Fit & Proper
Consulting

RESPONSE TO THE BASEL COMMITTEE'S REQUEST FOR COMMENTS ON THE CONSULTATIVE DOCUMENT *"SUPERVISORY GUIDELINES FOR IDENTIFYING AND DEALING WITH WEAK BANKS"*

Buenos Aires, 19th September 2014

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Ref.: Consultative Document "Supervisory guidelines for identifying and dealing with weak banks" – Fit & Proper´s comments

Dear Committee Members,

I am pleased to submit the following Fit & Proper´s comments and suggestions in response to the Consultative Document *Supervisory guidelines for identifying and dealing with weak banks*, issued by the Basel Committee on Banking Supervision (BCBS) on 18th June, 2014.

Fit & Proper LLC provides advisory and consulting services on issues related to banking supervision and regulation, central banking, financial institutions and financial inclusion and microfinance, among others, since the last ten years. On this regard, Fit & Proper provides services to banking supervisors, central banks, deposit insurance agencies, ministries of finance and multilateral organizations, including the Inter-American Development Bank, the International Monetary Fund, and the World Bank. Fit & Proper and its consultants have experience in more than 40 countries. You can find further information about the firm in www.fitproper.com.

These comments were prepared by Javier Bolzico, Marcelo Zárate, Eugenia Gozzi, Natalia Teplitz and Facundo Abraham.

I would like to express our appreciation to the BCBS for the opportunity to provide feedback on this Consultative Document.

Furthermore, I would like to take the opportunity to congratulate the BCBS and the staff members of the Secretariat of the Basel Committee on Banking Supervision for the good job that they have done regarding the supervisory guidelines for identifying and dealing with weak banks. We believe that these guidelines will be an important instrument to enhance financial stability and the protection of financial consumers.

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I would be pleased to provide more information or further discussion on any of these issues. If you have any comments or questions, please feel free to contact us at (54 11) 4719-0704 or info@fitproper.com.

Yours faithfully,

Javier Bolzico
CEO
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Comments and suggestions on Consultative Document *"Supervisory guidelines for identifying and dealing with weak banks"*

1. **3. Preconditions**

In the document, preconditions for supervisors to deal with weak banks in an effective way contain one precondition related to financial safety net:

"*A well functioning safety net (systemic protection) that enhances the public's trust in the banking system. Important features of a safety net are a lender of last resort facility with the central bank and deposit protection arrangements. During the crisis, the banking system came under severe stress, which necessitated central bank action to support both the functioning of money markets and, in some cases, individual institutions.*"[1]

An important feature for the appropriate functioning of the safety net has not been mentioned in the consultative document. It is widely accepted that the financial safety net includes three components: lender of last resort, bank resolution and deposit insurance. Therefore, the document should include the bank resolution framework as an important feature of a safety net.

On this regard, we suggest:

a) To include in this precondition as an important feature of a safety net to have a bank resolution framework. The proposed text is "*A well-functioning safety net (systemic protection) that enhances the public's trust in the banking system. Important features of a safety net are a lender of last resort facility with the central bank, **a pre-established bank resolution framework** and deposit protection arrangements. During the crisis, the banking system came under severe stress, which necessitated central bank action to support both the functioning of money markets and, in some cases, individual institutions.*"

2. **3. Preconditions**

Among the preconditions for supervisors to deal with weak banks in an effective way, the consultative document mentions that supervisors shall have:

"*A supervisory framework and culture that encourage early intervention. Risks emanating from banks and the banking system should be identified and addressed promptly. Supervisors must act at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor should have a range of tools permitting a graduated and flexible response to different problems, as well as timely corrective action and powers to enforce a range of penalties when prudential requirements are not met. And supervisors should have plans in place, in partnership with other relevant authorities – including through home-*

[1] The underlined text in these and other citations of the document throughout these comments is ours.

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host relationships – to take action to resolve non-viable banks in an orderly manner (Core Principles 8, 9, 11 and 13)."

