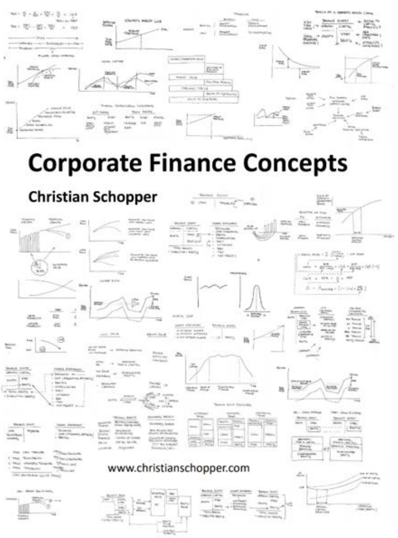
BANK MANAGEMENT IN A CRISIS

2018

For more concepts click on:



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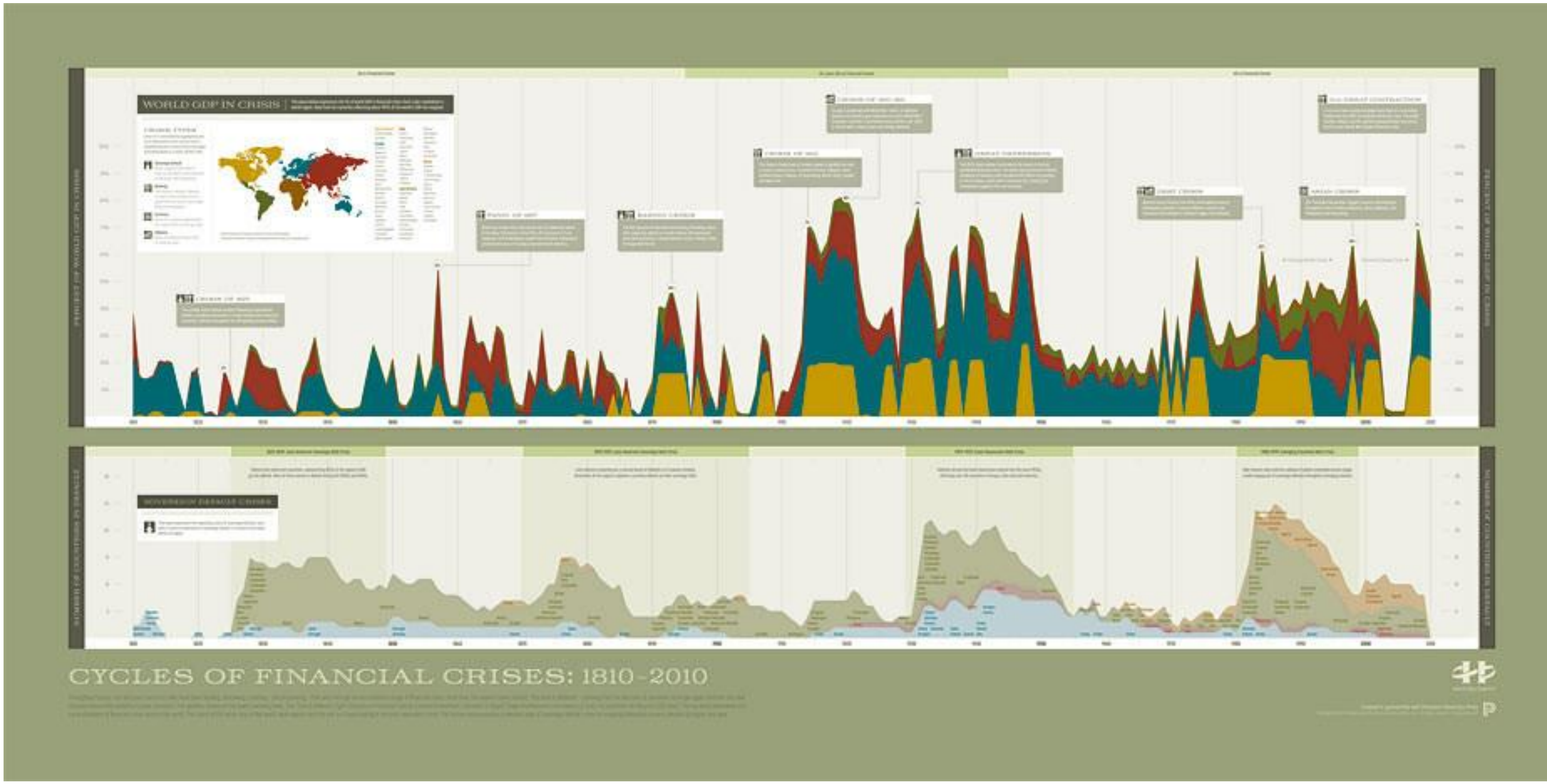
Financial Crises – A History of Cycles



When Banks Collapse

What Makes a Bank so Different?

- Balance Sheet Structure
- Maturity Transformation

Market Reaction in Banking Crises

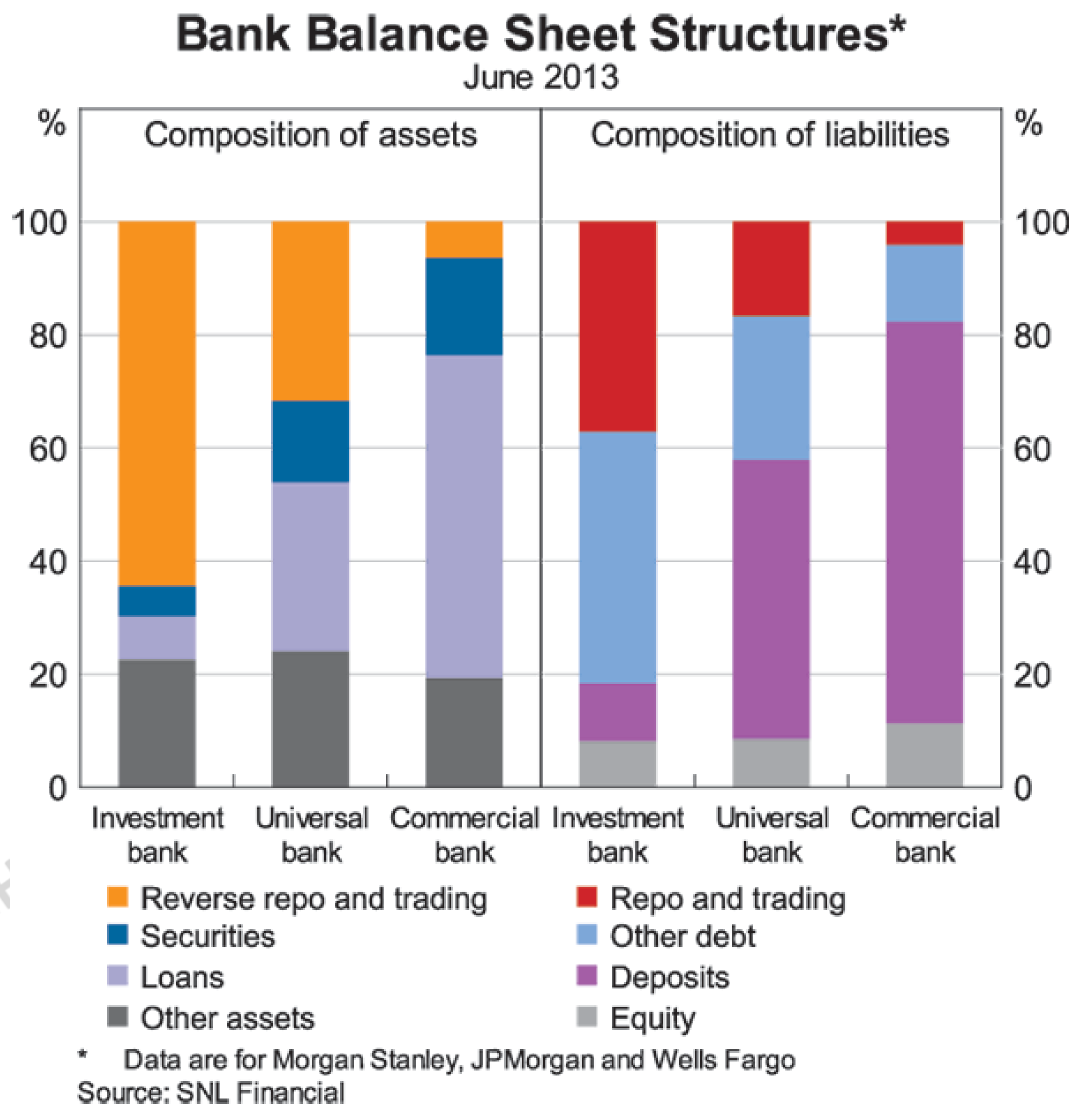
- Regardless of origin, crises typically emerge as a **liquidity problem** in one, or some, or all banks

- Liquidity problems and **deposit withdrawals** are symptoms of underlying problems

- Liquidity is rarely the driving factor, but a **bank running** out of liquidity forces decision making

