the bank. However, a lasting solution requires that the bank deals with the underlying deficiencies, e.g. the inadequacy of back-up systems.

6. Resolution issues and exit

133. This section sets out general principles for dealing with banks that encounter major difficulties, the various resolution techniques when failure is imminent, and closure of the bank in event of failure. Resolution techniques require specialised and legal skills. Supervisors that do not possess the required skills may need to hire experts to assist them.

6.1 Guiding principles for banks resolution policy

134. The principles for dealing with weak banks, as set out in section 2.2, are elaborated upon below to guide supervisors in bank resolution policy and the choice of the appropriate technique. It is recognised that, in some circumstances, not all of these principles can be achieved simultaneously:

- *Bank failures are a part of risk-taking in a competitive environment.* Supervision cannot, and should not, provide an absolute assurance that banks will not fail. The objectives of protecting the financial system and the interests of depositors are not incompatible with individual bank failures. The occasional bank exit may help provide the right incentive balance. To deal with these, there should be well-defined criteria for determining when a bank requires intervention or closure (legal or economic). When such criteria are met, the supervisor should take action promptly.
- *Private sector solutions are best*. A private sector solution – one that does not impose a cost on taxpayers and introduces the least distortions in the banking sector – is in line with the least cost criterion. This usually entails the takeover by a healthy institution that finds ownership of the bank attractive. The supervisor has a role to play, if necessary, to encourage a private sector solution. Public funds are only for exceptional circumstances.

- *Expedient resolution process.* Weak banks should be rehabilitated or resolved quickly and banking assets from failed institutions should be returned to the market promptly, in order to minimise the eventual costs to depositors, creditors and taxpayers. The longer a bank or banking asset is held by an administrator, the more value it will lose. Experience has shown that if left unchecked, the resolution of weak banks may drag on for a long time.
- *Preserving competitiveness*. In case of resolution by merger, acquisition, or purchase-and-assumption transaction, the selection of an acquiring bank should be done on a competitive basis. An additional factor to consider is whether competition for banking services would be adversely affected. Any sweetener to facilitate deals should not distort competition and penalise the more efficient banks.
- *Minimise disruption to market participants*. A bank closure may disrupt the intermediation of funds between lenders and borrowers, with potential negative effects on the economy. Borrowers may find it difficult to establish a relationship with a new bank and may find existing projects threatened if expected bank credits are not forthcoming. It may take the deposit insurer some time to determine who are the insured depositors, to close their accounts and pay them off.[25] In the absence of a deposit insurer, the delay to depositors – if they are entitled to receive any monies back - will be even longer as liquidation procedures can be protracted. In any case, the choice of resolution measures, and the choice between resolution and closure, should be made with the aim of minimising market disruption.

6.2 Resolution techniques

135. The distinction between a legal closure and economic closure of the bank is important. In a legal closure, the licence of the bank is withdrawn and the legal entity ceases to exist. In an economic closure, there is interruption or cessation of the operations of the bank which may often lead to severe disruption and possibly losses for the bank's customers. The art of resolving bank problems often entails achieving a "legal closure" while avoiding an "economic closure".

6.2.1 Restructuring plans

136. While a weak bank may be required to reorganise its operations as a corrective action, if insolvency is imminent, the bank may be required to carry out a radical restructuring. Such a strategy is only worth adopting if there is a real chance of getting the business back on a sound footing in the short term. Far-reaching restructuring may be the only solution for large and complex institutions that are unlikely to find partners with the financial resources to carry through a merger or acquisition.

137. On top of operational and organisational restructuring, there can be financial restructuring. Where the bank has issued capital instruments under Basel Committee rules that count as regulatory capital, the holders of these instruments must be available to absorb losses. The absorption of losses, by way of write-down or conversion into equity (after eliminating existing shareholders' claims) must be triggered prior to failure of the bank. In addition, the supervisor or other relevant authorities should pursue whether there can be

[25] The law or regulations must ensure that the deposit insurer has access to bank information early on in the process and that such information is accurate and relatively complete. Staff of the deposit insurer should also have the adequate expertise to respond quickly and put money in the hands of the depositors.

conversion of subordinated debt into preferential or new equity where the supervisor or other authorities have the required legal means.

138. When the Board of Directors, management or controlling shareholders are reluctant to take timely action, supervisors should consider the appointment of an administrator to draw up the restructuring plan and implement its initial phases. In such cases, the administrator should replace the management and take over running of the company and have all the functions and powers of the ex-directors. Some curtailing of shareholders' powers could also be necessary.

6.2.2 Mergers and acquisitions

139. When a bank cannot on its own resolve its weaknesses, it should consider a merger with, or acquisition by, a healthy bank. This is a private sector resolution technique. Banks (even those that fail) are attractive targets to investors, especially financial institutions, because of their intrinsic franchise value.[26]

140. Arrangements for a merger or acquisition (M&A) should take place early before assets dissipate in value. In some cases, owners and certain creditors may have to make concessions to attract acquirers. Acquirers should have sufficient capital to meet the costs of the new bank and a management capable of projecting and implementing a reorganisation programme. Where the acquirer is a foreign bank, the supervisor needs to pay attention to additional aspects such as the laws and regulations of the relevant foreign jurisdictions. The supervisor will also need to liaise closely with foreign supervisors to inform itself about the acquirer and its related activities.

141. Supervisors should keep in mind that M&As are, even in good times, not easy undertakings for the institutions. This stems from different corporate cultures, incompatibility of IT systems, need for personnel layoffs, etc. Integration of staff and information systems has to be very carefully thought through in any merger plan.

142. The interested bank should have a clear understanding of the underlying causes and problems of the weak bank. Full and accurate information should be provided by the weak bank to all potential acquirers, although this may have to provided sequentially and under strict confidentiality agreements. In countries where the law permits, this could be done in cooperation with the supervisors. Restricting access to information will discourage potential acquirers, leading them to demand more concessions from the regulators or acquired bank. It is possible that full information may result in the interested bank deciding to abort the planned M&A. But this is better than an ill-considered takeover that may result in serious subsequent difficulties for the acquiring bank itself. The supervisor must be careful to ensure that in solving one problem, the strategy does not create another (larger) problem at some stage in the future.