The Core Principles for Effective Banking Supervision establish that effective banking supervision includes the assessment of the risk profile of individual banks as well as of banking groups. Banking groups are increasingly complex organizations and the supervisor shall understand and assess its risks and how these risks can affect the safety and soundness of an individual bank or the banking system. For this reason, supervisor should address unsafe and unsound practices or activities that could pose risks not only for banks, as proposed in the consultative document, but for banking groups as well.

In addition, dealing with non-viable banks promptly may be difficult when there are no formal procedures for bank resolution established in the supervisory framework. A clear definition of the resolution alternatives available and formal procedures, as well as standard contracts, helps to address non-viable banks in an orderly manner. Resolution alternatives should distinguish those applicable for systemic banks from those applicable for non-systemic cases.

On this regard, we suggest:

a) To include in the text that supervisors should address risks in the banking groups and have formal bank resolution procedures to deal with non-viable banks. The proposed final text is: "*A supervisory framework and culture that encourage early intervention. Risks emanating from banks, **banking groups** and the banking system should be identified and addressed promptly. Supervisors must act at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor should have a range of tools permitting a graduated and flexible response to different problems, as well as timely corrective action and powers to enforce a range of penalties when prudential requirements are not met. And supervisors should have plans in place **and formal bank resolution procedures including resolution alternatives available for systemic and non-systemic cases,** in partnership with other relevant authorities – including through home-host relationships – to take action to resolve non-viable banks in an orderly manner (Core Principles 8, 9, 11 and 13).*"

3. **4.2.4 Supervisory evaluation systems**

The consultative document states that "*Many supervisors use a supervisory rating system (SRS) to draw together a numerical expression of risks to which the bank is exposed and their possible prudential impact*".

The document should take into account that supervisors also use risk matrices to evaluate the risks of banks. Risk matrices, like supervisory rating systems, allow supervisors to assess the risk of banks and establish an order or ranking according to their risk profile. Also, risk profiles are used to determine the scope of supervision strategies and plans.

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On this regard, we suggest:

a) To adapt the text to include risk matrices and that risk profiles should be used to determine the supervisory strategy. The proposed final text is: "*Many supervisors use a supervisory rating system (SRS)* ***or a risk matrix to evaluate banks' risk profiles,*** ~~*to draw together a numerical expression of risks to which the bank is exposed and*~~ *their possible prudential impact* ***and determine supervision strategies and plans***"

b) To add a reference to risk matrices whenever SRS is mentioned in the document. For example:
   - *"A major benefit of the SRS and* ***risk matrix*** *is that* ***they*** *provide a structured and comprehensive framework".*
   - *"SRS* ***and risk matrix*** *identify the banks that are more susceptible to future problems, which helps focus further supervisory resources".*

4. **4.2.4 Supervisory evaluation systems**

This section of the consultative document explains that "*Although rating systems may vary in name and in the particular components they encompass, they typically include many common factors. Importantly, an SRS will incorporate a judgemental assessment of the bank's board and senior management, including the appropriateness of their strategy and the quality of risk management and internal control systems. <u>These qualitative judgements help to provide forward-looking assessments of a bank's credit, liquidity, market, interest rate and operational risks and their implications for earnings and capital adequacy.</u>*"

The paragraph states that the assessment of the quality of risk management in a bank would "*help to provide forward-looking assessments of a bank's credit, liquidity, market, interest rate and operational risks and their implications for earnings and capital adequacy*". On this particular claim, two things should be noted. First, credit, liquidity, market, interest rate and operational risks are not the only risks that should be evaluated by the supervisor. Reputational, strategic, country and transfer risks, among others, also need to be assessed by the supervisor. Second, the supervisor not only needs to assess the implications of risks in earnings and capital adequacy but also in liquidity.

Finally, supervisory rating systems should also take into account as a factor the systemic impact of banks, as available supervisory and resolution tools may vary for systemic banks.

