APEC Policy Dialogue on Deposit Insurance: Trigger Mechanisms for Early Intervention

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1. Background / Assumptions

- In a competitive financial system, banks, like all other businesses, may fail
- Must ensure a framework (both legal and regulatory) exists for intervention to reduce costs associated with failures and ensure financial system stability
- Banks are in a unique position in the financial system
- Success or failure impacts on three levels:

1. Background / Assumptions (cont'd)

(i) Local:

- employees
- suppliers
- people in the community
- customers with good loans in need of banking services
- landlords

1. Background / Assumptions (cont'd)

(ii) National:

- other banks in clearing system
- deposit insurers
- runs on bank and runs on other banks
- customers with good loans in need of banking services

1. Background / Assumptions (cont'd)

(iii) International:

- international fx players
- capital markets
- international regulator and public confidence in national system
- foreign regulators concerned about bank branches or agencies failing and closing – protection of local deposits

1. Background / Assumptions (cont'd)

- To be licensed as a bank in Canada is a rigorous process – it is a privilege
  - eg. detailed business plan,
  - adequate capital,
  - suitable board of directors (experience, expertise and independence).
- A successful system must have professional and meaningful regulatory underpinnings

1. Background / Assumptions (cont'd)

- Three basic tenets:

  (i) properly trained and experienced regulatory personnel;

  (ii) codes of conduct for those personnel; and

  (iii) protection for personnel who perform their functions within the codes of conduct.

2. Canadian System (cont'd)

- OSFI – regulates and supervises banks – primary responsibility for supervising actions of a bank
- CDIC – federal Crown corporation that insures deposits of deposit-taking institutions – which are its members
    - the regulatory and intervention aspects of OSFI and CDIC are closely intertwined
    - high level of co-operation and sharing of information and responsibilities when intervention necessary
    - both OSFI and CDIC legislation provide a wide range of intervention powers when CDIC member bank is in difficulty

2. Canadian System (cont'd)

- Canada has proceeded on the basis of both hard criteria for intervention and soft "discretionary" criteria
  - primary objective is to identify problems early and intervention early to remedy and lessen cost and impact of losses to all
  - ability to be put on a regulator's "watch list", to meet with Board of directors, conduct on-site examinations, rectification orders, etc.

3. Lessons Learned from Canadian System

- Not many bank failures in Canada
  - fairly centralized banking system
  - 5 large banks account for lion's share of market
- Of the handful of bank failures – intimately involved in collapse of CCB 1985

Trigger Mechanisms for Early Intervention

Lessons learned:

(a) Insolvency Trigger – may well be too late

- Regulators must have the ability to intervene early in the process to avoid formal insolvency where possible
- Suppliers, depositors above insurance limits, other creditors all get hurt
- Claims resolution process can be time-consuming and costly
- Insolvency – easy to justify intervention because if a bank is insolvent, it necessarily follows that shareholders have no interest or value
    - submit not adequate for banks - larger public interest

Lessons Learned (cont'd)

(b) Two-Step Process

(i) OSFI – intervention – "take control"

(ii) second step – formal insolvency or winding-up order – must go to Court

- Concerns about actions during this hiatus period – in all cases in Canada, winding-up order has been granted after regulator has taken control – but it is discretionary and it could be a disaster if not granted

Lessons Learned (cont'd)

(b) Two Step Process

- Regulators in control? If no winding-up order – then what? What powers should regulators have? Confiscation of shareholders' equity? Ability to sell loan portfolio?

