



# TECHNICAL ASSISTANCE REPORT

## SEYCHELLES

### BANK RESOLUTION FRAMEWORK

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**Prepared By**

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**GLOSSARY**

BCP	Business Continuity Plan
CBS	Central Bank of Seychelles
FX	Foreign Exchange
DIS	Deposit Insurance Scheme
DSIB	Domestic Systemically Important Bank
ELA	Emergency Liquidity Assistance
EFF	Extended Fund Facility
EWI	Early Warning Indicators
FIA	Financial Institutions Act
FMI	Financial Market Infrastructure
FSA	Financial Services Authority
FSB	Financial Stability Board
FSC	Financial Stability Committee
ICAAP	Internal Capital Adequacy Assessment Plan
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions of the Financial Stability Board
LAC	Loss Absorbing Capacity
LEG	IMF Legal Department
MCM	IMF Monetary and Capital Markets Department
MOF	Ministry of Finance
MoU	Memorandum of Understanding
NBFI	Nonbank Financial Institutions
NCWOL	No Creditor Worse Off Than in Liquidation
NPL	Nonperforming Loans
P&A	Purchase and Assumption
PONV	Point of Nonviability
RBS	Risk-Based Supervision
RU	Resolution Unit
SIB	Systemically Important Bank
TA	Technical Assistance

## PREFACE

At the request of the Central Bank of Seychelles (CBS), a joint IMF technical assistance (TA) mission from the Monetary and Capital Markets (MCM) and Legal (LEG) Departments was conducted virtually during January 16–20, 2023, to provide policy and legal guidance to the CBS on the drafting of legal amendments that will provide an adequate institutional framework and effective powers for bank resolution, and thus contribute to financial stability, while limiting the use of public funds and addressing moral hazard concerns. The mission was led by Ms. Hanife Yesim Aydin (mission chief, MCM); and comprised Ms. Chia Yi Tan (LEG), Messrs. Sean Kerr (LEG STX); and Geoffrey Mortlock (MCM STX).

At the CBS, the mission met with Brian Commettant (First Deputy Governor) and Jenifer Sullivan (Second Deputy Governor); and with the following officials from the Financial Surveillance Division: Franchesca Melanie (Financial Surveillance Analyst, Financial Regulation Section); Nathalie Violette (Financial Surveillance Analyst, Financial Regulation Section); Vivienne Volcere (Senior Financial Surveillance Analyst, Financial Regulation Section); Tyron Scholastique (Senior Financial Surveillance Analyst, Financial Regulation Section); Joan Lespoir (Senior Financial Surveillance Analyst, Financial Regulation Section); Lynn Commettant (Financial Surveillance Analyst, Micro-Prudential Section); Gino Albert (Financial Surveillance Analyst, Micro-Prudential Section); Sheryl Laporte (Financial Surveillance Analyst, Micro-Prudential Section); Selma Valentin (Senior Financial Surveillance Analyst, Micro-Prudential Section); Shirlee Agricole (Senior Financial Surveillance Analyst, Micro-Prudential Section); Edouard Rose (Senior Financial Surveillance Analyst, Micro-Prudential Section); Diandra Cedras (Financial Stability Analyst, Financial Stability Section); Nadine Boniface (Financial Stability Analyst, Financial Stability Section); Sammia Marchesseau (Senior Financial Stability Analyst, Financial Stability Section); and from the Legal Unit, with Tanya Thyroomoody (Senior Legal Officer).

The mission wishes to thank the CBS officials for their cooperation and productive discussions. The mission benefited from the excellent preparations by the officials, including a self-assessment of the current resolution framework against the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs).



## EXECUTIVE SUMMARY

**The focus of this report is to provide high-level advice on the main components of a prospective resolution regime for banks, with a view to guide the legal drafting of bank resolution amendments by the CBS.** The mission sought to identify deficiencies in the Seychelles' current bank crisis management framework and financial safety net, and to recommend changes that would ensure alignment with international best practices—notably, the KAs published by the FSB.

**The Seychelles' banking system is undergoing regulatory reforms as part of the Extended Fund Facility (EFF) program.** Following a desk review by MCM and LEG Departments of the IMF, a policy paper on the Bank Resolution Bill was submitted to the Cabinet in October 2022. A Bank Resolution bill is planned to be submitted to the Cabinet for approval by end-September 2023. The advice provided to the CBS via this report builds on comments provided by staff in the context of this desk review.

**The current legal framework provides for corrective actions that the CBS may apply to a bank that has breached regulatory requirements or conducted its operations in a manner that is considered unsafe and unsound.** While the legislation provides the CBS with a wide range of powers to address bank stress and regulatory noncompliance situations, they do not follow an escalated structure commensurate with the severity of the situation. To address this, the policy paper on the Bank Resolution Bill proposes a set of strengthened early intervention powers, including the ability to require recapitalization by existing shareholders, mandatory changes to business practices, and limits on exposures as additional early intervention measures.

**The CBS should clarify the blurred lines between normal supervision and early intervention measures and establish a more forward-looking set of early intervention triggers.** There should be both qualitative and quantitative triggers for early intervention, but without being unduly prescriptive. Effective early warning systems (EWS), stress tests, and simulation testing are essential to ensure the capacity to respond to trigger events. The regulatory framework should allow for an escalated structure of early intervention measures, in response to specified triggers. The CBS needs to develop contingency plans for how it would respond to emerging stress in individual banks and noncompliance with regulatory requirements. The stress testing framework needs to be further developed and incorporated into the supervisory framework as a tool for the early detection of risks.

**Provisions to empower the CBS to require banks to maintain recovery plans should be included in the Bank Resolution Law.** The mission recommends the introduction of a general power in the law to require banks to have a recovery plan that complies with requirements specified by the CBS. Such a requirement could usefully be supplemented with a policy paper on recovery planning, which would provide guidance for banks by setting out the CBS' expectations on the structure and broad content of recovery plans. The policy paper should cover the principles for the integration of recovery plans into a bank's risk management framework,

recovery triggers, links to early warning indicators (EWIs), restoration points for capital and liquidity, definition of critical functions and services, recovery actions, scenario development, and a process for regular review and testing, and provide guidance on recovery scenarios and governance.

**The CBS should initiate a pilot program for banks' preparation of recovery plans following the issuance of regulation on recovery planning.** The pilot program would focus appropriately on the largest of the domestic systemically important banks (DSIBs). Once the pilot program has been completed, recovery planning requirements of a simpler nature should be extended to the smaller banks, differentiating between the two in terms of the comprehensiveness of requirements, review, and testing. The CBS should require the branches of foreign banks to have their own recovery plans that are closely integrated into and informed by the parent's recovery plans. Since subsidiaries of foreign banks are separate legal entities, they should have their own recovery plans, highlighting the nature of parent-bank support for the subsidiary, but also setting out recovery actions that could be taken independently of the parent bank. The plans should be signed off by the banks' senior management, submitted to the CBS for supervisory review, and periodically updated.

**Contrary to best practices, the current framework allows the CBS to provide emergency liquidity assistance (ELA) to deposit-taking institutions with severe and persistent liquidity problems, with inadequate safeguards in place to protect its balance sheet.** The legal framework should be revised to clarify that ELA can be provided by the CBS on a discretionary basis to solvent banks that face temporary liquidity shortfalls but are expected to remain viable over the medium term. The CBS needs to prioritize the development of internal guidance on the provision of ELA to solvent banks with temporary liquidity shortages. Additionally, the CBS should be empowered to provide ELA to a solvent bank that has run out of all marketable securities on a separate set of collateral deemed sufficient by the CBS. In exceptional situations where the provision of ELA is deemed imperative to maintain financial stability, but the recipient's solvency is in doubt or it cannot provide adequate collateral, any discretionary central bank liquidity support should be covered by a government indemnity to protect the CBS' balance sheet. The rules for providing liquidity to a bank in resolution under government indemnity also need to be clarified.

**The current bank resolution framework in Seychelles falls considerably short in comparison with the KAs and good practice.** It lacks clearly defined statutory objectives, triggers for entry into resolution, powers for implementing a range of resolution options, and robust safeguards that seek to balance public policy objectives with the interests of shareholders, creditors, and other stakeholders. As drafted, the current Financial Institutions Act (FIA) heavily constrains the resolution options available to the CBS. In addition, the CBS is not sufficiently designated as the resolution authority, with appropriate provisions relating to governance, transparency, operational independence, and accountability.

**Reflecting these fundamental gaps and deficiencies in the existing framework, the CBS has proposed major legislative reforms to establish a new Bank Resolution law that would be broadly aligned with the KAs.** The policy paper developed by the CBS proposes that it be formally designated as the resolution authority and be given a wide range of resolution powers to be executed by the resolution administrator.

**The mission commends the CBS’s proposal to fundamentally strengthen the resolution framework.** It recommends that the CBS draft a stand-alone Bank Resolution law, which would require significant consequential amendments to existing legislation, particularly to the FIA, to ensure a comprehensive set of resolution powers and safeguards under the legal framework. A new Bank Resolution Law should formally designate the CBS as the resolution authority and provide the CBS with sufficient powers to initiate resolution at a defined point of nonviability (PONV), well before insolvency has been reached, and implement appropriate resolution strategies and tools. The CBS should be empowered to exercise resolution powers at an early stage once the PONV is established. The new law should define the objectives and conditions for resolution. The resolution powers should be applicable to all banks in the Seychelles, including branches and subsidiaries of foreign banks, as well as holding companies and banks’ non-regulated operational entities that are significant to their operations. The law should empower the CBS to implement a range of possible resolution options.

**There should be a clear separation between supervision and resolution activities within the CBS to ensure that each function is carried out autonomously and conflicts of interest are minimized.** The mission recommended establishing a Resolution Unit (RU) to undertake the work needed on bank resolution. The RU should be operationally separate from the Surveillance Division, with distinct responsibilities and separate reporting lines to different Deputy Governors.

**A key task for the new RU will be to develop a resolution manual/toolkit.** This would provide comprehensive guidance on the entry into resolution, selection of the resolution strategy, implementation of resolution tools, and associated safeguards for an effective resolution regime. The second step, after preparing a (draft) manual, would be to commence resolution planning and resolvability assessments. It is suggested that the CBS commence this process by preparing a paper for consultation with DSIBs, which would explain the purpose of resolution planning and resolvability assessments, the intended process to be followed, and the division of responsibility between the CBS and the DSIBs—with the latter being responsible for submitting comprehensive data to the CBS to facilitate resolvability assessments. Given the complexity of the resolution planning process, and with a view to avoiding the inherent complexities with cross-border resolution planning, the mission suggests that the CBS start with a domestically owned DSIB as a pilot program.

**In the absence of sufficient loss-absorbing capacity (LAC), or the ability otherwise to allocate losses to the private sector, the resolution of a DSIB will inevitably require external funding.** The absence of a funding mechanism in Seychelles risks that public funding might be



provided in an ad hoc manner, potentially at greater taxpayer cost than would otherwise be the case. While the gradual build-up of greater LAC remains advisable, the CBS and the Ministry of Finance (MOF) should work together on the development of a framework governing the use of temporary public funding to facilitate resolution, should it prove to be necessary. If, as a last-resort measure, public funding is to be provided for solvency restoration purposes, it should be provided by the government, under the oversight of the Minister of Finance and the MOF—and not through the CBS—and subject to strict conditionality. Consistent with well-established international principles and practices, central bank funding should only be used for liquidity support and not for solvency or risk absorption. Any public funding arrangements for resolution should encompass an exit strategy identified by the CBS and the MOF.

**The absence of deposit insurance in the Seychelles exacerbates risks to financial stability and adds to the political pressures for a government-funded rescue of a failing bank.** It is therefore recommended that the authorities undertake an assessment of depositor protection arrangements, including a further evaluation of depositor preference arrangements, and give further consideration to the efficacy of some form of deposit insurance.

**The existing framework for domestic coordination and cross-border cooperation has important shortcomings.** The Financial Stability Committee (FSC) should be an advisory body that seeks to advance sharing information and rather than acting as a decision-making body—with its role pertaining to crisis management to be further formalized. Independence of each FSC member agency should be protected. As regards cross-border cooperation, the Bank Resolution Law should enable the CBS to recognize foreign resolution action taken by the foreign resolution authority that affects the Seychelles branch of a foreign bank—or otherwise take actions under the domestic resolution regime that are consistent with measures taken by a foreign peer. In the case of foreign-owned DSIBs, the mission recommends that the CBS works closely with home resolution authorities to deepen its understanding of home authorities' resolution plans. The CBS is encouraged to identify matters for which legal recognition in the Seychelles might be needed to facilitate the implementation of the home resolution authority's resolution plan, contingent upon the CBS being satisfied that the home resolution plan would meet the Seychelles' resolution objectives.

**Table 1. Seychelles: Key Recommendations**

<b>Recommendations and Authority Responsible for Implementation</b>	<b>Paragraph Reference</b>	<b>Priority</b>	<b>Timeframe<sup>1/</sup></b>
<b><i>Bank Resolution Law</i></b>			
Draft the proposed new Bank Resolution Law with a view to ensuring close alignment to the FSB Key Attributes, subject to ensuring compatibility with Seychelles' institutional arrangements.	24	H	NT
Evaluate the case for establishing deposit insurance in conjunction with a strengthening of depositor preference arrangements.	27	H	MT
<b><i>Early Intervention, Recovery Planning, Emergency Liquidity Assistance</i></b>			
Strengthen the capacity for early detection of bank risks through the development of early warning indicators and stress testing, integrated into off-site supervision.	10, 11	H	MT
Develop a more structured early intervention framework, comprising preventative and corrective actions, with an escalating set of triggers and corresponding supervisory responses.	10	H	MT
Undertake regular testing of CBS capacity to apply early intervention.	10	M	MT
Develop prudential requirements for recovery planning for all banks, supported by more detailed guidance for the industry.	12, 13, 14	H	NT
Introduce recovery planning requirements for all banks, starting with DSIBs, then extend to smaller banks in simplified form.	14,15	H	MT
Develop internal guidance for supervisors on assessment of recovery plans and integration of recovery planning activation into early intervention framework.	15	H	MT
Tighten the legal framework for ELA and develop internal guidance, indicative documentation and terms and conditions for ELA.	17	H	NT
<b><i>Resolution, Resolution Planning, and Crisis Management</i></b>			
Strengthen the separation between the supervisory and resolution functions of the CBS and ensure adequate resources.	30	H	NT
Develop a comprehensive resolution manual setting out internal guidance on bank resolution.	31	H	NT
Develop a framework for undertaking resolvability assessments and preparing resolution plans for DSIBs.	32 33,34,35	M	MT
Develop, jointly between MOF and CBS, a framework for using public funding in resolution, with robust safeguards and an ex-post recovery mechanism.	41, 42, 43,44	M	MT
Strengthen domestic cooperation and coordination for crisis management and resolution through a FSC, MoJ and inter-agency working group.	48	M	MT
Seek to strengthen CBS engagement with home supervisory and resolution authorities on cross-border recovery and resolution.	50, 51, 52	H	MT
<b><i>Capacity Building and Resolution Framework Testing</i></b>			
Undertake senior management workshops, staff training and, once the new framework is in place, a crisis management simulation exercise involving all relevant domestic agencies.	53	H	MT

<sup>1/</sup> Near Term (NT): < 12 months; Medium Term (MT): 12 to 24 months.

## I. BACKGROUND

1. **Seychelles has a large, bank-dominated financial system.** The size of total assets of the Seychelles' banking system is estimated to be 116 percent of the GDP, as of September 2022. There are eight licensed commercial banks, seven of them being active in the system. Three of these active banks are subsidiaries and two of them are branches of foreign-owned banks.
2. **Seychelles' banking system has a concentrated structure.** Total assets of the three largest banks correspond to 86.1 percent of the total assets in the banking system and 86.7 percent of total deposits are held by these banks. Two of these largest banks are subsidiaries of foreign banks and the other one is a state-owned bank. Subsidiaries of foreign banks hold 55.7 percent of assets and 55.9 percent of deposits, while the size of branches of foreign banks are small, corresponding to 4.6 percent and 4 percent of total assets and deposits, respectively.
3. **The banking system remains well capitalized, but there has been an increase in nonperforming loans (NPLs) with the unwinding of the COVID forbearance measures.** The average reported capital adequacy ratio (CAR) was about 20 percent at end-December 2022, and NPLs increased from 5.4 percent in January 2022 to 7.6 percent in December 2022. The NPLs are concentrated in the tourism sector. The banking system has a simple balance sheet structure and banks do not have complex financial instruments or exposures. Banks are principally deposit funded, with total deposits corresponding to 86.8 percent of total liabilities. Total assets are dominated by loans and balances with international institutions abroad, accounting for 30.6 percent and 30.3 percent of total assets, respectively.
4. **There is a high level of dollarization in the banking system.** Fifty percent of total liabilities (52 percent of deposits) and 42 percent of total assets (24 percent of loans) are in foreign exchange (FX). The current policy framework stipulates a foreign exchange exposure limit on each of the total short and long positions as 30 percent of bank capital. Although in practice banks do not extend foreign currency credit to firms without foreign exchange earnings, current banking regulations do not provide any guidance on foreign exchange loans. Banks in Seychelles do not have any interest rate or cross-currency swaps.
5. **The financial safety net in Seychelles comprises three institutions.** The CBS is mandated to regulate and supervise commercial banks, bureaux de change, credit unions, payment service providers, financial leasing companies, financial market infrastructures (FMIs), and nonbank credit-granting organizations. The Financial Services Authority (FSA) is responsible for the regulation of nonbank financial services in the Seychelles, including fiduciary services, capital market and collective investment schemes, and insurance. The MOF oversees the effective operationalization of the financial safety net. There is no deposit insurance scheme (DIS) in place, but depositor preference exists for deposits of up to R10,000 per account. Consideration is being given to the possible case for establishing a DIS or strengthening depositor preference.

6. **The Seychelles’ banking system is going through a regulatory reform agenda as part of the EFF program.** A policy paper on a draft Financial Stability Law and policy paper for the amendment of the capital adequacy regulation to adopt the Basel III capital definition were both approved by the Cabinet in May 2022. Following a desk review by the MCM and LEG Departments of the IMF, the policy paper on the Bank Resolution Law was submitted to the Cabinet in October 2022. The Bank Resolution Law is planned to be approved by the Cabinet by end-September 2023. There are additional ongoing reform initiatives in other regulatory areas, including the licensing framework, the fit-and-proper framework, large exposures, and enforcement measures.

## II. EARLY INTERVENTION AND BANK RECOVERY FRAMEWORK

### Findings

7. **Section 53 of the FIA provides for corrective actions that the CBS may apply to a bank that has breached regulatory requirements or conducted unsafe and unsound operation.** The FIA provides a wide range of powers for the CBS to address bank stress and regulatory noncompliance situations, although these powers do not follow an escalated structure by reference to the severity of the situation. The powers include: (a) the issuance of written warnings; (b) calling a meeting of the shareholders, or other owners, and the administrators of the financial institution to discuss and agree on remedial measures to be taken; (c) issuing written orders in respect of several areas, including to cease and desist from such particular activities and to undertake remedial action, imposing special prudential requirements that differ from those normally applicable to such financial institutions, and suspension of dividend payments or profit; (d) appointment of an adviser for the financial institution; (e) appointing an external auditor; (f) temporarily or permanently suspending one or more administrators from performing duties in the financial institution; and (g) appointing a reorganizing agent and revoking the bank’s license.

8. **The authorities’ recent policy paper on a new Bank Resolution Bill proposes a set of strengthened early intervention powers.** The early intervention measures proposed in the policy paper would be applied by the CBS when a bank is experiencing significant deterioration in its financial condition, or if there is a serious infringement of regulatory requirements. These measures include: (a) requiring banks to implement a recovery plan within a specified period of time; (b) requiring the removal or replacement of one or more administrators or senior managers of the bank, and appointing a provisional administrator (at the bank’s expense) to temporarily replace or work with the board under the oversight of CBS; and (c) empowering the CBS to undertake a range of interventions to facilitate the remediation of a bank. The CBS is also reviewing section 53 of the FIA to include the recapitalization by existing shareholders, requiring changes to business practices, and imposing limits on exposures as additional early intervention measures.

9. **Problem bank identification mainly relies on offsite monitoring, trend analysis, and a CAMELS rating system used in the onsite supervisory process.** The CBS is implementing a risk-based supervision (RBS) framework. The RBS rating and onsite examination rating are expected to guide the CBS in making the determination as to whether a bank is experiencing significant deterioration in its financial condition, or is in significant infringement of regulatory requirements. The CBS does not currently use a system of EWIs. Stress testing exercises are not used regularly as tools for early detection of risks and assessment of potential bank vulnerability to economic and financial shocks. The CBS has not developed internal contingency plans for how it would respond to bank stress and weakness. The current framework does not include any provisions related to recovery plans, and the CBS has not yet extended recovery planning requirements to banks. However, it has the intention of introducing recovery planning requirements for banks as part of the strengthening of the recovery and resolution framework.

### Recommendations

10. **The mission recommends that the CBS clarifies the blurred lines between normal supervision and early intervention measures in the FIA and establishes a more forward-looking set of early intervention triggers.** There should be both qualitative and quantitative triggers for early intervention, but without being unduly prescriptive. Effective EWS, stress tests, and simulation testing are essential in order to ensure the capacity to respond to trigger events. The mission recommends that the CBS develop a formalized EWS comprising a range of EWIs that can be used to inform CBS on incipient stress in individual banks and in the banking system as a whole. The FIA should be strengthened to allow for an escalated structure of early intervention in response to specified triggers. It is recommended that the CBS develop internal guidance on a formalized early intervention framework comprising preventative and corrective actions. In addition, the mission recommends that the CBS develop contingency plans for how it would respond to emerging stress and weakness in a bank and noncompliance with regulatory requirements, and undertake regular testing of its capacity to apply early intervention.

11. **The CBS should strengthen the capacity for early detection of bank risks through the development of EWIs and stress testing, integrated into offsite supervision.** In that context, the CBS should develop the capacity to undertake regular stress testing of individual banks and the banking system as a whole using a macrofinancial shock scenario, and ask the banks to use that scenario to provide data on their assessment of the impact of the scenario on their profitability, capital, and liquidity. Currently, banks are required to undertake stress-testing exercises and submit the results annually to the CBS as part of their Internal Capital Adequacy Assessment Plan (ICAAP)<sup>1</sup> and risk management review processes, but they should be required to use the results of stress tests to inform the calibration of risk appetite settings, as well as capital and liquidity buffers. DSIBs should conduct reverse stress tests to assist in the development of recovery plan scenarios.

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<sup>1</sup> AFS is actively providing technical assistance on ICAAP to CBS.



12. **Provisions to empower the CBS to require banks to maintain recovery plans have yet to be enacted; they will be included in the Bank Resolution Law.** The mission recommends the CBS have a general power in the law to require banks to have a recovery plan that complies with the prudential requirements specified by the CBS. The CBS could usefully start the recovery plan requirements with pilot banks, focusing on the larger DSIBs, with simpler requirements phased in for smaller banks at a later time.

13. **In the interim, the IMF team advises the CBS to prepare a policy paper on recovery plans while the Bank Resolution law is being developed.** This policy paper would provide guidance for banks setting out the CBS's expectations on the structure and broad content of recovery plans. The policy paper should cover the principles for the integration of recovery plans into a bank's risk management framework, recovery triggers, links to EWIs, restoration points for capital and liquidity, definition of critical functions and services, recovery actions, scenario development, and a process for regular review and testing. This guidance should be backed by the regulation on recovery planning.

14. **Guidance on recovery scenarios and governance will be crucial.** Recovery scenarios should cater for idiosyncratic, system-wide, and hybrid scenarios of bank stress, and should be linked to banks' stress testing. Recovery plans should have strong governance arrangements (signed off by a bank's board) and should be closely integrated into bank risk management frameworks, with well-defined triggers, restoration points, and recovery options.

15. **The CBS should initiate a pilot program for banks' preparation of recovery plans following the issuance of the policy paper on bank recovery plans.** The pilot program would appropriately focus on the largest of the DSIBs. Once the pilot program has been completed, recovery planning requirements of a simpler nature should be extended to the smaller banks. The CBS needs to differentiate between DSIBs and smaller banks regarding comprehensiveness of the requirements, review, and testing. Annual updates of recovery plans would be suitable for DSIBs, while three yearly reviews would generally be adequate for smaller banks, provided that a recovery plan should be updated if a bank has undergone major structural, financial, or operational changes. The CBS should require the branches of foreign banks to have their own recovery plans closely integrated into and informed by the parent's recovery plans. Since subsidiaries of foreign banks are separate legal entities, they should have their own recovery plans, highlighting the nature of parent-bank support for the subsidiary, but also setting out recovery actions that could be taken independently of the parent bank. The IMF team recommends requiring banks to do regular recovery plan testing. The recovery plan is a supervisory issue, and it should be the duty of the supervisors to review the plans and make it part of offsite supervision, with this being done in a way that recognizes the need for recovery plans to be closely integrated into a bank's risk management framework. It would be useful for the CBS to develop an internal guidance for supervisors on assessment of recovery plans and integration of recovery planning activation into early intervention framework. Detailed guidance on recovery plans is provided in Appendices I and II.

### III. EMERGENCY LIQUIDITY ASSISTANCE

#### Findings

16. **Contrary to best practices, the current framework allows the CBS to provide ELA to deposit-taking institutions with severe and persistent liquidity problems, with inadequate safeguards as regards their solvency or prospect of restoration to a sound liquidity position.** The banks need to meet the reserve requirements and pass a solvency test to have access to ELA. The CBS is currently working on a draft ELA Agreement that highlights the terms and conditions for extending the ELA. The current framework does not authorize the CBS to provide ELA to a bank in resolution.

#### Recommendations

17. **The Central Bank of Seychelles Act should be revised to include the ELA provisions and safeguards, and to clarify that ELA can be provided by the CBS on a discretionary basis to solvent banks that face temporary liquidity shortfalls, but are expected to remain viable over the medium term.** The IMF team also recommends the CBS prioritize the development of internal guidance on the provision of ELA for solvent banks with temporary liquidity shortages. As part of this guidance, the CBS is advised to draft the legal and procedural documentation needed to facilitate ELA, including the indicative terms and conditions for ELA, collateral eligibility, price haircuts on collateral, communications, and exit arrangements. ELA should be provided to solvent and viable banks at the CBS's discretion, against collateral specified by the CBS, and at appropriate penalty interest rates that reflect the cause(s) of a bank's liquidity difficulties. The bank receiving ELA should be required to present the CBS with a program specifying the remedial measures that it will take to restore its liquidity to an acceptable target level, and to address the cause(s) of its liquidity problems. Additionally, the CBS should be empowered to provide ELA to a solvent bank that has run out of all marketable securities on a separate set of collateral deemed sufficient by the CBS. In exceptional situations, where the provision of ELA is deemed imperative to maintain financial stability, but solvency of the recipient is in doubt, or it cannot provide adequate collateral, the CBS should be provided with a government indemnity to protect its balance sheet. Banks should be legally and operationally pre-positioned to enable the CBS to access banks' loan portfolios and other assets as collateral in situations where other collateral has been fully utilized. The CBS has not undertaken testing of its readiness to handle a request from a bank for ELA. The IMF team recommends the CBS undertake regular testing of its capacity to implement ELA through a program of regular simulation exercises.

18. **With a significant presence of foreign banks in the Seychelles banking system, the CBS could consider a set of actions to strengthen its host authority role in times of liquidity distress.** First, the CBS could strengthen the dialogue with home central banks to share information and discuss conditions for coordinated liquidity support. Second, once the recovery and resolution plans are in place, the CBS should prudently monitor banks' intra-group

contingency plans and other arrangements for providing liquidity support. Third, the ELA framework should incorporate adequate safeguards allowing for full oversight and, if needed, sanctions to ensure the provided ELA remains within the domestic subsidiaries/branches.

19. **Given the high level of dollarization in the banking system, the CBS' ability to provide ELA in FX warrants further attention.** In that context, the CBS should be legally empowered to provide ELA in FX, to the extent it has a sufficient level of FX reserves. One option for bolstering its FX reserves could be to request a swap arrangement with another central bank. Given that extension of the ELA in FX to foreign-owned branches or subsidiaries entail additional risks, the first-best option would be to obtain sufficient liquidity from the parent of the foreign-owned bank and, if necessary, supported by the home authorities. The risk of upstreaming could be higher in case of branches and requires a higher level of scrutiny—and potentially further restrictions—such as the provision of evidence from the parent that alternative funding cannot be sourced from other parts of the banking group, or from the home authority. In all cases, the ELA in FX should only be disbursed after enhanced supervisory monitoring and existence of a prudent mechanism for pre-approval of any flows from the foreign-owned subsidiary to its parent. The CBS should be in close coordination with home supervisors, both of the foreign-owned subsidiaries and branches.

#### IV. BANK RESOLUTION LAW

##### Findings

20. **The existing provisions in the FIA authorize the CBS to take possession of a bank when conditions are met.** Under the current framework, the CBS has 30 days to decide whether to reorganize the bank, liquidate the bank, or terminate possession of the bank. If the CBS decides to reorganize the bank, a reorganizing agent appointed by the CBS has to prepare a reorganization plan that must be circulated to all stakeholders, including shareholders. If the plan is objected to by persons holding one-third or more of the deposits and other liabilities of the bank, the agent has to modify the plan or request the CBS to revoke the license and start compulsory winding up. Approval is needed from the Supreme Court before a reorganization plan can be executed, and the Court may reject the plan with or without directing the CBS to revoke the license.

21. **As recognized by the CBS, the current bank resolution framework in Seychelles is fundamentally lacking by reference to the KAs and good practice.** It lacks clearly defined statutory objectives, triggers for entry into resolution, and powers for implementing a range of resolution options. As drafted, the FIA heavily constrains the resolution options available to the CBS, including no capacity to satisfactorily implement a sale of business (purchase and assumption, P&A) transaction, a bridge bank solution, or a recapitalization involving loss absorption by subordinated and potentially senior unsecured creditors. The FIA does not satisfactorily designate the CBS as resolution authority, with appropriate provisions relating to governance, transparency, operational independence, and accountability. The law is excessively

dependent on court-based processes, creating a major risk of delayed resolution actions, or a court-driven modification or reversal of resolution decisions made by the CBS. The law lacks an adequate framework for executing a temporary stay on contractual termination rights or the ability to impose a moratorium. It also lacks appropriate safeguards, such as a “no creditor worse off than in liquidation” (NCWOL) framework.

**22. Reflecting these fundamental gaps and deficiencies in the existing framework, the CBS has proposed major legislative reforms to establish a new resolution law broadly aligned to the KAs.** The policy paper developed by the CBS proposes that the CBS be formally designated as the resolution authority and be given a wide range of resolution powers to be executed by the resolution administrator, and a set of resolution tools that broadly align with the KAs and sound international practice. The intention is to take the proposals to the Cabinet later this year, with a view to legislation being enacted as soon as practicable thereafter.

**23. Seychelles lacks an effective depositor protection framework, and there is no DIS.** A depositor preference scheme applies in the event of a bank being liquidated, but this currently provides a preference for deposits of up to R 10,000 per depositor. The absence of an effective depositor protection framework creates a significant risk of depositor runs and inter-bank contagion in periods of individual bank and wider financial system stress. The lack of depositor protection also creates a heightened risk of the government being pressured into some form of taxpayer-funded resolution of a nonviable bank and potentially costly unfunded depositor guarantee arrangements. These risks are acknowledged by the authorities and a review of the arrangements is proposed.

## Recommendations

**24. The mission commends the CBS’s proposal to fundamentally strengthen the legal framework through the envisaged introduction of a resolution regime that is duly aligned with international best practices.** The proposed options are either to draft a stand-alone Bank Resolution Law or to amend the existing FIA. It might be simpler to draft a stand-alone law, which might also have the benefit of facilitating interpretation of the law. The IMF team reiterated that drafting a stand-alone Bank Resolution Law would also require significant consequential amendments to existing legislation, particularly the FIA, to ensure a comprehensive set of resolution powers and safeguards in the law. In case the option of a stand-alone Bank Resolution Law is ultimately preferred by the CBS, the IMF team provided a draft high-level outline of a stand-alone Bank Resolution Law, which would serve as a roadmap for the CBS, illustrating the possible architecture of a stand-alone law and describing how certain other provisions (at least of the FIA) might need to be amended as a consequence of the provisions in the new Law (Appendix III).

**25. The Law should formally designate the CBS as the resolution authority and provide it with sufficient powers to initiate resolution at a defined point of nonviability (well before insolvency has been reached), and to implement appropriate resolution strategies and tools.**

- The CBS should be empowered to exercise resolution powers at an early stage once the PONV is established. While the initiation of resolution could be preceded by the implementation of banks' recovery plans, the latter is not a precondition for the former; i.e., financial stability considerations may warrant the immediate use of resolution tools before recovery measures have been exhausted.<sup>2</sup> It would be desirable for the law to either set out criteria for the determination of nonviability, or to make provision for such criteria to be set out by CBS by way of an administrative instrument, with a view to establishing appropriate transparency on the grounds of which a bank could be placed into resolution.
- The law should define the objectives of and conditions for resolution.
- The resolution powers should be applicable to all banks in the Seychelles, including branches and subsidiaries of foreign banks, as well as holding companies and banks' non-regulated operational entities that are significant to their operations. The law should empower the CBS to implement a range of possible resolution options, including recapitalization of a failing bank (using bail-in, if feasible, or with external funding, including from the government where necessary), sale of business (P&A), bridge bank, and closure and payout.
- The law should enable resolution tools to be implemented without the need for court approval and without the possibility of the courts suspending or amending the implementation of resolution decisions. In that regard, the law should include comprehensive safeguards along the lines set out in the Key Attributes, limiting the power of the court to ex post compensation based on the principle of NCWOL.

**26. The mission recommends the inclusion of the NCWOL principle in the Law.**

Omitting this from the new Resolution Law risks considerable litigation, as losses are assigned to creditors through resolution proceedings, which may undermine the regime's efficacy. The new law should also include provisions requiring an independent valuer to make an ex post valuation to establish the "counterfactual" valuation. The provision should also establish the right to compensation for a creditor (in the amount of the difference) if the latter valuation should demonstrate that a creditor is rendered worse off than they would be in a liquidation under conventional insolvency law.

**27. The legal framework governing set-off rights, contractual netting, and collateralization agreements should be clear and transparent.** Where resolution powers permit transfers of property, resolution regimes need to provide sufficient safeguards to stakeholders by protecting customer property rights, security interests, and financial collateral

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<sup>2</sup> For example, when it is unlikely that the measures identified in the bank's recovery plan will restore viability in a reasonable timeframe, considering the risks that a failure of the bank would pose depositors and financial stability at large.



arrangements in financial contracts (including setoffs and netting rights). A description of netting and setoff arrangements, collateralization agreements, and a provision of safeguards for these in the Resolution Law will be suitable for Seychelles.

