Basel Committee's Guidelines for Identifying and Dealing with Weak Banks

Seminar on Crisis Management and Bank Resolution

Abuja, Nigeria

16-20 January 2017

Amarendra Mohan

Independent Financial Sector Expert

(formerly with the Financial Stability Institute
Bank for International Settlements
Basel, Switzerland)

amarendra.mohan@yahoo.com

Agenda

- **The Background**
- **Weak Banks**
  - – Identification of a Weak Bank
  - – Dealing with Weak Banks
    - Resolution not covered
- Concluding remarks
- Annex : Practical Examples (US & EU)

Background

- Weak banks are a worldwide phenomenon
- Pose a continuing challenge for bank supervisors and resolution authorities in all countries….
- Supervisors to be prepared to minimise the incidence of weak banks & deal with them when they occur
- Why deal with weak banks in a timely manner:
  - weak banks are not good for the economy
  - maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors
  - Preserve the value of bank's assets with *minimal disruption to its operations (ie maintaining the economic entity*)
  - Minimise any *resolution costs* and *systemic impact*

Basel Committee on weak banks: Policy Background

- 2002: Supervisory guidance on dealing with weak banks
  - Intended as a toolkit for supervisors, not prescriptive, identified good practices
  - examined a wide variety of bank problems and their background and causes, assessed pros/ cons of methods used to address them
    - preventive measures, early identification, corrective actions, resolution issues and exit strategies

- June 2014: Supervisory guidelines for identifying and dealing with weak banks - consultative document
- 9 comments received (September 2014)
- July 2015: Guidelines for identifying and dealing with weak banks

Guidelines for identifying and dealing with weak banks: July 2015

What is new in 2015?..

- Emphasis on the need for *early intervention* and the use of *recovery and resolution tools*, and updating *supervisory communication policies* for distressed banks
- Further guidance for improving supervisory processes-
  - Incorporating macroprudential assessments
  - stress testing
  - business model analysis
  - reinforcing importance of sound corporate governance
- Highlighted issues of liquidity shortfalls, excessive risk concentrations, misaligned compensation and inadequate risk management; and
- Expanded guidelines for information-sharing and cooperation among relevant authorities

What is a weak bank?

- Weak bank- ***liquidity or solvency*** is ***impaired*** or ***will soon be impaired*** unless there is a major improvement, ***in a timely manner***, in the bank's:
  - financial resources (capital, liquidity)
  - risk profile
  - business model
  - risk management systems and controls, and/or
  - quality of governance and management

- Weak Bank- *Potential/ immediate threats to liquidity & solvency*
  - different from isolated or temporary weaknesses that do not threaten ***bank's viability***
    - problems of a weak bank are more fundamental
- Banks do not become weak overnight

Weak banks: Preconditions for effective banking supervision

- Comprehensive rules for licensing of banks, permitting new major activities/ acquisitions/ investments by banks, and for ownership changes in banks (CP 4–7)
- Prudential rules/ guidelines for banks –capital, liquidity, connected lending and loan concentrations (CP 16–25)
- Requirements for effective corporate governance, compensation policies, internal controls & risk mgmt. consistent with strategy, complexity & scale of business (CP 14, 15 & 26)
- Forward-looking supervisory assessment of banks' risk profile proportionate to systemic importance (CP 8 &12)
- Supervisory reporting –collect, review & analyse prudential reports/ statistical returns - solo & consolidated basis (CP 10)

Weak banks: Preconditions for effective banking supervision

- Supervisory framework & culture to encourage early intervention
  - address unsafe/ unsound practices that could pose risks to banks/ banking system.
  - range of tools- graduated and flexible response to different problems, as well as timely corrective action
  - range of penalties when prudential requirements are not met
  - Resolution plans, in partnership with other relevant authorities – domestic & cross-border (CP 8, 9, 11 and 13)
- Accounting standards for financial statements ..(CP27)
- Bank Audits, reporting of matters of material significance directly to supervisor (CP 10 & 27)
- legal and judicial framework, including adequate resolution regimes (CP 1, FSB's Key Attributes 2, 3, 5, 6 and 7)