- 1996 – Canada removed Minister of Finance from decision-making authority and transferred the power to the regulators, with ability of Minister to stop intervention if in the public interest

(c) Regulator Protection

- Regulators must be protected – act in public interest – cannot be subject to criticism or liability.
  - separate panel addressed this topic
  - cannot have challenges to regulator’s exercise of discretion preventing intervention vs. checks and balances against abuse

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(d) Intervention Protocol

- Basically a 4-step process of review and intervention steps and objectives.
  - in Canada, deposit insurer and regulator are separate functions
  - deposit insurer has power to force regulator's hand by terminating insurance if the bank is in breach of certain specified standards and fails to remedy or by cancelling insurance if there is the threat of insolvency

4. Model Intervention Policy / Code

- Based on problems experienced in Canada in late 1980’s and 1990’s with bank, trust company and insurance company failures – revisiting of Canadian legislation and policy in 1990’s

- Model Intervention Policy/Code draws on that experience

- Clearly, many degrees of intervention

4. Model Intervention Policy / Code (cont'd)

- In Canada and in U.S., continuum related to specified thresholds – both countries have a 4-step intervention process
- Each threshold results in more restrictions on bank activities, more reporting to regulator, and more intensive monitoring by regulator
- Contrast between codification and specificity of U.S. approach and broad, discretionary nature of Canadian;

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4. Model Intervention Policy / Code (cont'd)

- In U.S., Section 38 of Federal Deposit Insurance Act "Prompt Corrective Action" codifies actions for regulatory intervention based on 5 capitalization levels:
  - well capitalized
  - adequately capitalized
  - undercapitalized
  - significantly undercapitalized
  - critically undercapitalized

4. Model Intervention Policy / Code (cont'd)

- Intervention begins at "undercapitalized" level, so effectively 3 levels of intervention leading to appointment of Receiver
- Discretion is left to banking agencies but there is a "floor" of tangible equity of not less than 2% of total assets
- Receiver must be appointed if bank is critically undercapitalized on average during the last quarter of the year in which it became critically undercapitalized
- American approach is to codify and make specific, as is generally the American approach

4. Model Intervention Policy / Code (cont'd)

- In Canada, leave greater discretion to Regulator, with no mandatory requirements for regulatory action
- Description of intervention in stages prior to taking control contained in Guide attached to paper
- 4 steps, final being taking of control after which there is application for liquidation
- Model deals with final stage of intervention, which may take a number of forms, including liquidation and expropriation of shares, but in any event, removal of control from shareholders and board of bank

4. Model Intervention Policy / Code (cont'd)

- Model betrays bias toward Canadian approach based on Canadian Bank Act and Canada Deposit Insurance Corporation Act
- Model grounds for intervention fall broadly into 3 categories, although there is clear overlap:
- Asset based (grounds (a) through (e));
- Conduct based (ground (f) through (g); and
- Viability based (grounds (h) through (j)).

Model Intervention Policy / Code

Regulator may intervene [to remove bank from control of board] – (1) [Subject to this Act], where any of the circumstances described below exist in respect of a bank, unless the [Political Master] advises the Regulator that it is not in the public interest to do so, the Regulator may intervene where in his opinion:

a) The bank has failed to pay its liabilities or, in the opinion of the Regulator, will not be able to pay its liabilities as they become due and payable
b) The assets of the bank are not, in the opinion of the Regulator, sufficient to give adequate protection to the bank's depositors and creditors;
c) Any asset appearing on the books or records of the bank or held under its administration is not, in the opinion of the Regulator, satisfactorily accounted for;
d) The bank is dependent to an excessive extent on loans, advances, guarantees or other financial assistance to sustain its operations;
e) The regulatory capital of the bank has, in the opinion of the Regulator, reached a level or is eroding in a manner that may detrimentally affect its depositors or creditors;
f) The bank has failed to comply with an order of the Regulator under the Act;
g) The bank's deposit insurance has been terminated by the Deposit Insurance Corporation;
h) The bank has lost the confidence of depositors and the public;
i) The bank has ceased, or is about to cease to be viable, and the viability of the bank cannot be restored or preserved by the exercise of the Regulator's powers under the Act; or
j) Any other state of affairs exists in respect of the bank that may be materially prejudicial to the interests of the bank's depositors or creditors or the owners of any assets under the bank's administration, including where proceedings under a law relating to bankruptcy or insolvency have been commenced in [any jurisdiction] respect of the holding body corporate of the bank.

