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November 2018

TECHNICAL NOTE ON BANK RESOLUTION, FINANCIAL SECTOR SAFETY NETS, CRISIS PREVENTION AND MANAGEMENT

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November 14, 2018

TECHNICAL NOTE

BANK RESOLUTION, FINANCIAL SECTOR SAFETY NETS, CRISIS PREVENTION AND MANAGEMENT

Prepared By
Monetary and Capital Markets Department, and Legal Department

This Technical Note was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission in Brazil during November 2017, led by Ms. Jodi Scarlata, IMF and Mr. Cortes, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance and Private Sector Development Vice Presidency, World Bank. The note contains the technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx.

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Glossary

BB	Banco do Brasil (state-owned commercial bank)
BCB	Banco Central do Brasil (central bank)
BNDES	Banco Nacional de Desenvolvimiento Economico e Social, National Development Bank
CDs	Certificates of deposit
Caixa	Caixa Economica Federal
COMEF	Committee on Financial Stability
CMG	Crisis Management Group
CMN	National Monetary Council
COPAR	Strategic Resolution Committee
COREMEC	Committee for the Regulation and Supervision of the Financial, Capital, Insurance, Social Security and Capitalization Markets
CVM	Securities and Exchange Commission (Comissao de Valores Mobiliarios)
D-SIB	Domestic Systemically Important Bank
Draft Law	Draft bill of resolution reform
ELA	Emergency Liquidity Assistance
FGC	Fundo Garantidor de Creditos (deposit insurance agency)
FRL	Fiscal Responsibility Law
FSB	Financial Stability Board
G-SIFI	Global Systemically Important Financial Institution
ICAAP	Internal capital adequacy assessment process
IADI	International Association of Deposit Insurers
KAs	Key Attributes of Effective Resolution Regimes for Financial Institutions
MoU	Memorandum of Understanding
MoF	Ministry of Finance
NCWOL	No-creditor worse off than in liquidation
OBA	Open bank assistance
RAET	Temporary Special Administration Regime
RRP	Recovery and resolution planning
SCV	Single customer view
SIM	Integrated Monitoring System
SUSEP	Superintendence of Private Insurance

EXECUTIVE SUMMARY[1]

Important improvements have been made to the bank resolution, safety net and crisis management framework since the last FSAP. The resolution framework has been strengthened with the creation, within the Banco Central do Brasil (BCB), of a new Resolution Department, and requirements for recovery and resolution planning have been established. The early intervention powers of the BCB are robust and flexible.

Notwithstanding this progress, the current framework has limitations that are broadly acknowledged by the authorities. Resolution powers are incomplete and no formal inter-agency arrangements for crisis management are in place. The BCB has taken the lead in preparing a comprehensive draft law (the "Draft Law") that seeks to introduce a new resolution regime in line with international best practices. This FSAP takes place therefore at a critical juncture. It provides recommendations on the design features of the new resolution regime, examining the existing framework as well as the areas not addressed in the Draft Law.

The Draft Law represents a major improvement of the resolution framework, although enhancements to its clarity and effectiveness are warranted. The reform gives options to restore the viability of a failed institution and broadens the toolkit of the authorities for dealing with systemically important institutions (including powers for limited bail-in and bridge banks). Importantly, it also strengthens the legal protection regime and removes impediments to temporary public support. However, elements of the law could be clarified, including the application of the resolution toolkit to medium and small-sized banks, details of the bail-in powers, bridge bank transactions, and conditions for transfers to asset management companies.

The Draft Law requires systemically important domestic banks to prepare recovery plans, which could be usefully extended to other institutions, subject to proportionality criteria. The BCB is beginning resolution planning and resolvability assessments. Additionally, the authorities could benefit from extending some form of RRP requirements (notably for recovery planning) to non-systemic institutions, in line with other jurisdictions. While such plans would necessarily be narrower and tailored to the conditions of the banks, resolution authorities could benefit from such a framework for any bank in distress.

The effectiveness of the new resolution framework could be strengthened by enhancing the operational autonomy of the BCB. The BCB is the resolution authority for banks in Brazil and takes a leading role in the resolution of banking groups. The BCB enjoys limited autonomy under the legal framework, and is hierarchically under the remit of the Ministry of Finance (MoF). Moreover, the governor and deputy governors do not have a fixed mandate and the BCB does not set its own budget. These shortcomings are partially compensated as the Governor has ministerial rank and

[1] This Technical Note has been prepared by David Hoelscher (external expert, MCM) and Alessandro Gullo (Legal Department, IMF). The FSAP team would like to thank the Brazilian authorities for their excellent cooperation.

reports directly to the President. Formal and fuller independence, however, would strengthen the BCB's institutional role.

Inter-agency coordination arrangements among financial safety net participants could be improved. Such arrangements currently exist but are ad hoc in nature. Moreover, they do not typically address resolution and contingency planning matters. Coordination between the BCB other safety net agencies would be strengthened by establishment of a formal, inter-agency crisis management framework. Such a framework should be tested by regular multi-agency crisis exercises.

The process for dealing with weak banks and providing emergency liquidity assistance ("ELA") should be tightened. While the early intervention powers of the BCB are robust and flexible, a regulation could be put in place identifying progressively tighter measures to address emerging risks in a bank. The role of the Resolution Department in the decision-making process leading to the resolution of a bank should be formalized. Further, ELA has not been used in over 20 years, due to, among other things, banks' concerns about triggering enhanced supervisory actions, and the existence of relatively easier access to open bank assistance from the deposit guarantee agency (FGC). Measures to limit the risk faced by the BCB could be implemented, including a solvency test of the recipient institution, and escalating measures such as enhanced supervision. Such measures do not reduce flexibility as ELA would remain a discretionary decision of the BCB, and at the same time pose a strong bulwark against supervisory forbearance and increasing resolution costs. An indemnity of the MOF could operate in systemic circumstances when solvency is in doubt and there are not sufficient assurances that the facility will be repaid.

The new Draft Law adds an important dimension to the funding framework, complementing the role of the deposit guarantee agency (the "FGC"). Under the Draft Law, the deposit insurance fund will be complemented with a new Resolution Fund, opening the possibility for the use of public resources under limited conditions. Clarity is however needed on the interaction between the operations of the deposit insurance fund and the resolution fund envisaged under the Draft Law, to reflect their different purposes, as the former should be designed for depositor protection.

The FGC should be strengthened, including by bringing it into the public sector and ruling out open bank assistance from the deposit insurance fund. The FGC is a non-profit private association composed of financial institutions. Measures to make the FGC more effective include enhancing arrangements for payout, strengthening access to supervisory data subject to adequate confidentiality safeguards, and establishing back-up funding facilities. In addition to depositor protection, the FGC provides open bank assistance to member institutions. Such a role exposes the deposit insurance fund to significant risk and could undermine depositor confidence in the scheme. Shifting the FGC into the public sector could address many of these limitations, as it would help prevent conflicts of interest, improve the exchange of confidential information, and allow the FCG to participate in high-level financial stability and crisis management committees. In addition, emergency liquidity provision by the FGC should be discontinued once the BCB ELA framework has become fully operational. If solvency support is required in systemic circumstances, it should be

provided from the resolution fund and open bank assistance from the deposit insurance fund should be ruled out. In the interim measures should be put in place to minimize the risk of the FGC lending to unviable and insolvent banks.

Formal inter-agency coordination arrangements for financial safety net participants should be put in place. Such arrangements currently exist but are ad hoc in nature. Moreover, they do not typically address resolution and contingency planning matters. The BCB has played a central role in coordinating policy responses to emerging crises. While there are several high-level agencies, responses to possible systemic crises are *ad hoc*. The role of the BCB could be formalized, and a formal, broad inter-agency framework should be developed to ensure consistent policy development and implementation in a crisis. Crisis simulations play an important role in both training and in testing procedures. While the BCB has strong simulation exercises, it would be advisable to conduct regular multi-agency crisis simulations to ensure that mandates and procedures are clear.

The reform of the legal protection regime is critical. Currently, BCB staff has limited legal protection, as its liability is subject to an ordinary negligence standard. The Draft Law seeks to strengthen the legal protection by raising the bar for liability to a fraud or willful misconduct test. This is a crucial change that will help strengthen the effectiveness of the safety net operations, including the provision of ELA, depositor protection, and resolution actions.

Table 1. Brazil: Table of Recommendations		
Recommendations and for Implementation	**Agency**	**Priority**
Institutional Arrangements		
Provide for a financial stability mandate of the BCB as a resolution authority and strengthen the operational autonomy of the BCB as a resolution authority.	MOF	High
Strengthen the inter-institutional arrangements among financial safety net participants in Brazil to require cooperation and exchange of information among them.	BCB	Medium
Formalize, upon adoption of the new resolution regime, arrangements among resolution authorities in charge of different segments of the financial sector, clarifying the leading role and the coordination mechanisms applicable in case of a resolution of financial conglomerates.	BCB	Medium
Review the provisions of the Draft Law on the scope of the resolution regime, to ensure that the BCB has clear and strong powers to resolve holding companies of banking groups and to apply the regime to entities providing services that are necessary for the continuity of critical functions of the firm under resolution.	BCB	High
Crisis Prevention		
Link the early warning indications to specific supervisory actions, reducing the risk of forbearance or delayed response to risk build-up.	BCB	High
Inform the FGC of any bank placed on the watch list once the FGC has established procedures to ensure that such information remains confidential.	BCB/FGC	High
Crisis Preparedness		
Expand regulations on RRPs to include all banks in the system (notably for recovery planning), based on proportionality criteria.	BCB	High
Undertake a formal program for inter-agency crisis simulations and exercises.	BCB	Medium
Ensure that supervisory MoUs include the exchange of information between the BCB and foreign authorities on resolution plans.	BCB/MoF	Medium

Table 1. Brazil: Table of Recommendations (continued)		
ELA		
Revise the ELA framework to provide for a solvency test that is tied to enhanced supervision, remedial plans, and possibly restructuring measures.	BCB	High
Finalize arrangements for the prompt operationalization of ELA.	BCB	High
Allow for the provision of the ELA in systemic circumstance, upon a MoF indemnity.	BCB	High
Resolution Framework		
Ensure that the new resolution framework—and its stabilization tools—can apply also to medium and small-sized banks, as appropriate under circumstances.	BCB	High
Providing for forward-looking criteria, based on the non-viability of a bank that allow for an early and timely entry into resolution.	BCB	High
Revise the provisions on the resolution toolkit by broadening the options for bail-in, bridge banks, and AMC.	BCB	High
Introduce tiered depositor preference, with the first tier of preference applicable to the claims of insured depositors and of the FGC.	BCB	High
Clarify safeguards available to creditors under the resolution regime and the effects of the stabilization and compulsory liquidation regime, and strengthen the rules regarding the independent evaluation of the failed bank.	BCB	High
Funding		
Strengthen information sharing between the BCB and FGC with related safeguards.	BCB/FGC	High
Consolidate FGC's funding resolution activities into the Resolution Fund and incorporate medium-term viability of an institution into borrowing criteria, while (i) clarifying the remit of the deposit insurance fund to pay out or fund the transfer of insured deposits in resolution processes; (ii) allowing the Resolution Fund to provide solvency support in systemic circumstances; (iii) ruling out open bank assistance by the deposit insurance fund, once the BCB ELA framework has become fully operational.	FGC	High

Table 1. Brazil: Table of Recommendations (concluded)		
Deposit Insurance		
Give the FGC timely access to supervisory information for all of FGC's members, subject to confidentiality safeguards.	FGC	High
Require banks to produce deposit data in Single Customer View (SCV) format.	FGC	Medium
Move the FGC into the public sector, by transforming it into a fully owned public institution, performing a public interest function regulated by law and included in high-level crisis management committees. Even if this reform proves challenging in the short term, put in place adequate mechanisms to ensure that FGC lending is not misused or used to maintain insolvent banks operating in the financial system.	FGC/BCB	Medium
Remove restriction on covering deposits of foreign residents.	FGC	High
Crisis Management		
Remove impediments to public support in resolution processes, when necessary for financial stability.	MOF	High
Review the budgetary rules and procedures to allow prompt temporary recourse to public funds subject to the above constraints, and amend the legal framework accordingly.	MOF	High
Establish a high-level, inter-agency crisis coordination committee with an effective Secretariat.	MOF/BCB	High
Legal Protection		
Adopt the legal protection regime provided under the Draft Law.	MOF	High
Extend the legal protection regime for acts or omissions taken in support of foreign resolution measures.	MOF	High

High: 6–12 months
Medium: 1–2 years

INTRODUCTION

1. **Considerable progress has been made on the bank resolution, safety net and crisis management framework in Brazil since the last FSAP.** The governance of the FGC has been strengthened, the rules and procedures regarding the provision of ELA by the central bank are undergoing a revision, requirements for RRPs have been put in place, and a new department within the BCB—the "Resolution Department"—has been established, with an ambitious agenda. More fundamentally, the BCB has taken the lead in designing an overhaul of the resolution regime in Brazil, by preparing a comprehensive bill—that is, the Draft Law that seeks to align this regime with the international best standards, as enshrined in the "Key Attributes for Effective Resolution Regimes for Financial Institutions" ("KAs") adopted by the Financial Stability Board ("FSB").

2. **This FSAP takes place at a critical juncture for the bank resolution framework in Brazil.** The current framework is outdated and has shortcomings that are broadly acknowledged by the authorities. The authorities are embarking on a major reform of the resolution regime, which is still under discussion, as the Draft Law has yet to be submitted to Congress. The mission fully supports the authorities' efforts and the leadership taken by the BCB on this important reform. This technical note seeks therefore to feed into the debate on the design features of the new regime, by examining the main contents and principles of the Draft Law.[2] At the same time, it reviews the existing framework, as its thorough understanding is necessary to provide advice on the forthcoming reforms.

