



# SLOVENIA

## TECHNICAL ASSISTANCE REPORT—BANK INTERVENTION AND RESOLUTION AND THE DEPOSIT GUARANTEE SYSTEM

October 2015

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Monetary and Capital Markets Department



**SLOVENIA**

**BANK INTERVENTION AND RESOLUTION  
AND THE DEPOSIT GUARANTEE SYSTEM**

**TECHNICAL ASSISTANCE REPORT**

**David Parker (Mission Chief)**

**October 2015**

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**GLOSSARY**

AB	Assuming Bank
BIM	Bank Intervention Manager
BOS	Bank of Slovenia
BRF	National Bank Resolution Fund
BRRD	EU Bank Recovery and Resolution Directive
CEO	Chief Executive Officer
DGS	Deposit Guarantee Scheme
DGSD	EU Deposit Guarantee Scheme Directive
DICPs	Core Principles for Effective Deposit Insurance Systems
FAQ	Frequently Asked Questions
FSB	Financial Stability Board
IADI	International Association of Deposit Insurers
IT	Information Technology
KAs	Key Attributes for Effective Resolution of Financial Institutions
MCM	Monetary and Capital Markets Department (IMF)
MoF	Ministry of Finance
MoU	Memorandum of Understanding
PBC	Problem Bank Committee
PCA	Prompt Corrective Action
P&A	Purchase and Assumption transaction
SRR	Special Resolution Regime
TA	Temporary Administrator

**PREFACE**

At the request of the Bank of Slovenia (BOS), a Technical Assistance mission from the International Monetary Fund's (IMF) Monetary and Capital Markets Department (MCM) visited Ljubljana, Slovenia from July 9 through July 20, 2015. The mission was led and solely comprised of Mr. David Parker (MCM).

The mission met with various staff of BOS and the mission's main findings and recommendations were presented at a wrap-up meeting on July 20, 2015. An aide-mémoire was left, ad referendum, with the authorities.

The mission would like to express its appreciation to the BOS officials and staff with whom the mission met, for their generous hospitality and cooperation extended to the mission.

## EXECUTIVE SUMMARY

**Prior to this mission, a Monetary and Capital Markets Department (MCM) mission visited Ljubljana during December 15–19, 2014 to assess Slovenia’s Bank Resolution Framework, the Deposit Guarantee Scheme (DGS), and Crisis Preparedness.** As a result of this mission, two follow-up missions were planned to provide technical assistance on: (i) bank resolution and deposit insurance; and (ii) crisis preparedness and management. This report represents the findings and recommendations of the first follow-up mission regarding the bank resolution framework and the deposit guarantee scheme. The success of this mission will lay a strong foundation on which to build for the second follow-up mission.

**There are three necessary requirements for effective bank resolution:** (i) a special bank resolution regime (SRR), which provides, at a minimum, that resolution decisions cannot be reversed by any court; (ii) advance preparation for bank intervention and resolution; and (iii) an adequately funded DGS. Slovenia’s banking law provides for the first, while the December 2014 mission’s recommendation to create a Resolution Unit within BOS (responsible for advance preparation) has been adopted. The extant DGS, however, is an ex post funded scheme which does not fulfill the third criteria. Soon, Slovenia must implement the EU Deposit Guarantee Scheme Directive (DGSD) into national law, which calls for an ex ante funded DGS.

**Technical assistance regarding establishing an effective bank resolution framework included early and intensive monitoring of a problem bank to prevent asset stripping and to gather information for intervention and resolution teams to begin advance preparation.** Information for advance preparation is envisaged to promote effective intervention by using a team approach, controlling discrete functions of a bank intervention. For bank resolution, the authorities were encouraged to prefer the Purchase and Assumption (P&A) transaction as an effective resolution tool, as it is virtually always the least costly form of resolution. Advance preparation was also stressed for resolution, including, inter alia, the need to canvas potential acquirers—both domestic and foreign—periodically, and in advance, for their interest in acquiring failing banks.

**Analysis and recommendations regarding the DGS were provided in accordance with the DGSD, as well as the International Association of Deposit Insurer’s (IADI) Core Principles for Effective Deposit Insurance Systems (DICP).** The recommendations concluded that the best arrangement for Slovenia would be a narrow mandate (paybox plus), ex ante funded DGS contained within BOS, but with separate operations, funding, and accounting, etc. Membership should be compulsory for all banks, coverage has already been established by the European Union at €100,000, and the mission assisted with methods to establish a target reserve fund, recommending that Slovenia adopt a target greater than the 0.8 percent of insured deposits mandated by the DGSD.

**Table 1. Slovenia: Recommendations**

Recommendations	Timeline
<b>Bank Resolution Framework</b>	
1. Create a Problem Bank Committee (PBC) within the Bank Supervision Department, and including the Head of the Resolution Unit and senior manager of the DGS as members, to be convened whenever any bank or banks enter problem status.	< 3 months
2. Appoint a Temporary Administrator for 4 and 5 CAMELs rated banks as well as for banks that are lingering in 3 rated status and show little signs of improvement. The Temporary Administrator should, inter alia, monitor insider and large transactions to prevent asset stripping and gather information for advance intervention and resolution preparation.	When necessary
3. Amend banking law to implement a policy of early intervention in financial institutions before capital deteriorates to zero.	< 6 months
4. Appointment of Temporary Administrator will activate the “pop-up” of intervention and resolution teams.	When necessary
5. Prefer P&A as resolution tool for non-systemic banks.	< 6 months
6. Head of Resolutions Unit to periodically canvas strong domestic and foreign banks for interest in acquiring a failed bank via a P&A transaction.	< 6 months and ongoing
7. For purposes of a P&A asset valuation, book value of performing loans can be considered market value.	When necessary
8. Develop effective “one-voice” communications plan for bank resolution.	< 6 months
9. Implement policy of requiring “least costly” resolution method.	< 3 months
10. Amend banking law to clearly and fully put bank bankruptcy as an administrative function under the central bank, superseding company insolvency legislation, and eliminating bankruptcy court role.	< 6 months
11. Maintain list, with contact information and CVs, of potential professional, qualified bank liquidators.	< 6 months
12. Develop a standard bank liquidation manual.	< 6 months
13. Require periodic reports from Liquidator.	When necessary
14. Amend banking law to require rules-based periodic distribution of recoveries on liquidated assets from Liquidator to claimants according to legal priority.	< 6 months



**Table 1. Slovenia: Recommendations (concluded)**

Recommendations	Timeline
<b>Deposit Guarantee Scheme (DGS)<sup>1</sup></b>	
15. Enshrine the DGS's public policy objectives in legislation or regulation.	< 6 months
16. Grant the DGS a separate legal personality; and ensure that DGS's accounting and funds remain separate from BOS's.	< 6 months
17. Include deposit insurance issues in supervisory MOUs with relevant foreign supervisors.	< 6 months
18. Change DGS's funding from <i>ex post</i> to <i>ex ante</i> .	< 6 months
19. Develop and set a target fund range based on clear, consistent and transparent criteria.	< 6 months
20. Specifically authorize in legislation that DGS funds can be utilized to facilitate a resolution action (i.e., P&A) but not to exceed that which would have been expended in a liquidation.	< 6 months
21. Impose initial contributions on member banks.	< 6 months
22. Explore the possibility of "seed" funding from the government.	< 6 months
23. Begin imposing periodic risk-based assessments on member banks.	< 6 months
24. Provide for the ability to temporarily raise premiums to replenish the fund, if necessary.	< 6 months
25. Create a formal investment policy for the DGS's reserve fund.	< 6 months
26. Arrange an emergency line of credit with MoF.	< 6 months
27. Ensure that the DGS's outlays are limited to: (1) administrative and operating expenses of the DGS; and (2) reimbursement of insured depositors in the event of a bank failure.	< 6 months
28. Undertake a public awareness program.	< 6 months
29. Be prepared to counsel insured and uninsured depositors after bank failures.	When necessary

<sup>1</sup> Most of these recommendations should be included in the DGS legislation or regulation, so carry the same timeline.

## I. BACKGROUND

1. **An International Monetary Fund (IMF) Monetary and Capital Markets Department (MCM) mission visited Ljubljana, Slovenia during December 15–19, 2014 to provide TA on Improving the Bank Resolution Framework, the Deposit Guarantee Scheme, and Crisis Preparedness.**<sup>2</sup> This mission recommended, *inter alia*, creating a separate bank resolution unit within BOS, with “pop-up” authority to expand and mobilize when a resolution was pending. Further, the mission recommended that this Resolution Unit undertake foundational work on bank resolution procedures and keep the preparatory material up to date. Progress in this regard is commendable, as BOS has developed an early intervention, resolution and insolvency manual, and is committed to maintaining this advance preparation readiness.
  
