



# THE BAHAMAS

## TECHNICAL ASSISTANCE REPORT— OPERATIONALIZING THE NEW BANK RESOLUTION FRAMEWORK AND AMENDED DEPOSIT INSURANCE LEGISLATION—FIRST MISSION

August 2023

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# TECHNICAL ASSISTANCE REPORT

## THE BAHAMAS

Operationalizing the New Bank Resolution  
Framework and Amended Deposit Insurance  
Legislation—First Mission

**August 2023**

**Prepared By**

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**Monetary and Capital Markets  
Department**

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**GLOSSARY**

BB	Bridge Bank
BCL	The Bahamas Cooperative League Limited
BCP	Business Continuity Plan
CBA	Clearing Banks Association
CBOB	Central Bank of The Bahamas
CMG	Crisis Management Group
CoCo	Contingent Convertible Bond
DIC	Deposit Insurance Corporation
DIF	Deposit Insurance Fund
D-SIB	Domestic Systemically Important Bank
ELA	Emergency Liquidity Assistance
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee
FTE	Full Time Equivalent
GFSR	Group of Financial Sector Regulators
IADI	International Association of Deposit Insurers
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IT	Information Technology
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
LEG	Legal Department
MCM	Monetary and Capital Markets Department
MOF	Ministry of Finance
MOU	Memorandum of Understanding
MPE	Multiple Points of Entry
NPL	Nonperforming Loan
P&A	Purchase and Assumption
RU	Resolution Unit
SCB	Securities Commission of The Bahamas
SCV	Single Customer View
SFI	Supervised Financial Institution
SPE	Single Point of Entry
TA	Technical Assistance

## PREFACE

At the request of the Central Bank of The Bahamas (CBOB), a Monetary and Capital Markets (MCM) Department mission provided offsite Technical Assistance (TA) between October 18–November 8, 2021 to assist the authorities in operationalizing the new bank resolution framework and the amended deposit insurance legislation. The mission team comprised Mrs. Gayon Hosin (MCM, mission chief) and Messrs. David Hoelscher and Geof Mortlock (MCM experts).

The mission engaged with the authorities through virtual meetings, workshops, and seminars held with officers of the CBOB and the Deposit Insurance Corporation (DIC), which included a number of presentations made by the CBOB and the DIC on recovery, resolution, and deposit insurance. Each session was followed by Q&A sessions, and the mission benefitted from forthright and constructive discussions with the CBOB and DIC management and staff. Meetings were also held with senior officers of the Ministry of Finance (MOF), the Securities Commission of The Bahamas (SCB), and DIC Board members regarding their respective roles in financial stability, crisis management, and bank resolution.

The mission met remotely with Mr. John Rolle, Governor; Mr. Charles Littrell, Inspector of Banks and Trust Companies; Mrs. Karen Rolle, Deputy Inspector of Banks and Trust Companies; and other senior staff of the CBOB, the DIC, and other relevant agencies. The mission also met with senior management executives of three commercial banks, the Clearing Banks Association (CBA), and The Bahamas Cooperative League Limited (BCL) regarding key risks to the sector, the nature of existing contingency planning, stress testing and integration into risk management frameworks, views on supervisory effectiveness, and recovery and resolution planning issues.

The second mission, which is targeted for the second half of 2022 (November 7 to 18, 2022), will focus largely on assisting the CBOB in the development of resolvability assessments, preparation of resolution plans and strategies, and other related resolution regime elements.

The mission wishes to thank the members of the CBOB and the DIC for their cooperation, productive discussions, and hospitality during this virtual TA mission.

## EXECUTIVE SUMMARY

**The Bahamas has made considerable progress in developing the infrastructure needed for an effective bank recovery and resolution regime.** Following recommendations of the 2019 FSAP, the new legislation brought into force in September 2020 provides a reasonably comprehensive legal framework for the resolution of banks, including triggers, legal powers, and safeguards. The amendments to the Protection of Depositors Act in 2020 clarify the DIC’s role and responsibilities within the country’s financial safety net and have expanded its membership to include not only commercial banks, but also credit unions.

**The Central Bank of the Bahamas (CBOB) should strengthen the design of recovery planning requirements.** Recovery plans must be closely integrated into banks’ and credit unions’ risk management frameworks, ICAAP, and existing contingency plans. The plans should be subject to robust governance arrangements, both in a business-as-usual capacity and in a recovery activation phase. Board ownership of the plan is essential. Periodic testing of the recovery plans should be required as part of ongoing review and capacity building. The CBOB should review and update its supervisory early intervention framework to incorporate the triggering of recovery plans and ensure that early warning indicators are used more effectively in the context of early intervention. This recognizes that, for some of the smaller banks and credit unions, there are constraints on the feasibility of some recovery actions (such as capital raising) and, therefore, early intervention is especially important. A consultation paper prepared by the CBOB proposed that all supervised financial institutions (SFIs)<sup>1</sup> prepare draft recovery plans by end-June 2022. A more manageable approach would entail a pilot program in which, initially, only the larger banks are asked to submit recovery plans. Following the review of the pilot, the CBOB could then extend recovery planning requirements to other SFIs.

**The institutional arrangements for bank resolution should be strengthened.** The CBOB is responsible for bank supervision, the resolution of nonviable banks, and depositor protection. To foster operational independence of the resolution function and to avoid conflicts of interest, the CBOB should establish a clear separation between its supervision and resolution functions. A separate Resolution Unit (RU) would have a wide set of responsibilities, including development of high-level resolution strategies and manuals for the use of resolution tools, evaluating the costs of alternative resolution options, preparing resolution plans, and organizing regular crisis-simulation and capacity-building exercises.

**The operationalization of the resolution regime should be facilitated by the development of a resolution “toolkit.”** The toolkit would be supported by the resolution powers and instruments in the law and should set out guidance on resolution options, the criteria for selecting the appropriate option, and detailed guidance on their implementation.

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<sup>1</sup> All banks, bank and trust companies, and credit unions—licensed or registered by the CBOB—are collectively referred to as SFIs.

The toolkit would form the basis for institution-specific resolution planning, including for smaller, non-systemic institutions (including credit unions), and for addressing financial distress in a D-SIB.

**The resolution safeguards in the legislation should be strengthened.** While the legislation includes a “no creditor worse off” safeguard, the CBOB should (as per the international standard) have the discretion to depart from equal treatment of creditors of the same class, if necessary to contain the potential systemic impact of a firm’s failure or to maximize value for the benefit of all creditors as a whole. Independent valuation of assets and liabilities should be required to inform the CBOB’s resolution actions. Depositor preference—conferring a statutory priority on deposits in the ranking of claims in a winding up—should also be introduced

**The Cooperative Credit Unions Act 2015 is in major need of review and amendment.** As recognized by the CBOB, the Act provides inadequate triggers and powers for resolution and associated safeguards. It should be subject to comprehensive review to align it to international principles and good practice, and to facilitate effective resolution.

**The Protection of Depositors Act has recently been amended but further enhancements to the DIC are warranted.** The DIC’s governance and organizational structure should be strengthened by increasing the number of external, independent directors and by reviewing its staffing needs (establishing a small core of permanent staff, supplemented by additional staffing from the CBOB). Payout arrangements should be enhanced with the aim of ultimately achieving a seven-day payout period by strengthening data collection, improving the technological base for reimbursements, and identifying paying agents. There is also a need to develop guidance for purchase-and-assumption (P&A) transactions for resolution and to improve the framework for the DIC to determine the maximum amount (“least-cost” principle) it would contribute to such a resolution. The DIC’s funding arrangement should be strengthened, including by establishing a higher target fund and increasing levies to meet that target within five years (but deferring the introduction of risk-based levies), and establishing a back-up contingency funding facility from the MOF or the CBOB (indemnified by the MOF).

**Domestic inter-agency cooperation and coordination are essential for an effective response to financial institution distress and failure.** Currently, domestic coordination is achieved through the Group of Financial Services Regulators (GFSR), which comprises the heads of the CBOB, SCB, Insurance Commission, Compliance Commission, Gaming Board, and the Financial Intelligence Unit. The GFSR focuses mainly on information exchange on financial regulatory issues but does not deal with financial crisis management, and it does not include the MOF or the DIC. The authorities should establish a new inter-agency coordination body—a Financial Stability Council (FSC)—comprising the chiefs of the GFSR member agencies that have a financial stability and crisis management role, plus the MOF and the DIC. Its focus should be to facilitate regular information exchange, advice, and

cooperation on financial stability and crisis management issues. The FSC should establish a Memorandum of Understanding (MOU) that sets out the responsibilities of the member agencies in dealing with financial stability and crisis management.

**Cross-border cooperation arrangements for recovery and resolution, as well as for crisis management, should be enhanced.** This is especially important for The Bahamas, given the dominance of foreign banks in the financial system. The CBOB has MOUs with home supervisory authorities to facilitate information exchange and is a participant in supervisory colleges. However, the CBOB has not entered into MOUs that are specifically focused on resolution and crisis management, and it has not had significant engagement with home authorities on recovery and resolution issues. The CBOB should seek to strengthen such cooperation through the development of new or amended MOUs that include focus on financial crisis management, recovery, and resolution.

**Operational capacity to manage financial crises should be enhanced.** This can be achieved through a program of regular staff training and senior management workshops in the CBOB and the DIC, and inter-agency workshops. The authorities should undertake regular testing of crisis management and resolution arrangements, including through inter-agency crisis-simulation exercises. Given the openness of The Bahamian financial sector, the authorities should seek to extend capacity-building efforts to include cross-border exercises.

**Table 1. The Bahamas: Key Recommendations**

<b>Recommendations and Authority Responsible for Implementation</b>	<b>Paragraph Reference</b>	<b>Priority</b>	<b>Timeframe<sup>1</sup></b>
Implement recovery planning through a pilot program, initially for the large banks and then extending it to all SFIs (CBOB).	9	H	NT
Strengthen early warning indicators and the early intervention framework, incorporating recovery plan activation (CBOB).	13	H	NT
Develop a draft resolution toolkit that is supported by the legislative tools and powers (CBOB).	25,	H	NT
Establish a domestic inter-agency coordination and information sharing structure, such as a Financial Stability Council with members that have a crisis management/financial stability role (all agencies).	48,	H	NT
Establish a Memorandum of Understanding (MOU) on financial crisis management for FSC (all agencies).	48	H	NT
Develop a strategy for structuring, organizing, and adequately resourcing the roles and functions of the Resolution Unit (RU) and the DIC independently from the Supervisory function within the CBOB (CBOB, DIC).	23, 24, 39,	H	NT
Develop procedures for DIC payouts (DIC).	39,	H	NT
Increase the DIC's target fund level and increase premiums sufficiently to meet the target within the projected five-year timeframe (DIC).	43	M	NT
Establish an emergency back-up liquidity facility (DIC, MOF, CBOB).	44	H	NT
Strengthen the operating framework and procedures to support faster payouts by requiring SCV data from banks, identify means for obtaining and processing the data, and identification of private paying agents (DIC).	40	H	MT
Strengthen the resolution regime for credit unions (CBOB).	35	H	MT
Allow departure in the pari passu treatment of creditors while ensuring no-creditor-worse-off safeguard and establish depositor preference (CBOB).	22	H	MT
Hold regular inter-agency senior management workshops on crisis management (CBOB and FSC).	48	H	MT
Hold regular staff training on resolution (CBOB, RU and DIC).	24, 39	H	MT
Develop a program of regular crisis simulation and contingency test exercises (CBOB, FSC, RU, DIC).	24	M	MT
Seek to modify cross-border MOUs with home authorities to incorporate recovery and resolution (CBOB).	51	M	MT

<sup>1</sup> Near term: < 12 months; Medium term: 12 to 24 months.

## I. INTRODUCTION

### A. Overview of the Financial System in The Bahamas

1. **The financial sector in the Bahamas is large and diversified (Table 2), with total banking system assets amounting to US\$173.8 billion at end-2020 (1,753 percent of GDP).** However, the majority of those assets (88.1 percent) are held in offshore banks that are supervised by the Bahamian authorities and are separated from the domestic banking/deposit-taking system through legislative provisions that prohibit them from doing banking business with residents of The Bahamas, and also limit interactions with domestic banks largely to operating a Bahamian dollar account to pay their local expenses. The domestic portion of the banking system is composed of 22 institutions (201 percent of GDP), including 8 commercial banks. Among the locally incorporated commercial banks, four are foreign-owned subsidiaries and three are locally owned. There is also a foreign bank branch. The seven credit unions are small (2.5 percent of locally incorporated banks' assets and 5 percent of GDP).

**Table 2. The Bahamas: Banking System Structure**

(At end-2020)

	Number	Assets		In percent	
		(USD billions)	GDP	Domestic Banks/LFIs <sup>1</sup>	Total
<b>Sub-total domestic</b>	<b>22</b>	<b>20.0</b>	<b>201.4</b>	<b>100.0</b>	<b>11.5</b>
Total commercial banks	8	15.2	153.3	76.0	8.7
Domestic	3	3.6	36.0	18.0	2.1
Foreign owned/branch	5	11.6	117.2	58.0	6.7
Other LFIs	14	4.8	48.2	24.0	2.8
<b>Credit unions</b>	<b>7</b>	<b>0.5</b>	<b>5.0</b>	<b>2.5</b>	<b>0.3</b>
<b>Development banks</b>	<b>1</b>	<b>0.1</b>	<b>0.4</b>	<b>0.5</b>	<b>0.1</b>
<b>Offshore banks</b>	<b>48</b>	<b>153.2</b>	<b>1546.3</b>		<b>88.1</b>
<b>Total system</b>	<b>78</b>	<b>173.8</b>	<b>1753.1</b>		<b>100.0</b>

Source: Central Bank of The Bahamas and IMF staff calculations.

<sup>1</sup> Local financial institutions.

