INTERNATIONAL MONETARY FUND
AND THE WORLD BANK

An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency

Prepared by the Staffs of the International Monetary Fund and the World Bank

For the IMF, approved by Sean Hagan and Christopher Towe

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Preface

This study provides an overview of the legal, institutional, and regulatory framework that countries should put in place to address cases of bank insolvency. It is primarily intended to inform the work of the staffs of the International Monetary Fund (IMF) and World Bank, and to provide guidance to their member countries.

The study is part of a broader work agenda of IMF and World Bank staff on issues of financial sector stability. Several projects are currently underway in the IMF that will address issues that are not covered by the present study, including an examination of the legal and regulatory questions that arise in the insolvency of non-bank financial institutions, the treatment of complex financial instruments in insolvency proceedings, and the legal framework for information sharing among domestic financial sector supervisors, and supervisory oversight and intervention in a cross-border context. IMF staff are also preparing papers for the IMF's Executive Board on the causes of the current financial crisis and the lessons which it holds for macroeconomic policy and regulation.

The World Bank works with international standard setting bodies and its client countries to strengthen the legal, regulatory, and supervisory frameworks for the financial sector. The World Bank supports financial sector development and stability through a variety of grant and lending instruments, bilateral technical assistance, and instruments such as the joint IMF/World Bank Financial Sector Assessment Program and Standards and Codes Initiatives.

IMF and World Bank staff acknowledge the important work being done by other international bodies on issues of financial sector stability—for example, the study currently underway in the Basel Committee on Banking Supervision on issues of cross-border bank resolution. IMF and World Bank staff will seek to ensure that their work is complementary to these other initiatives and will work closely with their colleagues in these other bodies for this purpose.

Executive Summary and Key Recommendations

This study discusses the principal features of the legal, institutional, and regulatory framework that a country may put in place in order to deal effectively with cases of bank insolvency in its own jurisdiction.

The study deals exclusively with the legal, institutional, and regulatory frameworks for insolvent banks—that is, deposit-taking institutions; other types of financial institutions are not covered. Moreover, it addresses the regime at the domestic level; issues of cross-border bank insolvency fall outside the scope of the study.

The study is divided into two parts.

- Part I discusses the legal, institutional, and regulatory framework that a country should put in place to deal with bank insolvency in periods of financial stability. It is based on the report of the "Global Bank Insolvency Initiative"—a joint initiative of the staffs of the International Monetary Fund (IMF) and World Bank that was launched in 2002 in coordination with other bodies and benefited from a broad consultative process conducted with supervisory authorities, international financial institutions, and leading experts.

- Part II discusses the legal, institutional, and regulatory framework that a country should put in place to deal with bank insolvency in periods of systemic crisis. It is an expanded and updated version of the relevant chapter of the report of the Global Bank Insolvency Initiative. It has been prepared by IMF staff and represents the views of IMF staff. Recognizing that practices in this area are still evolving, Part II is meant to stimulate discussion.

Part I. The Framework in Times of Financial Stability

Bank insolvency proceedings and their purpose. The primary objective of the bank insolvency framework is to safeguard the stability of the financial system. In the context of bank insolvency, the term "insolvency proceedings" refers to all types of official action involving the removal of management and/or the imposition of limits on, or suspension of, the rights of shareholders and the assumption of direct control by a banking authority or other officially-appointed person over a bank that has crossed a "threshold" for the commencement of insolvency proceedings. A country's legal framework will often distinguish between two types of bank insolvency proceedings, although they may be combined in a single proceeding:

- ***Official administration.*** In this form of insolvency proceedings, an official authority (either the banking authority, court-appointed administrator, or administrator appointed by a banking authority) assumes direct managerial control of a bank with a view to protecting its assets, assessing its true financial condition and, either conducting all the necessary restructuring operations, or placing the bank in liquidation.

- ***Liquidation proceedings.*** In contrast, the purpose of liquidation proceedings is the value maximizing realization of assets, and the orderly and equitable distribution of proceeds to creditors. Liquidation results in the dissolution of the bank as a separate legal entity.

A. Key Institutional and Legal Issues In Establishing A Bank Insolvency Regime

The powers and responsibilities of all agencies involved in bank insolvency need to be clearly and comprehensively specified in the law. Several important institutional questions need to be addressed.

- ***Choice of bank insolvency regime.*** Some countries apply their corporate insolvency framework, with appropriate modifications for banks, while other countries put in place a special legal regime for cases of bank insolvency. In recent years, there has been a trend towards the establishment of a special regime. While corporate insolvency proceedings invariably take place in the courts, insolvency proceedings under a special regime for banks may be either court-based or administrative in nature.

- ***Authority to commence proceedings.*** The banking authorities are almost universally empowered to initiate bank insolvency proceedings and, in many jurisdictions, are given exclusive competence to do so. Where other parties are allowed to commence insolvency proceedings, the banking authorities should be entitled to participate in all stages of the proceedings.

- ***Threshold for commencement of insolvency proceedings.*** Legislation needs to specify the "threshold" that must be crossed before insolvency proceedings may be commenced. To allow the banking authorities to take control of a bank at a sufficiently early stage of its difficulties, the framework should establish a "regulatory threshold" that permits the commencement of insolvency proceedings, for example, when a bank's net financial position has fallen below a specified level, even though it may still have a positive net worth. The crossing of the regulatory threshold should permit the authorities to initiate official administration. In some countries, it may justify the commencement of liquidation proceedings.

- ***Accountability and judicial review.*** For insolvency proceedings that are administrative in nature, judicial review should be provided for. Judicial review should be conducted expeditiously and should only seek to determine whether the banking authorities have acted legally and should not allow the court to reassess their exercise of discretion unless there is clear evidence of a manifest error of fact or an abuse or misuse of power. The legal framework should be clear as to the available remedies.

- ***Actions for damages against the banking authorities and their staff.*** Many jurisdictions have expressly limited liability that may be incurred by the banking authorities to cases involving gross negligence or bad faith. With respect to Board members, staff and other officers or agents of the banking authorities, the legal framework should grant express statutory protection from civil liability, and indemnification for legal expenses, for actions and omissions that they have taken in good faith in the discharge of their responsibilities.

B. Official Administration of Banks

Official administration normally comprises two phases: (i) diagnosis; and (ii) restructuring/liquidation. During the diagnostic phase, the official administrator conducts due diligence, and assesses the prospects for restoring the bank's business as a going concern. In the restructuring phase, attempts may be undertaken to salvage the banking business, through a variety of financial and operational measures. Those parts of the bank's business (if any) that are not viable may be subject to liquidation proceedings.

The legal framework should incorporate a number of important elements that are specified in detail in the study. The most important of these are set out below.

- ***Appointment, replacement and discharge of the official administrator.*** The law should specify clearly who may appoint, replace and discharge the official administrator, and should establish "fit and proper criteria." Only the appointing authority should be entitled to dismiss the official administrator, and on limited grounds such as gross negligence.

- ***Mandatory vs. discretionary system***. The legal framework must specify whether crossing a relevant "threshold" requires or permits the commencement of official administration.

- ***Transfer of control.*** The law should specify the moment and scope of the transfer of control from owners and managers to the official administrator, and should allow for no "interregnum" providing opportunities for the dissipation of the bank's assets.

- ***Protection of assets, and operation of the bank's business***. The official administrator should be explicitly authorized to take steps to continue the bank's operations to the extent necessary to maintain the value of the bank. The official administrator should have the power to apply to court for the avoidance of certain contracts including those which resulted in preferential treatment to some creditors.

- ***Moratorium.*** A moratorium will, at best, be effective for a very short period and, in some cases, may prove to be counterproductive. Accordingly, the legal framework should not provide for the automatic imposition of a moratorium upon the commencement of official administration but should permit the declaration of a moratorium on a discretionary basis.

- ***Licensing implications.*** The legal framework should specify whether the banking authorities are permitted to revoke a bank's license upon the commencement of official administration. It may also permit the license to be suspended or the decision on its revocation deferred as necessary.

- ***Confidentiality, transparency and accountability.*** While public disclosure of certain measures may be necessary, the authorities should retain sufficient flexibility to take decisions without advance disclosure in some cases. Full disclosure of the official administrator's reports should be implemented after the official administration is concluded.

- ***Termination of official administration.*** The powers of the official administrator should cease only after the necessary restructuring operations have been performed, the bank has been restored to health as a going concern or the bank (or its remainder) has been transferred to the liquidator. The official administrator should prepare a final report, and should then be discharged.

C. Bank Restructuring

Various methods can be used for the purpose of restructuring a bank in the context of insolvency proceedings. These techniques may be carried out in official administration and, in some cases, in liquidation proceedings. The discussion set out below assumes they are conducted in the context of official administration.

The legal framework should clearly address the following.

- ***Bank restructuring techniques.*** The official administrator should be authorized to use a wide variety of restructuring techniques separately or in combination, and to decide on and implement far-reaching corporate actions of the type that would normally require shareholder approval (subject in some cases to the approval of the court or the banking authorities).

- ***Negotiations with prospective investors.*** Subject to supervisory approval, the official administrator should generally be able to call for, receive and assess bids from prospective acquirers of the bank (either in its entirety or in parts), to negotiate the conditions of sale, and recognize valuations of assets at market value, even if this is lower than book value.

- ***Transfer of assets and liabilities.*** The official administrator must be authorized to sell any assets or arrange for the assumption of liabilities, on a piecemeal basis or as a pool, from the bank to interested parties. Explicit statutory provision should be made that no prior consent from creditors or counterparties would be required for the official administrator to transfer liabilities of the bank (e.g., deposits).

- ***Supervisory approval of the restructuring arrangements.*** The banking authorities must be able to approve new major shareholders and senior managers on fit and proper grounds, and examine the terms of restructuring transactions to ensure that prudential standards will be met. With respect to a foreign acquirer, the supervisor will need to consult with its counterpart in the acquirer's country.

- ***Use of the bank's proprietary information.*** The official administrator should be permitted to disclose information on the bank's operations and/or its assets to potential investors for the purposes of due diligence assessments. Confidentiality agreements may be employed.

The study discusses in detail the issues to be addressed in several types of transactions—that is, mergers, purchase-and-assumption transactions, "good-bank/bad bank" separation and bridge banks, and publicly-assisted bank restructuring.

D. Bank Liquidation

The legal framework for bank liquidation needs to address a number of questions that are discussed in detail in the study. The most important are the following.

- ***Appointment of liquidator.*** The law should specify who has the authority to appoint the liquidator. Upon appointment, the liquidator should immediately be given full control of the bank's assets, become its sole legal representative, and succeed to all governance rights and powers of its shareholders and management.

- ***Powers of liquidator.*** The liquidator should enjoy all legal powers necessary to preserve assets and protect the value of the bank's estate, and to engage in commercial transactions in the name of the estate. The liquidator must be able to enter into contracts to employ various professionals, to advance funds to protect collateral supporting the bank's assets, and to maintain deposit accounts and to make prudent investments.

- ***Supervision and oversight.*** The liquidator should not be required to obtain permission for every liquidation-related action. The appointing authority should be able to give directions on the general conduct of the liquidation and the general plan of the liquidation. The law may specify that some financially important decisions require the appointing authority's prior approval.

- ***Transparency and accountability.*** The liquidation process must be characterized by a high degree of transparency, and should be subject to reviews to ensure proper accounting, and periodic reporting.

- ***Moratorium***. The placement of the bank in liquidation should lead to an automatic moratorium or suspension of all collection activity against the bank. This should include a stay on all current legal actions against the bank together with a bar on the filing of new actions, except with the permission of the appointing authority. Where there is no deposit insurance scheme, the law may enable the liquidator, where possible, to make immediate distributions to depositors of up to a specified amount against the bank's deposit liabilities.

- ***Treatment of payment orders and financial contracts.*** The legal framework will need to address the moratorium's implications for a failed bank's uncompleted transactions in the payment and securities settlement systems, and for the treatment of netting, set off, novation and/or close-out arrangements set out in financial contracts.

- ***Avoidance of transactions.*** The legal framework should authorize the liquidator to terminate executory contracts in which the parties have not yet fully performed their obligations if this will increase the value of the estate. Subject to the need for payment system finality, the liquidator should also be authorized to apply to court for the avoidance or rescission of certain transactions or transfers made by the bank that are deemed to be unfair and prejudicial to creditors.

- ***Management and realization of assets.*** The liquidator should be authorized to manage the bank's assets, and to restructure loans, negotiate settlements or compromise claims and, more generally, to realize the assets of the estate in the manner that appears most advantageous in the circumstances. The law should permit the transfer of contractual relationships without the consent of the counterparty.

- ***Liability of bank officers.*** The liquidator will need to investigate the potential liability of the bank's ownership and former directors and managers for wrongful conduct. Where liability for civil wrongdoing can be established, the liquidator should be authorized, as part of the collection efforts, to bring civil actions.

- ***Distribution to creditors and depositor pay-off.*** The liquidator should invite creditors to file their claims against the bank within a specified period. In jurisdictions where a deposit insurance scheme is in existence, a parallel process of notices, filings and payments to insured depositors will normally be necessary. The legal framework should provide for the deposit insurance agency's subrogation to the rights of the depositors against the bank to the extent that payments have been made under the scheme.

- ***Distribution of proceeds.*** For the distribution of the proceeds of liquidation and the payout of creditors, the law will need to specify the order of priority to be followed. The classes of creditors that generally must be ranked are discussed in the study.

- ***Termination of the liquidation***. Upon completion of the final distribution and the preparation of the final accounts and report by the liquidator, the liquidation ends and (subject to the fulfillment of any applicable formalities) the legal personality of the bank is dissolved.

Part II. Key Features of the Framework for Systemic Crises

The legal, institutional and policy framework needed to address cases of bank insolvency during periods of systemic instability or systemic crisis is, in many ways, qualitatively different from the framework for periods of financial stability. As it is not possible to predict when systemic instability may occur, the framework for systemic crises will generally draw on the framework in place during stable periods. It must include a flexible policy response that aims at protecting the payment system, limiting the loss of depositor and creditor confidence, and restoring solvency, liquidity and stability to the banking system. While the current financial market turmoil is still unfolding, and the outcome of crisis response measures remains to be seen, many lessons can be drawn from previous systemic crises. This study explores relevant issues while recognizing that practices in this area are evolving.

A systemic banking crisis is typically characterized by financial sector distress of such a magnitude that it has an adverse effect on the real economy as a whole, and will usually include at least some of the following elements: (i) severe financial problems in a large part of the banking system; (ii) a system-wide loss in bank asset quality; (iii) widespread loss of credit discipline; and (iv) a danger of collapse of the payment and settlement systems. The banking authorities will often have to identify systemic risks quickly and, in most instances, with limited information.

A. General Considerations

Strategies to manage systemic crises typically include three phases that are interconnected and may run concurrently.

- ***Crisis containment***. The first and most urgent phase entails stabilizing creditor expectations, through a combination of liquidity provision and other measures, and halting creditor runs, including depositor runs.

- ***Restructuring***. The second phase seeks the resolution of banks in financial distress and their restoration to financial soundness and profitability or their liquidation.

- ***Asset management***. The third phase of the strategy, which has a medium-term time horizon, focuses on the restructuring of nonperforming assets.

A strong legal, institutional, and regulatory framework governing the resolution of individual cases of bank insolvency in normal times can help resolve bank insolvencies in a systemic crisis.

B. Institutional Arrangements for Systemic Crisis Management

A critical feature of a successful crisis management framework is a clear mechanism to ensure effective policy development and coordination. Although not universal practice, some countries have formed a high-level policy group, headed by a high-ranking government official. The following institutional questions should be considered.

- ***Crisis containment.*** The authorities will need to make the most urgent policy and budgetary decisions in relation to the containment of the crisis.

- ***Restructuring.*** Some authority must be responsible for diagnosing individual banks, reviewing their restructuring plans and ensuring their implementation, and requiring their modification where necessary. A choice must be made between relying on the existing banking authorities or establishing a new agency to oversee bank restructuring. A separate agency has a number of benefits, including the avoidance of the appearance of conflict of interest, and the concentration of needed skills in a single agency.

- ***Asset management.*** The principal role in the management of impaired (bad or doubtful) assets of the banking system, is often played by financial institutions other than banks (e.g., asset management companies or "AMCs") that may be either private or public sector institutions. AMCs can have mandates, in particular, to liquidate banking assets from closed institutions, or to conduct asset management in the context of broad restructuring activities. Where an AMC is established, it should be subject to adequate oversight that ensures adherence to principles of good governance.

C. Regulatory and Legal Arrangements for Systemic Crisis Management

The legal and policy measures to be employed will vary with each phase of the crisis.

Crisis containment. Four sets of measures have particularly been employed by countries to contain creditor runs: (i) emergency liquidity assistance; (ii) blanket guarantees; (iii) certain types of administrative measures; and (iv) exchange controls.

- ***Emergency liquidity assistance.*** The conditions for providing emergency lending by central banks differ in periods of financial stability and in a systemic crisis. Country practice in this area is evolving. Central banks are expanding the scope of emergency assistance while specifying appropriate safeguards.

- ***Blanket guarantees.*** Some authorities have resorted to a blanket guarantee of all bank liabilities (except to related parties) to calm market fears. The precise form has ranged from implicit guarantees or declarations of policy intentions to a formal guarantee set out in legislation. The essential feature of a successful blanket guarantee is its credibility. Determining when a guarantee is warranted is a difficult policy judgment, and presents several risks to financial stability over the medium term.

- ***Administrative measures***. Administrative measures or "deposit freezes" may take a variety of forms and, in particular, may restrict deposit withdrawals, extend deposit maturities, or securitize deposits. They are disruptive and will often be subject to legal challenge. Provision should be made for periodic withdrawals up to specified amounts.

- ***Exchange controls.*** Exchange controls are, in some cases, employed when a banking crisis is accompanied by pressure on the balance of payments. To be effective, such controls must be comprehensive, fully enforced, and part of a broader policy package. Moreover, they should be consistent with members' obligations under the IMF's Articles of Agreement.