Weak banks: Preconditions for effective banking supervision

Institutional preconditions –

- Supervisory authority –Operational independence, adequate resources, ability to take early action (Mandated in law) (CP 2)
- Legal protection to supervisory authorities and individual supervisors for supervisory actions taken in good faith (CP 2)
- Tax rules allow asset transfers etc in a bank resolution without distorting/mitigating the corrective nature of such actions
- A well functioning resolution regime:
  - lender of last resort facility with the central bank
  - pre-established bank resolution framework
  - well funded deposit protection arrangements

Identifying Weak Banks-
Supervisory Review Process

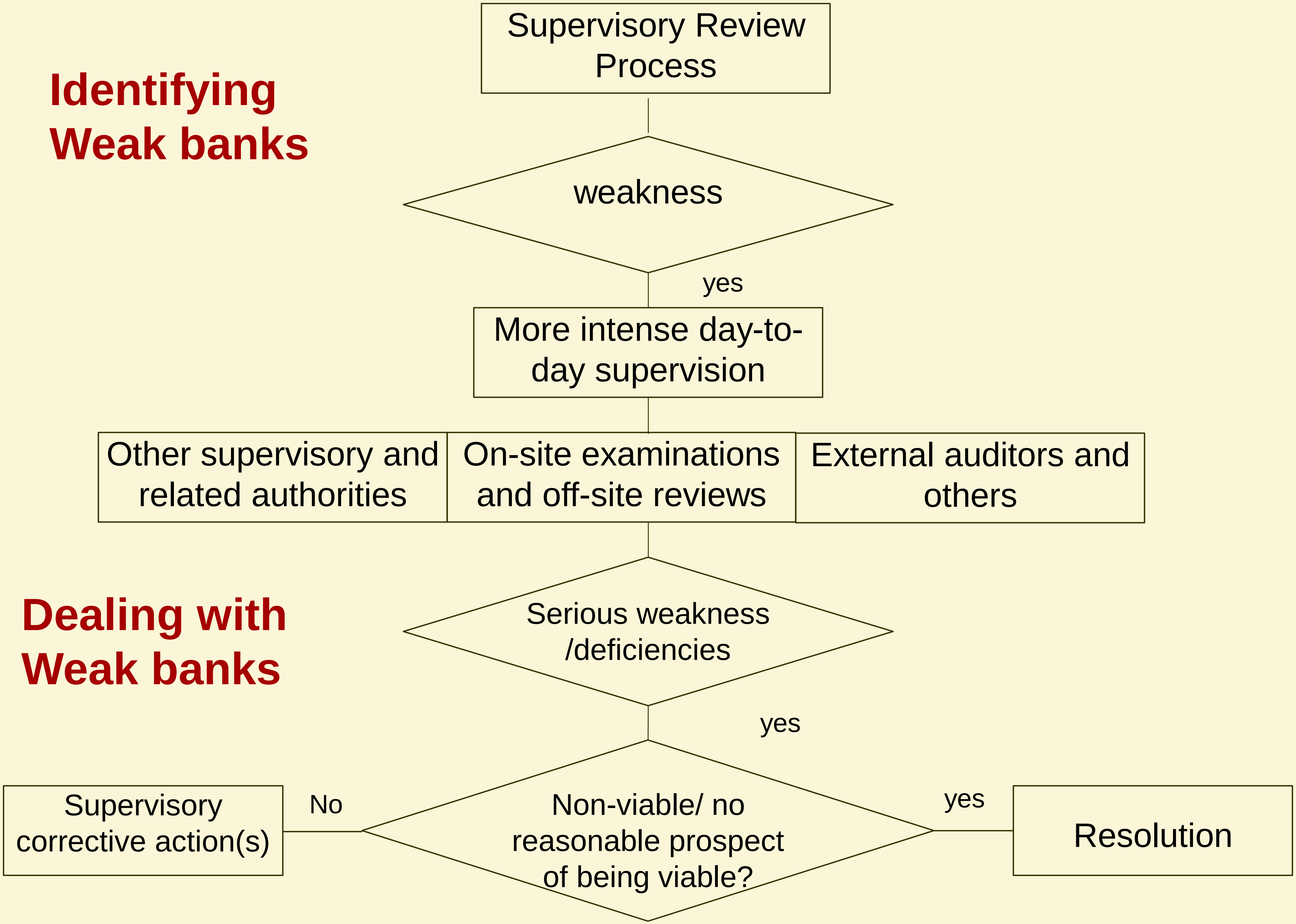
Supervisory review process

Macroprudential Tool (surveillance of bkg. system)	On-site examination and off-site reviews (forward looking)	Contact with other sources of information	Supervisory evaluation systems