3. **The focus of this technical note is on deposit-taking institutions and on the features needed to handle troubled banks and banking groups.** This technical note reviews Brazil's resolution regime by having as a reference the international best practices in this area, such as the KAs and the IADI's Core Principles for Effective Deposit Insurance Systems, without undertaking a formal assessment against these standards.[3] In particular, Section I examines the institutional arrangements in place in Brazil, by reviewing the mandate of the BCB, the cooperation mechanisms with other financial safety net providers in Brazil and abroad, and the coordination mechanisms in the resolution of entities that are part of the same group of financial conglomerate. Section II then examines various features of a safety net framework, such as the early intervention and crisis preparedness regime and the provision of ELA by the central bank. Subsequently, Section III examines the bank resolution and insolvency framework, as well as the funding mechanisms available in resolution, with a focus on the Draft Law, as well as the functioning of the deposit insurance scheme. Section IV and V examine, respectively, the crisis management framework and the legal protection regime.

[2] The analysis made in this TN is based on a version of the Draft Law shared by the authorities at the time of the FSAP November 2017 mission. The authorities have indicated that, after the mission, they have introduced a number of changes into the Draft Law, in line with the FSAP recommendations.

[3] The analysis of this technical note is also made in light of the KA assessment methodology for the banking sector, published by the FSB in October 2016.

INSTITUTIONAL ARRANGEMENTS

A. Domestic Institutional Framework

Current Framework

4. The BCB is the resolution authority for deposit-taking institutions, although it does not have a formal financial stability mandate. The BCB is responsible for licensing, ongoing supervision and resolution of banks. With respect to the latter, the BCB can intervene in problem institutions, manage a temporary special administration regime, and initiate and lead extra-judicial liquidation proceedings.[4] However, while the law provides it with functions and powers to fulfill these responsibilities, it does not grant to the BCB an explicit financial stability mandate.

5. The National Monetary Council ("CMN") has the broader responsibility to ensure the soundness of Brazil's financial system, including through general rule-making powers. The CMN is established under Law 4,595 of 1964 ("the Banking Law"), with the objective of formulating currency and credit policy—including to ensure the liquidity and solvency of financial institutions—thereby achieving the economic and social progress of the country. Its composition includes the Minister of Finance (acting as Chairperson), the Minister of Planning of Economic Affairs and the BCB Governor.[5] The BCB provides secretariat services to its functioning. In pursuing its objectives, the CMN issues regulations regarding the operations of financial institutions, such as on modalities of credit, equity ratios and other technical conditions. However, the legal framework does not explicitly grant rule-making powers on resolution matters neither to the CMN nor to the BCB.

6. There is no fixed term for the members of the BCB's highest decision-making body—its Board. The Constitution provides for the exclusive power of the President of the Republic to appoint the "President and the Directors" (i.e., the Governor and Deputy Governors, forming the Board) of the BCB, upon prior consent of the Senate. The Board is composed of eight deputy governors, with different deputies responsible for supervision and resolution. As there is no fixed term for their positions, the President can dismiss the Governor and Deputy Governor at any time. Nor does the law require that public disclosure is given on the reason for dismissal.

7. The CMN and the MoF exercise administrative power over BCB budgetary and administrative matters, encompassing also its resolution mandate. Under the Banking Law, the CMN approves the bylaws and accounts of the BCB and decides on its budget and accounting system, as well as on the technical and administrative structure of the BCB and its staff.[6] The BCB bylaws place the BCB under the remit ("*autarquia federal vinculada*") of the MoF. The authorities

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[4] The term "extra-judicial" is used in the English translation of the relevant laws, referring to a proceeding that is led by an administrative authority (the BCB) rather than by the court.

[5] Article 6 of the Banking Law sets out a broader composition of the CMN (including the representatives of BNDES and Banco do Brasil). However, while this provision has not explicitly abrogated, it has been effectively superseded by Law 9.069 of 1995.

[6] Article 3, XXV and XXVII, of the Banking Law.

report that the resources allocated to the resolution department of the BCB are determined by an annual decision of the BCB Board, within the budgetary envelope approved by Congress for the organizational expenses of BCB.

8. Inter-institutional arrangements among financial safety net participants are in place with respect to financial regulatory and supervisory matters. Complementary Law 105/2001 authorizes the BCB to enter into agreements with other financial sector supervisors. The BCB has thus entered into cooperation and information exchange arrangements with other financial sector authorities, such as the Securities and Exchange Commission (CVM) and the Private Insurance Superintendence (SUSEP). A committee of Regulation and Supervision of Financial, Securities, Insurance and Complementary Pension Markets ("COREMEC") has been established under Presidential Decree 5,685 of 2006, with a view to coordinate financial sector regulatory and supervisory activities in Brazil, under the lead of the MoF.

9. In case of resolution of financial conglomerates, the BCB would assume a lead role. Private and non-federal public financial institutions, as well as credit cooperatives, are subject to the intervention and extra-judicial liquidation regimes, conducted by the BCB.[7] These regimes apply also to brokerage companies, while federal, state-owned public banks are exempted. On a similar vein, the temporary special administration regime applies to private and non-federal public financial institutions. SUSEP is the resolution authority for insurance companies. The BCB can extend the intervention or extra-liquidation framework to legal entities involved in integrated activities (i.e. also defined as debtors of the institutions under intervention or extra-liquidation) or attached by common interests (i.e. when their shareholders participate in their capital with more than 10 percent).[8]

Envisaged Reforms

10. The Draft Law retains the BCB role as the resolution authority for banks, and seeks to grant to it broader rule-making powers. Under the envisaged reform of the resolution regime, the BCB would continue to act as resolution authority, empowered to resolve banks by commencing either a stabilization regime or a compulsory liquidation regime. The Draft Law also seeks to strengthen the rule-making powers of the BCB, which would be authorized to issue a wider range of implementing regulations, within the directives adopted by the CMN.

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[7] Financial institutions are defined under the Banking Law as "public or private corporate persons that have as their major or accessory activity the gathering, intermediation or investment of their own or third party financial resources in national or foreign currency, and custody services of assets belonging to third parties."

[8] See Article 51 of law 6024 of 1974. Presumably, the provision refers to the circumstance that the entity under resolution and the entity "involved in integrated activities" are under common control.

11. The Draft Law introduces sectoral responsibilities for resolution and provides for a broad scope of the resolution regime. Under the Draft Law, the BCB would be the resolution authority for financial institutions licensed by it and for financial market infrastructures, while the CVM and SUSEP would be empowered, respectively, to resolve securities and insurance companies.[9] Cooperation and exchange of information between resolution authorities in Brazil is stated as a principle of the resolution regime. BCB would also be able to extend the resolution regime to legal entities that maintain a related interest with the institution subject to such regime (that is, for instance, when they belong to the same economic group or conglomerate), and to their controlling shareholders and managers. Furthermore, the Draft Law seeks to provide resolution powers to the BCB over companies having an ownership stake in the resolved institution and providing services essential for the continuity of the business of such institution.

Assessment

12. While the BCB is effectively in charge of resolution processes, its formal mandate as a resolution authority presents certain limitations. Relevant laws have regulated over time the various proceedings and the role of the BCB in initiating them, but without defining the overarching objective of the BCB in this area. Similarly, the Banking Law sets out a list of responsibilities to be carried out by the BCB and vests to the CMN, rather than to the BCB, the overall competence regarding the soundness of the financial system. While BCB is effectively responsible for the supervision of financial institutions, the absence of a formal financial stability mandate for the BCB is not optimal, as it could complicate the correct understanding by the public, the Congress and the government, of its duties and powers and of its accountability if problems in the financial sector emerge.

13. The limited autonomy enjoyed by the BCB under the law applies also to its role in resolution. International best practices recommend that resolution authorities are, by law and in practice, operationally independent and that arrangements shield against undue political or industry influence. These arrangements should include rules and procedures for the appointment and dismissal of the head of the authority and members of the governing body, as well as statutory constraints on the possible removal from office only for reasons specified in the law.[10] While the mission has not encountered any evidence of an undue political influence in the exercise of the BCB's resolution mandate, from a strictly legal—as opposed to operational—perspective these arrangements are not in place. Moreover, the fact that the CMN determines the organizational rules on the functioning and resources of the BCB also may infringe on the autonomy of the BCB.

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[9] This TN focuses on deposit-taking institutions. However, as the new resolution regime will apply to different segments of the financial sector (insurance, securities, banking), consideration should be given to tailoring its provisions to the needs and specificities of these segments (for instance, to ensure that the sectoral resolution authority has the appropriate toolkit to resolve the relevant firm).

[10] See "Key Attributes Assessment Methodology for the Banking Sector", October 2016, essential criteria 2.3 and explanatory note 2(d).

14. Inter-institutional arrangements do not yet include resolution or crisis preparation matters. The cooperation and information exchange arrangements in place between BCB, CVM, and SUSEP are supervisory in nature and do not address issues related to resolution or contingency planning. No similar arrangements exist between the BCB and the FGC although both agencies are working to overcome certain legal impediments—also due to the private law status of the FGC—that are hindering the formal establishment of an MoU. COREMEC is an important forum for the coordination of financial sector activities in Brazil. However, its mandate does not include resolution issues, nor crisis planning and management. It would be important to strengthen inter-institutional cooperation between financial safety net participants, particularly as the resolution reform will be adopted, and a new role will be taken by the CVM and SUSEP as sectoral resolution authorities, as well as by the government as a potential provider of public funds in resolution on an exceptional basis.

15. These issues are only partially addressed by the Draft Law, also given that the authorities intend to handle them through separate legal reforms. The Draft Law makes strides toward putting in place a modern resolution regime also from an institutional perspective, including by clarifying the objective of resolution processes and by fostering inter-agency cooperation. However, in a number of areas improvements would be needed. These include:

(i) *Autonomy*. The BCB has put forward an ambitious agenda ("BC+") which also concerns its autonomy, viewed by it as critical and deserving strong support. At the same time, the Draft Law—which is expected to be approved soon—does not address the autonomy of the BCB, leaving this to a separate law. As a new resolution regime will be in place, it is important that the BCB autonomy is also enhanced. While it is legitimate that an inter-ministerial committee such as the CMN—of which BCB is part—is in charge of financial sector policies, the review of the BCB autonomy should also include its role and interaction with the CMN and the MoF.

(ii) *Objectives.* The Draft Law includes a set of resolution objectives, which are broadly in line with best international practices. (See Section III.A). However, these appear to be objectives of the regime, while the BCB may have other (not fully consistent) statutory objectives and functions.

(iii) *Rule-making powers.* The allocation of responsibilities between the CMN and the BCB on the issuance of regulations that will implement the provisions of the new resolution law is not clear. It would be important to clarify what will be the remit of the CMN in this respect, or the areas where it may exercise rule-making powers.

(iv) *Inter-institutional cooperation.* Cooperation and exchange of information between resolution authorities in Brazil is stated as a principle, while it appears to be more appropriate to include a specific provision setting out the duty of the various financial safety net participants to cooperate and exchange information on a regular basis. On the other hand, the Draft Law would remove impediments to share confidential information between

the BCB and FGC. While the FGC remains a private institution, safeguards protecting confidential information will have to be included.

(v) Holding companies and group entities. The Draft Law includes appropriately broad provisions extending the resolution regime to entities that belong to the same economic group or conglomerate. However, the contents of the relevant provisions are not clear. For instance, the BCB would have resolution powers over companies having an ownership stake in the resolved institution and providing services essential for the continuity of the business of such institution. These are two different cases, in that holding companies should be treated separately than other entities (e.g., IT service providers) performing essential services, and not all resolution powers and tools would apply to these entities to an identical extent. If this is not the case, effective implementation of resolution plans may be hindered. Moreover, the draft law extends the resolution regime to certain individuals (e.g., controlling shareholders and managers of the failed institution). This appears to be provided in light of the special liability regime applicable to these individuals under Brazilian law. Care should be taken in the interest of legal certainty and to minimize legal risks to identify the different provisions of the new resolution regime that will apply to holding entities, group companies, directors, and other related parties.

Recommendations

- Provide for a financial stability mandate of the BCB as a resolution authority.
- Strengthen the operational autonomy of the BCB as a resolution authority, by (i) providing for a fixed term of the members of the BCB Board of Governors, statutory constraints for the possible removal from office, and public disclosure over the reasons of any early dismissal, and (ii) clarifying the powers of the CMN and the MoF to regulate BCB administrative and organizational functioning, by ensuring its operational autonomy.
- Clarify the allocation of powers between the CMN and the BCB to issue regulations implementing the provisions of the Draft Law.
- Strengthen the inter-institutional arrangements among financial safety net participants in Brazil to require cooperation and exchange of information among them.
- Formalize, upon adoption of the new resolution regime, arrangements among resolution authorities in charge of different segments of the financial sector, clarifying the leading role and the coordination mechanisms applicable in case of a resolution of financial conglomerates.
- Review the provisions of the Draft Law on the scope of the resolution regime, to ensure that the BCB has clear and strong powers to resolve holding companies of banking groups and to apply the regime to entities providing services that are necessary for the continuity of critical functions of the firm under resolution.

CRISIS PREVENTION

A. Early Intervention

16. The BCB uses a range of tools to identify weak banks. The supervisory process is based on a supervisory cycle that includes a mix of onsite and offsite activities. The BCB ranks banks based on quantitative and qualitative indicators. It maintains a watch-list of banks, consisting of banks with rating "3-" or higher and by banks that face continuity risk and whose condition is deteriorating quickly.