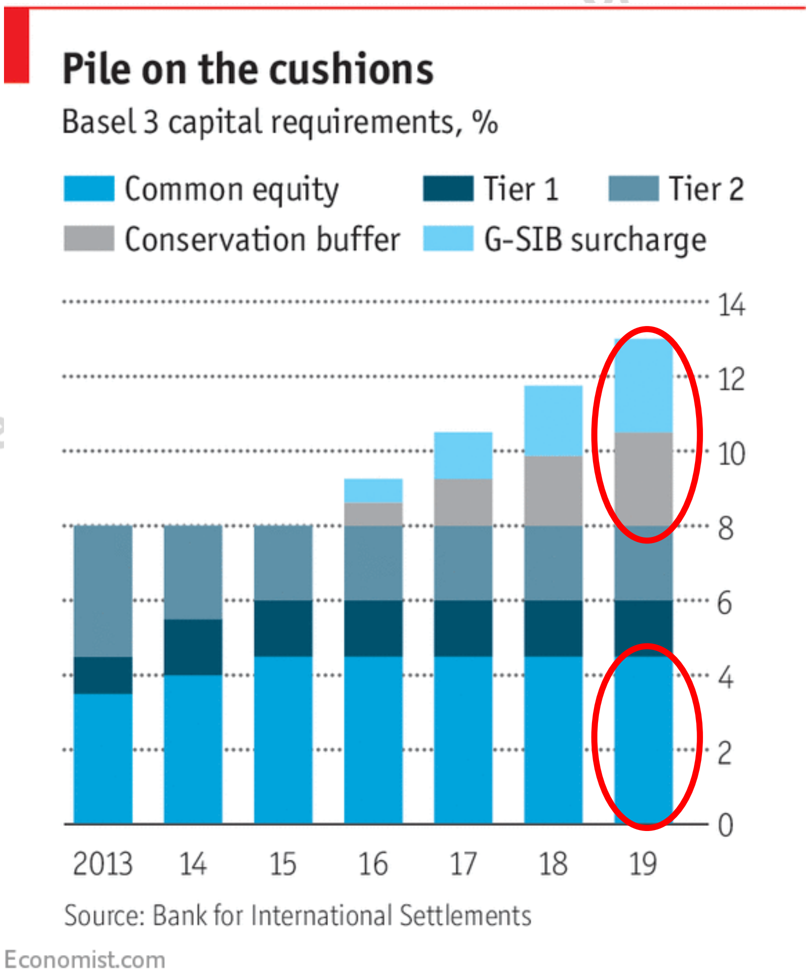
- **Panic must be stopped**
  - … this is not the time to implement policies …

Bank Balance Sheet Structures



Enhanced Capital Requirements - Towards Basel III

- The Basle Accord provides benchmark regulations for banks worldwide
  - Common Equity Tier 1: Equity instruments (discretionary dividends, no maturity)
  - Additional Tier 1: Subordinated to most subordinated debt (no maturity, dividends can be cancelled at any time)
  - Tier 2: Unsecured subordinated debt (original maturity of at least five years)



Why Banks are Failing

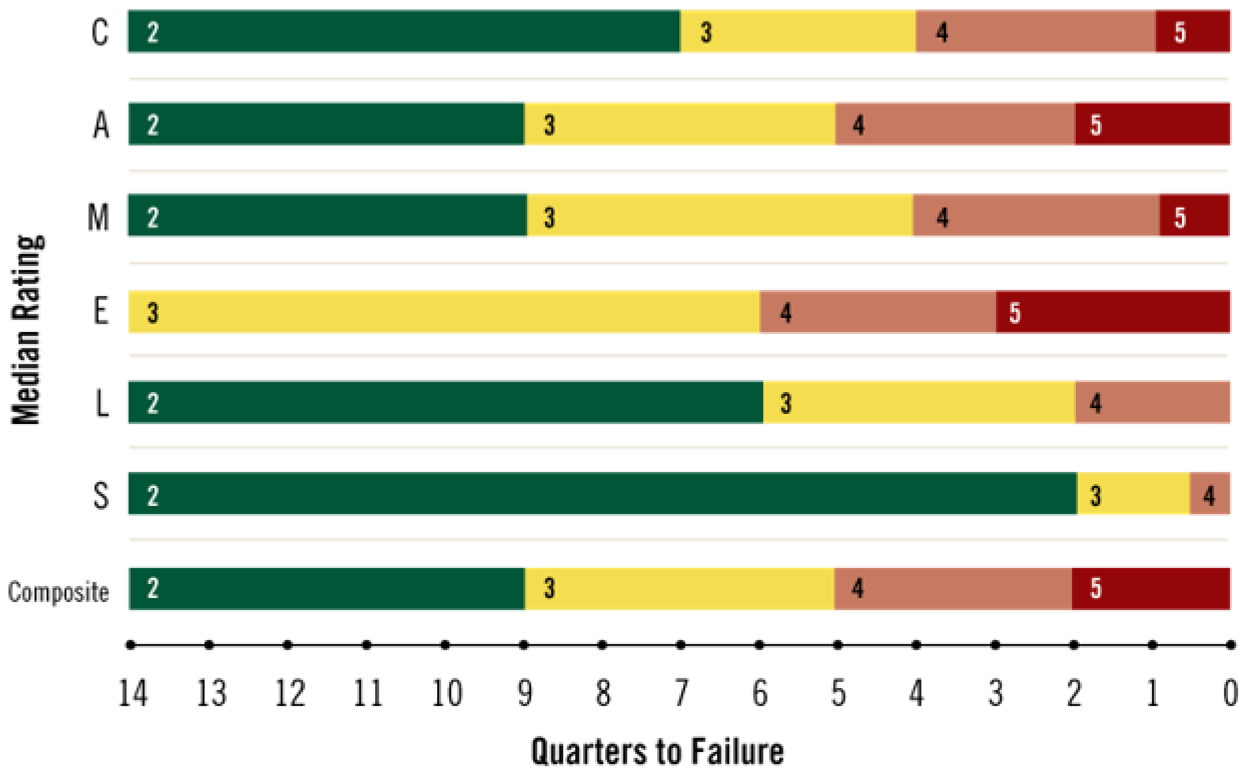
The four underlying reasons for bank failures have not changed from those of years' past, which are:

- An **imbalance of risk versus return**
- **Failure to diversify**
- Offering **products** and services that **management doesn't fully understand**
- **Poor management of risks**

Causes of bank failures as of BIS:

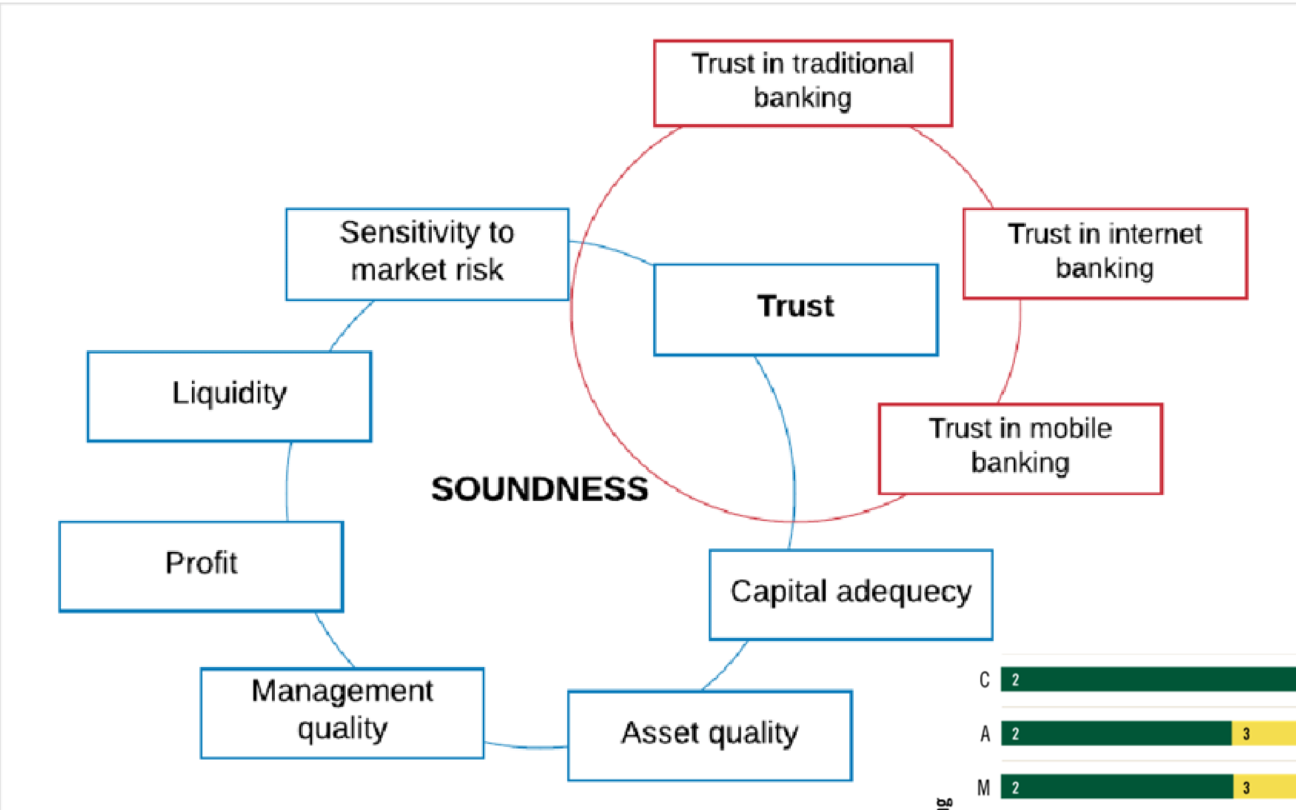
- Poor asset quality (98%)
- Poor management (90%)
  - Policy, planning, and management quality
  - Audits, controls, and systems
  - Liquidity and funds management
  - Non-funding expenses
- Weak economic environment (35%)
- Fraud (11%)
  - Insider abuse

