

EFFECTIVE COOPERATION FOR RESOLUTION OF FINANCIAL INSTITUTIONS IN THE AMERICAS



ASBA

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OF BANKS OF THE AMERICAS



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DISCLAIMER

The findings, interpretations, and conclusions expressed in this report are entirely those of the authors. They do not necessarily represent the views of the organizations they work for.

USE OF INITIALS AND ACRONYMS

The meanings of all acronyms and initials are presented at the end of the document.

DEFINITIONS

The definitions of key terms used in the document are presented at the end of the document and come from the October 2014 draft version of the assessment methodology for the Financial Stability Board *Key Attributes of Effective Resolution Regimes for Financial Institutions*.

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EXECUTIVE SUMMARY

Since the Association of Supervisors of Banks of the Americas (ASBA) published its report titled *Effective Deposit Insurance Schemes and Bank Resolution Practices*¹ in September 2006, a new generation of standards for deposit insurance and bank resolutions has emerged. In the aftermath of the global financial crisis of 2007 to 2008, it became evident that financial stability requires a well-integrated financial safety net (FSN). The prolonged effects of the financial crisis eased the way for regulatory bodies to agree on elements that should be present in orderly resolution processes for institutions of all sizes, in conjunction with effective protection schemes for depositors and other clients or customers. Authorities in ASBA member jurisdictions have revised their financial stability frameworks based on these standards.

To promote cooperation and knowledge transfer among members, ASBA established a Working Group (WG) made up of deposit insurers and supervisors from member jurisdictions in the Americas to share and disseminate their experiences in enhancing the regulatory environment in their respective jurisdictions. The WG's objectives were to identify current challenges, propose guidelines for effective cooperation and collaboration within the FSN, and ensure effective resolution processes in the Americas.

The findings in this report are based on responses from two surveys involving selected elements from the International Association of Deposit Insurers (IADI) *Core Principles of Effective Deposit Insurance Systems* (CPs), the Financial Stability Board (FSB) *Key Attributes of Effective Resolution Regimes for Financial Institutions* (KAs), and the Basel Committee on Banking Supervision (BCBS) *Core Principles for Effective Banking Supervision*

(BCPs). The three sets of international standards (BCPs, CPs, and KAs) together support the building of a collaborative environment and help to identify opportunities for cooperation among the FSN members.

Survey responses and exchanges among WG members helped identify how the absence of proper coordination and information-sharing mechanisms affect effective resolution processes and the performance of bank supervisors, deposit insurers, and resolution authorities. Dynamic discussions among WG members raised awareness of common and individual challenges. This exchange was fundamental in identifying solutions based on international standards.

The relationship between supervision, resolution, and deposit insurance is intricate and requires a safety net with well-aligned public policy objectives, mandates, and powers. Rigorous prudential supervision is essential for deposit insurance and resolution mechanisms to be effective. Supervisors play a central role in integrating FSNs because of their in-depth knowledge of the financial institutions they oversee. Likewise, a properly designed deposit insurance system (DIS) contributes to public confidence and thus limits contagion from banks in distress.

1/ See the September 2006 ASBA paper titled *Effective Deposit Insurance Schemes and Bank Resolution Practices*, <http://www.asbasupervision.com/en/todos/virtual-library/publications-of-asba/working-groups/280-gt03/file>.

And a regime that enables orderly resolution processes of nonviable (no longer viable, or likely to be no longer viable, and with no reasonable prospect that recovery actions will be successful)² institutions of all sizes without the use of public funds, while maintaining continuity of their vital functions, contributes to market discipline and avoids unnecessary losses.

Collaboration and coordination among these functions contribute to ensuring a well-integrated FSN. This report articulates opportunities for coordination within the FSN to enhance the effectiveness of all three functions both individually and collectively.

The effectiveness of deposit insurance and resolution mechanisms greatly depends on a supervisory regime that ensures timely intervention. In addition, the legal framework should incorporate a system of laws that guide financial transactions and provide the authorities with the power to determine and enforce prudential norms. The adequacy of deposit insurance and resolution regimes cannot be evaluated without taking into account the architecture of the FSN and how that framework assigns roles and responsibilities to these functions individually and collectively. Regardless of the FSN architecture, opportunities exist for enhanced coordination throughout the life of financial institutions (FIs).

Cooperation mechanisms should assist all stakeholders involved in the resolution process from beginning to end. The following actionable guidelines for effective cooperation are presented in the last section of this report:

- *Coordination agreements* that inform the decision-making process and provide structure for changes in leadership as the roles and responsibilities of FSN participants change and as events and developments occur and evolve.
- *Legal gateways* that create the opportunities and provide the right incentives for timely information sharing and collaboration.
- *Coordination mechanisms and information-sharing frameworks* enabled by memoranda of understanding (MOUs), financial stability committees, and crisis management groups.

- A *collaborative environment* that integrates day-to-day collaboration, timely intervention and preparation for resolution, application of resolution powers, and settlement and liquidation.

Regulatory bodies across the Americas are taking steps to enhance current safety net arrangements to affect orderly resolution processes. Yet the findings in this report indicate that continued development is needed to achieve this goal, as most responding jurisdictions stated that they lack a formal financial safety net platform (S1, Q39).

2/ This definition is used throughout the paper.

1. INTRODUCTION

1.1 BACKGROUND

In the aftermath of the most recent global financial crisis (GFC), standard-setting bodies—including the Financial Stability Board (FSB), the International Association of Deposit Insurers (IADI), and the Basel Committee on Banking Supervision (BCBS)—introduced international standards for deposit insurance and bank resolutions. IADI’s *Core Principles of Effective Deposit Insurance Systems* (CPs), the FSB’s *Key Attribute of Effective Resolution Regimes* (KAs), and the BCBS’s *Core Principles for Effective Banking Supervision* (BCPs) assert that supervision, deposit insurance, and resolution are distinct safety net functions that must be closely coordinated to safeguard the financial system in periods of stability and times of crisis.

ASBA member jurisdictions are taking steps to implement the international standards and to improve the level of coordination among safety net participants, but challenges remain. ASBA, therefore, created a WG to review jurisdictions’ resolution frameworks to determine how best to overcome these challenges, ultimately improving coordination and strengthening the FSN. The WG focused specifically on jurisdictions in the Americas—Latin America, the United States, and the Caribbean—as these jurisdictions are ASBA members.

The WG circulated surveys to ASBA member jurisdictions to (1) assess the level of coordination among safety net participants in those jurisdictions and (2) determine the challenges to increasing and improving coordination. The survey responses revealed that formal methods for coordinating safety net functions are not typical but that jurisdictions are taking steps to enhance coordination by focusing on best practices and, in some cases, proposing reforms to regulatory and legal frameworks.

1.2 OBJECTIVES AND METHODOLOGY

A supervisor’s core function is to be vigilant and ensure that “living” financial entities carry out their operations in a safe and sound manner. The deposit insurer (DI) and resolution authority’s (RA) core functions are to be vigilant and ensure that when “living” financial entities that are “dying or will most probably die”, can exit the system in a manner that is safe and sound for their customers, the financial sector, and ultimately, the whole economy.

The WG’s objective was to identify opportunities for jurisdictions to increase the level of cooperation between their deposit insurance and resolution functions.

To attain this objective, the WG:

1. Analyzed depositor protection schemes and resolution regimes to determine how they carry out their public policy objectives and mandates, and how they cooperate and coordinate actions with supervisors before, during, and after a resolution;
2. Explored bank supervision practices to identify current approaches for identifying and dealing with weak and problem institutions;
3. Studied the inter-institutional arrangements for early and timely intervention, and the resolution process for nonviable banks and financial group holding companies, as well as their affiliated entities;
4. Determined challenges in adopting a Special Resolution Regime (SRR); and
5. Produced recommendations to foster coordination among supervisors, DIs, and RAs in times of stability and times of crisis.

In this report, supervision regimes are analyzed in terms of their use of techniques and tools for identifying and dealing with weak banks, and entry into resolution. Deposit insurance is analyzed in terms of its role before, during, and after a resolution process. Resolution regimes are analyzed based on whether jurisdictions have a designated RA and an SRR to deal with nonviable financial institutions.

The WG circulated two surveys to ASBA member jurisdictions in Latin America, the United States, and the Caribbean. Twenty-one jurisdictions responded to Survey 1 (S1)³ on deposit insurance, and 21 responded to Survey 2 (S2)⁴ on resolution frameworks. The survey responses, along with testimony from WG members on their jurisdiction's efforts to adopt best practices for safety net functions, informed the WG's analysis. Throughout this report, jurisdictions that responded to the surveys are referred to as *responding* jurisdictions, and jurisdictions that participated in WG meetings, wrote letters, and responded to surveys are referred to as *participating* jurisdictions. Discussions among WG members during two meetings held in Lima, Peru, in April 2015 and June 2016 also informed the analysis.

The report has six sections. Section one is an introduction. Section two presents the findings from the surveys on selected features of supervision, deposit insurance, and resolution regimes. The second section also discusses challenges for each financial safety net function and demonstrates how weaknesses in coordination undermine each function's performance. The third section establishes links among the three sets of international standards for adequate collaboration and draws on the challenges from section two to identify goals for enhanced coordination that can be achieved by adopting best practices. Recommendations to solve coordination issues are proposed in this and the next two sections. Section four explains how the FSN participants can collaborate throughout the life span of FIs, before, during, and after resolution. Section five proposes general guidelines in establishing formal coordination and information-sharing mechanisms. The report concludes with the sixth section, which suggests that changing the collective mindset is necessary to create more effective and integrated FSNs.

3/ The following 21 jurisdictions responded to Survey 1: Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, ECCB, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Spain, Trinidad and Tobago, Uruguay, and the USA. Completed surveys were submitted in April 2015.

4/ The following 21 jurisdictions responded to Survey 2: Belize, Bolivia, Brazil, Cayman Islands, Chile, Colombia, Dominican Republic, ECCB, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Paraguay, Peru, Spain, Trinidad and Tobago, Uruguay, and the USA. Completed surveys were submitted in February 2016.

2. MAIN FINDINGS

Progress by financial authorities to adopt best practices for key FSN functions—bank supervision, deposit insurance, and resolution—varies widely among jurisdictions in the Americas. This report does not assess compliance with the international standards; rather, it presents the challenges that authorities in these jurisdictions have encountered in establishing effective coordination among financial safety net participants and describes the progress made to address those challenges.

In this section, we present challenges common to supervisors, DIs, and RAs as well as those unique to each of the FSN functions they perform. Survey findings are presented for each function.

2.1 COMMON CHALLENGES

According to the BCPs,⁵ effective crisis management frameworks and resolution regimes help to minimize potential disruptions to financial stability arising from distressed or failing banks and financial institutions. A sound institutional framework for crisis management and resolution requires a clear mandate and an effective legal underpinning for each participating authority in charge of supervision, deposit insurance, and resolution. The authorities should agree on their individual and joint responsibilities in times of stability and in times of crisis. Institutional arrangements should allow FSN participants to share confidential information in order to efficiently handle recovery and resolution situations when they occur.

Common challenges for participating jurisdictions lie in both their institutional legal frameworks and coordination arrangements. Specifically, these frameworks and arrangements do not plainly distinguish the responsibilities, scopes, and mandates of the FSN functions the way international standards would prescribe.

2.1.1 DIFFERENTIATING SCOPES

The scope of competence of each function comprising the FSN should be separate and distinct, regardless of the jurisdiction's institutional arrangements and legal frameworks that may have evolved over time within the safety net. A distinction should be made between resolution and supervisory powers within financial sector authorities. Resolution authorities must be able to deal with property and third-party rights related to a resolution process and the allocation of losses to creditors and shareholders. Supervisory authorities in all surveyed jurisdictions are authorized to require corrective action and enforce a range of penalties, including authorizing entry into resolution, when financial institutions do not meet prudential requirements. Several surveyed jurisdictions reported that supervisors also perform resolution functions, but the legal frameworks for those jurisdictions do not clearly address the treatment of operational or legal challenges that arise after closing a financial institution. When the supervisor carries out resolution actions, it performs such actions from a supervisor's perspective, not necessarily with the criteria and public policy objectives recommended for the RA contained in KA2. In addition, supervisory authorities might have limited capabilities to respond to the general public in times of crisis. Their organizational structures are not guided by customer service objectives in resolution; therefore, responsiveness to depositors and other creditors of a failed institution is generally lacking. Naturally, this lack of responsiveness is to be expected when an agency's main purpose is something other than deposit insurance and/or resolution, as an agency must predominately allocate its resources to its main missions.

Most participating jurisdictions recognize that aligning the mandates, objectives, and powers among authorities of their FSN may require legal reforms, and thus these jurisdictions are reviewing their legal frameworks to strengthen their crisis management capabilities. Specifically, they are addressing their FSN institutional frameworks and arrangements, better defining their functional scopes, and formulating SRRs.

⁵/ BCP, paragraph 51.

2.1.2 DIFFERENTIATING CLIENTELE

FSN participants have different clientele that may overlap. The clientele of lenders of last resort are typically governments, banks, and other real economy agents, while the primary clientele for supervisors are the entities they supervise. The main clientele of both DIs and RAs are depositors and other financial sector consumers. The deposit insurance and resolution functions are incentive compatible⁶ in minimizing losses to creditors and the economy, including to the deposit insurance fund (DIF).

To determine the appropriate institutional arrangements for the FSN, it is important to align the natural clienteles and incentives of each safety net participant. Such an alignment can facilitate identifying the proper distribution of mandates and objectives; which, in turn, would improve mandate deliverance and performance.

2.1.3 INTERACTING THROUGHOUT THE “LIFE” OF FINANCIAL INSTITUTIONS (FI)

During the WG discussion meetings, it became evident that a need exists for FSN participants to fully understand how FSN functions interact throughout the life and death of a financial operation. Supervisors, DIs, and resolution authorities each have unique roles and responsibilities in the financial safety net. In general, supervisors are responsible for licensing⁷ financial institutions and ensuring that only sound deposit-taking institutions participate in the financial system. DIs verify deposit data and ensure that deposit insurance terms and limitations are communicated properly to the public. When an FI enters resolution, DIs should also have a working understanding of the conditions leading to the FI's wind-down, the timeframe for the resolution process, and the criteria under which deposit insurance funds will be applied (should they be required). DIs also must ensure that the proposed use of the institution's funds results in the least permanent cost.

RAs must understand the operating arrangements of FIs in their jurisdictions, including whether those arrangements provide critical services, how they might be interconnected in the financial system and the economy, and the mechanisms that would allow for an orderly and least costly resolution.

