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RUSSIAN FEDERATION

FINANCIAL SECTOR ASSESSMENT PROGRAM

September 2016

TECHNICAL NOTE—BANK RESOLUTION AND CRISIS MANAGEMENT FRAMEWORK

This Technical Note on Bank Resolution and Crisis Management Framework on the Russian Federation was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on September 2016.

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TECHNICAL NOTE

BANK RESOLUTION AND CRISIS MANAGEMENT FRAMEWORK

Prepared By

Monetary and Capital Markets Department and the Legal Department, International Monetary Fund and Financial and Private Sector Development, the World Bank.

This Technical Note was prepared by IMF and WB staff in the context of the Financial Sector Assessment Program in the Russian Federation, and overseen by the Monetary and Capital Markets Department and Legal Department, IMF, and the Financial and Private Sector Development, the World Bank. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx, and www.worldbank.org/fsap.

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Glossary

AQR	Asset Quality Review
Banking Law	Federal Law No. 395-I of December 2, 1990, on Banks and Banking Activities
BCPs	Basel Core Principles
BSC	Banking Supervision Committee
CBR	Central Bank of the Russian Federation (Bank of Russia)
CBR Law	Federal Law No. 86-FZ of July 10, 2002, on the Central Bank of the Russian Federation (Bank of Russia)
CCP	Central Counterparty
DIA	State Corporation Deposit Insurance Agency
DIF	Deposit Insurance Fund
DI Law	Federal Law No. 177-FZ of December 23, 2003, on Insuring Natural Persons' Deposits Made with Banks of the Russian Federation
D-SIB	Domestic Systemically Important Bank
D-SII	Domestic Systemically Important Insurer
ELA	Emergency Liquidity Assistance
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	National Council on Ensuring Financial Stability
GDP	Gross Domestic Product
G-SIBs	Globally Systemically Important Banks
IADI	International Association of Deposit Insurers
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
Insolvency Law	Federal Law No. 127-FZ, dated October 26, 2002, on Insolvency (Bankruptcy)
KA	Key Attribute
KAs	Key Attributes of Effective Resolution for Financial Institutions
MoF	Ministry of Finance

MoU	Memorandum of Understanding
NWF	National Wealth Fund
OFZ	Federal loan bonds
P&A	Purchase and Assumption
RRP	Recovery and Resolution Planning
SOB	State-Owned Bank
SREP	Supervisory Review and Evaluation Process
TLAC	Total Loss Absorbing Capacity
VTB	Vneshtorgbank

EXECUTIVE SUMMARY[1]

The experiences of past financial crises have strengthened the Russian bank resolution framework. In December 2014, the framework was updated by consolidating existing resolution regimes, including making permanent the temporary measures introduced in 2008 to deal with the failure of large banks. Key changes included enhancing powers to exchange information with foreign resolution authorities and sanctioning managers of failed banks.

The resolution framework has been effective in preserving financial stability. Since January 2014, 28 banks were put into open bank resolution, and three banks were resolved by purchase and assumption (P&A) transactions. In addition, over the same period, the Central Bank of Russia (CBR) revoked the licenses of 214 credit institutions, of which 168 were participants in the mandatory deposit insurance system, resulting in deposit insurance payouts amounting to 0.8 percent of GDP.[2]

The effectiveness of bank resolution could be improved. In light of the fact that many of the resolved banks were deeply insolvent, the CBR should consider adopting a transparent early intervention framework with a clearly delineated set of mandatory and discretionary supervisory measures to take when a bank's financial situation begins to deteriorate. Triggers for entry into resolution could be further clarified to ensure the use of resolution powers before a firm becomes balance-sheet insolvent and before all equity has been wiped out. Increasing legal protection of CBR, the State Corporation Deposit Insurance Agency (DIA), and their staff and agents, as well as circumscribing the scope of judicial review, would also contribute to supervisory and resolution actions being taken in a timely manner.

The CBR is still at an early stage of recovery and resolution planning. The CBR obtained legal powers in December 2014 to require domestic systemically important banks (D-SIBs) and other banks to submit recovery plans, and has been tasked with preparing resolution plans for D-SIBs. The CBR should consider requiring all banks to submit recovery plans, giving priority to banks it identifies as being of federal or regional importance. The CBR should also prepare resolution plans for these banks. Additional legal amendments would be necessary to authorize the CBR to require banks to adopt appropriate steps to improve their resolvability.

Introduction of the full range of resolution powers and safeguards recommended by the Financial Stability Board (FSB) Key Attributes (KAs) would improve the framework's effectiveness. The scope of the resolution framework should be expanded to enable the CBR to resolve bank holding companies. In addition, the CBR's powers could be expanded to facilitate mergers and recapitalization, and business transfers while ensuring the continuity of critical functions. Certain legal and operational changes are critical to make P&A transactions an effective

[1] This Technical Note was prepared by Edda Rós Karlsdóttir and Mikari Kashima (both IMF) and Rinku Chandra (the World Bank).

[2] The numbers referred to in this technical note are as of end-April ,2016, unless stated otherwise.

tool for orderly resolution of systemic banks and to reduce the use of open bank resolution. These changes include removing financing constraints, using fair value for asset transfers, and increasing the flexibility in determining the scope of liabilities to be transferred. Introducing bail-in could reduce the reliance on public funds to recapitalize banks, but the framework would need to be carefully designed, taking into consideration its implications for financial stability and the reduction of legal risks. The introduction of shareholder and creditor safeguards would be essential to lessening the legal risks. Bankruptcy and liquidation proceedings could also be made faster and timely, and the coverage of deposit insurance could be expanded to include deposits of non-related party corporate entities. With such changes to the resolution framework, the authorities could, going forward, limit the use of open bank resolution measures with public funds in connection with bank failures that could cause widespread financial stability concerns.

Resolution measures should be taken without relying on the use of public funds. Currently, due to the negative balance of the mandatory deposit insurance fund (DIF) and the shortage of funds in the DIA's own account, the DIA needs to rely on public funds to conduct an insurance payout and to take resolution measures with DIA participation (that is, open bank resolution or a P&A transaction). Although the DIA may request funding from either the CBR or the federal government, the DIA almost exclusively relies on the loans provided by the CBR. Such financing amounts to a quasi-fiscal activity and thus should be provided by the federal government or, if provided temporarily by the CBR, with a federal indemnity. The decision-making process for resolution measures using federal budget funds should require the approval of the Minister of Finance. In the medium term, a funding mechanism for recovery of the costs of providing temporary public financing should be established by imposing ex-post levies on the banking industry. Moreover, imposing losses on unsecured creditors would reduce the total need for public funding. In addition, to strengthen the DIF's financing conditions, introduction of a two-tiered depositor preference rule could also be considered.

To ensure adequate bank capitalization, a comprehensive review of banks' asset portfolios and collateral valuations is warranted. The transparency of asset quality has suffered following the prolonged recession and the application of forbearance measures. A comprehensive asset quality review (AQR) could play an important role in reducing uncertainty and encouraging confidence. Prior to the AQR, the authorities should formulate a strategy to address the weaknesses that the review may uncover, and develop criteria for the potential use of public funds for banks' recapitalization.

Table 1. Main Recommendations

Recommendations	Responsibility	Priority
Institutional setting		
Revise the decision-making process for resolution measures using temporary public (federal budget) funds to require MoF approval, in line with the recommendation to discontinue the use of CBR loans to provide financing to the DIA.	CBR, DIA, MoF	Medium term
Strengthen cooperation with foreign authorities through Supervisory and Resolution Colleges.	CBR	Short term
Crisis preparedness		
Conduct an AQR to ensure adequate bank capitalization and formulate a strategy to address the weaknesses that the AQR may uncover.	CBR, MoF	Short term
Make recovery plans mandatory for all banks, starting with federal or regionally important banks.	CBR	Short term
Revise the law to provide the CBR the authority to require banks to adopt appropriate measures to improve their resolvability.	CBR, MoF	Short term
Early intervention		
Adopt a transparent early intervention framework.	CBR	Short term
Resolution framework		
Revise the law to provide triggers for entry into resolution based on non-viability.	CBR, MoF	Medium term
Provide the CBR with resolution power over bank holding companies.	CBR, MoF	Short term
Introduce the full range of resolution powers and safeguards recommended by the FSB KAs. In particular, implement legal and operational changes needed to improve the usability of P&A transactions: • Remove financing constraints for P&A transactions; • Increase the flexibility in determining the scope of liabilities to be transferred; • Use fair value for transfer of assets. Revisit the framework for statutory bail-in, taking into consideration financial stability implications and legal risks, ensuring that the following requirements are in place: • Triggers; • Consistency with hierarchy of claims in liquidation; • Scope of bail-in-able liabilities.	CBR, MoF	Short term

Table 1. Main Recommendations (concluded)		
Recommendation	**Responsibility**	**Priority**
Once improvements are made to enhance the effectiveness of the resolution framework, narrow the use of open bank resolution with public funds to cases that have broader systemic implications.	CBR, DIA, MoF	Medium term
Revise procedures to enable speedy liquidation.	CBR, MoF	Medium term
Funding		
Establish an emergency liquidity assistance (ELA) framework.	CBR	Short term
Review the use of public funds to finance the DIA for resolution purposes to be provided by the federal government. If it is necessary to use CBR funds, the federal government should provide indemnity.	CBR, MoF	Medium term
Establish a funding mechanism for recovery of the costs of providing temporary public financing through levies on the banking industry.	CBR, MoF	Medium term
Deposit insurance		
Consider broadening the coverage of deposit insurance to deposits of non-related party corporate entities.	CBR, DIA, MoF	Medium term
Introduce a two-tiered depositor preference rule.	CBR, DIA, MoF	Medium term
Legal protection		
Provide legal protection to the CBR, the DIA, and their staff and agents, acting in good faith.	MoF	Medium term
Circumscribe the scope of judicial review (including eliminating suspension of supervisory actions upon court challenge).	MoF	Medium term

INTRODUCTION

1. **The financial sector is relatively small and dominated by state-owned commercial banks (SOBs).** SOBs, dominated by Sberbank and VTB Group, hold 60 percent of system assets, and the top 10 private universal banks hold 15 percent. Many small and medium banks operate in mono-industrial cities and are often important in their respective regions. Banks are largely deposit-funded, with the majority of assets being loans.

2. **The banking system has been significantly affected by the protracted recession, but the authorities' decisive policy response has helped to preserve financial stability.** The sharp decline in oil prices and reduced access to international capital markets owing to sanctions hit the economy and the banking system hard. Loss of access to long-term funding in international markets increased financing costs and foreign exchange needs for external debt repayments. Large ruble depreciation and monetary tightening in late 2014 put further pressure on profitability and capital.[3] The authorities introduced an anti-crisis program in late 2014, consisting of liquidity provision, capital support, and temporary regulatory forbearance measures (Box 1). In addition, deposit insurance coverage was doubled to RUB 1.4 million (about US$ 20,000) per insured depositor.

3. **Russia has upgraded its crisis management and bank resolution framework since the 2011 FSAP.** The institutional setting for crisis management was strengthened by the establishment of the National Council on Ensuring Financial Stability (FSC) and the Central Bank of Russia (CBR)'s internal Financial Stability Committee. In December 2014, the bank resolution framework was updated by consolidating existing resolution regimes, including making permanent the temporary measures introduced in 2008: to appoint a provisional administrator, and to conduct an open bank resolution or a P&A transaction with DIA participation. Further, the authorities' powers to exchange information with foreign resolution authorities and to sanction managers of failed banks were strengthened. A risk-based insurance premium was also introduced.

4. **The authorities have resolved many banks in an orderly manner, mostly by open bank resolution or liquidation.** Since January 2014, 28 banks were put into open bank resolution using public funds amounting to 1 percent of GDP.[4] In addition, over the same period, the CBR revoked licenses of 214 credit institutions, resulting in deposit insurance payouts amounting to 0.8 percent of GDP.[5] P&A transactions have only been used in three cases.

5. **This note provides further information related to the recommendations made in the Financial System Stability Assessment (FSSA) report with respect to early intervention, bank**

[3] CBR moved to a free floating exchange rate in November 2014 and tightened monetary policy, including through an emergency 650 bps rate hike in December 2014 to 17 percent.

[4] Thirty banks were under open bank resolution at end-February 2016, with total assets amounting to 6.4 percent of system assets. (The number of credit institutions that had their licenses revoked (214) is as of end-April 2016.)

[5] Breach of anti-money laundering legislation was among the reasons for license revocation in 84 cases, and the exclusive ground in 20 cases. (The corresponding data for 2012–13 was nine and two licenses, respectively.)

resolution, and crisis management. While the existing framework has been successful in containing financial instability, the resolution measures relied on the use of a large amount of public funds as well as large losses incurred by creditors in liquidation proceedings. The note provides recommendations to further enhance the effectiveness of the bank resolution framework.

Box 1. Anti-Crisis Program 2014–16

This box explains the capital support programs and the regulatory forbearance measures introduced in late 2014–16.

1. Capital Support Measures

In 2014–16, the authorities pursued a capital support program funded by the federal budget with issuance of federal loan bonds (OFZ), the National Wealth Fund (NWF), and the CBR.

- **The OFZ program:** Funds worth 1.1 percent of GDP were transferred to the DIA for the recapitalization of 34 banks (over 40 percent of system assets) by July 25, 2016. This program targeted three categories of commercial banks: (1) banks with at least RUB 25 billion in capital, (2) banks that are directly or indirectly affected by economic sanctions, and (3) top regional lenders. Banks received capital in an amount equal to 25 percent of their existing total capital as of end-2014.
  Under the program, the DIA offered SOBs and sanctioned banks OFZ in exchange for preferred shares (Tier 1), and, for all other banks, OFZ in exchange for subordinated debt (Tier 2). Over 60 percent of the funds benefited SOBs.
  The capital support was provided to banks that were fully compliant with CBR's prudential requirements and with consumer loans below 40 percent (50 percent from July 2015) of total assets. When determining eligibility, the amount of lending to related parties and shell companies was also taken into consideration. Several banks were required to take remedial actions before approval.
  Banks are subject to intensified supervision and to certain operational conditions under the program. Compliance is monitored by the Chamber of Audit and reported to the DIA. Failure to comply can lead to an annual penalty of up to 2 percent of the capital support. The operational conditions are:
  - Private banks shall increase capital by half of the amount provided by the program over the duration of the subordinated loans by issuing new shares and/or retaining 75 percent of annual profits.
  - Banks shall increase credit to selected sectors by 1 percent monthly over three years.
  - Banks shall not increase management salaries and the overall wage bill for three years or until the required capital increase is met, whichever comes first.
- **NWF:** Up to 10 percent of the NWF assets (0.5 percent of GDP) were allocated for capital support of bank lending to infrastructure projects (40 percent of the funds allocated to two SOBs).
- **CBR:** The CBR received the government's authorization to inject capital in the largest SOB (Sberbank, with about 30 percent of system assets) if needed (this measure has not been used so far).
- Finally, the government replaced subordinated loans (Tier 2) provided to three SOBs in 2008–09 with preferred shares (Tier 1) worth 0.4 percent of GDP.

