CO-OPERATIVE BANKS DEVELOPMENT AGENCY

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PROBLEM CFI RESOLUTION FRAMEWORK

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CBDA SUPERVISOR

1) Introduction

This discussion paper provides a guide to intervention in problem CFIs. It promotes awareness and enhances transparency of the intervention process used by the CBDA Supervisor to supervise CFIs. It outlines the types of involvement that a CFI can normally expect from the Supervisor and summarizes the circumstances under which certain supervisory actions may take place.

The Supervisors have a responsibility to ensure that interventions within CFIs are timely and consistent, while ensuring that troubled CFI's that can be saved from failure are saved, and those that cannot be saved are allowed to exit as early as possible.

Due regard is taken of the need to ensure that in the absence of an enabling regulatory framework, interventions may largely be based on moral suasion. The guiding principles for a supervisor when dealing with weak CFIs are summarised in Table 2 below:

Table 2: Guiding Principles for Effective Problem Bank Resolution	
Speed	Supervisors should act promptly. Regulatory and supervisory forbearance can exacerbate the problems of a weak CFI. If not dealt with promptly, problems grow rapidly, thereby making the eventual resolution efforts more difficult and more expensive.
Cost-efficiency	A least cost criterion should guide the supervisor when making choices between alternative actions consistent with achieving the supervisory objectives.
Flexibility	Legislation frequently adopts a rules-based approach. However, it is also helpful if the legislation permits the supervisor to exercise discretion in the deployment and timing of supervisory approaches.
Consistency	Consistent and well-understood supervisory actions will minimise confusion and uncertainty in times of crisis.
Avoiding moral hazard	Supervisory action should not create incentives for CFIs to act in a manner that incurs costs which they do not have to bear entirely.
Transparency and cooperation	Inadequate or incorrect information from the CFI increases uncertainty for everyone involved leading to misplaced supervisory action and add to the costs of solving the problems. The CFI and the relevant authorities should aim for a high degree of information sharing and transparency about their intended actions.

In order to establish an effective risk-based supervision framework two key concepts must be addressed: risk assessment and intervention.

a) **Risk Assessment:** The CBDA Supervision Manual sets out the principles, concepts, and core processes that the Supervisor uses to guide its supervision of CFIs. It establishes a CFI's risk/compliance profile and assigns a corresponding rating.
b) **Intervention:** The guide to intervention is a resource which sets out levels of intervention commensurate with a CFIs' risk/compliance profile. It helps determine and organize supervisory actions, outlines clear timetables and identifies problems which pose a risk to depositors.

2) Intervention Stages

A fundamental aspect of risk-based supervision is the relationship between the risk profile of a CFI and the nature of supervisory interventions taken in response to that assessment. This relationship must be outlined in CBDA's response matrix.

Stage	Indicator	Intervention
Normal	>10% CAR >110% Solvency	**Risk Profile** The CFI has a sound financial position and sufficient governance and risk control frameworks for its nature, scope, complexity and risk profile. Its practices do not indicate significant problems or control deficiencies. The CFI is not expected to fail or pose any undue loss to depositors in any foreseeable circumstance. **Typical Supervisory Actions** a) periodic on-site examinations; b) monitoring of information received on a quarterly and/or annual basis; c) providing the CFI with a supervisory letter; and d) other supervisory activities as required or at the discretion of the supervision team.
Early Warning	9% - 10% CAR 100-110% solvency	**Risk Profile** A CFI categorized at this stage is not expected to fail or pose any immediate undue loss to depositors; however, there are aspects of its risk profile that may create vulnerabilities under adverse circumstances and as such requires more extensive oversight by the CBDA. The CFI is expected to implement an improvement

		plan to rectify or address identified concerns and commit to reducing its stage rating. The Supervisor expects a CFI to return to normal within the timeframes established by its improvement plan. **Typical Supervisory Actions** In addition to normal activities, actions may include: a) more frequent and/or more targeted on-site examinations b) more frequent and detailed collection and analysis of data; c) Provide emergency liquidity assistance for a limited period, if required d) communicating concerns to board of directors, CBDA Capacity Building (*consider internal and external auditors if applicable*); e) Establishing or issuing expectations under an undertaking or voluntary compliance agreement.
2- Risk to Financial Stability & Solvency	8%-9% CAR 100%-110% Solvency	**Risk Profile** Improvements are needed as the CFI's business operations or circumstances potentially put depositors at risk. In this stage, these improvements will be mandated by the CBDA Supervisor in consultations with CBDA Capacity Building. The CFI is unlikely to fail in the short-term but this expectation relies on the Supervisor's view that supervisory intervention is necessary to help avert any failure. The CFI must address identified problems or implement improvements to quickly reduce its stage rating. The board and senior management must demonstrate a commitment to improvement by establishing urgent timelines. The Supervisor expects a CFI to reduce its stage rating within this timeframe. **Typical Supervisory Actions** In addition to activities in preceding stages, actions may include: a) requiring recovery or restructuring plans; b) revising business plans; c) increasing capital; d) issuing other orders; e) placing the CFI under statutory supervision;