[(2) Notwithstanding subsection (1), the Regulator shall take control of a bank where the bank has failed to pay its liabilities and the bank's [regulatory] capital is below ●%.]

Intervention processes applied to federally regulated deposit-taking institutions by OSFI and CDIC

No problems/Normal activities — Routine supervisory and regulatory activities pursuant to mandates of OSFI and CDIC. In addition, both agencies conduct research and analyze industry-wide issues and trends, appropriate to their respective functions

OSFI Activities	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities
Incorporation of new financial institutions and issuance of orders to carry on business: • review and assess all relevant documents and information • make recommendation to Minister. Review and assess wide range of applications and requests for regulatory consents required by statutes including • corporate reorganizations • changes in ownership • acquisitions of other financial institutions • transfers of business. Ongoing monitoring of supervised institutions via information obtained from statutory filings and financial reporting requirements: • consider compliance with statutory and other regulatory requirements • assess financial situation and operating performance. Periodic on-site examinations of supervised institutions as required by statutes: • inform management and board of directors of findings • management requested to provide copy of report to external auditors • require that concerns be addressed by institutions • monitor remedial measures if required.	OSFI informs Minister of status of supervised institutions. OSFI reports to CDIC on post examination results for individual deposit-taking member institutions and confirms material compliance with standards of sound business and financial practices. Monthly OSFI-CDIC inter-agency meeting held to discuss corporate governance and activities of member institutions.	Process application for policy of deposit insurance and obtain appropriate guarantees and undertakings. Ongoing risk assessment of selected individual institutions via: • information available from OSFI, the Bank of Canada and, where necessary, individual financial institution reports • contacts with regulators • rating agency results • review and analysis of results of annual examinations of federal member institutions carried out by OSFI • other sources. Ensure compliance with CDIC Act and standards of sound business and financial practices by-laws, policy of deposit insurance and CDIC by-laws.

Intervention processes applied to federally regulated deposit-taking institutions by OSFI and CDIC

Stage 1 — Early warning — Deficiency in policies or procedures or the existence of other practices, conditions and circumstances that could lead to the development of problems described at Stage 2. Situation is such that it can be remedied before it deteriorates into a Stage-2 problem.

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
Management and board of directors of financial institution are formally notified of concerns and are requested to take measures to rectify situation. Monitoring of remedial actions may involve requests for additional information and/or follow-up examinations. OSFI may require that institution's external auditor enlarge scope of examination of institution's financial statements or that external auditor perform other procedures, and prepare a report thereon. OSFI may assign cost of external auditor's work to institution.	Activities below are in addition to those previously mentioned. OSFI and CDIC coordinate on requested remedial measures to deal with concerns and on establishment of time frame within which situation should be remedied. OSFI's post-examination report to CDIC identifies issues requiring remedial measures, including any material breaches of standards of sound business and financial practices, regardless of whether such issues are treated as formal qualifications to OSFI's report. The status of such issues is reviewed at monthly inter-agency meetings. CDIC notifies OSFI of contemplated intervention measures, discusses results of special examinations with OSFI, and coordinates communications with the institution about its status and placement on "watch list".	CDIC risk assessment and interventions listed here are in addition to those mentioned previously. Depending on CDIC's assessment of situation, · CDIC may request additional information from OSFI if available, or from the institution if necessary · CDIC may communicate its concerns to institution and may place it on its preliminary 'watch list' and inform institution of that fact · If circumstances warrant, CDIC may conduct or commission a special examination to obtain more information on the member institution and to be in a position to assess the extent of the institution's problem and CDIC's exposure · Institution may pay higher CDIC premiums, related to increased risk. CDIC may levy a premium surcharge if the institution does not remedy any of the following: · failure to follow CDIC's Standards of Sound Business and Financial Practices · failure to comply with its governing statute · failure to fulfil the terms of an undertaking provided to CDIC · failure to maintain records and information pursuant to provisions of the policies of deposit insurance. CDIC may request an undertaking from institution or from entity that controls the institution to rectify areas of concern.