17. The early intervention powers of the BCB are robust and flexible. The BCB has a set of preventive supervisory measures that can be used to preserve the soundness, stability, and regular functioning of the national financial system. The objective of such measures is to address problems in a bank as early as possible and to avoid deterioration in the condition of the bank. The measures are deployed at the BCB's discretion.

18. The early warning structure is composed of two departments: The Supervisory Department and the Financial System Monitoring Department. Information on early indications of financial difficulties are shared through the Integrated Monitoring System (SIM), a tool designed to focus on the integration and information exchange between these two departments. The Financial System Monitoring Department receives daily information on a variety of economic indicators. The department monitors both operational indicators and a variety of market indicators found in the Monitoring Panel homepage. Such information includes loan delinquency, provisions, migration matrix for credit operations, and data collected from clearing houses and trade repositories such as over-the-counter and exchange-traded derivatives, private and public securities, foreign exchange, equity and other fixed income bonds (all of which is reported to the BCB at a transaction-level basis and daily). These indicators are supplemented by qualitative indicators to detect emerging vulnerabilities.

19. The Supervisory Department is alerted when a financial institution reports indicators of stress and can take supervisory action. The supervisors have a range of supervisory actions, from discussions with senior management to specific actions that can include: (i) imposition of controls; (ii) reduction of risk exposures; (iii) increases of minimum capital levels; (iv) adoption of more restrictive operational limits; (v) increase of liquidity level; (vii) restrictions on the managers' compensation as well as on payments to shareholders; (vii) restrictions on operations, acquisitions, and opening of new branches; and (viii) sale of assets. If these measures fail to reverse the financial difficulties, in extreme cases, such as a severe impairment of assets or a continuous breach of regulation by a bank, the BCB can adopt resolution tools by imposing intervention, extra-judicial liquidation, or temporary special administration. While the list of measures is comprehensive, there are no automatic enforcement triggers. Supervisors have the flexibility to address any warning signs in the manner they feel is most appropriate.

20. The BCB may place a bank under such enforcement or corrective actions on a watch list and subject them to heightened monitoring. The main aspects of the monitoring are: (i) the monitoring of implementation of the corrective actions; (ii) requirement for a regularization plan; (iii) appointment of an independent auditor to monitor bank activities; and (iv) expanded reporting.

21. There are two levels of classification of problematic banks in the watch list: banks "under attention" and banks "under observation". Banks "under observation" are at a higher risk of failure, and must have both formal correction letters issued and a supervisory action plan. If the supervisors are concerned about any bank's medium-term viability, it is classified as "under attention." This information, however, is not passed to the FGC. If the potential failure of the problem bank could have systemic implications, the BCB initiates a financial crisis management plan, which establishes the coordination of actions with the FGC to be put in place for each scenario.

22. When the Supervision Department determines that an institution is failing or about to fail, it notifies the Resolution Department. The Supervision Department determines the non-viability. At that point, the two departments jointly consider—informally—resolution options, updating the resolution plan and determining resolution options. Resolution action is determined by the BCB Board, upon a proposal that can be submitted only by the Deputy Governor for Supervision. Once the institution fails, the Resolution Department then implements the identified resolution plan. In case of concerns about the financial conditions of a foreign subsidiary, the supervisor informs the home supervisor about the bank's conditions and any actions being considered or taken in Brazil. The home supervisor can then adopt appropriate actions in its jurisdiction.

23. Cross border arrangements are governed by MoUs. The MoUs between the BCB and foreign supervisory authorities focus on the exchange of supervisory information. They detail the circumstances and the type of information that can be exchanged, subject to the bank secrecy laws of each jurisdiction. Typically, the agreements provide that, in the performance of their duties, both authorities must meet the requests for information from the other party, except under a few exceptional circumstances specified in the MoU.

Assessment

24. The early warning framework is effective and identifies banks with emerging financial difficulties, but the process could be tightened by a stronger linkage between a bank's financial indicator and supervisory action. The offsite monitoring has up-to-date information that is quickly processed and it is shared within supervision. The supervisors have considerable flexibility in determining which actions to take. However, a closer linkage between the build-up of risk and specific actions to mitigate those risks could be warranted. For example, specific actions could be required as a bank's capital begins to deteriorate or as liquidity stress emerges. Supervisory measures could be implemented, including more formal escalating measures such as enhanced supervision. Such measures do not reduce flexibility in dealing with a distressed institution, particularly when financial stability is at stake, but they do pose a strong bulwark against supervisory forbearance and increasing resolution costs.

25. Banks are currently required to prepare contingency plans for liquidity and capital shortfalls. All banks (including those that are not yet in the watch list) need to prepare contingency plans for liquidity and capital, based on Resolution 4,557. This Resolution requires that the capital management framework of all banks and banking conglomerates must comprise a capital contingency plan, establishing responsibilities, strategies, and procedures to face stress conditions. The same Resolution requires that financial institutions implement a risk management structure, which must include a liquidity contingency plan. The verification of these plans is part of the supervisory process. These plans may be supplemented by the introduction of formal recovery plans (see below Section II.B).

26. The Supervision and Resolution Departments work well but their coordination could be improved and formalized. Preparing for a failure requires considerable preparation. The resolution plans must be updated, the current structure and governance arrangements reviewed and the funding for resolution assured. Under such circumstances, the Resolution Department should receive notification of any supervisory action that affects the solvency (i.e., capital level) or medium-term viability of the institution. Such notification should happen even if the bank is not classified as weak or likely to fail. While a formal communication would be made in a specific BCP committee (COMEF) when issues regarding weak banks are discussed, explicit processes could be put in place to require formal coordination between the Supervision and Resolution Departments.

Recommendations

- Link the early warning indicators to specific supervisory actions, reducing the risk of forbearance or delayed response to risk build-up.
- The Resolution Department should be notified whenever an institution has a correction order affecting capital, liquidity, or viability and its role in the decision-making process leading to the resolution of a bank by the BCB Board should be formalized.
- The FGC should be informed of any bank placed on the watch list. It should be informed whenever supervisory actions are required that affect the solvency of the bank or medium- term viability, even before the bank is classified as weak or about to fail. The FGC, in turn, must establish procedures to ensure that such information remains confidential.

B. Crisis Preparedness

27. The arrangements for crisis preparedness within the BCB have been strengthened. In January 2017, the BCB established a Strategic Resolution Committee (COPAR), constituted by the heads of the departments involved in resolution and crisis management (departments under the Deputy Governor for supervision and the Deputy Governor for resolution). This committee has the goal to improve the coordination between the supervision and resolution areas to deal with resolution planning, resolvability assessment, and resolution actions.

28. Recovery and resolution planning (RRPs) is an important component of resolution frameworks. Requirements for such plans have been incorporated in international standards for resolution (FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Annex I-4). (See Box 1).

Box 1. Recovery and Resolution Planning

Recovery and resolution planning (RRPs) are important components of resolution frameworks. Advance preparation by banks and authorities can enhance the ability to respond to sudden shocks and facilitate the implementation of appropriate measures in times of crisis. International standard setters have issued guidance on the essential elements of RRPs (FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Annex I-4). This guidance calls for RRPs to be prepared by systemically important institutions. There are benefits, however, for all banks to prepare such plans. The specific requirements for RRPs, however, should be consistent with, and proportional to, the size and complexity of each bank.

Recovery planning is part of banks' risk management frameworks and supervisory toolkits. Recovery plans are prepared by banks and include the measures that the institutions can implement—excluding any reliance on public support—to continue operations under stress or after a shock to capital or liquidity. The plans lay out how the bank will address adverse scenarios (for instance, through restructuring of business activities or recapitalization by existing or new shareholders). Banks' boards have oversight responsibility for the development and maintenance of recovery plans. Supervisory validation of recovery plans entails consistent review by the supervisors of completeness and quality. Supervisors should establish requirements for RRPs and may require banks to make any necessary changes that would facilitate their implementation.

Resolution plans identify the strategies that the authorities could deploy in the event that recovery measures are ineffective. Resolution plans are prepared by the authorities with information from the banks. They lay out specific resolution strategies for individual banks, based on an assessment of how best to protect financial stability while protecting the critical functions of the bank. Plans typically include (i) detailed information on the bank's various business lines and its corporate organization; (ii) a description of the full ownership structure; (iii) a complete accounting of the bank's assets, liabilities, and contractual obligations; (iv) a description of where critical functions—such as information technology or treasury functions—are conducted; and (v) data on credit, major sources of funding, capital situation, and cash flows, along with identification of foreign countries in which it operates. Plans will vary in complexity: for small banks with simple operations, a straightforward approach (e.g., purchase and assumption) may suffice, while for complex, systemically important institutions providing critical functions to the wider economy, a more detailed list of options and strategies is likely to be required.

29. The BCB is incorporating such planning into its crisis preparedness framework. RRPs are now mandatory for domestic systemically important banks ('D-SIBs"). The BCB will also evaluate the possibility of extending the requirement to other institutions, possibly including two cooperatives.

30. The BCB is in the early stages of recovery planning. It has issued directives providing guidance to the banks on the development of recovery plans. Banks had previously been required to prepare contingency plans for liquidity and capital shortfalls. Such plans were part of the internal capital adequacy assessment process ("ICAAP") exercise and supervisory oversight. In 2016, the BCB

began requiring banks to prepare more detailed recovery plans. These recovery plans describe how the bank would respond to a sudden shock or unexpected market development. Recovery plans add a number of requirements, including for detailed stress testing, identification of critical functions, a description of governance arrangements, and a communication program.

31. Recovery plans are currently required from all systemically important institutions. Plans have been required from the five D-SIBs, including the subsidiary of one G-SIFI (Santander). A phase-in schedule has been established. The development of plans began in December 2016. Preliminary plans are expected to be presented to the BCB in December 2017 and the final approval and implementation by July 2018. After that, the D-SIBs will update their recovery plans annually. The Supervision Department will assess the recovery plans and will share this content with the Resolution Department.

32. The BCB has detailed the components of the recovery plans in regulation. In their plans, banks have been asked to identify (i) critical functions, (ii) a monitoring program, (iii) stress scenarios, (iv) recovery strategies, and (v) governance mechanisms:

- *Critical functions.* These may include critical lending facilities, special financial services, any clearing activities, and other services that, if interrupted, will cause contagion. Banks are also including critical services such as IT and risk management functions.

- *Monitoring program.* Banks must develop both qualitative and quantitative indicators to monitor financial developments of the bank. For each indicator, banks identify the triggers for taking actions (an alert for preliminary actions and critical level for more aggressive recovery actions).

- *Stress scenarios.* Based on inputs on stress scenarios from the BCB, banks run two types of stress tests: one for idiosyncratic events and one for market-related or systemic shocks. The BCB then analyses both the individual results and conducts a peer analysis to identify system-wide weaknesses.

- *Recovery scenarios.* Banks are to identify the range of actions they will take to restore capital and liquidity or confront unexpected shocks. Measures could include a wide range of actions including asset sales and expenditure reduction including branch closures. Subsidiaries of international banks are not to assume financial support from the parent in their recovery scenarios.

- *Governance mechanisms.* Banks are asked to describe the internal governance arrangements for implementing the recovery mechanisms. The objective is to show who will do each action and ensure they have the necessary authority and tools to carry out the measures. For example, who has the legal power to sell assets and what steps will need to be taken by the bank to affect the sale?

33. The Draft Law would strengthen the framework for resolution planning. Resolution plans are currently based on the existing resolution framework but will be modified in light of the

Draft Law, which will have a wider range of instruments to be considered in the plans. The Draft Law would provide for resolution planning requirements, under the responsibility of the supervisory authority. These plans will be developed jointly between the supervisory and resolution departments, based on information provided by the banks but under the responsibility of the BCB. Currently, plans are being developed for banking conglomerates that are domestically systemically important. The first round of resolution plans is due in mid-2018.

34. The Draft Law also requires the BCB to assess the effectiveness of the resolution planning for systemically important banks. These resolvability assessments review the feasibility of the resolution of the institution and identify any impediments to effective resolution. One element of this approach is for the authorities to determine broad strategic approaches to resolution and to identify obstacles to a resolution. While designed for assessing resolvability of D-SIBs, the BCB could benefit from assessing the resolvability also of large or medium-sized banks that are subject to RRPs. Additionally, the authorities could benefit from extending some form of RRP requirements (notably for recovery planning) to non-systemic institutions, in line with other jurisdictions. While such plans would necessarily be narrower and tailored to the conditions of the banks, resolution authorities could benefit from such a framework for any bank in distress. At the same time, for the purposes of resolution planning requirements, the definition of systemic institutions should be interpreted with sufficient flexibility to encompass within such requirements also medium-sized banks, as appropriate.

35. The Resolution Department has the responsibility for both developing the resolution plans and the resolvability assessments. Work on resolvability assessments has yet to be initiated. In part, the current work is hampered by the lack of instruments included in the pending resolution reform. At the same time, the Resolution Department has been focusing on completing the resolution plans for the five D-SIBs.

36. The BCB conducts stress tests to determine the vulnerabilities of the financial system. It conducts a number of shocks including foreign exchange and credit shocks, as well as shocks to liquidity, NPL, funding, and total capital ratio. The results are presented at the joint regulators forum (COROMEC) and the BCB uses the results to identify potential weaknesses in the financial system. Those results are also used by the Supervisory Department in their bank supervision activities.

37. In 2017, a crisis simulation was conducted by the BCB to test the coordination within the BCB and among safety net players. That simulation tested the new "Contingency Plan for Confronting Financial Crises". The objective of the plan is to prepare the BCB to act quickly and in a coordinated fashion when facing a financial crisis. The plan identifies actions that may be taken, with a special focus on policy development within the BCB and coordinating actions across different areas within the BCB, with other national entities, and with international authorities. FGC and FGCoop, although part of the safety net, have not taken part in such tests. The broader rationale for this is that both institutions are private associations and are not part of the public sector.

