



TC NOTES

PRACTICAL **LEADERSHIP**
AND **GUIDANCE** FROM
TORONTO CENTRE

EXIT POLICY: TAKING SUPERVISORY ACTION TO DEAL WITH NON- VIABLE FINANCIAL INSTITUTIONS

OCTOBER 2020

EXIT POLICY: TAKING SUPERVISORY ACTION TO DEAL WITH NON-VIABLE FINANCIAL INSTITUTIONS

TABLE OF CONTENTS

Introduction	2
Why do we need an exit policy?	2
Exit policy	3
Excessive forbearance	4
Guide to intervention	5
Early intervention.....	7
Balance sheet insolvency not a pre-requisite for supervisory action	8
Exit policy derived	8
Identifying non-viable institutions.....	11
Insolvency/non-viability	11
Financial analysis and red-lines as indicators of non-viability	13
Consumer compensation schemes.....	14
Conclusions.....	15
References.....	16
Appendix 1: Distilling an exit policy from international standards of financial supervision	17
Appendix 2: Examples of red-lines for institutions	21
Appendix 3: Institution not viable – mini-cases	22

Copyright © Toronto Centre. All rights reserved.

Toronto Centre permits you to download, print, and use the content of this TC Note provided that: (i) such usage is not for any commercial purpose; (ii) you do not modify the content of this material; and (iii) you clearly and directly cite the content as belonging to Toronto Centre.

Except as provided above, the contents of this TC Note may not be transmitted, transcribed, reproduced, stored or translated into any other form without the prior written permission of Toronto Centre.

The information in this TC Note has been summarized and should not be regarded as complete or accurate in every detail.

EXIT POLICY: TAKING SUPERVISORY ACTION TO DEAL WITH NON-VIABLE FINANCIAL INSTITUTIONS

Introduction¹

International standards provide financial supervisors with a wide-ranging set of principles that offer guidance across virtually all areas of supervisory responsibility. The standards have been developed with input from supervisory authorities representing jurisdictions around the world. However, there is little specific guidance in connection with the most significant decision supervisors ever have to make, namely taking supervisory action to deal with non-viable financial institutions, which generally means removing them from the market.

Although international standards do not cover the exit process extensively, they do include many principles that are relevant to the exit decision. This Toronto Centre Note pulls together the most significant of these principles, including those providing the foundation for an exit decision that may ultimately be required. It is intended to help supervisory authorities, especially in jurisdictions where in-house resources are not extensive, to put in place an exit policy that will serve as a pragmatic guide to taking action to deal with failing financial institutions efficiently and confidently when the need arises.

The Note also discusses the challenges of determining when an institution may be approaching a state of non-viability or be non-viable. This Note should be read in conjunction with the related Toronto Centre Notes (2020a and 2020b) on recovery planning and on resolution.

Why do we need an exit policy?

Financial institutions are fundamental pillars of a country's economy. When a financial institution fails, there may be widespread financial loss to members of the public, as well as a system-wide impact that can shake confidence in the financial system and have a destabilizing effect on the entire economy.

The decision by a supervisory authority to remove a major financial institution from the market has enormous consequences on the customers, employees, and shareholders of the institution. Customers of a failed institution may find their lives disrupted if the contracts they have entered into, whether for banking, insurance, or other financial services, are not being honoured in accordance with the original terms, or not being honoured at all. Bank customers who lose their savings may find their retirement plans thrown into disarray; businesses may be unable to complete important transactions; and life insurance contracts that cannot be fulfilled may lead to personal tragedy for families that should have received the proceeds of policies. Failed general insurers may leave thousands of policyholders with life-changing losses due to fire and other contingencies, and with no compensation.

¹ This Note was prepared by Lawrie Savage.

For a supervisory authority, the failure of a major financial institution may mean long additional hours of work for staff, exposure to controversy, and possible criticism from the public and the media. And the political masters to whom the supervisory authority reports will also not welcome the issues that inevitably arise with regard to a failed financial institution.

International standards require exit action as soon as a financial institution is no longer viable, namely when it is judged by the supervisory authority to have reached a position where it will not be able to fulfill its obligations to the public. Non-viability may also arise from general non-compliance with financial or other laws, egregious treatment of consumers, or illegal activity such as money laundering.

Supervisors may make use of specific financial indicators (red-lines) to assist with the determination of non-viable status. When pre-determined red-lines are breached, the supervisor may, at least on a preliminary basis, interpret the result as a potential indication of non-viability.

However, taking action is often easier said than done. Almost inevitably, shareholders will vehemently argue that action is premature because new management (with a sure-fire turn-around plan!) is about to be appointed, or because new investors are about to contribute a significant amount of capital. Such assertions cannot be dismissed out-of-hand, but the institution should be given only a limited amount of time to recover, and the supervisor should consider restricting the business of the institution until the recovery is complete or until the time limit for the recovery plan is reached.

Given the significance of the decision to remove an institution from the market, and the pressures for and against taking action at a particular point in time, it is perhaps not surprising that supervisors may sometimes find it difficult to move forward with the key decisions that must be made. But the timing of these decisions is critical because this will greatly influence the outcome in terms of the ultimate impact on the public.

Exit policy

An important method by which organizations attempt to achieve their goals is by establishing policies which, in the opinion of those at the highest levels of the organization, will be most likely to keep the organization on track to achieve its objectives. A policy is a set of rules, approaches, or procedures that respond to a particular circumstance or series of circumstances. The existence of formal policies also avoids inconsistent decision making and inconsistent messages arising from different people responding in different ways to similar circumstances. Policies are developed in a reasoned and focused manner based on input from those who are most knowledgeable about the subject. When there is no policy, decisions must be made on an ad hoc basis, often quickly and during a period of high stress, frequently leading to sub-optimal responses.

Supervisory authorities should likewise have policies in place that are designed to maximize the probability that their objectives will be met. Supervisory policies typically describe the interpretation that the supervisory authority will place on certain provisions in the law or explain how the authority intends to proceed in specific types of situations. For example, many supervisory authorities make use of a guide to intervention, or risk ladder, an example of which is provided below. The guide to intervention includes a formal delineation of policies that the

authority intends to pursue as a supervised institution reaches particular levels of risk, as assessed by the authority.

A key objective of most financial supervisory authorities is to minimize the probability that a licensed institution will not be able to meet its obligations. Surprisingly, however, many authorities have not established policies governing how they intend to proceed should they find themselves in a situation where institutional failure is a looming possibility. International standards make it clear that failed (non-viable) institutions must be removed from the market. But how will the supervisory authority consistently ensure that a condition of non-viability has been reached? What specific steps does the supervisor intend to follow to remove a failing institution from the market? Will the supervisor be able and willing to take the necessary decisions and actions?

The objective of an exit policy is to provide guidance for supervisory actions with regard to non-viable institutions. Exit is usually accomplished either by taking away the institution's license to transact business, or by taking control of the institution. Then in either case, the institution is moved into a specific regime, which could include liquidation under the relevant legislative provisions or a resolution using the powers recommended by the Financial Stability Board (2014).

