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To: Members of the Executive Board

From: The Acting Secretary

Subject: **Czech Republic—Publication of Financial Sector Assessment Program Documentation—Technical Note on Crisis Management and Bank Resolution Framework**

Attached for the **information** of Executive Directors is a technical note on crisis management and a bank resolution framework that was completed in connection with the Financial Sector Assessment Program (FSAP) assessment of the Czech Republic.

It is intended that this paper will be published on the Fund's external website after July 13, 2012.

Questions may be referred to Mr. Prokopenko, MCM (ext. 38916).

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

# CZECH REPUBLIC

CRISIS MANAGEMENT AND BANK RESOLUTION FRAMEWORK

## TECHNICAL NOTE

JULY 2012

INTERNATIONAL MONETARY FUND  
MONETARY AND CAPITAL MARKETS DEPARTMENT  
LEGAL DEPARTMENT

Contents	Page
Glossary .....	3
I. Introduction .....	4
II. Executive Summary .....	5
A. Crisis Prevention .....	5
B. Crisis Preparedness .....	6
C. Crisis Management.....	7
III. Institutional Framework.....	8
A. Mandates and Division of Labor.....	8
B. Interinstitutional Coordination and Exchange of Information .....	11
IV. Prudential Supervision and Early Intervention.....	12
V. The Challenges of the Cross-border Dimension .....	14
VI. Crisis Management Tools .....	16
A. Official Financial Support.....	16
B. Orderly and Effective Resolution.....	19
C. Deposit Insurance Scheme .....	23
 Figures	
1. Liquidity Support Operations by the CNB .....	18
2. Composition of the Financial Reserves of the DIF (end.....	25
 Boxes	
1. Statutory Objectives and Functions for Resolution Authorities .....	9
2. Determining the Appropriate Size of a Deposit Guarantee Fund.....	26
 Annexes	
1. Key Recommendations on the Czech Crisis Management and Bank Resolution Framework .....	29
2. Status of Recommendations from Assessment of Core Principles for Effective Deposit Insurance Systems (2010).....	30

**GLOSSARY**

CNB	Czech National Bank
CBSG	Cross-border stability group
CMG	Crisis management group
CZK	Czech koruna
DIF	Deposit insurance fund
EC	European Commission
ELA	Emergency liquidity assistance
EU	European Union
FSAP	Financial Sector Assessment Program
FSCS	Financial Services Compensation Scheme
FSSA	Financial System Stability Assessment
FSB	Financial Stability Board
MOF	Ministry of finance
MOU	Memorandum of Understanding
RRP	Recovery and resolution plan

## I. INTRODUCTION<sup>1</sup>

1. **The Czech financial system weathered the global financial crisis relatively well.** Although banks were affected by the economic slowdown, financial ratios and profitability remained solid. The resilience of the Czech banks to the challenging operating environment contrasts positively with many other Central and Eastern European countries, reflecting the relatively conservative structure of bank balance sheets characterized by high shares of domestic deposits and loans, largely denominated in the local currency.
2. **As a result, the Czech banking sector is one of the few in the region where no exceptional state measures were needed.** There was no need to recapitalize banks using public funds, and the relaxation of monetary policy was sufficient to ensure adequate liquidity. In addition, the provision of liquidity by the European Central Bank and home-state authorities benefitted troubled parent banks and helped shield Czech subsidiaries from material financial stress.
3. **Nevertheless, the Czech financial system is confronted with mounting risks that mainly stem from negative developments in the European Union (EU).** Due to a high reliance of the Czech economy on exports to EU countries and the ownership of almost all large Czech financial institutions by parents from EU member states, the Czech financial sector could be materially affected by a deterioration of economic conditions in the EU. In practice, such risks would manifest themselves either directly by the debt crisis of a euro area sovereign (through their parent banks) or indirectly through weakened external demand. While the mission has established that Czech banks can withstand substantial shocks, stress tests indicate that the potential impact of cross-border spillovers on domestic banks could be material.
4. **In light of the foregoing, the need to examine the effectiveness of measures to prevent, prepare for, and manage crisis is unabated.** In connection with the Financial Sector Assessment Program (FSAP) Update, this technical note discusses the Czech crisis management and bank resolution framework and makes a number of recommendations for further enhancements.
5. **This note is structured as follows.** Chapter II summarizes the high-level observations of the mission based on its key findings and recommendations (summarized in Annex I); Chapter III analyzes the existing institutional framework and coordination arrangements for crisis management; Chapter IV discusses the resolution of problem banks; Chapter V discusses the cross-border dimension of crisis preparedness and crisis management; and Chapter VI examines crisis management tools.

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<sup>1</sup> This note was prepared by Constant Verkoren (MCM) and Dinah Knight (LEG).

## II. EXECUTIVE SUMMARY

6. **With respect to financial crises, there are three important perspectives that every jurisdiction should take into account: how to—as much as possible—prevent them, prepare for them, and, ultimately, manage them.** Crisis prevention rests heavily on the adequacy of micro and, increasingly, macroprudential supervision. In the event that supervisory measures are unsuccessful at preventing a crisis, the authorities should have at their disposal an appropriate and pre-established set of tools to manage the crisis in a timely and effective manner. Having these tools in place is a necessary but not a sufficient condition to being able to manage a crisis. The importance of preparedness cannot be understated. The mission’s overall observations in each of these three areas are presented below. In some cases, our overall observations are based on the conclusions drawn from other components of the FSAP Update mission; for example, the assessment of the Czech regulatory and supervisory framework conducted on the basis of the methodology for assessing the Core Principles for Effective Banking Supervision.<sup>2</sup> The mission’s key findings and recommendations with respect to crisis management and bank resolution that support the overall observations are summarized in Annex I.

### A. Crisis Prevention

*Overall observation: Measures to prevent crisis—primarily, microprudential supervision—should be more robust.*

7. **The mission has found weaknesses present in supervisory practices and has made recommendations to strengthen these deficiencies.** As a common theme among various areas of the FSAP mission, supervision has been encouraged to be more intrusive instead of relying on market discipline and bank management for appropriate actions to be taken; to be more proactive in dealing with emerging risks; to increase the frequency of the supervisory inspections (including at smaller entities, affiliated nonregulated entities and holding companies); and to ensure that matters are taken to their conclusion.

