MONTENEGRO: Financial Sector Assessment Program Financial Crisis Preparedness And Management—Technical Note

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FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2016

FINANCIAL CRISIS PREPAREDNESS AND MANAGEMENT—TECHNICAL NOTE

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TECHNICAL NOTE

FINANCIAL CRISIS PREPAREDNESS AND MANAGEMENT

Prepared By
Monetary and Capital Markets Department, IMF

This Technical Note was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission in Montenegro during September 2015 led by Peter Lõhmus, IMF and Alex Pankov, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance and Markets Global Practice, World Bank. The note contains the technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx.

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CONTENTS

GLOSSARY 3

EXECUTIVE SUMMARY 4

BACKGROUND 9

A. Financial Sector Structure 9

B. Recent Crisis Experience and Policy Responses 9

INSTITUTIONAL ARRANGEMENTS 10

A. Overview 10

B. Recommendations 10

FAILURE MITIGATION REGIME 11

A. Early Intervention 11

B. Recovery Planning 12

C. Recommendations 12

FAILURE RESOLUTION REGIME 13

A. Resolution Powers 13

B. Resolution Planning 16

C. Resolution Funding 16

D. Recommendations 16

DEPOSIT INSURANCE 19

A. Background 19

B. Recommendations 19

LIQUIDITY SUPPORT 20

A. Background 20

B. Assessments 21

C. Recommendations 22

SYSTEMIC CRISIS MANAGEMENT 23

A. Crisis Preparedness 23

B. Recommendations 24

TABLE

1. Key Recommendations for Crisis Preparedness and Management 7

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Glossary

BRRD	European Union Bank Recovery and Resolution Directive
BSD	Bank Supervision Department
CBM	Central Bank of Montenegro
DGSD	Directive on Deposit Guarantee Schemes 2014/49/EU
DPF	Deposit Protection Fund
DPL	Deposit Protection Law
ELA	Emergency Liquidity Assistance
EBA	European Banking Authority
FSC	Financial Stability Council
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NCP	National Contingency Plan
NPL	Nonperforming Loan
SIFI	Systemically Important Financial Institution

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EXECUTIVE SUMMARY[1]

1. The crisis preparedness and management framework is generally well developed. The authorities have the capacity to resolve smaller- and medium-sized banks. Additional legal powers set out in the draft *lex specialis*, which the government would table before parliament in a crisis situation, likely would need to be in place to be able to resolve a systemically important bank. While contingency planning has been undertaken, more work is required to ensure that the policies, procedures, and documentation required to efficiently and effectively resolve failing banks of all sizes, as well as the simultaneous failures of multiple banks, needs to be undertaken. While the eventual transposition of the European Union (EU) Bank Recovery and Resolution Directive (BRRD) in national legislation could be expected to provide additional legal powers and address many of the existing policy and procedural shortcomings, there is scope to undertake further planning and preparation in the interim.

2. In 2010 the Financial Stability Council (FSC) was established to maintain financial system stability and avoid financial distress. The FSC comprises the Central Bank of Montenegro (CBM) governor (chair), the Minister of Finance, the president of the Insurance Supervision Agency (ISA) Council, and the Securities and Exchange Commission (SEC) president. At present, only principals are allowed to attend FSC meetings. The Deposit Protection Fund (DPF) is not a member. To ensure the FSC's ability to function expeditiously, in the temporary absence of a principal, an alternate should be designated and empowered, to the extent possible to take decisions on behalf of the principal. The DPF Director General should become a member of the FSC. A single inter-agency Memorandum of Understanding (MOU) among the FSC membership should replace the existing MOUs, which have not been updated since the creation of the FSC.

3. The CBM functions as the *de facto* resolution authority for banks. When the BRRD is transposed, the CBM should be identified as the resolution authority for the institutions that are under its supervision at that time. There is no need to establish a new resolution authority. Given the increased workload associated with resolution planning and related work, a dedicated full-time Small Resolution Unit should be established with a reporting line to the CBM Board, which is kept separate from the department responsible for emergency liquidity assistance (ELA) and, eventually, also from the Bank Supervision Department (BSD).

4. The CBM has extensive early intervention powers to influence the actions of management and the Board, and may impose interim administration to effectively assume control of a bank's operations. Where the solvency or liquidity of a bank is jeopardized, the CBM is required to impose interim administration. Interim administration could be used to rehabilitate a bank under its current ownership, but it could also be used to resolve a failing bank (see below).

[1] This Technical Note has been prepared by David Scott, Runchana Pongsaparn, Atilla Arda, and Claudio Visconti. The section on deposit insurance has benefitted from the FSAP Technical Note 'Deposit Insurance System' authored by Jan Philipp Nolte (World Bank, January 2016).

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5. **The CBM requires banks to undertake contingency planning with respect to both capital and liquidity**. The BSD requires banks to prepare contingency plans for managing their liquidity in crisis situations and, as part of its regular supervisory process, requires banks to prepare capital plans that must be updated annually. Current supervisory processes lay the foundation to begin requiring banks to prepare recovery plans as envisioned under the BRRD.

6. **The CBM has powers to resolve a failing bank through interim administration**. A CBM-appointed interim administrator manages the affairs of, and could restructure, a bank under the CBM's direction and with its support. The administrator assumes the power of the Board of Directors, the executive managers, and the shareholders, and has wide powers to recapitalize, restructure, and resolve a bank. The outcome of interim administration for a failing bank is either the resolution via recapitalization or the transfer of some or all of the bank's assets and liabilities to another bank, or its bankruptcy. In principle, a bank may be recapitalized by existing shareholders, by existing and new shareholders, or solely by new shareholders. The CBM must approve the form of resolution. Failing these, the bank is liquidated and insured deposits paid-out.

7. **The current resolution regime exhibits weaknesses**. There is scope for existing shareholders to receive value for their shares, and for subordinated debt holders to incur no losses, where a failing bank is recapitalized by others. The DPF cannot finance an insured deposit transfer and there are no provisions for the government to establish a bridge bank.

8. **Institution-specific resolution planning has yet to be initiated**. While some relevant preparatory work was undertaken as part of the National Contingency Plan (NCP), it has not yet involved formulation of the policies, procedures, and documentation that would be required to effectively implement the powers envisioned in the *lex specialis,* which would be essential in the case of a systemically important bank.