Where the failing financial institution is an average-sized or smaller entity, its failure should not be expected to have a major impact on the financial markets. But such an institution will nevertheless have a significant number of customers who have placed their trust in the institution and whose interests need to be protected to the extent possible by the supervisory authority. In most cases envisioned in this paper, this "average-sized or smaller entity" will move directly from a licensed regime to liquidation under the relevant legislation.

An exit policy can be viewed as an example of supervisory risk management. If followed, the policy will lead to the efficient and effective transfer of non-viable institutions into liquidation or resolution, following a timeline, processes, and procedures that minimize the overall negative impact for consumers and the economy as a whole.

Excessive forbearance

Unfortunately, we have too frequently observed situations where supervisory decisions have not been made and action has not been taken, with the result that some licensed financial institutions become the walking dead. Their balance sheets include assets that any knowledgeable reviewer can see are worth far less than their balance sheet value, making their assets significantly less than their liabilities, so the institutions are materially insolvent. No financial supervisor should tolerate such situations, which are contrary to supervisory objectives and to public expectations.

There are a number of reasons why such situations do arise, notwithstanding the obvious potential for public harm.

- The owners of the institution concerned may have convinced themselves, despite all evidence to the contrary, that their institution is not actually insolvent, or that good times will soon return. Or they may simply understand that closure of their institution would be contrary to their own personal financial interests. Shareholders tend to be powerful

figures in society, sometimes with close connections to political figures, and they may be able to convince key supervisory decision-makers not to take action.

- Supervisors and other decision-makers may not fully understand the implications of what is happening, either because they do not have a full understanding of the institution's true financial situation, or because they do not comprehend the harm that will result from allowing the failing institution to continue carrying on business and accepting funds from the public.
- Sometimes, lacking any plan as to what should be done, supervisors and others just hope that things will improve over time (a seldom-realized dream), or perhaps that a recovery plan will somehow suddenly gain traction and restore the institution to financial health.
- The institution may legitimately be considered to be too big to fail – it is judged that closure of the institution would have such a catastrophic impact (on a particular industry, the wider public, or the economy as a whole) as to just be unacceptable. But this is precisely the situation for which the Financial Stability Board's recommendations for effective resolution were designed.²

Regardless of the reasons that have led to the existence of a non-viable institution in the market, the solution can never be to do nothing because then the situation almost always continues to deteriorate. Corporate failures are typically attributable to basic factors such as poor management, weak corporate governance, ineffective enterprise risk management, or uncompetitive products or pricing. Basic problems in these fundamental areas seldom improve over time, unless there are specific, well-thought-out plans for change, along with the financial and human resources needed to successfully execute the plans. In the absence of such fundamental improvements, the deteriorating institution will at some point run out of funds and be unable to carry on, with even greater public harm than if the situation had been dealt with at an earlier date. Part of that public harm will be a loss of credibility for the supervisory agency and possibly for the government as a whole.

Guide to intervention

Before focusing specifically on an exit policy, it is useful to step back and remind ourselves that circumstances can change over time, causing institutions to have increasing levels of risk, until they may reach a point where the exit policy should come into effect. An effective exit policy must be supported by effective policies for assessing risk, classifying risk, and moving institutions through the system as their positions deteriorate, until they may ultimately reach the exit/resolution gateway. An effective way of carrying out this process is by way of a document that is generally known as the guide to intervention or risk ladder.

Many jurisdictions have adopted a guide to intervention. This is usually a public policy document, describing the different levels of institutional risk as assessed by the supervisor, along with a listing of the most common supervisory actions/interventions that will typically be employed by the supervisor at each risk level.³

² Toronto Centre (2020a) explains the Financial Stability Board's recommendations for resolution and their implications for supervisors.

³ Toronto Centre (2019) discusses the use of a guide to intervention within a risk-based approach to supervision.

An example guide to intervention

Risk level	Description	Typical supervisory response
Level 1	Low risk: No particular areas of heightened risk. Adequate capital, strong financial position, Early Warning System (EWS) financial ratios not indicating any important risk flags.	Routine review of financial submissions; occasional, brief visits by on-site examiners and sometimes by senior supervisory official on courtesy visit with CEO and/or board.
Level 2	Emerging risk – Possible indicators: some EWS ratios moving outside of normal range; increasing risk in investment portfolio; downward trend in capital adequacy; poor quality of corporate governance; emergence of business practices such as rapid growth, overly competitive behaviour, aggressive accounting practices; on-site inspection reveals weaknesses in some control procedures.	Institution is requested to provide a plan for dealing with the noted areas of emerging risk, with milestones for completion. More frequent visits by on-site inspectors. Possibly more frequent submission of financial and other operational information. Meet with board and CEO to explain growing concerns.
Level 3	Moderate risk – Substantial number of EWS or other financial indicators are outside the normal range. Serious compliance issues. Capital adequacy is approaching the level considered to be a minimum operational level. On-site inspection reveals poor corporate governance and significant weaknesses in control procedures giving rise to critical business problems.	Senior supervisory personnel meet with board to explain concerns and request immediate action. Depending on whether at the higher end of the risk level or not, supervisor may intervene in operational matters, such as by restricting growth of business. Requirement to increase capital and improve governance and controls on an urgent basis.
Level 4	Unacceptable risk – If red-line thresholds have been established, some may now be breached or are close to being breached. Many Early Warning System (EWS) and other financial indicators are well outside normal ranges. Capital level has moved below statutory minimum. On-site inspection reveals fundamental weaknesses such as very weak corporate governance, lack of effective senior management, ineffective investment policy, weak or non-existent risk management.	Consideration of appointment of some new board members or members of senior management by supervisory agency. Possibly take control of the company and impose provisional management. Recovery plan should be implemented and very closely monitored by the supervisor. High probability that the plan will have to include an injection of capital on an immediate basis.
Level 5	The institution is no longer viable. If red-line thresholds have been established, many, if not all, are now being breached. Members of the public cannot be put at risk by allowing the institution to continue to operate.	Recovery plan has failed. Supervisor (or resolution authority) puts institution into liquidation or resolution.

The guide to intervention summarizes the supervisory policy being followed by a risk-based supervisor overseeing a licensed institution. The guide helps the supervisory authority to maintain a consistent approach to intervention and avoid inappropriate or inadvertent forbearance. Also, from an industry perspective, the guide ensures that boards of directors and senior executives of financial institutions are aware of how the supervisory agency intends to classify levels of risk, and the types of interventions that will typically be employed by the supervisor at each risk level.

This Note relates mainly to levels 4 and 5 of the guide, as neither of those levels can be considered to be sustainable positions. At risk level 4, recovery plans must be activated, and other actions taken that have the effect of reducing risk on a timely basis and taking the institution back to risk level 3 and ultimately to even lower risk levels. At risk level 5, we are in the realm of non-viability. The non-viable institution should be put into liquidation or resolution.