143. Where the controlling shareholders of a weak bank are reluctant to sell their holdings and yield control of the bank and thus delay the M&A, the authorities may consider appointing an administrator having all the powers of the former management. Some pressure to persuade the weak bank's shareholders to accept the M&A may be necessary – even up to the expropriation of the majority stake. All the above will be subject to the appropriate legislation, which should also provide for fair treatment of the disenfranchised shareholders.

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[26] Intangible benefits may include instant access to a particular market segment, acquisition of a desirable deposit pool and a vast financial distribution system with a minimum investment.

A key issue is how, when and with what authority the supervisor can write down the value of shares.

144. There are other considerations. Owners of a weak bank who are trying to sell their stake to reduce their own personal losses will generally not attach great importance to the identity of the prospective buyers. In these circumstances, there is a risk that some potential buyers will be less interested in the banking operations of the bank than in its legal title and registration. Shareholders who are not fit and proper may wish to misuse the bank for dubious purposes (e.g. money laundering) or other business interests that may jeopardise the bank's continuing existence. In accordance with the Core Principles, supervisors are obliged to check the reliability of any new shareholder and have the power to reject applicants. Supervisors should use these powers uncompromisingly.

145. The advantages of an M&A type solution is that it:

- maintains the failing bank as a going concern and preserves the value of the assets (thereby reducing the cost to the government or deposit insurer);
- minimises the impact on markets as there are no disruptions in banking services to customers of the failing bank; and
- all assets are transferred in an M&A and all depositors and creditors are fully protected.

146. In a resolution by M&A, the supervisor should continue actively to monitor the problems in the acquired bank and take steps to ensure that they will be adequately addressed by the management of the resultant bank.

6.2.3 Purchase-and-assumption transactions

147. If a private sector M&A is not forthcoming or cannot be arranged, a purchase and assumption (P&A) transaction may be considered. A P&A transaction is one where a healthy institution or private investor(s) purchases some or all of the assets and assumes some or all of the liabilities of a failed bank. P&A transactions in most countries require withdrawal of the bank licence and the commencement of resolution proceedings by the liquidator. The acquiring bank purchases assets of the failed bank but not its charter.

148. A P&A transaction may be structured in many different ways, depending on the objectives and requirements of the deposit insurer[27] or the government, as well as of the acquirer. The transaction may be structured so that the acquirer purchases all assets and assumes all deposits. As with a M&A, this type of P&A transaction can be attractive to an acquirer - because of the intangibles - even when the bank is insolvent. However, such situations are rare. More often than not, to make the bank attractive for potential acquirers, a financial inducement may be necessary. Incentives may take the form of cash injections by the deposit insurer [28], or in exceptional cases, by the government. This form of assistance must be justified as the least cost alternative.

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[27] The role of the deposit insurer in a resolution is mentioned here in a narrow context. In some countries, the deposit insurer plays a much bigger role, including providing financial support, assisting with capital restructuring, and facilitating mergers with other institutions.

[28] In some countries, the deposit insurance agency is restricted to paying out depositors only. This resolution technique will still be considered a private sector solution if the financial inducement is provided by a privately funded guarantee scheme.

149. A P&A transaction may be arranged so that the acquirer purchases only a portion of assets and assumes a portion of the deposits. For example, the liquidator may assign to the acquirer performing loans and other good-quality assets for an amount corresponding to the insured deposits it will assume.[29] A clean bank P&A transaction occurs when the acquiring institution assumes the deposit liabilities and purchases the cash and cash equivalent assets, the "good" loans and other high quality assets of the bank.[30] Assets not sold to the acquirer at resolution are passed on to the liquidator for disposal.

150. If non-performing loans and other risky investments are to be assigned to the acquirer, some arrangement will be needed to mitigate the consequent risk. This may take the form of a loss-sharing agreement or a put-back provision that allows the acquirer to return assets that become impaired within specified periods. In the sale of such assets, the acquirer must not be indemnified for all losses, otherwise there is no incentive for the acquirer to manage the bad loans to minimise losses, leading to a higher resolution cost. Alternatively, the acquirer could be hired, with appropriate incentives, to manage the non-performing loans but not take them onto its own balance sheet.

151. A P&A transaction should be completed as quickly as possible. This will avoid the interruption of business so as to preserve the value of the bank and reduce the resolution cost.

152. As with M&A, the acquirer should have the financial and organisational capability to combine with the failed undertaking. If there is more than one eligible acquirer, a winner could be decided by competitive bidding so that the best price is obtained for the net assets of the failed bank.

153. Closing the bank as a legal entity implies that the shareholders lose their investment and the management are removed. From this standpoint a P&A transaction is compatible with minimising moral hazard.

154. The P&A type solution has the following benefits:

- saves the value of the assets of the failed bank (thereby reducing the resolution cost);
- minimises the impact on the market by returning assets and deposits to normal banking operations with the acquiring bank quickly. It can typically be completed over a weekend; and
- customers with insured deposits suffer no loss in service and have immediate access to their funds at the acquiring bank if the P&A transaction can be completed over the weekend.

6.2.4 Bridge bank

155. A bridge bank is a resolution technique that allows a bank to continue its operations until a permanent solution can be found. The weak bank is closed by the licensing authority

[29] The deposit insurer should give to the liquidator cash for an amount equivalent to the insured deposits, whose protection is ensured through the assignment. The uninsured depositors will jointly share with the deposit insurer the allotments that the liquidator will distribute using the cash given by the deposit insurer and the recoveries obtained from the disposal of the poor-quality assets.

