INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/8

GEORGIA

FINANCIAL SECTOR ASSESSMENT PROGRAM

January 2015

SAFETY NETS, BANK RESOLUTION, AND CRISIS PREPAREDNESS AND MANAGEMENT ARRANGEMENTS—TECHNICAL NOTE

This Technical Note on Safety Nets, Bank Resolution, and Crisis Preparedness and Management Arrangements on Georgia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in October 2014.

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Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

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TECHNICAL NOTE

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Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Georgia. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

DIS	Deposit Insurance Scheme
ELA	Emergency Liquidity Assistance
ICAAP	Internal Capital Adequacy Assessment Process
LACB	Law of Georgia on Activities of Commercial Banks
MOF	Ministry of Finance
NBG	National Bank of Georgia
NBG Law	Organic Law of Georgia on the National Bank of Georgia
RRPs	Recovery and Resolution Plans

EXECUTIVE SUMMARY

Recent experience in handling troubled banks was limited. The National Bank of Georgia (NBG) is the lead authority responsible for managing problem banks**,** as it can appoint a temporary administrator, declare a bank as insolvent and bankrupt, and commence a liquidation procedure. In the 1990s, market entry was not subject to significant restrictions, and the number of banks operating in Georgia reached a peak of 229 in 1994. Since then, the authorities have commenced a significant number of liquidation procedures, and the last cases based on insolvency grounds have been closed in 2009. Therefore, the legal framework for bank resolution and liquidation has not been applied to a significant extent in recent times.

The framework for emergency liquidity assistance (ELA) has been improved, but enhancement is needed to protect the NBG against financial risk. The NBG is explicitly authorized to provide ELA to commercial banks that are considered to be viable, and a 2012 NBG decree sets out certain procedural rules governing the disbursement of the ELA. However, when financial stability is endangered, rules on collateral, interest rate, and duration of the facility can be relaxed. This special carve-out can expose the NBG to financial risks—the existence of a systemic threat, rather, calls for a role to be played by the government. Moreover, provisions on collateral, interest rate, and duration should be updated to better take into account the specificities of ELA, and accountability mechanisms should be enhanced.

The bank resolution and liquidation regime presents important shortcomings. The NBG can take control of a problem bank by appointing a temporary administrator, which can, in theory, arrange for certain resolution transactions. The bank liquidation framework is prescribed in more detail, given the significant experience gained by the NBG in the past. However, the bank resolution framework lacks a number of important features and several amendments are needed to update it in line with emerging international best practices, with a view to enabling the authorities to implement a speedy and cost-effective resolution process.

A deposit insurance scheme (DIS) should be introduced speedily with features that are conducive to financial stability. The Georgian authorities are committing to introducing a Deposit Insurance Scheme (DIS) in the context of the upcoming association agreement with the European Union (EU), within a seven-year period. A number of considerations favor the setup of a DIS in a shorter timeframe than the one envisaged in the EU association agreement. In particular, the establishment of a DIS would be conducive to public confidence, minimize the too-big-to-fail risk, and form part of a comprehensive financial safety net in Georgia. The design features of the DIS should be carefully considered also to take into account the concerns raised in the past by the authorities with respect to the unintended consequences of DIS.

Recent steps have been taken to put in place crisis preparedness and management arrangements, which could be further strengthened. While a memorandum of understanding was set up between the MOF and the NBG, certain legal impediments may still hinder the NBG's cooperation with domestic and foreign agencies. The government is prohibited from owning shares in financial institutions. The NBG is starting to require recovery and resolution plans (RRPs) for the major banks. All of these elements should be reviewed and, as appropriate, revisited, with a view to enabling the government to promptly deploy crisis management responses when needed.

Table 1. Georgia: Main Recommendations

Recommendations	Priority	Timeframe
Revise the framework for emergency liquidity assistance to mitigate financial risks for the NBG by clarifying rules on collateral, tightening the provisions on duration and interest rate, and spelling out explicitly the role of the government in systemic crises.	High	6–12 months
Overhaul the bank resolution regime by enhancing the temporary administration process and providing for the appointment of a temporary administrator at an early stage of a bank's financial difficulty, facilitating the application of resolution tools, and reinforcing safeguards in the resolution process.	High	6–12 months
Establish a deposit insurance scheme, underpinned by features in line with international best practices, consisting of an adequate mandate, funding, coverage, governance, and inter-institutional cooperation arrangements.	High	6–12 months
Enhance crisis preparedness and management arrangements by removing impediments to cooperation between the NBG and domestic and foreign agencies, and for possible government interventions in a crisis, setting up a Financial Stability Council, and strengthening the requirements for recovery and resolution planning.	Medium	1–2 years

INTRODUCTION

1. This technical note is structured as follows. [1] The first section provides a brief overview of the existing regime and past experience with bank resolution and liquidation in Georgia. The next section assesses the framework for emergency liquidity assistance (ELA) by the National Bank of Georgia (NBG). The third section reviews the bank resolution and liquidation regime. The fourth section makes certain considerations with respect to the possible need and design features of a deposit insurance scheme (DIS) in Georgia, which currently does not exist. The last section analyzes domestic and cross-border arrangements for crisis preparedness and management. In each of the sections, the assessment of the existing regime is accompanied by recommendations on areas for possible improvement.

OVERVIEW

2. Under the existing regime, the NBG has a leading role in handling troubled banks. The legal framework relevant to the areas reviewed in this technical note mainly consists of the Law on Georgia on Activities of Commercial Banks (LACB), the Organic Law of Georgia on the National Bank of Georgia (the NBG Law), and a few regulations and decrees adopted by the NBG focus mostly on the liquidation regime. The NBG is empowered to take a number of measures, such as to appoint a temporary administrator, to declare a bank as insolvent and bankrupt, and to commence a liquidation procedure. With the exception of a decree on ELA[2] enacted by the NBG in 2012, no amendments to the legal framework have been introduced recently. No DIS is in place.

3. Since the 1990s, the number of banks active in Georgia has fallen significantly, as numerous institutions have been liquidated or merged. In the initial period after Georgian independence, market entry was not subject to significant restrictions, and 229 active banks operated in 1994 without a regulatory framework. Subsequently, as such a framework was imposed, the authorities commenced a significant number of liquidations, which peaked in the late 1990s and continued throughout the following decade (Figure 1). As of the first quarter of 2014, there were 21 banks in Georgia.

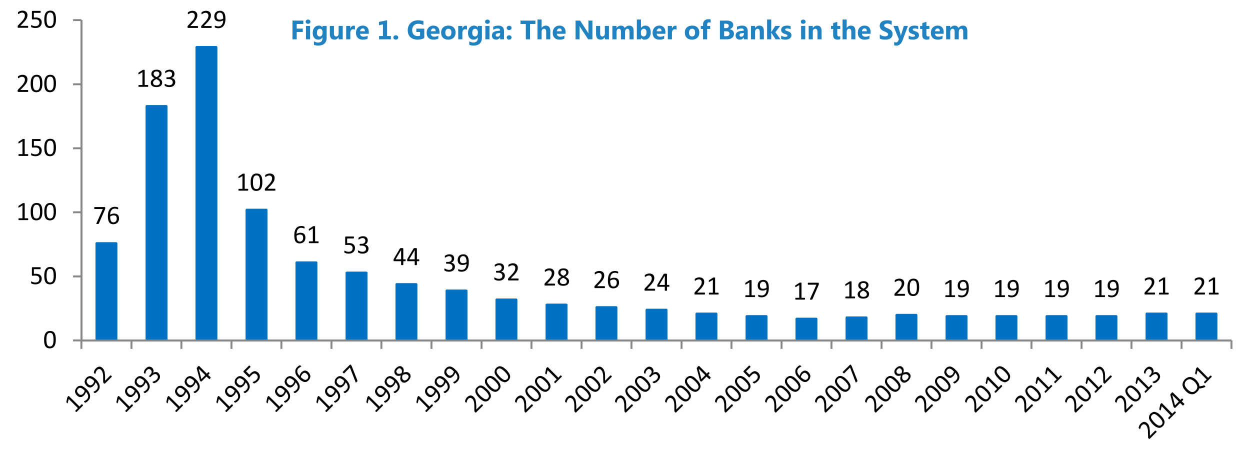
4. However, recent experience with bank resolution and liquidation is limited. The last significant cases of bank liquidations based on insolvency grounds were closed in 2009, after a number of years following their initiation. In a recent instance, the NBG has appointed a temporary administrator, but mainly with the aim of verifying the existence of sound practices and governance arrangements, and the appointment did not lead to the resolution of a bank. Therefore, the legal

[1] This Technical Note has been prepared by Alessandro Gullo, IMF.

