Trigger Mechanisms for Early Intervention and Failure Resolution: An Overview

APEC Policy Dialogue on Deposit Insurance
Kuala Lumpur, Malaysia
February 17, 2004

Christine M. Cumming
Federal Reserve Bank of New York

Disclaimer

The Views Expressed are Those of the Speaker and not of the Federal Reserve System or the Federal Reserve Bank of New York

The Role of Bank Failure in a Healthy Financial System

- Healthy risk-taking and innovation in the banking system involves some chance of failure
- Therefore, need a method for dealing with failed business strategy
- Salutary effect of bank failure: illustrates importance of sound governance, risk management, and internal control

A Simple Framework

- Emphasis on progressively worsening problem and its impact on market value and the book value of capital
- Emphasis on the decisions available to bank management and bank supervisors and their impact on the cost of resolution and the resolution authority
- Real life more complicated, nuanced

An *Ex Post* View: Stages in the Decline of a Troubled Bank

- **Early Stage:** All appears well, but mistakes are being made. Early signs of trouble appear.
- **Middle Stage:** Problem continues to grow; market becomes aware and progressively tightens terms of funding, market access; eventually bank faces a market squeeze.
- **Late Stage:** Failure and Resolution

The Market Value of the Bank

- Banks have a market value even if their equity is traded.
- Market value lies in both balance sheet **tangibles and intangibles** less **liabilities.**
  - Intangibles include franchise, brand, and technical know-how, among other things.
  - The deposit base is a key source of value.
- Market value is an **inherently forward-looking** estimate: the present value of the bank’s future income stream.

Market Value over the Three Stages of the Troubled Bank

- Market value gives management **flexibility** in addressing a problem.
- Market value **tends to decay in a troubled bank** as depositors reduce exposure to the bank, customers defect, cash flow ebbs, key employees leave.
- Market value declines further when it appears the **only option is to sell** assets or the whole bank.

The Capital of the Troubled Bank

- Book capital *at its best* reflects realized losses, recognized problems and reductions of income due to customer attrition.
- Book capital thus almost always lags the forward-looking market value of the bank.
- Thus, when book capital is zero, the actual market value is likely negative.

A Troubled Bank: Who Can Act?

Management

- Can correct problems
  - Can also maintain liquidity and recapitalize
- Has the **incentive** to maximize value
- Often doesn’t because out of denial

Bank Supervisor

- Can highlight problems, require a plan, require the bank to take actions
- Can limit growth, risk-taking, the draining of capital, liquidity and assets

A Troubled Bank: Who Can Act?

- For management and bank supervisors:
  - Probability of a turnaround is highest in the early stages.
  - Turnaround in the middle stage requires more draconian measures.
- For the deposit insurer, probability of failure increases as the probability of successful turnaround or management sale declines

The Early Stage: The Role of the Supervisor

- **Identify Problems** and bring to Management's attention for solution
  - – Serious problems at banks generally involve lack of management oversight, multiple breakdowns in internal control and risk management
  - – Internal audit should identify those breakdowns
  - – Risk-based, process-oriented bank examinations can usually uncover such developing problems--requires persistence and skepticism.

The Middle Stage: The Supervisor

- **Promote Problem Resolution and Maintenance of Financial Soundness**;
  - Get past denial that problem exists
  - Get management to develop and implement action plan addressing problem;
  - If necessary, management's contingency plan if action plan does not succeed;
  - Action plan often includes raising new capital; restricting or eliminating dividends and other drains on capital and liquidity;
  - Important goal: Encourage management initiative

More on the Middle Stage

- As problem worsens, supervisors adopt a progressively more restrictive and prescriptive supervisory program.
- Supervisors may engage directors about replacing key managers.
- Supervisors conduct an increasingly intensive information exchange and strategy setting with deposit insurer.
- As probability of turnaround declines, the importance of minimizing cost of resolution eventually predominates.

The Middle Stage: Role of the Deposit Insurer/Resolution Authority

- Gathering information required for resolution.
- Developing strategy for resolution.
- Developing interim plan, if necessary, for managing bank and preserving value while bank is resolved.
- Intensive monitoring for the handoff.

Objectives for a Trigger Mechanism for Early Intervention

- Accelerating process of handoff from supervisor to resolution authority to reduce social cost of private bank failure
- Promoting more rapid supervisory action, to reduce resolution cost
- Increasing management’s incentive to address problems, seek value-maximizing solution for shareholders

Some Final Thoughts

- Trigger mechanisms require and reflect a good infrastructure
- Good corporate governance at banks: management’s role
- Highlights the importance of supervisors’ indemnification: need to take decisive action.
- Highlights the importance of strong information-sharing and communication networks among “safety net” authorities

Prompt Corrective Action (PCA) in the U.S.

- Legislated in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)
- Mandated actions that supervisors must take for undercapitalized banks
- Sound supervisory practice would usually have these actions in place before PCA thresholds are crossed
- Required “Least Cost Resolution” and provided ability to close banks earlier

PCA Thresholds

Well capitalized	Total Capital $\geq$ 10 % AND Tier 1 Capital $\geq$ 6 % AND Leverage Ratio $\geq$ 5 %
Adequately Capitalized	Total $\geq$ 8 % AND Tier 1 $\geq$ 4 % AND Leverage $\geq$ 4% In some cases $\geq$ 3%
Undercapitalized	Total < 8 % OR Tier 1 < 4 % OR Leverage < 4 % or 3%
Significantly Undercapitalized	Total < 6 % OR Tier 1 < 3 % OR Leverage < 3 %
Critically Undercapitalized	***Ratio of Tangible Equity to Total Assets $\leq$ 2 %***

PCA: Key Mandatory Actions

Well capitalized	None—deposit insurance benefits
Adequately Capitalized	No Significant Limits except capital distributions that lead to undercapitalization
Undercapitalized	Must file a capital plan, must get approval of supervisor Restrictions on dividends and management fees Restrictions on growth
Significantly Undercapitalized	Same as undercapitalized Restrictions on executive compensation
Critically Undercapitalized	***Further Restrictions on Payments*** ***Subject to Closure***

PCA Implementation: Key Points

- Some Discretion for Supervisors
  - Can reclassify one category down for unsafe and unsound condition or practice
  - But not to critically undercapitalized
- Penalty for Failing to Submit Capital Plan or Failing to Implement it
  - Reclassification as “Significantly Undercapitalized”
- Exit from PCA for Recovering Banks
  - Four Quarters of Capital at “Adequately Capitalized” Levels