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# Note on the Strategic Development of an Enhanced Bank Resolution Framework for Ukraine in Alignment with the EU Acquis

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**Disclaimer:**

This summary is based on discussions held in a Working Group with experts from the National Bank of Ukraine and the Ukrainian Deposit Guarantee Fund. It was prepared by Pamela Lintner (FinSAC Senior Financial Sector Specialist) and Christian Stiefmueller, CEPA (FinSAC consultant) with input from Vahe Vardanyan (World Bank Lead Financial Sector Specialist). Miquel Dijkman, FinSAC Coordinator and Mario Guadamillas, Practice Manager provided oversight.

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## **Background**

As part of the Action Plan implementing its Association Agreement with the EU, signed in September 2017, Ukraine has undertaken to adopt essential cornerstones of the EU legislative framework by year-end 2019. In the area of financial services, a joint working group of the National Bank of Ukraine (NBU), the Ukrainian Deposit Insurance Fund (DGF), and the World Bank Financial Sector Advisory Center (FinSAC) was established to develop an enhanced bank resolution framework aligned with the European Bank Recovery and Resolution Directive (BRRD). Against the overall objective of international standards – ensuring effective bank resolution while safeguarding overall financial stability and reducing the likelihood of public support – the group identified current differences and proposes key measures and legal amendments required to align the Ukrainian bank resolution framework with the BRRD. It also references reforms warranted in related areas as well as conditions for operationalization (listed below) that should be addressed in order to ensure the efficient operationalization of a BRRD aligned framework. This does not imply a recommendation to pursue immediate and full compliance. The gradual phasing-in or postponement of certain elements, such as creation of a resolution fund or the introduction of minimum requirement of eligible liabilities (MREL), as well as divergences in light of particularities due to European integration processes (like state aid driven requirements) and adaptations to local financial market conditions will be warranted.

Significant legislative progress has been made in Ukraine since the financial crisis of 2008. One of the most important financial sector reforms was the transformation of the DGF from a pure deposit insurance and payout entity (paybox) to a bank resolution authority. Further reforms were initiated and supported by the World Bank Financial Sector Development Policy Loan series in 2014 and 2015, with FinSAC support, aimed at strengthening the operational, financial, and regulatory capacity of the DGF to cope with massive bank failures. New resolution tools were introduced and a mechanism for state participation in the resolution of systemically important banks was defined. Despite more than 90 bank failures since the beginning of 2014 authorities have managed to restore public confidence, giving an important stabilization signal to the market. However, the framework in practice relies almost exclusively on public funding and is confronted with a variety of complex implementation problems. Successful recoveries are rare due, in particular, to the substantial erosion of banks' asset base before insolvency (fraudulent payments and asset transfers pre-insolvency) and related party lending. As a result, the DGF has been burdened by high compensation payments which are borne, ultimately, by the government and taxpayers.

## Recommendations

**Improve early detection of distress and enable prompt preventive or recovery action, both critical to maintaining confidence in the banking system and containing systemic risk.** Current early intervention powers (“corrective action” & “special mode of control”) are insufficient to effectively correct deterioration of a bank’s business and financial position or to prevent asset erosion before and during resolution. Triggers for problem bank status and for insolvency are set too late: a bank is formally deemed problematic only when it is already in breach of prudential requirements and licensing conditions. Existing legal powers should be made more readily actionable in practice. Framework changes should enable authorities to step in earlier, at a point when a bank is still compliant but its condition, based on a combination of quantitative and qualitative indicators, is deemed to deteriorate to an extent that its failure could be imminent, i.e. it is failing or likely to fail. The NBU should be granted enhanced powers to counteract adverse developments as early as possible. These should include the ability to require the management to be (completely or partially) removed and/or replaced and to enforce changes in a bank’s legal structure or business strategy. The working group also recommends reappraisal of the effectiveness of the “special mode of control” and a reassessment of the role of the NBU “curator” with a view to strengthening the NBU’s early intervention powers aligned with the introduction of ex-ante recovery planning as envisaged by the BRRD.