- Early warning systems
- Business model
- Gover-nance & risk mgmt.
- Control function
- Stress Testing
- Mgmt. Info. System
- Review of recovery plan

Identifying Weak banks

Dealing with Weak banks



Symptoms and causes of bank problems

Symptoms

- poor asset quality
- lack of profitability
- loss of capital
- excessive leverage
- excessive risk exposure (conc. of risk)
- reputation problems
- liquidity concerns

Causes

- inappropriate business model
- Governance/ incentive structure
- credit problems
- liquidity
- market risk
- operational risk
- interest rate risk
- strategic risk

Principles for dealing with weak banks

Early identification of risk

- EWS to identify weak banks
- Governance & management reviews
- Macroeconomic surveillance & Stress Tests

Early Intervention

- Forbearance exacerbates problems
- Makes eventual resolution more difficult & costly

Effectiveness

- Best effort, given the available information
- Consider all costs, including failure of a systemic bank

Principles for dealing with weak banks

Flexibility	• Flexibly apply recovery measures • Decisive action in concert with resolution authority if weak bank reaches point of non-viability
Clear internal Governance processes	• Discretionary decisions taken at appropriate levels (consider significance of the issue)
Consistency	• Basis of action - Ratings under Supervisory Rating systems, similar problems receive similar treatment

Principles for dealing with weak banks

Transparency & Cooperation	• Between Banks & Authorities • Disclosures to wider financial community/public
Avoid potential systemic problems	• Systemic banks- more intensive framework
Early Preparation	• Systemic banks – recovery plans • Resolution authorities- resolution plans

Corrective Action

Financial weakness

Early remediation indicators

- Based on - regulatory capital, liquidity levels, stress tests, risk management weakness, market indicators
- early remediation measures- Not automatic

Remediation requirements

- Early Action – initial stages of financial weakness
- Heightened supervisory review
- Restrictions on expansion and dividends

More severe requirements

- Prohibition on expansion & capital distributions
- raising capital
- divesting certain assets

General Principles for Corrective Action

- Supervisory objectives- financial stability, depositor protection
- Immediate corrective action
- Bank’s senior mgmt. commitment
- Proportionality – circumstances, scale of problem
- Comprehensiveness –both causes & symptoms

Range of Corrective Actions

- variety of tools needed for dealing with weak banks:
  - Specific action by bank to mitigate weakness
  - Prohibit activities aggravating weakness

Impact on Governance

- Enhance governance, internal controls and risk management
- Submit an action plan of corrective actions
- Activation of recovery plans
- Changes in the legal structure of the banking group, in close cooperation with resolution authorities
- Remove directors and managers
- Limit compensation (including management fees/ bonuses) to directors/ senior executives (possible needs for clawbacks)
- Require prior supervisory approval of any major capital expenditure, material commitment or contingent liability

Range of Corrective Actions

Impact on cash availability

- Call for cash injection by shareholders/ new investors
- Call for new borrowing/bond issuing and/or rollover of liabilities/secure line of credit

Impact on shareholders' rights

- Suspend some/ all shareholders' rights, including voting rights
- Prohibit distribution of dividends
- Appoint an administrator or conservator
- Mergers and acquisitions

Impact on bank operations and expansion

- Enhance or change capital and/or liquidity & strategic planning
- Restrict concentrations or expansion of bank operations
- Downsize operations and sales of assets (close branches)
- Prohibit/ limit particular lines of business, products, customers
- Require immediate or enhanced provisioning for NPAs

Timely corrective action and preventing forbearance

- Timely corrective action is critical
- “Problems will rectify themselves”…. Hope?
- Laws should support prompt / adequate action
- Need also for a macroprudential perspective - financial stability implications (coordinate with Macroprudential Authority)
- Act pre-emptively when weakness detected, *without waiting for breach of a threshold*
- Decisive Action at Point of non-viability (no longer viable, or likely to be no longer viable):
  - Restore to viability, failing which
  - Resolve in orderly manner
    - timely and early entry into resolution before firm is B/S insolvent & before all equity fully wiped out
    - clear standards or suitable indicators of non-viability (conditions for entry into resolution)