2. **The financial position of the banking system appears to remain strong despite conjunctural developments weighing on profitability.** The banking system is highly capitalized and highly liquid (Table 3). At end-2020, the average capital ratio for the banking system was estimated to be 28.4 percent of risk-weighted assets and the liquid assets to total

assets ratio was estimated to be 32.4 percent.<sup>2</sup> All banks have significantly more capital than the CBOB's target capital adequacy ratio of 17 percent of risk-weighted assets.

Nonperforming loans (NPLs) have increased to 8.5 percent of total loans over the previous year's 8.0 percent, as pandemic deferrals of loans declined from about one-third of credit facilities in June 2020 to 9.1 percent of private sector loans by year-end 2020. Concurrently, provisioning strengthened, with specific provisions covering 83.4 percent of NPLs up from 76.4 percent at end-2020. Profitability of the financial system has been affected by the weakened macroeconomic conditions in 2020, reflecting in part the impact of the global pandemic and increases in loan provisioning.

**Table 3. The Bahamas: Financial Soundness Indicators**

(As of December 2019 and December 2020)

	2019 (in percent)	2020 (in percent)
<b>Assets of banks</b>		
Loans/total assets	62.4	61.8
Nonperforming loans/total loans	8.0	8.5
Specific provisions/nonperforming loans	76.4	83.4
<b>Liquidity</b>		
Liquid assets/total assets	29.6	32.4
<b>Capital adequacy</b>		
Regulatory capital/risk-weighted assets	28.1	28.4
Regulatory Tier 1 capital/risk-weighted assets	27.0	26.7
<b>Profitability</b>		
Return on assets	2.4	-0.1
Return on equity	10.6	-0.3

Sources: Central Bank of The Bahamas and IMF staff calculations.

**3. The liability side of the onshore financial system is dominated by deposits.**

Overall, almost 80 percent of bank liabilities are deposits, a pattern observed in all segments of the banking system. For the system's credit union segment, deposits represent almost 100 percent of total liabilities. Opportunities for placing securities in the capital markets are limited.

**4. The Bahamian financial system poses special difficulties for the resolution regime, particularly given the dominance of foreign banks.**

The system is highly concentrated. Of the 22 banking licensees in the domestic system, 11 are members of the

<sup>2</sup> Capital and liquidity buffers have remained stable at these levels since the 2019 FSAP, which assessed the banking system as resilient to a range of adverse scenarios, although some individual banks' high NPLs warranted caution.

DIC (Table 5). The commercial banking sub-sector assets are 76 percent of total system assets (Table 2), with the four largest commercial banks holding 54 percent of total system assets and 70 percent of total system insured deposits (Table 5). Those largest banks are foreign owned, with strong shareholders. The supervisory and resolution frameworks for banks have recently been strengthened following the 2019 FSAP and the CBOB's consultations with LEG, and further upgrades are needed to bolster resolution funding and institutional arrangements, and build capacity.

5. **In addition, the Bahamian financial system has some pockets of weakness.** The financial position of credit unions, which hold 3 percent of deposits (13 percent of total insured deposits), tends to be weaker than that of banks. Some face liquidity constraints, while others do not meet capital requirements. The supervisory and resolution frameworks for credit unions need to be strengthened.

## II. CRISIS PLANNING AND PREPARATION

### A. Recovery Planning

6. **Recovery planning is important for the effective restoration of banks to financial soundness following the materialization of stress.** At the least, all systemically important banks (SIBs) should be required to have recovery plans that set out the means by which they can be restored to financial soundness in the event of a significant financial shock. Given that recovery plans are a key element in any bank's risk-management framework, many supervisory authorities require all deposit-taking institutions to maintain recovery plans. The requirements for recovery plans are generally standardized across all supervised financial institutions, but are applied in a proportionate manner, with large banks being expected to have more comprehensive recovery plans than small banks and deposit-taking institutions.

7. **The authorities should issue detailed guidelines on the content of recovery plans.** They should require plans to contain well-specified objectives, governance arrangements, a description of critical functions and services, triggers for activation of the recovery plan, target restoration points for key financial variables, and recovery options. Recovery plans are generally expected to contain scenarios of a severe but plausible nature, including idiosyncratic and system-wide scenarios, with the plan setting out the likely recovery actions for each scenario. Recovery plans should be closely integrated into a bank's risk management framework, including its Risk Appetite Statement, Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP), capital and liquidity contingency plans, business continuity plan (BCP), and stress testing.

## Findings

8. **The CBOB is introducing recovery planning requirements for SFIs.** The intention is to require all SFIs to prepare recovery plans and to undertake regular reviews and updates of these plans. A draft consultation paper has been prepared by the CBOB for consideration by the SFIs, with the intention of receiving their comments within two months of its issuance. This proposed that all SFIs prepare recovery plans by end-June 2022 for CBOB review.

## Recommendations

9. **The implementation should be made more manageable by starting with a pilot of selected larger banks.** They could be asked to prepare such plans within six months after issue of the CBOB's consultation paper, scheduled to be by mid-2022. The CBOB could review these draft plans and identify the matters where further refinement might be needed.<sup>3</sup> Following the review of these draft plans and drawing on lessons learned from that process, the CBOB could then ask the pilot banks to revise their recovery plans and extend the recovery planning requirements to all SFIs, subject to CBOB resourcing capacity to manage the process.

10. **The draft consultation paper contains helpful guidance for SFIs but should be expanded upon.**<sup>4</sup> Areas that should be covered include:

- the addition of well-defined objectives anchored to the need for an SFI to demonstrate a capacity to restore financial soundness within a reasonable timeframe;
- robust governance for the recovery plan, with ultimate ownership by each SFI's Board;
- a section that demonstrates the linkages between the plan and other elements of the risk management framework, especially the Risk Appetite Statement, ICAAP, ILAAP, other contingency plans, and stress testing;
- the specification of critical functions and services and setting out how the recovery strategies will ensure continuity of these functions and services;

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<sup>3</sup> The second IMF mission, scheduled for the second half of 2022, could potentially assist in the review process by providing feedback to the CBOB on its initial assessments and findings for the pilot.

<sup>4</sup> Appendix I sets out further guidance on these matters, including indicative questions that supervisors could consider in reviewing recovery plans.

- triggers for activation of the recovery plan, with these triggers applying well before any breach of regulatory requirements, linked to early warning indicators;
- restoration points for key financial variables, including capital and liquidity, where the restoration points are set well above regulatory minima;
- recovery options that are realistic and suitably prioritized, with guidance on implementation steps and with an indication of the quantification of the contribution each recovery option could make to capital and liquidity;
- scenarios that are severe but plausible, and which include both idiosyncratic and system-wide scenarios, with an indication of the recovery actions likely to be selected for each scenario;
- preparatory measures to ensure that an SFI is legally and operationally pre-positioned to implement recovery options in a timely manner;
- communications strategies, with guidance on the information needs of stakeholders, key messaging, and communication channels; and
- processes for the review and regular testing of the recovery plan.

11. **The CBOB should establish a small team of senior supervisors with the appropriate experience and knowledge to lead and coordinate the review of SFI recovery plans.** The team would be responsible for ensuring a consistent approach to the review process and assist supervisors in reviewing the individual recovery plans for each SFI. Once recovery planning has become well established and the CBOB supervisors gain a deeper understanding of recovery plans, the team could be disbanded, leaving the supervisory review of recovery plans to each SFI supervisor.

12. **In the case of banks that are subsidiaries or branches of foreign banks, the CBOB should coordinate with the home supervisory authorities.** Inter-authority discussions would seek to establish whether, in the view of the home supervisory authority, the parent bank's recovery plan makes appropriate provisions for financial and operational support to the subsidiary or branch in The Bahamas, including capital and liquidity support, and how critical shared services provided to the subsidiary or branch will be maintained through periods of stress. Notwithstanding the need for these arrangements, the recovery plan for the subsidiary/branch should also identify initiatives to maintain its financial and operational soundness in the event of parent-based or group-wide stress. This will include the need to demonstrate how it will protect and conserve its local capital/net asset position<sup>5</sup> in a period of stress, the means by which critical functions and services could be maintained in

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<sup>5</sup> This could include the prevention of upstreaming of capital or other funding to the parent in a period of stress.

the event that parent-based systems are rendered non-operational, and the means by which a subsidiary could seek to access capital and funding in the absence of parent support.

13. **The CBOB should review its supervisory early intervention framework to integrate the activation of recovery plans.** In this context, the CBOB should further develop its early warning system to detect emerging stress at an early stage and to enable supervisory intervention to be escalated before stress threatens the viability of an SFI. The early warning system and early intervention framework should be tested regularly by the CBOB to build and maintain capacity.

### **B. Resolution Planning<sup>6</sup>**

14. **The CBOB should develop bank-specific resolution plans at least for SIBs that identify ways of resolution without putting public funds at risk.** The resolution plans should be tailored to each bank, informed by resolvability assessments undertaken by the CBOB. For a large bank, the most likely forms of resolution would involve either recapitalization by its parent/shareholders or separation of critical functions and systems and transfer of these to another bank, or to a bridge bank, or merger. A key element of any resolution plan is ensuring the continuity of critical functions and services, and to pre-position the bank and its structure and operations to enable this to happen at least cost.

15. **For foreign-owned banks, resolution planning should be developed in close coordination with the home resolution authorities.** The authorities should begin discussions with the resolution authorities of home countries to evaluate resolution strategies for such institutions, with a view to developing a coordinated resolution approach between the CBOB and the home resolution authorities where possible. The resolution strategy for the entity in the Bahamas should take into account the intended resolution strategy of the parent entity, where known. For a group with a single point of entry strategy, for example, resolution planning in the Bahamas should focus primarily on whether resolution would be implemented in ways that enable the parent entity to provide the required capital, liquidity funding, and operational support to the operations in The Bahamas.

16. **Resolution plans also need to cover scenarios in which the group resolution would not meet financial stability and depositor protection objectives in The Bahamas.** The authorities should prepare to resolve the local entity on a standalone basis, e.g., if information from, or coordination with, the home authorities is insufficient, or the resolution plan of the home authorities is to break up or liquidate the group. These plans should enable the subsidiary/branch in The Bahamas to be separated from the parent banking group and

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<sup>6</sup> Resolution planning and resolvability assessments will be covered in depth during the second mission.

resolved in a manner that maintains the continuity of critical functions and services in The Bahamas, in order to minimize the risk of disruption to domestic financial stability.

### C. Resolvability Assessments

17. **Resolvability assessments involve three main stages.** These comprise: (i) an assessment of the feasibility of different resolution options for the bank in question; (ii) an assessment of the systemic impact of each resolution option; and (iii) an assessment of the actions needed to improve the resolvability of the bank under the preferred resolution options. While the starting point of the resolvability assessments are the resolution plans for the institutions, resolvability assessments have a broader focus. Their objective is to identify any structural and operational impediments to implementing effective resolution, or that would make resolution ineffective. Like resolution planning, resolvability assessments for individual institutions are highly confidential, undertaken by the CBOB and are primarily focused on resolution options that do not involve putting public funds at risk.<sup>7</sup>

## III. BANK RESOLUTION AND CRISIS MANAGEMENT

### A. Bank Resolution Framework

18. **The legislation reforms introduced in 2020 have enhanced the CBOB’s powers to resolve troubled banks, including triggers, legal powers, and safeguards that facilitate the authorities’ development of the infrastructure needed for an effective bank resolution regime.** The legal framework for bank resolution was updated through reforms in the CBOB Act 2020, the Banks and Trust Companies Regulation Act 2020, and the Protection of Depositors Act 2020. Among other things, these reforms empower the CBOB to use an administrative approach to resolve troubled banks and establish the DIC as a paybox within the CBOB with its own Board. The Protection of Depositors Act 2020 also adds credit unions—which are supervised by the CBOB—as insured DIC members, although equivalent resolution framework reforms have not yet been established under the Cooperative Credit Unions Act 2015.

### Findings

19. **The CBOB is the resolution authority for banks.** It has responsibilities for bank supervision, the resolution of banks, and depositor protection (the DIC). Once the supervisors determine that an institution is failing or has failed, the CBOB triggers resolution and, as a

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<sup>7</sup> The Contingency Planning framework governs situations where worst case outcomes for resolution may require emergency back-up liquidity facilities and/or potentially have fiscal implications and/or involve DIC funding (refer section V below and Appendix III).

first step, places it under statutory administration. The administrator then determines the appropriate resolution, which may include forced mergers or the closure of the institution and the transfer assets and liabilities to a healthy bank or a bridge bank. The administrator may also allow recapitalization by new investors or the “bail-in” of subordinated debt and convertible securities. The legislation provides safeguards to protect creditors and shareholders, including a “no creditor worse off” safeguard. However, the CBOB does not have discretion to depart from pari passu treatment of creditors in the same class. This constrains the type of resolution that can be implemented and may impede some forms of resolution. For example, a bail-in involving the use of statutory powers to convert unsecured liabilities to equity or to write down the value of the liabilities may be more difficult to achieve if all senior unsecured liabilities (including deposits) are treated on a pari passu basis. In contrast, jurisdictions whose laws confer a preferential ranking on deposit liabilities, or specific categories of deposit liabilities, enable bail-in or selected business transfer to be implemented more flexibly by enabling non-deposit senior unsecured liabilities to be subject to bail-in or business transfer without interfering with the ranking of claims.

20. **Funding for resolution comes from asset recoveries from the institution placed under administration, and from the DIC.** The DIC can provide financing to an entity that acquires the business, or all or part of the assets and liabilities, or provide capital for the establishment of a bridge bank. The use of the DIC’s funds, however, cannot exceed the amount the DIC would have incurred in paying out insured depositors under liquidation.

21. **The new resolution law is broadly aligned with international standards for bank resolution (the Key Attributes).** It identifies appropriate triggers, legal powers, and safeguards. Resolution powers for banks include forced mergers, P&A powers, the establishment of a bridge bank, and an asset management company. However, some resolution tools, including bail-in authority, are not consistent with international standards and should be enhanced. In addition, creditor protection should be strengthened.