Early intervention

An important principle that relates to intervention generally, and which is especially important in the context of exit policy, is what is known as early intervention. International standards for all types of financial institutions stipulate that this policy must be adhered to by supervisory authorities. For example, under the Core Principles for Effective Banking Supervision,⁴ Principle 8 states that: “an effective system of banking supervision requires the supervisor to . . . have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.” (underlining added.) The Insurance Core Principles⁵ also require the supervisor to adhere to a policy of early intervention.

In general, early intervention means that as soon as there is strong, credible evidence to indicate that a supervisory decision is required, specific options should be considered, decisions should be taken, and the requisite measures should be put in place, all without undue delay. This should be the case whether the decision relates to revising the risk level of an institution, instituting a specific preventive or corrective measure, or in the ultimate case, putting the institution into liquidation or resolution. In this Note, early intervention relates in particular to the decisions and related actions required to put a financial institution into liquidation or resolution.

In the context of removing non-viable institutions from the market, an important objective of early intervention is that public stakeholders such as depositors and policyholders should be protected from undue loss. This means that public stakeholders should ultimately recover a reasonable percentage of the funds they had placed with the failed institution. For example, with the winding up of an insolvent bank or insurance company, one would want to see a return of deposits, payment of claims etc., of say, at least 80% to 90% of what is owed, with the shareholders (and holders of other investment-type obligations such as subordinated debt) of the institution having absorbed the first part of any losses.

⁴ Basel Committee (2012).

⁵ International Association of Insurance Supervisors (2019).

Balance sheet insolvency not a pre-requisite for supervisory action

Supporting a formal exit policy, legislation should make it clear that a financial institution should not have to be legally insolvent prior to the supervisor determining the institution to be non-viable. Non-viability will normally be considered to have been reached prior to the point at which the institution's financial statements show its assets to be worth less than its liabilities.⁶ International experience clearly supports this concept. Waiting until an institution is legally insolvent before declaring it to be non-viable almost always means that by the time the necessary legal and regulatory steps for liquidation or resolution can be executed, the ratio of assets to liabilities will in all likelihood have greatly deteriorated, leaving larger losses.

There are a several reasons why this typically occurs. First, when a financial institution is experiencing serious financial difficulties, there is often a tendency for the accounting regime to become increasingly aggressive. Thus, it frequently happens that when an institution is liquidated, its position is found to be considerably worse than was shown by the financial statements at the time. Second, when it appears to shareholders that the institution may not be able to survive, there can be pressure for them to remove assets from the institution quickly and by every means possible, including some that may be skirting or even crossing the boundaries of the law. Thus, what may have seemed to be a gradual deterioration in financial position may accelerate to rapid deterioration as the end draws near.

This concept of initiating exit policy prior to balance sheet insolvency is also recognized by international standards and by legislative provisions in some jurisdictions. The Financial Stability Board (2014) indicates that “resolution should be initiated when a firm is no longer viable or 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.” (underlining added.)

The Financial Stability Board also makes clear that ‘non-viable’ includes “no reasonable prospect of becoming viable,” and “no reasonable prospect of a recovery plan or sale of the institution.” With insurance as an example, the FSB suggests the following criteria to assist with the determination of non-viability: (i) the insurer is in breach of minimum capital, assets backing technical provisions, or other prudential requirements and there are not reasonable prospects of restoring compliance with these requirements; (ii) there is a strong likelihood that policyholders or creditors will not receive payments as they fall due; and (iii) recovery measures have failed, or there is a strong likelihood that proposed recovery measures will not be sufficient, to return the insurer to viability or cannot be implemented in a timely manner.”

Exit policy derived

Many aspects of international standards are relevant to the determination of a specific exit policy. Appendix 1 highlights the Insurance Core Principles that are relevant to an exit policy

⁶ ‘Liabilities’ in this case means the balance sheet value of its obligations, normally equal to assets minus equity, including retained earnings and any other sub-categories of the equity account.

and refers to similar provisions in the Basel Committee Core Principles and the Financial Stability Board's Key Attributes of Effective Resolution. Each point from the different standards is followed by a short summary statement to frame material from the excerpts in terms that are more specific to exit policy considerations.

The specific items developed from Appendix 1 are listed below. A number of the items describe important pre-conditions for the application of supervisory powers – powers that the supervisor must have in order to move an institution in an orderly manner towards liquidation or resolution as risk levels increase.

(1) The exit policy must be built on a foundation of early intervention. If the supervisory agency does not have the power, or the will, to commence the steps that efficiently lead to market exit, the exit policy will not be meaningful.

(2) The exit policy has to flow from the supervisor, which has the legal power to apply preventive and corrective measures in an escalating manner, and to have applied them, prior to the ultimate taking of action to remove an institution from the market.

(3) Supervisory powers of intervention must be strong, including restrictions on business activities and the ability to require that an institution's financial position be strengthened. Enforcement powers can include moving the institution up the risk levels of the guide to intervention, towards ultimate market exit. Additional strong powers can be exercised prior to market removal.

(4) Taking control of the institution and even moving to appoint a receiver are the ultimate steps to be taken as the institution is being removed from the marketplace.

(5) Financial institutions have important roles in the economy and for consumers. Therefore, these institutions require a range of special provisions in the law with regard to their liquidation or resolution, in particular to ensure that, compared to normal liquidations, the positions of depositors, policyholders, and other public stakeholders are preserved to the extent possible.

(6) Although the supervisor may not have responsibility for the resolution process, the supervisor should be authorized to play an important role in the resolution process, including advising on the possibility of takeover by a healthier institution, all with the objective of protecting the interests of depositors, policyholders and other public stakeholders.

(7) Legislative provisions dealing with the resolution of financial institutions must clearly indicate the bodies that will be involved in the resolution process and their specific responsibilities in the process.

(8) Laws, regulations, or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. As a supervised institution moves to risk level 4 of the guide to intervention, there are initial discussions between the supervisor and the relevant resolution authority. At risk level 5, the supervisor and resolution authority should be collaborating and coordinating closely in a mutually agreed upon series of actions governing market exit and the initial stages of a liquidation or resolution process.

(9) Resolution policies include provisions for working internationally with other supervisors and resolution authorities where relevant, because the home country institution that requires

resolution may have international connections.

(10) Market exit should be accomplished before an institution is balance-sheet insolvent. The supervisor should develop clear standards and suitable indicators of non-viability to help guide them on the timing of the exit decision.

(11) If, prior to forcing an institution to exit the market but in accordance with its legal authority, the supervisor requires officers of an institution to take certain actions, those officers should be indemnified against legal action by other parties such as shareholders or creditors.

(12) The presence of privately-funded consumer compensation funds can greatly assist the supervisor when it comes to triggering exit action: an important justification for deferring such action is the knowledge that it will give rise to hardships for consumers. A consumer compensation safety net protects consumers and removes that excuse for inaction.

(13) As part of the general process of collaboration between supervisory authority and resolution authority, the two authorities should agree on what specific thresholds will be utilized by the supervisor with regard to exit decisions. As well, they must jointly assess the extent to which the institution's internal processes and systems will be adequate to enable the institution to be phased out of the market without resulting in chaotic disruption to customers or others. If such processes and systems are not adequate, the supervisory authority and resolution authority need to decide how to proceed, for example, by retaining a professional audit firm to stand by in case it may be necessary to supply human and IT resources that would supplement the institution's own personnel, after the exit decision has been taken.