Timely Corrective Action & Preventing Forbearance

Weak bank

Timely corrective action (rule-based)

- Critical
- Hope?
- Legal/rules (protection from undue interference)
- Macroprudential focus
- Pre-emptive Action (don't wait for breach of thresholds)
- Decisive Action at PONV (not/likely to be viable)
  - (i) Recovery, or else
  - (ii) Resolution (still B/S solvent)

Discretion – limited role

<u>Limited role of discretion even in a world of early intervention</u>

- Structured internal Governance process
  - Appropriate level of seniority
  - Analyse probabilities of recovery, explicit analysis of risks (esp. critical economic functions)
  - Document underlying reasons to defer action
  - Avoid forbearance

Escalation of Corrective Action & Supervisory resources

Informal Methods	• Less intrusive corrective action • If bank management cooperates
Formal Action	• More serious problem/ bank management not cooperating • Supervisory/Enforcement notice – binding • “cease and desist”
More severe corrective action	• Increased danger of failure • Cooperate with resolution authority • Sale/payment prohibition to avoid asset dilution
Supervisory resources	• Increased intensity of supervision • Resource and cost implications • BCP – enough supervisory resources. Lack of resources is no justification for inaction

A plan of corrective action

- Supervisor - Priority to more serious areas
- Supervisor - A package of corrective measures (symptoms and causes)
- Bank to develop a detailed capital and operating plan showing how the bank's financial health will be restored
- commitment of the board of directors, and ultimately of the major shareholders
- No distractions - shelve any plans for new branches, acquisitions or major new business initiatives in the interim
- Bank's action plan should be approved by the board of directors

Dealing with weaknesses: Capital Adequacy

Symptom: Decline in capital ratios

Capital Reduction (redemption sub-debt)

Loss

$$\frac{\text{CAPITAL}}{\text{RWA}}$$

Increase in risk-weighted assets

Causes

Voluntary?
Need for high quality capital?

Underlying causes?
Unexpected mkt. develop. or chronic losses …….

Financial strength?
Mgr./org. capacity to handle new risks

- Capital remediation plan
- Buffers
- Sell/ securitise assets
- Replace assets to lower RWA
- Cut operating costs, capital expenditure
- Limit/restrict dividends, variable compensation, etc
- Restrict redemption of sub- debt/ other instruments
- Bring a new shareholder to contribute new capital

Dealing with weaknesses

Business Strategy

- Deviations from budget (poor results, unrealistic assumptions)
- Common weakness vs. weakness leading to solvency problems – not easy to identify

Asset quality

- Higher write-offs
- Poor underwriting standards?
- Market Confidence

Governance/ Management

- “Fit and Proper” Test
- Compensation
- Removal
- Temporary appointment by supervisor

Dealing with weaknesses

Earnings

- Variety of factors for earnings decline
- Restructure unprofitable activities (close branches, cut costs)
- Changes to business models/ operating plans

Liquidity

- Capital- no substitute for liquidity
- Short term & long term liquidity profile
- Private sector liquidity lines
- Central bank

Risk management

- All risks
- IT Risks
- business resiliency and continuity plans
- Recovery plans for SIBs

Public disclosure of problems

Conflicting objectives	• Stakeholders decision making, public confidence, vs.- • A bank run, bank's access to financial markets, financial stability aspects
When?	• Ratings downgrade, adverse analyst report • Rumors – publicise bank's remedial actions, let the bank communicate first • Comm. on resolution when decided to resolve a bank
Contents	• Succinct and clear – what is the decision taken, reasons, goals of authorities • "depositors have no cause for alarm" – might imply endorsement/ support of bank
Strategy	• Auth.- Ready comm. strategy for crisis • Bank's comm. strategy (increased IT support for internet banking during crisis times)

Concluding remarks

- Be prepared
- Clear objectives and a clear operating framework
- Prevention better than cure
- Be discerning
- Cross-border coordination and cooperation
- Banks can and do fail