2. **The mission further recommended that the BOS prepare to adopt a narrow mandate**<sup>3</sup> **ex ante funded deposit guarantee scheme (DGS), with a separate legal personality, but housed under BSI operationally and structurally.** Moreover, the mission recommended to establish a target reserve fund for the DGS and to ensure that it has access to back-up funding through the Ministry of Finance (MOF). Progress in this area has been mixed, as the recommendations have been proposed by BOS; however, it is unclear whether they will be endorsed by the MOF and parliament.
  
3. **At the conclusion of the December mission, the authorities expressed interest in further technical assistance to help strengthen the bank resolution framework, the DGS, and crisis preparedness.** That mission contended that covering all those issues could well prove overwhelming and, instead, advocated a bifurcated approach wherein a first mission would provide technical assistance on effective bank resolution and the DGS, while a second mission would focus on crisis preparedness and management. The idea was to lay a strong foundation by promoting an effective bank resolution framework (including involvement of the DGS) for non-systemic banks. The second mission, planned for fall 2015, would build on the basic tools envisaged as recommendations of the first mission and expand the toolkit and framework for crises situations (i.e., resolution of systemic banks or situations). This is the first of the two follow-up missions on the topic.

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<sup>2</sup> The December 2014 mission comprised Messrs. Daniel Hardy (Mission Chief), Atilla Arda, and David Parker (all MCM).

<sup>3</sup> The mission specifically recommended what is known as a “paybox plus” scheme, which means that the DGS’s primary responsibility is limited to repaying insured depositors in the event of a bank failure, but can also use its funds to facilitate a resolution transaction such as a Purchase and Assumption (P&A) or deposit transfer, not to exceed what would have been expended in a insured deposit repayment in a liquidation.

4. **BOS has a track record of forceful bank intervention; however, not always demonstrably the least-cost resolution.** In the recent past, they have mandated the restructuring of four banks, nationalizing the two largest Slovene banks, and they have intervened in two small banks to wind them down.
5. **In the near future, the authorities are mandated to transpose the EU Bank Recovery and Resolution Directive (BRRD) and Deposit Guarantee Scheme Directive (DGSD) into national law.** Notable features of these directives include the ability for swift resolution action, pre-funding requirements, assigning losses first to shareholders; avoiding government support; ensuring timely deposit payouts; and an emphasis on least costly resolution options. All of these issues are considered in conjunction with the Financial Stability Board's (FSB) Key Attributes for Effective Financial Institution Resolution (KA) and the International Association of Deposit Insurers' (IADI) Core Principles for Effective Deposit Insurance Systems (DICP).
6. **There is a need to enhance Slovenia's bank resolution framework and implement an ex ante DGS.** Recently, the authorities have established a limited-life national Bank Resolution Fund (BRF) based on borrowed bank contributions. There are imminent plans to pass legislation to implement the BRRD as well as establishment of a DGS, following the guidelines of the DGSD. The BOS would explicitly be the bank resolution authority, with a small separate resolution unit that can quickly be expanded and mobilized upon need. The proposed narrow mandate DGS would be housed within BOS, but with operational independence and separate financial accounts.
7. **This technical assistance report provides analysis and advice, based on international best practice adapted to the circumstances of Slovenia, regarding (i) intervening and resolving a problem bank in the least costly manner; and (ii) issues concerning introduction of a narrow mandate DGS.** The focus is on operational and managerial issues in the BOS, but some legislative issues and matters affecting other public sector bodies are touched upon, from a non-lawyer resolution specialist's perspective only.
8. **This report is organized as follows:** Section II addresses the Problem Bank Resolution process from the beginning when a bank enters problem status that requires intensified monitoring, continuing through advance preparation for intervention and resolution, and concluding with final resolution and selected bank liquidation issues. Section III sets forth the issues to consider in establishing the narrow mandate DGS under BOS that best fits Slovenia's unique circumstances.

## II. PROBLEM BANK RESOLUTION

### A. Problem Banks

9. **A supervisory authority's Bank Supervision Department must be proactive in identifying and responding to emerging issues and problems.** Off-site analyses of individual bank and banking system data, on-site inspection activity, and frequent open communication with bank administrators are essential to effective supervision. When problems arise, the supervisory authority should tailor its response to the situation and deal with the matter in a timely manner. Strong supervision can be effective in preventing undesirable consequences that lead to resolution actions.

10. **Progressive administrative or enforcement actions should comprise a formal policy for dealing with problem banks.** Actions should gradually become stronger based on failure to implement corrective measures. The best corrective measure strategy is the one that accomplishes the desired objective with the least exposure and risk to the Supervisory Authority. The best action is the one taken at the lowest level of authority under the law and produces corrective results in a satisfactory time. The Supervisory Authority should bear in mind that the corrective measures are designed to recover the bank and prevent its failure. Prevention of financial problems is always preferred to cures, which are inevitably more complex and costly.

11. **BOS currently has no formal Problem Bank Unit within the organizational structure of its Bank Supervision Department.** As a preventive measure and to provide for adequate advance preparation, the mission recommends that BOS create a Problem Bank Committee (PBC) to be convened whenever any bank or banks enter problem status (for purposes of this report, those rated CAMELS 3, 4, or 5). The PBC should include in its membership the Head of the Resolutions Unit as well as the senior-most representative of the DGS. This is in order that the DGS and Resolution Unit have adequate advance information to assist in preparing for an effective resolution, should it come to that.

12. **The PBC should closely monitor any CAMELS 4- and 5-rated banks as well as 3-rated banks that show no improvement in improving their situation.** As conditions deteriorate at particular problem banks, such as increasing losses that threaten capital adequacy, the BOS should institute progressively stronger enforcement measures (e.g., removing personnel; directing the bank to stop certain actions, etc.) with the aim to recover the bank and avoid closing it. As a precaution, BOS management should activate the "pop-up" resolution staff and appoint an Intervention Manager and a Resolution Manager to begin advance preparations.<sup>4</sup>

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<sup>4</sup> Based on the size and complexity of the bank under consideration for resolution, one person may adequately fill both positions.

13. **Concurrent with this, BOS should appoint a Temporary Administrator(s) (TA) for the bank(s), as provided in Article 259 of the banking law to provide intensified supervision and monitoring.**<sup>5</sup> Regardless of the trust that bank supervisors may have in a bank's senior management, it is wise and prudent to mitigate any asset-stripping risk, document destruction, or other damages by placing a TA on-site full-time. A TA would be expected to, *inter alia*:

(i) monitor, with authority to approve or block, insider and/or large transactions; (ii) monitor and ensure compliance with any outstanding corrective measures; (iii) monitor asset quality; and (iv) gather information for advance preparation for intervention and resolution, should the bank deteriorate to that point.

14. **Some initial duties of the TA include:**

- Monitor and approve or block insider transactions (approve only legitimate transactions, such as those for payroll of a related business—nothing to directly benefit the insiders).
- Monitor and approve or block intra-group transactions.
- Check for unusual compensation arrangements that may have been utilized to avoid income taxes.
- Ensure that the bank's IT service has the capacity to:
  - sort and aggregate accounts for deposit insurance calculations; and
  - code deposit accounts (insiders, interbank, etc.) for exclusion from coverage.
- Discreetly ascertain from loan officers which major loans are easily collectible.
- Examine activities with regard to suspected:
  - Dishonest or fraudulent acts (especially with regard to lending);
  - Forgery or alteration of documents;
  - Misapplication of funds or assets;
  - Impropriety in reporting financial transactions;
  - Profiting from insider knowledge; and

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<sup>5</sup> It should be noted that the Temporary Administrator in the Slovenian context differs from many countries' definition of a Temporary Administrator with a Conservator's role, as well as that of Articles 15 and 29 of the BRRD, in that the Temporary Administrator is not granted all the rights and powers of the bank's owners and management. Instead, the Temporary Administrator performs the functions of a member of a bank's Management Board and consults with the bank's Management Board on certain matters. In this context, the TA performs the role of an onsite examiner (or team) more common in other jurisdictions.

- Disclosing securities transactions to others.

15. **While the bank's and BOS's senior management should actively seek private resolution alternatives; BOS should concurrently plan for intervention and resolution of the bank.** With that in mind, another important duty of the TA(s) is to gather information for advance intervention and resolution preparation. This information should include, *inter alia*:

- **Number of offices**

- Open; and
- Not in operation.

- **Location of main offices and branch locations**

- Number of employees at each location;
- Records maintained on site (at each location);
- Banking premises owned or leased;
- Recorded value;
- Other tenants; and
- Information system—computerized or manual.