Intervention processes applied to federally regulated deposit-taking institutions by OSFI and CDIC

Stage 2 — Risk to financial viability or solvency — Situation or problems that, although not serious enough to present an immediate threat to financial viability or solvency could deteriorate into serious problems if not addressed promptly, as evidenced by:

- concerns over the institution's ability to meet capital and surplus, or vesting requirements on an ongoing basis
- deterioration in the quality or value of assets, or the profitability of the business undertaken by the financial institution
- undue exposure to off-balance sheet risk
- poor earnings or operating losses or questionable reporting of earnings or expenses
- low level of accessible liquidity or poor liquidity management in context of the institution's situation
- less than satisfactory management quality or deficiency in management procedures or controls (including material breaches of standards of sound business and financial practices)
- other concerns arising from:
  - a financially weak or troubled owner
  - non-compliance with regulatory requirements
  - systemic issues
  - rapid growth
  - credit rating downgrades

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
Senior OSFI officers meet with management and board of directors of financial institution and with external auditor of institution to outline concerns and discuss remedial actions. Management and board of directors are formally notified of the fact that institution is being placed on the regulatory 'watch list'. External auditor of institution may be required to perform a particular examination relating to the adequacy of the institution's procedures for the safety of its depositors, other creditors or shareholders, or any other examination that may be required in the public interest, and report thereon to OSFI. OSFI may assign cost of external auditor's work to institution. Scope of on-site examination and/or frequency of on-site examinations may be enlarged or increased. Monitoring of financial institution is enhanced as to frequency of reporting requirements and/or the level of detail of information submitted.	Activities below are in addition to those previously mentioned. CDIC and OSFI coordinate communications with the institution. OSFI immediately notifies CDIC of situation when uncovered, with a formal report to follow. Institution is placed on "watch list". OSFI sends a "watch list" progress report at least monthly to CDIC and Minister; report is discussed in regular meeting with Minister. Progress on remedial measures discussed at monthly OSFI/CDIC intera-gency meeting. Institution may be discussed at Financial Institutions Supervisory Committee. Contingency planning commences.	CDIC risk assessment and intervention listed here is in addition to those previously mentioned. CDIC informs management and board of directors of member institution of situation and of the fact that institution is being placed on CDIC's "watch list" leading to more vigorous monitoring. If institution is in breach of CDIC's Standards of Sound Business and Financial Practices, policy of deposit insurance, bylaws, CDIC may send the CEO or the Chairman of the institution a formal report pursuant to Section 30 of the CDIC Act. CDIC may advise institution that if CDIC is not satisfied with progress made in rectifying the situation referred to in the aforementioned formal report, CDIC may seek (federal institutions) Minister's permission to terminate the institution's policy of deposit insurance.

Stage 2 — Risk to financial viability or solvency (continued)

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
Institution must produce a business plan acceptable to both OSFI and CDIC that reflects appropriate remedial measures that will rectify problems within a specified time frame. Business restrictions appropriate to circumstances may be imposed on institution via undertakings provided by the institution, restrictions on the institution's order to carry on business or via direction of compliance covering such matters as: · payments of dividends or management fees · lending or investment powers · level of deposits and other indebtedness		

Intervention processes applied to federally regulated deposit-taking institutions by OSFI and CDIC

Stage 3 — Future financial viability in serious doubt — Situations or problems described at Stage 2 are at a level where, in the absence of mitigating factors such as unfettered access to financial support from a financially strong financial institution parent, unless effective corrective measures are applied promptly, they pose a material threat to future financial viability or solvency.