[30] This is one way of implementing a good bank-bad bank separation (section 6.5).

and placed under liquidation. A new bank, referred to as a bridge bank, is licensed and controlled by the liquidator. The liquidator has discretion in determining which assets and liabilities are transferred to the bridge bank. Those assets and liabilities that are not transferred to the bridge bank remain with the liquidator. A bridge bank is designed to "bridge" the gap between the failure of a bank and the time when the liquidator can evaluate and market the bank in such a manner that allows for a satisfactory acquisition by a third party. It also allows potential purchasers the time necessary to assess the bank's condition in order to submit their offers while at the same time permitting uninterrupted service to bank customers.

156. A bridge bank transaction is most commonly used when the failed institution is unusually large or complex or when the deposit insurer or the government believes there is value to be realised or costs minimised, but does not have a ready solution other than a payoff. It has the advantage of gaining time to find another bank willing to step in and prepare the terms of the operation. However, it should not be used to postpone a permanent solution, nor should the arrangement be allowed to remain in place for any significant length of time as the bank will lose value if customers withdraw.

6.3 Use of public sector monies in a resolution

157. Public funds are only for exceptional circumstances. Public funds for the resolution of weak banks may be considered in potentially systemic situations, including the risk of loss or disruption of credit and payment services to a large number of customers. An intervention of this nature should be preceded by a cost assessment of the alternatives, including the indirect cost to the economy.

158. Government support may take the form of financial inducements to facilitate a resolution measure discussed in section 6.2.

159. Alternatively, the government may offer solvency support to a weak bank to allow it to remain open for business. "Open bank assistance" may take the form of a direct capital injection; loans provided by the government to the bank; or the purchase of troubled assets by asset management companies created expressly for this purpose or other institutions and whose losses are covered by the government.

160. As the provision of solvency support puts taxpayers' money clearly at risk, the decision to do so should always be taken and funded by the government and the legislative body, and not by the central bank. The central bank is often required to advance the funding until legal changes have been made or budgetary appropriations have been approved. Close cooperation and information sharing between the central bank and the government is necessary.

161. The provision of solvency support is not a resolution measure in the sense of providing a lasting solution to the underlying weaknesses of the bank. The disbursement of public monies should be made dependent on the implementation of an action plan, approved by the supervisor, including measures to restore profitability and sound and prudent management. The government should always retain the option of getting its money repaid if the resolution of the bank so allows.

162. If public monies are used, shareholders of the weak bank should be made to bear the cost of the resolution via a dilution or even elimination of their shareholding interests. One principal difficulty of arranging such transactions is the time required to get shareholder approval for a significant reduction of their interests. When shareholders realise that government assistance may be forthcoming, negotiations can be complex and lengthy.

163. By rescuing a troubled bank, the government may find itself as the majority or sole owner, i.e. the bank is in practice nationalised. This should be a *temporary* solution, and the government should actively seek interested buyers in order to divest its holding. In the meantime, the government should operate the bank on market-oriented terms and with professional staff. The government should also make its intentions very clear to other market participants and to the general public.

6.4 Closure of the bank: Depositors pay-off

164. If no investor is willing to step in to rescue the bank, the repayment of depositors and the liquidation of the bank's assets are unavoidable. In countries with a deposit insurance scheme, closure of the bank and depositor pay-off is also the right decision where a depositor pay-off is less costly than other resolution measures. The costs of a depositor pay-off will fall in the first instance on the other banks if the insurance scheme is privately funded or on the government otherwise.

165. The liquidators will proceed with the direct realisation of the assets in order to pay creditors under the rules governing general insolvency proceedings or bank-specific insolvency proceedings, depending on the institutional framework in place. Where depositors are protected by deposit guarantee schemes, the schemes usually acquire creditor status after making payment and participate in the liquidation allotments in place of the depositors.

6.5 Management of impaired assets

166. In all resolution techniques, unless all of the assets of a weak bank are acquired by another institution, there will be a large amount of impaired loans and other bad assets that needs to be managed. This occurs both for open bank assistance as well as resolution techniques that result in a closed bank. Asset recovery should aim to be economic, fair and expeditious, with a view to maximising the recoveries on a net present value basis. Recovery of impaired assets can be done through direct collection (foreclosure of assets of debtors, especially from large debtors) or sales of assets to third parties, or by handling the assets (e.g. through debt work-outs) to prepare them for later sales.

167. Where the portfolio of assets is dismembered and sold individually to different acquirers at different times, a strategy that balances the risks and advantages of holding and managing the assets instead of rapidly selling them should be defined. Adverse economic effects from a strategy of rapid recoveries of non-performing loans should also be considered. The choice also depends on the capability and skills available for active management of the assets.

168. Different methods are available for selling the assets, such as sales *en bloc*, "portfolio" sales, asset-by-asset sales, securitisation or sales to a restructuring agency. The choice of method depends on the quality of the assets, overall economic and financial market conditions, interested domestic and foreign investors, and the available resources.

169. Experience has shown that there are several reasons to separate the handling of the bad assets from the rest of the bank:

- Once removed, the balance sheet is improved, thus making the bank more attractive.
- Bank management can focus on steering the bank through its present problems and on its strategic development rather than having to spend a large part of their scarce time on problem assets.

- Specialists may be hired with the aim of maximising the recovery of the impaired assets, for instance by adapting the assets to make them more attractive for investors**.**

170. The separation of assets can take different forms. They include a division in the bank, a subsidiary, or a separate asset management company, funded and managed by private investors or by the government.

171. Where all non-performing and other sub-quality assets are sold at market values to a separate company specially set up for this purpose, the resolution technique is called a “good bank - bad bank” separation. The asset management company - referred to a “bad bank” - will need to be capitalised by the government or deposit insurer since typically no private investor is available or interested, at least initially, in acquiring the sub-quality assets. The company has the objective of managing the assets to maximize cash inflows. Transparency, expertise, sound management and appropriate incentives are essential for the maximisation of recoveries of this company. The remaining part of the bank is referred to as the “good bank”. Recapitalisation will be needed if no share capital remains. The good bank should now focus on correcting operational weakness and its ongoing banking activities. Alternatively, the good bank can be offered for sale. A “good bank - bad bank” solution should be considered only if there is franchise value in the “good bank”.

