



BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER

PROPOSALS FOR A SPECIAL RESOLUTION REGIME FOR
DEPOSIT-TAKING INSTITUTIONS IN BERMUDA

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Introduction

This Consultation Paper sets out a proposal for a framework of powers designed to allow for the prompt and effective resolution of a Bermuda deposit-taking institution¹. The proposed framework reflects that Bermuda does not have a lender of last resort, nor does it yet have a deposit insurance scheme². Therefore, in Bermuda, the financial safety net relies almost exclusively on the prudential regulation and supervision of the Bermuda Monetary Authority (the “Authority” or the “BMA”).

The Special Resolution Regime (“SRR”) proposed in this Consultation Paper would provide stabilisation powers, an insolvency procedure and an administration procedure, as set forth in sections 2 to 6 of this paper.

The proposed framework reflects regulatory standards designed and promulgated by the Basel Committee on Banking Supervision and other international standard setting bodies.

The proposals made in this paper also seek to address a recommendation of The International Monetary Fund’s “Assessment of Financial Sector Supervision and Regulation in Bermuda”, published in October 2008. While this report recognised that the jurisdiction’s approach to banking supervision was in line with international standards, noted improvement in the regulatory framework since the previous review in 2003 and acknowledged compliance with the Basel Core Principles on Banking Supervision, one key recommendation was made: that “legislation should be enacted to provide the BMA with more direct intervention tools in the case of a troubled bank”.

¹ In this paper the terms “deposit –taking institution” or “bank” are used to refer to a deposit-taking institution licensed under the Banks and Deposit Companies Act 1999. The proposals in this paper are not intended to apply to credit unions.

² In a separate consultation paper the Authority has recently outlined a proposal to establish a limited Deposit Insurance Scheme (“DIS”) in Bermuda. While the DIS proposal provides for some protection of depositors in the event of bank failure, it does not make provisions for the resolution of the failed bank.

Comments from members of the public and other interested parties on the proposals in this paper are invited no later than 30th November 2011. Responses should be sent to policy@bma.bm.

1. Need for a dedicated resolution regime for deposit taking institutions

Special supervision regimes, or intervention tools, have been extensively used internationally during the financial crisis to resolve cases of troubled banks in an efficient and effective manner. SRRs have been used for example in the UK in the resolution of Bradford & Bingley and in the US in the case of Washington Mutual Bank. SRRs provide the regulatory authorities with tools to take extraordinary measures to pay depositors' claims and continue the day-to-day operations of the institution in a manner not permitted or contemplated under general corporate insolvency law.

1.1 At present the options in Bermuda for failing bank resolution are limited by corporate insolvency law. While this may be an effective regime for the resolution or liquidation of industrial or commercial companies it is much less appropriate for distressed banks for a number of reasons:

1.2 Speed of resolution is much more important in the case of a failing bank in comparison to a general company. Owing to the nature of their balance sheet structure, banks may be vulnerable to losses of confidence and market factors which may quickly lead to liquidity stress and subsequent failure, even in solvent institutions. Solvent banks may quickly become insolvent in the event of a run and contagion may spread rapidly. An SRR for banks must allow for swift intervention to stabilise failing banks before the point of insolvency. An SRR also facilitates the prompt payment of insured deposits.

1.3 Deposit-taking institutions are fundamentally different from industrial and commercial companies in that their failure can generate large externalities to the stability of the financial system. A loss of confidence may lead to runs, contagion and wider systemic impact. Corporate insolvency law does not require public policy objectives such as the maintenance of financial stability to be taken into account nor for shareholder and creditor rights to be overridden to protect the wider public interest.

1.4 In addition, general corporate insolvency provisions may freeze transactions and are therefore not suited to ensuring continuity of banking functions such as deposits and withdrawals and access to credit facilities.

2. Objectives of the Special Resolution Regime (“SRR”)

The following objectives will be considered in using, or considering the use of, the SRR Stabilisation Powers (see section 4), the Bank Insolvency Procedure and the Bank Administration Procedure (see section 6). It should be noted that there is an overriding statutory objective supported by three key objectives.

2.1. Overriding objective

The overriding objective of the SRR is to protect and enhance the stability of the banking and financial systems of Bermuda.

Stability of the financial system relates to the stable functioning of the systems and institutions (including trading, payment and settlement infrastructure) supporting the efficient operation of financial services and markets for purposes including capital raising, risk transfer, and the facilitation of domestic and international commerce in addition to day-to-day banking operations. This objective recognises that systemic risks may be posed by the potential or actual failure of a deposit-taking institution and the need for consideration of the likely impact of the use of (or failure to use) a SRR tool.