2. Temporary Regulatory Forbearance Measures

Regulatory forbearance can be an effective tool in a crisis, provided the measures are transparent, temporary, and combined with intensive supervision. The purpose is to avoid pushing adequately managed and otherwise sound banks into failure because of specific weaknesses that are transient and, in some circumstances, caused by external shocks beyond their control (for example, foreign exchange (FX) volatility).

Box 1. Anti-Crisis Program 2014–16 (concluded)

The authorities introduced temporary forbearance as part of a comprehensive policy package in December 2014. The strategy was appropriately combined with intensified supervision, but transparency of the banks' asset quality has decreased. The table provides an overview of the forbearance measures and their status:

Forbearance Measures	Status at end-April 2016
Valuation of securities Waive the requirement to recognize negative valuation changes for banks' securities holdings to limit the sensitivity to market risk.	Introduced in December 2014 at October 1, 2014, prices with an expiration date of July 1, 2015. **Lifted on July 2, 2015.**
Valuation of FX items I Allow the use of a fixed exchange rate on the conversion of FX-denominated assets and liabilities that existed before January 2, 2016, to limit the impact of FX depreciation on all prudential ratios (excluding net open FX position limits compiled and met based on the current exchange rates).	Introduced in December 2014 at October 1, 2014, rates, (39 RUB/USD and 50 RUB/EUR corresponding to 25–30 percent below-market rates), with an expiration date of July 1, 2015. The measure was extended to October 1, 2015 (using new rates of 45 RUB/USD and 52 RUB/EUR corresponding to 30 percent below-market rates), and was re-extended to January 1, 2016 (using new rates of 55 RUB/USD and 64 RUB/EUR corresponding to 20–25 percent below-market rates). **Lifted on January 2, 2016.**
Valuation of FX items II Allow the use of a fixed exchange rate for the conversion of FX-denominated assets and liabilities that existed before January 2, 2016, for the calculation of large exposure norms N6 and N21.	Introduced in January 2016 at January 1, 2016, rates (73 RUB/USD and 80 RUB/EUR) with an expiration date of April 1, 2016). By April 1, however, the ruble had appreciated and was below these levels. Therefore, banks did not apply the measure for 2016Q1 prudential reports. **Lifted on April 2, 2016.**
Loan loss provisioning I An existing forbearance measure in the law allows flexibility in classification of loans in extraordinary situations, such as calamities, wars, and so on. Loans affected by the conflict in Ukraine were eligible for this measure, and its application was extended from one year to three years.	Introduced in November 2014 with a deadline for expiration of three years from the start of the extraordinary event.
Loan loss provisioning II Allow flexibility in loan classifications and loan loss provisioning for: (1) loans that deteriorated because of economic sanctions and the related economic conditions; and (2) loans restructured as of December 1, 2014.	Introduced in December 2014 with an expiration date of July 1, 2015. The measure was extended until October 1, 2015, and re-extended until January 1, 2016. On January 2, 2016, measure (1) was lifted. Measure (2) was extended to apply to loans restructured in December 2014–15, but discontinued for loans restructured as of January 2, 2016.

INSTITUTIONAL FRAMEWORK

A. Institutional Setting

Each jurisdiction should have a designated administrative authority or authorities responsible for exercising the resolution powers over firms within the scope of the resolution regime. Where there are multiple resolution authorities within a jurisdiction, their respective mandates, roles, and responsibilities should be clearly defined and coordinated.

6. The CBR is the decision-making authority for the supervision and resolution of banks and other financial institutions.[6] All supervisory measures are decided solely by the CBR. With regard to resolution measures, if a bank is resolved through bankruptcy or liquidation proceedings[7] with insured deposit payouts, the decision is made solely by the CBR. If, however, the measure involves DIA participation (either an open bank resolution or a P&A transaction),[8] the DIA is given veto power over the CBR's proposal for its participation. The final decision to adopt the resolution measure is made by the CBR by endorsing the DIA's plan for participation. The DIA's decision on whether to participate is made based on the principles of fairness, reasonableness, sufficient awareness of the bank's financial position, and minimization of the assets of the DIF and of other DIA funds to be spent.[9]

7. Supervisory measures are implemented by the CBR, while resolution measures are implemented by both the CBR and the DIA. With regard to resolution measures, the CBR appoints a provisional administrator (except in cases where the law provides for the DIA to be the provisional administrator) and oversees the measures taken with DIA participation, bankruptcy and liquidation proceedings. The DIA is responsible for operational aspects of open bank resolution and P&A transactions, and acts as a bankruptcy receiver or a liquidator when the failed bank was licensed to take deposits from individuals**.**

[6] Within CBR, all key supervisory decisions (licensing, revocation, sanctioning, restrictions) are made by the Banking Supervision Committee (BSC), except for decisions involving the extension of CBR loans and the issuance of regulations, which are made by the CBR Board based on BSC's recommendations.

[7] There are two separate proceedings for liquidating banks in Russia, that is, liquidation proceedings apply when the bank is solvent (for example, its license was revoked based on anti-money laundering issues), and bankruptcy proceedings apply when the bank is insolvent.

[8] In an open bank resolution, which is referred to as "bankruptcy prevention measures with DIA participation" in Russian legislation, shareholders and subordinated creditors are written down, management is suspended or replaced, and the bank is sold to new investors in a competitive bidding process. DIA may provide financial assistance to the failed bank or the investor to close the negative balance, achieve the minimum capital adequacy ratio, and support liquidity needs. In addition, regulatory forbearance may be applied during the rehabilitation process of the bank, which may last for 10 years. In Russian legislation, P&A is referred to as "settlement of obligations with DIA participation."

[9] Insolvency Law Article 189.48(2).

8. The MoF does not have a direct role in bank resolution, but is involved through providing financing to the DIA, and through membership in the DIA's Board of Directors and non-voting membership in the CBR Board. The federal government may provide funding to the DIA's account for taking resolution measures with DIA participation. In addition, the DIA Board, which decides on sending proposals to the federal government or to the CBR to provide financing to cover the deficit of the mandatory DIF, is currently chaired by the MoF and two other high-level MoF officials participating as members of the DIA Board.[10] The MoF is also a non-voting member of the CBR Board, which decides on the extension of CBR loans to the DIA to finance resolution measures with DIA participation and the mandatory DIF.

9. The FSC serves as a high-level interagency advisory board to make recommendations on measures involving financial stability. In February 2015, the FSC was strengthened, particularly in terms of membership.[11] The FSC has served as an effective platform for interagency coordination, including on issues pertaining to anti-crisis measures. The implementation of the FSC's recommendations lies with the individual agencies under a rule of "comply or explain."[12]

10. To provide for a clear allocation of responsibilities, the authorities are encouraged to reconsider the decision-making process for resolution measures involving DIA participation. As noted earlier, the DIA has veto power regarding resolution measures taken with DIA participation, whereby the CBR proposes for the DIA's participation, and the DIA has the power to either deny or agree on its participation. The authorities advised that, in practice, all DIA decisions not to participate were taken together with the CBR based on a joint assessment of the failed bank. While the authorities noted that the decision-making process has not caused any delays or financial stability concerns in resolving banks, it could potentially hamper timely intervention or the adoption of effective resolution measures, particularly in the event that the two authorities have different views on the necessary measure to be taken.[13] The DIA's veto power may currently be justified due to the fact that the current resolution funding arrangement exposes the DIA to substantial credit risk (see Box 5 and the section on Funding Firms in Resolution). If the funding arrangements for

[10] The DI Law provides that the DIA Board shall include 13 members, that is, seven representatives of the Federal Government, five representatives of CBR, and the DIA's director general (Article 18(1)). Currently, the DIA Board is chaired by the Minister of Finance, and the members representing the Federal Government include: First Deputy Head of the Office of the Federal Government, Referent of the Expert Directorate of President of the Russian Federation, Deputy Minister of Finance, Deputy Minister of Economic Development, Director of Financial Policy Department of the MoF, and Director of Department of Finance-banking Operation and Investment Development of the MOED.

[11] The FSC is currently chaired by First Deputy Prime Minister and comprises 11 other senior officials, including the CBR Governor, the Minister of Finance, the Minister of Economic Development, and the DIA General Director.

[12] The FSC also serves as a forum to discuss legislative reforms relating to financial stability issues, including legislative reforms to introduce resolution tools recommended in the FSB KAs.

[13] In the past, there have been instances in which DIA has declined to participate owing to the risks identified by a subsequent joint inspection with CBR (for example, off-balance sheet commitments, money laundering activities, and so on), or owing to the outcome of a least-cost test analysis. In such cases, the banks were liquidated and insured deposits paid out (see also footnote 24). Such an approach, however, could be problematic when the bank has systemic implications that necessitate the continuity of critical functions.

resolution are revised in line with the recommendation in this note, the authorities should also consider eliminating the DIA's veto power, and providing the CBR the power to solely determine resolution measures, in consultation with the MoF and the DIA, so long as the decision is in line with a least-cost test or systemic necessity, and the DIA has the capacity to fund the resolution measure without resorting to public funds (see paragraph 55 about the least-cost test).

11. The MoF should have a prominent role in decisions on resolution measures involving the use of public funds. Currently, if an open bank resolution with DIA participation is to be financed by CBR loans, which is usually the case, the DIA requests financing from the CBR, and the CBR Board approves the loan. For the use of federal funds, the DIA can make a request of the MoF, which then requires parliamentary approval be reflected in the federal budget. In line with the recommendation to discontinue the use of CBR funds and to indemnify the CBR if any CBR funding is necessary, the MoF should have a prominent role in the decision-making process for resolution measures involving the use of temporary public funds, if necessary as a last resort.

12. In addition, with such changes to the decision-making process for bank resolution, the composition of the DIA Board should also be revisited. The current Board has 13 members, which includes five representatives from the CBR and seven high-level government officials, including from the Ministry of Finance, the Ministry of Economy, and the President's office. While the large presence of federal government officials may currently be justified by the use of public funds in taking resolution actions, it may conflict with the operational autonomy of the DIA regarding its internal functioning. In addition, the involvement of federal government and CBR officials in the DIA's decision-making process may raise concerns about potential conflicts of interest owing to the federal government and the CBR being owners of some of the member banks. Going forward, the authorities could reconsider the composition of the DIA Board to reduce the dominance of federal government and CBR officials.

B. Domestic Coordination and Cooperation

The legal framework should enshrine robust interagency coordination mechanisms.

13. Coordination among the safety net participants has proved effective. While the MoF as an institution is generally not involved in the resolution of individual banks, it is indirectly involved in the decision-making process through membership in the DIA Board and the CBR Board (as a non-voting member). Through board meetings, as well as bi-monthly FSC meetings and other high-level bilateral meetings, the MoF is well informed of the measures taken, and coordination with the CBR and the DIA is informal but effective. There is coordination between the CBR and the DIA because the law provides the CBR broad authority to share information with the DIA.[14] In addition, the framework for information exchange and coordination of actions between the two agencies is defined by an agreement signed in 2004. Further, the DIA may make proposals to the CBR to conduct an inspection with participation of DIA staff or to take certain supervisory actions against a

[14] DI Law Article 27.

bank. Joint inspections by the CBR and the DIA are conducted with an emphasis on commitment to depositors, insurance premiums' payment, and the development of the deposit database. When considering open bank resolution or P&A transactions, the CBR can invite the DIA to participate in a joint inspection.[15]

14. Sharing information at an earlier stage could improve the resolution process. While the CBR consults with the DIA about taking resolution measures with DIA participation, and shares with the DIA supervisory actions and other information regarding problem banks, the authorities advised of practical constraints to share information on the timing of license revocation. This is due to the fraudulent activities bank owners and managers frequently conduct when they acknowledge that such actions would be taken against their bank, and thus necessitate special caution to ensure there are no leakages of the CBR's intervention.[16] Thus, information about a license revocation would not be shared with the DIA until the decision is officially made by the CBR. Such practical constraints against information sharing hamper early preparation by the DIA to further facilitate prompt reimbursement of insured deposits. CBR and DIA staff advised that information sharing at an earlier stage was contingent on first bringing down the number and scope of fraudulent activities. The authorities should further intensify their efforts to hold bank owners and managers liable for fraudulent activities to ensure that the negative consequences of fraud outweigh their benefits.[17]

C. Cross-Border Coordination and Cooperation

The resolution authority should have the capacity in law, subject to adequate confidentiality requirements and protections for sensitive data, to share information, including recovery and resolution plans, pertaining to the group as a whole or to individual subsidiaries or branches, with relevant foreign authorities, where sharing is necessary for recovery and resolution planning or for implementing a coordinated resolution. Jurisdictions should provide for confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities.

15. The CBR was provided stronger legal power to share information with foreign authorities. Prior to 2014, the CBR was prohibited from providing information on individual client transactions to foreign authorities. Under the current law, the CBR may share information and documents received from banks, including those that constitute bank secrecy, provided that the

[15] Insolvency Law Article 189.47.

[16] DIA staff advised that criminal activities by bank owners and managers were detected in more than 80 percent of bank bankruptcies. Criminal activities often observed are asset stripping; splitting deposits of individuals (in order to increase deposit insurance coverage); changing the status of the depositor from a legal entity to an individual (to make them insured deposits); artificial records to form balances of accounts of individuals; destruction of IT servers and databases, and so on. Due to such illegal actions by the bank owners and managers, the asset recoveries in liquidation are on average fewer than 10 percent for all creditor claims.

[17] The DIA conducts an investigation of circumstances of the bank's bankruptcy, and shares its findings with law enforcement agencies. In addition, the Criminal Code was amended to make intentional false reporting to the CBR a criminal offense punishable by up to four years' imprisonment.

authority receiving such information treats it with the same level of confidentiality as the Russian authorities. The law was also amended to explicitly empower the CBR to exchange information relating to recovery plans (except state secrets) with foreign resolution authorities.[18] Furthermore, the law strengthened the confidential treatment of information shared by foreign authorities.[19]

16. Based on this new authority, the CBR plans to update and enter into new Memorandums of Understanding (MoUs) with foreign authorities for sharing information relating to bank resolution. Recently updated MoUs with foreign authorities include provisions aimed at enhancing cooperation regarding resolution and crisis management, for example, notification of resolution measures, measures to protect deposits in a parent institution, measures for cross border liquidity support, or other support measures. The CBR plans to negotiate to incorporate such clauses in existing MoUs with other foreign authorities. In addition, the CBR expects to enter into new MoUs with foreign authorities that have previously expressed concerns regarding the disclosure of confidential information to third parties, based on the new legal underpinning ensuring confidential treatment of exchanged information.