Bank restructuring in a crisis. Bank restructuring is a multi-year process and is discussed in detail in the study. In particular, the following issues should be considered.

- ***The legal framework.*** The legal and regulatory framework governing bank insolvency should be reviewed and, where necessary, strengthened. To be effective, it will need to embody the features of the framework for normal times described in Part I of this study, although some aspects may need to be modified to deal with the systemic crisis.

- ***Tasks in bank resolution.*** In approving a resolution strategy for each bank, the banking authorities would typically differentiate between banks that are (i) viable and meeting their prudential capital adequacy ratios and other regulatory requirements; (ii) viable but insolvent or undercapitalized; and (iii) insolvent and non viable.

- ***Options for restructuring.*** Bank restructuring strategies may involve private sector solutions or public sector assisted solutions. Under private sector solutions, shareholders retain the responsibility to recapitalize and restructure their bank. A public sector recapitalization program may be considered when it is necessary to preserve viable institutions that otherwise would have failed, or nonviable institutions whose creditors cannot be adequately protected or whose failure threatens the stability of the financial system. In certain cases, the authorities may consider temporary nationalization as a solution. Once financial conditions stabilize, the nationalized bank, or its surviving part, should be privatized at the earliest possible opportunity.

Asset management. AMCs should normally purchase assets at market value. The effective management of impaired assets depends to a large extent on the adequacy of the legal framework for secured rights and general corporate insolvency. Where the legal framework is not sufficiently well-developed, asset recovery vehicles may need to be given special powers, subject to proper oversight and mechanisms for judicial review.

D. Exiting From Crisis Measures

In systemic crises, any policy of temporary easing of regulatory compliance should be transparent (and thus explicit) and subject to close monitoring. If blanket guarantees or administrative measures have been introduced, they must be phased out at an appropriate pace. Firm deadlines may not be possible to establish at the outset of the crisis.

Part I. The Legal, Institutional, and Regulatory Framework in Times of Financial Stability

I. Introduction

A. Basic Objectives and Structure of this Study

1. The recent turmoil in the financial markets has highlighted the importance for member countries to put in place an effective legal, institutional, and regulatory framework for the resolution of insolvent banks.[1] While there is no firm consensus on a single standard or model that countries should employ in designing a bank insolvency framework, there is a growing recognition of many of the practices that should be observed for this purpose.

2. This study discusses the principal features of the legal, institutional, and regulatory framework that a country may put in place in order to deal effectively with cases of bank insolvency in its own jurisdiction. It is primarily intended to inform the work of the staff of the International Monetary Fund (IMF) and World Bank in helping countries strengthen their legal, institutional, and regulatory frameworks for bank insolvency. Its recommendations will be of particular importance as countries, in the wake of the present crisis, seek to strengthen their regulatory regimes to prevent financial crises in future. For IMF staff, its relevance will extend to its advice to countries designing programs of economic reform to be supported by IMF financial assistance, and its technical assistance.

3. The study is divided into two parts. Part I discusses the legal, institutional, and regulatory framework that a country should put in place to deal with bank insolvency in periods of financial stability. It is based on the work of the "Global Bank Insolvency Initiative"—a joint initiative of the staffs of the IMF and World Bank that was launched in 2002 in coordination with the Bank for International Settlements, the Financial Stability Institute, the Basel Committee on Banking Supervision, and the Financial Stability Forum. The report of the Global Bank Insolvency Initiative was drafted in 2003–2004 and benefited from a broad consultative process carried out by World Bank and IMF staff with bank supervisory authorities, international financial institutions, and leading international experts on bank insolvency, including a series of outreach seminars conducted in different regions. It was subsequently used by IMF and World Bank staff in technical assistance work in member countries and was modified over time in light of country experience.[2] Part I covers the following areas.

[1] In this study, the term "insolvent bank" refers to a bank in financial distress that is subject to insolvency proceedings.

[2] For a description of the process for the preparation of the report of the Global Bank Insolvency Initiative and the participants in the process, see Appendices I and II. While the Global Bank Insolvency Initiative report represented the views of IMF and World Bank staff, both institutions are grateful to the individuals and organizations who contributed to its development.

- general institutional and legal issues arising in insolvency proceedings (Chapter II);

- the legal framework empowering the banking authorities to assume direct control of a distressed bank in the context of "official administration" (Chapter III);

- the principles applicable to the restructuring of banks, the special problems associated with different restructuring techniques, and the legal approaches that may be followed to deal with them (Chapter IV); and

- the legal underpinnings and modalities for bank liquidation proceedings (Chapter V).

Part II discusses the legal, institutional, and regulatory framework that a country should put in place to deal with bank insolvency in periods of systemic crisis. It is an expanded and updated version of the relevant chapter of the report of the Global Bank Insolvency Initiative. It has been prepared by IMF staff and represents the views of IMF staff.

4. Two important limitations of the present study should be noted. First, it deals exclusively with the legal, institutional, and regulatory frameworks for insolvent banks—that is, deposit-taking institutions; other types of financial institutions are not covered. Second, it addresses the regime at the domestic level; issues of cross-border bank insolvency fall outside the scope of the study.[3]

B. What are Bank Insolvency Proceedings?

5. In the course of its operations, a bank may face financial difficulties. In some cases, the bank's existing management will be able to restore the bank's soundness and profitability on its own initiative or on the instruction of the banking authorities.[4] [5] In other cases, bank management will be unable or unwilling to solve the bank's problems and the banking authorities will need to become more directly involved. In these cases, the actions of the banking authorities will normally be taken in the context of various forms of insolvency proceedings in which, in particular, they assume direct control of the bank. These proceedings are the focus of the present study.

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[3] Important work in this area is currently underway in the Basel Committee on Banking Supervision.

[4] In this study, the term "Banking Authorities" refers to the public agencies that have the responsibility for exercising functions in the areas of bank supervision, bank restructuring, insolvency proceedings, or liquidation of banks. Such agencies would typically include the bank supervisory authority, central bank, deposit insurance agency, and specialized restructuring agency.

[5] In these cases, several types of official action may be undertaken to address the underlying problems including supervision and guidance (formal or informal) from the banking authorities with respect to actions and arrangements that a bank's management may take in order to solve the bank's problems (which may even include the bank's restructuring). Such actions are not the focus of the present study.

6. In the context of bank insolvency, the term "insolvency proceedings" refers to all types of official action involving the removal of management and/or the imposition of limits on, or suspension of, the rights of shareholders and the assumption of direct control by a banking authority or other officially-appointed person over a bank that has crossed a "threshold" for the commencement of insolvency proceedings described below.[6]

7. The economic objective of insolvency proceedings is the restructuring of the bank's business in whole or in part or the orderly cessation of the bank's activities ("closure"). From a legal perspective, such proceedings may result in either the bank's continuation as a legal entity or the dissolution of its legal personality.

8. A country's legal framework will often distinguish between two types of bank insolvency proceedings that serve somewhat different purposes: official administration (discussed in Chapter III); and liquidation proceedings (discussed in Chapter V). These proceedings will often be separate but may also be combined in a single proceeding.

9. Official administration is a form of insolvency proceeding in which an official authority (either the banking authority, court-appointed administrator, or administrator appointed by a banking authority) assumes direct managerial control of a bank with a view to protecting its assets, assessing its true financial condition and either conducting all the necessary restructuring operations, or placing the bank in liquidation.[7]

10. In contrast, the purpose of liquidation proceedings is the optimal (i.e., value maximizing) realization of assets, and the orderly and equitable distribution of proceeds to creditors. Although bundles of assets may be sold as part of a business with a view to maximizing their total economic value, liquidation results in the dissolution of the bank as a separate legal entity.[8]

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[6] Insolvency proceedings need to be distinguished from other forms of taking of control of a bank by the authorities (e.g., due to fraudulent or criminal activities). These actions are not directly considered in this study.

[7] In this report, the term "restructuring" is used in an economic sense to signify a set of actions designed to substantially modify the operations and financial structure of a bank. From a legal perspective, restructuring will, in some cases, result in the bank's survival as a legal entity while, in other cases, the bank's legal personality will be dissolved, even if some of the bank's economic operations will continue (as a consequence, for example, of a merger or of a purchase-and-assumption transaction with another bank). The purpose of restructuring is to ensure the continuation of the bank's business, in whole or in part, as an economic unit ("going concern") on a financially sound basis.

[8] Although liquidation may also be available in national law as a means of terminating institutions weakened by problems of criminality, non-compliance with regulatory rules, etc., the term is used here to encompass only proceedings triggered when a bank crosses a threshold for the commencement of insolvency proceedings.

C. Purpose of Bank Insolvency Proceedings

11. The purpose of bank insolvency proceedings is to safeguard the stability of the financial system, which includes:

- the smooth functioning of payment and settlement systems;
- the protection of the depositing public; and
- the preservation of the credit intermediation function.

12. A bank failure can produce a much wider spectrum of negative consequences than the failure of a non-financial enterprise. A bank's inability to execute payment instructions may disrupt the operation of payment and securities settlement systems. It may be a direct source of significant losses to other market participants and may negatively affect the interbank market and liquidity in the banking system. Moreover, most bank liabilities are owed to a large group of depositors, many of whom are individuals who are unable to mitigate the risk or to bear the loss. Although a deposit insurance scheme may help protect depositors, it transfers the underlying costs to the deposit insurer and, indirectly, either to the state treasury or to the rest of the banking industry. Finally, the interruption of transactions, the transmission of losses to counterparties and the resulting loss of public confidence in the banking sector that a bank failure can produce may all converge to trigger a systemic crisis, jeopardizing otherwise healthy banks and disrupting the intermediation functions of the financial system.[9]

[9] The principles governing the framework for bank insolvency may be compared to those relevant for corporate insolvency. For the latter, see: UNCITRAL Legislative Guide on Insolvency Law; "Principles for Effective Insolvency and Creditor Rights Systems", World Bank, Washington D.C., April 2001; and "Orderly and Effective Insolvency Procedures—Key Issues", Legal Department, IMF, Washington, D.C., 1999.

II. Key Institutional And Legal Issues In Establishing A Bank Insolvency Regime

13. In designing a framework for bank insolvency, consideration needs to be given to a number of fundamental legal and institutional questions.

A. Institutional Framework for Bank Insolvency

14. An important initial question concerns the division of responsibilities for insolvent banks between the various banking authorities—for example, the bank supervisor, the deposit insurance agency and the central bank. There is no preferred method for doing so. Different systems or structures can be equally effective, provided that the powers and responsibilities of all relevant agencies are clearly and comprehensively specified in the law, with no gaps in important areas, and no duplication of functions permitted. Moreover, the bank insolvency regime needs to be built upon a solid framework for banking supervision that, in particular, ensures the following:[10]

- ***Legal mandate.*** The legal mandate and functions of each agency involved with bank supervision should be clearly delineated and a mechanism for the resolution of potential conflicts should be provided for in the law.

- ***Autonomy.*** The banking authorities should be endowed with operational autonomy,[11] adequate legal powers and the human and budgetary resources necessary to effectively perform their functions free from external pressure.

- ***Coordination.*** Provision should be made for the exchange of information and timely coordination between the banking authorities and other relevant agencies (in particular, the supervisors of the securities and insurance sectors).

- ***Confidentiality and accountability.*** The banking authorities should be required to operate with the maximum degree of transparency compatible with the need to preserve confidentiality. Many decisions of the banking authorities involve confidential matters and, in most cases, confidentiality needs to be maintained.

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[10] An effective bank insolvency framework benefits from a well-designed legal framework for the recognition and enforcement of contracts and property rights.

[11] In contrast, there is no need for operational autonomy where an administrative body does not exercise any discretion but is merely called upon to apply rules in a quasi-automatic fashion. This would be, for example, the case of a deposit insurance agency with a narrow mandate to make payments to eligible depositors under precisely-defined conditions.

However, it is also important to ensure that the banking authorities are accountable for their actions, and that adequate reporting arrangements are in place.[12]

B. Choice of Bank Insolvency Regime

15. In designing their bank insolvency framework, the authorities must decide whether to rely upon the general corporate insolvency framework, with appropriate modifications, or to put in place a special regime designed exclusively for banks.

16. ***Corporate insolvency law.*** Some countries apply their corporate insolvency framework to banks and deal with insolvent banks in the same way they would any insolvent non-financial enterprise. However, it is rarely the case that countries will rely upon their corporate insolvency law without making any modifications that address the specific problems of bank insolvency. In particular, bank-specific rules will often be introduced to: (i) establish a procedure for the imposition of official administration; (ii) provide for special treatment of financial contracts, unsettled payment and securities transactions, and financial collateral; (iii) appoint the banking authority, or a person proposed by it, as administrator and/or liquidator; and (iii) address the operation of the deposit insurance scheme, including the establishment of a right of subrogation for the deposit insurance agency to the claims of depositors for the amounts it has paid them.

17. ***Special bank insolvency regime***. In contrast, many countries have put in place a special legal regime for cases of bank insolvency. The adoption of a special bank insolvency regime separate from corporate insolvency may facilitate timely action and provide for consistency between the supervisory and insolvency-related functions of the banking authorities. It may also prove to be particularly useful where the corporate insolvency framework is weak and ineffective.

18. There is no firm consensus in favor of a system based upon the corporate insolvency framework or a special regime for banks. However, there is a trend towards a special regime as, in recent years, a number of jurisdictions have put in place such systems or are considering doing so.

19. ***Judicial vs. administrative proceedings.*** While corporate insolvency proceedings invariably take place in the courts, insolvency proceedings under a special regime for banks may be either court-based or administrative in nature. In the latter case, the proceedings are initiated and conducted by the banking authorities without the need for judicial involvement.

20. In choosing between a court-based or administrative system, it is important to recognize that there is no consensus and that each system presents both advantages and

[12] The IMF Code of Good Practices on Transparency of Monetary and Financial Policies provides additional guidance on this matter.

disadvantages. While a court-based system may promote greater accountability and ensure that the rights of all affected parties are adequately protected, it may also be inappropriate in countries where judicial proceedings are generally slow, and the judiciary lacks the necessary experience in banking matters. A special bank insolvency regime that is administrative in nature will vest decision-making in the hands of experts in banking matters and will allow them to move quickly and efficiently to deal with an insolvent bank. To ensure that the banking authorities are accountable for their actions, however, provision for ex post judicial review of the banking authorities' actions will need to be provided for (see section D below). Some countries adopt a hybrid approach under which official administration is conducted by the banking authorities without judicial involvement, and liquidation proceedings remain under the control of the courts.[13]

C. Commencement of Bank Insolvency Proceedings

21. The bank insolvency framework must address three important questions respecting the commencement of insolvency proceedings:

- who may commence insolvency proceedings against a bank?
- what is the triggering event or "threshold" that must be crossed before insolvency proceedings may be commenced?
- who should be in control of a bank upon the commencement of insolvency proceedings?

22. ***Authority to commence proceedings.*** In specifying the parties who may commence insolvency proceedings, corporate insolvency law and bank insolvency law take fundamentally different approaches. In a corporate insolvency, a leading role is normally played by interested parties such as the insolvent enterprise itself or the creditors who seek to protect and enforce their claims against the enterprise. In a bank insolvency, the primary role is played by the banking authorities, given their mandate to protect the stability of the banking system, and their informational advantage in assessing a bank's true financial situation.

23. While the banking authorities are almost universally empowered to initiate insolvency proceedings against a bank[14], many jurisdictions go further, and grant to the banking

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[13] Even where insolvency proceedings are largely administrative in nature, the constitutional framework in some countries will require that certain actions taken by the banking authorities involving the limitation or extinction of property rights will need to be sanctioned by court order and/or accompanied by appropriate compensation.

[14] Depending on whether the jurisdiction follows the court-based or the administrative approach, the banking authority will need to either petition the insolvency court for the commencement of insolvency proceedings or take the necessary administrative actions to commence insolvency proceedings.

authorities exclusive competence to commence proceedings. Two justifications are usually put forward in support of this approach: first, that the commencement of insolvency proceedings (see below), once publicized, may have systemic implications and should, therefore, be the exclusive responsibility of the banking authorities; and second, that in case of decentralized proceedings, individual creditors may bring unsubstantiated or even frivolous actions against the bank. However, this approach is not universal. Many countries with court-based bank insolvency frameworks permit insolvency proceedings to be commenced not only by the banking authorities but also by a bank's owners, management and/or creditors. This approach seeks to preserve the rights of stakeholders in the bank and recognizes that these parties, in some cases, may initiate proceedings where the banking authorities are unjustifiably reluctant to take action.[15]

24. Where parties other than the banking authorities are allowed to commence insolvency proceedings, the law should require prior consultation with the banking authorities, who should be entitled to participate in all stages of the proceedings. In particular, the banking authorities should be consulted when a determination is made that the bank has crossed the threshold for the commencement of insolvency proceedings (see below). The banking authorities, or a member of their staff or other person proposed by the banking authorities, could also be eligible for appointment as official administrator and/or liquidator. The banking authorities should be given full access to the files of the court proceedings, receive all documents and notifications, and participate in all hearings and shareholders' or creditors' meetings. The banking authorities should be entitled to submit restructuring plans and other proposals to the court and raise objections to the proposals of other parties. It is important that the banking authorities are involved with respect to the timing and the manner of announcements relating to the insolvency proceedings in order to minimize any possible erosion of public confidence in the stability of the banking sector as a whole.

25. ***Threshold for commencement of insolvency proceedings.*** The bank insolvency regime needs to specify in legislation the "threshold" that must be crossed before insolvency proceedings may be commenced. Two thresholds are particularly common and crossing either will permit the initiation of insolvency proceedings.

- Under the "illiquidity threshold," insolvency proceedings may be commenced against an entity when it is unable to pay its obligations when they fall due.