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
Management, board of directors and external auditor of institution are informed of problems. A special audit may be required from an auditor other than the institution's own external auditor if OSFI is of the opinion that it is required. OSFI may assign cost of external auditor's work to institution. If financial institution is a deposit-taking institution, examination and monitoring responsibility is transferred to an internal special work-out group within OSFI. Enhanced examinations may be carried out, focussing on particular areas of concern such as asset or loan security valuations. Such examinations may involve any of the following: · substantial increase in sampling of credit files · more in-depth review of files · engagement of specialists or professionals to assess certain areas such as quality of loan security, asset values, sufficiency of reserves, etc. Depending on situation, OSFI examination staff may be posted at financial institution to monitor situation on an ongoing basis. Business plan must reflect appropriate remedial measures that will rectify problems within a set time frame so as to avoid triggering impaired viability or impaired solvency procedures (See Stage 4).	Activities below are in addition to those previously mentioned. OSFI immediately notifies CDIC of any material new findings or developments, with a formal report to follow. Results and data from enhanced examinations, expanded audits, etc. and from enhanced monitoring are discussed with CDIC. If financial institution is a deposit-taking institution and it is deemed to be, or is about to become, non viable, OSFI sends a formal report to CDIC to that effect.	CDIC risk assessment and interventions listed here are in addition to those mentioned previously. CDIC may seek Minister's permission to terminate the institution's policy of deposit insurance. In order to minimize risk to deposit insurance fund, CDIC may provide institution with temporary financial assistance or provide support for a restructuring transaction by such measures as: · acquiring assets from the institution · making or guaranteeing loans or advances with or without security, to the institution · making or guaranteeing a deposit with the institution. Following receipt of formal OSFI report to the effect that institution has ceased, or is about to cease, to be viable, CDIC may initiate a restructuring by asking the Minister of Finance to recommend that the Governor in Council issue a "FIRP" order, under the financial institutions restructuring provisions of the CDIC Act.

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Stage 3 — Future financial viability in serious doubt (continued)

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
OSFI may order institution to increase its capital. Monitoring of institution may be further enhanced as to frequency of reporting requirements and/or the level of detail of information submitted so as to monitor progress of remedial measures. Follow-up examinations may be carried out as required. Depending on circumstances, business restrictions may be enhanced or additional ones imposed on institution. Depending on circumstances, pressures may be exerted on management and board of directors to restructure institution or to seek out an appropriate prospective purchaser. OSFI develops contingency plan in order to be able to take rapid control of the assets of the financial institution if changes in circumstances so warrant.		

Intervention processes applied to federally regulated deposit-taking institutions by OSFI and CDIC

Stage 4 — Non-viability/ Insolvency imminent — Severe financial difficulties resulting in

- failure or imminent failure to meet regulatory capital and surplus requirements in conjunction with inability to rectify the situation within a short period of time

OR

- statutory conditions for taking control being met

OR

- failure to develop and implement an acceptable business plan, thus making either of the two preceding circumstances inevitable within a short period of time.

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
New business restrictions may be imposed on institution or existing restrictions may be expanded. Pressure to rectify situation is exerted on management and board of directors of financial institution through frequent meetings with senior OSFI officers. OSFI notifies management and board of directors of institution of intended regulatory intervention measures that will be taken unless situation is rectified imminently. If statutory conditions for taking control of assets exist and if circumstances are such that there is an immediate threat to the safety of depositors and other creditors, OSFI may take control of the assets of the institution for a short period. If statutory conditions exist, such as failure to comply with order to increase capital, and subject to representation to the Superintendent, OSFI may maintain control of assets or take control of the institution.	Other relevant regulatory agencies (provincial or foreign) are notified of proposed regulatory intervention measures to be applied to institution. If the institution meets any of the conditions that would make it eligible to be wound up pursuant to the *Winding-up Act*, the institution itself may voluntarily seek a winding-up order. Alternatively, either OSFI or CDIC, working in collaboration with the other agency, may seek a winding-up order. Minister may overrule this decision on grounds of public interest only. All intervention measures applied to deposit-taking institutions at this stage, whether initiated by OSFI or CDIC, are the subject of close coordination between the two agencies.	If CDIC is of the opinion that the institution is or is about to become insolvent, CDIC may seek Minister's approval to cancel the institution's policy of deposit insurance.