28. **The authorities are giving preliminary consideration to the possible establishment of an enhanced depositor protection framework.** Although a further assessment of these matters was beyond the scope of this mission, the mission team encourages the authorities to undertake a thorough assessment of the means by which a more effective depositor protection framework could be established, possibly including a new DIS with a “paybox plus” mandate, coupled with a recalibrated depositor preference framework. Such arrangements, if appropriately designed and implemented, would help to lower the risk of depositor runs and inter-bank contagion, and would facilitate a more cost-effective form of bank resolution than might otherwise be the case if the existing inadequate depositor protection framework is retained. Further MCM TA could be considered if the authorities would find this helpful.

## V. RESOLUTION POLICY DEVELOPMENT, RESOLUTION PLANNING, AND RESOLVABILITY ASSESSMENTS

### Findings

29. **The CBS has not yet developed internal guidance on the means by which a nonviable bank would be resolved.** It proposes to establish a small team of staff to take forward this work and to develop the proposals for the new Resolution Law. However, no substantive work has yet been initiated on the development of a resolution manual or similar guidance. Similarly, although the CBS has given preliminary thought to the need for resolution planning for DSIBs, no substantive work has yet been initiated.

### Recommendations

30. **There should be a clear separation between supervision and resolution activities within the CBS to ensure that each function is carried out autonomously and conflicts of interest are minimized.** The mission recommended establishing an RU to undertake the work needed on bank resolution. It recommends that the RU be operationally separate from the Surveillance Division, with distinct responsibilities, including to develop the proposed new Resolution Law, a resolution manual, a framework for resolution planning and resolvability assessments, the capacity to manage a bank resolution, and the ability to undertake regular bank resolution and financial crisis management training and simulation exercises. The organization structure should be designed with sufficient level of firewalls and governance structure facilitated by separate reporting lines to different deputy governors. The RU should have adequate staffing and budget, enabling it to hire external resources (legal, audit, IT, valuation) where required. There should be an effective level of information exchange between the Surveillance Division and the RU, including the RU’s access to confidential supervisory information on each bank, and a close consultation process between supervisors and resolution staff on recovery and resolution issues.

31. **A key task for the new RU will be to develop a resolution manual/toolkit.** This would set out comprehensive guidance on: (a) the assessment of a bank's viability (drawing on asset quality reviews, solvency assessments and stress testing); (b) the resolution options by category of bank (including recapitalization, bridge bank, P&A, and depositor payout); (c) the selection of a particular resolution option for a bank, having regard for its systemic importance, form of incorporation, and whether it is locally or foreign owned; (d) procedures for facilitating entry into resolution; (e) step-by-step implementation of resolution options; (f) coordination between home and host resolution authorities for each stage of resolution; (f) domestic coordination for the resolution of a bank (including, between the CBS and the MOF especially); (g) communications with stakeholders at each stage of a resolution; and (h) the exit from resolution (including exit by the government to the extent it has provided equity or debt funding, or guarantees to a bank in resolution). The mission recommends that the CBS develop a resolution manual over the next 12 to 18 months, in close liaison with other relevant agencies on matters pertinent to those agencies (especially the MOF, in respect of any government funding or guarantees that might be needed for a resolution). Appendix IV provides guidance on the development of a resolution manual.

32. **Once a resolution manual has been developed, the mission recommends that the CBS develop a framework for the CBS in order to prepare resolution plans and undertake resolvability assessments for DSIBs.** These assessments should identify how the CBS would resolve a bank cost-effectively, and in a manner that is consistent with maintaining financial system stability in the event that it was to become acutely distressed and unable to recover to a position of financial soundness through its own means. Resolvability assessments should be reviewed regularly and updated to ensure they remain current. The resolvability assessment should identify the feasibility of resolution options for each of the banks on the basis of achieving a least-cost resolution that meets the objectives of maintaining financial system stability and protecting depositors.

33. **Bank-specific resolution plans should be developed for the systemically important banks (SIBs).** These plans would be based on the resolvability assessments undertaken by the CBS and would draw upon the main resolution strategies and options identified by the CBS (either recapitalization using a combination of bail-in and external funding or transferring critical functions and services and associated assets and liabilities to a bridge bank). The plans would set out the resolution options considered to be practicable for that particular bank and also set out the processes and procedures required to implement each resolution option.

34. **The mission recommends that the CBS commence resolution planning and resolvability assessments once it has completed its resolution manual.** It is suggested that the CBS commence this process by preparing a paper for consultation with DSIBs, which would explain the purpose of resolution planning and resolvability assessments, the intended process to be followed, and the division of responsibility between the CBS and the DSIBs, with the latter being responsible for submitting comprehensive data to the CBS to facilitate resolvability assessments. The consultation paper would appropriately contain a draft of the data template that

the CBS would use to obtain data from the DSIBs to facilitate the resolution planning and resolvability assessment processes. The CBS could also hold a workshop with the DSIBs to respond to any questions or comments they may have, following which, the data template could be finalized and released to the DSIBs.

35. **Given the complexity of the resolution planning process, the mission suggests that the CBS start with a domestically owned DSIB as a pilot program.** This will avoid the inherent complexities with cross-border resolution planning. The learnings from the pilot program will inform refinement of the process and resolution planning could then be extended to the remaining DSIBs. Guidance on resolution planning and resolvability assessment is provided in Appendix V.

36. **In the case of foreign DSIBs operating in the Seychelles, cross-border resolution plans are the primary responsibility of the home resolution authority.** These plans set out how the parent bank and global group would be resolved. The development of the parent resolution plan should be undertaken in coordination with host authorities, desirably through a crisis management group or supervisory college. As part of this cross-border coordination process, the host resolution authorities should identify the means by which they would recognize, and support resolution actions taken by the home resolution authority to the extent that the home authority resolution actions meet host country resolution objectives. Although a holistic resolution strategy may have distinct advantages, there are situations where home and host authorities have diverging resolution objectives and priorities. In such cases, it is common practice for host authorities, in liaison with home authorities, to establish a fallback resolution plan for scenarios in which the home-country resolution proposals do not adequately preserve domestic financial stability. The fallback option would likely take the form of either winding down the subsidiary or branch (if it is not systemically important) or transferring its critical functions and systems, and associated assets and liabilities, to a bridge bank or another bank. These are matters that should be discussed between home and host authorities as part of a coordinated framework for cross-border resolution planning.

## VI. RESOLUTION FUNDING

### Findings

37. **The policy paper on bank resolution provides for temporary government funding.** This is where it is determined to be necessary to maintain financial stability, provided that it would permit implementation of a resolution option that is best able to achieve the objectives of an orderly resolution and that private sources of funding have been exhausted or cannot achieve these objectives. Additionally, the government should be able to recover any losses incurred from the failed bank and its shareholders. The policy paper outlines that recovery may be achieved by reducing any consideration payable to shareholders from the sale of their shares in the resolved bank by the amount of government outlays. The government would also seek to obtain commercial terms for the sale of its shares in a bridge bank, or in a nationalized bank, to recover its expenses, and thus protect taxpayers. In the case of a P&A, where government

funding is applied to facilitate the transfer of business, the government would seek to recover its funding outlays through repayments from the cashflows of the resolved bank and liquidation estate of the failed bank.

## Recommendations

38. **The authorities should seek to minimize the need for external funding in the resolution of a DSIB.** In the medium to longer term, the authorities should seek to ensure, to the extent practicable, that DSIBs hold sufficient capital, or LAC, via contractual bail-in liabilities, so as to achieve a relatively low level of probability of requiring external funding for resolution. This should include undertaking stress tests to assess the level of capital/LAC that would be needed in severe stress events to enable critical functions and services of a DSIB to be continued, either in the recapitalized DSIB or in a successor entity, without reliance on external funding. If LAC is to be facilitated via the issuance of contractual bail-in liabilities, the authorities will need to assess the feasibility of the issuance of such instruments, taking into account the limited development of capital markets in the Seychelles and with regard for the appropriate eligibility criteria for investors in such instruments. If the issuance of such instruments is assessed as impracticable, then consideration could usefully be given to the efficacy of increasing over time the capital requirements for DSIBs to a level that achieves a very low probability of nonviability.

39. **In the absence of sufficient LAC, which will take a considerable period of time to establish, or the inability to allocate losses to the private sector, the resolution of a DSIB will require external funding.** Although losses should always first be applied to shareholders, other capital instrument holders and creditors subject to bail-in arrangements (where feasible under the law), funding from external sources is likely to be needed for several purposes, potentially, including: recapitalization (if bail-in is insufficient for that purpose); the transfer of liabilities to an existing bank or bridge bank; compensation to parties left worse off under a NCWOL framework; and the provision of an indemnity to the CBS for ELA, or other forms of liquidity support to a bank in resolution. Some of the funding needed is likely to be sourced from the cashflows of the bank in resolution, but these amounts may be insufficient, and otherwise “front-loading” will be required. Taking into account that the Seychelles lacks a DIS that could otherwise be used for resolution funding purposes, subject to robust safeguards, it is likely that additional funding would need to be accessed, in particular, for systemic failure situations. The possible sources for such funding would be an ex ante bank resolution fund, if established for that purpose, or public funding.

40. **Some countries have established separate resolution funds in anticipation of the need for some form of external funding of DSIBs.** For example, this is the case in the European Union and United Kingdom. In such cases, systemic banks are subject to a regular levy to contribute to a bank resolution fund that could be applied in the resolution of DSIBs, subject to ensuring that loss absorption has first occurred in the bank by shareholders, other capital instrument holders, and bailed-in creditors.

41. **However, the feasibility and efficacy of a separate resolution fund is not obvious for the Seychelles.** This recognizes that the establishment of a bank resolution fund imposes additional costs on banks, which may reduce their ability to lend to the private sector. Often, the decision to not establish a bank resolution fund also reflects the need to further strengthen the funding base of DISs and, therefore, to focus bank levies on that objective. Such considerations would point to an ex post form of resolution funding, such that the government is the initial source of funds (subject to robust safeguards), with the capacity to levy banks for any recovery shortfalls after funding has been deployed.

42. **The absence of a funding mechanism in the Seychelles creates a risk that public funding might be provided in an ad hoc manner, potentially at greater taxpayer cost than would otherwise be the case.** It would be advisable for the authorities to develop a legislative framework under which public funding for resolution purposes could be provided, subject to robust preconditions and safeguards. This could be done in the proposed resolution law. Alternatively, if the authorities prefer not to “advertise” the availability of public funding for resolution, given the potential moral hazard risks associated with this (even though safeguards would substantially address any such risks), the alternative approach would be to prepare a contingency plan that sets out a draft law or other mechanism for public funding, should it prove to be necessary. This would reduce the risk associated with pulling together emergency legislation in a crisis without the benefit of having carefully considered the issues beforehand. Under either option (i.e., developing a resolution funding mechanism as part of the resolution law or developing a draft funding law that could be enacted, if required), it is recommended that the authorities given further consideration to:

- a clear set of statutory objectives for the provision of any financial assistance, anchored to maintaining financial system stability;
- a requirement that all estimated losses in the failed bank have been allocated to shareholders and subordinated creditors, and other senior unsecured creditors to the extent practicable, before external resolution funds are considered;
- the identification of the purposes for which public funding may be provided;
- conditionality attached to any such funding (including guarantees and indemnities);
- powers to recover funding outlays (including any fees and interest costs) from the cashflows of the resolved bank and assets of the insolvency estate of the failed bank; and
- powers to levy banks to recover the net present value of any funding outlays not recovered from the cashflows of the resolved bank and assets of the insolvency estate.

43. **It is critical that the CBS balance sheet is not used as a funding source for solvency support.** If public funding is to be provided for such purposes, outside of resolution, as an exceptional, last-resort type measure that is subject to strict conditionality, this should be



provided by the government under the oversight of the Minister of Finance, and not through the CBS. Consistent with well-established international principles and practices, central bank funding should only be used for liquidity support, with proper safeguards to protect the central bank balance sheet, and not for solvency or risk absorption.

44. **The mission recommends that the CBS develop comprehensive internal policies, processes, and procedures for lending to a bank in resolution.** These policies, processes, and procedures could be developed in parallel to the development of associated frameworks for lending in other situations, including ELA. Matters to be addressed in the context of lending to a bank (or other designated institution) in resolution would include:

- the preconditions for lending;
- processes for determining solvency/capital adequacy, including that the CBS is satisfied that the proposed resolution is likely to restore the bank in question to capital soundness;
- the purposes for which lending would be provided;
- the eligible collateral, including potentially parent entity collateral and need for government indemnities to provide additional assurances (on which close collaboration with the MOF will be needed);
- the terms and conditions of lending;
- exit arrangements; and
- disclosure and communications arrangements.

45. **In the context of any public funding arrangements for resolution, it is important for the CBS and the MOF to identify the exit strategy.** This recognizes that public funding, including public ownership of a bridge bank or a recapitalized bank, should only be temporary; the government's shares should ultimately be sold to private sector interests with the capacity to provide strong shareholder and governance support to the rehabilitated bank. As part of the development of a public funding strategy, the CBS and the MOF should consider how exit from the public funding arrangements can be managed. The aim should be for the government to extricate itself from all funding support arrangements and shareholdings as soon as market conditions permit following completion of the resolution, with a view to maximizing the net present value of recoveries in a manner consistent with resolution objectives. This would include consideration of the following factors:

- The options and timeframe for an optimal sale of government shares in a bank or bridge bank, with a view to maximizing recoveries but also ensuring that the bank/bridge bank is left with a sound ownership and governance structure;

- The repayment schedule for any debt funding provided by the government, with a view to ensuring that the full net present value of the debt and interest accumulated on the debt is recovered as soon as practicable, subject to not destabilizing the parties involved;
- The termination of guarantees and indemnities as soon as practicable, including the recovery of any funds from the resolved bank, or other party, arising from claims under guarantees and indemnities, and recovery of fees applicable to such arrangements, subject to not destabilizing the parties involved; and
- The termination of any ELA provided by the CBS.

## VII. DOMESTIC COORDINATION

### Findings

46. **The existing framework in the Seychelles has important shortcomings in terms of domestic coordination.** Currently, there are no explicit formal arrangements in respect of information exchange and coordination between the CBS, the MOF, and other relevant agencies in relation to bank resolution. The CBS has entered into bilateral Memoranda of Understanding (MoUs) with the FSA and the Public Enterprise Monitoring Commission (PEMC), and a tripartite MoU with the FSA and Financial Intelligence Unit in order to facilitate information exchange, cooperation, and coordination. There is also an MoU on cooperation between members of the FSC.

47. **The CBS has not developed strategies for responding to financial crisis beyond bank resolution, such as providing liquidity to the financial markets and taking initiatives to minimize the risk of systemic financial crisis.** The FSC is chaired by the CBS and represented by the MOF, the FSA,<sup>3</sup> and the Financial Intelligence Unit (FIU).<sup>4</sup> The authorities are in the process of drafting a Financial Stability Bill to formalize the Financial Stability Committee and its powers. The proposed Financial Stability Bill endeavors to legislate the FSC as the designated authority for financial stability matters with decision-making powers on financial stability issues.

### Recommendations

48. **It is important to strengthen domestic inter-agency cooperation and coordination on financial stability and financial crisis management.** The FSC should be an advisory body that has the role of information sharing, coordination, and giving advice to member agencies rather than being a decision-making body. Independence of each member agency within the FSC

<sup>3</sup> The FSA is responsible for the regulation and supervision of nonbank financial institutions (NBFIs), including insurance companies and securities firms.

<sup>4</sup> The FIU is responsible for the regulation of financial institutions and other reporting entities regarding risks associated with money laundering and the financing of terrorism, and for the detection and investigation of financial crimes affecting Seychelles

should be protected. The FSC's role should be formalized in relation to bank resolution, where the CBS would be responsible for resolution and the FSC would have an advisory role. The FSC should not have resolution or other regulatory powers; the powers should remain with the relevant member agencies. Each member agency should have clear roles and responsibilities to perform under stress and crisis situations. It would be useful to establish an FSC working group that is responsible for reporting to the FSC on bank resolution. A multilateral MoU should set out respective responsibilities of the member agencies for bank resolution, and the process for coordination of all stages of bank resolution. A working group could usefully be established under the FSC's auspices, chaired by the CBS, to develop the inter-agency coordination arrangements for approval by the FSC.

## VIII. CROSS-BORDER COOPERATION

### Findings

49. **The current framework provides minimal arrangements in place for cross-border cooperation purposes.** The CBS has two MoUs with home authorities for banking supervisory purposes, but these MoUs do not explicitly cover resolution matters. The CBS has not entered into any specific cross-border recovery or resolution MoUs with home supervisory and resolution authorities, and has not as yet participated in discussions with the home authorities on these matters.

### Recommendations

50. **The framework for cross-border cooperation and collaboration needs to be strengthened.** The Resolution Law should require the CBS to decide either to recognize, refuse to recognize, or recognize only in part the foreign resolution action taken by the foreign resolution authority which affects the Seychelles branch of a foreign bank. The IMF team recommends moving in the direction of several small south Asian countries and incorporate legal powers to enable the recognition of home authority resolution actions in Seychelles, subject to financial stability deposit protection objectives being met. The act should empower the CBS to establish working relationships with resolution authorities in foreign jurisdictions, including the signing of MoUs with those authorities, and to exchange information on recovery and resolution matters with them.

51. **In the case of foreign-owned DSIBs, the mission recommends that the CBS work closely with the home resolution authorities to deepen the CBS's understanding of the home authorities' resolution plans.** Where possible, the CBS's resolution plans for these banks should be informed by and complement the resolution plans of the home authorities. In that regard, the CBS is encouraged to identify the matters for which legal recognition in the Seychelles might be needed in order to facilitate the implementation of the home resolution authority's resolution plan for a DSIB with a subsidiary or branch in the Seychelles. Legal recognition in the Seychelles would appropriately be contingent on the CBS being satisfied that the home resolution plan would meet the resolution objectives in the Seychelles, including

maintaining continuity of critical functions and services, as well as protecting depositors and other creditors of the subsidiary or branch.

52. **Although a well-coordinated whole-of-group resolution, led by the home resolution authority, would be ideal, it is not always practicable given that home and host jurisdiction interests are not always fully aligned.** In recognition that home resolution authority resolution plans might not necessarily align fully with the CBS’s resolution objectives, the CBS is advised to develop fallback resolution plans that cater for situations where parent resolution actions do not adequately address the needs of the Seychelles. This should be done in cooperation with the respective home authorities. The fallback resolution options would depend on the systemic importance of the subsidiary or branch in the Seychelles. If the subsidiary or branch is systemically important, then the resolution plan might involve recapitalization of a subsidiary via bail-in, if feasible, or the transfer of critical functions and services, and associated assets and liabilities of a subsidiary or branch, to another bank or to a bridge bank established for the purpose. In either event, there would be a need to ensure that parent bank functionality support to the subsidiary or branch is maintained through pre-agreed arrangements, or for such functionality to be migrated to the subsidiary or branch as part of resolution pre-positioning. If the foreign bank subsidiary or branch is not systemically important, then the fallback option might involve a business transfer to another bank, where feasible, or an orderly winding down of the operations and payout of insured depositors.

## IX. CAPACITY BUILDING

53. **Capacity building should be an ongoing process covering regular staff training and senior management workshops.** The CBS should commit to and fund a training program for the resolution staff, together with annual workshops with people from supervision and resolution areas, including participation from the MOF and other financial safety net players. Senior management workshops with open dialogue, including guest speakers, will be useful to build capacity at senior levels. It would also be useful to receive TA on recovery planning. The BIS-IMF Bank Resolution Online Course (BROC) would be a good alternative for resolution training. Capacity building should include participation in crisis-simulation exercises within the safety net in order to train and test the ability to resolve a bank within a short timeframe (e.g., the “resolution weekend”).

## X. NEXT STEPS

54. **The report has recommended many initiatives towards progressing the development of an effective bank recovery and resolution framework.** Some of these initiatives fall to the CBS, while others, including legislation, will need to be advanced more broadly by the relevant Seychelles authorities—possibly supported by follow-up TA. In terms of next steps, the mission emphasizes that the following initiatives require particular attention:

- Establishment of an RU with responsibility for all resolution-related work, kept separate from the Supervision Department, and with a separate reporting line to the CBS Governor;
- Development of a draft Resolution Bill with assistance from the IMF. This will be facilitated in the second IMF TA mission, scheduled for April 2023. The aim should be to have a draft Bill ready for introduction to parliament before end-2023;
- Develop a prudential guidance for banks on recovery planning, setting out the CBS's expectations on the objectives, scope, and structure of bank recovery plans. It is recommended that this guidance be readied for release to banks for consultation in the second half of 2023;
- Implementation of a pilot program on recovery planning with the DSIBs, with a view to asking the DSIBs to prepare recovery plans for review by CBS by March 2024, with recovery planning being extended to all other banks in simplified form later in 2024;
- Refinement of a supervisory early intervention framework, comprising preventative actions for early-stage bank stress and corrective actions for more advanced stress and regulatory breaches, together with contingency plans to enable CBS supervisors to respond effectively and promptly to a range of stress situations. It is recommended that the CBS develop the early intervention framework and contingency plans over the course of the next two years and periodically undertake internal testing of their ability to respond to bank stress scenarios;
- Development of a comprehensive resolution manual, setting out practical guidance on the selection of resolution options by category of banks (taking into account systemic importance, form of incorporation and domicile of controlling shareholders) and implementation steps for resolution options. It is recommended that the CBS undertake this during 2023, with a view to completing it by mid-2024;
- Development of a framework for undertaking resolvability assessments (including a resolvability data template) and preparing resolution plans, with a view to this being completed during 2024, after first completing the resolution manual. Resolvability assessments and preparation of resolution plans for DSIBs should be progressively implemented over between late 2024 and end-2026, if possible;
- Undertake a fundamental review of depositor protection arrangements, including an assessment of the efficacy of deposit insurance, with a view to completing this assessment and formulating recommendations during 2024. If a decision is made that a deposit insurance scheme should be established, this should be completed by end-2025, if feasible; and

- Formalize the establishment of a Financial Stability Committee comprising the CBS, the MOF, and other relevant agencies, with a charter that sets out its purposes and modus operandi, anchored to the monitoring and promotion of financial stability. As part of this, an MoU for all FSC member agencies should be developed, which sets out the responsibilities of the FSC and each member agency in a bank resolution and financial system crisis.



## APPENDIX I. GUIDANCE ON RECOVERY PLANS

### Introduction

1. This appendix provides indicative guidance on bank recovery planning, including the purpose, structure and nature of content generally expected for a recovery plan. The issues addressed in the guidance are not exhaustive and should consider the size, nature, and complexity of the bank.

2. The appendix covers the following issues:

- Objectives of recovery plans;
- Principles for a recovery plan;
- Preparation of the recovery plan;
- General assumptions;
- Elements of a recovery plan;
- Recovery plan Executive Summary;
- Governance issues;
- Corporate overview;
- Triggers;
- Scenarios for recovery plans;
- Restoration points for recovery;
- Recovery actions;
- Communications;
- Preparatory measures;
- Testing of recovery plans; and
- Review and update of recovery plans.

### Objectives of recovery plans

3. The objectives of recovery plans are to enable a bank to:
- a. restore itself to financial soundness and compliance with prudential requirements within a short period following adverse shocks to capital, liquidity or other financial impairment, or in anticipation of such impairment;
  - b. maintain in an uninterrupted manner all critical functions and services, and ensure that operational support is provided to any entities in the banking group that perform such functions or services;
  - c. restore and maintain market confidence in the bank; and

- d. remedy the factors that caused the bank to sustain a fall in capital, liquidity, profitability or asset quality so as to minimize the risk of recurrence.

4. Recovery plans are based on scenarios in which a bank is severely impacted by economic and financial shocks and should cater for both ‘idiosyncratic’ scenarios (in which the bank itself is impacted, but the financial system remains stable) and system-wide scenarios (in which the bank is impacted, and the financial system is also under acute stress). A recovery plan is the financial parallel to a business continuity plan (BCP); i.e., a recovery plan deals with how a bank would deal with financial shocks that impact its financial soundness, while a BCP deals with how a bank would deal with operational shocks that affect a bank’s Information Technology (IT) and physical structures and systems.

5. Although the development of a recovery plan is mandated by regulation by most supervision authorities and is therefore a compliance issue in that context, it needs to be seen as core to the business strategy for a bank. The primary reason for developing and maintaining a recovery plan is to preserve a bank’s operational capacity and shareholder value. Ultimately, if a bank cannot recover from severe financial shocks and becomes nonviable (i.e., a very low capital ratio or insolvent, and/or structurally illiquid), the bank would likely be merged with another bank (if feasible) or placed into some form of resolution.

6. In other words, successful recovery is “make or break” for a bank, and for its shareholders, directors, management, and staff. It is therefore crucial that the recovery plan is not seen as mainly a regulatory compliance issue. Rather, it should be seen as the last line of defense to prevent the bank from failing in a crisis. It is something that senior management and directors need to get right to ensure the bank’s survival and to preserve shareholder value.

### Principles for a recovery plan

7. The general principles for a recovery plan include the following:
- a. **Timely:** the plan should contain a robust trigger framework, including a range of qualitative and quantitative triggers, to create a clear internal escalation process for early consideration and activation of the plan.
  - b. **Comprehensive:** the plan should contain a menu of recovery options sufficient to cope with a wide range of potential stress scenarios, including idiosyncratic and systemic scenarios, and within each, “slow-burn” and “fast-burn” stresses (i.e., stresses which impact gradually over many months—referred to as “slow burn,” and stresses which impact rapidly over days or a few weeks—referred to as “fast burn”).
  - c. **Credible:** the recovery options included in the plan should be realistic, providing a significant impact on capital and/or liquidity within a quick enough timeframe to restore market confidence, supported by a robust communication strategy. Recovery actions should be prioritized and quantified. They need to be capable of

implementation within, at most, three to six months, in order to address market concerns and provide stability for the bank.

- d. **Integrated:** the plan should contain robust governance arrangements to enhance its development, approval, and execution; be aligned and consistent with existing contingency plans; and embedded into the overall risk management framework.

### **Preparation of the recovery plan**

8. A recovery plan is a comprehensive document. It draws from many elements of a bank's risk management framework, ICAAP, capital and liquidity contingency plans, communication contingency plans, and BCP. It needs to be a whole-of-bank effort, drawing from all of the relevant parts of the bank (and wider group, where applicable). A structured work program is therefore necessary, including:

- a. a comprehensive project plan;
- b. allocation of responsibilities to particular individuals for different elements of the recovery plan;
- c. a working group to manage the process;
- d. milestones and a well-defined timeline;
- e. regular reporting of progress to senior management, with clear line-of-sight by the CEO;
- f. regular reporting of progress to the board and relevant board committees.

9. It would generally be expected that a bank would establish a senior-level working group with responsibility to develop, and periodically review and update, the recovery plan. Members of the group would typically comprise senior staff from the relevant areas of the bank, including:

- Finance, with responsibility for capital-raising aspects of the plan;
- Treasury, with responsibility for liquidity aspects of the plan;
- IT and Operations, with responsibility for business continuity and 'critical functions and services' elements of the plan;
- Risk, with responsibility for ensuring that the recovery plan is integrated with the bank's risk management framework, risk appetite statement, governance arrangements, ICAAP, liquidity contingency plan and BCP;

- Legal, with responsibility for all legal elements of the plan, including in relation to capital-raising, board approvals, legal consents and regulatory approvals;
- Compliance, with responsibility for ensuring that the plan addresses all regulatory compliance issues;
- Communications, with responsibility for the public and other stakeholder communications aspects of the plan; and
- Internal audit or other appropriate personnel, with responsibility for setting the proposed testing framework for the recovery plan.

10. A bank's board Risk Committee would typically have lead responsibility for reviewing and approving the plan for referral to the board. It needs to be satisfied that the recovery plan is fit for purpose, meets regulatory requirements, and is integrated with the risk management framework, risk appetite statement, governance arrangements, ICAAP, liquidity contingency plan, and BCP.

11. The board Audit Committee would be expected to have responsibility for ensuring that the recovery plan includes appropriate processes for testing, including through internal audit procedures. It also needs to assess the extent to which some form of regular external review of the recovery plan might be appropriate.

12. Once the recovery plan has been approved by the board, the bank's senior management need to ensure that it becomes a 'living document' within the bank. This involves several elements, including:

- a. ensuring that all relevant staff are made aware of the recovery plan and their respective responsibilities in it;
- b. establishing processes for annual reviews and updates to the plan, with board sign-off; and
- c. establishing processes for regular testing of the recovery plan.

### **Assumptions generally required for a recovery plan**

13. Recovery plans are generally prepared on the basis of the following assumptions:
- a. Additional public sector capital or liquidity support cannot be assumed to be available;
  - b. It should not be assumed that the supervisory authority would use its crisis management powers to facilitate recovery actions; and

- c. Although triggering contractual provisions for the write-off/conversion of debt instruments (including relevant regulatory capital instruments) would be expected to be included in a bank's menu of recovery options where such instruments exist, this should be based on automatic triggers rather than assuming action by supervisors.

### **Elements of a recovery plan**

14. A recovery plan would generally include the following key elements:

- a. Executive summary;
- b. Governance;
- c. Triggers;
- d. Corporate overview;
- e. Recovery options;
- f. Scenario analysis;
- g. Communication plan; and
- h. Preparatory measures.

### **Recovery plan executive summary**

15. The recovery plan should include an executive summary encompassing information on the trigger framework, internal escalation and decision-making processes, recovery options and communication strategy. This should serve as a roadmap to the recovery plan, which allows a bank's board to quickly understand and assess the recovery options in a severe stress situation.

16. The Executive Summary should be relatively brief and should provide a succinct summary of all of the elements of the plan, including:

- a. the objectives and scope of the plan;
- b. its integration with the risk management framework, ICAAP, BCP, and related matters;
- c. a brief description of the scenarios;
- d. the restoration points for key variables; i.e., especially capital and liquidity;
- e. the triggers for recovery plan activation, and escalation and implementation arrangements, and associated EWIs;
- f. recovery actions;
- g. communications aspects;
- h. process for regular review and testing; and

- i. governance arrangements in relation to the plan's approval.

### **Governance issues**

17. A recovery plan should contain a description of the specific governance arrangements relating to the plan, including clearly articulating the respective roles and responsibilities of the board and senior management during the different stages of recovery planning; namely:

- development, review, approval, and ongoing maintenance of the recovery plan during a business-as-usual environment; and
- monitoring and internal escalation processes for triggering the recovery plan and execution of recovery options during a crisis.

18. It would generally be expected that a bank would include in its recovery plan a section on governance that explains how the recovery plan was developed, the processes for obtaining senior management approval, and the processes for obtaining board committee and board approval. The recovery plan should demonstrate the linkages between the plan and other relevant elements of the bank's risk management framework, risk appetite, ICAAP, liquidity contingency plan, and BCP. It should identify how the bank will promote understanding of the plan by all relevant staff and the board, including the critical need for the board to understand its own responsibilities, both in relation to the plan's approval and in approving or actioning elements of the plan. The plan should clearly identify the responsibilities of the board, the relevant board committees and senior management in relation to the recovery plan.

19. The recovery plan should identify the intended process for annual reviews of the plan, including the factors to be taken into account in conducting these reviews. The factors would include changes to the bank's risk management framework and risk appetite statement, changes in the bank's scope and scale of operations, and changes to the bank's ICAAP, contingency plans and BCP arrangements. The review process should also take into account the results from any testing conducted of the plan in the previous year and the implications for possible changes to the plan.

20. The recovery plan should describe the proposed arrangements for testing the plan. See later in this note for guidance on testing.

21. The plan should describe how the recovery plan would be activated, based on the triggers for the plan, and identify who has responsibility for monitoring the triggers and for authorizing the activation of the plan or any part of the plan. It should also identify the management structure during recovery phase, including who has responsibility for particular recovery actions and the authorizations and delegated authorities required for recovery actions.

22. In performing its functions, senior management needs to ensure that the recovery plan covers all of the requirements and is comprehensive. As importantly, it needs to ensure that the



recovery plan is fit for purpose; i.e., that the recovery plan enables the bank to restore itself to financial soundness within a reasonably short timeframe (generally, within three months of the trigger points in the plan being breached, and no more than six months), sufficient to ensure that the bank is in compliance with all prudential requirements, is prudentially sound and resilient to future shocks, can resume normal operations (at least in respect of its critical functions and services), and has the confidence of all relevant stakeholders, including the financial markets. This means that the board must ensure that:

- a. the recovery plan has clearly defined triggers that apply before there is any breach of prudential requirements; i.e., the triggers should occur sufficiently early as to enable the bank to take corrective actions soon enough to avoid breaches of prudential requirements and to avoid, where possible, a significant deterioration in market confidence in the bank;
- b. the recovery plan is based on well-defined scenarios that are realistic and sufficiently severe as to result in the bank sustaining a major fall in capital and liquidity (see later in this note), with all relevant assumptions pertinent to the scenarios being clearly identified, and where scenarios include both idiosyncratic and market-wide scenarios;
- c. the recovery plan contains specific and detailed recovery actions that are realistic and practicable, with the priorities for each recovery action being clearly identified;
- d. the recovery plan quantifies the expected contribution of each recovery action to the purpose for which it is intended; e.g., that recovery actions designed to increase capital include quantification of the amount of capital expected to be raised by the particular recovery action;
- e. the recovery actions are supported by details relating to how each recovery action would be implemented, including step-by-step implementation guidance and associated documentation required for implementation;
- f. the stakeholders (internal and external) have been identified and their information needs assessed, and the means by which they will be provided with information (and when) is identified in the recovery plan;
- g. all staff are aware of the recovery plan and know their responsibilities in relation to it;
- h. the recovery plan is closely integrated into the bank's risk management framework, including EWIs, stress testing, risk monitoring, risk limits and controls, ICAAP, liquidity contingency planning, and BCP; and
- i. the recovery plan is kept under regular review, is updated to reflect changes to the bank's operations and structure and is subject to regular testing.

23. The board needs to maintain a close overview of management's performance of its responsibilities in relation to the recovery plan in order satisfy itself that the management has performed all of its responsibilities effectively. The board also need to understand its own responsibilities in relation to the recovery plan, including the recovery actions entrusted to the board. It needs to maintain a comprehensive understanding of the recovery plan and to be satisfied that it complies with all regulatory requirements, is comprehensive and is practical and realistic. The board also needs to ensure that the plan is subject to regular testing and to assess the results of the tests. Occasionally, it would be appropriate for the board to participate in the tests of the recovery plan, both as active participants and as observers.

24. As previously noted, recovery plans need to be integrated with banks' governance and risk management processes. To ensure effectiveness, recovery planning should be treated as a critical component of banks' risk management frameworks, rather than an isolated process that is merely conducted at the request of the supervisor. Several linkages are particularly noteworthy:

- a. the role that a bank's stress testing processes play in assessing the potential impacts on capital and liquidity arising from financial and economic shocks;
- b. the importance of EWIs, supported by robust management information systems, in informing a bank's management and board on the triggering of the recovery plan;
- c. the close linkages between the recovery plan and a bank's ICAAPs and liquidity plans;
- d. the linkages between recovery planning and business continuity planning, particularly in relation to key operational requirements for recovery actions; and
- e. the feedback from the recovery plan to the bank's risk appetite settings and risk limits (e.g., adjustments of risk limits and capital and liquidity buffers following the materialization of shocks that necessitated the activation of the recovery plan, or in situations where the supervisors conclude that recovery plan lacks credibility).

