A LEGAL FRAMEWORK FOR SYSTEMIC BANK RESTRUCTURING

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INTRODUCTION

Although leading economists from the World Bank and the International Monetary Fund have agreed for quite some time on the need to promote sound banking systems as both a legitimate policy objective in itself and a necessary adjunct to macroeconomic stability in developing and mature industrial economies,\(^1\) it took the East Asia crisis of 1997 to make comprehensive banking system reform a central element of a region-wide Bank/Fund rescue program. Even the extensive Bank/Fund assistance programs to resolve the Latin American debt crisis of the early 1980s or the Mexican crisis of the mid 1990s did not focus to the same extent on the need to restructure the entire financial systems of the debtor countries. In the case of the East Asia debt crisis, however, the Bank and Fund made a strategic decision that comprehensive banking sector reforms were integral to restoring confidence in the long term economic health of the region.

Although "bank restructuring" is a fairly common practice in a healthy banking system, this term usually refers to the failure of individual banks. When there is widespread evidence of banking failures that affect more than 20 percent of a banking system's total deposits, the package of institutional and regulatory programs used to resolve failed banks and return the banking sector to sustainable health is referred to as "systemic bank restructuring."\(^2\) The range of programs employed by governments in systemic bank restructuring includes both macroeconomic diagnoses of the multiple underlying causes for the systemic problems as well as microeconomic efforts to improve banking supervision, correct weaknesses in the legal, accounting and regulatory framework, and rehabilitate or resolve individual insolvent banks. The success or failure of systemic bank restructuring depends to a great extent on designing a comprehensive strategy that addresses all of these problems.

The legal work involved in systemic bank restructuring is an essential element of the government's microeconomic efforts. It requires the application of international "best practices" for strengthening banking supervision and enforcement, incorporating international accounting and auditing standards, and rehabilitating or resolving insolvent institutions within the context of the overall legal and judicial structure. In particular, legal efforts focus on the statutory and regulatory authority for systemic bank restructuring - the laws and prudential regulations governing the licensing, supervision and closure of financial institutions; the capabilities and constraints of the deposit insurance system; the legal and judicial framework for restructuring financial institutions, reorganizing insolvent corporate borrowers and foreclosing on collateral; and the overall


need for written procedures to be applied and enforced in a transparent, fair, and equitable manner.

The purpose of this paper is to set out the legal framework used in systemic bank restructuring with reference to recent examples in developing and industrial countries. As background, the paper first describes government strategies in the early stages of a debt crisis, which, depending on their success, may reduce the need for more comprehensive bank restructuring or be incorporated in a program of systemic bank restructuring.

I. GOVERNMENT STRATEGIES IN A PRE/NON-CRISIS SCENARIO

The initial hurdle to overcome in any bank restructuring, whether individual or systemic, is the lack of incentives for both bank managers and supervisors to recognize and resolve insolvent institutions. Although there has been considerable attention paid to adopting the Basle Committee on Banking Supervision (“Basle Committee”) capital standards for assessing the riskiness of bank assets, it is still quite difficult for bank supervisors and managers to admit that a bank is facing losses which cannot be corrected within the established time for rehabilitation as set out by law or regulation. The failure to acknowledge the extent of losses may be the result of inadequate accounting standards that permit a continuous rollover of non-performing loans, the political risk to imposing costs on taxpayers or bank owners or a governmental interest in maintaining a banking institution to provide funds to a particular economic segment. Unfortunately, the failure to recognize and take action with regard to individual banks can lead to a build-up of problem assets and institutions which increases the possibility of, and at the same time, hides more systemic problems.

The strategies available to governments as they try to resolve rather than close individual insolvent banks can be grouped under three categories: regulatory forbearance; government encouraged mergers; and direct government support. All of these strategies were employed to a greater or lesser degree by Thailand, Korea and Indonesia in the months leading up to the global recognition of the East Asia debt crisis.

3 The Basle Committee on Banking Supervision was established by the Central Bank Governors of the Group of Ten countries in 1975. It consists of senior bank supervisory representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the Unites States. The Basle Committee Secretariat is located at the Bank for International Settlements (BIS) in Basle, Switzerland. Among other guidelines for banking supervision, the Basle Committee in 1988, adopted a set of standards for defining capital and measuring risk. In particular, the Basle Committee recommended that countries adopt minimum capital standards of 8% risk-weighted capital for Tier I commercial banks.