[2] The concept of ELA is referred to in this note with the same meaning attributed to the wording “lender of last resort,” which is used in the English translation of the NBG Law.

framework for bank resolution and liquidation has not been applied to a significant extent in recent times, nor have there been court cases challenging the validity of the exercise of NBG powers.

Figure 1. Georgia: The Number of Banks in the System



EMERGENCY LIQUIDITY ASSISTANCE

5. **The NBG is explicitly authorized to provide ELA to commercial banks.** ELA can be given by the NBG at its discretion to viable banks facing, or likely to face, temporary liquidity needs. The legal framework defines the main features of the ELA: the duration of the loan should not be longer than three months; the interest rate should not be less than the rate of the NBG overnight facility; and the type of collateral is determined by the NBG based on a list of eligible assets.

6. **The NBG has adopted procedural rules and developed practices on ELA.** A 2012 Decree n.6 enacted by the NBG Board (ELA Decree) sets out other rules governing the disbursement of the ELA, and the subsequent monitoring over the liquidity and solvency of the borrowing institution, as well as over the status of the collateral. It also allocates responsibilities between the various departments and units of the NBG. The NBG has prepared a template contract ready to be adapted to each particular transaction.

7. **Greater leeway is envisaged when financial stability is endangered.** In such special circumstances, the duration of the loan could be extended, a different interest rate may be charged, and the ELA could be given without collateral. The NBG Board shall determine the existence of the grounds triggering these possible, differing features of the ELA, but no further guidance is given as to the principles, criteria, and safeguards that should govern the ELA in these special circumstances.

8. **The special carve-out from the typical safeguards of the ELA raises concerns.** The relaxation of the rules on duration, interest rate, and collateral could morph the nature of the ELA into a different kind of financial support, more akin to open bank assistance or long-term funding. Indeed, there were instances in the not too distant past when a bank with negative regulatory capital (although marginally solvent in economic terms) received significant and long-lasting ELA.

The risk is that, given the lack of a fully fledged safety net and crisis management framework in Georgia, ELA may be the only policy response available to the authorities, and particularly to the NBG; however, it may not be the tool that best fits the circumstances, and could expose the NBG to significant financial risk.

9. In the event of a systemic crisis, or likelihood thereof, the government should play a key role. While flexibility in the ELA regime is warranted, the NBG's exposure to financial risk should be minimized. When systemic stability is at stake, and uncertainties exist about the adequacy of collateral, the NBG should not provide ELA unless it is indemnified by the government through an explicit guarantee (activated in turn by means of compensation in cash or government securities). This safeguard would complement the preferential treatment already enjoyed by the NBG under insolvency law, allowing the NBG, in line with international best practices, to realize its collateral outside the ordinary bankruptcy proceedings. In such systemic circumstances, the granting of exceptional access to liquidity should also trigger strict supervisory action, such a repayment plan showing how the bank will recover the necessary liquidity, as well as intrusive onsite monitoring.

10. Other features of the ELA may be conducive to moral hazard. Contrary to international best practices, there is no requirement that the interest rate charged on the ELA be a penalty rate (i.e. higher than the overnight facility rate), which is normally done to mitigate moral hazard concerns. Likewise, the extension in the duration of the ELA beyond the original three months term is not subject to more stringent conditions, based on exceptional circumstances.

11. The collateral regime is subject to some legal uncertainties. It is not fully clear whether collateral rules for monetary policy operations apply *tout court* to ELA operations or other forms of collateral can be accepted on an *ad hoc* basis. Indeed, an NBG Board resolution sets out the types of eligible collateral (i.e., debt securities issued by the NBG, the government, or international financial institutions, international bank guarantees, or loan assets of commercial banks). This resolution, however, implements Article 31 of the NBG Law, governing NBG monetary policy operations, and not Article 33 of the NBG Law, governing the ELA. In theory, the NBG Board may determine to apply for the ELA the collateral rules governing monetary policy operations, but the criteria to make such determination—or to depart from it—are not spelled out. Likewise, for nonmarketable collateral (i.e., bank loans and other claims), the NBG applies a uniform, across-the-board 20 percent haircut. Again, the NBG Board may apply or depart from such haircuts, but no general guidance is given for its discretion.[3]

[3] NBG staff notes that the taking of collateral is legally perfected upon the disbursement of the ELA rather than after a time lag. This practice is important to avoid leaving the NBG claims uncollateralized in case the borrowing bank becomes insolvent after the ELA has been provided.

12. It is recommended that the ELA regime be revised first and foremost to explicitly recognize the role that the government must play in preserving financial stability. The 2007 FSAP had called for clearer rules as to whether and when the use of NBG resources or government funding will be provided, and had recommended specifying that NBG shall not subsidize the resolution of an insolvent bank. While the ELA Decree has usefully clarified the eligibility criteria for the ELA—based on the viability of the institution and on the existence of temporary liquidity needs—the role of the government remains unaddressed. In particular, a more flexible regime for the provision of ELA in a systemic crisis should be anchored to an indemnification by the government. Both the decisions of the NBG to provide ELA and of the government to indemnify the NBG should retain their discretionary nature. In non-systemic circumstances, the inability to provide inadequate collateral should constitute ground for a resolution action.

13. Likewise, the NBG Law and the ELA Decree should be revised to mitigate moral hazard concerns. Consideration should be given to raising the bar for extensions of the ELA and to introducing steeper penalty rates, at a rate higher than the overnight facility set, however, at a level which would not turn the liquidity problem into a solvency problem. The two measures could be combined – for instance by matching a longer duration of the ELA to higher penalty rates – and are both aimed at facilitating a prompt exit from the ELA.

14. The rules on collateral should be revised to better protect the NBG's financial soundness and to provide greater legal predictability. It is important to clarify the collateral regime applicable to ELA operations, including in systemic cases. The NBG discretion to disburse ELA may be steered by means of clarifying aspects such as the range of acceptable collateral, valuation and haircut rules, standardization and transferability of claims, definitions of solvency and systemic risk, and collateral management (earmarked or pools, cross border collateral). Where appropriate, such regime should draw from the rules applicable to monetary policy operations, but in such a manner that allows, at the same time, to retain flexibility (such as in systemic cases) and enhance legal certainty.