		f) Provide emergency liquidity assistance for a limited period, if required g) considering potential merger opportunities; h) entering into an undertaking or voluntary compliance agreement; and i) placing conditions or prohibitions on business authorization.
Future financial viability & Solvency in serious doubt	6%-8% CAR 90%- 100% Solvency	**Risk Profile** The CFI has severe safety and stability concerns and is experiencing problems that are expected to pose an undue loss to depositors unless corrective measures are promptly undertaken. The CFI failed to remedy the issues identified in the earlier stage and its situation is worsening. The CFI will be directed to immediately resolve issues or implement mandated improvements. The Supervisor expects immediate actions to reduce its stage rating. **Typical Supervisory Actions** a) In addition to activities in preceding stages, actions may include: b) placing the CFI under administration; c) winding down or merging; d) sale of assets; e) requesting financial assistance from the emergency liquidity facility, if liquidity is an issue; and f) preparing contingency plans
Non Viability/ Insolvent Imminent	≤ 6% CAR ≤ 90% Solvency	**Risk Profile** The CFI is experiencing severe financial difficulties and has deteriorated to such an extent that there is insufficient capital to protect depositors from undue losses. **Typical Supervisory Actions** In addition to activities in preceding stages, actions may include: a) withdraw deposit taking license; b) placing CFI into liquidation; and c) deposit pay-out (if available)

3) Red Flags

Each CFI will have its own unique set of problems, but generally this will manifest through solvency and liquidity weaknesses as a result of numerous possible internal causes such as poor strategy, weak controls and governance, or possible external events of an economic, social or political nature as detailed in Table 3 below.