To fulfill their mandates, FSN participants must have the appropriate resources, authority, organization, and constructive working relationships with each other and with other applicable agencies throughout an FI's “life” stages. Yet the WG's findings indicate that legal frameworks in participating jurisdictions do not fully enable such a collaborative and coordinated environment for “birth-to-death” regulatory oversight and interactions. WG members indicated the need for greater clarity not only for aligning mandates, objectives, and powers among FSN authorities but also for allowing safety net participants to engage, individually and collectively, with FIs throughout their different life stages.

6/ Beck, T., *The Incentive-Compatible Design of Deposit Insurance and Bank Failure Resolution*, The World Bank, May 2003.

7/ Licensing and chartering are terms used by participating jurisdictions to refer to the process for authorization to operate by financial regulators.

2.1.4 POINT OF NONVIABILITY

Determining the point of nonviability for FIs and, thus, when resolution actions should be implemented remains a challenge for participating jurisdictions. A change in mindset, away from compliance-based judgments by some supervisors, may be necessary to reach consensus on the determination of the point of nonviability, a point that should be of no return. However, in 13 responding jurisdictions, courts can override the RA (S2, Q20), and in most others an administrative process can delay entry into resolution, to the detriment of the objectives of effective resolution. Rules and criteria for determining the point of nonviability should be clear for all FIs and FSN participants.

In general, legal frameworks in participating jurisdictions provide supervisors with discretionary powers to require corrective action and to determine the point of nonviability based on a wide range of qualitative and quantitative criteria. However, existing incentives and institutional arrangements do not allow the necessary level of interagency consultation and integration recommended in the KAs. Moreover, many of the participating jurisdictions hold a traditional view of the failed FI wind-down process in which the supervisor closes the insolvent operation and prepares it for judicial liquidation, usually on the basis of capital thresholds for intervention, both of which can exacerbate the inefficiencies of the current institutional arrangements.

As expected, a majority of responding jurisdictions reported that they would trigger the resolution process when an FI reaches or is nearing the prudential thresholds. Approximately one-half of responding jurisdictions said they would do so when no viable private sector alternative exists to prevent the default (S2, Q7). Moreover, notwithstanding the criteria set forth in the legislation, in most responding jurisdictions,⁸ a court would have the power to suspend or overturn the decisions made by the RA. To implement effective resolutions in line with the objectives of the KA, a change of mindset about nonviability and resolution triggers is essential.

2.1.5 TREATMENT OF HOLDING COMPANIES AND FINANCIAL GROUPS

When supervisors oversee banks that are part of a corporate group, the BCPs recommend that supervisors consider the banks and their risk profiles from three different perspectives: on a solo basis, on a consolidated basis, and on a group-wide basis. Group entities, whether inside or outside the banking group, may be a source of strength. They may also, however, represent exposures that can adversely affect the financial condition, reputation, and overall safety and soundness of the bank.⁹

WG member jurisdictions reported having limited powers to create rules for financial holding companies and financial groups or conglomerates. They also reported having no authority to develop rules for mixed-activity holding companies. Without the authority to issue regulation that adequately captures the risk exposure of these groups, supervisors may be limited in their ability to properly monitor them and minimize their potential impact on the group and the financial system.

8/ Belize, Brazil, Cayman Islands, Colombia, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Peru, Trinidad and Tobago, and Uruguay.

9/ See BCPs, paragraph 22.

2.1.6 IMPLEMENTING RECOVERY AND RESOLUTION PLANNING

The KAs call on jurisdictions to implement recovery and resolution planning (RRP) as part of their supervisory and resolution regimes. RRP is different from issue-specific contingency planning in that it requires FIs to develop recovery plans based upon breaches of predetermined triggers. RRP takes into account the specific circumstances of the firm, including its nature, complexity, interconnectedness, level of substitutability, and size. The resolution plan is intended to facilitate the effective use of resolution powers in a way that ensures continuity of critical functions, without severe disruption and without exposing public funds to losses. Supervisory and resolution authorities should verify that recovery and resolution plans identify options to restore firms to a safe and sound condition, should the firms come under severe stress.

Among responding jurisdictions, only Mexico, Spain, and the United States of America (USA) require RRP as defined by the KAs. All three require resolvability assessments.¹⁰

2.1.7 IDENTIFYING AND MANAGING SYSTEMIC EVENTS

Financial system authorities are responsible for identifying systemic events. Generally, this involves a broader financial safety net that includes the ministries of finance and other relevant supervisors, depending on the scope and nature of the event and the structure of the financial system in the jurisdiction. Systemic events are not limited to those involving systemic institutions. Indeed, a nonviable FI, not classified as systemic or critical *a priori*, may present a systemic risk upon entry into resolution. And, without proper management, failures can evolve into events with systemic impact.

An integrated policy response requires seamlessness between stable and crisis modes, which can be achieved by a single piece of legislation that covers a variety of failures within the financial industry.

Participating jurisdictions are facing challenges in building practical and seamless resolution regimes for systemic or critical FIs and events.

According to survey results, the legal frameworks in 14 of the responding jurisdictions do not provide specific tools for determining the systemic importance of failing institutions (S2, Q6). Table 1 shows when and how the jurisdictions with systemic event tools use them.

^{10/} Resolvability assessments, as defined by KA 10, evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and the overall economy.

TABLE 1: APPLICATION OF SYSTEMIC EVENT TOOLS BY JURISDICTION

Country	Timing	Criteria
Honduras	<i>A priori</i>	FI controls 20% or more of total deposits, loans, or payment system transactions.
Mexico	Upon occurrence	Banking Stability Committee (CEB) determines whether a special resolution regime will be used in cases where the FI poses a systemic risk.
Nicaragua	Upon occurrence	In cases in which an FI poses a systemic risk, the DI, the central bank, and the supervisor jointly determine whether a special resolution regime is used.
Paraguay	Upon occurrence	The Ministry of Finance (MOF) and central bank, with a favorable review by the supervisor, determine the resolution approach if an FI poses a systemic risk.
Peru	Upon occurrence	The supervisor, with the favorable opinion of the MOF and the central bank, determine the resolution approach if an FI poses a systemic risk.
Dominican Republic	Upon occurrence	The Monetary Board, with the recommendation of the supervisor, determines the resolution approach if an FI poses a systemic risk.
United States	<i>A priori</i>	Upon satisfaction of predetermined criteria and the recommendation to the Secretary of the U.S. Treasury by two U.S. financial regulatory agencies, the FDIC will be appointed receiver of the financial company.

Source: Survey 2, Questions 6-9.

2.2 CHALLENGES FOR THE SUPERVISOR

When assessing the quality of supervisory systems, the BCPs emphasize that supervisory practices are not static. Lessons learned from financial system participants contribute to a dynamic process whereby supervisory systems are developed and refined. Supervisors often encourage banks to adopt best practices. Supervisors can consequently lead by example, continually moving toward higher international standards. They can also support, to the extent possible, the adoption of such standards for the other FSN functions in their jurisdictions.

The BCBS's *Guidelines for identifying and dealing with weak banks*¹¹ establish that the lack of both contingency arrangements and an understanding of the tools available for dealing with weak banks contribute not only to unnecessary delays in supervisory and resolution actions but also to the high cost of resolving banking sector problems.

Experiences of supervisors and RAs in recent years confirm the importance of enhancing risk-based supervision, intensifying efforts and resources dedicated to monitoring entities of systemic importance, adding a macro-prudential perspective to the micro-prudential supervisory regime, and strengthening crisis management frameworks with RRP that reduce the possibility of failures and their impact, should they occur.

Supervisors' commitment to building proper collaboration and information-sharing mechanisms to attain these objectives is imperative to the effectiveness of the FSN. However, supervisors in participating jurisdictions that have made this commitment have encountered several challenges, which are outlined in the next section.

11/ BIS, *Guidance for identifying and dealing with weak banks*, July 2015.

2.2.1 ENABLING COOPERATION AND INFORMATION SHARING

Formal and informal arrangements should be established to ensure cooperation, timely information sharing, and analysis of that information between relevant domestic and foreign supervisors (BCP3). At a minimum, the information shared should include a wide range of strategic and operational information, including bank-specific and sector-specific performance data as well as risk-monitoring reports and related analyses. The arrangements should also encourage collaboration while protecting the confidentiality of the information.

In approximately one-half of responding jurisdictions, law requires coordination among functions of the FSN (S1, Q36). However, survey respondents said coordination and information sharing were limited.

Even when coordination was required by legislation, information sharing was limited. Eight¹² of 21 responding jurisdictions have different regulators for different financial activities. Notably, most responding jurisdictions (16) do not have cross-border arrangements within their resolution functions or agencies (S1, Q40). Table 2 illustrates some elements of coordination arrangements among responding jurisdictions.

12/ Chile, Dominican Republic, Eastern Caribbean Central Bank (ECCB), Ecuador, Mexico, Panama, Paraguay, and the USA (S1, Q20).

TABLE 2: COORDINATION ARRANGEMENTS BY JURISDICTION

Country	Coordination within FSN	EWS*	EWS results shared	Systemic events treatment	Formal FSN	Cross-border arrangements for supervision	Cross-border arrangements for resolution
Bolivia	Required	Yes	No	Yes	No	Yes	No
Brazil	Discretionary	Yes	No	No	No	Yes	Yes
Chile	Required	Yes	with FSN	No	No	Yes	No
Colombia	Required	Yes	with FSN	Yes	Yes	Yes	No
Costa Rica	NR	NR	NR	NR	NR	Yes	No
Dominican Republic	Discretionary	Yes	No	Yes	No	Yes	No
ECCB	NR	NR	NR	NR	NR	NR	NR
Ecuador	Required	Yes	with DI	No	Yes	Yes	No
	Required	Yes	with FSN	No	Yes	Yes	No
Guatemala	Discretionary	Yes	No	Yes	No	Yes	No
Haiti	Discretionary	Yes	No	No	No	No	No
Honduras	NR	Yes	with FSN	Yes	Yes	Yes	No
Mexico	Required	Yes	with FSN	Yes	Yes	Yes	Yes
Nicaragua	Required	Yes	with DI	Yes	No	Yes	No
Panama	NR	Yes	No	Yes	No	Yes	No
Paraguay	Discretionary	Yes	with DI	Yes	Yes	Yes	No
Peru	Discretionary	Yes	No	Yes	No	Yes	No
Spain	Required	Yes	No	No	No	Yes	Yes
Trinidad and Tobago	Required	Yes	No	Yes	Yes	Yes	No
Uruguay	Required	Yes	with FSN	No	Yes	Yes	No
USA	Discretionary	Yes	with FSN	Yes	Yes	Yes	Yes

Source: Survey 1, Questions 36-40.

*NR = No Response

*EWS = Early Warning System

2.2.2 RISK MANAGEMENT ISSUES

Effective prudential supervision requires the bank supervisor to have the capacity and resources to fully understand all material risks assumed by or evident in regulated entities, and the ability to determine whether bank management has established a comprehensive risk management process (BCP15). Effective banking supervision most typically involves a risk-based approach using a mix of on-and off-site inspection and other monitoring tools. The vast majority of responding jurisdictions (S1, Q23) reported in the survey that they used this approach. However, WG discussions revealed that, in practice, many respondents rely heavily on a rules and compliance-based approach to bank supervision, which typically focuses on the financial institution's condition and adherence to prescribed regulatory requirements (e.g., rules and performance metrics) at a particular point in time.

An effective supervisory review process requires supervisors to implement a risk-based supervisory approach with forward-looking components. In this forward-looking approach, the supervisor identifies the areas of greatest concern by assessing the bank's various business lines and risks; its associated strategies; and the quality of its governance, management, and internal controls. Early risk detection will assist supervisors in gauging the risks institutions are exposed to as ongoing concerns and those that can impact the system when they need to be resolved.

The adoption of an effective risk-based supervisory approach that prioritizes early risk detection will also help bank supervisors, deposit insurers, and resolution authorities better prepare for bank failures. As emphasized by the FSB (KA3), resolution should be initiated when a firm is no longer viable or likely to be no longer viable. The resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully extinguished.

During WG discussions, participating jurisdictions reported that they are moving toward more effective risk-based supervision approaches and plan to adopt KA elements, such as RRP; in most cases, however, proper implementation requires legal reforms.

2.2.3 DEALING WITH WEAK FINANCIAL INSTITUTIONS (FI)

As the GFC illustrated, early intervention is essential for preserving value in a failing firm and limiting externalities and other spillovers. The supervisor is expected to act at an early stage to address risks to banks or to the financial system. Supervisors must have at their disposal an adequate range of supervisory tools to authorize timely corrective actions, including revoking a banking license or recommending its revocation (BCP11).

The BCBS defines a weak bank as “one whose liquidity or solvency is impaired or will soon be impaired unless there is a major improvement in its financial resources, risk profile, business model, risk management systems and controls, and/or quality of governance and management in a timely manner”.¹³ In addition, the BCBS recommends that banking supervisors maintain close communication with other domestic agencies that have an interest in the bank's financial condition, such as the central bank, the RA, and the DI, among others.

The legal framework in all responding jurisdictions mandates corrective actions when weaknesses in FIs are identified (S1, Q25). Supervisors in all surveyed jurisdictions appear to have substantive enforcement authority for taking formal and informal action, yet challenges arise when corrective actions are not successful and nonviability becomes imminent. At that point, supervisory authority might not be sufficient to ensure an orderly wind-down of the failed FI, resulting in delayed intervention and preventing a timely and orderly resolution.

13/ See BCBS *Guidelines for identifying and dealing with weak banks*, July 2015.

2.2.4 ACTION UPON NONVIABILITY

When an institution experiences high levels of stress and corrective actions are unsuccessful, the authorities should prepare for resolution. Supervisors across jurisdictions tend to agree on most of the objective elements recommended by the KAs to guide authorities in determining when an institution infringes, or is likely to infringe, on the requirements for continued authorization, which would justify the withdrawal of its license to operate.¹⁴ However, their legal frameworks in many cases emphasize capital compliance and often do not provide the incentives or the full menu of options to take resolution actions when other regulatory requirements, not only capital requirements, are breached. In addition, when the supervisory authority is also the resolution authority, resources are often focused on identifying recovery strategies, making resolution planning and coordination a lower priority.