26. Although important in both corporate and bank insolvency law, the concept of illiquidity is more complex is the case of a bank than of a non-financial enterprise. A bank can have temporary liquidity problems without being fundamentally insolvent, or be insolvent while not necessarily experiencing liquidity problems. Clearly, a bank's inability to

[15] In some countries, delay or failure by managers to bring such action may expose them to legal sanctions, including possible personal liability to creditors.

honor its payment obligations when they fall due indicates weaknesses, and such illiquidity may be an indicator of more profound financial difficulties. However, liquidity problems in a solvent bank can, in many cases, be addressed through inter-bank borrowing or, in some countries, through the extension of emergency liquidity assistance by the central bank. Still, the financial condition of the bank may deteriorate significantly when additional liquidity cannot be obtained quickly, particularly where market conditions for obtaining liquidity change.

- Under the "balance-sheet threshold," insolvency proceedings may be commenced against an entity when its balance sheet shows negative net worth (that is, when its liabilities exceed assets).[16]

27. In the case of both non-financial corporations and banks, negative net worth is a clear indicator of financial difficulty of sufficient gravity to justify the commencement of insolvency proceedings. With respect to bank insolvency, however, it does not, in itself, go far enough. By the time a bank has crossed this threshold, it will probably be too late to achieve a structured and orderly resolution.

28. It is therefore the case that the bank insolvency framework needs to establish an additional threshold that permits the commencement of insolvency proceedings at a relatively early stage of financial distress.

- Under this additional threshold—the "regulatory threshold"—insolvency proceedings may be commenced against a bank when its net financial position has fallen below a specified level, even though it may still have a positive net worth.

29. Where a bank crosses the "regulatory threshold", the law should stipulate that insolvency proceedings may be commenced. The "regulatory threshold" may be quantitative in nature and based on the bank's capital position, specified leverage ratio, or set as a fraction of the prudential ratios.[17] For bank supervisory purposes, the banking authorities almost universally set minimum capital adequacy requirements reflecting the risks that the bank undertakes. A bank's inability to comply with a minimum capital requirement may be an important indicator of a bank's financial weakness. Moreover, countries often provide for the commencement of insolvency proceedings when the banking authorities consider that a more qualitative threshold has been crossed, for example, the bank has reached a state of severe financial and/or operational stress, or creates a serious risk of contagion.

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[16] It is the banking authorities' duty to monitor banks' balance sheets for supervisory purposes to determine whether they reflect the real economic value of the banks' assets and liabilities.

[17] For quantitative thresholds, principles and procedures for asset valuation need to be in place.

30. The regulatory threshold reflects the very essence of bank insolvency proceedings—to permit the banking authorities to intervene in a bank at an early stage of financial difficulty (where its financial position has weakened substantially, even though the bank may still have a positive net worth), in order to protect the stability of the financial system. Although far from universal practice in countries' bank insolvency frameworks, the regulatory threshold provides an important tool allowing a prompt response by the authorities in cases of severe financial difficulty. At the very least, the crossing of the regulatory threshold should permit the authorities to initiate official administration to allow the banking authorities to take direct control of a bank with a view to restructuring the bank's business or placing it in liquidation (see Chapter III). In some countries, the crossing of the regulatory threshold may also justify the commencement of liquidation proceedings (see Chapter V).

31. ***Assumption of control.*** Upon the initiation of insolvency proceedings, full control of the bank should be transferred immediately to an official administrator or liquidator. In the case of court-based insolvency proceedings, if there is an interval between the filing of a petition and the court's formal decision to commence insolvency proceedings, some form of provisional administration pending the final decision must be in place to conserve the bank's assets.

32. As bank failure is often the result of poor management, key managers and possibly Board members in a failed bank will typically no longer meet the fit and proper criteria under the prudential supervisory framework. Therefore, the banking authorities should take action to bring about the suspension or dismissal of management and Board members responsible for the bank's failure. Where there are concerns that management may dissipate assets, such management may need to be expelled immediately and without advance notice. In a court-based system, the law should empower the banking authority either to unilaterally suspend management simultaneously with the filing of proceedings against the bank or to present to the court an *ex parte* application (i.e., without notice to other affected parties) for this purpose.

D. Challenges against the Banking Authorities' Actions

33. Actions by the banking authorities in the context of insolvency proceedings are frequently the subject of legal challenge by affected parties such as the bank's owners or its creditors. Such challenges are brought in the courts and may relate to the banking authorities' decision to commence insolvency proceedings or to actions taken after such proceedings have been commenced (e.g., the restructuring of the bank's assets and liabilities).

34. These challenges are an important means of ensuring that the banking authorities are accountable for their actions, and that the rights and interests of affected parties are protected. However, it is also important to ensure that such challenges do not undermine the effectiveness of the bank insolvency framework or the efforts of the banking authorities to preserve the stability of the banking system. The legal framework therefore needs to clearly

specify the circumstances in which such challenges may be launched and the remedies that affected parties may seek.

35. Challenges take two principal forms: (i) judicial review of the banking authorities' actions taken in the context of insolvency proceedings; and (ii) actions to seek damages from the banking authorities or their officials for the actions they have taken in the context of insolvency proceedings. In some cases, these two challenges may be combined.

36. ***Judicial review of the banking authorities' actions.*** In most countries, the system of administrative law will allow an affected party to ask a court to review the legality of actions taken by an administrative agency such as a banking authority. In such proceedings, the court will review the legality of decisions taken by the banking authorities and, where the authorities are found to have exceeded their authority, overturn their decision.[18]

37. In many countries, judicial review is available to parties affected by actions that the banking authorities have taken against a bank in the context of insolvency proceedings. Judicial review is not normally part of the insolvency proceedings themselves but will be a separate proceeding in which the court reviews, ex post, the actions of the banking authorities. It is generally only available where the insolvency proceedings in question are administrative in nature and the banking authorities have acted without the need to obtain prior approval from an insolvency court. Where the relevant insolvency proceedings are themselves court-based, the actions of the banking authorities will normally be subject to prior judicial authorization.

38. In the context of bank insolvency, the scope for judicial review should be clearly circumscribed so as not to undermine the effectiveness and credibility of the banking authorities' actions in their efforts to protect the stability of the financial system. The review process should not be so intrusive and unpredictable as to discourage the banking authorities from taking prompt and decisive action. In particular, the banking authorities' technical expertise should be respected and the legal framework should not permit a court to second guess or substitute its own policy views for those of the relevant banking authority. The review mechanism should only seek to determine whether the banking authorities have acted legally and should not allow the court to reassess of the exercise of discretion by the banking authorities unless there is clear evidence of a manifest error of fact or an abuse or misuse of power (e.g., an "arbitrary or capricious" decision). The reconsideration of decisions on the

[18] In most countries, a court engaged in judicial review proceedings may overturn a decision taken by an administrative agency but may not substitute its own decision. Many legal frameworks allow affected parties to appeal the decisions of the banking authorities to a special administrative tribunal with extensive expertise in banking matters that engages in a broader form of enquiry. For example, the tribunal may not only review the legality of the decisions taken by the banking authorities but may also examine the merits of their decisions on broader substantive grounds. Moreover, to the extent that the tribunal disagrees with the banking authorities' decision, it may not only overturn the decision but may also substitute its own decision.

merits should be confined within the banking authority to the extent possible, and incorporated into its internal operating procedures.[19]

39. Any proceedings involving the review of a decision of the banking authorities should be conducted as expeditiously as possible. Moreover, in most cases, it will be inappropriate for insolvency proceedings to be stayed pending the outcome of review proceedings. Where the relevant actions of the banking authorities inflict damage on a bank's owners or other interested parties without proper justification and the restoration of the prior situation is no longer feasible due to intervening events, the only effective remedy should be in the form of monetary compensation (i.e., damages) although the legal framework may limit the circumstances in which damages may be awarded (see below). In all cases, the legal framework should be clear as to the available remedies.[20]

40. ***Actions for damages against the banking authorities and their staff.*** It is often the case that parties affected by the actions of the banking authorities in insolvency proceedings will sue and seek damages from the banking authorities and, in addition, their officials on a personal basis. Such actions typically seek compensation for losses claimed to be the result of improper conduct by the authorities in exercising their responsibilities. The legal framework should establish clear limits on the circumstances in which such damages may be awarded. To this end, many jurisdictions have expressly limited liability that may be incurred by the banking authorities to cases involving gross negligence or bad faith.

41. A related question concerns the potential personal liability of Board members, staff and other officers or agents of the banking authorities (including individuals who are appointed as official administrators or liquidators) for actions they have taken in a bank insolvency.[21] The legal framework should grant such officials express statutory protection from civil liability for actions and omissions that they have taken in good faith in the discharge of their legal responsibilities.[22] Some jurisdictions follow a single standard approach where both the banking authorities and their officials are accorded legal protection under an equivalent standard. Other jurisdictions are more protective of individuals than the public agencies in that the banking authorities may be held liable for their wrongful acts or

[19] These arrangements may include an appeal to a specialized tribunal outside of the relevant banking authority with expertise in banking matters.

[20] Subject to the non-disclosure of confidential information on the banks' customers and third parties or other sensitive information, judicial review or special appeals proceedings should be made public, and their results reported.

[21] No protection should be provided for fraudulent actions or willful misconduct.

[22] In some jurisdictions, legal protection for individuals is provided through appropriate indemnification provisions in their contracts of employment.

omissions even though individuals would not incur any personal liability.[23] Under either approach, the relevant provisions on legal protection must be comprehensive and unambiguous to provide the right incentives. With respect to personal liability, the scope of protection should not require the relevant individual to demonstrate that his or her conduct was "reasonable", "not negligent" or consistent with some other state of mind of this type. Moreover, Board members, staff and other officers or agents of the banking authorities should not be subject to criminal investigation or prosecution for actions related to mismanagement or the negligent performance of their duties. Individuals should also be indemnified for any expenses incurred in successfully defending against a civil claim arising from actions and omissions taken by the individual in good faith in the normal course of their official duties.

[23] For example, legal protection for individuals can be provided by expressly identifying the banking authority as the respondent for any civil claims.

III. Official Administration Of Banks

A. Purpose of Official Administration

42. In many countries a form of insolvency proceedings is recognized, under which a bank is placed under "official administration".[24] Under official administration, the official authority (i.e., either the banking authority, court-appointed administrator or administrator appointed by the banking authority) will take control of the bank and decide on the extent to which the bank can be restructured or needs to be liquidated. Official administration provides for an opportunity to assess the bank's condition, as soon as possible, and to take actions to protect the bank's assets. Even if the accounts and/or regulatory returns of the bank seem to indicate otherwise, the banking authorities may have strong grounds to believe that the bank is insolvent, and that the bank's management cannot be relied on to effectively steer it away from liquidation.[25]

43. In building a legal framework for official administration, choices need to be made, and balances struck, in particular, between the protection of shareholders and the protection of the public and depositors' interests. Countries will often combine elements of different approaches to achieve an appropriate balance.

B. The Imposition of Official Administration

44. ***Threshold for commencement of official administration.*** As noted in Chapter II, the legal framework will need to specify the threshold that must be crossed before official administration may be commenced. These thresholds should include the regulatory threshold.

45. ***Mandatory or discretionary system.*** One of the basic choices to be made is between a mandatory and a discretionary system in providing for the commencement of official administration. In some countries, the banking authorities may be required by law to impose official administration once certain conditions that are specified in detail in the law are met ("mandatory system"), whereas in other countries the law may grant some flexibility for deciding whether or not official administration should be imposed ("discretionary system").

46. Mandatory and discretionary systems each have advantages and disadvantages. Mandatory systems can limit the exercise of regulatory forbearance, provide the banking authorities with a defense against possible political interference and unwarranted legal action, and provide signals to banks and the public that action will be taken. A discretionary system is more flexible, and may allow a more calibrated response to the circumstances of individual

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[24] Terminology differs widely from country to country. Terms such as bank intervention, conservatorship, temporary administration, trusteeship, are also used.

[25] Official administration is to be distinguished from supervisory action taken against a weak bank which is still under the control of its owners and managers.

cases. In practice, most systems incorporate a mix of mandatory and discretionary elements. This approach seems to be the most advisable, since it allows an optimal balance between excessive rigidity and uncertainty.

47. A predominantly mandatory system may be advisable in an institutional environment in which the banking authorities may be under pressure to exercise forbearance. The exercise of forbearance may lead to the further accumulation of losses and a distortion of competitive conditions, to the detriment of healthier banks. Furthermore, forbearance breeds non-compliance and moral hazard, undermines the role of the banking authorities and sends distorted signals to the markets and the public.

C. Phases of Official Administration

48. Official administration normally comprises two phases: (i) diagnosis; and (ii) restructuring and/or the placement of the bank in liquidation.

49. In a growing number of countries, official administration is performed by a banking authority and can last for a very brief period of time (e.g., no more than a few days or over a weekend) until the bank is taken over and reopens under another name or until its core business is sold to a sound bank and the remainder of the failed bank is placed in liquidation.

50. ***Diagnosis***. During the diagnostic phase, the official administrator should conduct, with or without expert assistance, due diligence with respect to the bank's financial situation, assess the value of its assets and liabilities, and determine its capital adequacy and liquidity position. The official administrator will also need to assess the prospects for restoring the bank's business as a going concern to full compliance with prudential requirements. Depending on the prospects of success and the assessment of the relative cost of possible restructuring approaches, the official administrator (with or without approval of the banking authorities) will decide whether a restructuring should be attempted or whether liquidation proceedings will need to be initiated as soon as possible. The diagnostic phase can, and in many cases will, be very short, where it is clear from the outset that a bank's business cannot be restored as a going concern.

51. ***Restructuring.*** In the restructuring phase of official administration, attempts can be made to salvage the banking business through a variety of financial and operational measures.[26] In some cases, an attempt at restructuring will be made before liquidation becomes inevitable. In practice, there is no clear division between restructuring and liquidation, as both can involve many of the same techniques, for instance the sale of business units.

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[26] See Chapter IV.

D. Elements of Official Administration

52. At a minimum, the legal framework for official administration should address the following basic elements.

- ***Speed.*** The threat of bank insolvency needs a quick and decisive response in order to minimize the eventual costs to depositors, other creditors and taxpayers (where applicable). The longer a bank remains under official administration, the more remote are the chances to preserve the bank as a going concern. The time a bank may continue its operations under official administration should, therefore, be as short as possible. Also, it is necessary to ensure through appropriate monitoring mechanisms that restructuring efforts cease once it becomes clear that such efforts will not be successful.

- ***Appointment, replacement and discharge of the official administrator.*** The law needs to specify clearly who will have the authority to appoint, replace and discharge the official administrator and set the administrator's terms of reference in case it is not an official agency.[27] The decision to impose official administration should: (i) name the official administrator; (ii) specify the official administrator's powers; and (iii) suspend or annul the powers of the management and other governance bodies of the bank.[28] The law must be absolutely clear on the moment and scope of the transfer of control to the official administrator, and should allow for no interregnum.

  The law should set out fit and proper criteria for the official administrator, which should include experience in banking and in managing banking resolution cases, training in banking, accountancy, or law, integrity and good reputation, and the absence of conflicts of interest.[29] The official administrator must be provided with feasible terms of reference that, in particular, set out the principal objectives, tasks, and methods of accountability.

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[27] As noted in Chapter II, the system for official administration may be either court-based or administrative in nature. Accordingly, the power to appoint the official administrator may be vested either in the courts or in the banking authorities, possibly subject to the subsequent approval of the court. The banking authorities are often better placed than the court to identify a suitable administrator and, in the case of a court-based system of official administration, could be given the authority to make binding recommendations to the court.

[28] In some jurisdictions, joint control is envisaged, for instance by leaving some management powers intact, subject to the concurrence of the official administrator for certain types of decisions. To limit the inherent risks in this process, only managers who meet the fit and proper criteria should be allowed to remain in charge of day-to-day decisions.

[29] Both natural persons (e.g., auditors, lawyers, or insolvency practitioners) as well as legal persons (e.g., accountancy firms) may be suitable candidates provided that they meet the requirements. In case the official administrator is not an official agency, the banking authorities may identify suitable candidates in advance. This can occur by way of a public tender in order to pre-qualify suitable candidates.

Only the appointing authority should have the right to dismiss the official administrator. When dismissing the official administrator, the relevant authority should, at the same time, appoint a successor, with a simultaneous transfer of powers. Grounds for replacement or dismissal of the official administrator should be specified in the law. They should be limited to circumstances such as the inability over an extended period of time to perform the necessary duties, gross negligence, unlawful conduct, or non-compliance with fit and proper criteria.

- ***Determination of the bank's financial condition.*** Within a time frame specified in the law, the official administrator should take stock and prepare an inventory of the bank's assets and liabilities. The official administrator needs the authority to obtain any and all information relevant to the financial condition of the bank. In particular, the official administrator should have unlimited access to all information at any locations where the business of the bank is conducted and needs to be able to conduct ad-hoc investigations, and recruit assistance to perform this task.

- ***Protection of assets, and operation of bank's business.*** The official administrator should be explicitly authorized to take the steps necessary to protect the bank's assets, pursue any of the bank's claims, and defend the bank in a court of law against claims brought against the bank. The official administrator must have sufficient autonomy in taking action and the power to protect the interest of depositors (and other creditors) and the financial system overall while avoiding unnecessary interference with property rights.

  The official administrator should be authorized to continue the bank's operations to the extent necessary to maintain the value of the bank. The official administrator needs full powers to manage the loan portfolio, including the collection of nonperforming loans.[30] Other powers that the official administrator should be given include hiring and firing of officers and staff of the bank, maintaining the premises and administrative systems, undertaking basic transactions, and deciding to limit certain types of business. The ultimate test of the appropriateness of these actions should be whether they are beneficial for maintaining the bank's value and are in the interest of depositors and creditors.

