Early Intervention Measures and SREP in Light of Bank Resolution

The role of supervision in bank resolution, practical experience from the assessment of recovery planning

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Agenda

1. Crisis Prevention
   - SREP
   - Recovery Plans
   - Interaction between Supervision and Resolution Authorities in crisis prevention

2. Crisis Scenario and Early Intervention Measures
   - Early intervention framework
   - Early intervention triggers
   - Interaction between Supervision and Resolution Authorities in crisis scenario

3. Resolution Planning and Resolution
   - Role of Supervision Authority in resolution planning
   - Coordination between Supervision and Resolution Authorities
   - Interaction between Supervision and Resolution Authorities in ensuring resolvability and resolution
Phases of Crisis

Crisis Prevention

- Deterioration metrics
- Business as usual
- Situation is deteriorating
  - Early warnings
  - Limits
- Situation is deteriorated
- Resolution
  - Point of non-viability

Indicators
- Bank’s indicators, taking into account the supervisor’s risk assessment
- Supervisors’ indicators (Recovery indicators and EIM)

Management
- Bank’s Management
  - Risk Appetite Framework (RAF)
  - Capital self-assessment (ICAAP)
  - Capital self-assessment (Contingency capital plan)
  - Liquidity self-assessment (ILAAP)
  - Liquidity self-assessment (Contingency liquidity plan)
  - Recovery Plan preparation and submission
- Supervisor
  - Supervisory review (SREP) and Risk assessment review
- Resolution Authority
  - Planning and analysis for resolution (Resolution Plan preparation)

Resolution Plan is implemented
- Management “on probation”
- Managed by authorities
- Recovery Plan is implemented
- Early intervention
SREP: Overview

SREP methodology at a glance: four key elements

1. Business model assessment
   Viability and Sustainability of Business Model

2. Governance and Risk Management assessment
   Adequacy of Governance and Risk Management

3. Assessment of risks to Capital
   Categories: e.g. Credit, Market, Operational Risk and IRRBB

4. Assessment of risks to Liquidity and Funding
   Categories: e.g. Short Term Liquidity Risk, Funding Sustainability

Overall SREP assessment – Holistic approach
→ Score + Rationale/main conclusions

SREP Decision

- Quantitative capital measures
- Quantitative liquidity measures
- Other supervisory measures

Feeds into the Supervisory Examination Programme (SEP)
SREP: Assessment Phases

Three phases in on-going risk assessment for each of four elements

- **Phase 1: Data gathering**
  - Main sources: quarterly ITS, STE reports

- **Phase 2: Automated anchoring score**
  - Scoring Risk Level
  - Formal compliance checking of Risk Control

- **Phase 3: Supervisory Judgement**
  - Adjustments based on additional factors and considering banks’ specificities and complexity

Risk Level (RL) vs. Risk Control (RC)

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<tbody>
<tr>
<td>RL</td>
<td>n/a</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>RC</td>
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Combined score (RL + RC)

n/a: not applicable

The intensity of the supervisory engagement is decided based on banks’ risk profile and size.
Recovery Plans: Overview

The recovery plan (RP) is the firm’s complete “menu of options” for addressing extreme financial stress caused by internal or system failures.

**Rationale**

- **Crisis management procedures for the identification and monitoring of a crisis which allows (and force) the management board to detail the provisions covering recovery option implementation**

- **Assessment of the overall recovery capacity**

- **It would help competent authorities with understanding of (1) the institution’s organization, (2) its priorities and (3) its key vulnerabilities**

**Recovery Plan**

**Aim**

**Governance / indicators**

**Recovery Measures**

**Strategic analysis and scenarios**

**Institutions should develop recovery plans**
Recovery Plans: Major Chapters

1. **General description**
   - Detailed description of the business model and information on the Group.

2. **Strategic analysis**
   - Critical economic function, shared services, core business and material legal entities. It also includes the description of main internal and external interconnections at Group level and between geographies.

