Check against delivery
As at 9 July 2007

9th SEACEN Conference of
Directors of Supervision of Asia-Pacific Economies
Singapore, 9 July 2007

Conference Theme: Building Intervention and
Resolution Framework for Problem Banks

"Management of Troubled Banks: A Practitioner's Approach"

Presentation
By
Mr. Jean Pierre Sabourin
Chair of the Executive Council and President of
the International Association of Deposit Insurers (IADI) and
Chief Executive Officer of the Malaysia Deposit Insurance Corporation

Good afternoon, Ladies and Gentlemen.

It is a great pleasure to be invited to this SEACEN Conference to discuss the management of troubled banks. Interestingly, the organizers have requested that I not only present to you a practitioner's approach to the management of troubled banks but also share with you what I believe to be the important guiding principles for the effective management of troubled banks, the role of the deposit insurer and the issues of coordination with other financial safety net players and finally the issues and challenges in selecting an appropriate resolution method.

You have heard the FDIC's approach to Bank Resolution methods and Prompt corrective Actions. These are very useful perspectives and provide useful material for provocative thought. The FDIC is a very established deposit insurer as you have heard and it has a history dating back to the early 1930s.

I now lead a young deposit insurer and seeing that there are some participants who are from countries with newly established deposit insurers, I shall present my perspective and views on these matters from my 32 years experience in deposit insurance matters. I have been fortunate to have had experience to lead a well established deposit insurer, CDIC Canada for 15 years where I dealt with 43 failures over a 30 year span. And, now lead the Malaysia Deposit Insurance Corporation, one that has two distinct and separate deposit insurance systems and one that have been in place for 23 months!!

My presentation will be in five parts. The first part is an identification of several effective G*uiding Principles*, the second on *The Role of Different Players in a Financial System*. The third part is on *The Role and Responsibilities of Safety Net Players in Dealing with Troubled Banks,* the fourth is on *Issues and Challenges in Selecting An Appropriate Resolution Method* and the fifth on *Challenges and Practical Considerations for Deposit Insurers.*

I should like to be as interactive as possible. So I shall offer some views and I would like your views as well. I shall therefore schedule an intermission after the second part. And we can discuss some of the issues in depth and their applicability to the country specific circumstances.

Part 1: Guiding principles
In understanding the guiding principles, let us first begin by defining guiding principles so that we all start on the same page. Principles are defined here as fundamental tenets pertaining to a broad policy area and is usually set out in a general way and therefore offer a degree of flexibility in implementation to suit country circumstances. Hence, it follows that these principles should be used to guide us in effectively managing troubled banks.

I have identified 6 guiding principles that I think are most useful and effective:

1. A bank's safety and soundness, performance and ongoing viability are the direct responsibility of the bank's Board of Directors and not that of regulators or supervisors. This point should be impressed upon all stakeholders that supervisors don't make loans, thus supervisors are not at fault unless they knew of the problems and did not act!!

2. Given the critical role of banks in the economy, sound and effective regulatory, supervisory and deposit insurance regimes are essential. Such regimes should include an early warning system to detect potential problems that may cause concern over the safety and soundness of a bank. An appropriate prompt corrective action framework should be applied and swift and effective actions should be instituted to resolve identified bank deficiencies.

3. Regulatory forbearance is all too often a sin with expensive consequences. Supervisors should guard against supervisory capture. Safety net players and the financial system as a whole are not well served with the use of constructive ambiguity as an intervention policy.

4. Effective resolution of troubled banks is optimal when there is a private sector solution without financial assistance being provided by the safety net players. Safety net players should have the power and the will to act to force private sector solutions.

5. When a bank's capital dips below minimum regulatory requirements, intervention should immediately follow. Towards this end, there should be clear intervention guidelines (Ladders of Intervention) issued to the banking sector detailing the consequences of such occurrence, and the range and sequence of prompt corrective actions that would be imposed by the supervisors. Financial penalties should be available to provide strong incentives for banks to never be off-side regulatory capital. Bank failure resolution processes and methodologies should be transparent, well understood and consistently applied to all banks to minimise moral hazard. There should be full disclosure on how the processes were applied so as to provide accountability.