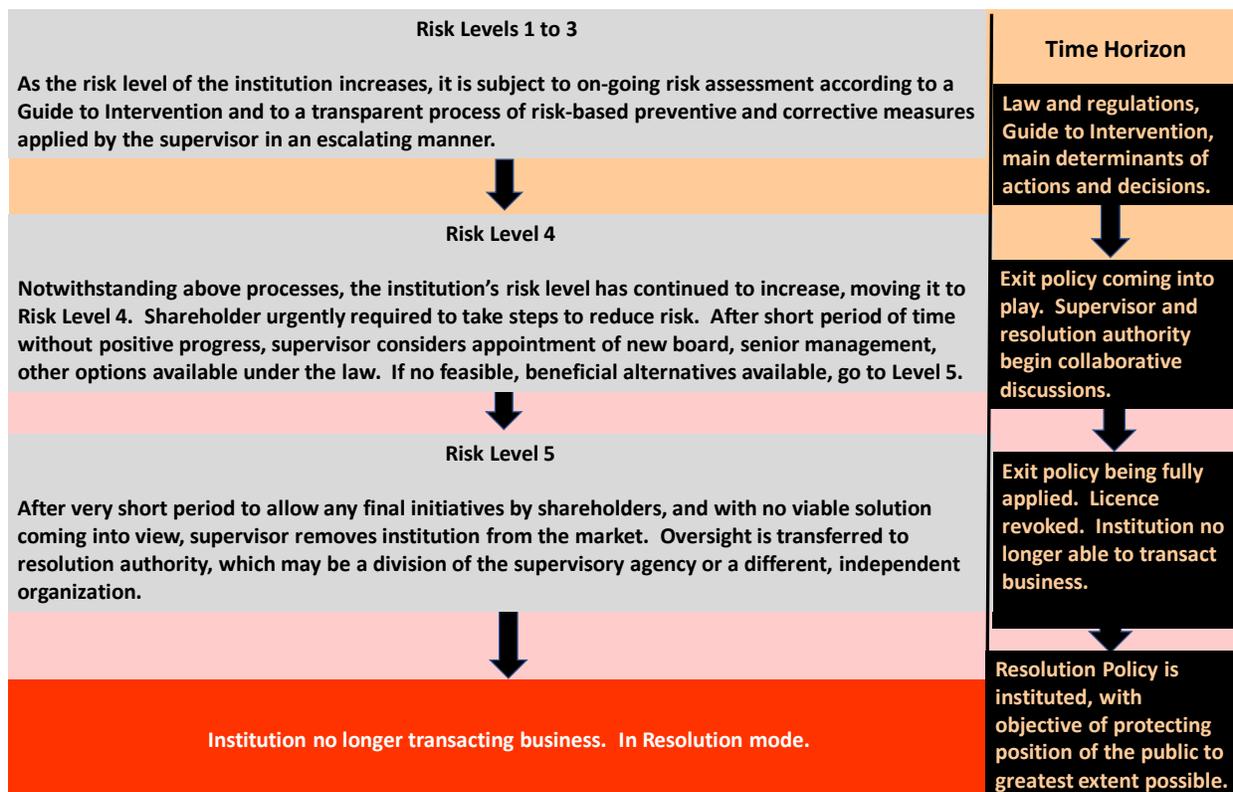
(14) Financial parameters and ratios can be pre-determined to serve as non-binding guides (red-lines) for use by the supervisory authority in assisting with the determination of non-viability. Such parameters or indicators should allow for timely and early entry into liquidation or resolution when the institution is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so, and before it is balance-sheet insolvent.

Where red-lines are part of the assessment process being employed by the supervisory authority, it would be beneficial to incorporate them into the guide to intervention. This is for the same reasons that the other guide to intervention material is beneficial: it fosters consistent decision making by the authority, and at the same time communicates items of critically important supervisory policy to the institutional shareholders, boards and senior managers of financial institutions.

Taking appropriate account of the details and context of the particular situation, the supervisory authority and all other involved parties should have confidence that there should be no hesitation in taking whatever steps are necessary to put the failing institution into liquidation or resolution when:

- the itemized points above have served to guide the supervisory authority in its oversight of institutions that may be approaching a state of non-viability;
- a selection of stipulated red-lines are being breached; and, if considered necessary,
- an independent professional advisor (auditor or actuary) has confirmed the supervisory view that “the institution is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so.”

The flow chart below illustrates how an institution might move through the risk levels specified in the guide to intervention, with the supervisor exercising the powers and decision guides outlined above, until ultimately the institution is put into liquidation or resolution.



Identifying non-viable institutions

Although international standards provide useful principles and concepts for establishing a foundation for dealing with non-viable institutions, they do not answer the important question of what constitutes a non-viable institution.

Insolvency/non-viability

A corporation is insolvent when its liabilities exceed its assets. Once a company is insolvent, its assets are not sufficient to pay off all the amounts that it owes – to suppliers, customers, and other creditors. For most types of corporations, it is clear when this point has been reached because liability amounts are well documented, and the values of assets are easy to establish.

But the situation for financial institutions is much less clear. For example, a major portion of a bank's assets are comprised of loans made to individuals and companies. Banks carefully track the financial positions of their borrowers, some of which will get into financial difficulty. In the more serious cases, accounting requirements and good practice dictate that the bank will have to recognize the likelihood that it is not going to see repayment of all or part of the loan. In that case the bank must make a provision for a non-performing loan, which reduces the net amount

of the bank's assets on its balance sheet.

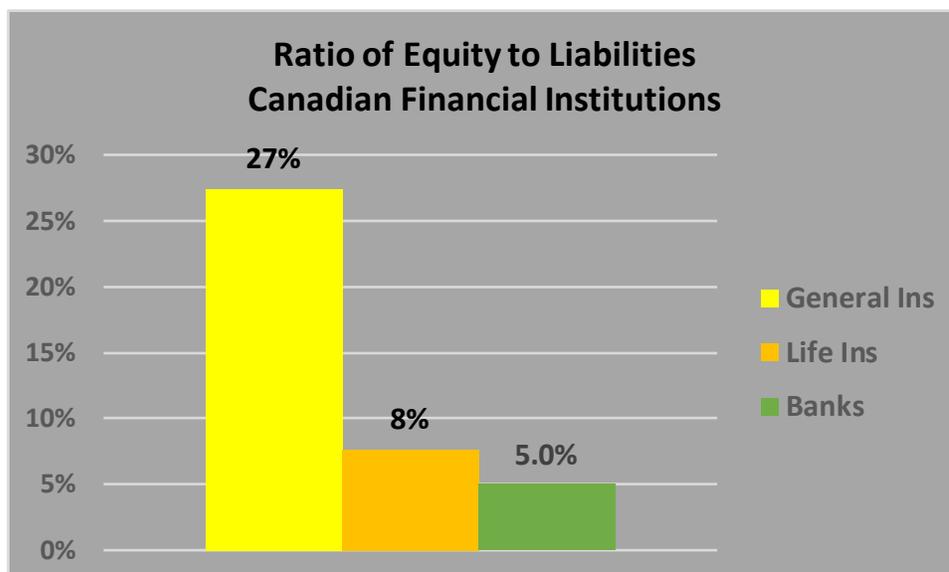
In the case of a general insurer, every time an insured event occurs the insurer must record a liability for the claim that will have to be paid. But claims cannot be settled immediately. It takes time to establish how much it will cost to rebuild premises or to determine the extent of the insured's liability under the policy. For some lines of business, the time between the occurrence of the claim and the payment of the claim is necessarily measured in years, due to the need to settle claim amounts through the courts. But because the insurer's liability exists from the moment the insured event happened, it must make an estimate of the ultimate payout amount, which will be included in the insurer's provision for outstanding claims. When all of the estimated outstanding claim amounts are aggregated, the total provision typically becomes the largest single liability item on a general insurer's balance sheet.