17. Resolution colleges should be established or the scope of supervisory colleges expanded to cover recovery and resolution planning. As a home country supervisor, the CBR hosts supervisory colleges for two D-SIBs (Sberbank and VTB), but the meetings have not been held since 2012. In addition, the CBR participates in supervisory colleges established for 10 international banking groups, including two foreign D-SIB subsidiaries.[20] Information shared through participation in such colleges is of a generic nature. The CBR should step up its effort to strengthen cross-border coordination for crisis management and resolution through broader participation in supervisory colleges.[21]

CRISIS PREPAREDNESS

A. Financial Stability Assessment and Contingency Planning

In view of the interplay between the real economy and the financial system, it is important that jurisdictions have a robust framework for macroprudential surveillance and the formulation and implementation of financial stability policy.

[18] CB Law Article 51, Article 51^1, Banking Law Article 26.

[19] The law prohibits the CBR from disclosing any information received from a foreign authority to third parties, including law enforcement bodies, except with the consent of the corresponding foreign authority. This, however, does not apply when transmitting such information to a court based on a criminal court proceeding.

[20] Sixteen foreign banks hold 7 percent of system assets in Russia (7 percent of GDP). Russian banks' foreign subsidiaries are primarily located in Austria, Cyprus, and Turkey with total exposures of 2–3 percent of Russian GDP.

[21] The CBR plans to start discussions on coordination arrangements with relevant foreign authorities once it has adopted regulations on recovery and resolution plans (see paragraph 26).

18. The CBR has strong technical capacity for systemic risk monitoring and assessment. As the regulator of banks, nonbanks, and financial markets, the CBR has extensive data and is in a position to conduct comprehensive risk assessments. The CBR conducts quarterly top-down stress tests for all banks and ad-hoc bottom-up stress tests for the largest banks. A recently developed early warning system provides weekly risk assessments based on over 30 indicators.[22] Regular stress tests are conducted for specific lending segments and for nonbanks. Surveys are conducted regularly for the 30 largest corporates and financial soundness is analyzed for the 87 largest companies on the basis of IFRS and Russian Accounting Standards reporting, as well as other public sources. The CBR also conducts weekly surveys for short-term liquidity risk assessments and forecasting. Stress test results and other assessments are discussed within the FSCom and presented to the FSC, and published in CBR's *Financial Stability Review* and annual *Banking Supervision Report*. A comprehensive set of weekly financial stability indicators discussed among CBR management appears to be an effective tool for monitoring developments in financial markets and the banking sector.

19. In addition to regular stress tests, a granular and comprehensive AQR is recommended to better assess financial conditions of banks, reduce uncertainty, and support confidence. Stress tests and the Basel Core Principles (BCPs) assessment, performed in relation to the FSAP, identified room to improve asset classification and valuation and expand the scope of the definition of related party lending. Transparency of banks' asset quality has also decreased following the prolonged economic contraction and the use of regulatory forbearance. A comprehensive review of banks' asset portfolios and collateral valuations could thus play a crucial role in putting the banking sector on a stronger footing, including by addressing related party lending. The AQR could be conducted by the CBR itself or by a third party (Annex 1). Prior to the AQR, the authorities should formulate a strategy to address the weaknesses that the AQR may uncover, including developing criteria for the possible use of public funds for banks' recapitalization. Given the level of effort involved, the AQR could first be conducted for those banks presenting the highest risks to the financial system.

20. The CBR has developed and used a number of macroprudential policy tools to deal with identified risks, mainly stemming from certain types of lending to households. The CBR has tightened provisioning requirements and increased capital risk weights to curb excessive growth of unsecured consumer lending. For mortgage lending, the CBR has preemptively adopted differentiated capital risk weights based on loans' risk characteristics. In 2016, the CBR also introduced stricter reserve requirements for banks' foreign-currency deposits and higher capital risk weights on banks' foreign-currency loans in an attempt to reduce dollarization in the economy.

21. Going forward, a stronger focus on macrofinancial linkages could be beneficial. Specifically, it would be important to complement the existing stress tests with additional analysis of

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[22] Triggers (caps and floors) are set for each indicator. Banks' actual data is analyzed in comparison with these triggers, and a bank breaching a trigger is categorized as being in a "risk zone." Special supervisory attention is paid to institutions that are in the "risk zones."

macrofinancial linkages (related to oil prices, in particular) and feedback loops between the real and financial sectors. In the medium term, greater volatility driven by oil price movements may warrant a larger buildup of buffers to protect banks against solvency risk. The buffers could be implemented in the context of the countercyclical capital buffer under the Basel III framework or Pillar 2 under the Basel II framework.[23]

22. The CBR advised that an internal contingency plan has been developed and can be activated in times of extreme stress. The plan benefits from the authorities' extensive experience in managing past crises. Its operationalization is well tested, as is coordination among the safety net authorities.

B. Strengthening Banks' Loss Absorption Capacity

It is critical that a high quality capital base backs banks' risk exposures and that an adequate stock of unencumbered quality liquid assets covers their liquidity profile. There must be sufficient loss-absorbing and recapitalization capacity available in resolution to implement an orderly resolution that, with a high degree of confidence, (1) minimizes impacts on financial stability; (2) ensures the continuity of critical functions; and (3) avoids exposing taxpayers to loss.

23. The CBR has intensified its supervision of banks considered of federal and regional importance.

- Ten D-SIBs have been identified in line with CBR's methodology of size, complexity, and systemic interconnectedness. In 2013, a special division was established to supervise the D-SIBs, along with five other large banks. The CBR has authorized supervisors on site in all D-SIBs, as well as in banks that have received funds from the government capital support programs.

- Additionally, there are banks (currently about 140) that are recognized to be of federal or regional importance and fall within CBR's second line of supervision. Significant supervisory decisions of such banks are made with the participation of the CBR head office and management. Some of these banks would be considered systemic on a case-by-case basis in the context of resolution. Although the mission did not conduct a full assessment of these banks, it is unclear whether they are indeed systemic from a financial stability perspective, as the criteria for determining regional importance is based on their impact on industries or enterprises within a specific region.[24]

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[23] CBR Direction No. 3855-U of November 30, 2015.

[24] In late 2013, DIA, in cooperation with the CBR, assessed the financial position of a number of banks in order to determine whether open bank resolution would be feasible. The assessment showed that this would be economically infeasible, in that the funding needed would exceed the DIF's funding liability in liquidation. The banks were consequently liquidated without causing financial instability (Novokuznetskiy Municipalniy Bank, Smolensk Bank, and Evropeisky Investment Commercial Bank).

24. Implementation of Basel III has already improved the quality of banks' capital. Russia has adopted the Basel timetable for implementation of the Basel III capital framework. This resulted in welcome changes in the definition of eligible capital in January 2016, which, inter alia, excluded reciprocal cross holdings and investments in affiliated entities.[25] D-SIBs also need to observe the liquidity coverage ratio and the additional systemic capital buffer. D-SIBs must comply with the Internal Capital Adequacy Assessment Process (ICAAP) on a solo basis by end-2016 and on a consolidated basis by 2017.[26] Through its Supervisory Review and Evaluation Process (SREP), the CBR will be able to determine bank-specific capital buffer requirements under Pillar 2 of the Basel II framework.[27] Finally, Russia plans to introduce Total Loss Absorbency Capital (TLAC) requirements for Russian subsidiaries of G-SIBs in line with FSB's recommendation and phase-in arrangements starting in 2019. As in many countries, preparations are at a preliminary stage.

25. The framework for loss absorbency capital requirements should be considered in conjunction with the ongoing discussions of introducing statutory bail-in. Given that instruments eligible for loss absorbing capital will need to absorb losses and contribute to recapitalization in case of resolution, it is essential that the authorities possess the necessary legal powers to expose such instruments to loss, and that they can exercise their powers without material legal risks or giving rise to compensation costs under the "no creditor worse off than in liquidation" principle. Similarly, the authorities must be confident that the holders of these instruments are able to absorb losses in times of stress in the financial markets without spreading contagion and without necessitating the allocation of losses to liabilities where that would cause disruption to critical functions or significant financial instability.[28] To ensure that such loss absorbing capital instruments are able to absorb losses prior to other liabilities, it would be necessary that the instruments be junior in the statutory hierarchy, if they are not contractually subordinated to other liabilities (see paragraph 42 and Box 4). Reflecting the complexity of implementing loss absorbency capital requirements, the authorities may want to consider a simpler way of increasing loss absorbency capacity, that is, by increasing banks' minimum capital adequacy requirements.

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[25] Consequently, the CBR reduced the regulatory minimum capital adequacy ratio from 10 to 8 percent, the level equivalent to Basel guidelines for minimum capital. The new definition of eligible capital will strengthen the quality of banks' reported capital because of higher required common equity (Tier1); the overall minimum effective capital, however, will be temporarily reduced. The CBR estimates that the stricter definition of capital lowered the sector reported capital by 0.6 percentage points compared with the definition in place.

[26] For other banks, the timeline is 2017 for solo and 2018 for consolidated.

[27] Based on legal powers acquired in 2013–14, the CBR issued regulations in 2015 to strengthen banks' risk management and governance, and the CBR's risk-based supervision. These include CBR Ordinance No. 3883-U on the Assessment of Quality of Risk and Capital Management Framework and Capital Adequacy of Credit Institutions and Banking Groups performed by the Bank of Russia (December 2015) and Ordinance No. 3624-U on the Requirements for the Risk and Capital Management System of a Credit Institution or a Banking Group (April 2015). The intended prudential outcomes will critically depend on the regulations' effective implementation, monitoring, and supervision.

[28] FSB, "Principles on Loss-Absorbing and Recapitalization Capacity of G-SIBs in Resolution Total Loss-Absorbing Capacity (TLAC) Term Sheet" (November 2015).

C. Recovery and Resolution Planning

With the aim of making the recovery or resolution of any firm feasible without severe disruption and without exposing taxpayers to loss, jurisdictions should have in place an ongoing process of recovery and resolution planning. The process should cover, at a minimum, domestically incorporated firms that could be systemically significant or critical if they fail.

26. The CBR is in the process of designing a new framework for Recovery and Resolution Planning (RRP) based on its newly acquired legal powers. Since December 2014, D-SIBs have been legally required to submit so called financial stability recovery plans, and the CBR may require other banks to submit recovery plans as well. The CBR has also been tasked with preparing resolution plans for D-SIBs.[29] Three regulations are currently being drafted: (i) a regulation to set out the framework for recovery plans; (ii) a regulation to state the CBR's assessment methodology of recovery plans; and (iii) a regulation on the CBR's resolution planning. The CBR is advised to bring the recovery planning process into line with the ICAAP timeframe to encourage banks to establish recovery plans as an integral part of their risk management framework.

27. Six of the 10 D-SIBs and 34 other banks have submitted financial stability recovery plans on a voluntary basis pursuant to a non-binding CBR letter issued in 2012.[30] CBR has approved one plan, and has evaluated and issued recommendations for further revisions on most plans. The CBR 2012 letter closely follows the requirements set forth in the FSB's KAs, but due to the voluntary nature of the exercise, CBR staff indicated that the content and the quality of the plans varied significantly among banks.[31]

28. In the medium term, all banks should be required to prepare and submit recovery plans. Priority should be given to banks identified by the CBR as systemically important in resolution, that is, banks of federal and regional importance as well as D-SIBs.[32] The requirements should be implemented in a way that reflects the nature, complexity, interconnectedness, level of substitutability, size, and extent of cross-border operations of the bank. Accordingly, the requirements for development and maintenance of recovery plans for small banks should be less detailed and less extensive than those for D-SIBs.

29. The CBR should consider a phased approach to resolution planning. Resolution planning should be conducted for all banks that could be systemic in resolution. As is the case in

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[29] CBR Law Article 57.

[30] Letter No. 193-T, December 29, 2012, on Methodical Recommendations for the Development of Plans for the Restoration of Financial Stability of Credit Institutions. As of end June 2016, 15 other banks have submitted financial stability recovery plans.

[31] A detailed overview of the essential elements of Recovery and Resolution Planning (RRP) is provided in Annex 3 of the FSB KAs.

[32] The criteria for determining banks' systemic importance in resolution are based on the now invalid CBR Direction No. 2106-U. The regulation has been under revision since the adoption of the new resolution framework in December 2014.

many countries, resolution planning and resolvability assessments are still at an early stage. In light of the inherent complexity of resolution planning, the CBR should first focus on developing stylized guidance on resolution options, and then conduct preliminary reviews of bank-specific factors. Finally, the bank-specific analysis could be refined via resolvability assessments.

30. For an SOB, the resolution plan must consider the role of the state as a shareholder. If the plan is to provide for the use of public funds, it should seek to reduce the ultimate cost to the state. The resolution plan would in effect be a recovery plan, focusing on: (i) protecting the banks' critical function; (ii) raising liquidity; (iii) divesting non-core assets and business lines; and (iv) operationally restructuring to improve the banks' profitability going forward. The resolution planning process would also be an opportunity to explore whether for certain banks, particularly the partly state owned banks, there would be an alternative resolution strategy, for instance through bail-in once it becomes part of the resolution toolkit.[33]

31. Legal amendments are necessary to provide the CBR with the authority to require banks to adopt appropriate measures to improve their resolvability. The authority should include measures to change banks' business practices, structure, or organization to reduce the complexity and costliness of resolution, duly taking into account the effect on the soundness and stability of the ongoing business (KA 10.5).

EARLY INTERVENTION AND RESOLUTION TRIGGERS

A. Early Intervention

Early detection of weak or problem banks is crucial for the effective and stable functioning of the financial system. The supervisor should maintain a forward-looking assessment of individual firms' risk profile, increase the intensity of supervision as firms encounter difficulties, and have the adequate range of enforcement tools to bring about timely corrective action, address unsafe and unsound practices, and perform an orderly resolution before a firm becomes balance-sheet insolvent or poses a risk to the financial system.

32. The CBR has an adequate range of early intervention powers provided in different pieces of legislation. The powers include the authority to: impose penalties, issue instructions to eliminate violations of laws and regulations, restrict payment of dividends, require submission of a rehabilitation plan, replace management, impose a ban on certain operations, appoint a provisional administrator to manage the institution, and revoke the banking license.[34] The intensity of CBR's

[33] For example, in European countries with SOBs, resolution plans for such banks assume that they would be resolved in line with private banks, including the application of statutory bail-in.