4 See A. Sheng (ed.) at 25.

5 The original forces that caused the bank crisis can be lost in the clamor for an immediate solution although they remain of utmost importance to the long term prospects for a successful restructuring. See C. Dziobek and C. Pazarbasioglu, Lessons from Systemic Bank Restructuring, IMF Working Paper, 1997, at 26.
A. Regulatory Forbearance

Before there was wide-spread public recognition of the deteriorating condition of the savings and loan (“S&L”) industry and political support for systemic restructuring, the U.S. regulators tried several forbearance techniques which have since been criticized for increasing the eventual cost of government assistance. Among those forbearance techniques was the adoption of a “net worth certificate program” that allowed the government to deposit funds in a failing S&L in return for a net worth certificate, which could then be treated by the institution as “regulatory” capital. Although this program had the intended effect of assisting institutions through a period of temporary high interest rates, the long term, unintended effect was to encourage regulators and institutions to look for forbearance solutions. Not surprisingly, the next time the S&Ls faced earnings or capital problems the regulators devised other accounting practices (referred to as “regulatory accounting principles” or RAP, to distinguish them from “generally accepted accounting principles” or GAAP) that hid these problems.\(^6\)

The use of such accounting techniques as part of a strategy of regulatory forbearance is not limited to the U.S. S&L crisis. The Bank of Korea placed large amounts of foreign currency deposits in offshore branches of Korean banks in order to provide liquidity in the early stages of the East Asia financial crisis. These deposits, which had the effect of hiding Korean bank losses, eventually resulted in such a significant drop in BOK usable foreign currency reserves that it was reported the BOK had only two weeks of foreign reserve left by the beginning of December 1997. Similarly, Thailand’s Financial Institutions Development Fund (FIDF), administered by the Bank of Thailand, made substantial liquidity loans to the nation’s finance companies before the effort to save them was abandoned. As a result, the FIDF is by far the largest creditor of the closed finance companies.

B. Government Encouraged Mergers

One of the most popular techniques employed by governments facing a deteriorating financial industry is to provide incentives for mergers between distressed and healthy institutions. This technique is particularly appropriate where the government has limited funds to handle the closure of insolvent institutions and the financial industry as a whole has sufficient private resources to absorb the failing banks. Mergers also have the advantage of leaving control of private sector banks in the hands of private investors and minimizing the risks of runs on weak banks. Because government induced mergers ultimately rely on market forces to be successful, they are often referred to as a “market-based” solutions.\(^7\) When most of the financial service market has collapsed, however, mergers are of limited value unless substantial new capital is brought in by the government or outside private investors.

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\(^7\) See A. Sheng supra note 2, at 36.
Mergers were used extensively in the early stages of the U.S. S&L crisis, in the Swedish and Norwegian debt crisis of the early 1990s and the Mexican bank restructuring of the mid 1990s. The U.S. regulators tried a series of merger programs to attract private capital to failing S&Ls. One program combined several smaller insolvent institutions into one large S&L which would have a better chance of survival or present a more marketable candidate for private investors. This program had limited success since it was difficult for these institutions to attract quality management and there were few buyers willing to risk capital for clearly deteriorating assets (the real estate market in the locations serviced by most failed S&Ls was in a free fall by then) without government guarantees of support. Once the U.S. regulators began to offer financial incentives, however, they were able to attract purchasers for the better franchises. The incentives employed by the U.S. regulators included government guarantees of yield or income, special tax allowances, protection against loss of capital, indemnification against lawsuits, and loss-sharing arrangements for future sales of assets.  

The most successful of the U.S. merger programs was the purchase of failed S&Ls by healthy commercial banks. Since the U.S. regulatory system at that time prevented commercial banks from merging across state lines, the regulators realized that commercial banks had a strong incentive to acquire failed S&Ls in other geographic areas. This type of market-based incentive has been used by other countries as an inducement for foreign purchases of failing institutions, particularly in Spain and Mexico. One of the principle techniques used in the Mexican debt crisis of mid 1990s was a combination of merger and foreign purchase. Eventually, the twelve largest Mexican banks were merged into seven banks and all but one acquired by foreign banks.

More recently, the Malaysian Government announced in March 1998, that it would facilitate the merger of failing finance companies by encouraging the healthiest institutions to acquire small and medium-sized companies through a government program of capital assistance. The ultimate goal set by the Malaysian Government is to reduce the existing thirty-nine finance companies to eight.

The legal issues involved in government encouraged mergers are similar to those discussed below for direct government support, i.e. the legal rights of existing shareholders and creditors, but the “voluntary” nature of the mergers helps to resolve many of these issues. In some instances, however, governments have sought the legal authority to force the mergers of failing institutions. For example, the Bank of Thailand after failing to persuade several of the largest finance companies to voluntarily merge in the Spring of 1997 sought and was granted merger powers in the October 1997 Emergency Decrees.

C. Direct Government Support

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See A. Sheng (ed.) at 80.