For life insurers, the largest single liability is usually the actuarial provision, which is an estimate based on assumptions about future trends in interest rates, policyholder mortality, company expenses, and other dynamics.

Because of these complexities, it is difficult if not impossible to determine an exact point in time at which the assets of the financial institution are not sufficient to pay off all the amounts that it owes.

Another unusual thing about financial institutions that compounds the challenges for supervisors attempting to formulate an exit policy is that for different types of institutions, the amount of equity standing between a condition of adequate financial health on the one hand, and non-viability on the other, is very different. For example, looking at Canadian financial institutions we find the relationships shown in the graph below (Bank of Canada data):

General insurers maintain, on average, more than five times the average capital ratio seen in the banking industry. Similar relationships exist in virtually all countries having reasonably developed financial systems, reflecting differences in the predictability of cash flows. These wide divergences further illustrate the problematic nature of assessing at what point one can conclude that an institution's capital has been substantially eroded and that the institution is no longer viable.



Financial analysis and red-lines as indicators of non-viability

Financial analysis of a company's past performance can reveal much about its likely future performance. This is particularly relevant when thinking about whether an institution is currently viable or not. As a simple example, consider an institution that had an equity base of \$30 million two years ago, but which lost \$5 million in the next year and \$10 million in the year after that, so that today it has equity of \$15 million. If this trend persists, it may lose \$15 million this year – and be non-viable by year-end or sooner. Thus, a very important aspect of assessing viability is considering trends in performance. If current trends persist, where is the institution likely to end up, and over what period of time?

In addition to trends, there are key financial ratios and other indicators that, if they reach specified threshold levels, can be interpreted as strong evidence that the viability of the institution is coming into question. For example, consider a jurisdiction that has adopted a risk-sensitive capital or solvency requirement of a type that meets accepted international standards. In such a case, there will be a lower-bound, or a reasonably narrow range for an accepted lower bound, at which point the supervisor and other independent professionals would usually agree that an institution should not be permitted to continue to accept funds from the public.

Such lower-bound threshold levels can be included in the guide to intervention as red-lines, which, if crossed, will be interpreted as a strong indication that a condition of non-viability has been, or is close to being, reached. These types of red-lines can be applied in conjunction with previously mentioned more general indicators of non-viability, such as there being no reasonable prospect of a recovery plan, so as to provide greater assurance with regard to the exit decision. If red-lines are specified in the guide to intervention or elsewhere, it is important to keep in mind that they are *indicators*, not definitive measures of non-viability.⁷

If supervisors do not have seasoned in-house expertise, they would normally want to consult with an independent, professional advisor such as a well-established audit firm or actuarial firm to obtain expert confirmation of the supervisory opinion. There will usually be parties who will object to any finding of non-viability, and those parties are likely to obtain their own professional advice on the subject and in some cases to take legal action against the supervisory authority. Thus, as a general rule, it is wise for the supervisory authority to buttress findings of non-viability with outside professional support.

In selecting an advisor, and in case it becomes necessary to take control of the institution, the supervisor should ensure that in addition to having the requisite human resources, the advisor has the capacity to draw on IT and other technological resources that may be required to process and analyze institutional data. Any such advisor should be retained on a highly confidential basis, sometime before the authority expects that a critical exit decision will have to be made. This is because the advisor needs to be fully informed and abreast of developments so that if required, a well-balanced, professional opinion will be able to be rendered within a

⁷ As already noted, the guide to intervention is a guideline or set of policies. Thus, if red-line thresholds are included as part of the guide, it does not mean that the supervisor is compelled to act because the red-line indicators are breached. But the presence of well-considered red-line thresholds can provide the supervisor with additional, explicit guidance that can assist with fending off political interference or other actions that could be used to try to justify inappropriate supervisory forbearance.

short time-frame.⁸

Appendix 2 sets out a number of red-lines, or key financial/operational indicators for different types of institutions, that may be helpful to supervisors in recognizing when they may be dealing with institutions where viability is becoming an issue. However, it must again be emphasized that indicators such as these should be considered as preliminary, with additional investigation needed prior to taking action. Another point to be kept in mind is that sometimes ratio values need to be calibrated to local conditions. For example, in an economic environment that is unusually volatile, it may be necessary and appropriate to maintain somewhat higher levels of capital, for all types of institutions, than would typically apply internationally. If that is the case, the relevant example red-line levels in Appendix 2 should be adjusted accordingly.

To assist supervisors further in recognizing how situations of non-viability tend to develop, and how they can typically be recognized, Appendix 3 sets out three mini-cases in which different types of institutions are approaching, or have reached, a stage of non-viability.

Consumer compensation schemes

At least for non-systemically-important financial institutions, the presence of a consumer compensation scheme (CCS) reduces the negative impact of the failure of a financial institution, because consumers' interests are looked after in a timely manner (albeit depending on the coverage of the scheme and the payout levels). A CCS is typically designed to cover members of the public with regard to losses that have been caused by the failure of a covered financial institution, for example deposit savings lost as a result of the collapse of a bank, or claims that cannot be paid by an insurer because it has become insolvent. The premium for the plan is typically assessed against the members of the covered financial sector, for example banks or insurance companies. Bank deposit insurance is well established internationally, and similar types of plans exist for insurance and some other types of institutions, although not as universally as for bank deposit insurance.

The main benefit of a CCS is the immediate assistance provided to affected consumers. Even with early intervention, liquidation of a financial institution normally takes years to accomplish. Under the rules for liquidation it is typically not possible to begin distributing the assets of a failed institution until such time as it can be established how much is available for distribution and how much each creditor should receive. In the meantime, during that potentially long period, and without access to assets, depositors and policyholders may face considerable hardship.

