Chapter

27 Five Observations About Banking Failures

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1. Every Bank Failure Is a Regulatory Failure

Certainly banks do not fail *only* because regulators fail in their oversight responsibilities. Many other failures are typically involved in any bank failure, including failures of governance, internal controls, loan execution, and credit review. The impact of local, regional, and national economies is always a factor. Yet it is rare indeed for a bank failure, even in a banking crisis, not to have been preceded by numerous warning signals, such as excessively high levels of (i) connected (insider) lending; (ii) risk, including foreign exchange, interest rate and investment risk; (iii) direct investments in real estate; (iv) fraud and other criminal activity; and (v) spending on a headquarters building, typically with palatial executive suites and board rooms.

In many cases, bank regulators exercise regulatory forbearance, a wink and a nod in the other direction, while the bank sinks toward and then past the point of insolvency. In fact, it is atypical to find insolvent banks at zero capital, but more often than not at a significant negative net worth, which, for large banks around the world, can amount to billions of dollars. Timidity in enforcement, supervision, examination, and regulation may have the effect of encouraging management to engage in the high levels of risk noted above, and therefore may result in greater losses by the bank.

Bank failures are also a failure of external auditors, who may be negligent or engage in deliberate attempts to mislead the regulators and the public to protect their clients, as well as of negligent or willful

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acts by the bank's management, its consultants, advisors, investment bankers, and yes, even lawyers.

Banks that are already insolvent are often unmasked by a banking crisis, leading some to think that their insolvency was brought about by the crisis itself. The insolvent condition is sometimes mistakenly thought to be a result of the crisis (the fallacy of *post hoc ergo propter hoc*: after, therefore, because of), when, in fact, the insolvency often preceded the crisis but was never brought to light, either by regulators, external auditors, or the bank management itself.

2. Banks Experiencing Runs on Deposits Are Almost Always Insolvent

On an accounting basis, a run is a symptom of illiquidity, which means in the banking context that the long-term assets of the bank—loans—can't be liquidated fast enough to pay the bank's short-term liabilities—deposits. As a result, the bank runs out of cash and must often borrow on the interbank market or from the central bank's liquidity window.

In theory, when a bank is illiquid prior to or as a result of a depositor run, the bank is not necessarily insolvent, since it may simply be experiencing a short-term inability to liquidate long-term assets to pay short-term liabilities, an asset-liability mismatch. In practice, it is rare indeed to find a bank that is experiencing a run that is not subsequently found to be insolvent.

It is almost always the case, however, that once a depositor run is in full sway, and banking regulators examine the bank on an emergency basis, the bank turns out to be insolvent on a book basis, that is, its assets (primarily loans) are less than its liabilities (primarily deposits). In a number of crisis countries, external auditors (typically not the auditors that were previously associated with the bank) were brought in to examine insolvent banks to determine the extent of the losses. Typically, the losses calculated by the new auditors in these cases exceed everyone's expectations.

If in fact it is almost always the case that a bank experiencing a run is insolvent, even in the case of a systemic banking crisis, a more interesting question is why banking regulators and external auditors were unaware of the bank's problems, while members of the public know enough to line up outside a bank to withdraw their deposits. Or perhaps regulators and auditors knew and did nothing, hoping that the problem would go away, or they were negligent in doing their job and didn't know the severity of the problem or, worse, colluded with owners to deceive the public.

3. Lender-of-Last-Resort Financing May Have Unforeseen Consequences

Typically, central banks have the authority either explicitly, or implicitly (as is the case in the United Kingdom), to provide emergency liquidity financing (ELF) outside of the normal liquidity window, with or without the pledge of assets by the bank. However, when central banks provide ELF without adequate security, or with the pledge of assets by the illiquid bank that are sufficient based on book value but not on market value, the potential exists for the financing not to be repaid when the bank fails.

This possibility has at least two outcomes, both bad: the first is that the central bank becomes the largest creditor of the bank, since it has replaced deposits with ELF. The nonpayment of this financing can result in a charge against the capital of the central bank. Given enough such financing or a large enough bank that receives it, central banks themselves can become insolvent. The second possible outcome is that the central bank or banking regulator decides not to close the bank since to do so would result in nonpayment of the financing. Hence, banks are kept open that would (or should) otherwise be closed.

It is an article of faith among central bankers that ELF financing should not be provided to insolvent banks, but only to those experiencing short-term liquidity shortfalls. However, this policy (sometimes required by law) presumes that banks undergoing depositor runs will *not* be found to be insolvent later. If in fact the presumption were to be changed so that such banks were presumed to be insolvent, then ELF should only be provided, if at all, to banks that are "too big to fail." At the very least, this would eliminate the need to fund the myriad of smaller, nonessential banks that typically receive ELF. While the concept of "too big to fail" is a controversial one, in every crisis country there are banks that were considered too big or too essential to be allowed to close, and therefore regulators acted in some manner to prevent them from failing.