- **Loans**

- Number and value of loans at each location;
- Name and amount of major debtors;
- Insider lines (directors, officers, shareholders, affiliates);
- Location of legal documentation representing indebtedness; and
- Loan classifications.

- **Deposits**

- Ensure that IT system can:
  - Sort and aggregate accounts for deposit insurance calculations; and
  - Code accounts for exclusion.
- Number and value of deposits at each location.
- Name and amount of major depositors.
- Insider depositors (directors, officers, shareholders).
- Distribution of depositors.
- Debtor/depositor relationships—offsets.

- Borrowings: secured or unsecured.
- Subsidiaries.
- Trust Department or activities.
- Ownership structure.
- Enforcement actions pending.
- Litigation—both offensive and defensive.
- Other—leases, etc.

16. **As called for by the BRRD, BOS must implement a policy of early intervention in financial institutions before capital deteriorates to zero.** In some jurisdictions, the statutory and regulatory framework of Prompt Corrective Action (PCA) establishes a capital-based supervisory scheme that requires regulators to place increasingly stringent restrictions on banks as regulatory capital levels decline. PCA assigns banks to certain capital categories and subjects them to the respective requirements, limitations, and restrictions of those categories. Importantly, PCA calls for revocation of a bank's license before capital reaches zero. In line with BRRD and KA's, the authorities should include this in their banking legislation.<sup>6</sup>

## B. Advance Preparation

17. **As a bank lingers in problem status, the Resolution Unit should be making advance preparations for intervention and resolution.** Advance preparation is critical to effective bank intervention and resolution. Intervention is the act of physically taking over a bank, while resolution represents the decisive action to resolve a problem bank situation.

18. **Although intervention and resolution are two separate activities, preparing for both involves same or similar information to help ensure the success of both.** As a bank resolution is basically a bankruptcy procedure, these procedures represent an exercise of a fiduciary capacity:

- in intervention, to control, secure, and inventory a bank's assets and prepare final financial statements for the failed bank;
- in resolution, because of the special nature of banks and to fulfill the mandate of the DGS, to transfer insured deposits to a stronger, healthier bank, using good assets to help offset the insured deposit liabilities (basically a *de facto* liquidation of these assets); and
- the rump of the failed bank (bad assets, DGS', uninsured depositors', creditors' and shareholders' claims) left behind in a receivership estate where assets will be liquidated

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<sup>6</sup> These, and other recommended amendments to banking law can be included in the imminent BRRD and DSGD transposition into Slovenian law.

and recoveries distributed to claimants according to the established legal priority of claims—this is important because the receivership provides an additional legal barrier to protect BOS and the sovereign from onerous claims or litigation—all claims must go first against the receivership.<sup>7</sup>

The following sub-sections present an overview of advance preparation for bank intervention and resolution. The below material is not comprehensive; however, it will provide an idea of what to expect to deal with during the bank intervention and resolution process.<sup>8</sup>

## **Intervention**

19. **As mentioned above, intervention is taking control of a bank and its assets and preparing final financial statements.** Since the BOS intervention team is essentially acting in a role of a bankruptcy trustee, that fiduciary capacity must guide the thoroughness and accuracy of their actions.

20. **Advance preparation for bank intervention begins with appointment of a Bank Intervention Manager (BIM) who has ultimate responsibility for the successful takeover of the problem bank.** The BIM's main function is managing and coordinating all intervention team members to assure that the intervention goes as smoothly as possible. He can delegate many of the functions to others; however, the BIM bears ultimate responsibility to assure completion of intervention activities as required. The BIM is responsible for organizing and supervising Intervention personnel in all aspects of the action, assuring that all resources are efficiently and properly utilized. To aid in this task, it is advisable to develop an Intervention Action Plan; a checklist to ensure that no intervention duty is omitted or forgotten and to ensure that all areas of risk are addressed.

21. **Bank closings are best carried out using a team approach.** Team members may be drawn from the Supervisory Authority and assisted at intervention by “rank and file” failed-bank employees. The teams should understand their objectives and use checklists to ensure that no

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<sup>7</sup> This is more important in systemic situations when the BOS and the government may consider nationalizing banks. Then it would be more expedient to revoke the bank's license and do a P&A with the government to create a bridge bank owned and operated temporarily by the government. The bridge bank also involves the “good bank/bad bank” process in order that the result is a “clean” and financially healthier and stronger bank that will be attractive to potential acquirer(s). The bridge bank resolution tool will be covered more fully in the second mission regarding crisis preparedness and management.

<sup>8</sup> More detailed material in this area is contained in Parker, David C., 2010, “Closing a Failed Bank: Resolution Practices and Procedures,” (International Monetary Fund, Washington, DC), which was left with the authorities. The authorities are encouraged to use this book to develop customized bank intervention and resolution manuals as well as Temporary Administrator and Bridge Bank Managers.



activity is omitted. The teams are generally structured on a functional basis as follows<sup>9</sup> (including some indications of the teams' advance preparation):

- **Accounting:** review bank's financial reports, and proposed transactional document (i.e., P&A) for asset and liabilities splits with Assuming Bank (AB).
- **Asset management:** review the initial information to estimate the number and composition of assets.
- **Branch operations:** identify the number of branches and the types of activities offered at each branch, ensuring contact person information.
- **Deposit operations:** perform a preliminary insurance determination according to governing deposit insurance law.
- **Facilities and security:** arrange for necessary supplies, official seal, tape or other means to control drawers, and use labels for inventory. Meet with contracted Security Guard firm or police; provide instructions, determine locations and assignments.
- **Information technology:** If possible, the IT Manager should visit the failing institution in the advance preparation stage to help prepare data files, equipment, and information needed for the intervention. Additionally, determine capability of stopping accruals, when to expect the download files, report generation capability, delivery logistics, and staffing.
- **Legal:** the Legal Department will be involved throughout the process, drafting corrective measures, P&A transactional documents, any required legal notices (for registering with court, posting on premises, publishing, etc.), preparing the proper legal order (i.e., appointment of Temporary Administrator or license revocation) as required by law, and to accompany the authorities when the legal notice is served on the bank.

## Resolution

22. **Generally, all resolution actions should be guided by the least-cost principle.** In other words, the resolution action should avoid unnecessary expenditures from taxpayer or DGS funds. Probably the most effective bank resolution tool (at least for non-systemic banks) is the P&A. This transaction provides that another bank will take certain good assets and assume the bank's insured deposits, acting as paying agent for the DGS to compensate insured depositors or make their funds available virtually immediately. In some jurisdictions, depending on the competitive environment, banks may bid for the right to assume the deposits because it is a

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<sup>9</sup> Depending on the size of the bank, the team could possibly combine some of the intervention functions.

cheap method to increase market share or expand into areas where they do not have a presence. In other cases, an AB may ask the DGS to pay a fee to act as their paying agent.

**23. Resolution actions should be conducted to meet the following objectives:**

- Maximize the price of such sale or disposition, consistent with the goal of depositor and creditor protection.
- Ensure fair competition among potential purchasers or merger partners.
- Prohibit any kind of discrimination in the solicitation and consideration of offers.
- Ensure that the acquirer, merger partner, or combined bank is a strong bank, majority owned and controlled by private owners.

**24. Advance preparation for bank resolution is just as important as for bank intervention.** When a problem bank is dealt with swiftly, asset and franchise values are preserved, generating maximum return. This makes the failing bank more desirable to potential acquirers and lowers the ultimate cost of resolution. Resolution preparation involves:

- Compiling initial information about the bank (same as for intervention-see above);
- Asset valuation (if time permits);
- Completion of a financial information package (bid package); and
- Marketing meeting logistics.

**25. Ideally, to meet the competition objective mentioned above, a failed bank should be marketed to a wide universe of potential acquirers, including larger (at least twice the asset size of the failed bank) and stronger domestic and foreign banks.** In smaller jurisdictions where confidentiality of the process is not ensured, however, it may be necessary to modify the process. The head of the Resolutions Unit should, on a periodic basis (quarterly or semi-annually) informally canvass large and strong domestic and foreign banks to elicit their interest in acquiring a failed bank at some point in the future. Those that are interested should be asked to sign robust confidentiality agreements; those that are not must be cautioned to not reveal the exercise because of the potential risk to financial stability.

**26. When a resolution situation appears imminent, the Resolutions Manager should select one of these banks to acquire the failed bank via a P&A.** A P&A transaction is an excellent opportunity for an acquiring bank to either increase market share or to expand into areas where the acquirer does not have a presence. Paying a premium for deposits and options on banking premises is much more cost-effective than obtaining premises and soliciting deposits on a *de novo* or organic basis. (In the United States, estimates are that the acquirers in these types of transactions retain approximately 70 percent of deposits.) Additionally, a P&A is virtually always the least costly resolution option (see Appendix I). Table 1 demonstrates the financial impact of a troubled bank that is resolved via a P&A transaction.