The presence of a CCS safety net provides a smoothly functioning mechanism for moving non-viable institutions into a process of orderly liquidation or resolution, without a lot of stakeholders suffering in the process. With most plans, the CCS makes payments up-front to stakeholders and then is able to subrogate for compensation from the failed institution as it is liquidated over time. So, it is the CCS that waits for many years to be compensated by the liquidator to the extent possible, rather than the ordinary consumers who trusted their deposits or insurance

⁸ To facilitate this, some resolution authorities are beginning to require major financial institutions to be valuation prepared ahead of the possibility that such a valuation may be required. See Toronto Centre (2020a).

needs to the failed institution.

This, in turn, can reduce the grounds for controversial debate and dispute, along with media coverage and other adverse consequences that often accompany the closure of a financial institution. Indeed, one of the reasons that financial industries such as banking and insurance are agreeable to paying the costs of a CCS, is that the CCS reduces the reputational damage that might otherwise be suffered by the entire industry when one of its members cannot meet its obligations.

Conclusions

- Financial supervisors must deal with many challenging issues, but regardless of their complexity and significance, liquidation and resolution decisions must be made in an objective and timely manner in order to meet supervisory responsibilities.
- The policy of early intervention must be followed in all situations, including with regard to protecting the public interest when institutions are judged to be no longer viable.
- In keeping with well-accepted principles of sound risk management, the presence of specific policies, guidelines, and thresholds can assist with decision making and action, even in the face of the most challenging of situations, such as the need to put a financial institution into liquidation or resolution. The existence of a formal exit policy helps supervisors avoid unjustified supervisory forbearance in cases where it has been determined that an institution is no longer viable.
- Application of formally designated red-lines and other indicators can serve as a useful aid in flagging situations of non-viability on a preliminary basis. When in-house resources need to be bolstered, supervisory authorities need to be able to consult with professional advisors such as highly reputable audit firms and actuarial firms for confirmation of their judgement.
- Specific policies and principles are highly beneficial, but at the end of the day the supervisory authority must have the will to follow the principles and fully discharge its responsibilities to the public and the country.
- The presence of a consumer compensation scheme to protect consumers from loss caused by the failure of their financial institution can be an important addition to the supervisory framework and facilitate the timely and effective implementation of liquidation and resolution policies.
- A well-thought-out exit policy, applied in every relevant situation, will constitute an important pillar of the financial supervisory framework.

References

Basel Committee on Banking Supervision. *Core Principles for Effective Banking Supervision*. September 2012.

<https://www.bis.org/publ/bcbs230.pdf>

Financial Stability Board. *Key Attributes of Effective Resolution Regimes for Financial Institutions*. October 2014.

http://www.fsb.org/wp-content/uploads/r_141015.pdf

International Association of Insurance Supervisors. *Core Principles and comframe*. November 2019.

<https://www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe//file/91154/iais-icps-and-comframe-adopted-in-november-2019>

Toronto Centre. *Turning Risk Assessments into Supervisory Actions*. August 2019.

https://www.torontocentre.org/index.php?option=com_content&view=article&id=18:turning-risk-assessments-into-supervisory-actions-2&catid=10&Itemid=101

Toronto Centre. *Resolution: Implications for Supervisors*. August 2020a.

https://www.torontocentre.org/index.php?option=com_content&view=article&id=179:resolution-implications-for-supervisors&catid=11&Itemid=99

Toronto Centre. *Recovery planning*. August 2020b.

https://www.torontocentre.org/index.php?option=com_content&view=article&id=194:recovery-planning&catid=13&Itemid=99

Appendix 1: Distilling an exit policy from international standards of financial supervision

In part 1 of the items below, the numerical reference at the start of each point is with reference to the IAIS Insurance Core Principles. After each item, reference is made to the corresponding Basel Committee Core Principle (BCP). Part 2 contains a number of elements drawn from the Financial Stability Board's Key Attributes of Effective Resolution.

Each red-font item sums up the corresponding item from international standards, using terminology that is more specific to an exit policy. The number at the start of the red-font material is the number of the item as it appears in the main text of this Note.

1. From the Insurance Core Principles:

9.2.4 The framework should promote pro-active and early intervention by the supervisor, in order to enable the insurer to take appropriate action to mitigate risks and/or minimise current or future problems. (BCP 8 – Supervisory Approach) (1) **The exit policy must be built on a foundation of early intervention. If the supervisory agency does not have the power, or the will, to commence the steps that efficiently lead to market exit, the exit policy will not be meaningful.**

10.2 The supervisor has sufficient authority and ability, including the availability of adequate instruments, to take timely preventive and corrective measures if the insurer fails to operate in a manner that is consistent with sound business practices or regulatory requirements. There is a range of actions or remedial measures which include allowing for early intervention when necessary. Preventive and corrective measures are applied commensurate with the severity of the insurer's problems. (BCP 11 – Corrective and Sanctioning Powers) (2) **The exit policy has to flow from the supervisor, which has the legal power to apply preventive and corrective measures in an escalating manner, and to have applied them, prior to the ultimate taking of action to remove an institution from the market.**

11.2 The supervisor has a range of actions available in order to apply appropriate enforcement where problems are encountered. Powers set out in legislation should at a minimum include restrictions on business activities and measures to reinforce the financial position of an insurer. (BCP 11 – Corrective and Sanctioning Powers) (3) **Supervisory powers of intervention must be strong, including restrictions on business activities and the ability to require that an institution's financial position be strengthened. Enforcement powers can include moving the institution up the risk levels of the guide to intervention, towards ultimate market exit.**

11.4 The supervisor has effective means to address management and governance problems, including the power to require the insurer to replace or restrict the power of Board Members, Senior Management, Key Persons in Control Functions, significant owners and external auditors. (BCP 11 – Corrective and Sanctioning Powers) (3) **(continued) Additional strong powers can be exercised prior to market removal.**

11.5 Where necessary and in extreme cases, the supervisor imposes conservatorship over an insurer that is failing to meet prudential or other requirements. The supervisor

has the power to take control of the insurer, or to appoint other specified officials or receivers for the task, and to make other arrangements for the benefit of the policyholders. (BCP 11 – Corrective and Sanctioning Powers) (4) Taking control of the institution and even moving to appoint a receiver are the ultimate steps to be taken as the institution is being removed from the marketplace.

ICP 12 Winding-up and Exit from the Market

The legislation defines a range of options for the exit of insurance legal entities from the market. It defines insolvency and establishes the criteria and procedure for dealing with insolvency of insurance legal entities. In the event of winding-up proceedings of insurance legal entities, the legal framework gives priority to the protection of policyholders and aims at minimising disruption to the timely provision of benefits to policyholders. (The Basel Committee has an entire, separate set of core principles with regard to resolution of banks.) (5) Financial institutions have important roles in the economy and for consumers. Therefore, these institutions require a range of special provisions in the law with regard to their liquidation or resolution, in particular to ensure that, compared to normal liquidations, the positions of depositors, policyholders, and other public stakeholders are preserved to the extent possible.

