G2 Risk Solutions

The Financial Impact of Bankruptcy

What banks and financial institutions need to know

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Bankruptcy can occur from unforeseen circumstances or poor decision-making. However, it’s sometimes a necessity to move forward.

When you think of filing for bankruptcy, most people think about it on the individual level. Outside of that, organizations occasionally move in the filing direction. Bankruptcy filings happen because there’s a need to address financial distress. For banks and financial institutions (FIs), the consequences are unique and vastly different.

Interestingly, there is not much information on banks filing for bankruptcy, even though “bank failures” happen a few times each year. In these failures, banks are closed by federal or state banking regulatory agencies. They occur when a bank lacks the funds to cover all its customers’ deposits, and it owes money to others[1]. While rare, there were five bank failures in 2023 and two in 2024[2].

FIs, that aren’t banks, include organizations like money market funds, hedge funds, pension funds, ETFs, mortgage companies, and brokerage firms. Since there are many types, bankruptcy filings can be rare and vary depending on the organization.

Although bank and FI bankruptcy filings are few and far between, they still have a ripple effect on the financial industry.

In this ebook, we will explore:

+ What happens when banks and FIs file for bankruptcy
+ Preventative measures banks and FIs can take to avoid bankruptcy
+ How banks and FIs can bounce back after filing for bankruptcy

These vantage points will provide a better understanding of the complexities of bankruptcies and strategies for insolvency recovery.

1 2024, When a Bank Fails - Facts for Depositors, Creditors, and Borrowers | FDIC
2 2024, Oct. List Of Failed Banks: 2009-2024 | Bankrate

Consequences when declaring bankruptcy

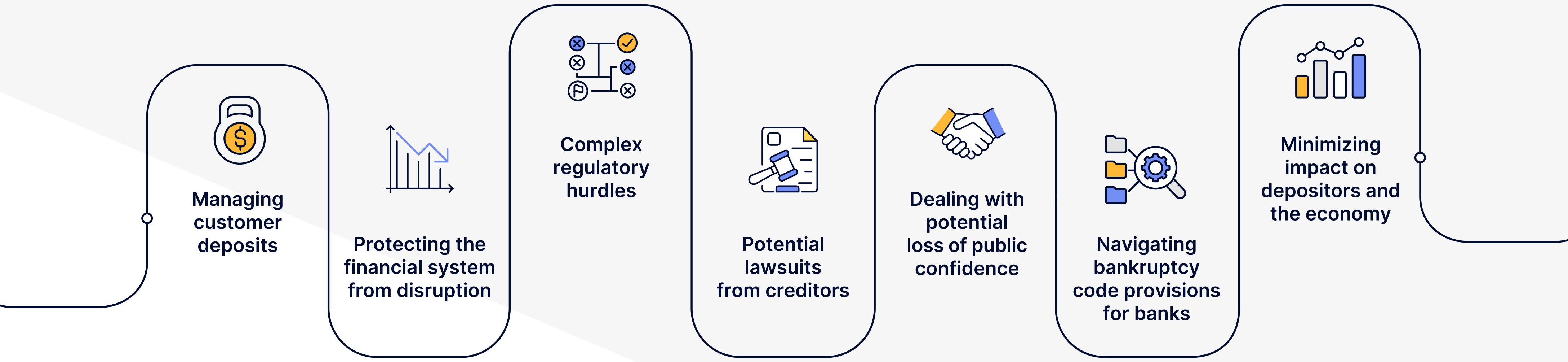
Any time a bank or FI declares bankruptcy, there's a larger impact when they file as opposed to on the individual level or in other industries. Since they are tied to large amounts of people and everyday businesses' finances, banks and FIs have a more complex bankruptcy process.

Depending on the size of the bank or FI, government intervention may be needed. In the US, for example, the Consumer Financial Protection Bureau (CFPB) accepts consumer complaints, provides educational materials, and closely supervises all types of institutions. It also provides oversight on financial technology (fintech) companies often charged with monitoring, analyzing, and advising on large amounts of corporate data.