2.2 Three key supporting objectives

2.2.1 Protect Depositors

This objective relates to the protection of depositors from the effects of the failure of an institution, to the extent of DIS coverage by prompt payout to insured depositors via the deposit insurance company or through facilitating continuity of banking services through a stabilisation option.

2.2.2 Protect Public Funds

An SRR should ensure that the burden in the event of bank failure rests on the institution and its shareholders and not on the taxpayer. This objective is a key part of the revision to

international regulatory policy developed post-financial crisis which seeks to eliminate bailouts from public funds.

2.2.3 Avoid Interference with Constitutional Property Rights

The SRR provides a detailed framework for the payment of compensation to claimants whose property rights have been overridden. These claimants can be the institution itself, its shareholders, creditors, counterparties and other third parties.

3. Triggers for the SRR

- 3.1 The SRR may not be triggered unless certain pre-conditions and conditions are met:

Preconditions

- 3.2 The Authority must be satisfied that the following pre-conditions are met:
- a. That the institution is failing, or is likely to fail, to meet the Minimum Criteria for Licensing in the Second Schedule to the Banks and Deposit Companies Act 1999 relating to the maintenance of adequate liquidity and capital; and
 - b. It is not reasonably likely that (ignoring stabilisation powers) action will be taken by, or in respect of, the institution that will enable the institution to meet the Minimum Criteria for Licensing.

Conditions

- 3.3 If the Authority is satisfied that the pre-conditions are met, then the Authority may trigger the SRR, upon consultation with the Minister of Finance:
- a. where it appears necessary or expedient to maintain the stability of the Bermuda financial system and where the Authority considers that there would be a serious threat to the financial system³ if the SRR was not triggered;
 - b. where financial assistance has already been provided by the Bermuda Government (the “Government”) to an institution for the purposes of maintaining the stability of the Bermuda financial system. (This power could be used in circumstances where the Government has moved quickly to support a failing institution and while after the provision of support the institution may

³ To determine whether a failing licensed bank represents a serious threat to the financial system a number of factors will be considered. Factors such as the relative size and importance of the institution in the Bermuda market, size of depositor base, impact on local credit availability, role in the payment and settlement system and impact on local economy through employment, suppliers and third party service providers will all be considered. Given the very concentrated nature of the Bermuda banking market even the failure of what may be regarded as a smaller institution has the potential to threaten the financial system, even if only through the contagion effect.

not present a threat to the financial system, orderly resolution may nevertheless be required); or

- c. where it appears necessary or expedient to protect depositors.
- 3.4 The nature of the powers granted to the Authority when it has triggered the SRR is described in section 4 of this Consultation Paper.
- 3.5 Bermuda courts would have no authority to trigger the SRR or ability to reverse any decision to trigger. The role of the court would be limited to the bank insolvency and administration process and determining disputes concerning application of compensation orders.

4 Resolution toolkit – stabilisation powers

The SRR provides three key stabilisation tools, one or more of which may be used in a particular case:

4.1 Private Sector Purchaser (“PSP”)

This option involves the use of the power to direct and accelerate a transfer of part or all of a failing bank’s business to a private sector purchaser. This approach is broadly equivalent to the “purchase and assumption” approach. In such a transaction a financially healthier bank will purchase some or all of the assets and assume some or all of the liabilities of a failed bank.

The advantages of this approach are that customers suffer no loss in service and the overall cost is less than a pay-off scenario. In addition the acquiring bank, which has an opportunity to increase market share, can offset the deposit liabilities assumed with assets transferred. This approach also keeps assets in the private sector, avoiding the use of public funds.

The PSP approach also provides the flexibility for both a whole-bank and part-bank solution. A part-bank solution may arise for example in circumstances where the failing bank has certain problem assets which a purchaser may be unwilling to acquire. In that case, it is likely that “good assets’ and deposit liabilities will be transferred to the purchaser and the problem assets and remaining creditors will remain in the residual bank (the “bad bank”) and this will enter the special bank administration procedure as described in section 6.

Resolution by way of PSP is generally likely to be the resolution option that best meets the SRR objectives if it can be effected swiftly and in a cost-effective manner.

This option is however reliant on finding a private sector purchaser. In the case of Bermuda banks this may be more challenging given the very small number of local

institutions and the likely lack of familiarity with the Bermuda market of any potential foreign acquiring institutions. Where an immediate purchaser cannot be found the temporary use of the Bridge Bank option may be appropriate.

4.2 Bridge Bank

This option involves the assumption of control of part or all of a failing bank's business through a bridge bank, a company wholly-owned by the Government.