Assessment

38. The RRPs provide important information for the supervisors. The scope for RRPs should be extended to include most banks in the system. However, not all banks need to complete the full RRPs. Small and medium sized banks could provide information on balance sheets items, governance, and basic operations with fewer and simpler stress tests. As the banks become more complex, fuller RRPs could be required.

39. Currently banks are strictly following the structure outlined in the BCB regulations. However, banks have very different structures and different business models. Not all business plans will necessarily fit into the standard framework. More flexibility, together with some proportionality concerning requirements, could make the RRPs more useful.

40. While the RRPs provide insights into the resolvability of the banks, there is a potential for correlation among the measures included in recovery plans. Banks may have similar recovery strategies (selling branches or other assets). If all banks follow the same strategy, however, implementation may be hampered. If all banks have similar strategies, and there is a system-wide disturbance, the plans may not be fully effective. Some analysis would be warranted on the extent to which strategies overlap and, if it were significant, modifications of the plans would be in order.

41. Considerable progress has been made in running crisis simulation and testing of BCB mechanisms. Lessons have been learned and those lessons incorporated in BCB operations. The simulations have focused, however, on the BCB. Such crisis preparedness efforts could be expanded to include inter-agency crisis simulations. Such simulations should include all safety net regulators and the MoF. There is benefit of running such inter-agency simulations on a regular basis as both personnel and operating conditions evolve. Annual tests could be run either on specific operations of the BCB or addressing information sharing and policy development across institutions.

Recommendations

- The regulations requiring RRPs could be expanded to include (notably for recovery planning) all banks in the system. At the same time, for the purposes of resolution planning requirements, the definition of systemic institutions should be interpreted with sufficient flexibility to encompass within such requirements also medium-sized banks, as appropriate.
- The BCB could urge banks to tailor their recovery plans to match more clearly the bank's structure.
- The BCB should carefully analyse all the recovery plans together looking for correlation among measures.
- The BCB should undertake a formal program for inter-agency crisis simulations and exercises.

C. Cross-Border Coordination

42. The BCB is both home and host supervisor for several cross-border institutions. As such, it has developed a web of arrangements and coordinating mechanisms to exchange information and share analysis of financial conditions.

- *The BCB is the host supervisor for a subsidiary of a G-SIB (Santander).* However, resolution of the holding company will be conducted using a multiple point of entry resolution strategy, leaving the BCB also as home resolution authority for the subsidiary. In this role, the BCB has agreed to Cross-border Cooperation Agreements (CoAg) with authorities from EU, Spain and the United Kingdom concerning the Santander Group. This CoAg sets out how members cooperate, both during normal periods and in times of crisis. The CoAg would guide the resolvability, recovery, or resolution of Santander.

- *BCB is host supervisor for six other international SIBs.* It participates in the supervisory colleges for Credit Suisse; UBS, Deutsche Bank, JP Morgan Chase, Citibank, and Rabobank.

- *The BCB is a home supervisor for the two cross-border domestic banks.* It is supervisor for Banco do Brasil and Itaú-Unibanco. Those institutions have some cross-border activities and have the largest international presence among Brazilian banks. The BCB hosts the supervisory college meetings of these two institutions. However, as Banco do Brasil has concentrated on domestic operations, reducing its international presence, the BCB has temporarily suspended its supervisory college.

43. Information sharing poses an obstacle to cross-border cooperation. The BCB has MoUs with relevant jurisdictions to address this issue. These MoUs, however, are bilateral and can limit the effectiveness of the colleges if participants have different components in their MoU. The BCB is in the process of standardizing the MoUs of all members of their supervisory colleges.

44. Progress is being made on extending MoUs. The BCB has MoUs with supervisory authorities from countries where Brazilian banks have foreign operations (host authorities) and those where foreign banks have operations in Brazil. These MoUs aim at facilitating information flows and to allow on-site examinations of subsidiaries (Cayman Islands, Germany, Indonesia, Mexico, Panama, Paraguay, Portugal, Spain, and the United States and Uruguay). However, most of them focus on exchange of supervisory information. As the review of MoU with the most relevant jurisdictions is underway, consideration should be given to expanding their scope to include exchanging information on early warning of problems and on resolution planning.

Recommendation

- Ensure that the review of the supervisory MoUs, currently underway, include the exchange of information on resolution plans.

D. Emergency Liquidity Assistance

45. The regime for emergency liquidity assistance ("ELA") by the BCB is framed within the BCB general authority to provide loans and rediscount operations. The BCB is authorized to perform these operations under Law 4,595 of 1964, which also provides the CMN with the authority to regulate their limits, terms, and other conditions. The Fiscal Responsibility Law ("FRL") prohibits the use of public funds to rescue or seek the recovery of financial institutions, but carves out from this prohibition BCB's discount window operations and loans with maturities of less than 360 days. [11]

46. During the global financial crisis, the authorities sought to ensure the existence of adequate liquidity in the financial system also by revising the ELA framework. Law 11,882 of 2008 has set out the collateral policies for loans and rediscount operations of the central bank, by allowing the BCB to accept security interest on real property and personal guarantees and by authorizing the CMN to set criteria for the acceptance and assessment of assets regarding rediscount operations in national currency and loans in foreign currency.

47. The BCB has a wide margin of flexibility with respect to its decision to give ELA and to the assessment of the relevant conditions. Eligible counterparties for ELA are banking institutions. The required collateral is determined based on credit risk scores of debtors of securities and loans that are maintained in the BCB credit information system (SCR), and non-marketable assets can also be accepted as collateral. Haircuts apply in accordance with a pre-determined schedule that is based on the types of assets accepted as collateral and on the credit scores. No explicit solvency test of the recipient institution is in place, and in its determination the BCB will consider the consequences for financial stability if ELA is not disbursed. A penalty rate applies, with a steeper charge for operations longer than 90 days. Lastly, the decision to give ELA is discretionary and is taken by the Deputy Governor for monetary policy (when the maturity of the operation is 15 days or lower) or by the Board of Governors (in all other cases).

48. The BCB is accountable to Congress, ex post, for the ELA provided. The BCB is required to submit to the National Congress, at the end of each quarter, a report setting out the total outstanding amount of rediscount operations and loans, the general terms of these transactions, information detailing their performing and non-performing status, as well as a statement about the impact on the BCB financial condition. The BCB Governor must present the findings in congressional hearings. While these reporting requirements appear to be for aggregated amounts only, consideration should be given to mechanisms to delay or maintain confidential such reports in the event that public disclosure of ELA operations could undermine confidence in the banking system.

49. Safeguards for BCB's creditor position are in place. The law provides that, in case of default, the BCB may alienate, through public offer, assets that secured loans or rediscount operations, and that the alienation will not be obstructed by intervention, judicial recovery, liquidation, bankruptcy, or civil insolvency proceedings. These assets will not be part of the estate of the defaulting entity. Moreover, intervention, liquidation, or bankruptcy shall not affect the BCB

[11] Complementary Law 101 of 4 May 2000.

claims arising from rediscount operations or loans. In the authorities' interpretation, these provisions give a super-priority creditor status to the BCB, whose claims do not become part of the insolvency proceeding.

50. The Draft Law contains a very general provision on ELA. The BCB would be authorized to provide loans and to enter into rediscount operations with financial institutions for the provision of liquidity, including with entities subject to a stabilization regime. In the authorities' intention, the BCB should be able to provide liquidity to the FGC, as owner of the deposit insurance fund and of the resolution fund, as well as to central clearing counterparties.

51. The BCB has not granted ELA in recent times. Ordinary liquidity operations are conducted through the discount window facility of the central bank, on an overnight or intra-day basis. On the other hand, no ELA has been granted over the last years. As a matter of fact, the role of lender of last resort in favor of troubled institution has been provided by FGC, including recently in the case of the financial assistance to a systemic institution, BTG Pactual. (See III.C Section on Deposit Insurance). This shift of a quasi-form of ELA to a privately-owned FGC reflects several factors including (i) concerns about lack of legal protection in the public sector, and (ii) the preference of the banks to borrow from the industry in order to avoid the reputational issues connected with borrowing funds from BCB, and (iii) avoid triggering enhanced supervisory actions.

Assessment

52. In reviewing specific rules and procedures for ELA, it is important to retain flexibility. Currently, the BCB has wide discretion to give ELA and to determine its rules and conditions. This can give to the central bank adequate assurances that it can perform its lender-of-last resort role as appropriate under the relevant circumstances. Nonetheless, the provision of the Draft Law on the ELA appears very broad as it does not include any general principles (e.g. on collateral or a solvency test) to safeguard the central bank. Specific criteria implementing these safeguards could be spelled out in the BCB regulations.

53. ELA should be subject to a solvency test that is tied to a remedial plan and to restructuring measures. The rules could be revised to specify that the ELA can be provided only to viable but illiquid institutions. At the same time, when a bank receives ELA, it should always be required to submit a remedial action plan and be subject to enhanced supervision. Plans should be revisited on an ongoing basis, with detailed measures and benchmarks. In periods of financial turmoil, medium-term, forward looking viability assessments with agreed restructuring measures might be necessary. Repetitive borrowing from the central bank should represent a red flag and may prompt resolution processes.

54. When systemic circumstances are at stake, the BCB could provide ELA but under adequate safeguards. In these circumstances, assets prices are volatile, collateral values difficult to establish and it may become difficult to distinguish between solvent and insolvent institutions. The BCB may not have sufficient assurances that the potential ELA recipient will be able to repay, but it

could view the disbursement as necessary for financial stability reasons. In these cases, the BCB should ensure that there is a time-bound, qualitative restructuring program that results in a solvent institution within a short period of time (3-6 months) and that the institution is viable in the medium run. In addition, in systemic circumstances when solvency or viability is in doubt or the quality of the collateral unclear, the BCB should seek a guarantee from the government, and be indemnified against the losses incurred possibly, this may be provided in the context of the envisaged amendments to the FRL that would be made in the Draft Law. While the authorities believe that the MoF obligation to recapitalize the central bank is an adequate protection, an explicit indemnity for ELA losses allows for faster support for the BCB and enhance its credibility. It also places the decisions making on the possible liquidity support and resolution of institutions in systemic cases in the remit, within their respective responsibilities, of both the BCB and the MoF.

55. The decision-making process should be formalized, by leaving the decision on general ELA policies to the Board. The rules should specify the roles of the various departments (supervision, monetary policy, and resolution) and of the responsible deputy governors in the decision-making process that leads to the disbursement, the procedures to be followed, and the documentation to be examined. Rules and procedures on the decision-making process should aim at reconciling any possible divergent view within the central bank on the condition of the bank and on the merits of disbursing the ELA. For reasons of expediency, consideration could be given to leaving the decision on the specific ELA disbursement to the Governor.

56. Preparedness can be enhanced. As ELA has not been given by the central bank in recent times, it is crucial to review the BCB's rules and procedures in this area, lest the BCB be unprepared when difficult circumstances materialize. This would entail reviewing templates, processes, standard contracts, as well as collateral requirements and procedures for the prompt assessment of the collateral.

57. The liquidity assistance is a core part of the BCB mandate and it should not be the responsibility of private agencies. As mentioned under Section III.C, the role of the lender-of-last resort function has been performed by the FGC in recent times. While this approach has functioned so far, it poses challenges and sets the wrong incentives. It raises the concern that confidential information could leak to the market. Moreover, the private sector may be unwilling or not able to contribute to resolving liquidity problems in large or systemic institutions. Maintaining this system, therefore, could undermine the functioning of the safety net. The FGC is not equipped to analyze appropriately and monitor its clients and does not have a perspective on the viability of banks. Concerns about the exposure of the BCB to risks and litigation for a decision to give ELA can be addressed by reviewing rules and procedures of the central bank, and ensuring that processes are properly followed when ELA is disbursed. In addition, the strengthening of the legal protection regime will be key, as it can provide reasonable assurances to the BCB when the difficult decision of disbursing ELA has to be made. Returning the ELA function to the BCB should be a high priority. The possible distortion caused by leaving that function in the private sector could undermine the strength of the banking system. Efforts should be made to adopt the necessary policies so that the ELA function shifts back to the BCB.

Recommendations

- Revise the ELA framework to provide for a solvency test that is tied to enhanced supervision, remedial plans, and possibly restructuring measures;
- Allow for the provision of the ELA in systemic circumstances, when the BCB has concerns about the viability of the recipient institution or the quality of the collateral, upon a MoF indemnity;
- Establish the decision-making process for the disbursement, by clarifying the roles of the various BCB departments and deputy governors, through a circular of the Board; and
- Enhance preparedness and test ELA against the BCB's current rules and procedures.

RESOLUTION FRAMEWORK AND FUNDING MECHANISMS

A. Resolution Powers[12]

Current System

58. Currently, Brazil's resolution framework consists of different proceedings: temporary administration, extra-judicial liquidation, and intervention, while bankruptcy is led by the courts. The main features of these proceedings—as set out under law 6024 of 1974, decree law 2321 of 1987 and law 9447 of 1997—are as follows.

- *Temporary special administration (RAET)*. Upon issuance by the BCB of a temporary special administration decree, the bank's managers and members of the audit committee are replaced by a directors' council appointed by the BCB, with full management powers over the ordinary course of business of the institution. The bank under RAET remains operational. Further to a proposal of the directors' council, the BCB may (i) authorize the merger, spin-off or transfer of the shareholding control of the institution; (ii) propose the expropriation, for reasons of public interest, of the shares of the institution, which would be taken over by the state against a contribution that is determined based on the balance sheet of the institution, prepared by the directors' council; or (iii) initiate the extra-judicial liquidation of the institution. Under the decree law of 1974, the BCB is authorized to use the monetary reserve fund— which is set up as part of the central bank activity— to remedy the financial condition of the institution. However, this provision has not been used recently.