On this regard, we suggest:

a) To adapt the text so that it is clear that other risks, besides those already mentioned, should be assessed by the supervisor and that the supervisor should analyze the implications in liquidity as well as in earnings and capital adequacy. In addition, the text should specify that supervisory rating systems should take into account the systemic impact of banks. The proposed final text is: "*Although rating systems may vary in name and in the particular*

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components they encompass, they typically include many common factors. Importantly, an SRS will incorporate a judgemental assessment of the bank's board and senior management, including the appropriateness of their strategy and the quality of risk management and internal control systems. These qualitative judgements help to provide forward-looking assessments of a bank's credit, liquidity, market, interest rate, ~~and~~ operational ~~risks~~ ***and other risks*** *and their implications for earnings, ~~and~~ capital adequacy* ***and liquidity. Also, supervisory rating systems should take into account the systemic impact of banks****.*"

5. **6.2.2 Range of corrective actions**

Examples of the main corrective measures which supervisors need to have at their disposal are listed in this section. The corrective measures that impact on shareholders' rights included are:

- "*Suspend some or all shareholders' rights, including voting rights.*
- *Prohibit the distribution of dividends or other withdrawals by shareholders.*
- *Appoint an administrator or conservator.*"

An additional corrective measure that could be included is the possibility to convert certain debt instruments into capital (bail-in). When the solvency of a bank is compromised, certain liabilities could be transformed into capital; in this way, liabilities are reduced and capital increases restoring the solvency of the bank without having to inject additional funds. Only the more sophisticated liabilities should be converted and not the liabilities of medium and small depositors.

On this regard, we suggest:

a) To include conversion of debt instruments into capitals as a corrective measure that has an impact on shareholders' rights. The proposed final text is:
    - *"Suspend some or all shareholders' rights, including voting rights.*
    - *Prohibit the distribution of dividends or other withdrawals by shareholders.*
    - *Appoint an administrator or conservator.*
    - ***Convert the more sophisticated debt instruments into capital.***"

6. **6.2.7 Cooperation and collaboration with other agencies**

This section of the consultative document emphasis that "*In enforcing corrective action, <u>the bank supervisor needs to consider whether to consult with or inform the government, the central bank, and other regulatory agencies</u> about the assessment and proposed course of action*".

The deposit insurance agency plays an important role in bank resolution procedures. The agency is responsible for providing funds to cover guaranteed deposits in liquidation and, in some cases, participates in bank resolution through financial contribution under the "least cost rule" in order to facilitate the solution of failing banks. Thus, there is a need to establish a framework for close coordination and

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information sharing among the supervisor and the deposit insurer. Because deposit insurance agencies are not generally considered a regulatory agency, the document should explicitly emphasize the importance of cooperation and collaboration between the supervisor and the deposit insurance agency.

Also, in cross-border banking, cooperation and information sharing between the home and host country is necessary. On the one hand, in order to supervise the global activities of financial groups established in the country, home supervisors must be able to assess all the significant aspects of the operations of a bank that belongs to a financial group. On the other hand, host supervisors should be promptly informed if the home supervisor has reasons to believe that the integrity of the operations of a financial group is threatened and could negatively impact a supervised bank.

On this regard, we suggest:

a) To include the deposit insurance agency and foreign supervisors among the institutions that the bank supervisor needs to consider whether to consult with or inform in enforcing corrective action. The final proposed text is: "*In enforcing corrective action, the bank supervisor needs to consider whether to consult with or inform the government, the central bank,* ***the deposit insurance agency*** *and other regulatory agencies about the assessment and proposed course of action.* ***When a bank belongs to a financial group, the bank supervisor should consult with or inform the home or host supervisor (whichever is applicable)***".

7. **7.1 Guiding principles for bank resolution policy**

Section 7.1 of the consultative document includes the following guiding principles for bank resolution policy:

- "*Bank failures are a part of risk-taking in a competitive environment.*
- *Private sector solutions are best.*
- *Expeditious resolution process.*
- *Preserving competitiveness.*
- *Minimise disruption to market participants.*"

Bank resolution should be conducted in a way that no bail out of shareholders is produced; losses must be born in first place by shareholders. Failure to do so will increase the total cost of resolution and create perverse incentives for bankers (moral hazard).

On this regard, we suggest:

a) To add as a guiding principle the following: "***Minimise moral hazard. In non-systemically important banks, no public funds should be put into the resolution process. Only funds from the deposit insurance agency should be put into the bank resolution process, under the least cost rule. In systemically important banks' public funds may be put into the process under extraordinary situations. In no case, the external funds (from the deposit insurance agency or from the State) should end on shareholders or sophisticated investors' pockets***."