**Aim to develop an ex-ante resolution framework under which all banks, including the biggest, are resolvable without relying on taxpayer solvency support while limiting detrimental effects on financial stability.** Resolvability can be ensured either via liquidation (straight sale of assets) or via the application of special resolution powers. The option of a pre-packaged sale of the failed bank’s assets and liabilities, similar to the standard closed bank purchase and assumption model (P&A), should be retained for smaller banks that are not providing critical economic functions. Resolution authorities should be given appropriate tools and powers to be used in resolution, especially of systemically important institutions and banks that carry out critical functions in the economy. Banks and authorities should be better prepared for responding to distressed situations and banks’ own crisis management mechanisms should be strengthened. Authorities need to have better tools for detecting and analyzing potential vectors of contagion that could pose a threat to financial stability. The DGF, in cooperation with the NBU, would need to be equipped with the necessary tools and powers to analyze and remove impediments to resolvability. In particular, the NBU in cooperation with DGF should be enabled to require banks to make changes to their legal or operational structure so as to reduce complexity and facilitate the continuity of critical services.

**Require that ex-ante plans for recovery and resolution are put in place, subject to an appropriate phase-in period and simplified plans for smaller banks.** Recovery plans should be drawn up by banks, as part of their risk management, outlining possible actions to be taken in case of deteriorating financial conditions and assessed by the NBU as the supervisory authority. Recovery plans would be activated, by the bank itself or failing that by the NBU, when the bank’s condition was in severe decline but before failure was imminent (unlike current ‘restructuring plans’ under the Banking Law). Building upon these recovery plans, the DGF, as the resolution authority, would be responsible for the adoption of individual bank resolution plans preparing for the event that a bank would actually fail and ensuring a bank is “resolvable”. In contrast to restructuring plans under the current Deposit Guarantee System Law, resolution plans under the BRRD are designed ex-ante and set out a strategy for dealing with a failing bank while continuing its critical economic functions. Their aim is not to restore the bank as such, but to continue its critical functions, although a “restructuring plan” might be developed in case of need when applying the open bank bail-in tool. Recovery and resolution are work and resource intensive both for banks and regulatory authorities; resolution reporting requirements (information templates) should be tailored to the ‘systemic importance’ of banks (principle of proportionality).

**Replace the current two-stage process with a single-stage resolution process.** The current ‘problem bank’ and ‘provisional administration’ stages should be merged into a new resolution stage with only one trigger point (failing or likely to fail) that enables the authorities to take action at a point in time when the bank is not yet balance sheet-insolvent. The decision to trigger resolution should be based on proper evidence including, where relevant, a valuation of the bank’s assets and liabilities by independent experts. The DGF’s decision on taking resolution action and choice of resolution tools should be based on a broad, comprehensive set of resolution objectives that, in addition to the DGF’s current ‘least cost’ criterion, also include the continuity of critical economic functions and the preservation of financial stability. It should be made explicit in law that, in line with international good practice, shareholders and creditors of a failing institution have no right to a solution that is least costly to them (liquidation as default).

**When taking resolution action alternatives to liquidation should become a more realistic option.** Taking prompt resolution action will allow authorities more flexibility to consider alternatives to liquidation. The current legal framework already provides the NBU and the DGF with a comprehensive set of resolution powers; including to dispose of a failed bank’s shares, transfer assets and liabilities to an acquirer, or transfer assets and liabilities to a bridge bank (for a maximum period of 2 years). In practice, however, the vast majority of insolvent banks have been placed into liquidation, i.e. wound up and their assets sold off. World Bank research indicates that recovery rates from liquidation proceedings in Ukraine are among the lowest worldwide. Recovery rates from asset sales and loan restructuring tend to be significantly higher. To reduce value destruction, intervention should take place sufficiently early to allow for restructuring or winding down, in addition to enhanced efforts to reduce related party lending.

**Build on current powers to develop an enhanced resolution toolkit that ensures the protection of a failing bank’s critical economic functions.** A revised resolution framework should allow the take over and restructuring of a bank while it is a going concern and the recapitalization of a systemically important bank for which no acquirer can be found (open bank resolution over a “weekend”). Under the revised framework, recapitalization of the bank as a going concern should be effected over time without recourse to public funds, e.g. by way of a mandatory write-down and conversion of capital instruments or by way of a bail-in of the bank’s creditors in particular institutional creditors, such as interbank loans, and holders of debt instruments. The bridge bank tool could be used in specific cases when there is certainty of finding a buyer in the near future in order to bridge the time gap. For smaller banks, the bridge bank tool may be used to maintain and, if appropriate, combine the viable operations of failing institutions, provided that its usability and effectiveness are improved, in order to take on the viable operations of several smaller insolvent banks in a more effective and cost-efficient manner.