15. Accountability can be enhanced by formalizing internal procedures for the approval of ELA. The ELA Decree states that "relevant structural units" shall submit an assessment of the liquidity, solvency and collateral value of the borrowing bank. The soundness of the process could be further enhanced, by clearly allocating – drawing also from existing practices - roles and responsibilities of such structural units. For instance, further clarity may be ensured by explicitly requiring the Supervision Department to issue a "solvency opinion"—such concept to be flexibly determined under relevant indicators—and to make a proposal to the NBG Board on the need to disburse the ELA. In this manner, the Supervision Department would be clearly recognized as the "structural unit" taking the lead in the ELA decision-making process.

16. Likewise, to enhance *ex post* accountability, the NBG should report on the use of ELA in line with sound practices and predefined criteria. ELA is one of the key operations at the core of a central bank's mandate, and it entails a delicate balance between the central banks' role in contributing to financial stability and the need to mitigate their financial exposure. Inevitably, this exposes it to high scrutiny. Predefining the basic features of the ELA, as recommended in the above paragraphs, would enhance transparency of rules and uniformity of practices. At the same time, there is also merit in requiring the NBG to report to parliament and/or to the public—once confidentiality concerns subside—on certain elements of ELA operations, to account for the use of public funds, taking into consideration such rules and practices.

RESOLUTION FRAMEWORK

17. The NBG can take control of a problem bank by appointing a temporary administrator. Circumstances triggering the appointment by the NBG of a temporary administrator include the bank's inability to pay depositors or to fulfill other obligations, as well as "special cases, when the interests of the bank's depositors and other creditors are jeopardized." Temporary administrators are accountable to the NBG and do not benefit from legal protection in discharging their functions, unless they are NBG employees. Neither the time limits for the possible extension of the temporary administrator, nor the eligibility criteria for its appointment, and the oversight and periodic monitoring of its actions, are spelled out in the law.

18. Through temporary administration, the NBG may, in theory, arrange for certain resolution transactions. The temporary administrator takes over shareholders' and managerial powers and can pursue all necessary actions to remedy the financial situation of a bank, including by blocking funds of individuals and legal entities. The law provides, in a rather concise wording, that the temporary administrator has the authority to arrange a merger with another bank, a recapitalization of the bank under administration, and the acquisition of all or part of its assets and the assumption of its liabilities by another bank. Under the NBG Law, the NBG may set up and manage a temporary bank.

19. The liquidation process is also handled by the NBG and is triggered by the revocation of a bank license. The bank liquidation framework is a self standing regime set out in the NBG Law, the LACB, and in the implementing regulations, as the general provisions of the insolvency law do not apply. It is prescribed in more detail than the temporary administration, given the significant experience gained by the NBG in the past. The NBG may determine to revoke a bank license when, *inter alia*: a bank no longer complies with regulatory capital ratios; has lost creditors' confidence for failure to fulfill its obligations and thus to ensure the safety of the assets entrusted to it; is involved in unhealthy banking practices, pernicious for its depositors and financial position; and is insolvent (that is, under the law, when the bank's assets are lower than its liabilities). The competence to declare a bank bankrupt or insolvent lies exclusively with the NBG.

20. The liquidator has certain powers to realize assets, liquidate claims, and arrange for an assumption of the failed bank's liabilities. Upon revoking a bank license, the NBG appoints a liquidator, who conducts an inventory of the bank's assets and liabilities and is authorized to sell the fixed assets at a public auction, transfer other assets, and arrange for an assumption of liabilities by other banks. The liquidator must have appropriate qualifications and professional experience. The NBG may lend to a liquidator for the discharge of its functions and request relevant information at any time. It may also terminate at will the appointment of a liquidator—which is justified in light of the NBG ultimate authority to oversee the liquidation process.

21. Under creditor hierarchy rules, depositors enjoy a preferential ranking. Upon liquidation, NBG claims, as well as claims that arose after license revocation, are satisfied first, followed by individual depositors, other deposits held by legal entities, state claims, and other unsecured creditors. The law preserves the position of secured creditors by carving out from the creditor hierarchy their claims on the collateral. The liquidator can pool amounts received separately from the realization of assets to satisfy the failed bank's creditors.

22. Legal uncertainties have arisen on the treatment of secured creditors, even though in a manner that affects banks to a lesser degree. Recent amendments to the Tax Code have modified creditor hierarchy rules, in that, if tax authorities register a lien over the debtor's assets, the priority enjoyed by the state shall be determined with reference to the date when the tax claim arose.[4] Moreover, if the property encumbered by the tax lien is sold, all secured interests perfected after the registration of the tax lien are cancelled. An exception applies if an asset has been encumbered, prior to the registration of the lien by the tax authorities, to satisfy a bank claim (or other financial institutions' claims); in this case, the bank's secured interest is not altered. The authorities report that the security interest attached to the bank's claim would maintain its legal status and priority also upon its sale or transfer. A special regime applies to financial collateral arrangements, which would prevail over other security interests accorded by law.

23. The framework for judicial review of NBG actions aims to strike a reasonable balance between the NBG expertise and the need for accountability, but it has not been heavily tested. Challenges to NBG actions are brought to the administrative court, and the review by the latter is a necessary prerequisite if the affected parties intend to file a lawsuit before the civil court for damages arising from the NBG act. The latter is not stayed until a final court decision is issued, and the burden of proof lies with the plaintiff. In principle, courts can enter into the merits of NBG decisions, and the remedy awarded by them can either entail monetary compensation or the unwinding of the relevant decision, unless the latter is not practically possible under the circumstances. Since court challenges are not very frequent, and there are no recent cases of bank resolution, it is not possible to draw practical lessons. It is any event recommended that the relevant laws be amended to explicitly limit the remedy available to claimants to a compensation for loss, without the possibility of unwinding the resolution measure.[5]

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[4] See Article 239, paragraph 2, of the Tax Code: "The entitlement to the registration of tax lien/mortgage shall emerge simultaneously with the emergence of the tax debt and from the instance of registration at a registration body and shall be applicable within the range of the tax debt on the property (with the exception of that received under leasing) owned by and/or recorded on the books of a person, including the property acquired following the emergence of tax arrears."

[5] On the best practices regarding legal remedies and judicial action, see the KSB Key Attributes 5.4 and 5.5.

24. Although certain elements are sketched out in the legislation, the legal framework for bank resolution lacks a number of important features. The legal framework refers to certain bank resolution powers, but it remains to be seen whether the existing regime would be workable in practice. The provisions enabling the NBG to resolve a bank are general, and may not be conducive to a predictable, uniform, and legally certain process. Nor has the system been recently tested to allow for a different conclusion: recent cases of temporary administration have not led to bank resolution, and the cases of liquidation—which lasted for a number of years—are distant in time. More in particular, consideration should be given to a number of weaknesses and related areas for improvement:

- *Temporary administration regime.* The law does not provide for the oversight and monitoring of the temporary administrator's activity (e.g., through periodic reporting to the NBG and required authorization by the NBG to perform certain transactions), nor does it prescribe the temporary administrator to act under conservative principles (e.g., on lending limits). It does not specify who can be a temporary administrator (e.g., a legal entity or an individual) and whether any professionalism and integrity criteria apply. The legal status itself of a temporary administrator—who ought to be qualified as a public official exercising a public function, which should be given a limited legal protection—is not mentioned. While in past cases the NBG has closely liaised with the temporary administrators appointed by it, the temporary administration regime should be revised to explicitly reflect all of these elements on a more uniform basis. General principles – such as those governing powers and duties of a temporary administrator – could be enshrined in the primary law, while further procedural rules may be spelled out in NBS regulations or decrees.