Annex: Practical Examples

US Prompt Corrective Action (PCA)

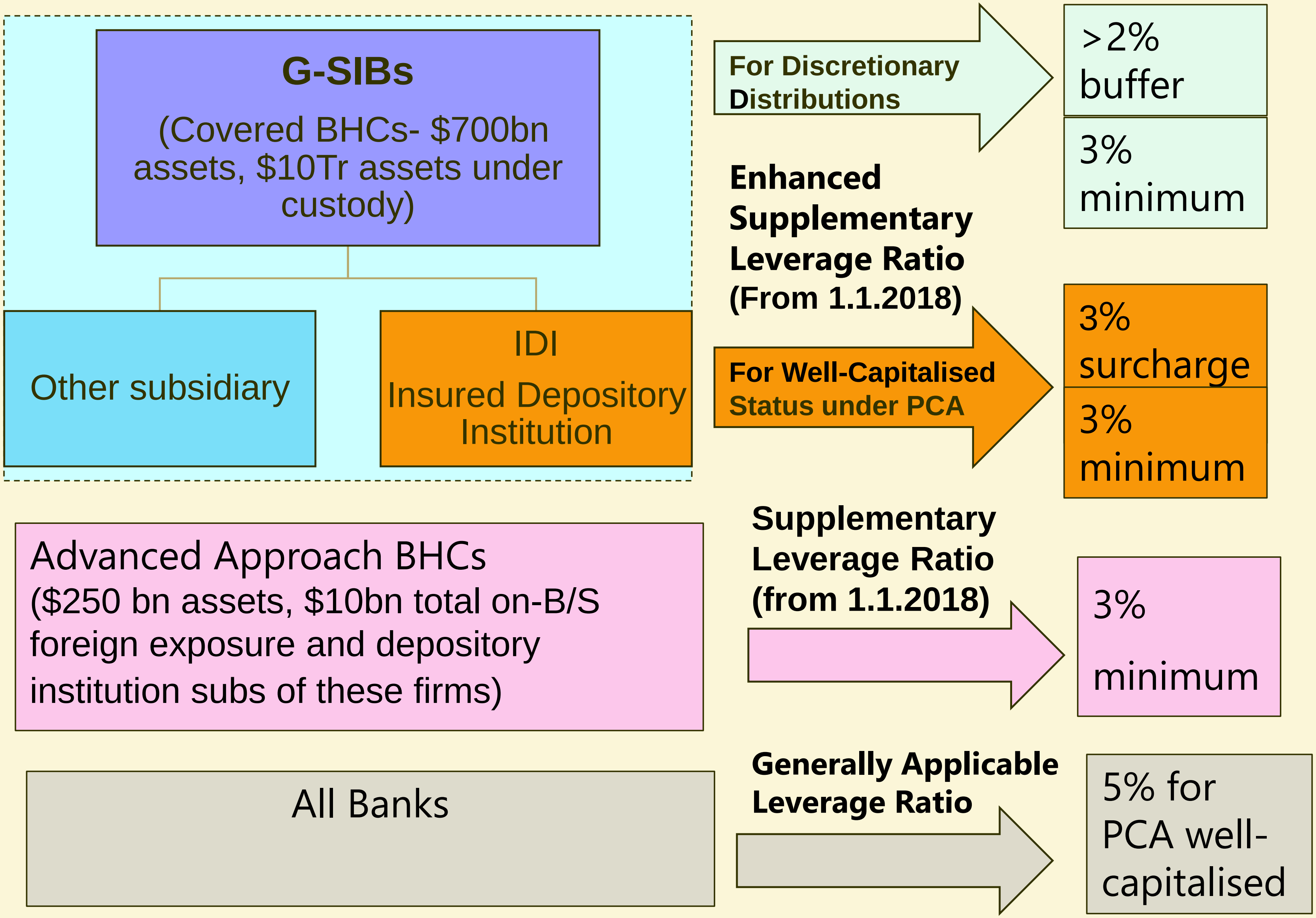
- 5 categories of capitalization levels
- 3 measures of Capital- RBC, Tangible Equity, Leverage
- PCA Capital levels do not include buffers
- 3 measures of leverage –
  – generally applicable leverage ratio (traditionally applied in US, does not include off-B/S exposures)
  – Supplementary leverage ratio (US implementation of Basel III leverage ratio) includes many off-balance sheet exposures in its denominator
  – Enhanced Supplementary Leverage Ratio
- For US G-SIBs, in addition, Enhanced Supplementary Leverage Ratio applies (buffer of 2% + min. ratio of 3%).
  – If below 2% leverage buffer, prescribed payout ratios limit discretionary distributions