9. **There is no readily available source of finance for capital support in resolutions**. The DPF funds cannot be used to finance an insured deposit transfer; the Deposit Protection Law (DPL) should be amended to provide for this. The MOF has no funding earmarked in the annual budget for this purpose. It should be vested with statutory authority to borrow or use budgetary means up to a certain limit without *ex ante* parliamentary approval, though with *ex post* parliamentary accountability, and subject to safeguards on the use of taxpayer funds for this purpose (see below). It has no contingent lines of credit with banks. It should seek to establish stand-by arrangements with a reputable foreign bank outside the region or with an international financial institution (e.g., EBRD) for this purpose. (See further in section on ELA below.)

10. **A formalized ELA framework is in place, but further refinements and preparations could be made to align the framework with the best international practice**. The ELA framework is in place under the CBM law and additional arrangements are laid out in the *lex specialis*. Both should be brought under a single framework. The CBM should prepare (for internal use) a list of acceptable collateral, and pricing and haircut methodologies. Without the ability to create money, the CBM's ability to provide liquidity assistance is constrained. To address this, MOF could establish a dedicated account at the CBM for ELA, arrangements could be made for MOF to reimburse the

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CBM for losses stemming from ELA, and MOF and/or the CBM could set up stand-by arrangements with international financial institutions and major central banks.

11. **Capital and/or ELA support by the MOF or the CBM should be subject to strict safeguards**. Circumstances under which this would be considered should be defined in written policy. The policy criteria should include quantifiable and measurable indicators that would guide a decision as to whether a bank is so systemically important that its failure would have severe repercussions for the financial system or the economy. Shareholders of banks benefiting from such support should lose the full value of their shares, and losses should be fully borne by holders of the bank's hybrid capital instruments, subordinated debt, and senior debt. The use of MOF or CBM funds to support the resolution of a systemically important bank should include a least-cost objective.

12. **The deposit insurance system in Montenegro is relatively well developed and well capitalized, but needs to be more closely integrated in crisis preparedness mechanisms**. As noted, the DPL should be amended to enable the DPF to finance the transfer of insured deposits to another bank. The DPF should be allowed to use other options for pay-out rather than the use of an agent bank. In the process of transposition of EU directives, it should further shorten the pay-out timeframe to seven working days and introduce risk-based premiums. In cooperation with the CBM and MOF, the DPF should undertake testing of the pay-out procedures and strengthen internal contingency planning. If, as recommended, the DPF should become a member of the FSC, it should be involved in contingency planning and crisis management. The DPF should sign an MOU with MOF to address the issues of back-up finance from the budget, as foreseen in the DPL and guarantees from MOF for DPF borrowing, in both cases, to cover any shortfall of the fund. The DPF's mandate could be enhanced to take over other responsibilities, which will have to be introduced into national law during the EU accession process (e.g., bank resolution fund, investor compensation scheme).

13. **Montenegro's approach to crisis preparedness and management should be broadened, deepened, and operationalized**. While the adoption of the NCP should be welcome, the authorities should focus now on its implementation and the agencies' readiness. Progress reports on the implementation of the NCP should be regularly tabled for discussion by a new FSC committee dedicated to crisis preparedness and management. Periodic system-wide crisis simulation exercises should be held with all FSC member agencies to test, in particular, major contingencies, such as bank runs, depositor pay-outs, financial assistance to failing banks, and resolution of systemically important financial institutions (SIFIs).

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Table 1. Montenegro: Key Recommendations for Crisis Preparedness and Management	
Recommendations	**Time** 1/
Institutional Arrangements	
• Amend the FSC Law to grant membership to the DPF, provide for representation by alternates. • Streamline various inter-agency MOUs into a single (updated) multilateral agreement. • Organize a dedicated, full-time Small Resolutions Unit within the CBM to undertake resolution planning and resolvability assessments, with ready access to resources throughout the CBM and with a reporting line to the CBM Board that is separate from the department for ELA and eventually the BSD.	I NT I
Failure Mitigation Regime	
• Begin now to require banks to prepare recovery plans, as envisioned under the BRRD, and engage with relevant home supervisory authorities.	NT
Failure Resolution Regime	
Resolution Planning • Start bank-specific resolution planning, including resolvability assessments, both as envisioned under the BRRD, prioritizing banks based on their CAMEL ratings, and engage with relevant with home resolution authorities. • Adopt an explicit policy for CBM and MOF liquidity and capital support, setting strict and objective criteria for determining systemic importance of receiving bank.	I I
Resolution Funding • Strengthen resolution funding options, including (i) amending the DPL to enable DPF funding for transfer of insured deposits during resolution; (ii) vesting statutory authority in MOF to borrow or use budgetary means up to a certain limit without ex ante parliamentary approval and with ex post parliamentary accountability; and (iii) establishing a credit line for MOF with a reputable foreign bank or IFI. • Establish safeguards on the use of MOF or CBM funds to resolve a systemically important bank, and adopt a least-cost objective.	NT I
Deposit Insurance	
• Adopt and implement methodology for risk-based contributions from member banks and amend the DPL to introduce pay-out of insured depositors within seven working days in line with EU DGSD.	NT
Liquidity Support	
• Bring ELA under the CBM Law and the *lex specialis* under a single framework. • Prepare a list of acceptable collateral, and pricing and haircut methodologies for internal use. • Strengthen safeguards to protect the CBM's financial autonomy in case of ELA, including (i) requiring foreign-owned banks' parents to provide a letter of comfort to provide liquidity in times of stress; (ii) a dedicated MOF ELA sub-account at the CBM under the latter's autonomous decision making and administration; (iii) a cap on the use of the CBM's fund for ELA; and (iv) ex ante arrangements for MOF reimbursement of CBM losses stemming from ELA within 30 days upon an independent audit report; and (v) appropriate safeguards for the use of ELA by the receiving bank and enhanced monitoring to minimize moral hazard.	NT

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Table 1. Montenegro: Key Recommendations for Crisis Preparedness and Management (concluded)	
Systemic Crisis Management	
• Under auspices of the FSC, ensure regular (i) progress reports on implementation of the national and agency-specific contingency planning and underlying procedures, with involvement of line units; and (ii) simulation exercises for key contingencies such as bank runs, depositor pay out, emergency financial assistance, and resolution of an SIFI.	I
• Establish two standing FSC working groups at the deputy principal level for macroprudential oversight and crisis management, the former led by the CBM and the latter by MOF; consider adding two external, independent members to the macroprudential oversight working group.	NT

1/ I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years.

