The Polish Bank Insolvency Regime

Issues/Assumptions for the Design and Specification of an Upgraded Bank Resolution Framework

July 26, 2012

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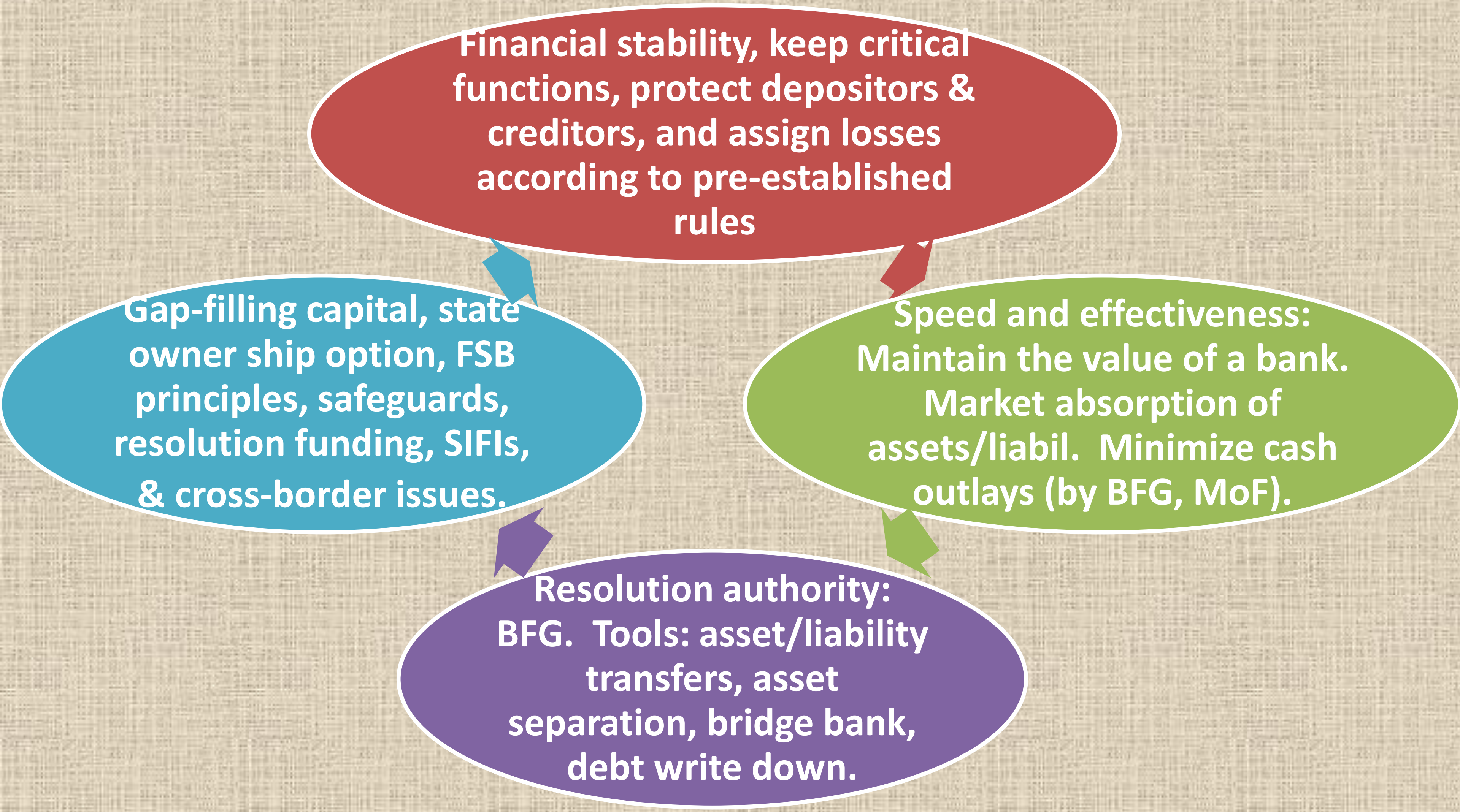
The Bank Resolution Reform: Objective/Features



The case for the new regime

- Preservation of bank value (and protect deposits), critical given economic stability effects that in banks can cascade rapidly.

- Judicial/corporate liquidation at economic insolvency is overly late: assets lose value, & deposits are withdrawn. Costly for all parties.
- EU new Directive proposes what several countries have already been practicing (U.S., Japan, Canada, Malaysia, Spain, UK, Germany).

Nature of the new insolvency (resolution) regime

- An “administrative” versus “judicial” procedure. Resolution is an administrative procedure based on regulatory insolvency and triggers around potential failure. Once evident, resolution is approved by KNF and executed by BFG. Resolution will occur prior to the existing liquidation and/or bankruptcy phases.
- Triggers: bank regulatory insolvency, illiquidity, failure to meet obligations, imminent failure, or assessment of likely failure in short term.