8. **Supervision should pay particular attention to emerging risks.** In particular, the current uncertain environment calls for intensive monitoring of subsidiaries of foreign banks. While the Czech National Bank (CNB) has already introduced extraordinary off-site monitoring through weekly reporting of subsidiaries’ liquidity positions and the exposures toward their parent companies, on-site visits of, and greater dialogue with, the subsidiaries should be undertaken.

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<sup>2</sup> See <http://www.bis.org/publ/bcbs130.htm>.

9. **It is advisable that the CNB continue to take a proactive role in cross-border cooperation with relevant home-country supervisors.** The various supervisory colleges and crisis management groups in which the CNB participates allow for a continuous dialogue on the financial condition of parent banks and their Czech subsidiaries. Given the structure of the Czech banking system, it is also appropriate for the CNB to encourage further cross-border cooperation, inter alia, via joint inspections and joint decisions related to cross-border banking groups. Timely and coordinated action in response to emerging weaknesses may limit, if not prevent, the occurrence of crisis.

## B. Crisis Preparedness

*Overall observation: The authorities could enhance their crisis preparation efforts, particularly in light of recent events in the global economy.*

10. **At the domestic level, more frequent, formal coordination on crisis management related issues between the CNB, the deposit insurance fund (DIF), and the ministry of finance (MOF) would be beneficial.** This would include, for example, enhanced policy coordination and discussions on potential improvements of the crisis management framework. The mission also recommends the authorities engage in scenario analysis, allowing them to reflect ex ante on the appropriateness of various policy responses under different circumstances, and to launch annual crisis management simulation exercises, aimed at testing, and subsequently strengthening, crisis preparedness.

11. **Coordination will be facilitated by clearly defined roles for the relevant stakeholders.** In this regard, the institutional framework should be improved. In particular, the CNB should have an explicit financial stability objective, as well as supporting objectives and functions that would allow it to act effectively as a resolution authority. In coordination with the CNB, the MOF, and the DIF should take more active roles in crisis preparedness and management.

12. **To ensure adequate preparedness, it would be useful to operationalize the framework for using public funds to provide exceptional support to the banking sector.** The authorities should ensure that they have appropriate legal bases, as well as internal policy guidelines and plans of action in place that would enable them to swiftly provide such support in the event that systemic financial stability is at stake. The authorities could consider establishing an industry-funded resolution fund to reduce the public costs of any future financial crisis.

13. **Given the structure of the Czech banking system, contingency plans of the authorities could usefully include possible measures aimed at averting cross-border contagion.** In case of a material deterioration of the condition of parent banks, the CNB may want to consider the deployment of firm-specific prudential measures that could protect subsidiaries from spillovers (e.g., increasing capital and liquidity requirements, requiring pre-approval of material intra-group transactions, or reducing intra-group limits). Although such

measures should not be deployed lightly and should be designed with a view to maintain credible host-home coordination, the CNB may already want to prepare an inventory of potential actions it could avail itself of in the case of emerging cross-border contagion. In this context, ex ante analyses of the appropriateness of policy responses under different circumstances would be appropriate.

### C. Crisis Management

*Overall observation: The Czech crisis management framework includes a number of important tools that will position the authorities to respond well to a crisis, but certain weaknesses should be addressed.*

14. **The CNB is authorized to appoint a conservator with broad powers to resolve a going concern; however, the threshold relating to the appointment could undermine the effectiveness of the entire framework.** The threshold requires an ex ante determination of systemic importance, which for most institutions will be difficult to make. As the British experience of Northern Rock has illustrated, even the failure of a small bank could, under certain circumstances, jeopardize the stability of the financial system as a whole. A more flexible threshold, based on qualitative (e.g., the activities or condition of the bank poses serious risks to the bank's depositors) and quantitative (e.g., based on capital or liquidity requirements) criteria would be more appropriate.

15. **The liquidation and insolvency framework could involve a more tailored approach for banks.** Taking into consideration the special characteristics of banks, administrative procedures could be introduced that would allow for the rapid transfer of a bridge bank or one or more private institutions of insured deposits (possibly combined with good assets) and critical banking functions (payment services, trade finance) out of the failed bank's estate before the remainder is dealt with through liquidation or insolvency proceedings, as appropriate.

16. **The ability of the DIF to accomplish its objectives should be strengthened in several respects.** Improvements to the governance structure by limiting the participation of active industry representatives on the Board should be made and the financial means of the DIF should be increased. Additionally, the trigger for payout needs to be clarified to facilitate timely compensation of depositors in line with their expectations of a 20-day payout. The DIF's powers should be expanded to enable it to provide financial support to purchase-and-assumption transactions involving the transfer of insured deposits to a healthy institution on a least-cost basis. Finally, the DIF should be given preferential treatment in insolvency, which will promote more effective recoveries, and to facilitate purchase-and-assumption transactions.

### III. INSTITUTIONAL FRAMEWORK

17. **A robust institutional framework is paramount to effective crisis management and bank resolution.** At minimum, such a framework should provide for clear mandates for the institutions involved, a distinct allocation of labor across institutions, and explicit coordination mechanisms between the relevant institutions, including a solid legal basis for the exchange of confidential information in times of distress. Responsibilities related to crisis management and bank resolution in the Czech Republic are primarily allocated between four institutions: the CNB, the MOF, the DIF, and the judicial system. Their mandates, division of labor, and coordination mechanism are further described below.

#### A. Mandates and Division of Labor

18. **The CNB serves as the central bank and the integrated financial sector supervisor.** In accordance with the Act on the CNB (Act No. 6/1993 Coll.), the primary objective of the CNB is to maintain price stability and its secondary objective is to support the general economic policies of the government. Notwithstanding the formulation of its objectives, the CNB is recognized as the primary authority responsible for financial stability in the Czech Republic. In addition to serving as the central bank and integrated financial sector supervisor, the functions of the CNB include, among other things, (a) analyzing the evolution of the financial system; (b) seeing to the sound operation and development of the financial market in the Czech Republic; and (c) contributing to the stability of the financial system as a whole. In light of its mandate, the CNB has authority to provide emergency liquidity assistance (ELA) to banks and credit unions, and to initiate conservatorship, liquidation, and insolvency proceedings. It may also select a candidate to serve on the Board of Directors of the DIF.