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BACKGROUND

A. Financial Sector Structure

15. The banking sector dominates the financial system and accounts for about 90 percent of financial system assets, equivalent to about 93 percent of GDP as of June 2015. There are 14 banks operating in Montenegro, which is up from 11 in 2013. The sector comprises mostly foreign subsidiaries holding 79 percent of the sector's assets. Banks' assets are concentrated in lending products (60 percent), with most of the lending in the trade sector and households (mostly mortgages), each representing about 38 percent of total loans. Loans to nonresidents represent 18 percent of the total. Liabilities are concentrated in deposits (75 percent of the total), which are closely split between demand (46 percent) and time (53 percent) deposits. Foreign deposits represent about 20 percent of the total deposits.

16. The insurance sector and rest of the nonbanking financial system is very small. Total insurance premiums represent only 2 percent of GDP. The life insurance sector insures less than 10 percent of the population and the non-life insurance sector is predominantly compulsory motor third-party liability insurance. While the nascent stock exchange's market capitalization is significant, the turnover is very low and the bond market is thin. The total size of the five micro-credit institutions (MCIs) is 2 percent of GDP with assets slightly over 1 percent that of banks. The leasing market is small and has been declining since the crisis.

B. Recent Crisis Experience and Policy Responses

17. The Montenegrin economy has yet to recover from the collapse of the lending boom. The crisis triggered a prolonged period of balance sheet deleveraging, which has translated into a near uninterrupted credit contraction. Banks are still vulnerable due to high nonperforming loans (NPLs), low profitability, weak capital, and high private sector indebtedness. Progress in the intervening years to address the debt overhang, reduce NPLs, and restructure/recover assets has been limited, owing partly to a weak and depressed market for real estate, banks' unwillingness to take further losses, and gaps remaining in the debt resolution framework.

18. Policy measures were adopted to reduce credit growth with limited results. By late 2007, the CBM introduced stricter rules for asset classification and provisioning (which were relaxed again during the crisis), and increased CAR by two percentage points to 10 percent. Early 2008, temporary bank-specific ceilings on credit growth in the 30–60 percent range were introduced. Furthermore, the reserve requirement base was broadened to include public sector deposits and the required reserves rates on certain deposits were increased. To reverse an outflow of deposits in late 2008, the government guaranteed all bank private deposits through a temporary Law on Measures for the Protection of the Banking System. This anti-crisis law also allowed for liquidity support from the CBM and the government, with one large domestically owned bank receiving a sizeable loan from the government. The anti-crisis law lapsed at end-2009, and, at the same time, the coverage of the insured deposits was increased by four-fold to EUR 20,000 (now EUR 50,000).

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INSTITUTIONAL ARRANGEMENTS

A. Overview

19. In 2010 the Financial Stability Council (FSC) was established to maintain financial system stability and avoid financial distress. For this purpose, the FSC is to monitor, identify, prevent, and mitigate potential systemic risks. The FSC comprises the CBM governor (chair), the Minister of Finance, the president of the Insurance Supervision Agency (ISA) Council, and the Securities and Exchange Commission (SEC) president. The CBM provides administrative and technical support to the FSC, including collecting pertinent data and information. After each meeting, the FSC issues a press release about its assessment and, annually, the FSC reports to parliament on its activities.[2]

20. While the establishment of the FSC and its activities should be welcomed, there is scope for improvement.

- The FSC members function in a personal capacity; they are expected to attend the meetings in person without authority to send representatives. This could hamper the functioning of the FSC.
- The DPF Director General is not an FSC member; while the FSC Law permits to do so, he has not been invited to any of the 26 FSC meetings that have been held to date—this includes the principals' meetings concerning the NCP for financial crisis management.[3] This is not helpful for effective coordination with an important actor in crisis management.
- Several inter-agency MOUs have not been updated after establishment of the FSC; overlapping scopes with the FSC Law, varying participation, and the absence of MOUs between DPF-MOF and between CBM-ISA raises questions about the applicability and effectiveness of these MOUs.

21. The CBM functions as the de facto resolution authority. It has been responsible for managing bank failures in the past, and MOF looks to the CBM for recommendations as to any role it may need to play. Resolution activities in the CBM are led mainly by the Bank Supervision Department in coordination with other relevant units. The CBM Council and the governor are responsible for resolution decision making.

B. Recommendations

22. In the temporary absence of an FSC member, an alternate should be designated. The alternate would participate in FSC meetings and be empowered, to the extent possible, to take decisions on behalf of the principal.

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[2] This is separate from the CBM's annual financial stability report.

[3] The FSC did involve the DPF in the FSC working group that prepared the NCP.

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23. The DPF should become a member of the FSC. This will allow the DPF to have early access to financial stability analyses that help it prepare at an early stage. The DPF membership would also strengthen the FSC's focus on crisis preparedness and management.

24. A single inter-agency MOU among the FSC membership should replace existing MOUs. This MOU would cover all topics that require further detail, be it between all the FSC member agencies or a selection thereof. One could imagine chapters that apply to all the FSC member agencies and chapters to address specific issues concerning two or more of FSC member agencies.

25. When the EU Bank Recovery and Resolution Directive (BRRD) is transposed into national legislation, the CBM should be identified as the resolution authority for the institutions under its supervision. The CBM is the *de facto* resolution authority for banks. In light of the size of the country and its banking sector, there is no need to establish a new resolution authority. If, as has been proposed by the CBM under new legislation for financial institutions, which is being prepared by MOF, the CBM would become the supervisor for other financial institutions, the CBM should also be the resolution authority for these institutions. To support the CBM's effectiveness, a dedicated full-time, Small Resolution Unit should be established. The unit should have ready access to resources throughout the CBM. Its reporting line to the CBM Board should be separate from the department responsible for emergency liquidity assistance and, eventually, also from the Bank Supervision Department.

FAILURE MITIGATION REGIME

A. Early Intervention

26. The CBM may impose a wide variety of early intervention measures on banks under a range of circumstances, including if, in its assessment, the bank's financial viability could be threatened. These measures include: scaling down or ceasing certain operations, establishing adequate reserves for losses, selling assets, restricting or ceasing dividends, increasing capital, and removing Executive Directors or Board members, among others. In practice, measures to raise capital have been successfully imposed on several occasions over the last five years. The measures, in general, could be imposed by means of a letter to the bank, requesting that certain actions be taken, a written agreement between the bank and the CBM under which the bank undertakes to take certain actions within a specified timeframe, and written CBM orders requiring that certain actions be taken within a specified timeframe. The special contingent legislation drafted under the auspices of the Financial Stability Council, which could be introduced in the context of a financial crisis (see description further below), gives the CBM additional powers to impose more restrictive measures on banks in crisis circumstances.