27. **If time permits, the Supervisory Authority staff or other experts should estimate the worth of a bank's assets using valuation models.** Because time is of the essence, however, there is often not enough time to appraise every asset, so the models will provide statistical sampling. They can divide the assets into categories, identify a sample, and carefully review the assets to establish a liquidation value for each asset. Sometimes, time constraints will require that asset valuation be done ex post. Regardless, when executing a P&A, book value of performing loans should always be acceptable as a market value. In fact, usually a discount of 10 percent to 15 percent on performing loans is acceptable simply because of the overhead and holding costs incurred if a liquidator must service them.

28. **The bid package should build on the initial information and include detailed data on the amounts and types of assets and liabilities that the failing bank holds.** The information may vary from bank to bank, depending on business strategy, as reflected in the asset and liability structure. The bid package should include demographic information, including market area, population, the bank's history, customer type, competition, and makeup of the local economy.

29. **As time permits, the potential acquirer may be permitted to conduct due diligence on the failed bank.** Care must be taken, however, that this action not be highly visible and send adverse signals to the public, affecting confidence. Due diligence will allow the potential acquirer to make an on-site inspection of the premises, records, and operations of the failing bank. It allows the potential acquirers to assess the franchise value and calculate a knowledgeable bid amount.

30. **To provide a comfort level to both parties to the transaction, the P&A contracts should be signed several days prior to the actual closing of the bank, with the contracts put in escrow until the closing date.** This eliminates last-minute conditions or demands by either party. The "to be" appointed Liquidator and the AB will sign the P&A Agreements. Both parties will also sign the escrow agreement.<sup>10</sup> The escrow agreement merely states that the aforementioned documents were signed and put into escrow until the stipulated date. The AB receives only a copy of the escrow agreement. The other signed agreements will be delivered to the AB at the time of the bank closing.

31. **It is of utmost importance that confidentiality be stressed throughout the resolution process.**

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<sup>10</sup> Ideally, BOS will maintain a list of qualified financial experts that they may hire as Liquidators. Identifying and arranging to hire one for the problem bank in question is part of BOS' advance preparation.

**Table 2. Slovenia: Example of P&A Transaction****Assuming Bank P&A (Example)****Failed Bank - Original Balance Sheet**

<b>Assets</b>		<b>Liabilities</b>	
Cash and bank deposits	154	Deposits	800
Investments	185	Borrowings	70
Loans	710	Other liabilities	110
Fixed Assets	25	Subordinated debt	10
Investment in subsidiaries	5	Capital	110
Other Assets	21		
<b>Total:</b>	<b>1,100</b>		<b>1,100</b>

**Failed Bank - Original Balance Sheet - Adjusted for Loss**

<b>Assets</b>		<b>Liabilities</b>	
Cash and bank deposits	154	Deposits	800
Investments	185	Borrowings	70
Loans 1/	410	Other liabilities	110
Fixed Assets	25	Subordinated debt	10
Investment in subsidiaries	5	Capital 2/	-190
Other Assets	21		
<b>Total:</b>	<b>800</b>		<b>800</b>

1/ Loss of 300 in Loans

2/ Charged loss results in insolvency

**"Split" - Assuming Bank**

<b>Assets</b>		<b>Liabilities</b>	
Cash and bank deposits	140	Insured Deposits	550
"Good" Investments	85	Borrowings	
"Good" loans	200	Other liabilities 2/	20
Other Assets 1/	5		
<b>Sub-total</b>	<b>430</b>		<b>570</b>
Cash from State	140		
<b>Total:</b>	<b>570</b>		<b>570</b>

1/ Accrued interest on "Good" loans

2/ Accrued interest on insured deposits

**"Split" - Receivership**

<b>Assets</b>		<b>Claims</b>	
Cash	14	Cash from DGS	140
Investments	100	Uninsured Deposits	250
Loans	510	Borrowings	70
Fixed Assets	25	Other liabilities	90
Investment in subsidiaries	5	Subordinated debt	10
Other Assets	16	Capital	110
<b>Total:</b>	<b>670</b>		<b>670</b>

Source: Staff analysis.

## Communications

30. **Well before any problem bank intervention, the BOS Communications Department should diligently coordinate information with the Resolutions Manager (and the DGS) and control information through one spokesperson—a “one-voice” communications policy.**

They should prepare and deliver a media statement immediately after taking control of a bank, providing information in a positive light to reassure the public. It should stress that the authorities have taken forceful action to strengthen the banking sector, acting in the best interests of depositors and financial stability. To avert any uncertainty and misconception, all communication should be provided in simple terms. Advance preparation for communications includes, *inter alia*:

- Press releases should be brief, factually accurate, and as positive as possible.
- Possible follow-up questions (frequently asked questions (FAQs)) should be anticipated and answers prepared.
- The authorities should share as much information as possible with the media in order to create and maintain goodwill.
- The initial message should describe the action taken and how the resolution will be handled.

31. **Press release templates as well as FAQs can be prepared well in advance of any resolution activity to ensure accuracy and effective communication.** The BOS should use all available media platforms, including print, television, radio, central bank, DGS, and failed bank websites, etc.

### C. Final Resolution

32. **Both the BRRD and the KAs were developed following the crisis of 2008–09 as a result of deficiencies in bank resolution frameworks virtually worldwide, as demonstrated primarily by the inability to take prompt actions and the lack of effective resolution tools.** Both were developed primarily to provide a framework to solve the “too big to fail” problem, attempting to develop methods to resolve systemic banks in an orderly manner. Although many of the tools documented in both standard sets are not as effective in non-systemic bank resolution (e.g., AMCs, asset purchases, bail-in, bridge banks, etc.), a few very important tools make non-systemic bank resolution more effective. Specifically, the provisions for an SRR as well as a P&A (aka sale of business), allow the authorities to take swift action that does not disrupt the financial sector or communities. In fact, with these two provisions, the authorities can make insured depositors’ funds available to them promptly, potentially preventing a systemic crisis arising from contagion and deposit runs on other banks.

33. **Resolution can broadly be regarded in three major categories:** (i) private—where the current owners recapitalize the bank, sell it or merge it; (ii) assisted transactions—such as a P&A transaction where certain liabilities and certain assets are transferred to a stronger, healthier bank;<sup>11</sup> and (iii) direct liquidation. This section of the report will primarily be concerned with the second—the assisted transaction (note that the advance preparation mentioned above is necessary even for liquidation resolutions).

34. **Any bank resolution method should be subject to the “least costly” form of resolution.** One of the most effective bank resolution tools is a P&A.<sup>12</sup> A basic P&A transaction provides that a financially healthier bank will purchase certain “good” assets and assume insured deposit liabilities (there can be variations on the basic transaction). The P&A is an expedient method of resolving a failed bank because, with advance preparation, it can be accomplished quickly (usually over a weekend), and has the potential to maintain banking services in under-served communities. Following is a description of a bank intervention and resolution via a P&A, which represents a culmination of the advance preparation described above.

35. **A small initial intervention team enters the bank and meets with the CEO or other appropriate key bank officials.** The BIM explains to the key bank officials what is taking place and presents the intervention order to the CEO or his representative. The BIM advises the CEO or his representative of the bank’s license revocation and appointment of a Liquidator and introduces the Liquidator. By lawful authority the CEO and selected management are relieved of their authority and responsibilities. The CEO and problem management personnel should then be escorted from the premises (after collecting bank-owned property—including any keys for automobiles or bank issued credit cards). They are not allowed to remove any items, personal or otherwise. The team should ensure that the bank intervention notification is prominently posted on the bank’s door.

36. **Immediately following license revocation, the BOS will appoint a Liquidator.**<sup>13</sup> The Liquidator will then bring the pre-negotiated, pre-signed P&A document out of escrow and deliver to the AB, and it will go into effect.

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<sup>11</sup> Generally, this transaction depends on the “good bank/bad bank” process, wherein the good assets represent the certain assets that are transferred along with usually, insured deposit liabilities. Because the good assets are unlikely to be sufficient to offset the amount of liabilities transferred, the difference must be funded, usually by a deposit insurance system, hence the term “assisted transaction.”

<sup>12</sup> Note that, although a P&A is probably the most effective bank resolution method, there is no guarantee of its success, since it is dependent on finding a legitimate third-party acquirer.

<sup>13</sup> The Liquidator should have been selected and briefed in advance.