25. It is therefore suggested that the bank ensures that its recovery planning processes are fully integrated into the wider risk management framework. The plan should include information that sets out the nature of the linkages between the recovery plan and the above matters, and the means by which the bank seeks to ensure that there is a strong degree of integration of recovery planning into the risk management framework.

### **Corporate Overview**

26. The recovery plan should include comprehensive information on a bank's structure and operations. This should include information on:

- a. the ownership structure of the bank, including an identification of all parties with a significant ownership stake;

- b. the group structure if the bank has subsidiaries or is owned by a holding company, including an organization chart for the group and an identification of each entity in the group;
- c. the functions performed by the bank and each of the other entities in the group;
- d. the financial products and services provided by the bank and each entity in the group;
- e. key risks of the bank and each entity in the group, and a description of (or reference to) the risk management framework applied to identify, measure, monitor and manage all material risks;
- f. nature of the inter-connections between entities in the group, including financial and operational inter-connections;
- g. location of all branches of the bank and offices of other entities in the group;
- h. identification of correspondent banks and other banks or financial service providers with which the bank or group has significant business dealings;
- i. nature and extent of participation of the bank and group in financial markets, by category of financial market;
- j. nature and extent of participation of the bank and group in payment and settlement systems;
- k. entities that provide critical functions or services to the bank and group (see below for a definition of critical functions and critical services); and
- l. extent and nature of any outsourcing of critical functions and services to parties outside the group.

27. An important aspect of recovery planning is the identification of a bank's critical functions and services. Banks need to identify the critical functions and services they perform, the legal entities and jurisdiction in which the functions and services are located, and the inter-dependencies between these entities. Recovery actions should be designed to ensure that, at a minimum, these functions and services can be maintained without interruption.

28. The definitions of critical functions and critical services applied by the FSB, the international body that provides guidance on bank recovery plans, are set out Appendix Box 2.

29. Recovery plans should identify all critical functions and services, as well as the legal entities (including outsourced providers) that perform these functions and services, the jurisdiction in which they are located, and the inter-dependencies between them.

30. At a minimum, the critical functions should include:

- deposit taking, particularly the capacity to receive deposits into transaction-facilitated deposit accounts and short-term deposits;
- wholesale funding, including the capacity to receive deposits from other banks, correspondent banks and corporate entities, capacity to transact with the central bank for money market operations, issuance and servicing of bonds and paper, capacity to meet obligations under securities lending, repos and risk transformation services;
- lending and loan servicing, particularly the capacity to provide credit under committed credit facilities (such as overdrafts and standby facilities), participation in existing syndicated lending facilities, trade finance, leasing and factoring;
- credit card services;
- payments, clearing and settlement, and custodial services, including retail and wholesale payments services, capacity to meet obligations to payment and settlement service providers and other FMIs, treasury and cash management services;
- capacity to meet obligations (paying and receiving) in relation to financial derivatives, such as swaps, options, forward contracts and other financial instruments used by the bank or its clients for risk hedging purposes; and
- capacity to meet obligations in relation to capital market transactions and services.

31. At a minimum, the critical services should include the IT and other systems and controls required to:

- perform all critical functions (as identified above);
- maintain all customer and client records;
- maintain all financial and management accounting records and reporting obligations;
- identify, measure, monitor and control all material risks (including credit risk, exposure concentration risk, liquidity risk, interest rate risk, basis risk, currency risk, equity risk, asset price risk, operational risks and reputation risk); and
- meet all regulatory obligations.

32. The recovery plans should set out the recovery actions—financial and operational—to ensure that all critical functions and services can be maintained without interruption.

## Appendix Box 2. FSB Definition of Bank Critical Functions and Services

*“Critical functions are activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability due to the banking group’s size or market share, external and internal interconnectedness, complexity and cross-border activities. Examples include payments, custody, certain lending and deposit-taking activities in the commercial or retail sector, clearing and settling, limited segments of wholesale markets, market-making in certain securities and highly concentrated specialist lending sectors.”*

*“A critical function has the following two elements:*

- *it is provided by a bank to third parties not affiliated to the bank; and*
- *the sudden failure to provide that function would be likely to have a material impact on the third parties, give rise to contagion or undermine the general confidence of market participants due to:*
  - *the systemic relevance of the function for the third parties; and*
  - *the systemic relevance of the bank in providing the function.”*

*“Critical shared services are activities performed within the firm or outsourced to third parties where failure would lead to the inability to perform critical functions and, therefore, to the disruption of functions vital for the functioning of the real economy or for financial stability. Examples include the provision of information technology given the dependency of core banking processes on IT and other services such as facility management and administrative services.”*

### Triggers

33. The recovery plan needs to have clearly identified triggers. First, there is a need for triggers to invoke the recovery plan itself. Second, there should be specific triggers for particular recovery actions where appropriate. The triggers for the recovery plan as a whole should relate to the key areas for recovery actions (especially capital and liquidity, but also profitability and asset quality). These triggers would provide the threshold for invoking the recovery plan as a whole (but not necessarily triggering all recovery actions). The triggers for particular recovery actions would occur once the primary triggers have been reached and would pertain to particular actions. For example, there might be an escalating set of triggers relating to the severity of capital depletion that would, once breached, result in an escalating set of capital-related recovery actions. Similarly, there could be a set of triggers for liquidity recovery actions in which an escalation in the severity of liquidity impairment opens up an escalation in liquidity recovery actions.

34. The triggers should be set at a level that enables the recovery plan to be invoked before the bank breaches prudential requirements and before it gets into any significant difficulties. The triggers should enable a recovery plan to be invoked proactively ahead of emerging stress so that a bank is well placed to respond quickly and effectively to avoid breaches of prudential requirements or adverse market confidence impacts.

35. In the case of capital triggers, it is suggested that the triggers be set at a comfortable margin above minimum capital ratio requirements applicable to the bank so that recovery actions can be initiated sufficiently early as to avoid, if possible, any breach of capital requirements. The same principle applies to the liquidity triggers.

36. In the case of the triggers relating to profitability and asset quality, the triggers should be set at levels that enable early action to be taken in situations where profitability declines below, or impaired assets rise above what the bank in question would regard as a normal range (allowing for business cycle fluctuations).

37. As noted above, in addition to the triggers for the recovery plan as a whole, a bank should identify triggers of an escalating nature for each category of recovery action, covering capital, liquidity, profitability, and asset quality. Consideration should also be given to the inclusion of triggers for operational disruption, particularly in respect of the operational systems and frameworks required to maintain critical functions and systems. In addition, banks can usefully consider the inclusion of triggers that relate to credit ratings, given the significance that ratings have for market confidence, funding access, and funding pricing. As an example, a recovery plan might include triggers based on information provided by a rating agency that it is considering the possibility of a rating downgrade or rating watch status.

38. Not all triggers need to be quantitative. Recovery plans can also be designed to include triggers of a qualitative nature. Qualitative triggers could include elements such as: requests from counterparties for early redemption of liabilities; difficulties in issuing liabilities at current market rates; an unexpected loss of senior management; adverse court rulings; negative market commentary, fraud or malfeasance events, and significant events that could cause significant reputational damage.

39. In addition to the triggers, banks should include in their recovery plan, or in supplementary material, the nature of the EWIs they have in place in respect of each trigger, and the means by which they monitor such indicators. Banks should maintain comprehensive EWIs that enable them to identify, as early as possible, emerging stress that could potentially lead to a breach in one or more triggers for the recovery plan. The EWIs would appropriately relate to each category of trigger, including capital, liquidity, asset quality and profitability, as well as EWIs relating to qualitative triggers.

### **Scenarios for recovery plans**

40. A typical recovery plan would include scenarios that involve moderately severe impacts on a bank's financial condition. Three broad scenario types are often featured in recovery plans, encompassing both "fast-burn" (i.e., hours and days) and "slow-burn" (i.e., weeks and months) stresses:



- a. an idiosyncratic scenario; i.e., a scenario in which the bank has been impacted by financial stocks, such as major loan losses, liquidity events or operational risk losses, but where the financial system remains stable;
- b. a systemic scenario; i.e., where the financial system is in stress, such as in a severe recession, with many banks sustaining capital and liquidity pressures, and with the bank in question being similarly affected; and
- c. a hybrid scenario; combining elements of the idiosyncratic and systemic scenarios which occur simultaneously.

41. The recovery plans should provide reasonably comprehensive descriptions of the scenarios used for the recovery plan, including information on the magnitude of impact on capital, profitability, asset quality and liquidity, together with all material assumptions made. It is particularly important that the scenarios used include (as a worst case) severe impacts on both capital and liquidity.

42. It is important that banks do not design recovery plans on the basis of particular causes of an adverse impact on their capital and liquidity position. The *cause* of the impact on capital and liquidity is much less important than the *magnitude* of the impact. The recovery planning process risks becoming overly complicated if plans are developed on the basis of detailed macroeconomic analysis.

43. The financial impacts need to be integrated so that there is internal consistency and that they fit with the scenario. For example, the scenario might involve a rise in NPLs, an increase in provisioning expenses, a resultant immediate impact on CET1, reduced profits due to both provisioning expenses and reduce income on the loan portfolio, further impact on capital, and associated impacts on liquidity (both due to adverse cash flow impacts and, potentially, adverse market reactions that lead to withdrawals of deposits and cuts to inter-bank funding).

44. The recovery plan should identify recovery actions on a graduated scale, beginning with the types of recovery actions that would be suitable in mild to moderate impacts on profitability, asset quality, capital and liquidity, and escalating to more comprehensive and far-reaching recovery actions that would be needed for more severe outcomes for profitability, asset quality, capital and liquidity.

45. The recovery plan should draw a clear distinction between the idiosyncratic scenarios and the system-wide scenarios, with all relevant assumptions being clearly laid out for each. In both sets of scenarios, and in a hybrid of the two, it is important that the plausible worst-case outcomes for capital and liquidity be incorporated into the scenarios; e.g., a reduction in capital (including CET1, tier 1 and total capital) to 50 percent of the minimum required capital ratios and a fall in liquidity to 50 percent of the applicable liquidity requirement.

46. Although the assumed impacts on profitability, asset quality, capital and liquidity may be similar between idiosyncratic and market-wide scenarios (and the worst-case impacts should be similar), there will be important differences in the nature of the recovery actions between idiosyncratic and system-wide scenarios. This recognizes that in an idiosyncratic scenario, it is just one bank that is needing to take recovery actions, while in a system-wide scenario many banks will need to do so. As a consequence, many recovery actions that are feasible in an idiosyncratic scenario might not necessarily be feasible (or at least as readily achievable) in a system-wide scenario; e.g., as with the sale of portfolios of loans, accessing liquidity in the interbank market or raising capital. It is therefore important that the recovery plan draws a clear distinction between the recovery actions in idiosyncratic versus system-wide scenarios, with all relevant assumptions being identified.

#### **Restoration points for recovery**

47. The restoration point for recovery needs to be clearly specified in a bank's recovery plan. At a minimum, a bank must restore capital and liquidity to levels that meet the supervisory authority's regulatory requirements, with a sufficient cushion to achieve a very low probability of any future breaches of these requirements. However, in many situations, higher restoration points should be specified in order to ensure that the bank in question can restore and maintain market confidence—and as such, retain access to inter-bank funding—and to reduce the probability of subsequent near-failures.

48. Bank recovery plans should set out clearly the restoration points being applied by the bank and the rationale for the restoration points. The restoration points would often include restoration levels in relation to:

- CET1 ratio;
- Tier 1 capital ratio;
- total capital ratio;
- LCR or other applicable liquidity ratio;
- profitability, expressed both in ROA and ROE terms; and
- asset quality, expressed in terms of relevant indicators of impaired and restructured assets as a percentage of total assets or total loans.

49. The restoration points for the recovery plan should also include reference to a target credit rating (where the bank already has a rating). Other restoration points can also be applied, including ones relating to defined measures of market confidence in the bank, depositor satisfaction, other stakeholder satisfaction, and resumption of business-as-usual operation of all critical functions and services.

## Recovery actions

50. It is essential that recovery actions are set out in a comprehensive manner, in sufficient detail as to enable any person using the recovery plan to understand what is required to implement the recovery action. Each recovery action should be accompanied by step-by-step implementation guidance. The person(s) authorized to take each action in the implementation process should be identified clearly, with all delegated authorities made clear.

51. Emphasis needs to be on recovery actions which are practicable and can be implemented within a relatively short timeframe (e.g., within three months, but no longer than six months). A risk associated with bank recovery plans is that they evolve into long lists of potential actions, without adequate specification of how practical they are, their contribution to recovery, and the timeframe for implementation. This risk can be lessened by banks prioritizing the recovery actions, giving prominence to recovery actions with the greatest near-term benefit in terms of restoring capital, liquidity, profitability and improving asset quality, and which will have credibility with key stakeholders (such as depositors, other creditors, the news media and rating agencies).

52. For each recovery action, the recovery plan should specify:

- a. the quantitative amount that the recovery action would contribute to the restoration of capital, liquidity, profitability or asset quality;
- b. the period of time required to complete the recovery action;
- c. the processes and procedures required to implement the recovery action to the point of completion;
- d. the documentation that has been prepared or that will need to be prepared to ensure prompt implementation of the recovery action;
- e. the terms sheets for capital issuance and underwriting arrangements needed for capital issuance, for standby facilities, repo agreements, etc.;
- f. the potential legal and regulatory requirements which must be met to implement the recovery action and the means by which these requirements will be met;
- g. the persons in the bank (including directors) with the authority to approve implementation steps for the recovery action.

53. Communications aspects of recovery plans are important. In particular, recovery plans need to identify all stakeholders (internal and external), the information needs of each stakeholder category and the means by which those needs can best be addressed. Communications actions should include proactive and reactive communication initiatives, including:

- a. call center communications arrangements and upscaling for high volumes of calls;
- b. web-based communications;
- c. Question and Answer material;
- d. communications with correspondent banks and other counterparties on matters relating to scheduled payments and settlements;
- e. communications with credit rating agencies and the financial news media; and
- f. information and processes to facilitate news media briefings.

54. Recovery plans should also address the need for synchronized communications, especially the ability of a bank to announce, with credibility, the recovery actions it plans to take at the same time as it announces the adverse impact that prompted such actions. This is especially important for banks listed on the stock exchange or with other regulatory arrangements that require the banks to announce material developments that could impact on the share price as soon as the information becomes available. In that situation, it is critical that a bank has a well-developed strategy to enable it to announce the ‘good news’ (i.e., the recovery actions) at the same time as the “bad news.”

55. Recovery actions also need to address the underlying causes of the problem in order for the recovery action to have credibility. For example, if poor lending decisions led to a deterioration in asset quality and associated loan losses, and a decline in capital, the recovery actions need to go beyond restoring capital adequacy and asset quality. The recovery package also needs to address the underlying cause of the problem—in this example, the poor lending decisions. Accordingly, recovery actions should provide at least generic guidance as to the steps that a bank would take to identify and resolve the underlying cause of the problems, and to do so in a manner that has credibility to all stakeholders, including rating agencies, depositors, market participants and the news media. This would often suggest the need for some form of independent expert party to be engaged to assist in the resolution process; and, hence, the need for guidance in the recovery plan on how this would be facilitated.

### *Recovery actions in relation to capital*

56. The recovery plan should set out comprehensive and detailed recovery actions to restore capital (CET1, Tier 1 and total capital) to the target level. The recovery actions need to be realistic, practicable and credible. Priority should be given to recovery actions that have the greatest probability of successful implementation in the shortest period of time, and which make the greatest contribution to capital restoration. Recovery actions should be capable of completion within three months desirably, and not more than six months.

57. Recovery actions should be classified into specific categories, including initiatives to:
- a. raise equity from existing shareholders via a rights issue (desirably underwritten by an investment bank) or through private placement of equity to existing controlling shareholders, consistent with what is permitted under the bank's constitution;
  - b. raise equity from new investors, such as the issuance of shares to selected potential shareholders;
  - c. convert debt into equity where the bank has a tranche of debt with contractual provisions to enable it to be converted into equity upon specified triggers being met;
  - d. write down debt where the bank has a tranche of debt with contractual provisions to enable the debt to be written down upon specified triggers being met;
  - e. suspension of distributions (including dividends) to shareholders;
  - f. reduction or suspension in new lending, so as to reduce the amount of additional capital required;
  - g. initiatives to reduce operational expenses, so as to reduce the amount of additional capital required;
  - h. sale of assets or change in the mix of assets so as to reduce the amount of additional capital required and to increase the risk-weighted capital ratio by reducing the amount of risk-weighted credit exposures;
  - i. sale of subsidiaries; and
  - j. issuance of new debt that meets the eligibility criteria for inclusion in tier 2 capital.

58. With each recovery action, the bank should specify the amount estimated to be raised or capital savings induced by the recovery action and the timeframe for completion. In each case, the recovery plan should set out the step-by-step implementation arrangements, together with the draft documentation required for the recovery action to be implemented. In the case of issuing new capital instruments or raising capital from existing shareholders, the recovery plan should include as attachments the draft capital issuance documentation and underwriting documentation, or at least detailed terms sheets for the documentation.

### ***Recovery options for liquidity***

59. Recovery actions for liquidity, like all recovery actions, should be specific, realistic, practicable and credible. The recovery actions should be set out in order of priority, based on the probability of successful implementation and contribution to the estimated need for additional

liquidity. Speed of implementation is critical for any liquidity actions, where success and credibility of recovery actions are measured in hours and days, rather than weeks or months.

60. Recovery actions should be set out under specific categories, such as initiatives to:
- a. sell marketable securities;
  - b. obtain liquid assets from controlling shareholders where feasible;
  - c. raise liquidity via borrowing from other banks under committed standby facilities;
  - d. borrow from the central bank under business-as-usual liquidity facilities provided routinely to banks by the central bank;
  - e. sell illiquid assets in exchange for liquid assets, including via sale and repurchase agreements;
  - f. lengthen the maturity profile of liabilities;
  - g. shorten the maturity profile of assets (where feasible);
  - h. reduce the need for liquidity by reducing new lending and reducing operating expenses, where feasible; and
  - i. renegotiating the terms of scheduled debt repayments and debt servicing where this is considered feasible and prudent.

61. All recovery actions should be quantified in terms of the estimated impact on liquidity. The implementation steps and timeframe for implementation should be set out in relation to each recovery action. Any documentation needed for liquidity actions should be set out in draft form attached to the recovery plan or at least detailed terms sheets for documentation provided as part of the recovery plan.

### ***Recovery options for profitability***

62. All recovery actions should meet the standard test of being realistic, practicable and credible, and capable of delivering the intended outcomes in a realistic timeframe. Given that the restoration of profitability is likely to be less urgent and critical to a bank's survival (in the short-term), and likely to take longer to achieve than capital and liquidity recovery actions, the recovery plan could be expected to attach lower priority to profitability restoration initiatives in the short-term. However, the restoration of profitability will be critical for the longer-term survival of the bank, both in terms of capital maintenance and market confidence.



63. Recovery actions should be set out comprehensively with detailed implementation steps. The following categories of recovery actions are likely to be helpful:

- a. Initiatives to increase collections on loans made by the bank.
- b. Initiatives to increase the risk-adjusted rate of return on loans and other assets, consistent with a prudent risk appetite and within the bank's risk management framework.
- c. Initiatives to reduce operating expenses, consistent with maintaining acceptable risk management practices.
- d. Initiatives to increase revenue from under-performing business lines where feasible and where this is consistent with the bank's risk appetite and risk management frameworks.
- e. Initiatives to reduce or eliminate business activities that do not meet defined ROA and ROE hurdles.
- f. Initiatives to reduce average funding costs where feasible, consistent with the bank's risk appetite and risk management frameworks.

64. Where feasible, each category of recovery action should include estimates of the contribution that the initiatives in question are likely to make to increased profitability, the timeframe expected to achieve this, and the steps required to achieve it.

#### ***Recovery options for asset quality***

65. Recovery actions in respect of improving asset quality need to meet the standard tests of being realistic, practicable and credible. By their nature, recovery actions relating to asset quality improvements will tend to be somewhat longer term than the more immediate needs of restoring the bank to sound capital and liquidity positions. Nonetheless, recovery actions should be achievable within timeframes that are likely to be seen as credible and realistic by financial markets, rating agencies, depositors and other stakeholders—they need to assist in restoring market confidence in the bank.

66. Recovery actions should be classified into categories, such as initiatives relating to:

- a. the restructuring of loans to enhance recoverability; e.g., by elongating the term of the loan, suspending interest payments, etc.;
- b. transferring impaired loans into an asset management company owned by the bank;
- c. selling impaired loans to other parties;
- d. write-off loans considered to be irrecoverable; and

- e. strengthening the quality of lending policies and procedures, and associated credit risk management arrangements, in order to enhance asset quality for new loans.
67. In the case of each recovery action, the plan should identify expected impacts on asset quality and the timeframe required to achieve the desired outcomes. Implementation steps should be specified in detail.

## **Communications**

68. The recovery plan should include a robust communication strategy to ensure that stakeholders—both internally and externally—are suitably informed during the bank’s recovery process. Internal stakeholders will include the bank’s staff and relevant internal bodies/committees. External stakeholders will include shareholders and other investors, authorities, counterparties, financial markets, FMI, depositors and the public more broadly.

69. Managing communication is a key element in successfully implementing the recovery plan, with a particular focus on ensuring that consistent, timely and appropriately detailed information on the recovery strategy is articulated at the outset. It is vital that a bank has the capacity to announce quickly what the problem is and what its proposed recovery actions are, in order to convince the market that it has a credible and timely route to restoring financial viability. Effective proposals for managing any potential negative market reactions must also be considered.

70. The recovery plan should set out the communications elements associated with particular recovery actions, as well as the more general communication strategies needed for each scenario. It should identify all stakeholders; their information needs, and the key information they should be provided (and when) in each scenario. The plan should also identify the means by which communications will be channeled, including through private telephone and email communications to particular stakeholders, news media releases, web-based information, automatic telephone responses to queries, call center responses and social media communications. The allocation of responsibilities to particular office holders for particular communications should be made clear in the recovery plan.

## **Preparatory measures**

71. To improve the credibility of recovery plans, a bank would need to fully consider the key dependencies for implementing each recovery option and consider the preparatory measures that could be taken in advance to alleviate operational barriers and complexities. Often referred to as pre-positioning, such preparatory measures might, for example, include possible changes to organizational or legal structures or the preparation of documentation ahead of time to facilitate potential transactions or capital initiatives.

72. The recovery plan should describe the preparatory measures that could be taken to improve the credibility and effectiveness of individual recovery options, with an indicative timeframe and estimated cost for their completion.
73. Examples of preparations that should be made include:
- a. Share issuance documentation and procedures.
  - b. Indicative shareholder resolutions and board resolutions for particular recovery actions.
  - c. Liquidity standby facilities.
  - d. Draft indicative news media statements and Q and A material.
  - e. Strengthened documentation of service level agreements for all outsourced services and critical shared services.

### **Testing of recovery plans**

74. It is critical that recovery plans are subject to rigorous testing. Testing can be done in a number of ways, depending on objectives and scope. For example, tests can be structured to evaluate:

- the ability of the bank to detect emerging stress, such that the triggers for the recovery plan are able to be invoked as and when required;
- the ability of the bank to implement recovery actions relating to particular categories of recovery—capital, liquidity, asset quality, profitability, etc.;
- the ability to communicate effectively with the full range of stakeholders (role-played);
- the performance of senior management in terms of its responsibilities in a recovery process;
- the performance of the board in terms of its responsibilities in a recovery process—especially high-level approvals and communication with external stakeholders and the financial news media;
- the data systems required for recovery;
- the legal documentation required for certain recovery actions;
- the ability to implement recovery actions within the specified timeframes, especially for time-critical actions;

- the degree of integration of the recovery plan with the bank's risk management framework, ICAAP, BCP, and governance arrangements.

75. There are several different forms of testing for recovery planning purposes. The options can include 'walk-through' tests of processes and procedures for particular scenarios, live simulation exercises for particular elements of the recovery plan (e.g., capital, liquidity or communications), and full-scale live simulations to test the entirety of the recovery plan. For any substantive testing, it is imperative that the members of senior management are involved in the tests, especially for live simulation exercises, with each member of senior management playing his/her own role. For some tests, it will also be appropriate for members of the board to be included in the exercise; e.g., to test the board Chairman's ability to communicate effectively with external parties (role-played). Of particular importance is the testing of senior management and board members' capacity to communicate with role-played news media and financial markets, including under realistic time pressure.

76. The recovery plan should set out the framework for the regular testing of the plan. This should include the objectives and scope of testing, the parties responsible for organizing and conducting the tests, the processes and procedures for conducting the tests, and the means by which the test results will be documented and reviewed by the board, and by internal audit.

### **Review and update of the recovery plan**

77. A bank's recovery plan needs to be subject to comprehensive and regular review. The recovery plan should identify in detail the internal review processes that will be applied by the bank, including in respect of reviews by risk management units and internal audit. Reviews should be undertaken in respect of all aspects of the recovery plan, including the scenarios, triggers, recovery actions and governance arrangements. The reviews should be informed by the testing to be undertaken of the recovery plan; therefore, test results should be one of the inputs into the review of the recovery plan.

78. Although reviews of recovery plans can generally be undertaken by a bank's own staff, occasional external reviews by independent experts can also be helpful. This is especially helpful if external, independent experts are present at regular tests of the recovery plan, given that they will be able to use their insights into the testing process and results of the tests to assess the adequacy of the recovery plan. External reviews are also important in relation to reviewing the adequacy of the bank's management and board in relation to their respective responsibilities in the recovery plan, given that internal staff reviews might be less well placed to conduct such reviews freely and impartially.

## APPENDIX II. QUESTIONS FOR SUPERVISORY REVIEW OF RECOVERY PLANS

1. These questions provide a guide to issues that the supervisors should consider, and they are not exhaustive and should consider the size, nature, and complexity of the bank.
2. This appendix provides indicative questions for *bank* supervisors to consider in their review and assessment of bank recovery plans, covering the following elements of recovery plans:
  - Executive summary of the recovery plan;
  - Governance of recovery plans;
  - Integration of recovery plans with the bank's risk management framework;
  - Overview of the bank and group, and critical functions and services;
  - Triggers for activation of the recovery plan;
  - Restoration points to achieve financial soundness;
  - Recovery options;
  - Scenarios;
  - Communications;
  - Preparatory measures;
  - Testing of the recovery plan; and
  - Review of the recovery plan.

### Executive summary of the recovery plan

3. Questions for supervisors include:
  - a. Does the recovery plan contain an executive summary that is succinct and practical in its focus?
  - b. Would the executive summary be a useful guide for senior management and directors for use of the recovery plan in a situation where the plan needs to be applied? Is the executive summary easy for a user to access and apply?
  - c. Does the executive summary contain a checklist of key decisions and actions that senior management and the board need to make in deciding to invoke the recovery plan, in determining the nature and impact of the problem being addressed, and in applying recovery actions? If not, does a separate document exist which contains such a checklist?

### Governance of recovery plans

4. Indicative questions that supervisors should consider in reviewing the governance arrangements for recovery plans are:

***Governance over the preparation and sign-off of the recovery plan***

- a. Does the recovery plan have an ultimate ‘owner’ in the bank, with suitable skills, experience and seniority, such as the Chief Risk Officer?
- b. Was the recovery plan prepared by a senior-level team of staff with dedicated responsibility for developing the recovery plan?
- c. Did the team responsible for preparing and maintaining the recovery plan comprise representatives of the key areas of the bank relevant for the plan, including the CRO (or deputy), CFO, Head of Treasury, Head of Operations, Head of IT, Head of Legal, Head of Compliance, and Head of Communications?
- d. Was the recovery plan subject to comprehensive oversight by the board Risk Committee and ultimately by the board?
- e. How thorough was the board Risk Committee and board review and sign-off of the plan? How much time did the board Risk Committee and board dedicate to reviewing the recovery plan?
- f. How thorough was the controlling shareholders’ review and sign-off of the plan, particularly as regards responsibilities applicable to them, such as in relation to capital issuance?
- g. What arrangements have been made to ensure that all relevant staff are aware of the recovery plan?
- h. Do the members of the board demonstrate a thorough understanding of the recovery plan and the board’s responsibilities in relation to all relevant elements of the plan?

***Governance in the activation of the recovery plan***

- a. Is there a clearly defined governance process for the activation of the recovery plan? Who has the power to activate the recovery plan?
- b. If the board is not involved in activating the recovery plan, when would the board be convened to consider the situation and determine or agree to the recovery strategy, and to ensure that the board has effective oversight of the recovery process?
- c. Does the recovery plan clearly set out responsibilities for decision-making in respect of particular recovery actions? For example, does it set out those recovery actions which are subject to board approval, those which are subject to CEO approval, and those which can be made by others under delegated authority?
- d. Is there a clear allocation of authorities for exercising recovery actions?

- e. Is there a crisis committee with responsibility for coordinating recovery actions?
- f. Is there a board-level crisis committee that oversees and approves the recovery strategy and key recovery actions?
- g. Do members of the board understand their responsibilities in the recovery plan, including for particular recovery actions?

### **Integration of recovery plan with risk management arrangements**

5. Indicative questions that supervisors should consider in reviewing the integration of the recovery plan with the bank's risk management framework and related matters are:

- a. Is the recovery plan adequately integrated with the bank's stress testing arrangements?
- b. Have the scenarios, restoration points and recovery actions been informed by stress test results? In particular, have reverse stress tests been used by the bank to identify the magnitude of economic and financial shocks required to cause the bank to breach recovery plan triggers?
- c. Is the recovery plan integrated with the bank's risk management framework and RAS, especially as regards the setting of triggers and restoration points? Are the triggers for the recovery plan aligned to minimum tolerance levels in the RAS in respect of capital and liquidity?
- d. Are EWIs used in the recovery plan informed by the bank's stress testing and RAS?
- e. Is the recovery plan integrated with the bank's ICAAP and capital contingency plan?
- f. Is the recovery plan integrated with the bank's liquidity contingency plan?
- g. Is the recovery plan integrated with the bank's business continuity plan?

### **Overview of the bank—and critical functions and services**

6. Indicative questions that supervisors should consider in reviewing the recovery plan information relating to the overview of the bank, and critical functions and services, are:

- a. Does the recovery plan provide sufficient detail of the bank's organizational structure and group structure? If the bank is part of a financial conglomerate, does the recovery plan set out the nature of the interlinkages and interdependencies between the bank and other entities in the conglomerate?
- b. Is there sufficient information on the ownership structure of the bank, including an identification of all parties with a significant ownership stake?



- c. Does the recovery plan identify adequately all critical functions and services, including critical shared services within the bank and group (see later in this paper)?
- d. Does it identify the legal entities that provide critical functions and services?
- e. Does it identify the inter-dependencies (functional and financial) between legal entities providing critical functions and services?
- f. Does it identify all material outsourcing arrangements for critical functions and services, including the legal entities with responsibility for performing these functions and services, the jurisdictions in which they are based, and reference to the legal contracts under which they operate?
- g. Does it identify back-up and business continuity arrangements for all critical functions and services, or refer to these matters being identifiable in the bank Business Continuity Plan?
- h. Are cross-border operations adequately identified?
- i. Does it identify the financial products and services provided by the bank and each entity in the group?
- j. Does it identify the sources of funding for the bank and other entities in the group?
- k. Does it identify the key risks of the bank and each entity in the group, and a description of (or reference to) the risk management framework applied to identify, measure, monitor and manage all material risks?
- l. Does it identify correspondent banks and other banks or financial service providers with which the bank or group has significant business dealings?
- m. Does it identify the nature and extent of participation of the bank and group in financial markets, by category of financial market?
- n. Does it identify the nature and extent of participation of the bank and group in payment and settlement systems?

### **Triggers for activation of the recovery plan**

7. A recovery plan needs to have clearly defined triggers for invoking the recovery plan. The triggers should relate to the key risk metrics relevant to the financial soundness of a bank and banking group. Typically, the triggers will comprise:

- Capital ratio (e.g., CET1, tier 1 and total capital ratios)
- Liquidity ratio (e.g., HQLA to total liabilities, LCR)

- Asset quality (e.g., NPLs over 90 days past due as a percentage of total loans)
- Profitability (e.g., NPAT as a percentage of total assets or equity)
- Credit rating

8. The triggers should be set at a level that enables the recovery plan to be invoked well before the bank breaches prudential requirements and before it gets into any significant difficulties. The triggers should enable a recovery plan to be invoked proactively ahead of emerging stress so that a bank is well placed to respond quickly and effectively to avoid breaches of prudential requirements or adverse market confidence impacts. Triggers for capital and liquidity ratios are often set at or slightly above the minimum tolerance levels in the bank's RAS. Similarly, triggers for asset quality are generally set at or below the maximum tolerance in the case of NPLs/total loans and, for profitability, at or slightly above the minimum tolerance for ROE or ROA. If a credit rating is used as a trigger, then this would usually be set at or slightly above minimum tolerance for the rating level in the RAS; e.g., one or two notches above the minimum rating for investment grade (BBB- or equivalent).

9. It is often desirable for a bank's recovery plan to include a trigger relating to the disruption in the performance of critical functions and services. For example, some banks include a trigger relating to a sustained interruption to the performance of any material critical functions and services for more than x hours (e.g., more than 8 hours) or where the disruption to critical functions and services has the potential to cause material damage to the bank's reputation and/or ability to meet payment and settlement obligations.

10. Not all triggers need to be quantitative. Recovery plans can also be designed to include triggers of a qualitative nature. Qualitative triggers could include elements such as: requests from counterparties for early redemption of liabilities; difficulties in issuing liabilities at current market rates; an unexpected loss of senior management; adverse court rulings; negative market commentary; fraud or malfeasance events; and significant events that could cause significant reputational damage.