To understand the rationale behind these guiding principles, let us understand why banks are special and requires supervision.

Every country needs a sound and robust banking system as an engine of growth. A sound and credible banking system promotes savings, prudent lending, and directly contribute to a country's financial stability.

Banks are special. They are chartered, regulated, supervised and deposits they accept are insured.

We all know that banks are in the business of taking calculated risks and making a sound return for their investors. Interestingly, banks get the majority of their funding from depositor and bank investors are for the most part individuals who either purchase bank shares directly or they have a stake in the bank through their pension funds, and/or mutual funds who invest on their behalf.

Banks also have many suppliers and purchase numerous services and are for the most part, large employers. And, often are prominent in certain geographical areas.

As a result, the failure of a bank would have severe economic, social and political consequences since it affects a large number of the population, is disruptive and is therefore to be avoided.

Hence banks are regulated and supervised extensively to ensure they remain financially safe and sound! And the public relies on that fact!

I would advance that it is therefore a privilege to own a bank and not a right! As a principle therefore, the rights of bank depositors are paramount and shareholders should and do rank last in the priority of claims!

It is interesting to note that in the evolution of banking, we have lost a major incentive in our arsenal of tools. Previously, under the old Scottish banking system, not only did shareholders rank last in recovering their funds, they also had a double liability. Thus, if a bank was undercapitalized, the supervisors had a right to call upon the existing shareholders to top up the capital and they were legally required to do so. This system worked extremely well in many countries and provided shareholder vigilance and oversight. But with the advent of limited liability, the double liability laws were repealed.

This was replaced one time with more comprehensive regulation and supervision. Thus, the level of regulation and supervision is justified on the basis that it replaces past shareholder vigilance and provides the necessary checks and balances if followed and applied consistently!

Bank regulations set out the framework under which a banking system will operate. It provides a roadmap and parameters by which banks are expected to follow and are therefore set in law.

Regulations however can be soon outdated if not kept current and relevant in concert with the changing financial institutional landscape. To remain competitive, the regulations must keep in tandem with international best practices and fit a country's current financial system development. As well the supervisory framework must change with the environment as we now see the move to risk-based supervision.

Part 2: The Role of Different Players in a Financial System

So who is responsible for the ongoing safety and soundness of a bank?

While there exist an effective regulatory, supervisory and deposit insurance system in the majority of countries today, the basis of a safe and sound banking system relies on a number of key players being able and willing to fulfill their roles and responsibilities diligently. The ongoing stability of the financial system can only be assured when all players fulfill their role.

One must understand that the ongoing stability of a country's financial system is only as strong as its weakest link. If there exists problem banks which are allowed to continue in operation while they are no longer viable or hopelessly insolvent, this provides competitive distortions between the banks to the detriment of the financial system as a whole.

The first and foremost responsible players are the directing minds of banks—the board of directors! They are expected to lead and manage their banks prudently, having regard to the regulations imposed on their industry. The boards of directors are responsible for the effective oversight and management of their bank. The board must ensure that the bank operates and complies with all of the regulations and that sound internal controls are implemented and complied with.

They must ensure that the bank performs optimally in the interest of all stakeholders. They must also set the strategic direction and set the tone for establishing and complying with sound risk management policies based on the sound understanding of the risk inherent in their business, hiring the expertise to deliver the business plan objectives they have set, and ensuring that the bank is well managed and in control.

Do boards of directors understand their roles and responsibilities? Do they have the right qualifications? Can they challenge the bank's management and do they fully understand the requirement for the implementation and compliance with sound corporate governance? This is somewhat suspect and requires further work in this area. If one assess a bank's corporate governance practices, their risk assessment framework and their quality internal controls, one has a pretty good early warning system. But in many countries today, directors of public companies are required to take educational programmes which lead to certification as qualified directors. Given the complexities of banking, given that banks are in the business of taking risks, and that their demise would be a significant event for a country's financial system stability, bank directors should be required to be fully qualified! Furthermore directors should be personally held joint and severally liable for the performance of their obligations thereby providing the right incentives for optimal performance. Since it does take time to train qualified directors, a timeline should be provided to individuals who wish to serve or continue on bank boards. Thereafter, only qualified individuals could be appointed by law.