## **Recommendations**

### ***Legal underpinnings of resolution***

22. **The resolution tools should be supported by stronger protections for creditors and greater flexibility in developing resolution options.** The CBOB should require an independent valuation of assets and liabilities to inform its resolution actions. While resolution powers respect the hierarchy of claims and the no-creditor-worse-off safeguard, the resolution should be able to depart from pari passu treatment of similarly ranked creditors, either to prevent contagion in the financial system or to maximize the bank’s value. Moreover, the authorities should introduce depositor preference that places deposit liabilities in a more senior position than other senior unsecured creditor claims. It also facilitates the

use of resolution tools (such as P&A) where not all depositors are transferred to another institution.

### ***Governance structure***

23. **The CBOB should ensure the independent structures and governance of the departments responsible for the supervision of financial institutions, their resolution, and the deposit insurer for the financial sector.** These units within the CBOB carry out very different functions and have very different perspectives on the risks facing institutions. For this reason, a clear separation between supervision and resolution is needed to ensure that each function is carried out autonomously and is free from conflicts of interest. The CBOB, therefore, should consider establishing an RU within the CBOB, with appropriate governance arrangements (including a different reporting line from that applicable to supervision) to manage any conflicts of interest. Such an RU would have a wide variety of tasks, including to develop manuals for the use of resolution tools; identify resolution options for credit unions; develop resolution strategies for each category of SFI (such as locally incorporated banks, branches of foreign banks, credit unions, systemic versus non-systemic SFIs, etc.); undertake resolvability assessments; prepare resolution plans; and organize regular crisis-simulation exercises. In the event of the failure of a financial institution, the RU would identify the least-cost resolution option and ensure that the needed finances are available. It would oversee the implementation of the strategy. If a purchase and assumption transaction is used, the RU will package the performing assets and any supplemental resources needed to match the deposits to be assumed and offer the packages for bidding to financial institutions. If the failed bank is to be recapitalized and restructured, the RU will ensure adequate resources are available and identify an agent to oversee the restructuring.

24. **The issue of staffing is critical.** In a relatively small central bank, the question may arise why a dedicated RU is needed. In part, this need arises from the complex steps that need to be taken to organize and make a resolution regime functional. Such activities require specialized knowledge and specialized skills. These cannot be developed when a crisis is emerging. Moreover, some sectors, such as the credit unions, require special, dedicated efforts. The RU would include three or four staff and specific training would be provided.

## **B. Resolution Strategies and Powers**

### **Findings**

25. **The CBOB is seeking to effectively operationalize the legislation powers and instruments under the new resolution regime.** Although a well-designed legal framework is a prerequisite for effective resolution, it is also necessary to develop guidance for how the legal framework can best be applied to achieve the desired resolution objectives.

## Recommendations

26. **The operationalization of the resolution regime would be facilitated by the development of a resolution toolkit.** Such a toolkit would set out guidance on resolution options, the criteria for selecting the appropriate option, and detailed guidance on their implementation. The toolkit would identify strategies and powers needed for resolving specific institutions, including smaller, non-systemic institutions, D-SIBs, and a framework for addressing financial distress in a D-SIB. The establishment of a resolution toolkit will be a prerequisite to the development of bank-specific resolution plans, which will draw on the resolution options set out in the guidance contained in the resolution toolkit.

27. **Indicative guidance on the matters that such a toolkit would need to contain is included in Appendix II.** Development of a comprehensive toolkit would also need to address some specific issues concerning the existing resolution powers.<sup>8</sup>

### *Purchase and assumption (P&A)*

28. **When a bank's closure does not present systemic risks, the resolution authorities can seek to package performing assets and deposits for sale to a sound bank and liquidate the residual entity.** There are a number of policy issues to be determined in conducting such P&A transactions. First, as drafted, the law appears to permit the DIC to provide funding directly to the acquiring institution to balance packages of assets and liabilities. However, the DIC does not provide open bank assistance to the acquiring banks. Once the resolution authority determines the funding needs for the P&A transactions, it arranges the provision of funding, that, in part, can come from the DIC. The resolution authority must determine which depositors should be incorporated into the P&A. While, at a minimum, all insured deposits should be transferred using DIC resources, there may be scope for transferring all depositors, with the aim being to reinforce depositor confidence if needed to preserve financial stability. That possibility will depend on the amount of performing assets and the public policy question of whether to impose losses on uninsured depositors, or potentially find fiscal resources to supplement the DIC contribution. Third, the valuation of the assets in the failed bank can be difficult. Accordingly, bidders may be unwilling to take on assets without an adequate due-diligence examination. Jurisdictions should, when possible, give advanced notice to potential acquiring banks, subject to strict confidentiality requirements, or can provide "sweeteners," e.g., allow acquiring banks to "put back" an asset under certain limited circumstances.

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<sup>8</sup> A more detailed discussion of these issues is contained in Appendix II, paragraph 38.

### ***Bridge bank***

29. **If there are no immediate interested acquirers for a P&A transaction, but the bank’s failure would have a negative systemic impact, the resolution authorities may decide to establish a bridge bank as an interim step.** A bridge bank may be a desirable option for a systemically significant bank if the failing bank comprises substantial amounts of impaired loans and non-critical functions and systems; such that the transfer of only critical functions and systems, and viable assets, to a bridge bank may be lower cost than alternative options and may make the eventual sale of the bridge bank to a suitable private sector investors easier and quicker to achieve. This option is allowed under Bahamian law. The bridge bank operates as a normal bank, taking deposits and providing credit over a temporary period while a suitable acquirer is sought. When activated,<sup>9</sup> the RU can transfer performing assets and on-balance sheet liabilities from the failed bank to the bridge bank.

30. **The bridge bank is typically owned by the government, either directly or via a special holding company that seeks to ensure arm’s-length ownership.** Neither the CBOB nor the DIC should be shareholders, as it would reflect potential conflicts of interest. If the bridge bank may operate in the market for an extended significant period, it should meet all prudential regulations, including capital requirements.<sup>10</sup> Bridge banks should be used primarily to allow more time for due diligence and a sales process should ideally be completed within a few months. More time may, however, be needed, which the legislative framework should allow for (for example, up to two years, with appropriately limited extension clauses where necessary, for example, to accommodate challenging market conditions following severe stress).

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

31. **Bail-in involves statutory powers to impose losses on creditors.** The CBOB can already write down shareholders and creditors and can trigger contingent convertible bonds (CoCos). The use of CoCos, however, is extremely limited in The Bahamian market. There are a number of impediments to expanding the scope of bail-in powers in The Bahamian environment. First, excluding insured deposits, bank liabilities largely comprise retail deposits, which are often also excluded from such operation. Second, the market is not deep enough for the development of loss-absorbing securities. Given that use of bail-in powers also require complex valuation in real time, which may be more legally contested, they may

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<sup>9</sup> Some jurisdictions may establish empty shell entities which can be activated and licensed quickly once the resolution authority determines that a bridge bank solution is needed.

<sup>10</sup> It is true that some jurisdictions, such as the United States, do not require that a bridge bank be fully capitalized. Rather, the authorities depend on intensive supervision to limit risk taking. However, not meeting all prudential regulations gives the bridge bank an unequal advantage in the market and can distort competition.

be better suited to complex banks and may benefit from more pre-positioning of loss absorbing capacity to reduce the risk of legal challenges upon their use. If bail-in powers were to be adopted, several additional measures would need to be taken, including (i) ensuring banks' holding of sufficient loss-absorbing liabilities; and (ii) exclusions to prevent contagion to other banks.

32. **Notwithstanding these limitations, bail-in powers may have a place in the Bahamian resolution tool kit, as supported by the legal provisions.** Bail-in might be a feasible option as part of a cross-border group resolution if the home authority is not willing to allow the parent bank to cascade capital down to its subsidiary in The Bahamas, without some of that capital being funded by bail-in of unsecured liabilities on the subsidiary balance sheet, e.g., if the subsidiary sustained significant losses in its own right. In addition, bail-in might be a feasible option for a major domestically owned bank, particularly if it has significant unsecured liabilities beyond its deposit liabilities. It would be advisable for the CBOB to include in its toolkit the possibility of bail-in and, in that context, to assess the nature of the authorities' statutory bail-in powers and the bank liability structures that would be needed to make bail-in feasible, including the possibility of requiring D-SIBs to establish additional loss-absorbing capacity (e.g., via long-term senior unsecured bonds). These are issues that could be explored further in the second mission in November 2022.

#### *Asset management companies*

33. **While potentially useful under some circumstances, an AMC comes with a high potential cost and should only be considered under exceptional circumstances.** The effectiveness of an AMC depends, importantly, on the purchase price of the assets. When the AMC pays market prices for the weak assets, the bank in distress recognizes the losses and must restructure its operations. Such a bank is likely to require recapitalization and restructuring of operations. If the assets are taken off the bank's balance sheet at book value, the bank's financial performance is strengthened at the cost of passing the losses to the government. Experience suggests that AMCs operate slowly, with economic and political constraints on realizing value from distressed assets. Losses of AMCs can become an important drain on government resources, increasing fiscal costs and resulting in warehoused assets for a number of years. In addition, the AMC addresses the backward-looking problems but not the forward-looking issues of ensuring that the entity is viable. As a result, such a tool should be considered at best only in specific circumstances of a system-wide banking crisis where there would be efficiency benefits in managing homogenous NPLs (such as large, syndicated loans) centrally.

### *Special conditions in the credit unions*

34. **An area of weakness is the resolution framework for credit unions, and the Cooperative Credit Unions Act 2015 should be reviewed and amended.** In particular, the law needs to provide a well-specified and comprehensive set of triggers for entry into resolution, including triggers that enable resolution to be initiated well before balance sheet insolvency. The law also needs to be amended to enable the CBOB to initiate and complete resolution without court approval, and without the need for a mandate from a credit union's members. The legal powers needed include the ability to appoint a statutory manager/administrator to assume control of a credit union, to transfer some or all of the business undertaking of a credit union to another financial institution (not necessarily being a credit union), to merge credit unions, and to execute a stay on actions that could be taken by creditors and other parties to impede the implementation of the resolution transactions. There is also a need for the CBOB to have strengthened powers to close a credit union quickly and efficiently, and request the DIC to make payouts to insured depositors under the deposit insurance scheme. The new law should limit the power of the courts to conducting an ex post review for the purpose of determining compensation to be paid to parties rendered worse off than they would have been under a conventional winding up.

### **C. Deposit Insurance<sup>11</sup>**

#### **Findings**

35. **The Protection of Depositors Act has recently been amended.** The law lays out the DIC's structure, powers, and responsibilities. It operates within the CBOB with its own Board of Directors, composed of six members, four ex officio members, and two external directors. The DIC has no formal employees but is staffed by employees of the Bank Supervision Department. The DIC insures all deposits denominated in Bahamian dollars of both residents and nonresidents. Deposits denominated in foreign exchange are not protected. The DIC's mandate is to provide insurance against the loss of part or all of the deposits and to promote and contribute to financial stability. It is authorized to provide financing for resolution measures. Membership in the DIC is compulsory for every licensed bank with Bahamian dollar deposits. The Act explicitly increased the membership to include not only commercial banks but also credit unions. The DIC is financed by annual premiums levied on member institutions.

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<sup>11</sup> An expanded and more detailed discussion of the issues in this section is contained in Appendix V.

36. **The DIC aims to pay out deposits within 20 days.** This compares adversely to the international target of seven days. However, achievement of even this 20-day goal is hampered by a lack of deposit data in the appropriate single customer view (SCV) format, and by access limitations in some of the smaller banks and the credit unions.

37. **Funding of the deposit insurance fund (DIF) is provided through premiums paid by members and interest earned from investments.** Member banks, including credit unions, pay premiums on a biannual basis (at end-March and end-September) into a single fund. The fund currently holds B\$69.1 million or approximately 0.9 percent of total insurable deposits and 2.7 percent of total insured deposits (Table 3). This funding level is low and would cover the failure of only the three smallest credit unions and the four smallest banks. It would not be able to cover the failure of the largest credit union, or any of the medium-sized banks in the Bahamian financial system. In the event of a shortfall, the Protection of Depositors Act does not envision funding by the CBOB or placing funds in the market. However, the DIC may request a loan from the government. If the fund is in danger of being exhausted, the DIC may assess extra levies on member institutions.

## **Recommendations**

### ***Governance and staffing***

38. **The DIC's governance structure and staffing warrant strengthening.** The current board, while adequate by international standards, is dominated by ex officio members of the government, including the Governor of the CBOB as Chair.<sup>12</sup> This structure reduces the DIC's independence from policy pressures. Currently there are proposals to increase the board size from six to nine members, increasing the number of external directors from two to five.<sup>13</sup> It will be critical to balance potential benefits with potential risks, including with regard to ensuring adequate DIC fund and coverage levels.

39. **The DIC should also review its long-term staffing needs.** It should appoint a small core of permanent staff and establish arrangements to enable it to quickly ramp up staffing, as needed, to discharge its responsibilities, e.g., via the "insourcing" of additional FTE from the CBOB during times of stress. Initially, the DIC will be tasked with a significant amount of work, including developing guidelines for reimbursements and appropriate safeguards for

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<sup>12</sup> With regard to governance standards, Core Principle 3 of the IADI Core Principles for Effective Deposit Insurance Systems states: "The composition of the governing body minimizes the potential for real or perceived conflicts of interest. In order to maintain operational independence, representatives of the other financial safety-net organizations that participate in the governing body do not serve as Chair or constitute a majority."

<sup>13</sup> As is the case in the current law, the current staff or executives of any member institution should not be appointed to the Board.

the use of DIC funds. A minimum staff of three to four persons seems reasonable, including a CEO, a staff person for all funding issues, and one to two staff for reimbursement, data preparation, and evaluation. Specific training should also be provided.