- ***Avoidance of contracts and liability claims.*** The official administrator should have the power to apply to the competent courts for the avoidance of certain contracts that were entered into within a defined time period preceding the commencement of insolvency proceedings, such as contracts that resulted in preferential treatment to some creditors or were entered into in an effort to preempt the collective rights of

[30] In the case of a systemically-important bank, the official administrator may be given full authority to negotiate financial assistance from the authorities.

creditors. To mitigate the negative effects of avoidance powers on contractual certainty, the categories of transactions that may be subject to avoidance, and clear criteria on the exercise of avoidance powers, should be established in the law. The official administrator should also be responsible for bringing legal action on behalf of the bank against former directors and managers for damages resulting from their mismanagement, negligence or fraud.

- ***Decision on restructuring or liquidation.*** The official administrator needs to assess the extent to which the bank may be restructured or liquidated. Depending on the system in place in the jurisdiction, the official administrator may be authorized to take this decision independently, or with the approval of the court or the relevant banking authorities.

- ***Bank restructuring techniques.*** As is discussed in greater detail in Chapter IV below, the legal framework should authorize unambiguously the official administrator to make use of a wide variety of techniques to restructure the bank's business. In particular, the law should make clear that the official administrator is authorized not merely to take normal managerial decisions, but also to decide on and implement far-reaching corporate actions of the type that, in a normal situation, would require shareholders' approval (e.g., the sale of the bank's business or parts thereof), provided that for some decisions the approval of the court or the relevant banking authorities may be required.

- ***Set off and netting arrangements.*** The appointment of an official administrator may trigger close-out under certain netting arrangements that could complicate the transfer of contracts to a third party or bridge bank. The legal framework could specify whether a very brief suspension is permissible.[31]

- ***Timetable.*** The legal framework needs to set out a timetable for the performance of the critical elements of official administration. The maximum duration of official administration differs considerably across jurisdictions and will depend on the precise mandate and objectives of official administration. While the process should be completed as quickly as possible, the legal framework should avoid excessive rigidity in specifying a timetable. Knowing that time is running out for the official administrator can drive down the remaining value of the bank, as potential purchasers will hold out for a better price.

- ***Confidentiality, transparency and accountability.*** The law needs to strike a balance between the need for confidentiality, transparency and accountability in the conduct of the official administration. For certain measures, public disclosure may be

[31] For a discussion of set off and netting in liquidation, see Chapter V.

necessary or even mandated by law. However, the authorities should retain sufficient flexibility to take decisions rapidly and without having to disclose information in advance in some instances. For example, the work of the official administrator may need to remain undisclosed during negotiations with a potential investor or purchaser. Full disclosure of the official administrator's reports should be implemented after the official administration is concluded.

- ***Cost of official administration.*** The legal framework should provide clear rules on who carries the expenses of the official administration, at a minimum providing that the bank should bear all relevant expenses.[32] In many jurisdictions, the administrative expenses are given a preferred ranking in insolvency proceedings.

- ***Flexibility and systemic implications.*** There is a need for the law to provide flexibility to the official administrator in handling the exceptional cases of bank failures with clear and direct systemic implications. If the authorities deem that the failure of a bank has serious systemic implications, they will need to employ a restructuring technique that minimizes any contagion within the financial system and possible adverse effects on the real economy. The objective to curtail systemic risk will take precedence in official administration. These issues are discussed in greater detail in Part II.

- ***Termination of official administration.*** The powers of the official administrator should cease only after the necessary restructuring operations have been performed, the bank has been restored to health as a going concern or the bank (or its remainder) has been transferred to the liquidator. In the latter case, provision needs to be made for an orderly transfer of power and information from the official administrator to the liquidator. The official administrator should prepare a final report on the conduct of the official administration, including a balance sheet and a profit-and-loss statement. After the report has been issued, the official administrator should be officially discharged from duty. Any remaining responsibility of the official administrator should be based on an assessment of the official administrator's report.[33]

E. Selected Legal Issues Arising from an Official Administration

53. A number of important legal issues arise in the context of official administration. Three particularly important questions are: (i) the precise scope of the official administrator's powers and their impact on the rights of the bank's shareholders; (ii) the implications of official administration for a bank's license; and (iii) the imposition of a moratorium.

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[32] Consideration could be given to periodic reporting on expenses incurred.

[33] The standards under which the official administrator can be held liable should be clearly established in the law.

54. ***Scope of official administrator's powers.*** While the present study recommends that the legal framework provide the official administrator with extensive powers to deal effectively with an insolvent bank (including the power to significantly restructure the bank's business without the consent of the bank's owners), it should be noted that not all countries provide the official administrator with such a broad grant of authority. Some legal systems only confer a more limited set of powers on the official administrator, and seek to preserve all or some of the governance rights of shareholders.[34]

55. In the context of official administration, Three categories of decision-making powers can be distinguished:

- normal managerial powers regarding the conduct of the bank's day-to-day affairs of the type exercised by the management prior to the commencement of insolvency proceedings;
- extraordinary powers of insolvency law (relating to the avoidance of certain contractual obligations, the binding transfer of assets and liabilities, etc.); and
- powers to engage, in the context of bank restructuring, in corporate actions of the sort that, in normal times, would require the approval of shareholders in a general meeting.

56. In an official administration, the legal framework must draw a balance between the need for prompt and effective action by the banking authorities and the preservation of the shareholders' property rights, including their continuing stake in a potentially viable enterprise. Those legal systems which give the official administrator complete control over the failing institution resolve these competing interests entirely in favor of speed and effectiveness. Other legal frameworks adopt a more nuanced approach by giving the official administrator the power to manage the bank on a day-to-day basis while requiring the official administrator to obtain shareholder approval before proceeding with more far-reaching restructuring plans. Whatever the approach taken, the legal framework will need to ensure that the survival of shareholders' property and governance rights (e.g., voting rights) will not unduly complicate the restructuring process. For example, where the shareholders refuse to consent to a proposed restructuring plan, the official administrator could be empowered to seek approval of the plan by a court, or to invite the shareholders to participate in the bank's recapitalization.

57. In the typical case of a failing bank, its shares will be of little or no value. A difficult question concerns the dilution of the existing shareholders' financial participation in the bank

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[34] In certain countries, the official administrator does not directly replace the existing management, but is given a range of extraordinary powers to supervise the execution or to order particular actions. This approach, however, if not well designed and speedily executed, can result in delays in the restructuring process and/or provide opportunities for further mismanagement and dissipation of assets.

as part of a restructuring plan as existing shareholders should not unduly benefit from financial contributions provided by third parties (e.g., new shareholders or public funds) such as by means of recapitalization. Where a bank's share capital is written down recognizing the accrued losses in anticipation of a restructuring, existing shareholders that are not participating in the subsequent capital increase should not benefit from the effects of the recapitalization.[35]

58. ***Licensing implications of official administration.*** The law should clearly specify the implications that the commencement of official administration may have on a bank's license. In many countries, the banking authorities are permitted by law to revoke the bank's license upon the commencement of or during official administration. In other countries, revocation is not only permitted but is required by law upon the commencement of official administration, thereby leading to the termination of any banking business in the bank. The latter approach may be too rigid, given the possibility that the bank's business can be restructured as a going concern, and liquidation avoided. As an intermediate approach, the law may provide for the license to be suspended or for the decision on its revocation to be deferred as necessary to accommodate restructuring measures during official administration. Upon the completion of a restructuring, the banking authorities will need to ensure that all licensing and operational requirements are met.

59. ***Imposition of moratorium.*** Under corporate insolvency law, the commencement of insolvency proceedings against a non-financial entity will usually involve the imposition of a moratorium, that is, the mandatory suspension of all or most collection activity by individual creditors against the insolvent enterprise. The purpose of the moratorium is to prevent an enforcement race between creditors seeking to collect their respective claims before the enterprise's assets are exhausted. In this manner, the moratorium provides time for the exploration of reorganization possibilities and, in liquidation, enables the orderly, *pro rata* satisfaction of claims out of the estate. In the case of the official administration of an insolvent bank, however, the existence and operation of a moratorium raises complex issues that need to be addressed by the legal framework.

60. In official administration, a moratorium will provide, at most, a very narrow window for the exploration of restructuring possibilities.[36] In some cases, it may help protect an open bank from its creditors while restructuring operations are conducted but, in many other cases, may simply constitute a step towards the bank's liquidation. A complete and protracted moratorium will be tantamount to the termination of the bank as a going concern while a

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[35] Where the bank still has positive net worth, and its shares are transferred, existing shareholders should receive compensation, whether at the time of the relevant action or at a later point. In some countries, it may be required to decide the compensation at the time of the transfer. In any case, shareholders should be granted the right to seek a review of the valuation process.

[36] For instance, it could be used as legal justification for a "bank holiday" of a few days' length.

partial or temporary moratorium may not be enough to prevent the further deterioration of the bank's financial situation. A moratorium in the context of official administration will, at best, be effective for a very short period and, in some cases, may prove to be counterproductive. Accordingly, the legal framework should not provide for the automatic imposition of a moratorium upon the commencement of official administration; rather, the law should permit the declaration of a moratorium on a discretionary basis.[37]

[37] A moratorium may be combined with a prohibition to make payment (partial or full) and take new deposits. While a bank may be allowed to make payments to retail customers up to a certain amount, the bank should only be permitted to accept new deposits to the extent that they are covered by deposit insurance or secured otherwise. It may thus be necessary to determine the scope of such restrictions in close collaboration with the deposit insurance agency.

IV. BANK RESTRUCTURING

A. Purpose and Scope of Bank Restructuring

61. Once the bank's financial situation has been diagnosed in the context of official administration, the official administrator may seek to restructure[38] the bank's business with a view to securing its continuation. Any such restructuring should be completed as rapidly as possible, in a manner that minimizes disruptions to the financial system and limits costs to depositors, other creditors, and taxpayers (where applicable).[39]

62. Bank restructuring must aim at addressing the causes, not just the symptoms, of bank insolvency. In many cases, far-reaching measures will be necessary to resolve the bank's financial problems, and may include the transfer of the bank's shareholding or asset base to new investors who are able to conduct business operations in a sound manner in compliance with the applicable prudential requirements or the bank's merger with (or acquisition by) another well-capitalized and well-managed bank. Moreover, special techniques such as purchase-and-assumption transactions involving some of the bank's assets and liabilities or more complex structures—such as so-called "bridge banks" or the "good-bank/bad-bank" separation technique—may be used. In certain cases, a combination of restructuring techniques may have to be implemented.

63. As a start, the official administrator must compare the cost of existing possibilities for the bank's restructuring. As a first priority (and the legal framework should be designed to such effect), a full or partial restructuring by means of any available private-sector solution[40] should be attempted. At the same time, bank restructuring should not distort competition by subsidizing failure and implicitly penalizing the more efficient banks in the system. This principle may be contained in competition law and enforced by the competition authorities, though often in cooperation with the banking authorities.

64. Particular restructuring techniques may allow the bank to survive as a legal entity. This, for example, will happen if the bank is acquired and recapitalized by a new owner. In other cases, however, the restructuring will involve the spinning-off of the bank's viable units—for instance, by way of a purchase-and-assumption transaction of some of the bank's assets and liabilities—and the liquidation of the residual entity; this approach will entail the

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[38] The purpose of bank restructuring is to secure the continuation of the bank's business, in whole or in part, as an economic unit ("going concern") rather than as a legal unit, on a financially sound basis.

[39] Any contribution of funds by the deposit insurance agency should be guided by a well designed least-cost principle, i.e., such contribution would be less than the amount that would need to be paid out to cover insured deposits in the case of liquidation.

[40] A private-sector solution is one in which a recapitalization is carried out with private funds. For instance, the financial restructuring can take the form of an increase of the share capital by the existing or new shareholders, a debt-equity swap, or debt forgiveness.

dissolution of the bank's legal personality. Thus, the bank's legal status will depend on the type of restructuring technique implemented.

65. During bank restructuring, the basic elements identified as relevant under official administration and described in the previous chapter continue to apply. Particular emphasis is needed to ensure that the restructuring proceeds with speed and flexibility. With respect to the latter, it is often difficult to determine whether a bank failure may have systemic implications, given that decisions must be taken quickly and on the basis of limited information. Justifying the use of exceptional tools (such as the use of public resources, granting forbearance, or postponing the implementation of strict resolution mechanisms) is not a simple task and the authorities must be reasonably certain that a combination of the following events would result from the bank failure: (i) interruption or collapse of the payment and settlement systems; (ii) runs on other banks; and (iii) severe downturn in economic activity.

B. General Legal Considerations Relating to Bank Restructuring

66. Various methods can be used for the purpose of restructuring a bank in the context of insolvency proceedings. The most common techniques employed are: mergers or acquisitions; purchase-and-assumption transactions; operations involving the creation of bridge banks or a "good-bank/bad-bank" separation; and, in the event of a large bank failure with major systemic implications, temporary nationalization of the bank as a last resort.

67. Some restructuring techniques (especially, the failed bank's merger with, or acquisition by, a healthy bank) are comparable to normal corporate finance transactions. In any case, it is imperative that a country's legal framework not hinder the operations necessary for implementing the chosen technique. While the various restructuring techniques will typically be carried out in the context of official administration, similar techniques may also be employed under liquidation proceedings. In the discussion which follows, it is assumed that the restructuring is being carried out in the context of official administration. For countries where official administration is conducted under judicial supervision, references to the powers of the official administrator should be read to include powers exercised by the insolvency court or with its approval.

68. The legal framework applicable to bank restructuring should include clear dispositions on the matters outlined below.

- ***Bank restructuring techniques.*** As is noted in Chapter III, the legal framework should authorize unambiguously the official administrator to make use of a wide variety of restructuring techniques, which can be used separately or in combination, as well as to adopt new restructuring practices that may arise in the future. In particular, the law should make clear that the official administrator is authorized not merely to take normal managerial decisions, but also to decide on and implement far-reaching corporate actions of the type that, in a normal situation, would require shareholder approval, provided that for some decisions the approval of the court or the relevant banking authorities may be required.[41]

- ***Negotiations with prospective investors.*** In general terms, the official administrator should have the legal capacity, subject to supervisory approval, to call for, receive and assess bids from prospective investors interested in acquiring a bank under official administration (either in its entirety or in parts). Moreover, the official administrator should be legally empowered to negotiate the conditions under which potential investors may acquire a bank under official administration.[42] In this regard, the official administrator should also be empowered to recognize valuations of assets at market value, even if this is lower than book value, and to negotiate compensation, indemnification or recourse arrangements, as appropriate.

- ***Transfer of assets and liabilities.*** The official administrator must have sufficient authority to sell any assets or arrange for the assumption of liabilities, on a piecemeal basis or as a pool, from a bank under official administration to other banks or interested parties. In some jurisdictions, the approval of the court or the relevant banking authorities may be required. Moreover, the sale of assets and assumption of liabilities by third parties can raise special problems, which need to be addressed in a country's legal framework.[43] In particular, the effective transfer of a failed bank's business as an open banking operation often involves the assumption of at least its entire deposit liabilities by another bank. The novation of individual liabilities may be a very burdensome and economically unsatisfactory means of achieving this result, especially where the assumption of liabilities is the consideration paid by the acquirer for the purchase of assets of equivalent value. Accordingly, the lack in many countries of a legally certain and effective technique for the assumption of liabilities on a wholesale basis will be a significant impediment to effective restructuring. This could be addressed by an explicit statutory provision that no prior consent from creditors or counterparties would be required for carrying out operations of this type.

[41] In addition to the special powers conferred under bank insolvency proceedings, in many cases the official administrator will be able to pursue a bank's restructuring by relying, in whole or in part, on the tools of general commercial law (for instance, in relation to the sale or securitization of assets or a debt-equity swap). The official administrator should always be aware of these existing tools and empowered to utilize them in implementing the preferred restructuring scheme.

[42] In some jurisdictions, the approval of the court or the relevant banking authorities may be required.

[43] In cases of partial transfers of assets and liabilities, the legal framework needs to include safeguards to address concerns respecting the equal treatment of depositors and unsecured creditors. For example, in cases where some but not all deposits are transferred (together with matching performing assets), those deposits (and other liabilities) that are left behind may have a diminished chance of being repaid in their entirety. Also, where a portfolio of performing assets is sold at a discount, the loss will have an impact on those creditors left behind in the residual bank.

- ***Supervisory approval of the restructuring arrangements.*** The banking authorities must be able to vet on fit and proper grounds new major shareholders and senior managers that may be put in place during a bank restructuring. The banking authorities should also examine the financial terms of any restructuring transaction in order to satisfy themselves that any relevant prudential standards will continue to be met after the transaction is executed.[44] Where the bank's ownership is to be transferred, in whole or in part, to a foreign acquirer, the supervisor will need to consult with its counterpart in the acquirer's country with a view to establishing effective supervisory arrangements.

- ***Use of the bank's proprietary information.*** The official administrator should seek to protect the bank's proprietary information. As the disclosure of detailed and accurate information relating to the bank's operations and/or its assets to potential investors is indispensable for the purposes of due diligence assessments, the professional duty of confidentiality owed by the official administrator should not preclude disclosures of this type. However, commercially sensitive disclosures should only be made under confidentiality agreements and to parties who can show that they are seriously interested in participating in the bank's restructuring.

C. Mergers or Acquisitions

69. Where a third party—and especially another healthy bank—is capable and willing to assume responsibility for recapitalization and future management, a failed bank can be restructured on an open-bank basis (i.e., without suspension or interruption of its banking operations) by means of a transfer of all shares from the existing shareholders to the third party. In these circumstances, the new owners acquire not only the assets and liabilities of the bank (as is the case in a purchase-and-assumption transaction as described below) but the ownership of the legal entity itself. The transfer of ownership can be structured as a simple acquisition of the failed bank's shares by the solvent bank, as a bank-to-bank merger, or even by means of the use of a bank holding company to bring the two previously unaffiliated banks under common ownership, provided that such "parallel" bank ownership does not give rise to supervisory problems. A country's general company and/or banking laws determine the range of techniques that may be used in each case.