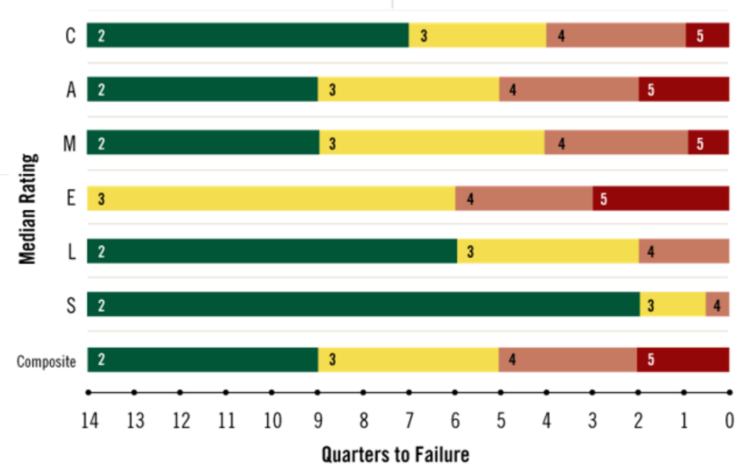
Failed Banks 1990 - 2009



This chart takes all of the failed banks from 1990 to 2009 and looks at their CAMELS ratings 14 quarters before failure. The ratings go from 1 to 5, with 1 and 2 considered healthy, 3 being the threshold for deterioration and 5 being the worst. The earnings component deteriorates first because asset quality problems in banks lead to greater provisioning for loan losses – which have a direct impact on a bank's earnings.

The Relevance of Trust





Containment Measures

- Support the overall **strategy**
- Credible **policies** announced and **immediately enacted**
- Measures are **temporary** – they cannot last forever

- Options available
  - Emergency **liquidity assistance**: Restore depositor and creditor confidence
  - Blanket **guarantees**: Stop bank runs caused by loss of depositor confidence
  - Bank **intervention**: Contain the collapse of a banking system
    - Deposit freezes
    - Deposit restructuring
    - Capital and exchange controls
- If containment measures prove to be ineffective, the adoption of **administrative measures** may become inevitable

Emergency Liquidity Assistance

- Objective: **Restore depositor and creditor confidence**

- Gives rise to various risks
  - Increases monetary aggregates
  - Losses to the central bank
  - Moral hazard
  - Authorities may end up supporting insolvent banks
  - Prone to abuse
  - Dollarized/ Euroizedeconomies

- Policy options
  - Sterilizedliquidity injections
  - Introduce liquidity triggers
  - Enhanced supervision of recipient banks
  - Measures for dollarized economies

Blanket Guarantees

- Objective: **Stop bank runs caused by loss of depositor confidence**
- Deployed by many countries facing systemic distress, but with mixed results
- Policy considerations
  - Typically ineffective if used in isolation –prone to abuse, fosters complacency, increases moral hazard
  - Fiscal costs can be substantial
  - Exit to be carefully managed

Administrative Measures

- Objective and assumptions
  - **Contain the collapse** of a banking system due to deposit runs and financial outflows
  - **Loss of confidence in the authorities‘ ability to manage the crisis** de facto limits effectiveness of blanket guarantees
  - Ability to introduce and enforce **financial sector regulations and capital controls**

- Key steps for the adoption of restrictions
  - Preparation of relevant **law(s)**, **regulations** and **implementation** modalities **<u>in secret</u>**
  - **Ascertain** that the central bank has **up-to-date information on liabilities**, including those to non-residents
  - Develop a **clear communication strategy** to foster understanding of the measures

- Aim: **Stop liquidity outflows when confidence is not restored**
  - Deposit freezes
  - Deposit restructuring
  - Capital and exchange controls

Administrative Measures (cont´d)

- **To be used with care** as administrative measures are **extremely disruptive to**
  - Payment systems
  - Economic activity
  - Private sector confidence
  - Exemptions
  - Unwinding process

- **Must be viewed as a final, desperate measure to stop runs if all other tools have failed**

Bank Restructuring

- Institutional requirements
- Guiding principles
- Evaluating options
- Key resolution tools
- Resolution triggers
- Funding arrangements

Bank Restructuring: Institutional Requirements

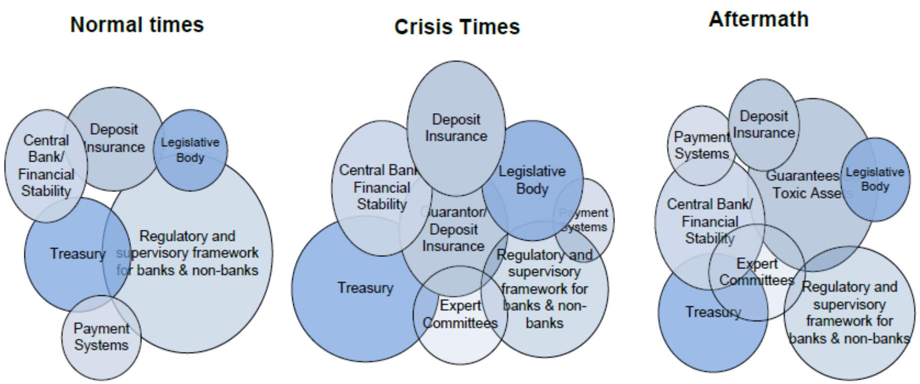
- Establishment of a **single** high-level **authority**
- High credibility **agency**, responsible for **implementation** of restructuring strategy
- Specialized **skills**
- Emergency **legislation**

Principles of Bank Restructuring

- **Speed** of intervention is essential
- **Protection of depositors** facilitates the restructuring process
- Process should be fair and **rules** should **equally applied** to all banks
- In diagnosis, **focus on medium-term** viability
- State intervention in capitalization may be justified

- **Recognize losses** upfront
- **Preserve** viable, undercapitalized banks
  - Request time-bound recap/restructuring plans
  - Close oversight and prompt corrective actions
- **Resolve** insolvent, unviable banks
  - Not all institutions to be rescued
  - Close/merge and liquidate asset

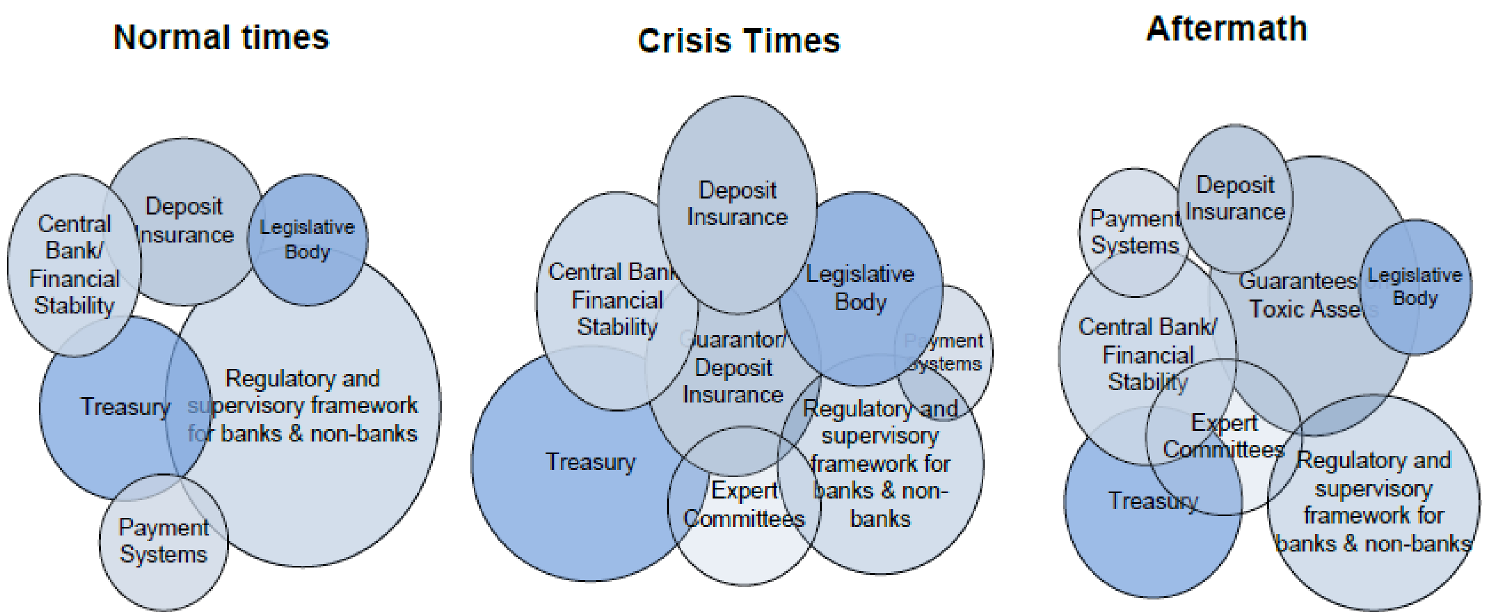
Financial System Safety Net



- Traditionally consists of
  - A lender of last resort (central bank)
  - Prudential regulation (by a bank supervisor)
  - Government department (Ministry of Finance or Treasury)
  - Explicit deposit protection (insurance or other form of a limited guarantee)