11. In addition to the triggers, banks should include in their recovery plan or in supplementary material the nature of the EWIs they have in place in respect of each trigger, and the means by which they monitor such indicators. Banks should maintain comprehensive EWIs that enable them to identify, as early as possible, emerging stress that could potentially lead to a breach in one or more triggers for the recovery plan. The EWIs would appropriately relate to each category of trigger, including capital, liquidity, asset quality and profitability, as well as EWIs relating to qualitative triggers. Indicative examples of EWIs are set out below:

Risk category	EWIs
Capital	<ul style="list-style-type: none"> <li>• Early-stage deterioration in capital ratios</li> <li>• Capital ratios falling below target levels in the RAS or in ICAAP</li> <li>• Rapid growth in lending</li> <li>• Increase in the proportion of higher-risk lending</li> <li>• Increase in risk appetite</li> <li>• Adverse movement in risk environment</li> <li>• Deterioration in risk management quality</li> <li>• Increase in risk-preferent activity</li> <li>• Deterioration in asset quality</li> <li>• Declining profitability</li> </ul>
Liquidity	<ul style="list-style-type: none"> <li>• Early-stage deterioration in liquidity ratios</li> <li>• Reduced reinvestment of maturing deposits</li> <li>• Shortening of average maturity of funding</li> <li>• Acceleration in withdrawal of deposits</li> <li>• Increase in risk premium on funding costs</li> <li>• Adverse movements in asset/liability maturity mismatch</li> <li>• Reduced cashflows (actual or forecast) from loan portfolio</li> <li>• Reduced ability to obtain funding in the inter-bank market</li> </ul>
Asset quality	<ul style="list-style-type: none"> <li>• Early-stage deterioration in asset quality indicators</li> <li>• Increase in unemployment and underemployment</li> <li>• Lengthening in loans past due</li> <li>• Increase in requests from borrowers for loan restructuring due to stress</li> <li>• Increase in interest rates</li> <li>• Increase in household and corporate leverage</li> <li>• Decline in asset prices relevant to collateral values</li> </ul>
Profitability	<ul style="list-style-type: none"> <li>• Increase in operating expenses</li> <li>• Reduced net interest margins</li> <li>• High wage inflation</li> <li>• Weakening in asset quality</li> <li>• Increased competitiveness and contestability in key financial markets</li> <li>• Higher forecast expenses associated with IT/cyber security risk factors</li> <li>• Higher forecast expenditures on bank restructuring and technology updates</li> </ul>

### *Issues to be assessed by supervisors*

12. Indicative questions that supervisors should consider in reviewing the triggers for recovery plans are:

- a. Does the recovery plan differentiate between the triggers for activation of the recovery plan as a whole, and the triggers for the activation of specific recovery actions?

- b. Do the triggers enable the recovery plan to be activated well before any breach of prudential requirements has occurred?
- c. Are the triggers set in relation to the risk tolerances in a bank's Risk Appetite Statement (e.g., the bank's lower tolerance levels for capital ratios and liquidity ratios, and its upper tolerance for impaired loans and for exposure concentration ratios)?
- d. What monitoring arrangements are in place to enable the senior management and the board to regularly monitor data in relation to the triggers?
- e. What systems apply for alerting the senior management and board to a breach or risk of future breach of the triggers?
- f. Are the triggers supported by comprehensive EWIs? Are there EWIs that provide reliable predictors of possible future breaches of recovery plan triggers, including in relation to capital, liquidity, asset quality and profitability?
- g. What monitoring arrangements are in place to enable the senior management and board to regularly monitor data in relation to the EWIs?
- h. Are the EWIs structured so that they identify escalating levels of potential risks of future trigger breaches, such as a 'traffic light' structure for EWIs?
- i. Does the plan clearly set out the process by which a bank would activate its recovery plan and to activate particular recovery actions?
- j. Does it identify the persons responsible for the different elements of the activation process?
- k. Is there a clear documentation of delegated authorities for particular actions?
- l. Is there an appropriate process for escalation of decision-making?

### **Restoration points for recovery**

13. The restoration point for recovery needs to be clearly specified in a bank's recovery plan. At a minimum, a bank must restore capital and liquidity to levels that meet the regulator's regulatory requirements, with a sufficient cushion to achieve a very low probability of any future breaches of these requirements. However, in many situations, higher restoration points should be specified in order to ensure that the bank in question can restore and maintain market confidence—and as such, retain access to inter-bank funding—and to reduce the probability of subsequent near-failures. In many cases, banks tend to set their restoration points towards the higher end of the target range for key risk metrics in their RAS; e.g., as for capital and liquidity.

14. Bank recovery plans should set out clearly the restoration points being applied by the bank and the rationale for the restoration points. The restoration points should include restoration levels in relation to:

- CET1 ratio;
- Tier 1 capital ratio;
- total capital ratio;
- HQLA ratio;
- LCR ratio;
- profitability, expressed both in ROA and ROE terms; and
- asset quality, expressed in terms of relevant indicators of impaired and restructured assets as a percentage of total assets or total loans.

*Issues to be assessed by supervisors*

15. Supervisors should assess whether the recovery plan sets out clearly and specifically the restoration points for the above factors, and the reasons stated by the bank for selecting the restoration points in question. Supervisors need to satisfy themselves whether the restoration points are realistic and achievable. They also need to assess whether the restoration points are consistent with the bank resuming normal operations, especially for critical functions and services, and maintaining market confidence.

16. Indicative questions that supervisors should consider in reviewing the restoration points for recovery plans are:

- a. Does the recovery plan establish restoration points for key variables, such as capital, liquidity, asset quality and profitability?
- b. How has the bank set these restoration points? Were the levels of restoration points for capital and liquidity set in relation to the bank's minimum tolerances in the Risk Appetite Statement? Were they set taking into account the bank's stress tests?
- c. Do the restoration points provide reasonable assurance that future breaches of prudential requirements will not occur? In particular, has the bank set post-recovery capital and liquidity levels at a sufficiently high level?
- d. Would the restoration points enable the bank to retain an acceptable credit rating (sufficient to maintain access to financial markets and inter-bank funding)?

## Recovery options

17. It is essential that recovery options are set out in a comprehensive manner, in sufficient detail as to enable any person using the recovery plan to understand what is required to implement the recovery action. Each recovery action should be accompanied by step-by-step implementation guidance. The person(s) authorized to take each action in the implementation process should be identified clearly, with all delegated authorities made clear. The maximum plausible amount that the recovery action would contribute to capital or liquidity should be identified.

18. Emphasis needs to be on recovery actions which are practicable and can be implemented within a relatively short timeframe (e.g., within three months, and no longer than six months). A risk associated with bank recovery plans is that they evolve into long lists of potential actions, without adequate specification of how practical they are, their contribution to recovery and the timeframe for implementation. This risk can be lessened by banks prioritizing the recovery actions, giving prominence to recovery actions with the greatest near-term benefit in terms of restoring capital, liquidity, profitability and improving asset quality, and which will have credibility with key stakeholders (such as depositors, other creditors, the news media and rating agencies).

19. For each recovery action, the recovery plan should specify:

- h. the quantitative amount that the recovery action would contribute to the restoration of capital, liquidity, profitability or asset quality;
- i. the period of time required to complete the recovery action;
- j. the processes and procedures required to implement the recovery action to the point of completion;
- k. the documentation that has been prepared or that will need to be prepared to ensure prompt implementation of the recovery action;
- l. the potential legal and regulatory requirements which must be met to implement the recovery action and the means by which these requirements will be met; and
- m. the persons in the bank (including directors) with the authority to approve implementation steps for the recovery action.

20. Recovery actions also need to address the underlying causes of the problem in order for the recovery action to have credibility. For example, if poor lending decisions led to a deterioration in asset quality and associated loan losses, and a decline in capital, the recovery actions need to go beyond restoring capital adequacy and asset quality. The recovery package also needs to address the underlying cause of the problem—in this example, the poor lending

decisions. Accordingly, recovery actions should provide at least generic guidance as to the steps that a bank would take to identify and resolve the underlying cause of the problems, and to do so in a manner that has credibility to all stakeholders, including rating agencies, depositors, market participants and the news media. This would often suggest the need for some form of independent expert party to be engaged to assist in the resolution process—and hence the need for guidance in the recovery plan on how this would be facilitated.

### *Recovery actions in relation to capital*

21. The recovery plan should set out comprehensive and detailed recovery actions to restore capital (CET1, Tier 1 and total capital) to the target level. The recovery actions need to be realistic, practicable and credible. Priority should be given to recovery actions that have the greatest probability of successful implementation in the shortest period of time, and which make the greatest contribution to capital restoration. Recovery actions should generally be capable of completion within three months desirably, and not more than six months.

22. Recovery actions should be classified into specific categories, including initiatives to:
- a. raise equity from existing shareholders via a rights issue (desirably underwritten by an investment bank) or through private placement of equity to existing controlling shareholders, consistent with what is permitted under the bank's constitution;
  - b. raise equity from new investors, such as the issuance of shares to selected potential shareholders;
  - c. convert debt into equity where the bank has a tranche of debt with contractual provisions to enable it to be converted into equity upon specified triggers being met;
  - d. write down debt where the bank has a tranche of debt with contractual provisions to enable the debt to be written down upon specified triggers being met;
  - e. suspension of distributions (including dividends) to shareholders;
  - f. reduction or suspension in new lending, so as to reduce the amount of additional capital required;
  - g. initiatives to reduce operational expenses, so as to reduce the amount of additional capital required;
  - h. sale of assets or change in the mix of assets so as to reduce the amount of additional capital required and to increase the risk-weighted capital ratio by reducing the amount of risk-weighted credit exposures;
  - i. sale of subsidiaries; and



- j. issuance of new debt that meets the eligibility criteria for inclusion in tier 2 capital.

23. With each recovery action, the bank should specify the amount estimated to be raised or capital savings induced by the recovery action and the timeframe for completion. In each case, the recovery plan should set out the step-by-step implementation arrangements, together with the draft documentation required for the recovery action to be implemented. In the case of issuing new capital instruments or raising capital from existing shareholders, the recovery plan should include as attachments the draft capital issuance documentation and underwriting documentation, or at least detailed terms sheets for the documentation. As noted in the discussion on scenarios, later in this document, the feasibility, amount, sequencing and timeframe for implementation of recovery options will be different in an idiosyncratic scenario than in a market-wide scenario. In general, recovery actions will be more feasible, faster to implement and capable of contributing a greater amount to recovery in an idiosyncratic scenario than in a market-wide scenario. This is as true for capital-related recovery actions as it is for other recovery actions.

### ***Recovery options for liquidity***

24. Recovery actions for liquidity, like all recovery actions, should be specific, realistic, practicable and credible. The recovery actions should be set out in order of priority, based on the probability of successful implementation and contribution to the estimated need for additional liquidity. Speed of implementation is critical for any liquidity actions, where success and credibility of recovery actions are measured in hours and days, rather than weeks or months.

25. Recovery actions should be set out under specific categories, such as initiatives to:
- a. sell marketable securities;
  - b. obtain liquid assets from controlling shareholders where feasible;
  - c. raise liquidity via borrowing from other banks under committed standby facilities;
  - d. borrow from the central bank under business-as-usual liquidity facilities provided routinely to banks by the central bank;
  - e. sell illiquid assets in exchange for liquid assets, including via sale and repurchase agreements or securitisation;
  - f. lengthen the maturity profile of liabilities;
  - g. shorten the maturity profile of assets (where feasible);
  - h. reduce the need for liquidity by reducing new lending and reducing operating expenses, where feasible; and

- i. renegotiating the terms of scheduled debt repayments and debt servicing where this is considered feasible and prudent.

26. All recovery actions should be quantified in terms of the estimated impact on liquidity. The implementation steps and timeframe for implementation should be set out in relation to each recovery action. Any documentation needed for liquidity actions should be set out in draft form attached to the recovery plan or at least detailed terms sheets for documentation provided as part of the recovery plan.

### ***Recovery options for profitability***

27. All recovery actions should meet the standard test of being realistic, practicable and credible, and capable of delivering the intended outcomes in a realistic timeframe. Given that the restoration of profitability is likely to be less urgent and critical to a bank's survival (in the short-term), and likely to take longer to achieve than capital and liquidity recovery actions, the recovery plan could be expected to attach lower priority to profitability restoration initiatives in the short-term. However, the restoration of profitability will be critical for the longer-term survival of the bank, both in terms of capital maintenance and market confidence.

28. Recovery actions should be set out comprehensively with detailed implementation steps. The following categories of recovery actions are likely to be helpful:

- a. Initiatives to reduce operating expenses, consistent with maintaining acceptable risk management practices and critical functions and services.
- b. Initiatives to increase revenue from under-performing business lines where feasible and where this is consistent with the bank's risk appetite and risk management frameworks.
- c. Initiatives to reduce or eliminate business activities that do not meet defined ROA and ROE hurdles.
- d. Initiatives to reduce average funding costs where feasible, consistent with the bank's risk appetite and risk management frameworks.

29. Where feasible, each category of recovery action should include estimates of the contribution that the initiatives in question are likely to make to increased profitability, the timeframe expected to achieve this, and the steps required to achieve it.

### ***Recovery options for asset quality***

30. Recovery actions in respect of improving asset quality need to meet the standard tests of being realistic, practicable and credible. By their nature, recovery actions relating to asset quality improvements will tend to be somewhat longer term than the more immediate needs of restoring the bank to sound capital and liquidity positions. Nonetheless, recovery actions should be achievable within timeframes that are likely to be seen as credible and realistic by financial

markets, rating agencies, depositors and other stakeholders—they need to assist in restoring market confidence in the bank.

31. Recovery actions should be classified into categories, such as initiatives relating to:
- a. the restructuring of loans to enhance recoverability; e.g., by elongating the term of the loan, suspending interest payments, etc.;
  - b. transferring impaired loans into an asset management company owned by the bank;
  - c. selling impaired loans to other parties;
  - d. write-off loans considered to be irrecoverable;
  - e. strengthening the quality of lending policies and procedures, and associated credit risk management arrangements, in order to enhance asset quality for new loans.
32. In the case of each recovery action, the plan should identify expected impacts on asset quality and the timeframe required to achieve the desired outcomes. Implementation steps should be specified in detail.

***Other types of recovery actions***

33. The recovery plan would generally also include other recovery actions, depending on the bank and group, and the situation. Examples include:
- a. Possible removal of staff, including senior management, to the extent that they have been responsible for the cause of the bank's stress situation or are impediments to the recovery process.
  - b. Actions to minimize or manage potential contagion risk between entities in the banking group or financial conglomerate.
  - c. Actions to address the underlying causes of the bank's/group's financial stress, potentially including:
    - i. Establishment of an internal review process to evaluate the causes of the situation and the remedies to address those causes.
    - ii. Possible appointment of an external, independent party to undertake an assessment of the causes and remedies.
    - iii. board oversight of these processes.
    - iv. Reporting to the regulator.

- v. Transparency, including public reporting on causes and remedies.

*Issues to be assessed by supervisors*

34. Indicative questions that supervisors should consider in reviewing the recovery actions (in general terms) are:

- a. Does the recovery plan contain a comprehensive suite of recovery actions in respect of capital, liquidity, asset quality, profitability, maintenance of critical functions and services, and communications with stakeholders?
- b. Are the recovery actions credible and realistic?
- c. Have the recovery actions been set out by priority of action (i.e., sequence of implementation) and in the relevant categories?
- d. Have the impacts of the recovery actions been quantified (e.g., in terms of contribution of the bank's capital, liquidity, etc.)?
- e. Can the recovery actions be implemented in a timely manner (e.g., within 1 week for near-term liquidity recovery, within 1 month for longer-term liquidity recovery, and within three to six months for capital recovery)?
- f. For each recovery action, is there comprehensive and detailed guidance on step-by-step implementation procedures?
- g. Have the responsible persons and delegated authorities been identified for each recovery action?
- h. Have any legal or regulatory obstacles to recovery actions been identified and the solutions to those obstacles set out in the recovery plan?
- i. Is there supportive documentation for recovery actions; e.g., capital issuance term sheets, indicative capital offer documents, liquidity standby facility documentation, etc.?
- j. Does the recovery plan adequately differentiate between idiosyncratic and system-wide scenarios in terms of the impact these would have on?
  - i. the selection of recovery actions;
  - ii. the implementation process for recovery actions;
  - iii. the likely success or failure of recovery actions;
  - iv. the amount of funds obtained (or saved) by particular recovery actions; and
  - v. the timeframe for implementation of recovery actions?

***Capital recovery actions***

35. Indicative questions that supervisors should consider in reviewing the capital-related recovery actions include:

- a. Do the recovery actions include sufficient capital-raising options?
- b. Have the capital-raising options been prioritized in terms of the sequence in which they would occur?
- c. Have the capital-raising options been quantified, indicating a maximum plausible amount of capital that could be raised (or capital savings that could be made)?
- d. How long would it take to raise capital? Does the recovery plan provide sufficient detailed information to determine whether capital can be raised within (at most) a three-to-six-month period from the time that the recovery plan activation has been triggered?
- e. Does the recovery plan identify in detail the implementation steps required to implement particular capital-raising recovery actions?
- f. Does the recovery plan identify all regulatory approvals needed for capital-raising recovery actions?
- g. Has the bank prepared the necessary legal documentation, or at least terms sheets, for capital-raising recovery options?
- h. For bail-in debt (if any), is the process for contractual bail-in documented?
- i. Does the recovery plan adequately differentiate between idiosyncratic and system-wide scenarios in terms of the types of capital recovery actions that could be used, the amounts likely to be raised, the probability of successful implementation and the timeframe required for implementation?
- j. Have other recovery actions for capital restoration and conservation been identified in sufficient detail, such as:
  - i. selling assets;
  - ii. selling subsidiaries;
  - iii. reducing the average risk weight of assets by changing the composition of assets to lower-risk assets;
  - iv. reducing new lending;

- v. suspending distributions to shareholders;
  - vi. reducing expenditures, etc.?
- k. Have these options been prioritized and quantified?
  - l. Have the implementation procedures for each option been documented adequately?

***Liquidity recovery actions***

36. Indicative questions that supervisors should consider in reviewing the liquidity-related recovery actions include:

- a. Have the liquidity-raising/saving recovery options been prioritized?
- b. Are the recovery options practicable? Can they be implemented in sufficient time to meet liquidity needs?
- c. Are they quantified?
- d. Do they contain detailed implementation guidance?
- e. Do the recovery actions include sufficient options for reducing cash outflows; e.g., via reduced new lending, reduced expenditures, suspension of dividends, etc.?
- f. Do the recovery actions include sufficient options for increasing cash inflows; e.g., via access to standby facilities, liquid asset injections from shareholders, acceleration of loan repayments?
- g. Does the plan contain sufficient initiatives to increase High Quality Liquid Assets?
- h. Does it contain sufficient measures to attract new deposits and retain existing deposits, and to lengthen the maturity of funding where feasible?
- i. Has draft documentation been developed to facilitate liquidity recovery actions, such as draft liquidity injection documentation, standby documentation, terms sheets for such documentation, etc.?
- j. Do the recovery options identify potential sources of borrowing; e.g., particular banks, securitization vehicles, or a borrowing facility with shareholders?

***Profitability recovery actions***

37. Indicative questions that supervisors should consider in reviewing the profitability-related recovery actions include:

- a. Do the recovery actions include adequate initiatives to restore the bank to an acceptable level of profitability, and within a reasonable period of time?
- b. Are cost reduction actions adequately identified and quantified? Would cost reduction options weaken the ability of the bank to continue to perform critical functions and services?
- c. Are actions to increase revenue and margins adequately identified and quantified?
- d. Would revenue-enhancing recovery actions be consistent with maintaining prudent risk management or create excessive risks?
- e. Have the recovery actions been prioritized and quantified?
- f. Have the procedures required to implement them been adequately documented?

#### ***Asset quality recovery actions***

38. Indicative questions that supervisors should consider in reviewing the asset quality-related recovery actions include:

- a. Do the recovery actions include adequate initiatives to identify impaired assets?
- b. Do the recovery actions include undertaking an asset quality review (if needed)? If so, have the procedures been adequately identified and documented?
- c. Does the recovery plan identify how impaired assets would be managed in ways that maximize recovery value?
- d. Does it contain measures to address the problems that created asset impairment; e.g., measures to strengthen the credit risk management process?
- e. Does it contain initiatives to prevent further deterioration in asset quality; e.g., ceasing to extend credit to poor quality borrowers, etc.?

#### ***Critical functions/services recovery actions***

39. Indicative questions that supervisors should consider in reviewing the critical function/service-related recovery actions include:

- a. Does the recovery plan identify all material critical functions and services, including the legal entities that perform each category of function and service and the legal jurisdiction in which it operates?
- b. Does the recovery plan identify how the bank will maintain critical functions and services with no or minimal interruption?



- c. How realistic are these recovery actions?
- d. Have the recovery actions been prioritized?
- e. Are the recovery actions supported by detailed implementation processes and IT arrangements?
- f. Are they consistent with the bank's business continuity plan, where consistency would be expected?

### ***Other recovery actions***

40. Indicative questions that supervisors should consider in reviewing other possible recovery actions include:

- a. Does the recovery plan include actions that are designed to identify and potentially remove persons from the bank/group to the extent that they are thought to have been part of the cause of the problem or are obstructing the recovery process?
- b. Does the recovery plan identify actions to address possible intra-group contagion risk, particularly in the bank is part of a large group or financial conglomerate?
- c. Does the recovery plan identify generic processes for reviewing and assessing the causes of the problem in question and the remedies to seek to avoid a repeat of the problem?

### **Scenarios for recovery plans**

41. Standard supervisory regulation on recovery planning requires banks to include three types of scenarios in their recovery plans:

- a. an idiosyncratic scenario; i.e., a scenario in which the bank has been impacted by financial stocks, such as major loan losses, liquidity events or operational risk losses, but where the financial system remains stable;
- b. a market-wide scenario; i.e., where the financial system is in stress, such as in a severe recession, with many banks sustaining capital and liquidity pressures, and with the bank in question being similarly affected; and
- c. combined scenario, combining elements of the idiosyncratic and market-wide scenarios which occur simultaneously; e.g., where the financial system is under stress and the bank in question sustains major losses.

42. The recovery plans should provide reasonably comprehensive descriptions of the scenarios used for the recovery plan, including detailed information on the magnitude of impact on capital, profitability, asset quality and liquidity, together with all material assumptions made. It is particularly important that the scenarios used include severe impacts on both capital and liquidity, where the bank's minimum regulatory requirements for capital and liquidity are breached.

43. It is important that banks do not design recovery plans on the basis of particular causes of an adverse impact on their capital and liquidity position. The *cause* of the impact on capital and liquidity is much less important than the *magnitude* of the impact. The recovery planning process risks becoming overly complicated if plans are developed on the basis of detailed macroeconomic analysis and with overly specific narratives. Moreover, recovery plans tend to be less useful if they are overly scenario specific. Therefore, it is generally preferable for a recovery plan to have broad-based, high-level scenarios that do not involve detailed storylines, but that provide relevant details for impacts on:

- a. loan losses;
- b. operation risk losses (if the scenario involves these; e.g., a fraud or money laundering event);
- c. profits;
- d. capital;
- e. cash inflows and outflows;
- f. liquidity position;
- g. losses (or gains) arising from market risks as a result of assumed changes in asset prices, interest rates and exchange rates.

44. Scenario analysis should include an identification of all material assumptions made for the scenario, including in respect of macroeconomic variables and the state of the financial system. Financial projections for each scenario should generally extend for two years from the point of initial impact. The projections should incorporate the financial impacts of recovery actions taken in the scenario. The selection of recovery actions should take into account the nature of the scenario. For example, initiatives to raise capital and to access liquidity from other banks are likely to be much more challenging in a market-wide or combined scenario than in an idiosyncratic scenario. The recovery strategy should reflect these types of considerations.

45. Scenarios should be informed by stress tests, particularly reverse stress tests that involve breaching the bank's and group's minimum regulatory capital and liquidity ratios. In the market-wide scenario, consideration should be given to including climate change impacts to the extent that the bank in question considers them to be relevant to their risk profile.

*Issues to be assessed by supervisors*

46. Indicative questions that supervisors should consider in reviewing the scenarios for recovery plans are<sup>5</sup>:

- a. Does the recovery plan contain credible and severe scenarios, with clearly specified and quantified impacts on capital, liquidity, asset quality and profitability?
- b. Do the scenarios include impacts on capital and liquidity that are severe enough to cause the bank to breach its minimum capital and liquidity regulatory requirements?
- c. Are the scenarios based on the bank's stress testing (especially reverse stress tests)? If so, are the assumptions and model parameters for the stress tests identified (either in the recovery plan or by reference to another document)?
- d. Do the scenarios include financial projections for the bank and banking group extending out two years?
- e. Are the financial projections supported by clearly identified assumptions?
- f. Do the scenarios clearly differentiate between an idiosyncratic scenario (in which the financial system is operating normally and only the bank in question has sustained major losses) and a market-wide scenario (in which many banks are experiencing very adverse economic and financial shocks)?
- g. Does the recovery plan identify the assumptions made as to the different impacts that idiosyncratic and market-wide scenarios have on the nature, feasibility, timeframe and success of recovery actions?
- h. Does the recovery plan adequately identify the recovery actions taken for each scenario and the incorporate the financial impacts of these actions into the financial projections?

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<sup>5</sup> See also the guidance provided by other supervisory authorities on recovery plans. The Bank of England's guidance *Supervisory Statement SS9/17 Recovery Planning*, December 2020 is a good example. This can be accessed at:

<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2020/ss917update-december-2020.pdf?la=en&hash=7EE218D863A63481884C23BD12C17AA72C147F81>

- i. Does the recovery plan differentiate between recovery actions needed for fast-moving events and slow-moving events, especially as regards impacts on liquidity and the likely recovery strategies needed to respond to these?

## Communications

47. Communications aspects of recovery plans are important. In particular, recovery plans need to identify all stakeholders (internal and external), the information needs of each stakeholder category and the means by which those needs can best be addressed.

Communications actions should include proactive and reactive communication initiatives, including:

- a. call center communications arrangements and upscaling for high volumes of calls;
- b. web-based communications;
- c. Question and Answer material;
- d. communications with correspondent banks and other counterparties on matters relating to scheduled payments and settlements;
- e. communications with credit rating agencies and the financial news media;
- f. information and processes to facilitate news media briefings; and
- g. guidance for communications via social media.

48. Recovery plans should also address the need for synchronized communications, especially the ability of a bank to announce, with credibility, the recovery actions it plans to take at the same time as it announces the adverse impact that prompted such actions. This is especially important for banks listed on the stock exchange or with other regulatory arrangements that require the banks to announce material developments that could impact on investor decisions as soon as the information becomes available. In that situation, it is critical that a bank has a well-developed strategy to enable it to announce the ‘good news’ (i.e., the recovery actions) at the same time as the ‘bad news’.

49. The recovery plan should identify the responsibilities of the board, CEO, CFO and other key officers in the communications strategy. The plan should set out the means by which communications will be coordinated within the bank, within the group and with the relevant agencies (e.g., banking supervisor and the stock exchange). If the bank is part of a financial conglomerate, the communication strategy should include guidance on how the different entities in the conglomerate coordinate their communications processes and achieve consistency of message.

*Issues to be assessed by supervisors*

50. Indicative questions that supervisors should consider in reviewing the governance arrangements for recovery plans are:
- a. Does the recovery plan identify all internal and external stakeholders?
  - b. Does the recovery plan set out stakeholder information needs in sufficient detail?
  - c. Does it set out how and when the information will be provided to each category of stakeholder?
  - d. Does the recovery plan cover communications via different processes and are these adequate, including communications via:
    - i. news media statements;
    - ii. news media conferences;
    - iii. social media;
    - iv. call centers;
    - v. web-based information;
    - vi. automated emails; and
    - vii. telephone banking messaging?
  - e. Does the recovery plan contain communication process steps in sufficient detail?
  - f. Does the recovery plan identify who would be the lead communicators within the bank (including at board and senior management levels)?
  - g. Does it include draft material for news media releases, call center scripts, etc.?
  - h. Does the bank have a strategy to escalate call center capacity for high-volume calls?

**Preparatory measures**

51. To improve the feasibility of recovery actions, a bank needs to consider the key interdependencies for implementing each recovery action and identify the preparatory measures that should be taken in advance to alleviate operational barriers and complexities. Such preparatory measures might, for example, include possible changes to organizational or legal structures in the bank and group, the separation of critical functions and services so that they can be self-supporting, and the preparation of documentation and procedures to facilitate recovery actions

(especially those involving capital issuance, securitization, asset sales and accessing liquidity via standby facilities).

52. The recovery plan should describe the preparatory measures to be taken to improve the effectiveness of recovery options, with work program to implement the measures.
53. Examples of common preparatory measures include:
- a. Share issuance terms sheets, documentation and issuance procedures—for ordinary shares, preference shares and hybrid instruments (e.g., subordinated debt capable of conversion to equity).
  - b. Subordinated debt terms sheets, documentation and issuance procedures, including tier 1 subordinated debt and tier 2 subordinated debt.
  - c. Terms sheets and documentation for equity and debt underwriting agreements.
  - d. Identification of potential underwriters.
  - e. Identification of potential institutional investors.
  - f. Identification of potential merger partners and indicative procedures for merger.
  - g. Documentation and operational pre-positioning for securitization of loans.
  - h. Documentation and operational pre-positioning for asset sale and repurchase arrangements.
  - i. Procedures and arrangements needed to sell subsidiaries if required.
  - j. Indicative shareholder resolutions and board resolutions for particular recovery actions.
  - k. Terms sheets and documentation for liquidity standby facilities.
  - l. Draft indicative news media statements and Q and A material.
  - m. Documentation of service-level agreements for all outsourced services and critical shared services.

*Issues to be assessed by supervisors*

54. Indicative questions that supervisors should consider in reviewing preparatory measures for recovery plans are:
- a. Has the bank identified potential impediments to recovery actions that could be addressed through preparatory measures?

- b. Has the bank identified the preparatory measures it intends to put in place?
- c. Is the list of preparatory measures complete and comprehensive?
- d. Does the bank have a work program to implement preparatory measures? Is the work program adequately structured and resourced?
- e. What progress has been made in implementing preparatory measures?
- f. Have the preparatory measures been approved by the board?
- g. Has internal audit assessed the progress made in implementing preparatory measures?

### **Testing of recovery plans by banks**

55. It is important that recovery plans are subject to rigorous testing. Testing can be done in a number of ways, depending on objectives and scope. For example, tests can be structured to evaluate:

- the ability of the bank to detect emerging stress, such that the triggers for the recovery plan are able to be invoked as and when required;
- the ability of the bank to implement recovery actions relating to particular categories of recovery—capital, liquidity, asset quality, profitability, etc.;
- the ability to communicate effectively with stakeholders (role-played);
- the performance of senior management in terms of its responsibilities in a recovery process;
- the performance of the board in terms of its responsibilities in a recovery process—especially high-level approvals and communication with external stakeholders and the financial news media;
- the data systems required for recovery;
- the legal documentation required for certain recovery actions;
- the ability to implement recovery actions within the specified timeframes, especially for time-critical actions; and
- the degree of integration of the recovery plan with the bank’s risk management framework, ICAAP, business continuity plan and governance arrangements.



56. There are several different forms of testing for recovery planning purposes. The options can include walk-through tests of processes and procedures for particular scenarios, live simulation exercises for particular elements of the recovery plan (e.g., capital, liquidity or communications), and full-scale live simulations to test the entirety of the recovery plan. For any substantive testing, it is imperative that the members of senior management are involved in the tests, especially for live simulation exercises, with each member of senior management playing his/her own role. For some tests, it will also be appropriate for members of the board to be included in the exercise; e.g., to test the board Chairperson's ability to communicate effectively with external parties (role-played). Of particular importance is the testing of senior management and board members' capacity to communicate with role-played news media and financial markets, including under realistic time pressure.

57. The recovery plan should set out the framework for the regular testing of the plan. This should include the objectives and scope of testing, the parties responsible for organizing and conducting the tests, the processes and procedures for conducting the tests, and the means by which the test results will be documented and reviewed by the board, and by internal audit.

*Issues to be assessed by supervisors*

58. Indicative questions that supervisors should consider in reviewing the testing arrangements for recovery plans are:

- a. Has the bank identified the proposed arrangements for testing the recovery plan on a regular basis? Has the bank specified clear objectives for testing?
- b. Is the scope of testing sufficient? Does it cover all elements of the recovery plan?
- c. Does testing include members of senior management team (including CEO) and board?
- d. Is Internal Audit involved in the testing process?
- e. Is the frequency of testing sufficient?
- f. Has an 'owner' for the testing process been identified?
- g. Is the testing process adequately resourced?
- h. Are external parties be involved in the testing process?
- i. Are the results of tests reported to the board and integrated into future revisions of the recovery plan?

## Review and update of the recovery plan

59. A bank's recovery plan needs to be subject to comprehensive and regular review—generally annually. The recovery plan should identify the internal review processes that will be applied by the bank, including in respect of reviews by the risk management unit and internal audit. Reviews should be undertaken in respect of all aspects of the recovery plan, including the scenarios, triggers, recovery actions and governance arrangements. The reviews should be informed by the testing of the recovery plan.

60. Although reviews of recovery plans can generally be undertaken by a bank's own staff, occasional external reviews by independent experts can also be helpful. This is especially helpful if external, independent experts are present at regular tests of the recovery plan, given that they will be able to use their insights into the testing process and results of the tests to assess the adequacy of the recovery plan. External reviews are also important in relation to reviewing the adequacy of the bank's management and board in relation to their respective responsibilities in the recovery plan, given that internal staff reviews might be less well placed to conduct such reviews freely and impartially.

### *Issues to be assessed by supervisors*

61. Indicative questions that supervisors should consider in assessing the processes for reviewing and updating recovery plans are:

- a. Has the bank set out the proposed arrangements for the regular review of recovery plans? Are the arrangements adequate?
- b. Has an 'owner' for the review process been identified?
- c. How frequently is the recovery plan reviewed?
- d. How will the review be integrated with the bank's review of its risk management framework, risk appetite, ICAAP, BCP, etc.?
- e. What is the involvement of the CEO, EXCO, board Risk Committee and board in the review process?

## APPENDIX III. SKELETON LAW—BANK RECOVERY AND RESOLUTION

### Part 1—Preliminary and governance

#### *Short title*

#### *Interpretation*

Create new definitions as needed and incorporate by cross-reference definitions already established in FIA 2004 or other legislation (no need to cross-refer individually but rather include a provision to the effect that terms which are already defined in FIA 2004/CBA and that are used in this Act (e.g., bank) have the same meaning in this Act unless there is explicit indication to contrary).

Suggest finalising the list of new definitions only once drafting of the Law is at an advanced stage (to avoid proliferation of needless definitions). Keep defined terms simple and descriptive and try to avoid using definitions to establish important substantive concepts or rules (e.g., the notion of nonviability or the test of when a bank is failing/likely to fail should not be concealed within a definition in this section but rather established clearly in relevant, later part of the Act).

#### *Establishment of a resolution function*

A provision to establish a distinct function within CBS (separate from existing supervisory function within FSD) with responsibility for resolution matters. This provision should also confirm that the resolution authority for Seychelles is CBS.

#### *Division of tasks within CBS*

Include a provision affirming that the supervisory and resolution functions of CBS are structurally separate from one another but that they cooperate in the performance of their respective tasks. Allocate responsibility for matters relating to recovery planning and early intervention under relevant parts of this new Act to the supervisory function of CBS (FSD). Allocate responsibility for resolution planning and resolution action to the new resolution directorate of CBS.

Although separate provisions later in the law should enable CBS to make secondary rules/issue guidelines on specific topics, it may also be helpful early in the legislation to have a general/sweeper provision (if legally possible in Seychelles) empowering CBS to issue guidelines on any matter that is reasonably necessary to the successful implementation of the legislation. This could prove helpful to ‘plug gaps’ in the framework if, at a later stage a need for guidance/more detail in certain areas is clearly needed but a specific legal basis to issue such guidance is not otherwise found.

