CONTINGENCY PLANNING WORKSHOP
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THE CHALLENGES OF CONTINGENCY PLANNING FOR DGS

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On behalf of IADI Europe Regional Committee and Bank Deposit Guarantee Fund of Romania, I wish to welcome you to the "Contingency Planning Workshop" devoted to explore best practices in an area of high sensitivity for the general public and for bank customers in the first place.

Contingency planning aims to prepare an organization to respond well to an emergency and its potential impact. Developing a contingency plan involves making decisions in advance about the management of human and financial resources, coordination and communications procedures, and being aware of a range of technical and logistical responses. Such planning is a management tool, involving all sectors. Time spent in contingency planning equals time saved when a disaster occurs. Effective contingency planning should lead to timely and effective disaster-relief operations.

The contingency planning process can basically be broken down into three simple questions:

- What will happen?
- What shall we do about it?
- What can we do ahead of time to get prepared?

This workshop aims at helping planners to think through these questions in a systematic way. Contingency planning is most often undertaken when there is a specific threat or hazard; exactly how that threat will actually impact is unknown. Nevertheless, developing scenarios is a good way of thinking through the possible impacts. On the basis of sensible scenarios it is possible to develop a plan that sets out the scale of the response and the resources needed.

In business continuity and risk management, a contingency plan is a process that prepares an organization to respond coherently to an unplanned event. The contingency plan can be also used as an alternative for action if expected results fail to materialize. A contingency plan is sometimes referred to as "Plan B."

A bank's contingency planning effort has one main goal: to get back to "business as usual" as quickly as possible. Quick recovery of functioning capability may prove to be more difficult and take longer than the approval of bank's recovery strategies.

Proceeding from the 15th Core principle – **Early detection and timely intervention and resolution,** the IADI research and guidance paper on "General Guidance on Early Detection and Timely Intervention for Deposit Insurance Systems", issued this June states:

"It is important for the bank supervisor, the resolution authority and the deposit insurer to have well-developed action/contingency plans for ensuring timely and effective implementation of intervention measures that are adequate and proportionate to the seriousness of a bank's weaknesses. It is good practice for intervention measures/corrective action to be coordinated between the deposit insurer, the resolution authority and the primary bank supervisor."

To which of the DGSs functions does the discussion apply?

According to Core Principle 17 for Effective Deposit Insurance Systems, "the deposit insurance system should give depositors prompt access to their insured funds."

Does the mandate of the DGS matter for this discussion?

There are four types of mandates (FSB, "Thematic Review on Deposit Insurance Systems – Peer Review Report", 2012):

- "Narrow" mandate systems that are only responsible for the reimbursement of insured deposits ("pay-box" mandate);
- A "pay-box plus" mandate, where the deposit insurer has additional but limited responsibilities, such as some specific resolution functions;
- A "loss minimizer" mandate, where the insurer actively engages in the selection from a full suite of appropriate least cost resolution strategies; and
- A "risk minimizer" mandate, where the insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities.

This discussion does not address the mandate, but it fits the least common denominator of the narrow mandate.

According to the 16^{th} Core Principle, an **Effective resolution process** should facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimize resolution costs and disruption of markets; maximize recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (e.g. providing depositors with continuous access to their funds and maintaining clearing and settlement activities).

The responsibilities of deposit insurers for various aspects of supervision, prudential regulation and the resolution of troubled banks are country specific, reflecting the particular mandates of financial safety net participants. However, regardless of the specific responsibilities of the deposit insurer in any particular country, the manner in which banks are supervised and regulated and how troubled banks are resolved has a major impact on the costs and other aspects of the deposit insurance system.

What is important is that whoever has responsibilities in this regard recognize that the determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and the intervention and resolution process be initiated on the basis of well-defined criteria. This can help reduce the cost of resolutions and avoid unnecessary confusion. Criteria vary between countries and include: concerns over a bank's ability to meet capital requirements; low level of accessible liquidity; deterioration in the quality or value of assets; and a finding that the bank is operated in an unsafe and imprudent manner.