Benefits of the new resolution regime

- Minimization of public funds and deposit insurance funds through preservation of assets of failed bank & prompt transfer (w/deposits) to acquiring banks before full insolvency.
- Ability to stem financial system contagion or deposit runs by transferring working parts of balance sheet (or entire bank) to another bank.
- Resolution authority can be providing 'gap' funding to complete 'deal' provided it is not higher than payout cost to insured depositors.

Assignment of Losses

- The transfer/sale of assets with liabilities to a sound bank, constitutes de facto protection of depositors/creditors. No need for cash payout to insured depositors nor early closure of bank.
- Creditors are assigned losses according to a hierarchy when insufficient assets exist to cover liabilities. Creditors/claimants can challenge the process legally but not stop it. Compensation to them should be at least as much using resolution, as under liquidation (NCWO rule).

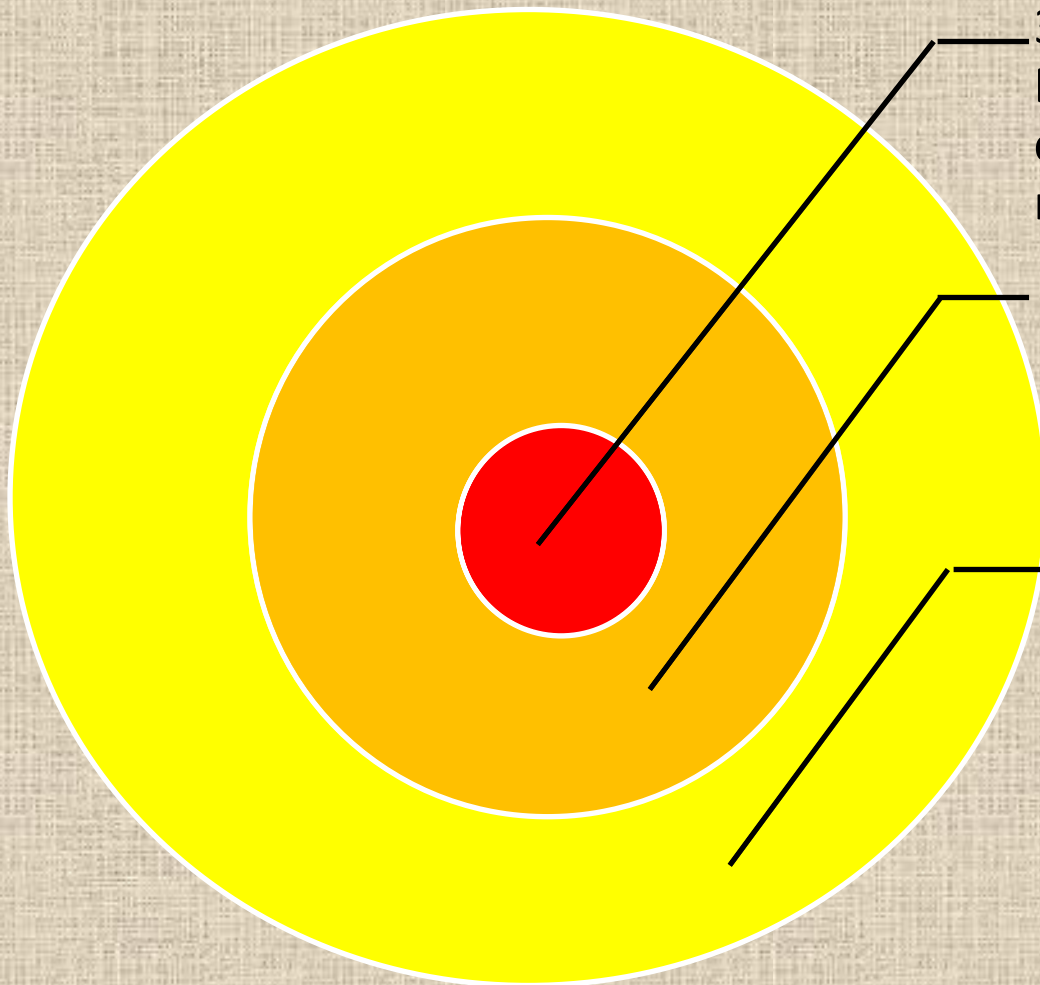
Creditor Claims Hierarchy

FIRST ORDER	(a) Cost of services/TA to conduct resolution, (b) insured deposits, (c) secured senior creditors, (d) short term cash/labor contracts, (e) advances or loans of the deposit insurance agency.
SECOND ORDER	(a) Central Bank loans, (b) Other senior creditors, (c) other retail deposits (stratified by size), (d) unsecured creditors & bondholders, (e) loans from commercial banks
THIRD ORDER	(a) Deposits from public sector, (b) subordinated loans, (c) general tax obligations.
FOURTH ORDER	(a) Other claims not included above, (b) shareholders of the institution being resolved.