[34] The Banking Law, CBR Law, Insolvency Law, and AML Law (115-FZ, August 7, 2001, on Combating Money Laundering and Terrorist Financing).

intervention, in practice, depends on the seriousness of each case.[35] As was observed in the 2011 FSAP, the CBR should consider adopting a transparent regime for supervisory actions, with a clearly delineated set of mandatory and discretionary supervisory measures as a bank's financial situation deteriorates. In addition, the authorities should reconsider the mandatory ban on accepting deposits from natural persons, as was recommended in the 2011 FSAP.[36]

33. Although the CBR has actively used its intervention powers in past years, most banks are already deeply insolvent when they enter into resolution. The mission sees four key areas for action:

- **Continue to close legacy problem banks.** Since 2013, the CBR has stepped up its effort to remove banks that are weak or involved in dubious transactions from the financial system. This is an ongoing process that may take some time to finalize.

- **Further strengthen supervision to ensure accurate reporting of financial information.** CBR audits frequently reveal overstated asset values and significantly less capital than reported. This creates "series breaks" as banks drop from a capital adequacy ratio above minimum to close or below zero. The Basel Core Principles (BCP) Assessment conducted as part of this FSAP provides guidance on areas to be addressed.[37] Further, in light of related-party transactions being the underlying factor for many bank failures, the authorities should consider making any related-party deposit, withdrawal, or loan over a certain amount subject to CBR approval for banks categorized below a certain rating by the Bank.

- **Strengthen legal protection of the CBR and its staff.** Lack of protection provided to the CBR and its staff acting in good faith may reduce the use of the CBR's powers to act on the basis of forward-looking assessments. Legal protection could help advance the CBR's transition from rule-based to risk-based supervision. Enhancing transparency of the early intervention framework would be a key factor in gaining public support for strengthening the CBR's legal protection.

- **Eliminate suspension of supervisory actions upon court challenges.** A challenge of a supervisory action suspends its execution until a court ruling is made regarding the appeal. The CBR's supervisory actions are sometimes challenged by a bank merely to delay their execution. In such cases, the CBR could be hampered in its ability to take necessary measures to prevent further deterioration of the bank's financial condition due to asset

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[35] See also BCP Assessment CP 11.

[36] The law binds the CBR, when certain conditions are detected, including the bank's failure to meet mandatory norms within six months, to ban banks from accepting deposits from natural persons, in compliance with the decision of the BSC. DI Law Article 48.

[37] CBR staff advised that the recent amendments to the Criminal Code, which make intentional false reporting a criminal offense, were already having positive effects. See footnote 17.

stripping or risky activities. In line with international good practice, a judicial action should not suspend or reverse early intervention measures taken in good faith (see paragraph 49).

34. Plans are underway to strengthen the CBR's supervisory authority. Draft legislation establishing a requirement for banks, external auditors and other professional service providers to pro-actively inform the CBR on matters of material significance will support the CBR in obtaining more accurate information regarding banks' financial condition.

B. Triggers for Entry into Resolution

Resolution should be initiated when a firm is no longer viable or is likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out. There should be clear standards or suitable indicators of non-viability to help guide decisions on whether firms meet the conditions for entry into resolution.

35. Triggers for entering into resolution could be strengthened to explicitly provide for forward-looking criteria based on non-viability. Resolution actions need to be taken at a sufficiently early point, ideally when the bank still has some positive net asset value, if there is no reasonable prospect of recovery outside of resolution. For resolution measures taken with DIA participation, entry into resolution is triggered when there are signs that the financial position is unstable, thus endangering the interests of its creditors (depositors). The instability of the bank's financial position is considered based on quantitative criteria specified in the law. These include the breach of the capital adequacy requirements, as well as "availability of other proof of a threat to the interests of creditors/depositors supported by documents."[38] For closure of banks without DIA participation, the grounds for license revocation include both mandatory and discretionary grounds. Mandatory grounds are based on the financial condition of the bank, but the criteria are relatively late. Discretionary grounds for license revocation include the bank's being subject to the CBR's order multiple times after a breach of law or regulation.[39] It is, however, not necessarily clear when a breach of a law or regulation and the subsequent CBR orders would justify license revocation, as in some cases, a license revocation could be considered disproportionate to the severity of the situation. To ensure that the CBR can take resolution measures when the bank becomes non-viable or is likely to become non-viable, it is recommended that such criteria be explicitly provided in the law. The authorities are encouraged to provide for further quantitative (objective) and qualitative

[38] Insolvency Law Article 189.47.

[39] The CBR often applies this criterion to revoke the license, before waiting for mandatory license revocation criteria to be met, by subjecting the bank to remedial measures after the bank falls below the minimum capital adequacy ratio or other prudential requirements.

(subjective and more flexible) resolution triggers. This would enable the use of the resolution powers before a firm is balance-sheet insolvent and before all equity has been fully wiped out.[40]

CRISIS MANAGEMENT

A. Scope of Resolution Regime

Any financial institution that could be systemically significant or critical if it fails should be subject to a special resolution regime.

36. Resolution tools should apply to the bank holding companies. Resolution tools and the special liquidation and bankruptcy proceedings with modifications from the general corporate proceedings are only applicable to banks, and not to bank holding companies.[41] As there are more than 40 bank holding companies in Russia,[42] the authorities should consider introducing resolution powers over the head entities of bank holding companies.[43] This would allow the authorities to take resolution actions against the parent company rather than, or as well as, the bank itself (for example, bail-in of creditors of parent entities rather than bank creditors/depositors), if this would allow for a more orderly resolution and ensure the preservation of financial stability.

37. Work is underway to strengthen the recovery and resolution regime for non-bank financial institutions. There are currently no special resolution frameworks applicable to systemically important financial institutions other than banks.[44] The law was amended end-2015 to require systemically important central counterparties CCPs to develop recovery plans, and the CBR to develop resolution plans. In addition, the authorities advised that a draft law was under discussion that would provide for the appointment of the DIA as the bankruptcy receiver and liquidator for insurance firms in bankruptcy and liquidation proceedings, respectively. The

[40] No framework of regulatory intervention or resolution can be effective if the data on which the supervisor relies are fraudulent. Therefore, it is of the utmost importance to ensure strong supervision, starting with vigilant implementation of recent regulations on risk management and supervision, and addressing the deficiencies identified in the BSC assessments. (See also section on early intervention.)

[41] It should be noted that the definition of "bank holding companies" in Russia refers to the bank holding company group rather than the parent entity of the bank holding company group (Banking Law Article 4). In this note, however, the term "bank holding company" is used to refer to the parent entity of the bank holding company group, as is typically the case.

[42] Numbers for bank holding companies are as of July 2015. In addition, there are over 110 banking groups (that is, groups of legal entities that are headed by a bank) as of end-March 2016.

[43] A draft law has been prepared that provides that the CBR and the DIA shall perform an analysis of the financial conditions of legal entities that form part of the same banking group (including heads of bank holding companies) when performing an analysis of a bank's financial condition to determine whether the DIA should participate in the resolution process. The draft law, however, does not provide the CBR with direct resolution powers over the head of bank holding companies.

[44] The CBR has developed an assessment methodology for designating domestically systemically important insurers (D-SIIs) (internal methodology, not published) and systemically important financial market infrastructures (FMIs) (Ordinance No. 3341-U). The CBR has designated 22 D-SIIs (not published) and two systemically important FMIs (published).

authorities may want to consider whether the current bankruptcy and liquidation procedures applicable to insurance firms would allow critical functions to be maintained (for example, continuity of insurance policies and prompt insurance payments) through insurance portfolio transfers and insurance run-offs.

B. Resolution Powers and Safeguards

Resolution authorities should have at their disposal a broad range of resolution powers. They should include the ability: (i) to achieve continuity of systemically important or critical functions by way of (a) a sale or transfer of all or part of the firm's business, shares, or assets, either directly or through a bridge institution; or (b) an officially mandated creditor-financed recapitalization (bail-in); and (ii) to provide for the orderly closure and wind-down of all or parts of the firm's business in a manner that protects insured depositors, insurance policy holders, and retail customers.

Resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal treatment of creditors of the same class (with transparency about the reasons for the departure), if necessary, to contain the potential systemic impact of a firm's failure or to maximize the value for the benefit of all creditors as a whole. Creditors should have a right to compensation of, at a minimum, what they would have received in a liquidation of the firm under the applicable insolvency regime ("no creditor worse off than in liquidation" safeguard).

Resolution powers

38. Other than liquidating a failed bank and paying out depositors, the CBR has the power to conduct an open bank resolution or a P&A transaction with DIA participation.

39. The CBR may conduct an open bank resolution with DIA participation as follows:

- *Eligibility:* The law provides that the CBR can propose that the DIA participate and provide financial assistance for the open bank resolution when the interest of depositors and creditors and/or the stability of the banking system are endangered.[45] While the law is thus unclear as to whether the measure is limited to systemic cases, internal CBR rules require that banks meet the following criteria of "systemic-ness," that is, when a bank's failure poses: (i) a threat of deposit runs in other banks; (ii) a threat to the operation of the financial market, specific economic sectors, or large employers and taxpayers; (iii) the need for

[45] Insolvency Law Article 189.47(1). The condition provided in the law differs from the condition provided for DIA participation in P&A transactions in that the former includes the condition "and/or the stability of the banking system." The provision is unclear, however, as to whether the risk to financial stability is an essential criterion for bankruptcy prevention measures with DIA participation.

substantial payouts from the DIF; and (iv) a risk of defaults among the public and/or a wide range of enterprises and organizations.[46]

- *Use of public funds:* The DIA may provide financial assistance in the form of: (i) collateralized below-market rate loans to a failed bank or an investor that acquires more than 75 percent of the failed bank's ordinary shares; or (ii) a contribution to the authorized capital of the failed bank.[47] The financial assistance is funded with uncollateralized CBR loans or federal funds (see section on resolution funding). The DIA may also acquire part of the failed bank's bad assets in relation to the transaction (that is, in the form of a good bank/ bad bank split).[48]

- *Appointment of the DIA as provisional administrator:* In addition to managing the bank, the DIA as provisional administrator has broad powers to override shareholder rights to issue new shares or to restructure the resolved bank.

- *Writing down capital and issuing new shares:* The CBR may write down the amount of authorized capital of the failed bank, and the provisional administrator (DIA) may adopt a decision to issue new shares overriding pre-emptive rights of existing shareholders. Such issuance of new shares shall result in the DIA's and/or the investor's acquiring more than 75 percent of the failed bank's ordinary shares.

- *Determination of acquirer:*[49] The acquirer is determined based on a competitive bid requesting the least financial assistance among those that satisfy the necessary financial status as determined by the CBR.

40. The CBR may conduct a P&A transaction with DIA participation as follows:

- *Eligibility:* Where there are signs of the instability of the bank's financial position endangering the interests of its creditors (depositors),[50] the CBR may request the DIA to participate in a P&A transaction. One of the conditions for DIA participation is that the value

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[46] The guidelines are spelled out in the now invalid CBR Direction No. 2106-U. The regulation has been under revision since the adoption of the new resolution framework in December 2014.

[47] Insolvency Law Article 189.49(8)–(12).

[48] The DIA used this power to purchase the failed banks' bad assets during the previous crisis in 2008, but has not done so in the current crisis. The authorities noted that this is because of the large amount of resources necessary to manage and collect from the bad assets acquired by the DIA, and their assessment that this function is better performed by other banks.

[49] In Russian, the acquirer is referred to as the investor.

[50] Signs of the instability of the bank's financial position endangering the interests of its creditors (depositors) shall include, in particular (1) evidence from the bank's own reports and/or as established by the CBR, DIA, or other persons, showing [without doubt] that the bank's financial condition is (or will be) in breach with the conditions for participation in the DIF; and/or (2) meet the criteria for measures aimed at bankruptcy prevention measures; and/or (3) other documented proof that the interests of creditors/depositors are endangered.

of the bank's assets is sufficient for conducting P&A transactions. [51] Transferred assets must be equal to transferred liabilities.[52] In practice, book value is used to determine whether transferred assets are equal to transferred liabilities.

- *Use of public funds:* The DIA can provide financial support in the form of (i) financing a reverse transfer (as a put-back option) or (ii) granting a loan for liquidity needs.[53] The funding may be provided by the DIF within the payout cost if it does not affect the stability of the DIF.[54] If financing by the DIF is not possible, the DIA may provide financial assistance through its own account with federal budget financing.

- *Appointment of the DIA as provisional administrator.*

- *Transfer of assets and liabilities:* The acquirer is decided based on a competitive bid requesting the least financial assistance from among those that satisfy the necessary financial status as determined by the CBR. The acquirer has 14 days to evaluate and choose the assets to acquire, and to complete the P&A transaction.[55] Transfer powers are exercisable without the consent of the shareholders or the creditors.

41. There is room for improvement of the effectiveness of the resolution framework. First, in cases where the failed bank was considered systemic or regionally important, most often the authorities applied open bank resolution and saved the entire bank, rather than focusing on the continuity of its critical functions and viable operations through a partial business or asset and liability transfer. This required the use of a large amount of public funds (see section on resolution funding). Second, for banks that were not considered systemic or of regional importance, the authorities liquidated the entire bank and conducted insured deposit payouts. A P&A transaction could be useful even when the bank is non-systemic as an alternative to conducting an insured deposit payout (Box 2).[56]

[51] The joint assessment is based on a fair value methodology, as stipulated in CBR Instruction 3691-U. For P&A transactions, additional work is conducted and presented in accordance with Instruction 3707-U.

[52] Insolvency Law Article 189.51(2) and 189.52(7). The law does not specify that assets be evaluated based on book value. This requirement is established in CBR guidelines.

[53] Insolvency Law Article 189.52(10) and 189.55(2)–(4).

[54] Insolvency Law Article 189.56(4).

[55] Insolvency Law Article 189.52(1).

[56] In the limited cases in which banks were resolved with P&A transactions, the P&A transaction did not necessarily capture the benefits usually associated with such transactions; that is, minimal disruption of financial services and preservation of the banks' franchise value (see also Box 2). For example, in the case of Nota Bank, which was one of the two banks resolved with a P&A transaction in 2015, the P&A took place two months after the bank was put under CBR's provisional administration. A moratorium was imposed, and by the time the P&A transaction was announced and conducted, 50 percent of insured depositors had already received insurance payouts, and borrowers had been instructed to make payments through other banks to honor their obligations.

42. The authorities should adopt the full range of resolution powers recommended in the FSB KAs in order to make resolution less costly, while preserving the bank's critical functions. This would entail broadening and enhancing existing powers, as well as introducing new powers.