This suggests that the rules for providing ELF in many countries should be revisited and the tilt toward providing financing for every bank experiencing a run addressed. It should be noted that under many bankruptcy laws around the world, illiquidity, typically defined in banking laws around the world as the "inability to pay debts as they become due" is one of the grounds for the appointment of a bankruptcy receiver. This test is also one of the grounds for closure of a bank under some banking laws, such as those of the United States. The adoption of a ground for closure such as this would eliminate at least in part the need to provide ELF. At the same time, there should be sufficient flexibility in the law to allow a central bank to provide ELF on an unsecured basis when needed in a banking crisis. In the case of a banking crisis, such financing should be provided by the government, using the central bank as its agent, since the health of an essential part of the economy is at stake, rather than the liquidity needs of a particular bank, which is the normal province of any central bank.

4. Without Effective Laws, Bank Restructuring Agencies Are Doomed to Failure

It is virtually impossible to have a successful bank restructuring agency without the passage of a new law by the legislative branch to create the agency. When presidential or executive decrees are used to create the agency and endow its legal powers, such decrees rarely if ever have the force of law necessary to overcome existing statutory law, even in transitional countries or countries without a fully functioning democracy. Typically, existing laws, such as those relating to banking, bankruptcy, companies, securities, and taxation must be amended in some way to provide sufficient authority for the new agency to fully address a banking crisis. In some cases a law is necessary to provide the new agency with appropriate "super powers," powers usually reserved for court-appointed receivers or administrators in bankruptcy cases, such as the power to repudiate contracts that have not been fully executed, as well as to keep contracts in force that would otherwise be terminated.

It is also virtually impossible to have a successful outcome without a political consensus that involves not only the executive and legislative branches of government, but also the major political parties, and not just the ruling party, but the opposition as well.

Three principles—autonomy, adherence to the rule of law, and transparency—are useful analytic tools in examining whether a bank restructuring agency law has been properly drafted. It is virtually impossible for a bank restructuring agency to function effectively without a law that conforms to these principles.

"Autonomy" in this context means that a bank restructuring agency should be created as an independent agency of the government and, in particular, should be separate and distinct from the central bank, banking regulator, and ministry of finance.

"Adherence to the rule of law" means that there should be clear and unambiguous restrictions on the exercise of power by the state, particularly where the taking of private property through the termination of ownership interests is concerned. Constitutional limitations on government takings of private property should also be taken into account.

"Transparency" means that any bank restructuring agency law should contain clear, comprehensive, and unambiguous language that is comprehensible to bank owners and management, potential investors in restructured banks, and buyers of assets, as well as the public at large.

Examples of successful bank restructuring agencies, such as the Swedish Bank Support Agency, or the Resolution Trust Corporation (RTC) and Federal Deposit Insurance Corporation (FDIC) in the United States, suggest that adherence to all three principles is essential to a good outcome.

5. Lawsuits Against Banking Regulators Increase When Banks Fail

Legal protections against civil lawsuits that may be brought against employees of central banks and banking regulators are always a good idea, but never more so than when banks fail. Once a bank fails and is closed, owners, shareholders, directors, managers, depositors, and creditors all have a greater likelihood of bringing suit against regulators, typically alleging that either the bank was solvent and the regulators were negligent in closing the bank, or the bank was insolvent and the regulators were negligent in not closing it earlier. Often, such lawsuits are not only brought against the central bank, banking regulator, or national government but also government employees in their personal capacity. This means that the costs of defending the suit, as well as any settlement or judgment rendered by a court, must be borne by the employee, and not the government.

Principle 1 of the Basel Core Principles provides that "[a] suitable legal framework for banking supervision is necessary, including . . . legal protection for supervisors." The explanation of this provision is found in the commentary to Principle 1, which states that a suitable legal framework requires a number of components to be in place, including "protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties."[1]

Public disclosure of statutory protections is considered an international best practice. See the Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles, adopted on September 26, 1999. Sections 4.4.1 and 8.4.1 of the Code refer to the need to publicly disclose information about statutory protections for employees of banking and financial regulators. The text of the Code is available on the IMF's website at www.imf.org/external/np/mae/mft/code/index.htm. The Code is available in a number of languages in addition to English, including Russian and Chinese.

A research paper by the author entitled "Statutory Protections for Banking Supervisors," Financial Sector Website Paper No. 4 (1999), is currently available on the World Bank's website at www1.worldbank.org/finance/html/policy_issues_debates_pubs.html. The study surveys the laws of 20 jurisdictions, including Australia,

[1] The full text of the Basel Core Principles and commentary is set forth as item no. 30 (www.bis.org/publ/index.htm).

Ecuador, Germany, Hong Kong, the Philippines, Sweden, Switzerland, the United States, and the United Kingdom.[2]

[2] The paper is also available in Russian from the author.