Resolution by way of a transfer to a bridge bank may be appropriate where an immediate private sector sale is not possible, and where a stable platform is needed to prepare for and effect the onward sale of all or part of the bank to a private sector purchaser. Typically, in the event of a partial transfer, "good assets" and insured deposits would be kept within the bridge bank while "bad assets" and other creditors would fall within the Bank Administration Procedure. The bridge bank is designed to be a temporary financial institution.

In situations where there is expected to be a lengthy period of time prior to a sale, the Authority shall put in place an appropriate governance structure. This structure shall be based on the objective of taking steps to manage the relationship with the bridge bank at arm's length.

In many cases the purchase phase may immediately follow the stabilisation phase. In these situations, it is likely that arm's length management may not be appropriate. The Authority would be expected to take an active role in managing the affairs of the bank, first to ensure stabilisation, and second to ensure a successful transition to a private purchaser.

4.3 Temporary Public Ownership

This option involves the Government taking control and ownership of a failing banking institution through the transfer of shares, in order to provide a stable platform for restructuring. This option is available only where the Authority and the Minister of Finance determine that use of the option is necessary or expedient to maintain the stability of the Bermuda financial system.

While this is generally likely to be the least preferred resolution option, it may be the most suitable if the Government has provided a failing institution with a significant amount of public money in order to stabilise it prior to its entry into the SRR, or where it is necessary to resolve a serious threat to the stability of the Bermuda financial system.

5. Compensation and creditor safeguards

In exercising the stabilisation tools under the SRR, by transferring bank property or securities, the normal rights of bank shareholders and creditors may be overridden. The SRR contains a number of explicit safeguards designed to protect creditors, counterparties and shareholders of a failed bank, particularly in a partial property transfer:

5.1. Compensation orders

The Minister may make a compensation order when any of the stabilisation options have been used, and may compensate the shareholders or creditors of the bank or other third parties who suffer compensatable interferences in their property rights as a result of an exercise of the stabilisation tools. The framework will make provision for the making of a compensation order establishing a scheme for determining whether, and to whom, compensation should be paid and, where necessary, establishing a scheme for paying this compensation.

In making an order the Minister shall have regard to the desirability of ensuring that if a residual institution (e.g. the “rump” of the bank following a partial transfer of assets following a PSP or Bridge Bank transaction) enters insolvency after transfer that pre-transfer creditors are no worse off had the bank entered insolvency immediately before transfer. The introduction of a broad depositor preference (see section 6.3) may limit unsecured creditors claims in bank insolvency and hence limit potential claims under compensation arrangements.

5.2. Other creditor safeguards

In the case of a partial property transfer certain interests defined as protected arrangements will be safeguarded. Specifically, under set-off and netting arrangements, financial contracts with any given counterparty could not be cherry-picked for transfer. All must be transferred or all left behind in the residual bank. Similarly, secured creditors' claims cannot be separated from the securing assets and structured finance arrangements, such as securitisations, will also be protected.

6. Bank insolvency regime

6.1 Bank Insolvency Procedure (BIP)

The BIP is a whole-bank liquidation process and is designed to be used where stabilisation tools are not triggered. Under the BIP an insolvency order may be made where:

- a. A deposit-taking institution fails to meet the minimum licensing criteria under the Banks and Deposit Companies Act 1999; and
- b. the deposit-taking institution has insured depositors; and
- c. The deposit-taking institution is unable, or likely to become unable, to pay its debts and the winding up of the bank would be in the public interest and fair.

A bank liquidator has two statutory objectives:

- a. to work with the deposit insurance company to ensure that either the accounts of insured depositors are transferred to another institution or payments are made to insured depositors; and
- b. to wind up the affairs of the failed bank in the interest of creditors as a whole.

6.2 Bank Administration Procedure (BAP)

This procedure is intended to be applied following a partial property transfer of a deposit-taking institution's business to a bridge bank or private sector purchaser. Such a transfer may leave the residual bank insolvent, but at the same time it may be vital that the residual bank continues to provide services and facilities to the purchaser or bridge bank to enable the transferred business to operate effectively.

The bank administration procedure imposes two objectives on the bank administrator: first to provide support to a private sector purchaser or bridge bank in relation to the transferred business; and second to rescue the residual bank as a going concern or wind up its affairs in the best interest of creditors.

6.3 Priority Ranking in Insolvency

It is proposed that the normal priority ranking of creditors be altered in both the BIP and the BAP as follows:

- a. Secured creditors
- b. Pension claims- under s44 National Pension Scheme Act
- c. Employee claims - under s33 of the Employment Act 2000
- d. Insured depositor claims
- e. Other depositors
- f. Government taxes - under s236(1) of the Companies Act 1981
- g. Workmen's compensation under s236(1) Companies Act 1981
- h. Unsecured creditors
- i. Subordinated debt holders
- j. Shareholders.