US Prompt Corrective Action (PCA) Thresholds

PCA Category	Risk-based Capital (RBC)			Leverage Ratio		
	Total RBC Ratio	Tier 1 RBC Ratio	CET1 RBC Ratio	Tier 1 Leverage Ratio	Supplementary leverage ratio-Adv. App banks	Supplementary Leverage Ratio for subsidiary IDIs of covered BHCs (GSIBs)
Well Capitalized	10%	8%	6.5%	5%	N.A.	≥6%
Adequately Capitalized	8%	6%	4.5%	4%	≥3.0	≥3%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%	≤3.0	<3%
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%	N.A.	NA
Critically Undercapitalized	Tangible Equity/Total Assets ≤ 2% (T1+non-Tier1 perpetual preferred stock) to Total Assets				N.A.	NA

IDI- Insured Depository Institution

US Leverage Ratio



Leverage Buffer – US

- Enhanced Supplementary Leverage Ratio rules (From 1.1.2018), for G-SIBs (Covered BHCs- $700bn assets, $10Tr assets under custody)

Calculation of Maximum Leverage Payout Amount	
Leverage Buffer	**Maximum leverage payout ratio (as % of eligible retained income)**
>2%	**No payout ratio limitation applies**
≤2%, >1.5%	**60%**
≤1.5%, >1.0%	**40%**
≤1.0%, >0.5%	**20%**
≤0.5%	**0%**

PCA Actions

- Section 38 of FDI Act - FDIC to apply one/ more of following provisions on a significantly undercapitalized institution or an undercapitalized institution that failed to submit and implement a capital restoration plan:
  - Require recapitalization
  - Restrict transactions with affiliates
  - Restrict interest rates paid
  - Restrict asset growth
  - Restrict activities involving excessive risk
  - Improve management
  - Prohibit deposits from correspondent banks
  - Prior approval for capital distributions by a bank holding company
  - Require the bank or holding company to divest of subsidiaries
  - Require a holding company to divest of the bank, or
  - Require any other action to resolve problems of the institution
- Dismissing a Director or Senior Executive Officer, etc.

EU: Ongoing Supervision & Early Intervention

Probability of failure			Impact of failure	
Ongoing Supervision	Severe Stress: Recovery measures		"Failing/Likely to Fail": Resolution	Insolvency/ Liquidation
Prudential rules: - Governance - Bank's Corporate structure - Capital - Liquidity - Large Exposure norms - …. Early intervention by Supervisor under Pillar 2: - Addl. capital - Reduce inherent risk - Strengthen risk controls	Recovery plan indicators show a worsening financial position - capital indicators - liquidity indicators - profitability indicators - Asset quality indicators Bank takes measures under its recovery plan - Supervisory Authority notified	Financial conditions deteriorate further: - Bank infringes or is likely to infringe prudential regulation (CRR/CRDIV) - Not complying with own funds req. (Pillar1 + Pillar2) +1.5%, as per BRRD - Overall SREP scores - Material changes/ anomalies under SREP Supervisory Authority takes Early Intervention Measures - Remove mgmt. - Temp. administrator	Conditions for resolution: - failing/likely to fail (infringement of requirements for continuing authorisation; assets less than liability; etc..) - No private sector solution - Public interest Resolution plan implemented by Resolution Authority: - Sale of business - Bail-in - Bridge Bank - Asset Separation	Judicial insolvency procedure Winding up/ Liquidation as per national insolvency law

Basel Committee's Guidelines for Identifying and Dealing with Weak Banks

Seminar on Crisis Management and Bank Resolution

Abuja, Nigeria

16-20 January 2017

Amarendra Mohan

Independent Financial Sector Expert

(formerly with the Financial Stability Institute
Bank for International Settlements
Basel, Switzerland)

amarendra.mohan@yahoo.com