37. **The Security Function Manager should immediately take control of SWIFT and/or other wire transfer facilities.** The Security Function and IT Managers should ensure that ATMs are disabled and applicable networks notified; unless the AB has previously decided to continue those operations. The security team should also ensure that cash and loan documents are controlled pending arrival of the asset team.

38. **The BIM then notifies the remaining intervention team members to enter the bank and commence their assignments.** The intervention team will be much larger than the initial intervention team and, in that case, team members should enter in small groups. Coordinate the entry scheduling of intervention team members to eliminate any confusion. Intervention team members with branch operations responsibilities should coordinate by phone.

39. **The Function Managers should then begin their duties as outlined in their objectives and checklists.** This work will be performed throughout the weekend and will involve AB personnel in the areas relevant to their acquisition. Briefly the teams will perform the following:

- **Accounting team:** ensure that all work is processed and reconcile subsidiary accounts to the general ledger to produce final financial statements, which they will split between the AB and the Liquidator.
- **Asset team:** secure and control assets, especially cash and loan documents, and work with accounting to balance asset accounts.
- **Branch team:** secure and control branch premises, including assets.
- **Deposit team:** perform insured deposit calculations and work with accounting to balance deposit accounts.
- **Facilities team:** ensure all teams have adequate supplies and working space.
- **Security team:** ensure that a contracted security firm is controlling the premises.
- **Information Technology team:** ensure that processing for final close-out of financial statements is completed promptly; compile and distribute reports as needed.
- **Legal team:** ensure intervention notice is posted to assist BIM and Liquidator as needed.

40. **After the bulk of these activities is performed, presumably over a weekend, the intervention team will deliver their work product to the AB or the Liquidator, as applicable.** The AB will continue operations at the failed bank for at least 90 days and have an exclusive option to purchase owned premises at market value or assume the leases of leased premises. The AB should be granted first choice of any failed bank employees they wish to hire. The AB will work off the failed bank's IT system, paying deposits based on instructions from the deposit team. They should not pay deposits exceeding the insured limit or otherwise frozen (e.g.,

insider deposits, deposits frozen for offset to nonperforming loans, etc.). The AB will likely be asked to provide interim asset servicing and accounting for the Liquidator until his/her office is established (see Appendix I for additional standard provisions of a P&A).

#### **D. Bank Liquidation—Selected Issues**

41. **Slovenia has a court-based bank liquidation regime: insolvent banks must go through bankruptcy court in accordance with company insolvency law.** BOS can, however, take over an undercapitalized bank and appoint Special Management, which will replace existing management and suspend the rights of shareholders and the Supervisory Board. The BOS defines the terms of the Special Management, which can range from rehabilitation, resolution via a P&A, or a winding-down liquidation.

42. **It is recommended to change the banking law and put all bank liquidation under BOS as an administrative function.** The BOS could then adopt a resolution policy reliant on advance preparation, as advocated in this report, and avoid the period of Special Management, which could adversely affect public confidence.

43. **BOS should maintain a list of professional qualified financial experts to act as bank liquidators when the occasion arises.** Moreover, BOS should develop a standardized Liquidation manual, detailing how to establish a liquidation office as well as asset management and disposition procedures to liquidate the “rump” of the failed bank.<sup>14</sup> The instructions should be to maximize recoveries and minimize losses. The measures could include, *inter alia*, establishing a functional office structure, with positions established to ensure that all the responsibilities of bank liquidation are covered. These would include hiring loan collection specialists, real estate and other assets sales specialists, to liquidate assets that accrue to a Liquidator as a result of a bank closing. Other personnel would be needed to address the administrative needs of the liquidation, including specialists to handle uninsured depositor (coordinated with DGS) and creditor claims, settlement functions with the AB, personnel matters, contracting and facilities. The office will also need accounting and IT specialists and legal staff.

44. **In bank liquidation, there is often a culture of non-repayment—borrowers may think that since the bank is closed they no longer have to repay their loans.** Nothing can be further from the truth and the Liquidator must ensure that his staff collect loans aggressively, taking into account the time value of money while trying to maximize recoveries. The policy should be to try and collect full book value and accrued interest of the loan; however, based on

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<sup>14</sup> Chapters 6 and 7 of Parker, David C., 2010, “Closing a Failed Bank: Resolution Practices and Procedures,” (International Monetary Fund, Washington, DC), which was left with the authorities, can serve as the basis for creating Liquidation manuals.



time value of money concepts, sometimes it makes good business sense to accept less than that in full settlement. Actions should be guided by good business judgment and guidelines provided by BOS. The Liquidator must develop delegations of authority detailing at what level loan collection specialists can settle loans for less than full book value and accrued interest, above which more senior management approval will be required. It is a good idea to have a credit review committee to facilitate these processes.

45. **The Liquidator must also develop and maintain a record keeping system to demonstrate the efforts exerted in liquidating assets, particularly regarding those settled for less than full book value and accrued interest.** Specialists should also be required to develop budgets for real property assets and encouraged to use auction processes to dispose of movable assets such as automobiles, furniture, and equipment. The liquidator must develop and adhere to a reporting system as required by BOS. Some examples of required reports would include: gross cash collections by asset type; expense to collection ratio (this is a cost benefit tool—when expenses begin to exceed collections, it may be time to consider shutting the liquidation down), asset sales, real estate assets sold, assets in litigation, claims filed (approved or disapproved), and comprehensive periodic financial statements.

46. **Bank liquidation is faced with perverse incentives—the ultimate objective of the Liquidator and his/her staff is to work themselves out of a job.** With this in mind, it is imperative that Liquidators not be hamstrung by legal requirements to wind down a liquidation within a certain timeframe. For example, if the banking law requires that the liquidation activities be completed within two years, borrowers who know of this provision can simply out-wait the liquidator and simply not repay their debts. Instead, the Liquidator should be directed to accomplish his/her work “as soon as possible” and be given performance-based incentives to work toward this goal (e.g., bonuses based on gross cash collections within a certain time frame, reducing staff, etc.). Finally, it is imperative that the Liquidator be required by legislation or regulation to make periodic distributions of recoveries on asset liquidation to claimants on a pro rata basis, according to the legal claim priority. This way the Liquidator should not be tempted to drag out the liquidation process in order to perpetuate his and his staff’s jobs.

### **E. Recommendations**

- Create a Problem Bank Committee (PBC) within the Bank Supervision Department and include the Head of the Resolution Unit and senior manager of the DGS as members, to be convened whenever any bank or banks enter problem status.
- Appoint a Temporary Administrator for 4 and 5 CAMELs-rated banks as well as for banks that are lingering in 3-rated status and show little signs of improvement. The Temporary Administrator should, inter alia, monitor insider and large transactions to prevent asset stripping and gather information for advance intervention and resolution preparation.

- Appointment of Temporary Administrator will activate the “pop-up” of intervention and resolution teams.
- Prefer P&A as resolution tool for non-systemic banks.
- Head of Resolutions Unit to periodically canvass strong domestic and foreign banks for interest in acquiring a failed bank via a P&A transaction.
- BOS to maintain list of potential Liquidators.
- For purposes of a P&A asset valuation, book value of performing loans can be considered market value.
- Develop effective “one-voice” communications plan for bank resolution.
- Implement policy of requiring “least costly” resolution method.
- Amend banking law to clearly and fully put bank bankruptcy as an administrative function under the central bank, superseding company insolvency legislation, and eliminating bankruptcy court role.
- Phase out the National Bank Resolution Fund.
- Require periodic reports from the Liquidator.
- Require rules-based periodic distribution of recoveries on liquidated assets from the Liquidator to claimants according to legal priority.

### III. DEPOSIT GUARANTEE SCHEME

#### A. Introduction

50. **The DGS in Slovenia is envisaged to operate under the auspices of BOS with a “paybox plus” mandate.** Thus, its role will be limited to the full protection of insured depositors in the event of a bank failure. The “plus” means that its funds can be used to facilitate a P&A (sale of business) or deposit transfer resolution action as a form of reimbursement, on a least-cost basis, not to exceed the expenditure that would be required under a straight liquidation process. Responsibility for the overall resolution strategy and the pursuit of other objectives—such as overall systemic stability—will rest elsewhere in BOS. Following are recommendations on the establishment of such a DGS in line with DGSD and IADI’s DICPs.