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8. **7.2.1 Restructuring plans**

In this section of the consultative document it is explained that *"If the board of directors, management or controlling shareholders are reluctant to take timely action, supervisors should consider the appointment of an administrator to draw up the restructuring plan and implement its initial phases. In such cases, the administrator should replace the management and take over the running of the company and have all the functions and powers of the ex-directors. Some curtailing of shareholders' powers could also be necessary."*

The appointment of an administrator to run an open bank may generate two negative consequences for the supervisor. First, during the time the bank is opened, all the legal demands and economic costs will have to be faced by the supervisor or the government. Second, if the bank is then closed and liquidated, the "fault" for the failure of the bank could be attributed to the management and shareholders, the administrator or both. Thus, the responsibilities assigned to the management and shareholders for the failure could be diminished. As a consequence, the appointment of an administrator to run an open bank should be an exceptional measures and only if it is necessary to prevent systemic impacts.

On this regard, we suggest:

a) To explicitly state that appointing an administrator to run an open bank should be an extraordinary measure. The proposed text is: "*If the board of directors, management or controlling shareholders are reluctant to take timely action **and that inaction poses a threat on financial stability**, supervisors should consider the appointment of an administrator to draw up the restructuring plan and implement its initial phases. In such cases, the administrator should replace the management and take over the running of the company and have all the functions and powers of the ex-directors. Some curtailing of shareholders' powers could also be necessary.*"

9. **7.5 Management of impaired assets**

Section 7.5 of the consultative document, explains "good bank-bad bank" resolution technique within the framework of the tools for managing impaired assets.

The "good bank-bad bank" resolution technique is not just a tool to manage impaired assets but a tool to resolve troubled banks. This technique can be considered as a particular case of P&A transactions with the difference that it requires matching assets and liabilities (instead of the transfer of only assets or liabilities or both, but separately).

On this regard, we suggest:

a) To remove the reference to the "good bank-bad bank" resolution technique from section 7.5 and, instead, include it under section 7.2.4 "Purchase and

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assumption transaction". The proposal is that the reorganized text remains as follows:

"7.2.4 Purchase and assumption transaction

(…) Closing the bank as a legal entity implies that the shareholders lose their investment and management is removed. From this standpoint, a P&A transaction is compatible with minimising moral hazard.

A particular case of P&A transaction is the resolution mechanism called "good bank–bad bank". This mechanism entails selling all non-performing and other low-quality assets at market values to a separate company specially set up for the purpose. The asset management company – the bad bank – will need to be capitalised by the government or deposit insurer if, as is typical, no private investor is initially available or interested in acquiring the low-quality assets. The bad bank manages the assets to maximise cash inflows. Transparency, expertise, sound management and appropriate incentives are essential for the maximisation of recoveries by this company. The good bank will require recapitalisation if no share capital remains, and then it should focus on its ongoing banking activities and the correction of operational weaknesses. Alternatively, the good bank can be offered for sale. A good bank–bad bank solution should be considered only if there is franchise value in the good bank. (…)

Sectión 7.5 Management of impaired assets
(…) The separation of assets can be accomplished in various ways. They include use of a division in the bank, of a subsidiary or of a separate asset management company funded and managed by private investors or by the government.

~~A resolution technique called "good bank–bad bank" separation entails selling all non-performing and other low-quality assets at market values to a separate company specially set up for the purpose. The asset management company – the bad bank – will need to be capitalised by the government or deposit insurer if, as is typical, no private investor is initially available or interested in acquiring the low-quality assets. The bad bank manages the assets to maximise cash inflows. Transparency, expertise, sound management and appropriate incentives are essential for the maximisation of recoveries by this company. The good bank will require recapitalisation if no share capital remains, and then it should focus on its ongoing banking activities and the correction of operational weaknesses. Alternatively, the good bank can be offered for sale. A good bank–bad bank solution should be considered only if there is franchise value in the good bank.~~ (…)"

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