[12] As mentioned in the introductory section, the authorities are embarking on a major reform of the resolution regime. This section of the TN heavily focuses therefore on the envisaged reform, as the Draft Law is still under discussion. However, to give appropriate context and background, an analysis of the current resolution framework is also provided.

- *Extra-judicial liquidation*. The BCB is empowered to conduct an extra-judicial liquidation by appointing a liquidator that will manage the institution, establish the value of creditor's claims, and sell assets, with BCB authorization, through public auction. Liquidation triggers the payout to insured depositors and will result in the suspension of the enforcement proceedings against the liquidated institution and in the acceleration of its obligations. The acts of the liquidator can be appealed before the BCB. The law also authorizes the liquidator, upon prior authorization of the BCB and for the purposes of protecting the public economy and private savings, to alienate the institution's properties, settle its liabilities, and assign the assets to a third party, in order to ensure the general or partial continuity of the business of the institution. However, this provision has not been applied, due to, among things, concerns regarding the possible exposure of the BCB and of the liquidator to legal risks.

- *Intervention.* The BCB can appoint an interventor with full management powers, for a period of six months which can be extended for no longer than six additional months. Intervention triggers depositors' payouts and the suspension of the enforcement of matured liabilities against the bank. The interventor can dispose of the assets or encumber them upon the BCB's authorization. However, intervention has not been applied in recent times by the BCB.

59. Court-led bankruptcy and ordinary liquidation are two other frequently used proceedings for banks, often as a subsequent step to extra-judicial liquidation. RAET or intervention may cease if, among other reasons, extra-judicial liquidation is decreed. In turn, the BCB may authorize the liquidator to file for the bankruptcy of the institution, when its assets are not sufficient to cover at least half of the value of the non-privileged credits or when there are indications of bankruptcy crimes. Extra-judicial liquidation or intervention can also be converted into ordinary liquidation, conducted under shareholders' control, in the existence of assurances to the satisfaction of the General Creditor's Meeting about the continuity of the institution. This is a route often preferred by the authorities, as it is viewed as an amicable way to settle claims, in contrast to the litigious and resource-intensive process of liquidation.

60. The triggers for RAET, intervention, and extra-judicial liquidation are very broad and qualitative in nature. The BCB can initiate these proceedings under a variety of circumstances, such as repeated infractions to banking legislation, existence of covered liabilities, losses submitted by the entity which put creditors at risk, engendered financial and economic situation.[13] While these triggers would allow the BCB to step in at an early stage, they are not specifically based on an assessment of non-viability (or likelihood thereof) of a bank, relating to solvency or liquidity grounds.

61. The current framework provides for some general transfer powers. A general provision of law 9447 of 1997 (Article 6) authorizes the temporary special administrator, liquidator and interventor, in order to protect the public economy and the interests of depositors and investors, to:

[13] For a detailed description of these triggers for each of the three proceedings, see "Safety Net, Bank Resolution, and Crisis Management Framework", IMF Technical Note, Financial Sector Assessment Program—Brazil, 2012.

(i) transfer assets, rights and liabilities of the company or of its businesses, individually or together, to other entities; (ii) assign assets and rights to third parties and agree with the assumption of its liabilities by other societies; and (iii) work on the constitution or on the reorganization of an entity or entities to which the assets, rights, and liabilities of the institution submitted to intervention, extra-judicial liquidation, or RAET shall be transferred, partially or as a whole, in order to permit the general or partial continuity of its business. It is not clear, however, if any requirement for creditors or shareholders' consent to perform these acts is overridden.

62. Other features of modern resolution regimes are not contemplated. The current framework does not provide for a number of features that are recommended by the FSB KAs, such as the "no-creditor worse off than in liquidation" safeguard, stays from early termination rights, and the principle of departure from *pari passu* treatment of creditors belonging to the same class, under certain circumstances.[14]

63. Over the last five years, extra-judicial liquidation has been, out of the three proceedings described above, the only one applied. RAET and intervention have remained unused, except for one bank—Banco Cruzeiro do Sul—which was briefly put under temporary special administration and was then subject to extra-judicial liquidation. On the other hand, the BCB commenced extra-judicial liquidation processes over six institutions, none of which was deemed systemic. While three proceedings are ongoing, the other three liquidations have been converted into either bankruptcy or ordinary liquidations conducted by shareholders. Typically, the overall proceeding is lengthy, with very low asset recovery rates, and litigation protracted. When the liquidator applies for bankruptcy, the relevant proceeding is often left in a limbo, in that the bankruptcy judge may not formally start the review of the file, and the extra-judicial liquidation is not yet formally closed. (See Box 2 on recent cases of bank failures).

64. A strict liability regime over controlling shareholders and management of a failed institution is in force. Persons or legal entities having a control relationship with the institutions subject to RAET, intervention, or extra-judicial liquidation are jointly liable with the managers for the institution's liabilities. Their property is unalienable and cannot be encumbered until the relevant proceeding is concluded and their responsibility ascertained by the court. This prohibition may be extended to those who have acquired assets from managers when this occurred with the intent of avoiding liability. An objective test for liability applies, whether or not fraud or negligence has been established. Controlling shareholders are liable only for the uncovered liabilities of the institution.

[14] See KAs 4 and 5.

Box 2. Recent Liquidation Cases

Over the last five years, six banks were subject to liquidation.

Name	*Initial date*	*Closing Date*	*Duration*
Banco Cruzeiro do Sul S.A.	04/Jun/2012	03/Sep/2015	39.5 months
Banco Prosper S.A.	14/Sep/2012	06/Jan/2016	40.3 months
Banco Bva S.A.	19/Oct/2012	15/Oct/2014	24.2 months
Banco Rural S.A. (conglomerate)	02/Aug/2013	Ongoing	Ongoing
Banco Brj S.A.[1]	13/Aug/2015	Ongoing	Ongoing
Banco Azteca do Brasil S.A.	08/Jan/2016	Ongoing	Ongoing

1 – BRJ filed for bankruptcy but the liquidation hasn't been closed by BCB yet.

Selected issues of interest on these cases include the following.

Banco Cruzeiro do Sul. The BCB initiated a RAET not only with respect to the bank, but also to the holding company and other group companies. During the RAET, the FGC attempted to negotiate a market solution for the sale of the institution, but this was not possible. The bank was put under liquidation due to a number of serious irregularities found in inspecting its books, and investigations have been ongoing with respect to its shareholders and directors.

Banco BVA. Certain depositors have filed a lawsuit claiming that FGC should pay to them a higher coverage based on the new rules on depositor protection which were passed after the commencement of the extra-judicial liquidation (that is, the trigger for depositor payout).

Banco Rural. A regional court suspended payments by FGC in favor of insured depositors for more than two months, claiming that employees should have priority over depositors.

65. **The courts provide *ex post* review over BCB resolution actions.** As a resolution decision is taken by the BCB Board, it can be challenged before federal courts, with the superior court of justice being the last instance. Other acts (for instance, of the liquidator) can be challenged before state courts, although in such case the BCB has to be summoned as an interested party and can request that the lawsuit be heard only by the federal courts. Competent courts can, at least in principle, overturn the decision, and may also suspend the resolution action while judicial review is pending. In general, federal courts where a challenge against BCB resolution decisions is filed tend not to enter into the merits of such decisions, as the principle of deference to specialized regulatory agencies is well established in judicial practice and in the literature.

Envisaged Reforms

66. **The Draft Law overhauls Brazil's resolution framework, by introducing two different proceedings: stabilization and compulsory liquidation.** The objectives of the new resolution framework are, among others, to preserve the public interest and the continuity of critical functions. If BCB decides to initiate a stabilization regime, it appoints an administrator (a legal entity or a board of officers), with full management powers and responsibility to execute the resolution strategy determined by the BCB. If, on the other hand, the BCB initiates a compulsory liquidation, it appoints a liquidator (an individual or a legal entity) with full powers to manage and liquidate the failed firm. In both cases, shareholders' rights are suspended and taken over by the BCB as resolution authority.

These two regimes would replace the RAET, intervention, and extra-judicial liquidation, but court-led bankruptcy processes for banks would remain in place. The BCB would be authorized to resolve all financial institutions licensed by it, including state-owned banks (see Box 3).

Box 3. Adapting the Design of Resolution to State-Owned Banks—General Considerations

State-owned banks play a major role in Brazil's financial sector and economy. State-owned banks account for 40 percent of banking sector's assets and have aggregate liabilities of R$3,561 billion (57 percent of 2016 GDP), 95 percent of which is owed by Banco do Brasil, Caixa Econômica Federal, and BNDES (respectively the first, second, and fourth largest banks in Brazil by liabilities). Not only they conduct a commercial activity (and, in the case of Banco do Brasil and Caixa, deposit-taking), but they also perform a policy function in credit supply and in conducting government policies.

There is a strong argument that state-owned banks should be subject to the same resolution regime as commercial banks—their competitors. From the point of view of competition, having state-owned banks subject to the same framework as any other commercial bank contributes to put both kind of institutions on a level playing field. It is also in the public interest, as it may help reduce fiscal and financial risks. Indeed, in principle, state-owned banks would be subject to market discipline mechanisms and would be resolved when they are not viable.

The resolution of state-owned banks poses, however, specific challenges. As the government often guarantees, explicitly or implicitly, their liabilities, it may naturally step in to provide capital even when the institution is not viable over a medium-term horizon. If the law establishes the public bank as fully government-owned on a permanent basis, it may be argued that the government is even required to inject equity. This may make it difficult, for instance, to conceive the application of certain resolution mechanisms such as bail-in through debt-to-equity conversion, which may change the ownership structure of the institution. Nevertheless, it is possible that resolution mechanisms are applied to public banks. For instance, a transfer to a bridge bank would allow to re-establish a clean balance sheet by removing off-balance sheet exposures. More in general, in designing a resolution regime for public banks the following issues are relevant.

- *Recovery and resolution planning*. Requiring state-owned banks to prepare recovery plans and to provide input to resolution plans allows to examine on an ongoing basis the viability of the bank, its risk profile and balance sheet structure, the complexity of the group, and to take appropriate action.

- *Autonomy*. It is more likely that supervisory and resolution authorities would take action to intervene early and to deploy appropriate restructuring and resolution mechanisms when they have a high degree of operational autonomy.

- *Restructurings*. The injection of public money into a state-owned bank whose viability is in doubt should be subject to constraints and safeguards. The injection must be accompanied by a restructuring plan that puts the bank back on a sound track, or allows its orderly wind-down. The law could explicitly require these conditions, given that in the case of public support to state-owned banks it would be more difficult to have mechanisms for *ex post* recovery from the industry.

67. As the triggers for stabilization and compulsory liquidation are the same, the BCB has a wide discretion to opt for either regime. Resolution can be activated by the BCB when an institution is not viable, or likely not to be viable, that is, among other things, when it (i) is insolvent; (ii) has insufficient liquidity; (iii) is failing to observe regulatory requirements; and (iv) is exposed to risks, or has incurred in losses that may compromise its regular functioning. Once it determines that any of these triggers are met, the BCB may initiate the proceeding—stabilization or compulsory liquidation—that it considers best suited to the objectives of the resolution regime.

68. Stabilization and compulsory liquidation produce different effects, as the former is aimed at preserving the continuity of the firm under resolution. The approach taken by the authorities in the reform is as follows.

- *Stabilization.* Stabilization suspends, for two business days, the contractual clauses that provide for the early maturity of the institution's obligations, the cancellation of its service agreements, or its exclusion from access to in financial market infrastructures. These clauses will no longer be applicable when the institution has been recapitalized (e.g. in a bail-in) or the relevant contracts have been transferred to another firm. The BCB may order the temporary suspension, for up to two business days, of the maturity of the institution's obligations, including deposits and investment and except in certain cases (obligations with the central bank and financial market infrastructures, "offsetting of derivatives" which shall be called upon). Debts and claims of the institution under stabilization shall be offset, and the trading of its publicly listed securities automatically suspended.

- *Compulsory liquidation.* The commencement of compulsory liquidation shall produce certain effects that are typical of insolvency proceedings, such as the acceleration of the institution's obligations and the suspension of enforcement actions by creditors against the institution's assets.

69. Stabilization measures include a range of options. When a stabilization decree is issued by the BCB, the administrator hires an appraiser to assess the market value of the assets and liabilities of the institution. The BCB may then order the administrator to take any of the following measures: (i) the transfer of assets, entitlements, and obligations of the institution, individually or as a pool; and (ii) the formation of subsidiaries, corporate reorganizations, or the spin-off of the firm under resolution. The transfer shall include only the assets, rights, and obligations specified in the relevant agreements, and shall not automatically entail the assignment or assumption of other assets or liabilities not included therein, such as those deriving from tax or labor laws.[15] The acquiring party shall be entitled to terminate, within twelve months from the transfer, the obligations assumed. In addition, the Draft Law provides that transfer arrangements shall include mechanisms to ensure their "economic and financial equilibrium", taking into account that certain liabilities would be not transferred. The exact meaning of this provision is, however, unclear.

[15] The mandatory transfer of tax and employment liabilities was identified as an impediment to an effective purchase and assumption transaction in the technical note prepared for the previous FSAP (see footnote 13).

70. The Draft Law introduces two important tools - bail-in and bridge bank powers. The authorities intend to broaden the resolution toolkit available to them with two important powers.