## **Liability**

The law should provide some immunity for CBS officers performing their functions under the Act either as supervisor or resolution authority. To check against existing Central Bank Act as to adequacy of current level of protection.

## **Part 2—Recovery and resolution planning**

This part of the new law logically breaks down into two further sub-parts. According to local practice/statutory norms it would be helpful to have several distinct logical ‘layers’ to the Act. For example, at the lowest level is the Section/Article (numbered) and its paragraphs and sub-paragraphs. Above this there are ‘Parts’ but those Parts can be further divided into multiple distinct Chapters to allow for more logical separation within a single Part.

For example, the first Chapter of this Part 2 deals with recovery plans, the second with resolution plans. Rather than attempt to prescribe in minute detail every stage of the planning process or all the potential content of either recovery or resolution plans, this part of the law should rather establish the basic obligations and powers in ‘high-level’ terms and should empower CBS to issue circulars/guidelines on the process of recovery and resolution planning so that flesh can be added to the bone in due course.

### ***CHAPTER 1—Recovery planning***

For example, rather than trying to prescribe in the statute itself which banks would first be subject to the requirement to generate recovery plans (whether DSIBs only or all banks) it may be better simply to have at the statutory level, a general provision empowering CBS to require banks which it supervises (including the Seychelles branches of foreign banks) to produce recovery plans and then have a further statutory provision enabling CBS to issue public guidelines which will define which banks the CBS currently requires to produce recovery plans, what those plans should contain and how frequently they should be updated. If we are too detailed/prescriptive in the Act itself on those types of question, then we are somewhat ‘tied down’. Too much detail in the statute beyond the bare essentials may make it harder for CBS to modify its approach to recovery planning as policy evolves and experience is gained (e.g., through pilot programmes). Any supporting instruments could, e.g., go into detail on EWIs (among other things).

This said, the statute itself should describe the basic purpose of a recovery plan (i.e., to define actions that the bank would take to restore its financial situation following a serious deterioration, whether that deterioration is attributable to idiosyncratic or system wide factors; and to identify the critical functions and services which the bank provides). The statute should also establish the bank’s own responsibility for the recovery plan; i.e., draft recovery plans need approval of the bank’s board before they are submitted to the CBS).

This Chapter should also establish a clear obligation for CBS to review any draft recovery plan that it receives and for the responsible directorate within CBS to share draft recovery plans with the resolution directorate before the plan is finalised. The statute itself should also empower the CBS, following its review, either to affirm the recovery plan or to require changes to draft plans if the CBS finds the draft plan deficient/inadequate.

There should be a provision empowering CBS to liaise with relevant foreign supervisory authorities when conducting recovery planning for Seychelles branches or subsidiaries of foreign banks. These provisions should also permit CBS to request copies of plans from relevant foreign authorities.

## ***CHAPTER 2—Resolution planning***

A provision should require CBS to draw up a resolution plan for any bank from which it has required a recovery plan. At this stage, such a provision may be more suitable than a general one which would impose a legal obligation on CBS to draw up a resolution plan for *all 7* operational banks within its charge—because there may not be at present the operational capacity to draw up and continually maintain several resolution plans.

The statute should make clear that the purpose of the resolution plan is to assess the resolvability of the bank and to define the resolution actions (which Part 4 of the Act will establish) that CBS may take where a bank reaches the point of nonviability and where CBS considers that resolution action (as opposed to normal insolvency) will best promote financial stability and best preserve the continuity of the bank’s critical functions and services.

As with Chapter 1 of this Part, it would be prudent to avoid statutory provisions on resolution plan content or the procedure/timetable of the planning process that are too detailed or granular. Rather, the statute should establish the basic obligations/permissions and describe only the basic type of content, then allow the CBS to define further the content and procedure in more detailed terms via secondary measures/subordinate legislation or via non-legislative instruments like central bank circulars, guidelines, etc.

Best laid plans can go out of the window in a crisis so the statute should also clarify that a resolution plan is not a legally binding document. i.e., if a resolution should occur, the CBS is not legally compelled to follow the plan but may deviate from it if, in CBS’ judgment, doing so would better promote the objectives of resolution (those objectives being defined in Part 4 of the Act on resolution).

Resolution plans should be considered internal documents of the resolution and protected by confidentiality given the sensitive content. The law should nevertheless require the resolution directorate to share the plan with the supervisory function of CBS. The bank itself should be entitled to see a summary of the plan (but not the whole plan).

Chapter 2 of Part 2 on resolution planning should also contain provisions for liaising with authorities outside the Seychelles (analogous to those described above for recovery plans).

### **Part 3—Recovery and early intervention**

#### *Early intervention measures*

One section in this part should define (in the form of a list e.g., (a), (b), (c) etc.) those actions which constitute early intervention measures (such as requiring the bank to take one or more recovery actions defined in the RP, replace management, appoint temporary administrator, place limits on distribution/dividend payment etc.)

Within the list of possible actions, some would constitute preventive measures (i.e., the earliest intervention to stop further decline) while others would be corrective in nature (e.g., measures to restore the capital position once a bank is already breaching regulatory capital requirements).

#### *Conditions for early intervention*

The next section in this part should then define the triggers/thresholds for early intervention. Triggers (especially any quantitative ones) should be framed so that early intervention is possible long before the bank reaches the point of nonviability.

For example, of structure of provision:

1. *The following constitute early intervention measures:*

(a)....

(b)....

2. *When a bank is in one of the following situations, CBS may take any of the early intervention measures described in Section 1 above.*

(a)...

(b)...

The statutory provisions on early intervention in this Part 3 should require FSD promptly to inform the resolution directorate of CBS whenever a bank reaches an EI threshold and regardless as to whether or not FSD is going to take an early intervention measure.

The statutory provisions should be comprehensive (i.e., provide all the powers and define all the thresholds clearly) but do not necessarily need to be very detailed. Indeed, it would be helpful if the statute contained a provision empowering CBS to make further rules or adopt further

guidelines to describe the early intervention framework and in particular, the procedure for its practical implementation, in greater detail.

For example, on temporary administration as an early intervention measure, this part of the statute itself should specify essential elements (e.g., time limit for period of temporary administration, status/role of shareholders during temporary administration) but in terms of legal drafting this can be done succinctly, leaving much of the detail for secondary legislation/guidance.

## **Part 4—Resolution**

This part of the law will deal with resolution tools and powers (basically everything connected with resolution other than resolution planning or creditor safeguards). Due to multifarious provisions, it makes sense to further sub-divide this part of the law into separate chapters.

### ***CHAPTER 1—Resolution objectives, principles, and conditions for resolution***

#### ***Resolution objectives and principles***

First provision in this part should define (in a list) the purpose/objective of resolution action (e.g., the continuity of a bank’s critical functions/services, the preservation of financial stability in Seychelles, protection of depositors, protection of public funds etc).

The law should also enshrine resolution principles that CBS must follow when acting under this Part. For example, shareholders bear losses first, then creditors (in line with the priority of claims for ordinary insolvency), *pari passu* treatment for creditors in the same class, etc.

#### ***Conditions for resolution***

Next provision in this part should define the conditions for resolution action and should empower the CBS to take resolution action/use resolution powers if those conditions are met. The provision should make clear that these are the conditions for resolution action to be taken both in respect of a regulated bank and in respect of the relevant subsidiaries of such bank. The legislation should also clearly indicate that, subject to the conditions in Part 6 (on cross-border resolution, relevant resolution tools (e.g., ones based around property transfer) can also be used in respect of the local branches of foreign banks. (Part 6 will establish a statutory presumption in favour of CBS deferring to foreign resolution proceedings and using its resolution powers in support of those proceedings. However, Part 6 will also allow CBS to refuse to recognize the foreign proceeding and instead to resolve the branch separately, in limited circumstances).

Most important among the conditions is that the bank is nonviable or likely nonviable. The specific threshold for determining whether a bank has reached, or is likely to reach, the ‘point of nonviability (PONV), as distinct from the complete set of resolution conditions, should be



subject to its own, discrete definition and should have at least three (alternative, not cumulative) elements covering regulatory, balance sheet and cash flow thresholds. For example:

(i) bank is in such serious breach of its licensing conditions as would justify license revocation (e.g., bank facing losses that would significantly erode its capital); (ii) bank's assets worth less than liabilities (or expected to be worth less than liabilities in near future); (iii) bank unable (or expected in near future to become unable) to meet obligations as they fall due.

Rigid quantitative thresholds for defining PONV are best avoided as they unnecessarily restrict the authority's discretion. The 'regulatory' threshold is important because, conceptually, the resolution is more likely to succeed the earlier it can be commenced and a potential problem with the balance sheet/cash flow thresholds (which are rather close to the traditional thresholds for corporate insolvency) is that resolution potentially commences too late to be of real value. Indeed, if one actually were to wait until the bank has actually defaulted on an important payment obligation, arguably such a bank could not be convincingly restored to viability through resolution but rather should be wound up in a normal insolvency proceeding. Having a regulatory element to the definition of PONV also ensures that CBS can take into account serious governance/operational failings that could threaten the bank's viability independently of any capital/liquidity problems.

The legislation should make clear that the 'arbiter' of whether a bank is at the point of nonviability is the CBS wearing the hat of supervisor (i.e., FSD) rather than the resolution directorate. PONV is the point at which responsibility shifts from the domain of the supervisor to that of the resolution authority and this should be clear in the legislation.

This part of the legislation should also affirm that entry into resolution is not subject to ex ante judicial approval (though parties with standing may seek ex post judicial review of CBS decisions in this field—those judicial review provisions to be dealt with in the Part of the law covering safeguards and review).

### **Resolution vs "ordinary" insolvency**

Although the CBS and IMF preparatory papers reject the inclusion of a distinct 'public interest' test, it is nevertheless important that among the statutory conditions for *resolution* action (as distinct from ordinary insolvency) there is included a requirement that CBS (as resolution authority) itself has determined: (a) that there is no private sector alternative to resolution action that could successfully avert the bank's failure; and (b) that resolution (rather than ordinary insolvency) is the course of action that best promotes the statutory resolution objectives (including financial stability in the Seychelles).

So, while this part of the legislation might not contain explicit reference to public interest, it is nevertheless important that whenever the CBS judges a bank to be at the point of nonviability, the CBS makes a choice (and that the CBS be capable of rationally justifying that choice) between either using special resolution tools and powers to deal with the failing bank, or in the

alternative, allowing the bank to fail and for its business to be wound up via the normal insolvency procedure applicable to banks (currently the compulsory winding up procedure in the Schedules to the FIA, potentially to be replaced by more comprehensive framework for bank insolvency proceedings in part 7 of the new law).

Indeed, if the CBS determines that a bank is at the point of nonviability *and* that there is no private sector alternative in play, *but* CBS also determines that financial stability in Seychelles would not be undermined by allowing the bank to be wound up under the normal bank insolvency procedure, then it should be mandatory for such an insolvency procedure to commence. The legislation should therefore avoid creating a sort of ‘limbo’ status for a bank that is no longer viable, but which enters into neither a resolution nor insolvency proceeding.

Absence of private sector alternative is also an important statutory pre-condition to resolution. It ensures that before the CBS resorts to the use of mandatory resolution powers, all other less onerous alternatives have been exhausted, including possibly viable recovery options contained in the recovery plan (logically, recovery options should have been tried and failed before one reaches the stage where one is prepared to resort to resolution action).

## **CHAPTER 2—Resolution Tools**

### **Resolution tools**

The next section should define the resolution tools. One section of the act would list all the tools together and describe them only in high-level terms. Subsequent individual sections (logically, one per type of resolution tool) would explain each tool in more detail.

CBS policy papers present rational justification for limiting the range of resolution tools (e.g., no bail-in, no asset separation/use of asset management vehicle). However, it would be better to ‘future-proof’ the law as much as possible and it is not harmful to have at one’s disposals powers one doesn’t expect to use yet. Within 5 or 10 years’ time, the situation could be different. So, in terms of resolution tools there should at least be the following ones:

**sale of business tool** (to enable CBS to compulsorily transfer either some of the property (selected assets and liabilities) of the failing bank or the bank’s shares, to a private sector purchaser.

**bridge bank tool** (essentially similar to the first tool, albeit that transfer would be made to a specially incorporated, gov’t owned bridge institution).

**Bail-in tool** this should be drafted as a tool that allows for the recapitalisation of the bank by writing down (including to zero) the principal amount of the bank’s liabilities (other than ones expressly excluded from the scope of bail-in—see “Bail-in tool”) or by converting them into equity.

The legislation should maintain a conceptual distinction between on the one hand *bail-in* (which connotes a resolution tool for recapitalisation and, in theory, may affect ordinary unsecured liabilities (both subordinated and senior) and on the other hand, the *write down and conversion of capital instruments* (which is an economically similar device to bail-in but which is something only affecting capital instruments (as part of the initial process of absorbing losses and prior to recapitalising the bank via a bail-in or otherwise resolving its business via the application of one of the other resolution tools).

**Temporary public support tool** to allow, in extremis, the state to purchase the whole bank or participate in recapitalisation using public funds.

### *Sale of business tool*

This section will define the sale of business tool in more detail and prescribe (at high level) the operational and legal mechanics of using such a tool. For example, the section would affirm that the tool is used by the CBS making some sort of legally binding instrument (decision, order, notice—depends on local norms) by which transfer of property or shares is effected in a legally perfect manner without any need for shareholder approval or any other consents and expressly derogating (in broad, generic terms) from any substantive or procedural rules governing such transfers that would otherwise apply under normal company or securities law.

This section should also mandate that CBS strive to obtain commercial terms for any transfer and that consideration for the transfer is paid to the shareholders (in the case of a share sale) or to the transferor bank (in the case of an asset sale). CBS should be allowed to make supplemental transfers following the first one and to make reverse transfers (i.e., back from the purchaser to the bank)

A provision should empower CBS to make further detailed rules/issue further guidance on implementation of resolution using this tool.

### *Bridge bank tool*

This section would mimic the previous one (e.g., by again excluding the normal operation of companies/securities law to the transfer) and would differ from the previous section only in dealing with some of the specificities relevant to a bridge bank transfer. For example, how the state would incorporate a bridge institution, temporary and short relief from full compliance with bank licensing conditions, continued access to payment and settlement systems for the bridge bank etc.

### *Bail-in tool*

This section will define the bail-in tool in more detail including by clarifying its scope. This would include provisions to exclude certain liabilities from scope of bail-in completely.

Normally liabilities excluded from bail-in would at least comprise: insured deposits (where there is a DGS, where there isn't the exclusion could extend to the amount of deposits preferred in insolvency if there is depositor preference); secured liabilities (only to the extent of the value of the security/collateral); short maturity (<7 days) liabilities owed to other banks; liabilities with remaining maturity <7 days owed within payment, clearing and settlement systems; liabilities in respect of employee fixed salary; liabilities owed to trade creditors that provide critical services (e.g., IT).

Other exclusions from bail-in are typically encountered too (e.g., fiduciary liabilities, liabilities in respect of client assets) but they may be less relevant in Seychelles depending on scope of activities of banks in the jurisdiction. See by way of EU example Art. 44 BRRD.

### **Temporary public support tool**

This section would place strict conditions on state support. These should involve consultation between CBS and the ministry, with the government ultimately deciding that application of one of the other tools won't suffice to safeguard Seychelles financial stability. i.e., on the face of the law it should be clear that use of public funds is very last resort. There must also have been very significant loss absorption by shareholders and creditors *first*, before any public intervention can occur and that condition should be enshrined in the law here. (In the EU the requirement is that shareholders and creditors susceptible to bail-in have first absorbed losses worth 8% of the total liabilities including own funds (i.e., capital) of the bank).

This section would also establish the right of the State to make an *ex post* recovery from the surviving banks (potentially via a levy). The sections on temporary public support should empower CBS and/or the Ministry to make further rules controlling the use of public funds in resolution. (It's neither necessary nor desirable to attempt to specify every single detail of this delicate topic in the primary legislation itself).

### **CHAPTER 3—resolution powers**

The following sections should enshrine the legal powers which CBS needs in order to apply resolution tools successfully. It should be clear from the legislation that CBS as resolution authority can use these powers directly against the bank in resolution and the relevant subsidiaries of that bank. It should also be clear on the face of the law that the CBS can use these powers in full derogation from the normal operation of companies, securities or insolvency law. This part of the legislation should also clearly state that, subject to the provisions in Part 6 (on cross-border) resolution, relevant powers can also be used in respect of the local branches of foreign banks.

### **Power to write down and convert capital instruments**

The first section would deal with the write down and conversion of capital instruments (not to be confused with bail-in). Use of this power should be a pre-requisite to (or should accompany

simultaneously) the use of *any* of the resolution tools (whether or not bail-in) to ensure that when a failing bank is dealt with using the special statutory regime for resolution (rather than ordinary insolvency) shareholders and creditors first absorb losses before the legal entity is recapitalised (in a bail-in) or before the bank/its business restored to viability (through a share or property transfer) or before there is any public support (through temporary public support tool).

### **General resolution powers**

This section would define (in the form of a list) all of the legal powers that CBS could conceivably need if it is to successfully use any of the resolution tools. For example, (but not limited to)—haircutting the value of claims (principal and interest) and altering their maturity, powers to transfer the bank’s shares and its property to another person, power to assume all of the normal functions of bank’s management and shareholders (either by CBS acting directly or appointing a special manager as CBS’ agent), power to require bank to issue new capital instruments etc.

### **Automatic exclusion of early termination clauses linked to occurrence of resolution**

This section should provide that any action to take early intervention under part 3 of the law, or to conduct resolution under part 4 of the law shall not *per se* constitute an event of default, termination event or otherwise entitle the counterparty to the contract to terminate the contract, provided that the bank in question continues to perform its obligations under the contract (the latter proviso is itself of course effectively subject to the possible temporary stay—i.e., nonperformance by the bank during the brief (two day maximum) resolution stay would not constitute nonperformance, so it would not enable the counterparty to terminate).

This provision should be distinguished from the broader CBS power to suspend termination rights (see below). This first provision is characterised by the fact that it will operate *as a matter of law* whenever action of any type is taken under part 3 or part 4, i.e., CBS does not need to make any special instrument or order invoking its effect. (Cf the other power relating to termination rights below, which will require CBS to make an order).

For an EU example of this and the following powers, see Arts. 68-71 of BRRD.

### **Power to temporarily suspend obligations**

This provision would give CBS the power to make an order temporarily suspending the bank’s payment and delivery obligations (except for obligations owed within systemically important payment, clearing and settlement systems). In jurisdictions with DGS, insured deposits would also be excluded from this provision. The effect of the suspension should be time limited (maximum end of the business day following the business day on which resolution commences—if these days are either side of a weekend, the effective duration is lengthened by the weekend).

### *Power to restrict enforcement of security*

This provision will allow CBS to make an order restricting enforcement of security by the secured creditors of the bank in resolution. It should be subject to an equivalent time limit as the previous provision. The provision should not apply in relation to security taken from the bank by the CBS in the context of CBS lending/market operations.

### *Power to temporarily suspend termination rights*

This provision will allow CBS to make an order suspending the termination rights of any contractual counterparty of the bank in resolution. It should be subject to an equivalent time limit as the previous provisions and should be subject to the proviso that the bank continues to perform its obligations under the contract to make payments, deliveries and provide collateral.

Unlike the first of these sequence of powers (which would *automatically* ‘switch off’ termination rights expressly or implicitly linked to recovery or resolution action) this latter provision actually requires CBS to make a written order. However, it can apply to a potentially broader range of termination rights (including rights that might not be triggered by the mere occurrence of recovery or resolution).

## **Part 5—Resolution safeguards and judicial review**

### *No creditor worse off*

This provision will establish the rule that no creditor of the bank should make a worse recovery in resolution than they would have done in a normal insolvency of the bank conducted under Part 7. Provision should be made for an independent valuer to make an *ex post* valuation in order to establish the ‘counter-factual’ valuation. The provision should also establish a right to compensation for a creditor (in the amount of the difference) if that latter valuation should demonstrate that a creditor would have made a better recovery in insolvency.

### *Protection of netting and set-off arrangements*

This provision will affirm that CBS may not use its resolution powers to transfer some but not all of the rights and liabilities that are protected under netting or set-off arrangements. This preserves the inviolability of netting/set-off arrangements in resolution.

In some systems of law, the equivalent of this protection also extends to ‘title transfer financial collateral arrangements’ (a type of credit risk mitigation common in OTC derivatives and repo transactions and which—unlike normal security interests—can be enforced quickly and without formality in a normal corporate insolvency and under which enforcement is not prevented even by the standard corporate insolvency law moratorium). To be discussed whether protection for such specific collateral arrangements needed in Seychelles (if banks in the jurisdiction have any

business under market standard OTC derivatives documentation; e.g., ISDA, the protection under this provision arguably should also extend to title transfer collateral arrangements).

For statutory definitions of netting/set-off arrangements (and title transfer arrangements if needed) S.48 of the UK Banking Act 2009 provides suitable precedents that are generic/not jurisdiction specific. E.g.

*“set-off” arrangements are arrangements under which two or more debts, claims or obligations can be set off against each other,*

*“netting arrangements” are arrangements under which a number of claims or obligations can be converted into a net claim or obligation and include, in particular, “close-out” netting arrangements, under which actual or theoretical debts are calculated during the course of a contract for the purpose of enabling them to be set off against each other or to be converted into a net debt*

As with the protection below for security interests, if there were deposit insurance, it would be logical to establish a carve out for insured deposits, to the effect that derogation from the provision is possible to the extent needed to ensure the availability of insured deposits.

### **Protection of security interests**

This provision should ensure that when transfer powers are used to transfer a secured liability to another bank/bridge bank during resolution, then the asset which is the security for that liability must also be transferred (and vice versa i.e., no transfer of an asset against which a liability is secured unless the accompanying liability is also transferred).

If deposit insurance is established, there could be a ‘carve out’ or derogation from this provision where needed to ensure the continued availability of insured deposits.

The law should also expressly prevent CBS from using its resolution powers to modify or change the terms of contracts that created the security interest where the effect of the modification is to cause the liability to no longer be a secured liability.

As far as protection for security interests against bail-in is concerned, special provision is not needed here. Rather, the exclusion from bail-in for secured liabilities (to the extent of the value of the security) is best established in the section dealing with bail-in.

### **Judicial review**

As discussed, if constitutionally possible, the determination that a bank is at the point of nonviability and the subsequent decision either to resolve it or liquidate it, should not be subject to *ex ante* judicial review.



However, legal right for interested parties to seek judicial review *ex post* should be protected in law, though remedies and effects can be limited. For example, application for judicial review of the resolution decision must not have any automatic suspensive effect on the challenged decision, also where a challenge is ultimately successful, this should not enable the unwinding of any property transfers done pursuant to the challenged act (so the remedy of the person bringing the successful challenge should be limited to compensation for damages).

## **Part 6—Cross-border resolution**

### *Recognition of foreign resolution action*

This provision will require CBS, when it is informed by a foreign resolution authority of foreign resolution action which affects a Seychelles branch of a foreign bank, to decide either to recognize, refuse to recognize or recognize only in part the foreign resolution action.

The law should create a statutory presumption in favour of recognition, with refusal to recognize or partial recognition only possible on select grounds e.g., if CBS considers that recognising the foreign proceeding would harm financial stability in the Seychelles, would have material fiscal implications for Seychelles or that Seychelles creditors/depositors would receive worse treatment than those in the foreign jurisdiction.

### *Non-recognition of foreign resolution action*

The law should affirm that when one of the statutory grounds to refuse recognition (or only partially recognize) the foreign resolution action, CBS can deploy its resolution tools and powers under part 4 of the Act to resolve the Seychelles branch of the foreign bank independently.

### *Resolution of Seychelles branches without a foreign resolution*

Separately from the question of branch resolution when the parent itself *is* subject to foreign resolution proceedings, the law must *also* empower CBS to take resolution action in relation to the Seychelles branch where the bank of which that branch forms part is *not* subject to any foreign resolution proceeding and where CBS determines the conditions for resolution action in Seychelles are met with respect to that branch.

### *Cooperation with other jurisdictions*

Within this part of the law, a section should empower CBS to establish working relationships with resolution authorities in foreign jurisdictions e.g., to sign MoU with those authorities and to exchange information on recovery and resolution matters with them.

## Part 7—Bank insolvency

### *Conditions for compulsory winding-up of a bank*

The threshold for ordinary insolvency will overlap somewhat with the ‘nonviability’ test already established in law and should enable CBS to appoint a liquidator to conduct the compulsory winding up of a bank where:

- (a) CBS has already made a determination that the bank is at the point of nonviability pursuant to Section [x] in Part 4 of the Act; and
- (b) CBS determines that the resolution objectives are better served via the process of compulsory winding up this Part rather than by resolution action under Part 4.

It should also be possible for CBS to appoint a liquidator to commence compulsory winding up of any bank which is unable to pay its debts or is likely to become unable to pay its debts. (Recall that it is not inevitable that a bank which satisfies the threshold of nonviability would already be in that condition. So, it is important to establish this as a distinct threshold for commencing normal insolvency).

The law should also clearly establish that once the CBS has decided to take resolution action in relation to a bank under Part 4, it should not be possible to commence the compulsory winding up of the bank except with the consent or at the initiative of CBS. The importance of such a provision depends on whether Seychelles law otherwise makes it possible for third parties to seek the commencement of a winding up of a bank (e.g., creditor petitioning court to order the winding up).

Conceivably, in a property transfer resolution, after CBS has affected the transfer of property to a bridge bank or purchaser, CBS will wish to commence the winding up of the now insolvent ‘shell’ from which the property was transferred. Provision should also be made in the law to enable such an entity to continue to provide such administrative and operational support as might be needed by the transferee pending conclusion of the winding-up.

### *Typical provisions—appointment, goals, powers, and objectives of liquidator, etc.*

Apart from the need for a clearer creditor hierarchy (see below) much of the existing content on compulsory winding up could be re-purposed. i.e., on some of the ‘boilerplate’ content, there is no need to re-invent the wheel.

The law could however specify clearer statutory objectives for the liquidation. Classically (for nonbanks) this would be winding-up the affairs of the insolvent company to achieve the best result for creditors as a whole. If a system of deposit insurance is instituted, a statutory priority could be given to the goal of ensuring that insured depositors are repaid promptly.

The law should define the powers available to the liquidator in pursuit of the statutory goal (much of this is already to be found in P2 of Sch 2 FIA and can be copied across. It's not clear however if there is a moratorium provision already. If not, one should be included which would establish a general moratorium on all other legal process against the bank undergoing winding-up (e.g., to prevent secured creditors enforcing, landlords or lenders seizing property etc.)

### **Creditor hierarchy**

This part of the law should define clearly the priority of claims in insolvency and specify that at the conclusion of the winding-up process, when the liquidator is ready to make a distribution from the insolvent estate, it makes that distribution according to the priority of claims (first to last). The question of whether and to what extent a depositor preference is established is for further discussion. A typical creditor hierarchy in a jurisdiction with deposit insurance and depositor preference might look as follows.

*Secured liabilities*

*Other preferred liabilities (e.g., salaries, taxes, pension contributions)*

*Insured deposits up to the insurance ceiling*

*Uninsured deposits*

***Ordinary unsecured creditors (a wide variety of unsecured claims, all ranking pari passu)***

*Subordinated debt*

*Tier 2 regulatory capital*

*Additional Tier 1 instruments*

*Common equity Tier 1*

## **Part 8—Consequential amendments to other legislation**

### **Section 13 FIA**

FIA applies also to nonbank financial institutions (chiefly BDC). Thus, unless there is a strong policy imperative to do so, it is not necessary to alter the effect of any FIA provision insofar as they affect BDC but only select provisions insofar as they currently affect banks.

On S.13 the current grounds for variation/revocation of license are very wide-ranging. One could criticize this current drafting because, ostensibly, it gives the power to revoke the license of a bank in situations where it would be clearly disproportionate to do so. However, the fact that the CBS has to justify its action and the right for review mitigates this concern.

On point (1)(f) of S.13 we would caution against trying to define the threshold for bank insolvency/apparent insolvency or of bank resolution within this provision itself, especially in any quantitative terms. Rather, the existing point (f) could be limited in scope to BDC and a new point (fa) inserted immediately after as follows:

*only in respect of a financial institutions that is a bank, [bank] satisfies the statutory conditions for compulsory winding-up established under Part 7 of [Bank Recovery and Resolution Act 2024] or the conditions for entry into resolution established under Part 4 of that Act.*

This way, one avoids trying to deal with the thorny question as to what are the legal thresholds for bank insolvency or bank resolution, within the provisions on license revocation. One also makes it legally possible for license revocation to occur in either a bank resolution or a bank insolvency but without any automaticity of that revocation (since, as discussed, in many cases entry into resolution would and should not entail immediate revocation of license).

Point (1)(c) of S.13 (which cross-refers to section 53) could be supplemented (for banks only) to refer to failure to comply with early intervention measures under the new legislation. E.g.

*(c) either fails to comply with the terms and conditions of the license or any corrective measures required by the Central Bank in accordance with section 53 (Central Bank’s power over unsafe practises) or, in respect only of a financial institution that is a bank, fails to act in accordance with any measure taken by the Central Bank under Part 3 of the [Bank Recovery and Resolution Act] (Recovery and Early Intervention).*

In practice though, license revocation at that stage might be rather unusual. If the bank fails to act in accordance with CBS instructions for recovery, the logical ‘escalation’ is to move towards resolution rather than revoke license (which necessarily implies death of the business)—unless CBS sees no alternative.

### **Section 53 FIA**

Conceptually, insofar as it applies to banks, Section 53 should continue to apply with minor modification as the legal anchor for ‘normal’ supervisory intervention (i.e., before one has reached the threshold for early intervention/recovery under Part 3 of the new act and potentially including ‘heightened’ supervision that still falls short of formal recovery action/early intervention).

Either within Section 53 itself, or in Part 3 of the new act, some provision should affirm that in order for early intervention under that Part 3 of the new act to commence it is not necessary for CBS to have previously taken any action under Section 53 FIA.

Within Section 53 FIA, with the advent of the new legal regime for recovery and resolution, the framework for reorganising agents under S. 66 FIA and Sch. 4 is redundant for banks so point (1)(k) should be limited to BDC/’switched off’ for banks. For example,

*(k) only where the financial institution concerned is not a bank, appoint a reorganising agent in accordance with the provisions of section 66 of this Act.*

### **Section 66 FIA and Schedules 1 to 5 FIA**

S. 66(1) and Sch 1 should not be amended because the advent of a special regime for dealing with failing banks does not alter the fact that changes of control of regulated entities in the ordinary course, takeovers etc. should be subject to regulatory approval. Only point to note is that in Part 4 of the *new Act* (i.e., the part dealing with resolution) the operation of Sch 1 FIA could be expressly excluded in bank resolution.

S.66(2) and Sch 2: Part I of Sch 2 (voluntary winding up) could continue to apply to solvent banks that simply decide to ‘close shop’. However, Part II (compulsory winding up) should be disappplied to banks and limited only to financial institutions that are not banks. In its place, new Part 7 of the BRRRA will establish provisions for winding up a failed bank that is not being subject to resolution action (though, as noted above, much of the existing content of Part II of Sch 2 can be recycled for that purpose; i.e., for the bank insolvency procedure it is more a question of supplementing existing provisions, rather than wholesale replacement).

S. 66(3) and Sch 3 FIA should be limited in scope to financial institutions that are not banks because, for banks, the regime in Sch 3 becomes redundant with the advent of the new legal framework for resolution under Part 4 of the new Act.

S. 66(4) and Sch 4 FIA should be limited in scope to financial institutions that are not banks because, for banks, the regime in Sch 4 becomes redundant with the advent of the new legal regime for recovery/early intervention under Part 3 of the new Act.

S.66(5) and Sch 5 FIA could continue to apply to foreign financial institutions that are banks but it would be sensible to include a provision which affirms that the framework for the closure of a foreign FI in Sch 5 is without prejudice to any of the powers and tools for dealing with the resolution of a foreign FI that is a bank under Part 4 (Resolution) and Part 6 (Cross-border resolution) of the new act/affirming that where the CBS takes action to deal with a foreign bank under Part 4/Part 6 of the new Act, then the application of Sch 5 of the FIA is suspended.

Whenever any provision (especially the Schedules) to the FIA is being expressly disappplied to banks or modified in their application to banks, the content of those provisions should be carefully checked to ensure there is no explicit reference within them to banks/banking (if any are found, they should either be deleted/amended as necessary).

#### APPENDIX IV. GUIDANCE ON THE DEVELOPMENT OF A BANK RESOLUTION MANUAL

1. This appendix provides guidance on the development of a bank resolution manual. The issues addressed here are not exhaustive and should consider the size, nature, and complexity of the bank.

##### *Introductory comments*

2. The purpose of a bank resolution manual is to provide guidance to a resolution authority on the means by which a bank may be resolved. It should be designed to be accessible and user-friendly. This appendix provides guidance for the Central Bank of Seychelles (CBS) on the main issues that would need to be covered in the manual, including nonviability assessment; entry into resolution; selection of the resolution strategy by category of bank; implementation of the resolution; and communication. It also provides guidance on the coordination of resolution actions among domestic agencies and, in the case of foreign-owned banks or domestic banks with foreign operations, cross-border coordination.

3. Although the resolution manual would be developed by the resolution staff in the CBS, there will be a need for input from the other relevant agencies on particular matters. For example, the CBS and Ministry of Finance (MOF) will need to work closely together on elements involving public funding and the provision of government guarantees, as well as on the ownership of a bridge bank if a bridge bank option is used. The MOF will also need to be closely involved in the content relating to the exit from any public support and ownership arrangements. The securities regulator will need to be closely involved in any matters relating to the temporary suspension of disclosures to the stock exchange and on arrangements for public listing of shares in a restructured bank that emerges from resolution. The communications elements of the manual will require input from all agencies, given that each agency has a role to play in bank resolution (especially as between the CBS and MOF), and there is a need for coordination of crisis management communications. It is suggested that a working group of all agencies be established by the CBS, led by the CBS, to coordinate the development of the resolution manual and related matters.

4. Separate from the resolution manual is the need for the CBS to develop resolution plans for each DSIB, drawing on guidance in the resolution manual and in the separate appendix that addresses this matter. The resolution plans would be informed by resolvability assessments that draw on comprehensive data obtained from each DSIB. Guidance on resolution planning and resolvability assessments is contained in a separate appendix.

5. The key elements of a bank resolution manual are set out below, including:

- Crisis diagnostics—viability assessment and systemic impact assessment;
- Resolution strategies, including the criteria to assist in selecting which strategy might be appropriate in particular circumstances by category of bank;

- Step-by-step implementation plans for resolution tools; and
- Cross-border cooperation and coordination.