19. **The objectives of the CNB should be more closely aligned with its functions and its role as the primary authority responsible for financial stability, including crisis preparedness, management, and resolution.** The CNB is a creature of statute and can only execute powers vested in it for the performance of the functions and the fulfillment of the objectives assigned to it. Accordingly, the CNB's financial sector supervision and financial stability functions, including crisis management and resolution, should be considered within the context of its price stability or support for government economic policies objectives. The current formulation of the CNB's mandate may serve as a constraint to the exercise of its crisis management and bank resolution powers for legitimate public purposes, such as the protection of insured depositors' interests or limiting the cost of resolution for taxpayers when there is no clear relation to price stability. To overcome this potential constraint, the CNB should have an explicit financial stability objective, as well as subsidiary objectives and functions that would allow it to effectively act as a resolution authority (Box 1).

### Box 1. Statutory Objectives and Functions for Resolution Authorities

**The objectives of the CNB should be recalibrated consistent with developing international best practices for resolution authorities.** For example, the Financial Stability Board's (FSB's) *Key Attributes of Effective Resolution Regimes for Financial Institutions*<sup>1/</sup> (Key Attribute 2.3.) provides that as part of its statutory objectives and functions, and where appropriate in coordination with other authorities, the resolution authority should:

- pursue financial stability and ensure continuity of systemically important financial services, and payment and clearing settlement functions;
- protect, where applicable and in coordination with the relevant insurance schemes and arrangements, such depositors, insurance policy holders, and investors as are covered by such schemes and arrangements;
- avoid unnecessary destruction of value and seek to minimize the overall costs of resolution in home and host jurisdictions and losses to creditors, where that is consistent with the other statutory objectives; and
- duly consider the potential impact of its resolution actions on financial stability in other jurisdictions.

Such an approach is consistent with legislative trends in various jurisdictions. In the United Kingdom, for example, the objectives for the use of the special resolution regime include protecting public funds, protecting depositors, and protecting and enhancing the stability of the financial system. Section 4 of the UK Banking Act. (2009).

1/ <sup>1</sup> FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (October 2011) ("Key Attributes," herein) [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

20. **The MOF serves as the fiscal authority and the sole authority empowered to propose financial market legislation on behalf of the government, including legislation related to crisis management and bank resolution.**<sup>3</sup> In the event that public resources are needed to support bank resolution (e.g., to capitalize a bridge bank) or to provide financing to the DIF when its own resources are insufficient, such funding could only be provided by the MOF. The MOF has a special relationship with the DIF that falls short of oversight, but is worth mentioning nonetheless. Under the Act on Banks (Act No. 21/1992 Coll.), which governs the activities of the DIF, in addition to having authority to provide financial assistance to the DIF,<sup>4</sup> the minister of finance appoints the Board of Directors of the DIF, and has the ability to influence the framework under which the DIF operates.<sup>5</sup> More specifically, the consent of the minister of finance is required for the adoption or amendment of the

<sup>3</sup> Article 37 of the Act on the CNB. The CNB is obliged to cooperate with the MoF in preparing draft financial market legislation.

<sup>4</sup> Article 41(i) of the Act on Banks.

<sup>5</sup> Article 41b of the Act on Banks.

internal governing statute of the DIF.<sup>6</sup> Additionally, and as noted above, any change to the legal framework for the DIF must be proposed (and thereby agreed to) by the MOF.

21. **In light of the above, the MOF should take a more active role in crisis preparedness and management, while respecting the traditional division of labor between the MoF and the CNB.** The Czech government, as represented by the MOF, will be responsible for the fiscal costs associated with maintaining financial stability in the event of a crisis. In light of this role, active involvement of the MOF in crisis preparedness and management is essential. However, the need for government involvement should be appropriately balanced with the autonomy of the CNB.<sup>7</sup> The MOF should ensure the appropriate legislation and contingency plans to deal with a crisis are in place and facilitate effective policy communication among key stakeholders, which will help to minimize mistakes during crises and ultimately reduce costs. On the other hand, interference with supervisory decisions—including regarding when a bank should be intervened—is to be avoided.

22. **The authorities should consider establishing an industry-funded resolution fund to reduce the public costs of any future financial crisis.**<sup>8</sup> The global financial crisis made abundantly clear that, where necessary and to the extent possible, private rather than public resources should be used to fund resolution. Given that the Czech banking system emerged from the global financial crisis relatively unscathed, banks would likely be able to cope with the necessary contributions that would have to be imposed to enable the establishment of such a vehicle. In designing a resolution fund and calibrating the accompanying industry contributions, attention should be paid to specific characteristics of the Czech banking sector, taking into account that foreign-owned institutions may indirectly also benefit from support provided to the banking group by resolution funds established abroad. The division of labor and interaction between the resolution fund and the DIF should also be taken into account in light of the various models for defining such relationships.<sup>9</sup> Finally, as the buildup of a resolution fund will take a number of years, the authorities should consider how to best structure contingency-funding arrangements that could support the fund in case the demand placed on it exceeds its financial resources.

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<sup>6</sup> Article 41b(7) of the Act on Banks.

<sup>7</sup> See IMF, “Lessons from the European Financial Stability Framework Exercise” (in particular, *Annex I: Institutional and Legal Issues from FSAPs in EU Member States*), July 2011.

<sup>8</sup> See FSB Key Attribute 6.

<sup>9</sup> In Portugal, under pending legislation, the deposit insurance fund and resolution fund would be two separate legal entities with distinct purposes (i.e., insured depositor protection and resolution financing, respectively). In contrast, Sweden intends to combine the deposit insurance fund and resolution fund into a single “stability fund” with a broad mandate. The consultation paper on a possible framework for bank recovery and resolution, issued by the European Commission in January 2010, provides for national discretion in such matters on the design of resolution funds, see [http://ec.europa.eu/internal\\_market/consultations/docs/2011/crisis\\_management/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf).