What are the responsibilities of the bank's Managers? Does Management have the right incentives to perform their roles and responsibilities? Are their incentives aligned with stakeholders in good times and in bad times?

As stated earlier, the board of directors is responsible for ensuring that the bank has qualified and responsible individuals to manage the day to day business and affairs prudently.

Boards must ensure that Management is given specified and detailed roles and responsibilities and that the expectations on performance are clear. The board also is responsible for setting the key performance indicators of the CEO and that a proper and appropriate succession plan is in place to ensure ongoing continuity and quality of management.

Management responsibility is to implement the business plan as approved by the board of directors and manage the business and affairs of the bank according to approved board controls and limits. Management is also responsible to provide in-depth reports to the board on the performance of the bank so that the board can fulfill its governance responsibilities.

Incentives must be compatible with the expected results and the Board should be prepared to challenge Management if expectations are not achieved.

When Management takes inappropriate risks and expose the bank to large financial losses, the board must act to either eliminate that risk and or change Management.

It is sound governance to separate the role of the Chairman of the Board and that of the CEO. The separation of duties and responsibilities of the board and management reinforces that the board delegates its responsibilities to the CEO and the CEO takes instructions from the Board.

What are the responsibilities of Auditors (both internal and external)?

Internal controls play a vital role in mitigating risks. A sound internal audit function provides the Management and the Board with assurance that sound internal controls are in place and are working to reduce the risk exposure of the bank.

The external auditors' role is to opine on the presentation of the bank's financial statements as provided by the Management of the Bank. The presentation of the financial statements is the

responsibility of Management. And I should stress that Management must ensure that the financial statements reflect fairly the actual financial position of the bank at all times, not just at year end.

As part of the audit, the external auditors would rely on the work of the internal auditors to ensure that effective internal controls are in place, have been tested and validated, and that the internal controls are working so that the external auditors can rely on the internal controls to set the scope of their audit programme.

What are the responsibilities of the Supervisors?

The Supervisors undertake examinations to ensure that banks are managed according to the regulations, rules and guidelines in place to assess the safety and soundness of a bank.

The supervisors have a number of authorities and powers to ensure that banks are well governed and well managed. They also ensure that banks have sound risk management systems in place and they are working.

Increasingly supervisors are undertaking risk-based examinations to ensure that they focus their limited resources in the areas where they consider the risks are highest. An important point here to note, supervisors can no longer represent or provide an opinion, at any point in time, that a bank's safety and soundness is assured. As a result, supervisors should rely more and more on the work undertaken by the bank's internal and external auditors to ensure that they have a full understanding of the risks inherent in a bank's operations at all times!

Some supervisors have made it explicit and have set out their expectations on the bank's internal and external auditors. Arising from such expectations, internal and external auditors are put on notice that supervisors rely on the work performed by them. Auditors are then held personally responsible if significant deficiencies are later identified. One important caveat in this arrangement is that bank boards must accept that both internal and external auditors now have a direct responsibility and accountability to the supervisors. The issue of independence is of paramount importance. This indeed is a positive development.

Part 3: The role and responsibilities of safety net players in dealing with troubled banks

There are two challenges that I would highlight. The first is to decide ***who should be involved and at which point.*** In many jurisdictions, only the supervisor or the central bank is vested with the power to review the causes of distress or prescribe the remedy or intervene at the treatment stage. This sole supervisor approach is deemed justifiable since the responsibility and accountability for financial system stability are placed solely on the shoulders of the supervisor or central bank. This perception is particularly strong in the case of deposit insurers with paybox mandates. Due to such perception, paybox deposit insurers normally do not participate in bank failure resolution. Simply put, their role is to send a cheque to the widow.