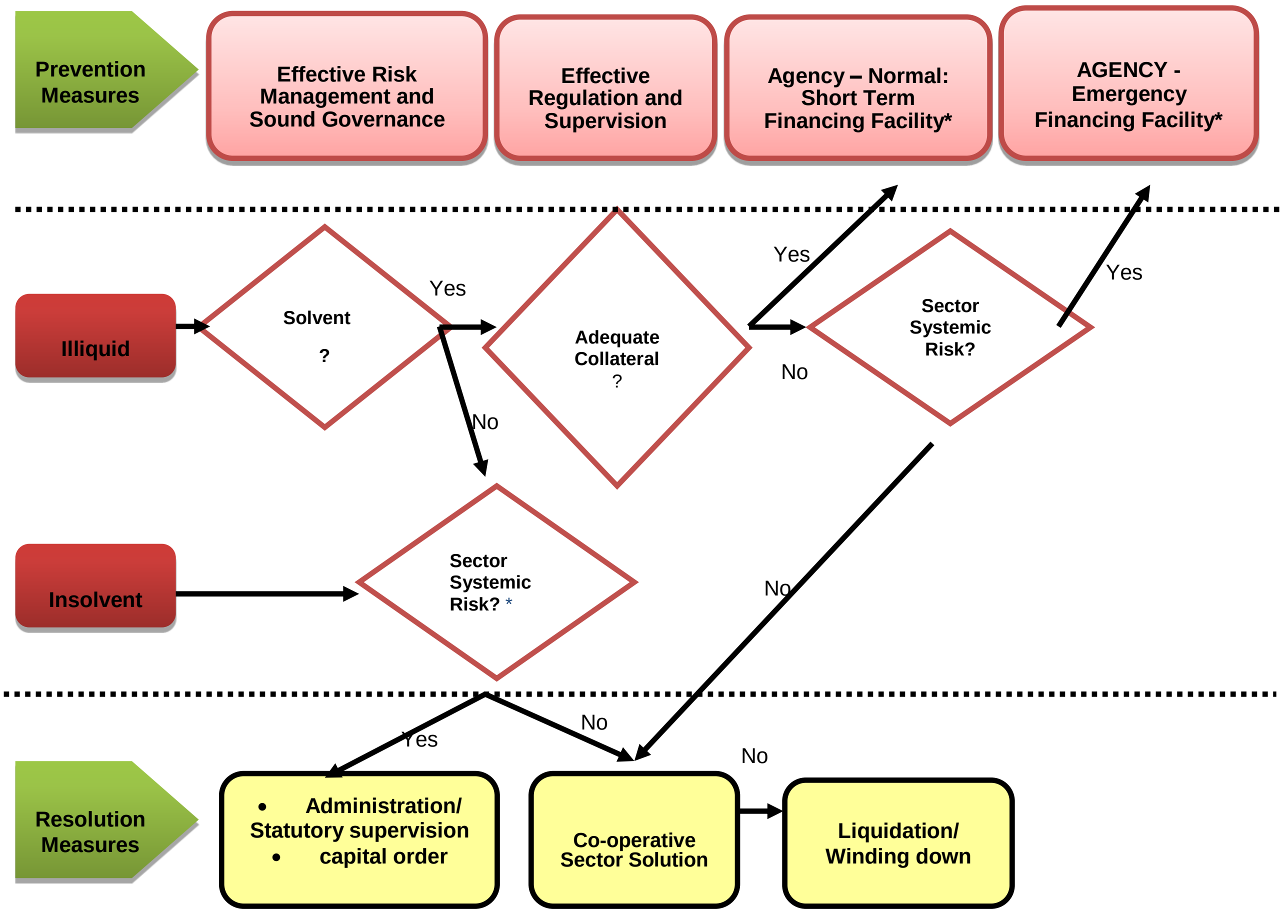
Table 3: Red Flag	
Rapid/aggressive growth strategies	• Precursor to credit quality problems • Poor underwriting standards. • Growth is not consistent with growth experienced by peers in the sector. • High growth in total loans • Growth is not pro-rata to growth in number of new members and no explanation to sudden growth in deposits
Management oversight and deficiencies	• Non-responsive management • Passive or uninformed Board of Directors • Non-attendance of board members at feedback sessions from Supervisors • Irregular Board meetings • Delay in AGM meetings • Insufficient planning and not responsive to risks • Inadequate qualifications, experience, talent. • Increasing non-compliance with laws/standards.
Delay in supervisory information	• Refusal to provide information to supervisors/on-site examiners • Delays beyond a reasonable time period • Use of agents, lawyers to screen requests • Alteration and/or disappearance of documents • No access to third party records • Attacks on credibility of supervisory staff • Non-return of telephone calls by supervisors • Requests for meetings, rather than reports
Risk management deficiencies	• Loan and savings policies that are not well defined or understood • Management failure to anticipate emerging technology needs • Lack of sufficient due diligence for new products and markets • A supervisory committee or internal audit committee that lacks independence. • No consideration given to welfare of large employer groups in the community • Delays in daily balancing practices

	• Increased non-compliance with prudential requirements
Asset Quality Deterioration	• High loan growth, increased delinquencies and non-performing loans • Increased level of interest accrued • Large policy and loan policy exceptions • Inadequate documentation • Inaccurate MIS • Litigation
Provisions	• Postponement of recognition of problems. • Provisioning growth rates are higher than growth rate of loans • Non-Performing Loans (NPLs) increasing faster than assets
Strained liquidity	• Non-compliance with minimum liquidity requirements • Low levels of short term liquidity • Increase in large deposits or deposits made above market rates • Increase in external borrowings (including from the central finance facility) • Increased funding mismatches
Insider abuse and fraud	• Fraudulent acts • Forgery/alteration of documents • Excessive salaries paid to staff • Loans granted to staff on more favourable terms than what the loan policy allow • Leave not taken for long periods by key personnel • Higher interests on staff deposits than what policy allows • Unexplained transactions with affiliates • No delegation of functions (that can be delegated) or taking over of functions of other staff members • Unwillingness to rotate board members • Unnecessary delays in receiving audited financial statements • Qualified audited financial statements • Employment involves nepotism • Board and staff related loans not declared to the same extent as other co-operative banks
External events	• Political events, such as strikes affects the co-operative bank • High level of political interference • Signs of recession • Commodity prices impacting on a particular sector • Sector analysis applicable to specific co-operative banks • Weakness in a secondary co-operative bank/CFF

4) HIGH LEVEL INTERVENTION FRAMEWORK

Where a CFI liquidated or wound down, it is important that the bankruptcy procedures allow insured depositors and other creditors prompt access to the insurance payments, if available. The various resolution options are summarised in diagram 1 below:

Diagram 1: Intervention Framework



*Section 55 (1)(f) and (h) of the Act. Stabilisation fund?

** Section 25 of the Act. Stabilisation fund?