See A. Sheng (ed.) at 36.
The techniques for direct government intervention of failed financial institutions can be divided into two types based on whether the perceived problem is related to temporary liquidity ("flow") or excessive leveraging with inadequate capital relative to the risk ("stock"). Flow techniques for problems of liquidity are often used in the early stages of a banking crisis when banks have at least some positive capital and the problem is a truly temporary or timing mismatch of asset and liabilities. Stock techniques on the other hand need to be employed by governments when they recognize that the problem is far greater than a temporary liquidity shortfall and goes to the very heart of the bank’s ability to survive.\(^{10}\)

Flow techniques usually involve some form of subsidized central bank liquidity support or government ceiling on lending rates (which passes the loan losses onto the depositors) combined with a prohibition on transferring deposits abroad or an expansion of the types of businesses in which banks are permitted to engage (in the hope that the banks will be more successful at non-core business than they have been at traditional banking business).\(^{11}\) Stock techniques are intended to address balance sheet and capital adequacy problems.

The best known stock technique (sometimes describes as “open bank” assistance) is the direct government injection of capital into a failing bank. The U.S. experience with the Continental Illinois National Bank (“CINB”) failure provides a model for successful restructuring using a government injection of capital and also sets the terms for debating the wisdom of a government policy that recognizes some banks as “too big to fail”.

Despite a decades-long history of closing failed banks and paying off only the insured depositors, albeit in smaller institutions, the U.S. Federal Deposit Insurance Corporation (FDIC) in 1984 decided that it was too risky to follow this procedure when one of the ten largest U.S. commercial banks was judged to be insolvent. After failing to find a voluntary merger partner for CINB, the U.S. regulators devised a plan to inject capital through the purchase of bad assets from the bank and preferred stock from the holding company.\(^{12}\) At the same time, existing shareholders consented to a reduction of their equity to a small minority interest and the FDIC replaced management with its own slate of officers and directors. The most controversial action, however, was the FDIC decision to guarantee in full all uninsured depositors and other general creditors. These latter protections have been criticized for creating an atmosphere of “moral hazard” eventually leading to excessive risktaking by some S&Ls.

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\(^{10}\) See A. Sheng (ed.) at 40-41, 181.

\(^{11}\) The problem inherent in encouraging banks to expand their range of business activities in order to offset substantial losses in traditional business were demonstrated by the high risk enterprises engaged in by failing institutions during the U.S. S&L crisis.

\(^{12}\) See History of the Eighties - Lessons for the Future, supra at 244.
The most significant legal issues confronted by the U.S. regulators in the course of restructuring CINB are also problems for the bank regulators of Thailand, Korea and Indonesia and any other country that wants to utilize an “open-bank” assistance program, i.e., the legal rights of existing shareholders and holders of outstanding bank or holding company debentures. In the CINB situation, the regulators decided that they did not have the legal authority to reduce the equity held by the existing shareholders or breach the conditions of the holding company debentures unless they decided to close the bank. Once the regulators made the policy decision to keep CINB open they were forced into a situation in which they had to persuade the existing shareholders to accept a reduction of their capital interest and guarantee the debt of the holding company.

Setting aside the implications of a too big to fail policy and issues of moral hazard, the resolution of CINB has been viewed by some commentators as a successful bank restructuring since the government intervention effectively prevented the problems of CINB from infecting other commercial banks and CINB was eventually sold back to the market by the FDIC at price which repaid the FDIC with interest.

II. SYSTEMIC BANK RESTRUCTURING

Whether you look at the U.S. savings and loan crisis of the 1980s, the Norwegian and Swedish crises of the early 1990s, the Mexican crises of the early 1980s and mid 1990s, or the current East Asian crisis, analysts will tell you that they could have predicted the eventual collapse of a particular banking system because of its underlying systemic problems; yet somehow no one recognized these inherent problems until they were in the midst of a banking crisis. Unfortunately, that seems to be one of the unwritten laws of banking - it takes a crisis to focus on the need for systemic bank restructuring.

Systemic bank restructuring, unlike the individual bank restructuring techniques described in Section I, encompasses a series of measures that need to be coordinated in order to maintain the national payments system and access to credit while correcting problems in the financial system that caused or contributed to the crisis. Coordination of these measures is even more important in a developing country. As Joseph Stiglitz, Senior Vice President and Chief Economist of the World Bank, has explained, 13 “Restructuring the banking system is even more difficult in many developing countries, for several reasons. First, there is less technical, legal, and institutional capacity for tasks like asset resolution. Second, the fraction of the banking system with bad assets and insolvencies is often far larger; there are fewer healthy banks to take over the weak banks. Third, the banking systems may be more complex, with a mixture of state and private banks. The state banks may carry with them an implicit guarantee for depositors. A government announcement that it will not guarantee the private banks can easily generate a

run on the private banks, especially if the government shuts down some banks but leaves doubts about the health of some of the remaining banks.”