- The recent financial **crisis** underscored that the group of official safety net players has become somewhat more **elastic**
  - Need to consider the respective roles as decisions that they take can have an important impact and threaten financial system stability
  - Compelling reasons to **consider other stakeholders** and bring them into the dialogue so that financial system stability can be addressed more effectively and efficiently

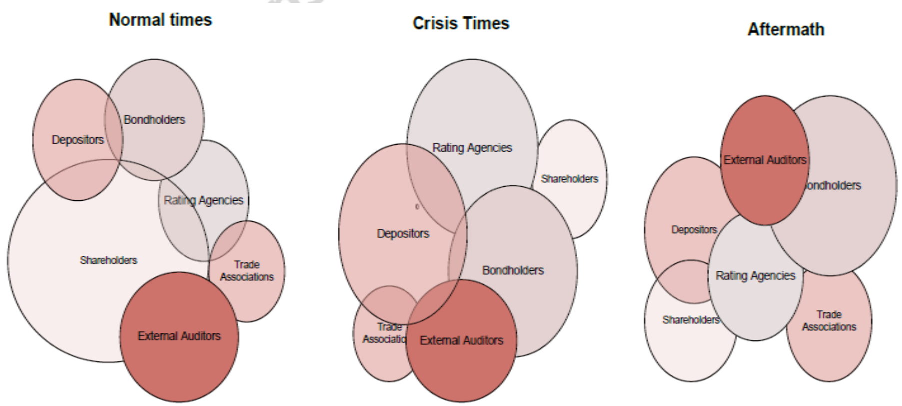
Financial System Safety Net (cont´d)



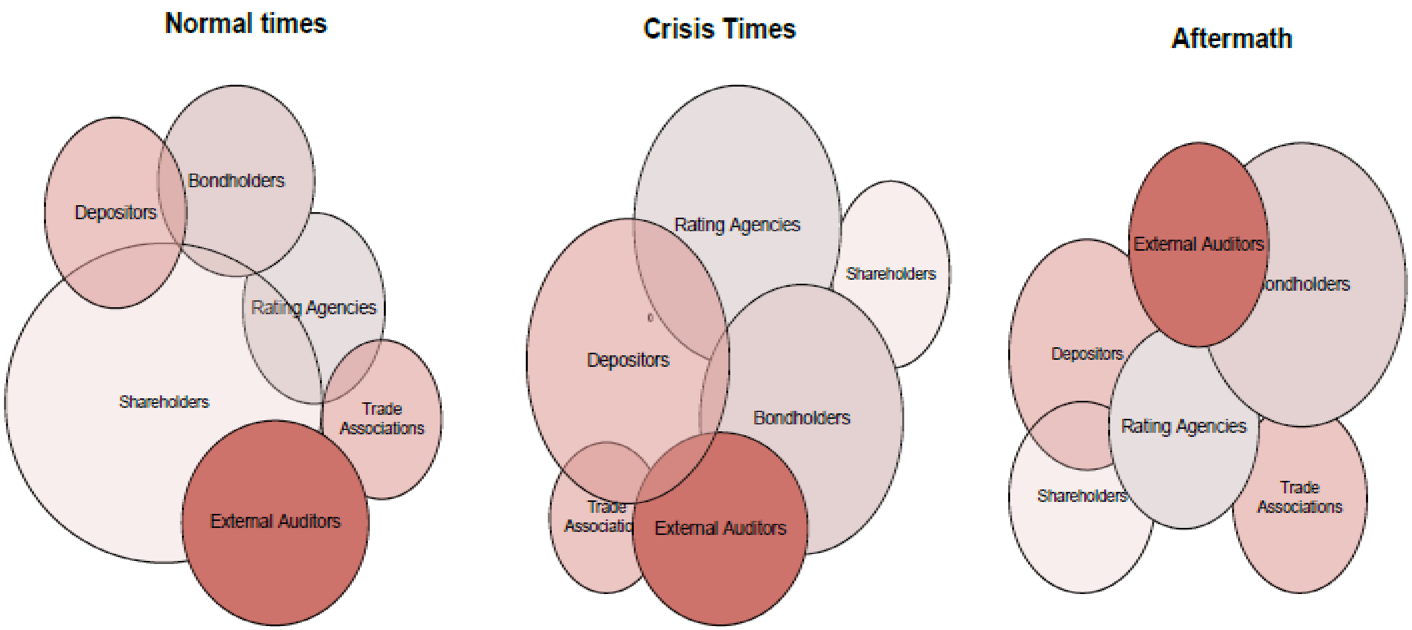
Source: OECD / Developing a Framework for Effective Financial Crisis Management

Stakeholders in the Financial Markets

- Intervention by the authorities during the crisis was partly a result of financial intermediaries‘ inability to raise funds in the markets
- In **normal times** the principal focus of managements is the interests of **shareholders and shareholder value**
  - The interests of depositors in such periods are not necessarily at the forefront of the minds of the banks, albeit there is a general duty on the FSN to protect depositors and to a lesser extent investors rather than owing a duty to the shareholders as a whole
- **In times of crisis** the priority placed on the interests of stakeholders changes
  - During the crisis the **interests of depositors** were very much **at the forefront** of the FSN players‘ minds because of concerns of a bank run or panic selling

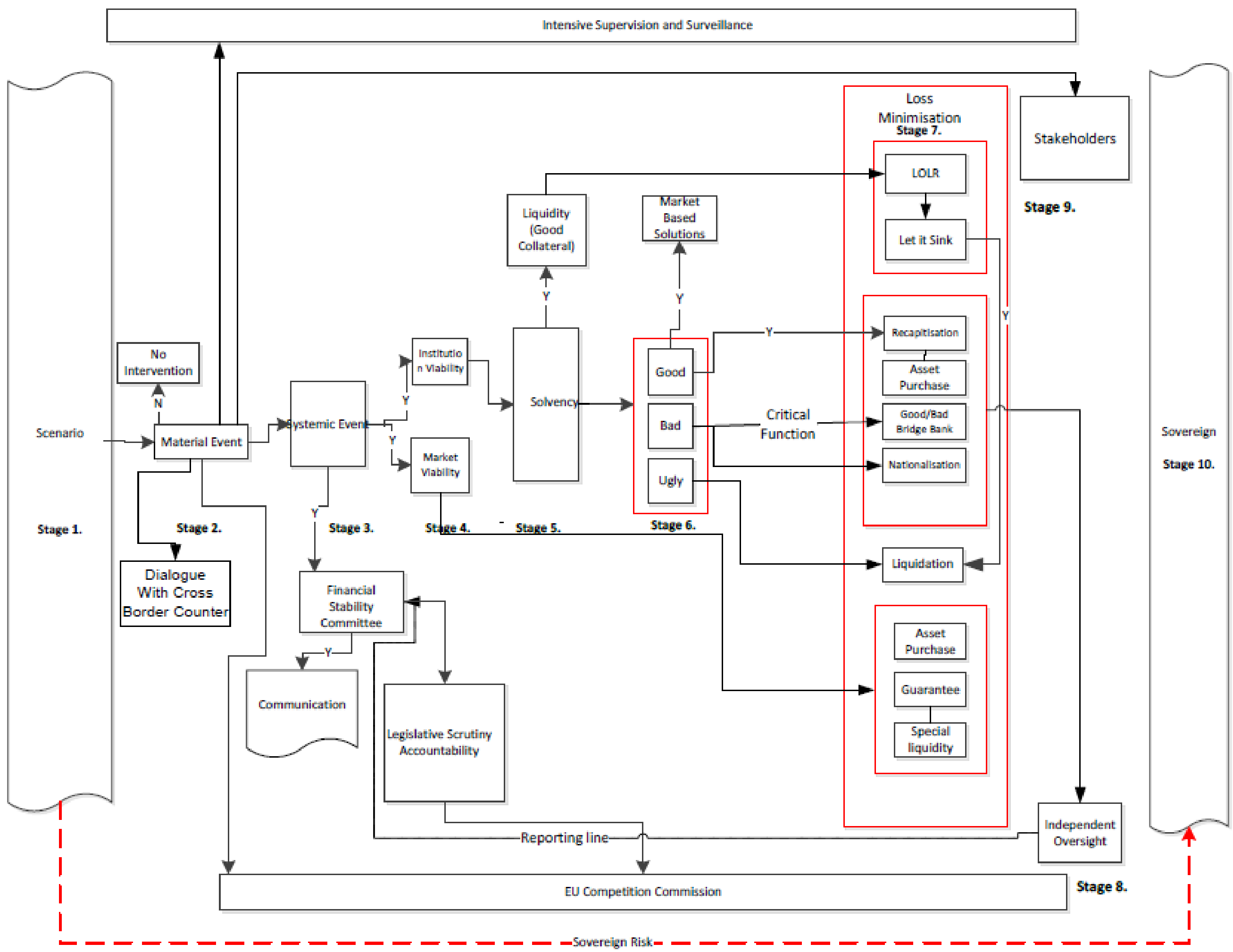


Stakeholders in the Financial Markets (cont´d)