27. Where a bank's solvency or liquidity is jeopardized, the CBM is required to impose interim administration. Interim administration must be imposed where the bank's own funds or solvency ratio falls below half the prescribed level, or where the bank has failed to implement early intervention measures within the prescribed timeframe and that failure may jeopardize the bank's

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solvency or liquidity. Interim administration could be used to rehabilitate a bank under its current ownership, but could also be used to resolve a failing bank. See section on Resolution Powers for a description of how interim administration is used for that purpose.

B. Recovery Planning

28. The CBM requires banks to undertake contingency planning, including for purposes of restoring capital and liquidity. The Bank Supervision Department requires banks to prepare contingency plans for managing their liquidity in crisis situations and has issued detailed written guidance outlining its expectations. The guidance addresses plan governance and reporting requirements, the development of early warning indicators and triggers, the identification of measures to be taken in case the triggers are reached, and an assessment of the timeframes in which measures could be executed, and other related matters. Banks' liquidity contingency plans are evaluated as part of individual bank supervision. Similarly, as part of its regular supervisory process, the CBM requires banks to prepare capital plans that must be updated annually. All banks must conduct capital stress tests and define measures that would be taken to restore capital. Separately, in the context of formulating the CBM and the NCP, led by the Financial Stability Department, a guideline for the preparation by banks of recovery (and resolution) plans has been drafted, though it has not been put into effect.

29. Current supervisory processes lay a sound foundation for the eventual adoption of a requirement that banks prepare recovery plans, such as are envisioned under the BRRD. As noted immediately above, many of the elements are already in place. The CBM has begun to engage with the supervisory college organized by the home authority of one of the systemic bank subsidiaries in Montenegro in the context of recovery planning. In October 2015, the CBM will participate in meetings sponsored by the European Banking Authority for the purposes of clarifying and deepening the engagement of supervisory (and resolution) authorities in the region with the respective home authorities.

C. Recommendations

30. In the context of current ongoing efforts and practices, the CBM could consider accelerating the implementation of recovery planning requirements, especially for the larger domestic banks. Leveraging on existing supervisory practices and experience with bank liquidity and capital contingency planning, on increasing engagements with the home authorities of the foreign subsidiaries who are implementing recovery planning requirements for the parent banks, on the preparatory work being undertaken to adopt of the BRRD, and on the guideline for the preparation by banks of recovery plans developed in the context of the CBM Contingency Plan, the CBM could implement supervisory requirements for recovery planning at an early stage. Knowledge gained in engagement with the more advanced home authorities should be applied to the largest domestic banks where the CBM's role in ensuring recovery and mitigating weaknesses and potential failures is critical. Adopting provisions for formal recovery planning by banks need not wait for transposition of the BRRD into Montenegrin law.

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FAILURE RESOLUTION REGIME[4]

A. Resolution Powers

31. The CBM has extensive powers under the Banking Law to resolve a failing bank through interim administration. Although, in practice, the CBM has not used these powers under the current law (in place since 2010), it has the authority under an adequate range of circumstances to appoint an interim administrator with the power to manage the affairs and restructure a bank. Upon appointment of the interim administrator, the terms of office of Board members and the duties of the Executive Directors are terminated and the administrator assumes the powers of the shareholders' General Meeting, the Board, and the Executive Directors. The CBM has substantial powers to direct the actions of the administrator. It has the power to impose a moratorium on the payment of liabilities for up to six months (though the CBM may authorize the payment of insured deposits during the moratorium). Should a moratorium be imposed, all proceedings against the bank and administrator are suspended during the moratorium period; the bank's assets may not be subject to the execution of a judgment and the bank may not assume any new liabilities except to the Montenegro government, the CBM, and the DPF. Within 30 days, the administrator is to submit a resolution plan. The administrator has wide powers to restructure and resolve the bank, including the sale of assets and the transfer of assets and liabilities to another bank. Under the Banking Law, the CBM directs and supports the interim administration and has procedures in place for doing so. The outcome of interim administration for a failing bank is either the resolution via recapitalization or the transfer of some or all of the bank's assets and liabilities to another bank, or its bankruptcy.

32. While a decision by the CBM to impose interim administration could be subject to challenge in an Administrative Court, this is not seen as a significant constraint on the exercise of resolution powers. The court is to evaluate whether the CBM has fulfilled procedural requirements for imposing administration, but not the merits of the CBM's decision. The filing of a challenge does not suspend the administration. Should the court support the challenge, administration would be suspended, but the CBM is able to, and would immediately, reimpose administration after remedying the procedural defect.

33. As noted, a bank under interim administration may be resolved either through recapitalization or the transfer of assets and liabilities to another bank. A key task of the interim administrator, supported by the CBM, is to establish the amount of capital required to adequately recapitalize the bank in line with its risk profile, and to raise, if possible, the required capital. In principle, a bank may be recapitalized by existing shareholders, by existing and new shareholders, or solely by new shareholders. Alternatively, some or all assets and liabilities may be transferred to another bank. The CBM must approve either form of resolution.

[4] Given the authorities' plans to transpose the BRRD by 2017, this section describes how the CBM and MoF could strengthen the existing resolution framework in the interim period.

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34. The Banking Law provides that existing bank shareholders may be given the opportunity to provide additional capital to a bank under interim administration. Existing shareholders could be given the opportunity to provide the necessary capital, though the interim administrator is not obliged to do so in cases where the shareholders had failed to comply with a CBM order to recapitalize prior to the imposition of interim administration. The practical consequence of the relevant legal provisions is that it is possible that shareholders would either recapitalize the bank fully, recapitalize partially with the remaining required capital provided by new shareholders, or lose most or all of the value of their shares in the context of recapitalization by new shareholders. In the latter case, should the bank be deemed by the interim administrator—in collaboration with the CBM—to have positive net asset value, the shares of existing shareholders are mandatorily sold to the new shareholders under a pricing arrangement set out in law. Should the bank be deemed to have no or negative net asset value, the shares reportedly are able to be transferred to the new shareholders at no cost.