The challenge for governments is how to address the immediate crisis without adversely affecting the ability to use systemic solutions for long term problems. Thus, in taking the initial steps to intervene as forcefully as possible to restore confidence to the entire banking system, a government should be careful not to distort the incentives for comprehensive reform. To be successful over the long run, systemic bank restructuring should employ measures which are "cost effective and simple to implement, distribute losses equitably, aim at minimizing the burden on the public sector, avoid generating future moral hazard problems, [and] promote good governance."15

The legal framework for systemic bank restructuring can be separated into four linked elements: A) Restoring Confidence in the Banking System, B) Establishing a Legal Process for Government Intervention, C) Establishing a Mechanism for Intervening Failed Banks, and D) Establishing a Mechanism for Maximizing Recovery on Non-Performing Loans.

A. **Restoring Confidence in the Banking System**

1. **Guaranteeing deposits**

Invariably, the first action governments take in a systemic bank crisis is to restore public confidence in the banking system’s ability to repay deposits. Once public confidence has been lost the level of deposit insurance or other structural support for bank deposits becomes irrelevant. In order to restore confidence the government must provide a new level of deposit support16. This can take the form of a government guarantee for the increased borrowings by the deposit insurance fund but most often the government through an executive decree or emergency legislative act provides an outright guarantee of all deposits for a substantial time as happened in Thailand, Indonesia and South Korea17.

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14 The need for immediate government action is often triggered by a liquidity crisis which in turn was triggered by an exchange rate crisis or preemptive termination of external lines of bank credit. In these situations governments face severely limited policy and timing choices. *See* W. Alexander et al., *supra* note 2, at 26.

15 *Id.* at 34.

16 Although deposit insurance remains a controversial measure for many banking analysts, the reality of a banking crisis has forced government to adopt some form of deposit support albeit temporary. The long term value of deposit insurance as compared to the moral hazard it may engender remain to be debated another day.

17 In addition to a general deposit guarantee until December 31, 2000 for all depositors, the Korean government subsequently guaranteed the loans of foreign branches of Korean banks as part of a package of inducements for foreign creditors to rollover their loans. In January 1998 the Indonesian government announced it was guaranteeing the claims of depositors and creditors of the Indonesian banks, both private and state-owned and that the guarantee would be in force for at least two years.
The legal work done during this phase of systemic bank restructuring will require analysis of the government's authority to issue emergency decrees and the legal challenges that could be mounted against the government's initiative. In addition, government officials will need to consider in as much detail as possible the long term legal consequences of the guarantee. For example, in order to minimize future lawsuits about the extent of the guarantee, the definition of which deposits are to be covered should be precise as to type of bank account and duration of the guarantee (including treatment of funds added to existing covered accounts during the course of the guarantee and funds that remain in a covered account after the guarantee expires) as well as the extent to which the guarantee covers interest on deposits. Another issue that needs to be addressed is whether government guarantee will cover deposits by bank owners and other individuals who could be held responsible for the bank losses.

2. **Strengthening the regulatory structure**

The next step to restoring confidence in the banking system is the strengthening of prudential regulations, including adoption of accounting and auditing standards consistent with internationally accepted practices (particularly in relation to recognition of loan losses and asset classification), adoption of enhanced compliance measures and training of government bank examiners and auditing personnel.

New legislation will often require bank supervisory agencies to: (1) apply Basle capital standards to continued operation of banks; (2) establish rules governing bank activities including prior notice to the regulatory authorities of significant transfers of shares, major acquisitions or investments, and approval of establishment of offshore branches; (3) establish periodic on-site examinations and off-site monitoring; (4) evaluate internal bank mechanisms for their ability to adequately measure risk based on the nature and scale of the bank's business; (5) establish internationally acceptable objective standards for loan classification and policies for the provisioning against problem loans; and (6) require adequate public disclosure of financial information as to performance.

In the East Asia crisis, the Korean Government quickly moved to adopt the Basle prudential standards as part of its systemic bank restructuring; one of the first Thai Government initiatives to address its banking crisis was an acceleration in the phase-in of internationally acceptable standards for loan classification and more stringent provisioning standards.

3. **Enhancing regulatory compliance mechanisms**

Systemic bank restructuring legislation will often enhance the authority of the government agencies to seek and enforce monetary and other penalties against banks and banking officials, including the ability to remove bank officers and directors. This is particularly true when the penalties that were in place prior to the banking crisis have only nuisance value as a result of inflation or alternatively, when the only penalty available to government regulators is closing the bank. Legal work to strengthen
regulatory compliance should include analysis of best practices as well as the most effective ways to remove legal impediments to compliance. For example, in some countries banking supervisors have been deterred from taking actions to enforce regulations because of the threat of personal liability for actions undertaken in the course of their official duty.\textsuperscript{18} To remedy this deterrent to enforcement governments may want to consider legislation to protect or indemnify supervisory personnel from personal liability actions by private parties.