The legal framework should contain pre-determined criteria for entry into resolution, but triggers for resolution action should not be automatic. On the contrary, in each case, the relevant authorities should decide whether the institution is failing, or is likely to fail, based on a comprehensive assessment of qualitative and quantitative criteria. Discussions are ongoing in participating jurisdictions on the qualitative and quantitative criteria, as well as the appropriate time for determining when such criteria have been satisfied for entry into resolution.

It is essential to harmonize criteria for determining nonviability in order to coordinate among domestic and cross-border authorities. As the resolution dialogue continues, authorities should consider adopting legal provisions that define nonviability to include circumstances in which firms are no longer viable or likely to be no longer viable and have no reasonable prospect of becoming so. Only five responding jurisdictions—Belize, Cayman Islands, Spain, Trinidad and Tobago, and USA—have legal provisions containing criteria that include the concept of nonviability as defined by the KA (no longer viable or likely to be no longer viable) (S2, Q26).

14/ General examples of elements to determine nonviability in advance, according to the FSB *Key Attributes Assessment Methodology for the Banking Sector*, Explanatory Note 3(c), are:

- i. Regulatory capital or required liquidity falls below specified minimum levels;
- ii. There is a serious impairment of the bank's access to market-based funding sources;
- iii. The bank depends on official sector financial assistance to sustain operations or would be dependent in the absence of resolution;
- iv. There is a significant deterioration in the value of the bank's assets; or
- v. The bank is expected in the near future to be unable to pay liabilities as they fall due .

2.3 CHALLENGES FOR THE DEPOSIT INSURER (DI)

A significant lesson from the financial crisis, according to IADI's Core Principles, is that deposit insurance plays an important role in the safety net and must be part of contingency planning and crisis management frameworks (CP6). As the GFC unfolded, deposit insurance systems (DISs) were put to the test. In the crisis aftermath, many jurisdictions formally adopted the lessons learned to refine their systems where appropriate. The roles of DIs¹⁵ and the legal mandates of DISs have evolved since then, reflecting greater international consensus on appropriate design features.¹⁶ Opportunities for improvement remain, but as more jurisdictions adopt the CP, convergence in system design will help to identify opportunities for improvement, including improvement in building cooperation mechanisms. This section presents challenges to cooperation encountered by DIs in surveyed jurisdictions.

2.3.1 MANDATE AND INTEGRATION WITH THE FINANCIAL SAFETY NET

The main public policy objectives of DISs are to protect depositors and to contribute to financial stability (CP1). These objectives are most often shared with the other FSN participants. Therefore, it is important to ensure that the legal framework states not only the DIS mandate and objectives but also the authorities granted by law to the deposit insurance agency (DIA) to meet those objectives. A clear and cohesive legal framework would facilitate consistency among the safety net participants, collectively and individually, and would improve their performance and operations. The DIS mandate should guide the design of the DI's operation and specify the roles that the DI must perform to contribute to financial stability; it should also specify the mechanisms and timing for engaging with DIS members and all other stakeholders.

According to the FSB, deposit insurer mandates can vary from "paybox" to "risk minimizer," as described below.

- *Pay box* mandate: the deposit insurer is only responsible for the reimbursement of insured deposits.
- *Pay box plus* mandate: the deposit insurer has the responsibilities of a pay box mandate in addition to other responsibilities, such as certain resolution functions (e.g., financial support).
- *Loss minimizer* mandate: the insurer selects from among several least-cost resolution strategies.
- *Risk minimizer* mandate: the insurer has comprehensive risk minimization functions that include risk assessment/management, a full suite of early intervention and resolution authorities, and in some cases prudential oversight responsibilities.

Exhibit 1 displays the DIS mandates for responding jurisdictions. Fifteen of the 16 responding jurisdictions that have a DIS reported that their DI schemes were established by legislation (S1, Q5). Of those, most (12) are independent entities (S1, Q4).

WG members shared that, in some cases, the mandates of their DISs are not always clearly aligned with their legal frameworks. For DIs to carry out their role properly, the DIS mandate must be supported by law. In addition, in jurisdictions where the DI has not fully established the capacity to execute its mandate or is unable to fulfill its mandate because of insufficient resources or staff, attention and resources should be allocated to ensure that the DI develops the appropriate capabilities, rather than having another safety net participant make up for it.

15/ Not all jurisdictions have an agency to perform the DI's role.

16/ See FSB *Thematic Review on Deposit Insurance Systems*, February 2012.

EXHIBIT 1: DIS MANDATES BY JURISDICTION



Note: ECCB, Costa Rica, Haiti, Panama and Chile do not operate explicit deposit insurance systems.

2.3.2 OPPORTUNITY FOR ACCESS TO INFORMATION

The CPs list several DI responsibilities for reimbursing depositors (CP15), including the following: (1) the DI reimburses most insured depositors within seven working days; (2) the DI has access to depositor records at all times, so that it can provide depositors prompt access to their funds; and (3) the DI can carry out the reimbursement process promptly.

Most often, the DIS relies on the supervisor to provide timely, accurate, and comprehensive information on FI weaknesses. Regardless of mandate, all DISs must have sufficient notice of emerging problems in order to be adequately prepared before a firm's failure (CP6). They must prepare for deposits restitution, either through direct payout or by facilitating a resolution, which

means they may need to consolidate information provided by supervisors with information collected from insured institutions. Survey data reveal that this information consolidation could be improved. Only Ecuador, Honduras, Paraguay, Nicaragua, and USA share examination reports with the DI (S1, Q24).

Cooperation agreements for most participating jurisdictions grant the DI access to quantitative data but do not provide the DI an opportunity to analyze the data in a timely manner if received weeks or even months after processing. Further, the agreements do not always include qualitative information. Supervisors in Ecuador, Paraguay, and Nicaragua share their early-warning systems reports exclusively with the DI. Chile, Mexico, Uruguay, USA, El Salvador, Colombia, and Honduras share them with all FSN participants (S1, Q37).

2.3.3 BUILDING TRUST IN THE DEPOSIT INSURANCE SYSTEM (DIS)

Trust is a key component for financial stability. To build and maintain trust, DIs should have a permanent public awareness program. In addition, they should work closely with banks and other safety net participants to ensure the consistency and accuracy of the information provided to depositors. Likewise, DIS member institutions should support the DI's efforts to maximize the public's awareness of the benefits and limitations of the DIS. Banks should be required to provide information about deposit insurance in the language(s) and format prescribed by the DI (CP10.6).

For effective trust building, DIs should present their system's key features in the context of the particular role they play in the FSN. The following need to be comprehensively explained in such a context: the operational arrangements of the DIS; its policies according to its mandate; and the means by which it engages in the safety net before, during, and after member institutions fail. Trust-building efforts also require the DI to have a

continuous presence in the public's mind, rather than only when a member institution has failed. Too often, DIs are given a less relevant role in the FSN out of concern that their presence will disrupt financial markets. To the contrary, markets are likely to remain calm when DIs frequently engage with member institutions. Indeed, DIs should engage with member institutions throughout their "lives." Yet this is not standard practice among participating jurisdictions.

The level of engagement by DIAs in different financial sector events varies. Jurisdictions were asked to qualify¹⁷ whether, in practice, the DIA engaged in a range of events. The results, shown below in Table 3, point to several opportunities for enhancing information sharing and collaboration to ensure the DI may contribute more effectively to financial stability.

17/ Answer choices—not at all, somewhat, by invitation, much, and very much—are meant to represent how the participating DIAs perceive their actual participation in the different events included in the question, "What is the level of participation of the deposit insurer in the following processes?" (Survey 1, Q11).

TABLE 3: DIA POWERS/LEVELS OF FI ENGAGEMENT BY JURISDICTION

	License authorization to member institutions	Changes or Transformations	Issue of regulation	Setting the level of coverage	Scope of coverage	Timely intervention	Setting premiums	Resolution processes	Resolution strategy
Bolivia	None	None	None	By Invitation	None	None	None	Much	None
Brazil	None	None	None	Much	Much	None	Much	By Invitation	By Invitation
Colombia	None	By Invitation	None	None	None	By Invitation	None	By Invitation	By Invitation
Dominican Rep.	None	None	None	None	None	None	None	Much	Much
Ecuador	None	None	By Invitation	By Invitation	By Invitation	Much	By Invitation	Much	By Invitation
El Salvador	None	None	Much	None	None	By Invitation	Much	Much	Much
Guatemala	None	None	None	None	None	None	None	None	None
Honduras	None	None	Much	Much	Much	Much	Much	Much	Much
Mexico	None	None	Little	None	None	Much	Little	Much	Much
Nicaragua	None	None	Much	Much	Much	Much	Much	Much	Much
Paraguay	Little	Little	Little	Much	Much	Little	NR	Much	Much
Peru	None	None	Little	Little	Little	None	Little	Little	None
Spain	None	None	None	None	None	None	None	None	None
Trinidad & Tobago	None	None	None	Very much	Very much	None	Very much	Somewhat	Somewhat
Uruguay	By Invitation	Little	Much	Much	Little	Much	Much	Much	Much
USA	Somewhat	Very much	Very much	Very much	Very much	Very much	Very much	Very much	Very much

Source: WG Effective cooperation for resolution of FIs in Latin America, Survey 1 Question 11

2.3.4 FUND SUSTAINABILITY AND PROMPT REIMBURSEMENT OF COVERED DEPOSITS

In the absence of some form of a deposit protection scheme, financial system authorities face an ever-present threat of deposit runs. The certainty of prompt payment is as important as the speed of reimbursement. Timely and orderly resolutions facilitated by supervisors, together with DI funding, prevent deposit runs, contagion to healthy FIs, and exposure of the DI fund

to losses. Also, timely resolutions that avoid unnecessary losses to all creditors, including the DI fund, contribute to increased confidence in the FSN, its participants, and the financial system. A DI should be funded appropriately, with access to contingency funding, to ensure that it can fulfill its objectives.

Funding and fund targets for deposit insurance vary across responding jurisdictions, as shown in Exhibit 2.

EXHIBIT 2: FUNDING AND FUND TARGETS

Primary source is the banking sector	Mixed funding (government and banking sector)	Predetermined target fund as a % of <i>insured</i> deposits	Predetermined target fund as a % of <i>total</i> deposits
<ul style="list-style-type: none"> • Bolivia • Brazil • Dominican Rep. • Ecuador • El Salvador • Guatemala • Mexico • Nicaragua • Peru • Spain • Uruguay • USA 	<ul style="list-style-type: none"> • Colombia • Honduras • Paraguay • Trinidad and Tobago 	<ul style="list-style-type: none"> • Brazil 2% • Ecuador 10% • Uruguay 5% • USA 2% 	<ul style="list-style-type: none"> • Bolivia 5% • Dominican Rep. 5% • Honduras 5% • Paraguay 10%

For most DIs in responding jurisdictions, the main source of funding is premium income from member institutions. Four of the jurisdictions rely on a combination of both government and banking sector funding (S1, Q7). No jurisdiction in our sample relies solely on its government for DI funding. Fund targets are not explicitly determined in legislation but rather through provisions for suspending premiums or contributions at a set percentage of total or insured deposits. The law is silent on fund targets in El Salvador, Nicaragua, Peru, and Spain (S1, Q9). Among surveyed jurisdictions, the most common method for determining premiums for insured firms is a risk-adjusted rate or percentage premiums.

In the absence of formal public policy objectives, issues related to funding, fund targets, and uses of DI funds are

considered judgment calls by the authority that determines their application. If the authority determining their application is not the DI, conflicts of interest may arise, which may also be detrimental to DIF sustainability.

For DI funding to be adequate, funding and target fund objectives must be consistent with coverage levels. In addition, coverage levels will influence the effectiveness of the DI when it funds resolution mechanisms. For example, if the coverage is too low and DI funding of resolution alternatives has to pass a least-cost test, payout would likely be the least costly solution. If these DIS design elements cannot be measured against pre-established public policy objectives, the effectiveness of the DIS will be limited.

2.4 CHALLENGES FOR THE RESOLUTION AUTHORITY (RA)

Financial crises have taken place in most economies in the world at different points in time and with varying levels of severity.¹⁸ Until the GFC, past experiences with bank failures did not encourage the development of internationally consistent solutions for preventing systemic exposures. Policy debates paid little attention to the practical and legal aspects that would need to be settled in the aftermath of bank failures. The assumption was that in a heavily regulated industry like banking, the financial or operational failure of institutions would be rare events. The regulatory community found it more natural to discuss and develop safety standards, which were designed to minimize the emergence of undue risks, than to contemplate failure as a likely scenario requiring contingency planning. In many instances, the regulatory community would handle bank failures in an *ad hoc* fashion with improvised crisis management based on a combination of administrative actions that lacked clear legally binding guidance and discretionary financial interventions.¹⁹

Since the GFC, authorities across the globe are adopting international standards that aim to prevent unnecessary loss of value and deter interruptions to the financial system and the economy as a whole. Such an update of resolution regimes presents challenges as it requires a change in the ways resolution processes are envisioned, a redistribution of roles and powers, and safeguards that depart from what is customary in most jurisdictions.

2.4.1 BINDING OBJECTIVES FOR RESOLUTION

As mentioned previously, supervisors in all responding jurisdictions have the powers to require corrective actions and to enforce a range of penalties when prudential requirements are not met, including the power to instruct entry into resolution. However, many legal frameworks do not provide clear solutions for addressing operational and legal challenges that arise after a financial institution fails. In general, supervisors use a special

legal provision to manage the estate of the failed bank after the decision to revoke its license to operate. Resolutions are approached as a last resort supervisory action, rather than as a forward-looking function that ensures the orderly exit of the FI in a manner that protects depositors and contributes to financial stability.

Survey data indicate that most jurisdictions follow an alternative resolution regime rather than a general bankruptcy code when winding down deposit-taking institutions. In most cases, however, these alternative regimes do not have resolution frameworks as recommended by the KA. In general, jurisdictions largely rely on supervisory powers that are based on banking or other financial laws, rather than a separate resolution regime with a designated administrative RA.

18/ Laeven and Valencia identified 147 systemic banking crises during the period 1970 to 2011. L. Laeven and F. Valencia, "Systemic banking crisis database: An update," IMF Working Paper No WP/12/163 (June 1012), available at www.imf.org/external/pubs/ft/wp/2012/wp12163.pdf.

19/ Hadjiemmanuil, Christos, "Special Resolution Regimes for Banking Institutions: Objectives and Limitations," LSE Law, Society and Economy Working Papers 21/2013, available at https://www.lse.ac.uk/collections/law/wps/WPS2013-21_Hadjiemmanuil.pdf.