#### **Public policy objectives**

51. **The two most basic public policy objectives (DICP 1) are: (1) a consumer protection function to protect small, financially unsophisticated depositors; and (2) a greater public**

**good function to help maintain financial stability by making prompt payment to insured depositors in the event of a bank failure.** This can prevent contagion and deposit runs on other stronger banks and also limit the economic cost to those clients of the non-availability of liquidity. The consumer protection function is generally achieved through coverage level and scope; however, since the DGSD specifies coverage of €100,000 and scope of virtually all deposits (including corporate, but excluding certain deposits such as interbank and insider and related parties), Slovenia's DGS has no room to customize this feature. Slovenia is well positioned for the second objective, however, with the existence of a special bank resolution regime (SRR), which provides that no court can reverse a resolution decision (i.e., license revocation), thus permitting prompt resolution actions such as a sale of business.<sup>15</sup>

### **Mandate and powers**

52. **The size and composition of Slovenia's banking sector inform the most efficacious mandate (DICP 2) and governance structure (DICP 3).** As the authorities envisage, the DGS in Slovenia should have a "paybox plus" mandate, whereby its role is merely to fully protect insured depositors in the event of a bank failure, but the "plus" means that its funds can be used to facilitate a sale of business or deposit transfer resolution action as a form of reimbursement.

53. **The efficiency and good governance of the DGS would be served by giving the DGS legal personality with its own organic law setting out its mandate, accountability framework, and governance structure.** It is critical that the DGS maintain monetary resources and financial statements separate from those of the BOS. The alternative of having the DGS as part of the BOS, but somehow distinct, may easily lead to confusion over responsibilities and accountability and, possibly, unacknowledged conflicts of interest. Transparency and accountability can be enhanced by including full reporting of its activities and financial condition as part of BOS's annual report to parliament.

54. **Nonetheless, and especially because the envisaged remit of the DGS would be restricted to that of a "paybox plus," it should operate within the BOS.**<sup>16</sup> Such a structure would be most cost efficient and operationally effective, with features to preserve DGS autonomy. The DGS could be constructed as a subsidiary or department, with dedicated (part-time) employees, seconded as necessary from BOS. Moreover, the DGS Board would coincide with the BOS Board. The DGS would then enjoy easy access to information and automatically be coordinated within the financial safety net. Cross-border deposit insurance concerns can

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<sup>15</sup> There should be due process; however, the level of judicial review should be such that any successful challenges to the resolution decision would be limited to monetary compensation for damages.

<sup>16</sup> In accordance with the IADI core principles, the use of DGS funds should be limited to: (1) administrative and operating expenses of the DGS; and (2) reimbursement of insured depositors in the event of a bank failure (possibly through a sale of business transaction or deposit transfer).

easily be included in supervisory Memorandums of Understanding (MoUs) with authorities in other jurisdictions.

## **Governance**

55. **Best practices regarding governance call for operational autonomy, transparency, accountability, and insulation from external (e.g., political or industry) influences.** That means, because of the access to confidential information and conflicts of interest, no active bankers or members of a bankers association should be on the Management Board. The current arrangement of the DGS contained within the central bank is acceptable and appropriate. The authorities should give the DGS a legal personality, however, thus enabling smoother operations (e.g., such as entering into contracts, etc.), and perhaps contributing further to public confidence. The DGS can be constructed as a kind of subsidiary or in a separate department, with dedicated employees, seconded as necessary from BOS (possibly on a part-time basis), who have a clear assignment of duties and responsibilities. Benefits of such an arrangement include: cost-effectiveness, the ability to share staff resources and skills, and better information sharing and cooperation. It is critical, however, that the DGS maintain separate monetary resources and financial statements. Transparency and accountability can demonstrate clear oversight by including full reporting of its activities and condition as part of BOS's annual report to parliament.

56. **The organization and ongoing fulfillment of BOS responsibilities toward the DGS will need to be revised once its structure is amended, but only a very “skeletal” DGS structure will be needed at most times.** Various BOS departments would be involved and report on DGS matters to the common Board. For example, the Banking Supervision Department staff would devote some of their inspection efforts to auditing DGS premium payments, testing IT systems for capability to make insured deposit calculations, and other matters of concern to the DGS.<sup>17</sup> Meanwhile, the Banking Operations Department staff would manage the investment of the DGS reserve fund. The DGS staff would contribute materials on DGS operations (e.g., related to the separation of insured from uninsured deposits) to the bank intervention and resolution manuals being prepared for these contingencies. The DGS would compensate the BOS for services provided out of its premium income.

57. **Housing the DGS in the BOS will help ensure compliance with DICPs 4—Relationships with Other Safety-Net Participants; 5—Cross-border Issues; and, 6—Deposit Insurer’s Role in Contingency Planning and Crisis Management.** As a subsidiary unit of the BOS, the DGS will enjoy essentially the same access to information and automatically be coordinated within the financial safety net. Cross-border deposit insurance concerns can easily be included in supervisory MOUs with authorities in other jurisdictions. And the deposit insurer’s role in contingency planning and crisis management will be limited, as in most narrow

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<sup>17</sup> The DGS should be billed for the attendant costs.

mandate DGSs, to a preventive role within the operations of the traditional financial safety net—i.e., as mentioned above, providing prompt payment to insured depositors in the event of a bank failure, which can prevent contagion and deposit runs on other stronger banks, possibly preventing a systemic crisis.

### **Membership and coverage**

58. **Slovenia’s current DGS complies with both DICPs 7: Membership, by requiring compulsory membership of all banks and 8: Coverage, as dictated by the DGSD. Slovenia’s current DGS, however, excludes deposits from large and medium sized corporates.** The authorities will have to reconsider this exclusion, as the DGSD requires it (there is also an international trend toward covering such deposits). Extending coverage to such enterprises can facilitate insured deposit calculations, as it would remove the duty to closely examine the entity to determine whether or not it meets criteria for coverage. And, as coverage levels are limited (albeit high), the exposure of the DGS fund should not be so much greater than in the absence of coverage.

### **Sources and uses of funds**

59. **One of the most important aspects of deposit insurance regards funding.** There are several aspects of funding including: (i) the target, or reserve fund; “seed” funding, member banks’ contributions; emergency funding; and, uses of assets (including investments).

60. **Ex ante funded DISs are preferred over ex post arrangements because, *inter alia*, of the ability to take more prompt action and avoiding procyclicality of ex post schemes.** International best practice and the DGSD call for ex ante funding, with a target reserve funded by periodic assessments on member banks.<sup>18</sup> Many jurisdictions, in addition to periodic premiums, require an initial contribution, or entrance fee, to be a member of the scheme.<sup>19</sup> Also, in many countries, this can be augmented by a “seed” contribution from the government. In such cases, it is important to ensure that no premiums assessed on banks be reduced or eliminated until such “seed” contributions are repaid in full. This is in compliance with both FSB’s KAs and IADI’s DICPs, which hold that the cost of bank failures should be borne by the banking industry.

61. **Generally, insurance reserve funds are based on historical loss data.** However, in many jurisdictions there have not been enough bank failures to provide legitimate data. Therefore, other, perhaps less scientific, methods must be used. Some aspects to consider regarding the fund size: (i) what is the DGS’ exposure (i.e., amount of insured deposits

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<sup>18</sup> The target reserve fund should be established in legislation; while premium rates should remain flexible and be determined by the DGS Board, subject to safeguards against caprice.

<sup>19</sup> Initial fees are usually expressed as a percentage of insured deposits, and entry fees are a percentage of paid in capital for start-up banks.

system-wide); and (ii) how is that exposure distributed (e.g., over small, medium and large banks)? Clearly, however, inadequate reserves can lead to costly delays in problem bank resolution as well as loss of confidence in the DGS.

**62. Determining the optimal reserve target is often more an art than a science.**

Therefore, legislation should not be too prescriptive but rather define a range for the target, which would be specified by the DGS authority (e.g., 5 percent to 6 percent of insured deposits), rather than a specific, hard target (e.g., 5 percent of insured deposits). By prescribing a range for the target, the legislation would ensure a minimum level of protection for depositors while limiting the banking sector's fee burden. A range rather than a fixed target can mitigate the need to increase premiums drastically during difficult economic times, when the fund may need to be replenished because of one or more bank failures. This will provide discretion and greater flexibility in managing the reserve fund by gradually increasing or reducing premiums, depending on need and economic conditions. Thus, a range will help prevent sharp fluctuations in the premiums charged from banks, which can result from a legislated mandate to maintain a specific target ratio. There is the very real possibility that sharp increases in premiums can affect banks' financial conditions adversely, especially during unfavorable macroeconomic conditions, when banks can least afford to pay. Yet, eventually DGS reserves may reach the maximum permitted level, when premiums would be reduced to a level that covers DGS operating expenses.

**63. The DGSD establishes 0.8 percent of eligible deposits as a minimum target, but in Slovenia it is considered appropriate to aim for a higher target, which the Directive allows.**

A conservative rule of thumb for similar jurisdictions is that the reserve fund should be adequate to cover insured deposits at four to six small banks or two to three medium-sized banks. Analysis of insured deposits in the Slovenian banking sector points toward a minimum target of around 5 percent. To be conservative, the mission recommends a target reserve fund range of from 5 percent to 6 percent.<sup>20</sup> The DGS would not consider rebates or credits until the fund exceeded 6 percent, nor would it have to automatically raise premiums until the fund dipped below 5 percent. This range provides for more nuanced target reserve fund management to try and avoid procyclical effects on member banks.