Because regulatory forbearance is usually a significant factor in the depth, if not the original cause, of the banking system collapse, enactment of new prompt corrective to remove insolvent institutions is usually needed to restore investor confidence in the integrity of the bank regulatory system. Although the Basle Committee’s risk based capital standards provide guidance for restoring bank capital at each stage of financial soundness, the Basle standards are not self-enforcing. Bank supervisors must be given explicit direction about government policy for imposing corrective action. The extent of discretion to be given banking supervisors is one of the critical policy decisions to be incorporated in any prompt corrective actions regulations. The U.S. dealt with this issue after the S&L crisis by mandating supervisory actions after trigger points were reached in the capital adequacy calculations.

4. Reorganizing bank regulatory agencies

Systemic bank crises invariably cause government and private sector leaders to look at the structure of the governmental authorities responsible for supervising banks as well as the effectiveness of the regulations themselves. The areas of government supervision are often divided into three parts that may be housed in one or more separate and/or independent government institutions: (a) the licensing of new entrants and revocation of licenses for existing entities; (b) the authorization for new activities by existing entities and supervision of existing entities, including the ability to impose penalties and recommend or revoke banking licenses; and (c) the operation of a deposit insurance fund or other structure for supporting bank deposits, which may include the authority to receive and dispose of assets of failed banks.

As a country's banking system grows and changes over time to meet changes in the evolving financial marketplace, so do discrepancies and redundancies among the various government agencies responsible for supervising the banking system. Although many of the gaps in supervisory coverage and duplicative work by the various banking agencies are well known by government leaders, these administrative problems are often put aside until a banking crisis focuses public attention on all aspects of banking regulation. Consequently, governments often find the urgency of systemic bank

\textsuperscript{18} In some countries, such as the Philippines, the problem of personal liability of government officials for actions undertaken in their official capacity is further compounded by uncertainty as to whether these officials can be represented in these lawsuits by government attorneys.
restructuring presents an opportunity to make organizational changes in the banking agencies that would otherwise require too much political capital.\textsuperscript{19}

The legal work involved in this aspect of systemic bank restructuring requires a thorough understanding of the history of each of the bank regulatory authorities and their relationship to other governmental agencies. Because any realignment of government agencies carries political as well as practical consequences this often turns out to be one of the most sensitive and problematical elements of systemic bank restructuring and, therefore, may require local legal expertise.

\section*{B. Establishing a Legal Process for Government Intervention}

The second crucial element in systemic bank restructuring is the government’s process for intervening failed banks. From a legal perspective it is important that this process be designed to fit within the existing legal framework or that new laws be drafted and enacted as quickly as possible so the government’s program will have a firm legal foundation. The legal principles to be applied in designing any strategy for intervening insolvent institutions should focus on fair and equitable written standards and procedures, proper documentation, and transparent government decisions.

1. **Ensuring that the deposit insurance system has sufficient funds to handle the crisis or authority to raise such funds quickly and efficiently**

   Although other options may be available to government authorities who have the luxury of restructuring a single failed institution, government authorities who are in the midst of a systemic banking crisis will be under great pressure to quickly resolve a large number of insolvent banks that have been kept open through the infusion of government funds and forbearance by supervisory authorities. In order to restore confidence in the banking system as a whole and encourage domestic and foreign capital to return to healthy banks, governments must undertake a rapid and thorough clean up of insolvent institutions. Unfortunately, most deposit insurance systems lack the funds and capacity to handle more than a small percentage of failed banks.

   Before embarking on the resolution of failed institutions, therefore, the government will want a legal analysis of the existing laws governing the operation of a deposit insurance system or other financial support mechanism for bank deposits in order to assess the need for additional governmental authority and funding sources. Those deposit insurance systems that are financed by the government may need a special allocation of funds or the ability to borrow in the market with government backing. Other

\textsuperscript{19} In one of its first actions to restore confidence in the financial institutions regulatory system, the Korean Government established a new Financial Supervisory Commission with responsibility for the supervision of all depository institutions, insurance companies, securities and commodity futures companies. In order to accommodate the interests of the various government agencies responsible for regulating these financial sector institutions the head of the FSC reports directly to the Prime Minister, rather than any individual government department.
insurance systems which rely on their premium base or the creditworthiness of system members in order to borrow funds may also need some form of government support.  