12.0.2 An insurer may no longer be financially viable or may be insolvent. In such cases, the supervisor can be involved in resolutions that require a take-over by or merger with a healthier institution. When all other measures fail, the supervisor should have the ability to close or assist in the closure of the troubled insurer having regard to the objective of the protection of policyholder interests. (The Basel Committee has an entire separate set of core principles with regard to resolution of banks.) (6) Although the supervisor may not have responsibility for the resolution process, the supervisor should be authorized to play an important role in the resolution process, including advising on the possibility of take-over by a healthier institution, all with the objective of protecting the interests of depositors, policyholders, and other public stakeholders.

12.1.1 The bodies responsible for dealing with the insolvency of an insurer, including the possible restructuring or portfolio transfer, and winding-up of the insurer are clearly set out in legislation. (The Basel Committee has an entire separate set of core principles with regard to resolution of banks.) (7) Legislative provisions dealing with the resolution of financial institutions must clearly indicate the bodies that will be involved in the resolution process and their specific responsibilities in the process.

25. The supervisor cooperates and coordinates with other relevant supervisors and authorities subject to confidentiality requirements. (BCP 3 – Cooperation and collaboration) (8) Laws, regulations, or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. As a supervised institution moves to risk level 4 of the guide to intervention, there are initial discussions between the supervisor and the relevant resolution authority. At risk level 5, the supervisor and resolution authority should be collaborating and coordinating closely in a mutually agreed upon series of actions governing market exit and the initial stages of a liquidation or resolution process.

26.2 The supervisor develops and maintains plans and tools for dealing with insurers in crisis and seeks to remove practical barriers to efficient and internationally coordinated

resolutions. (BCP Principle 13 – Home, Host Relationships) (9) Resolution policies include provisions for working internationally with other supervisors and resolution authorities where relevant, because the home country institution that requires resolution may have international connections.

2. From the FSB's Key Attributes of Effective Resolution:

3.1 Resolution should be initiated when a firm is no longer viable or 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 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. (10) Market exit should be accomplished before an institution is balance-sheet insolvent. The supervisor should develop clear standards and suitable indicators of non-viability to help guide them on the timing of the exit decision.

5.3 Directors and officers of the firm under resolution should be protected by law (for example, from lawsuits by shareholders or creditors) for actions taken when complying with decisions of the resolution authority. (11) If, prior to forcing an institution to exit the market but in accordance with its legal authority, the supervisor orders officers of an institution to take certain actions, those officers should be indemnified against legal action by other parties such as shareholders or creditors.

6.3 Jurisdictions should have in place privately-funded deposit insurance or resolution funds, or a funding mechanism with *ex post* recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm. (12) The presence of privately funded consumer compensation schemes can greatly assist the supervisor when it comes to triggering exit action: an important justification for deferring such action is the knowledge that it will give rise to hardships for consumers. A consumer compensation safety net protects consumers and removes that excuse for inaction. (See section "Consumer compensation schemes" below.)

4.1 Annex 4 In addition to the overall resolution strategy and the underlying strategic analysis, authorities should identify regulatory thresholds and legal conditions (i) that the provide grounds for the initiation of official actions (including thresholds for entry into resolution) . . . and (vi) the internal processes and systems necessary to support the continued operation of the firm's critical functions. (13) As part of the general process of collaboration between supervisory authority and resolution authority, the two authorities should agree on what specific thresholds will be utilized by the supervisor with regard to exit decisions. As well, they must jointly assess the extent to which the institution's internal processes and systems will be adequate to enable the institution to be phased out of the market without resulting in chaotic disruption to customers or others. If such processes and systems are not adequate, the supervisory authority and resolution authority need to decide how to proceed, for example, by retaining a professional audit firm to stand by in case it may be necessary to supply human and IT resources that would supplement the institution's own personnel, after the exit decision has been taken.

Annex II, Resolution of Insurers, 4.1 The resolution regime should set out clear standards or suitable indicators of non-viability to guide the decision as to whether an insurer meets the conditions for entry into resolution. Such standards or indicators

should allow for timely and early entry into resolution when the insurer is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so, and before it is balance-sheet insolvent. Suitable standards or indicators may include a determination by the supervisory authority, in consultation with the resolution authority (where the supervisory authority is not also the resolution authority) that, for example:

- (i) The insurer is in breach of minimum capital, assets backing technical provisions, or other prudential requirements and there are not reasonable prospects of restoring compliance with these requirements;
- (ii) there is a strong likelihood that policyholders or creditors will not receive payments as they fall due; and
- (iii) recovery measures have failed, or there is a strong likelihood that proposed recovery measures will not be sufficient, to return the insurer to viability or cannot be implemented in a timely manner.

(14) Financial parameters and ratios can be pre-determined to serve as non-binding guides (red-lines) for use by the supervisory authority in assisting with the determination of non-viability. Such parameters or indicators should allow for timely and early entry into liquidation or resolution when the institution is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so, and before it is balance-sheet insolvent.

Appendix 2: Examples of red-lines for institutions

Banks

- Corporate governance practices far from meeting international standards.
- Risk management framework deficient in many important respects.
- Equity (i.e. balance sheet equity including retained earnings and any other components of the equity account) < 1.5% of liabilities or < 5% of risk weighed assets.
- ROE < -20%, or less than -15% in two most recent years.
- Loans to related parties plus total value of all other transactions with related parties (e.g. joint ventures etc.) > 25% of equity.
- Liquid Coverage Ratio < 85%.

General insurers

- Corporate governance practices far from meeting international standards.
- Risk management framework deficient in many important respects.
- Equity (i.e. balance sheet equity including retained earnings and any other components of the equity account) < 10% of liabilities.
- Net premium written to equity > 5 to 1.
- ROE < -20%, or less than -15% in two most recent years.
- Loans to related parties plus total value of all other transactions with related parties (e.g. joint ventures etc.) > 25% of equity.
- Liquid assets < 85% of liabilities payable within 1 year.
- Provisions for outstanding claims deficient by more than 20% of equity.
- Combined ratio (claim ratio plus expense ratio) > 120% in the most recent year, and in at least one of the three years prior to that.

Life insurers

- Corporate governance practices far from meeting international standards.
- Risk management framework deficient in many important respects.
- Equity (i.e. balance sheet equity including retained earnings and any other components of the equity account) < 3% of liabilities.
- Premiums to equity > 8 to 1.
- ROE < -20%, or less than -15% in two most recent years.
- Loans to related parties plus total value of all other transactions with related parties (e.g. joint ventures etc.) > 25% of equity.
- Liquid assets < 85% of liabilities payable within 1 year.

These suggested red-lines are considered to be indications of potential non-viability, but they must be confirmed by reference to the over-riding condition that the financial institution is no longer viable or likely to be no longer viable and has no reasonable prospect of becoming so.

It is possible for a financial institution not to breach any of the red-line thresholds set out above, and yet still, by expert consensus, be non-viable or likely to be no longer viable. Similarly, an institution might exceed a number of these thresholds and yet, by expert consensus, continue to be viable. There may be other conditions and factors to be considered that would cause the supervisor to override the conclusion that might be indicated by the red-line thresholds alone.