**64. Achieving that target in a reasonable period (i.e. less than 10 years) may be very difficult without a large up-front contribution from some source.** Many jurisdictions, in addition to periodic premiums, require an initial contribution, or entrance fee, to be a member of the scheme. In the case of Slovenia, the initial contribution could come from the reserves for deposit protection purposes that banks are already required to maintain. Again, in many countries, this can be augmented by a "seed" contribution from the government and/or a donor

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<sup>20</sup> Experience in other similar countries would suggest a reserve fund of 4 percent to 6 percent of eligible deposits (e.g., Macedonia 4 percent; Bulgaria 5 percent; Kazakhstan 5 percent; Bosnia 7 percent – Source: IADI survey).

agency. In such cases, it is important to ensure that no premiums assessed on banks be reduced or eliminated until such “seed” contributions (particularly from the government) are repaid in full.

65. **New DGSs are generally encouraged to begin with flat-rate premiums while the scheme is being implemented.** Introducing risk-based premium scan be a long and complex process which, ordinarily, is recommended to be attempted only after the DGS has been established and running smoothly for several years. Typically, the risk-based premium process involves developing a risk-model to apply to banks, testing the model, soliciting input from stakeholders (member banks) and perhaps repeating this progression to improve the framework.

66. **As the DGSD requires risk-based premiums, however, BOS’s DGS should adhere to the absolute minimum variables dictated by DGSD in order to keep the process as simple as possible to better ensure successful implementation.**<sup>21</sup> DGS should keep in mind that the buckets, or categories, of risk that inform the premiums charged banks with certain risk profiles are as important as a comprehensive risk model is. That is, the authorities must ensure that the categories are distinct enough—with significant differences in charges—to incentivize banks to improve their risk profile, enabling them to move into a less risky category and reduce their operating expenses.

67. **Emergency or back-up funding should also be included in the DGS legislation.** An existing fund may be depleted by bank failures or a new fund may initially lack resources to reimburse depositors when a bank fails. Therefore, it is necessary to have arrangements in place for the DGS to have access to funds to fulfill its mandate. Perhaps the most expedient arrangement is to have a pre-approved line of credit with the MoF, so as to avoid delays that may be encountered in trying to borrow from the market or devising alternate funding sources.<sup>22</sup> According to the DGSD, the borrowing arrangement should be the same as the DGS’s target reserve fund amount. As with “seed” funding, these borrowings would have to be repaid in full before banks’ premiums are reduced.

68. **Emergency funding should be supplemented by granting the DGS powers to temporarily increase premiums on banks to replenish the reserve fund.** This power would have to be carefully managed in order to balance the need to rebuild the fund with the possible procyclical effects of requiring increased premiums from banks in times of financial distress. For

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<sup>21</sup> EBA guidelines regarding DGS risk-based premium calculations can be found at: <https://www.eba.europa.eu/documents/10180/1089322/EBA-GL-2015-10+GL+on+methods+for+calculating+contributions+to+DGS.pdf>

<sup>22</sup> The mission notes that the DGSD permits DGSs to borrow from one another. Given Slovenia’s tight fiscal situation, the authorities may want to explore the possibility for such arrangements with other jurisdictions. Any such borrowing arrangements should ensure that Slovenia’s DGS will be able to access the necessary funding within two days.

example, it is easy to imagine a situation where emergency funding was needed and acquired from MOF. The DGS may consider that the current financial situation is too stressful to impose extraordinary premiums on banks and may decide to wait for, say, two years before imposing the higher premiums.

69. **Because it may be impossible to adequately and fully anticipate bank failures and the need for the use of funds, the DGS should have a formal investment policy that emphasizes safety and liquidity over yield.** Investments, therefore, should be of the highest quality that can be easily liquidated with little to no loss of principal. The investment policy should not unduly require the fund to be invested in domestic government securities: otherwise the need for liquidating the investments may occur in times of financial distress when banks may be attempting to meet liquidity needs by selling their domestic instruments. The result would be downward pressure on the redemption price. Investment in very low risk, non-Slovene securities would not present this danger of negative feedback.

70. **The use of the DGS's funds should be limited to: (1) administrative and operating expenses of the DGS; and (2) reimbursement of insured depositors in the event of a bank failure.** It is important to note that a resolution tool, such as a P&A or a deposit transfer, does not represent an expansion of the DGS's mandate—these are merely other methods of fulfilling the DGS's mandate to reimburse, or make funds available to, insured depositors. It is less disruptive to communities to make insured deposit funds available at another bank than to make direct payments to customers as part of a bank liquidation process. Provided that the least-cost condition is demonstrably met, and other creditors are treated equitably, the DGS can contribute to a sale-of-business operation that involves the transfer of non-insured deposits; in some cases, such an operation may yield a business that is more attractive to purchasers.

### **Public awareness**

71. **The degree of public awareness (DICP 10) programs that DGSs undertake varies significantly worldwide.** But, at a minimum, the DGS should make publicly available the terms and conditions of deposit insurance; and, more importantly information regarding payment of insured deposits in the event of a bank failure. Regarding the former, at a minimum, the DGS should require banks to display signs, seals or certificates of membership in the scheme. The DGS should also provide brochures to banks to distribute to clients that describe the terms and conditions of deposit insurance (e.g., what instruments are covered and to what level, what instruments are not covered, when these instruments are covered, etc.).<sup>23</sup> This information should also be featured on the DGS' website (or BOS's if DGS does not have a separate one). When a bank fails, the DGS/BOS would be expected to provide information regarding insured depositor repayment—where, how, and when depositors will have access to their funds. This information

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<sup>23</sup> It is important for the DGS to provide standardized language in the brochures that all banks must use in order that member banks not distort deposit insurance to imply greater coverage at their bank.



should be included in various media, including press releases to print media, as “frequently asked questions” on the DGS website, as well as radio and television.

### **Legal protection**

72. **DGS directors, officers and employees should be provided legal protection for decisions made and actions or omissions taken in good faith in the normal course of their duties (DICP 11).** Since it is expected that the DGS will be staffed by seconded BOS employees, the same level of legal protection currently enjoyed by BOS employees should automatically be accorded to them.

73. **DICPs 12–15 regard bank supervision and resolution and, consequently, are out of the control of a narrow mandate DGS.** In Slovenia, with the recommended “paybox plus” mandate, it would be expected that these DICPs be addressed under the auspices of BOS’s bank supervision and resolution functions.

### **Recoveries**

74. **Finally, the DGS should have the legal right to recover its expenditures for insured deposits repayment from liquidation of the assets of the failed bank.** By virtue of insured deposit payment, the DGS should be subrogated to the insured depositors’ preferred claims on the failed bank’s receivership estate. International best practice, and the BRRD, requires that claims of insured depositors and thereby the DGS, as subrogee, enjoy a very high priority, after secured creditors (but only up to the value of the collateral) and the receiver’s administrative expenses. In a typical claims priority, claims of uninsured deposits, general unsecured creditors, subordinated debt-holders and shareholders, would follow, in that order.<sup>24</sup> As mentioned above, BOS should direct the liquidator in his/her activities and ensure that periodic distributions are made to claimants in order to prevent unnecessary perpetuation of the liquidation process.

## **B. Recommendations**

- Enshrine the DGS’s public policy objectives in legislation or regulation.
- Grant the DGS a separate legal personality; and ensure that DGS’s accounting and funds remain separate from BOS’s.
- Include deposit insurance issues in supervisory MOUs with relevant foreign supervisors.
- Change DGS’s funding from *ex post* to *ex ante*.

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<sup>24</sup> Note that some jurisdictions give varying levels of priority to, for example, employees’ claims and taxes.

- Develop and set a target fund range based on clear, consistent and transparent criteria.
- Impose initial contributions on member banks.
- Explore the possibility of “seed” funding from the government.
- Begin imposing periodic risk-based assessments on member banks in accordance with EBA guidelines.
- Establish in legislation or regulation the ability to temporarily raise premiums to replenish the fund, if necessary.
- Create a formal investment policy for the DGS’s reserve fund.
- Arrange an emergency line of credit with MoF.
- Ensure that the DGS’s outlays are limited to: (1) administrative and operating expenses of the DGS; and (2) reimbursement of insured depositors in the event of a bank failure.
- Undertake a public awareness program.
- Be prepared to counsel insured and uninsured depositors after bank failures.