2. **Ensuring that the government has the legal authority necessary to promptly intervene failed banks**

Because a systemic bank crisis rarely permits the option of using market remedies without substantial government support, the next step is to examine the alternatives available for government intervention. From a legal perspective this analysis starts with the government’s authority to intervene failed banks, including which government agency has the authority to intervene particular institutions. For example, in some countries the ministry of finance has the authority to license certain types of banks but not to regulate or supervise those banks, while other banks are licensed and regulated by the central bank or another national or regional agency. If the crisis is systemic, as is the current situation in Korea, Thailand and Indonesia, the laws governing the different types of financial institutions will need to be examined. The regulatory authorities should be sufficiently empowered to intervene banks using transparent processes that can reasonably be expected to withstand a legal challenge.

Government procedures for determining insolvency will also have to be reviewed to ensure that they are transparent, fair and consistent in their application. One of the legal issues to be considered is the extent to which any changes in regulatory procedures or criteria of insolvency run the risk of being successfully challenged in court. To a certain extent the role of judicial review may be limited (by establishing special review courts or limiting damages) but it should never be completely eliminated. For example, in at least one country, judicial review of a decision to close an insolvent bank has been limited to an award of monetary damages (U.S.), while in another country, a successful challenge to a decision to close an insolvent bank resulted in the closed bank being reopened after five years of litigation (the Philippines). These are among the legal issues which can be addressed in executive decrees or legislation.

3. **Establishing a process for evaluating bank solvency**

The next step in resolving failed banks is to identify those institutions whose assets have fallen so short of their liabilities that either they have no positive capital under the Basle standards or there is no reasonable possibility of raising sufficient capital to bring the institution up to prevailing standards. This requires a thorough analysis of the bank’s loan portfolio, including analyzing the underlying value of collateral as well as the borrower’s ability to pay back the loans. If the previous supervision has been lax or the government has discouraged banking supervisors from closing failing institutions (as is often the case with system-wide bank failures) or has adopted a policy of regulatory forbearance in order to avoid write-offs of non-performing loans, the supervisors may not

20 The Korean Government in its April 1998 Economic Restructuring program announced that it would be issuing bonds backed by government guarantees in order to supplement deposit insurance funds.

be equipped or staffed to handle the large number of potential failures and will need to hire additional outside experts to assist in this analysis.

From a legal perspective, the key issues here are to make sure that the standards to be applied by each regulatory agency in its review and determination as to the viability of banks under its jurisdiction, are written, transparent and applied equally to all institutions for which the agency is responsible.

C. Establishing a Mechanism for Intervening Failed Banks

The intervention techniques most often used in systemic bank restructuring involve a capital injection by the government that results in the government (i) replacing the existing shareholders and selling the bank after it has been rehabilitated or (ii) supporting the existing shareholders with the understanding that the government funds are to be repaid when the bank has recovered.

1. Government assistance linked to government ownership

Although the capital injection technique can be used to resolve individual failed banks, as was done in the case of Continental Illinois National Bank, described in Section I of this paper, it has been used most extensively in systemic bank restructuring particularly in the successful restructuring programs of the Norwegian and Mexican Governments in the early and mid 1990s. The most significant difference between using a capital injection technique to resolve an individual insolvent bank and using this technique to resolve a series of insolvent banks during a systemic bank restructuring is that private investors may be willing to inject new capital into a single failed bank in an otherwise healthy environment but the government is usually the only entity willing to inject capital in the midst a systemic crisis.

This technique links direct government intervention (in the form of a capital contribution) to a reduction in the ownership by the existing shareholders. As described in Section I, the ability of the government to force a write down of the capital held by existing shareholders (without closing the bank) will depend to a great extent on the legal rights of those shareholders. In many cases the government will need the voluntary consent of the existing shareholders. The amount of the government contribution is determined based on an analysis of the extent of the known asset losses. In other words, the losses incurred by the insolvent bank (which have been identified through a process of due diligence conducted by the government or by an independent third party) are deducted first from the reserves and then from the capital held by the bank prior to the injection of new capital; as a result, the existing shareholders should realize the identified losses before the government provides new capital.

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22 See A. Sheng (ed.), supra note 2, at 45.
Although it is theoretically possible for the write down of assets to leave some capital, the write down typically results in capital falling below zero. Negative capital may present legal problems in those countries whose laws require government authorities to revoke the banking license of institutions whose capital falls below a certain amount. This problem may be resolved by temporarily leaving existing shareholders with the minimum amount of shares necessary to support minimum capital requirements. Existing shareholders may also need to retain a small share in order to avoid breaching subordinated debt obligations, or in the recent write down of capital for two insolvent Korean commercial banks, to avoid potential shareholder litigation.