### *Supervision to resolution*

6. The management of weak and failed banks is a continuum, ranging from early supervisory actions, including preventative actions to address early-stage stress or compliance issues, to more intensive corrective actions to address more advanced stress or noncompliance matters, through to the placing of a bank into resolution if it becomes nonviable and is not recoverable. In that process, a clear distinction should be maintained between activities for supervision and those for resolution. Increasingly, experience has suggested that there are significant benefits when supervision and resolution are managed as separate processes. Supervision and resolution are very different activities that require different skill sets and different analytical tools. Supervision policies are about keeping the bank functioning in a safe and sound manner. Resolution policies are about resolving the failed bank as quickly as possible.

7. This separation of supervision and resolution is outlined in Figure 1. The first stages of managing a weak bank involve the identification of financial distress and the use of informal, and then formal preventative and correction measures. The bank would be required to take appropriate remedial measures to restore itself to financial and operational soundness and to full compliance with regulatory requirements. This might involve invoking a bank's recovery plan to take initiatives within the plan to restore the bank to acceptable financial and risk positions. If unsuccessful, a private-sector solution may be sought, involving the continuity of critical functions with a private sector solution (e.g., merger with a larger, financially sound bank). This part of the process is managed by the supervisors, with the bank treated as a going concern.

8. The process of managing early-stage and more serious bank stress and regulatory compliance issues should involve a structured framework of preventative and corrective actions, based on an escalating set of quantitative and qualitative triggers and supervisory response actions. The preventative and corrective action framework should include triggers for requiring a bank to invoke its contingency plans, including its recovery plan. In addition, the supervisory authority should maintain contingency plans for how it would apply its preventative and corrective action framework in a range of scenarios.

9. The key elements of an effective early intervention framework are set out in Appendix Box 1.

10. If early intervention initiatives are unsuccessful and a bank is deemed to be nonviable (within the terms specified in resolution law), the supervisory authority should trigger resolution and the resolution staff should take over responsibility for the bank. The decision to initiate resolution should be based on an analysis of the bank's viability, such that if the bank is assessed as being nonviable and unable to restore itself to viability, the bank would be placed into resolution. Accordingly, there is a need for a clear definition of nonviability and a framework for



assessing it. The principal element of viability assessment is solvency assessment to determine the risk-weighted capital ratio and the non-risk-weighted leverage ratio of the bank/group on the basis of an asset quality review that involves estimating the probable recoverable value of assets of the bank. It will also involve assessment of the liquidity position of the bank on a projected basis, using a stress testing framework. This indicator-based analysis should be complemented with a qualitative assessment of the bank's medium-term prospects. Such an assessment will be based on an evaluation of the bank's business model, governance arrangements and quality of risk management.

### Appendix Box 1. Key Elements of an Early Intervention Framework

The key elements of an effective early intervention framework comprise:

- a. *Clarity of objectives.* The early intervention framework should be based on well-specified and understood objectives. The principal objective should be to identify and respond promptly and effectively to emerging stress in banks or other financial institutions in order to promote remediation of the causes and impacts of the stress and to restore the bank/financial institution to a sound financial condition as soon as practicable.
- b. *Integrated approach.* An effective early intervention arrangement needs to be closely integrated into a risk-based supervisory framework. In particular, early intervention needs to be informed by supervisory risk assessments and ratings, with banks that are assessed as having relatively high risk and/or relatively poor risk management and governance arrangements being subject to an escalation in supervisory intensity. Early intervention needs to be an integrated element in the escalation of supervisory intensity. It should not sit in isolation to risk-based supervision.
- c. *Early-stage intervention.* An early intervention framework should be designed to ensure that supervisory actions are taken at an early stage of emerging stress in banks, well before any breach of regulatory requirements has occurred. Triggers for intervention therefore need to be based on early-stage indicators of bank risk.
- d. *Early warning system.* Early intervention should be informed by a comprehensive, structured system of EWIs that enable supervisors to detect deterioration in a bank's risk condition and/or deficiencies in risk management and governance, at an early stage. EWIs should be linked to the main risk factors for the relevant bank and should desirably be consistent with EWIs used by a bank in its risk appetite statement (e.g., EWIs linked to minimum/maximum risk tolerances) and in its recovery plan (e.g., EWIs linked to the trigger variables in the recovery plan). EWIs should include indicators that provide predictive indications of stress for capital, asset quality, profitability, liquidity, market risk and operational risk.
- e. *Structured framework.* Early intervention should comprise a structured framework of preventative and corrective actions, based on clearly identified triggers and with corresponding responses, with an escalation in response depending on the severity of the trigger. In this regard, a well-designed early intervention framework often involves a two-stage process: *preventative action* (for early-stage stress situations) and *corrective action* (for more advanced stress or regulatory noncompliance situations).
  - i. Under *preventative action*, the triggers are based on early-stage stress in a bank, and include a deterioration in EWIs, and a deterioration in risk relative to a bank's risk appetite tolerances or supervisory peer group benchmarks; e.g., a rise in special mention, substandard and/or nonperforming loans (NPLs) (or Stage 2 loans under IFRS), a weakening in profitability, a weakening in capital and liquidity buffers above regulatory minima, and the occurrence of material operational risk events, such as money laundering, fraud or cyber-based losses. Supervisory actions in response to these early-stage triggers are designed to deepen the understanding of the bank's/group's financial condition and to limit any further deterioration by addressing the underlying cause(s) of the problem and by promoting remedial action to restore the bank/group to desired risk settings.

- ii. *Corrective actions* are taken in response to more advanced stress or regulatory noncompliance situations. A corrective action framework is generally based on quantitative triggers, such as specific levels of capital ratio, liquidity ratio and NPLs, but also usually include triggers of a qualitative nature, such as supervisory concerns over operational risk events, breaches of regulatory requirements, or deterioration in governance or management. Corrective actions are designed to ensure that a bank/group rectifies the cause(s) of the problem and restores the bank/group to defined levels of financial health and compliance with regulatory requirements, such as prescribed levels of capital ratio.
- f. *Proactive, prompt, decisive and time-limited.* An early intervention framework should involve supervisory responses that are proactive (especially in the preventative action phase), prompt and decisive. There should be defined timeframes within which decisions are made—from the point of first detection of the relevant risk or stress event, to the formulation of recommended actions, to the determination of actions, through to the execution of actions (and subsequent monitoring). As a general rule, preventative and corrective actions should be time-limited; a bank should not be under any form of preventative or corrective action for more than the period needed to complete the required actions. In that regard, it would be unusual and potentially concerning for a supervisory authority to allow a bank to be in any form of preventative or corrective action for longer than around six months before it is either restored to a supervisory intensity setting (based on the supervisory risk rating) or, if circumstances warrant, to be transitioned to voluntary exit from the industry (e.g., through merger or structured wind-down) or resolution in the case of a nonviable bank.
- g. *Documentation.* The early intervention framework should be clearly documented, with the triggers and corresponding responses being laid out in a structured format, desirably in a way that clearly demonstrates a structured escalation in responses based on rising levels of triggers. The documentation should be sufficiently clear that supervisory staff can readily use the material to guide their proposed actions.
- h. *Consistency of approach.* There should be a consistency of approach to early intervention, such that each supervised bank is treated in broadly the same way in the same or similar circumstances. This approach is consistent with the regulatory principle of competitive neutrality, such that regulation and supervision are applied in a manner that does not discriminate between banks of like kind and in similar circumstances. Consistency of approach in early intervention also helps to reduce the risk of regulatory forbearance and the attendant risk of moral hazard.
- i. *Transparency.* The early intervention framework should be transparent, such that stakeholders, including regulated entities, have the ability to access information on the framework and to understand how it will be applied by the supervisory authority. Transparency helps to enhance the legitimacy and credibility of the early intervention framework. It helps to create the incentives for banks' directors and management to conduct the affairs of a bank in a manner consistent with supervisory objectives, and to reduce the risk of preventative or corrective action being needed. Transparency also helps to promote accountability by the supervisory authority by enabling stakeholders (including relevant ministers) to assess the supervisory authority's performance in respect of early intervention by reference to the actions expected of the authority under the early intervention framework.
- j. *Governance.* There should be a clearly specified and documented governance framework for early intervention (as for all aspects of regulation and supervision). In particular, the framework should specify the allocation of powers and responsibilities for each element of early intervention, including the responsibilities for monitoring trigger indicators and thresholds, for recommending particular response actions, for approving particular response actions, for supervising the implementation of response actions, and for ex post review of response actions.
- k. *Contingency planning.* An important element in an early intervention framework is the establishment of contingency plans by the supervisory authority for how it would respond to a range of bank stress or regulatory noncompliance situations. A common approach is for a supervisory authority to set out indicative response strategies for a range of scenarios. This is intended to assist supervisors to select appropriate response options from the early intervention framework to deal with particular scenarios

of bank stress or regulatory compliance. The contingency plans should be refreshed on a regular basis and periodically tested (see below).

- l. *Testing.* Early intervention frameworks should be subject to regular testing. This can involve “desktop” testing formats, where supervisory staff use particular scenarios to determine appropriate response strategies, and for the supervisory decisions to be assessed by other staff, with lessons drawn from the exercise to inform possible changes to the contingency plans. A more comprehensive form of testing is for the supervisory authority to conduct regular live simulation exercises to test aspects of the early intervention framework. Simulation exercises often include the participation of the most senior level of management as well as supervision staff. The exercises can be designed to test for a range of scenarios and are generally held over a one-to-two-day period, followed by a debrief session and assessment process. Lessons drawn from the exercise are used to inform possible modifications to the early intervention framework and associated contingency plans.
- m. *Transitioning from intervention to resolution.* There needs to be a clear pathway to transition a nonviable bank from heightened supervisory intervention to entry into resolution. This generally requires the supervisory authority, in conjunction with the resolution authority (if a separate agency), or the supervisory team and the resolution team (if supervision and resolution are performed in the same agency), to have an established process for undertaking an assessment of the viability of a bank. The concept of nonviability needs to be clearly defined, with an analytical framework to enable the supervisors and resolution staff to make a determination of whether a bank is viable (or on the path back to sustained viability) or nonviable. Irrecoverable nonviability (appropriately defined) would normally be the point at which a bank is placed into resolution. The procedures for entry into resolution should be clearly identified and documented.

11. Irrespective of a bank’s perceived medium-term prospects, it is desirable to have a hard trigger for entry into resolution as a fallback if there is uncertainty over viability assessment outcomes. For example, a hard trigger could be where the bank’s capital ratio, calculated using an asset quality review, is estimated to be below a defined threshold (e.g., 3 percent of risk-weighted exposures).

12. If the bank is assessed as being nonviable or otherwise where the capital threshold has been reached, the bank would be passed from the supervisors to the resolution department/resolution authority. At this point, the resolution authority evaluates the bank’s condition and explores various resolution options. These options will depend on the systemic importance of the bank and other considerations—see later in this appendix.

13. The steps set out in the diagram of the Intervention and Resolution Process are explained below.

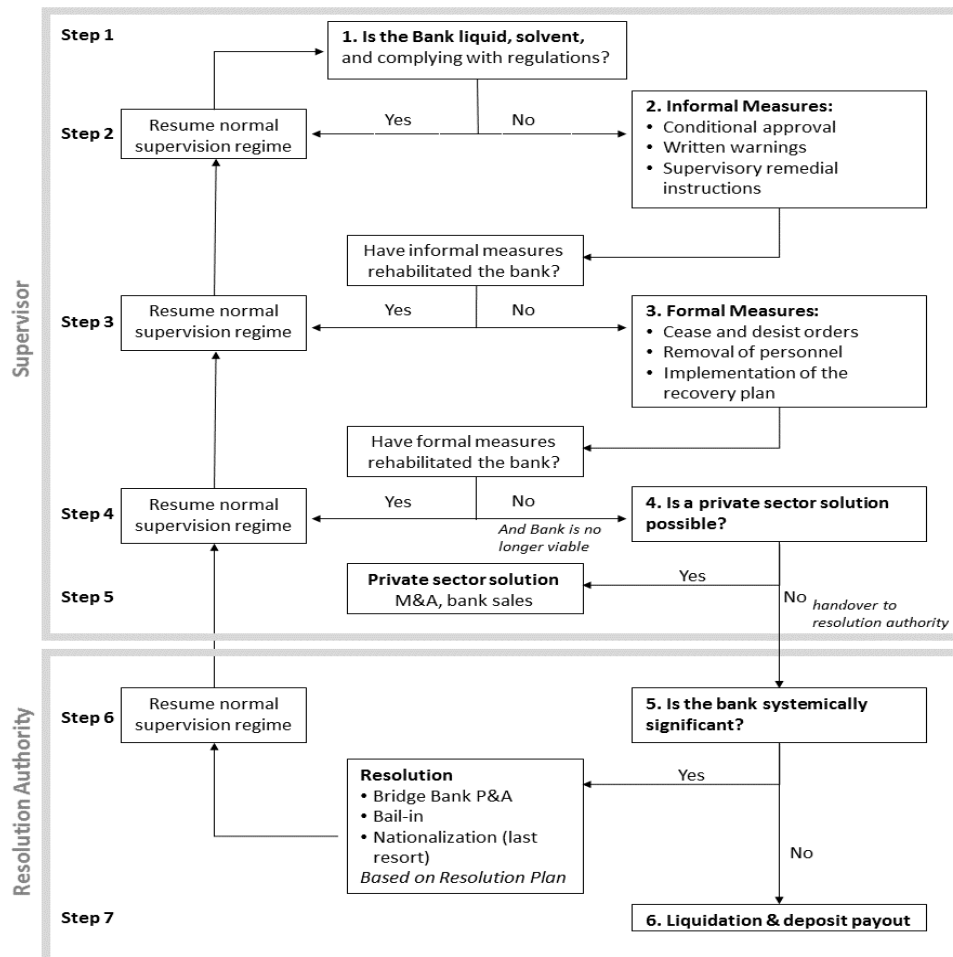
#### ***Steps 1—4: Supervisory Assessment: crisis diagnostics***

14. In a period of emerging stress, any bank considered to be potentially vulnerable should be assessed by the supervisory authority to determine the bank’s:

- Solvency (i.e., surplus of assets over liabilities);
- Common equity tier 1 capital position;
- Total tier 1 capital position;
- Total capital position;
- Exposure to shareholders and other related parties;
- Level of NPLs;

- Level of specific provisions in relation to NPLs;
- Expected loss on NPLs; and
- Liquidity position

### Overview: Intervention and Resolution Process



15. The analysis would include an estimation of a range of capital values for the bank, from best case to worst case, with assets estimated at expected recoverable values net of realization expenses. Valuations of assets should be undertaken on a going-concern basis, unless there is an expectation that the bank will be closed, in which case valuations would be on a gone-concern basis. The supervisory authority should develop a methodology for asset quality review, including the methodology for valuing individual loans and other assets above a given amount and the methodology for valuing a portfolio of smaller loans. In a bank's financial condition is deteriorating relatively slowly and there is time for a thorough due diligence of the bank, this could be achieved through a combination of on-site assessment by the supervisors and engaging specialist asset valuation experts from an external party (such as one of the major accounting

firms, other than the bank's external auditor) to assist in the review. If the bank's condition is deteriorating rapidly, then the supervisors may need to undertake a fast-tracked solvency and asset quality review based on relatively conservative estimations of asset valuation.

16. The analysis would also include an assessment of the bank's liquidity position and a stress-tested assessment of how vulnerable the bank is to wholesale and retail liquidity withdrawals. Liquidity assessment would include analysis of, among other matters:

- the amount and quality of liquid assets;
- access to parent or other shareholder liquidity (where applicable);
- access to committed standby facilities with other banks;
- amount and nature of assets capable of being used for collateral to obtain liquidity from the CBS or other sources;
- maturity profile of liabilities, both using contractual and behavioral maturities, under assumed stress conditions;
- schedule of projected payment and settlement obligations for a defined period (e.g., next one, two weeks, month, etc.); and
- stress testing of liquidity by estimating the capacity of the bank to meet payment and settlement obligations, including deposit withdrawals, under a range of plausible stress scenarios.

17. Where a bank has subsidiaries that perform essential functions for the bank, there should also be a capital/solvency and liquidity assessment of the relevant subsidiaries.

18. The supervisory authority should have the capacity to undertake solvency assessments, capital adequacy assessments and liquidity assessments under acute time pressure (e.g., within 1 to 2 days). Mechanisms and processes for such analysis should be developed and tested on a regular basis. In this regard, it is useful for the supervisory authority to develop a data template that sets out in detail the information needed to undertake an asset quality review/solvency assessment, and a liquidity assessment. Banks should be required to have the ability to provide data to the supervisors upon request, within a tight timeframe (e.g., 24 hours) using the data template. This should be tested periodically.

19. An important supervisory tool is peer review of selected banks, under which the supervisors identify banks similar to the bank under examination. The financial statistics, described above, are then compared across banks. The supervisors will come to a judgment whether the bank under examination is broadly in line with peer banks or, if an outlier, what remedial actions are needed to strengthen the bank.

20. If the supervisors determine that the bank is failing and supervisory actions cannot reverse its financial distress, or that the bank is nonviable, responsibility for the oversight and management of the bank passes to the responsibility of the resolution authority, as noted earlier.

***Step 5: Supervisory Triggers for Determining Nonviability***

21. The legal framework should establish a clear dividing line between supervisory intervention and resolution by the resolution authorities. Early intervention, which is a supervisory tool, is designed to reduce the likelihood of a bank's failure, whereas resolution aims to minimize the impact of a failure. It is important for legal frameworks to clearly demarcate early intervention and resolution by establishing well-designed triggers.

22. Resolution triggers should include both qualitative and quantitative indicators, which should not be unduly prescriptive.

23. Quantitative triggers can include capital and liquidity indicators. A possible discretionary ground could be the decrease of a bank's regulatory capital level to below a predefined threshold (e.g., CAR or leverage ratio below 50 percent of the minimum required). In doing so, this resolution trigger should not necessarily specify the minimum CAR or leverage ratio in law, as these may change under the supervisory framework. However, some authorities specify in their internal guidance a minimum level or hard trigger for entry into resolution (in addition to any other triggers that might also apply), such as the CAR falling below 3 percent of risk-weighted credit exposures. This has the advantage of lowering the risk of regulatory forbearance leading to a delayed entry into resolution and the associated risk of greater losses for creditors.

24. Quantitative triggers should be based on a forward-looking evaluation that supplements the conventional insolvency test. The following conditions can be made resolution grounds where the bank: (i) has become or is likely to become insolvent; (ii) has suspended or is likely to suspend payments as they fall due; (iii) has defaulted or is likely to default in making payments to depositors and other creditors; (iv) is otherwise in a situation or circumstance that may materially impair the ability of the bank to make payments or otherwise continue its operations; (v) the commencement of an insolvency or reorganization proceeding (other than on a solvent basis) over a group entity (including holding company); or (vi) is a branch or subsidiary of a bank that has had its license in the country of its origin cancelled or been subjected to a resolution action or insolvency process. The CBS could also add other indicators corresponding to above circumstances, such as the bank's inability to access financial markets or reliance by the bank on extraordinary public financial support.

***Steps 5–6: The resolution assessment process***

25. Once the supervisory authority triggers resolution (passing responsibility for the bank to the resolution department/authority), several steps are then taken.

26. The immediate task of the resolution authority is to review the diagnosis of the failed bank, determine the range of possible resolution options, and select the least-cost option that



meets defined resolution objectives taking into account the systemic importance of the bank and the risk of inter-bank contagion. Typically, this process of diagnosis and review of resolution options will have begun before the supervisors activate resolution (the resolution trigger). Thus, once the trigger is breached, the resolution authority is able to move quickly.

27. Once entry into resolution is determined, the resolution authority would immediately appoint a statutory manager or administrator to the bank or would itself assume control of the bank and any subsidiaries relevant to the bank's critical functions and services. The statutory manager's/resolution agent's responsibility is to implement the resolution strategy developed by the resolution authorities.

28. The selection of the resolution option will depend on a variety of factors:

- In the case of a small bank with little or no systemic impact, closure and prompt pay-out of insured/preferred depositors or deposit account transfer to another bank via a P&A transaction would be the likely resolution option.
- In the case of a bank whose failure would have a significant systemic impact, a form of 'open resolution', where the bank's critical functions and services are kept open, would be the likely resolution option.

29. The statutory manager/resolution agent will need to have different skills depending on the resolution strategy. For that reason, the resolution authority should develop a list of available candidates, including their backgrounds and experience. Such a list will allow the authority to respond quickly in the face of a failing bank.

#### ***Step 5a: Systemic impact assessment***

30. The determination of the systemic impact of a failure should be taken by the supervisory/resolution authority in liaison with other relevant agencies. This assessment would be based on CBS's framework for determining DSIBs, but the assessment would need to take into account the particular circumstances of the bank and financial system at the time of the distress event. In that regard, it is important to remember that the potential systemic impact of a bank varies over time and on the fragility of the financial system. In a period of financial system stability, the failure of a single small to medium-sized bank might be assessed as having a low systemic impact, whereas in periods of financial system instability the failure of the same bank might have a significant impact on the financial system given the potential for contagion and adverse confidence effects. Accordingly, it is essential that the systemic impact assessment is made at the time of distress and that it factors in the then prevailing circumstances affecting financial system stability.

31. Systemic impact assessments would appropriately draw on the criteria applied in the DSIB framework developed by the BCBS. The analysis would therefore take into account:

- the market share of each bank in each of the key lending sectors;



- the market share of each bank in the deposit market (differentiating between retail and wholesale deposits);
- the bank's share of payments services, differentiated by payment system and payments product;
- the bank's share of lending to economic and social infrastructure providers;
- inter-connectedness (including intra-group and between banks);
- potential for the bank to cause contagion (drawing on the contagion criteria referred to below);
- substitutability of systemically important financial functions (including considerations related to the concentrated nature of the banking sector); and
- complexity (including any complexities arising from group structures and the location of essential banking functions in subsidiaries, and cross-border activity).

32. The systemic impact assessment should be undertaken not just for the bank on a solo entity basis, but also on a banking group basis (i.e., taking into account the systemic impact of the failure of subsidiaries of the bank), where banks have significant business in subsidiaries.

33. As part of the systemic impact assessment, contagion risk should be assessed. The analysis would appropriately include an assessment of:

- contagion via inter-bank exposures;
- contagion arising from related party exposures, such as credit exposures to parent banks and other substantial shareholders;
- credit rating downgrade risks associated with parent bank stress;
- reputation impacts associated with parent bank or other major shareholder distress;
- contagion risks associated with functional dependencies between banks with common shareholdings;
- contagion via banks having common credit exposures (e.g., syndicated lending, where the failure of one bank to meet commitments under a syndicated loan could impact the other banks in the syndicate);
- the contagion impact of bank defaults on interest rate and foreign currency derivatives (i.e., requiring other banks to replace interest rate and currency contracts they had with

the failed bank, and the potential difficulty in doing so under stressed conditions, possibly leaving them with unhedged exposures); and

- confidence-linked contagion risks and the potential for a generalized depositor run on banks.

34. Special considerations are needed if the bank is deemed to be systemic. Systemic banks contain functions that need to be continued. Options may include the recapitalization of the bank or transferring critical functions and services and relevant assets and liabilities to a bridge bank or an existing bank. The resolution manual should set out the generic functions that would normally be regarded as critical functions required for systemic stability. It would also include guidance on what quantitative thresholds might appropriately be applied by CBS in determining, as part of bank-specific resolution plans, whether particular banks have sufficient critical functionality as to warrant a form of resolution that maintains the continuity of these functions (i.e., an “open resolution,” in essence). See later in this appendix.

#### ***Step 5b: Resolution strategies and implementation of resolution***

35. The resolution authority is responsible for determining the appropriate resolution strategy for both systemic and non-systemic financial banks. The standard resolution options that would normally be considered are set out below, including the circumstances in which each resolution option may be appropriate.

36. ***Option 1: Closure of a bank and pay-out of insured deposits (if deposit insurance is established) or preferred deposits (if depositor preference is relied on), followed by liquidation of the bank.*** This would involve appointment of statutory manager/resolution agent to the bank and withdrawal of the bank from all payment channels. Eligible deposit balances would be calculated on the basis of end-of-day positions. CBS (or a deposit insurer if one is established) would confirm the amount to be paid to each depositor, capped at the level of the deposit insurance or depositor preference cover per depositor/deposit category. Payments would then be made to depositors, generally via a bank appointed as the paying agent, funded by the deposit insurance fund if one exists. Payments should be made as soon as practicable following the closure of the bank, and desirably within seven days.

37. Option 1 might be appropriate if:

- a. the bank is nonviable;
- b. the bank cannot recover; i.e., there is no prospect of shareholder support or external financial private sector support in the required timeframe;
- c. no other bank is prepared to acquire equity in the failing bank or to assume deposit liabilities (either total or solely insured deposits) and acquire assets from the failing bank;

- d. closure of the bank would not have a significant adverse impact on the stability of the financial system or economy; and
- e. closure and pay-out is a lower cost option than the alternative closed resolution options (such as P&A).

38. **Option 2: Closure of a bank and transfer of insured deposit accounts and performing assets to a receiving bank (either an existing bank or a bridge bank)—referred to as a purchase and assumption (P&A) form of resolution.** This would involve appointment of a statutory manager/resolution agent to the bank and withdrawal of the bank from all payment channels. Eligible deposit balances would be calculated on the basis of end-of-day positions. CBS (or a deposit insurer if one is established) would confirm the amount to which each depositor is entitled, capped at the level of the deposit insurance cover per depositor (if deposit insurance is established) or the depositor preference cap. The deposit accounts (together with the legal right to operate associated IT systems) would be transferred to an acquiring bank willing to assume the deposit liabilities or to a bridge bank established for the purpose. The acquiring bank/bridge bank would administer the failed bank's IT systems required to operate the deposit accounts. The deposit accounts would operate as usual, with no change of account numbers, once transferred to the receiving bank. The receiving bank would purchase assets from the failed bank at market value. If only insured/preferred deposits are transferred (if deposit insurance is established), the deposit insurer would fund any shortfall in assets over deposit liabilities.

39. If uninsured deposits are also transferred, the deposit insurer (if one is established) would provide funds up to the amount of insured deposits and the resolution authorities will fund the remaining gap. The failed bank would then be wound up through the insolvency law arrangements, and the deposit insurance agency (if one exists) would have a subrogated claim of the insured depositors on the assets of the bank in liquidation.

40. A similar process would apply in the case of a depositor preference system, such that preferred deposits would be transferred to the acquirer and any funding gap relative to transferred assets would be met by a resolution funding source. If there are sufficient assets to fund the transfer of nonpreferred deposits (in addition to preferred deposits), then nonpreferred deposit liabilities could also be included in the P & A transaction.

41. For a P&A transaction to be effective, it requires the deposit insurance agency/resolution authority to pre-identify banks with the prudential and operational capacity to assume at least the insured deposits/preferred deposits and acquire performing assets, and associated critical functions and systems, of the failing bank. This should be done through regular assessments of suitable candidate banks. If there is sufficient time leading up to the invoking of resolution, the deposit insurance agency/resolution authority would require the candidate banks to submit bids for the eligible business of the failing bank, and would select the bank on the basis of least cost to the deposit insurer and suitability of the candidate bank. (See section on P&A.)

42. Option 2 might be appropriate if:
- a. the bank is nonviable;
  - b. the bank cannot recover; i.e., there is no prospect of shareholder support or external financial private sector support in the required timeframe;
  - c. no other bank is prepared to acquire equity in the failing bank;
  - d. one or more banks are willing to assume the deposits (either all deposits or at least insured deposits), funded either fully by the deposit insurance agency or funded through a combination of deposit insurance funding and assets transferred to the acquiring bank.;
  - e. closure of the bank would not have a significant adverse impact on the stability of the financial system or economy; and
  - f. closure and transfer of insured deposits is assessed as being a lower cost option than the alternative closed resolution options (such as payout).
43. *As the third option, P&A option could also be conducted through the transfer of most or all of the failed bank's assets, liabilities and business functions to another existing bank or a bridge bank.* This would involve the acquiring bank or a bridge bank purchasing a broader range of the failed bank's business; e.g., it might involve the transfer of derivatives contracts, insurance business, ownership of key subsidiaries, etc.).
44. It would involve the appointment of a statutory manager/resolution agent to the bank and the withdrawal of the failed bank from the payment systems. An assessment would be made of the systemically important and otherwise viable business and associated functionality that is to be transferred to either an existing bank willing to acquire this business or to a bridge bank established for the purpose. The business to be transferred (most likely including all critical functions and performing assets) would be valued and transferred at assessed market value.
45. If the assets to be transferred at least equal the liabilities to be assumed by the acquiring bank, then no resolution funding would be required. A surplus of assets relative to liabilities transferred would entail payment of the net amount to the account of the bankruptcy estate of the failed bank. A deficiency in assets relative to liabilities transferred would require funding from either the bail-in of uninsured and unsecured liabilities (where feasible), the deposit insurance agency (if there is one) or the government (as a last resort only). A deposit insurer's funding would be capped at the amount it would have paid (net of recoveries) under a least-cost deposit insurance pay-out or insured deposit account transfer, where deposit insurance exists.
46. The failed bank, including any nonperforming loans that are excluded from the transfer would be closed, and its residual business wound up under insolvency law. Ex post compensation would be paid to creditors, respectively, to the extent they were rendered worse off

than under a conventional winding up had the bank been retained whole and wound up, applying the statutory ranking of claims in winding up.

47. Option 3 might be appropriate if:

- a. the bank is nonviable;
- b. the bank cannot recover; i.e., there is no prospect of shareholder support in the required timeframe;
- c. the closure of the bank would have a significant adverse impact on the stability of the financial system;
- d. at least one suitably capitalized bank is able and willing to acquire the systemically important business of the bank, or a bridge bank could be established to acquire the relevant business. (The latter would be an option where no existing bank is willing or able to immediately acquire the systemic business of the failed bank. This option should be used with great caution, however, as bridge banks are inherently difficult to operate and if not well designed, may crystalize significant costs for taxpayers over the medium term); and
- e. the implementation of the P&A tool would not create market concentration concerns (and if such concern does exist, then a bridge bank could be used).

48. **Option 4: Sale of the bank to another bank.** This would involve placing the bank into administration and selling a majority shareholding position to an acquiring bank. This could be done by cancelling existing shares (assuming the powers were in place to do this), with compensation to shareholders for the assessed value of the shares (if any) under a ‘no creditor/no shareholder worse off’ framework and issuing new shares to the acquiring bank. Alternatively, it could be achieved by issuing new shares to an acquiring bank and diluting existing shares to their assessed market value, resulting in the acquiring bank assuming a controlling shareholding. In either case, the distressed bank would be recapitalized to the appropriate target level (i.e., sufficient to comfortably exceed the regulatory requirements and to maintain an acceptable credit rating and maintain depositor and investor confidence).

49. Option 4 might be appropriate if:

- a. the bank is nonviable;
- b. the bank cannot recover; i.e., there is no prospect of shareholder support in the required timeframe;
- c. the closure of the bank would have a significant adverse impact on the stability of the financial system;

- d. at least one suitably capitalized bank is able and willing to acquire either 100 percent or a majority shareholding in the bank, sufficient to recapitalize the bank to the required target level; and
- e. the acquisition of the failed bank by the acquiring bank would not lead to excessive market concentration or systemic risk.

50. **Option 5: Recapitalization of the bank through bail-in.** This option would involve appointing an administrator to the bank, assessing the worst-case capital position of the bank (taking into account the need for any capital support to essential subsidiaries) and determining the amount of capital required to meet a target capital ratio sufficient to comply with capital requirements and maintain market confidence and credit ratings. Subject to the law, bail-in could be implemented via a number of routes, including by write-down or conversion of applicable liabilities (being either contractual loss-absorbing debt issued as an additional tier 1 or tier 2 capital instrument or otherwise through statutory bail-in of unsecured and uninsured liabilities) to an equity instrument that ranks equal to the diluted equity of existing shareholders or converted to preference shares that rank above existing equity and that would qualify for inclusion in CET1. Liabilities would be bailed-in in the inverse order of their ranking in a winding-up; i.e., the lowest ranking liabilities (such as loss-absorbing capital-eligible debt instruments or subordinated debt) would be bailed-in first, followed by senior unsecured bonds, followed by uninsured deposits, etc. Insured deposits would be exempted from bail-in but the deposit insurance agency would bear the bail-in cost if it had subjugated their claims. If no deposit insurance exists, but a depositor preference arrangement applies, then preferred deposits would likely be exempted from bail-in. Some other liabilities might also be exempted from bail-in, potentially including liabilities payable to suppliers of essential services and liabilities in relation to derivatives required to maintain balance sheet hedges.

51. Bail-in can be achieved through different mechanisms, as discussed later in this note.

52. Option 5 might be appropriate if:

- a. the bank is nonviable and cannot recover; i.e., there is no prospect of shareholder support in the required timeframe;
- b. the bank has sufficient loss-absorbing debt, subordinated debt and senior unsecured debt (excluding insured deposits) to be a source for recapitalization, either through conversion to equity or other eligible capital instrument or write-down, after first writing down existing equity;
- c. the closure of the bank would have a significant adverse impact on the stability of the financial system; and
- d. bail-in would not trigger contagion or other systemic disruption on a significant scale. Bail-in is more likely to be a viable solution for an idiosyncratic bank failure, where the other banks in the financial system are in a prudentially sound condition and market

confidence in the banking system as a whole is reasonably strong. Bail-in is generally dependent on banks having a tranche of loss-absorbing capital in the form of senior or subordinated debt that can be contractually converted to equity or written down upon specified nonviability triggers but can also be applied using statutory bail-in powers (if they exist) to other forms of junior unsecured debt. Bail-in is less likely to be an attractive option in the case of multiple bank distress and where the bail-in of one bank could trigger a contagious run on other banks.

53. **Use of public support as a last option:** Under some extreme conditions, the above resolution options may not be possible and some form of temporary public financial support may be the only way to avoid widespread financial contagion and collapse. In times of significant contagion risks, when markets are dislocated or frozen, the failure of a SIB could exacerbate contagion and undermine confidence. If bail-in is not feasible, the temporary use of public funds may be the only viable alternative.

54. This option requires a careful review of the bank's capital position, including on a forward-looking basis and including the need for any capital support to essential subsidiaries, and determining the amount of capital required to meet a target capital ratio sufficient to comply with capital requirements and maintaining market confidence and credit ratings. Recapitalization would be implemented by the issuance of shares to the government (either directly or via a government-owned entity) sufficient to achieve the target capital ratio. This would be a last resort option where all other options (including bail-in) have been assessed and found to be nonviable or systemically destabilizing. Government-funded recapitalization should occur only after existing shareholders have been fully bailed-in, such that their shares are either cancelled (if of no value or very little value) or diluted to the assessed market value. Subordinated debt should also be bailed in.

55. The government's shareholding could either take the form of ordinary shares with full voting rights or preference shares with full or limited voting rights (where existing shareholders and bailed-in creditors hold a substantial proportion of total equity). In either case, the government should ensure that it prices the shares it holds, and any other support it provides (e.g., guarantees or indemnities), at appropriate commercial pricing to ensure that taxpayers are compensated for the risks involved. It should also ensure that it has sufficient control of the bank to manage all risks arising from its equity stake and other forms of support it provides.