- *Bail-in*. The BCB would be empowered to convert certain categories of debt into equity. After full losses are allocated to equity, claims of controlling entities and former directors, and subordinated debt, bail-in would be applied to senior, unsecured debt as well. For the purposes of conversion, the value of the instruments subject to bail-in must be based on their book value. Certain liabilities are automatically excluded from bail-in, including insured deposits, financial instruments held under custody, claims of legal entities under domestic public law, and secured claims. In addition, the BCB can exclude from bail-in other liabilities upon certain grounds (e.g., risks to financial stability).[16]

- *Bridge banks.* The Draft Law provides that assets and liabilities of resolved entities may be transferred to bridge banks ("transitional financial institutions"), which would be owned by the FGC (in its capacity as manager of the resolution fund), with management appointed by the BCB. Bridge banks would be established as shell entities under the private control of the FGC and would not be allowed to engage in any financial activity until they are activated in the context of a resolution process.

71. The Draft Law introduces, although only in the case of bail-in, the "no-creditor worse off than in liquidation" safeguard (NCWOL), while it is not fully clear if it also allows to depart from the *pari passu* treatment. The BCB shall compensate creditors if the amount they would have received in liquidation is higher than what they have received as a consequence of the conversion of their claim into equity in a bail-in. The compensation will be paid by the resolution fund if the firm under resolution is a member of the resolution fund—which would be always the case in the authorities' intention. The compensation will be determined based on a report assessing the market value of the institution's assets and liabilities. The Draft Law also provides that, in the context of a bail-in or for the purposes of other stabilization tools, the contractual clauses that impose to treat creditors of the same class in an equal manner can be disregarded. While this provision may arguably allow to depart from the *pari passu* treatment, it is not fully clear whether it allows to do so in all relevant circumstances and with adequate legal certainty.

72. In compulsory liquidation, the liquidator conducts the activities typical of liquidation processes, although its powers to transfer assets and liabilities are not fully clear. The liquidator overseen by the BCB disposes of the assets of the failed institution and verifies and satisfies liabilities. A council of creditors provide its opinions on proposed settlements and debt reliefs, oversees the activities of the liquidator, and examine its accounts. The BCB may order the

[16] The authorities conveyed that, during the stabilization regime, all voting rights would be suspended. Any shareholder that acquires a controlling interest on the institution, via bail-in or through other means, will only be able to exercise the related voting rights after the regime is lifted. It is BCB's intention to establish, in secondary legislation, that the approval of the new shareholder must be decided before the regime is lifted, so as to ensure compliance with the Basel Core Principles for Effective Banking Supervision.

(continued)

liquidator to transfer assets of the liquidated institution to an investment fund, for the purposes of managing the portfolio of assets and refunding the proceeds to the shareholders. The BCB, as resolution authority, can advance funds to the liquidated institution, to cover essential expenditures. While it is understood that compulsory liquidation would trigger depositors' payouts by the FGC, it is not fully clear if under the Draft Law the liquidator can transfer assets and liabilities (other than insured deposits) in bulk, and if so, whether any procedural step is required.[17] When the BCB detects liabilities not covered by the assets of the institution subject to compulsory liquidation, it may require the liquidator to file for bankruptcy.

73. The Draft Law does not change creditor hierarchy rules, although the authorities' position does not seem to have been yet settled. As mentioned above, the Draft Law exempts insured deposits and FGC claims from bail-in. However, it does not introduce any change to the general creditor hierarchy rules in insolvency, by retaining insured depositors under the same status as unsecured creditors. It is worth noting though that in a previous version of the Draft Law depositor preference was explicitly provided for.

74. Under the Draft Law, judicial powers to suspend resolution actions would be significantly curtailed. The Draft Law prohibits that the decision to adopt a resolution be suspended or that a provisional measure be granted by the court. Moreover, judicial decisions of first instance (i.e., where cases are heard for the first time) affecting acts undertaken by the BCB shall have effect only after being confirmed by a court of second instance (where cases are heard in case of appeal). It is understood that this provision refers to the case where the court rules that the act of the resolution authority is not valid. The authorities consider that a provision stating that the court may not reverse resolution measures but only award damages would be legally problematic, and point out that, in any event, the possibility of reversal would be remote.[18]

Assessment

75. There is recognition that the existing resolution framework is not in line with international standards and must be revised. The current framework cannot ensure the exercise of speedy and effective resolution powers, posing the authorities with the alternative between a temporary administration, which does not clearly impose losses on shareholders, and a liquidation proceeding, which can be lengthy and costly. Nor does it seem that the general resolution powers available to the authorities can be promptly operationalized—as a matter of fact, they have not been applied in recent times. These shortcomings are broadly acknowledged by the BCB, whose efforts to vigorously move forward the resolution agenda over the last years, in spite of the challenges faced by the country, must be commended and deserve full support. For these reasons, the assessment

[17] A general provision of the Draft Law exempts the transfer of liabilities of an entity subject to a resolution regime from the required consent of creditors or other stakeholders.

[18] The relevant provisions on this matter are being revised and the authorities have designed a provision that would circumscribe judicial review to the legality of the actions taken by the resolution authority and limit the remedy to the award of damages.

and recommendations made in this section focus on the new resolution regime contemplated under the Draft Law, rather than on the features of the existing framework.

76. The resolution regime envisaged in the Draft Law represents a major improvement. The Draft Law provides a comprehensive framework, giving options to restore the financial strength and viability of troubled institutions, plan for their orderly failure, and apply a broad toolkit of resolution powers, including bail-in and bridge bank schemes. It also thoughtfully strikes to achieve a delicate balance between the preservation of public interest, by providing for the allocation of losses of failed banks to shareholders and creditors, and the objective of financial stability, by allowing for government support in exceptional circumstances. (See Section III.B and IV).

77. At the same time, the Draft Law presents issues that warrant close attention. While conceptually the features of the Draft Law are comprehensive and go in the right direction, the legal drafting is not always very clear and in certain areas is not specific or defined enough. This understandably reflects the fact that discussions on the policy design of the reform have been thorough and protracted over time. Nonetheless, uncertainties in the interpretation of the law may increase legal risks and hinder prompt resolution action of the authorities, once the BCB determines to activate the framework. Technical improvements can be made on a number of issues, to allow the authorities to act quickly and effectively. Given the importance of this reform, it is recommended that the Draft Law be closely reviewed to remove any ambiguity and to provide the authorities with a framework that is as efficient and cost-effective as possible. More specific rules could then be added in regulations or other secondary legislation.

78. There is scope for improving the design of the various proceedings for failed banks, and to ensure that the authorities are able to apply resolution powers to medium and small-sized banks, as appropriate under the circumstances. It is not fully clear when the BCB would opt for stabilization or compulsory liquidation, given that the triggers are identical. At the same time, while bankruptcy can only be activated when the BCB decides so, the existence of such an additional process may create uncertainties, particularly as it seems to overlap with extra-judicial liquidation. Nevertheless, it is understood that the BCB views extra-judicial liquidation (or, under the reform, compulsory liquidation) as a mechanism to control the orderly wind-down of a firm—something that court bankruptcy cannot be relied upon. In the design of the resolution regime, it is crucial to clarify the resolution strategy which would guide BCB action in initiating either stabilization or compulsory liquidation. The tools are very different in either case, with compulsory liquidation leading to an orderly wind-down and stabilization to some form of resolution. It is important to retain flexibility, to ensure that stabilization can apply, if appropriate, to small and medium-sized banks (e.g. through a purchase and assumption or a bridge transaction).

79. While the triggers for entry into resolution are adequately broad, they can be improved by providing for forward-looking criteria and by requiring action when the BCB determines that the relevant trigger (e.g., solvency) is met. The Draft Law refers to a number of conditions evidencing the lack of viability (or likelihood thereof) of a bank. However, these conditions do not include prospective assessments on a “likely default” or “likely breach” of a bank,

which would provide greater flexibility to intervene at an earlier stage. This kind of assessment could be provided for, to support the test on the non-viability or likely non-viability of a bank. Moreover, the Draft Law allows, but does not require the BCB to begin intervention once it determines that the triggers are met. It is important to maintain a certain degree of discretion to determine whether the triggers for resolution have been met. However, to minimize the risk of forbearance, consideration could be given to whether the provisions of the Draft Law should state that the resolution regime will be triggered automatically upon a determination that its conditions have been fulfilled. Even if the Draft Law includes such a requirement, the BCB will also have the option to adopt appropriate strategy. The selection of that strategy would have to entail, inter alia, the systemic impact of any resolution option.

80. Some specifics regarding the bail-in technique should be reviewed, to improve its effectiveness. It is worth noting the following.

- *Haircuts and other loss-absorption tools.* The Draft Law contemplates bail-in only in the form of a conversion of debt into equity and does not seem to allow the authorities to terminate or write down debt instruments (e.g., by reducing principal and/or interest amounts due on unsecured creditor claims). Nor does it seem possible to perform other actions that might also be typically included in the bail-in toolkit (e.g., overriding pre-emption rights, exchanging different types of equity and debt instruments, and issuing warrants).

- *Valuation.* The legislation should provide for a mechanism to override the book value where the BCB considers it necessary, e.g., if the BCB or an independent valuation determines that liability instruments have been incorrectly recorded on the books. Otherwise, the risk is that not sufficient losses may be absorbed, and public funds may be needed.

- *Voting rights.* It is not clear why the suspension of voting rights in case of debt-for-equity conversion until the transfer is approved by the supervisory authority would apply only for a controlling interest, and not to any significant holding (e.g. 10 percent, 20 percent of shares). Moreover, it would be appropriate to specify who would exercise voting rights (e.g. the resolution authority) and how.

81. There are limited rules on the establishment, governance, and operations of bridge banks. The Draft Law sets out the regime for bridge banks before their effective operationalization, rather than for their functioning after the transfer of assets and liabilities is made. We understand that further detail will be set out in the regulations or other secondary legislation. However, while the desire for flexibility is fully warranted, at least certain general rules should be spelled out in the primary law in the interest of legal certainty. This is even more important given that bridge banks would be owned by the FGC, that is a private association in turn owned by the banks. These rules should include general principles on the governance of the bridge banks and on the role of the authorities over its strategy and risk profile.

82. It is unclear if the resolution toolkit includes the power to establish an asset management company (AMCs). Typically, AMCs would purchase assets of the troubled bank such as non-performing loans, while the bank is restructured. A provision in the Draft Law allows the authorities to operate a spin-off, but it is not fully clear whether this would provide the legal basis to establish an AMC. As in the case of bridge banks, more specific provisions on the setup, governance and strategy of the AMC could be added in the law, while reserving details to implementing regulations.

83. It should be clarified whether the BCB would be allowed to depart from the general principle of equal treatment of creditors of the same class. In a bail-in and in other stabilization tools, the authorities can disregard the contractual clauses imposing that creditors of the same class be treated in an equal manner. This seems equivalent to a power to depart from the *pari passu* treatment, although in a limited range of cases. Consideration should be given to clarifying in the Draft Law the relevant circumstances whereby the BCB could depart from the *pari passu* treatment of creditors of the same class.[19]

84. The possibility for the acquirer of assets and liabilities to terminate, within 12 months from the acquisition, the obligations assumed in the transfer should be revisited. Leaving this power in the hands of a private sector acquirer risks leaving in a limbo the transfer of assets and liabilities, potentially severely undermining the resolution objectives. It is critical that the BCB has the authority to arrange for a transfer, whereby certain liabilities would be left behind in the shell of the liquidated institution. Mechanisms for returning assets and liabilities to the failed bank could be envisaged, but under precisely defined circumstances, a short timeframe, and the close control of the resolution authority.

85. The NCWOL safeguard should also be extended to the other resolution tools. Tools such as transfers of assets and liabilities can be used to achieve the same economic effect as bail-in (e.g., by leaving some creditors behind facing losses after transferring others of the same rank to a healthy bank or bridge institution). There is therefore no reason to apply the NCWOL only to a bail-in, and not when other tools are used.

86. It is recommended to introduce tiered depositor preference. Having general depositor preference—with insured depositors and the FGC, subrogating to their claims, ranking in the first tier, and uninsured depositors ranking in the second tier, higher than other unsecured creditors—can produce several benefits. First, it fosters financial stability as it facilitates the transfer of deposits to a healthier institution, in the context of a purchase and assumption technique or a bridge bank. Second, it may allow the FGC to obtain higher recovery rates over the estate of the failed institution. Third, by preserving the financial condition of the FGC it protects the public purse, as it seeks to avoid a depletion of deposit insurance funds, which would likely need to be replenished by the state in case of systemic crises.

[19] See KA 5.1.

87. The provisions on the evaluation over the failed bank's assets and liabilities could be improved. Requirements regarding the eligibility criteria of the evaluator (e.g., concerning its independence) and the main principles to be adopted in the evaluation could be introduced. The BCB could ensure that there is an adequate list of available evaluators who meet specific requirements and can be called upon quickly. Where appropriate to allow for swift actions, mechanisms for preliminary evaluations, with *ex post* final opinions, should be in place. More specific rules could also be adopted in implementing regulations.

88. Certain effects of the stabilization regime could be clarified. A more precise distinction could be made on the various effects triggered by the stabilization regime. For instance, it should be provided that the commencement of a stabilization regime does not entitle a counterparty to terminate a bond early. The moratorium powers to suspend payments should also be distinguished from the power to temporarily stay certain specific contracts (e.g., derivatives), and the latter power could be usefully clarified under the Draft Law. Lastly, consideration should be given to making the power to suspend the trading of the securities issued by firm under stabilization discretionary rather than automatic, and providing for adequate forms of coordination between the resolution authority and the securities regulator.