Source: OECD / Developing a Framework for Effective Financial Crisis Management

Decision Tree Surrounding Financial Crisis Management

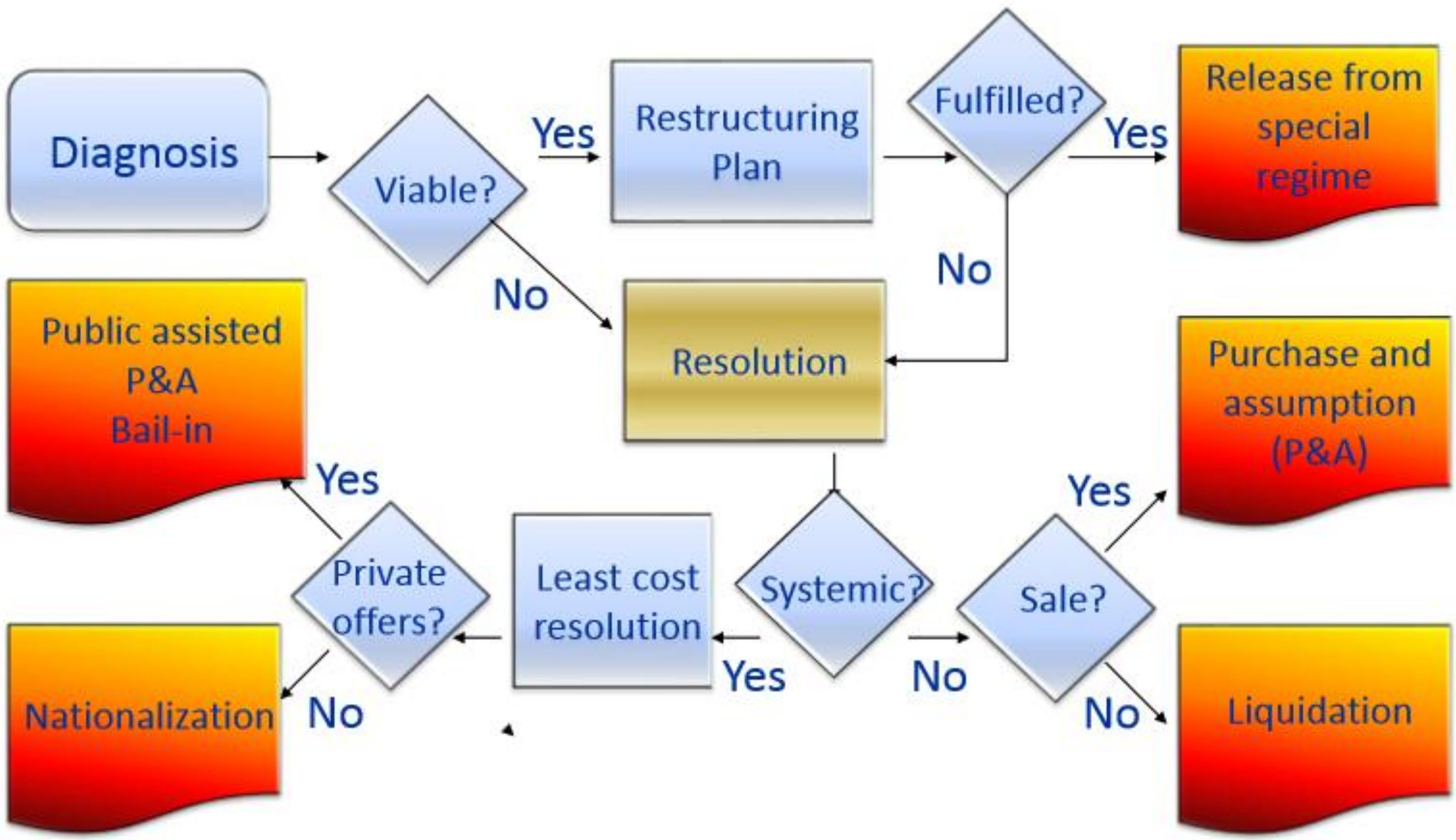


Source: OECD / Developing a Framework for Effective Financial Crisis Management

Common Challenges

- Inability to write down shareholder capital
- Limited legal authority to facilitate bank sales
- Weak mandate to restructure banks
- Ineffective procedures to implement Purchase & Assumption (P & A) transaction
- Insufficient knowledge of judges on banking matters
- Lack of legal protection to staff and board members

Which Option to Pursue?

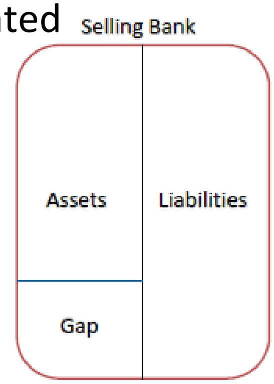


Key Resolution Tools

- Bank **Nationalization**
  - Direct bank **recapitalization with public funds**

- **Bridge bank**
  - Operates a failed bank **until a buyer can be found**
  - Assumes all or part of the assets and liabilities of the failed bank within a short period of time (i.e., 90 days or less)
  - Excludes nonperforming assets, subsidiaries, assets in litigation or fraud-related and contingent liabilities

- **Purchase & Assumption**
  - Acquiring institution absorbs assets and liabilities …
  - … while gap is filled through deposit guarantee scheme (receiving a claim on the residual entity)
  - Residual entity liquidated



- **Bail-in**
  - Recapitalize a distressed bank by converting and/or writing down its unsecured debt

Key Resolution Tools: Bank Nationalization

- Direct bank **recapitalization with public funds**

- Risks
  - Significant **state ownership** of financial institutions
  - **Political interference**
  - **Contingencies** for the sovereign’s fiscal position

Key Resolution Tools: Bridge Banks

- Establishment
  - Bridge bank **assumes all or part of the assets and liabilities of the failed bank within** a **short period of time** (i.e., 90 days or less)
  - **Excludes nonperforming assets**, subsidiaries, assets in litigation or fraud-related and contingent liabilities

- Operation
  - Regulators appoint **new management** and Board, who — together with **existing employees** — will continue operating the bank under a conservative approach
  - The government may contribute additional resources to strengthen its balance sheet

- Termination
  - Disposal over 2-3 years

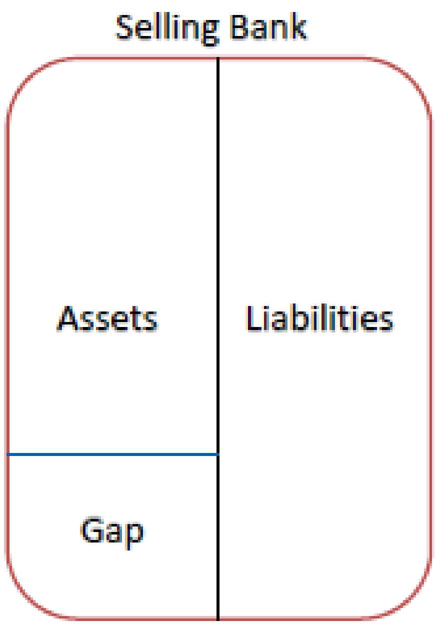
Key Resolution Tools: Bridge Banks (cont´d)

- Key advantages
  - **Stabilizes the institution** (and thus maintains franchise value) while a thorough assessment is performed, and the bank is marketed to prospective buyers
  - May facilitate the **sale to a buyer** that has done due diligence but is **not interested in the entire failed institution**
  - Useful for large and small institutions, or when resolving several institutions at the same time
  - It helps to leave in the bank under liquidation contingencies

- Concerns
  - Possible perception by other banks of **unfair competition** because of the state ownership
  - Excessive time in state hands, increasing risk of **political interference**
  - **Cost overruns** with respect to the original estimate
  - **Possible reduction of the deposit base** leading to a potential loss in franchise value

Key Resolution Tools: Purchase& Assumption (P&A)

- **Acquiring institution** absorbs assets and liabilities, while **gap is filled through deposit guarantee** scheme (which receives a claim on the residual entity)
- The residual entity liquidated



Key Resolution Tools: Purchase& Assumption (P&A) (cont´d)

- Resolution via P&A has distinct advantages
  - Helps **preserve confidence** in the banking **sector**
  - **Minimizes disruption** to bank customers
  - Preserves **financial stability** by minimizing likelihood of a bank run

- P&As provide depositors with **prompt access to insured deposits**, while …
- … **maintaining the value of performing assets** via the immediate transfer thereof to healthy bank

Key Resolution Tools: Bail-in

- Statutory power to **recapitalize** a distressed bank **by converting and / or writing down** its **unsecured debt** while maintaining its legal entity