2.4.2 POWERS TO CARRY OUT RESOLUTIONS

During the GFC, governments around the world were forced to rescue very large, complex banks as well as other financial institutions. This response illuminated the need to establish specific competencies of each of the functions within the FSN for the resolution of assets, the maximization of recoveries, and the continuity of critical functions.²⁰ The KAs recommend designating a public authority, either alone or in combination with other authorities, to be responsible for the resolution of nonviable firms. RAs should have the resolution powers to control, manage, marshal, and dispose of the financial institutions' assets and liabilities in carrying out their specific competencies.²¹

The legal frameworks of 19 of the 21 surveyed jurisdictions establish one or more resolution authorities for insolvent FIs (S2, Q3). However, some of these designated authorities do not have the full suite of resolution powers contained in KA3. Specifically, 15 of 21 respondents said they do not have a legal framework specifying one or more administrative RAs for holding companies (S2, Q13). And, in 13 of the 21 responding jurisdictions, courts have the power to suspend or overturn the decision of the RA (S2, Q20).

2.4.3 THE RESOLUTION TOOLKIT

As mentioned above, most jurisdictions rely on supervisory powers and special provisions in their banking and other financial laws to carry out resolutions, but they do not have a designated administrative resolution authority with a full range of resolution powers, as recommended by the KAs. Slightly more than half of the responding jurisdictions (11 of 21) stated that they have the authority to establish a temporary bridge bank to take over assets, rights, and liabilities from a firm in resolution (S2, Q43). And most jurisdictions (18) (S2, Q29 & 48) have the authority to:

- Transfer all or selected assets and liabilities to a healthy FI;
- Displace all management organisms;

- Take control of and operate a firm in resolution, including the ability to enter into, continue, terminate and assign contracts and service agreements; and
- Purchase or sell assets.

Few jurisdictions reported having bail-in mechanisms, the capacity to reduce unsecured obligations, or the power to suspend termination rights. Table 4 shows the resolution tools available in participating jurisdictions.

20/ Board, Financial Stability. "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Identification of Critical Functions and Critical Shared Services." (2013).

21/ Krimminger, Michael, "Controlling Moral Hazard in Bank Resolutions: Comparative Policies & Considerations in System Design," 2006.

TABLE 4: RESOLUTION TOOLS AVAILABLE IN PARTICIPATING JURISDICTIONS

	Belize	Bolivia	Brazil	Cayman Islands	Chile	Colombia	Dominican Rep	Ecuador	El Salvador	Spain	Guatemala	Haiti	Honduras	México	Nicaragua	Paraguay	Peru	St Kitts and Nevis	Trinidad & Tobago	Uruguay	USA
Remove Control Organs	✓	✓	✓	✗	✓	✓	✓	✗	✓	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Remove Management	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Continuity of Critical Functions	✓	✗	✗	✓	✓	✗	✓	✓	✓	✗	✓	✓	✓	✗	✗	✓	✗	✓	✗	✓	✓
Continuity of Affiliated	✗	✗	✗	✗	✗	✗	✗	✓	✓	✗	✗	✓	✓	✗	✗	✗	✗	✗	✗	✓	✓
Establish Bridge Bank	✓	✗	✗	✗	✓	✓	✗	✗	✓	✗	✗	✓	✓	✓	✗	✓	✓	✓	✗	✓	✓
Asset Management Co.	✓	✓	✗	✗	✓	✓	✓	✓	✓	✓	✗	✓	✓	✗	✗	✗	✗	✓	✓	✓	✓
Transfer Assets and Liabilities	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓	✓
Reduce Capital	✓	✗	✗	✗	✓	✓	✓	✗	✓	✗	NR	✓	✗	✓	✓	✓	✗	✗	✗	✓	✓
Reduce Unsecured Claims	✗	✗	✗	✗	✓	✓	✗	✗	✓	✗	NR	✓	✗	✓	✓	✗	✗	✗	✗	✓	✓
Bail-in	✗	✗	✗	✗	✓	✓	✗	✗	✓	✗	NR	✗	✗	✓	✓	✗	✓	✗	✗	✓	✓
Suspension of Termination Rights	✗	✗	✗	✗	✗	✓	✗	✗	✓	✗	✗	✓	✓	✓	✗	✓	✗	✗	✗	✓	✓

Source: ASBA WG Survey 2

*NR = No Response

2.4.4 SAFEGUARDS

An SRR has a broad range of tools and powers that may affect property rights. Consequently, a regime needs to provide certain safeguards for creditors, the failed FI personnel working under the direction of the RA, and others that might be affected by the resolution process. These safeguards are designed to balance the needs of the creditors with the needs of the authorities. They also assure equitable treatment of creditors and other affected parties in a resolution. In addition, these safeguards provide authorities sufficient time and flexibility to carry out an orderly resolution. Safeguards also ensure that the authorities are not able to “cherry pick” which assets or liabilities to include in a resolution transaction.

As shown in Table 4, 14 of the 21 participating jurisdictions do not have an RA with the power to temporarily stay the exercise of early termination rights that may otherwise be triggered upon early entry into resolution of a firm or in connection with the use of resolution powers (S2, Q65).

In cases where a liquidator may suspend payment of obligations, binding safeguards on the suspension timeframes often do not exist.

Legal protections should also be part of an SRR so that authorities are willing to act, when they have the power to do so, without the fear of legal consequences. They should be protected for their acts and omissions when representing their FSN functions.

3. STANDARDS INTERACTION

The revised BCPs (2012) discuss several key trends and developments from the past few years of market turmoil that underscore the need to better integrate FSN functions. For effective supervision, the BCPs emphasize the following:

- The need for greater intensity and resources to effectively deal with systemically important banks.
- The importance of applying a system-wide, macro perspective to the micro-prudential supervision of banks that will assist in identifying, analyzing, and taking pre-emptive action to address systemic risk.
- The need for an increased focus on effective crisis management, recovery, and resolution measures to reduce the probability and impact of a bank failure.²²

The three sets of international standards—BCPs, CPs, and KAs—support the building of a collaborative environment and identify opportunities for cooperation among the RA, supervisor, and DI. They provide a common ground to promote an FSN structure that avoids duplication of efforts and resources for regulatory authorities and FIs. The standards overlap with regard to procedures and operational arrangements among FSN participants. Adopting these best practices facilitates the separation of each FSN function while helping to identify coordination mechanisms that best integrate the participants, regardless of the architecture of the FSN.

3.1 CORE PRINCIPLES AND PRUDENTIAL SUPERVISION

The strength of prudential regulation and supervision influences the functions and effectiveness of a DIS and is a critical factor in mitigating moral hazard.²³ Prompt corrective action and deposit insurance work in collaboration to complement each other. Before insolvency, prompt corrective action imposes increasingly stringent supervisory controls on a weak institution in an attempt to reduce risk-taking and improve the firm's financial condition. Enforcement of prompt corrective action limits the exposure of the DIF to losses by mandating supervisory action and requiring the closure of a failing bank before it exhausts its capital and accumulates additional losses.²⁴ DIs must understand the condition of member institutions, both as ongoing concerns and as failing operations, in order to properly manage the risks they represent to the DIF and to prepare for fulfilling their mandate. Therefore, DIs must be kept informed of all enforcement actions, including regularization measures, taken by bank supervisors and must be advised about the possibility of a closing as soon as the supervisory authority contemplates such an action.

22/ Basel Committee on Banking Supervision, *Core Principles of Effective Banking Supervision*, September 2012.

23/ IADI, *Core Principles for Effective Deposit Insurance Systems*, November 2014.

24/ Krimminger, Michael, "Controlling Moral Hazard in Bank Resolutions: Comparative Policies & Considerations in System Design," 2006.

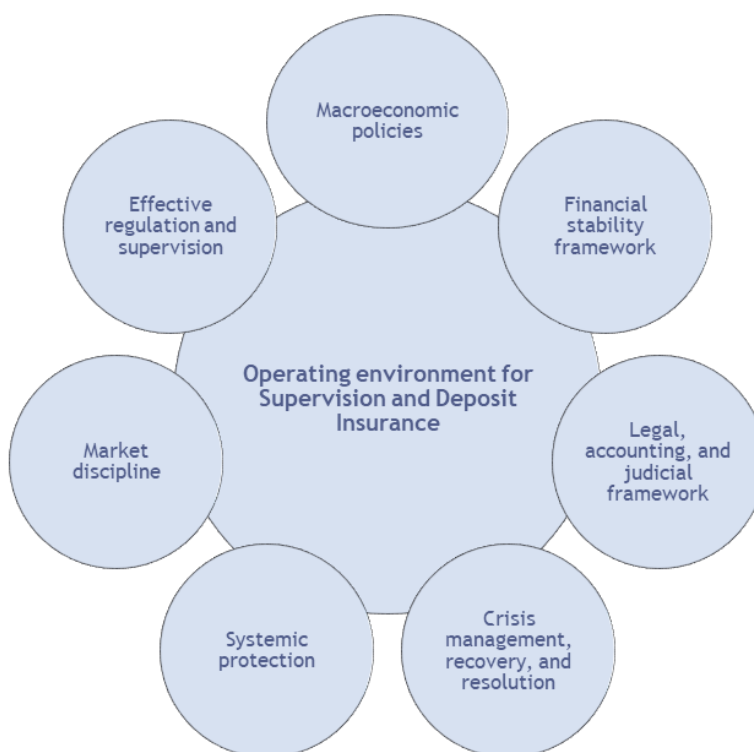
3.1.1 SHARING OPERATING ENVIRONMENTS

The operating environment required for an effective DIS is affected by (1) the quality of supervision and (2) the level of coordination between the deposit insurer and the supervisor. A DIS designed with careful regard to best practices will not be effective unless the DI and supervisor share information and coordinate their activities. A strong and fluid relationship between the DI and the supervisor enables an effective DIS, while a weak and inconsistent relationship dwarfs the role of the DIS and renders the FSN weaker. As DIs and supervisors share the same operating environment, the DIs will adjust their policies within their legal mandates when changes and developments in the financial sector occur. Exhibit 3 displays the shared operating environment of the supervisor and the DIS.

In the absence of a collaborative environment, potential tensions between the two authorities could arise, for example, if the DI believes that the supervisor is delaying or avoiding instructing entry into resolution (forbearance). This, in turn, can create an incentive for troubled institutions to engage in riskier activities (moral hazard). Coordination between the supervisor and the DI in making transparent and well-informed decisions will help to prevent these types of situations and strengthen the DIS's potential contribution to financial stability.

Structuring the most appropriate coordination and information-sharing frameworks for FSN participants will always pose challenges, as institutional arrangements can vary widely.

EXHIBIT 3: CONDITIONS OF THE SUPERVISOR'S AND DI'S OPERATING ENVIRONMENT



3.1.2 GOOD GOVERNANCE

CP3 recommends that the DI be operationally independent, well-governed, transparent, accountable, and insulated from external interference. The DI should have the capabilities to support its operational independence and fulfill its mandate. It should benefit from an institutional structure that minimizes the potential for real or perceived conflicts of interest. The institutional arrangements should be made public and recognized by the other FSN functions, and they should allow the DI to deliver its clear and formally specified public policy objectives (CP1). Regardless of the DIS mandate, deposit insurance is meant to protect retail and other small depositors, minimize the potential of deposit runs, and minimize contagion in the financial system.²⁵ Governance will deteriorate if the DI is established in law but exists only on paper without the proper resources, or if its powers are not in line with its legal mandate.

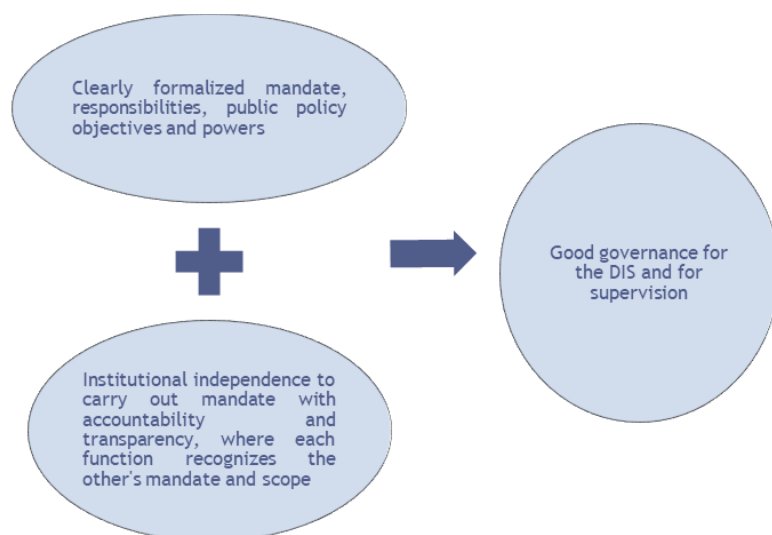
This is particularly true in cases where the DI is a standalone entity, yet relies on the infrastructure, staff, or resources of another FSN participant. The powers assigned to the DI must enable it to do in practice what its mandate sets out in theory (CP2).²⁶

According to BCP1, supervisors must be able to undertake timely corrective action to address safety and soundness concerns by imposing a range of sanctions, triggering resolution when appropriate, revoking the bank's license to operate, and cooperating with relevant authorities to achieve the orderly resolution of a bank. BCP2, on independence, accountability, resourcing, and legal protection for supervisors, calls for the supervisors to have operational independence, transparent processes, sound governance, financial autonomy, and adequate resources, and to be accountable for its duties and use of its resources. Exhibit 4 displays the recommended standards that drive good governance for both the DIS and for supervision.

25/ See Ellis, D., *Building Credible and Effective Deposit Insurance Systems*, FDIC, November 2016.

26/ IADI, *A Handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance System*, March 2016.

EXHIBIT 4: RECOMMENDED STANDARDS FOR GOOD GOVERNANCE



3.1.3 INFORMATION SYMMETRY

All jurisdictions should have coordination and information-sharing frameworks that include the DI. According to CP4, FSN participants should exchange information regularly, particularly when material supervisory actions affect DIS member institutions. The agreements for coordination and information sharing between the DI and other safety net participants must be in writing and be viable, without any impediments for accessing information pertinent to the DI.

The DI should have full and direct access to deposit records at all times and should have the authority to require banks to maintain and share information in a standard format created by the DI.²⁷

In addition, DIAs must participate in pre-crisis planning to ensure that they have a voice, especially if they will be funding the resolution alternative.²⁸

DIAs should be informed of the current conditions and practices of all insured institutions as part of its risk management regime. DIs with broad mandates²⁹ may be responsible for planning and implementing the resolution process, which requires continued access to a suitable flow of information.