6.6 Public disclosure of problems

172. An important issue is whether, and at what point, the bank, the supervisor, central bank or perhaps the government, should comment publicly on problems faced by a weak bank.[31] As a general rule, disclosure should be favoured to the extent legally permissible and required. Both the timing and content of any disclosure are important, bearing in mind that delays in disclosure could results in winners and losers (in particular new depositors) depending on whether they have access to the privileged information. The overriding consideration in the choice of timing and content of the disclosure must be how they contribute to resolving the weak bank, while maintaining overall confidence and systemic stability.

173. If there are already persistent rumours about the bank’s problems, giving publicity to the remedial action being taken by the bank may help maintain or boost confidence in the bank. The bank should be encouraged to declare the situation and the prospects of returning to normal activity ahead of the supervisor’s announcement. If the senior management of the bank are to be dismissed as a result of a supervisory decision, the supervisor should be the first to disseminate the information and set it in the right context. Information, at least the initial set presented by the supervisor, should be succinct and clear, and should contain only the content of the decision taken, a brief description of reasons why and the goals being pursued by the supervisor. Comments such as “depositors have no cause for alarm” or similar may be interpreted as implying endorsement of, or support for, the bank and the supervisor may feel morally obliged to to bail out the bank subsequently.

174. If the problems of the bank are not yet in the public domain, the supervisor should consider whether it is less costly and disruptive to disclose a bank’s problems after remedial

[31] The discussion on public disclosure refers to all weak banks, whether under corrective action (section 5) or under resolution measures (section 6).

actions have started. If the bank's problems are severe, premature disclosure may result in a bank run.

175. In all cases, the bank has to be mindful of any statutory or regulatory obligations to make disclosures. For example, if the bank's shares are listed on the stock exchange, certain disclosures may be required by the listing rules. The supervisor may also have obligations, formal or informal, to keep other parties informed such as other domestic supervisors, and overseas supervisors if the bank has overseas presences.

176. A related issue is whether formal supervisory action taken against the bank should always be disclosed. The same considerations apply. In some countries, all enforcement actions taken are made public in the interest of transparency.

177. In any case, whenever there is a decision on disclosure, it is essential that there is close co-ordination between the bank, the supervisory authority and other interested parties such as the central bank, the deposit insurer and the government. The co-ordination applies to both the timing and content of the disclosures. Experience has shown that when banks and authorities have made inconsistent or discordant disclosures, this has led to confusion and has made the resolution efforts more difficult.

7. Selected institutional issues

7.1 Conglomerate issues

178. Additional factors may apply to a bank that is part of a conglomerate group. This is because events and weaknesses in the wider group, including ownership and organisation structure, could have an adverse impact on the bank, even if the latter is in good health. A particular risk is that the bank's assets or liquidity are used to support weak entities in the group, particularly those that engage in unregulated activities.

179. Conglomerates can comprise exclusively financial entities or be a mix of financial and non-financial firms. More often than not, the situation may be complicated by an international dimension – for example, if the bank is part of a multinational group. The prudential approach to be taken in each case is similar: namely to obtain all relevant information and ring-fence the bank as much as possible from contagion in the group.

7.1.1 Tools available

180. The supervisor can use a combination of the following tools:

- Undertake a *group* assessment. By pooling information from all the group's supervisors, a clearer picture of group-wide risks may emerge, facilitating the identification and resolution of problems. It is helpful to hold regular meetings with the other relevant sector supervisors, even while the group is problem-free. This helps to build trust between the supervisors, making information flows easier when difficulties emerge.
- Obtain *information* from and on other group entities. This is most straightforward where the other entities are financial and their supervisors are prepared to share information. If a group has an important unsupervised entity, supervisors will have to seek information through other routes, e.g. from publicly available data or by applying pressure via the authorised entity.

- Appoint a *coordinator.* Especially in a crisis affecting the whole group, it is important that one supervisor acts as the "lead". This does not mean taking decisions on behalf of all individual supervisors but acting to (i) collate information from the solo supervisors; and (ii) act as a point of contact and liaison for the group on group-wide issues.
- *Ring-fence* the bank. Options here include: limiting exposures to the rest of the group; limiting funding from group entities (in case it is withdrawn at short notice); and imposing more stringent capital and liquidity requirements**.**
- Ensure that *governance* of the bank is relatively *independent* of the wider group. This can be achieved by, for example, insisting that some or all of the bank's directors are independent of the group.

7.1.2 International conglomerates

181. The same issues and basic options apply to international conglomerates. Information sharing on a cross-border basis may present additional cultural or legal difficulties (e.g. data protection). If anything, this makes it all the more important to establish and test a robust framework for pooling information as part of normal supervisory activities. There are many examples of regular dialogue between supervisors cross-border.[32] On occasion, joint inspection visits in the host country can also be valuable.

182. One lesson from resolutions of banks with cross-border operations is that different legal structures in different countries may limit the range of available tools to resolve problems. It is thus important that supervisors of such banks inform themselves in "normal times" of the legal situation and are prepared for a possible future resolution of the bank.

7.2 Cross-border issues

183. There are four permutations: A foreign bank having a (i) subsidiary or (ii) a branch in a host country, or a home country bank having a (iii) subsidiary or (iv) branch in a foreign country. The different structures call for different supervisory roles and responses.

184. A *subsidiary of a foreign bank* is legally incorporated in the host country and is subject to the same supervisory and regulatory measures as a domestic bank. However, the fact that it is part of a foreign bank group leads to some additional complexities, but also to additional channels for information and may increase the scope of remedial action. The main risks are that the subsidiary is affected not only by events in the host country, but also in the home country of its parent. It is important that the host country supervisor keeps abreast of such developments, for example, by requesting information from the home country supervisors. In the event of a problem in the subsidiary, the host supervisor should, at an early stage and if possible before action is taken, inform and consult with the home authorities about planned supervisory decisions.