In my view a deposit insurer should be involved at the earliest stage when a bank becomes troubled. It may not be immediately apparent to you as to why deposit insurers, especially those with paybox mandates, should be involved when the bank begins to show signs of distress.

In many jurisdictions, the deposit insurer is not the gatekeeper for new bank entrants. Still, it bears the financial risk of all entrants to the banking system. It also bears the risk of the supervisor's inability and lack of will to act to resolve troubled institutions efficiently. As a result, the deposit insurer should stand as the watchdog and is the last line of defence against the use of its funds and the possibility that public funds may also be used to bail out a troubled bank.

In today's corporate world, the honest accountant who pays upon the instruction of the managing director has long been replaced by the chief financial officer who participates in the decision-

making process to ensure that the financial decisions are the result of an effective least cost production process and in the best interest of the organisation. Following the aftermath of the Enron and Parmalat debacles, corporate governance of listed entities has been given even greater emphasis. In contrast, deposit insurers with accountability for large sums of money are often passive by-standers until after the insolvency of the bank.

It is inequitable that the deposit insurer as the financial steward of funds collected from the banking sector and their clients can only act as a funeral director.

Good governance is equally, if not more important, in the public sector. Our financial stewardship over deposit insurance funds creates an inherent responsibility for us to be transparent and accountable for the efficient use of our funds. This builds confidence in the banking system and protects bank clients who pay the freight. And good governance exerts a responsibility on the deposit insurer to conduct ongoing risk assessment of its member banks and to work closely with the supervisor should there be signs of distress in banks and their response to prompt corrective action.

Good governance requires pro-activeness on the part of the deposit insurer. It must be able to mitigate its risks by making appropriate contingency plans before a bank slides into insolvency. Therefore, earlier involvement of the deposit insurer is far better than later if one considers the financial system as a whole.

In the case of MDIC, we conduct our own independent on-going assessment on the health of our member banks.

We are responsible for the resolution of ailing banks when notified by the supervisor that a bank has ceased or likely to cease to be viable and we do not await the insolvency. Therefore, we are always kept informed by the supervisor of signs of distress among our banks. In fact, we are advised the moment signs of distress are detected. We work closely with the supervisor on the treatment and the progress of the bank throughout the rehabilitation process.

A second challenge is to determine **who should lead the bank failure resolution process.** In my judgment, I would say that it depends on who has responsibility for the troubled bank. If the supervisor is responsible and able to be fully accountable to all stakeholders, it should lead throughout the resolution process. But when the resolution of a bank is part of the deposit insurer's mandate (least-cost or risk minimising), there should be a corresponding change in leadership when it is clear that the bank is unlikely to be rehabilitated.

Let me share Malaysia's approach in this area. The Central Bank of Malaysia, which is the supervisor, notifies MDIC when the troubled institution ceases or is likely to cease to be viable. At this point, the MDIC Act obligates MDIC total responsibility and accountability for the resolution of the troubled member by law. I should point out that this does not mean an abdication of responsibility by the supervisor. It continues to remain as the supervisor until the bank is closed. It is only not responsible for the bank failure resolution, the process used or how depositors are protected.

Thus it is vitally important that each safety net player's mandate is fully defined in law.

There are many benefits to clear accountability for each player that is involved in a bank failure resolution. Among others, it enables each player to be clear as to its role within the safety net system and the powers that it would need to fulfil this role effectively. In some jurisdictions, the supervisor has a mandate which includes the power to rehabilitate a troubled bank. This would require that the supervisor has powers to sell part or all assets of the bank, set up a bridge bank, assume control of the business of the bank and possibly, the power to appoint the deposit insurer as receiver. Such an arrangement may however not be effective for the financial system. It increases moral hazard by creating a perception that the supervisor stands ready to guarantee

the rehabilitation. In addition, the inability or the lack of will to resolve troubled banks expeditiously by the supervisor creates more losses to the deposit insurer.