23. **The role of the DIF with respect to crisis preparedness, management, and resolution should be strengthened.** Currently, the DIF serves as a paybox for the compensation of depositors in the event that a bank is unable to meet its obligations to insured depositors. Although the DIF is established and governed by the Act on Banks, it is not considered to be a public agency and its funds are not part of the government budget. In fact, although the Act on Banks does not preclude the DIF from having a public sector-dominated Board, in practice a majority of the Board comprises individuals from the private sector. As discussed further in Part V, the DIF should have expanded powers that would allow it to contribute funds to bank resolution, subject to certain conditions. To better perform this new function, as well as its existing functions, coordination with the CNB and the MOF should be enhanced (see paragraph 26). Changes to the DIF's governance structure to limit potential for conflicts of interests posed by active industry involvement on its Board as proposed in Part V, could facilitate interinstitutional coordination.

24. **The division of labor between the judicial system and the CNB with respect to bank liquidation and insolvency should be adjusted to enhance financial stability.** The judicial system conducts bank liquidation and insolvency proceedings, and, of course, adjudicates legal disputes surrounding actions taken by the CNB, the MOF, and the DIF related to crisis management and bank resolution. Given the CNB's policy preference for banks to be subject to liquidation or insolvency proceedings rather than other forms of resolution such as conservatorship, the judicial system plays a significant role in bank resolution. As discussed in Part V, the bank liquidation and insolvency processes are characterized by long delays and low recovery rates. To preserve value and the continuity of critical banking functions, the CNB should be authorized to execute and oversee the rapid transfer of certain assets and liabilities of a closed bank to a private sector purchaser or a bridge bank while the remainder of the bank's estate proceeds through liquidation or insolvency, as applicable. Such transfers would be subject to judicial review.

#### **B. Interinstitutional Coordination and Exchange of Information**

25. **Formal coordination mechanisms between the CNB, the MOF, and the DIF either have not been fully implemented, do not exist, or are not sufficiently clear to promote effective coordination.** For example, in 2007 the CNB and the MOF entered into an Agreement on Cooperation in the Area of Financial Stability and Financial Markets Crisis Management ("Crisis Management MOU") that establishes a coordination group on financial stability matters. Under the Memorandum of Understanding (MOU), the coordination group is required to meet at least once a year. In practice, no such meetings have occurred. With respect to the DIF, formal mechanisms ensure the cooperation of the DIF with the CNB and the MOF, but coordination in the reverse direction is less effective.<sup>10</sup> The CNB's only

<sup>10</sup> Under the Act on Banks, the DIF is required to cooperate with the CNB and the MOF. Article 41a(7) Act on Banks. Moreover, the DIF must verify the functioning of the compensation payment system at least annually and submit a report thereof to the CNB and the MOF. Article 41n of the Act on Banks.

obligation vis-à-vis the DIF is to provide advance notice of the possibility that a bank will be unable to meet its commitments to insured depositors and actual notice when the CNB has confirmed that this is the case. Determinations of when such notice will be given are made on an ad hoc basis by the CNB. On at least one occasion, the DIF has learned of the possibility of a payout from the media prior to being notified by the CNB. Similarly, the DIF is not notified by the CNB of the issuance of a new license, which would result in the addition of a new participant, the deposit insurance scheme. Finally, the MOF has no legal obligation to cooperate with the DIF and there is no MOU in place on how such cooperation would occur. Such cooperation could become crucial in the event that the DIF does not have sufficient funds to compensate depositors and needs support from the government.

26. **Interinstitutional coordination should be enhanced by strengthening formal cooperation arrangements.** Coordination between the institutions (mainly through the MOF and the CNB) does occur through informal channels and on an ad hoc basis. To ensure effective coordination during a crisis, informal arrangements should be supported by formal arrangements. In particular, the Crisis Management MOU should be activated and updated to provide for more frequent, formal coordination on crisis management related issues and involvement of the DIF. The coordination group offers a suitable platform for (a) enhanced policy coordination; (b) the preparation of scenario analysis allowing for ex ante reflections on the appropriateness of various policy responses under different circumstances; (c) discussions on potential improvements of the crisis management framework, taking into account emerging international best practices;<sup>11</sup> and (d) launching annual crisis management simulation exercises, aimed at testing, and subsequently strengthening, crisis preparedness. In addition, legislative changes should be made that would require the CNB and the MOF to cooperate with the DIF and include more explicit notice provisions with respect to actions by the CNB that could potentially impact the DIF.

#### IV. PRUDENTIAL SUPERVISION AND EARLY INTERVENTION

27. **Intrusive supervisory practices and prompt supervisory intervention should minimize the need for the use of more drastic crisis management tools.** In the run-up to the global financial crisis, supervision in some jurisdictions failed to recognize and/or address growing risks. This failure of supervision was reflected in various forms, including:

- not intruding sufficiently into the affairs of financial institutions, and instead relying bank management to take appropriate actions and market discipline;
- not being sufficiently proactive in dealing with emerging risks and adapting to the changing environment;
- not being comprehensive in their scope; and

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<sup>11</sup> Reflecting, for example, the contents of the FSB's Key Attributes.

- not taking matters to their conclusion.<sup>12</sup>

28. **The FSAP (update) mission has found that each of these weaknesses is present in the Czech supervisory practices to varying degrees and has made recommendations to strengthen these deficiencies.** These were discussed in Section III.C. of the Financial System Stability Assessment (FSSA). Recommendations include, for example:

- Supervisory staff should broaden their contacts with banks' management and supervisory boards, play a more important role in setting the bank's strategies and policies, and more actively challenge banks and their managements.
- Given the level of uncertainty surrounding global financial and economic conditions, close monitoring of subsidiaries of foreign banks should be stepped up, in particular via more frequent on-site visits. Moreover, in case of a material deterioration of the condition of parent banks, the CNB may want to consider the deployment of firm-specific prudential measures aimed at limiting cross-border contagion, such as increasing capital and liquidity requirements, requiring pre-approval of material intra-group transactions or reducing intra-group limits; such measures, however, should not be deployed lightly and should be carefully designed, inter alia, reflecting the need to maintain credible host-home coordination. Notwithstanding, the CNB may already want to prepare, as part of its contingency planning, an inventory of potential actions it could avail itself of in the case of emerging cross-border contagion
- On-site inspections should be more frequent. Due to constraints on supervisory resources, it may pass three years or more between full inspections for large banks.
- To reduce delays on the imposition of remedial measures, the CNB could issue more detailed guidance to the interpretation of some of its laws and regulations, including a structured framework for early intervention (or decision not to intervene), based on quantitative as well as judgmental criteria.<sup>13</sup> The CNB should also develop more seamless interaction between the onsite supervisors and enforcement staff in order to reduce the delays.