185. In the event of significant problems in the parent bank, or elsewhere in the group, the host country supervisor may, insofar as the legislation permits, try to protect the subsidiary by ring-fencing. This may entail limiting the subsidiary's exposures to the other parts of the banking group, stopping the parent bank from booking exposures in the subsidiary, or closing the bank if it does not meet authorisation requirements.

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[32] One example is the bilateral meetings between EU banking regulators.

186. Efforts to ring-fence the subsidiary will be made more difficult if large parts of the subsidiary's operations are outsourced to the home country.

187. A *branch of a foreign bank* is not legally incorporated in the host country and the home country supervisory authority bears responsibility for its solvency. Nonetheless, the host supervisor may apply similar corrective measures as for a subsidiary recognising that ring-fencing would not be as effective as in the case of subsidiaries. The supervisor may also wish to require the branch to maintain certain assets to meet their obligations. Ultimately, the host country supervisor has the power, both for a subsidiary and branch, to revoke the banking license or to require the home authorities to close the branch. This could be applied when the bank violates prudential rules or limits or when other conditions for the bank are not upheld, such as if the parent bank refuses access to vital information.

188. Home country *banks' subsidiaries as well as branches abroad* should be treated equally (as the inverse) in the corresponding situations mentioned above. It is important for the home country supervisor to:

- get a clear view of the legal and financial situation in the host country, including of the competence of its supervisory authority;
- obtain agreements with the host authorities on information sharing, particularly in a crisis;
- ensure that the parent bank has full information of the risks and also full understanding and control of the activities of the foreign entity;
- have access to all relevant information on the entity abroad, through the entity itself, its parent, the foreign supervisor and onsite examinations.

189. Cross-border issues also arise when a domestic bank is controlled by a very large foreign shareholder. The bank can become weakened if the controller suffers reputational damage. To some extent, similar actions to those above and also as described in 7.1 may be applied, such as intensified information sharing with the "host country" (of the controller) authorities.

7.3 Public sector banks

190. The Basel Core Principles state that, in principle, all banks should be subject to the same operational and supervisory standards, regardless of their ownership. In practice, and for historical, institutional and ideological reasons, many countries have a legacy of very large public sector banks. Many of these banks do not operate on market terms; instead they are used as quasi-public institutions to provide special services to the public and to the economy at large. Examples of non-commercial factors include:

- offering loans to specific sectors at the behest of the government without requiring that the customer meet normal credit underwriting criteria or pricing the loan at a level that is not commensurate with the level of inherent risk;
- granting credits to public enterprises based on public guarantees rather than on prudent credit underwriting and credit risk assessment practices;
- performing various "social services" not normally conducted by banks;
- subsidising certain banking services and products.

191. A further problem arises from the frequent misapplication of the fit and proper test when hiring directors and management at public sector banks. Often officials are retained

who do not have sufficient experience in managing and operating commercial, for-profit banks. Finally, when compared with privately-owned banks, there is a greater reluctance by employees and the public at large for the restructuring of operations and staff reductions.

192. Against this background it is not surprising that in many countries there are large, even dominant, public sector banks with significant financial and operational weaknesses. In some cases these weaknesses are not immediately evident from the bank's financial statements. For example, delinquent loan payments "covered" by guarantees from the government or other public bodies may not be classified and provisioned, even though in reality it is unlikely that the bank will be able to collect the amounts due from the guarantor.

193. The effects of the practices mentioned above include: high levels of non-performing loans and resulting low levels of interest income; inadequate provisioning; high administrative and operational costs; and ultimately a declining capital base. Liquidity problems are normally averted because of special access to public facilities, such as the central bank's discount window or other arrangements. [33]

194. Treating weak public sector banks in many cases requires an approach different from that used when dealing with private banks. This is not to say, however, that the treatment should be less stringent. For public sector banks, as for all other banks, the aim is to restore the bank to financial strength and profitability. If this is not possible, the bank should be sold or closed and the assets liquidated. It is imperative that, when treating public sector banks, the various non-market oriented diversions and interferences are terminated. If these functions are still needed, e.g. financial services to people in remote places, the authorities should consider a more cost-efficient and streamlined method of providing them. Moreover, the costs associated with the services or products should be financed out of explicit government budget appropriations and when possible, through other and less resource consuming channels.

195. Complicating the successful implementation of the resolution strategy in many public sector banks is their sheer size. It may be impossible in practice to find willing and sufficiently strong partners who are able to absorb a large public sector bank in a merger or acquisition. Some countries have solved this problem by splitting the bank into several smaller entities and dealing with each one separately. It should be noted, that such an approach can also be used effectively when resolving large non-public sector banks.

196. To be effective, corrective measures and resolution strategies for public sector banks must address the financial and political issues simultaneously. Strategies addressing the financial issues must treat the bank like any other commercial entity. Strategies focusing on political issues require actions to free the bank from its non-commercial operations and influences. As a consequence, implementing and carrying out corrective measures and resolution strategies for public sector banks will typically require more time; in the meantime, the government is likely to be called upon to provide additional capital.

197. In summary, for competitive reasons and in order to maintain credibility in the financial sector, it is imperative that the supervision and the resolution of weak public sector banks be carried out in a manner that is not more favourable than that applied to private banks.

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[33] In the EU, special access for public banks to public facilities, and in particular, to the financial resources of the central bank is expressly forbidden, in accordance with article 101 of the EC Treaty.

8. Conclusions

198. This report has tried to draw some lessons from recent experience on how to deal with weak banks. All supervisors will have to face this problem in some form. Although each occasion is different, there are important, common strands. The main ones are summarised below:

(i) Supervisors should be prepared. In a crisis, time is short and problems have to be faced immediately - often several at once. Delay makes things worse and the solution more costly. It helps considerably if supervisors understand the issues and the options for handling weak banks and also who they can talk to in other organisations and countries.