Appendix 3: Institution not viable – mini-cases

Case 1 – General insurer

Summary balance sheet:

Assets	10,000,000
Liabilities	<u>8,500,000</u>
Equity	1,500,000

This insurer, which specializes in motor insurance and home insurance, has been growing at three times the average rate of growth exhibited by general insurers, over each of the last several years. Underwriting losses have been significant, so that even after taking account of investment income, the company has suffered after-tax losses of \$700,000 and \$900,000 in the last two years. At a recent on-site examination, the examiners concluded that this insurer's provision for outstanding claims is understated by approximately \$600,000. A follow-up review by an independent actuary has indicated that taking into account the additional six months that has elapsed since the previous year-end balance sheet, the deficiency in the provision is estimated to have increased to \$1 million.

This company may no longer be viable or will soon be non-viable due to:

- Growth rate and underwriting results – if the company is able to grow at a rate three times faster than the market average, this is almost certainly because its rates are substantially lower than the rates of its competitors. It may therefore be charging too little, as is confirmed by its operating results. Premiums are not going to be sufficient to pay claims plus underwriting expenses, so the insurer's rate of after-tax loss will continue to accelerate.
- Losses – the company lost \$900,000 in the previous year and had only \$1.5 million of equity at the start of this financial year. The loss for the current year will exceed the \$900,000 loss last year, reducing equity still further to an unacceptable low level. At the time of the actuarial review, the deficiency in the provision for outstanding claims was estimated to be \$1 million. Applying this figure to the most recent balance sheet figure of \$1.5 million, the actual equity amount was probably \$500,000 or less. When combined with a forecast operating loss of \$1 million, equity at the upcoming year-end can be estimated at minus \$500,000.

Case 2 – Mid-sized life insurer

Summary balance sheet:

Assets	100,000,000
Actuarial liabilities	86,000,000
Other liabilities	8,000,000
Equity	6,000,000

This life insurer has been growing its business but has drawn supervisory attention because of its high level of investment in real estate. At the end of the most recent year-end, 50% of the company's assets consisted of various parcels of commercial real estate. In addition, the supervisor had expressed a concern that much of the real estate was over-valued in the company's accounts, possibly by as much as 20% on average, based on some studies carried

out by the supervisor. Under pressure from the supervisor, the company has indicated that \$30 million of real estate has now been disposed of. After disposal, the CEO wrote to the supervisor indicating that “despite your concerns, the high quality of our real estate valuation was clearly demonstrated by virtue of the fact that the \$30 million book value of real estate disposed of, actually generated sale proceeds of \$40 million. Our conservative valuation policies have thus been well demonstrated and we hope they will not be questioned in the future.”

An examination team has now had an opportunity to visit the company. One part of the report states that “We were surprised to note that each of these properties has been sold to a numbered company and we were unable to determine the identities of the actual owners. Moreover, in each case the life insurer has provided 100% mortgage financing to the buyer. The company’s CEO says that these are perfectly valid transactions and of a nature that is routine in the life insurance business. We were assured that all purchasers are well-known entities but are entitled to confidential treatment for reasons of privacy.”

The examiner’s report also stated that “We noticed that the underlying interest assumption used by the actuary with respect to the company’s business is 4%. The company’s average rate of return on invested assets over the five most recent years was only 1.5%. The bulk of the policyholders are quite young, and the actuary advised us that expected average duration of the policies is 36 years.”

This company may no longer be viable or will soon be non-viable due to:

- Real estate valuation – the real estate being represented as ‘disposed of,’ has almost certainly just been parked with friendly parties or perhaps with the life insurer itself through numbered companies which, using a series of transactions, are owned and controlled by the life insurer. By extending 100% financing to the ‘buyers,’ the life insurer is able to transfer the properties to the numbered companies without those companies having to have any funds for actual payment for the parcels of real estate. Ideally, and in keeping with international standards, the supervisor should have the legal power to obtain professional valuations of any assets of a licensed insurer. The vendor-take-back mortgages are assets of the insurer and a professional mortgage appraiser or real estate valuator could be retained by the supervisor to value those mortgages. If the mortgages are not truly arm’s length transactions, that should be revealed through the information gathered by the valuator. If the insurer refuses to provide the required information, the supervisor should have the power to write down the value of the mortgages to amounts that might be suggested by the appraiser or valuator. If the real estate purportedly sold by the insurer is actually still part of its asset base, then total owned real estate remains at \$50 million, and if the shortfall is about 20% on average, then the overstatement of the company’s asset base would be \$10 million. This is considerably more than the year-end equity base and the company would be insolvent.
- Actuarial liabilities and interest rate earned on investments – the company’s own actuary has said that the life insurer needs to invest at 4% in order to accumulate sufficient funds to be able to meet the claim liabilities that will ultimately be generated under the policies. But it has only been investing at 1.5%. Over a period of 36 years, the accumulated value at 4% will be almost 2.5 times greater than the accumulated value of a fund earning 1.5%. An independent actuarial valuation should be undertaken immediately, to determine the impact of inadequate investment earnings.

Based only on the real estate situation, the company is likely not viable. The completion of an independent actuarial valuation is critically important to determine whether the insurer is non-viable. It may currently be assessed by the supervisor as being at risk level 4, but the results of the actuarial valuation and some additional research on the real estate situation may quickly move the insurer to risk level 5, requiring liquidation or resolution.

Case 3 – Mid-sized bank (specializing in loans to small commercial businesses)

Summary balance sheet:

Assets	500,000,000
Liabilities	475,000,000
Equity	25,000,000

The supervisor has just received a report from its examination staff which states: “At the time of our last visit six months ago, the bank’s equity position was \$25 million, with a provision for non-performing loans amounting to \$15 million. The provision remains at \$15 million. However, on this occasion our team reviewed loan documentation in much more detail. We found that a large number of additional loans have now ceased to perform. In addition, for virtually all these loans, the bank has adopted the policy of increasing the value of the loan and not showing any amount by which the loan is in arrears. Our rough estimate is that if the bank were not following this policy of capitalizing the amount of interest not received, the proper amount of NPL could be approaching double the \$15 million shown on the balance sheet, reducing the true equity position to \$10 million. With economic indicators suggesting that we are heading into a recession and thinking of the nature of the bank’s typical borrowers, we may be about to see a considerable acceleration in the level of non-performing loans. We spoke to the bank’s auditor who happened to visit the bank during our examination. He defended the bank’s practices with regard to NPLs.”

The bank may no longer be viable or will soon be non-viable due to:

- Provisioning practices – the bank’s policy of capitalizing interest payments not received is extremely aggressive and is making the bank’s position look significantly better than is actually the case. If the true amount of provisions should be increasing in the current economic environment by \$15 million over 6 months, as estimated by our examiners, and accelerating, then the examiners’ estimate of current equity equal to \$10 million would mean that in less than 6 months, equity will become negative.
- Accounting practices – it is startling to think that the auditor defends the provisioning policy. When very aggressive practices exist in one area, they will usually exist in other areas as well. With a compliant auditor we can assume that there are other unpleasant surprises to be found here, and some of them are probably material relative to determining whether this bank is viable.