29. **Of course, there must be an appropriate legal basis for supervisors to adopt necessary practices.** Certain powers for the CNB to intervene in a problem bank while it is still under private control could usefully be strengthened or added. The CNB has fairly comprehensive powers to intervene in a problem bank while it is still under private control if the CNB detects "shortcomings" in the activities of the bank.<sup>14</sup> For example, the CNB could

<sup>12</sup> IMF, "The Making of Good Supervision: Learning to Say 'No'" (2010).

<sup>13</sup> Early intervention frameworks developed by the supervisory authorities of Canada and Denmark could serve as an appropriate benchmark.

<sup>14</sup> Articles 26 and 26a of the Act on Banks.

replace members of the banks management or supervisory Board;<sup>15</sup> require the bank to maintain capital above the standard threshold;<sup>16</sup> or restrict the payment of dividends.<sup>17</sup> Any action taken must be proportional to the revealed violation.<sup>18</sup> For some actions, triggers for action are explicitly stated in the Act on Banks. In the context of crisis preparedness, the authorities should consider including power for the CNB to order the adoption or implementation of recovery plans, particularly for the largest banks.

## V. THE CHALLENGES OF THE CROSS-BORDER DIMENSION

30. **The banking sector is highly concentrated and dominated by foreign banks.** The five largest banks, which are wholly or majority foreign owned, control 70 percent of total banking assets. A material deterioration of the financial position of foreign parent banks can thus have significant spill-over effects in the Czech banking system. In addition to potential demands for increased profit upstreaming, which would limit the ability of the local subsidiaries to build buffers, there is a risk that parent companies draw excess liquidity from their Czech operations or transfer risky assets to their Czech subsidiaries. If done excessively, such actions could be harmful for the Czech banking system, which may—should the crisis persist—already be negatively affected by a deterioration of the European environment.<sup>19</sup> Intra-group exposures of Czech subsidiaries illustrate the magnitude of potential contagion channels—although the current exposures do not breach the regulatory limit applicable to EU credit institutions (100 percent of regulatory capital), they are significant.

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<sup>15</sup> Article 26(2 and 4) of the Act on Banks.

<sup>16</sup> Article 26(8) of the Act on Banks.

<sup>17</sup> Article 26(14) of the Act on Banks.

<sup>18</sup> Article 26(2) of the Act on Banks.

<sup>19</sup> The mission notes, however, that the general requirement for banks to “carry out [their] activities with prudence and pursue [their] business in a manner which is not detrimental to the interests of its depositors in respect of the recoverability of their deposits and which does not endanger the bank’s safety and soundness” (Article 12 Act on Banks) limits the chance of such excessive transactions occurring. Also, the CNB is closely monitoring intra-group transactions between Czech subsidiaries and their foreign parent companies.

31. **As is appropriate given the interlinkages between domestic banks and their foreign parents, progress has been achieved in enhancing cross-border cooperation between the CNB and international peers.** Within the EU, the multilateral MOU on cooperation in the area of Financial Stability and Financial Market Crisis Management, agreed in 2008, was meant to provide a basis for cross-border cooperation via the establishment of so-called cross-border stability groups (CBSG). To date, CBSGs, which are aimed at enhancing crisis preparedness for individual institutions, have gotten limited traction.<sup>20</sup> However, supervisory colleges have provided an alternative forum to address issues related to crisis preparedness and crisis management. At the time of the mission, the CNB actively participated in seven colleges and has signed the accompanying multilateral cooperation and coordination agreements.<sup>21</sup> Going forward, the CNB should continue to pursue cross-border coordination, encourage joint inspections and decisions, and foster a continuous dialogue with its main peers on the financial condition of parent banks and their Czech subsidiaries, with a special focus on potential contagion channels. Timely and coordinated action in response to emerging weaknesses may limit, if not prevent, the occurrence of crises situations in individual banks.

32. **Active participation in crisis management groups (CMG) is essential for the Czech authorities.** As of 2011, several home supervisors established CMGs, as also recommended by the FSB.<sup>22</sup> Amongst other things, such groups seek to assess and discuss specific issues and barriers to coordinated action that may arise when handling severe stress at specific firms, and share information on groups that may be pertinent in crisis situations (intra-group exposures, contingency funding plans, clearing and settlement linkages, global interconnectedness, etc.). Such groups will provide the Czech authorities access to discussions of the recovery and resolution plans (RRPs) of banking groups that are critical for the financial stability of the Czech banking sector. The CNB participated in the inaugural meetings of groups for various banks active in the Czech Republic, but has so far refrained from signing written agreements on crisis management, as it prefers to await the finalization of the EU framework for bank recovery and resolution. The mission, however, recommends the authorities to take a proactive stance and help shape these groups, even in the absence of a final EU framework.

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<sup>20</sup> This MOU aims to enhance cooperation between central banks, financial market supervisors, and finance ministries of EU member states in the management and resolution of cross-border financial crises. [http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/supervision\\_financial\\_market/conduct\\_of\\_supervision/memoranda\\_of\\_understanding/multilateral\\_memoranda/mou\\_2008.pdf](http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/supervision_financial_market/conduct_of_supervision/memoranda_of_understanding/multilateral_memoranda/mou_2008.pdf).

<sup>21</sup> <http://www.eba.europa.eu/Supervisory-Colleges/Publications/CEBS-today-received-a-call-for-technical-advice--s.aspx>. The CNB has signed multilateral agreements with regard to Erste, KBC, ING, Raiffeisenbank, Societe Generale, Unicredit, and Volksbank.

<sup>22</sup> FSF Principles for Cross-Border Cooperation on Crisis Management, issued in April 2009, [http://www.financialstabilityboard.org/publications/r\\_0904c.pdf](http://www.financialstabilityboard.org/publications/r_0904c.pdf), and more in the FSB's Key Attributes.