To ensure access to the information, without burdening FIs with redundant reporting requirements, it is important to coordinate the collection and sharing of existing information between the DI and the other safety net participants, especially supervisors. Whenever pertinent, DIs should still be able to access supplemental information directly from its member institutions. The DI must receive information in a timely manner and well in advance of failure, so that it has sufficient opportunity to prepare for payout or other resolution options and can meet its reimbursement obligations or engage in resolution options.³⁰

The primary concern of all safety net participants should be ensuring that all relevant information is known to all participants, addressing data gaps and timeliness, and strengthening reporting and accounting standards. Because the financial sector is a constantly evolving and innovating industry, FSN participants should be in a constant learning mode so that they may understand and respond appropriately to new products, new markets,

new services, and new risks. As supervisors develop and implement policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate risk on a timely basis (BCP17), a framework should be in place that promotes cooperation and collaboration between supervisors and all other relevant domestic authorities (BCP3). Such a framework should provide an opportunity for the DI to actively engage as its legal mandate requires.

3.1.4 EARLY INTERVENTION AND TIMELY RESOLUTION

In a well-integrated FSN, the supervisor is expected to be the lead authority on early intervention and timely resolution.

The supervisor, in turn, would support the DI and RA in gathering pertinent information so that they can prepare for and perform their roles in resolution. Bringing together the views of all FSN participants in healthy debate should contribute to better-informed decisions that lead to financial stability.

Since the GFC, DIs across participating jurisdictions are performing functions that are closer to those required by a “loss minimizer” mandate. The expansion in DI mandates will likely continue as more attention is paid to developing effective resolution regimes. With a clear focus on protecting depositor funds and ensuring rapid and orderly resolution, DIs now have a more prominent role among safety net participants.³¹

RRP must incorporate DIs to ensure proper contingency planning. RRP and the information exchange that it fosters among supervisors and other participants in the safety net facilitate timely intervention.

27/ See *A Handbook for the Assessment of Compliance with the Core Principles for Effective DIS*, IADI, 2016.

28/ *Idem*.

29/ DIs with mandates of loss minimizers and risk minimizers are considered of a broad mandate.

30/ *Idem* (Handbook CP 4, EC3).

31/ Financial Stability Board, *Thematic Review on Deposit Insurance Systems*, February 2012.

In mitigating the risk of loss to creditors, including the DIF, supervisory actions should aim to preserve the value of the bank's assets with minimal disruption to its operation, subject to minimizing total resolution costs. Formal coordination mechanisms should grant authorities the tools and powers necessary to intervene in banks at a sufficiently early stage, with the goal of minimizing externalities of a crisis such as the interruption of core financial services, contagion to other market players and fiscal costs.³²

3.2 KEY ATTRIBUTES AND THE RESOLUTION REGIME

The general goal of an SRR is to resolve nonviable FIs quickly, thereby ensuring the stability of the financial system, preserving the main banking operations, and ensuring the continuity of the payment system. A resolution framework that is not distinct from an ordinary corporate insolvency regime, that relies exclusively on supervisory powers, or that lacks most of the recommended resolution powers would not be compliant with KA1.³³

An SRR links the supervisory and insolvency functions of the safety net authorities, thereby allowing resolution strategies to be carried out by relevant experts; avoiding unnecessary loss of value; and ensuring prompt response to depositors, other users, and clients of the failed institutions. An SRR also should contain proper safeguards which ensure that shareholders and unsecured creditors, being the first to absorb losses, still have due process and an opportunity for judicial review, allowing only financial redress. This type of resolution regime allows for departure from a judicial liquidation priority of claims based on the principle that no creditor will be worse off under a resolution process, allowing the subrogation of the DIA to the claims of depositors for the amounts it paid them.

3.2.1 RESOLUTION AUTHORITY (RA)

The operational independence recommended in KA2 does not imply that the RA is to have no other function

aside from resolution. An authority that carries out resolution functions may also perform other functions, such as supervision or deposit insurance, provided that adequate governance arrangements are in place to manage any conflicts of interest that may arise³⁴. This operational independence requires that some aspects of resolution be under the exclusive discretion of an executive RA, such as when temporary public funding is provided to support a resolution process (including DI funds when deposit insurance is a function of a government agency).

A resolution regime should be clear about the distribution of roles and responsibilities of the RA³⁵ and the supervisory authority. RAs must be able to deal with third-party rights related to a bank resolution and the allocation of losses across creditors and shareholders. Supervisory authorities perform preventative functions, through risk identification and minimization, and determine entry into resolution, among other responsibilities. Most legal frameworks in participating jurisdictions include such preventative functions but lack clarity on specific powers for determining and executing resolution mechanisms.

After a determination of nonviability, the supervisory authority either instructs or recommends entry into resolution. FSN participants are then responsible for three different actions as shown in Exhibit 5. The administrative public entities responsible for each of these actions may vary among jurisdictions, depending on the institutional arrangements of the FSN, but they should carry out these actions according to their mandate and in a manner that avoids conflicts of interest.

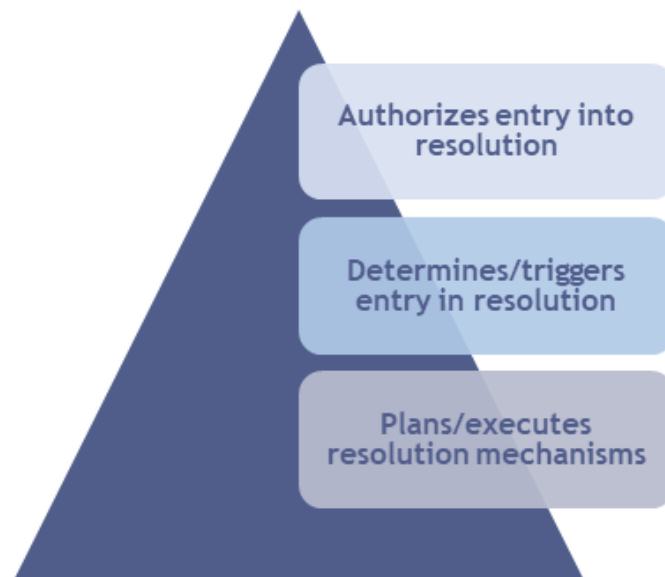
32/ EBC, Monthly Bulletin, "The New EU Framework for financial crisis management and resolution," p. 85, July 2011.

33/ FSB, *Key Attributes Assessment Methodology for the Banking Sector*, October 2016, p. 17.

34/ Idem, p. 21.

35/ KA 2.1 provides that "[...]Each jurisdictions should have a designated administrative authority or authorities responsible for exercising the resolution powers over firms within the scope of the resolution regime ("resolution authority") Where there are multiple resolution authorities within a jurisdiction their respective mandates, roles, and responsibilities should be clearly defined and coordinated".

EXHIBIT 5: RESPONSIBILITIES AT ENTRY INTO RESOLUTION



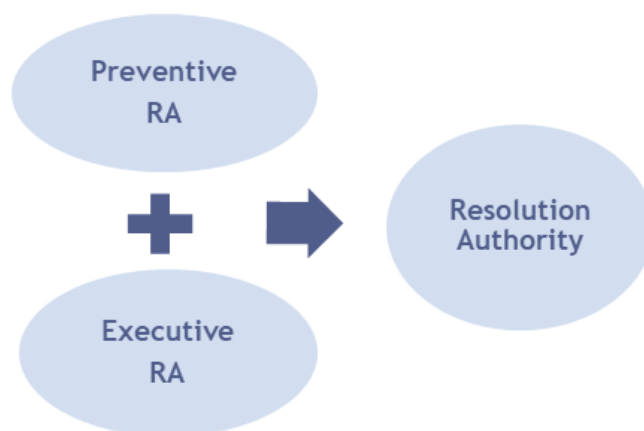
To better align mandates and powers while making KA operational,³⁶ a practice is emerging whereby the RA is integrated with (1) an administrative authority that performs preventative actions and (2) an authority that executes resolution functions, as seen in Exhibit 6. Preventative resolution functions are typically carried out by applying supervisory powers. Resolution powers, as those recommended in KA3, need to be clearly established to enable the executive RA.

The legal framework should distinguish between preventative and executive functions. The authority charged with the preventative function requires FIs to maintain updated recovery planning and ensures a timely assessment as well as a comprehensive, credible, and proportionate corrective action plan upon identification of weaknesses. The authority in charge of executive functions must have the appropriate powers

to carry out resolution planning and resolvability assessments. These resolvability assessments evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and the overall economy (KA10.1). The executive RA must also be able to determine the resolution strategy upon entry into resolution in conjunction with the DIS and any other protection scheme in place in the jurisdiction. Notably, the BCPs do not include specific practices for resolution, precisely because resolution is a separate and different function from supervision.

36/ Recovery, F. S. B., and Resolution Planning, Making the Key Attributes Requirements Operational, FSB Consultative Document, 2012.

EXHIBIT 6: EMERGING PRACTICE FOR COMPOSITION OF THE RA



3.2.2 RESOLUTION TRIGGERS: DETERMINING THE POINT OF NONVIABILITY

Developments in the aftermath of the crisis have highlighted the particular risks that large and interconnected banks, financial holding companies, and financial market infrastructures (FMI) can pose to financial stability, should they need to be resolved. In response, supervisors and other authorities have focused on developing tools and techniques to mitigate these risks, including enhanced capital standards, heightened micro prudential supervision, complementary macro prudential surveillance, and the development of recovery and resolution regimes specifically tailored to large institutions.

Resolution regimes should enable the preventative RA (which is typically the supervisor) to determine the criteria for the point of nonviability, and authorities should enforce it fully. Supervision cannot, and should not, convey the perception that banks and other supervised FIs will not fail. Individual bank failures are not impediments to financial authorities' objectives of protecting the financial system and the interests of depositors. In fact, the occasional bank exit will contribute to the credibility of financial authorities, therefore providing the right incentive balance.³⁷

Moreover, if bank resolutions are carried out in an orderly manner and at the lowest cost, they will likely enhance market discipline and financial stability.

Emerging practices in making the KAs operational, such as the Bank Recovery and Resolution Directive (BRRD),³⁸ recommend that resolution actions be implemented when all of the following conditions are satisfied:

- The competent authority, after consulting the resolution authority, determines that the institution is failing or likely to fail.
- The resolution authority after consultation with the competent authority, determines that the institution is failing or likely to fail.
- Having regard to timing and other relevant circumstances, the competent authority deems that there is no reasonable prospect that any alternative private sector measures would prevent the failure of the institution within a reasonable timeframe.
- The competent authority determines that a resolution action is necessary in the public interest.

³⁷/ See *Guidance for dealing with weak and problem banks*, paragraph 195.

³⁸/ See Directive 2014/59/EU.

The BRRD adds to these conditions, that an FI is failing or likely to fail when one or more of the following circumstances are met:

- The institution has breached, or there are objective elements to support a determination that the institution will breach, the requirements for continuing authorization.
- The assets of the institution are, or there are objective elements to support a determination that the assets of the institution will in the near future be, less than its liabilities.
- The institution is, or there are objective elements to support a determination that the institution will be in the near future, unable to pay its debts as they fall due.
- Extraordinary public financial support is required, except when it is the only alternative to remedy a serious disturbance in the economy and preserve financial stability.

The KAs emphasize the need for the RA to be able to act before technical insolvency. Resolution planning would therefore facilitate the difficult decision to place a firm into insolvency proceedings when necessary.³⁹ RRP should capture the main issues that authorities should consider in preparing resolution strategies.

3.2.3 ENABLING ORDERLY RESOLUTION

An SRR is a framework that ensures the orderly resolution of financial institutions. It also includes elements that attempt to prevent failures in the first place. The framework should allow for enhanced oversight by the RA through all phases of a banking crisis. This will ensure that the RA can carry out preparatory actions and preventative and early detection measures and implement timely intervention strategies to return the institution to viability. If the preventative measures do not succeed, the framework should enable the winding down of the operation.⁴⁰

The conditions for entry into resolution aim to achieve a balance between facilitating an orderly exit before all of

the institution's value has been eroded and avoiding placing a firm into resolution before all realistic options for a private sector solution have been exhausted.⁴¹ Coordination is fundamental for ensuring that the RA has the opportunity to determine the most appropriate resolution strategy and operational plan, and is aware of the timeframe necessary to close the FI.

Upon entry into resolution, the RA's actions and decisions should be irrevocable.⁴² The RA should be able to use a wide range of resolution options and powers in any combination or sequence necessary to attain the objectives of the resolution regime. Once the RA takes control of the nonviable FI, it should be able to take quick and decisive action to stabilize and restructure the entire institution's business or some part of it, as appropriate. The RA should be able to act without shareholder or creditor consent. The decision-making process in determining the most appropriate mix of resolution tools will be better informed if a collaborative environment exists among FSN participants throughout the life of FIs, rather than only when FI failure is imminent.

39/<http://www.oecd.org/finance/financial-markets/48963966.pdf>

40/ See KA 3 for a comprehensive list of resolution powers.

41/ Bank of England, *The Bank of England's approach to resolution*, October 2014.

42/ KA 5.5 - The legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. Instead, it should provide for redress by awarding compensation, if justified.

3.2.4 RESOLUTION COSTS AND DEPOSIT INSURANCE FUND (DIF) SUSTAINABILITY

Minimizing resolution costs and ensuring the sustainability of the DIF requires effective resolution, effective deposit insurance, and effective supervision. According to CP6, every DI should engage in contingency planning and crisis management to ensure that the DI is prepared to fulfill its mandate, whether that involves effectively implementing a payout, facilitating a purchase and assumption transaction (P&A), or taking other resolution measures that may be included in its mandate.

Deposit insurance funds should only be applied to protect the depositors of DIS member institutions and to resolve nonviable FIs. In theory, an exit strategy that requires closing the bank when it still has positive capital should provide sufficient sale proceeds to pay depositors and other creditors. In practice, however, capital ratios are lagging indicators of the true value of the bank. In addition, under typical market conditions, the sale or liquidation value of the bank will always be less than the value of an operating business. Consequently, even if the bank is closed with positive regulatory capital, it is likely that the proceeds from the sale of its assets will be less than its liabilities to depositors and creditors.⁴³ As a result, deposit insurance funding is necessary to guarantee prompt payment to depositors and to facilitate the transfer of assets and liabilities to a healthy acquiring institution.