So what is so different in Malaysia's approach? The answer is in the supervisor-deposit insurer partnership approach to bank resolution. When the supervisor leads, the deposit insurer works alongside the supervisor and vice-versa. In creating MDIC, the supervisor gave MDIC the same bank resolution powers that it had. Then, the supervisor gave MDIC special asset management provisions which it did not even have. The rationale, which is enshrined in the MDIC Act, is that such provisions are in the public interest for MDIC to implement promptly resolution actions at a minimum cost to the financial system.

Areas of Cooperation

Let me now turn to areas of cooperation for supervisors and deposit insurers in managing troubled banks.

An important area for cooperation is the sharing of knowledge and analysis of early warning signals. The correct diagnosis and therefore the prescriptive remedy are dependent on the quality of early signals. Many deposit insurers already implement some form of early warning system as part of their internal risk assessment systems. An early warning system is not specific to deposit insurers.

Private fund managers, international financial institutions and supervisors have their own early warning systems. Only the sophistication and their effectiveness differ. Since both the supervisor and the deposit insurer are involved in monitoring individual banks, it would be a logical process for both deposit insurer and supervisor to cooperate and compare notes on their assessment of the financial system and on individual banks. The benefits of a dual monitoring system are increasingly being appreciated. Not only does a dual filter system ensure all the early signals are captured, it provides a check and balance between the views of the supervisor and that of the deposit insurer.

Another area of cooperation is the sharing of knowledge on the financial condition of banks under surveillance, those undergoing treatment and their progress. A number of jurisdictions have cooperated in the above areas. Malaysia is one such example. It has taken the approach that the deposit insurer is an integral component of the financial safety net. MDIC does not have examination powers but has the right to information and must independently assess the risks of individual banks and the financial system as a whole so that it can administer the deposit insurance fund prudently, be in a position to form its own opinions from that of the supervisors and contribute to and fulfil its safety net role effectively. As such, the supervisor and MDIC exchange all relevant information, such as the exchange of timely and up-to-date information on the condition of the financial system, including:

- emerging issues and threats affecting the financial system, in particular, assessment of the risks of specific banks that may affect the position of MDIC as the insurer, and the monitoring of regulatory and supervisory action plans set out to deal with troubled banks;
- Development and implementation of an early warning system with a view to reduce or avert a risk to the financial system and to banks;
- Development and implementation of prompt corrective measures for dealing with potentially troubled or high-risk banks including the criteria for defining non-viability; and
- Development and implementation of a framework for intervention of banks that have been determined as non-viable.

Collaboration of actions must be formal and legislated. At MDIC, the access and sharing of information is in law and it is formalised into a Strategic Alliance Agreement (SAA) between MDIC

and the Central Bank. The SAA sets out the roles and responsibilities of both agencies, arrangements for sharing of information[1] and resources as well as the coordination of actions. The SAA recognises that although MDIC and the Central Bank have distinct and separate mandates and responsibilities, both are integral regulatory agencies that have a common objective of promoting the stability of the financial system.

An example of the collaboration of actions between MDIC and the supervisor can be seen in the Terms and Conditions of Membership which we have issued for public consultation a few weeks ago. Among others, the upcoming regulation on the Terms and Conditions of Membership will set out the obligation of banks to provide accurate information, adhere to prudential and regulatory requirements set by the supervisor including their commitments given in letters of undertaking. Once the regulation is in place before year end, failure to comply may result in the imposition of premium surcharge by MDIC on banks. In this regard, MDIC directly supports the supervisor through the imposition of financial incentives on our members.

Part 4: Issues and challenges in selecting an appropriate resolution method.

Let me now address the issues and challenges in the selection of an appropriate resolution method.

First, the best course of action in regards to a troubled bank is to implement appropriate prompt corrective action immediately when signs become visible to ensure that the problems are rectified before they become terminal. Supervisors are rarely exposed if they adopt a prompt corrective action regime and take tough action on banks that are not following regulations. But time and again, supervisors provide regulatory forbearance in the hope the problems will vanish in due course or the bank will outgrow its problems. In reality, this approach results in what I call supervisory capture. The bank's problems then become those of the supervisor who is left with no choice but to continue the forbearance. In time, the problem grows and grows.