70. Outside the context of insolvency proceedings, certain corporate restructuring techniques (such as a share write-down or the issuance of new capital) typically require a majority vote of the general shareholders' meeting. For the restructuring of a failed bank, the official administrator should have the necessary powers to force a write-down of the value of

[44] This includes an examination of the origin of the funds in order to ensure their legitimate source and the suitability of the investors.

existing shares in formal recognition of accrued losses, and enable the subsequent recapitalization of the bank by the issuance of new shares to new investors.

71. Where the law confers on the official administrator a power, framed in abstract and general terms, to sell a bank under official administration, a number of additional issues need to be addressed by means of carefully-drafted technical provisions. These include the exact mechanism for the recognition of shareholders' losses and the writing down or mandatory transfer of their shares,[45] the treatment of minority shareholders, and the distribution of any proceeds from the bank's sale. A special set of problems arise where the bank's shares are traded in a stock exchange, in which case the law must also include arrangements for the de-listing and consequent treatment of the listed shares. In the event of a merger, procedural and accounting issues concerning the consolidation of the two entities will also have to be addressed. In some countries, the banking law establishes special procedures, including shortened notification periods, to facilitate the expeditious execution of banking mergers.

D. Purchase-and-Assumption Transactions

72. Under the purchase-and-assumption technique, the viable part of the bank's business is transferred to another bank which, for this purpose, acquires some of the bank's assets and assumes some of its liabilities as a pool or as part of an ongoing business unit. At a limit, all of the bank's assets and liabilities may be transferred to an acquirer, in which case the technique serves as a close substitute to a full merger or acquisition of the legal entity; in other cases, only a portion of the bank's business is transferred. In all cases, however, the acquirer purchases the operations, but not the corporate entity or its license.[46] In other words, the bank under official administration is left under the original ownership as a legally distinct entity, and the official administrator remains responsible for the restructuring of any remaining operations or taking steps towards the bank's placement in liquidation.[47]

73. Purchase-and-assumption transactions can be an effective restructuring technique in situations where a full merger or acquisition is unfeasible or undesirable. Moreover, purchase-and-assumption transactions present benefits such as lower transaction costs, and greater flexibility enabling the official administrator to separate the non-viable from the viable operations, and to spin-off the latter.

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[45] This should include provisions for determining any compensation as warranted.

[46] As in the case of a merger or acquisition, however, a purchase-and-assumption transaction should be disallowed if, in the opinion of the supervisory authority, the acquiring institution will not be able to meet the requisite prudential criteria. In a similar vein, the competition authority should be able to object to a transaction that would result in a dominant position of the acquiring institution.

[47] Purchase-and-assumption transactions can also be performed as part of liquidation proceedings as will be discussed in Chapter V.

74. The modalities for purchase-and-assumption transactions will depend on their exact economic objective. Where the transaction takes the form of an effective take-over of the bank's ongoing business in its existing form, the transfer of intellectual and industrial property intangibles (such as trademarks) should be provided for. In the case of partial transfers, the official administrator may need to assign to the acquirer specified pools of assets together with a proportional amount of deposits or other liabilities. The legal treatment will depend on whether the transaction involves the full transfer of distinct sub-units of the bank (such as whole lines of business, divisions, or branches, including both good and poor quality assets) or a "clean" transfer, entailing the carving out and transfer of the bank's portfolio of good-quality assets (including performing loans), while the bad assets are left for liquidation (specific versions of this technique are discussed in the next section below).[48]

75. The law should also establish clear rules for the treatment of deposits. Where possible, these should be transferred to the acquiring bank and the position of the depositors should not otherwise be affected. Any deposits whose transfer cannot be covered by a corresponding transfer of assets or cash infusion of equivalent value should remain with the bank under official administration, to be liquidated.[49] In addition, it may be useful to provide for the formal approval of such transfers by the banking authorities or the courts.

E. "Good-Bank/Bad-Bank" Separation and Bridge Banks

76. Some jurisdictions, in the context of insolvency proceedings, allow the use of purchase-and-assumption transactions that separate the good-quality assets from the substandard portion of a bank's portfolio and provide for the continuation of its business operations as an open bank, free of the burden of carrying over past losses or, at least, of managing impaired assets. A variety of such techniques have been used, usually on an *ad hoc* basis, in different countries.

77. The authorities may transfer a bank's assets with or without recourse. In the first case, the impaired assets are separated from the bank—for instance, by being assigned to a subsidiary, to an asset-management company, collection fund or other special-purpose vehicle—with a view to ensuring more effective handling and asset recovery in the hands of specialists, thus permitting the bank's management to concentrate on returning the bank's operations to profitability. Where, in this context, the impaired assets are moved for collection to a person outside the bank's own corporate group, full or partial recourse or indemnification arrangements could be employed, in combination with contractual incentives for the maximization of that person's collection efforts. In the second case, the separation of

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[48] In the event of a "clean" transfer, criteria for the classification of individual assets and/or appropriate recourse arrangements (for instance, provisions for the return of sub-standard transferred assets or for the indemnification of losses) will have to be agreed.

[49] These types of partial transfers may give rise to concerns about the equal treatment of depositors and unsecured creditors; see the discussion in paragraph 68.

the bank's assets without recourse seeks to isolate the bank's surviving part from all further liability arising from the existing impaired assets, thus achieving a clean break with the past and a fresh start.

78. A specific example of the second (without recourse) approach is the so-called "good-bank/bad-bank" separation technique employed in many countries. Under this approach, the official administrator sells the nonperforming loans and other substandard assets to a separate company or entity (the so-called "bad bank") for collection.[50] The sale of assets normally takes place at market values or, in the case of operations assisted with public funds, at higher (possibly nominal) values or in conjunction with some form of subsidy. Typically, the "bad bank" is not actually a bank, because it does not conduct any banking business; rather, it is established only as an entity of a temporary nature which is wound up once the assets are liquidated, and can therefore more accurately be called an asset management company. Where the "bad bank" is set up by the official administrator, the banking authorities or the state, it should adhere to the principles of good governance, sound and transparent management and effective collection of the transferred assets.

79. In contrast, under the "bridge-bank" technique, a bank is split in two parts, by setting up a new licensed bank (the so-called "bridge bank") under the control of the banking authorities or an appointed official administrator to carry on the bank's operations. The bridge bank is then assigned the failed bank's performing assets and some or all of the deposits and other liabilities.[51] The impaired assets and remaining portion of liabilities stay with the bank under official administration, which is subsequently closed down and liquidated. This technique allows the operations to continue without interruption in the bridge bank, pending a permanent solution, for example, through the purchase of the bank by new owners.

80. In this sense, bridge banks are an interim, rather than a permanent, solution for banks under official administration. Bridge banks should be operated in a conservative manner, while serving the specific needs of their customers. Such banks are normally allowed to accept deposits and make low-risk loans to regular customers. A bridge bank's management goal is to preserve the franchise value of the bank and to minimize any disruption to the financial system. A balanced and transparent legal and regulatory framework for the setting up of the bridge bank and its interim operation under the control of the official administrator,

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[50] The transfer of assets can take place in a variety of ways, such as sales *en bloc*, "portfolio" sales, asset-by-asset sales, securitization, etc.

[51] There are a number of possible approaches depending on the design of the bridge bank and on whether or not it is an assisted or unassisted transaction. For example, the transfer may extend to all liabilities, all deposits but only some non-deposit liabilities, or only the insured deposits. To the extent that only some but not all liabilities are transferred, concerns regarding equal treatment of depositors and creditors may arise.

as well as a requirement for its rapid transfer to the private sector as soon as conditions permit, are essential for the success of this approach.

F. Publicly-Assisted Bank Restructuring

81. There has been broad international convergence on the principle that, in the absence of concerns over a systemic crisis, the discretionary, open-ended application of public funds for the purpose of keeping afloat failed banks and making good their losses is unjustifiable, because it ultimately transfers commercial losses to the taxpayer, validates poor bank management, and prevents the operation of the financial sector under conditions of market discipline and undistorted competition.

82. Generally, in situations where the failure of an individual bank does not have a systemic impact, no public funds should be used in the bank's restructuring or liquidation, except in those jurisdictions where the use of deposit insurance funds to restructure a failed bank is permitted, and it is deemed more advantageous and cost-effective than the pay out to depositors against insured deposits in the case of liquidation. To minimize the cost of bank failures, the laws of some countries authorize (or even require) the deposit insurance agency, or another agency with restructuring functions and powers, to provide limited financial assistance for the restructuring of failed banks under official administration to the extent that this is likely to result in a less costly resolution from the perspective of the agency (as distinct from that of the bank or its stakeholders).

83. Where countries do decide to make use of public funding, the forms of assistance may vary. The government may provide a direct capital injection, guarantees, loans or various inducements or incentives to potential acquirers. Under exceptional circumstances, such incentives may also include "loss-sharing" arrangements. Invariably, however, the assistance will be aimed at making possible the bank's merger or a purchase-and-assumption transaction in circumstances where this would not be commercially feasible otherwise. These operations can be performed either within or outside a formal official administration scheme.

84. A fundamental principle underpinning any type of publicly-assisted bank restructuring is that recapitalization should only be attempted after the bank's existing owners have been made to absorb all accumulated past losses. This means that the shareholders' net position in the bank should be verified and recognized through appropriate write-downs of the own-fund items. For banks under official administration that have crossed the "regulatory threshold" but still have some positive net worth, shareholders' participation in the restructured bank should be diluted accordingly. For banks whose liabilities exceed their assets and have, therefore, crossed the "balance-sheet threshold", public funds should be forthcoming only after the shareholders have surrendered their shares or their position has been written down or eliminated, in recognition of accumulated past losses. More generally,

the shareholders should not gain any benefit from a bank's restructuring except to the extent that they have directly participated in bearing the costs.[52]

85. In all cases, the provision of public assistance cannot, of itself, address a bank's underlying weaknesses. Thus, it should always take place in conjunction with the implementation of a plan for the bank's restoration to sound management and profitability. Finally, the state should always retain a right to reclaim its expenditure and participate in any gains when the restructuring has been successfully completed.[53]

[52] One reason why publicly-assisted restructuring may not be effectively carried out by means of voluntary transactions outside the formal bank insolvency framework, is that, once the shareholders become appraised of the likelihood of assistance, they will be unwilling to approve the dilution of their own interest in the bank and will hold out for some additional benefit.

[53] Publicly-assisted bank restructurings other than those specifically indicated by the least-cost criteria as described in this section should only be allowed under the circumstances of bank failures with systemic implications and subject to the legal requirements and limitations as described in Part II.

V. BANK LIQUIDATION

A. Nature and Objectives of Bank Liquidation

86. In liquidation, a bank is dissolved after a liquidator assumes legal control of its estate, collects and realizes its assets, and distributes the proceeds to creditors, in full or partial satisfaction of their claims, in accordance with the principle of equal (*pari passu*) treatment of similarly situated creditors and the applicable rules on priority.[54]

87. Liquidation will be appropriate where the bank's restructuring does not appear feasible, or where the restructuring involves the spinning-off of the viable operations of the bank, leaving only its residual, non-viable part with the original legal entity for liquidation.[55] During the commencement of liquidation and until the final act of dissolution, the bank will continue to exist as a legal entity, but will no longer be a going concern. However, bundles of assets may be sold as part of a business, rather than on a piecemeal basis, in order to ensure the maximization of their economic value.

88. The primary objective is to preserve and optimize collection of the bank's assets in order that creditors (including depositors) receive as much as possible of what is owed to them. This objective is the same for a bank as for any other enterprise. However, effective bank liquidation presupposes that the legal system provides satisfactory answers to certain special problems, which may not be present in a non-financial enterprise. The absence of such a framework will not only result in a disorderly closure of individual banks, but also increase the risk of spill-over effects, with potential systemic implications.

89. Accordingly, the liquidation framework should comprise clear rules for:

- formally placing the bank in liquidation;
- terminating the banking activities;
- assigning to a qualified official the tasks related to the liquidation of the failed bank's estate;
- preserving the bank's assets, which includes a suspension of all collection activity against the bank ("moratorium");

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[54] The voluntary liquidation of solvent banks is not discussed in this chapter. The discussion also excludes the compulsory liquidation of solvent banks on grounds of fraudulent or other illegal conduct, where this is provided for under domestic law.

[55] In procedural terms, a bank that has crossed the relevant threshold may be placed directly in liquidation, without going through a phase of official administration. In this case, partial restructuring, possibly in the form of purchase-and-assumption transactions, may take place under the umbrella of the liquidation proceedings.

- realizing the assets in an orderly and cost-effective manner;
- distributing the proceeds equitably to the various classes of creditors (including depositors) in a fair and transparent manner, which does not violate their relative priority;
- protecting the validity of orders entered into payment and securities settlement systems;
- ensuring the immediate enforceability of close-out netting and collateral arrangements relating to financial transactions;
- immediately separating the securities held in custody by the bank on account of third parties; and
- providing for the speedy compensation of depositors through the deposit insurance scheme.

B. Commencement of Liquidation and Role of Liquidator

90. There are different ways in which bank liquidation will be initiated, depending on the type of system in place in the particular jurisdiction. As noted in Chapter II, the law will, in all cases, have to specify the grounds upon which liquidation proceedings may be commenced. While the crossing of the "regulatory threshold" will often suffice for a bank's placement in official administration, a more stringent test may be applied to the decision to liquidate and ultimately dissolve the bank. Some legal systems require for this purpose that the bank be insolvent in the full balance-sheet sense, i.e., its net worth be negative, rather than very low ("balance-sheet threshold"). In some jurisdictions, it is regarded as sufficient to demonstrate that a bank is unable (or expected to become unable in the near future) to honor its payment obligations as they fall due (general cessation of payment) ("illiquidity threshold"). In any event, the overall objective is to initiate insolvency proceedings sufficiently early to avoid the dissipation of assets and the pursuit of assets by individual creditors to the detriment of other creditors.

91. The commencement of liquidation proceedings against a bank will normally lead to the withdrawal of the bank's license, thereby terminating any banking business in the bank. In most countries, the banking authorities are required to revoke the bank's license upon the commencement of liquidation proceedings. In a few countries, the banking authorities are permitted but not required to do so.

92. The law should specify who has the authority to place a bank in liquidation and appoint the liquidator (e.g., a court or the banking authorities). The decision of the appropriate authority to place the bank in liquidation should include the appointment of a liquidator. Immediately upon appointment by the court or banking authorities (appointing

authority), the liquidator should be given full control of the bank's assets, become its sole legal representative and succeed to all governance rights and powers of its shareholders and management whose involvement in the running of the bank should thereby be terminated.

93. The role of the liquidator is to conserve, realize and distribute the estate's assets. To perform these tasks in an effective and economically optimal way, the liquidator will need extensive powers which must be set out clearly in the legislation.

94. The liquidator's role does not include managing the bank as a going concern in an attempt to restore it to viability. Nonetheless, the continuation of certain operations may be necessary in order to ensure the best possible return to creditors through the sale of certain assets as part of an ongoing business.[56] The liquidator should, accordingly, be given the power to engage in commercial transactions in the name and for the account of the bank's estate. It is, however, unlikely that a partial continuation of banking activities (as distinct from non-banking operations that the bank may possibly carry on) will even be possible on this basis.

95. The law should also specify the form and degree of supervision to which the liquidator is subject. The liquidator should not be required to obtain permission for every liquidation-related action, since this could cause increased costs and delays and might even result in a virtual paralysis of the process. Nonetheless, the appointing authority should be able to give directions on the general conduct of the liquidation and the general plan of the liquidation. Moreover, the law may specify that some financially important decisions of the liquidator require the appointing authority's prior approval.

96. More generally, to protect interested parties, the liquidation framework must be characterized by a high degree of transparency. The owners, management, and creditors of the bank (as well as the public) need to be given an opportunity to obtain information on the decision to close a bank and on subsequent decisions that affect them. The liquidation process should also be subject to reviews to ensure proper accounting and require periodic reporting. Persons should have a right to be heard when their rights, interests in assets or duties under the insolvency law are affected, provided that such proceedings take place in an expedited manner so as not to unduly delay the liquidation process. In particular, creditors should have the right to challenge decisions concerning the validity and value of their claims. In some instances, it may be permitted to set-up a creditors' committee to advise the liquidator and review the liquidator's actions that affect creditors' interests (e.g., the sale or auctioning off of the bank's assets).

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[56] Such operations will primarily concern the bank's asset portfolio but should not include the acceptance of new deposits since this will be inconsistent with the very essence of liquidation.

C. Establishment of Estate and Protection of Assets

97. Possession of all of the insolvent bank's assets should pass automatically to the liquidator upon appointment. In particular, the liquidator should be given physical possession of the bank's books and records (including all computer files) and supporting documentation (including all documents creating security interests) governing the bank's lending transactions.

98. At the start of the liquidation, the liquidator will need the power to perform a stock-taking and prepare an inventory of the estate. This will comprise all assets owned by the bank at the time when it entered into liquidation.[57] The liquidator will also need to verify each asset and determine its value, both nominal (as reflected in the bank's books) and real (as revealed by appraisals and other valuation methods appropriate for each type of asset).

99. Once in control of the estate, the liquidator must enjoy all legal powers necessary for preserving individual assets and protecting the value of the estate as a whole. In particular, the liquidator must be in a position to exercise all rights of the bank in the assets, and any claims on borrowers must not be affected by the liquidation proceedings.

100. The legislation must ensure that the liquidation process will not be derailed by the liquidator's legal or practical incapacity to make immediate payments against its various costs which, in certain cases, can be very substantial. Accordingly, a mechanism whereby the liquidator can make such payments directly out of the estate, or otherwise recover running costs of the liquidation without having to wait for the final distribution of the estate's assets to claimants, must be provided for in the law. This should include recovery of the liquidator's own remuneration; in this context, however, additional safeguards, such as a requirement of prior approval by the appointing authority (or the courts), are essential.

101. Furthermore, to preserve assets and to carry on effectively the functions necessary for the liquidation process, the liquidator must be able to enter into contracts for the purpose of employing the services of various professionals and outside contractors. Relevant services would include the servicing of loans (billing and collection), legal advice, appraisals, the auctioning of assets, and accounting.