- *Grounds.* The triggers for temporary administration do not allow capturing all possible, specific circumstances where taking control of a problem bank may be necessary to prepare for resolution. The current grounds for temporary administration refer to the inability to fulfill obligations or, generically, to the interest of depositors and creditors being jeopardized. The definition of insolvency—triggering license revocation —is linked exclusively to a "balance sheet" test (i.e., when assets are lower than liabilities), and temporary administration prompts either the suspension of a bank's operations or license revocation. These triggers should be comprehensively revised to give the NBG the discretionary authority to resolve a bank through a temporary administration process under a more defined range of grounds, and at an early stage of a bank's financial difficulty, before reaching insolvency (that is to be inferred through a cash flow or balance sheet test) and without necessarily suspending the operations of a bank or revoking its license.[6] The triggers

[6] The possibility to take control of a problem bank and resolve it when there is still positive equity should be assessed in light of possible constitutional constraints, both in terms of substantive and procedural requirements, given the possible qualification of such actions as "expropriation." As a general matter, it should be noted that constitutional provisions, while protecting property rights, often allow for the taking of property when a public interest arises, and provided that certain safeguards (e.g., compensation) are in place. In particular, Article 21 provides that the

(continued)

should be based on the nonviability (or likely thereof) of a bank, in turn defined through several criteria (e.g., breach of capital or liquidity requirements, unsafe and unsound conditions, etc).

- *Objectives and principles*. Under best practices, resolution should aim at preserving financial stability, protecting depositors and public confidence, and minimizing taxpayers' support. This is also achieved through the imposition, upon adoption of a resolution measure, of losses to shareholders and creditors of a failed bank (for instance, in the context of a transfer of assets and liabilities to a healthy acquirer).[7] The Georgian framework partially recognizes these elements and the requirement for a least-cost resolution strategy, mentioned in the 2002 NBG Decree on the "Analytical Framework for Problem Bank Resolution." However, the provisions of this decree are not always clear and coherent, and there is merit in more thoroughly enshrining the above principles and objective in the legislation. Moreover, the mandate of the NBG as a resolution authority could explicitly incorporate such principles and objectives, so as to steer the action of the NBG in bank resolution.

- *Tools*. The law merely states that the temporary administrator can "arrange" for certain transactions (recapitalizations, mergers, or sale of businesses), and that the NBG can set up and manage a temporary bank. These provisions do not shed enough legal certainty on the rules that would accompany the deployment of resolution tools. Several aspects need to be flexibly specified in the legislation, for instance with respect to: governance arrangements and prudential requirements of a bridge bank; criteria for the establishment of an asset management company and assets purchase; safeguards and procedures in the recapitalization of a bank (see Box 1). The toolbox may also be expanded to encompass other resolution techniques (e.g., statutory debt restructuring); on the other hand, certain tools such as mergers may not entail loss absorbing features and are not likely to favor a least cost solution – as such, their use presents drawbacks relative to other tools. Lastly, the law should not exclude that relevant tools be used with immediate effect and without completing all the steps of a temporary administration process.

- *Effectiveness in the implementation of resolution tools*. A number of impediments can significantly hamper the application of bank resolution tools and should be revised or, in any event, reviewed. For instance, under the Civil Code the transfer of a problem bank's claim is subject to the consent of the relevant creditors (e.g., depositors). This rule is not waived in the LACB. Likewise, the right of contractual counterparties to terminate contractual arrangements upon the adoption of a resolution measure should be temporarily restricted

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deprivation of property rights shall be permissible for pressing social needs in the cases determined by law and in accordance with a procedure established by law, and only with appropriate compensation.

[7] See the FSB "Key Attributes of Effective Resolution Regimes for Financial Institutions" (particularly, the Preamble and Key Attribute 2), as well as the recently approved EU Directive on bank recovery and resolution (Directive 2014/59), and particularly Articles 31 and 34.

to facilitate the implementation of such measure. Lastly, a revision of creditor hierarchy rules is warranted to ensure that no conflicts and uncertainties arise with respect to the application of various laws (e.g., Tax Code, Law on Payment Systems and Payment Services), and to remove possible obstacles to the transfer of secured claims (for instance, by preserving the position of secured creditors whose claim has been perfected after the registration of a tax lien).

- *Safeguards*. A number of elements aimed at ensuring a fair and impartial resolution process could also be explicitly incorporated in the legislation. These include, for instance, introducing the requirement for an independent evaluation of a failed bank's assets and liabilities (which would guide the attribution of losses to shareholders and creditors), and enshrining the "no creditor worse off" principle (which compares losses in resolution with the treatment that shareholders and creditors would have received in a straight liquidation). Lastly, the provision allowing the NBG to lend to the liquidator should be revisited, to better protect the NBG's financial exposure.

- *Systemic crises*. The inability for the government to provide financial support, under extraordinary circumstances, on a temporary basis and through several possible forms, should be revisited, in order to cater for the full spectrum of possible responses in a crisis.[8]

25. Governance arrangements for resolution should be reviewed to take into account possible conflicts with the supervisory function. The NBG Supervision Department is vested with the task of handling problem banks, and does so by defining the resolution strategy, examining possible alternative options and assessing the related costs against a straight liquidation. Supervision and resolution, however, are two distinct activities entailing different know-how, and resources. The absence of a separation between these two tasks gives rise to concerns about possible regulatory forbearance, as the authorities may not have the right incentives to "pull the plug." This highlights the need to address possible conflicts of interest between the supervisory and resolution functions in line with emerging international best practices through a system of checks and balances. Where resolution and supervision are conducted by the same agency, appropriate internal governance arrangements can be designed to reconcile possible conflicts and divergences through a collegial decision-making process.

[8] See paragraphs 35 and 41 below.

Box 1. Selected Legal Considerations in the Application of Resolution Tools

Tools applied to resolve banks often resemble typical business transactions. However, since bank resolution bears a public interest, the legal framework must incorporate a special regime permeated by public law elements, which interact with the commercial law principles ordinarily applied to such transactions. A few examples of this approach are set out below. In all of these instances, the authorities should be able to apply resolution tools by overriding shareholders and creditors' consent.

- *Sale of business (or "purchase and assumption).* Assets and liabilities of the problem bank may need to be transferred as a pool rather than on a piecemeal basis. The transfer should make it possible to allocate losses to certain categories of creditors by leaving selected liabilities with the problem bank and passing on other classes of liabilities (i.e., those with a higher ranking under creditor hierarchy rules) to the acquirer. The legal framework should also enable the authorities to make use of rapid mechanisms to dispose of the assets and liabilities. Typically, an open auction process can be envisaged, but it needs to be complemented by the possibility of an informal bidding if unusual and compelling circumstances are at stake (e.g., when the bank is systemic and/or a public bidding may lead to a loss a confidence and risks of a bank run). If the authorities pursue the latter route, the legal framework should set out strict confidentiality requirements, and *ex post* transparency should enable verifying the process has been conducted in a fair and impartial manner.

- *Bridge bank.* Assets and liabilities may be transferred to publicly owned vehicles carrying out banking operations for a limited duration. Special provisions should set out the regime for the establishment and ongoing prudential requirements of bridge banks in bank resolution. For instance, the procedure to set up a bridge bank should be expedited and rules for its governance should be clarified.

- *Capital increases.* When the authorities take control of a problem bank, the temporary administrator has to estimate any capital shortfall, recognize losses, write down capital, and draw a new balance sheet accompanying the injection of new capital. This entails special provisions in the law, partially departing from those applying to capital reorganizations under general corporate law.

- *Debt restructuring.* The statutory debt restructuring or "bail-in" tool also entails the conversion of debt into equity and/or debt haircuts, thus restoring a bank's capital requirements. While this is a restructuring technique also used for commercial companies, special features apply, given the absence of required approvals from (certain majorities of) creditors, and a more limited role played by the judiciary.