- *Control or operate a bank.* During resolution, the CBR, or a provisional administrator appointed by the CBR, should have broad powers to take control of all decision-making bodies of the ailing bank, including the management board, the supervisory board, and the general assembly of shareholders (KA 3.2). The administrator should be competent to make any transactions and decisions. It should have the authority to override shareholder rights, including (i) requirements for approval by shareholders of particular transactions, (ii) forced recognition of losses and write-downs of the value of shares, and (iii) derogation or limitation of preemption rights to allow the prompt entry of new participants. Under the current Russian resolution framework, such broad powers for taking control of the ailing bank are only provided to a provisional administrator appointed when bankruptcy prevention measures are taken with DIA participation.[57] To facilitate the resolution of non-viable banks, whose owners are unable or unwilling to raise new capital, it is recommended that the CBR or the provisional administrator should be armed with the same powers as required when measures are taken in resolution with DIA participation, with the important difference that the use of public funds would not be an option.
- *P&A transactions.* While the authorities have the general power to use P&A transactions to resolve both systemic and non-systemic banks, certain legal and operational impediments hamper the broad application of such transactions. The obstacles include (i) the use of book value in determining the scope of transferable assets, (ii) financing constraints, (iii) restrictions on deviating from *pari passu* treatment, and (iv) the lack of preparation time prior to the bank's failure (Box 3).
- *Statutory bail-in powers*. Introduction of statutory bail-in will enable recapitalization of a failed bank by imposing losses on existing creditors or converting their claims to equity (KA 3.5). From the experience of using voluntary bail-in to conduct open bank resolutions,[58] the authorities are planning to introduce statutory bail-in.[59] They noted that the triggers for its application, as well as the scope and the order of bail-in-able liabilities, is still under discussion. Although the legal framework should provide for the power to apply statutory bail-in to all banks, as a matter of practice, due to the complexity of the transaction, the tool

[57] The power of the provisional administrator appointed without DIA participation is limited, and requires the approval of the Board of Directors and/or the general assembly of shareholders in order to conduct certain business transactions. Participation in the management of troubled banks can therefore create reputational risk for CBR and/or a contingent fiscal liability. CBR rarely appoints provisional administrators without DIA participation.

[58] In 2015, voluntary bail-in was used in two cases of bankruptcy prevention measures with DIA participation (Tavrichesky Bank and Fundservice Bank). Both involved writing down the capital to 1 ruble, converting current deposits of large corporate depositors to subordinated long-term (20 and 10 years, respectively), below-market rate (0.51 percent) deposits, and bringing in Rossiysky Capital as a temporary owner until an investor is found.

[59] The authorities plan to develop a draft bill by end-2016.

would seem best suited for the resolution of large, complex systemic banks. For less complex, relatively small banks, a P&A transaction or a liquidation of the whole bank would in most cases be more suitable. To ensure feasibility of loss absorbing capacity in resolution and to reduce the risk of legal challenges, the bail-in framework needs to be carefully designed, taking into account the creditor hierarchy in liquidation, while allowing deviation from *pari passu* treatment in exceptional cases (Box 4).[60] The timing of introducing bail-in powers should be carefully considered in light of financial stability concerns. While early introduction of statutory bail-in would enable the authorities to reduce the use of public funds, such a measure could cause deposit or liquidity outflows from relatively weak, small banks if introduced in time of financial distress.[61]

- *Power to establish bridge entities and asset management companies*. The law does not provide the power for the resolution authority to establish a bridge entity or an asset management company. This would enable the authorities to take over and continue operating certain critical functions and viable operations of a failed bank (KA 3.4) or to transfer nonperforming loans or difficult-to-value assets (KA 3.2).[62]

- *Continuity of critical functions*. To ensure the continuity of essential services and functions, the authorities should be equipped with the power to require other companies in the same group to continue to provide essential services to the ailing bank, any successor, or an acquiring entity, or to procure necessary services from unaffiliated third parties (KA 3.2).[63] In addition, the residual entity in resolution should also be able to temporarily provide such services to a successor or an acquiring entity.

- *Temporary stay of early termination rights*. While the CBR has the power to impose a moratorium based on the occurrence of certain events, the CBR does not have the power to temporarily stay early termination rights that may arise merely from the entry into resolution of the ailing bank (KA 4.3).

[60] The authorities noted that the change of creditor hierarchy is currently not being discussed.

[61] Such effect, however, could also be observed in the case of introducing an effective P&A framework.

[62] While the DIA could currently possibly use its subsidiary, Rossiysky Capital, to perform bridge functions, it would be desirable to provide the legal power to establish bridge entities to enable the authorities to conduct temporary transfers, regardless of the ownership stake in a failed bank.

[63] In its discussions with CBR and DIA staff, banks, and consulting firms, the mission was advised that outsourcing of domestic as well as foreign banks' essential functions was rare due to concerns about fraud and security issues.

Box 2. Purchase and Assumption Transactions

In a P&A, an investor bank will purchase certain assets and assume insured deposits and other liabilities of the failed bank. If the liabilities transferred exceed the assets transferred, then the DIF must provide financial assistance to fill the difference and balance the transaction, but not to exceed the amount needed to reimburse insured depositors in a straight liquidation.

The general benefits of a P&A transaction are that it provides depositors with prompt access to their insured deposits, and performing assets of the failed bank are quickly transferred to a healthy bank so that their value is maintained and remain in the private sector. In addition, a P&A transaction may be more attractive to investor banks because the assets and liabilities transferred are clearly defined, and there is limited risk of facing unexpected liabilities, including litigation.

These benefits help promote and preserve confidence in the banking sector, minimize disruption to bank customers, and preserve financial stability by minimizing the likelihood of a bank run and contagion to the rest of the banking sector. The goal is to make insured deposit payments as soon as possible. Intense advance preparation for bank intervention and resolution is critical to accomplish an effective P&A transaction.

P&A is always less costly than a liquidated payout, simply because the liquidation process bears a significant cost and is a direct reduction of the recoveries through liquidation, thereby reducing funds available to distribute to uninsured depositors and other creditors. Note that a legislated two-tiered deposit preference rule (insured deposits get super priority) permits ease of a P&A transaction because the transfer of insured deposits would always satisfy the "no creditor worse off than in liquidation" principle under such rules.

Focusing on the scope of assets to be transferred, P&A transactions can be largely categorized into the following three types of transactions:

Basic P&A. The investor takes on only limited assets, usually cash and cash equivalents. Bank premises, including furniture and fixtures, can be offered on an optional basis, with a purchase price to be agreed upon by the acquirer and the resolution authority.

Loan Purchase P&A/Modified P&A. The investor acquires selected assets in addition to cash and cash equivalents (for example, performing loans, mortgage loan portfolio, selected nonperforming loans). The following arrangements could provide incentives for investors to take on a large share of the assets:

- *Provide a "put" option on some of the transferred assets.* The investor is granted the power to return transferred assets to the resolution authority within a specified period of time (for example, 60 or 90 days) if the value turns out to be of less quality than previously assumed. The disadvantage of this arrangement is that during the put back period, assets can deteriorate from lack of attention, thereby making them harder for the resolution authority to market or collect on later.
- *Enter into a (profit and) loss share agreement.* The investor and the resolution authority share any future losses (and possibly also profits) on a defined set of assets. The investor is usually reimbursed for a percentage of the expenses associated with managing the assets. The investor also assumes a percentage of the losses, which should incentivize the investor to engage in good credit management. The disadvantage of this arrangement is that the investor must work with the resolution authority throughout the term of the loss share agreement and take on administrative duties, which may not be attractive to potential investors.

Whole Bank P&A. The acquirer purchases the entire portfolio of the failed bank on an "as-is" basis with no guarantees. This type of sale minimizes the outlay of cash and reduces the assets held for future liquidation.

Sources: David Parker, *Closing a Failed Bank* (IMF, 2011); Claire L. McGuire, *Resolution of Troubled Banks* (The World Bank, 2012); David S. Hoelscher, *Guidelines for Bank Resolution* (IMF, 2002).

Safeguards

43. The resolution framework should be amended to provide for shareholder and creditor safeguards. The resolution authority should, as a general rule, be required to allocate losses through the exercise of resolution powers in a way that respects the hierarchy of creditor claims in liquidation and the principle of equal treatment of creditors in the same class (KA 5). All creditors should be compensated a minimum of what they would have received in liquidation ("no creditor worse off than in liquidation"). As noted in Box 3, this principle is only narrowly adopted to apply to first priority creditors in P&A transactions. It should be employed to protect all creditors and for the exercise of all resolution tools.

44. On the other hand, the legal framework should permit departure from *pari passu* treatment of creditors in clearly specified circumstances. Such departure should be permissible only in exceptional circumstances, where it is necessary to protect financial stability by containing the systemic impact of the firms' failure, or to maximize the value of the firm for the benefit of all creditors (KA 5.1).

Box 3. Impediments for the Use of Purchase and Assumption Transactions Under the Russian Resolution Framework

The following impediments exist for the use of P&A transactions in Russia, effectively excluding P&A as a tool for orderly resolution of systemic banks.

- **The use of book value in determining the scope of assets.** In determining the equivalent amount of assets and liabilities to transfer, assets are evaluated at book value (see paragraph 40). As such, the acquirer only has an incentive to acquire the best (performing) assets, so as not to incur a loss from the transaction. This substantially limits the availability of the assets that could be attractive to the acquirer, and hence the applicability of P&A transactions. The authorities should consider using fair value rather than book value for the evaluation of transferred assets.

- **Financing constraints.** The DIA may only provide financing for P&A transactions in relation to a reverse transfer of assets (from the acquirer to the DIA due to the bad quality of assets) or a loan to provide liquidity to the acquirer. The law does not allow the DIF to finance the difference between the value of the transferred assets and the transferred liabilities, which would be the typical way to fund a P&A transaction when there are insufficient assets to transfer. The DIF should be able to fund the negative balance of the transferred assets and liabilities subject to the payout cost. Under the temporary resolution framework introduced in 2008, the DIF was given the power to fund such differences, but such power is not provided under the permanent framework introduced end-2014.

  Another financing issue is that the law allows the CBR to provide loans to the DIA to finance open bank resolutions, but not to finance P&A transactions. While the use of CBR loans is in general not recommended, allowing the use of such loans for open bank resolution but not for P&A transactions could distort the choice of resolution tools in favor of open bank resolution.

  The authorities advised that draft laws are currently being discussed to eliminate both funding constraints.

- **Deviation from *pari passu* treatment is not allowed except for the transfer of insured deposits.** The law requires that all of the failed banks' liabilities that fall under the same priority in liquidation generally need to be transferred together. The only exception is insured deposits, which the DIA may transfer without transferring the other first priority creditors (for example, the uninsured amount of individual depositors). This could be an issue due to the broad range of creditors that are categorized as third priority creditors in Russia. Third priority creditors include secured creditors, corporate depositors, and other corporate unsecured creditors. While in general, creditors should be treated *pari passu* within the same class, the authorities should have the flexibility to deviate if that would maximize the return to all creditors or if it is essential for the maintenance of financial stability, subject to the principle that no creditor is worse off than in liquidation. Currently, the principle is provided only in relation to individual depositors; an individual depositor would be compensated from the DIF the difference between what would have been received in liquidation regarding the uninsured deposit if the P&A transaction had not occurred.

- **Lack of preparation time.** P&A transactions enable the continuity of financial services without disruption. To reap such benefits, it is essential that the P&A transaction occur immediately after the failure of the bank, with no interruption of the bank's operation (for example, the transfer occurs during the weekend). This would require early and thorough preparation prior to the failure of the bank to evaluate the assets and to determine the acquirer. As noted earlier, advance preparation could be a challenge in Russia due to concerns of information leakages leading to fraud or other criminal activities. In that respect, in addition to the existing power to conduct reverse transfers of the transferred assets, the use of a temporary bridge bank could be useful to allow for the necessary time to determine the acquirer and determine the value of the assets.

Box 4. Issues to Consider in Introducing Statutory Bail-In

Scope of bail-in-able liabilities. The scope of bail-in-able liabilities should be determined to (i) include liabilities that can absorb losses without causing disruption to financial stability and (ii) minimize legal risks.

- *Type of liabilities.* The FSB recommends that instruments determined as loss absorbing capital instruments: be paid in; be unsecured; not be subject to setoff or netting rights; have a minimum remaining contractual maturity of at least one year; and not be redeemable by the holder. In addition, insured deposits and short-term deposits, liabilities from derivative contracts, and other liabilities that could give rise to financial stability concerns are excluded from the scope of such loss absorbing capital instruments.
- *Reducing legal risk:* The FSB recommends further that instruments defined as loss absorbing should be subordinated to other liabilities, preferably statutorily or structurally.

Consistency with creditor hierarchy in liquidation. Losses imposed on creditors should be consistent with the priority of claims in liquidation. In the allocation of losses in bail-in (that is, the order of bail-in in the law) differ substantially from the creditor hierarchy in liquidation as provided in the law, the authorities may face significant legal risks or it will become more likely that the authorities would need to compensate creditors.

- The authorities noted that one option under consideration is to apply the statutory bail-in powers in the following order:
  1. All shares and liabilities to shareholders (shares, as well as deposits of shareholders);
  2. subordinated debt;
  3. all liabilities to corporate entities exceeding a certain amount; and
  4. deposits of natural persons exceeding a certain amount.[1/]
- This order of bail-in-able liabilities largely deviates from the creditor hierarchy in liquidation as provided in the law. Bailing in ordinary shareholder deposits before subordinated creditors would entail providing certain (insider) senior creditors less protection than subordinated creditors. In addition, changes may be necessary to reflect that large depositors, both natural persons and legal entities, would rank lower in the creditor hierarchy compared to the other depositors.

Exclusion of certain liabilities from absorbing losses. The authorities can still apply more specificity as to which liabilities will be deemed loss absorbing capital and which liabilities will not. For example, some countries exclude certain liabilities from the scope of statutory bail-in in order to avoid causing disruptions to critical functions or raising systemic risks (for example, exclusion of insured deposits, short-term deposits, liabilities arising from derivative contracts, and the like from bail-in liabilities). In such cases, however, the loss absorbing capital needs to be properly subordinated, preferably statutorily (through revising the creditor hierarchy in liquidation) or structurally (by applying the bail-in to the non-operating parent entity of the bank so as not to require bail-in of depositors).

Safeguards. Adequate safeguards, such as a "no creditor worse off than in liquidation" requirement, can mitigate litigation risk by ensuring that a creditor who receives less in resolution due to bail-in or other resolution measures would be compensated. The authorities should apply the principle for all creditors, not only for individual depositors. In particular, equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt has been written off entirely (FSB KA 5.1). In addition, although the authorities should generally treat all creditors in the same class equally, the authorities should be allowed in exceptional circumstances certain flexibility to deviate from *pari passu* treatment, provided such treatment would be necessary to preserve financial stability and would increase the repayment for all creditors.