(ii) To deal effectively with weak banks, supervisors need clear objectives and a clear, operating framework. The Basel Core Principles for Effective Banking Supervision provide this; and the growing adoption of these standards since 1997 lessens the risk of supervisory action being undermined by legal and accounting gaps and political interference.

(iii) Prevention is normally better than cure. Supervisors should use new as well as existing tools to 'know' their banks. This is not always easy, given resource and time constraints; but a combination of financial reporting and monitoring, on-site inspection and regular liaison with auditors and bank management already provide a good basis, in many cases, for detecting problems early. If so, these can often be remedied before a bank's solvency is threatened.

(iv) Supervisors need to be discriminating. They have to distinguish between the symptoms and the underlying causes of weakness, which will influence their choice of corrective action. They have to allow for the 'special' factors of state-banks and international conglomerates, but this does not imply forbearance or lenient treatment. They have to be proportionate and flexible in their use of tools, judging when a remedial programme is more appropriate than penalties and when (and when not) to publicise restrictions.

(v) Banks can and do fail, and there should be public awareness of this. Public bailouts are a last resort. Liquidation is often the right solution, particularly where deposit insurance is well established. Before then, there are a number of now well-tried resolutions and exit techniques which can suit certain circumstances to minimise the disruption to the financial system and resolution costs.

(vi) In an increasingly interdependent world, close international co-operation among supervisors in this area is a necessity. Weak bank problems, especially big ones, spill over national boundaries very quickly. This report contributes, in a practical way, to the goal of co-operation.

Annex 1

Membership of the Task Force on Dealing with Weak Banks

Chairman: Mr Göran Lind	Sveriges Riksbank Basel Committee on Banking Supervision
Wayne Byres	Australian Prudential Regulation Authority
Cornelio Farias Pimentel	Banco Central do Brasil
Petr Jirícek	Czech National Bank
Hans-Joachim Dohr	Federal Banking Supervisory Office, Germany
Werner Gehring	Deutsche Bundesbank
Simon Topping	Hong Kong Monetary Authority
M R Srinivasan	Reserve Bank of India
Giuseppe Boccuzzi Alessandra De Aldisio	Banca d'Italia
Arjen Geerling Roel Theissen	De Nederlandsche Bank
Alexey Simanovskiy	Central Bank of the Russian Federation
Fahd Al-Mufarrij	Saudi Arabian Monetary Agency
Foo-Yap Siew Hong Teo Lay Har	Monetary Authority of Singapore
Christo Wiese	South African Reserve Bank
Per Mattsson	Sveriges Riksbank
Glenn Hoggarth	Bank of England
Michael Ainley Toby Fiennes	Financial Services Authority, UK
John Lane Vanessa Villalba	Federal Deposit Insurance Corporation, USA
Nestor Lopez Ramela	Banco Central del Uruguay
Massimo Marchesi	European Commission
Jason George	Financial Stability Institute, BIS
David Hoelscher Michael Andrews Olivier Frecáut	International Monetary Fund
Ernesto Aguirre Jose de Luna	World Bank
Andrew Khoo	Secretariat Member, Basel Committee on Banking Supervision

Annex 2

Dealing with Weak Banks – Mandate

The following mandate was approved by the Basel Committee in July 2001:

“The prime aim of the Task Force is to provide guidance for dealing with weak banks, including preventive measures, early identification, remedial actions, resolution issues and exit strategies. The guidance could take the form of identifying and agreeing on good practices, primarily those that already have been used in actual situations. The work, and the guidance, of the Task Force will not focus on any specific category of countries or banking systems.

The Task Force shall focus on problems and resolutions pertaining to individual banks. Issues and methods aiming to restore overall financial stability, e.g. Emergency Liquidity Assistance and government solvency support to banks, will only be mentioned indirectly and to the extent they refer to the specific situation of the individual bank.

The same applies to issues pertaining to the legal aspects of insolvency and liquidation of banks. Work on these issues is currently underway in the World Bank and IMF jointly and will not be duplicated by the Task Force.

The Task Force will present a progress report to the September 2001 meeting of the Financial Stability Forum (FSF), outlining the content and process of the work. The aim is to present a final report to the year 2002 spring meeting of the FSF. However, should the scope of the project prove to require further deliberations, an interim report will be presented at the Spring meeting and a final report at the Autumn meeting of the FSF.

Since the FSF has delegated the execution of the work to the Basel Committee on Banking Supervision and to the Core Principles Liaison Group, these fora will be given the opportunity to comment on and to endorse the Task Force report before it is sent to the FSF.”