26. A variety of possible flexible approaches can be considered. In some jurisdictions, the resolution authority is different from the supervisor; however, this may not necessarily be an effective alternative solution, nor might it be feasible in a small country like Georgia. Possible measures may lead to a review of the NBG's internal governance, which could still leave unaltered the broader institutional setup in Georgia and without establishing a separate agency. For instance, in calm periods a small unit could be established to deal with recovery and resolution planning and with crisis preparedness arrangements, and to liaise with the DIS, once it is established;[9] staffing needs would then be revised in crisis times. While closely cooperating with the supervisory function, such unit would be structurally separate and could have different reporting lines (including, possibly, to a deputy governor or to the NBG governor).

DEPOSIT INSURANCE SCHEME

27. In the context of the association agreement with the European Union, the Georgian authorities are committing to introducing a DIS. The authorities have considered the merits of the establishment of a DIS for some time, weighing pros and cons typically considered in this respect (on one hand, preserving public confidence, mitigating the risk of bank runs, and ensuring adequate contribution by the industry when a bank fails, and, on other hand, maintaining market discipline, increasing moral hazard, and minimizing costs for banks and, in turn, for their clients). The recently signed association agreement with the European Union represents a turning point, since it envisages the introduction of a DIS. The timing currently planned for its setup is seven years, and no other specific features have been determined so far.

28. The FSAP mission supports the establishment of a DIS and considers it appropriate to set it up earlier than the envisaged seven-year period. The case for a DIS is not always clear-cut, and the objections that have so far deterred its introduction could have their merits. This is true particularly for the moral hazard argument—taking into account the fiscal costs involved, had the DIS been set up in the past when the banking system underwent significant distress—and the need for a gradual, institutional capacity building for the financial sector. Nonetheless, taking into account where the Georgian financial sector lies at the current juncture, a number of considerations make it advisable to set up a DIS, and to start the preparatory work for its design in the short term, under a timeframe and with features which should be consistent with the revamp of the bank resolution framework:

i. *Public confidence*. In past cases of bank liquidations, it took several years for depositors to be reimbursed. There have not been recent examples, and clarifications in the creditor hierarchy rules have improved the process of liquidation. However, it cannot be excluded that liquidation processes would be lengthy, should an insolvent bank be liquidated in the future.

[9] See Sections on Deposit Insurance and Domestic and Cross-Border Arrangements, respectively, for a discussion on the DIS and on crisis preparedness and management arrangements.

The main function of a DIS would be indeed to protect insured depositors by ensuring a prompt payout, thus preserving public confidence and minimizing the risk of a bank run and deposit outflows;

ii. *Reducing the "too-big-to-fail" risk*. In a way, an implicit, free, and discriminatory DIS already exists today, as banks deemed to be too-big-to-fail have a *de facto* cost advantage to the detriment of the smaller banks. A DIS would remove—or at least reduce—this implicit state guarantee and level the playing field for smaller banks. Moreover, typically, DISs, supported by a good communication strategy, can play a useful role in maintaining public confidence and in fostering the placing of deposits also with small and medium banks, since depositors are aware that their insured deposits are protected in any case. The argument could also be made, therefore, that a DIS may increase competition in the banking sector, even though this would be more difficult to prove;

iii. *Adequate funding tools in resolution*. The absence of a DIS may put undue pressure on the NBG, possibly leading to a misuse of the ELA, as noted above under Emergency Liquidity Assistance. If no adequate resolution framework is in place, the risk is that central bank's resources may be used to fund troubled banks for a protracted period, while the strategy should rather be to seek an appropriate resolution tool (including a recapitalization, dilutive of existing shareholders, in systemic cases). The ELA (or other lending facilities by the central bank) may disguise forms of open bank assistance, which could ultimately increase fiscal costs. A DIS may mitigate these risks, as it is a key component in the funding of problem banks' resolution;

iv. *Conjuncture*. The introduction of a DIS seems timely at this point in time for the banking system in Georgia, when banks' profitability is relatively high; and[10]

v. *Savings rate*. A DIS could increase savings, as shown in the following tables illustrating responses to a survey. [11]

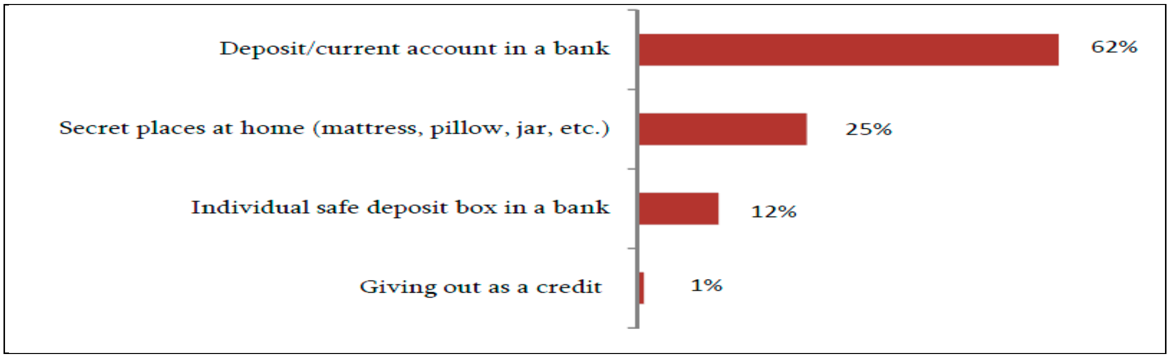
29. The DIS should be underpinned by key design features in line with international best practices. The FSAP is a diagnostic tool which, in a "snapshot," assesses risks and vulnerabilities under the existing situation. Delineating the precise characteristics of a future DIS is therefore outside the remit of this exercise. Nonetheless, on a preliminary basis, it is worth drawing the

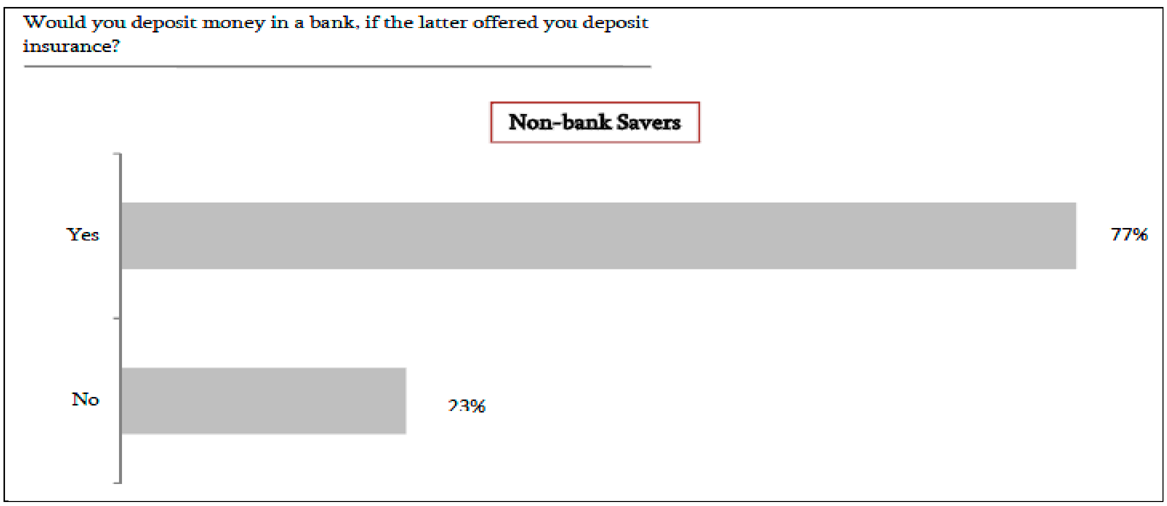
[10] For a more detailed analysis, see in general the Financial System Stability Assessment.