1/ Since the time of the FSAP mission, the FSC decided not to include large individual depositors in the scope of bail-in.

C. Bank Bankruptcy and Liquidation Proceedings

Authorities should develop procedures that allow for liquidating banks in an orderly manner. This involves rapidly transferring insured deposits and critical banking functions (for example, payment services, trade finance) out of the insolvent estate to continue operating as a going concern before the remainder is liquidated and removed from the market.

45. Banks are liquidated through court-based proceedings, with modifications introduced to the general bankruptcy and liquidation proceedings. The procedure ensures that the CBR has sufficient control over the commencement of such proceedings, oversight through appointment of the bankruptcy receiver and liquidator, and regular reporting requirements to the CBR.

46. It is recommended that the liquidation proceedings commence immediately after, or shortly after, license revocation. Under the current law, it could take a maximum of one and a half months to commence liquidation proceedings after license revocation. After the license is revoked, the CBR must petition the court for either liquidation or bankruptcy proceedings within 15 days, depending on the bank's solvency.[64] Further, the court takes the decision to commence liquidation proceedings within one month of the petition filing by the CBR. During this interim period from license revocation to commencement of liquidation proceedings, a CBR-appointed provisional administrator manages the bank.[65] Upon appointment of the administrator, a moratorium is adopted by the CBR on payment of creditors' claims. To ensure swift and orderly liquidation, a license revocation should trigger automatic commencement of liquidation proceedings.

47. The authorities should consider providing the bankruptcy receiver stronger powers to transfer assets and liabilities. The authorities noted that a P&A transaction with DIA participation could be used for banks, when conditions are met regarding economic feasibility. Without DIA participation, it is necessary to obtain the prior consent of the failed bank's creditors to transfer liabilities, after the acquirer is decided.[66] The bankruptcy receiver needs to provide notice of the transfer of assets and liabilities at least one month prior to the supposed date of the transfer. This process is lengthy, and the authorities advised that it is not used in practice. To preserve continuity of financial services, transfer of assets and liabilities should be conducted at the same time as the closing of the bank, without requiring creditors' prior consent.[67] The authorities should consider expediting the process for P&A transactions that are conducted without DIA participation.

[64] Banking Law Article 23.1.

[65] Insolvency Law Article 189.32.

[66] The requirement for obtaining prior consent of the creditors is made inapplicable for P&A transactions conducted with DIA participation.

[67] If creditor consent is considered necessary from the perspective of creditor protection, the authorities could consider introducing a procedure for creditors to oppose the transfer ex post and make the transfer null, retroactive for opposing creditors.

D. Legal Protection and Judicial Review

The resolution authority and its staff should be protected against liability for actions taken and omissions made while discharging their duties in the exercise of resolution powers in good faith.

The legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. Instead, it should provide for redress by awarding compensation, if justified.

48. As recommended in the 2011 FSAP, legal protection of the supervisory and the resolution authorities and their staffs should be strengthened. There are no special provisions in Russian legislation for protection of the CBR, the DIA, their staffs, or their agents (for example, bankruptcy receivers, liquidators, and so on) against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. Rather, the law provides that the head of the provisional administration for managing a credit organization shall be held liable for failure to discharge or for improper discharge of duties.[68] Individual employees could be held personally liable for their actions, and there is no indemnification for the costs incurred by individuals for defending against lawsuits. The supervisory and resolution authorities and their staffs and agents should be protected against liability for actions taken and omissions made while discharging their duties in good faith.

49. Furthermore, the scope of judicial review is not circumscribed. In addition to the fact that an appeal of a supervisory action suspends its execution, the courts may overturn supervisory and resolution actions based on the merits. While in most cases the court ruled in favor of the CBR, in some cases the court overturned or reversed the CBR's decision to take supervisory action or to revoke the bank's license.[69] As the burden of proof is on the CBR to substantiate that the CBR had grounds to take such actions, concerns about litigation may limit the scope in which the CBR may exercise discretionary powers and take a risk-based supervisory approach.[70] Litigation concerns may delay the determination to take early intervention measures or to enter into resolution on the grounds of forward-looking assessments (that is, non-viability). The law should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken

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[68] Insolvency Law Article 189.29. Furthermore, bankruptcy receivers are required to insure for losses that they could cause creditors participating in the bankruptcy case above a certain amount (Insolvency Law Article 189.77(10)).

[69] In 2014, 14 cases of bank license revocation were challenged in court, and one was overturned (in 2015, 22 were challenged with no overturns). When the license revocation order is overturned, the CBR is required to reinstate the license. As for orders against credit institutions (regional branches), 23 were challenged in 2014, 2 of which were overturned. In 2015, 3 cases were overturned out of 46.

[70] For example, the CBR recently faced a situation in which it had doubts regarding the quality of the subordinated debt issued offshore and whether it would qualify as Tier 2 capital. The subordinated debt in question, which was raised to fulfill CBR's call for additional capital to cover capital deficiency discovered during onsite inspection, involved transactions involving multiple countries, and it was unclear to the CBR whether there was a beneficial owner. Confronted with such difficulties, the CBR is now in the process of revising Regulation No. 395-P (On the method of determining the value and evaluating the adequacy of own funds (capital) of credit institutions ("Basel III")) to require the banks to demonstrate the quality of the subordinated debt for Tier 2 purposes.

by supervisory and resolution authorities acting within their legal powers and in good faith, with the burden of proof placed on the plaintiff (that is, the bank). Instead, it should provide for redress by awarding compensation, if justified.

SAFETY NET AND RESOLUTION FUNDING

A. Emergency Liquidity Assistance (ELA)

It is widely accepted that central banks should provide short-term liquidity support to the financial system in the event of a liquidity crisis, as a discretionary measure for individual banks as well as for the system as a whole. In the case of support to individual banks and to guard against moral hazard, the provision of liquidity should be provided to solvent banks at a spread to market rates, against good collateral, and with a clear, time-bound repayment plan. A government guarantee or indemnity should be sought if there is a risk that the bank might not be able to repay on the agreed terms.

50. During the past two years, the CBR's successful management of systemic liquidity has played a crucial role in maintaining financial stability. CBR liquidity provision—both domestic currency and foreign exchange (FX)—helped banks and markets weather the severe stress that followed banks and companies' loss of foreign market access and the large ruble depreciation. This was performed by adjusting the parameters of the existing monetary policy instruments and by introducing a market-wide repo to meet FX needs. At its peak in December 2014, provision of liquidity by the CBR amounted to 12 percent of the banking sector's total liabilities, but the CBR has since significantly drawn down its support (7 percent of liabilities at end-2015).

51. The CBR has in place a market support program aimed at reducing counterparty risk arising from revocation of bank licenses. The CBR Law was amended to provide the CBR the power to grant partial guarantees to banks and CCPs that had claims against banks that had their licenses revoked.[71] Under the arrangement, the CBR has signed agreements with a number of institutions that in periods of pronounced stress (as deemed by the CBR), the CBR guarantees 90 percent of the outstanding amount of interbank transactions with the failed entities. The CBR does not impose a fee for this commitment, and any potential losses (between the amount of the guarantee and the amount recovered in liquidation) are borne by the CBR. While it indeed may be that defaults in the interbank market or in centrally cleared transactions have potential systemic effects, it raises strong moral hazard concerns. The program shifts the majority of the risks associated with such transactions away from market participants to the public sector. It would be preferable to address the underlying credit concerns in the market through prudential measures or the application of bank resolution measures.

52. In addition to its framework for managing systemic liquidity, the CBR should consider establishing an emergency liquidity assistance (ELA) framework to meet the needs of

[71] CBR Law Article 46(7), introduced in June 29, 2015, by Federal Law No. 167-FZ. A similar program was used during the global financial crisis. The program has not been activated yet.

individual solvent but illiquid institutions. Such an arrangement should be at the discretion of the CBR and should only be extended once all other funding options have been explored. ELA should only be provided to solvent and viable institutions, with adequate collateral and at a spread to market rates. Government indemnities should be made available as required, especially when the CBR has concerns about the banks' financial conditions, the quality of the collateral, the length of support, or the exit strategy from the arrangement.

B. Funding Firms in Resolution

The resolution of firms whose failure could have systemic repercussions may require the provision of extraordinary financial assistance. Arrangements should be in place to provide temporary financing to facilitate effective implementation of a chosen resolution strategy. To limit the risk of moral hazard, public support should be subject to strict conditions and should be recovered from the industry.

53. Resolution measures may be funded either by the DIF or by the DIA's own account. The DIF may provide financing for resolution measures within the payout cost if such financing would not hamper the stability of the DIF.[72] All other financing for resolution shall be provided by the DIA's own account, either through the appropriation of the federal budget or CBR loans. The account for the DIF (funded by industry contributions) and the DIA's own account are financially segregated, and may not be used to finance the other account (Box 5). In the past five years, all resolution measures with DIA participation were funded by the DIA's own account, mainly with the use of CBR loans. During 2011–15, public funds used for taking resolution measures amounted to 1.6 percent of GDP, of which CBR loans amounted to 98.4 percent of the total (Figure 2).[73]

54. Use of public funds in resolution is subject to a strict requirement that shareholders and subordinated creditors absorb the first losses. In an open bank resolution, the DIA can provide liquidity and solvency support and purchase bank shares using its own funds.[74] Additional conditions include: (i) the appointment of a provisional administrator; (ii) an investor or the DIA acquiring at least a 75 percent stake in the bank; (iii) preparation of a restructuring plan that is subject to BSC approval; (iv) restrictions on the remunerations to the former management team, and (v) intensive monitoring by the DIA. In the event that the DIA becomes a shareholder in the resolved bank, the DIA is obliged to sell the stake in an open tender as soon as it is approached by an interested investor.[75]

[72] Insolvency Law Article 189.56(4).

[73] If replaced with federal funds in the form of direct asset contributions, the amount necessary would be 1 percent of GDP, which is the subsidy embedded in CBR loans of 1.6 percent of GDP.

[74] Insolvency Law Article 189.49(12).

[75] Insolvency Law Article 189.57. The DIA currently holds all the shares in Rossiysky Capital, which entered into open bank resolution in 2009.

Box 5. The Functions of the State Corporation Deposit Insurance Agency (DIA)

The DIA has several functions, each of which is financially segregated and thus cannot be used to fund other functions under the DIA's purview. The main functions are management of (i) the DIF (2004), (ii) the receivership of failed DIF member banks (2004); (iii) the Pension Savings Guarantee System (2014), (iv) the Government Recapitalization Program (2014), (v) the operational aspects of bank resolution (2008), and (vi) the receivership of non-public pension funds (2014). This box discusses financial risks related to items (i), (iv), and (v).

The mandatory Deposit Insurance Fund (DIF): All banks licensed to accept retail deposits are members of the DIF and pay quarterly premiums. In addition, the DIF can request backup funding from the federal government, the Reserve Fund, and the CBR. Due to the extraordinarily high number of insured events, the DIF depleted its own funds in 2015, and had a negative balance of RUB 377 billion in mid-March 2016. The negative balance was funded with long-term CBR loans at 0.1 percent and short-term funding from agent banks managing deposit payouts on the DIA's behalf to conduct deposit payouts. While the DIF does not have a statutory target size, the DIA Board has adopted an informal target of 5 percent of insured liabilities less Sberbank's. The DIF is expected to reach its target size in 7 to 10 years.

Manager of the Government Capital Support Program: As part of the anti-crisis measures introduced in December 2014, the federal government injected RUB 1 trillion of capital in the form of federal bonds (OFZ) into a separate account at the DIA (see also Box 1).[1/] The OFZ was to be exchanged against eligible banks' preferred shares (public banks) and subordinated debt (private banks). The shares and bonds pay a 1 percent margin above OFZ rates, but the banks can, under certain conditions, suspend interest payments and convert the instruments into common equity. The DIA's dividend payments to the MoF mirror income received by the DIA.

Operational aspects of the resolution of failed member banks: To fund solvency and liquidity support in open bank resolution and P&A transactions, the federal government provided initial capital of 200 billion rubles in 2008. In addition, the DIA has borrowed RUB 1.2 trillion from the CBR, in the form of five-year extendable unsecured loans at 0.5 percent (for solvency support) and 6 percent (for liquidity support). The loans are on-lent against collateral to banks undergoing resolution measures at an interest margin of 0.01 percent (see also Box 5). The on-lending poses several risks to the DIA, which seeks to mitigate via quarterly monitoring of banks rehabilitation plans. The risks include:

- *Credit risk:* As discussed in paragraph 71, the Insolvency Law ranks collateralized claims among third priority claims in bankruptcy, that is, behind deposits of individuals and wage claims of bank employees. For several of the banks undergoing open bank resolution, the rehabilitation plan has been adjusted to accommodate unexpected challenges of the resolved bank. There has been at least one instance where the DIA provided additional support in the form of a 11-year maturity extension of deposit at a subsidized rate, funded by the CBR.[2/] The support increased the capital by RUB 100 billion of the investor bank (VTB) in December 2014. In the past, the CBR has provided additional funding to the DIA to account for potential credit losses arising from the deterioration of the financial condition of the failed bank.

- *Maturity risk:* While CBR loans have a five-year maturity, the DIA typically on-lends with a 10- year maturity. While CBR loans are extendible, the authorities noted that the CBR is not obliged to do so.

1/ Subsequently RUB 170 billion out of the 1 trillion was used to support nonfinancial enterprises, as estimates for capital needs were reduced. Thus, RUB 830 billion (1.1 percent of GDP) benefited banks.
2/ The deposit was originally provided in 2011 in the context of VTB's acquisition of the Bank of Moscow (Source: VTB Annual Report 2014).

55. The law does not restrict the use of public funds to systemic cases, nor require the application of a least-cost test for the selection of resolution measures. In practice, however, the authorities have applied a form of a least-cost test and have restricted the use of public funds in resolution to banks considered of systemic and/or regional importance. Public funding in resolution could be restricted further.