### *Strengthening the reimbursement framework*

40. **Rapid payout requires that the deposit insurer have appropriate organization, authority, and infrastructure.** Factors for effective reimbursement include (i) adequate human resources; (ii) information-sharing arrangements with other safety-net participants; (iii) early warning arrangements; (iv) advance access to data on depositors, including qualitative review of data; (v) access to adequate funding sources; (vi) management information system; and (vii) pre-arranged contracts with outsourcing partners, such as paying agents, call centers, and legal services. Not only should the deposit insurer have such elements, but it needs to test their continued effectiveness. For example, can member institutions produce appropriate data in a specified timeframe, can they generate SCVs, and can paying agents be quickly and effectively activated? These requirements are detailed in Appendix IV.

41. **Consideration should be given to covering foreign exchange-denominated deposits of domestic banks.** While such deposits play a small role in the current financial system, adding foreign exchange deposits has a number of benefits while exposing the DIC to limited costs. First, not covering such deposits may limit the development and deepening of the financial system. Particularly, in an open economy, foreign exchange transactions can be important for financial intermediation. Second, international principles call for no discrimination among deposits by currency.<sup>14</sup> Payout of such deposits should be in local currency at the exchange rate on the day of failure.

### *Funding*

42. **The DIC should conduct an analysis of the fund's adequacy.** Such an analysis could look at the structure of the banking system, the probability of default and the loss-given default of the institutions, and historical data from bank failures in other jurisdictions. A back-of-the-envelope calculation would show that even if the fund target were only doubled, increasing it from 2 percent of insured deposits to 4 percent, the fund would at least be able to cover the small and two medium-sized credit unions, the largest credit union, or the small banks and one medium-sized bank.

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<sup>14</sup> IADI Core Principle 8, and IADI Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage, 2013.

43. **The premium structure should be evaluated in light of the need to strengthen the DIF.** The CBOB is already examining the possibility of increasing premiums in a scaled approach by 5.5 bps, 6 bps, 7.5 bps, and 10 bps. These increases should be reviewed in light of the need to reach the DIF target within five years. In addition, the DIC should be cautious about applying risk-based premiums at this stage. Increasing premiums in the weakest or riskiest banks in the system could be counterproductive.

44. **The DIC should have a dedicated, pre-arranged back-up funding arrangement.** The back-up funding should be sufficient and available to ensure that liquidity requirements are met. Typically, such back-up funding is provided by the MOF. However, the provision of such funding must be extremely fast. In this context, the CBOB may provide the funding within the formal agreement that all credits to the DIC are indemnified by the MOF. Any use of this emergency funding facility should be repaid from asset recoveries or levies on members.

#### *Public awareness*

45. **The DIC should develop a public awareness policy framework.** Such a framework would identify member institutions; what information on deposit insurance information should be distributed; and the communication tools and channels to be applied, including (i) website; (ii) mass media: newspapers, magazines, television, and radio; (iii) online and social media; and (iv) educational activities. This framework would identify mechanisms for enhancing public awareness, such as preparation of information leaflets, a dedicated website, and provision of information sheets for banks to provide deposits that outline the main elements of the deposit insurance systems, and how reimbursement will be provided. An independent evaluation is needed to measure the effectiveness of the public awareness program or activities.

## IV. INTER-AGENCY COORDINATION

### A. Domestic Coordination

46. **Effective cooperation and coordination among the key government agencies in any bank distress or resolution process is crucial.** Coordination is needed for information sharing; the development of crisis management policies and procedures; regular training and crisis management exercises; and the development of policy responses to financial crisis. Coordination is also needed for the development of strategies for dealing with a wider systemic crisis.

## Findings

47. **In The Bahamas, domestic coordination on financial stability and crisis management matters is underdeveloped and would benefit from strengthening.** The existing domestic coordination body is the Group of Financial Services Regulators (GFSR), which comprises the heads of the CBOB, Securities Commission, Insurance Commission, Compliance Commission, Gaming Board, and Financial Intelligence Unit. The GFSR meets quarterly and focuses mainly on information exchange on financial regulatory issues. It does not specifically deal with financial crisis management matters and does not include the MOF or the DIC. Although the CBOB and MOF engage bilaterally on a range of issues, there is no regular mechanism by which the MOF is engaged on financial stability and crisis management issues. The DIC is also not sufficiently engaged in its independent capacity in inter-agency discussions on financial stability and crisis management issues.

## Recommendations

48. **The Bahaman authorities should establish an inter-agency body, such as a Financial Stability Council (FSC), comprising the heads of the relevant members of the GFSR with a financial stability and crisis management role, plus the MOF and the DIC.** It would focus on facilitating regular information exchange, cooperation and coordination on financial stability and crisis management issues, with capacity building supported through a program of regular staff training and senior management workshops within the CBOB and the DIC, and on an inter-agency basis. It would operate under a published MOU that sets out the FSC's objectives and modus operandi, the responsibilities of each member agency, and the matters on which cooperation and coordination are needed. The FSC should meet at least quarterly to review financial stability indicators and to coordinate the approach to financial sector regulatory issues. Working groups should be established, as appropriate, to support the FSC's analysis and policy development. The nature of possible working groups could be discussed in the second mission to the extent that these relate to resolution matters.

49. **The administrative arrangements for the proposed FSC warrant careful consideration.** It is important to ensure that all member agencies are equal participants in the coordination body, and that a suitable chairing arrangement is agreed by the member agencies. In some jurisdictions, the coordination body is chaired by the central bank in recognition of its financial stability mandate. However, in other jurisdictions, it is chaired by the MOF, given its potential importance in a financial crisis. Other examples of domestic coordination bodies involve a rotating chair arrangement under which each member agency chairs the body on a rotating basis. A common principle in such bodies is that, regardless of which agency chairs it, any member agency can require an item to be placed on the agenda and call for a meeting at any time. Working groups formed by the domestic body are usually

chaired by the agency with the most responsibility for the matters addressed by the working group in question.

## **B. Cross-Border Cooperation and Coordination**

### **Findings**

50. **In a banking system with significant participation of foreign-owned banks, as in The Bahamas, effective cross-border cooperation and coordination is essential.** The CBOB has MOUs with home supervisory authorities of both offshore and domestic banks to facilitate information exchange and is a participant in supervisory colleges. However, the CBOB has not yet entered into MOUs that are specifically focused on resolution and crisis management and has not had significant engagement with home authorities on recovery and resolution issues. There is an underdeveloped framework for cross-border coordination of early stress alerts, early intervention, recovery planning, resolution planning, and resolution. This is a significant gap in the institutional framework.

### **Recommendations**

51. **The CBOB should strengthen cross-border cooperation arrangements.** This could include the development of new MOUs or modifications to existing MOUs to establish the respective responsibilities of the authorities in The Bahamas and their counterparts in the relevant home jurisdictions, in relation to all phases of bank stress from early intervention through to resolution. It is also likely to require either an extension of the scope of supervisory colleges to incorporate recovery and resolution issues, or the establishment of crisis management groups to facilitate discussion of these matters.

52. **It will be especially important to develop a coordinated approach to the development of recovery and resolution plans for foreign banks operating in The Bahamas.** In the case of recovery plans, the CBOB should work with the home authorities to clarify, where possible, the extent and nature of parent-bank support arrangements. In the case of resolvability assessments and resolution plans, there needs to be an agreed framework for information exchange and coordination between the home and host authorities, with a view to agreeing to a whole-of-group (parent-led) form of resolution that ensures continuity of critical functions and systems in the subsidiaries/branches in The Bahamas. Where a whole-of-group resolution plan is not feasible or satisfactory from the perspective of The Bahamas authorities, or they are unable to gain visibility on such plan, the CBOB should prepare to pursue resolution strategies on a stand-alone basis that would enable the separation of the host business from the parent banking group in a manner consistent with maintaining continuity of critical functions and systems and minimizing disruption to The Bahamas' financial system stability. Cross-border coordination may be necessary not only between the CBOB and the home resolution and supervision authorities,

but also between the other home and host agencies involved in resolution. This suggests that cross-border MOUs on crisis management and resolution may need to include the MOF, the DIC, and their respective counterparts in the home jurisdictions on funding aspects of resolution contingencies.

## V. CONTINGENCY PLANNING

### Findings

53. **The Bahamas has a long record of financial stability.** The banking system is sound, with both high capital and liquidity levels. As a result, the CBOB authorities and the DIC authorities have little experience on which to draw from operational lessons for dealing with a failure. When faced with unexpected developments or shocks, the process and procedures may be unfamiliar and, therefore, result in a relatively costly resolution.

### Recommendations

54. **The implementation of a comprehensive contingency planning and testing framework is an important step to mitigate this danger.** Contingency planning allows the authorities to develop familiarity with tools and procedures, as well as to ensure that the processes in place will operate as expected. Many jurisdictions in similar situations create a specialized contingency planning group to design and then implement testing of multi-year testing programs. In The Bahamas, such a program would be discussed and approved either by the heads of each agency or by the proposed FSC, which is chaired by the Governor of the CBOB, and with senior-level representatives from the MOF, the Securities Commission, and the DIC. This way, all agencies would be aware and participate in the testing process.

55. **Contingency planning and strategies would have a wider system focus than bank resolution plans, to include public options where this is determined necessary.** Given that the MOF will be involved whenever public funding, guarantees, or temporary public ownership of a bank are required, the MOF should also be involved in the development of those elements in the contingency plan that relate to public funding. This could be achieved through the establishment of an inter-agency working group on resolution contingencies led by the CBOB under the auspices of the proposed FSC. (Also refer Appendix III regarding considerations for public funding in resolution)

56. **A variety of contingency tests can be planned to make sure that basic procedures are effective.** For example, the resolution authority will want to know it can arrange P&A packages quickly, that it knows the procedures for allowing potential buyers to have access to confidential information, and be sure they can establish and activate a bridge bank. The DIC will want to ensure it can obtain deposit information in the correct format, process the deposit data, identify claims, and arrange for funding and payouts. Each one of those

processes can be tested individually on a yearly basis. At the same time, the contingency planning group could propose a multi-institutional scenario test, where different approaches can be tested and then refined. The authorities should ensure that critical areas are tested regularly. The frequency of testing should be decided in light of the nature and importance of each critical area.

## VI. NEXT STEPS

**57. The mission recommended that the authorities complete the following tasks ahead of the second mission scheduled for the second half of 2022 (in November 2022):**

- a) Establish a domestic inter-agency coordination and information sharing structure;
- b) Draft the following:
  - (i) a paper for strengthening the credit union resolution framework;
  - (ii) a strategy for structuring and organizing the roles and functions of the Resolution Authority and the DIC;
  - (iii) a resolution toolkit that is supported by the tools and powers in legislation, based on guidance provided; and
  - (iv) the DIC's preliminary procedures for payouts; and
- c) Preliminary analysis of recovery plans.

These documents will be reviewed at headquarters and feedback will be provided to the CBOB.

**The second mission, will provide further guidance on the development of the resolution regime, including the resolution toolkit, resolvability assessments, and resolution plans, as well as next steps in restructuring and operationalizing the DIC.** A comprehensive framework for undertaking resolvability assessments of D-SIBs and large banks will include the data requirements needed from the banks to enable the CBOB to identify critical functions and shared services, the legal structure of the banking group (where applicable), the functions performed by legal entities in the group, the extent and nature of parent-bank functional support arrangements, the funding structure of the banks, and the extent of separation—or separability—of critical and non-critical functions and services. The mission will also review and advise on the resolution regime for offshore banks and credit unions and provide further guidance on the DIC's strategy for operationalizing its role, including payouts and reimbursements.

**Table 4. The Bahamas: Financial System Structure**

(At end-2020)

Financial Institutions		Total Assets	
Type	Number	(B\$ mn)	(% GDP)
<b>Domestic financial market</b>			
<b>Total</b>	<b>22</b>	<b>19,957.6</b>	<b>201.4</b>
Commercial banks:	8	15,185.1	153.2
Foreign owned/branch	5	11,615.4	117.2
Domestic owned	3	3,569.7	36.0
Other Local Financial Institutions	14	4,772.5	48.2
Cooperatives:			
Credit unions	7	492.1	5.0
Other			
Development bank/ foundation	1	38.0	0.4
Insurance companies	31	2,211.3	22.3
Money Service Companies:			
Remittance/ money transfer providers	5	391.6	4.0
Foreign exchange bureaux			
<b>Total (A)</b>	<b>66</b>	<b>23,090.6</b>	<b>233.1</b>
<b>International financial sector</b>			
Banks, Banks & Trust	48	153,202.1	1,546.3
Other nonbank financial institutions - Pure Trusts	14	43.9	0.4
<b>Total International (B)</b>	<b>62</b>	<b>153,246.0</b>	<b>1,546.7</b>
<b>Total Financial Sector (A+B)</b>	<b>128</b>	<b>176,336.6</b>	<b>1,779.8</b>

Source: Central Bank of The Bahamas.

**Table 5. The Bahamas: Insured and Insurable Deposits of DIC Members**

(As at June 30, 2021)

Member Institutions (B\$ million) Deposits	Insured Deposits (June 2021)	Insurable Deposits (Jun 2021)	Covered Deposits % of Insured to Insurable Deposits
<b>Banks</b>			
Bank 2	510.878	1,866.487	27.4
Bank 5	448.524	1,397.321	32.1
Bank 1	424.104	1,575.571	26.9
Bank 3	402.233	1,028.958	39.1
Bank 6	172.559	663.438	26.0
Bank 9	165.761	535.093	31.0
Bank 7	90.334	357.622	25.3
Bank 11	15.000	137.096	10.9
Bank 4	1.749	68.474	2.6
Bank 10	0.521	2.508	20.8
Bank 8	0.283	2.016	14.0
Total	2,231.946	7,634.584	29.2
<b>Credit Unions</b>			
Credit Union 1	156.542	190.993	82.0
Credit Union 2	50.799	62.506	81.3
Credit Union 3	44.673	53.143	84.1
Credit Union 4	33.132	44.565	74.3
Credit Union 5	33.116	37.427	88.5
Credit Union 6	14.482	20.081	72.1
Credit Union 7	1.312	1.312	100.0
<b>Total</b>	<b>334.056</b>	<b>410.027</b>	<b>81.5</b>
Aggregate	2,566.002	8,044.611	31.9
Total DIC Fund B\$69.1 million			
- as a percent of aggregate insured deposits	2.7%		
- as a percent of aggregate insurable deposits		0.9%	

Source: CBOB and Fund staff calculations.