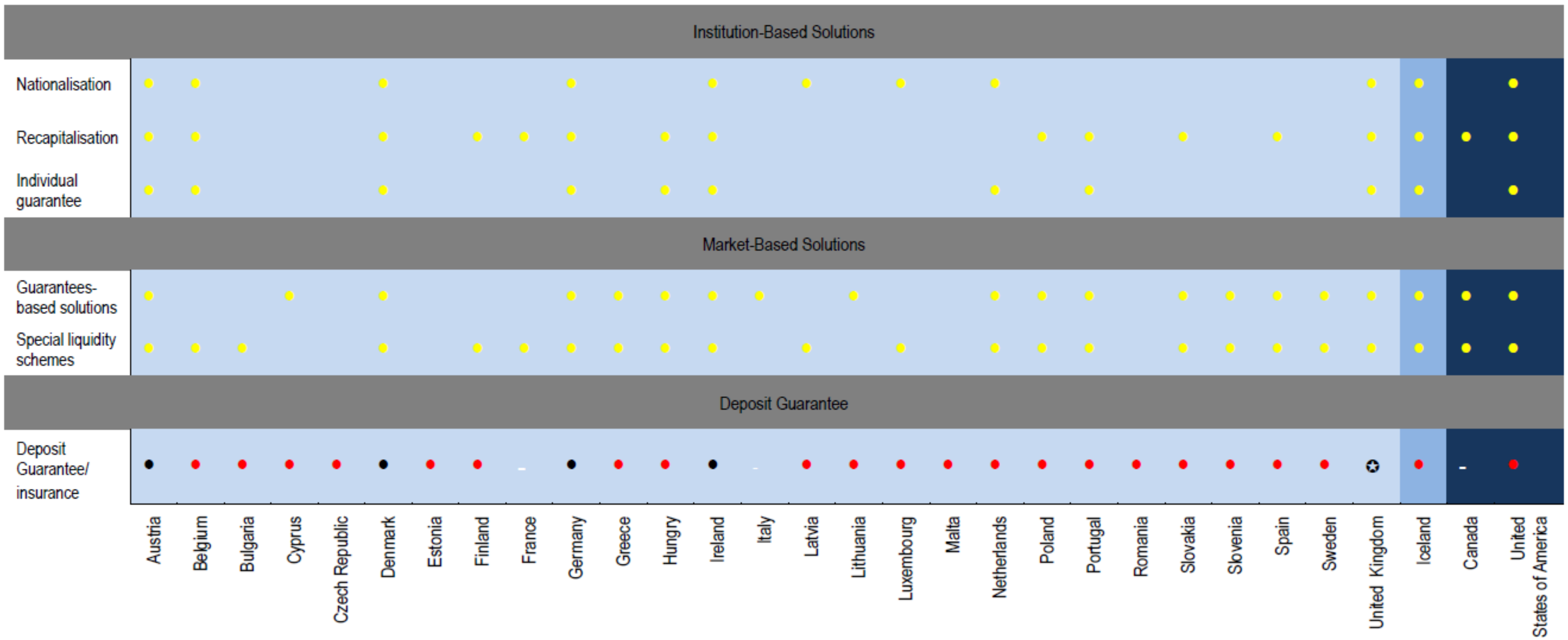
- Rationale
  - The crisis demonstrated the need to **expand resolution powers** and tools **that permits** expeditious action to **preserve asset value** and financial stability
  - There is increasing recognition that general corporate **insolvency proceedings do not provide appropriate tools** to manage the risks to financial stability, which can arise from the failure of a financial institution
  - **Systemic banks are too expensive to be saved with public funds**

- Benefits
  - **Mitigation of moral hazard**
  - More **speedy and efficient** resolution mechanism for distressed banks, **while** supporting **continuation of services** critical for the economy and financial stability
  - **Avoidance of complexities** of transferring assets and liabilities (cross-border …)
  - The intended outcome is that **institutions** would be **incentivized to raise capital or restructured debt voluntarily** <u>**before**</u> the **triggering of the bail-in** power

Key Resolution Tools: Bail-in (cont´d)

- Implementation Issues
  - **Legal**: Requires a solid and **comprehensive legal framework as implies the modification of contractual rights without the consent of counterparties**
  - **Resolution tool**: To be used under conservatorship, official administration or special resolution regimes
  - **Triggers**: There is need of **clarity** when and how the bail-in tool will be used
    - Early stage or relatively late stage of the financial decay of a bank?
  - **Size of losses**: Capital needs must be **validated** by third party
  - **Contagion risks**: Market participants might **anticipate** bail-in at other banks and **hedge** themselves by withdrawing deposits or selling securities
  - **Governance risk**: How to ensure **former creditors** behave **as shareholders**?
    - What to do meanwhile the new shareholders get organized?

The International Response to the Financial Crisis 2007-2010



Notes: Measures taken (•) Blanket: Explicit(•) and Implicit (✪),Increased: (•) and No change (-)

Source: OECD / Developing a Framework for Effective Financial Crisis Management

Funding Arrangements

- Resolution authorities will require **funding at different stages** in the resolution process

- The **banking industry**, rather than the taxpayer, **should**, **ultimately**, **shoulder** the **burden** of resolution
  - This is a widely accepted among international standards setters and senior policy makers

- Options
  - **Ex-ante resolution funds**: Financed via ex ante contributions from the industry
  - **Ex-post funding**: Public resources are recovered through the industry's contribution

Use of Public Money for Recapitalization

- **Last resort** measure
  - Only appropriate in **systemic crises**
- Often cited **concerns**
  - **Does not pass "least cost" test** as losses of problem banks are virtually always underestimated
  - Greater temptation and opportunity for asset stripping
  - **"Pouring good money after bad**"
  - Moral hazard, "gambling for resurrection"
  - **Political pressure clouding** good business **decisions**
  - Psychological entrapment, increasingly difficult to say "no"
- **Preferably**, **capital** needs to be provided by **private** resources
  - **Inability** to attract fresh capital indicative of viability concerns**?**
- But … **private solutions** typically **scarce** during a systemic crisis
  - System-wide **capital needs** might simply be **too large**
  - (Perceived) bank weaknesses reduce investors' risk appetite
  - Swift balance sheet adjustments unfeasible or detrimental to economic recovery

Use of Public Money for Recapitalization (cont´d)

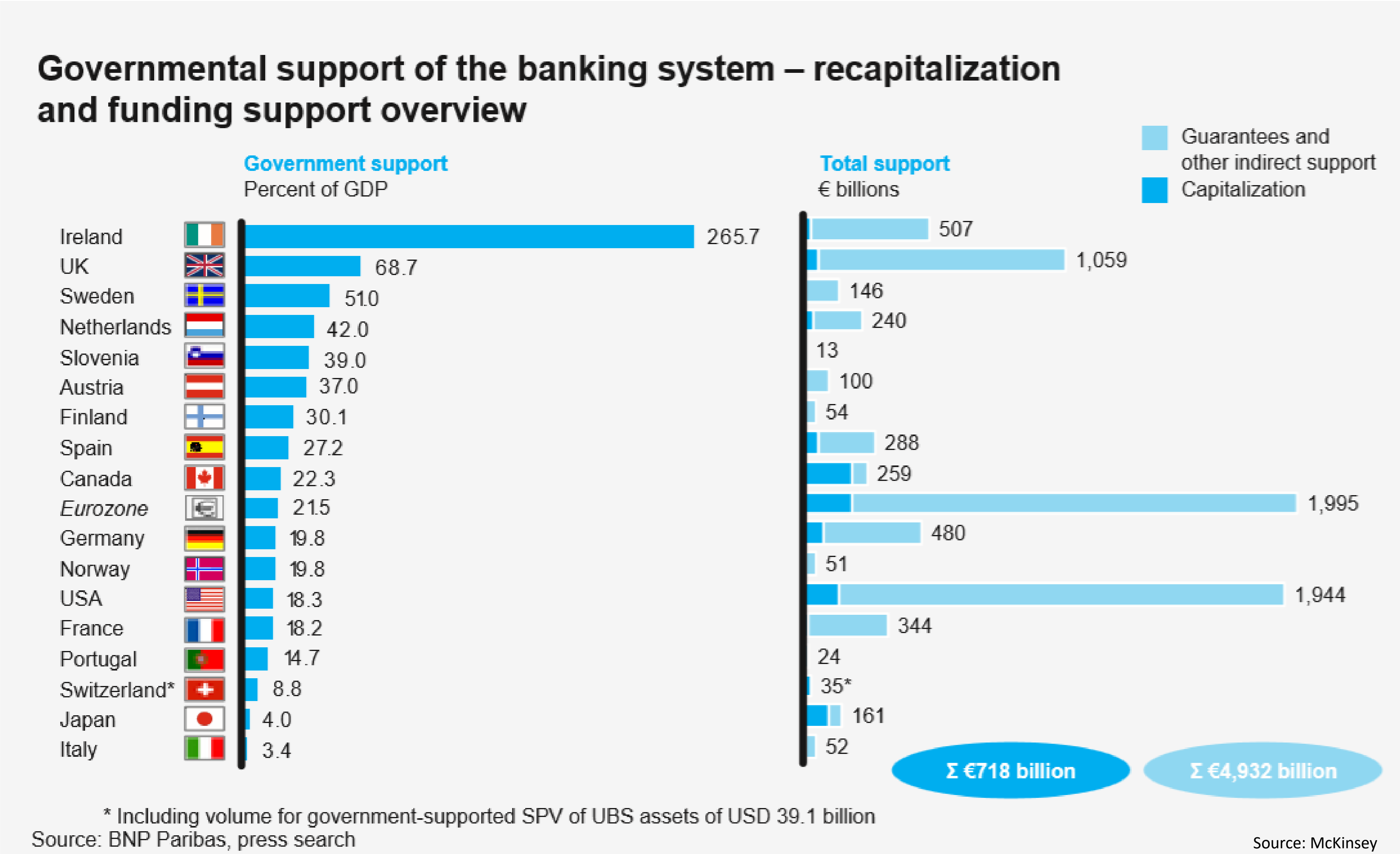
- Necessary safeguards
  - Former **shareholders** to absorb **first loss**, be heavily **diluted** or wiped out
  - Simultaneous **injection of private capital** to further reduce outlays for the taxpayer
  - Comprehensive **restructuring plans**, subject to **strict oversight**
  - **Management changes** often necessary (… also to “sell” the recipient’s new strategy to investors)
  - Ownership at arm’s length, **no public involvement in day-to-day management**
  - **Exit scenario** allowing for full repayment within reasonable timeframe

Why Often Government?