And when deficiencies are identified, it is the norm for supervisors to require banks to issue letter of undertakings setting how the bank will voluntarily address the identified deficiencies. In many ways, such undertakings are weak at best, are not followed and the problems persists or increase. While undertakings are great when they work, supervisors should be far more prepared, as a matter of course, to issue compliance orders against banks which have significant deficiencies. And the issuance of such orders should be disclosed to provide market discipline. As an alternative, letters of undertaking should be reinforced by money penalties if the bank fails to meet its commitments. In Malaysia, the MDIC has the power to do so!

In many instances, it is not a single problem that would cause a bank to become terminally ill but a set of problems which working together compound the problem and complicates the early identification of appropriate solutions.

Liquidity often Masks Insolvency

A bank's liquidity situation often masks other problems. If a bank is often finding itself in a liquidity crunch and is using the lender of last resort facilities from the Central Bank, it often signals that the bank has far more serious problems and it may not be viable or is on the brink of insolvency. In my mind, this is an early warning system and the cause must be thoroughly investigated. If a bank cannot manage its liquidity, what does it say for its risk management systems.

[1] The SAA covers the sharing of up-to-date information on emerging threats to the banking system, cooperation and consultation on new regulations and other policy initiatives, the development of early warning system, development and implementation of prompt corrective measures, intervention framework and incentives to promote sound risk management.

Supervisors should also realize that it is not appropriate to blindly rely on the representation of the bank's management to disclose the full extent of the problems faced by the troubled bank. Simply put, often their continued employment depend on not disclosing the full extent of the problems.

Take non-performing loans as an example. It is often the case that management will only recognize non-performing loans and record appropriate provisions if their balance sheet can absorb it. And often large loans are restructured in some way (e.g. evergreen) to mask the problem in the hope that the situation will turn around or to delay the recognition since it would affect their capital requirements.

I call this the iceberg approach. As a result, one only sees the tip of the NPL iceberg while the majority of the problem is hidden from view, only to appear later (while the supervisor thought the problem had been resolved). Supervisors must always ask probing questions and investigate the matter fully when a bank decides to take large provisions to ensure that they know enough about the performing loans, the quality of the underlying security and underwriting practices.

Supervisors who find bank management being less than honest should take immediate action to impose sanctions on the individuals including insisting on their dismissal. Only then will bankers understand the seriousness of the matter.

Interventions and Resolutions

Everyone would agree that the optimal solution to a problem bank is a private sector solution. Either the bank is able to nurse itself back to health quickly or a private sector solution is necessary. The question is always at what time or when should the supervisor force a board of directors to seek a private sector solution such as finding a purchaser or a merger partner. A balance is to be found between giving the board of directors the opportunity and time to rectify the problem either by recapitalizing the bank or to find a purchaser or merger partner and to take regulatory action to force a solution.

In my mind, the decision should be driven by the level of the bank's capital and the quality of the bank's action plan to address its deficiencies. If the bank is well capitalized (above the regulatory capital requirements) and the bank is still profitable, it then has time to deal with its deficiencies and a course of action should be determined and monitored closely.

If the bank's capital has eroded and it's in danger of falling below regulatory capital requirements and no plan exists to recapitalize the bank in short order, then the supervisor must force the board of directors of a bank to find a purchaser or a merger partner forthwith in the hope of saving the bank's remaining value.

If the bank's capital is below regulatory capital requirements and a recapitalization is not expected, then the supervisors must trigger an intervention in the best interest of the financial system.

Failure Resolution

Now let's deal with Failure Resolutions.

Prior to assessing the failure resolution options, a viability assessment of the bank's business and affairs should be undertaken to assess the size of the problem. Unless one knows the extent of the exposure, one cannot assess the merits of different failure resolutions.