## **APPENDIX I. GUIDANCE FOR SUPERVISORS ON RECOVERY PLANS**

1. This appendix sets out indicative questions that supervisors may wish to consider in their review and assessment of SFI 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.

The guidance set out in this appendix is particularly focused on the recovery plans for the larger banks. In the case of the credit unions and other small SFIs, a proportionate approach needs to be taken to recovery planning, with recovery planning requirements being scaled back to the needs, circumstances, and resource capacity of the SFIs in question. That said, even with a small SFI, such as a credit union, a recovery plan would still need to cover the topics contained in these guidelines but would do so on a more limited scale than for a larger financial institution. In the case of credit unions and other mutual entities, the capital issuance options are limited, and hence this element of a recovery plan would be scaled back considerably relative to that for a non-mutual.

### **Executive summary of the recovery plan**

#### ***General guidance***

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

3. 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. governance of the plan, both in terms of approval process and governance in a recovery plan activation process;
  - c. its integration with the risk management framework, ICAAP, BCP and related matters;
  - d. the triggers for recovery plan activation, and escalation and implementation arrangements;
  - e. the “restoration points” for key variables; i.e., especially capital and liquidity (being set at levels that are comfortably above regulatory minima);
  - f. the recovery options;
  - g. a brief description of the scenarios;
  - h. communications; and
  - i. process for regular review and testing.
4. The Executive Summary should either contain or include reference to a short checklist of decisions and actions that the senior management team and board can use to:
- a. determine whether to invoke the recovery plan;
  - b. ascertain the nature of the problem affecting the bank, its cause, and its impact;
  - c. determine the recovery strategy, including recovery actions and communications; and
  - d. ensuring that all actions are subject to effective oversight and coordination.

***Indicative questions for supervisors***

5. Supervisors could consider the following matters in reviewing a recovery plan:
- a. Does the recovery plan contain an executive summary that is succinct and practical in its focus?
  - b. Does the executive summary cover the items listed above?

- c. 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?
- d. 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**

### ***General guidance***

6. The 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 the execution of recovery actions during a crisis.

7. The recovery plan should contain 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 Risk Committee and board approval. There should be a senior-level “owner” of the recovery plan, with responsibility for overseeing its development and review, and submission for approval. The owner is often a bank’s Chief Risk Officer. The plan should clearly identify the board’s responsibilities, the relevant board committees, and senior management in relation to the recovery plan.

8. The recovery plan should describe how the 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. The plan should also identify the management structure during the recovery phase, including who has responsibility for particular recovery actions and the authorizations and delegated authorities required for recovery actions. It is common for the CEO, or the CEO and Chairperson of the Board, to have responsibility for the activation of the recovery plan. A Crisis Management Team (CMT) is often established by the CEO to coordinate the recovery process, overseen by the CEO and EXCO, and with ultimate oversight by the board. It is usual for the recovery plan to

specify, for each recovery option, the level of authority needed to obtain approval to undertake that particular recovery option.

9. Senior management and the board need to ensure that the recovery plan covers all of the regulatory requirements and is comprehensive. As importantly, they need 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 senior management team and 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 system-wide scenarios (and a hybrid of the two);
- 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 early warning indicators, stress testing, risk monitoring, risk limits and controls, ICAAP, liquidity contingency planning and business continuity planning; and
  - i. the recovery plan is kept under regular (generally annual) review, is updated to reflect changes to the bank's operations and structure, and is subject to regular testing (e.g., an annual "desktop" form of testing and a live simulation exercise every three years).
10. The issues referred to above are covered in more detail later in this paper.
11. The board needs to maintain a close overview of senior management's performance of its responsibilities in relation to the recovery plan in order satisfy itself that senior management has performed all of its responsibilities effectively. The board also needs to clearly understand its own responsibilities in relation to the recovery plan, including the recovery actions entrusted to the board. The board 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. They also need 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.

*Issues to be assessed by supervisors*

12. Indicative questions that supervisors could 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 board members 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 the board members understand their responsibilities in the recovery plan, including for particular recovery actions?

## Integration of recovery plan with risk management arrangements

### *General guidance*

13. Recovery plans need to be closely integrated with banks' risk management policies and processes. To ensure effectiveness, recovery planning should be treated as a critical component of a bank's risk management framework, rather than an isolated process that is merely prepared for regulatory compliance reasons. Several linkages are particularly noteworthy:

- a. the role that a bank's stress testing processes (and especially reverse stress tests) play in assessing the potential impacts on capital and liquidity arising from financial and economic shocks, and for informing scenarios used in the plan;
- b. the importance of early warning indicators, supported by robust management information systems, in informing a bank's management and board on the triggering of the recovery plan, and the linkage between the early warning indicators and relevant risk settings in the Risk Appetite Statement (RAS);
- c. the close linkages between the recovery plan and a bank's ICAAP and ILAAP, particularly as regards the setting of the restoration point for capital and liquidity;
- d. the importance of the triggers in the recovery plan being informed by and linked to the minimum risk tolerances in the RAS;
- e. the importance of the restoration points in the recovery plan being informed by and linked to the desired risk settings in the RAS;
- f. the linkages between the recovery plan (especially triggers and recovery actions) as regards capital-related matters in the recovery plan and the bank's capital contingency plan, and as regards liquidity-related matters in the recovery plan and the bank's liquidity contingency plan;
- g. the linkages between recovery planning and business continuity planning, particularly in relation to key operational requirements for recovery actions; and
- h. 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).

14. It is therefore important that a bank ensures that its recovery planning processes are fully integrated into the wider risk management framework. The recovery 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.

*Issues to be assessed by supervisors*

15. Indicative questions that supervisors could 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 early warning indicators (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 BCP?

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

*General guidance*

16. 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. if the bank is part of a wider financial conglomerate, the nature of its functional interdependencies with the various entities in the conglomerate;
- d. the functions performed by the bank and each of the other entities in the group – domestically and in other countries;
- e. the financial products and services provided by the bank and each entity in the group;
- f. 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;
- g. the nature of the inter-connections between entities in the group, including financial and operational inter-connections;
- h. location of all branches of the bank and offices of other entities in the group, domestically and in other countries;
- i. identification of correspondent banks and other banks or financial service providers with which the bank or group has significant business dealings;
- j. nature and extent of participation of the bank and group in financial markets, by category of financial market;
- k. nature and extent of participation of the bank and group in payment and settlement systems;
- l. entities that provide critical functions or services to the bank and group (see below for a definition of critical functions and critical services); and
- m. extent and nature of any outsourcing of critical functions and services to parties outside the group.

17. An important aspect of recovery planning is the identification of a bank's critical functionality. 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 interdependencies between these entities. Recovery actions should be designed to ensure that, at a minimum, these functions and services can be maintained without interruption.

18. The definitions of critical functions and critical services applied by the Financial Stability Board (FSB)—the international body that provides guidance on bank recovery plans—are set out in the box below.

**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.”

19. 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.

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

- a. deposit-taking, particularly the capacity to receive deposits into transaction-facilitated deposit accounts and short-term deposits;
- b. 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;
- c. 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;
- d. credit card services;

- e. 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 Financial Market Infrastructures (FMIs), treasury and cash management services;
- f. 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
- g. capacity to meet obligations in relation to capital market transactions and services.

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

- a. perform all critical functions (as identified above);
- b. maintain all customer and client records;
- c. maintain all financial and management accounting records and reporting obligations;
- d. 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
- e. meet all regulatory obligations and other legally binding regulatory requirements.

22. 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. It should also set out the recovery actions needed to manage contagion risk that could arise from interlinkages with entities in a financial conglomerate or exposures to wider corporate connectedness.

***Issues to be assessed by supervisors***

23. Indicative questions that supervisors could consider in reviewing the recovery plan information relating to the overview of the bank 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 BCP?
- 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

### *General guidance*

24. 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); and
- Credit rating.

25. 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).

26. 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.

27. 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.

28. In addition to the triggers, banks should include in their recovery plan or in supplementary material the nature of the early warning indicators (EWIs) they have in place in respect of each trigger, and the means by which they monitor such indicators. Banks should maintain comprehensive early warning indicators 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 early warning indicators would appropriately relate to each category of trigger, including capital, liquidity, asset quality and profitability, as well as early warning indicators relating to qualitative triggers. Indicative examples of EWIs are set out below:

Risk Category	Early Warning Indicators
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*

29. Indicative questions that supervisors could 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

### *General guidance*

30. 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 comfortably 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, so as to minimize the risk of any future breach of regulatory minima and to facilitate the restoration of market confidence in the bank.

31. 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.

32. 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.

*Issues to be assessed by supervisors*

33. 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.

34. Indicative questions that supervisors could 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**

*General guidance*

35. 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.

36. 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).

37. 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 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
  - f. the persons in the bank (including directors) with the authority to approve implementation steps for the recovery action.

38. 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***

39. 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.

40. 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.

41. 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***

42. 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.

43. 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.

44. 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***

45. 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.

46. 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.

47. 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***

48. 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.

49. 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.
50. 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***

51. 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*

52. Indicative questions that supervisors could 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 3 to 6 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***

53. Indicative questions that supervisors could 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 3 to 6 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; and
  - vi. reducing expenditures, etc.?
- k. Have these options been prioritized and quantified; and
  - l. Have the implementation procedures for each option been documented adequately?

***Liquidity recovery actions***

54. Indicative questions that supervisors could 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***

55. Indicative questions that supervisors could 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***

56. Indicative questions that supervisors could 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***

57. Indicative questions that supervisors could 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 BCP, where consistency would be expected?

***Other recovery actions***

58. Indicative questions that supervisors could 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**

***General guidance***

59. 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 shocks, 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. a 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.

60. 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.

61. 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; and
- g. losses (or gains) arising from market risks as a result of assumed changes in asset prices, interest rates and exchange rates.

62. 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.

63. Scenarios should be informed by stress tests, particularly reverse stress tests that involve breaching the bank's—and the 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*

64. Indicative questions that supervisors could consider in reviewing the scenarios for recovery plans are<sup>1</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?

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<sup>1</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>

- 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?
- 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**

### ***General guidance***

65. 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.

66. 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.”

67. 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*

68. Indicative questions that supervisors could 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**

### ***General guidance***

69. 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).

70. 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.

71. 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*

72. Indicative questions that supervisors could 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?
- h. Has there been any testing of the preparatory measures?

## Testing of recovery plans by banks

### *General guidance*

73. 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:

- a. 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;
- b. the ability of the bank to implement recovery actions relating to particular categories of recovery—capital, liquidity, asset quality, profitability, etc.;
- c. the ability to communicate effectively with stakeholders (role-played);
- d. the performance of senior management in terms of its responsibilities in a recovery process;
- e. 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;
- f. the data systems required for recovery;
- g. the legal documentation required for certain recovery actions;
- h. the ability to implement recovery actions within the specified timeframes, especially for time-critical actions; and
- i. the degree of integration of the recovery plan with the bank’s risk management framework, ICAAP, BCP and governance arrangements.

74. 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.

75. 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***

76. Indicative questions that supervisors could 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**

***General guidance***

77. 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.

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.

***Issues to be assessed by supervisors***

79. Indicative questions that supervisors could 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 the board in the review process?

## APPENDIX II. GUIDANCE ON THE DEVELOPMENT OF A RESOLUTION TOOLKIT

1. This appendix provides indicative guidance on the development of a resolution toolkit to facilitate the resolution of banks. Its purpose is to assist the CBOB in the development of a resolution toolkit, in coordination with the other relevant government agencies, particularly the DIC and MOF.
2. The purpose of a resolution toolkit is to provide guidance for the resolution authority on the activation of resolution, selection of the resolution strategy, implementation of the resolution, and communication. A resolution toolkit also provides guidance on the coordination of resolution actions between domestic agencies and, in the case of foreign-owned banks or domestic banks with foreign operations, cross-border coordination. It needs to be supplemented by bank-specific resolution plans that set out the details of how particular resolution options could be implemented for individual banks.
3. The key elements of a bank resolution toolkit are set out below, including:
  - Crisis diagnostics—solvency assessment and systemic impact assessment.
  - Resolution strategies, criteria to assist in selecting which strategy might be appropriate in particular circumstances, and implementation steps.
  - Cross-border crisis resolution.

### **Crisis diagnostics**

#### *Solvency and financial soundness assessment*

4. In a period of emerging stress, any bank considered to be potentially vulnerable should be assessed by the supervisory authority to assess the bank's position currently and on a forward-looking basis, as regards:
  - balance sheet 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; and
  - expected loss on NPLs.

5. The analysis would appropriately 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.
6. 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 CBOB 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.
7. Where a bank has subsidiaries that perform essential functions for the bank, there should also be a solvency and liquidity assessment of the relevant subsidiaries.
8. It would be desirable for the supervisory authority to develop the capacity to undertake solvency assessments, capital adequacy assessments and liquidity assessments under acute time pressure (e.g., within 24 hours), and undertake periodic testing of that capacity.

### ***Systemic impact assessment***

9. The resolution toolkit should include guidance on undertaking an assessment by the CBOB, in liaison with the MOF, DIC and other relevant agencies, of the systemic impact of the bank in distress. This would be based on the CBOB's framework for determining SIBs, 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, small to medium-sized banks might be assessed as having a low systemic impact, whereas in periods of financial system instability the failure of the same banks might have a significant impact on the financial system, given the potential for contagion and 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.

10. Systemic impact assessments would appropriately draw on the criteria applied in the D-SIB 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 share of payments services, differentiated by payment system and payments product;
- the 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 analysis referred to earlier);
- 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).

11. 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.

12. 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.

13. The systemic impact assessment undertaken by the CBOB, in liaison with the other relevant agencies, will significantly influence the type of resolution strategy to be adopted. In the case of a small bank with no or little systemic impact, and where recovery is not possible, then closure and prompt pay-out of insured depositors or deposit account transfer to another bank via a P&A transaction would be the likely resolution option. In the case of a SIB, a form of “open resolution,” where the bank’s core banking functions are kept open, would be the likely resolution option.