102. The ability of the liquidator to advance funds to protect collateral supporting the bank's assets should be explicitly delineated.[58] Similarly, where the bank itself has granted a

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[57] The term "assets" includes all rights to real property, all contractual rights and any actionable claim that the bank has. In addition to pre-existing assets, the estate should also include any asset recovered or acquired by the liquidator for the benefit of the estate. Difficult questions can be involved in determining the scope and value of certain assets. In particular, in some cases it may be difficult to determine to what extent a bank owns intellectual property, e.g., in proprietary software and other information technology products.

[58] Expenditures of this category would include, for instance, in the case of security rights in real property, the payment of taxes or the elimination of unsafe conditions concerning such real estate.

security interest over certain assets to any creditor, the liquidator should have the right to redeem the relevant assets if this could increase the value of the estate.

103. For the conservation of the proceeds from the collection of assets, the liquidator will need authority to maintain deposit accounts and to make prudent investments. In many countries, the ability to invest will be limited to a range of eligible instruments—in particular government securities. In some cases, the making of investments may require the approval of the appointing authority; alternatively, the legal framework may require that the proceeds be transferred to the appointing authority or a specified trustee, pending final accounting and distribution to creditors.

D. Moratorium

104. To provide for an orderly realization of assets and equitable distribution of proceeds, the placement of the bank in liquidation will invariably lead to an automatic moratorium or suspension of all collection activity against the bank.[59] This should include a stay on all current legal actions against the bank together with a bar on the filing of new actions, except with the permission of the appointing authority. It should also include a bar on the exercise against the bank of contractual rights which become exercisable on a debtor's default (with the exception of the enforcement of close-out netting provisions, as discussed below, and the ability of secured creditors[60] to foreclose on their collateral, in accordance with domestic provisions on secured rights).

105. The moratorium will also cover deposits, thus preventing depositors from gaining access to their savings. The effect on depositors will be mitigated where a deposit insurance scheme is in place. Where this is not the case, to alleviate hardship for small depositors, it may be useful to include in the law a provision enabling the liquidator to make immediate distributions of up to a specified amount or proportion against the bank's deposit liabilities, insofar as the bank's liquidity position so allows.

E. Treatment of Payment Orders and Financial Contracts

106. The impact of the freezing effect of the moratorium is particularly significant in relation to the failed bank's uncompleted transactions in the payment and securities settlement systems. Two critical issues must be addressed by the legal framework for liquidation: the exact time at which the moratorium takes effect; and the treatment of

[59] The moratorium only covers the enforcement of claims against the bank, and should not preclude the liquidator from exercising any right in favor of the estate.

[60] These will primarily comprise holders of collateral interests in securities. It is highly unusual for a bank to grant general secured interests over its assets, e.g., in the form of floating charges.

contractual arrangements in financial contracts that provide for the set off of mutual claims on the commencement of insolvency proceedings of one of the parties.

107. Some insolvency systems apply what is known as the "zero-hour rule", pursuant to which the effects of the initiation of insolvency proceedings, notably the stay on obligations, are dated back to the beginning of the day on which the commencement of insolvency proceedings against the bank was declared. As a consequence of this rule, all outgoing (but not the incoming) payment orders and transfers of securities taking place within the critical day (including those that preceded the declaration) could be rendered void and would need to be unwound. This can be exceptionally disruptive, because it can generate gridlock across the payment and securities settlement system and spread losses widely to other system participants. Therefore, in the interest of systemic stability, many countries have introduced "settlement finality" provisions, whereby, in so far as transactions processed through payment and settlement systems are concerned, the commencement of insolvency proceedings against a system participant produces only prospective effects and cannot lead to the reversal of payment orders that precede the commencement of insolvency proceedings. A few countries go further than that by establishing that the moratorium takes effect on the beginning of the day following the declaration, or at a moment determined in the decision itself.[61]

108. Concerns regarding the effects of insolvency proceedings particularly arise under payment and securities settlements systems that operate on a net-settlement basis.[62] Similar netting, set off, novation and/or close-out arrangements can be found in a variety of other financial contracts, such as foreign-exchange contracts, repurchase agreements, securities trades and derivatives, frequently in the form of provisions in master agreements. In normal times, such arrangements serve the purpose of economizing on liquidity, by ensuring that the mutual obligations of the parties are discharged by set off and that only a liquidated net

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[61] The payments and securities settlement system should be notified of decisions on the commencement of insolvency proceedings against a system participant.

[62] Generally, payment and securities settlement systems follow either the net settlement or the gross settlement model. In the former case, contractual arrangements are in place for the multilateral or bilateral netting of participants' mutual obligations over a specified period; such arrangements ensure that only the balance owed by a participant to counterparties (either individually or as a group) is ultimately settled at the end of the period, thus reducing substantially the number and overall value of actual transfers. In the gross settlement model, which for safety reasons is the preferred one for most systemically important systems, each transfer is executed immediately after its initiation (in "real time"), without the benefit of netting. Net settlement systems in particular, but to some extent also real-time gross settlement systems, give rise to considerable credit risks. Cross-border payment systems may cause additional difficulties, arising from conflicts between the multiple legal systems involved. Further risks are involved in the cross-border settlement of foreign exchange or securities transactions (see Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems and the CPSS/IOSCO Recommendations for Securities Settlement Systems, the ECB Oversight Standards for euro retail payment systems, and the ECB-CESR standards with respect to the settlement of securities transactions as well as CLS Bank which was set up as a mechanism to address risks arising from the cross-border settlement of foreign exchange transactions).

amount must be paid in the final settlement at the end of each trading period. Upon the commencement of insolvency proceedings, however, the contractual provisions may seek to reduce credit (and, to a lesser extent, liquidity) risk by stipulating that, in the event that insolvency proceedings are commenced against a party, its contracts are closed out and its mutual obligations with counterparties (including obligations that have not yet accrued at the moment of the commencement of insolvency proceedings) are subject to set off. A valid exercise by counterparties of such extended set off rights will give them the benefit of applying all their claims against the amount of their obligations to the estate. Conversely, if set off is not permitted, the counterparties will need to pay their side of the mutual obligations in full into the bank's estate, to be used for the collective satisfaction of creditors, and then file for what is owed to them as unsecured creditors, thus facing significant delays and the probability of recovering only a fraction of their claim.

109. In the absence of netting, set off or close-out provisions in connection with the commencement of insolvency proceedings, the insolvent party's failure to perform under a contract (in particular, following a decision to perform only profitable and to reject unprofitable contracts) could cause its counterparty to be unable to meet related financial obligations with other market participants. As a result, the insolvency of one significant market participant could result in a series of defaults in back-to-back transactions, potentially causing financial distress to other market participants and, in the worst case, their financial collapse. Therefore, where the law limits the effect of automatic termination clauses or the exercise of set off rights, specific exceptions to permit full enforcement of termination clauses with respect to financial contracts[63] in the context of bank insolvency may be advisable, provided that, based on careful analysis, the perceived need to reduce risk in financial markets outweighs the inequality of treatment between financial-sector counterparties and non-financial creditors (including depositors). A country that recognizes insolvency set off might nonetheless exclude from its scope the obligations of members of the bank's own group and other connected persons so as to prevent the conferment on such persons of an unjustified advantage over outside creditors.

110. More generally, the law should indicate whether or not the liquidator or the depositors have the right to set off a deposit against outstanding loans in the context of insolvency proceedings and, if so, under what conditions.[64] Establishing the net claims for each individual depositor is a cumbersome exercise and may delay payments to depositors. In this context, the law should also address the effects of any set off regarding pay outs by the deposit insurance agency. There are good reasons not to permit the set off of any insured part of deposits against outstanding loans. Not only does it take time to calculate the net claims,

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[63] Such exceptions may also extend to avoidance provisions that otherwise might apply to financial contracts.

[64] In the absence of deposit insurance, by means of set off, the depositor would be able to reduce any liabilities vis-à-vis the bank by the full amount of the deposit (rather than just the quota applicable in liquidation proceedings). Concerning any insured deposits, the depositor will not have an interest in set off.

the setting-off of insured deposits against outstanding loans may frustrate the purpose of deposit insurance, which is to provide small depositors with liquidity.

F. Avoidance of Transactions

111. In line with corporate insolvency law, the legal framework for bank insolvency will usually authorize the liquidator to terminate executory contracts in which the parties have not yet fully performed their obligations if this will increase the value of the estate. The liquidator may, in particular, be able to walk away from leases of property, dismiss employees (subject to applicable labor law provisions), and address supply and service-provision contracts. This power may be used by the liquidator for the purpose of keeping alive only those ongoing contractual relationships which are beneficial for the estate while rejecting the rest.

112. Subject to the need for payment system finality, the liquidator should also be given the authority to apply to the courts for the avoidance or rescission of certain transactions or transfers made by the bank within a specified period prior to insolvency, where these are deemed to be unfair and prejudicial to creditors, and to seek to reclaim relevant property. In particular, this could lead to the reversal of fraudulent or illegal transactions, transactions seeking to create a preference in favor of a particular creditor in circumstances where insolvency was already imminent,[65] gifts or transfers for less than fair market value, and transactions with certain related parties, including members of the bank's group or individuals related to its management.

G. Treatment of Borrowers

113. To dispel any confusion, at the start of the liquidation, it will be appropriate for the liquidator to give notice to the bank's borrowers that their debts are still extant but must now be paid into the estate. The implications of the moratorium for the contractual rights of borrowers, including any cancellation of credit lines, should also be notified to the parties concerned promptly and accurately.

H. Realization of Assets

114. An effective liquidation system will give the liquidator comprehensive powers to realize the assets of the estate in the manner that appears most advantageous in the light of the specific circumstances.

115. Given that a bank's estate will largely comprise financial claims, not real property, the sale of assets should not be pursued only through a limited range of traditional methods,

[65] Nevertheless, it must be taken into account that, in relation to financial contracts, the possibility of avoidance or rescission of preferential transactions may have the pernicious effect of discouraging counterparties from extending liquidity support to a bank in difficulty.

prescribed in the general insolvency law (e.g., by public auction), because such methods may not produce the best returns. Instead, the law should provide the liquidator with sufficient flexibility to use a variety of techniques, often of a fairly complex nature, in order to collect or sell assets, either individually or in bulk, with minimal loss of value, after taking into account prevailing market conditions. The liquidator should also be allowed to give representations and warranties in the name of the bank in connection with the sale of assets. Since the assets will often be in the form of contractual interests and will entail corresponding obligations, the law should permit the transfer of contractual relationships without the consent of the counterparty[66] and should clarify that the person succeeding the bank acquires validly all its rights and remedies.

116. Furthermore, to the extent that the timing of asset sales will be of critical importance, the actions of the liquidator should not involve a prolonged process. On the other hand, where the liquidator proposes to realize assets in a manner perceived as controversial, the law might allow him to seek the prior approval of the appointing authority or a creditors' committee, in order to avoid any uncertainty and to protect against potential challenges.

117. The liquidator should be given authority to manage the bank's assets, service its loans, apply interest and fees, and collect payments and release collateral upon full repayment by borrowers. The liquidator should also be able to: restructure loans by extending their maturity, revising the amortization schedule, or changing the applicable interest rate; negotiate settlements or compromise claims; and, more generally, engage in transactions involving a reduction in the nominal value of the bank's claims on counterparties if this is commercially justified.[67] To prevent irregularities, however, such transactions should be subject to full transparency and accountability. To this end, the law should provide for regular reporting by the liquidator to the appointing authority. In the case of large settlements, the prior approval of the appointing authority may be appropriate. The same may also apply to the settlement of any claim against insiders of the bank.[68]

118. Exactly as an official administrator would need to investigate the actions of those who had been involved in the management of the bank, the liquidator will need to investigate

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[66] However, it seems advisable to provide for notification requirements to the affected counterparties.

[67] In many countries, a liquidator will have the capacity to disclaim assets that he considers to be onerous. These could include unprofitable contracts or property to which the bank is entitled but which it would be uneconomical to sell, for example, because a significant sum of money must be spent to make it fit for sale. The power to disclaim should not be unlimited and, in some jurisdictions, the appointing authority will retain control over its exercise.

[68] In addition, the law should specify the grounds upon which creditors may question either the decisions or administration of the liquidator. To prevent unreasonable disruption of the liquidation process, the law should adopt appropriate limitations, such as determining the standard of proof that needs to be met in order to uphold the creditors' challenge or by protecting certain aspects of the administration against challenge.

the potential liability of the bank's ownership and former directors and managers for wrongful conduct, in particular, with respect to any transactions at a preference or for less than fair market value or involving fraud, and conversion of assets. Where liability for criminal or civil wrongdoing can be established, the liquidator should be authorized, as part of the collection efforts, to bring civil actions against directors, managers and/or owners for the recovery of damages or for the recognition of their personal responsibility to cover certain liabilities. In some legal systems, the liquidator would have a duty to inform the law enforcement authorities if there is a suspicion that criminal acts have been committed.

I. Distribution to Creditors and Depositor Pay-off

119. Soon after the commencement of liquidation proceedings, the liquidator should invite creditors to file their claims against the bank. To this effect, a notice should be published in a manner likely to bring it to the attention of most people who may have had dealings with the bank. The notice should set out the procedure and deadline for the filing of claims. The purpose of a deadline is to allow the liquidator to determine the total amount of the bank's outstanding liabilities, finalize the accounts of the estate, and calculate what proportion of each claim can be paid. Of course, many liabilities will be evident from the bank's own records.[69] The liquidator will have to check both the amount and the validity of each claim. Any claims that are filed after the closing date should only be paid from any surplus, after all claims that were filed in time have been paid. There are differing views as to the length of the appropriate period for filing claims. In some jurisdictions, the period may be as short as 90 days whereas, in others, it may be six months, and possibly even one year. What is essential is that a realistic opportunity should be provided for creditors to make their claims.

120. In jurisdictions where a deposit insurance scheme is in existence, a parallel process of notices, filings and payments to insured depositors will be necessary (except if the deposit insurer is also the liquidator). Payments under the scheme take place outside the liquidation process and they will be made regardless of whether the bank's estate has sufficient assets. Deposit insurance can have the effect of removing the majority of depositors from the liquidation process. However, if a scheme does not provide full coverage of deposits, a depositor whose claim has been satisfied only in part, in addition to making a claim to the deposit insurance agency, will also have to file a claim in the liquidation proceedings for the remainder. Payout of insured deposits should take place as quickly as possible and, in any event, within a maximum period specified in the relevant domestic law. This is necessary to alleviate small depositors' hardship and to maintain public confidence in the system. The legal framework should provide for the deposit insurance agency's subrogation to the rights

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[69] Frequently, the liquidator will be able to establish depositors' claims without requiring any action on the part of the depositors. In such cases, filing one's claim should not be a condition for participation in the distribution of the proceeds of liquidation. Consideration may be given to arrangements providing for additional verification of depositors claims.

of the depositors against the bank to the extent that payments have been made under the scheme.

121. Once claims have been verified, the liquidator will need to pay creditors, including depositors, by distributing the proceeds from the realization of assets amongst them in proportion to their respective claims and relative order of priority. The priority of different classes of claimants should be set out in the law. Practices on the matter differ but, generally, the classes that must be ranked include:

- the liquidator for the costs and expenses relating to the liquidation (which in many jurisdictions will rank first in the list of priorities);
- employees (whose place in the list of priorities will depend to a large extent on country-specific labor laws and social policies);
- the central and local government for taxes and various other claims (the rank of which will vary widely from one country to another, from second only to the liquidator to junior to unsecured creditors);
- secured creditors (including, in particular, interbank lenders holding interests in securities as collateral and, if applicable, the lender of last resort);
- unsecured general creditors, including bondholders and holders of certificates of deposit;
- depositors;
- the deposit insurance agency, to the extent that it has been subrogated to the rights of depositors for the amount of payments made to them;
- subordinated bondholders who will rank last of all holders of claims of nominal value; and
- the bank's shareholders as residual claimants who will be entitled to a distribution in the unlikely event that there is any surplus after the repayment of all bank liabilities at their full nominal value.

122. Generally, depositors rank as unsecured creditors. However, some jurisdictions give depositors a degree of preferential treatment over other unsecured creditors, or even first priority for part of their claim. This may be considered appropriate especially in jurisdictions without a deposit insurance scheme.

123. All unsecured creditors will be paid what they are entitled to by the liquidator once the net estate is ready for distribution. In so far as the secured claims against the bank are

subject to the moratorium, those should be handled through the claims process for general unsecured claims; however, in the distribution of proceeds, secured creditors will receive in preference payment out of the realization value of their security up to the full amount of their claim. Where the security does not suffice for the satisfaction of a secured creditor's claim, the latter will become an unsecured creditor for the balance.[70]

124. The law should specify the methods that can be used to reimburse creditors, including depositors, and the manner in which the latter should be notified of their right.

J. Termination of the Liquidation

125. In all cases, once the liquidator has completed the realization of all assets of the estate, final distribution will be made to claimants. In this connection, provision needs to be made for unclaimed assets (including where bank customers could not be contacted). For example, it may be provided that such unclaimed assets be held by a designated trustee for a specified period of time, after which they become the property of the state. Upon completion of the final distribution and the preparation of the final accounts and report by the liquidator, the liquidation ends and (subject to the fulfillment of any applicable formalities) the legal personality of the bank is dissolved.

[70] This applies both in cases where self-enforcement of secured rights is allowed and where these rights are subject to the moratorium and require realization by the liquidator.