**APPENDIX I. PURCHASE AND ASSUMPTION AS LEAST COSTLY RESOLUTION**

1. **A deposit insurance law should specifically permit the DGS to use its funds to facilitate a P&A transaction.** A P&A, like a liquidated payoff, is simply a method for the DGS to fulfill its mandate to promptly reimburse insured depositors in the event of a bank failure. A liquidated payout likely will not satisfy financial stability objectives and is generally more costly than other resolution methods.
2. **The general benefits of a P&A transaction are that it provides depositors with prompt access to their insured deposits and performing assets of the failed bank are quickly transferred to a healthy bank, so that their value is maintained and they remain in the private sector.** These benefits help promote and preserve confidence in the banking sector, minimize disruption to bank customers, and preserve financial stability by minimizing the likelihood of a bank run and contagion to the rest of the banking sector. The goal is to make insured deposit payments as soon as possible. Intense advance preparation for bank intervention and resolution is critical to accomplish an effective resolution.
3. **These important benefits of a P&A can only be achieved if the transaction can be accomplished without undue delay.** If the transaction cannot be accomplished swiftly, then the benefit to depositors of prompt access to their funds will not be achieved and the assets of the failed bank will lose value, increasing the costs of the bank failure. With a special non-judicial bank resolution regime (including depositor preference), and with adequate advance preparation by the supervisory authority and the DGS, a P&A transaction can be executed that will provide for prompt reimbursement of insured depositors, with a goal of three to five days.
4. **In a P&A, a stronger bank will purchase certain assets and assume insured deposits of the failing bank.** If insured deposits exceed the assets purchased, then the DGS must advance funds to “fill the hole” and balance the transaction, but not to exceed the amount that would have been expended to reimburse insured depositors in a straight liquidation. Using assets from the failed bank to help fund the insured deposit assumption has several advantages, *inter alia*: (i) lessens the impact on the DGS’s reserve fund; (ii) keeps assets in the private sector; and (iii) minimizes financial disruption (see below).
5. **In the following example, it is clear that the DGS is certainly in a better short-term position when a P&A is used instead of a payoff.** At first glance, the P&A is clearly the least costly resolution option, simply based on the time value of money concepts and the opportunity cost related to the impact on the DGS’s reserve fund—the DGS must expend much less in a P&A than in a payoff.

### Comparison of P&A and Liquidation Payoff (Example)

#### Failed Bank - Original Balance Sheet

<b>Assets</b>		<b>Liabilities</b>	
Cash and bank deposits	154	Deposits	800
Investments	185	Borrowings	70
Loans	710	Other liabilities	110
Fixed Assets	25	Subordinated debt	10
Investment in subsidiaries	5	Capital	110
Other Assets	21		
<b>Total:</b>	1,100		1,100

#### Failed Bank - Original Balance Sheet - Adjusted for Loss

<b>Assets</b>		<b>Liabilities</b>	
Cash and bank deposits	154	Deposits	800
Investments	185	Borrowings	70
Loans 1/	410	Other liabilities	110
Fixed Assets	25	Subordinated debt	10
Investment in subsidiaries	5	Capital 2/	-190
Other Assets	21		
<b>Total:</b>	800		800

1/ Loss of 300 in Loans

2/ Charged loss results in insolvency

### Comparison of Insured Deposit Effect under Liquidation and P&A Scenarios

#### Insured Deposit Repayment in a Liquidation Payoff

<b>Assets</b>		<b>Liabilities</b>	
Cash from DIS	570	Insured Deposits	550
		Other liabilities 1/	20
<b>Total:</b>	570		570

1/ Accrued interest on insured deposits

#### Insured Deposit Repayment via an Assuming Bank in a P&A

<b>Assets</b>		<b>Liabilities</b>	
Cash and bank deposits	154	Insured Deposits	550
"Good" Investments	85	Borrowings	
"Good" loans	200	Other liabilities 2/	20
Other Assets 1/	5		
<b>Sub-total</b>	444		570
Cash from DIS	126		
<b>Total:</b>	570		570

1/ Accrued interest on "Good" loans

2/ Accrued interest on insured deposits

6. **Additionally, a P&A is always less costly than a liquidated payout simply because the costs of servicing assets that are not transferred to a bank as part of a P&A significantly reduce the ultimate recoveries in the liquidation.** If a bank undergoes liquidation and the DGS performs a payoff, then somebody must either continue or establish a loan servicing system for the failed bank's loans. Systems must be developed (or continued) and staff must be hired to process payments, compute payoffs, send collection letters, and engage in other collection activities. This process bears a significant cost (conservatively estimated at 15 percent up to recovery realization) and is a direct reduction of the recoveries through liquidation, thereby reducing funds available to distribute to uninsured depositors and other creditors. When the loans are passed to an AB via a P&A, then 100 percent of book value (205 in the above example) is counted as a liquidation recovery; ergo, uninsured depositors, other creditors, and perhaps others (e.g., subordinated debt holders) are better placed for recoveries on asset liquidation. [Note that legislated depositor preference permits ease of a P&A transaction because the "no creditor worse off" concept is legally null.]

7. **A P&A is not simply a financial transaction, however.** There are many other duties and responsibilities of the AB to the counterparty as well as those designed to minimize disruption to local communities. Some standard provisions of a P&A transaction include:

- Liabilities assumed at book value.
- The acquiring bank (AB) must pay contract rate of interest on deposits for 14 days, after which it may adjust the interest rate. Depositors have the right to withdraw their deposits without penalty.
- AB must report to the DGS on a monthly basis all deposits claimed (withdrawn) or ratified (any transaction on a deposit account, i.e., additional deposit or partial withdrawal, which constitutes a ratification of that deposit account; i.e., the depositor implicitly accepts the transfer of his deposit to the AB).
- All deposits unclaimed or not ratified must be returned to DGS at the end of 18 months.
- Assets purchased at book value (with the stipulation that fixed assets are to be adjusted to market value ex post, following legitimate appraisals).
- Loans fully secured by deposits may also be passed to AB at book value.
- Assets are passed with limited warranty and/or non-recourse ("as is", "where is").
- AB may be required to service assets for the liquidator in accordance with reasonable and prudent banking standards for a limited time, for which AB will be entitled to a reasonable fee. An example would be if the liquidator needed the AB to temporarily

process payments, compute loan payoffs, etc., for loans the liquidator is responsible for (until his office is up and running, for example).

- AB may be granted exclusive option to purchase loan pools.<sup>25</sup> AB agrees to assumption of certain duties and obligations.
  - Continuation of banking business at every branch location for a specified period of time (not less than 90 days).
  - Continuation of safe deposit boxes business (if any) for a specified period of time.
  - Continuation of safekeeping business (if any) for a specified period of time.
- Fixed assets (bank premises, furniture, fixtures and equipment) shall be adjusted to fair market value.<sup>26</sup>
- May require AB to provide office space for the liquidator.
- AB must pay checks, drafts, and orders as in the normal course of conducting a banking business.
- AB must give notice to depositors within seven days, by mail and by advertising in a newspaper of general circulation, informing of AB's assumption of failed bank's deposit liabilities. Such notice must include instructions to claim deposits as well as any changes in interest rates and fees, which would apply within two weeks after the transfer at the earliest. Until such an adjustment fees and interest rates for the failed bank apply
- All records pertaining to assets purchased by and deposit accounts transferred to AB must be preserved by AB for the legally mandated period of time.
- Any bid amount (premium) that AB agrees to pay is stipulated in the P&A.

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<sup>25</sup> Loan pools represent groups of loans (usually similar types) that are offered in bulk to a potential purchaser—for example, performing mortgage loans. Also, the failed bank may have some commercial customers that an AB also has a relationship with. So it may be advantageous to purchase those related loans to strengthen the banking relationship.

<sup>26</sup> An example of a method to achieve fair market value is to have two appraisals performed—one by an appraiser selected by the authorities and another by an appraiser selected by the AB—and use the average as fair market value. If there is an unacceptable discrepancy between the two appraisals, then a third appraisal, conducted by a mutually agreed upon appraiser will mediate the difference.

- Adjustments for errors and omissions in constructing the pro forma balance sheet, asset purchases (e.g., adjustment for fixed assets from book value to fair market value) shall be paid by either party during a Settlement period (not to exceed 180 days).
- AB agrees to cooperate with the Supervisory Authority and DGS and the liquidator on general matters as well as in conjunction with claims and suits.
- AB is indemnified by receiver/liquidator (or maybe the Supervisory Authority depending on local law) for any claims, not expressly assumed, against the failed bank (e.g., shareholders, creditors, etc.). A P&A agreement, along with the rights and obligations, shall be governed by applicable law.