The sustainability of the DIF complements the resolution objective of avoiding the use of the public purse. Adequate fund sizes, together with contingency funding mechanisms, contribute to ensuring that adequate resources are available in the event of a bank failure.

Coming full circle, the adequacy of the fund will be influenced by the DI operating environment, and a collaborative FSN environment will buttress its sustainability.

Regardless of its mandate, when the DI funds a resolution mechanism, it should understand the potential for the subsequent recoveries or losses of its funds that can result.⁴⁴ Once a bank is authorized to operate and becomes a member of the DIS, the supervisor should work

with the DI and the RA to identify, assess, and mitigate emerging risks across banks and to the banking system as a whole.⁴⁵ Information sharing and close cooperation among relevant FSN participants are vital when identifying bank weaknesses and when the corresponding corrective actions are required. In preparation for resolution, the DI should work closely with the supervisor and RA early in the process to ensure the continuity of access to insured deposits⁴⁶ and to determine the least costly resolution.

3.2.5 CROSS-BORDER ISSUES

Increasing cross-border activity without robust risk management may be a potential threat to financial stability, but these potential risks can be avoided. Enhanced cross-border consolidated supervision across Latin America and the Caribbean should enable supervisors to monitor complex cross-border activities of banks and financial conglomerates.

Supervisory and resolution colleges together with MOUs that pledge cross-border cooperation should provide early warnings of problems and help manage those that occur. With this expanded toolkit, jurisdictions may be more willing to integrate regionally, as the benefits begin to outweigh the cost of enhancing the regulatory regime to protect financial systems from systemic risks.⁴⁷ Harmonizing legal frameworks for bank resolution and restructuring, as well as nonbank insolvency regimes should contribute to a more dynamic financial sector regional integration.

43/ Krimminger, Michael. "Controlling Moral Hazard in Bank Resolutions: Comparative Policies & Considerations in System Design." (2006).

44/ See CP 9 Sources and uses of funds.

45/ See BCPs 8 and 9.

46/ See BCBS, *Guidelines for identifying and dealing with weak banks*, July 2015, paragraphs 146 and 195.

47/ IMF. *Financial Integration in Latin America*, 2016.

3.3 CONVERGING STANDARDS TO STRENGTHEN THE FINANCIAL SYSTEM

Compliance with the Core Principles should foster overall financial system stability, but it will not guarantee it nor will it prevent the failure of banks. In a market economy, failures are part of risk-taking.⁴⁸ Moderating moral hazard and contributing to market discipline are shared responsibilities of FSN members. The moral hazard present in protecting deposits needs to be mitigated by a careful DIS design and a strict supervisory regime that fully enforces prudential regulation and enables timely determination of nonviability. A special resolution regime will reduce moral hazard through timely intervention and by ensuring that owners, shareholders, and unsecured/uninsured creditors are the first to suffer losses from the bank failure.

The principles guiding the BCPs, the CPs, and the KAs are intended to strengthen the FSN and safeguard the financial system.

To enhance the effectiveness of the FSN as a whole, each safety net function must be clearly defined. Self-assessments on compliance with international standards may help authorities clarify the roles of the FSN participants in their jurisdictions to build proper cooperation mechanisms.

In turn, this would facilitate the creation of crisis management frameworks with the required flexibility to respond when necessary. The outcome of such coordination would be a more resilient

48/ BCBS, BCPs, paragraph 44.

TABLE 5: INTERNATIONAL STANDARDS' CONVERGING GUIDANCE

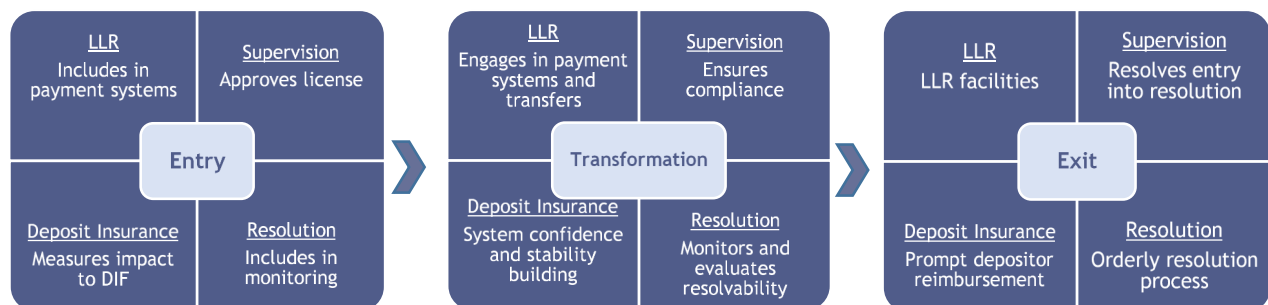
Principles	Concept	Guidance
BCP3, CP4, KA7.6, KA2.1	Cooperation and collaboration	Authorities (including supervisors, DIs, and RAs) should have the legal capacity to establish coordination and information-sharing mechanisms, subject to adequate confidentiality requirements.
BCP8, BCP9, CP13, KA3.1, KA2.7	Early detection and timely intervention	Supervisors should have a framework in place for early intervention, and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become nonviable. The supervisor, in conjunction with other relevant authorities, seeks to identify, assess, and mitigate any emerging risks across banks and to the banking system as a whole.
BCP11, CP14, CP15, KA2.3	Failure Resolution	The supervisor cooperates and collaborates with relevant authorities in deciding when and how to instruct entry into resolution. Coordination mechanisms help the RA to <ul style="list-style-type: none"> i. Pursue financial stability and ensure continuity of systemically important financial services, by carrying out payment, clearing, and settlement functions; ii. Protect depositors and investors, where applicable, and coordinate with the relevant schemes and arrangements in place; iii. Avoid unnecessary destruction of value and seek to minimize the overall costs of resolution in home jurisdictions, host jurisdictions, and to creditors; and iv. Duly consider the potential impact of its resolution actions on financial stability in other jurisdictions. Depositors should be reimbursed promptly (ideally no later than seven days after the bank's closing).
BCP Preconditions, CP15, CP16, KA5.2	Settlement and Liquidation	When depositors and other legitimate creditors have pending claims, they are provided with credible solutions to their claims and queries in compliance with the order of priorities set out in the law, and in line with the assumptions (and policy decisions) in the "no worse off than in liquidation" safeguard scenario. Reporting and audit processes are considered and included. Actions and conditions for the authority requesting liquidation of residual assets and extinction of the legal entity of the failed institution, through judicial action, are also included.
BCP Preconditions, CP6, KA2.2, KA10.2	Crisis Management Framework	The development of system-wide, crisis preparedness strategies and management policies are the joint responsibilities of all safety net participants. Where multiple RAs in a single jurisdiction are charged with resolving different entities within the same financial or economic group, a leading RA coordinates the resolution process. To enable the continued operations of systemically important functions, authorities coordinate responsibilities and actions to follow.
BCP13, CP5, KA7.7, KA2.4	Cross-border MOUs	Legal gateways support cooperation mechanisms. Home supervisors, host supervisors, and other key authorities of cross-border banking groups share information and cooperate for effective supervision of the financial group and group entities, and for effective handling of crisis situations. Agreements include formal information sharing and coordination arrangements among DIs in relevant jurisdictions.

4. OPPORTUNITIES FOR ENHANCED COORDINATION

Ensuring smooth cooperation, trust, and goodwill among FSN participants is vital. And, as with all relationships, creating an environment for effective collaboration requires time and continued engagement. Exhibit 7 displays the opportunities for engagement throughout the life of an FI. Information sharing and coordination are particularly essential, and explicit arrangements

should be designed to avoid or minimize potential conflicts. The more complex the safety net institutional arrangements are, the more crucial it becomes to define formal mechanisms. It is particularly necessary for safety net participants to coordinate their actions when the need to handle an FI failure arises.

EXHIBIT 7: BIRTH-TO-DEATH FSN COLLABORATION



4.1 ENGAGING WITH FINANCIAL INSTITUTIONS (FI) FROM “BIRTH TO DEATH” ON A LEVEL PLAYING FIELD

Each participant in the safety net shares in the responsibilities of ensuring financial stability and engaging with FIs in the market place on a level playing field. Collaboration at the entry, transformation, and exit of FIs should be possible, regardless of FSN architecture, as long as the safety net participants have a clear mandate and the powers to carry out their competencies. Each of the FI’s stages of “life” presents opportunities for collaboration among the FSN functions.

When an FI enters the financial system, all FSN basic functions are involved to a certain extent. Their involvement may include authorizing, acknowledging, or including the new institution into their span of control and action. At this point, the FSN may have the following roles:

- a) Lender of Last Resort (LLR) - issues favorable opinion or approves license to operate and includes new entities in payment systems.
- b) Supervisor - ensures compliance with regulatory requirements for license authorization and continued safe and sound practices.
- c) DI - registers⁴⁹ newly licensed entities so depositors are protected, includes the FI in public awareness and outreach efforts, and monitors and measures the FI’s impact on the DIF.
- d) RA - acknowledges and includes the new entity in RRP, resolvability monitoring, and the evaluation regime.

As FIs operate their business, supervisors remain vigilant in ensuring that they grow in a safe and sound manner. Supervisors make sure that those who own and run the FIs are fit and proper. Accordingly, they establish the rules that must be followed, provide guidance on management and disclosure of risks, continuously monitor FI actions, and impose penalties for unsound behavior.⁵⁰

After an FI is established, other functions in the FSN also continue to be engaged.

The LLR, DI, and RA are all notified of any changes in the composition of capital and shareholders of the institution and its business model. In addition,

- a) The LLR engages with the institution as an agent to implement microeconomic policy in the financial system;
- b) The DI measures any potential impacts on the DIF and, in partnership with the institutions, builds confidence through public awareness strategies; and
- c) The RA continues to monitor/evaluate the FI’s resolvability.

Once the supervisor identifies a weakness in an FI (which cannot be solved through an enhanced supervisory regime and corrective measures) and determines that the institution is not viable, the FI enters resolution. During this phase, any earlier collaboration efforts among FSN participants during the life of the FI will reap the benefits, as cooperation within the FSN is vital to financial stability. Ideally, cooperation and integration among FSN participants should gradually increase as the problem institution approaches resolution. The following explains the role of each FSN function during resolution:

- a) LLR - determines whether emergency liquidity is feasible and appropriate; otherwise, the LLR approves revocation of the institution’s license to operate and, if appropriate, participates in the vetting of the resolution strategy.
- b) DI - assesses insured deposits to estimate the institution’s liquidity requirements, resource needs, and possible risk exposure. To ensure that the proposed resolution strategy represents the least cost to the DIF, the DI requires an understanding of the value of the institution’s assets and the timeframe for the resolution process (given that the value of the institution’s assets depends on the time necessary to liquidate them).

49/ In Peru, newly licensed deposit-taking institutions (DTI) will pay contributions to their DIA (FSD) for 24 months before having their deposits covered.

50/ Vinals, J. and Fiechter J., *The Making of Good Supervision: Learning to Say “No,”* IMF, May 18, 2010.

- c) RA - implements resolution strategies and plans with a full understanding of the FI's operation and the knowledge of the fair value of the FI's net assets. At this point, it is essential to accurately determine the quality of the loans, the number of loans impaired, and whether collateral can be executed.
- d) The RA also appropriately adjusts and applies the provisions for nonperforming loans. In addition, it is essential that the RA assess the extent of insider and connected lending, as well as measure the fair value of assets that are difficult to value, and complex financial products held in the trading book. An accurate assessment of the fair value of the bank's net assets should determine the actions required.

4.2 RECOVERY AND RESOLUTION PLANNING (RRP)

Recovery and resolution plans, also known as “living wills,” are tools for pre-crisis contingency planning; they enhance the credibility of the resolution regime and contribute to market discipline. The KA provides guidelines for the implementation of an ongoing RRP process to promote resolvability as part of the overall supervisory process. At a minimum, RRP should cover domestically incorporated firms that could be systemically significant or critical should they fail (see KA11). The RRP process involves the cooperation of FI management, the RA, and all other relevant authorities. It is a compelling supervision and resolution tool that allows supervisors, DIs, and RAs to be on the same page about each other's roles in contributing to financial stability and in preparing for resolution.

4.2.1 TIMELY INTERVENTION GUIDED BY RECOVERY PLANS

The goal of recovery planning is to identify quantitative and qualitative criteria that would trigger the implementation of the recovery plan, whether fully or partially. Banks can become weak at any time and for many different reasons. Thus, recovery planning requirements are meant to help FI management identify coping mechanisms for a wide range of scenarios.

The requirements are also created to ensure timely implementation of recovery options, making corrections before enforcement measures are required by the supervisory authority. FIs, along with the supervisor and RA, should ensure that triggers for implementing recovery plans are calibrated in order to provide a warning early enough to allow the FI to take corrective action and for the RA to begin appropriate contingency planning. The aim of triggers in recovery planning is to enable banks to restore financial strength and viability through their own efforts.⁵¹ FIs should provide supervisors and RAs with an explanation of the process leading to determination of the trigger calibrations and demonstrate that these triggers would be breached early enough to be effective.

The BIS *Guidance for identifying and dealing with weak and problem banks* recognizes that individual bank weaknesses do not appear in isolation, but rather as a series of problems that evolve simultaneously. If recovery plans are not successful and if the FI begins to face greater distress, then an escalation of corrective actions should ensue. Whether or not the supervisor is flexible in allowing the FI an opportunity to recover, coordination with the DI and the RA can allow for preparatory tasks in case remedial action does not return the FI to viability. To help safety net participants coordinate action, they should develop joint criteria that allows for proportionality and graduality in the decision-making process.

⁵¹ / FSB, *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational Consultative Document*, November 2012.

4.2.2 READINESS BY RESOLUTION PLANNING

The objective of resolution strategies and plans is to facilitate an orderly resolution of an FI while avoiding severe systemic disruption and the use of public funding. Resolution strategies and operational resolution plans must adapt to fit an FI's individual characteristics and conditions in the marketplace at the time of resolution. The FSB advises⁵² authorities to determine the appropriate approaches for resolution and rely on FIs to supply up-to-date, accurate information and analysis to support their resolution planning. Specifically,

- Resolution strategies need to include the key elements of the proposed resolution approach in terms of the resolution powers (refer to KA3) to be applied, such as recapitalization, restructuring, or transferring all or part of the FI.
- Operational resolution plans must provide details regarding the actions, conditions, and arrangements for implementing the plan, including requirements for funding, information, and data.
- Firm-specific cross-border cooperation agreements (COAGs) must guide the activities of Crisis Management Groups (CMGs) in planning, coordinating, and implementing resolution strategies and plans that incorporate home and key host authorities.⁵³

Resolution strategies and operational plans, in addition to COAGs, should be maintained as living documents that are improved and updated over time. This requires continued coordination and collaboration among all relevant authorities.