Part II. Key Features of the Legal, Institutional and Regulatory Framework For Systemic Banking Crises[71]

A. Overview

126. The legal, institutional and policy framework needed to address cases of bank insolvency during periods of systemic instability or systemic crisis is, in many ways, qualitatively different from the framework that is appropriate during periods of financial stability. As it is not possible to predict when systemic instability may occur, the framework for systemic crises will generally draw on the framework in place during stable periods. The dynamics of systemic crises are driven by uncertainty and lack of confidence in the financial system as a whole. Unable to distinguish between solvent and insolvent institutions, creditors run from the system. A downward spiral involving a loss of private sector confidence, preemptive creditor runs, illiquidity, and a further loss of confidence can result in the inability of banks to meet their commitments and a generalized collapse of the financial system. While the current financial market turmoil is still unfolding, and the outcome of crisis response measures remains to be seen, many lessons can be drawn from previous systemic crises. This chapter explores relevant issues while recognizing that practices in this area are evolving.[72]

127. The framework needed to manage a systemic crisis must address the sources of the loss of confidence. In particular, it must include a flexible policy response. As described in earlier chapters, the legal and institutional frameworks that should apply during stable periods will normally contemplate the immediate resolution of insolvent banks and provide to depositors only a limited payout of deposits according to the deposit insurance laws. In a systemic crisis, however, such policies would aggravate uncertainties, exacerbate the loss of confidence and could lead to a catastrophic outcome. The policy and legal framework for systemic crisis, therefore, is different and must aim at: (i) protecting the payment system; (ii) limiting the loss of depositor and creditor confidence; and (iii) restoring solvency, liquidity and stability to the banking system.

128. Defining a systemic crisis is a difficult undertaking. No generally accepted definition exists for this purpose. However, a systemic banking crisis is typically characterized by financial sector distress of such a magnitude that it has an adverse effect on the real economy as a whole, and will usually include at least some of the following elements: (i) severe

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[71] Part II of this study is an expanded and updated version of the chapter on systemic crises that appeared in the report of the Global Bank Insolvency Initiative and is meant to stimulate discussion on this topic. This version has been prepared by IMF staff and represents the views of IMF staff. IMF staff's views have been previously outlined in a series of publications including Bank Restructuring and Resolution (Macmillan, 2006) and Occasional Paper 224, Managing Systemic Crises (IMF, 2003.)

[72] In future, IMF staff intends to revisit the discussion in this chapter in light of the outcome of the current financial market turmoil.

financial problems in a large part of the banking system; (ii) a system-wide loss in bank asset quality; (iii) a widespread loss of credit discipline; and (iv) a danger of collapse of the payment and settlement systems. The banking authorities will have to determine quickly and, in most instances, with limited information whether the risks to the system are substantial enough to justify the use of exceptional systemic tools.

B. General Considerations

129. Strategies to manage systemic crises typically include three phases. These phases are interconnected and may run concurrently. However, they have different implications for both institutions and policy implementation.

- ***Crisis containment.*** The first and most urgent phase entails stabilizing creditor expectations and halting creditor flight, including depositor runs. At this stage, crisis management seeks to avoid, where possible, the imposition of losses on creditors, and may have to rely on strategies that are very different from bank insolvency practices followed during periods of financial stability.

- ***Restructuring.*** The second phase seeks the resolution of banks in financial distress—either through their restoration to financial soundness and profitability, or through their liquidation.[73] This restructuring phase usually starts once creditor and depositor runs have been halted.

- ***Asset management.*** The third phase of the strategy, which has a medium-term time horizon, focuses on the restructuring of nonperforming assets.

C. Institutional Arrangements for Systemic Crisis Management

130. The breadth and intensity of systemic crises puts extraordinary pressure on the authorities. They must respond quickly to developing events yet act with minimal information. Delays in response tend to aggravate the situation and may increase the eventual cost of the crisis. Under such circumstances, close coordination among official actors as well as clarity on their respective roles is essential. The institutional framework can facilitate such coordination.

131. In designing the institutional framework for systemic crisis management, a country's authorities must decide whether the special institutional structures necessary for this purpose (i) should be provided for in legislation that applies on a standing basis and is ready for activation whenever a crisis occurs, or (ii) should only be put in place after the crisis has struck. While there may be some advantages involved in having these features in place

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[73] In this context, "resolution" is used in general terms to indicate a broad menu of policy interventions that are described in the previous chapters of this study.

prospectively, such an approach may present some difficulties. Each crisis is different and it would be difficult to specify what framework and measures would be appropriate ex ante. While it is never easy for the authorities to take the necessary steps in "real time" as the crisis unfolds, such an approach allows a country to respond to the crisis at hand with the measures that will be appropriate in that case.

132. Regardless of which approach is taken, a critical feature of a successful crisis management framework is a clear mechanism to ensure effective policy development and coordination within the government. With this objective in mind, some countries have established a high-level policy group that provides strong leadership and accountability in the development and implementation of the stabilization strategy. This group is often headed by a high-ranking government official (e.g., the minister of finance, or even the prime minister) and will typically include senior representatives of the banking authorities. Such an authority has a variety of responsibilities. It provides political support to deal with vested interests and determines burden sharing practices. It develops the initial strategy, coordinates and monitors its implementation, and modifies the approach in response to unexpected developments. Other countries have relied on a more decentralized approach in which technically-oriented advisory committees provide advice to policy makers within the existing governmental structure. The choice depends on a variety of factors including the strength of existing institutions and past experiences in coordinating policy development.

133. Under either approach, the authorities must speak with one voice and explain clearly to the private sector who is responsible for implementing and coordinating policy development. More generally, a coordinated and comprehensive communication strategy by the authorities is essential. The private sector must understand how the authorities diagnose the problems facing the economy and the strategy being followed to address those problems. In addition to the high level coordination group, the roles and responsibilities of other government agencies involved in each phase of the crisis containment strategy must be clearly established to preserve accountability. Moreover, for each phase of the crisis, the following institutional issues should be considered.

134. ***Crisis containment***. The authorities will need to make the most urgent policy and budgetary decisions in relation to the containment of the crisis. Decisions about the feasibility of alternative containment strategies will require a broad understanding of the fiscal and monetary conditions in the country.

135. ***Restructuring***. The restructuring of the banking system entails detailed diagnosis of individual banks and the development and monitoring of their restructuring plans. Some authority must be responsible for: (i) conducting the diagnosis; (ii) reviewing the restructuring plans submitted by the banks; (iii) ensuring the plans are adequately implemented; and (iv) requiring modification of the plans where necessary. This detailed implementation is time consuming and requires specialized knowledge.

136. A choice must be made between relying on the existing banking authorities or establishing a new agency to oversee the bank restructuring. Under the first approach, the banking authorities will retain a central role in restructuring individual institutions; they would agree on and monitor the restructuring plans presented by shareholders of undercapitalized or insolvent institutions. Under the second approach, a bank restructuring agency will be established (particularly if the government has nationalized a significant number of banks) that would: (i) in coordination with the banking authorities, approve and monitor restructuring plans; (ii) coordinate the work of other agencies (particularly the banking authorities) involved in resolving the crisis; and (iii) own and manage any banks that have been nationalized. In a systemic crisis, the establishment of a separate agency has three benefits: (i) it can dispel the appearance of conflict of interest; (ii) it will concentrate specialized skills for the restructuring of banks in a new, separate agency; and (iii) it allows traditional supervisory resources to be dedicated to strengthened supervision.

137. A strong legal, institutional, and regulatory framework governing the resolution of individual cases of bank insolvency in normal times, as outlined in earlier chapters, can facilitate the resolution of bank insolvencies even in a systemic crisis. Such a framework provides the basis for the implementation of most operational aspects of a successful restructuring strategy. Moreover, the quality of the country's system of commercial and property law as well as its prudential regulation will influence the speed and efficiency of the restructuring and asset management phases of crisis resolution.[74] In some cases, this existing legal framework will be sufficient. In other cases, however, changes may be necessary to expand the tools available to deal with a systemic crisis.

138. ***Asset management***. The third phase of crisis management, the resolution of impaired assets of the banking system, is often played by financial institutions other than banks (such as "bad banks", collection agencies, or asset management companies). In a systemic crisis, bank administrators and/or liquidators can be overwhelmed by the volume of impaired assets. In addressing such pressures, two broad approaches have been adopted. One is individual-bank based, where banks set up work-out units or private asset management companies (AMCs) to deal with the impaired assets. Private institutions can respond quickly and efficiently in selling assets to other private entities. The other is a more centralized approach whereby the public sector establishes a public AMC (or several specialized public AMCs) to deal with the impaired assets of the entire system. Government-owned or public AMCs may be relatively more efficient when the size of the problem is large, special powers for asset resolution are needed or the required skills are scarce. Such institutions, in particular, acquire

[74] For instance, it will be essential to have in place effective rules on asset valuation, accounting and auditing, transfers of property, loan recovery powers of banks, and the fitness and propriety of bank owners and management.

banks' assets and restructure individual loans, thus relieving banks from this time consuming process.[75]

139. Regardless of the ownership structure, the mandate of the AMCs must be unambiguous. AMCs can have narrow mandates or broad mandates. Narrow-mandate AMCs take over and liquidate banking assets from closed institutions. Such AMCs often focus on rapid asset disposition by quickly selling assets to the private sector—in many cases, to the detriment of value maximization. AMCs with broad mandates conduct asset management in the context of broad restructuring activities. Such AMCs resolve assets from failed institutions and also take on the role of a bank restructuring agency, overseeing the restructuring of viable but distressed institutions. Some AMCs have multiple objectives.

140. Where an AMC is established, it should be subject to proper oversight that ensures adherence to the principles of good governance (e.g., respecting the transfer of assets to the AMC). This is even more important in the case of public AMCs, where good governance is essential to maximize the value of the impaired assets, to minimize the fiscal costs, and to prevent a deterioration in credit discipline. The institutional structure of a public AMC must ensure that it is independent in its operations, free from political interference, and accountable for its performance. With these objectives in mind, public AMCs are normally established as independent entities, with a separate budgetary process.[76] They typically report regularly to the parliament and the public, and are subject to strict audit procedures.

141. Public AMCs are meant to be temporary entities. By achieving their goal, they make themselves redundant. The self-liquidating nature of public AMCs necessitates the introduction of an incentive structure consistent with the achievement of their objectives and the avoidance of an undue prolongation of their activities.

142. Experience with the performance of public AMCs is mixed, reflecting a number of problems that can arise if proper governance mechanisms are not observed. They have been found to work more effectively in countries with sounder and more transparent institutional environments. The assessment of the legal and institutional framework for supervision is mixed. More than 80% of the 135 countries assessed through the Financial Sector Assessment Program (FSAP) were found to be compliant or largely compliant with the principles contained in the Basel Core Principles of Banking Supervision that deal with the legal framework for supervision, authorization of banking, compliance and soundness. However, compliance was much lower (66%) in terms of taking necessary remedial action under the legal framework, including for bank resolution.

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[75] It is also possible for public and private AMCs to exist side-by-side, or to create a public-private AMC.

[76] A public AMC will often be funded with the proceeds of bonds issued by the government or by the agency itself with a government guarantee, with the repayment period of the bond issue designed to be consistent with the expected life of the agency.

D. Regulatory and Legal Arrangements for Systemic Crisis Management

143. The legal and policy measures to be employed by the authorities in a systemic crisis will vary with each phase of the crisis. Measures that may be necessary at the crisis containment stage may differ from those to be applied in the restructuring and asset management phases. Some of the key measures that may be relevant in the three phases are described below.

Crisis containment

144. The immediate priority of the authorities is to develop a comprehensive restructuring strategy that, at the outset, contains the crisis and stabilizes creditor confidence. Four sets of measures have particularly been employed by countries to contain creditor runs: (i) emergency liquidity assistance; (ii) blanket guarantees; (iii) certain types of administrative measures; and (iv) exchange controls. Each measure has different institutional, and regulatory conditions for successful implementation.

145. ***Emergency liquidity assistance (ELA).*** In stable periods, illiquid banks can obtain short-term liquidity from the standing central bank credit facilities. Such facilities have very strict access requirements, are limited in size, are only available to solvent banks, and charge penalty interest rates in order to limit incentives to borrow. In a systemic crisis, however, such limitations on access can aggravate the situation. If creditors fear that even solvent banks have difficulty obtaining liquidity, they may engage in pre-emptive runs from otherwise sound banks. ELA should be available to all banks (not just large or systemically important banks) as market participants will run if they believe their bank to be unprotected from liquidity pressures. For similar reasons, some central banks have recently expanded the coverage of such assistance to include all types of institutions whose failure could have a systemic impact. Central bank liquidity, for example, has been provided to interbank markets, insurance firms, and other non-bank financial institutions. Accordingly, the central bank may need the authority to provide liquidity support to a wide range of institutions whose failure would undermine financial stability.

146. Countries take different approaches in determining whether or not to set out in legislation or in regulations the conditions governing the provision of emergency liquidity assistance either in normal times or in a systemic crisis. Some countries make explicit provision for this purpose; other countries have been reluctant to do so, believing that "constructive ambiguity" diminishes the risk of moral hazard and provides flexibility to respond to changing conditions.[77] Experience has shown that having explicit authority and a

[77] Even when the authorities prefer constructive ambiguity in their dealing with the market, contingency planning is an essential element of crisis preparation. The authorities should ensure that their problem bank resolution framework is comprehensive, meeting many of the elements described in Part I of this document, and that internal plans are developed on how an emerging crisis would be managed.

facility available can help stabilize private sector expectations in the face of severe market disruptions.

147. The policy, legal and institutional framework governing the provision of emergency liquidity assistance is evolving. At the same time, safeguards are being included in the emergency liquidity framework of some countries to mitigate risks to the financial system arising from excessive liquidity support. Presently, most such safeguards refer to support for banks and typically seek to ensure the following:

- The monetary authorities have adequate tools to sterilize monetary expansion, and can introduce or intensify their use of open market operations to control monetary aggregates.

- Recipients must provide collateral and pay at least an above-average rate of interest. Over the course of the crisis, the conditions governing such support may need to be eased in comparison to those which apply in normal times.

- Liquidity triggers set out in the legal framework (e.g., central bank legislation or regulations) will reduce the likelihood that excessive liquidity assistance is provided. These triggers typically require the banking authorities to take specified supervisory actions as the amount of emergency liquidity assistance provided to a bank increases. A typical trigger is the measure of liquidity as a percent of bank capital. As that ratio increases, increasingly strong supervisory measures are initiated.[78]

- The authorities will engage in enhanced supervision of banks receiving emergency support to ensure that central bank liquidity is used as intended and, in particular, to fund deposit runs rather than increase the volume of assets held by recipient banks. Attention needs to be paid to corporate governance in these banks, particularly if problems in the recipient banks are the result of poor management rather than pure contagion.

- When operating in highly dollarized economies, central banks have established higher liquidity requirements than customary in non-dollarized economies and built up international reserve buffers.

148. ***Blanket guarantees.*** Market confidence—of both depositors and general creditors—is fragile: easy to lose and difficult to reestablish. When standard policy options of macroeconomic adjustment and supervisory intervention are ineffective in halting runs, the

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[78] Banks are typically first subject to special on-site inspections, followed by placement of supervisors on the Boards of Directors. At a point determined by law, liquidity triggers can permit supervisory intervention in the bank, thus overcoming any limitations in the bank insolvency regime.

authorities in some countries have resorted to a generalized guarantee—a blanket guarantee of all bank liabilities except to related parties—to calm market fears.

149. The immediate fiscal costs of a successful blanket guarantee are limited, as creditor runs are halted immediately. However, the medium-term costs are difficult to quantify. Once bank restructuring begins, the authorities have a variety of options at their disposal to finance the cost of restructuring without the use of public resources. Weak banks can be restructured, recapitalized or merged with stronger institutions, relying on private resources from original shareholders or new private investors. Public resources will be needed only to cover residual costs.[79]

150. Credibility of a blanket guarantee is essential because creditor expectations must stabilize immediately, often before other policies have time to take effect. Common determinants of a blanket guarantee's credibility include: (i) the political commitment (and sometimes, statutory backing) for the guarantee; (ii) the strength of the banking system and the bank resolution framework; (iii) the perceived ability of the government to cover resulting costs; and (iv) the strength and comprehensiveness of the authorities' communication strategy in describing the guarantee and how it will be financed.

151. Blanket guarantees typically cover all creditors who are unrelated to the relevant institution. Protected creditors include depositors, interbank creditors, and foreign creditors. Protecting only some creditors (e.g., only depositors) may undermine rather than restore stability by creating incentives for uncovered creditors to run preemptively.[80] Foreign currency deposits have been generally covered by blanket guarantees but payout can be made in local currency. Off-balance sheet liabilities such as swaps and derivatives are also covered because such instruments convert to on-balance items in the event of a default.

152. The exceptions to a blanket guarantee are generally few in number. They often include: (i) shareholders and holders of subordinated debt; (ii) deposits held by insiders, related parties, and unnamed accounts; and (iii) deposits held in foreign subsidiaries of domestic banks.

153. The precise form of the guarantee has varied across countries, ranging from implicit guarantees, declarations of policy intentions, to a formal guarantee set out in legislation. Implicit guarantees arise when the authorities make no public announcements but in practice protect all creditors of each failed bank, thereby creating an expectation among market

[79] Under some circumstances, the central bank may provide immediate financing but the government will be expected to directly fund the program or commit to the recapitalization of the central bank in the case of losses. The fiscal costs of the guarantee will be higher, the weaker the financial system is, and the smaller the available private resources are.

[80] Runs by creditors with very small exposure to the banking system may not jeopardize stability but, because they are small, the costs of including them in the guarantee will be correspondingly small.

participants that similar steps will be taken in future cases of bank failure. A declaration of policy intention is not formalized in law but may, in some cases, prove sufficient to calm market fears—in particular, when it represents a clear and credible indication of public policy. Some countries go further by setting out in legislation a clear legal framework specifying precisely how the guarantee will operate and providing market participants with an assurance that their claims will be repaid. The choice will depend on specific conditions in each country.

154. Determining when a blanket guarantee is warranted is a policy judgment that is difficult to make ex ante. Crises evolve in unpredictable ways and policy decisions have to be made without full or adequate information. If the stability of the banking system is not threatened, a blanket guarantee will rarely be advisable as it can contribute to moral hazard and undermine risk-taking incentives. In contrast, a blanket guarantee may be warranted when a country's authorities fear they are losing control of events and determine that contagion—or the threat of contagion—from failing banks to the broader banking system is significant. Once such a determination is made, the blanket guarantee should be quickly put in place.