When banks and FIs file for bankruptcy, many factors must be considered for forward progression. When a government steps in to assist, it's typically to avoid a larger fallout for the overall financial system.

To ensure a smooth process for all involved, there should be close attention to detail in any of the necessary measures banks and FIs take. Here, we review the most common challenges faced during the bankruptcy filing process.

Top issues for banks and FIs throughout the bankruptcy filing process



Managing customer deposits

One of the primary concerns for banks during bankruptcy is ensuring the security and accessibility of customer deposit accounts. Unlike FIs, banks maintain and hold customer deposits, which are sometimes covered by deposit insurance schemes. For example, any Federal Deposit Insurance Corporation (FDIC)-insured bank in the US automatically insures deposits up to $250,000 in the event of bank failures[3].

Managing withdrawals and funds access during bankruptcies can sometimes cause tension between customers and banks. To help ease this, and avoid a wider financial collapse, regulatory bodies can step in to ensure protection for depositors. In addition to deposit insurance schemes, regulatory bodies can also help with oversight, liquidity support, bailouts, and other legal safeguards.

Protecting the financial system from disruption

Banks and FIs are inextricably part of the financial system fabric around the world. This is why the failure of any major financial institution can trigger systemic risks that have a ripple effect on liquidity, credit markets, and investor confidence.

As we talked about earlier, government bodies often step in to ensure everything goes smoothly and there's little to no disruption to the financial system. A great example of this would be in the Lehman Brothers collapse in 2008 which led to widespread credit freezes and losses for other FIs. To stop a broader reach of this, the US Congress put more protective measures in place, which ultimately resulted in the adoption of the Dodd-Frank Act[4].

3 2024, Understanding Deposit Insurance | FDIC
4 2013, Feb. Chapter 2: The Dodd-Frank Act and the Financial Crisis: A Retrospective Assessment of the Act's Systemic Risk Regulation Provisions in: Current Developments in Monetary and Financial Law, Volume 6

Complex regulatory hurdles

When navigating bankruptcy, banks and FIs must do so while being aware of all regulations—all of which vary from country to country. Due to vast amounts of regulations, bankruptcy filings must be navigated with specialized legal and regulatory frameworks. Each aspect of the process is checked from multiple sides, including not just the banks and FIs but whichever government entity has put in regulations in the specific filing country.

Potential lawsuits from creditors

It’s not just bank customers that are looking to collect but also larger creditors. In each bankruptcy proceeding, everyone wants to make sure they recover whatever amount is owed to them. If these funds aren’t correctly and swiftly allocated, creditors—including bondholders, investors, or other FIs—may file lawsuits.

Dealing with potential loss of public confidence

It’s understandable that when banks and FIs file for bankruptcy, there’s a high possibility of severely damaging public perception. When this happens, trust can be lost, which results in massive customer withdrawals. To survive, banks and FIs will need to rebuild customer trust, which will likely involve very transparent communication with all involved stakeholders.

Navigating unique bankruptcy code provisions for banks

Bankruptcy codes provide special provisions for banks that aren’t available to individual filings. These are again in place to help put a stopgap on negative impacts on the overall financial system. Depending on the type of banking or FI, there are different provisions available. We go into more detail on these later in our “Preventative bankruptcy measures” section.

Minimizing impact on depositors and the economy

Banks and FIs touch every part of society and because of that, there’s a certain responsibility to ensure minimal impact. Without taking measures to reduce negative consequences as a result of their bankruptcy filings, a ripple effect will likely occur resulting in widespread panic and long-term economic instability.

Preventative bankruptcy measures

In an ideal world, banks and FIs would never have to file for bankruptcy. However, that's not the case, so it's necessary to put preventative measures in place to help avoid or alleviate bankruptcy. To help minimize the risk of bankruptcy or financial instability for banks and FIs, we've put together a list of adoptable guardrails.