35. Subordinated debt claims are not written down or off when a bank is recapitalized under interim administration, even when recapitalized by third parties. Although hybrid capital would have been already converted into equity, there are no provisions in subordinated debt contracts or law that require write-down or conversion into equity.

36. In the absence of ability to arrange full recapitalization, the interim administrator may sell some or all assets and liabilities to another bank. Sale does not require the approval of depositors, creditors, debtors, or shareholders. The value of assets and liabilities to be sold is negotiated by the interim administrator and the acquiring bank, and is subject to the CBM's approval.

37. Should recapitalization or the sale of assets and liabilities not be achieved, the license of the bank under interim administration is revoked and it is placed into bankruptcy. Interim administration may run for six months, extendable by three months. After that period, in principle, the bank is to be placed into bankruptcy in the context of the revocation of its license.

38. The Banking Law provides adequate grounds for the revocation of a bank license, which in turn leads to the bank being wound-up under either bankruptcy or liquidation proceedings under the Bank Bankruptcy and Liquidation Law. In the CBM's judgment, undercapitalization and inadequate liquidity are among the grounds for license revocation. Liquidation proceedings are initiated by the bank itself and could be applied only in instances where it is judged that the bank will be able to satisfy all claims. Bankruptcy proceedings are employed when the CBM determines that all claims cannot be satisfied, including in the course of liquidation proceedings. The initiation of bankruptcy proceedings is subject to challenge in an Administrative Court, but, as with the imposition of interim administration, this is not seen as a significant constraint on the implementation of bankruptcy proceedings. The commencement of bankruptcy proceedings triggers the DPF's obligation to pay out the bank's guaranteed deposits. A revoked license cannot be restored.

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39. The CBM conducts both liquidation and bankruptcy proceedings. The commencement of bankruptcy includes the appointment of a bankruptcy administrator who assumes the powers and authorities of the bank's managing bodies. The administrator is drawn from a list of qualified individuals maintained by the CBM, is deemed a body of the CBM, and has adequate legal protections under the law. The administrator functions under the oversight of a Bankruptcy Board comprised of five members appointed by the CBM. Upon commencement of bankruptcy proceedings, all pending lawsuits against the bank are suspended, no lawsuit may be filed against the bank and no collateral could be foreclosed against the bank; any proceedings related to security foreclosure and enforcement are stopped and no new lien or other encumbrances may be attached to the bank's property during the course of the bankruptcy proceedings. On the commencement of bankruptcy, all bank staff are terminated and the administrator may rehire only 10 percent of such staff. Bankruptcy proceedings are closed when the administrator determines that the bank's remaining property is insufficient to cover the costs of the administration proceedings.

40. The Bank Bankruptcy and Liquidation Law sets out a clear hierarchy of claims in bankruptcy. For unsecured claims, the priority is as follows: (i) the CBM; (ii) the DPF in subrogation of insured deposits; (iii) claims of depositors eligible for deposit protection in excess of the insured amount; (iv) claims of other depositors; (v) claims of other creditors, including tax claims; and (vi) claims of creditors arising from subordinated debt and/or hybrid capital instruments. Employee claims are settled as a cost of the bankruptcy proceedings.

41. There are no resolution provisions that enable the continued operation of a systemically important bank while suspending certain actions of creditors during the resolution process. Suspension of such actions could be achieved only by imposition by the CBM of a general moratorium under interim administration. The moratorium applies to incurrence of new liabilities and payment of liabilities by the bank, with the possible exception only of the payment of insured deposits. As such, banks whose operations might be deemed systemically important to the financial system or the economy would cease to be able to accept deposits and would not be able to meet their liabilities (other than, potentially, insured deposits) when due. These actions are likely to impede the efficient resolution of the bank, could lead to potential contagion to other financial institutions, and, generally, might undermine financial stability.

42. Under the auspices of the Financial Stability Council, special legislation providing additional resolution powers to the government, including "unconventional instruments," has been drafted. This *lex specialis* could be submitted to the parliament if and when the CBM Council determines that current circumstances constitute a financial crisis, and that existing primary and secondary legislation is insufficient to deal with the crisis. The *lex specialis* would be temporary and would lapse when the CBM determines the crisis has ended.

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C. Resolution Planning

43. The CBM, as the *de facto* resolution authority, has yet to initiate institution-specific resolution planning. The groundwork for such planning is being laid in the context of the preparatory work being undertaken to adopt the BRRD.

44. Efforts to prepare for the resolution of a failing bank or banks in general have been undertaken in the context of the CBM and National Contingency Plans, though more work is required. Under the auspices of the Financial Stability Council, in addition to the preparation of the overall contingency plans, this work has involved drafting a large number of documents that might need to be employed when dealing with banks in distress, particularly in the context of a systemic bank or of systemic distress/crisis. This work has been led by the CBM's Financial Stability Department and undertaken by a working group, involving participation of other units within the CBM, the DPF, the MOF, and the capital markets and insurance authorities. It has not yet involved preparation of the documentation or procedures required to implement the government's powers as envisioned in the special law. For example, the Charter (Articles of Association) of a government-owned bridge bank has not been drafted. Similarly, the detailed procedures under which the powers available in the special law, likely in combination with the interim administration powers of the Banking Law, would be implemented within a short period of time (such as a "resolution weekend") have not been developed or tested. While the overall contingency plans were tested in a 2013 crisis simulation exercise (CSE), no revision of the documentation or further work by the staff who would be involved in implementation of the special law has been undertaken as a result of the CSE or subsequently.

D. Resolution Funding

45. The DPF currently has the capacity to fund the resolution via a purchase (of assets) and assumption (of insured deposits) transaction of all but the seven largest banks. Once it has reached the target level of 10 percent insured deposits, the DPF could reimburse all insured deposits of the six smallest banks simultaneously. The funds would further be sufficient to cover the insured deposits of up to the twelfth largest bank on a single basis.

46. Only limited *ex ante* arrangements to finance the CBM and government funding of bank resolutions are in place. The CBM could provide liquidity funding by drawing on its capital and by releasing the requesting bank's required reserves. The government, at present, has no funding earmarked in the annual budget for these purposes, and no contingent lines of credit with banks or others.