3. **Governance / indicators**
   - Preparation, approval, and update Plans
   - Crisis Management Framework which includes recovery metrics, stress stages, and escalation procedures per deterioration phase

4. **Scenarios**
   - Includes several types of scenarios: (i) Idiosyncratic; (ii) Systemic and (iii) Combined

5. **Recovery measures**
   - Assessment of the recovery capacity

6. **Communication Plan**
   - Contains an internal and external communication plan
Recovery Plans: Proportionality

i. Supervisor should apply the principle of proportionality in the scope, frequency and intensity of supervisory engagement and dialogue with a bank, and supervisory expectations of the standards the bank should meet, in accordance with the category of the bank

ii. While proportionality on scope is limited, proportionality on frequency is very important.

iii. Recovery Plans submission requirement by itself is subject to proportionality:
   o In the EU all banks are required to submit Recovery Plans on a regular basis.
   o In other parts of the world only systemically important banks are required to prepare Recovery Plans.
Interaction between Supervision and Resolution Authorities in Crisis Prevention

A. Recovery Plans should be mandatory shared with Resolution Authority as they should be the starting point for Resolution Plans but not the only source for them.

B. Resolution Authority should provide comments on Recovery Plans during the assessment process.

C. Definition of Critical Functions and identification of Material Legal Entities are areas of particular interest and conflict between Supervision and Resolution Authorities.

D. In order to avoid negative influence on Recovery Plans, some elements of Resolution Plans can be kept secret for Resolution Authority.
Link between On-going Supervision, Early Intervention and FOLT
**Early Intervention Framework (Arts 27, 28, 29 BRRD)**

### Triggers

**Article 27**
- Actual or likely breach of requirements (including own funds requirement + 1.5%)
- Due to rapid financial deterioration (liquidity, leverage, NPLs, concentration of exposures)

**Article 28**
- Significant financial deterioration
- Significant breaches laws / regulations / statutes
- Serious administrative irregularities
- EIM of 27 not enough
- Removal of board members or senior management 28 not enough

### Measures

Require the management body to
- Implement one or more of the measures of the recovery plan
- Action program to overcome problems and a timetable for its implementation
- Meeting of shareholders setting the agenda and requiring certain decisions to be considered
- Remove or replace managers and directors
- Plan for debt restructuring with some or all of its creditors
- Changes to the business strategy
- Changes to the legal or operational structures
- Acquire, including through on-site inspections and provide to the resolution authority, all the information necessary to update the resolution plan and prepare for resolution and for valuation
- Contact potential purchasers (Resolution Authority)
- Removal (directly by the supervisor of all or part of the board or senior management (art 28)
- Appoint temporary administrator (art 29)
# Triggers for EIM (EBA/GL/2015/03)

<table>
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<tr>
<th>SREP</th>
<th>Triggers</th>
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|      | • Overall score 4  
|      | • Overall scores 3, and 4 in  
|      |   • Internal governance and institution-wide controls  
|      |   • Business model and strategy  
|      |   • Capital adequacy  
|      |   • Liquidity adequacy  |

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<tr>
<th>Material changes / anomalies in key indicators</th>
<th>Triggers</th>
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|                                               | • Key indicators (financial and non-financial)  
|                                               |   • Evolution / peer comparison  
|                                               |   • Own funds <P1 +P2+1.5pp  
|                                               |   • Liquidity requirements  |

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<th>Significant (fast) events</th>
<th>Triggers</th>
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|                          | • Major operational event  
|                          | • Significant deterioration MREL  
|                          | • Signals of need to AQR:  
|                          |   • SREP concern  
|                          |   • Emphasis of matter in audit  
|                          |   • Unfavorable events  
|                          |   • Material errors in valuation  
|                          | • Significant outflow of funds  
|                          | • Unexpected loss of top brass  
|                          | • Failure to comply requirements  
|                          | • Significant rating downgrades  |

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| ➢ Make a decision on whether to apply early intervention measures  
| ➢ Change SREP  
| ➢ Investigate further  
| ➢ Notify SRB and start gathering information for Valuation 1  |
Case Study 1: Taking EIM in case of Bank X