### **Resolution strategies and implementation of resolution**

14. The resolution toolkit should identify the main resolution strategies and options to deal with banks which cannot restore themselves to financial soundness and the criteria for determining which option would be appropriate in the circumstances. The toolkit should also identify the procedures required to implement particular resolution options.

15. An important part of the resolution toolkit is establishing guidance on systemically important functions; i.e., those functions that need to be continued, either in the recapitalized bank, a bridge bank or other acquiring bank, in order to minimize adverse impacts on the failed bank’s customers, the financial system and economy. The toolkit would 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 the CBOB 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).

16. Systemically important functions would generally include, as a minimum:

- deposit facilities;
- committed credit facilities;
- payment system interface and payments execution functions;
- inter-bank settlement functions;
- settlement functions performed for other financial institutions on an agency basis; and
- currency and interest rate derivatives functions.

17. Systemically important services would typically include:

- IT support, risk management and other back-office arrangements required for systemically important functions;
- systems needed to maintain deposit accounts and loan balances up to date; and
- systems needed to enable the bank to manage its risks prudently and comply with regulatory requirements.

18. Resolution options which could be considered in developing the resolution toolkit (and on which resolution plans would be based) are likely to include the following:

19. ***Option 1: Closure of a bank and pay-out of insured deposits, followed by liquidation of the bank.*** This would involve appointment of an administrator 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. The DIC would confirm the amount to be paid to each depositor, capped at the level of the deposit insurance cover per depositor/deposit category. Payments would then be made to depositors, generally via a bank appointed as the paying agent, funded by the DIF. Payments should be made as soon as practicable following the closure of the bank, and desirably within seven days.

20. Option 1 might be appropriate if:

- a. the bank is insolvent (i.e., negative equity) or close to insolvent, or otherwise very substantially below minimum capital requirements;
- 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).

21. ***Option 2: Closure of a bank and transfer of insured deposit accounts to a receiving bank (either an existing bank or a bridge bank)***. This would involve appointment of an administrator 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. The DIC would confirm the amount to which each depositor is entitled, capped at the level of the deposit insurance cover per depositor. The insured 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 it wished to do so. The net cost to the acquiring bank of assuming the insured deposit liabilities would be funded by the deposit insurance agency. The failed bank would then be wound up through the insolvency law arrangements, and the deposit insurance agency would have a subrogated claim of the insured depositors on the assets of the bank in liquidation.

22. Option 2 might be appropriate if:

- a. the bank is insolvent (i.e., negative equity) or close to insolvent, or otherwise very substantially below minimum capital requirements;
- 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. If there was sufficient time available, the DIC would seek competitive bids from banks which the CBOB regards as being in a sufficiently sound financial condition to acquire the insured deposits of the failed 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).

23. ***Option 3: Transfer of some or all of the failed bank's assets, liabilities and business functions to another existing bank or a bridge bank.*** This would be a more comprehensive business transfer than the standard P&A transaction, as it would involve the acquiring bank or a bridge bank (in the absence of an acquiring 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.). It would involve appointment of an administrator to the bank and withdrawal of the bank from the payment systems. An assessment would be of the systemically important and otherwise viable business that is to be transferred to either an existing bank willing to acquire this business and associated functionality 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.

24. If the assets (including estimated franchise value) 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) or the deposit insurance agency. The DIC'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. Any resolution funding required beyond the DIC would fall outside of the Resolution Toolkit, as this would be a matter for consideration by the government as a last resort only, under the authorities' Contingency Plan.

25. The failed bank would be closed, and its residual business wound up under insolvency law. Ex post compensation would be paid to shareholders and 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.

26. NPLs could either be retained in the failed bank or transferred to an asset management company established by the MOF for the purpose, or to an existing private sector entity in the business of acquiring and working out impaired assets.

27. Option 3 might be appropriate if:

- a. the bank is still solvent (i.e., has positive equity), at least with respect to deposit liabilities and possibly other senior unsecured debt, but can be used if the bank is insolvent if resolution funding is applied to make up for any deficiency in assets relative to liabilities being transferred;
- 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; and
- 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 acquire the systemic business of the failed bank or where market concentration factors would make it undesirable for the business to be transferred to an existing bank).

28. **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) 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).

29. Option 4 might be appropriate if:

- a. the bank is still solvent; i.e., has positive equity;
- 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% 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.

30. **Option 5: Recapitalization of the bank through bail-in.** (It is recognized that, for the time being, bail-in is unlikely to be a feasible option in The Bahamas.) This 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. 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 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 either be exempted from bail-in, or the deposit insurance agency would bear the bail-in cost if it were applied to insured deposits. 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.

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

32. Option 5 might be appropriate if:

- a. the bank 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 non-viability 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.

33. Note that any consideration that would involve the use of public funds or guarantee for recapitalization of a bank would be a last resort option that falls outside of the parameters of the Resolution Toolkit. Such approach is addressed under the country's Contingency Plan (refer Appendix III).

#### **No creditor worse off**

34. In any form of resolution, the principle of 'no creditor (or shareholder) left worse off than under liquidation should be applied, such that shareholders and creditors 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 toolbox 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 'counter-factual' 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 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.

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

35. In the case of recapitalization of an existing bank or transfer of business to a bridge bank, the following issues would need to be considered:

- a. *Nature of directions to the bank.* For example, if there is a likely need to recapitalize the bank or to transfer some or all of the bank's business and functionality to another entity, the CBOB may need to issue directions to the bank to undertake the required pre-positioning; e.g., preparation of specific documentation for capital issuance, IT changes to facilitate the transfer of some parts of the undertaking to another entity, etc. There may also need to be directions

to remove directors and management to the extent they are thought to be obstacles to resolution and not required for the resolution process.

- b. ***New directors and management.*** If the CBOB 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 CBOB 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 CBOB 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.
- c. ***Administration.*** It is suggested that the CBOB document the process required to appoint an administrator, if that becomes necessary, and maintain a list of possible appointees for administrator (e.g., senior staff from another government agency, or possibly a seconded senior executive from a bank or parent bank with a sound understanding of The Bahamas banking system). The administrator might need to be supported by advisers to bring market credibility and assist in the management of technical aspects of the resolution process. The toolkit should desirably include a list of potential firms and individuals for this purpose, updated regularly. It should also include draft terms of reference and documentation for appointment.
- d. ***Directions to an administrator.*** The CBOB would also need to identify the directions to give to an administrator; i.e., as to the particular business functions to keep open (e.g., deposit-taking, payments functions, meeting commitments on derivatives, meeting commitments under committed credit facilities, etc.) and which ones to be suspended. Directions would also extend to what actions should be taken to keep subsidiaries functioning where this is necessary for the functioning of the bank. The toolkit should also identify the particular pre-positioning directions to an administrator applicable to each type of resolution.
- e. ***Public and other stakeholder communications.*** The toolkit should include guidance on public and other stakeholder communications for each type of resolution. For example, if, in an open resolution, most or all of the business of the bank is to be maintained, the CBOB 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.
- f. ***Determination of the capital requirement for the recapitalized bank or bridge bank.*** The CBOB 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 be 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).<sup>1</sup>

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<sup>1</sup> Any consideration that would involve the use of public funds or guarantee to support recapitalization, establishment of a bridge bank or other resolution option would be a last resort option that falls outside of the parameters of the Resolution Toolkit. Such approach would be addressed under the country's Contingency Plan (refer Appendix III)

- g. **Establishment of a bridge bank.** If a bridge bank is to be used, the contingency plan should identify the steps required for the CBOB to establish the legal entity. It is suggested that the contingency plan 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 toolkit should also include guidance on the steps required for fast-tracking bank licensing and other consent processes, as appropriate.
- h. **Business transfer to a bridge bank.** Consideration needs to be given to what assets and liabilities are transferred to the bridge bank; i.e., only systemically important business or the entire business, and whether impaired assets are retained in the liquidation estate of the failed bank, transferred to the bridge bank or transferred to an asset management vehicle established for the purpose. Consideration is also needed to identify the risks of counterparty defaults as a result of business transfers occurring and how these can be avoided where possible; e.g., assurances or guarantees that the contracts in question will continue to be met by the new bank. At a minimum, one would expect the plan to provide for all systemically important business and performing assets to be transferred to the bridge bank, including deposit liabilities, payments functionality, committed credit facilities, risk hedges, relevant IT infrastructure to maintain all transferred functions and performing assets.
- i. **Bail-in.** 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 business transfer 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).

### **Communications and coordination**

36. Communications and coordination are essential in a crisis. For each resolution strategy, the toolkit 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 toolkit 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.

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

37. The toolkit 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, including where The Bahamas is home jurisdiction). 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's 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.

- e. 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). Under an SPE model, the recapitalization of the subsidiary in a host country would be performed by the parent bank, 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. 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 CBOB. 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) until alternative arrangements can be made.

### APPENDIX III. CONTINGENCY PLAN—GUIDANCE ON PUBLIC FUNDING IN RESOLUTION

#### Resolution strategies and implementation of resolution

1. The use of public funding and/or guarantee is a last resort option and would only be used where the other Toolkit options are considered to be impracticable and that some form of government-funded bail-out is required for the purpose of meeting resolution objectives. It should be applied with robust safeguards, as discussed below.

#### *Recapitalization of the bank through use of public funds.*

2. This 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 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 non-viable 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.

3. 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.

4. This option might be appropriate if:

- a. the bank cannot recover; i.e., there is no prospect of shareholder support in the required timeframe;
- b. the bank does not have sufficient subordinated debt and senior unsecured debt (excluding insured deposits) to be a source for full 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;
- d. bail-in would likely trigger contagion or other systemic disruption on a significant scale; and
- e. the government ensures that existing shareholders and subordinated creditors are required to absorb all losses to the extent of their holdings before any government-funded support is provided.

***Determination of the capital requirement for the recapitalized bank or bridge bank.***

5. In the case of recapitalization of an existing bank or transfer of business to a bridge bank using public funds or guarantee, the following issues would need to be considered:

- a. The CBOB 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 will be influenced by whether the government is providing an interim guarantee of the bank's liabilities and, if so, the term of the guarantee. If there is a guarantee, the required capital ratio would be lower than in the absence of a guarantee. However, given the desire to avoid open-ended commitments by the government, such as those arising under a guarantee, it would generally be better to set the capital ratio at a level where the bank can operate without a guarantee.
- b. ***Capital support by the government.*** If the distressed bank is to be recapitalized by the government, or a bridge bank is to be capitalized 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).
- c. ***Government guarantee of a bridge bank.*** It may be necessary for the government to provide a guarantee of a resolved bank's liabilities for a period until the bank has been stabilized. This should be avoided unless absolutely necessary. If this is considered necessary, the guarantee should be on commercial terms where practicable, such that the government charges a fee for the provision of the guarantee. The guarantee documentation may also need to include covenants which confer specific powers on the government to control the bank while the guarantee is in place, such as the need for specific business transactions to be approved by the government, the need for director and management appointments and removals to be approved by the government, etc. The contingency plan should include preparation of an indicative terms sheet for a government guarantee, together with draft documentation. These are matters for which the MOF needs to take responsibility.

## APPENDIX IV. COMMENTS ON THE 2020 DIC LEGISLATION

### I. THE PROTECTION OF DEPOSITORS (AMENDMENT) BY-LAWS, 2020

1. **The Bahamas' Deposit Insurance Corporation (DIC) is a public corporation, established under the Protection of Depositors Act, 1999 (the Act).** The Act was subsequently amended in 2020. DIC insures eligible deposits in case of bank failure. Membership in the DIC is compulsory for every licensed bank with Bahamian dollar deposits. The DIC, which is financed by annual premiums levied on member institutions. The law lays out the structure, powers, and responsibilities of the DIC. Although recently amended, there remains scope for additional changes, aimed at bringing the DIC Act into line with international principles, as promulgated by IADI.
  
2. **A complete review of the needed strengthening of the DIC is best carried out by a formal assessment of the IADI Core Principles.** An effective deposit insurance system is designed to meet the conditions laid out in the IADI Core Principles for Effective Deposit Insurance Systems. Those principles are designed for all types of deposit insurance regimes—from a simple paybox to a risk minimizer. Accordingly, the principles should be applied proportionally in the evaluation of the Bahamian DIC. An assessment could be carried out with the IADI's assistance or under the aegis of additional assistance from the IMF or the World Bank.

#### Comments on the DIC Act<sup>1</sup>

DIC Act	Comment
4A1 The Corporation may, by notice in writing to an institution, cancel a certificate of insurance where—(a) in the opinion of the Bank, the institution is or is about to become insolvent.	The DIC should not have the authority to cancel insurance unless the CBOB or the resolution authority intervenes the institution and halts its participation in the market.
4A2 The Corporation shall, prior to taking action—(a) under paragraph (1) or (2) notify the minister of such intended action and <b>shall not proceed to take such action if advised by the minister that such action would not be in the public interest;</b> (b) under paragraph (1): (i) <b>not later than 21 days</b> before it intends to take such action, notify the institution in writing of the intention, stating the reasons therefore; (ii) afford to the institution an opportunity at a date and time specified in the notice (being not	The decision to intervene and close an institution should rest with the CBOB or the resolution unit. To that end: a. The minister should not be able to reverse a supervisory determination that an institution is unsafe and non-viable. b. Neither the DIC nor the supervisory staff should be required to give an institution a 21-day notice that it will be intervened, and insurance coverage terminated. The supervisor, as part of the supervisory ladder, in contact with

<sup>1</sup> These comments represent the views of the mission team and not of the International Monetary Fund. They do not comprise a formal review and have not been subject to the peer review that a formal review would undergo.