Once the government takes control of the bank, it can change management and begin the process of rehabilitating the bank’s problem loan portfolio. The options available for managing and ultimately disposing of bad assets are described below in Section D.

2. **Government assistance to existing shareholders**

The best example of this technique is the Swedish systemic bank restructuring of the early 1990s and the best description of the government’s role should be that of “informed investor” rather than regulator or supervisor. After providing a blanket guarantee for all bank deposits for an unlimited time, the Swedish Government decided to provide (on a voluntary basis) temporary support to its failing commercial banks under a system that would utilize the incentives of private sector ownership. Because the government’s role was similar to that of a private investor, the Government set the following principles as the basis for financial support:

(a) the amount of support would be the least necessary to provide bank management with time to restore financial stability; and

(b) the support would terminate when the conditions set out in written agreements between the banks and the government had been met - including a system for repaying the government support.

Before beginning the process of negotiations with each bank to determine exactly how much support was necessary, the Government first conducted an extensive analysis of the information provided by the banks. In keeping with its reliance on private sector incentives and responsibility, the Government required the Board of Directors and bank managers to take responsibility for the information provided in the evaluation process. Each bank’s financial condition and management capabilities (including risk control systems) was individually assessed and its support structure determined after negotiations between the bank and the Government. One of the crucial elements in the Swedish support agreements was each bank’s ability to manage and dispose of its portfolio of non-

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23 Most of my information about the Swedish experience is derived from papers written by A. Berggren, a consultant to the World Bank and one of the chief architects of the Swedish bank restructuring program.
performing loans. The methods for accomplishing this goal are described in Section D below under the heading “good bank/bad bank”.

Once support measures were agreed upon the actual implementation of the recovery program was the responsibility of the bank although there was extensive government surveillance of each bank’s operations. In keeping with government’s role as informed investor, this surveillance program was independent of the Government’s role as supervisor of the banking system. Indeed, the bank supervisory authorities played no part in the support agreement between the bank and the Government but continued to enforce bank compliance with regulatory requirements.

Although Swedish restructuring efforts were quite successful this was due in large measure to the considerable attention and effort devoted to exhaustive planning before the support systems were set in place. In the East Asia crisis the perceived need for immediate action has thus far led Thailand, Indonesia and Korea in the direction of government ownership in exchange for government support.

D. **Establishing a Mechanism for Maximizing Recovery on Non-Performing Loans (“Bad Assets”)**

Systemic bank restructuring programs have followed one of two models for managing and ultimately recovering whatever value remains in the non-performing loans held by failed banks. The one similarity that both models have in common is the separation of core banking activities, (including the management of performing loans and loans too small to have a significant impact on the bank’s balance sheet) from the management and disposition of large non-performing loans by:

(a) establishing a separate operation within the bank that is charged with responsibility for asset recovery (this was done most successfully during the Spanish systemic bank restructuring of the 1980s, “bank hospitals” and the Norwegian and Swedish restructuring of the 1990s or “good bank/bad bank”); or

(b) transferring the bank’s bad assets to an existing government agency, such as the deposit insurance corporation (this was done most successfully by U.S. Federal Deposit Insurance Corporation for banks that failed at the same time as the S&L crisis) or establishing a new government entity (“asset management corporation”) solely for the purpose of receiving, managing and selling the bad assets of insolvent financial institutions, as was done at the final stage of the U.S. S&L crisis and, most recently, in Thailand, Korea and Indonesia.

The decision as to the best structure for disposition of bad assets depends on legal as well as government policy considerations. In addition to maximizing recovery of asset value, the establishment of separate vehicle for collecting and managing recovery of whatever value resides in a bank's problem loans or the collateral underlying those loans, sends a signal to the borrowing community that they are still expected to comply with their contractual obligations. The adaptation of best practices for establishing effective
asset recovery mechanisms should be done within the context of the existing legal and judicial framework to the extent possible. In some cases, however, the existing legal mechanisms, particularly bankruptcy and foreclosure laws, may be inadequate and need legislative revisions.

1. **Good bank/bad bank**

Although the Norwegian and Swedish Governments both utilized the “good bank/bad bank” approach to separating an insolvent bank’s performing loans from its non-performing loans, they did so through different legal structures. In the Norwegian systemic bank restructuring, the Government, after injecting capital, took control of the three largest troubled banks and divided each bank’s assets into performing or non-performing loans (similar to the CINB approach). After effectively managing the three banks for several years, during which the “bad banks” assets were worked out, the Norwegian Government reprivatized the banks in 1996.