**Phase 1**

- Asset Quality levels: very negative (>15% NPL), coverage levels very low in relation with the peer group (<35%).
- Capital levels above minimum capital requirements and buffers but significantly below peer group (CET1 FL 9%, CET1 PI 11% vs CET1 requirement + buffers 10%).
- Liquidity levels above minimum LCR requirements but lower than peer group (115% vs minimum of 80% due to phase-in).
- Recent Removal of the Senior Management and some board members, including the CEO and chairman of the board (new management team). The new management is selected from outside to bring new and unconflicted approach to the management of the bank.
- The supervisor approves the appointing of the new managers according to Fit and Proper.
- The bank was listed and the share price has fallen 80% in that year, while the share prices in the banking sector have gone up a 20% yoy on average.
- Capital levels above minimum capital requirements and buffers but significantly below peer group (CET1 FL 9%, CET1 PI 11% vs CET1 requirement + buffers 10%).
- Doubts about reputation and integrity of management and board of directors.

**Phase 2**

- The bank does not activate the Recovery Plan, since no recovery indicator is breached.
- Supervisor takes the following supervisory measures (article 104 CRD):
  - Increasing Pillar 2 bank-specific capital requirements.
  - Demands revision of the internal control and risk management procedures.
  - Demanding a specific Recovery Plan, with measures to increase the capital and liquidity levels.
  - Request the set up of a specialized and independent workout unit for dealing with NPLs.

Since the bank has recently changed their management and (some) board members, the supervisor does not have the need to take an EIM of removing the bank’s management or appointing an special manager for the bank.
Case Study 1: Taking EIM in case of Bank X

Phase 3

1 month later

- New losses recognized in accounting, due to additional reclassification of loans to non-performing status and new identified forborne loans.
- The bank’s share price continue to fall, and P/B < 15%
- Corporate and financial depositors start to withdraw significant amounts of money from the bank.
- Bank’s management submit a plan to the supervisor to seek a M&A transaction with other bank. The bank submit the invitation for the sale and purchase transaction.
- Press coverage of the weakness of the bank has increased and become more and more negative.
- The supervisor decides not to take any new supervisory measures.
- However, on EIM, the Resolution Authority decides to start the preparation of the resolution of the bank. In particular, it starts the preparation to actively market the sale of the bank to potential third-party buyers. For this, it submits a letter to the bank requesting the assistance in preparing the data room for the due diligence.

Phase 4

15 days later

- More intense and further deposit withdrawals (30% of the deposit base). The liquidity situation is unsustainable.
- All the potential buyers refuse to participate in the M&A transaction with the bank.
- Most of the details of the crisis of the bank are leaked to the press.
- The supervisor decides to place the bank into resolution (FOLT) due to:
  - Bank’s inability to comply with its liabilities due to its lack of liquidity.
  - Absence of private sector solution that can assist the bank to overcome the situation.
  - Public interest in placing the bank into resolution, since the bank provides critical economic functions.

The Resolution Authority proceeds to the resolution of the bank by selling its shares to a private sector buyer.

Final Outcome: Bank X is sold to a private sector buyer
Case Study 2: Not taking EIM in case of Bank Y

Phase 1

During 2 years

- The bank is listed in the stock exchange but it has an individual as the controlling shareholder (35% of the shares and voting rights).
- The bank has raised capital from the markets and major shareholders two times in the last two years.
- The bank has structural problems:
  - A very inefficient business model, with a cost-to-income ratio higher than 90% on a recurrent basis.
  - Asset quality issues, NPL reached 35% in 2015 and has been gradually coming down to 21% in 2018.
  - In the last two years, the bank has changed two times its CEO and its management team.
  - There is no independent risk management function.
  - Share price has decreased significantly in last years (-95%).
- The liquidity of the bank is still satisfactory (LCR 150%).
- The supervisor has taken the following supervisory measures:
  - Require the reduction of the NPL ratio to 10% in one year.
  - Require the set up of an independent risk management function.
  - Require the presentation of a reviewed business plan.
- No early intervention measures were taken at this stage.