**Require that bank shareholders and creditors absorb losses from bank failures in the first instance.** In line with emerging international practice, a system should be developed ensuring that the public does not bear the main costs of financial stability. Most costs associated with the resolution or liquidation of banks in Ukraine have, until now, been publicly funded. An effective framework for bank resolution should be able to deal with failing banks of any size. Even the largest, systemically important institutions – previously deemed too big to fail – should be able to be resolved without the use of taxpayers’ money. Bail-in should be introduced as a generic resolution tool applicable, in principle, to all unsecured creditors (not limited to ‘related parties’) as soon as market conditions allow for building up loss absorbing capacity and with clear legal safeguards. In addition to the write-down and conversion of capital instruments, unsecured creditors’ claims would be written down or converted into equity, as appropriate, to cover the funding needs for loss absorption and potential recapitalization and minimize taxpayers’ potential exposure to the bank’s losses. To support the statutory recapitalization of a failing bank by way of bail-in all banks would be required to build up, over the course of a suitably calibrated phase-in period, adequate levels of internal loss-absorbing capacity (MREL). MREL consists primarily of unsecured mostly subordinated financial debt

instruments, such as loans and bonds, that may be bailed-in as necessary, shielding the bank's depositors and preventing adverse impacts on the stability of the financial sector. In a banking system funded primarily by deposits, as is the case in Ukraine, the availability of eligible, potentially loss-absorbing, instruments is inherently limited and will depend critically on progress in the deepening of domestic interbank lending and the bond market to shield depositors from bail-in. Improving access to the international capital markets would be particularly important to avoid a concentration of eligible liabilities in the hands of a few systemically important market participants, which could again lead to unhealthy levels of interconnectedness and may increase systemic risk.

**Introduce additional measures for resolution financing and a broader approach to crisis management in the event of a system-wide financial crisis.** In the longer term a separate resolution fund, financed ex-ante by banking industry contributions, should be established to recapitalize a bank or provide ad-hoc liquidity and guarantees. The DGF should continue to fulfil the protection of covered depositors. It would also contribute to resolution funding to the same extent as it would have had to pay for deposits under hypothetical liquidation if no resolution powers had been applied. It should no longer, however, act as a de-facto resolution fund (while relying on public support). If public funds were required to support resolution, which should be the exception, the government (Ministry of Finance) would also need to be involved in preparing resolution action. A dedicated inter-agency committee involving the NBU, the DGF, and the Ministry of Finance should meet regularly to discuss systemic questions related to resolution e.g. general progress of recovery and resolution planning, MREL sufficiency, and system wide resolution funding needs.

**Update and enhance the respective roles of the NBU and the DGF in order that they can effectively implement the proposed measures.** The NBU's powers as a supervisor should be enhanced to be better prepared for taking early intervention measures. They should be empowered to require banks to submit recovery plans as part of their risk management and to declare a bank failing at a stage before it is deemed to be balance-sheet insolvent. The NBU must make the final decisions on the operation of a viable bank. The DGF, as the resolution authority, should become a more active participant in resolution preparations. It should continue to be responsible for decisions on taking resolution action and on the application of specific resolution powers under a revised, BRRD-aligned system, this time with an enhanced set of powers and based on resolution plans drawn up in advance.

**Improve the flow of information between the NBU and the DGF.** Arrangements should be more fluid both in scope and process. Information should be shared in or near real-time. The exchange of information should not be limited to raw data and final actions but include analysis and findings. Coordination in the early detection of, and response to, emerging problems improves effectiveness and reduces duplication of analysis. Under a new BRRD-aligned framework many critical decisions would be made by the supervisory and resolution authorities, jointly or subject to mutual consultation. In particular, the NBU would need to provide regular information to the DGF on supervisory assessment and ensure close cooperation from the point of early intervention action and before triggering 'failing or likely to fail' in order to allow time for the DGF and independent valuers to prepare for resolution. Once an institution was determined to be failing or likely to fail, control of the process would pass to the DGF which would be responsible for the decision to liquidate or take resolution action and, in the event of resolution, the choice of resolution tools. When, for example for public interest reasons, resolution action is decided on instead of liquidation the DGF would rely on close cooperation with the NBU, especially for the macro-prudential assessment of the effects of a failure of the institution on the real economy or the stability of the financial system. The DGF's preferred resolution strategy should be notified to the NBU and any resulting action agreed, for example with regard to licensing a bridge bank. Close cooperation would also be required in recovery and resolution planning including on the assessment of a bank's minimum loss-absorption and recapitalization capacity (capital, MREL). The removal of impediments to resolvability would have to be decided in close cooperation between both authorities and may