DIC Act	Comment
less than seven days after the date thereof) to show cause why the certificate of insurance should not be cancelled.	the institution to avert failure. However, once the decision is made, the authorities should act quickly.
4A(8) Notwithstanding the cancellation of a certificate of insurance, the amount of any insured deposit on the date of cancellation, less any subsequent withdrawals therefrom, shall continue to be so insured for a period of two years.	Depositors that are paid out and then redeposit their funds in another bank should enjoy only the protection of a new deposit. However, if the depositor holds another account in the recipient bank, the depositor may have full protection for both accounts (in excess of the maximum coverage level) for a brief period. Such additional coverage may be for 3 to 6 months. Two years is unnecessarily long.
4A 10 If the certificate of deposit insurance of an institution is cancelled by the Corporation under paragraph (1), the Central Bank must, under section 10(2) of the Banks and Trust Companies Regulation Act, 2020 or section 5(2) or 88(7)(b) of The Bahamas Co-operative Credit Unions Act, 2015 ( <i>No.9 of 2015</i> ), as the case may be, impose conditions on the institution to prohibit the institution from accepting deposits.	If the certificate of deposit insurance is cancelled, the institution must be intervened and resolved. Just prohibiting new deposits is insufficient protection for the financial system. No institution should be able to accept deposits without deposit insurance coverage.
8C2 Every institution must be able to produce SPV data.	While correct, the law should include an enforcement clause so that the banks are compelled to comply.
11 In calculating the sum to be paid to the depositor under section 15(d) of the Act, there shall be deducted only any loan payment or instalment amount due to the institution by the depositor, as may be owed or past due.	The term “as may be owed” could be misconstrued to include any outstanding loan balance. In a failure, only past due claims should be deducted before the deposit payout.
<p>12 1. A claim for deposit insurance shall be in the form set out in the Schedule and shall be accompanied by satisfactory evidence of the claimant’s ownership of or interest in the deposit.</p> <p>(2) A separate claim shall be submitted for each deposit in respect of which, in whole or in part, a claim is made.</p> <p>(3) The claim shall be made by the person in whose name the deposit account is recorded, or by the assignee thereof.</p>	The depositor should only be required to show adequate identification if the deposits are transfer to another bank view a P&A transaction. Typically, depositors need not submit a claim for reimbursement as such processes slows the payout process.
<p><b>18 Appeal against cancellation.</b></p> <p>(1) An institution notified under by-law 4A of the intention of the Corporation to cancel its certificate of insurance may, within three days of the date of receipt of the notice, appeal in writing to the minister against the decision of the Corporation.</p>	The minister should not have the authority to reverse a supervisory determination that a financial institution is no longer viable. If the CBOB were to close an institution in error, only monetary compensation should be paid.

DIC Act	Comment
<p>(2) The minister shall hear an appeal within seven days after it is lodged and on hearing such appeal, may:</p> <p>(a) dismiss the appeal; or (b) direct the Corporation to withdraw the notice of the intention to cancel the certificate of insurance.</p>	
<p>19 (2) The depositors of a surviving merged or amalgamated institution shall have coverage of their deposits in each of the institutions existing before the merger or amalgamation, up to the amount prescribed by subsection 6(2) of the Act for a period of two years.</p>	<p>As described previously, a two-year period for additional coverage is too long. Typically, depositors have between three and six months to make the needed change.</p>

## II. MISSING ELEMENTS IN THE DIC ACT

In addition to these comments, the DIC Act is missing some important elements. Specifically:

3. **The Act should clarify the mandate of the DIC.** The mandate has been narrowed, shifting responsibilities for implementing resolution measures to the CBOB. The mandate of the DIC should be made explicit. It should be stated that the policy objective of the DIC is to preserve financial stability and protect depositors up to the maximum coverage. The Act should also permit the DIC to finance resolution measures proposed by the RU. While it should not provide funding for going-concern institutions, it should be permitted to contribute such resolution measures as P&A transactions and bridge bank operations.
4. **While the DIC can contribute to resolution measures, the Act should be specific about safeguards against excessive use of DIC funds.** The Act should limit the use of DIC funds to (i) the amount it would have paid to depositors in a liquidation. Consideration could also be given to setting a maximum e.g., 50 percent of the existing fund that could be used in resolution. This second safeguard ensures that the DIC fund will not be exhausted. Once the DIC fund is exhausted, its role in preserving depositor confidence is severely undermined.
5. **In that context, the Act should authorize the DIC to analyze risks in the financial system.** While this work is also done by the supervisors, the DIC can review risks from its perspective. In many jurisdictions, discussions between the two units on emerging risk enhances the overall analysis and strengthens the coordination between supervision and resolution

6. **While the Act may permit the provision of funds for the establishment of a bridge bank, the DIC should not provide capital nor become a shareholder of the bank.** Those activities are the responsibility of the Ministry of Finance or, in the event of severe financing limitations in the MOF, the responsibility of the CBOB. Any resources provided by the CBOB for capitalization of support for resolution must be fully indemnified by the MOF.

7. **The Act should provide for the possibility of establishing an emergency back-up funding facility.** Depositors need to believe that their deposits will always be protected, irrespective of the financial balance in the DIC Fund. Absence such confidence, small failures may lead to a loss of confidence and preemptive runs from weak but still solvent institutions.

8. **The DIC has a fiduciary responsibility to protect the resources of the DIF.** Member institutions contribute to that fund in the expectation that their funds will be used appropriately. The DIC should be required to safeguard deposit insurance funds. The DIC must be assured that the resolution options meet the least-cost requirements and that the institution receiving its funds is viable. In the absence of such assurances, the DIC should have the authority to deny use of its funds.

9. **There are a number of standard powers that all deposit insurers should have explicit in their law.** Those powers include:

- assessing and collecting premiums, levies or other charges;
- transferring deposits to another bank;
- reimbursing insured depositors;
- obtaining timely, accurate and comprehensive information in the necessary format;
- receiving and sharing timely, accurate and comprehensive on the risk profile of member institutions from the supervisors;
- compelling banks to comply with their obligations to provide access to depositor information;
- setting operating budgets, policies, systems, and practices; and
- entering into contracts.

10. **The Act could expand the board's size.** Currently ex officio members are in the majority, and it is chaired by the Governor of the CBOB. Increasing the number of private sector representatives, as is currently envisioned is desirable, but should be carefully

managed to ensure that the banking sector does not dominate the board. One of the independent private sector representatives could chair the board.<sup>2</sup>

11. **The Act should make information sharing and sharing of risk assessments mandatory.** While currently the existing MOUs clarify such information sharing responsibilities, it is stronger if the Act enshrines such obligations in law. In the context of managing a cross border institution, the Act should also authorize the DIC to share information with other host and home authorities.

12. **The law should include the requirement for the DIC to participate in contingency planning and crisis management preparation.** The DIC will need to conduct such plans and scenario testing both to ensure that the procedures remain current and to practice payout actions. Bank failures are uncommon. When they happen, it is not unusual for the DIC staff to have little experience. The regular testing of procedures will enable them to respond immediately.

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<sup>2</sup> “In order to maintain operational independence, representatives of the other financial safety-net organizations that participate in the governing body do not serve as Chair or constitute a majority.” IADI, CP3, EC8.

## APPENDIX V. DEPOSIT INSURANCE

1. **An effective deposit insurance system is a prerequisite for a successful resolution regime.** A weakened or ill-designed deposit insurance system may undermine depositor confidence and, in the event of a banking failure, can lead depositors to run preemptively not only from the failed bank but, also, from otherwise sound institutions. Key elements for an effective deposit insurance system are found in the IADI's Core Principles for Effective Deposit Insurance Systems

2. **The Protection of Depositors Act has recently been amended.** The law lays out the structure, powers, and responsibilities of the DIC. The amendments clarify the role and responsibilities of The Bahamas' Deposit Insurance Corporation (DIC) and its role within the Bahamian safety net. The DIC is a public corporation operating within the CBOB that insures eligible deposits in event of bank failure. The DIC's mandate is to provide insurance against the loss of part or all of deposits and to promote and contribute to financial stability. It is authorized to provide financing for resolution measures. Membership in the DIC is compulsory for every licensed bank with Bahamian dollar deposits. The Act explicitly increased the membership to include not only commercial banks but also Credit Unions. The DIC is financed by annual premiums levied on member institutions. Although recently amended, there remains scope for additional changes, aimed at bringing the DIC Act into line with international principles, as promulgated by IADI.

3. **A complete review of the DIC is best carried out by a formal assessment against the IADI Core Principles.** An effective deposit insurance system is designed to meet the conditions laid out in the IADI Core Principles for Effective Deposit Insurance Systems. Those principles are designed for all types of deposit insurance regimes—from a simple paybox to a risk minimizer. Accordingly, the principles should be applied proportionally in the evaluation of the Bahamian DIC. An assessment could be carried out with the IADI's assistance or under the aegis of additional assistance from the IMF or the World Bank.

### A. Governance and Staffing

4. **The DIC operates within the CBOB.** It has a Board of Directors, composed of six members, four ex officio members and two external Directors. The DIC has no formal employees but is staffed by employees of the Bank Supervision Department. Being a part of the CBOB, the DIC has access to confidential data on the financial conditions of members as well as to other onsite and offsite related supervisory records. DIC team members are copied on exchanges between the supervisory unit and specific member institutions.

5. **Strengthening the DIC will require strong leadership, adequate skilled staff, and support from members.** An important step in achieving this objective is the strengthening the DIC's governance structure and staffing. The current board size would appear adequate

by international standards, but the board is dominated by ex officio members of the government. Moreover, the chair of the DIC is the Governor of the CBOB. This structure reduces the independence of the DIC from policy pressures. However, the DIC has a fiduciary responsibility to protect members' contributions and ensure that any use of the DIC resources derived from members' contributions is appropriate and least cost for the DIC. In the absence of such assurances, members' confidence in the efficacy of the DIC's ability may be jeopardized and the ability to make any changes needed for financial stability may be undermined.

**6. Strengthening the governance structure could include the increase in the size of the DIC Board.** Currently, there are proposals to increase the board size from six to nine members, increasing the number of external Directors from two to five. This is an important change. It would give external Directors a majority on the board and ameliorate any concerns about the ability to ensure the appropriate use of DIC funds. As is the case now, the external Directors cannot be current staff or executives of any member institution. In addition, the Chair of the DIC Board should be drawn from the external Directors. IADI Core Principles explicitly state that the Chair of the Deposit Insurance Board should not be one of the ex officio officers.

**7. Staffing of the DIC raises a number of critical policy decisions.** Currently, the DIC has no employees but, rather, depends on staffing from the Supervision Department of the CBOB. However, the DIC will be responsible for a complex set of activities, including working with member institutions to ensure adequate data preparation, testing of IT arrangements, negotiations with possible paying agents for both commercial banks and credit unions. The DIC will need to have the technical capacity to ensure that any use of DIC funds is appropriate and is consistent with the safeguard requirements. These tasks are complex and require experience to implement successfully. Accordingly, there is a strong argument for having a full time staff in the DIC.

**8. The DIC will begin to take on financing of resolution measures.** In that context, the DIC will need to develop new skills. Funding resolution can mean funding for P&A transactions, financing establishment of a bridge bank, or possibly recapitalizing a failing but viable institution. Under these circumstances, the objective of the DIC will be to ensure that the resolution approach taken is the least cost option and that the resources from the fund are appropriately used. A major concern of deposit insurers who finance resolution is that after they contribute to resolution measures, the restructured bank fails, and the deposit insurer then has to pay out depositors. This "double dipping" can exhaust the fund. Accordingly, the DIC will need to develop adequate analytical capacity. It should be in a position to complement the work of the RU in analyzing resolution options. While not making the final decision, the DIC may contribute to the analysis of the resolution options and ensure that DIC funds are appropriately used.

## B. Strengthening the Reimbursement Framework

9. **An essential element of an effective deposit insurance system is the ability to pay out depositors expeditiously.** If depositors lose confidence or believe the insurance system is illiquid, they may run in anticipation of a bank failure, resulting in serious liquidity and solvency difficulties for a range of banks. In order to meet this objective, the DIC must have adequate resources, it must have the necessary data, and it must have appropriate mechanisms to pay out depositors.

10. **The IADI Core Principles envision a target payout period of seven working days for most insured depositors.** Minor exceptions are permitted for the payout of deposits that are operationally difficult to meet, such as trust accounts with multiple beneficiaries. Many jurisdictions, however, cannot meet immediately the 7-day payout objective because of operational limitations. Accordingly, the IADI Core Principles allow for a transition period of up to two years for deposit insurers to implement necessary reforms.

### I. CONDITIONS FOR EFFECTIVE REIMBURSEMENT OF DEPOSITORS

11. **Rapid payout requires that the deposit insurer have appropriate organization, authority, and infrastructure.** Factors for effective reimbursement include (i) adequate human resources; (ii) information sharing arrangements with other safety net participants; (iii) early warning arrangements, (vi) advance access to data on depositors, including qualitative review of data; (iv) access to adequate funding sources, including pre-arranged back up funding; (v) management information system; and (vi) pre-arranged contracts with outsourcing partners such as paying agent, call centers, and legal services. Not only should the deposit insurer have such elements, but it needs to test their continued effectiveness. For example, can member institutions produce appropriate data in a specified timeframe, can they generate SCV, and can paying agents be quickly and effectively activated

12. **The DIC has made progress in meeting several of these conditions.** As members of the CBOB, DIC staff have access to supervisory data as well as to supervisory judgments about the risk profile of member institutions. The DIC has a DIF (discussed below) and receives regular premium payments from members. The DIC also receives information about supervisory actions taken to mitigate institutional risks. In this way, it can be prepared for addressing expeditiously any failure. Nonetheless, there are areas where further reforms would be useful.

#### *Human resources capacities*

1. **The DIC should have a dedicated, full time staff that is knowledgeable and experienced in issues concerning reimbursement processes.** Currently, the DIC has no employees and, rather, depends on staff from the supervisory unit. However, managing a deposit insurance system and making adequate payouts is a technically complex process

where dedicated and experienced staff are needed. However, few deposit insurers will have adequate resources to manage all failures. Instead, the DIC should be allowed to acquire temporary staff such as short-term experts, legal support and other expertise from the CBOB as needed. It would be beneficial for the DIC to identify such staff before they are needed.