56. The use of public resources should be subject to strict conditions and robust safeguards to protect taxpayers and prevent competitive distortions. Specifically:

- **Systemic stability:** Use of public resources should be a last resort, limited to cases that threaten the financial system or jeopardizing the continuity of essential payment, clearing, and settlement functions.
- **Loss recognition:** All unrecognized losses must be recognized and the bank's equity and other capital instruments written down for the losses.



- **Restructuring:** Solvency support needs to be combined with a comprehensive restructuring plan that restores long-term viability. That plan should include time-bound, monitorable targets and recipients must be subjected to strict supervision and enhanced reporting requirements.
- **Recovery:** Use of public resources should be repaid within a reasonable timeframe, either through participating in asset recoveries of the failed bank or through special levies on the industry.

Option 6 requires great caution and should only be considered as a last resort measure when financial stability is severely threatened, i.e., at times of acute contagion risks, when placing institutions in resolution will likely exacerbate the risk of contagion and further undermine confidence. Prior conditions for public solvency support should include all losses first being recognized (and equity capital written down) before public funds are injected, to avoid bailing out shareholders. If losses exceed equity capital, attribution of losses to other creditors will be a key decision in the resolution strategy, balancing financial stability with cost minimization and moral hazard concerns

### Criteria for selecting resolution options

57. **The selection of the resolution option will depend on many considerations.** The relevant factors will typically include the following:

- The impact of the potential closure of the bank (especially its critical functions and services) on the stability of the financial system and economy.*** In general, a bank whose closure would have little impact on the stability of the financial system and real economy could be subject to a closed resolution, whereas a bank whose closure would have significant adverse impact on the financial system or economy would generally be subject to an open resolution (at least in respect of its critical functions and services). For banks with significant potential adverse impact on the stability of the financial system and real economy, the key focus should be to ensure that the form of resolution adopted maintains continuity of critical functions and services with minimum interruption and disruption. It should also seek to avoid or at least minimize contagion risk and adverse impacts on confidence in the financial system and economy. See the next section for a brief discussion on the factors relevant for assessing systemic impact.
- The cost of resolution.*** Subject to meeting financial stability and real economy impact considerations, the resolution option selected should generally be the one which involves the lowest cost of implementation, including the costs (measured in terms of Net Present Value (NPV)) of:
  - loss of value from assets upon disposal;
  - cost of recapitalization (if applicable);
  - costs associated with guarantees and indemnities (if applicable);

- legal, accounting and other professional fees;
  - tender costs (where applicable); and
  - administration costs.
- c. ***Protection of insured depositors (or preferred depositors in a country without deposit insurance)***. Whichever form of resolution is selected, it should ensure that insured depositors (if a deposit insurance scheme exists) or preferred depositors are provided with prompt access to 100 percent of their insured deposits at minimum inconvenience. Any closed resolution option should be designed to achieve this, either via prompt payout to insured depositors (e.g., via an agency bank selected by the deposit insurance agency/resolution authority or the payment infrastructure of the failed bank) or transfer of insured deposit accounts to another bank via a P&A process. Under an open resolution, insured deposits, as with most other deposits, would be preserved with minimal interruption to access through either a recapitalization of the bank, or a bridge bank or transfer of deposit accounts (insured and uninsured) to another bank. In any of these options, if there is a deposit insurance scheme, the deposit insurance agency's contribution to the resolution should be on a 'least cost' basis—i.e., the least amount required to be disbursed from the deposit insurance fund to ensure prompt access to insured deposits (including accrued interest thereon), net of recoveries from the balance sheet of the bank.
- d. ***Impact on public funding***. The resolution option selected should, in principle, involve zero public funding (including the costs and risks associated with guarantees and indemnities). For closed resolutions, this would generally be achieved by ensuring that the deposit insurance fund (if there is one) is sufficient to meet expected claims under a plausible range of bank failure situations and that any supplemental funding required is fully reimbursed (in NPV terms) from the banking industry. For open resolutions, the least impact on public funding is generally achieved by ensuring that shareholders and other capital providers absorb losses to the maximum extent of their legal liability and that, where practicable, other liabilities are bailed-in to absorb remaining losses if necessary. However, in some situations, public funding might be unavoidable; e.g., in an open resolution in which losses exceed shareholders' funds and other capital, and where bail-in is considered to be destabilizing for the financial system. In that situation, if public funding is provided, then it should be on the basis of commercial pricing (e.g., for capital funded by the taxpayer and for guarantees and indemnities) and with any amounts in NPV terms being recovered from levies on the banking industry to the extent that the assets of the resolved bank are insufficient to meet these amounts.
- e. ***Impact on moral hazard and market discipline***. The resolution option selected should seek to minimize moral hazard risks and preserve or enhance market discipline on the financial system. This is best achieved by ensuring that losses are borne by shareholders, other capital instrument holders and then creditors in the order of their claims in a winding up, with zero or minimal contribution from the taxpayer.

- f. ***Impact on competition and financial system efficiency.*** The resolution option selected should be designed to minimize adverse impacts on competition and financial system efficiency. Resolution options that lead to significantly reduced competition tend to have adverse impacts on financial system efficiency; e.g., via higher margins, reduced range of financial services, greater market concentration. The closure of many small banks create this risk. Likewise, the merger of large or medium-sized banks can result in excessive market concentration and reduced competition and efficiency in the financial system.

### ***Aspects of resolution implementation***

#### ***A. Legal framework***

58. The resolution manual should include the relevant documents that provide the legal foundation for resolution. Typically, implementing the resolution of a failed bank involves affecting shareholder and creditor rights. Accordingly, the resolution authorities need to have easy access to the legal basis and legal documents supporting their activities. While admittedly, the resolution staff will be fully aware of their legal rights, having access to the specific documentation in the midst of an emerging crisis and save time and make the process more effective.

#### ***B. No creditor worse off***

59. In any form of resolution, the principle of ‘no creditor (or shareholder) left worse off’ than under liquidation should be applied, such that creditors and shareholders are compensated to the extent that the resolution option chosen left them worse off than had the bank been retained whole and liquidated under conventional insolvency law. The manual should set out the procedures to be followed for assessing what the outcome (in net present value terms) would have been for shareholders and each category of creditor under a conventional winding up so as to determine whether any compensation is payable to the affected parties. This would involve undertaking a “counterfactual” valuation of the estimated recoverable value of assets of the failed bank in a winding up through an independent valuation process. The assessed valuation, and any compensation, should be subject to robust transparency and accountability arrangements, with scope for the affected parties to challenge the valuation through court processes, and where the courts have the capacity to impose alternative valuations if reasonable cause is found for doing so.

#### ***C. Communications and coordination***

60. Communications and coordination are essential in a crisis. For each resolution strategy, the manual needs to identify what communications need to be made to each category of stakeholder (including depositors, the wider public, banks, other financial institutions, foreign counterparties, foreign regulators, rating agencies, news media and social media). The manual should identify the key information to be conveyed to each category of stakeholder and which agency has responsibility for each element of this. It should also include the development of

checklists for the issues to be considered by each agency in preparing media statements and other forms of communication.

61. There must be clear and concise guidance on public and other stakeholder communications. For example, if, in an open resolution, most or all of the business of the bank is to be maintained, the resolution authority needs to be ready to publicly announce at the time an administrator is appointed the intended scope of business of the bank under administration, which obligations will be continued, and which will be suspended. Clarity and certainty are crucial for counterparties, depositors, and other stakeholders. The communications strategy should include an identification of the information to be conveyed by each agency, to each category of stakeholder, the timing of each communication in the resolution process and the channels used for communications. Key stakeholders will include:

- depositors of the bank being resolved;
- depositors in other banks;
- other creditors of the bank being resolved;
- borrowers of the bank being resolved, especially those with overdraft and other committed credit facilities;
- the management of other banks;
- the financial institutions which meet their payment obligations through the bank being resolved;
- foreign regulators (e.g., of the foreign banks operating in the country); and
- the financial news media and general news media;
- social media; and
- the general public.

#### *D. Cross-border coordination and cooperation*

62. The manual needs to include guidance on cross-border coordination and cooperation. Matters that should be covered in this area include the following:

- a. A clear delineation of resolution responsibilities between the parent authorities (the prudential supervisor/resolution authority and ministry of finance in the home and host countries. These should be documented in either a multilateral MoU (for all agencies) or bilateral MoUs.

- b. Identification of information exchange arrangements between the respective agencies, based on the above-mentioned MoU(s).
- c. Coordination of the development and enforcement of recovery plans, resolvability assessments and resolution plans, such that the recovery plans and resolution plans for the subsidiary banks in the host country are informed by, and not materially inconsistent with, the parent bank recovery and resolution plans.
- d. Processes for coordinating the solvency/capital assessment and liquidity assessment for the parent banking group and subsidiaries in the host country.

63. Process for coordinating the identification and assessment of resolution options. This is especially important for recapitalization options for the subsidiary, drawing on the two generic models for group-based recapitalization: Single Point of Entry (SPE) and Multiple Points of Entry (MPE).

64. Under an SPE model, the recapitalization of the subsidiary in a host country would be performed at the parent level, either via bail-in of liabilities in the parent bank, bail-in of liabilities in the subsidiary (in exchange for shares in the parent bank) or external injection of capital into the parent bank, with the capital being cascaded to the subsidiary in the host country.

65. Under an MPE model, the recapitalization of the subsidiary in the host country would be performed at the level of the subsidiary, either by bail-in of liabilities of the subsidiary or injection of capital into the subsidiary by the government or another party approved by the CBS. Under an SPE approach, the parent bank remains the shareholder of the subsidiary. However, under the MPE approach, the subsidiary might cease to be a member of the parent banking group, reflecting its new shareholding arrangements. In that event, it would be necessary to ensure that contractual arrangements are entered into between the subsidiary and parent bank for all essential functional support provided by the parent bank to be continued (on commercial terms).

### **Procedure for conducting a P&A transaction**

66. The process for implementing a P&A must be clearly laid out in decrees and resolution manuals. The P&A process involves valuing a bank, marketing it, soliciting and accepting bids for its sale, and working with an acquirer through the closing process. These tasks include:

- a. Resolution preparation;
- b. Marketing strategy;
- c. Legal documents;
- d. Potential acquirers;
- e. Marketing presentation;
- f. Due diligence;
- g. Bid acceptance;
- h. Contract signing;

- i. Closing the transaction; and
- j. Public awareness.

### ***Resolution preparation***

1) When a problem bank is dealt with swiftly, asset and franchise values are preserved, generating maximum return. This makes the failing bank more desirable to potential acquirers and lowers the ultimate cost of resolution. Resolution preparation involves four steps:

- Compiling Initial Information;
- Asset Valuation;
- Completion of a financial information package (Bid Package); and
- Marketing Meeting Logistics.

2) In preparing for the P&A, specialized staff may be needed including an asset valuation specialist and a marketing specialist.

### ***Initial information***

3) The resolution authority must gather preliminary information regarding the bank. Such information includes:

- Bank premises and owned property:
  - Location and number of main offices and branches;
  - Number of employees at each location;
  - Records maintained on site (at each location);
  - Banking premises owned or leased;
  - Recorded value;
  - Other tenants; and
  - Information system—computerized or manual.
- Loans including:
  - Name and amount of major debtors;
  - Insider lines (directors, officers, shareholders, affiliates); and
  - Loan classifications.
- Deposits
  - Number and value of deposits at each location;
  - Name and amount of major depositors;
  - Insider depositors (directors, officers, shareholders);
  - Distribution of depositors; and

- Debtor/depositor relationships (for potential offsets<sup>6</sup>).
  - Borrowings—secured and unsecured;
  - Subsidiaries;
  - Contingent liabilities;
  - Trust Department activities;
  - Ownership structure;
  - Enforcement actions pending;
  - Litigation; and
  - Other—leases, contracts, etc.
- 4) This preliminary information will give the marketing specialist an idea of the condition of the bank and will likely affect the decision as to what type of transaction to offer. A more comprehensive information package (discussed below) will be prepared for potential acquirers' review.

### ***Asset valuation***

- 5) The supervisory authority staff or other experts must estimate the worth of a bank's assets. Because time is of the essence, there is not enough time to appraise every asset, so models may be used to provide statistical sampling. They can divide the assets into categories, identify a sample, and carefully review the assets to establish a liquidation value for each asset.
- 6) The liquidation value is derived from the future cash flows and the expenses likely to be incurred during the collection of the asset. Adjustments can be made to discount future cash flows and to account for liquidation expenses. The loss factor that results from that estimate is then applied to the category from which the sample was taken.
- 7) When all categories are sampled and evaluated, the loss factors are aggregated and extrapolated to the bank as a whole. This computation will produce a loss factor, or cost of liquidation, which will be used in assessing bids from potential acquirers.

### ***Bid package***

- 8) The bid package should build on the initial information include detailed data on the amounts and types of assets and liabilities that the failing bank holds. The information may vary from bank to bank, depending on business strategy as reflected in the asset and liability structure. Some of the more important information contained in the bid package includes:
- Demographic information, including market area, population, history of bank, customer type, competition;

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<sup>6</sup> Depending on local law.



- Schedules that represent the book value of items that comprise bank's balance sheet:
  - Cash and equivalents—due from banks spread by Bank name, term and interest rates;
  - Investment securities—separated by marketability, and listed by name, term and interest rates;
  - Loans—summary reports by type (commercial, real estate, installment, credit cards, etc.), concentrations of credits, maturity, interest rate, etc., including accrued interest receivable. Provide separate reports for local currency and each foreign exchange currency used;
  - Fixed assets—location of bank premises, including branches, appraisals (if available), terms of leases and leasehold improvements (as applicable), computer and other equipment, furniture and fixtures, applicable insurance coverage. Distribution of ATM machines, itemizing the number of operations per day, per location, and the mean volume per transaction;
  - Other real estate—individually listed by name, location, book value, and appraised value (if available);
  - Subsidiaries—name, type, purpose and status (active or dormant);
  - Other assets—detailed listing;
  - Deposit base—summary reports reflecting cost of deposits, by type (demand, savings, time) and maturity, including accrued interest payable. Detailed listing of individual deposits, concentrations, and number of debit cards Provide separate reports for local currency and each foreign exchange currency used;
  - Borrowings—identified by name, term and interest rates;
  - Guarantees—identified by name and other details (including obligations regarding term, interest rates, etc.);
  - Other liabilities—detailed listing;
  - Contingent liabilities; and
  - Capital accounts—include recent income and expense statement.
- Detailed description of the data processing facilities:
  - Description of the communications map;
  - Description of the security modules (redundant files, back-ups, etc.); and

- If the data processing is outsourced, it will be necessary to include the contract, with any negotiations underway, as well as the terms and scope of the service so acquired.
  - Employees—short biographies of key management personnel, unusual situations (golden parachutes, onerous employment contract obligations), chart of ALL employees: titles, number, capabilities, training and salaries if possible;
  - Contracts—detailed listing of all contracts, whether the bank is party as provider or receiver of goods or services; and
  - Litigation—Detail of pending court cases, including a legal opinion estimating the outcome and foreseeable consequences for the bank.
- 9) Both the asset valuation and the bid package are proprietary and strictly confidential. Although the bid package will be provided to potential acquirers, the asset valuation will not.

### ***Marketing presentation logistics***

10) The marketing specialist should estimate the necessary time for completion of the asset valuation and the bid package, so that a presentation can be scheduled for potential acquirers. Confidentiality Agreements will need to be prepared for all potential acquirers who will be invited.

11) Once the information mentioned above has been compiled, the marketing specialist can begin determination of the best transaction form to offer potential acquirers. Some factors that affect the marketing strategy are:

- Asset and liability composition of the failing bank;
- Competitive and economic conditions of the bank’s market area;
- Prior resolution experience in the same market; and
- Other relevant information (such as potential fraud at the bank).

12) Some of the questions that must be answered to determine the appropriate form of the transaction are:

- What types or categories of assets will be offered?
- How should the assets be packaged?
- How should the assets be priced?

13) P&As with put options on assets allow acquirer to perform due diligence after transaction (although this “cherry-picking” often leads an acquirer to neglect servicing questionable assets).

14) Under the P&A concept, assets and insured deposits of the failed bank are transferred to bank at market value. If there are not enough “good” assets to balance the amount of insured

deposits, the deposit insurance scheme must advance the cash to balance the transaction--assets must equal liabilities.

15) This resolution technique will try to include as many assets as possible in the transaction while being sure that they are of adequate quality so as to not jeopardize the financial position of the acquirer.

16) Some examples of the forms a P&A can take are:

- **Whole Bank**—where a resolution authority pays an acquirer to take virtually all assets and liabilities of a failed bank).
- **Clean Bank**—some good assets are sold to an acquirer who also assumes insured deposit liabilities. There are many variations of the asset sale. It can include:
  - Put back rights;
  - Exclusive asset purchase options; and
  - Representations and warranties.

17) Of these, the exclusive asset purchase option is the simplest. The liquidator, or receiver, may lack funds to pay for assets put back, and asset quality is usually insufficient to justify representations and warranties.

18) The basic P&A Agreement is adaptable to change. The provisions of the P&A should be accommodating enough to return the greatest value for the failed bank. When liquid assets are sufficient to cover payment of insured deposits, a good strategy may be to offer a P&A with exclusive option to purchase certain assets. This will give an acquirer enough time for asset review to determine which ones meet their criteria. Purchase of additional assets may fund payment of all or part of uninsured deposits and other creditors, and will quickly return assets to the private sector.

19) Another alternative is to pass assets at book value initially and then provide for third-party valuation after the fact. The government and the Assuming Bank can each hire an independent auditing firm to value the assets and negotiate from the two results. If there is more than a ten percent variation between the two reports, a third can be ordered.

### *Legal documents*

20) There are several standardized documents for a P&A transaction. The legal staff will need to review to ensure compliance with applicable legislation. Briefly, the documents include:

- **Confidentiality Agreement**—this agreement must be signed by any bank or investor group who is interested in receiving any information regarding the pending transaction.

Confidentiality is paramount in order to maintain public confidence and limit competitive abuse

- **Deposit Transfer Agreement**—the Deposit Transfer Agreement identifies the deposits, terms and conditions under which they are to be assumed.
- **Asset Sales Agreement**—this document comprises the terms and conditions of any assets to be sold as part of a problem bank resolution.
  - These two documents can be combined to create various P&A Agreements as discussed above.
  - In all these agreements, the acquirer is indemnified for any actions of the failing bank prior to failure, unless expressly assumed. (This is not a monetary indemnification, but a legal re-direction of claims to the receiver.)
- **Interim Asset Servicing Agreement**—this agreement requires an acquirer to responsibly service specific assets for a certain period. This can apply in cases where the acquirer has an exclusive purchase option on assets, or when the liquidating Supervisory Authority lacks personnel to service their assets
- **Escrow Agreement**—this provides an opportunity to consummate a P&A in advance of the scheduled bank closing. It assures both parties that commitments will be honored
- **Bid Agreement Form**—a legal document and form that commits the potential acquirer to abide by the restrictions of the resolutions process and pay the amount specified

### *Potential acquirers*

21) A P&A transaction provides an acquiring bank to either increase market share or to expand into areas where the acquirer does not have a presence. Paying a premium for deposits and options on banking premises is much more cost-effective than obtaining premises and soliciting deposits on a *de novo* basis. (In the U.S., estimates are that the acquirers in these types of transactions retain approximately 70 percent of deposits.)<sup>7</sup>

22) In many cases, it may be prudent to maintain a database of approved banks and investors that are interested in establishing bank operations in the country. When evaluating investor groups for approval, the resolution authority must consider, among other factors:

- The length of time required for licensing a new bank;
- Whether the investor group can raise sufficient capital; and

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<sup>7</sup> In many countries, banks do not seem to recognize this opportunity; occasionally it is necessary to pay a fee to an agent bank to make repayment of deposits on behalf of the Deposit Insurance Agency or Supervisory Authority.

- Whether the investor group can provide competent management.

23) The supervisory authorities and the resolution authority must be confident that those parties on the list are strong enough to acquire a failed bank and sustain profitable operations. The supervisory authority should keep track of any seriously interested bank or investor group and provide that information to the Marketing specialist.

### *Marketing presentation*

24) After potential acquirers have been identified they should be contacted and invited to a marketing presentation. Registration forms and Confidentiality Agreements should be mailed or faxed to the potential acquirer. Neither of these forms should identify the failing bank under consideration. Potential acquirers should return a copy of each of the forms. This will guide the marketing specialist in preparing the appropriate number of information packages. The potential acquirers should retain the original forms and present them as their admission tickets to the marketing presentation.<sup>8</sup>

25) Before the meeting, the marketing specialist should ensure that logistical requirements of the meeting are met. There should be adequate amounts of chairs and tables. Any audio-visual equipment (e.g., microphones, overhead or slide projectors, personal computers for PowerPoint presentation, etc.) should be tested.

26) At registration, an information package consisting of financial data, legal documents, transaction description, and other material should be provided to each potential acquirer. (More than one representative from a potential acquirer may attend the presentation, but only one package should be provided.)

27) The marketing specialist should cover the following topics:

- **Financial data on the bank**—this should consist of applicable portions of the Bid Package discussed above redacted of any confidential information.
- **P&A transaction summary**—provide a sample pro forma balance sheet, clearly marked “For Reference Purposes Only,” that demonstrates the financial effects of the transaction. It should show the effect of the required assets to be purchased and deposits to be assumed. Optional asset purchase opportunities can be on other schedules.
- **Legal summary**—a resolution authority attorney should make a short presentation describing the nature of the transactional documents and be available to address legal issues.

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<sup>8</sup> Where there is expected to be a limited amount of interest in acquisition of a problem bank, this process can be conducted in a more informal manner.

- **Regulatory requirements**—briefly describe the capital and other requirements of a new or enlarged bank.
- **Due diligence scheduling**—potential acquirers should have the opportunity to go onsite and examine the relevant records of the failing bank. Depending on the nature of the proposed transaction and the size of the failing bank, this could range from 1 day to 1 week or more. The marketing specialist should provide contact information for due diligence scheduling.
- **Bid process**—the Bid Agreement Form, provided in the package of materials, spells out the legally binding process for bid acceptance. The marketing specialist should estimate the time needed for due diligence and establish tentative dates for bid acceptance and closing of the transaction.

28) The marketing specialist should clearly advise potential acquirers that they are not to discuss the bank failure or the impending transaction with any failed bank employee, bank’s vendors, lessors, attorneys, or accountants prior to the actual closing of the transaction. Any such communication is a violation of the Confidentiality Agreement. The marketing specialist should stress that potential acquirers are strictly prohibited from contacting other potential acquirers regarding any aspect of the process.

### *Due diligence*

29) Due diligence is the potential acquirers’ onsite inspection of the premises, records, and operations of the failing bank. Due diligence allows the potential acquirers to assess the franchise value and calculate a knowledgeable bid amount.

30) Approved potential acquirers will have the opportunity to go onsite and examine the relevant records of the failing bank. The potential acquirer must have completed a Confidentiality Agreement and should be reminded of the need for confidentiality regarding the transaction. The confidentiality agreement is a legally binding document and violations are subject to criminal penalties.

31) Potential acquirers should be granted adequate review time, keeping in mind the urgency of the resolution process. If the failing bank is relatively small and/or the contemplated transaction is a deposit transfer with no asset sales, due diligence may be accomplished in a day or less. On the other hand, a larger bank in a transaction with possible asset sales may require a week or more. In cases of lengthy due diligence, appropriate financial information may be updated and provided to all potential acquirers.

32) Policies regarding record review access must be developed. For example, to prevent customer raiding, due diligence policy may dictate providing depositor information represented only by account numbers, with no names and addresses (if possible). More

access should be allowed in asset review, because it is in the best interest of the Supervisory Authority to divest as many assets as possible.

33) Copying of the failing bank's records should be prohibited, although handwritten notes or personal computer-generated information may be permitted. Additionally, the potential acquirers conducting due diligence should not have access to:

- board minutes;
- Supervisory examinations; and
- Personnel or other sensitive records.

### ***Bid acceptance***

34) After all potential acquirers have finished due diligence, they will submit their bids to the resolution authority. The bid amount (or premium) is the price a potential acquirer puts on the value of the transaction (asset purchase options, deposit base, branch network, etc.).

35) The resolution authority reserves the right to accept or reject any bid for any reason. After bids are received, the winner is selected. Because the P&A transaction is so simple, usually this is a matter of selecting the highest bid. When priced pools of assets have been offered as an option, however, more complex analysis may be necessary.

36) The winning bidder should be notified and a meeting to sign contracts should be scheduled. A reminder of the confidentiality of the process is appropriate at this point. Losing bidders should also be notified; however, again because of confidentiality concerns, the identity of the winning bidder should not be disclosed. The winning bidder is referred to as the "Agent Bank" in the P&A because they are assuming deposits as an agent of the Supervisory Authority.

### ***Contract signing***

37) To provide a comfort level to both parties to the transaction, the P&A contracts are signed several days prior to the actual closing of the bank. This eliminates last minute conditions or demands by either party. Authorized representatives from the resolution authority and the Agent Bank will sign the Deposit Transfer and Asset Sales Agreements, and, if applicable, the Interim Servicing Agreement. Both parties will also sign the Escrow Agreement. The Escrow Agreement merely states that the aforementioned documents were signed and put into escrow until the stipulated date. The Agent Bank receives only a copy of the Escrow Agreement. The other signed Agreements will be delivered to the Agent Bank at the time of the bank closing.

### ***Closing the transaction***

38) Bank failures can disrupt a community and undermine confidence in a banking system. Because it is critical to provide prompt access of customers to their deposits, a quick



resolution to the event is required. The final step in the resolution process is actually closing the bank and transferring the assets purchased and deposits assumed to the Agent Bank.

39) If the bank has been operating under conservatorship, much of the preparation for the final resolution can be done in advance. The final resolution will occur in a similar fashion to the initial intervention and appointment of a Conservator.

40) The resolution authority is responsible for settling the affairs of the closed bank. At the closing, the accounting team will prepare Pro Forma financial statements. According to the terms of the P&A Agreement, the team will:

- Balance the accounts of the bank;
- Transfer certain assets and insured deposits to the acquirer;
- Prepare a pro forma balance sheet demonstrating the division of assets and deposit liabilities that pass to an acquirer and those that remain with the liquidation; and
- Calculate any amount necessary to balance the transaction (assets purchased compared to deposits assumed, minus bid amount).

41) An efficient use of time is to close a bank at the usual time on a Friday, work through the weekend to prepare the Pro Forma, and allow the Agent Bank to re-open the bank as a branch the following Monday morning. The Agent Bank will sign Official Receipts documenting the assets and liabilities transferred to it.

42) On Monday, the Agent Bank will have access to the liquid assets purchased in an amount necessary to fund the transferred deposits. This will be based on the Pro Forma created over the weekend. If the Pro Forma is not completed, an estimate will be produced, subject to adjustment for errors and omissions.

### ***Public awareness***

43) When the bank is closed and the resolution authority appoints an administrator, the CBS issues a press release to inform the public. The press release should stress that the action is being taken to minimize the impact of a bank failure on the local economy, by finding an Agent Bank to handle deposits, and transferring assets into the private sector. The Agent Bank may also issue a press release; however, the P&A requires that the resolution authority approve it in advance.

### ***Bail-in***

44) Bail-in is the means by which subordinated and senior liabilities can be converted to equity or another form of eligible capital, or written down, to absorb losses and to facilitate

either the recapitalization of a bank in resolution or a bridge bank. The guidance below is drawn from the FSB and guidance prepared by IMF consultants.

45) In order to minimize the need for government funding and risks to the taxpayer, consideration should be given to the possibility of achieving some form of bail-in of existing bank debt, e.g., subordinated debt and possibly senior unsecured bonds. Bail-in could potentially be achieved by any of the following mechanisms:

- Requiring banks, as part of recovery planning requirements, to have a tranche of debt capable of being contractually converted to eligible capital instruments or written down upon defined triggers (such as the capital ratio falling below a trigger level).
- Using statutory powers to bail-in any unsecured debt instrument by converting it to an eligible capital instrument or write it down. The bail-in would apply to debt in a manner consistent with the ranking of claims in a winding up—i.e., lower-ranked debt in a winding up would be bailed-in before higher-ranked debt.
- Implementing a bail-in using P&A powers, whereby a tranche of debt is retained in the failed bank, such that the reduced level of debt transferred to a bridge bank provides the funding for capital in a bridge bank. A similar option would be to assess whether tranches of debt could be transferred out of the failed bank to a special entity established for the purpose if the decision were made to recapitalize the failed bank rather than establish a bridge bank. The creditors of the debt retained in the failed bank or transferred to the special entity, as the case may be, would be compensated ex post to the extent that they are left worse off than if the bank had been liquidated in its entirety (on the basis of the ranking of claims in winding up).

46) In the case of complex and SIBs or their groups, bail-in is one resolution tool for addressing their potential failure.

47) Using the bail-in tool as such consists in the write-down and conversion of capital and liabilities (that are not compulsorily excluded from bail-in treatment) to the extent sufficient to restore regulatory capital to the level necessary for continuation of the activities for which the bank is authorized (in particular identified critical functions) and to maintain sufficient market confidence. The bail-in tool as such is implementable on the basis of a decision by the resolution authority.

48) If resolution proceedings using the bail-in tool are to achieve their objectives, the tool must be implemented in a credible and transparent manner. This requires both sufficient preparation on the part of active participants in the process (i.e., the failing bank, the resolution authority, securities depositories, or other persons keeping records of affected instruments, and organizers of regulated markets) and the ability of market participants to anticipate each step taken throughout the resolution process.

49) This simplified bail-in process outlines the steps to be followed. When preparing this simplified process, the resolution authority relies on the applicable legal framework and the Principles on Bail-in Execution<sup>[1]</sup> issued by the FSB, and worked in a close cooperation with the Central Securities Depository, the Stock Exchange and the supervisors overseeing these FMIs. The proposed process uses the existing procedures, technologies and conventions of the above-mentioned FMIs to the maximum extent possible and takes into account the possible involvement of international central securities depositories (“ICSDs”).

50) The process deals with the implementation of the bail-in tool, that recapitalized the undercapitalized bank, The resolution authority must combine bail-in measures with broader restructuring policies to ensure the resulting bank is viable.

Step/Action	Responsibility	Description of Step/Action
1	Central Bank	<p>Before taking resolution action, the supervisors ensure that a fair, prudent and realistic valuation of the assets and liabilities of the bank is carried out, to provide information necessary to:</p> <ul style="list-style-type: none"> <li>a. decide whether the conditions for resolution are met (“<b>Valuation 1</b>”)</li> <li>b. determine the appropriate type and extent of resolution action to be taken in respect of the bank (“<b>Valuation 2</b>”)</li> </ul> <p>The valuation must be carried out by a person who has sufficient experience and knowledge in valuing banks and who is independent of the resolution authority, any other relevant public authority and the failing bank (“the independent valuation”). Where, due to urgency or other serious circumstances, it is not possible to conduct an independent valuation, the resolution authority will ensure that a provisional valuation of the bank’s assets and liabilities is carried out, with the independent valuation to be conducted as soon as possible.</p> <p>In relation to the central guiding principle of the resolution framework that no creditor shall incur greater losses than would have been incurred if the bank had been wound up under normal insolvency proceedings, the resolution authority will ensure that an independent valuation providing information on compliance with that principle (“<b>Valuation 3</b>”) is carried out. On the basis of Valuation 3, the resolution authority, no later than 1 year after the application of the resolution measure, will decide on any potential compensation in order to comply with the above principle. Creditors who registered<sup>[2]</sup> their claims with the resolution authority within 6 months after the bail-in decision became enforceable are the only creditors entitled to compensation.</p>
A	Central Bank/Resolution authority	<p>Based on the information from Valuation 1, the central bank will decide whether the bank is failing or likely to fail (“FLTF”). Subsequently, the resolution authority will assess whether the conditions for the use of the bail in tool have been met.</p>

Step/Action	Responsibility	Description of Step/Action
2	Resolution authority	<p>The resolution authority may introduce resolution administration. In line with the requirements, the resolution administration may be performed either by the resolution authority directly or by a special administrator.</p> <p>By virtue of the imposition of resolution administration, the exercise of the powers of the management body and of the supreme body of the liable entity is suspended and their responsibilities are exercised by the administrator.</p>
3	Resolution authority	<p>In the event of the failure of a bank whose instruments subject to bail-in (“the instruments concerned”) are admitted to trading on a regulated market, the resolution authority will inform the relevant regulated market operator without delay.</p> <p>Depending on the situation, the resolution authority will require the regulated market operator to suspend, delist or remove the instruments concerned from trading on the relevant regulated market.</p> <p>In order to enable the settlement of unsettled transactions in the instruments concerned that were traded before their suspension, delisting or removal from trading (“in-flight transactions”), the transferability of the instruments concerned will not be limited in any way (i.e., settlement, including suspended settlement, will be governed by the rules and procedures of the relevant settlement system operator).</p>
B	Regulated market operator	<p>Based on the obligation imposed by the resolution authority, the regulated market operator will suspend, delist or remove the instruments concerned from trading on the relevant regulated market for the time necessary for the implementation of the bail-in tool.</p>
4	Resolution authority	<p>The resolution authority will select a bank with adequate technical, procedural and governance capabilities and entrust it with administering the implementation of the bail-in tool (“the bail-in agent”).</p> <p>Depending on the scope of the bail-in implementation and on practical experience, in particular in the field of securities processing, settlement and custody services, the role of bail-in agent may also be entrusted to the bank subject to the bail-in implementation, i.e., the bank determined as being FLTF, meaning that the bail-in agent and the FLTF bank are one and the same bank.</p>
C	Resolution authority	<p>Based on the information from Valuation 2, the resolution authority will issue a decision, or a measure of a general nature, implementing the bail-in tool (“the bail-in decision”). The bail-in decision contains in particular the identification of instruments against which the bail-in tool is to be applied and conversion rates determined. When setting the conversion rates, the resolution authority will make sure that no creditor</p>

Step/Action	Responsibility	Description of Step/Action
		<p>will receive treatment which is worse than the treatment they would have received if the bank had entered national insolvency proceedings, and that all creditors within the same insolvency class are treated equally.</p> <p>The implementation of the bail-in tool may lead to a situation where creditors of a particular insolvency class contribute to the bank's loss absorption and recapitalization at the same time, i.e., the market value of shares received in conversion is lower than the receivable from the instruments concerned. Therefore, if the bail-in tool is to be implemented on the basis of a provisional Valuation 2, the resolution authority may deem it appropriate to distribute to such creditors, along with shares, also securities that can be converted into shares or debt instruments issued by the bank ("certificates of entitlement"), so that the losses to be borne by these creditors correspond to the outcomes of the independent Valuation 2.</p>
5	Resolution authority	<p>Straight after the bail-in decision is issued, the resolution authority will inform the failing bank, the central securities depository ("CDC") and other (I)CSDs where applicable about its relevant attributes. The resolution authority's communication will contain, but is not limited to, information on:</p> <ul style="list-style-type: none"> <li>• the instruments subject to the bail-in tool implementation, including the treatment each instrument is to receive;</li> <li>• the parameters of the instruments to be issued in the process of bail-in implementation (e.g., type, quantity and face value);</li> <li>• the conversion rates per instrument and insolvency class, i.e., the rate to be used for conversion into shares of the bank.</li> </ul> <p>Where the bail-in implementation process requires new shares to be issued by the bank, these will be issued and registered at the CDC.</p> <p>If the resolution authority requires the bank to issue certificates of entitlement, these will be issued and registered primarily at the CDC, and their transferability will not be limited.</p>
6	Failing bank	<p>Based on the information on the scope and process of the bail-in implementation, the failing bank will prepare all the necessary information and documents, which will then be made available to the bail-in agent.</p>
7	Bail-in agent	<p>The bail-in agent will process the information and documents prepared by the failing bank into electronic instructions, which will be transmitted to the CDC and, where relevant, to other persons maintaining registers of the instruments concerned.</p>

Step/Action	Responsibility	Description of Step/Action
D	CDC	<p>The CDC, on the basis of instructions received, will process the write-down and conversion of the instruments concerned, as a result of which:</p> <ul style="list-style-type: none"> <li>• the original instruments (whether shares or instruments representing bank's debt): <ul style="list-style-type: none"> <li>a. will be cancelled: where these instruments are no longer needed for the successful completion of the bail-in process; or</li> <li>b. their face value will be reduced accordingly: where part of the instruments are to remain issued either at the time of the bail-in implementation or as a result of compensation according to the independent Valuation 2</li> </ul> </li> <li>• shares and, where applicable, certificates of entitlement will be distributed to the creditors affected by the implementation of the bail-in tool.</li> </ul> <p>For <b>instruments registered in the CDC</b>, the CDC will, in accordance with the instructions received, exchange these instruments for an appropriate number of shares and, where relevant, also certificates of entitlement directly on the owners' accounts where the original instruments are registered at the time just before the bail-in execution.</p> <p>For <b>instruments registered in other records or registers</b>, the CDC will, in accordance with the instructions received, credit the corresponding number of shares and, where relevant, also certificates of entitlement to the designated owner's account of the bail-in agent.</p> <p>Where certificates of entitlement have been used, these will be converted into shares or instruments representing the debt of the bank using the conversion rates corresponding to the outcomes of the independent Valuation 2. The conversion will be performed by the CDC, in accordance with the instructions received, directly on the owners' accounts where the certificates of entitlement were registered just before the exchange.</p>
E	ICSD	<p>ICSD, on the basis of the electronic instructions received, will process the write-down of the instruments concerned, as a result of which:</p> <ul style="list-style-type: none"> <li>• the original instruments: <ul style="list-style-type: none"> <li>a. will be cancelled: where these instruments are no longer needed for the successful completion of the bail-in process; or</li> </ul> </li> </ul>

Step/Action	Responsibility	Description of Step/Action
		<p>b. their face value will be reduced accordingly: where parts of the instruments are to remain issued at the time of the bail-in implementation;</p> <ul style="list-style-type: none"> <li>the corresponding number of shares and, where relevant, the certificates of entitlement will be credited to the owners' accounts in the follow-up records maintained by the ICSD</li> </ul>
8	CDCP/ICSD/ Custodian	The CDC, using the standard means of communication, will inform the owners' accounts' beneficiaries about all the transactions that took place on all the relevant owner's accounts with the CDC. The owners' accounts' beneficiaries will inform their clients where applicable.
F	Bail-in agent	The bail-in agent, based on information and documents from the failing bank, will maintain a list of real owners of the shares and, where applicable, the certificates of entitlement that have been credited to the dedicated bail-in agent's owner's account with the CDC. The bail-in agent will inform the real owners from the list above and invite them to provide instructions according to which these securities can be transferred to the corresponding owners' accounts (held either directly with the CDC or in the follow-up records maintained by a CDC's participant).
9	Shareholders	Beneficiaries of securities that are held on a bail-in agent's owner's account will instruct the bail-in agent to transfer the corresponding amounts of securities to the owners' accounts of their choice.