1. Banks have key role in facilitating and providing **liquidity for economic growth**
2. **Deposit insurance** to provide capital support (in the interests of depositors)

- Types of Government Support
  – Acquisition of **shares**
    - … or other form of equity participation
  – Acquisition of **subordinated debt** and other forms of capital constituting regulatory capital issued by banks
  – Acquisition of **distressed** or other **assets** owned by banks
  – Continuing **support**
    - … in respect of distressed assets in the form of (among other things) loss-sharing arrangements and yield guarantees

Government Support - The Recent Financial Crisis



Source: McKinsey

Loan Restructuring

- **Resolution of debt overhang** needed **to restart supply and demand of credit**
- Corporate and retail debt restructuring often neglected
- **Issues** with institutional framework
  - Speed **versus** value
  - Centralized **versus** decentralized
  - **Legal reforms** necessary (bankruptcy / foreclosure), **as tools are often outdated** and not fit for dealing with large-scale debt overhang
  - **Out-of-court debt restructuring** (London approach) to alleviate administrative burden

Loan Restructuring – State-Funded AMCs

- Purpose
  - **Remove troubled assets** from banks' balance sheets and …
  - … thereby **reduce** the high **uncertainty** about the quality of banks' assets which made access to finance very difficult
- Mandate
  - From **narrow**: Minimize taxpayer losses …
  - … to **broad**: Minimize fire-sale effects and value destruction
- Pricing
  - Current market value
- Legal backing
  - **Strong** legal basis needed **for transfers of titles**
  - Adequate powers to **maximize recoveries**
- Funding
  - **Adequate capitalization** by Treasury
  - **Consider joint ventures** with private investors
  - Be clear about costs and risks
- Governance
  - Independent **board**
  - **Private sector** participation
  - **Disclosure**
  - **Auditing**
  - **Reports** to Parliament

Loan Restructuring – Dealing with Impaired Assets

- Dilemma
  - Restructure NPLs **inside or outside** banks
- Size of impaired assets
  - **Sometimes too great** for AMC or other (single) state bailout
  - **Burden sharing** with creditors may be necessary
    - This would also reduce moral hazard
- **Objectives** of broad mandate AMCs, ambitious and long term
  - Probably still too early to reach final conclusions

- Recent EU experience
  - Viability of participating banks …
    - … if receive AMC bonds that are de-facto long maturity, illiquid, pay low interest rate, and carry non-credible state guarantee (even if ECB-eligible)
  - Ownership and funding structures should not leave significant risk with participating bank groups
    - Will not insulate banks from the problem assets (potentially defeating AMC aim)
  - While much good practice from previous crises learnt this time (transparency, good governance, fair value), more is required on active restructuring and work out of loans

THE BAD BANK

The Concept

- The bank divides its assets into two categories
  - **Good**: Assets that represent the **ongoing business** of the core bank
  - **Bad**: Illiquid and risky securities, along with other **troubled assets** such as nonperforming loans
  - The bank can also off-load non-strategic assets it wants to exit, or assets it simply no longer wants to own as it seeks to lessen risk and deleverage the balance sheet

- Bank keeps the bad ones from **contaminating** the good
  - Otherwise, investors and counterparties are uncertain about the bank's financial health and performance, impairing its ability to borrow, lend, trade, and raise capital

- While the idea is simple, the **practice** is quite **complicated**
  - There are many organizational, structural, and financial **trade-offs** to consider
  - The effect of these choices on the bank's liquidity, balance sheet, and profits can be difficult to predict, especially in a global crisis environment

The Concept (cont´d)

- The bad-bank idea is **not new**
  - Pioneered at **Mellon Bank in 1988** in response to deep problems in the bank's commercial real-estate portfolio
  - It was applied in past banking crises in Sweden, France, and Germany
- Every self-dividing bank seeks to do three things
  - **Clean up the balance sheet** and so restore confidence
  - **Protect profit and loss** (P&L)
  - Assign **clear responsibility** for the management of both good and bad banks
- Much of the focus is on **rebuilding trust** with investors and rating agencies
  - **Clearly separating the assets**
  - Providing **transparency** into the bank's operating performance
  - With trust restored and capital to back investors' faith, banks are convinced that their economics will improve

Key Design Elements

Five core design topics for establishing a bad bank

Several steps can usually be run in parallel

	1 Asset scope	2 Legal framework	3 Business case	4 Portfolio Business Strategies	5 Operating model and processes
Description	▪ Define assets to be included in bad bank vs. core bank: – Strategic and non-strategic assets – Performing and non-performing loans	▪ Develop basic legal bad bank structure – On- vs. off-balance sheet – Structured solution vs. banking entity	▪ Create business plan to maximize economics and define speed of run-down	▪ Define optimum portfolio rundown strategies: passive rundown, transactions, work-out on balance sheet ▪ Set up reporting; implement/monitor portfolio strategies	▪ Set up organization, operating model, and processes ▪ Define interface, SLAs with core bank ▪ Set up incentive system aligned with strategic objectives
Specific challenges from crisis	▪ Complexity of assets ▪ Sufficiently forward-looking selection but considering capital/ funding constraints ▪ New risk types (MtM, RWA) and external requirements (EU)	▪ Trade-off between comprehensiveness of solution vs. speed of implementation	▪ Primary focus on protecting capital, less on long-term NPV-maximization ▪ Also: additional constraints considered in business case, e.g., B/S reduction, liquidity	▪ Limited P&L budgets; illiquidity of markets for unwind ▪ Focus on longer-term, more complex strategies (also given heterogeneous assets)	▪ More complex setups given constraints (costs, legal setup, external view) ▪ Limitations on bonus-based incentives

Source: McKinsey

On- and Off-Balance Sheet vs Bank Entity and Structured Solution

Individual bad bank solutions can be clustered into 4 basic structures

Legal structure

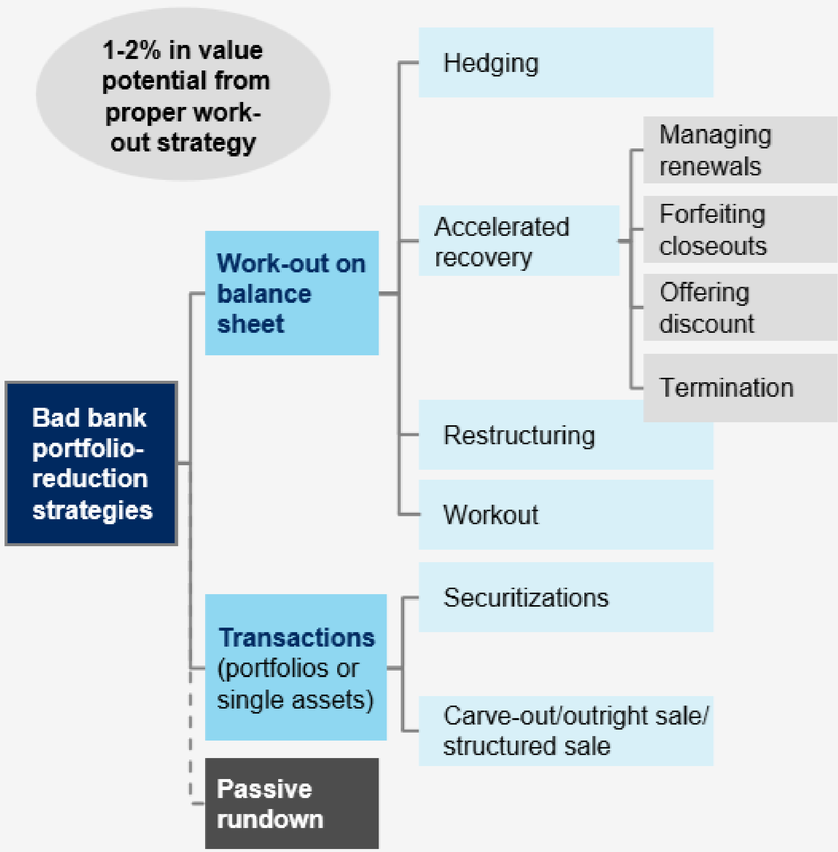
De-consolidation

	Structured solution	Banking entity	
On-balance sheet	**On balance sheet guarantee** ▪ No B/S de-consolidation ▪ High structural complexity – External guarantee – Specific regulatory/legal framework	**Internal restructuring unit** ▪ No B/S de-consolidation ▪ Transfer of assets into one separate BU (locations, subs.) ▪ Separate org. and operations ▪ Internal risk/profit split between BUs and bad bank	▪ **Capitalization available** ▪ **Faster, simpler** ▪ **Limited risk transfer**
Off-balance sheet	**Off balance sheet SPE** ▪ Limited asset scope (part. living loan portfolios) ▪ Complexity in current market – External rating/funding – Asset transfer, P&L implications – Capitalization needs	**Bad Bank spin-off** ▪ Structural complexity – Legal, tax, accounting, regulatory – Asset transfer vs. carve-out ▪ Capitalization and funding restrictions ▪ Operational complexity and set-up	▪ **Maximum risk transfer/protection** ▪ **Higher complexity**