E. Recommendations

47. The CBM and government have begun to take steps to transpose the BRRD into local law. The BRRD is largely consistent with the *Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)*, the internationally agreed standard for bank resolutions promulgated by the Financial Stability Board. The recommendations in this section are based in part

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on the Key Attributes and, thus, many may be implemented in the course of transposing the BRRD. In the process, it could be anticipated that elements of the *lex specialis* will be incorporated into national legislation.

48. The CBM could immediately start bank-specific resolution planning, including conducting resolvability assessments to determine impediments to the resolution of specific banks. This work should be prioritized based on banks' CAMEL ratings. While, to the extent possible and where relevant, this work should be coordinated with relevant home country resolution authorities, the CBM should proceed with resolution planning regardless of the state of development of group-wide resolution plans and conduct of resolvability assessments by the home authorities. This planning should be geared toward giving the CBM the comfort that it could resolve the local subsidiary on a stand-alone basis if needed.

49. Much additional work is required to prepare to be able to implement the powers of the *lex specialis*. This includes developing the policies and procedures required to be able to implement a resolution of even a systemically important bank over a weekend, as well as supporting documentation and templates.

50. A small dedicated full-time Resolutions Unit within the CBM should be established to deal with the increased number of resolution-related activities. One near-term task would be to support further resolution planning. The unit should have ready access to resources throughout the CBM. Its reporting line to the CBM Board should be separate from departments responsible for ELA and, eventually, from the BSD to mitigate possible conflicts of interest.

51. While the use of a moratorium under interim administration should be avoided, certain features of it will be retained upon transposition of the BRRD. The goal would be to ensure that bank operations deemed critical to maintaining financial system stability and/or economic activity could continue to be provided while other powers that are features of a moratorium, such as the suspension of legal proceedings against the bank in administration, are retained. Nonetheless, should a moratorium be employed, if they are not exempted from the moratorium as is permitted under the law, insured deposits should not be blocked longer than the pay-out timeframe of the DPF under the DPL (currently, 15 working days).

52. Losses should be imposed on holders of hybrid capital instruments, subordinated debt, and senior debt when the net asset value of a bank is found to be negative, regardless of the means of resolution. This would be the expected outcome of bank failure resolution under either bankruptcy or a purchase-and-assumption (P&A) transaction involving either another private bank or, in rare circumstances, a bridge bank established by the government. It should also be an outcome in the case of failure resolution involving full recapitalization by third parties (or, in rare circumstances, by the government). In principle, subordinated and unsecured senior debt holders should bear losses up to the amount they would lose in bankruptcy. Legal provisions enabling the write-down of such debt holders should be put in place and should be reinforced by required contractual provisions in debt contracts. The legal provisions should also envision the circumstances

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under which such creditors' claims would be converted into equity, and they could be accompanied by legal protections against losses in excess of that which would have been realized in bankruptcy.

53. Greater flexibility as to the proportion of employees that could be re-hired in the case of bankruptcy should be considered. The current legal limit capping the proportion at 10 percent may act as an indirect constraint on the willingness to place some banks into bankruptcy and may constrain efficient management of a bankruptcy.

54. The DPF should be able to use its funds to finance a purchase (of assets) and assumption (of insured deposits) transaction. Such a transaction may well prove less costly than a payout of insured deposits in the context of bankruptcy, and would prove less disruptive to depositors and other bank clients.

55. The objective to a least-cost resolution decision should be explicit in law. In practice, this would be relevant not only to decisions as to whether the DPF should pay out deposits or arrange an insured deposit transfer under a P&A transaction, but would also guide decisions on the possible use of "unconventional instruments" included in the *lex specialis*.

56. Explicit policy criteria for any potential provision of extraordinary support by the CBM and/or the government should be developed. As a fundamental principle, the failure of all banks should be resolved under legal arrangements that provide for either (i) a private sector solution (either via recapitalization or a purchase and assumption transaction perhaps with assistance from the DPF); or (ii) bankruptcy. Only in exceptional circumstances would the provision of public sector financing to support a resolution be deemed acceptable. Strict criteria regarding the circumstances under which this would be considered should be defined in written policy. The policy criteria should include quantifiable and measurable indicators that would guide a decision as to whether a bank is so systemically important that its failure would have severe repercussions for the financial system or the economy. As a condition for such support, shareholders, hybrid capital instrument holders, subordinated debt holders, and senior unsecured debt holders should fully absorb losses, which should be estimated by relevant professionals using conservative valuation principles. Such policy criteria should be agreed in advance between the resolution authority (CBM) and the government (MOF), and the decision in a particular case should be made on a joint basis.

57. Additional arrangements to ensure the availability of adequate resolution funding should be considered. MOF's ability to provide extraordinary financial assistance (liquidity or capital) and for the CBM to provide ELA may be constrained by a shortage of funding. Resolution funding options should be strengthened by (i) establishing credit lines for MOF and the CBM with international financial institutions that would not be effected by a crisis in the Western Balkans region; and (ii) vesting statutory authority in MOF to borrow or use budgetary means up to a certain limit without *ex ante* parliamentary approval and with *ex post* parliamentary accountability.

58. Policies for the conditions and limits under which the DPF's funds could be used to support an extraordinary public-sector-financed resolution should be developed. The DPF's funds should be used for this purpose only when the resolution results in a viable, solvent, and

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restructured bank, and insured depositors continue to have access to their deposits. The amount of its assistance should be restricted to the costs that the DPF would otherwise have incurred in a pay-out of insured deposits in a liquidation net of recoveries. The DPF should be informed and involved in the resolution decision-making process. Safeguards should be put in place to provide protections (via compensation) to the DPF against incurring costs in excess of that which it would have realized in bankruptcy.