Recommendations

- Ensure that the new resolution framework—and its stabilization tools—can apply also to medium and small-sized banks, as appropriate under circumstances.
- Upon introduction of the new resolution regime, adopt a resolution strategy that would also inform the authorities' approach toward stabilization and compulsory liquidation.
- Provide for forward-looking criteria, based on the non-viability of a bank, that allow for an early and timely entry into resolution.
- Revise the provisions on the resolution toolkit available to the authorities, by broadening the options for bail-in, specifying the rules applicable for bridge bank transactions, clarifying the availability of powers to establish an AMC, and facilitating a transfer of assets and liabilities to a healthier purchaser.
- Introduce tiered depositor preference, with the first tier of preference applicable to the claims of insured depositors and of the FGC.
- Clarify safeguards available to creditors under the resolution regime and the effects of the stabilization and compulsory liquidation regime, and strengthen the rules regarding the independent evaluation of the failed bank.

B. Resolution Funding

89. Given the authorities' limited flexibility for using public funds, the FGC stepped up in providing open bank assistance in 2009. The Fiscal Responsibility Law prohibits injection of public money into failing institutions, unless a specific law is approved. The BCB will informally advise a distressed bank to seek assistance directly from FGC. FGC provides liquidity support, structural assistance programs, loans to shareholders or prospective shareholders, and acquisition of loan portfolios from troubled institutions. Typically, such support is limited to the maximum of the depositor payout that would occur in the case of liquidation (least cost).

90. The FGC provides liquidity support by guaranteeing wholesale deposits and providing direct support. Two guarantee programs are currently in place. A special guarantee (DPGE1) was introduced in 2009 for time deposits, with coverage of up to R$ 20 million per depositor per bank and R$ 5 billion in total of guaranteed deposits per bank under DPGE "Special Guarantee". DPGE 1 was provided based on BCB approval, without an independent evaluation by the FGC. The amount per bank is determined on the basis of the bank's total deposit level. No new lending has occurred through DPGE1 and the stock is being repaid on a regular schedule. The full stock is expected to be repaid by 2020. On the other hand, DPGE2 requires collateralization, and the FGC has the discretion to accept or to refuse collateral proposed by the bank. The FGC can also provide direct assistance above least costs terms in the event of a systemic threat.[20] The financial support was given to a large bank (BTG Pactual) that suffered losses when the CEO was accused of fraud (Box 4). The FGC provided the assistance with informal consent of the BCB but without adequate information on medium-term viability.

91. While the FGC has limited access to bank information, it can engage in informal discussions about troubled banks with the BCB. However, this arrangement may not be sufficient for the FGC to play an adequate role in timely intervention, especially given its role in open bank assistance. Currently, the FGC is restricted to using public data available with a 60-day lag.

92. During the past five years, the FGC has made five significant loans to four institutions (Table 2). While fully collateralized and made with the informal support of the BCB, the support was provided with limited information.

Table 2. Brazil: Recent FGC Lending to Financial Institutions

Bank	Date	Amount of Support	Purpose
Banif Brasil (Banif),	May 2015	R$ 236 million	Liquidity assistance
Banif Brasil (Banif),	End 2016	R$ 228 million	Liquidity assistance
BTG Pactual	Oct 2015	R$ 5 billion	Liquidity assistance
Banco Mercantil S/A	March 2013, 2014	R$ 375.1	Purchase of loan portfolio
Banco Gerador S/A	Dec 2014	R$ 136 million	Loan to shareholder

[20] In addition, FGC support to a single institution is limited to 25 percent of the fund's net worth and 50 percent of the fund's net worth, for the aggregate of all transactions

93. **Under the Draft Law, the FGC's open bank assistance will be complemented with a new Resolution Fund**. The FGC will manage the two funds separately but within the FGC. While the details of this funding mechanism will wait for the final passage of the resolution law and implementing regulations, some indications of likely funding sources can be identified. The current deposit guarantee fund will continue to be managed by the FGC. It will fund the payout of deposits and provide open bank assistance to medium-sized institutions, as needed. The Resolution Fund will be used by the FGC and—while the authorities are still exploring various options—it would presumably be targeted for financing the resolution of systemically important banks. It will be used to make loans or capitalize an institution under a stabilization regime. As such, resources for the fund will only be used once the shareholders have fully absorbed costs. Both failing SIBs and bridge banks can access the Resolution Fund.

Box 4. BTG Crisis

The financial difficulties of BTG Pactual in October 2015 were of high interest given the significance of the institution. BTG was the seventh largest bank of the country, with a complex decentralized structure. The bank had several business lines including investment banking, corporate lending, sales and trading, asset management, wealth management, and significant participation in companies (health sector, drugstores, credit recovery, department stores, and media group).

In November 2015, BTG Pactual's CEO and main shareholder, André Esteves, was arrested in an anti-corruption probe. As a consequence, the value of BTG stocks and bonds prices fell sharply and investors in its asset management companies began to withdraw significant amounts of deposits. BTG faced serious liquidity problems.

The FGC provided emergency liquidity assistance of R$ 5 billion. The loan was made at market rates, against collateral. The loan stabilized market perceptions, giving the bank time to sell some assets and re-establish depositor confidence. BTG repaid the loan 10 months after the assistance.

The size of the FGC's loan was higher than permitted under its internal regulations. Accordingly, the BCB confirmed to the FGC Board that the possible collapse of BTG could have been a systemic event that posed a threat to the financial stability. Evoking that exception, the FGC Board approved the emergency loan.

The BTG crisis had international implications. In 2014, BTG acquired the Swiss bank, BSI. Initially the Swiss regulatory authority, FINMA, was unable to obtain critical information on BTG's operations because there was no information sharing agreement between the two countries. That MoU was signed in May 2015 allowing the sharing non-public data. When the crisis in BTG broke out, the MoU permitted the sharing of all available information including volumes withdrawn, LCR ratios, and emergency measures to restore liquidity. Most of the information was shared through conference calls, held initially twice a week, a number that was gradually reduced as the bank's situation stabilized.

94. **An option under consideration is that the Resolution Fund will be capitalized by excess resources currently in the FGC deposit-guarantee fund**. It is estimated that the deposit insurance fund is currently near target. Once it is fully funded, industry premiums will be paid into the

Resolution Fund. Firewalls will be established between the deposit guarantee fund and the resolution fund to prevent comingling of resources. If demands on the Resolution Fund were to exceed available resource, the MoF will be able to provide emergency lending to the FGC and be subsequently repaid by the industry through their premiums.

95. As a mechanism for supporting the restructuring of a G-SIB, the authorities believe the demands on the Resolution Fund will be limited. Before the Resolution Fund can be drawn on, shareholders and subordinated debt holders will have to be wiped out, capital buffers exhausted, and eligible senior unsecured debt converted into equity. The MoF will provide any additional financing needs. The Draft Law also permits the MoF to provide such funding before senior unsecured debt is hit (but after the Resolution Fund is depleted) if, in their view, financial stability would be better preserved.

96. The new Draft Law adds an important dimension to the funding framework. The introduction of the Resolution Fund is a useful tool for resolving large, complex institution. Under the new legislation, the government can provide resources to the Resolution Fund. Such funding is possible only after shareholders and subordinated debt holders have absorbed losses and the Resolution Fund has been depleted. The government will be able to provide loans or capitalization, in the form of common or preferred shares.

Assessment

97. Currently, the funding arrangements for resolution are limited. The Fiscal Responsibility Law limits government support for resolution and the BCB is restricted in its ability to finance resolution. As a result, the financing of bank restructuring has shifted to the private sector. The FGC receives premiums from the industry and uses those resources both for the deposit guarantee and for open bank assistance.

98. The use of private institution to finance resolution raises a number of important concerns that could potentially undermine financial stability. The lack of access to information raises the possibility that weak or insolvent institutions will continue to operate without a restructuring plan guided by the BCB. In addition, while the FGC has limited information, there is a risk that whatever warnings it may receive in terms of preparing for a closure could leak to the market. As the FGC takes on more responsibility for resolution under the Draft Law, it will need timely and accurate information on the conditions of the banks. Subject to confidentiality safeguards, it should receive early warning indicators, information on any substantial supervisory enforcement measure, and early financial data on filing or likely to fail banks.

99. In the new law, the use of deposit insurance funds to finance resolution may become inefficient. Treating the resolution of systemically important banks separately from the open bank assistance and resolution for non-systemic banks may not be effective. First, continued use of the deposit insurance fund for open bank assistance, without an adequate emergency liquidity back up system, could raise depositor concerns about the solvency of the deposit insurance fund. Open-

bank assistance could deplete the fund and lead to uncertainty about the strength of the deposit insurance system. Second, the resolution functions for managing systemically important banks and non-systemic banks are similar. Having the deposit insurance fund and the resolution fund both undertake resolution raises a question of duplication of work. Tools for both could include purchase and assumption transactions, bridge banks, and even AMCs. Third, the resolution fund will be used infrequently for the resolution of systemically important banks. For that reason, the banks will raise concerns about contributing and, as the fund accumulates resources, pressures would develop to use them for other activities. Such pressures will be mitigated if the resolution fund is used for more frequent resolution activities.

100. The FGC could consolidate all resolution funding into the Resolution Fund and reserve the depositor insurance fund for reimbursing deposits either through direct payout or for financing the transfers of depositors to other viable institutions. Public confidence in the deposit insurance system will be strengthened if depositors understand that the deposit insurance fund remains for their protection. Emergency liquidity provision by the FGC should be discontinued once the BCB ELA framework has become fully operational. If solvency support is required in systemic circumstances, it should be provided from the resolution fund (subject to safeguards, such as prior dilution of existing shareholders and subordinated debt) and open bank assistance from the deposit insurance fund should be ruled out.

Recommendations

- The BCB and FGC should strengthen information sharing and related safeguards.
- The remit of the deposit insurance fund should be limited to the payout or the funding of the transfer of insured deposits in resolution processes.
- The FGC should consolidate all resolution funding into the Resolution Fund, including by allowing it to provide solvency support in systemic circumstances, subject to safeguards in the interest of taxpayers.
- Open bank assistance by the deposit insurance fund should be ruled out once the BCB ELA framework has become fully operational
- The FGC should incorporate an analysis of the medium-term viability of an institution borrowing from it.
- Finally, in the interim BCB should have to give a “no objection” to any liquidity support, even DPGE2.

C. Deposit Insurance

100. The FGC is a non-profit private association composed of financial institutions. Its function is to protect depositors and investors by guaranteeing deposits up to a maximum level and

provide open bank assistance to members. Because it is a private institution, its access to information is limited, and so is its participation in crisis preparation and management with other safety net members.

101. FGC membership becomes compulsory for all deposit-taking institutions when the license is issued. Membership is broad and include all institutions that (i) receive demand deposits, savings accounts, or time deposits; (ii) accept bills of exchange; (iii) issue real estate notes, mortgage notes, real estate letters of credit, or agribusiness letters of credit; and (iv) raise funds through repurchase operations. These institutions include Caixa Econômica, commercial banks, investment banks, development banks, credit, consumer credit and investment companies, real estate credit companies, mortgage companies, and savings and loan associations. As of the end of June 2016, the FGC had 183-member institutions.

102. The FGC provides two different kinds of guarantees to creditors of its member institutions.

- The Ordinary Guarantee, currently limited to the amount of R$ 250,000 per depositor per institution or conglomerate, covers the following instruments: demand deposits or deposits available for drawing upon notice; savings deposits; time deposits; bills of exchange; real estate notes; mortgage notes; real estate letters of credit (LCI); agribusiness letters of credit (LCA); repo deals involving securities issued after March 8, 2012.

- The Special Guarantee covers creditors holding investments in Time Deposits with Special Guarantee (*Depósito a Prazo com Garantia Especial – DPGE*) up to R$ 20 million. There are two Special Guarantee programs in place—DPGE1 and DPGE2. (For a description, see Section III.C.)

103. The FGC does not cover a number of deposits. It does not include protection for deposits, loans or funds held abroad, balances related to programs of government interest, judicial deposits, shares in investment funds, financial instruments with subordination clauses or any other credits not specified in the above list. The FGC also does not cover deposits of nonresidents in the Brazilian banking system nor deposits denominated in foreign exchange. Differential treatment of depositors can introduce distortions. However, the bylaws of the FGC are being modified and coverage will be extended to nonresident depositors.

104. Deposit coverage is high but retains scope for market discipline. Deposit coverage amounts to R$ 250,000 per depositor per institution. This coverage level fully protects 99 percent of depositors and 55 percent of the value of deposits. This level of coverage preserves financial stability but allows scope for market forces to limit moral hazard.

105. The FGC provides open bank assistance (both the special guarantee and direct assistance) to member organizations. Such assistance includes providing operating liquidity to banks, funding restructuring, and direct lending to shareholders or potential shareholders of troubled banks. Such assistance is limited by a least-cost test, which restricts transactions (i) to a

maximum that would be paid out in a liquidation, (ii) to 25 percent of the FGC's net assets per institution/conglomerate and (iii) 50 percent of the FGC's net assets. However, FGC's board can authorize transactions that exceed these limits if the Central Bank issues a document recognizing that the situation at hand is adverse and put at risk financial stability.

106. The FGC does not have the capacity to analyze bank financial conditions nor power to investigate banks to ensure the conditions for lending are met. The FGC has some in-house capacity to evaluate the financial health of banks but it does not have access to necessary information. The FGC does not have access to confidential information from BCB and therefore, cannot effectively assess financial needs or bank viability. It does not have access to supervisory assessments such as "CAMEL" ratings or on-site supervisory reports.

107. The FGC mitigates the risk of market transactions by fully collateralizing its credits. However, losses to FGC can occur in cases of bank default when the value of assets recovered may be less than the anticipated value.

108. The FGC funds activities through ex-ante premiums charged to members. Contributions are based on eligible deposits held by each institution and paid on a monthly basis. The premiums are not risk-based as the rate is identical for all institutions, regardless of their risk profile. The FGC cannot set its own premiums; it is dependent on the Monetary Council and BCB. There is significant dialogue between BCB and FGC; however, the final decision rests with BCB.