Such an assessment should be undertaken by the agency which has the financial exposure in resolving the bank failure. It should be undertaken by individuals who can value assets (on and off balance sheet) on a going concern basis and under a liquidation scenario. Deposit insurers with least cost and risk minimization mandates should undertake the viability assessment to

provide it with the knowledge necessary to formulate the best resolution option. In such viability assessments, the objective is to assess the extent of the risks and exposures in the bank. It is imperative to develop a valuation methodology that can stand up to public scrutiny. As such, ranges of values for assets (including tangibles and intangibles) need to be determined and validated, determining the amount of secured debts, insured and uninsured deposits, as well as the valuation of all liabilities (including contingent liabilities). As well, debt obligations documentation should be reviewed to understand the extent of negative covenants and their trigger points.

Once the assessment has been undertaken and validated with the bank's management, then different resolution methods can be assessed by different teams who would then substantiate the assumptions under which the resolution methods were assessed. It is important to ensure that the assumptions are valid and include all in costs, the use of nominal or net present value assumptions, funding and administration costs. Then the available resolutions methods would be compared and evaluated.

Providing financial assistance to resolve troubled banks, if done right, can provide substantial benefits and reduce the costs of resolutions to the deposit insurer. However such transactions must be based on some criteria and be well structured. Here is a list of criteria that I think is important to consider.

Criteria for Providing Financial Assistance

When considering providing financial assistance to a troubled bank, the deposit insurer should set out criteria under which it would consider providing financial assistance such as:

- There is no private sector solution available;
- The supervisors have exhausted all of their powers to effect a solution;
- The deposit insurer has undertaken or has commissioned a viability study and fully understands and appreciates the extent of the troubled bank's problems and full exposure;
- The deposit insurer understands the political, system stability and social realities in resolving the troubled bank (e.g. significance of the bank to the economy, the contagion effect, political fallout, employment etc.);
- A formal bidding process must be established to ensure that all interested parties have an opportunity to bid on the business and affairs of the troubled bank thereby providing for an opportunity to get the best solution at the least cost;
- A term sheet should be developed to provide interested parties with instructions on how the bids should be made (all or part of the business and affairs, acquisition of the entity or shares), how it will be assessed and the terms and conditions under which the deposit insurer will determine the final bidder. As an example, the deposit insurer must have a cap on the level of financial assistance it is prepared to provide depending on the evaluation of other options (e.g. losses under a liquidation scenario, bridge bank);
- The time allotted to due diligence by buyers will determine the extent of guarantees and undertakings to be provided. If the buyers have little time to undertake their due diligence, they will demand more subsidies to guarantee the value of the assets;

- The financial assistance provided is conditional on the third party (the acquirer) having the financial capability, capacity and the expertise to undertake such a transaction successfully;

- No regulatory or supervisory forbearance is to be provided to the acquirer. In other words, the acquirer must be onside all regulatory requirements at the date the transaction closes;

- The resolution must be structured in a way to ensure that the deposit insurer will only pay once. In other words, the transaction must be assessed on the probability of success in the medium to long-term (e.g. Credit Lyonnais);

- The acquirer must have some form of exposure to losses based on their performance to meet expectations as set out in the agreements and the deposit insurer should not provide unlimited or 100% coverage on any subsidies provided on the value of assets;

- The transaction should be disclosed to the public sufficiently to ensure transparency and accountability;

- Any financial assistance should be based on a LIFO basis (e.g. U.S. Chapter 11). When financial assistance is provided and the existing shareholders maintain an interest in the bank, their diluted interests should rank after the rights of the deposit insurer. In other words, the existing shareholders should get a hope certificate which is repayable only after the deposit insurer's claims are made whole; and

- Recapitalization of banks without changing the board of directors and management and without diluting the existing shareholders should be avoided since such transactions are seldom successful.

Part 5: Challenges and Practical considerations for deposit insurers

I shall now move on to challenges and practical considerations of bank failure resolution for deposit insurers.

There are several but I shall highlight only three key challenges and this is from the perspective of a deposit insurer which has a least cost mandate for bank resolution.

The first is the **lack of information** in respect of the assets and liabilities of the troubled bank. This is often due to poor documentation and poor management information system in respect of assets and deposit liabilities. This impedes the deposit insurer's ability to assess accurately the viability of a troubled bank. This makes it difficult to conduct a cost benefit analysis of the various options and in turn, the selection of the least cost resolution option.