DEPOSIT INSURANCE

A. Background

59. The deposit insurance system in Montenegro is relatively well developed. The DPF was established in 2006 and operates under the narrow mandate of a pay-box. It is financed by annual premiums from banks, supported by a standby credit line with the EBRD, and a general back-up provision with the government. The current level of funding is sufficient to cover all insured deposits in the small banks. The deposit insurance fund has a target ratio of 10 percent insured deposits, which should be reached in the next 5–6 years (provided there is no pay-out). The coverage level was raised over the year and is currently EUR 50,000 per depositor per bank. The DPF covers natural and legal persons. Since its establishment, the DPF has developed much of the infrastructure required to ensure the prompt pay-out of deposits, including a pay-out software to reimburse depositors within 15 working days after a bank failure, and an MOU to support information exchange and coordination with the CBM. Furthermore, the DPF and member banks are involved in public awareness activities to inform depositors about the benefits and limits of deposit insurance. The deposit insurance system has never been triggered

B. Recommendations

60. To further enhance the effectiveness of the deposit insurance system, the DPL should be amended to enable the DPF to finance the transfer of insured deposits to another bank. This method of reimbursement is the least disruptive for depositors, as they keep access to their deposits. In addition, the DPF should be allowed to use other options for pay-out, including the ability to make payments electronically to deposit accounts established by depositors in other banks or the use of interim or advanced payments in the case of prolonged delays. Furthermore, the DPF should, in the process of transposition of EU directives, further shorten the pay-out timeframe to seven working days. The DPF should make use of its power to introduce risk-based premiums. It should finish the already started work with other authorities on the premium methodology and ensure that it is compliant with the EU DGSD and EBA Guidelines. However, the introduction of risk-based premiums should not negatively impact the fund’s ability to replenish itself and must therefore be designed in such a way as to be income-neutral.

61. It is essential for the DPF, in close cooperation with the CBM and MOF, to undertake testing of the pay-out procedures and to strengthen internal contingency planning. There has been no system-wide crisis simulation (involving the DPF) with a focus on facilitating a prompt

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pay-out of deposits, including the transfer of deposits and the availability of back-up finance arrangements. The DPF should also become a member of the FSC in order to be closely involved in contingency planning and crisis management. Although the DPF has tested depositor data in the past, this testing should take place on a more frequent basis and involve more banks and, therefore, made mandatory by the DPL. In conjunction with this, the DPF should pre-arrange the use of agent banks for pay-outs, call centers, and other contractors, in order to be prepared for a pay-out in case of a bigger bank. Cross-border issues are of high importance for the DPF, as the banking system in Montenegro is primarily foreign owned and the current arrangements need improvement. The DPF has not signed any MOUs with foreign deposit insurers and should reach out to foreign deposit insurers to be aware of problems at the parent bank, which might spill over to the local subsidiary.

62. The DPF's mandate should be enhanced to take over other responsibilities that will have to be introduced into Montenegrin law during the EU accession process. The BRRD foresees the introduction of a mandatory bank resolution fund that would be financed by contributions from financial institutions. As the DPF is already tasked with collecting annual premiums for deposit insurance purposes from banks, it has the needed knowledge and experience to collect also contributions for the resolution fund and to manage the collected funds. Furthermore, Montenegro will have to transpose the Investor Compensation Scheme Directive (1997/9/EC) and establish an investor compensation scheme. Such a scheme could also be managed by the deposit insurer, as it is done in other EU member states (e.g., the United Kingdom).

LIQUIDITY SUPPORT

A. Background

63. To facilitate commercial banks liquidity management, banks have some flexibility to use part of their reserve requirements, at the same time, the CBM liquidity loans are also available. To provide some flexibility in banks' daily liquidity management, commercial banks are allowed to use up to 50 percent of their reserve requirement deposits during the day. In the case where this allowance is not sufficient or liquidity is required for a longer period, the CBM also has three types of liquidity facilities available—intraday, overnight, and short-term (up to 15 days) liquidity loans. To borrow funds from the CBM through these facilities, banks need to pledge collateral and pay a penal interest rate (benchmarked on the treasury bills rate[5]) on their borrowings.

64. A formalized emergency liquidity support framework is also in place under the CBM Law and the *lex specialis*. The CBM Law and the complementing ELA regulation include several essential conditions of an effective ELA framework: financial assistance from the CBM would be available only to solvent banks against adequate collateral with minimum haircuts (10 percent) and under penalty interest rates (3 percent markup on ECB rates for refinancing operations) for limited

[5] The CBM charges interests at the average annual rate recorded at the last auction of treasury bills with zero, one percentage point and two percentage points markups on intraday, overnight, and short-term liquidity loans respectively. (Source: CBM website.)

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periods (up to two periods of 90 calendar days). The terms and conditions for the CBM ELA also envisage detailed remedial plans to solve liquidity problems and cash-flow plans for the duration of financial assistance. While, traditionally, this would not be considered ELA, the framework under the CBM Law also authorizes MOF to grant emergency financial assistance for up to 180 days without the conditions that apply to the CBM ELA. The *lex specialis* covers emergency liquidity support as well.

65. Thus far, there has been no activation of either the liquidity loans or ELA under the current framework. While there has been some usage of required reserves during the day (as allowed), commercial banks have not approached the CBM for liquidity loans or ELA. This is due partly to surplus liquidity in the system, sufficient liquidity buffer, and available sources of liquidity, especially from parent banks. At the same time, reserve requirement ratios at 9.5 percent and 8.5 percent of short-maturity and longer-maturity deposits[6] provide banks with some room to maneuver, since required reserves could be used up to 50 percent during the day. Despite no actual activation, the CBM has simulated and tested the decision-making procedure for ELA as part of the World Bank Crisis Simulation exercise in 2013, and the procedural guidelines are available.

B. Assessments

66. While requests for financial assistance may not be envisaged at present or in the near future, prudential regulations and preparations for the activation of financial assistance are essential. Although it may be unlikely that the Montenegrin banking system will face liquidity stress in the near future due to surplus liquidity, a volatile global financial system would call for the authorities to be on guard. To strengthen the financial system's resiliency to shocks, prudential regulations are crucial. On this front, the Montenegrin authorities are in the process of enhancing their prudential safeguards. Another equally important element is to ensure that financial assistance could be readily activated and promptly disbursed, if needed. Rapid and effective liquidity backstop could help reduce the possibility of bank failure.

67. It is likely that non-standard collaterals may be pledged for financial assistance. Due to a limited supply of Montenegrin government securities, banks in Montenegro tend to have a portfolio with a mixture of both domestic and foreign assets, of which assets classified as loans register around 70 percent of total. If a condition to exhaust all existent sources of liquidity is enforced (see Part C), it is likely that Montenegro banks may need to pledge loans as collateral. Such types of collaterals could fall under 'other collateral deemed acceptable.'