## VI. CRISIS MANAGEMENT TOOLS

33. **The authorities should have at their disposal an appropriate and pre-established set of tools to facilitate timely response to a crisis.** The tools for crisis management and bank resolution should include solid but flexible arrangements for official financial support (ELA and solvency support) of banks; robust resolution powers for banks as a going concern; a mechanism for orderly liquidation as a gone concern; and a well-designed deposit guarantee scheme.

### A. Official Financial Support

#### Solvency Support

34. **The global financial crisis did not require a recapitalization of the Czech banking system.** The capital adequacy ratio, which is mainly made up of Tier I capital, increased from 12.3 percent in 2008 to 15.9 percent end-June 2011, in part reflecting profit retention. In the event that the capital position of domestic subsidiaries of foreign banks would materially deteriorate, additional capital would ideally first be provided by their parent companies. Should private capital not be forthcoming, the authorities could intervene through the resolution framework discussed below, or pursue a recapitalization via public means. The Act on Budget Rules (Act. No. 218/2000 Coll.) commendably provides for the possibility of both a nonrepayable subsidy and a repayable loan from the state budget to a (bridge) bank.<sup>23</sup> Depending on the amount involved, it may be possible to provide support from the budget reserve within days. Alternatively, in the case of an emergency situation the authorities could pursue a simplified legislative procedure, which allows for the preparation of specific legislation regarding the provision of public support; such procedure is expected to take two weeks at most.

35. **Notwithstanding the foregoing, the framework for using public funds to provide exceptional support to privately-owned banks should be further clarified.** The authorities should ensure that they have appropriate policy guidelines and plans of action in place that would enable them to swiftly provide such support in the event that stability of the financial system is at stake. This would include, for example, obtaining prior budgetary authorization for the amount necessary to meet the minimum capital requirement for a bridge bank. In addition, it would be appropriate to pre-establish conditions under which support could be offered, including mechanisms to attribute losses to existing shareholders, guidelines on the exercise of voting rights in banks obtained by the government (if any), transparency requirements vis-à-vis the public and parliament, and conditions relating to executive compensation. The authorities should also consider establishing an industry-funded resolution fund (see paragraph 22 above).

<sup>23</sup> Such support would be subject to the EU state aid rules, as enforced by the European Commission's (EC's) DG COMP.

## Liquidity support

36. **The financial crisis did not necessitate the provision of exceptional liquidity support to individual Czech banks, in part thanks to their strong funding profiles.** This notwithstanding, the global disruptions that occurred during the financial crisis did have an impact on Czech funding markets, as activity on the interbank money market became limited to maturities shorter than one week. The CNB responded in October 2008 by relaxing its monetary policy via a temporary liquidity-supplying repo facility and a foreign exchange swap facility to provide Czech koruna (CZK) funding against EUR.<sup>24</sup> Through the repo facility, Czech credit institutions could obtain financing with a two-week or three-month maturity on a fully collateralized basis (e.g., against Czech government bonds or bonds issued in CZK by other eligible issuers).<sup>25</sup> The repo operations were scaled down again as of January 1, 2011, as the three-month facility was discontinued.<sup>26</sup> While the repo operations have only been used in small volumes (Figure 1), the CNB is of the view that their mere existence contributed to safeguarding confidence in the Czech financial system.

37. **Czech legislation allows the CNB to provide, against adequate collateral, ELA to Czech banks.**<sup>27</sup> ELA relates to the discretionary provision of liquidity by a central bank to financial institutions. Under the EU framework, ELA may only be provided to illiquid but solvent banks. Under exceptional circumstances, providing ELA may prevent that illiquidity at a specific bank leads to its insolvency and can thus prevent a systemic loss of confidence from emerging. In addition to providing ELA, the CNB is authorized to render financial assistance to a bank that has been placed under conservatorship.<sup>28</sup> During the financial crisis, the provision of ELA to Czech banks has not been necessary.

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<sup>24</sup> Press releases CNB October 14 and November 20, 2008, [http://www.cnb.cz/en/financial\\_markets/money\\_market/param\\_liquidity-providing\\_repo.html](http://www.cnb.cz/en/financial_markets/money_market/param_liquidity-providing_repo.html).

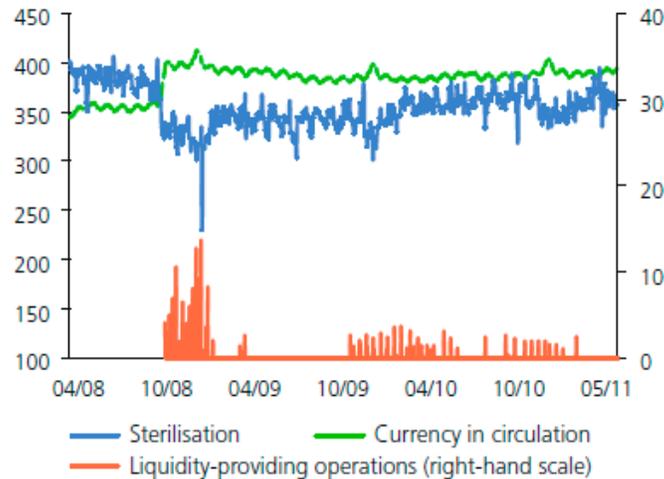
<sup>25</sup> The general framework for the operations of the CNB on the domestic money market are described in the official CNB Announcement on the Conduct of CNB Operations on the Domestic Money Market, version dated July 29, 2011 (translated from Czech), [http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/legislativa/vestnik/2011/download/v\\_2011\\_09\\_21311\\_610.pdf](http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/legislativa/vestnik/2011/download/v_2011_09_21311_610.pdf). The framework covers the wider range of CNB operations and is not specific to the facilities introduced during the financial crisis.

<sup>26</sup> In September 2011, the CNB Board decided to leave the two-week repo operations in place, as this facility was deemed important for the stability of the domestic financial market and the functioning of the government bond market. Simultaneously, the CNB decided to leave the swap arrangement unchanged. Press release CNB September 28, 2011: [http://www.cnb.cz/en/public/media\\_service/press\\_releases\\_cnb/2011/20110929\\_repo.html](http://www.cnb.cz/en/public/media_service/press_releases_cnb/2011/20110929_repo.html).