<sup>1/</sup> Available online at <https://www.fsb.org/2018/06/principles-on-bail-in-execution-2/>

51) In considering bail-in as a loss absorption mechanism, the resolution authority will need to develop guidance in its resolution manual on the following matters:

- a. The methodology to determine the extent to which identified losses can be absorbed by diluting shareholders. In this context, there should be guidance on how a share dilution would be executed, including the company law and stock exchange listing requirements that might apply.
- b. The determination of the extent to which subordinated debt (if any) will be written down or converted to equity (if technically possible) as part of the loss-absorption process. In the case of a business transfer, this might involve determining the treatment of subordinated debt, including whether it is left in the failed bank for liquidation or transferred to a recipient bank (existing bank or bridge bank).
- c. The means by which contractual bail-in debt (if any) would be converted to equity or written down, if that had not already been done under prompt corrective action administered by the CBS or as part of the bank's recovery plan.



- d. The means by which a forced bail-in would be applied to unsecured liabilities if the CBS resolution plan contains a proposal for a bail-in using emergency decree provisions, including the liabilities to be subject to bail-in, the methodology to determine the proportion of the selected liabilities to be bailed in, the mode of bail-in (such as conversion to equity or write-down), the communications with affected creditors, the arrangements for any NCWOL compensation process, and public communications relating to the bail-in.
- e. The determination of whether existing shareholders are left in the bank as minority shareholders if a recapitalization is to be implemented, or are paid out for any residual value of their shares and the shares cancelled.

### **Bridge bank**

52) In the case of establishing and capitalizing a bridge bank, the following issues would need to be considered:

#### ***Rationale for establishing a bridge bank***

53) When the resolution authority determines that a bank is nonviable but the authorities determine that the failure of the bank will cause systemic distress in the financial system, the authority may establish a bridge bank for a temporary period. In this case, the resolution authority transfers critical functions and services, insured and possibly uninsured deposits, and viable assets, as well as contractual rights and obligations relating to critical functions and services of the failing bank to the bridge bank. This temporary bank will help preserve financial sector stability. Other assets and liabilities, including “bad” assets that are not critical and certain liabilities such as subordinated debt, can be left behind in the failed bank for liquidation.

54) The resolution authority must decide on the amount of deposits to be transferred. At a minimum, all insured deposits are transferred, with the deposit insurer providing any additional cash necessary to ensure transferred assets equal transferred deposits. If there are sufficient performing assets in the failed bank, all deposits may be transferred, with the deposit insurance contributions limited to what it would payout to insured depositors. Bail-in of contractual bail-in debt and possibly of other unsecured liabilities would occur in the resolution phase immediately preceding the transfer of business to the bridge bank.

55) The key objectives of a bridge bank are to maintain critical services and continuity of operations that are important for financial stability. This would minimize the disruption to the financial system that might otherwise occur if those functions were subject to wind-up and liquidation procedures.

### ***Preconditions for establishing a bridge bank***

56) The pre-conditions for the use of bridge bank resolution tool are:

- The supervisory authorities must determine the nonviability of the bank.
- The resolution authorities determine that the bank's failure poses a systemic threat and proposes the establishing of a bridge bank. That proposal will include (i) the future business plan of the bridge bank; (ii) the funding necessary to ensure it has adequate capital and liquidity; and (iii) any requirement for public sector support.
- If the bridge bank requires the use of public resources, the resolution authority reviews options and recommends the resolution approach for the failing bank to the Minister of Finance. The Minister of Finance approves the resolution approach.

57) If a bridge bank is to be used, the contingency plan should identify the steps required for the resolution authority to establish the legal entity. The contingency plan should include pre-prepared documentation for the establishment of a bridge bank, including a company constitution, governance structure, management structure, etc. It will also be necessary to maintain updated lists of potential directors and senior management for a bridge bank. The resolution manual should also include guidance on the steps required for fast-tracking bank licensing and other consent processes, as appropriate

58) A bridge bank resolution would be designed to span the time between when the bank has failed and when a sale of the bridge bank or its assets can be completed. Unlike the conventional forced sale tool, a bridge bank may be used when there are no immediate private sector acquirers.

59) The bridge bank model would be especially suited for member banks that deteriorate rapidly with little notice and where a potential buyer does not emerge and there are financial stability concerns. This would promote stabilization for depositors and all creditors that are passed to a bridge bank.

### ***Governance of the bridge bank***

60) In this process, the resolution authority will need to ensure that there is adequate capital and liquidity in the bank and will need to ensure necessary IT changes to facilitate the transfer of some parts of the undertaking to another entity, etc. There may also need to remove directors and management to the extent they are thought to be obstacles to resolution and not required for the resolution process.

61) If the resolution authority believes new directors and management are needed before the appointment of an administrator or as an alternative to administration, they should pre-identify candidates for the appointments, potentially including senior staff from the resolution authority or from suitable foreign banks. For example, the replacement of directors

and senior management might be required ahead of the appointment of an administrator in situations where the resolution authority wants to pre-position the bank for an expected resolution; e.g., to restructure the bank, curtail new lending, etc., and where they do not have confidence in some of the existing directors or management team to undertake pre-positioning for resolution.

62) The bridge bank is not to be viewed as having a competitive advantage over other banks. It should meet the same prudential norms and regulations of other member banks. The bridge bank should be required to meet all prudential regulations of other member banks and should not have a competitive advantage over other banks in the system. In that sense, the resolution authority would need to determine an appropriate capital ratio, and therefore capital injection, required to restore the distressed bank to financial soundness or to capitalize a bridge bank. The capital ratio would need, at the least, to be around the same level as for other banks in the peer group and sufficient to obtain a credit rating similar to the rating that applied before the bank became distressed. In order to restore market confidence and enable the bank to resume normal funding, the target capital ratio is likely to have been higher than it was pre-distress, based on a target credit rating (e.g., at least investment grade and likely higher for any major bank).

63) The goal would be to return the bridge bank to the private sector through one or more transactions (e.g., a sale of the bridge bank to a third party or an amalgamation with another bank) as soon as possible. It is expected that the pricing of loans and deposits at the bridge bank and various fees would be roughly equivalent to industry norms.

### ***Capital support by the government***

64) If the bridge bank is to be recapitalized by the government, it is essential that this is done as a last resort (i.e., failing any other sources of capital) and on commercial terms. It is also essential that the existing shareholders are either removed from the recapitalized bank (e.g., by using a bridge bank and leaving shareholders in the failed bank) or diluted in accordance with the assessed value of shareholders' funds immediately pre-resolution. If the government does need to provide capital support, the MOF will need to develop guidance on the following matters:

- whether capital provided by the government is in the form of preference shares (which would rank ahead of ordinary shares and therefore reduce the risk of the government) or ordinary shares ranking equally with existing ordinary shares;
- the pricing of the shares paid for by the government, based on a conservative valuation of the bank immediately pre-resolution;
- the voting rights on preference shares if that form of capital is used;

- the other forms of control which the government may wish to exercise (either via voting rights on shares or through another means, such as a deed poll entered into by the bank), such as:
  - the right to appoint directors, in proportion to the share of the capital the government holds;
  - veto rights over the appointment of directors by other shareholders (if they are minority shareholders);
  - the right to appoint (or veto the appointment of) the CEO, CFO and CRO;
  - the right to approve (or veto) key transactions, such as lending to related parties, large exposures, disposal of business, acquisition of new business, etc.;
  - the right to determine the risk appetite and nature of business strategy adopted by the bank; and
  - the nature of the exit arrangements, such as eventual sale of the government's shares to another party (subject to the approval of the RA).

### ***Financial support to a bridge bank***

65) The resolution guidance needs to identify the extent and nature of liquidity which may need to be provided by the central bank to a bridge bank. This should be done on the basis of a methodology that involves a stress-tested liquidity projection for the bank at the point of resolution, taking into account the debt funding needs of the bank and its subsidiaries for the continuity of all critical functions and services, the possible withdrawal of some deposit funding, and the possible difficulty that the bank may have in financing from the markets for a period.

66) The guidance should set out indicative terms and conditions for any liquidity support to be provided by to the bridge bank, including maximum funding amount, purposes for which funds may be applied, preconditions for drawdown, term of the funding, interest rate, fees, repayment schedule, terms of rollover (if applicable), financial reporting requirements, restrictions on risk-taking activity, events of default, remedies for events of default, and debt acceleration provisions in a situation of default.

67) Funding should be provided on a collateralized basis, where possible. In that regard, the guidance should identify the types of collateral that could be used, the legal and operational arrangements needed to access the collateral, and the level of haircuts applied to collateral (by category of collateral). Funding should be provided on commercial terms, with pricing that reflects the risk associated with the funding.

68) All other forms of financial support, such as guarantees and indemnities of the bank's counterparties should be identified where feasible. The guidance should set out the terms and conditions of such support, including preconditions, obligations to be covered by the guarantee or indemnity, fees, conditionality, reporting requirements, duration of the support, events of default, and remedies for default. Guarantees and indemnities should be provided on commercial terms, with pricing that reflects the risk associated with the support arrangements.

## APPENDIX V. RESOLUTION PLANNING AND RESOLVABILITY ASSESSMENTS

1. This appendix sets out guidance on resolution planning and resolvability assessments. The issues addressed here are not exhaustive and should consider the size, nature, and complexity of the bank.

### Resolution plans

2. A resolution plan sets out the means by which a DSIB or other large bank would be resolved, taking into account the specific features of that bank and any entities in its financial group (e.g., holding company and subsidiaries) relevant to the performance of a bank's critical functions and services. Resolution plans are prepared by the resolution authority on the basis of selecting one or two resolution strategies suitable for the DSIB, informed by the guidance in the resolution authority's bank resolution manual.

3. A resolution plan is intended to facilitate the effective use of resolution powers to maintain continuity of systemically important functions ('critical functions') and associated services ('critical services'), with the aim of making the resolution of any bank and its associated group feasible without severe disruption to the financial system and economy, and without exposing taxpayers to loss where practicable. It should include a resolution strategy and an operational plan for its implementation, and should identify, in particular: (i) financial and economic functions, and associated services, for which continuity is critical; (ii) suitable resolution options to preserve those functions or wind them down in an orderly manner; (iii) data requirements on the bank's and associated group's business operations, structures, and systemically important functions; (iv) potential barriers to effective resolution and actions to mitigate those barriers; (v) actions to protect insured depositors and insurance policy holders and ensure the rapid return of segregated client assets; and (vi) clear options or principles for the exit from the resolution process.

### Resolvability assessments

4. Resolution plans are informed by resolvability assessments. Resolvability assessments comprise three stages: (a) an assessment of the feasibility of different resolution options for the bank in question; (b) an assessment of the systemic impact of each resolution option; and (c) an assessment of the impediments to resolvability and identification of the actions needed to improve the bank's resolvability under the preferred resolution options. A resolvability assessment needs to be done on a consistent basis across all DSIBs using a framework developed by the resolution authority. It should involve an assessment of the resolvability of each DSIB and its relevant banking group based on the most practicable resolution options.

5. Subject to assessing the particular characteristics of a bank and its relevant group, the most likely resolution options for a DSIB are generally (i) recapitalization of the bank (likely slimmed down to focus on critical functions and services, and associated assets and liabilities);

or (ii) transferring critical functions and services and other relevant assets and liabilities from the failing DSIB to a bridge bank.

6. The resolvability assessment framework is necessarily a relatively complex process. It needs to be undertaken thoroughly and on a consistent basis across all systemic banks. The framework for assessment would typically involve assessing such matters as: (a) the existing capital structure of the bank and the availability of any contractual bail-in debt; (b) the estimated maximum losses and capital shortfalls for a range of severe financial shocks; (c) the availability of debt that could potentially be subject to contractual bail-in, and separately, the debt that could be subject to statutory bail-in; (d) the technical issues involved in diluting existing shares and implementing bail-in; (e) the identification of all critical functions and services, and the entities within which these are performed; (f) the ability to separate critical from noncritical functions and services; (g) the extent to which critical functions and services are performed by parties outside the banking group (i.e., outsourced) and the contractual arrangements applicable to them; (h) the payment and settlement systems of which the bank or its subsidiaries are members, and the implications of entry into resolution or change of ownership for each such system; (i) the types of capital instruments that would be used in a recapitalization of the bank or of a bridge bank; (j) the regulatory requirements, including disclosure requirements, associated with each phase of resolution; (k) the fast-track licensing steps needed if a bridge bank solution is used; (l) the rights of termination of counterparties to the bank upon entry into resolution or change of ownership, and the means by which this could be avoided where it is desirable to do so; (m) the arrangements required to ensure continuity of critical functions and services of foreign subsidiaries and branches if applicable, including foreign regulatory requirements; (n) the process for establishing a bridge bank; and (o) the funding requirements for each aspect of resolution for each resolution option.

### **Critical functions and services**

7. A key focus of resolvability assessments and resolution plans is to identify a bank's/group's critical functions and services. These represent the parts of a bank/group that need to be continued in order to minimize adverse impacts on the financial system and economy. Any form of resolution for a bank assessed as being systemically important should ensure that critical functions and services are continued, either in the bank itself or in another entity (i.e., a bridge bank or another bank).

8. The FSB notes that a critical function has the following two elements:
- a. it is provided by a bank/group to third parties not affiliated to the bank/group; and
  - b. the sudden failure to provide that function would be likely to have a material impact on the third parties, give rise to contagion or undermine the general confidence of market participants due to:
    - o the systemic relevance of the function for the third parties; and



- the systemic relevance of the bank/group in providing the function.
9. Critical functions will typically include functions relating to:
- Deposit-taking, particularly the capacity to receive deposits into transaction accounts.
  - Transactions capacity—the ability to make and receive payments.
  - Clearing and settlement functions.
  - Wholesale funding, particularly the ability to receive funding via on-call wholesale deposits.
  - Correspondent banking functions.
  - Treasury functions.
  - Derivatives servicing; e.g., with respect to interest rate and currency swaps, forwards and options.
  - Provision of credit under committed credit facilities.
  - Loan servicing.
  - Provision of risk hedges to customers.
  - Provision of financial services to markets in which the bank is the sole or predominant provider and where significant disruption to the financial system or economy would result if the services were discontinued.
10. Critical services also need to be identified. Critical services (including services shared between or among entities within a group) are activities performed within the firm or outsourced to third parties where failure would lead to the inability to perform critical functions and, therefore, to the disruption of functions vital for the functioning of the real economy or for financial stability.
11. The critical services will include systems, data and other functionality required to:
- perform critical functions;
  - maintain customer accounts;
  - maintain financial records;
  - meet financial obligations as they become due and payable;

- maintain payroll and other employee obligations;
- maintain operational security, including the security of all premises required for critical functions and services;
- maintain all assets required for the performance of critical functions and services;
- identify, measure, monitor and manage all material risks;
- comply with prudential requirements; and
- comply with other legal requirements.

12. As part of the resolvability assessment, there needs to be an identification of the entities that perform critical functions and services, and the country or other jurisdiction in which the entities are located. In many cases, some critical functions will not necessarily be performed by the bank itself; some functions might be performed by other entities in the financial group. In the case of critical services, it is often the case that some of these services are performed by a holding company or parent bank (if applicable) or by subsidiaries of the bank or by other entities in the group (e.g., subsidiaries of a parent bank, if applicable). In addition, it is common for some critical services to be performed by entities outside the group through outsourcing arrangements.

13. The resolvability assessment also needs to identify the contractual arrangements on which critical functions and services are performed, including Service Level Agreements (SLAs) and the contractual implications for each function and services of the bank or any entity in the banking group being placed into resolution. Potential impediments to the continuity of critical functions and services under each resolution option should be assessed, and the means by which these impediments can be avoided or managed should be identified. Drawing on the resolvability assessment, resolution plans pull together the operational details required for continuity of operation of critical functions and services for each resolution option.

### **Loss absorption**

14. The resolvability assessment also needs to assess the potential for loss absorption and funding to facilitate recapitalization of the bank or capitalization of a bridge bank based on the capital and liabilities of the bank. This should be done by assessing possible worst-case losses in a nonviability scenario (e.g., informed by reverse stress tests) and assessing the amount of loss absorption available from: (i) common equity; (ii) additional tier 1 capital; (iii) tier 2 capital; (iv) subordinated liabilities capable of contractual bail-in not included in capital; (v) senior unsecured liabilities capable of contractual bail-in not included in capital; and (vi) other unsecured liabilities capable of statutory bail-in, consistent with the ranking of claims under applicable insolvency law. If there is an insufficient amount of loss absorption available to absorb losses under a plausible worst-case nonviability scenario and to facilitate recapitalization of the bank or capitalization of a bridge bank without causing financial stability risks (e.g.,

contagion impacts), the resolution authority should assess the feasibility and cost/benefit trade-offs of requiring the bank in question to increase its capital or contractual bail-in liabilities.

### **Impediments to resolution**

15. Other potential impediments to resolution should be assessed and appropriate solutions should be identified. These include: (i) domestic statutory and regulatory impediments to resolution implementation; (ii) foreign statutory or regulatory impediments; and (iii) contractual impediments. In the case of critical services that are provided within a financial group on a shared-services basis (e.g., via a holding company, parent bank, regional hub entities, or a centralized services provider within the group), the potential impediments to continuity of services under selected resolution options should be assessed and the means by which these can be avoided or managed should be identified. Options that can be considered include: (i) requiring shared services to be contractually documented in ways that prevent suspension or termination of services merely as a result of entry into resolution or the exercise of resolution powers, provided that the bank in resolution and its relevant subsidiaries continue to make payments due under contractual arrangements; (ii) requiring back-up systems for critical services to be located within the bank; or (iii) requiring critical services to be located within the bank. The resolvability assessment should assess the feasibility and costs/benefits of each applicable option.

16. Once a resolvability assessment has been completed for each DSIB, a resolution plan can then be prepared. The resolution plan should set out in detail the specific nature of the resolution arrangements for the selected resolution options. Depending on the resolution options selected, the resolution plan should include: (a) an identification of the amount and nature of capital injection required; (b) the type of capital instruments to be used; (c) the nature of dilution of existing shareholders and write-down or bail-in of subordinated creditors; (d) the critical business to be continued; (e) the business lines to be discontinued; (f) the separation of critical functions and services from noncritical functions and services; (g) the nature of business to be transferred to another bank or to a bridge bank (if that option is applied); (h) the transfer of impaired assets to an AMC (if that option is to be applied); and (i) the nature of cross-border resolution actions required (if applicable).

17. Resolution plans should be reviewed and updated on a regular basis. This is done by the resolution authority on the basis of periodic resolvability assessments that take into account any material changes to the business operations of the bank.

### **Cross-border cooperation and coordination**

18. In the case of cross-border banking groups, the home resolution authority should lead the development of the group resolution plan in coordination with members of the banking group's Crisis Management Group (CMG) or supervisory college. Host authorities that are involved in the CMG or are authorities of jurisdictions where the banking group has a systemic presence should be given access to resolution plans and the information and measures that would have an impact on their jurisdiction. Host resolution authorities may maintain their own resolution plans

for the banking group's operations in their jurisdictions, cooperating with the home authority to ensure that the plan is as consistent as possible with the group plan.

19. The parent entity resolution plan should focus primarily on how a whole-of-group resolution would be implemented. This would generally be done in ways that enable the parent entity to provide the required capital, liquidity funding and operational support to the operations in a host country. This might involve some form of Single Point of Entry (SPE) resolution, under which any capital and liquidity injections needed by the bank subsidiary/branch in the host country would be facilitated via the parent entity (either through some form of bail-in at parent level or an alternative capital-raising mechanism). Alternatively, the resolution plan might involve a Multiple Points of Entry (MPE) form of resolution, under which capital and liquidity would be injected separately into the parent bank/holding company and each relevant subsidiary bank; e.g., through bail-in at each legal entity. The costs/benefits of each option should be assessed in the resolvability assessment and resolution planning processes.

20. If the parent resolution involved a sale of the bank to another party or the transfer of some of its business to a bridge bank in the home jurisdiction, the resolution plan would desirably set out the means by which the subsidiary/branch in the host country is integrated into the parent bank resolution strategy, including by way of appropriate legal recognition or facilitation by the host resolution authority of resolution actions needed in the host country to accommodate the parent resolution strategy.

21. Resolution plans also need to cater for situations where the home authorities do not implement a form of resolution that meets the financial system and depositor protection needs of the host country. In such cases, it will be important to incorporate into resolution plans a host country 'fallback' resolution option that enables the subsidiary/branch in the host country to be separated from the parent banking group and resolved in a manner that maintains continuity of critical functions and systems in the host country so as to minimize disruption to the domestic financial system. This is likely to involve consideration of the means by which critical functions and services can either be performed by the subsidiary/branch or performed through a shared-services company in the parent group and structured so that there is reasonable certainty of the ability to maintain continuity if the subsidiary/branch is separated from the parent. This resolution option would also likely involve the transfer of the relevant business functions of the subsidiary/branch to either another bank in the host country (if feasible) or to a bridge bank established for the purpose. In such a case, some host resolution authorities require foreign subsidiaries or branches to be pre-positioned to enable them to maintain critical functions and services on a stand-alone basis so that, in a resolution, they could be fully separated from the parent entity, if necessary.

22. These are complex issues and require careful consideration and planning by the home and host authorities. The development of cross-border banking group resolution plans needs to recognize that the home and host countries have overlapping interests, with both seeking to achieve cost-effective financial stability outcomes in the home and host countries. However,

there also needs to be a clear recognition of divergent interests between the home and host countries. The home country authority's primary focus is the financial stability of its own country and the achievement of a least-cost resolution for the home country. In contrast, the host authority's primary focus is on protecting the financial stability impact in the host country and minimizing resolution costs at a local level. These divergent and competing interests should be dealt with openly, with a view to seeking a workable whole-of-group resolution that meets the needs of home and host countries, but with an understanding of the likely need for the host authority to establish a fallback resolution option that can be implemented by the host resolution authority in the event that the home authority's proposed approach does not adequately meet the needs of the host country.

### **Indicative process for preparing resolution plans and conducting resolvability assessments**

23. An indicative process for preparing resolution plans and conducting resolvability assessments is set out below.

#### ***Step 1—Identify potential resolution options for a bank and relevant group***

24. The resolution authority identifies likely resolution options for a bank and its relevant group, drawing on the resolution manual guidance. In the case of a DSIB, the most likely resolution options are:

- Recapitalization of the bank (slimmed down to exclude noncritical functions and services). This would desirably be done through a bail-in of liabilities to the extent feasible, but might require some public funding; and
- P&A. This would involve transferring critical functions and systems, and associated assets and liabilities, and contractual rights and obligations, to a bridge bank established by the resolution authority and capitalized by bail-in and selective liability transfer to the extent possible, supplemented with external resolution funding if necessary.

25. A resolution plan might focus just on one of these resolution options, but will often allow for both options, with the resolution authority then selecting the preferred option on the basis of least-cost resolution based on information at the time of nonviability.

#### ***Step 2—Consult DSIBs on resolution planning and resolvability assessments***

26. The resolution authority should prepare a paper that sets out its approach to the resolution of DSIBs, including resolution objectives, nature of resolution powers, the point of entry into resolution, the purpose of resolution plans and resolvability assessments, and the resolution options. It should explain the intended process and timeline for undertaking resolvability assessments and preparing resolution plans, and the inputs required from the DSIBs in that process. The paper would note that DSIBs may be required to make changes to their structure and operations for the purpose of enabling particular resolution options to be capable of

implementation. The resolution authority would include as an attachment to the consultation paper a draft data template (see below in Step 3).

27. The resolution authority might usefully hold a workshop with the DSIBs to explain the issues and respond to questions. Banks would be invited to make submissions on the paper and suggest changes. Once this has been completed, the resolution authority would finalize the paper and data template.

***Step 3—Obtain comprehensive data from a bank and relevant group***

28. The resolution authority should develop a data template to be used to obtain the information it needs in order to assess the feasibility of the resolution options. The same data template should be used for all DSIBs in order to obtain data in a standardized format and to enable peer review by the resolution authority.

29. The data template would typically require data in relation to:

- a. Organization structure of the banking group, including identification of a holding company (if applicable), bank, all subsidiaries of the bank, and any ‘sister’ entities of the bank (i.e., subsidiaries of the bank holding company that are outside the banking group) that provide material functions or services to the bank or any of its subsidiaries. The information should include an identification of the country of domicile of each entity.
- b. For each entity in the group, an identification of the functions it performs (i.e., business products and services it provides to persons outside the group) and services it performs (i.e., services it provides to entities within the group).
- c. Nature of the legal form (e.g., company, cooperative) and capital structure of the holding company and the bank.
- d. Detailed balance sheet of the bank and holding company and of any subsidiary that provides critical functions or services on which the bank is dependent, including detailed information on capital, quasi-capital, subordinated debt, and liabilities by category of liability.
- e. Critical functions and services performed by the bank and group, including the entities performing each function and service.
  - Critical functions are activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability due to the banking group’s size or market share, external and internal interconnectedness, complexity and cross-border activities. Examples include payments functions, custody, certain lending and deposit-taking activities in the commercial or retail sector, clearing and settling, segments of wholesale markets,

market-making in certain securities, provider of swaps, futures and options in the interest rate and foreign exchange market, and highly concentrated specialist lending sectors.

- Critical shared services are activities performed within the firm or outsourced to third parties where failure would lead to the inability to perform critical functions and, therefore, to the disruption of functions vital for the functioning of the real economy or for financial stability. Examples include the provision of information technology given the dependency of core banking processes on IT and other services such as facility management and administrative services.
- Critical functions would be selected by reference to the following criteria:
  - the function is provided by an institution to third parties not affiliated to the institution or group; and
  - a sudden disruption would likely have a material negative impact on the third parties, give rise to contagion or undermine the general confidence of market participants due to the systemic relevance of the function for the third parties and the systemic relevance of the institution or group in providing the function.
- Critical services would be selected by reference to the following criteria:
  - an activity, function or service is performed by either an internal unit, a separate legal entity within the group or an external provider;
  - the activity, function or service is performed for one or more business units or legal entities of the group;
  - the sudden and disorderly failure or malfunction would lead to the collapse of or present a serious impediment to the performance of, critical functions.

See FSB guidance on critical functions and services: *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Identification of Critical Functions and Critical Shared Services*: [https://www.fsb.org/2013/07/r\\_130716a/](https://www.fsb.org/2013/07/r_130716a/)

- f. For critical systems, the identity of any providers of such services under outsourcing arrangements and their country of domicile need to be identified. The bank should provide details of contractual arrangements for each outsourced service provider, with particular focus on the grounds on which the service may be terminated or suspended by the outsourced provider.
- g. For each critical function, the local currency amount of the function performed; e.g., by reference to the total amount of lending or funding as at the most recent date for which



data are available or as at a date specified by the resolution authority. This should be done at a granular level by category specified by the resolution authority; e.g., lending by borrower and loan product category, and deposits by customer category. This will enable the resolution authority to assess the market share of the bank/group in each category and therefore assess the extent of potential impact if there was a discontinuity of those functions and substitutability.

- h. Participation of the bank in each payment and settlement system, including the types of payments/settlements performed by the bank. The bank should provide information on average payment/settlement volumes for a period specified by the resolution authority (e.g., over a given month or quarter or year). This will enable the resolution authority to assess the bank's share of total volume of payment and settlement transactions made in each payment/settlement system in the given period.
- i. Amount of inter-bank funding and credit exposures as at a date specified by the resolution authority. This will enable the resolution authority to assess the potential implications of the bank's failure for inter-bank liquidity and contagion.
- j. For bank and holding company, the amount of loss absorption capacity, including ordinary share capital (and extent to which it is fully paid), preference share capital, Additional Tier 1 capital instruments, Tier 2 capital instruments, other subordinated debt, uninsured deposits (disaggregated between retail and wholesale deposits), and unsecured bonds and paper issued by the bank or holding company. The bank should identify those debt instruments with a contractual capacity for conversion to equity or ability to be written down, and the terms on which this may be done.

#### ***Step 4—Initial resolvability assessment***

30. Based on the data provided by each DSIB, the resolution authority would undertake a resolvability assessment to evaluate the feasibility of either or both resolution options. This would take into account:

- a. The nature of critical functions and services and the location of them by legal entity in the group.
- b. The nature of critical services performed by outsourced parties and the nature of the contractual arrangements, focusing on the capacity for the providers of outsourced services to suspend or terminate the services.
- c. The noncritical functions and services that could be discontinued.
- d. The market share of the DSIB in each category of critical function, and its share of participation in FMI and key financial markets, and assess the impact of failure of the DSIB on the financial system and economy and on other banks, and the speed with which

other banks could replace the functions provided by the DSIB if the functions were to be discontinued.

- e. The potential amount of loss absorption needed and the sequencing with which this could be facilitated. This should be assessed on a working assumption that the DSIB's capital ratio has fallen to not more than 3 percent of risk-weighted exposures and potentially as low as -20 percent (informed by stress tests based on nonviability scenarios).
- f. An evaluation of whether recapitalization should be undertaken (under option 1) on a SPE or MPE basis.
- g. An evaluation of the business that would be transferred to a bridge bank (under option 2).
- h. An assessment of the extent to which there is a funding shortfall required to establish the recapitalized bank or bridge bank to a capital rate that is at least 300 bps above the regulatory minimum for DSIBs, taking into account termination of noncritical functions.
- i. An assessment of the external funding sources needed and the process for obtaining the funds.
- j. Obstacles to implementation of either resolution option, including contractual impediments, location of critical functions and services, cross-border complications, and regulatory impediments.

#### ***Step 5—Discuss with DSIB***

31. Discuss the results of the analysis in step 4 with the DSIB to seek clarification on issues on which there are uncertainties and where further information may be required. Discuss possible changes to the bank and group that may be required to facilitate resolution under either option.

#### ***Step 6—Prepare comprehensive resolution plan***

32. Based on the analysis in steps 4 and 5, the resolution authority should prepare comprehensive resolution plans that set out the means by which each resolution option would be implemented, including the changes needed to group structure, locations of critical functions and services, contractual arrangements with service providers, and the amount and structure of contractual bail-in liabilities that would be required for a sufficient level of loss absorption to minimize the need for external funding.

33. It would also identify the capital structure that would evolve from bail-in and the form of capital arising from any external capital sources.

34. It would identify the possible need for government guarantees and indemnities by amount and duration.

35. It would identify possible liquidity support from the central bank by amount and duration, and collateral available and possible indemnity requirements.
36. It would identify communications required for each resolution option from the point of entry into resolution through each stage of resolution.

***Step 7—Pre-positioning the DSIB***

37. The resolution authority would specify the pre-positioning needed for each DSIB to implement the selected resolution options, such as the simplification of a group structure, the movement of some critical functions and services from other legal entities to the bank, establishing specific contractual arrangements for outsourced critical services that do not provide for termination in a resolution situation, and the establishment of a tranche of bail-in debt.

**REFERENCES**

See below for useful reference material.

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