The management and disposition of bank assets is typically the most visible and the most expensive activity of the resolution process. To ensure that appropriate resolution strategies are adopted, it is important to evaluate the assets accurately. Efficient and effective asset-management strategies reflect the type and quality of assets being realized and the market under which the assets are being disposed. It also requires the validation of valuation assumptions employed in the asset valuation/appraisal process and business plans. Interest rate risk, market risk and legal risks among others need to be identified, evaluated, quantified and managed. The ability of the deposit insurer to assess such risks is dependent on accurate, reliable and timely information.

Other problems include lack of information on borrowers as it hampers tracing of the collateral, the status of repayment, balance outstanding or even the ability to contact the borrowers. This creates a host of problems, such as pricing and recovery.

The lack of information is not only restricted to the internal condition of the troubled bank. There is also a lack of information as to the appetite of the market to acquire loans and the loan loss projections for the different types of loans. This is particularly acute in some countries in Asia given that their markets for non-performing loans are relatively new or have yet to be developed. This makes it difficult to value assets accurately.

Transparency and access to information are two important factors in asset management and disposition. The quality and availability of information and the imposition of a formal and transparent bid process has an important bearing on asset values since it generates greater buyer interest through competition.

Without adequate information and competition, potential buyers will require heavy discounts on assets purchased. In order to expedite a sale and to increase sale value, guarantees may be provided to make good any loss experienced by the purchaser.

This may also include a repurchase provision should any loan become non-performing. This increases the exposure of the deposit insurer but may be mitigated by requiring the purchaser to meet performance standards on managing and collecting loans and alternatively for the purchaser to pay a fee once a loan is underwritten by the purchaser for its own account.

Other factors which affect asset management and disposition performance include the current general economic conditions, whether assets are subject to competing creditor claims and the depth of the securitization market. This brings us to the second challenge, the lack of a market for bank assets in Asia.

Once the assets have been examined and categorised, the timing and method of disposition may be considered in light of the nature of the assets being disposed of and the condition of the markets into which they are being sold. Selling assets immediately at resolution or thereafter has the advantage of returning assets to the market quickly, as well as replenishing the deposit insurance fund and minimising government involvement. Valuations of assets should also be determined based on net present values of future cash flows and the expected appreciation of the market in mid to long term. These advantages and disadvantages should be considered against the risk of lower recoveries and potential resistance from creditors who might stand to benefit from a lengthier realisation process. However, the lack of a market will influence the timing of asset sale as well as determine whether a private sector based approach can be effectively adopted.

A third challenge is the **lack of appropriate skilled personnel** needed for asset management. The development of capabilities and skills involved in claims-and-recoveries activities is an ongoing process. In most countries, professionals are drawn from the insolvency, accounting, banking, real-estate, information-technology and legal professions. Although projecting staffing requirements for future failures is problematic, it is important that those responsible for the claims-and-recoveries function have both the funding to hire and retain the expertise internally or to pay for outsourcing services.

Many deposit insurers have developed the expertise and the contingency plans to undertake the asset-management function. This enables the consolidation of skills, resources, and uniform workout practices within one agency, thereby providing efficiencies and the proper incentives for recovering maximum value from claims paid by the deposit insurer.

Concluding remarks

I should like to conclude with an observation on organisational effectiveness of the safety net player responsible for troubled bank management. How do we measure its effectiveness? From my experience, while each of the safety net players would strive for individual organisational

effectiveness, it is not sufficient. If we are to be effective in terms of our impact on the banking system, each safety net player must strive for organisational effectiveness as well as synergistic effectiveness with each other. Our role, contribution and effectiveness must be assessed together with those of the other safety net players. It is about what we can achieve together. I see the bank failure resolution process as a team effort. The combined strength of each safety net player is needed to steer financial stability and each has a role to play. The real measure of our individual effectiveness is when the total financial system effectiveness is greater than the sum of our individual contributions.

Thank you for your attention.