Annex 3

Reference List

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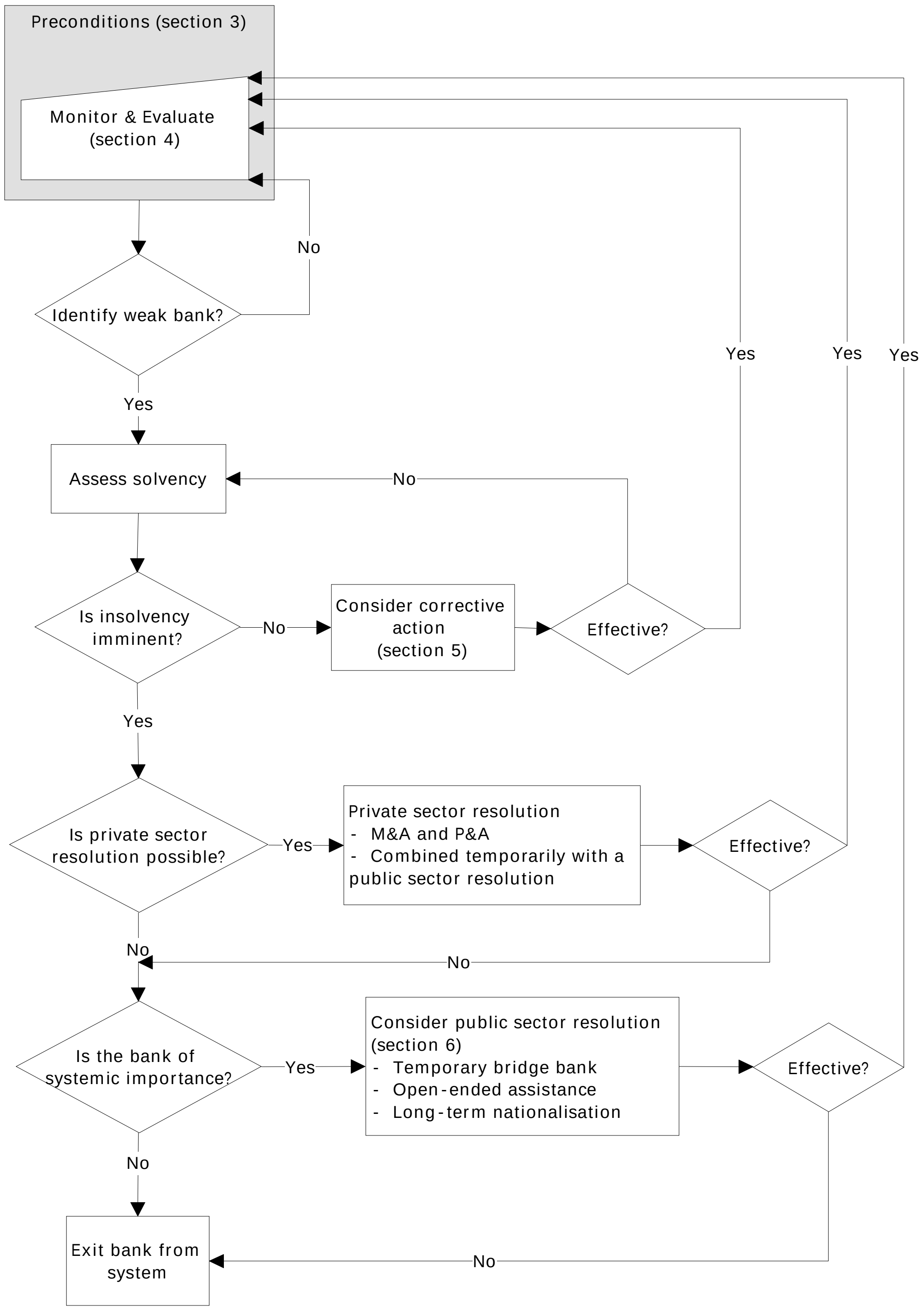
Annex 4

Flow Chart to Assist Resolution of Weak Banks

Focus on solvency and systemic issues



Annex 5

Glossary

This Glossary contains a definition of terms as used in this Report. In different countries, the same term may have a slightly different meaning, or different terms may be used to describe the same matter.

Glossary Item	Location in Text
Asset management company - A special purpose company set up by a government, a bank, or by private investors to acquire loans and other assets, a majority of which are usually impaired, for subsequent management (including restructuring) and in many cases, sale to investors.	6.5
Administrator - A person or entity, including a government agency, appointed by the court or relevant authority, to operate a weak bank in an effort to conserve, manage and protect the bank's assets until the bank has stabilised or has been closed. Also called "Conservator" in some jurisdictions.	5.22, **5.24**, **6.21**, 6.22
Bridge bank - A resolution technique that allows a weak bank to continue its operations until a permanent solution can be found. The weak bank is closed by the chartering authority and placed under liquidation. A new bank, referred to as a bridge bank, is chartered and controlled by the liquidator according to statutory or legislative provisions. It is designed to "bridge" the gap between the failure of a bank and the time when the liquidator can evaluate and market the bank in such a manner that allows for a satisfactory acquisition by a third party.	6.2.4
Cease and desist order - A written directive - usually legally enforceable - issued by a supervisor to a bank and its management that requires the former to stop engaging in specified unsafe or unsound practices or violations of law and regulations.	5.2.4
Conservator - see Administrator.	5.2.2
Contagion - The risk that adverse events affecting one bank are quickly transmitted to other banks, e.g. bank runs.	4.2.3, 5.2.6
Contingency plan - A plan, developed by the supervisory authority that describes what it has to do in order to deal with a variety of weak bank problems. Among other things, the plan should outline the options available to the supervisor and parties that should be informed.	**4.4**, 5.2.1, 5.2.2
Core Principles on Effective Banking Supervision - A set of 25 principles set out by the Basel Committee on Banking Supervision that represent minimum requirements for an effective supervisory regime.	1.2, **3**, 4.3.1, 4.3.2, 5.2.3, 5.2.4, 5.2.7, 6.2.2, 7.3, 8
Corrective Action - Action required to deal with deficiencies and change behaviour in a weak bank. They can be implemented voluntarily by the	1.1, 1.3, 2.1, 2.3, **5**, 6.2.1,