[11] In theory, one option would be to distinguish between deposits in local and foreign currency, introducing the coverage only for the former category. In a way, this would amount to a macro-prudential instrument put in place to foster de-dollarization. However, a number of arguments may weigh against this option. In particular, a differential coverage may discourage savings from low-income individuals and may possibly raise issues in terms of the envisaged approximation of the Georgian legislation to the EU law.

attention to certain elements that should be considered in the design of a DIS in Georgia, also bearing in mind the reservations expressed in the past by the authorities.

People save/accumulate money at different places. Which one do you consider particularly preferential?





Sources: Savings Banks Foundation for International Cooperation, NBG. With respect to the latter table, the NBG makes the argument that respondents are sensitive towards interest rates, and there could be some bias when offering benefit without cost; more in general, NBG considers that, given the low level of non-bank savings and low coverage of deposit insurance, additional savings may not necessarily be material.

Box 2. Design Features of a Deposit Insurance Scheme

While a DIS needs to be tailored to local specificities, it is possible to identify a number of key aspects that, in line with the IMF and the WB staff advice, stand out in the design of a sound DIS.[12]

- *Public interest function.* The DIS should be vested with a public interest function aimed at protecting insured deposits and contributing to financial stability. When the DIS entails the setup of a separate legal entity, which—according to the domestic legal tradition—is established as a commercial company, it is still important that such public interest function is spelled out in the legal framework, and public law elements duly inform the mandate of the DIS.

- *Funding.* The need to minimize systemic risk and avoid pro-cyclicality calls in favor of an *ex ante* funded DIS, with the possibility of extraordinary premiums levied on the industry and with the authority to borrow from the MOF. A different issue arises as to the funding of the DIS upon its inception. One possibility is that the government contributes to the initial capital, with the aim to boost the credibility of the DIS. Alternatively, the DIS can be built gradually through contributions from the banks, while the possibility of borrowing from the government would ensure the existence of an adequate backstop; possibly, this would set the right incentives from the beginning.

- *Coverage.* The coverage of depositors should strike a balance between the need to insure enough depositors – thus contributing to financial stability – and to mitigate moral hazard concerns through a reasonably low amount. This is typically achieved by meeting the internationally accepted benchmark of 80/20 recommended by the International Association of Deposit Insurers, namely not less than 80 percent of depositors and 20 percent of deposits amount covered by a DIS.[13]

- *Governance.* Sound governance arrangements should be in place by ensuring adequate independence from the industry and the government.

- *Operational effectiveness and role in resolution*. Regardless of its specific legal form as a separate legal entity, the DIS should be operationally able to make quick payouts to depositors when a bank is liquidated. The legal framework should also provide that the DIS could perform its function by funding resolution transactions through the use of DIS funds in the interest of depositors (such as, for instance, by "filling the hole" between assets and liabilities in the sale of a troubled bank's business to a healthy acquirer), and subject to the "least cost" test (i.e. up to the amount that would be otherwise covered in a liquidation).

- *Inter-institutional arrangements.* While a variety of institutional arrangements are conceivable, where the DIS is established as a legal entity, it should closely cooperate with the supervisory and resolution authority (NBG), particularly to share information on problem banks and to take steps to be operationally ready in case of a pay-out or of a resolution.

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[12] See also "Core Principles for Effective Deposit Insurance Systems," Basel Committee on Banking Supervision and International Association of Deposit Insurers, June 2009.

[13] In a technical assistance report dated April 2014, the World Bank considers that, based on the updated banking sector deposits data as of February 28, 2014, the deposit insurance coverage amount of GEL 5,000 per individual depositor per bank would be sufficient to provide 100 percent insurance for 96.64 percent of all individual depositors and 20.91 percent of their deposited amount. This would meet the above-mentioned 80/20 rule.

CRISIS PREPAREDNESS AND MANAGEMENT

30. The NBG's cooperation with other domestic and foreign authorities is limited by law. Under the NBG law, the NBG cooperates with foreign supervisors, provided that adequate confidentiality safeguards are in place. However, no equivalent provisions existed at the time of the FSAP mission with respect to the possible cooperation with other agencies (MOF or foreign resolution authorities), including for contingency planning purposes or in times of a systemic crisis.[14]

31. The MOF and the NBG informally share system-wide information on the status of the banking system, and have recently entered into a formal arrangement. The MOF and the NBG have periodically discussed, but in an *ad hoc* way, possible distress scenarios for the banking system and have cooperated during the 2008 crisis in seeking solutions in the interest of financial stability. A financial stability plan prepared in 2009, envisaging forms of inter-institutional cooperation and setting out possible policy responses to systemic crises, has not been implemented. A recent important development, however, is the signing in June 2014 of a memorandum of understanding between the NBG and the MOF, providing for the exchange of information relevant for financial stability and the coordination of crisis responses. It is important that this arrangement is effectively implemented so that the NBG and the MoF systemically share information and conduct joint analyses on possible threats to financial stability, draw contingent plans, simulate crisis exercises, and prepare for policy responses.

32. The NBG has started work on recovery and resolution planning by requiring the most systemic banks to prepare recovery and resolution plans (RRPs). Recovery and resolution plans aim to assess, respectively, banks' resilience against plausible shocks to their balance sheet and the possibility of their orderly resolution; the onus with recovery plans lies with the banks (with periodic update and review by the authorities), while the authorities take the lead in validating resolution plans, with banks' input. In the context of the ICAAP, the NBG is requiring the major institutions to submit RRPs. The contents of the RRPs are kept to the minimum and mainly describe the contingent measures that banks can put in place in case of financial distress (e.g., asset sales, liability exercises, rights issues), as well as the procedural steps (e.g., calling of a shareholders' assembly for a capital increase or delegation to the Board of Directors of the bank, possible contractual impediments to asset sales). The NBG assesses the feasibility and effectiveness of such measures from a substantive and procedural standpoint.

33. The NBG has also put in place, for internal purposes, a contingency plan and a Financial Stability Committee. The contingency plan is linked to the stress test exercises, and to the resulting capital needs and probability of banks' failures. A Financial Stability Committee is operational at the NBG staff level, but it has still to be formalized at the highest managerial positions.

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[14] As noted above, an MOU was signed subsequent to the mission.

34. In case of a financial crisis, the authorities can take certain extraordinary measures, but the toolkit available to the government faces limitations. In emergencies, the NBG can impose a bank holiday, restrict banks' operations, set exemptions, or take other actions as necessary for the maintenance of financial stability. The government may provide financial assistance in the form of loans, and could do so through its ordinary budgetary authorization and without the need for a specific appropriation approved by parliament. However, state guarantees need to be ratified by the parliament, even though this has not been reported as a problematic issue in the 2008 crisis. Moreover, a specific legal provision prohibits the government from owning shares in banks and other financial institutions.

35. The NBG is required to revoke the bank license of subsidiaries or branches of a foreign bank when the latter "has lost authority to carry out its operations in its home country." The law compels the NBG to adopt a predetermined course of action through the measure of license revocation. This stance does not give to the NBG flexibility in calibrating its response when a foreign parent bank is in trouble. It should also be noted that, under the LACB, branches of foreign banks can operate in Georgia, but the regime applicable in case of their insolvency is not spelled out; for instance, provisions on temporary administration and liquidation formally apply only to "banks" defined as legal entities licensed by the NBG.