The resolution of troubled banks involves three basic options: liquidation and reimbursement of depositors' claims (which typically involves the closure of the bank), purchase-and-assumption transactions (sale) and open-bank financial assistance. In addition, the deposit insurer or other relevant financial system safety net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (through the use of a bridge bank, assisted acquisition or provisional administration).

Bankruptcy/insolvency and other laws may heavily influence the choice of resolution methods since such laws vary considerably among countries and, in some cases, may make a particular resolution method difficult to implement. Because of the special significance of banks and bank failures, policymakers may wish to review whether bankruptcy/insolvency laws facilitate the orderly exit of troubled banks. In this regard, establishing a separate insolvency regime for banks should be considered.

What are the DGS's obligations?

The Core Principles for Effective Deposit Insurance Systems mention "contingency planning" on two occasions:

- Principle 12 (Public awareness) states on item 12.4: "There should be an effective contingency planning process for public awareness and communication that addresses plausible future scenarios and that involves the cooperation and coordination of other safety-net participants as appropriate".

- Principle 17 (Reimbursing deposits) comes with additional criteria saying at item 1 that "The deposit insurer should have contingency plans as well as regularly scheduled tests of its systems".

The IADI report on "Enhanced Guidance for Effective Deposit Insurance Systems: Reimbursement Systems and Processes" (November 2012) proposes additional guidance points, among which the 14th reads:

- "Adequate resources and trained personnel dedicated to the reimbursement function should be made available to ensure readiness in undertaking reimbursements. Where internal resources are insufficient, a contingency plan should be in place to augment resources in times of need".

Both IADI surveys and IMF point towards two weaknesses in the functioning of deposit insurers:

Lack of accurate depositor information in order to timely identify depositor claims and lack of appropriate IT systems to manage such information, and

Insufficient public communication and need to increase public awareness about deposit guarantee process.

A framework for contingency planning implies a series of scenarios imagining things that could go wrong in as many as possible aspects of a DGS activity and coming up with solutions for the identified problems.

The activity of a DGS could be divided into three categories – normal times, the failure, the period when deposits have to be reimbursed.

Normal times aspects that could go wrong:

- Evolution of deposits by volume, maturity and location (branch or subsidiary). The method of measuring deposits volume (yearly average or end year) can negatively affect a DGS' resources. The transformation of branches to subsidiaries (or/and the other way around) as banks will shrink assets and change the structure of liabilities will impact the funds of DGSs.

- The changes in volume and location of deposits will change the compensation a DGS has to pay. As previous experience has shown, deposit-guarantee obligations may be higher than initially thought in the event of a crisis (so a DGS should have an extra cushion for any scenario imagined). A DGS has to carefully chose its investments and limit its dependence on the banking sector (ex. avoid taking letters of guarantee from the banks that create the DGS's obligation to pay if they fail and the letters become worthless papers as was the case in Iceland)

- The Contingency planning exercise at a DGS should include the central bank (as a LOLR and financial stability actor) and the supervisor of commercial banks? And if yes, which supervisor (from the home country or the host country)?

- Articles in the foreign press on a DGS from a home country should be monitored in order to avoid any loss of confidence from misinterpretation (fear of lack of deposit guarantee if the DGS is private) or overconfidence (if there are top-ups in covering deposits)

The failure moment and elements that can become a problem:

- A DGS has to communicate with the public during a crisis (yet most of the communication has to be made in normal times). A set of ready-made statements for different situations should be available beforehand. If communication is perceived as difficult panic is the normal conclusion.

- Identifying guaranteed deposits and calculating reimbursements obligations depends on accurate information. What are the alternatives if the information is not available, as it was believed?