Capital requirements

Setting aside funds for emergencies isn't just for individual financial planning. It's also an important part of ensuring stability for banks and FIs. By strengthening capital reserves, these organizations can ensure resilience during times of economic downturns. It also helps to have financial buffers to absorb any unforeseen losses.

Deposit insurance

Earlier in this ebook, we talked about deposit insurance schemes that help protect assets during bankruptcies. By having these in place, banks and FIs increase consumer confidence in them as well as prevent any panic withdrawals. Deposit insurance helps create further economic stability for these institutions and the overall financial industry.

Bail-ins

Rather than building up capital reserves, bail-ins are another way for banks and FIs to absorb losses. This can be done by using the organization's internal resources, such as converting debt into equity or writing off liabilities. By choosing a bail-in, banks and FIs avoid relying on taxpayer-funded bailouts while simultaneously stabilizing their finances.

Swing pricing

During times of economic strife, banks and FIs can turn to swing pricing. By implementing this, they can adjust prices of shares or fund units to reflect large withdrawals. This helps ensure investors are repaid rather than keeping debts on their books.

Rehabilitation plans

For banks and FIs, rehabilitation plans are their form of crisis communication plans. When there's financial instability, there needs to be a process that's set in motion for seamless recovery. By putting together a detailed plan of action, banks and FIs can significantly reduce the possibility of bankruptcy filings.

Cram-down provision

In lieu of a rehabilitation plan, banks and FIs can have a court approve a reorganization of its operations over any creditor objections. When this happens, these organizations are able to restructure debt, reduce financial obligations, and boost solvency. It also avoids liquidating assets to stay out of bankruptcy.

Bouncing back after filing for bankruptcy

The aftermath of bankruptcy filings for banks and FIs is a long and arduous journey, but it is possible. When starting down the recuperation path, we recommend these organizations increase recoveries and reduce operational loads.

How to increase recoveries

Complete recovery is the ultimate goal after filing for bankruptcy. It's how FIs can recover, rebuild, and maximize returns post-bankruptcy. In the beginning of the recovery process, maintaining daily notifications can help improve efforts. This ensures creditor actions and claims are carried out efficiently. Another great way to stay on top of changes and updates in bankruptcy cases is real-time tracking.

How to reduce operational loads

When in doubt, start automating time-consuming tasks. More often than not, there's a way to get administrative activities into automation. This helps streamline the recovery process even more while allowing banks and FIs to focus their resources on more strategic recovery efforts.

Reducing your operational load can be done through:

Docket Event Monitoring (DEM)	Bankruptcy Case Search (BCS)	Automated Court Filing (ACF)
Receive time-sensitive information while reducing FTE workload with curated daily docket event updates.	Locate case overviews more quickly directly from court data.	Reduce the burden of paperwork while increasing efficiency during bankruptcy recovery.

Conclusion

Bankruptcy is a challenging and often destabilizing process for banks and FIs. However, by adopting the preventative measures we've outlined in this ebook, banks and FIs everywhere can mitigate risks, manage the financial fallout, and work toward a strong recovery.

Key takeaways to prepare for insolvency include:

+ Strengthening capital and risk management frameworks
+ Implementing proactive measures like deposit insurance and bail-ins
+ Leveraging technology to improve recovery efforts and minimize operational disruptions

By focusing on these strategies, banks and FIs can emerge more resilient, ensuring long-term stability and economic improvements even in the face of bankruptcy.

To learn more about how to address future risk liabilities, visit our bankruptcy risk solutions page.

About G2 Risk Solutions (G2RS)

G2 Risk Solutions is the definitive expert in risk and compliance business intelligence for financial institutions and online platforms. We are industry pioneers providing market-leading solutions for merchant risk, digital commerce risk, bankruptcy risk, and credit risk and regulatory reporting. We are driving innovation and shaping the future of risk management through unprecedented data, technology, and global compliance and risk expertise, providing the financial services and digital commerce ecosystems with the tools needed to navigate complex and ever-changing regulatory requirements and mitigate risk.

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