bank under the supervisor's informal oversight or, if necessary, via formal supervisory intervention.	7.2, 7.3
Depositor pay-off - An exit strategy whereby a bank is closed and the liquidators pays creditors, including depositors, under insolvency laws applicable to banks from the proceeds of the liquidation of assets. Where there is deposit insurance, the deposit insurer pays all of the failed bank's depositors the full amount of the insured portion of their deposits. The deposit insurer then participates in the liquidation allotments as a creditor (the insured depositors having exchanged their claim against the receivership estate for payments under the deposit insurance protection scheme) together with depositors with uninsured funds and other general creditors.	6.4
Early warning system - Empirical based models that attempt to estimate the likelihood of failure or financial distress of the bank over a fixed time horizon, based on the bank's current risk profile.	4.1.2
Emergency Liquidity Assistance – See Lender of last resort.	5.3.5
Exit – The closure of a failed bank followed by its liquidation and the involvement of deposit insurance agency where applicable.	6
Fit and proper - The evaluation of the competence, integrity and qualifications of major shareholders, directors, and management officials in order to assess their banking skills, other business experience, personal integrity, other relevant skills, and ultimately to determine their suitability for office.	5.3.3, 6.2.2, 7.3
Good bank - bad bank separation. Resolution technique where all non-performing and other sub-quality assets of a weak bank are sold at market values to a separate company specially set up for this purpose. The company - referred to the "bad bank" - will need to be capitalised by the government or deposit insurer, and has the objective of managing the assets to maximize cash inflows. The remaining part of the bank is referred to as the "good bank". Recapitalisation will be needed if no share capital remains. The good bank should now focus on correcting operational weakness and its ongoing banking activities. Alternatively, the good bank can be offered for sale.	6.2.3, **6.5**
Lender of Last Resort - The central bank's role as a lender to whom banks may ask for liquidity when other sources are unavailable at or near usual terms and conditions. At its discretion, the central bank can lend either to individual institutions or to the market as a whole. In order to minimise moral hazard, the central bank will maintain ambiguity as to the exact circumstances when such lending would be made. Such lending is sometimes referred to as emergency liquidity assistance.	2.2.1, 3
Liquidation - The winding-up of the business affairs and operations of a failed bank through the orderly disposition of its assets after it has been placed in receivership. The petition to wind-up a bank may be presented by a creditor, the bank itself or the supervisor of the bank.	3, 6.1, 6.2.4, **6.4**
Liquidator - A person or entity, including a government agency, appointed by the court or relevant authority to liquidate the assets and pay off	6.2.3, 6.2.4, 6.4

creditors of a failed bank.	
Moral hazard Behaviour – Behaviour where an individual does not have to bear all the costs associated with his or her actions. For example, people may take excessive risks in order to obtain higher returns, in the confidence that they are assured government support.	2.2, 5.3.5, 6.2.3
Open bank assistance - A resolution method in which a bank in danger of failing receives government financial assistance in the form of a direct loan, capital injection, guarantee or a purchase of troubled assets by assets management companies whose losses are covered by the government. The bank continues to offer all of its normal banking services. Open bank assistance does not provide a lasting solution to the weaknesses of the bank and should be linked to the implementation of other measures.	6.3
Public sector bank - A bank that is controlled, directly or indirectly, by the government, including banks that provide special or social services at the direction of the government.	7.3
Purchase and assumption (P&A) - A P&A is a resolution transaction where a healthy institution or private investor(s) purchases some or all of the assets and assumes some or all of the liabilities of a failed bank.	6.2.3
Resolution - The plan to resolve a bank when failure is imminent and will typically involve some change to the legal structure and ownership of the bank. The art of resolving bank problems entails achieving a legal closure of the bank while avoiding economic closure.	1.1-1.3, 2.1, 2.2, 2.2.1, 3, 5.2.4, 5.2.6, **6**, 7.1.1, 7.1.2
Revocation of Licence - The cancellation of a banking licence by the chartering authority, and hence the requirement to cease all banking business.	5.2.6
Ring-fencing - The supervisory process of protecting the assets or liquidity of a foreign branch or subsidiary by limiting its exposures or liabilities to the parent bank and banking group. In the context of a conglomerate, the term is used to describe the process of protecting a bank from adverse impact of events occurring in the wider corporate group, especially those engaging in unsupervised activities.	7.1 7.2
Risk-focused supervision - Supervision based on an assessment of risks. The supervisor assesses the various business areas of the bank and the associated quality of management and internal controls to identify the areas of greatest risk and concern. The intensity of supervision is directed most at these areas.	4.2.2
Sale and payment prohibition – The supervisor or some other authority vested with this power may order a bank to freeze payments and asset sales in order to stop outflows from the bank. This could be done, e.g. to gain time for finding a suitable resolution.	5.2.4
Sanctions - The penalty for a breach of a rule, a law or a supervisory order, or for engaging in unsound practices. Sanctions can be ordered by the supervisor or where appropriate a court of law. This could be a fine or in some countries, criminal charges. The penalty can be directed toward	4.2.3, 5.2.5

the bank itself or toward an individual.

Securitisation of assets - This involves the legal or economic transfer of assets or obligations to a third party that issues asset-backed securities (ABS) that are claims against specific asset pools.	2.3, 4.4, 5.3.1, 6.5
Supervisory rating system - A rating system used by supervisors, the purpose of which is to reflect in a comprehensive fashion a bank's financial condition, compliance with laws and regulations and overall operating soundness. As such, the system helps to identify those banks whose financial, operating or compliance weaknesses require special supervisory attention and/or warrant a higher than normal degree of supervisory concern. Many countries use variations of a CAMEL supervisory rating system (<u>C</u>apital adequacy, <u>A</u>sset quality, <u>M</u>anagement quality, <u>E</u>arnings quality and <u>L</u>iquidity).	4.2.1
Surveillance - Monitoring by the supervisory authority of the financial condition of individual banks and general condition of financial markets as a whole.	4.2.3
Systemic situations - One with serious adverse effects on the general health or structure of the financial system and financial stability. For example, the failure of a major bank might cause a substantial number of other banks to fail, leading to a loss in confidence in the safety and soundness of a significant sector of the banking system and the disruption of payment services.	2.2.1, 5.2.7, 6.3
Timely corrective action – Speedy action by the supervisor to deal with bank problems so as to prevent the problems from growing and becoming more difficult and costly to handle. Some countries have formal legal framework which require the supervisor to take a certain prescribed course of action in the event of certain defined weakness or violations.	5.2.3
Weak bank - One whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management.	1.1-1.3, **2.1**-2.3, 3, 4.2.1, 4.3.4, 4.4, 5.1, 5.2.2, 5.2.3, 5.2.5, 5.2.7, 5.3, 5.3.3, 6.1, 6.2.1-6.2.4, 6.3, 6.5, 6.6, 8