- *Narrowing the scope of banks eligible for public funds in resolution:* The law could be amended to limit the use of public funds to resolution of banks whose failure could have broader consequences to the financial system or to the economy.[76] In this context, as noted earlier, improvements to the framework for P&A transactions are crucial to enable orderly resolution without relying on open bank resolution.[77]

- *Amending the least-cost test to include expected recoveries:* When performing a least-cost test, the CBR considers gross cash outlays. If the amount of solvency support necessary to raise a bank's capital to zero exceeds the DIF's deposit insurance liability in liquidation, the CBR considers that the least-cost test is not met to perform an open bank resolution, and resolves the bank with the use of P&A transactions or through liquidating the whole bank.[78] The test should take into account that the DIF and the DIA have recourse on the receivership, with DIF ranking among first priority claimants.[79]

56. The CBR should not provide subsidized loans to the DIA. CBR loans to the DIA are unsecured long-term loans at below-market rates (typically 0.5 or 6.0 percent compared to a market rate of 10–11 percent). Such financing to the DIA constitutes quasi-fiscal activities, and thus should be the role of the federal government. When the scale of the support is significant, the funding could complicate monetary management and contribute to inflation, since the CBR has a limited capital and revenue base and would have to monetize losses. The authorities argued that the current extraordinary economic circumstances, combined with the urgent need to remove weak banks from the system, justified the extensive use of CBR funds. The federal government should compensate the CBR for any subsidy/grant provided by the below-market rate loan and guarantee for the credit risk due to the provision of unsecured loans to the DIA.[80]

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[76] The bank can either be a D-SIB or have systemic implications in times of severe financial instability.

[77] The failed banks' critical functions (deposits, payment services, and the like) would be transferred to an existing healthy bank or to a bridge bank.

[78] The two P&A transactions conducted in 2015 were decided after a joint CBR/DIA assessment revealed a large negative balance of the bank's capital, which resulted in the open bank resolution measure failing the least-cost test.

[79] The term "least-cost test" is usually used to compare the DIF outlays necessary for (i) P&A transfers; and (ii) deposit payouts (liquidation). It is not typically used in the context of the use of public funds.

[80] Although the DIA formally incurs the credit risk of the restructured bank, the CBR has provided additional funding to the DIA to accommodate for credit losses arising from the deterioration of the bank's financial condition based on the plan for DIA participation in bankruptcy prevention measures.

57. Financial assistance by the DIA takes the form of long-term loans at below-market interest rates. The law provides that financial assistance for open bank resolution must be repaid to the DIA, effectively limiting DIA funding options to subsidized lending and purchases of shares, regardless of whether the financial assistance is funded by CBR loans, federal budget contributions, or DIF funds.[81] In most cases, the DIA provides long-term loans at below-market rates, and the interest margin gained (by the difference of the DIA loan rate and the market funding rate) covers the losses incurred by the troubled bank (that is, the negative balance between assets and liabilities). It is estimated that 60 percent of the resolution funds in 2011–15 were effectively a grant to cover such losses.

58. To facilitate a swift return of healthy resolved banks to the market, the authorities should consider replacing below-market rate loans with direct capital injections.[82] DIA loans are collateralized with the failed bank's assets and with collateral provided by the investor and/or a third party related to the investor (Box 6). This can result in a heavily encumbered balance sheet, restricting the bank's access to market funding as well as its flexibility to restructure its balance sheet. Furthermore, private investors are unlikely to be willing to provide collateral to cover losses already incurred in the failed bank. These disadvantages may be of particular concern if the failed bank is a large systemic bank. This could leave nationalization (for example, a merger with a SOB) as the only option. If open bank resolution is to be used, the authorities should consider closing the negative balance of the failed banks with grants from the federal budget instead of with subsidized loans. This would facilitate swift and orderly resolution, a quicker return of the failed bank to a healthy condition, and an enlargement of the investor pool.

59. In the medium term, the authorities could consider arrangements to recover public outlays from the financial industry. Replenishing the negative balance of the DIF should be given priority. Cross-country experiences point to significant variations in designing funding arrangements for resolution; two stylized options are (i) the creation of resolution funds, financed via ex ante contributions from the industry; and (ii) the use of public resources, with the ability to recoup any outlays from the industry on an ex post basis.[83] The credibility to an ex post arrangement depends on the available fiscal space, which at this time is expected to be adequate.

[81] Insolvency Law Article 189.56(7).

[82] Since the 2011 FSAP, the term of the DIA loans has been extended from five to 10 years, shifting their nature from liquidity to solvency support, prolonging the resolution process and increasing DIA's financial risk.

[83] The United States, for example, has opted to provide the FDIC, its resolution authority, with a credit line from the Treasury, subject to certain restrictions, and the ability to impose levies on the industry if recoveries from the distressed firm's assets are insufficient to repay the Treasury. Germany and Sweden have decided to establish resolution funds that are to be gradually built up via industry levies. Also see FSB KA 6.

Box 6. Use of Subsidized Loans for Solvency Support in Open Bank Resolution

In Russia, solvency support provided in open bank resolution is funded from the DIA's own account, either in the form of below-market rate loans or the purchase of share capital. The size of the DIA loan is determined to provide enough subsidy (interest margin) to cover the negative balance of the failed bank. To protect the DIA's balance sheet, DIA loans are collateralized with either the failed bank's assets or the assets of the investor or a third party related to the investor. For this purpose, traded securities are valued at market prices less a 0–5 percent haircut; real estate and shares are valued by independent appraisers; and performing loans are valued at face value less a 5–20 percent haircut.

DIA loans are provided with 10-year maturity, 0.51 percent interest rate, and the principal due at the end of the loan term. At current market funding rates (10–11 percent), the implied subsidy of a loan amounts to 60 percent of its face value. Cash outlays would be even higher if market-funding rates were to fall. Besides the large cash outlays, this funding arrangement has several drawbacks. These include:

Limited access to market funding. The resolved bank's highly encumbered balance sheet reduces the bank's ability to obtain financing from the market.

Less flexibility for balance sheet restructuring. The flexibility to restructure the resolved banks' balance sheet is restricted owing to the large share of collateralized assets, and the fact that DIA loans can only be prepaid at par (see below), which deprives the banks' net-present value gain provided by the loans' below-market interest rate.

Extensive use of regulatory forbearance. Under Russian accounting standards, the DIA-loan subsidy is recognized over the maturity of the loan (10 years). During this time, the CBR may exempt the resolved bank from complying with prudential norms and, as the funding source for the DIA loan provided to the bank, the CBR may have an incentive to do so. At the outset, problem assets are reported at book/face value and annual provisions are made only in the amount equal to the annual subsidy recognized by the below-market loan.

Lack of incentive to expedite the collection of problem assets. The rehabilitation plan approved by the CBR upon adopting an open bank resolution measure includes a detailed plan for the collection of problem assets. Recoveries in excess of what is contemplated trigger an early repayment of the DIA loan at par, which deprives the investor of the subsidy provided by the loans' low interest rate. This is especially true for excess recoveries achieved in the early years of the plan.[1]

Prolonged DIA involvement. For the maturity of the DIA-loan, the bank is subject to quarterly monitoring by the DIA, including on problem asset recoveries and loan loss provisioning.

Finding an investor for large banks. For banks that are small relative to the investor bank, the above-mentioned issues may not be a matter of concern. However, these disadvantages would make a large systemic bank less attractive to a private investor, and hence, more difficult to find a potential investor.

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[1] For example, if a DIA loan of RUB 100 is provided and the market funding cost is 11 percent, a problem loan recovery of RUB 10 above the contemplated recovery amount would create RUB 2 of profit for the investor and RUB 8 in early repayment of the DIA loan. If made in the first year of the rehabilitation process, the early repayment deprives the bank of RUB 5 in future profits.

C. Deposit Insurance Scheme

60. The deposit insurance scheme has functioned effectively in protecting individual depositors through payout in liquidation proceedings. The DIA has made insured deposit payouts in 168 insured events since 2014 related to 1.6 million depositors. A payout is commenced on average in 12 days from the occurrence of an insured event.[84]

61. Risk-based premiums were introduced in July 2015. All banks pay the basic insurance premium on individual deposits. An additional rate is applied to banks that have collected a deposit or have amended an agreement with a depositor to provide an interest rate exceeding the sector's average (as determined by the CBR) by 2–3 percentage points. An enhanced additional rate is applied if (i) the bank has collected a deposit or made an agreement to provide an interest rate exceeding the sector's average (as determined by the CBR) by more than 3 percentage points; or (ii) the bank's financial condition is below a certain criteria. [85]

Scope and Coverage

62. The scope and coverage of the deposit insurance scheme has recently been expanded. The scope was expanded to include individual entrepreneurs in January 2014, which had a negligible effect on the insurance liabilities of the DIF. At end- 2014, the coverage was doubled to provide coverage for up to a maximum of RUB 1.4 million per depositor.[86] This was to reflect the depreciation of the ruble and its impact on the coverage of foreign currency-denominated deposit accounts. The DIA estimates that the changes to the scope and coverage had an impact of increasing the DIF's payouts in 2015 by 10 percent. The current scope and coverage of the deposit insurance provides full coverage for 99.7 percent of insured depositors, and 56.9 percent of the amount of insured deposits.

63. In line with the recent international trend, the authorities are exploring the option of expanding insurance coverage to corporate depositors. The expansion of coverage would contribute to protecting small and medium-sized enterprises from bank failures, reducing the impact to the real economy. In addition, it could expedite the deposit payout process, as it will no

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[84] An insured deposit payout is triggered upon revocation of a bank's license by the CBR or imposition of a moratorium by the CBR on honoring the claims of the bank's creditors (DI Law Article 8). The DIA is obliged to prepare a list of insured deposits within seven days from the occurrence of an insured event, and to make payouts within 14 days (DI Law Article 12).

[85] Quarterly insurance premiums paid in the 1st quarter of 2016 amounted RUB 25.5 billion, including RUB 0.04 billion—on additional rate and RUB 2.12 billion—on enhanced additional rate. 140 banks corresponded to the criteria for paying a higher premium for the 1st quarter of 2016. From the 2nd quarter of 2016, the rates are 0.1 percent (basic rate), 0.15 percent (basic plus additional rate), and 0.3 percent (basic plus enhanced additional rate). The rates will be 0.18 percent (basic plus additional rate), and 0.36 percent (basic plus enhanced additional rate) from the 3rd quarter of 2016, and 0.48 percent for basic plus enhanced additional rate from the 4th quarter of 2016.

[86] The bank's counterclaims to the depositor are subtracted in determining the insured amount of a depositor (DI Law Article 11(7)).

longer be necessary for the DIA to identify the status of the depositor (that is, whether the depositor is a natural person or a legal entity). This would also greatly reduce the DIA's work as a bankruptcy receiver, by reducing the number of creditors left in the bankruptcy proceedings by 80–90 percent.[87] However, the authorities see several complications that cause them to lean away from extending the insurance coverage to corporate depositors. First, disclosure of beneficiary owners does not apply to small companies, which increases the risk of fraud and multiple coverage of the same person or entity. Second is the risk and public perception that owners of failed banks would benefit at the expense of uninsured individuals. Third is the cost to the DIF, which could increase by 10–20 percent. The mission estimates that such cost could be recovered by increased revenues from collecting insurance premiums on the corporate deposit base, which will provide for 15–20 percent revenue increase. The authorities should seek ways to address the identified problems, and consider expanding insurance coverage only to non-related party corporate depositors.

Reimbursement

64. Difficulty in obtaining accurate deposit data prevents the DIA from further speeding up the payout process. While international guidelines recommend that payouts commence within seven days, the average time of 12 days for DIA payouts has not caused stress or disturbances among the public. This can be contributed to the DIA's credibility, gained through effective communication and an excellent track record of deposit payouts. There are some practical impediments in further shortening the timeframe for insured deposit payouts. First, as noted above, the DIA is only informed of the license revocation after the decision has been made by the CBR, making the DIA unable to prepare for reimbursement prior to the revocation. Second, although the DIA has confirmed through onsite inspections that all banks have IT systems to produce single-customer view data, the IT systems are sometimes destroyed by the bank managers, requiring the DIA to rebuild the database. Third, for banks located far from the DIA head office, in Moscow, it can take more than a day for a DIA expert to enter the failed bank and commence the preparation for reimbursement. Certain practices in other countries to remove impediments to prompt reimbursement could be considered. These include providing insurance coverage on a gross basis without subtracting the bank's counterclaims, and removing the need for claims to be made by depositors for reimbursement. The potential benefits of such changes, however, need to be weighed against the potential risks of such changes, that is, the risk of overpayment due to fraudulent and dubious transactions, and the like.

65. The authorities should consider legal and operational changes to make deposit transfers more usable as an alternative to deposit payouts. As noted above, this would include authorizing the DIF to fund the transfer of insured deposits from failing banks to a healthy bank. Transfer of assets together with insured deposits can considerably reduce DIF outlays and, if conducted with sufficient preparation time, they could enable insured depositors to obtain earlier access to their deposit accounts. The authorities advised that in many bankruptcy cases, there were

[87] DIA estimate.

no good assets to transfer. This may change in the future, however, when the CBR concludes its efforts to close banks with legacy problems.

Funding of the Deposit Insurance Fund

66. The DIF has strong backup funding arrangements with the CBR and the federal government. The DI Law provides that federal budgetary assets and the government Reserve Fund may be used to secure the financial stability of the DIF.[88] A legal amendment in 2013 added the CBR as a source of backup funding. The DIA Board determines whether to request backup from the federal budget or the CBR. Until now, the DIA Board, chaired by the MoF, had opted to request backup funding only from the CBR. As of mid-March 2016, the CBR had approved a credit line to the DIF of RUB 250 billion, of which RUB 137 billion were drawn.[89] Such backup funding preferably should be provided by the federal government; if it is to be provided by the CBR, it should only be provided with federal government indemnity.

67. To preserve the DIF's credibility, the government should consider strengthening the financial position of the DIF. At mid-March 2016, due to the frequent occurrence of insured events, the DIF had a negative balance of RUB 377 billion.[90] Building the DIF up from its current negative balance to its implicit target level (5 percent of insured liabilities excluding Sberbank deposits) is estimated to take seven to 10 years, depending on the number and size of insured events in the future. In April 2016, the DIA board of directors raised the basic rate from the current 0.10–0.12 percent.[91] Given the outlook for low sector profitability in the next two years (due to compressed interest margins and large loan loss provisioning), further increases in the insurance premium should be gradual. Moreover, the authorities are urged to consider providing federal funds to allow for a faster DIF buildup and to enhance the public's confidence in the system. Deposit insurance funds should have the financial capacity to provide deposit payouts in the event of the failures of a few medium-sized banks, but not to withstand systemic crisis, in which case the government would need to step in. The extraordinarily high number of insured events in the past two years can be considered as a systemic event justifying the federal government's involvement to support confidence in the deposit insurance system.

[88] DI Law Article 41.

[89] By end-June 2016, the credit line was expanded to RUB 420 billion, of which RUB 372 billion were drawn.