<sup>27</sup> Article 29(2) of the Act on the CNB.

<sup>28</sup> Article 32 of the Act on Banks.

Figure 1. Czech Republic: Liquidity Support Operations by the CNB  
(In billions of Czech Korunas)



Source: CNB, Financial Stability Report 2010-2011

38. **The CNB's operational framework for providing ELA should be further operationalized.** Since the provision of ELA may have to be effected under stressful circumstances and within a tight timeframe, the availability of policy guidelines and plans of actions is highly beneficial. Items to consider in this context include (a) the internal decision making process; (b) assets that the CNB would accept as collateral (presuming that collateral for regular refinancing operations will already have been exhausted), including valuation thereof and accompanying haircuts; (c) the (presumably punitive) interest rate to be charged; (d) the maturity of support provided; and (e) additional measures that may be imposed on the bank (for example, measures aimed at decreasing the likelihood of future liquidity problems or, in the case of subsidiaries of foreign banking groups, measures to prevent the withdrawal of the liquidity support provided by parent companies). In addition, the CNB may want to publish its ELA policy principles, following the example of other countries (e.g., Sweden).

39. **In the context of ELA, close coordination between different departments of the CNB is essential.** While the responsibility for providing ELA has been allocated to the Financial Markets Department, close coordination with the Financial Market Supervision Department is necessary. In particular, the Financial Market Supervision Department will have to carry out viability assessments prior to the extension of credit by the Financial Markets Department and perform intensive supervision on the recipient bank while it works toward restoring their access to market funding. Crisis-simulation exercises can be helpful tools in testing the effectiveness of such cross-departmental coordination. The last exercise, conducted in November 2007, highlighted some operational issues, inter alia regarding unclear definition of responsibilities. While procedures have reportedly been tightened since, a new crisis simulation has not yet taken place.

## B. Orderly and Effective Resolution

### Going-concern resolution

40. **The Act on Banks permits going-concern restructuring of a problem bank through the appointment of a conservator entrusted with an appropriately broad range of powers.** The CNB is authorized to appoint a conservator to a bank on specified grounds (discussed below). The conservator has discretion, with the prior consent of the CNB, to impose a partial or full moratorium on deposit liabilities and may also partially or fully suspend, for a maximum of six months, any payments to persons with a special relation to the bank.<sup>29</sup> The conservator is empowered to act in the capacity of the bank's decision-making bodies.<sup>30</sup> Accordingly, during conservatorship, the general meeting of the bank's shareholders does not take place and, with two notable exceptions, the conservator decides on all matters falling within the powers of the general meeting of shareholders. A conservator may not decide to increase the bank's capital in a manner that excludes shareholders' preferential rights, unless the bank failed to comply, within the time limit prescribed by the CNB, with a remedial measure requiring the bank to increase its capital.<sup>31</sup> On the other hand, a conservator could authorize a merger, or sale of all or substantially all of the bank's assets and liabilities to a private sector purchaser or bridge bank, without approval of the bank's general meeting of shareholders, other decision-making bodies, or the consent of its creditors.<sup>32</sup> Any transaction that would involve the transfer of the bank's liabilities to another party would require the CNB's consent.<sup>33</sup>

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<sup>29</sup> Articles 29(3) and (4) in the Act on Banks.

<sup>30</sup> Article 29(2) of the Act on Banks.

<sup>31</sup> Article 29(2) of the Act on Banks. Additionally, shareholders and management of the bank retain their rights to file legal claims related to the imposition of conservatorship. Article 29(1) of the Act on Banks.

<sup>32</sup> Article 29a of the Act on Banks.

<sup>33</sup> Article 29a of the Act on Banks.

41. **Recent amendments to the Act on Banks usefully provide for explicit authority for either a bank under private control or a bank under conservatorship to transfer assets and liabilities to a bridge bank.**<sup>34</sup> Such a transaction would occur through a contract entered into by the bank with the bridge bank. For a bank under private control, the contract would be signed by the management of the bank with the consent of the general meeting of the bank's shareholders. For a bank under conservatorship, the contract would be signed by the conservator and shareholders' consent is not necessary. In either case, bridge bank authority could prove to be an important tool in light of the structure of the Czech banking sector where there is significant presence of domestic subsidiaries of foreign banks. In the event that a foreign parent bank is in distress, the bridge bank authority could facilitate the transfer of the business of the subsidiary (on a voluntary basis or otherwise) and the continuation of its vital operations, until a suitable private sector purchaser can be identified. The bridge bank must have the minimum capital as required by the Act on Banks. In all other aspects, the licensing procedures are significantly simplified.

42. **Despite the strong features of the conservatorship framework, the threshold relating to the appointment of a conservator could undermine the effectiveness of the entire framework.** The Act on Banks authorizes the CNB to appoint a conservator to a bank only where "shortcomings in a bank's activities endanger the stability of the banking or financial system."<sup>35</sup> Properly designed, the legal threshold for the appointment of a conservator should provide the resolution authority with a sufficiently clear and well-supported legal basis to take control of a problem bank. The triggers for the appointment of a conservator should allow for timely intervention in a bank at a sufficiently early stage following signs of distress to minimize the potential consequences of the disorderly failure of the bank (i.e., deposit runs, rapid deterioration of value, and systemic risk). Typically, the thresholds for the appointment of a conservator combine qualitative (e.g., the activities or condition of the bank poses serious risks to the bank's depositors) and quantitative (e.g., based on capital or liquidity requirements) criteria that are sufficiently flexible to allow the resolution authority to respond to a range of circumstances. Under the current threshold, for certain institutions it should be relatively easy to prove that the legal threshold has been satisfied. However, for most institutions, assessing whether their failure may pose systemic risks can be difficult, since the consequences of a bank failure may depend on factors that are not measurable, such as public confidence in the financial sector at a particular moment in time.<sup>36</sup> Amendments should be made to the Act on Banks to allow for the introduction of a conservator based on thresholds that include quantitative(?) and qualitative criteria tied to the condition of the particular financial institution at issue.

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<sup>34</sup> Article 16(5) and(6) of the Act on Banks.

<sup>35</sup> Article 30(1) of the Act on Banks.