109. The FGC will soon reach its target level of 2 percent of insured deposits. As of the end of 2016, FGC had R$ 33.8 billion in immediately available funds, corresponding to 1.78 percent of the balance of eligible deposits in the financial system.

110. The FGC does not have access to emergency liquidity funding from the authorities. This lack of funding potentially could undermine the public confidence in the deposit insurance system. The FGC may ask its members for extraordinary contributions of up to 50 percent of the monthly contribution or payment in advance of up to 60 monthly contributions. It may also borrow from other financial institutions or issue negotiable credit instruments.

111. Depositor payout is slow and limited by structural impediments. The FGC takes from several weeks to several months to reimburse covered deposits largely due to delays in obtaining depositor data from the liquidator. In addition, payout is delayed because of the absence of a single customer view (SCV) While some depositors are quickly paid out, total payout can be delayed. In the case of Banco Cruzeiro (2012), for example, wholesale deposits equivalent to R$1.8 billion (379 depositors) were paid out in within 6 days the remaining R$79 million (2026 depositors) of "ordinary deposits" took the FGC two months to pay.

112. There is no formal, comprehensive framework in place for the coordination of activities and information sharing between the deposit insurer and other safety-net participants. Coordination is based on personal connections and informal meetings. The FGC does

carry out stress tests but does not participate in contingency planning activities. Greater contact is warranted at both senior and working levels to further improve crisis preparedness, communication, and management.

Assessment

113. The FGC has a number of design features that could be strengthened. The activities of the FGC are limited by the design of its operations and the data it receives. Specifically:

- FGC cannot prepare for effective evaluation of banks seeking open bank liquidity assistance because it does not receive timely financial data. Supervisory information and notification of pending supervisory actions that affect bank viability should be immediately given to FGC, subject to confidentiality safeguards

- The FGC cannot prepare for payout because it does not receive adequate deposit information in a timely manner, resulting in slow depositor payout and difficulties in evaluating the strength of borrowers. It should aim, over time, to develop the capacity to payout in 7 days following a bank's failure.

- The lack of back-up funding is a serious constraint in the ability of the FGC to maintain public confidence in its ability to ensure timely payout. Arrangements should be made with the MoF (or the BCB) for immediate and unambiguous access to emergency liquidity to fulfill its deposit payout obligations.

- Contingency plans and tests of operations are limited and could be enhanced. The lack of information undermines the analysis of risks in the banking system. Once greater information is available, the processing and analysis of such information would be important. The Draft Law should also introduce emergency back-up funding, preferably from the MoF.

- The funding framework is precarious. While the overall fund is adequate by international standards, FGC is responsible for covering a wide range of instruments outside the normal scope of a deposit insurer. In addition, its open bank assistance is set at a maximum of 50 percent of its net assets to a single borrower. Were demands on FGC exceed available resources, it has no access to emergency backup funding and must turn to the industry.

- Overall coverage of deposits is extremely wide and unusual in international comparison. This breadth of coverage increases the work of the FGC as it must monitor and analyze a wide range of deposit-like instruments and the institutions issuing them. The prohibition on covering nonresident deposits is unusual and could create adverse incentives in the financial market.

114. The approach taken in the Draft Law to maintain the FGC as a private sector association owned and managed by the banking industry, rather than converting it into a public-sector agency, raises concerns. As a private institution, the FGC has limited access to bank data and no access to supervisory reports. While there are informal mechanisms of cooperation with

the BCB, information sharing faces inherent constraints. As a result, the FGC can neither do an effective analysis of bank risks nor prepare in advance for a bank failure, which may contribute to slow depositor payout. The FGC has few means of countering incentives for supervisory forbearance as it has no formal voice in the review and oversight of weak bank. While certain confidentiality safeguards are in place and the board of the FGC cannot be composed of active bankers, the fact that its shareholders are financial institutions is problematic. Ownership by the banking industry may also not provide the appropriate incentives to act quickly if systemic risks are at hand. This arrangement can limit the effectiveness of the resolution process and lead to higher resolution costs.

115. The FGC's provision of open bank assistance is a quasi-central bank function but without central bank safeguards. Banks have automatic access to FGC financing if collateral is adequate. Weak or failing banks that might be frozen out of the market will thus be able to obtain liquidity with appropriate collateral. While effective under some circumstances, this private sector arrangement could distort the financial sector by supporting weak institutions without corresponding restructuring plans, delaying resolution and prolonging asset deterioration. The simple provision of liquidity without a solvency test or assessment of medium-term viability misses an important safeguard of such lending and should be ruled out, replaced by properly designed ELA from the central bank, with adequate safeguards. Moving the FGC into the public sector would prevent conflicts of interest, help improve the exchange of confidential information, and allow the FGC to be included in high-level crisis management committees. Even if this reform proves challenging in the short term, the FGC should seek to strengthen its loan approval mechanisms, by expanding its access to financial and supervisory data, adding financial analysis to the approval process, and requiring that the borrowing institution be reviewed in a medium-term context. Moreover, the BCB should be informed of such borrowing and mechanisms put in place to ensure that any FGC lending is not misused or used to support insolvent banks.

Recommendations

- The FGC should have access to timely, direct information for all of FGC's members, including supervisory data subject to appropriate confidentiality safeguards.

- Banks should be required to provide depositor data in SCV format.

- The FGC should be moved into the public sector—by transforming it into a fully owned public institution, performing a public interest function regulated by law – and included in high-level crisis management committees. Even if this reform proves challenging in the short term, adequate mechanisms should ensure that FGC lending does not artificially maintain the operation of weak banks without restructuring plans (including through a right of "no objection" by the BCB for any liquidity support, and by incorporating an analysis of the medium-term viability of an institution borrowing from the FGC).

- The FGC should develop a time bound plan to reduce the payout period.

- The FGC should have access to emergency liquidity support from the MoF (or the BCB) in case it is unable to meet the demands for deposit payout.
- The FGC should evaluate more completely its revenue base. Given the wide scope of its coverage, consideration could be given to expanding its revenue base.
- The FGC should have contingency plans and procedures for payout, financial assistance, and assistance to systemic banks, also to facilitate prompt transfers of insured deposits in the case of a purchase and assumption transaction. A multi-year plan could be devised outlining payout simulations using de-identified data, failure simulations, and desktop communication exercises with other safety-net organizations.
- The restriction on covering deposits of foreign residents should be removed.

CRISIS MANAGEMENT REGIME

116. BCB has a number of tools to manage systemic crises. BCB is capable of monitoring deposits runs on a daily basis and with one-day lag. Furthermore, during periods of financial stress, the BCB can conduct stress tests targeted to identify and monitor sound banks exposed to deposit runs due to flight to quality behavior.

117. The BCB's response to a systemic banking crisis differs in important ways from its treatment of individual bank failures during stable periods. In a systemic crisis, events can change rapidly, banking conditions may deteriorate quickly, information on the true condition of banks tends to be limited and often outdated, and there may be a need for some public money. For this reason, the BCB has reviewed its crisis management framework in order to improve the decision-making process and the coordination among the several stakeholders involved on a systemic crisis management.

118. For this purpose, the BCB has established a high-level policy group for managing systemic-wide crises. The group— composed of the BCB's governor and deputy governors and other internal and external relevant stakeholders— guides the decision-making process and ensures its implementation. It is supported by teams charged with the rapid collection and analysis of information and preparation of clear policy options. In stable times, COMEF meets on a regular basis to analyze risks in the system. In a crisis, the crisis management group would meet more frequently, possibly every day, to guide the analysis and the policy making decision.

119. While Brazil has several formal high-level policy bodies, they do not fully conform with the requirements for a systemic monitoring regime. The CMN— the highest regulatory authority in the Brazilian financial system— does not provide a forum for discussing and analysing broad financial issues. The BCB can, on an ad hoc basis, call meetings of financial sector authorities to facilitate coordination during stress periods, and it has done so in the past. However, such arrangements are *ad hoc* and not formalized.

120. The FRL restricts the injection of public money into troubled financial institutions. Brazil's legal framework includes a number of constraints on the use of public funds in favor of troubled firms, which are also the result of the crisis suffered in the '90s. According to the FRL, "unless provided otherwise under specific law, public funds must not be used to rescue financial institutions, even through recovery loans or financing aimed at enabling the transfer of the shareholders control."[21] The FRL also requires that the prevention of insolvency and other risks be exercised through funds and other mechanisms established by the industry. The Constitution provides that a legal entity indebted to the social welfare system may not contract with the government nor receive benefits or fiscal or credit incentives.[22] This provision is applied, for instance, when the BCB considers giving ELA and verifies that the potential recipient has no debts vis-à-vis the social welfare system.

121. The Draft Law would remove some of the impediments to public support in the context of a resolution. An exception would be introduced in the FRL, with the aim to carve out from the above-mentioned general prohibition the support given in the context of resolution processes, under the conditions set out in the law. (See Section III.B on Funding).

122. As described above, the Draft Law allows for the possibility of support for the resolution of large complex institutions. The Resolution Fund, managed by the FGC, will have the ability to fund large bank resolution. If resources from the write-down of equity and subordinated debt, capital buffers, and bail in of senior creditors is insufficient, the treasury will be able to lend to the Resolution Fund to cover the remaining resolution costs. The Treasury will be repaid by future contributions of the industry. This mechanism may be effective for individual failures but mechanisms may be needed for broader public sector support to the financial sector in a systemic crisis. The FGC could play a role but more direct lending could be required.

Assessment

123. The removal of the impediments to public support in resolution is appropriate, insofar as it is temporary, based on financial stability reasons and subject to adequate safeguards. As recognized by the international standards, resolution regimes may provide for temporary recourse to public funds, when this is necessary for financial stability and safeguards are in place to recover the costs from the industry. [23] It is therefore appropriate that the FRL is amended to provide for this possibility. At the same time, fiscal discipline – that is the underlying principle of the FRL – can be preserved by providing in the new resolution regime that the recourse to public funds is temporary, justified on financial stability reasons, and accompanied by appropriate mechanisms to allocate losses to shareholders and creditors of failed banks and to recover the costs from the industry.

[21] Article 28 of FRL.

[22] Article 195, paragraph 3.

[23] See KA 6.

124. Further analysis is required to understand the procedures and mechanisms that would allow for a prompt support of public funds in resolution. The authorities' understanding is that, when public support is needed and is confined within the budget approved by Congress, the provision of funding would take place through a presidential decree, and that no burdensome procedures for budgetary appropriation would be needed. This conclusion would however need to be confirmed, including with respect to whether different considerations apply based on the nature of the support provided (e.g., equity or loans).

125. Establishing a formal high-level crisis coordination committee would be an important step in strengthening the crisis management framework. The current structure is ad hoc in nature and not formally designed to address the broad issues that drive a systemic crisis. This group could be made more effective by establishing an effective Secretariat, capable of gathering data from a wide range of agencies and preparing policy options. Consideration could be given to using, for these purposes, COREMEC, by expanding its mandate.

126. The restrictions on public funding limit the policy tools that may be needed in a systemic crisis. The current arrangements do not permit such funding by the public sector. The new law, however, introduces that option. Procedures and policies will need to be developed, however, governing the provision of such funds as part of a crisis situation. The authorities should ensure that the mechanisms are available should multiple banks need financial support.

Recommendations

- Remove, as provided under the Draft Law, impediments to public support in resolution processes, when such support is necessary for financial stability reasons and under safeguards allowing for the recovery of the support
- Review the budgetary rules and procedures to allow prompt temporary recourse to public funds subject to the above constraints, and amend the legal framework accordingly.
- Establish a formal high-level crisis coordination committee with an effective Secretariat.
- Ensure that the emergency mechanisms for funding the resolution of a G-SIB or highly complex financial institution are developed.
- Develop contingency plans for public support in the event of a systemic crisis.

LEGAL PROTECTION

127. While the Constitution provides a general liability regime applicable to public entities (including to BCB as a resolution authority), the BCB staff is liable for acts or omissions that are willful or negligent. Under the Constitution, public legal entities are liable for damages that any of their agents cause to third parties, and will have the right of recourse against the agent in

cases of malice or fault. The party seeking damage will only have to prove a causality nexus— i.e., that the damage was caused by the action of the agent—regardless of any culpability of the agent. On the other hand, BCB staff is liable for any acts or omissions relating to resolution actions which are willful or negligent and cause damage. The BCB Governor has the status of a minister, and his/her actions can be only challenged before the superior court of justice. Interventors, temporary administrators, and liquidators are not subject to the liability regime of civil servants, but would be liable under the rules of the civil code—which also provide for a liability test based on willful default or negligence, and on the existence of damages.

128. When lawsuits are brought against them, the BCB Governor, deputy governors, and staff are represented by the BCB Legal Department. The same protection applies to those who had these positions at the time of the relevant act or omission. The BCB would cover the costs and expenses of the legal assistance.

129. Challenges against BCB officials have been rare in recent times. The authorities report very few cases of challenges against BCB officials for resolution measures, and no recent cases where damages have been awarded.

130. The Draft Law would significantly enhance the legal protection regime. The bar to ascertain liability would be raised, in that BCB officials would be liable only in case of fraud or willful misconduct. The legal protection regime would extend to the managers of the FGC, the administrators and liquidators of failed institutions, and to the management of bridge banks. The BCB—as a resolution authority—would continue to be liable according to the objective test set out in the Constitution. Given the limitations of the existing framework and the risk that fear of unjustified liability lead to inaction, it is critical that the legal protection regime is promptly enhanced.

Recommendations

- Adopt the legal protection regime provided under the Draft Law.
- Extend the legal protection regime for acts or omissions taken in support of foreign resolution measures.