68. Limited resources to finance ELA constrain the CBM's lender-of-last-resort (LOLR) ability. Due to its inability to create money, the CBM would need to provide financial assistance from its capital, which stands at around 2 percent of total banking system deposits, which could be

[6] Reserve requirement ratios are comparable to countries of similar settings, i.e., euroized/currency board arrangements, for instance, reserve requirement of 10 percent in Kosovo, 10 percent and 7 percent on short-term and long-term deposits in Bosnia-Herzegovina, and 10 percent in Bulgaria (Source: Information System for Instruments of Monetary Policy (ISIMP) by the IMF, 2013).

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rapidly depleted when deposit outflows could be as high as 15 percent of total deposits. Although, during the global financial crisis in 2009, foreign banks facing liquidity outflows could tap into financial assistance from their parents or shareholders, there is no guarantee that such credit lines would be readily available again. With limited resources, the CBM cannot be expected to act effectively as an LOLR in case of a system-wide liquidity shock.

69. Currently, there is no specific provision for the potential loss to the CBM in providing financial assistance. Article 70 of the CBM Law indicates a possibility of recapitalization if the CBM incurs a deficit on its initial capital. This implies that the losses incurred from providing financial assistance may not necessarily be reimbursed, especially in the case where the initial capital remains in surplus. A loss to the CBM's capital could limit its ability to fully perform a central bank's functions.

C. Recommendations

70. ELA provisions under the CBM Law and the *lex specialis* should be brought under a single framework. The new single framework should include only the components of the existing and draft legislation that reflect best international practices (for example, prescription of eligible collateral, pricing and haircuts) and should include certain essential safeguards, such as the prohibition of financial transactions by the receiving banks with their related parties. In acknowledgement of the CBM's eventual adoption of EU directives, a streamlined and harmonized ELA framework could be implemented in the interim.

71. To avoid delays in providing ELA and to limit its risk exposure, the CBM should prepare—for internal use—a list of acceptable collateral, and pricing and haircut methodologies. While the mission appreciates that it is difficult to prepare for all possible scenarios and types of collateral, it advised that the CBM could prepare a list of what would constitute 'other collateral deemed acceptable' along with pricing and haircut methodologies, as well as develop its capacity to administer such assets. The list might include, for example, residential mortgages and corporate loans, and, to maintain the CBM's discretion, the list should not be announced. While thus far the CBM has not extended ELA, it is expected that financial assistance could be promptly disbursed.

72. To safeguard the CBM's financial autonomy, the mission proposed alternative sources of funds and additional conditions and restrictions for CBM ELA. The mission explored several options to expand the envelope of ELA funding. These include a dedicated MOF sub-account at the CBM for ELA, which the CBM could use at its discretion[7]—in addition to its own limited resources—and arrangements for MOF to reimburse the CBM for losses stemming from ELA within 30 days upon an independent audit report. The authorities could also seek stand-by arrangements with international financial institutions (such as EBRD) and major central banks.

[7] If a dedicated MOF sub-account for ELA were to be established, funds from this account may be used first before the CBM's funds to avoid jeopardizing the CBM's financial position.

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73. Banks requesting access to ELA must exhaust all existent sources of liquidity. Further safeguards could include (i) requiring an objective, predetermined solvency test both at the start and for the duration of the ELA; (ii) capping the use of the CBM's fund for ELA up to a certain maximum amount and implementing measures to reimburse the CBM for its ELA-related losses; (iii) requiring foreign-owned banks' parents to provide a letter of comfort to provide liquidity in times of stress; (iv) prescribing appropriate safeguards for the use of ELA by the receiving bank and enhancing monitoring to minimize moral hazard[8]; and (v) allowing banks to draw down their reserves at the CBM below the minimum reserve requirement only for a short period.[9] The mission team ruled out the option of a pooled liquidity arrangement for ELA funded by the banks due to potential difficulties in the implementation.[10]

SYSTEMIC CRISIS MANAGEMENT

A. Crisis Preparedness

74. The FSC has adopted the national contingency plan for financial crisis management (NCP) to complement the contingency plans of the CBM, MOF, ISA, and SEC—the CBM contingency plan is considered the NCP's backbone.[11] Together, these plans provide a comprehensive set of policies and procedures for the agencies' response in case of a financial crisis.

75. While the agencies' contingency plans and the NCP should be welcomed, there is scope for improvement. In particular, the FSC does not pay continued attention to its crisis preparedness and management mandate, which is laid down in the FSC Law; it focuses on its systemic risk-monitoring mandate. Progress with the NCP's implementation is not regularly tabled for discussion by the FSC—see, for example, the shortcomings in the section on 'Liquidity Support'—and it has yet to organize a system-wide crisis simulation exercise involving all the FSC

[8] For instance, the regulation should prohibit the upstreaming of funds from foreign subsidiaries/branches to their parents during the period of financial assistance. During the period of financial assistance, banks may also be subject to more intensive supervision.

[9] Currently, the CBM allows banks to draw down up to 50 percent of reserve requirement on an intraday basis. By the end of the day, reserve requirements have to be met. This recommendation refers to a temporary, but beyond intraday, drawdown of reserve requirements—applicable only in the case of illiquid but solvent banks seeking ELA. In doing so, this could help relieve pressure on banks' liquidity and reduce the need to resort to the CBM funding.

[10] Ecuador has such a fund and staff has discussed a similar approach with Kosovo. However, given the high share of foreign subsidiaries in Montenegro, it would be very difficult to agree on a similar solution with foreign-owned banks, which would essentially lead to their parents providing liquidity to less liquid, mostly domestically owned banks. Moreover, an additional financial burden for banks on top of a future bank resolution fund in line with BRRD and a potential increase in deposit insurance contributions could be distortive.

[11] The DPF does not have a contingency plan.

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members and the DPF.[12] Moreover, none of the agencies has engaged with home resolution authorities to undertake cross-border crisis simulation exercises

B. Recommendations

76. The FSC's focus on its crisis preparedness and management mandate should be strengthened.

- The FSC should ensure regular (i) updates on progress with implementation of the national and agency-specific contingency planning and underlying procedures, with involvement of line units; and (ii) simulation exercises for key contingencies such as bank runs, depositor pay-out, emergency financial assistance, and resolution of an SIFI.
- Under the FSC, two working groups should be established at the deputy principal level for macroprudential oversight and crisis management. The former would be led by the CBM and the latter would be led by MOF.[13]

[12] In 2013, a crisis simulation exercise was held with support from the World Bank Vienna Financial Sector Advisory Center. Only the CBM and MOF participated in this exercise.

[13] The authorities should consider adding two external, independent members to the macroprudential oversight working group.

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