Further, resolvability assessments⁵⁴ will inform necessary adjustments to RRP as resolution strategies and plans are evaluated to measure (1) how they meet the stated objectives of protecting systemic stability and protecting critical functions without exposing public funds to loss and (2) whether their implementation is feasible and credible.

4.3 DEALING WITH PROBLEM BANKS AND DETERMINING NONVIABILITY

Supervisory regimes should establish incentives that encourage supervisory authorities to take early and decisive action in response to indications of material deterioration in an institution's viability. Supervisors should have the discretion to act preemptively when weaknesses in a bank are detected, without necessarily waiting for a threshold to be breached. A best practice is to act as quickly as possible to prevent an escalation of the problem. Once an institution has reached the point of nonviability, the supervisor and the RA should act decisively to ensure that the failing institution is either restored to viability or resolved in an orderly manner. Clear criteria or suitable indicators of nonviability should be in place to help the supervisor determine whether an institution meets the conditions for entry into resolution.⁵⁵

Once FIs have been given an opportunity to present their case to the supervisory authority, and if all corrective measures have failed or appear to be failing to restore the institution to health, resolution actions need to be implemented. Criteria for nonviability should take into consideration the requirements and conditions that an institution must meet to gain license approval and be guided by the principles and objectives of the KAs. The supervisor should be the leading authority in determining such criteria, since the decision to trigger entry into resolution is, in essence, a regulatory judgment. When a bank or FI no longer meets the conditions for authorization and has no prospect of doing so in the future, it would be reasonable to move it into resolution.⁵⁶

52/ Idem.

53/ Key host authorities are those host authorities that are members of the CMG

54/ See section 3.2.1 for more on resolvability assessments.

55/ See Guidelines for identifying and dealing with weak banks, paragraph 26.

56/ Brierley, P., The UK Special Resolution Regime for failing banks in an international context, Bank of England, Financial Stability Paper No. 5, July 2009.

Leaving the determination of nonviability to the supervisor may lead the supervisor to delay too long in triggering entry into resolution, an issue known as regulatory forbearance. Forbearance can be addressed by a legal framework that allows for entry into resolution before the FI is balance sheet insolvent, thus increasing the likelihood of an orderly, rapid resolution that would preserve the value of the remaining operation. An additional measure used to avoid regulatory forbearance is allowing the DI and other protection schemes to terminate membership of the weak or problem FI, on the grounds that such forbearance exposes the protection scheme funds to unnecessary potential losses.

Whenever the RA is a separate entity from the supervisor, the RA could trigger entry into resolution on the grounds that further delay by the supervisor would diminish the opportunity for an orderly resolution, making it more difficult for the RA to succeed in its resolution objectives.⁵⁷ Nonetheless, termination of membership to a protection scheme should be subjected to the nonviability criteria determined by the supervisor. Also, whichever authority is terminating the membership should have to notify the supervisor so actions can be coordinated in such a way that they are consistent with the objective of an orderly resolution.

4.4 CRISIS MANAGEMENT FRAMEWORKS: DOMESTIC AND CROSS-BORDER

The leadership role of crisis management must be delegated to one FSN participant. Management of a crisis may present concerns about conflicts of interest for any of the FSN functions, yet the least-exposed function to such conflicts is the one without responsibility for the day-to-day oversight of the operations of institutions in the financial system. Conflict could arise, especially when determining whether to use public funds for a bail-out. Administrative and technical independence is tantamount for accountability and decision making.

The decision to close an FI, systemic or not, should be economic rather than political. Clear mandates should be assigned (1) to monitor systemic risk in order to facilitate macro prudential oversight, and (2) to carry out system-wide crisis preparedness.

Handling systemic failures requires an explicit and comprehensive framework. When managing a systemic crisis, vast amounts of financing may be required, and system-wide relaxation of prudential regulation may be necessary.

In essence, these actions amount to an almost complete reversal of the policy priorities of the SRR, since in an isolated bank failure, including that of a systemically important institution, strict enforcement of the balance-sheet constraints may dominate the choices of the RA (at least in the form of the least-cost resolution principle). In contrast, the preferred resolution approach in a systemic crisis will typically disregard such constraint.

An effective crisis management framework entails both institutional and operational components, which allow for managing both domestic and cross-border situations. This framework should provide the proper authorities and tools in the areas of systemic risk detection, early intervention, official liquidity assistance, resolution, and deposit insurance. Deciding the appropriate level of systemic protection is a policy question for all relevant authorities, particularly if a commitment of public funds is certain. In handling systemic issues, it is imperative to balance several factors, including risks to confidence in the financial system, risk of contagion to otherwise sound institutions, and possible distortion to market signals and discipline.

57/ *Idem*.

It is important to note the significant presence of regional financial groups among ASBA member jurisdictions. Home and host supervisors of cross-border financial groups must share information and cooperate for effective supervision of the group and group entities, and for effective handling of crisis situations (BCP13). Based on a bank's risk profile and systemic importance, the home supervisor, working with its domestic RA, should be able to develop a framework for cross-border crisis cooperation and coordination among the relevant home and host authorities. To effect a successful resolution, relevant authorities should share information on crisis preparations from an early stage while adhering to applicable confidentiality provisions. Even though most participating jurisdictions have some kind of information-sharing and cooperation agreements, these are not legally binding. In addition, during the WG meetings, jurisdictions voiced concerns about inconsistency in the language used when MOUs are signed bilaterally, versus multilaterally, since cross-border issues could involve more than the two signing jurisdictions.

Whenever a safety net fails to anticipate political and economic pressures during a crisis, the result is a weaker safety net in which risk-shifting is driven by governmental discretion rather than by prudential rules.⁵⁸ Legal frameworks should be reviewed to ensure public policy objectives, mandates, and powers are properly aligned so that each FSN function can deliver its responsibilities in a consistent and reliable manner, both individually and collectively. Since the GFC, it has become apparent that the strength of safety nets is determined by their weakest link. Indeed, prudential regulation, supervision, deposit insurance, and the resolution regime all influence each other and their effectiveness.

58/ Brock, P., *Financial Safety Nets and Incentive Structures in Latin America*, University of Washington Seattle, Washington, August 1998.

5. GUIDELINES FOR EFFECTIVE COOPERATION

Tensions between organizations can arise as a result of conflicting mandates, limited resources, and reputational incentives, among other things. Building cooperation mechanisms that promote coordination and goodwill among safety net participants is therefore a challenging, yet important, task. One way to smooth this coordination is to create an irrefutable division of powers and responsibilities for each organization.

If formal information-sharing arrangements are used, they should clearly acknowledge the roles and responsibilities of the respective parties. In addition, these arrangements should specify the type, level of detail, and frequency of information to be exchanged and by whom. Confidentiality of information exchanged between parties should be respected at all times. Coordination mechanisms should be general enough to cover all possible scenarios.

As mentioned in previous sections, difficulties in timing the shift in policy stance, questions about triggering mechanisms, and concerns about the size of contingent liabilities have all pointed to the need for a unified safety net framework. These issues should be addressed in cooperation MOUs, and safety net functions should be mandated by law.

5.1 PRINCIPLES GUIDING COORDINATION AGREEMENTS

MOUs should clearly assign roles and responsibilities among FSN functions when opportunities for collaboration exist. Criteria contained in the BCPs, CPs, and KAs can guide the content and language in these agreements. In addition, MOUs should inform the decision-making process and changes in leadership,

considering that the roles and responsibilities of each FSN function may have more or less influence as events and developments occur and evolve. A bank closing may become a crisis, or it may run its course uneventfully. To enable effective collaboration, MOUs should therefore address coordination channels for general and everyday collaboration, as well as describe what would be expected from all functions engaged in the different stages of a resolution process.

5.2 LEGAL GATEWAYS AND PURPOSE

Legal frameworks should include gateways⁵⁹ that create the opportunity for information-sharing and coordination mechanisms to be established and executed by authorities in their engagements with domestic and cross-border counterparts. All authorities involved should be authorized to share timely information, subject to any applicable data protection or bank secrecy requirements, and under appropriate confidentiality obligations for all current and past employees and representatives. In addition, authorities should not refuse to disclose information relating to resolution for reasons of confidentiality if the recipient is subject to adequate confidentiality requirements.⁶⁰

59/ Legal gateways refer to provisions set out in statute or other instruments with the force of law that enable the disclosure of nonpublic information to specified recipients or for specified purposes. Legal gateways may be contingent on, or supported by, memoranda of understanding (MOUs) or other forms of agreement between the providing and recipient authorities.

60/ See *Key Attributes for Effective Resolution Regimes of Financial Institutions*, I-Annex 1, Information Sharing for Resolution Purposes, 2014.

According to the KAs, legal gateways should be sufficient to permit disclosure of firm information to appropriate authorities for the purposes of carrying out functions relating to resolution, including the following:

- i) A resolvability assessment
- ii) Development of resolution strategies
- iii) The development of operational resolution plans
- iv) The conduct of simulation exercises and scenario analyses for the purposes of resolution planning
- v) Early detection and monitoring, and the supervision, regulation, and oversight of firms
- vi) Implementation of recovery measures
- vii) An assessment of the effectiveness of recovery measures for restoring viability, the likelihood that resolution measures might be required, and the possible timeframe in which those measures might be required
- viii) Preparation for the implementation of resolution measures
- ix) The exercise of resolution powers

5.3 COORDINATION MECHANISMS AND INFORMATION-SHARING FRAMEWORK

A well-established institutional framework is a crisis management tool and a pre-condition for an effective safety net. Relevant authorities should agree on their individual and joint responsibilities for crisis management and resolution, as well as how they will discharge these responsibilities in a coordinated manner.⁶¹

Jurisdictions are increasingly recognizing the need for *ex ante* planning, both at the domestic and cross-border levels. An effective coordination and information-sharing framework should be enabled by MOUs, financial stability committees, and CMGs. Each of these mechanisms should have clear descriptions of roles and applications and be reviewed to ensure that they work in practice.

5.3.1 MOUS FOR EFFECTIVE RESOLUTION

Resolution legal frameworks should empower and encourage continued collaboration. The KAs advocate that coordination agreements between supervisors, DIs, and RAs contain the following basic elements:

- Provisions for regular and extraordinary meetings of the parties involved and the relationship with existing collaboration structures.
- The statutory and contractual bases for prompt information sharing among the different FSN members and other extended domestic and cross-border parties, considering existing constraints for proper and timely coordination and how these could be addressed.
- The level of detail in regard to information sharing
 - Whether and how it would change in everyday collaboration, intervention, closing, and resolution phases.
 - Whether and how it would change in settlement and liquidation, providing for enhanced coordination in cases of extraordinary or systemically important events.
- Procedures for information sharing at both senior and technical levels, and tools used for information exchange (e.g., the use of a secure website) staff.
- Commitment to maintain up-to-date contact lists, covering multiple means of communication for key senior and working-level staff.
- Commitment to maintain confidentiality of shared information and measures to ensure confidentiality (e.g., limiting the number of personnel with access to the data, having a confidentiality agreement signed by all relevant personnel, having a procedure in place in case confidentiality is breached).

61/ See BCPs (September 2012), in particular, on preconditions for “Clear framework for crisis management, recovery and resolution.”

Institution-specific agreements containing the key elements on how home and host authorities will cooperate should also be signed. These agreements should establish the objectives and processes for cooperation through CMGs; define the roles and responsibilities of the authorities in preparation for, during, and after a crisis; and outline mechanisms and timeframes for information sharing.

Coordination agreements should be tested through simulation exercises and be periodically reviewed.

5.3.2 FINANCIAL STABILITY COMMITTEES

Financial stability committees are established as strategic cabinets that are responsible for a wide range of tasks, including (1) sharing information; (2) identifying and developing tools to monitor the financial sector; (3) analyzing the impact of macroeconomic events, as well as other evolving risks, on the financial system; and (4) identifying and creating risk-mitigating tools. To function properly, each jurisdiction's financial stability committee requires the involvement of all main FSN participants such as central banks, supervisory authorities, ministries of finance, DIs, and RAs.

Financial stability committees should be formally established so that their decisions are legally binding. This is particularly important when determining strategies for managing systemic events. The committee should have a governance framework, along with formal objectives, mandates, and powers to ensure legal certainty for their actions and decisions.

5.3.3 CRISIS MANAGEMENT GROUPS (CMGS)

The KAs require that a CMG be established for each globally systemically important financial institution (G-SIFI) to facilitate the resolution of the institution. The CMG should allow home and host key authorities to coordinate and develop the preferred resolution strategy for the FI.

In addition, CMGs should continually review the FI and report on the following:

- Progress in coordination and information sharing within the CMG participants, and with host authorities that are not represented in the CMG
- The RRP process for G-SIFIs under institution specific cooperation agreements
- The resolvability evaluations of G-SIFIs

5.4 EVERYDAY COLLABORATION

FSN participants should establish coordination arrangements that ensure symmetry in the access to information. Timely shared information informs everyday decisions, the analysis when monitoring financial institution operations, and policy determination and communication. Agencies should avoid duplication of functions and overburdening institutions under their authority. The member of the FSN primarily tasked with day-to-day responsibilities for the financial system is most likely the prudential supervisor.

The supervisory authority must ensure that only safe-and-sound firms enter the financial system and should be the leading authority that triggers an FI's exit from the system. This is notwithstanding the fact that the resolution of problem banks may be a function of a different administrative entity.⁶² Information-gathering mechanisms should be coordinated with the supervisory authority. The monitoring reports produced by all three functions—supervisory authority, resolution authority, and deposit insurer—should be shared, so that FSN participants can gain insight from different analysis and perspectives.

62/ Singh, D. and LaBrosse, J.R., "Developing a Framework for Effective Financial Crisis Management," *OECD Journal: Financial Market Trends* 2011, no. 2 (2012).