Source: McKinsey

Wind-Down

Portfolio-reduction strategies focused on traditional work-out; restructuring strategies to be reviewed in light of today's market environment



Description

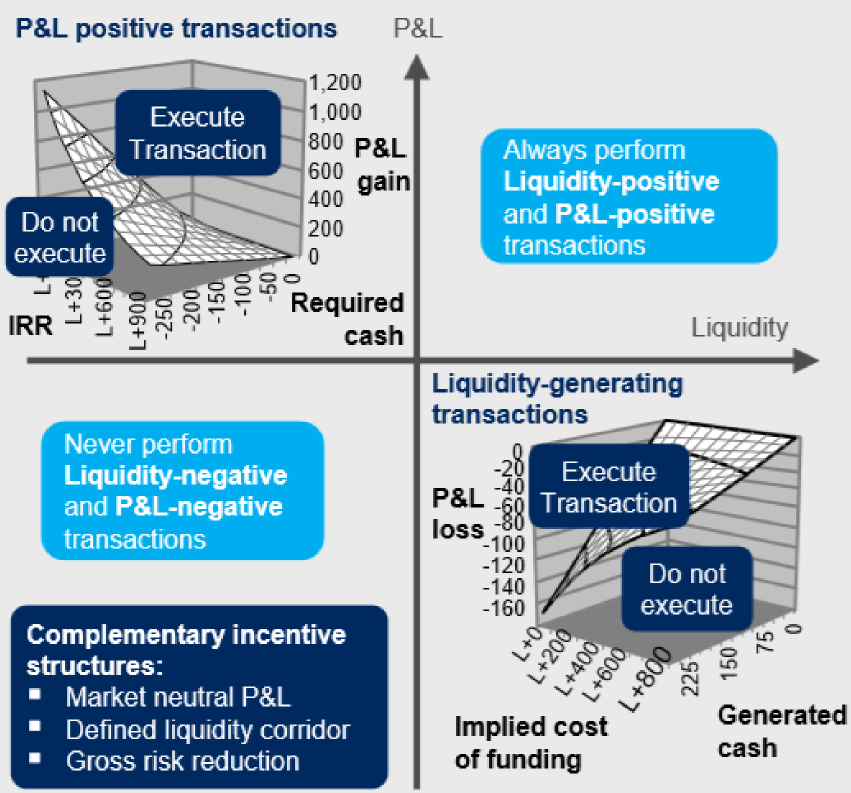
- Hedging of portfolios on the basis of representative indices
- Increase pre-payments/cease retention activities through migration of customers to other banks by offering defensive/unattractive pricing conditions for renewals
- Increase pre-payments/cease retention activities through offering customers opportunity to refinance loan early with other bank, while forfeiting closeout costs
- Offering (high-risk) customers the opportunity to repay loan early, while accepting discount on capital (up to 5, 10, 15, 30% depending upon risk)
- Termination of loans in the case of lacking fulfillment of covenants by customers
- Active restructuring to prevent default of high-risk customers
- Modify loan with low collateral risk/increase collateralization
- Improve work-out strategies/control rates
- Securitization of assets: at lower costs compared to working out on-balance sheet; if migration to other bank not achieved
- NPLs (migration not possible)
- De-consolidation through sale to external investor agencies – potentially with structural protection/financing, high-risk collaterals
- Passive rundown until maturity – **often the base case today**

Source: McKinsey

Wind-Down (cont´d)

Decision framework for unwinding transactions on toxic asset portfolios requires trade-offs between various KPIs

Approach to optimizing P&L, Liquidity, and NPV



All considerations

	Execute	Do not execute
Liquidity	Cash inflow	Significant cash outflow
P&L impact/ pricing	Fully priced; P&L gain if terminated	No flexibility; loss if terminated
NPV at hurdle rate	Unwind is NPV-positive	Unwind is strongly NPV- negative
Market and credit risk	Risk reducing	Risk increasing
Operational risk	Eliminates complex trades	Increases operational risk
Client franchise	Responsive to client request	Not responsive to client request

Source: McKinsey

BAD BANK INVESTOR

Focus on Asset Quality

- Initial steps in the rescue process
  - Detailed **assessment** of the quality of the bank's **assets**
  - Determine the extent of the **deterioration** in value
  - Make appropriate **adjustments**
    - Accurate picture of the bank's current capital base supporting its liabilities

- **Valuation** of assets can be **problematic** …
  - **Especially** for **globally operating** banks
    - Each **jurisdiction's** bank regulators will adopt or require their own particular valuation methodologies in calculating the present value of any distressed assets and the level of provisioning required

- … and a further **deterioration** (or improvement) over time is **difficult to** accurately **assess**

Initial Recapitalisation

- Relevant government agency will often provide **initial capital support**…
- … **generally in the form of new shares** in the bank (either before or after an initial restructuring of the bank's assets) …
- … usually **paid in form of a government-issued or guaranteed note, cash or other securities**
- Purpose of this initial recapitalisation:
  - Extinguish or considerably **dilute** the interests of **existing shareholders**, passing control of the bank to the hands of the regulators
  - To **equalise at least the bank's asset and liability position** to provide the foundation on which any prospective purchaser of an interest will invest

Second Recapitalisation and New Shareholder

- Second round of capitalisation usually carried out in connection with the **prospective (strategic) purchaser**

- Negotiation revolves around **competing interests**
  - **New investor** wants to be **insulated against** further **asset deterioration**
  - **Government** wishes to **return the operational risk and control** back to the private sector at the **lowest cost to taxpayers**

- This second round of re-capitalisation may be followed by:
  - An acquisition of the government's interest by the purchaser, or
  - A combination of government and investor support through an issue of new shares to both

Second Recapitalisation and New Shareholder (cont´d)

- Recapitalisation usually **subject to adjustment** after completion
  - **Change in the asset quality** during any interim period
  - Can range from an effective **discount** to book value to - in rare cases - a premium
  - However, the total **cost to the government, can be significantly increased** or decreased depending on whether the government is required - as part of the terms of the acquisition - to **continue to provide support for a period following the acquisition**

Asset Classification

- Inherent **difficulty** in valuing assets of a distressed bank

- **Financial support of specific assets or classes of assets** usually sought from the government by the investor

- Assets separated into **classes** according to **extent of distressed nature**
  - **Loans**, for example, will be **broken down** into – among other parameters:
    - Value
    - Class of borrower
    - Whether they are performing or not, and
    - Whether they have been or are undergoing incourt or out-of-court restructuring
  - **Securities**, for example, will be valued based on their **liquidity** and **recovery** rate

- Clear and transparent dispute resolution mechanic needs to be agreed upon
  - Focus is any asset deterioration and its value to be assessed and adjudicated

Management Control and Operation

- Even if **government** gives up an equity stake it **may continue** a **financial support** obligation
  - Requires **control mechanisms** to protect the government from any further asset deterioration due to poor management decisions
  - Conversely, any **investor** will **wish** to obtain the **greatest freedom** possible in managing the acquired bank and reduce the risk of interference

- Typically issues covered:
  - Employees/labour protection;
  - Voting rights in respect of shares;
  - Dividend policy;
  - Directors appointments/removals;
  - Capital reorganisations, new issues of shares (including under share option plans) and capital reductions;
  - Sale of assets;
  - Bankruptcy/dissolution; and
  - Change of auditor

Subsequent Sale

- Irrespective of whether the government has retained an interest in the bank, an agreement is generally put in place to establish the mechanics that will operate if
  - The bank is sold as a business, or
  - Either the government or the investor wish to divest of their interests

- Parameters:
  - Investor locked in for at least an initial period (e.g. two or three years) after purchase
  - Government and investor may be granted preemption (first right of refusal) rights in respect of a sale by the other and/or …
  - … there may be drag-along or tag-along rights which will operate to allow shareholders to align themselves in the event that a prospective purchaser wishes to acquire the entire, or a portion of, the issued share capital of the bank
  - Provide for exit strategies involving a re-listing of the bank on the equity capital markets

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