- How feasible from the legal point of view is the alternative of taking over IT systems of a failing bank by the DGS? Who and how often checks the availability of information on depositors for each bank

- How helpful is the presence of representative of the government in the board of a DGS, should a government owned bank collapse? May party politics and elections play a part in such a scenario? (it happened both in Iceland and UK)
- If several banks collapse in the same time and they are not both small and medium, which depositors are to be reimbursed first and on what grounds?

Reimbursement period and items that might turn out to be a thorny issue:

- If the Ministry of finance has to supplement the funds of a DGS through bond issue isn't this going to develop a new panic? Should the Ministry of finance be prepared with a communication contingency plan?

- How will the auditor of the Ministry of Finance treat such a financial aid given to the DGS? Their possible future reaction and the legal consequences on employees of the Ministry of finance and DGS will impede such financial aid?

- In order to answer any future claim of reimbursements a DGS should keep all information regarding banks' offers for deposits. Usually banks advertise their products through their web pages and flyers, but their products change over time and the information is lost. Such information may contain details regarding to what was promised in terms of deposit guarantee.

The main guiding principles for timely intervention require:

- **Comprehensiveness**. A comprehensive intervention should address all aspects of specific problems that a bank faces and their causes and other underlying issues. The corrective or enforcement action should be aimed at achieving predetermined outcomes within a specified period of time. If problems are not dealt with promptly, they can grow rapidly, making the eventual resolution effort more difficult and more expensive, as well as having the potential to spread and become systemic.
- **Proportionality**. Intervention should be proportional to the scale and scope of the identified problems or weaknesses. Inadequate or ill-prepared intervention measures may not fully address the existing problems, leaving the bank in an unsound condition. On the other hand, excessive intervention measures could result in ineffective use of resources, both for the deposit insurer (or other relevant authority) and the bank's management.
- **Consistency**. To ensure certainty and a clear understanding of possible intervention measures that can be applied to banks facing difficulties, it is important to treat similar problems in different types of banks in a consistent manner.
- **Flexibility**. While it is typical for legislation or regulations to specify a set of triggers or rules concerning the application of specific intervention measures, in practice a deposit insurer (or other relevant authority) should have the possibility to choose from the available range of actions, taking into account its assessments of various factors.
- **Cost efficiency.** Intervention measures can involve significant costs for both the bank and the deposit insurer (or other relevant authority). Before taking certain actions, it is therefore necessary to assess possible options and try to choose the one that allows the desired outcome to be achieved at the lowest direct and indirect costs for both the bank and the deposit insurer. It is also recommended to have in place a mechanism to review decisions taken with respect to the early detection and timely intervention and resolution of troubled banks.
- **Management commitment.** The management of the bank must be committed to the action plan for corrective action.

Impact on shareholders of corrective/intervention measures

- Call for cash (equity) injection by shareholders
- Suspension of particular or all shareholders' rights, including voting rights
- Prohibition on the distribution of profits or other withdrawals by shareholders

Impact on directors and managers

- Removal of directors and managers
- Limitations on compensation (including management fees and bonuses) to directors and senior executive officers

Impact on banks

- Require the bank to improve governance, internal controls and risk management systems
- Maintain higher capital adequacy and liquidity ratios
- Set restrictions or conditions on the business conducted by the bank
- Downsize operations and sale of assets
- Restrict expansion of branches or closing of branches at home or abroad
- Immediate or enhanced provisioning for those assets of doubtful quality and for those that are not represented in the accounts at fair value
- Bann principal or interest payments on subordinated debts
- Cessation of any practices harming the institution, such as irregularities and violation of laws or regulations governing the bank's activity
- Prohibit or limit particular lines of business, products or customers (including concentration limits)
- Seek prior supervisory approval of any major capital expenditure, material commitment or contingent liability
- Appoint an administrator or conservator

Dear colleagues,

During the further two days discussions we have the opportunity to see and share the experience, best practices concerning contingency planning, resources and resolution planning, case studies, etc. Although the Deposit Guarantee Systems regulation may differ from one jurisdiction to other, the globalization of financial crises affects all countries. The solutions are local, but they should not be indifferent to regional and global impact.