[90] In addition to the CBR loan outstanding amount of RUB 137 billion, the DIF owed RUB 170 billion to agent banks for deposit payouts, and RUB 70 billion of insured liabilities for a deposit payout that had not yet commenced.

[91] DI Law Article 36 (4) provides for a maximum quarterly premium of 0.15 percent. In addition, the DIA may increase the basic rate up to 0.3 percent for six months at most within 18 months for the purpose of restoring the DIF (DI Law Article 36(5), 41(4)).

D. Depositor Preference

The treatment of depositors in the credit hierarchy can have a profound impact on the costs incurred by the deposit insurer and the failure resolution regime more generally. Depositor preference, particularly insured depositor preference, can reduce the costs of liquidation and depositor reimbursement. It may also facilitate the resolution options, such as partial deposit transfers, the use of bridge institutions, and statutory bail-in. On the other hand, changing the existing creditor hierarchy could give rise to some potential unintended consequences. Jurisdictions should weigh the advantages and disadvantages in the context of their legal and judicial framework and financial system structure.

68. Individual depositors are provided first priority after payments for current obligations.[92] First-priority creditors consist of individual depositors, DIA subrogated claims from reimbursed depositors, and CBR subrogated claims in cases where the CBR reimburses individual depositors when the failed bank is not a member of the deposit insurance system. Secured creditors rank top among the third-priority creditors with regard to the pledged assets, prior to corporate unsecured creditors, including corporate depositors.[93]

69. The authorities should consider introducing a two-tiered depositor preference rule. To better ensure the recovery of the DIF's outlay of deposit payouts in liquidation proceedings, some countries (for example, the U.K. and other countries in Europe) have introduced into law a two-tiered depositor preference rule whereby the insured deposits and the DIA subrogated claims are preferred over uninsured deposits, and both the insured deposits and uninsured deposits are preferred over other senior unsecured creditors (Box 7). This will ensure a higher probability and amount of repayment in the liquidation proceedings for the DIF. In addition, introduction of such a two-tiered system would also have an impact on how "no creditor worse off than in liquidation" would be determined if statutory bail-in were applicable to individual depositors. If the scope of insurance coverage is to be expanded to corporate entities, it is commendable to also include such claims in the first tier of claims. The authorities, however, expressed the view that such change of priority may lead to social unrest, as other creditors will receive less in the liquidation proceedings due to the change of hierarchy.[94]

70. In addition, certain adjustments may be necessary to the creditor hierarchy if the statutory bail-in is to be introduced (see section on resolution powers and safeguards).

71. The priority of secured creditors should also be reconsidered. In most jurisdictions, a security interest of a secured creditor is provided priority to receive repayment of the value of the pledged asset. Any residual claim will rank *pari passu* with other unsecured creditors. Under the Russian creditor hierarchy in liquidation, however, secured creditors only rank top among the third-

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[92] Insolvency Law Article 189.84.

[93] In line with the FSB KAs (KA 7), claims of creditors of a foreign branch of a Russian bank, if any, should rank *pari passu* with claims of creditors of the same class in a local branch.

[94] Owing to such concerns, while deposit insurance coverage was expanded to cover individual entrepreneurs in 2014, such entrepreneurs were not provided first priority in the creditor hierarchy.

priority creditors, and will only be repaid after, among others, all individual depositors, DIA subrogated claims, employment wages, and the like are repaid. This would also imply that the CBR's provision of ELA or DIA loans extended in relation to bankruptcy prevention measures have a high possibility of not being repaid if the bank enters into bankruptcy proceedings. Such weak protection of secured creditors may also impact or limit the extent to which banks may obtain secured loans or credit to fund liquidity needs.

Box 7. Depositor Preference Rules

Depositor preference may have the following potential benefits for bank resolution: [1]

1. **Reduce the cost to the deposit insurer and the bank resolution regime:** The costs of liquidation to the depositor and depositor reimbursement (where subrogation is present for the insurer) will be reduced.
2. **Facilitate the implementation of resolution options:** By providing a higher priority for certain or all depositors, the resolution authority may conduct a partial deposit transfer or a statutory bail-in without affecting certain or all depositors, while respecting the creditor hierarchy and equal treatment among the same class of creditors.
3. **Contribute to effective cross-border resolutions:** By having uniform treatment of depositors across jurisdictions, cross-border resolutions may become more effective.
4. **Enforcing market discipline.** By increasing the potential loss exposure of non-preferred creditors, depositor preference provides stronger incentives for these creditors to monitor banks' risk-taking behavior.

There are three distinct forms of depositor preference, with varying implications for the cost to the deposit insurer as well as the implementation of resolution options:

Types of Depositor Preference

<table>
<tr><th>Insured Depositor Preference</th><th>General Depositor Preference</th><th>Tiered Depositor Preference</th></tr>
<tr><td>Insured deposits (with the DIA subrogated for insured deposits.)</td><td rowspan="2">All deposits or all deposits eligible for deposit insurance (with the DIA subrogated for insured deposits).</td><td>Insured deposits (with the DIA (subrogated for insured deposits).</td></tr>
<tr><td rowspan="2">Other senior unsecured (including uninsured eligible deposits).</td><td>All deposits or eligible deposits over deposit insurance limit.</td></tr>
<tr><td>Other senior unsecured.</td><td>Other senior unsecured.</td></tr>
</table>

Source: IADI Core Principles for Effective Deposit Insurance Systems, November 2014.

1/ Note: A higher position in the table indicates a higher claim.

Annex I. Asset Quality Reviews

72. Asset quality reviews (AQR) are key diagnostic tools to better assess capital adequacy and the economic condition of banks, reduce uncertainty, and support confidence. Comprehensive AQRs are useful to understand the health of banks' balance sheets, particularly when asset underperformance becomes systemic. Such cases can threaten the long-term viability of the banking system. In deep economic contractions, excessive debt burdens and the lack of viability of many projects can become apparent. Banks may take unrealistic views of underperforming assets to avoid loan loss provisioning, increases in regulatory capital requirements, and funding costs. AQRs can help better establish the value of assets against a rigorous standard, and identify whether banks have sufficient financial resources to absorb medium-term losses. They can also be used to inform decisions on bank restructuring and private sector debt resolution.

73. Loans, almost always the largest asset item, should be the primary focus of AQRs. AQRs shed light on the extent to which the loan portfolio can deteriorate and on losses incurred. This depends on many factors, including the scale of deterioration of the macroeconomic environment, the strength of the bank's credit administration, and the legal environment for effective resolution of underperforming assets. Onsite analysis is essential to review individual loan files and to accurately assess the valuation and enforceability of collateral.

74. The design and implementation of the AQR must be credible and be perceived as such by market participants. This is usually achieved through a rigorous design, transparent public disclosure of procedures and results, and engagement of independent third-party expertise to conduct and/or oversee the AQR. The experts' tasks may include advising on setting scope and methodologies, drafting terms of reference, and overseeing the conduct of the AQR.

75. Operationally, the AQR can be conducted in one go or in phases, using a risk-based approach to prioritize banks. For each bank, the review should provide a comprehensive assessment of capital needs that can support decisive supervisory actions. Two approaches could be considered, individually or as a combination:

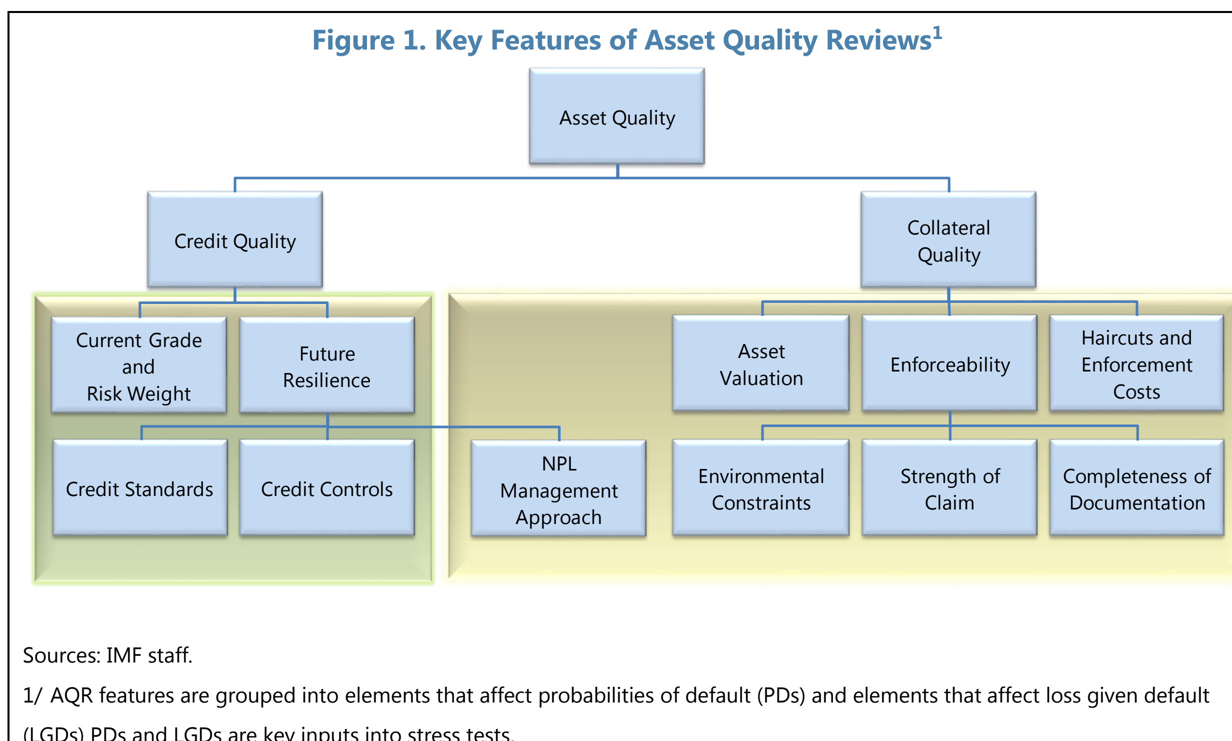
- *Independent external auditors:* Banks are required to hire independent external auditors (different from their normal auditors) from a pre-approved list of reputable firms to perform the AQR. Large and complex banks could be required to use international firms or audit partners based in other countries.

- *Bank supervisors:* Supervisory staff conducts the AQR, with independent external advisors participating in designing the terms of reference, and discussing and challenging the results of the review. The experts could be domestic and/or international.

Before the AQR, the authorities should formulate a strategy to address any weaknesses that the AQR may reveal. The strategy should include a method for assessing banks' viability on a

forward-looking basis, based on the AQR's results and, usually, a business plan and possibly stress tests using the results of the AQR as a starting point. Audited accounts often do not pick up the true extent of asset quality problems, as they do not allow for a forward-looking viewpoint. Eligibility criteria for banks to receive public solvency support, if justified due to systemic risks, and under strict conditions, also need to be thought through before the results are announced. Undercapitalized but viable banks should be required to submit time-bound recapitalization plans. Advance preparations for orderly resolution should be made for banks that are not deemed viable.

Figure 1. Key Features of Asset Quality Reviews[1]

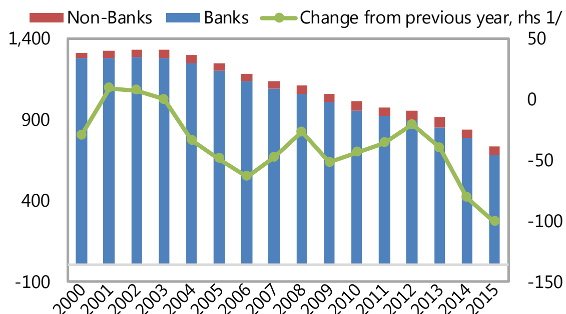


Sources: IMF staff.

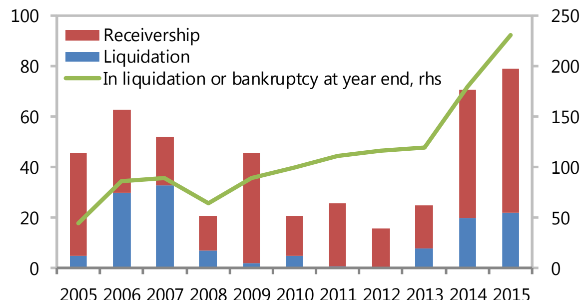
1/ AQR features are grouped into elements that affect probabilities of default (PDs) and elements that affect loss given default (LGDs) PDs and LGDs are key inputs into stress tests.

Figure 2. Bank Resolution in Russia

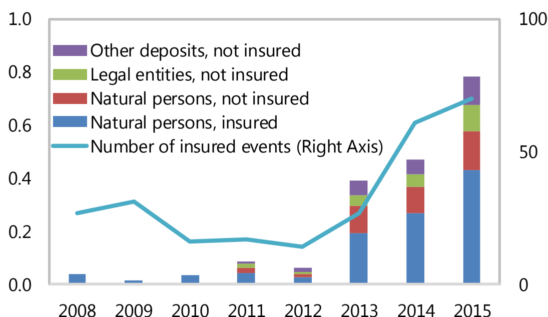
Number of Licensed Credit Institutions
(In number of institutions)



Number of Banks in DIA Managed Receivership and Liquidation

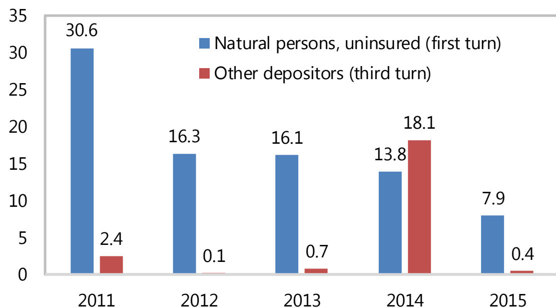


Deposits in Failed DIF Member Banks[2]
(In percent of GDP)

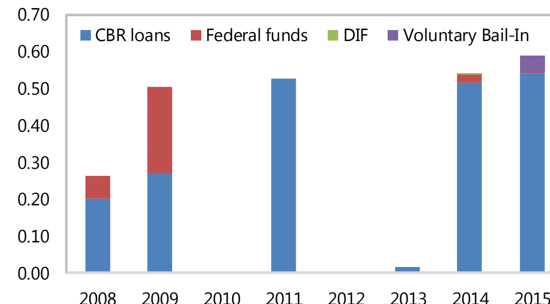


Number of Bank Resolution With DIA Participation

Estimated Recoveries of Uninsured Deposits of Failed Banks[2]
(In percent of deposits in respective priority order)



Sources of Funding in Open Bank Resolution[2]
(In percent of GDP)



Sources: DIA, CBR, and IMF.
1/ New and revoked licenses.
2/ 2015 numbers as of November 25, 2015.