2. **The optimal size of the DIC staff in normal times must be determined.** Initially, the DIC will be tasked with a significant amount of work. Internal organizational arrangements will have to be developed, guidelines for reimbursement policies and regulations covering data requirements must be developed and promulgated. Vulnerable sectors of the financial sector will have to be analyzed and any particularities in meeting payout requirements resolved. Accordingly, a minimum staff of 3-4 seems reasonable. They could include a CEO, a staff person for all funding issues including managing the fund and member contributions, and one-two staff for reimbursement and data evaluation.

*Advance access for review of the quality of data:*

3. **The DIC has access to depositors' data in advance of the bank closure but banks do not provide customer data in a Single Customer View format (SCV).** However, Section 8C of the amended Protection of Depositors Act laws contains provisions for such a data requirement. The DIC needs to ensure that the data should be in the appropriate format (i.e., SCV). Banks have to be able to produce depositor data in SCV format, identify excluded deposits, and be able to identify past-due loans for each depositor (as past-due loans should be deducted from deposit payout).

*Emergency funding*

4. **The DIC should have a dedicated, pre-arranged backup funding arrangement.** The backup funding should be sufficient and available to ensure that liquidity requirements are met. Such a backup arrangement is essential for the credibility of the DIC. Typically, such back-up funding is provided by the MOF. However, the provision of such funding must be extremely fast. In this context, the CBOB may provide the funding within the formal agreement that all credits to the DIC are indemnified by the MOF. Any use of this emergency funding facility will be repaid from asset recoveries or levies on members. Therefore, the government is only providing bridge financing, it is not absorbing the losses for the bank failure.

*Management information system (MIS)*

5. **The DIC should have appropriate technology-based systems.** Such a system must be able to obtain accurate insured deposit determination and an efficient depositor reimbursement process. The MIS can be used to support the whole reimbursement process from submission of data by member institutions to payout through paying agents.

### *Outsourcing partners*

6. **Outsourcing partners are a critical component for an efficient reimbursement process.** They should be identified early and their services pre-arranged in advance to ensure operational readiness. For instance, the paying agent services can be pre-arranged on a standby contract to be used in normal times in simulation exercises and in case of bank failures. The selection of paying agents such as a payout agent bank should be subject to prudential criteria, as well as organizational and technical capacities to meet the requirement for an efficient reimbursement process.

### **ii. REGULATORY FRAMEWORK SUPPORTING REIMBURSEMENT**

19. **An effective reimbursement process must be supported by an adequate regulatory framework.** That framework should cover regulation, procedures (including a range of templates) and risk management policies.

#### *Regulation on submission of depositor data by member institutions*

20. The regulation should specify the data for insured deposit determination as well as the submission deadlines to enable correct and timely depositor data. The regulation would define how SCV is determined and identify which deposits will be paid out and the netting obligation against past due loans.

#### *Regulation on criteria and selection process of the paying agent*

21. The regulation should define the characteristics of the paying agent and the qualifications it must meet to participate in reimbursement. The regulation would specify such requirements as the organizational and technical requirements. It would specify that the paying agency must meet prudential requirements. The regulation could specify that the supervisors should approve of the use of the paying agent.

#### *Regulation on selection process of the outsourcing partners*

22. A regulation is needed outlining the criteria and the selection process of the outsourcing partners (i.e., specialized service providers) including legal and administrative services such as call center services and printing services.

#### *Regulation on guidance to depositors in the reimbursement process.*

23. A robust public awareness framework is a critical element of the reimbursement process. Regulations are needed that provide guidance to depositors in the reimbursement process (see below). Issues addressed would include key information on how and when depositors will receive their insured deposits, in terms of timing and the process. The regulation should identify communication channels, reimbursement methods, and the process for claiming the insured amount.

### iii. THE REIMBURSEMENT PROCESS

#### *Preparation phase*

1. **The preparation phase starts as soon as the DIC is notified by the CBOB that a member is facing an imminent risk of failure.** The key activities to be performed in this phase are:
  - a) Early warning and notification by CBOB on member institution's classification as high risk posing an imminent risk to viability. Strong coordination is needed with the supervisory staff.
  - b) Onsite review of the quality of depositors' data and submission timeframe. In coordination with CBOB, the DIC will undertake onsite review of the quality of the data and members' capability for timely submission.
  - c) Review sufficiency and readiness of DIC's human resources and its outsourcing partners. The DIC should build policies to ensure specialist knowledge is built within its permanent staff and contingency is planned to draw on external resources, as needed.
  - d) Review financial standing of the DIF. The DIC should ensure that back-up funding arrangements for liquidity purposes are in place and immediately available.
  - e) Review draft engagement letters for paying agents and other outsourcing partners providing specialized service such as call centers, etc.

#### *Reimbursement phase*

2. The reimbursement phase is the principal undertaking of the exercise. Data availability and funding available are central tasks. Meeting the 7-day payout target means that the funding of the payout will come from the DIC fund. Any resources derived from recovery of the asset of the failed institution only goes to replenish the DIC fund and is not a direct source of resources for the payout. The key activities to be performed in this phase are:
  - a) CBOB's notification on license revocation of a member institution. Timely notification of DIC on license revocation is critical to the start and effective completion of the reimbursement activities.
  - b) Communication to the public. In coordination with CBOB, the DIC will make an announcement to the public on the start of the reimbursement process and provide key information for the depositors on how they will receive the compensation. The DIC should activate different communication channels such as website, toll free number, radio announcements, and press. The key success factor is to have the process formalized and template announcements drafted.

- c) Decision making. It is critical that the board meeting is convened as soon as possible. A draft agenda and supporting documents for the topics will enable an efficient reimbursement process.
- d) Data submission by the failed member institution. In coordination with CBOB, as part of the formal coordination arrangements, ensure accurate and timely submission of depositor data to ensure prompt determination of insured deposits.
- e) Engage paying agent and other outsourcing partners. On the basis of pre-arranged stand-by contracts, engage a paying agent and other specialized service providers. Prior to engaging the paying agent, the DIC should consult CBOB to ensure that the paying agent's financial standing and risk profile are appropriate.
- f) Insured deposit determination. Calculate insured deposit amount per depositor and undertake verification of the excluded depositors/deposits.
- g) Affect the payment to the paying agent. According to terms of reference with the paying agent, the funds should be transferred in advance of the start of the payout to depositors. The reporting framework by the paying agent should be determined in the stand-by agreement.
- h) Reimbursement of insured depositors. DIC should announce the start of the payment of the insured deposits by making depositors aware when and where they can get their insured deposits reimbursed. In addition, the announcement should say which documents will be required to confirm their identification.
- i) DIC reporting on the reimbursement process. DIC should regularly report on the progress of the reimbursement process to the board, as well as CBOB and eventually also the MOF. The reports can be designed as templates to ensure they address reporting requirements for each forum.
- j) Customer service to depositors. Depositors should be informed and have available communication channels to not only get information on the reimbursement process but also to make a complaint or a reclamation. These critical processes should be formalized, and templates drafted.

### ***Closure and archiving phase***

3. The final phase is to ensure completeness, archiving of the documentation, and establishing the completion of the reimbursement process. The key activities to be performed in this phase are:

- a) Submit payment documents by the paying agent;
- b) Back up of the payout data according to the applicable regulation;

- c) Produce a final report on the payout case for the DIC Board, the CBOB, and the MOF; and
- d) Develop an action plan for the implementation of the recommendations deriving from the final report of the completed payout case.

### A. Funding

4. **The DIC's funding structure, including crucial emergency liquidity funding, can be enhanced.** Funding of the DIC is carried out through contributions from the private sector and interest earned from investments. Member banks, including credit unions, pay premiums on a biannual basis (at end-March and end-September). The single fund is used to protect all depositors in member institutions, including the credit unions. In the event of a shortfall, the Protection of Depositors Act does not envision funding by the CBOB or placing funds in the market. However, the DIC may request a loan from the government. If the fund is in danger of being exhausted, the DIC may put extra levies on member institutions.

5. **Premiums are paid by member institutions and collected in the DIC Fund.** The Fund currently holds B\$69.1 million or approximately 0.9 percent of insurable deposits and 2.7 percent of insured deposits. This level is low by international standards. That level of funding could cover the failure of only three of the smallest credit unions and four of the smallest banks. It would not be able to cover the failure of the largest credit union nor any of the medium-sized banks in the Bahaman financial system.

6. **The DIC should conduct an analysis of the adequacy of the fund.** Such an analysis would look at the probability of default and the loss-given default of the institutions. In the interim, however, a back-of-the-envelope calculation would suggest that the target size of the fund could be increased. Even if the fund target were doubled, increasing it from 2 percent of insured deposits to 4 percent, the fund would be able to cover the small and two medium sized credit unions, the largest credit union, or the small banks and one medium sized bank. An assessment of the risk profiles of those institutions is warranted.

7. **The premium structure should be evaluated in light of the need to strengthen the deposit fund.** The CBOB is already examining the possibility of increasing premiums in a scaled approach by 5.5 bps, 6 bps, 7.5 bps, and 10 bps. These increases should be evaluated in light of the need to significantly increase the DIF. The DIC should evaluate the impact of those increases to determine if it is possible to meet the fund target within five years. In addition, the DIC should be cautious about applying risk-based premiums at this stage. Currently, the priority should be to strengthen the fund. Increasing premiums in the weakest or riskiest banks in the system could be counterproductive. In addition, at this stage, risk-based premiums could influence market perceptions of different banks leading to a possible "flight to safety" and generating liquidity problems in the weaker banks.

Size	Insured Deposits (June 2021)	Cumulative per Group
<b>Banks</b>		
Total	2,231,946,000	
Large	510,878,000	2,231,946,000
Large	448,524,000	1,721,068,000
Large	424,104,000	1,272,544,000
Large	402,233,000	848,440,000
Medium	172,559,000	446,207,000
Medium	165,761,000	273,648,000
Medium	90,334,000	107,887,000
Small	15,000,000	17,553,000
Small	1,749,000	2,553,000
Small	521,000	804,000
Small	283,000	283,000
<b>Credit Unions</b>		
Total	334,056,000	
Large	156,542,000	334,056,000
Medium	50,799,000	177,514,000
	44,673,000	126,715,000
	33,116,000	82,042,000
	33,132,000	48,926,000
Small	14,482,000	15,794,000
	1,312,000	1,312,000

8. **There is a need for an emergency back-up liquidity facility to be available from the MOF or the CBOB in the event of an unforeseen shortfall in the DIC's resources.** Such an emergency facility should be immediately available for depositor payout or financing resolution measures. The DIC will then repay such credits over time from asset recoveries and premiums collected from the industry. If the MOF is unable to provide such emergency back-up facility, the CBOB could provide that protection but with the credits to the DIC being indemnified by the MOF.

### **B. Public Awareness**

9. **Public awareness is an essential pillar of effective deposit insurance systems.** Public confidence is enhanced when the public knows the benefits and limitations of the insurance program. When assured that their deposits are safe, deposits are less inclined to run preemptively from failing banks. The key elements of such a program include disseminating: (i) scope of the insurance (i.e., which financial instruments and depositors are covered); (ii) the membership list of the DIS and how members are identified; (iii) deposit insurance coverage level; and (iv) the financing of the program.

10. **The DIC should develop a public awareness framework.** Such a framework could consist of the following elements:

- a. **First, the board should approve a document outlining a public awareness program.** Such a program will cover all areas of public awareness from policy decisions to DIC activities. A comprehensive public awareness policy typically defines, at minimum, the following elements:
  - Identification of what information on deposit insurance information should be distributed.
  - Identification of communication tools and channels tailored to target audiences. Typical communication tools and channels are: (i) website; (ii) mass media: newspapers, magazines, television, and radio; (iii) online and social media, (iv) events; and (v) educational activities, etc.
  - Target audiences are critical to be defined since they will ensure that public awareness activities and related information is targeted efficiently.
  - A plan and monitoring methodology are essential for evaluating the effectiveness of the public awareness program.
- b. **Second, regulations should be developed outlining the content for disclosure and how information is provided to depositors.** Member institutions are critical to a successful public awareness program. But to be successful, the content and method for information provisioning should be regulated. The most critical aspects to be regulated are: (i) procedure for the supply of depositor information leaflets/brochures; and (ii) key content presented in the leaflets/brochures.
- c. **Third, the DIC should clearly identify those institutions that are members of the DIC.** The depositors and the public need to know which financial institutions are members of the DIC. Member institutions can be identified using different documents which are placed at the banks' premises opened for clients.
- d. **Fourth, a depositor information leaflet is a helpful document to raise depositors/public's awareness in the deposit insurance system.** The leaflet should describe all the relevant information for depositors but should, at the same time, be written in clear language, understandable for all depositors. The leaflets are made available in all branches opened for clients, in a visible place, and should be given to clients when opening an account with a member institution.

- e. **Fifth, the DIC should ensure its website is up-to-date.** The website is a key communication channel for any deposit insurer to promote knowledge of deposit insurance. Such a website can help provide assurances for the public and depositors that there is a specific institution mandated for guaranteeing deposits up to the insured limit.
- f. **Sixth, the DIC should be clear what information will be given to depositors in the event of the bank failure.** The public awareness function should work closely with the reimbursement function and other relevant functions to identify all communication needs for the public, if necessary going beyond the minimum requirements of the law, to ensure accurate and timely information is provided on the reimbursement process. The DIC should develop draft announcements and other necessary communications so it can respond immediately to a failure and reinforce the public's confidence.
- g. **Finally, an independent evaluation is needed to measure the effectiveness of public awareness program or activities.** The independent evaluations can be done by surveying the public in order to learn about their awareness level on key deposit insurance information, such as, but not limited to, the deposit insurance limit, and insurance rules (coverage per depositor, per bank). Additionally, the surveys will help to learn which communication tools and channels are most effective in public awareness activities.