36. The above considerations point out the need to buttress crisis preparedness and management arrangements in the interest of financial stability. Tools and institutional arrangements should be strengthened both on a domestic and on cross-border basis. From a domestic perspective, the absence of a DIS—a key component of a financial safety net—makes it even more important that the NBG and the MOF cooperate closely to prepare for, or to respond to, a financial crisis. On the other hand, the need for adequate cross-border arrangement is reinforced by the high share of foreign ownership of the Georgian banking system. In particular, the action of the authorities could take a multi-pronged approach.

37. First, legal impediments that hamper cooperation should be removed. The NBG should be able, and, indeed, required, to cooperate with the competent domestic and foreign authorities in the resolution of a bank or in times of crisis, subject to adequate confidentiality safeguards and, with respect to cross-border aspects, to the maintenance of domestic financial stability in Georgia.[15] Likewise, the provision that renders automatic the revocation of a bank license when the parent bank ceases its operations in its home country should be revisited. Such a rigid rule, contrary to emerging best international practices, is neither conducive to domestic financial stability nor to cross-border cooperation. Instead, the NBG should be empowered to seek a cooperative solution

[15] While being a useful initiative, the signing of a memorandum of understanding between the MOF and the NBG does not eliminate the need for enshrining cooperation duties also at the level of the primary law.

with foreign resolution authorities. Lastly, the legal regime applicable to branches of foreign banks upon insolvency or liquidation should be clarified in the law.[16]

38. Second, there is merit in setting up a Financial Stability Council. More structured and formalized arrangements for crisis preparedness and management should be put in place, comprising the NBG, MOF, other regulatory agencies and relevant stakeholders, to meet on a regular basis to share information and analysis on systemic threats to financial stability, and prepare policy responses. The Council would carry out a number of activities, such as developing guidelines and checklists with roles and responsibilities of the MOF, the NBG, and other relevant agencies (including the DIS) and its key personnel, drawing crisis communication plans and conducting simulation exercises, verifying the adequacy of operational procedures, and elaborating possible policy responses (including rules for extraordinary public support) and related legal powers.

39. Third, the work on RRPs should further advance. RRPs can be helpful tools to gather information on risks borne by supervised banks and their group structures, to identify options for recovering the financial strength of an institution, or to facilitate an orderly resolution while protecting systemically important functions and avoiding losses to the taxpayers. Based on a proportionality principle, at an initial stage the NBG could require comprehensive RRPs (or the submission of relevant information for the preparation of a resolution plan) only from the systemic banks. The legal basis for such requirement may also be enhanced, given that the NBG could exercise intrusive powers to implement the actions envisaged in the RRPs. The ongoing analysis on stress tests could also be usefully integrated in the RRPs on a more structural basis.[17]

40. Fourth, the effectiveness of crisis responses deployed by the government should be enhanced. The MOF should be able to own shares in banks and financial institutions; this possibility may indeed not be excluded in a financial crisis, provided, of course, that any such form of public support is viewed as temporary and extraordinary, and is accompanied by appropriate measures that allocate losses on relevant stakeholders. Public support along these general principles should also contribute to transparency and fairness – the risk is otherwise one of hidden and inappropriate forms of public support. Likewise, the need that each guarantee issued by the government be ratified by the parliament should be reviewed while maintaining forms of strong oversight over public debt and contingent fiscal liabilities.

[16] See the FSB "Key Attributes of Effective Resolution Regimes for Financial Institutions", n.7.

[17] See Appendix I for examples of other jurisdictions and international standards on RRPs.

Appendix I. Examples of Recovery and Resolution Plans (Financial Stability Board, United Kingdom, United States, and the European Union)

Financial Stability Board

(Based on the Key Attributes of Effective Resolution Regimes for
Financial Institutions, Annex III,
October 2011, published November 24, 2011)

Objective and governance of RRPs

- Recovery and resolution planning should take into account the specific circumstances of the firm and reflect the nature, complexity, interconnectedness, level of substitutability, and size of the firm.

- The underlying assumptions of the RRPs and stress scenarios should be sufficiently severe.

- The RRPs should make no assumption that taxpayers' funds can be relied on to resolve the firm.

- The RRPs should serve as guidance to firms and authorities in a recovery and resolution scenario. They do not imply that the authorities would be obliged to implement them or be prevented from implementing a different strategy whenever it is needed to resolve a financial institution.

Recovery plan

- Serves as a guide to the recovery of a firm that has not yet met conditions for resolution. There should be a reasonable prospect of recovery.

- Is developed by the firm's senior management and its credibility and ability to be effectively implemented is assessed by the authorities.

- Must be updated at regular intervals and upon the occurrence of events that materially changes the firm's structure or operations, its strategy or risk exposure.

- Should include the following essential elements:

  - Actions to strengthen the capital situation;

  - Possible sales of subsidiaries and spin-off of business units;

  - Possible voluntary restructuring of liabilities through debt-to-equity conversion;

- Measures to secure sufficient funding and adequate availability;
- Consideration to possible transfers of liquidity and assets within the group;
- Assessment of requirements to maintain membership in financial market infrastructures;
- Contingency arrangements that enable the continuation of operations as recovery measures are implemented;
- Triggers for implementation of the recovery plan or individual measures; and
- Communication strategy with the authorities, the public, the financial market, and the staff.

Resolution plan

- The resolution plan serves as a guide to achieve an orderly resolution in the event that recovery measures are not feasible or have proven ineffective. Identifies potential resolution strategies and assesses the necessary preconditions and operational requirements for implementation.
- The plan is developed and maintained by the authorities. They may decide not to disclose a resolution plan or parts of it. All relevant authorities should participate in the recovery and resolution planning.
- Firms should provide the information required for resolution planning on a timely basis.
- In addition, the authorities should identify:
    - Regulatory thresholds and legal conditions for the initiation of official actions and scope for authorities' discretion;
    - Interdependencies and the impact on other business lines and legal entities; markets and other firms;
    - Estimate of losses to be borne by creditors and any premium associated with various resolution strategies;
    - Range of sources available for resolution funding;
    - Process for disbursements by deposit insurance funds and other insurance schemes;
    - Processes for preserving uninterrupted access to financial market infrastructures;
    - Processes and systems to support the continued operation of critical functions;

- Processes for cross-border implementation of the resolution strategies; and
- Communication strategies and processes to coordinate communication with foreign authorities.

Further details can be found at:

http://www.financialstabilityboard.org/search/?sp_q=key+attributes&adv=1

United Kingdom

(Based on the supervisory statements SS 18/13 Recovery Planning
and SS 19/15 Resolution Planning, December 2013)

Recovery plans

Firms are required to maintain and update recovery plans that outline credible recovery actions to implement in the event of severe stress. The objective of the plan is to enable firms to restore their business to a stable and sustainable condition. The recovery plan is a firm's complete menu of options addressing a range of severe financial stresses caused by idiosyncratic problems, market-wide stress, or both. It is expected that the recovery plan includes all credible options for addressing both liquidity and capital difficulties.