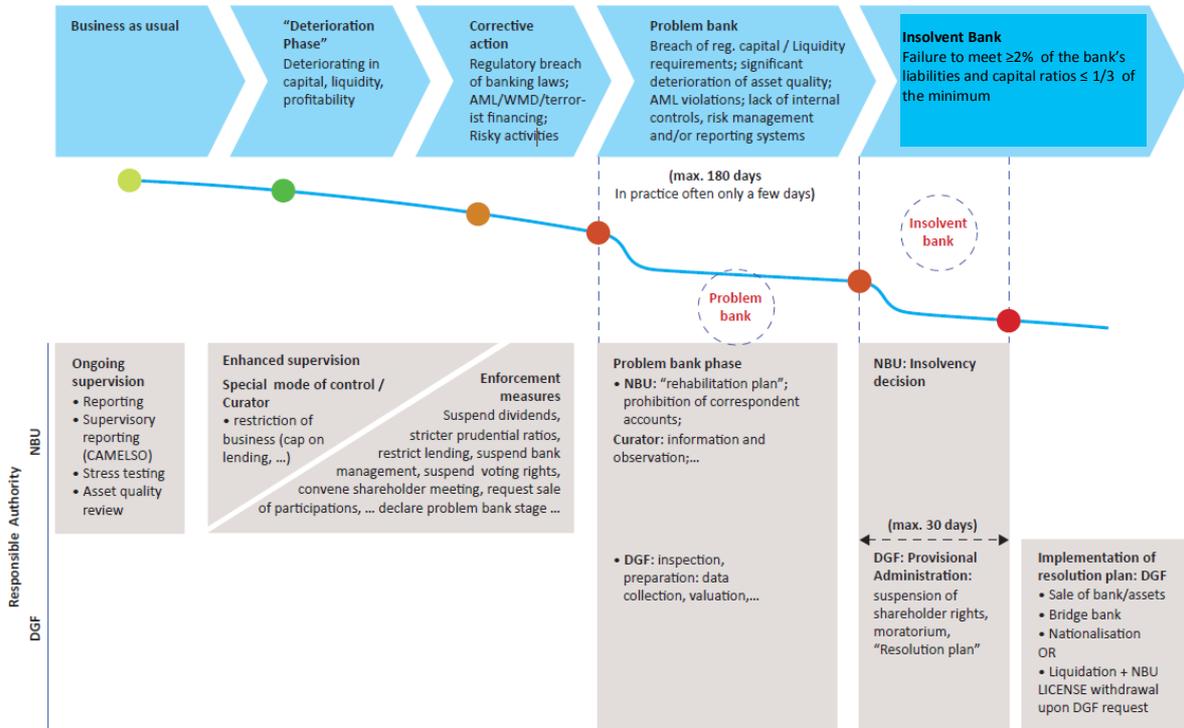
require supervisory action by the NBU. The information required from banks for recovery and resolution planning should be based on a common set of templates agreed upon between the NBU and the DGF.

**Increase the capacity of the NBU and the DGF to properly discharge their new expanded responsibilities.** Recovery and resolution planning and the assessment and monitoring of resolvability are resource-intensive tasks that may test the capacity of both institutions, but particularly the DGF which does not currently require specialism in these areas to exercise its powers. The introduction of the bail-in tool and MREL calls for additional skills (e.g. debt capital markets, structured finance) that may be in limited supply and require additional training. Staffing of the relevant departments of the NBU and, in particular, the DGF may need to be reinforced and specific competencies added. Training of NBU and DGF staff should be initiated as early as practically possible, including joint training sessions where appropriate.

**Reconsider the role of the judiciary in bank resolution and liquidation.** Legal action and court proceedings have at times contributed significantly to the ineffectiveness of bank liquidation procedures. Under a BRRD-compliant framework, judicial control should, as a rule, be non-suspensive and sanctions limited to ex-post financial compensation. The application of resolution powers and evidence to ensure the protection of legal safeguards like the requirement that ‘no creditor be worse off than under liquidation, should be based on proper valuations provided, ideally, by an independent, professional valuer. Such “economic assessments” usually include a wide margin of discretion to be exercised by the independent authority and should as a rule be taken over by the Courts, i.e. Courts should be held to assess the lawfulness of the contested decision but not the appropriateness, where this involves the proper exercise of discretionary power for example as regards a bank’s valuation. Resolution authority officials, like supervisors, should be afforded adequate legal protection in the exercise of their duties.

ANNEX: overview current resolution framework and possible revised BRRD aligned framework

Resolution Framework in Ukraine: status Quo



Possible revised future resolution framework for Ukraine

