Cross -border Bank Supervision and Resolution: A Case Study

This case study is in 2 parts. Working in groups, you are required to present the group views on the issues raised in the case study (points for discussion).

Part 1

(a) We are in the year 2030.

Snowland is a small but rich country with a well-developed financial system. Prudent bank is the largest bank in Snowland. Prudent Bank is engaged in rapid expansion overseas and operates through branches in 11 countries. Prudent Bank's foreign operations are very important as its foreign assets, foreign lending and foreign income form more than 50% of the total assets, lending and income of the bank.

Homeland is a big economy with a GDP of $2 trillion. The Homeland Supervisory Authority is an integrated supervisory agency. The risk-based supervision framework of Homeland Supervisory Authority optimizes supervisory resources by focusing more on banks with a higher risk profile.

Prudent Bank operates in Homeland through a branch which is not considered "significant" as the branch's assets form only 0.3% of the total banking assets of Homeland. The branch has, however, expanded its retail operations in the past three years by offering internet deposit accounts with higher interest rates. Currently, the depositors of the branch number a little over 1 million.

(b) We are in the year 2032.

The Central Bank of Snowland has observed that there are vulnerabilities building up in the financial system due to excessive credit growth and fall in house prices by 15%. Due to its rapid expansion, Prudent Bank has accumulated high level of non-performing assets and is facing liquidity strains. Prudent Bank has approached the Snowland Central Bank for emergency liquidity assistance. A few days later, the on-site exam by Supervisory Agency reveals that the bank's solvency is impaired. There is a run on the bank and its branches on 1 March 2032.

On 3 March 2032, the authorities in Snowland declare the bank as insolvent, ring-fence it and take it into receivership. Homeland Supervisory Authority freezes the assets of the branch. In order to avoid contagion, Homeland Authorities inject public funds in Prudent Bank's branch to pay off depositors (especially as large number of depositors are involved).

Points for discussion:

1. Year 2030 – Prudent bank's branch is not "significant" in Homeland and the Supervisory Authority optimizes supervisory resources by focusing more on higher risk profile banks. As an official of the Homeland Supervisory Authority, what measures would you take to ensure effective supervision of Prudent Bank's branch? Please give reasons in support of your view.

2. Year 2032- As a supervisor in Snowland what measures would you take to ensure effective cross-border cooperation and coordination in crisis management? What measures would you take if you are a supervisor in Homeland? Please give reasons in support of your views.

Part 2

We are now in year 2034.

(1) Early Intervention

Homeland has recently implemented Basel III. It is in the process of implementing an early intervention scheme as a part of Recovery and Resolution Planning (RRP) framework. The early intervention measures are based on capital adequacy triggers as shown in Table 1. The Supervisory Authority has proposed to the Government to give it necessary powers under law for strengthening the enforcement function (eg, legal powers to remove/replace directors/senior managers of banks, appoint a temporary administrator, etc.). The Authority is also hiring new staff for enforcement function.

Table 1

Category	Former Standards (prior to Basel III)	Current Standards (under Basel III)	Measures to be taken (unchanged)
Exception from Category	$8\% \leq TCR$	$4.5\% \leq CET1$ $6\% \leq T1$ $8\% \leq TCR$	- Nil -
Category 1	$4\% \leq TCR < 8\%$	$2.25\% \leq CET1 < 4.5\%$ $3\% \leq T1 < 6\%$ $4\% \leq TCR < 8\%$	Request to submit a reasonable improvement plan to secure sound management, and an order for its implementation
Category 2	$2\% \leq TCR < 4\%$	$1.13\% \leq CET1 < 2.25\%$ $1.5\% \leq T1 < 3\%$ $2\% \leq TCR < 4\%$	An order pertaining to measures which contribute to equity capital adequacy
Category 2-2	$0\% \leq TCR < 2\%$	$0\% \leq CET1 < 1.13\%$ $0\% \leq T1 < 1.5\%$ $0\% \leq TCR < 2\%$	An order to select any of the measures intended to ensure the adequacy of equity capital, drastically reduce business, merge, or abolish banking and to implement the measure pertaining to said selection
Category 3	$TCR < 0\%$	$CET < 0\%$ $T1 < 0\%$ $TCR < 0\%$	An order to suspend all business or a portion thereof

(2) Resolution:

Homeland has classified its banks into three categories:

(i) Small banks. These banks have small balance sheet size, run localized operations in a few cities and do not perform any critical functions. They undertake traditional banking by accepting deposits and lending to small borrowers. The Micro Bank, however, is a small bank with a large number of customers (over 2 million).

(ii) Regional banks. These banks are relatively larger in terms of asset size and operate in one or two provinces of Homeland. The regional banks are also engaged in primarily traditional banking activities (accepting deposits and lending) but some regional banks have decent sized trading books and are quite active in the derivatives markets.

(iii) Domestic Systemically Important Banks (DSIBs). Homeland has classified three banks as DSIBs based on their size, interconnectedness, and complexity. The failure of any one of these banks can have systemic risk implications.

As a part of the Recovery and Resolution Planning (RRP) regime, Homeland has decided to implement FSB's framework of Total Loss Absorbing Capacity (TLAC) <u>for all banks.</u> The Central Bank's Financial Stability Department is of the view that the RRP Regime, including the level of TLAC, should be applied in a uniform manner to all banks for ensuring competitive equality. The Homeland Supervisory Authority, which is responsible for resolution of banks, is considering to adopt a proportionate approach to RRP and have different TLAC levels for different types of banks (small, regional, DSIB). The Governing Board of the Homeland Supervisory Authority is seeking independent expert advice from the IMF on this issue.

Points for Discussion

(1) Early Intervention: You are an assessor from the IMF. What according to you, are the strengths and weaknesses (if any), of the Early Intervention Framework implemented by Homeland? Do you have any recommendations to further enhance effectiveness of the Early Intervention Framework?

(2) Resolution: As an expert in the IMF, what would be your advice to the Authorities? Would you recommend a uniform RRP regime with a uniform level of TLAC for all banks or otherwise? Please give reasons in support of your recommendation.