Key elements

- Confirmation that the firm's Board of Directors or other appropriate senior governance committee or group have reviewed and approved the recovery plan.
- Summary of a firm's complete list of recovery options and an overview of the full range of further possible options.
- Identification of any remedial actions that should be taken to improve the credibility and effectiveness of individual recovery options.
- Description of each recovery option, including the firm's assessment of the probable success and quantitative estimate of each option's benefits.
- Assessment of the implications of the option on the franchise and viability of the firm.
- Embedding the recovery plan into the firm's existing risk management framework.
- Identification of a range of forward-looking triggers to activate the implementation of the recovery plan. Triggers should go beyond regulatory capital and liquidity ratios and include internal quantitative and qualitative metrics from the firm's overall risk management framework, and shall allow sufficient time for corrective actions to be taken.
- Clear description of the escalation and decision-making process that shall ensure effective action is taken in a timely manner.
- Identification of the key people involved and their roles and responsibilities.
- Operational plan for accessing central bank liquidity facilities.

- Communication plan to ensure that stakeholders (internal and external) are given timely and appropriate information during the firm's recovery process.

Resolution plans

To minimize the adverse impact on the financial system of firms failing by ensuring that they can be resolved in an orderly fashion, firms are required to submit resolution packs containing information to enable the authorities to prepare for orderly resolution. The information submitted in resolution packs will allow the authorities to identify the appropriate resolution strategy for a firm; work with firms to identify barriers to an optimal resolution plan; and develop the remedial actions for the removal of barriers.

The authorities will assess and determine in detail the corporate structure and the legal entity information, economic functions, strategy, resolution trigger events, operational continuity, liquidity needs, collateral, critical functions, payment, and clearing and settlement systems.

Further details can be found at:

http://www.bankofengland.co.uk/pra/Documents/publications/policy/2013/recoveryplanning1813.pdf

http://www.bankofengland.co.uk/pra/Documents/publications/policy/2013/resolutionplanning1913.pdf

United States

Resolution plan

Each nonbank financial company supervised by the Federal Reserve Board and each bank holding company with total consolidated assets of US$50 billion must periodically submit to the Board, the Federal Deposit Insurance Corporation and the Financial Stability Council a resolution plan or ''living will'' that includes:

- Information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- Full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;
- Identification of the cross-guarantees tied to different securities;
- Identification of major counterparties;
- A process for determining to whom the collateral of the company is pledged; and
- Any other information that the Board and the corporation jointly require by rule or order.

The proposed rule would require a strategic analysis by the covered company of how it can be resolved under Title 11 of the U.S. Code (the ''Bankruptcy Code'') in a way that would not pose systemic risk to the financial system. In doing so, the company must map its:

- Business lines to material legal entities and provide integrated analyses of its corporate structure;
- Credit and other exposures;
- Funding, capital, and cash flows;
- The domestic and foreign jurisdictions in which it operates; and
- Its supporting information systems for core business lines and critical operations.

The Dodd-Frank Act requires that in applying the requirements of Section 165(d) to any foreign nonbank financial company supervised by the Board or any foreign-based bank holding company, the Board give due regard to the principle of national treatment and equality of competitive opportunity, and to take into account the extent to which the foreign financial company is subject, on a consolidated basis, to home-country standards that are comparable to those applied to financial companies in the United States.

The proposed rule requires that each covered company periodically submit to the Board and corporation:

1. A plan for the rapid and orderly resolution of the Covered Company under the Bankruptcy Code in the event of material financial distress at or failure of the Covered Company (''Resolution Plan''); and

2. A report on the nature and extent to which the Covered Company has credit exposure to other significant nonbank financial companies and significant bank holding companies and on the nature and extent to which other significant nonbank financial companies and significant bank holding companies have credit exposure to the Covered Company (''Credit Exposure Report'').

Further details can be found at:

http://www.federalreserve.gov/newsevents/press/bcreg/20110412b.htm.

http://www.federalreserve.gov/bankinforeg/resolution-plans.htm

European Union

(Based on the Directive establishing a framework for the recovery
and resolution of credit institutions and investment firms (BRRD) 17958/13)

EU Recovery and Resolution Directive

The EU draft Directive is designed to provide "adequate tools at European Union level to effectively deal with unsound or failing credit institutions." It aims to make sure a bank or an institution can be resolved speedily and with minimal risk to financial stability. The Directive preserves systemically important functions when a bank fails so that, on failure, shareholders and creditors, rather than taxpayers, bear the losses. The proposed implementation date for the draft Directive is January 1, 2015.

Recovery plans

Member states shall ensure that each institution draws up and maintains a recovery plan providing, through measures taken by the management of the institution or by a group entity, for the restoration of its financial situation following significant deterioration.

The annex to the Directive contains information requirements for the recovery plan, including:

- A summary of the key elements of the plan, strategic analysis, and summary of overall recovery capacity;
- A summary of the material changes to the institution since the most recently filed recovery plan;
- A communication and disclosure plan outlining how the firm intends to manage any potentially negative market reactions;
- A range of capital and liquidity actions required to maintain operations of, and funding for, the institution's critical functions and business lines;
- An estimation of the timeframe for executing each material aspect of the plan;
- A detailed description of any material impediment to the effective and timely execution of the plan, including consideration of impact on the rest of the group, customers, and counterparties;
- Identification of critical functions;
- A detailed description of the processes for determining the value and marketability of the core business lines, operations, and assets of the institution;

- A detailed description of how recovery planning is integrated into the corporate governance structure of the institution, as well as the policies and procedures governing the approval of the recovery plan and identification of the persons in the organization responsible for preparing and implementing the plan;
- Arrangements and measures to conserve or restore the institution's own funds;
- Arrangements and measures to ensure that the institution has adequate access to contingency funding sources, including potential liquidity sources, an assessment of available collateral, and an assessment of the possibility to transfer liquidity across group entities and business lines, to ensure that it can carry on its operations and meet its obligations as they fall due;
- Arrangements and measures to reduce risk and leverage;
- Arrangements and measures to restructure liabilities;
- Arrangements and measures to restructure business lines;
- Arrangements and measures necessary to maintain continuous access to financial markets infrastructures;
- Arrangements and measures necessary to maintain the continuous functioning of the institution's operational processes, including infrastructure and IT services;
- Preparatory arrangements to facilitate the sale of assets or business lines in a timeframe appropriate for the restoration of financial soundness;
- Other management actions or strategies to restore financial soundness and the anticipated financial effect of those actions or strategies;
- Preparatory measures that the institution has taken or plans to take in order to facilitate the implementation of the recovery plan, including those necessary to enable the timely recapitalization of the institution; and
- A framework of indicators that identifies the points at which appropriate actions referred to in the plan may be taken.

This gives the resolution authority information to help plan how the essential functions of the institution or group may be isolated and continued.
Resolution authorities will also have powers to require an organization to take steps to restore financial soundness or to reorganize its business.

Resolution plans

The resolution authority will prepare a resolution plan for an institution (at an entity and group level) setting out options for resolving the institution in different scenarios, including systemic instability.

The resolution plan will include details of how to apply the resolution tools and how to make sure the institution continues to provide critical functions, specifically the resolution plan shall include a:

- Summary of the key elements of the plan;
- Summary of the material changes to the institution that have occurred after the latest resolution information was filed;
- Demonstration of how critical functions and core business lines could be legally and economically separated, to the extent necessary, from other functions so as to ensure continuity upon the failure of the institution;
- Estimation of the timeframe for executing each material aspect of the plan;
- Detailed description of the assessment of resolvability;
- Explanation by the resolution authority as to how the resolution options;
- Detailed description of the different resolution strategies that could be applied according to the different possible scenarios and the applicable timescales;
- Description of critical interdependencies;
- Description of options for preserving access to payments and clearing services and other infrastructures;
- Analysis of the impact of the plan on the employees of the institution; and
- Plan for communicating with the public.

Further details can be found at:

http://register.consilium.europa.eu/content/out?lang=EN&typ=ENTRY&i=SMPL&DOC_ID=ST 17958 2013 INIT