The Resolution Authority

- *Legally independent and autonomous: senior management, management board, and Council selected according to professional criteria*
- *Protection of officials and staff (lawsuits, if existent to be directed to the authority, not individuals)*
- *Affected claimants can file suit on account of non-legal economic compensation but cannot halt a resolution process. Compensation can only be awarded if claimants/creditors received less in resolution process than under traditional liquidation.*
- ***The resolution law is separate from the banking law so as to elaborate the detailed processes required.***

Planning for Resolution



3. KNF invokes resolution. BFG executes. (BFG or NBP can also recommend for resolution to be invoked).

2. Contingency plans for resolution prepared.

1. Prior to resolution: KNF and BFG conduct joint visits during bank supervision. Resolution discussed as option if potential failure is a possibility; but not yet invoked.

Executing the Resolution Process

Take Over and Suspension of Activities

Resolution Authority to take over management of the bank and suspends activities, lending, etc., as it sees fit, to preserve the value of the bank.

Determining bank's capital position

Resolution Authority to assess value of loans, assets, collateral, to apply correct loss provisions and fix the real value of capital if any, or the capital deficit. Technical services may be contracted by the authority to conduct this.

Arranging Asset/Liability Transfers/Sales

Following on earlier pre-resolution investigations of potential buyers, BFG works to effect sale of failed bank in part or whole to eligible buyers via P&As , and if needed separating out bad assets for liquidation.

Securitization also may be used to facilitate transfers

Other Options if P&As not feasible

If transfers to other banks not possible, BFG can consider a bridge bank option to transfer viable assets and deposits/liabilities under temporary BFG ownership.

If bank is a SIFI, BFG can consider not only shareholder loss but also debt write down of subordinated creditors to "inject" capital .

BFG can separately recommend to MoF a state ownership option .

Elaboration on resolution tools

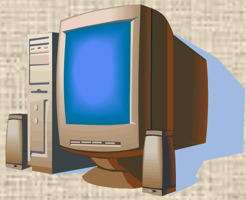
- Asset separation tool is meant to exclude non performing assets. These can be managed separately via a contracted asset management outfit to obtain recoveries on such 'bad' assets.
- Simple loan securitizations can facilitate asset transfers to more than one bank. These are "plain vanilla" securitizations. Banks acquire such securities as on-balance sheet items. Other banks or AMCs may manage underlying loans for collection for a fee (i.e., off balance sheet since such loans are collateral for the securities sold).

Elaboration, continued …

- The resolution authority, BFG may also participate in the financial structures, e.g.: a balance sheet ‘gap filling’ loan, contribution, temporary portfolio purchase, or other measure, to facilitate speedy transfer if such contribution remains less than the quantum of insured depositor payouts.
- The bridge bank option should only be used once other resolution options have failed. The bridge bank objective is for BFG to temporarily own and manage it until it can be sold to a private investor/bank.
- The bridge bank must meet KNF’s prudential and supervisory requirements. KNF approves its license.

Set-off, Netting, Termination Rights

- Collateralized securities, derivatives, structured transactions cannot be separated in resolution operations and are treated as combined (to avoid counterparty, systemic effects). Claims can be netted but not split.



- Creditors cannot terminate contracts only due to a resolution proceeding having begun. The resolution authority can suspend contracts in the interest of preserving asset value. Creditors can only terminate if default occurs. Invoking resolution is not considered default.

License Revocation and its Equivalency

- In conducting resolution, license revocation should not be done too soon, or else BFG will need to pay all insured depositors shortly. Revocation should be timed until after assets/liabilities are transferred once BFG has taken control of bank.
- **Besides the triggers to invoke resolution and subsequent realization of losses, the fact is that triggering of resolution can, if desired, immediately trigger license revocation and thus suspension of shareholder rights. Thus, even while not revoking the license, entering into resolu-tion automatically suspends shareholders.**

Systemically Important Financial Institutions

Too big to fail SIFIs – What are the tools?

- Debt write down (can be used for non-SIFIs, but most likely for SIFIs where P&A transfers are too large to be absorbed.
- Debt write down: following shareholder write downs, subordinated creditors written down. Recommend to use capital level/capital deficit as objective trigger for write down. Converting debt to equity (COCO) can be an option too but less likely as bondholders may not accept such new asset.
- Resolution and Recovery Plans (RRPs) mandatory for SIFIs.
- Asset securitization of loan portfolio can assist in distributing SIFI assets across a larger number of potential buyers/banks.
- MoF/FSC can also provide as part of banking support measures, special lending or capital facilities, for all banks; but particularly apt for SIFIs.

Funding of Resolution Operations

- It is recommended that the resolution authority/deposit insurance agency (BFG) keep deposit insurance funds and resolution funds under the same institutional oversight given their interrelationship.
- Deposit insurance funds and their deployment essentially are already a form of resolution resource. However, a sub-account for resolution funding alone can be created but should not be managed by a separate agency. Sourced differently from dep. guarantee fees.
- Besides ex ante funding from the industry, ex post assessments can also be charged if unexpected 'contributions' need present funding.
- NBP should only provide liquidity support on standards terms with requisite collateral and prudential requirements. Under systemic ---stability situations, if BFG, for example needed liquidity-------to pay off insured depositors not absorbed in a resolution----NBP could provide a loan to BFG if MoF/Govt. guaranteed.

Thank you