5.5 TIMELY INTERVENTION AND PREPARATION FOR RESOLUTION

Dealing with a failing institution, much less a crisis, can be complex. Coordination among FSN participants, with pre-determined rules of engagement, is paramount in guiding the decision-making process. *Ad hoc* pronouncements and actions usually result in market instability and loss of confidence in policymakers. MOUs containing the basic elements (see section 5.3.1) seek to ensure accountability, independence, and transparency in the FSN working environment, and aim to minimize the cost of resolving failed institutions. Sound coordination mechanisms should complement resolution legal frameworks in providing speed, transparency, advance planning, and as much predictability as possible through clear procedures.⁶³

It is important for the bank supervisor, the RA, and the DI to have well-developed action and contingency plans that ensure timely and effective implementation of intervention measures that are proportionate to the gravity of a bank's weaknesses.⁶⁴ DIAs with resolution responsibilities should be able to accompany the prudential supervisor to on-site examinations to gather information (DIAs would not carry out examination activities or tasks). Such advanced planning will also reinforce a macro prudential perspective, mitigating the buildup of excess risks across the system and identifying the effects of actions taken and policy decisions made by the participants individually and collectively.

5.6 ENTRY INTO RESOLUTION

Determining that a failing entity must enter resolution because it has either become nonviable or has no prospect of returning to viability requires the involvement of the supervisor, the DI, and the RA. Coordination mechanisms should enable the actions needed to implement the resolution strategy and operational plans. These actions include carrying out valuations, appointing advisors, ensuring continuity of payment systems and other FMI, reviewing information and data requirements, and communicating with stakeholders and the wider public.

Importantly, the coordination mechanisms should provide for the post-resolution restructuring and restoration to viability of those parts of the business that are to be continued, and the orderly wind-down of those (if any) that are not.⁶⁵ In jurisdictions where it is appropriate, MOUs should include details for single or multiple points of entry (SPE or MPE).

5.7 SETTLEMENT AND LIQUIDATION

Depending on the FSN institutional arrangements, MOUs may be required for coordinating settlement and liquidation actions. These MOUs should include provisions for the following situations:

- Depending on the resolution strategy, settling transactions such as the exercise of options by the acquirer, either any repurchase of assets by the receiver or any “put back” of assets to the receiver by the assuming institution.
- Disposing of the failed institution’s residual assets.
- Conducting investigations to determine if negligence, misrepresentation, or wrongdoing was committed that contributed to the failure of the FI and, when appropriate, filing a lawsuit to help recover losses caused by these acts.
- Reviewing and settling payment of eligible claims.
- Notifying and approving requests for the judicial extinction of the failed FI.
- Determining lessons learned from the process and identifying opportunities for enhancements and adjustments.

Cooperation mechanisms should assist all stakeholders through the end of the resolution process.

^{63/} See the preamble to the Kas.

^{64/} See *General Guidance on Early Detection and Timely Intervention for Deposit Insurance Systems*, IADI (2013).

^{65/} See *Guidance on Developing Resolution Strategies and Operational Resolution Plans*, FSB (2012).

6. FINAL COMMENTS

Financial sector authorities face multiple challenges in harmonizing their operational and legal frameworks to replicate the implementation of international standards. Jurisdictions have different legal systems—civil or common law—that involve different legislative processes and enforcement capabilities. They also have financial systems and safety nets with varied levels of depth and complexity, developed over decades, through events that have influenced the evolution and structure of their legal and operational frameworks.

Jurisdictions that are reforming their resolution schemes must carefully design frameworks, guided by the objectives set out in the KAs, to achieve feasible orderly resolutions without severe systemic disruption and without creating the expectation of publicly funded bailouts. Establishing a Special Resolution Regime (SRR) should enable financial sector authorities to carry out resolutions with enhanced legal certainty for every party involved, ensure continued access to critical financial functions, and instill market discipline.

An SRR provides tools to protect financial stability by effectively managing banks and other deposit-taking institutions (DTIs), investment firms, banking group companies, and central counterparties that are failing while protecting depositors, client assets, taxpayers, and the wider economy. It should assign powers to the RA that allow it to take flexible and decisive actions that maximize recoveries, limit delays in reimbursing depositors, and minimize the time necessary to return client assets to the financial system. When multiple administrative entities comprise the RA within a jurisdiction, their respective mandates, roles, and responsibilities should be distinctly defined and coordinated.

If a jurisdiction's laws do not authorize prompt, decisive action to restructure or continue key banking functions of nonviable FIs of all sizes, the inevitable response will be to bypass any prohibitions and effectively prop up weak institutions (including through injections of public funds), keeping them in operation. Moral hazard can, and should, be controlled by limiting the use of public funds while providing responsible authorities with the legal tools to maintain key banking operations through the sale of the business or transfer of assets and liabilities to another bank or through operation of a temporary bridge bank. Review of legal frameworks where appropriate, with the goal of adopting international standards, should allow for a departure from the compliance-based culture. In turn, reformed legal frameworks should be more conducive to better data-gathering capabilities through careful planning. Such reforms also would allow for a comprehensive understanding of the risks involved in individual FIs, both as ongoing concerns and as they become nonviable operations, as well as how their entry into resolution could affect the financial system as a whole.

The starting point in the reform agenda begins with changing our collective mindset about the importance of a strong safety net where each function, individually and collectively, can help to foster financial system stability. Close coordination based on recognizing the mandates and competencies of all FSN participants will drive effective resolution processes.

DEFINITIONS OF TERMS USED IN THIS REPORT*

Administrator - receivers, trustees, conservators, liquidators, or other officers appointed by a resolution authority or court, pursuant to a resolution regime, to manage and carry out the resolution of a firm.

Bail-in within resolution - restructuring mechanisms (howsoever labelled) that enable loss absorption and the recapitalization of a firm in resolution or the effective capitalization of a bridge institution through the cancellation, write-down, or termination of equity, debt instruments, and other senior or subordinated unsecured liabilities of the firm in resolution, and the conversion or exchange of all or part of such instruments or liabilities (or claims thereon) into or for equity in or other instruments issued by that firm, a successor (including a bridge institution), or a parent company of that firm.

Bank - any firm that takes deposits or repayable funds from the public and is classified under the jurisdiction's legal framework as a deposit-taking institution. For the purposes of this report a bank may mean, as appropriate in the context, an individual institution or a banking group.

Bridge institution - an entity established to temporarily take over and maintain certain assets, liabilities, and operations of a failed firm as part of the resolution process.

Critical functions - activities performed by a firm for third parties, where failure would lead to disruption of services critical to the functioning of the real economy and for preserving financial stability.⁶⁶

Deposit insurance - a system established to protect depositors against the loss of their insured deposits in the event that a bank is unable to meet its obligations to depositors.

Deposit insurer - the specific legal entity responsible for providing deposit insurance, deposit guarantees, or similar deposit protection.

Deposit insurance system - the deposit insurer and its relationships with the financial safety net participants that support deposit insurance functions and resolution processes.

Depositor preference - granting deposit liabilities a higher claim class than other general creditors against

the proceeds of liquidation of an insolvent bank's assets. Depositors must be paid in full before remaining creditors can collect on their claims. Depositor preference can take the following forms:

- National (or domestic) depositor preference gives priority to deposit liabilities booked and payable within the domestic jurisdiction and does not extend to deposits in foreign branches abroad.
- Eligible depositor preference gives preference to all deposits meeting the eligibility requirements for deposit insurance coverage.
- Insured depositor preference gives preference to insured depositors (and the deposit insurer under subrogation).

Deposit insurance system - the deposit insurer and its relationships with the financial safety net participants that support deposit insurance functions and resolution processes.

Depositor preference - granting deposit liabilities a higher claim class than other general creditors against the proceeds of liquidation of an insolvent bank's assets. Depositors must be paid in full before remaining creditors can collect on their claims. Depositor preference can take the following forms:

- In a two-tiered depositor preference concept, eligible but uninsured deposits have a higher ranking than claims of ordinary unsecured, non-preferred creditors, and insured depositors have a higher ranking than eligible depositors.
- For general depositor preference, all deposits have a higher ranking than claims of ordinary unsecured, non-preferred creditors, regardless of their status (insured/uninsured or eligible/not eligible).

Differential premium system (or "risk-based premiums") - a premium assessment system that seeks to differentiate premiums on the basis of criteria such as individual bank risk profiles.

^{66/} See the July 2013 FSB Guidance on Identification of Critical Functions and Critical Shared Services, http://www.fsb.org/wp-content/uploads/r_130716a.pdf.

Entry into resolution - the determination by the relevant authority that a firm meets the conditions under the applicable resolution regime for the exercise of resolution powers and that it will be subject to the exercise of such powers.

Ex ante funding - the regular collection of premiums, with the aim of accumulating a fund to meet future obligations (e.g., reimbursing depositors) and cover the operational and related costs of the deposit insurer.

Ex post funding - systems in which funds to cover deposit insurance obligations are only collected from surviving banks after a bank failure.

Financial firm or financial institution - any entity whose principal business is to provide financial services or conduct financial activities, including banks, insurers, securities or investment firms, and financial market infrastructure firms. References in this report to “firm” refer to a financial firm or financial institution.

Financial group - a group composed of entities the primary activities of which are financial in nature.

Financial safety net - the functions of prudential regulation, supervision, resolution, lender of last resort, and deposit insurance. In many jurisdictions, a department of government (generally a Ministry of Finance (MOF) or Treasury responsible for financial sector policy) is included in the financial safety net.

Firm in resolution - a firm in which resolution powers are being exercised. Where resolution powers have been or are being exercised in relation to a firm, that firm is considered to be “in resolution” for as long as it remains subject to measures taken or supervised by a resolution authority or to insolvency proceedings initiated in conjunction with resolution.

Group - a parent company (which may be a holding company) and its direct and indirect subsidiaries, both domestic and foreign.

Holding company - a company formed to control financial firms. The holding company concept covers direct, intermediate, and ultimate control, and includes a parent company that itself carries out financial operations.

Home jurisdiction - the jurisdiction where the operations of a financial group are supervised on a consolidated basis.

Legal framework - the comprehensive legal system for a jurisdiction established by any combination of the following: a constitution, primary legislation enacted by a legislative body that has authority in the jurisdiction, subsidiary legislation (including legally binding regulations or rules) adopted under the primary legislation of the jurisdiction, or legal precedent and legal procedures of the jurisdiction.

Legal gateways - provisions set out in statute or other instruments with the force of law that enable the disclosure of nonpublic information to specified recipients or for specific purposes. Legal gateways may be contingent on, or supported by, memoranda of understanding (MOUs) or other forms of agreement between the providing and recipient authorities.

Liquidation (or receivership) - the winding down (or *winding up* as used in some jurisdictions) of the business affairs and operations of a failed bank through the orderly disposition of its assets after its license has been revoked and it has been placed in receivership. In most jurisdictions, *liquidation* is synonymous with *receivership*.

Liquidator (or receiver) - the legal entity that undertakes the winding down of the failed bank and the disposition of its assets.

Moral hazard - when parties have incentives to accept more risk because the costs that arise from the risk are borne, in whole or in part, by others.

Public policy objectives - the goals which the deposit insurance system is expected to achieve.

Public ownership - full or majority ownership of an entity by the State or an emanation of the State.

Resolution - the exercise of resolution powers, including in particular the exercise of a resolution power specified in KA3, by a resolution authority for a firm that meets the conditions for entry into resolution, with or without private sector involvement, with the aim of achieving the statutory objectives of resolution set out in KA2.3. The exercise of resolution powers may include or be accompanied by an insolvency proceeding with respect to the firm in resolution (for e.g., to wind up parts of that firm).

Resolution authority - a public authority that, either alone or together with other authorities, is responsible for the resolution of firms established in its jurisdiction (including resolution planning functions). References in this document to a *resolution authority* should be read as *resolution authorities* where appropriate.

Resolution powers - powers available to resolution authorities under the legal framework for the purposes of resolution and exercisable without the consent of shareholders, creditors, debtors, or the firm in resolution, including in particular those set out in KA3.

Resolution regime - the elements of the legal framework and the policies governing resolution planning and preparing for, carrying out, and coordinating resolution, including the application of resolution powers.

Subrogation - the substitution of one party (e.g., the deposit insurer) for another (e.g., the insured depositor) with reference to a lawful claim, demand, or right, so that the party which substitutes succeeds to the rights of the other in relation to the debt or claim, and its rights and remedies.

Supervisor or supervisory authority - the authority responsible for the supervision or oversight of a financial institution. The *supervisor* or *supervisory authority* includes prudential and business or market conduct supervisors, and oversight authorities in the case of FMs.

Systemically important financial institution - a financial institution or group that, because of its size, complexity, and systemic interconnectedness, would, in the view of the relevant authorities, cause significant disruption to the domestic or broader financial system and economic activity if it were to fail in a disorderly manner.

Systemically significant or critical - a financial firm is *systemically significant* or *critical* if its failure could lead to a disruption of services critical to the functioning of the financial system or real economy.

Target fund size - the size of the ex-ante deposit insurance fund, typically measured as a proportion of the assessment base (e.g., total or insured deposits), sufficient to meet the expected future obligations and cover the operational and related costs of the deposit insurer.

* The definitions of key terms come from the October 2014 draft version of the assessment methodology for the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions*. An earlier version of the draft methodology was circulated for public consultation in August 2013 (http://www.fsb.org/wp-content/uploads/r_130828.pdf), and in the *Handbook for the Assessment of Compliance with the Core Principles for Effective DIS* issued by IADI on March 2016.

ABBREVIATIONS OF TERMS USED IN THIS REPORT

ASBA	Association of Supervisors of Banks of the Americas
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles for Effective Banking Supervision
BRRD	Bank Recovery and Resolution Directive (EU)
CMG	Crisis Management Group
CP	IADI's Core Principles for Effective Deposit Insurance Systems
DI	Deposit Insurance (a FSN Function)
DIA	Deposit Insurance Agency (an FSN participant)
DIF	Deposit Insurance Fund
DIS	Deposit Insurance System
D-SIBs	Domestic Systemically Important Banks
ECCB	Eastern Caribbean Central Bank
FI	Financial Institution
FMI	Financial Market Infrastructure
FSB	Financial Stability Board
FSN	Financial Safety Net
GFC	Global Financial Crisis
G-SIBs	Global Systemically Important Banks
G-SIFIs	Global Systemically Important Financial Institutions
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
LLR	Lender of Last Resort
MOF	Ministry of Finance
MoU	Memorandum of Understanding
P&A	Purchase and Assumption transactions
RA	Resolution Authority
RRP	Recovery and Resolution Planning
SRR	Special Resolution Regime
USA	United States of America
WG	Working Group

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EFFECTIVE COOPERATION FOR RESOLUTION OF FINANCIAL INSTITUTIONS IN THE AMERICAS

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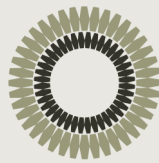
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