In the Swedish bank restructuring, the Government worked with individual banks to establish separate units within each bank to be responsible for the management and disposition of bad assets. Although the work out units varied to some degree from bank to bank the Government required all banks to develop and implement resolution strategies which ensured that capable and experienced personnel with sufficient support and organizational control were assigned to handle the bad assets so the core bank could focus on rebuilding the bank’s franchise. In both countries the “good” and “bad” banks reported to the same board of directors.
2. **Asset management corporation (AMC)**

The use of an AMC has become a favored mechanism for systemic bank restructuring since it was used successfully in the last stage of the U.S. S&L crisis of the 1980s with the legislative establishment of the Resolution Trust Corporation (“RTC”). Establishing an AMC allows new owners of banks, including government owners, to remove their non-performing loans from their books, thereby immediately strengthening their balance sheets, and at the same time allowing bank managers to concentrate on core (and presumably profitable) business. However, the AMC must have adequate legal authority and sufficient incentives to actually foreclose on collateral or work out non-performing loans.

AMCs can be set up as a single agency or several agencies responsible for managing the collective bad assets of all insolvent banks. An AMC is particularly helpful in those situations in which the banks lack skills to collect bad assets or management of the banks has been so compromised by prior actions that they are considered unreliable to collect on bad assets. In the U.S. S&L crisis the RTC was set up as a limited term governmental entity to handle the assets of failed S&Ls. In the East Asia debt crisis, centralized AMCs have been established as part of the systemic bank restructuring of Thailand, Korea and Indonesia.

In the case of Indonesia, the Indonesian Bank Restructuring Agency (“IBRA”), was established to resolve, restructure or dispose of those banks which were referred to it by the Bank of Indonesia, while a separate entity, ACTIVA, was intended to dispose of the assets held by the IBRA banks. Similarly, in Thailand two agencies were set up: the Finance Sector Restructuring Agency (“FRA”) responsible for assessing the finance companies’ rehabilitation plans and the disposing of their assets within the first year of its operation; and the Asset Management Corporation (“AMC”) responsible for managing the sale of assets acquired from insolvent banks and for serving as the buyer of last resort for the assets sold by the FRA. It will take some time before analysts will be able to evaluate the success of these agencies in accomplishing their objectives in countries where the entire banking system is under pressure from excessive leveraging in the corporate sector.

**CONCLUSION**

Systemic bank restructuring is a long term process encompassing a series of legal measures that progress in stages from emergency measures to restore confidence in the banking system (such as deposit guarantees, strengthened prudential regulation, adoption of internationally accepted accounting and auditing standards, and enhanced compliance programs) through the creation of new government entities or other mechanisms for resolving failed institutions and disposing of their assets. The legal work to be done in connection with systemic bank restructuring requires attorneys to adapt the best international restructuring practices to the existing legal and judicial framework and to assist governments to make the legislative modifications necessary to the success of the systemic bank restructuring program.
Of course, new banking laws and internationally accepted prudential regulations and accounting standards are just the beginning of the process for successful long term bank restructuring. Bank examiners and supervisors must be trained in the skills necessary to implement the new laws and regulations and bank managers must see the personal benefits to complying with the prudential regulations and internationally accepted accounting practices before such measures can gain the acceptance necessary to change institutional behavior. The legal framework must have a consistent risk/reward structure that punishes fraud and speculation and rewards prudent behavior.

It is also crucial to recognize that bank restructuring is inseparably linked to the ability to maximize recovery on non-performing loans held by insolvent banks or asset management corporations. Consequently, the success of bank restructuring is ultimately dependent on the adequacy of bankruptcy and corporate reorganizations laws, market incentives that encourage debt rescheduling and the legal capacity of government entities, such as government owned or controlled banks, to convert debt into equity. Because the insolvent banks or asset management corporations usually hold a large of portfolios of non-performing real estate loans, government laws restricting ownership of real estate may need to be re-examined in order to maximize asset recovery. In addition, governments may consider legislation to encourage or expand capital markets and remove inhibitions to domestic and foreign capital investment.

In the final analysis, however, the long term success of systemic bank restructuring depends on having a fair transparent and reliable legal environment as well as strong and enforced prudential regulations. Bankers must have the ability as well as the incentive to make rational business decisions in allocating credit. Although a thorough examination of the legal structure necessary to support the long term health of a banking system is beyond this paper, it is worthwhile pointing out a few legal issues that need to be addressed in rebuilding the legal system at the same time that the banking system is being restructured. These legal issues include: (i) transparent forms of ownership that clearly define the legal structure and liability of borrowers; (ii) judicial and alternative dispute resolution mechanisms that can be relied upon to enforce contracts; (iii) accurate and maintained title registries for all categories of property used as loan collateral, including access to lien information; and (iv) established procedures and institutions for handling the conversion of collateral into cash in a timely and efficient manner. Without these legal foundations, any systemic bank restructuring no matter how successful it appears, will only be temporary until the next banking crisis.

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