Phase 2

- No actions taken by the bank.
  - The supervisor finished an on-site inspection. A significant amount of loans were reclassified to non-performing status, which result in the need to raise fresh capital.
  - As a result of this, the supervisor requested the bank to prepare a Recapitalization Plan.

Phase 3

- The major shareholder opposes to the Recapitalization Plan. In particular, it makes clear he does not want to participate in the capital raising, nor he would allow any capital raising that dilutes its stake.
- As a result of this situation the supervisor decides to remove the current board of directors and appoints a special manager.
Role of Supervision Authority in Resolution Planning

Resolution Planning is in charge of Resolution Authority but supervisors should be consulted since Resolution Plan presents an action plan for timely reaction in a case of crisis.

Supervisors are responsible for providing information for Resolution Plans drafting.

Supervisors should be obliged to inform Resolution Authority if there is any material change in the business position of a bank, its legal or organizational structure or financial change.

Supervisors are interested in particularly three elements of Resolution Plans:

- **Resolution strategy** since it has an impact on business model of the bank
- **MREL** which affects funding structure of the bank and its costs
- **Resolvability assessment** as it has an impact on going-concern
Coordination between Supervision and Resolution Authorities in Normal Times: Information Sharing

A

It should be mandatory for Supervision Authority to share Recovery Plans with Resolution Authority but this is not enough.

B

Resolution Authority should be able to get all necessary information from Supervisors and ask the institution for information only if Supervisor does not have it.

C

Coordination between authorities would ensure avoidance of uncoordinated activities or conflicting messages towards institutions.

D

In order to avoid conflicting situations and eliminate or decrease inefficiency the two authorities should sign MoU in respect of cooperation and information exchange in order to define form, scope rights and responsibilities in data exchange and give the whole process more weight.

MoU between SRB and ECB (2018)

“The ECB and the SRB should collaborate to avoid an unnecessary increase in the reporting burden of the institutions. Any duplication in the collection of data should be avoided. Therefore, the SRB may require institutions to provide all information necessary for the performance of its tasks after making full use of all the information available to the ECB or to National Competent Authorities. For example, the SRB should be able to obtain, including on a continuous basis, any information necessary for the exercise of its functions, in particular information on capital, liquidity, assets and liabilities.”
Coordination between Supervision and Resolution Authorities in Crisis Times: Division of Powers

Crisis times are those when coordination between Supervision and Resolution Authorities is essential.

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<tr>
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<th>Supervision authority</th>
<th>Resolution Authority (SRB/NRAs)</th>
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<tbody>
<tr>
<td>Early Intervention Measures</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Determination of FOLTFF</td>
<td>Should be in charge of any of them</td>
<td></td>
</tr>
<tr>
<td>Resolution process</td>
<td>Advisory role</td>
<td>✓</td>
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Obstacles to resolvability

The assessment of resolvability is required to take place and be updated at the same time as drawing up or updating the Resolution Plan, and the conclusions of the assessment should form part of the Plan.

Assessment of resolvability is an iterative process of identifying material impediments to resolvability and outline relevant actions to address impediments. It is only possible on the basis of a identified preferred resolution strategy. Resolution authorities may conclude at the end of the process that an amended or wholly different strategy is more appropriate.

The identification of impediments during assessment of resolvability should concern, issues from the following categories: (i) structural measures concerning the organizational, legal, and business structure of an institution, (ii) financial measures relating to its assets and liabilities, (iii) additional information requirements.

The conclusions of the assessment of resolvability should included a detailed justification of any impediments to resolvability identified, and of any measures proposed by the bank or group or required by the resolution authority to address or remove those impediments.

Removing material impediments recognized during resolvability assessment can significantly affect business and structure of the financial institution. Therefore resolvability assessment is of great interest for Supervisor.
Importance of Resolvability Assessment for Supervisor

1. Coordination in removing obstacles for resolvability is crucial!

2. Measures to remove obstacles to resolvability may affect business model, operations of a bank, its structure and funding model.

3. It is important for Supervisor to ensure that measures for removing resolvability obstacles do not negatively affect the prospects of the going concern while keeping it resolvable.
Thank you!

Q&A

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