155. Reliance upon a blanket guarantee raises at least three risks to financial stability over the medium term. First, blanket guarantees are prone to abuse, particularly in an environment where the banking authorities are subject to political interference and the system is dominated by vested interests. Second, blanket guarantees remove pressure for the rapid resolution of banking problems and can increase the overall costs of the crisis by delaying restructuring efforts. Third, as described above, blanket guarantees can pose a contingent liability for the government that is difficult to quantify ex ante. These risks point to the importance of taking advantage of the relative stability resulting from the guarantee to move aggressively to identify and resolve insolvent and nonviable institutions.

156. ***Administrative Measures.*** If all measures described above are unsuccessful, a country's authorities may have little option other than to adopt more drastic administrative measures to prevent the collapse of the financial system. These measures may take a variety of forms and are often referred to as "deposit freezes." Typically, the authorities will take measures (including the enactment of legislation) to restrict deposit withdrawals, extend deposit maturities, or securitize deposits.[81]

157. Such measures have been used sparingly in recent times. Administrative measures are disruptive to the payment system, to depositor confidence, and to economic activity more generally. In many cases, they will also be subject to legal challenge, in particular, by

[81] To the extent that such measures restrict the transfer of balances held by nonresidents that represent the proceeds of current international transactions, they may also be inconsistent with Article VIII, Section 2 (a) of the IMF's Articles of Agreement. This provision prohibits members of the IMF from imposing, without IMF approval, restrictions on the making of payments and transfers for current international transactions.

affected parties who argue that the measures constitute confiscation and an illegal interference in their property rights. Administrative measures, therefore, should be viewed as a final—possibly desperate—effort to stop a generalized run on banks.

158. If administrative measures are used, periodic withdrawals up to specified amounts should be permitted. Moreover, they should only be in place for limited periods of time and exit policies should be prepared in advance.

159. Bank holidays, another form of administrative measure, are of only limited value in a crisis. In a bank holiday, the authorities simply close the banks, thereby suspending the ability of market participants to transact. Bank holidays do give the authorities a very limited period in which to develop a comprehensive strategy. If a bank holiday extends for more than a few days, however, it will aggravate the crisis, resulting in: (i) substantial economic costs; (ii) pressure for selective "defrosting" by allowing certain types of transactions to be conducted; and (iii) significant opportunities for abuse and rent-seeking. Moreover, to be effective, the lifting of a bank holiday must coincide with the implementation of a highly credible and comprehensive strategy for addressing the crisis.

160. ***Exchange controls.*** Exchange controls, in some cases, may be employed by countries when the banking crisis is accompanied by unsustainable pressure on the balance of payments. In these circumstances, the authorities may restrict the making of certain types of international payments and transfers. The introduction of such controls may slow a run on the currency and the liability base of the banking system.[82] However, the authorities should only impose such measures as part of a comprehensive strategy to respond to their balance of payments difficulties. Moreover, such measures should be comprehensive, fully enforced, and consistent with members' obligations under the IMF's Articles of Agreement. Experience indicates that any beneficial effects of such controls are temporary, as they encourage circumvention and discourage legitimate transactions and may negatively affect market confidence.

Bank restructuring

161. Once the crisis has been contained, the banking authorities' primary task becomes the restructuring of individual banks. The main objective of this phase is to identify viable banks and restore them to profitability and solvency. Bank restructuring is a multi-year process, involving several steps described below.

162. ***The Legal Framework.*** To facilitate bank restructuring, the legal and regulatory framework governing bank insolvency should be reviewed and, where necessary,

[82] The IMF's Articles of Agreement permit countries to impose restrictions on capital movements and, with IMF approval (that is generally granted on a temporary basis and subject to certain conditions), restrictions on the making of payments and transfers for current international transactions.

strengthened. To be effective, it will need to embody the features of the framework for normal times described in previous chapters. Otherwise, even where the bank restructuring strategy is comprehensive and fully agreed, weaknesses in the legal framework may undermine bank resolution efforts. Such weaknesses have resulted in (i) incentives to postpone effective treatment of failing banks, and (ii) higher costs for bank resolution.

In countries that have experienced systemic crises, some of the most common shortcomings in the legal framework have been the following.

- ***Weak mandate of resolution authorities to restructure banks.*** The bank resolution entities may not have a clear mandate to restructure banks, or the organizational framework, financial resources, and professional leadership to accomplish their objectives.

- ***Inability to restructure banks.*** The banking authorities may lack the legal authority (with or without judicial oversight) necessary to write down shareholders' equity, sell bank shares, or engage in purchase-and-assumption transactions and transfer certain categories of liabilities (e.g., deposits) to other institutions along with bundles of assets.

- ***Lack of legal protection for Board members, staff, and other officials of agencies responsible for bank restructuring.*** In many countries, officials of the banking authorities are not given sufficient legal protection from personal liability for actions respecting an insolvent bank they have taken in good faith in the normal course of their duties. Their bank resolution efforts will often be impeded by civil actions brought against them personally by interested parties.

163. In some cases, aspects of the legal framework for bank insolvency and supervision that are appropriate in "normal times" will need to be modified. For example, the authorities may wish to permit temporary, explicit forbearance for some prudential requirements. Such forbearance would provide shareholders with an explicit, monitored period in which to restructure their bank and meet prudential requirements in full. At the same time, changes to prudential regulations may also be needed to (a) adapt accounting and auditing rules, and loan and collateral valuation rules, (b) strengthen the rules governing the fitness and propriety of owners and managers of banks, (c) improve entry criteria for new banks, and (d) limit related-party lending and risk concentration.

164. ***Tasks in bank resolution.*** An important task facing the authorities is the diagnosis of the financial condition of individual banks. A decision must be made between relying on existing supervisory staff or hiring external audit teams to conduct the assessment. If supervisory staff are used, they will need to update available information and examine banks' ownership structures (public or private, foreign or domestic, concentrated or dispersed) to help determine the scope for upfront financial support that will be needed from existing or

potential new private owners. The use of external audit teams offers an independent judgment but takes considerable time to implement.[83] One alternative is for the supervisors to do an initial assessment, and then for more complete evaluations to be conducted by external auditors later in the restructuring process.

165. Following the diagnoses, the banking authorities need to approve the appropriate resolution strategy for each bank; it is important that the relevant authorities be given the necessary power to do so. Typically, the banking authorities differentiate between banks that are: (i) viable and meeting their prudential capital adequacy ratios and other regulatory requirements; (ii) viable but insolvent or undercapitalized; and (iii) insolvent and non viable.

166. The determination of a bank's viability is a critical step in this process. Banks may have intrinsic franchise value that can be preserved in spite of the deterioration in asset value. In a systemic crisis, however, financial statements and asset values of a bank can be distorted, making it difficult to determine a bank's financial position. In assessing the potential viability of banks in such circumstances, the authorities may require bank owners and management to develop medium-term business plans and cash flow projections, based on realistic macroeconomic assumptions, that show future profitability and medium-term strength. The authorities must also develop a view as to the future volume of activity that the economy can absorb and ensure that banks will become profitable in the new environment.

167. In many cases where banks do not meet prudential ratios, the authorities may allow the bank to operate under a time bound restructuring plan. This is particularly the case where the relevant bank is undercapitalized and viable, and the shareholders are fit and proper but are unable to fully recapitalize the bank immediately. The plan will need to set out quantitative targets that are monitored closely until the bank meets fully all prudential requirements. The bank's recapitalization plan would typically include some limitations on bank activities, including the suspension of dividend distributions.

168. Losses must be recognized promptly. In a crisis scenario, the authorities' restructuring strategy should generally apportion losses in the following order: (i) shareholders; (ii) subordinated creditors; (iii) general unsecured creditors[84]: and (iv) secured creditors up to the value of their collateral.

169. ***Options for restructuring.*** Bank restructuring strategies in a systemic crisis can be broadly divided into private sector solutions and public sector assisted solutions.

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[83] Contracting auditors and conducting the exams typically takes over three months

[84] General unsecured creditors include a wide range of different parties (e.g., depositors, interbank lenders, trade creditors, suppliers, employees, and bond holders) and a country's legal framework will normally establish priorities within this group. If a deposit insurance system is in place, insured deposits can be paid immediately, up to the limit of their coverage, and the deposit insurance agency takes the place of the depositor in the priority of claims.

170. Under private sector solutions, shareholders (either the original shareholders or new shareholders) retain the responsibility to bring back capital to a positive level, develop an appropriate restructuring plan, and implement any needed operational restructuring of their bank. If the original shareholders are unable to bring bank capital to a positive level within a specified period, other private owners should be sought.

171. A public sector recapitalization program may be considered when it is necessary to preserve viable institutions that otherwise would have failed, or nonviable institutions whose creditors cannot be adequately protected or whose failure may threaten the stability of the financial system.[85] The legal framework should provide enough flexibility to pursue the recapitalization through a wide range of mechanisms, including the injection of cash, bonds, subordinated debt and other types of financial instruments. For those cases where there are no concerns about the quality of the shareholders and managers, it should allow approaches that avoid direct public control of financial institutions and, with this in view, may rely on the injection of hybrid instruments (Tier II capital) including preference shares, convertible notes, or participation certificates that do not have voting rights or interfere with the management of the institution. If the authorities opt for an approach that gives them voting rights and a degree of control over the bank's operations, they should receive ordinary equity shares in the institution. The design of such a program must be clearly laid out in regulation. A summary of good practices for such public programs is included in Box 1.

[85] If creditors are protected, nonviable institutions should be liquidated as their removal from the system will not undermine financial stability. If creditors cannot be protected, bank nationalization, recapitalization and restructuring may be the only option for addressing failed institutions.

Box 1. Criteria and Incentives in the Recapitalization Scheme

Public sector recapitalization programs must be designed in light of specific circumstances and government policies. Not all programs will be alike. The availability of shareholder resources, the extent of recapitalization needed, and the legal structure will all affect program design.

Typically, public sector recapitalization programs have the following characteristics:

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

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

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

Original shareholders should not be bailed out. Capital needs in banks must be thoroughly assessed and all losses imposed on existing shareholders before public funds are injected. The assessment of capital needs should be verified by a third party.

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

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

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

Convertibility. If the government provides Tier 2 capital, it should automatically be converted into Tier 1 capital if the CAR falls below a specified ratio (possibly 8 percent).

172. Public funds may also be required to finance the repayment or transfer of deposits of failed banks. In addition, they may be used for the purchase of impaired assets (such as nonperforming loans) and the fulfillment of any commitments under guarantees granted in the course of supporting banks, including through temporary nationalization.

173. When a suitable acquirer cannot be rapidly found, and the bank's potential collapse threatens to destabilize the entire payment system, disrupt credit relations and undermine confidence in the overall banking sector, the authorities may consider temporary nationalization as a solution. Under this technique, the state assumes temporary ownership of the bank for the purpose of allowing it to remain open for business with public financial assistance for some time, while its restructuring is pursued. Once financial conditions stabilize, the nationalized bank, or its surviving part, should be privatized at the earliest possible opportunity.

174. The efficient administration of a nationalized bank is indispensable as a means of preventing losses from growing and preparing the bank for rapid privatization. The law should permit the scaling down of the bank's operations, transfers of assets, debt collection and renegotiation, and employee layoffs.

175. The public authority owning or controlling the bank should have the power to design and implement a privatization plan. In particular, it should have the power to hire external advisors to assist in identifying potential investors, preparing financial and operating information, and marketing the bank. Moreover, it should have the authority to negotiate the bank's sale with prospective investors. The law should not seek to predetermine the price for privatization (for instance, by reference to certain indices or ratios), since this should depend on the bank's underlying situation and the prevailing market conditions at the time of the sale.[86]

Asset Management

176. The asset management phase will typically involve the restructuring of non-performing assets by AMCs. An AMC can be structured to engage in all or some of a variety of different transactions including (i) the purchase and subsequent resale of bad assets from all banks in the system and possibly from non-financial entities as well, or (ii) the purchase and subsequent resale of both good and bad assets held by banks that are the subject of insolvency proceedings.

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[86] The law should, however, contain basic principles with regard to the procedure, the applicable controls and the transparency of the selling process, with a view to avoiding abuses and corruption. The relevant rules should incorporate a rigorous set of checks but should not eliminate the flexibility of the selling process or prevent the selling authority from choosing the most beneficial privatization method.

- If the AMC resolves both good and bad assets from institutions that are the subject of insolvency proceedings, it will be important to transfer the good assets to another operating institution as soon as possible. Moreover, any proceeds that are acquired from the AMC's disposition of the assets of such institutions will accrue to the liquidation account for creditor reimbursement.

- If the AMC can purchase or resolve bad assets from both closed and open institutions, it will need to apply strict criteria in its selection of assets. In principle, the AMC should only take on those assets it is likely to manage more effectively than the institution holding them.

177. Irrespective of its objectives, the AMC should normally purchase assets at market value (or another appropriate price such as the estimated long-term recovery value). Using public resources to purchase assets at relatively high prices from an open bank provides a hidden subsidy and bails out private shareholders, concealing the cost of recapitalization. In such situations, an incentive will be provided to financial institutions to sell to AMCs a greater portion of their assets than would be justified. If public resources are used to purchase assets at relatively high prices from a closed institution, the public sector effectively subsidizes the bank's creditors.

178. The effective management of impaired assets depends to a large extent on the adequacy of the legal framework for secured rights and general corporate insolvency. Systemic crises may affect the functioning of even relatively well-developed creditor enforcement and corporate insolvency frameworks, thereby compromising the effectiveness of asset recovery vehicles. Accordingly, AMCs may need to be given special powers—in particular, to facilitate the enforcement of creditor claims. While this approach may enhance the recovery vehicle's ability to resolve matters quickly and maximize recovery, it is a serious political matter, with implications for the existing system of property rights. Such steps should only be taken after careful consideration. At a minimum, the granting of such extraordinary powers should be temporary in nature, fully transparent, and subject to proper oversight and mechanisms for judicial review.

E. Exiting from Crisis Measures

179. While forbearance may be temporarily justified, it carries significant risks that the government must mitigate. At a minimum, any policy of temporary easing of regulatory compliance should be transparent (and thus explicit) and subject to close monitoring. Forbearance must be phased out as quickly as possible but at a pace that does not undermine progress made in achieving financial stability. The banking authorities must pay particular attention to distortions that might arise from such forbearance.

180. If a blanket guarantee has been introduced, it must be phased out at an appropriate pace. The longer that blanket guarantees are in place, the greater the moral hazard, and the

greater the opportunities to distort financial intermediation. The blanket guarantee should be removed once the banking system is sound. The market can be given advance notice of removal (possibly 6–12 months) and the lifting carefully phased, by removing the protection first from the more sophisticated creditors (e.g., interbank creditors), followed by large creditors. Once the system has been shown to be stable, the guarantee on all remaining depositors can be lifted.

181. While a clear plan for eliminating the blanket guarantee is needed, establishing a concrete timetable at the onset of the crisis may be difficult given the uncertainty that surrounds systemic banking crises. The authorities in general should have an appreciation of the importance of removing a blanket guarantee as soon as possible but firm deadlines may not be possible. It has proven difficult to know in advance when the guarantee is no longer needed and can be safely removed, and some countries have opted to extend the guarantee beyond the initial deadline.

182. Administrative measures pose a more serious threat to the resurgence of private confidence than forbearance or guarantees. Such measures must be eliminated as quickly as possible. When combined with an aggressive and successful stabilization program, such measures may be rapidly removed.

Appendix I. Global Bank Insolvency Initiative Preparation of Report and Consultation Process

1. The report of the Global Bank Insolvency Initiative was prepared during 2003–2004 by the staffs of the World Bank and the IMF, and was updated periodically thereafter in light of country experience. The work at the IMF was coordinated by Ross Leckow (Legal Department (LEG)) and David Hoelscher (Monetary and Capital Markets Department (MCM)) with contributions from Jan Willem van der Vossen (MCM), Marc Quintyn (MCM), Maike B. Luedersen (LEG), and IMF consultants Christos Hadjiemmanuil, Andrew Campbell, Jose Benjamin Escobar, and Eva Huepkes, and from Yvonne Wong (Monetary Authority of Singapore), LEG visiting lawyer. On the World Bank side, the work was coordinated by Ernesto Aguirre (Banking and Financial Restructuring Unit (BFR)/Financial Sector Operations and Policy Department (OPD)) with contributions from José de Luna Martinez (BFR/OPD) and Ruth Neyens (BFR/OPD).[1]

2. In addition to the normal review processes within the World Bank and the IMF, the document was subject to a broad consultative process that can be summarized as follows: A Core Consultative Group with representatives from the Bank for International Settlements (BIS), the Basel Committee on Banking Supervision, the Financial Stability Institute, and the European Commission as well as participants from 17 developed and developing countries in addition to a selected group of independent experts met on several occasions in 2002 and 2003 to provide advice, comments and recommendations, and to discuss successive versions of the draft document (see the list on Members of the Core Consultative Group in Appendix II). This consultative process also included discussions with deputy governors of central banks, heads of independent banking supervisory agencies and general counsels of central banks from 78 countries of different levels of development and from the international organizations participating in two global seminars held in Basel (January 2002) and Washington, D.C. (June 2003). In addition, the draft report was discussed at regional outreach seminars held in Warsaw (March, 2002), Montevideo (April 2002), Cape Town (October, 2003), Kuala Lumpur (December, 2003), and Tunis (March 2004) with the participation of representatives from most countries of the different regions, regional development banks and other regional institutions.

[1] Individual member's titles and affiliations as of 2003–2004.

Appendix II. Members of the Core Consultative Group of the Global Bank Insolvency Initiative (2002–2003)[1]

In the course of the work on the report, the Core Consultative Group provided valuable comments and suggestions, and the contributions by its members are gratefully acknowledged.

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