<sup>36</sup> For example, prior to its failure, Northern Rock was not considered to be systemically important by the U.K. authorities.

43. **The role of the conservator vis-à-vis the CNB and the objectives of conservatorship should be better defined in the law.** The law specifies that a conservator shall be an employee of the CNB and may be dismissed and replaced by the CNB.<sup>37</sup> For a bank under conservatorship, there are two important roles that must be fulfilled—the role of bank management and the role of bank supervisor. Recognizing that under the Czech legal framework there may be administrative reasons for hiring a conservator as an employee, rather than an agent, of the CNB, the division of labor between the conservator (bank management) and the CNB (bank supervisor) should be clearly stated in law. In principle, the conservator should have day-to-day responsibility for managing the bank and the appropriate skill set to do so; be accountable to CNB but—in contrast with “regular” CNB staff—not embedded in the corporate hierarchy of the CNB, and be subject to legal protection to the same extent as supervisory staff of the CNB. The conservator should be explicitly charged with assessing the financial condition of the bank, preparing a new balance sheet, and preparing and implementing a resolution plan. In contrast, the CNB should conduct intensive supervision of the bank under conservatorship; decide on the resolution plan prepared by the conservator; and approve all major transactions entered into by the conservator (e.g., a merger, transfer of all or substantially all of the bank’s assets and liabilities, or recapitalization).

44. **The authorities are encouraged to follow closely emerging best practices for resolution and to further enhance the Czech Resolution framework, as appropriate.** In particular, the following work streams are likely to be relevant for the Czech financial system:

- **Scope of application of resolution:** There is ongoing international debate regarding the application resolution measures to nonbank financial institutions and domestic or cross-border banking groups. While there is increasing recognition that resolution measures should apply to more than just domestic banks, the means of accomplishing this are still being developed.<sup>38</sup> Currently, the conservatorship framework under the Act on Banks focuses on domestic banks. Other types of financial institutions (e.g., non-EU-based foreign branches,<sup>39</sup> credit unions, building societies, and insurance firms), domestic or cross-border banking groups, and financial conglomerates are not addressed.

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<sup>37</sup> Article 28 of the Act on Banks.

<sup>38</sup> See, e.g., FSB Key Attribute 1.1, 3.7 and 7 and IMF, “Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination,” 2010.

<sup>39</sup> Under the EU Winding-Up Directive, branches of EU-based foreign bank would be subject to the resolution framework of the home country of the parent institution.

- **New resolution tools.** The authorities should continuously evaluate the appropriateness of new resolution tools—for example, mandatory debt restructuring—as best practices are developed.<sup>40</sup>

### **Bank liquidation and insolvency**

45. **There are two types of procedures that deal with winding-up failed banks— involuntary liquidation and insolvency.** Involuntary liquidation of banks is governed by the Act on Banks and the Act on Insolvency and its Resolution (Act No. 182/2006 Coll.).<sup>41</sup> Bank insolvency is governed exclusively by the Act on Insolvency.<sup>42</sup> If a bank’s license has been revoked, the CNB may petition the court to appoint a liquidator to commence involuntary liquidation of a solvent bank or to appoint an insolvency trustee to commence insolvency proceedings for an insolvent bank. Both proceedings are carried out under the supervision of the courts. In the case of liquidation proceedings, the CNB determines the remuneration for the liquidator, monitors and assesses the liquidator’s activities during the course of the liquidation, and can petition the court to have the liquidator dismissed. In the case of insolvency, the responsibilities of the CNB terminate following the appointment of the insolvency trustee. Both procedures have proven to be ineffective with respect to time delays and low recovery rates.<sup>43</sup>

46. **Amendment should be made to the legal framework for bank liquidation and insolvency that would promote the preservation of value and the continuation of critical banking functions.** As they stand, the liquidation and insolvency frameworks do not fully address the unique features of banks that call for special treatment during these processes. Banks have long been recognized as distinct from other companies given the structure of their balance sheets (which are subject to rapid deterioration when the bank is under stress) and special functions (e.g., credit intermediation, payment systems functions). Notably, the Insolvency Act was amended in 2008, and now includes a special chapter on banks and other financial institutions. Although the amendments include some useful features,<sup>44</sup> the effectiveness of the liquidation and insolvency framework could still be significantly enhanced. In this regard, it is strongly recommended to enable, under the oversight of the CNB, the rapid transfer of insured deposits (possibly combined with good assets) and critical banking functions (payment services, trade finance) to a bridge bank or a private institution

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<sup>40</sup> See, e.g., FSB Key Attribute 3.5 and IMF, “From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions” (forthcoming).

<sup>41</sup> Article 36 of the Act on Banks.

<sup>42</sup> Title IV of the Insolvency Act.

<sup>43</sup> There are currently three banks in liquidation proceedings, all of which were initiated in the 1990s. There are also nine banks undergoing insolvency proceedings, the most recent of which commenced in 2003.

<sup>44</sup> For example, establishing the revocation of a banking license is a necessary precursor to the commencement of insolvency proceedings against a bank.

before the remainder of the estate is dealt with under the insolvency or liquidation procedures as applicable. Thus, those critical elements continue to operate in going concern (hopefully preserving the value of the assets, the continuity of critical functions, and depositors' access to their funds), while the remainder of the failed bank is removed from the market.

### C. Deposit Insurance Scheme

47. **The Act on Banks provides for the establishment of a pre-funded deposit insurance scheme.** Participation in the deposit insurance scheme is mandatory for all banks, credit unions, and building societies licensed in the Czech Republic, as well as for all branches of non-EU banks; deposits held at branches of EU banks are covered by deposit insurance schemes of their EU home country. Since its establishment in 1994, the DIF has obtained significant experience in relation to its compensatory function, having made payouts to insured depositors in 16 cases, in total amounting to CZK 25.5 billion (end-2010).<sup>45</sup> Payouts to insured depositors are triggered by a notification from the CNB or, in the case of a branch of a non-EU bank, from the home-country supervisory authority that the bank is unable to meet its commitment to insured depositors.<sup>46</sup> The DIF is required to pay compensation within 20 working days.<sup>47</sup>

48. **The Czech Republic's deposit insurance scheme has been enhanced in recent years, reflecting EU legislative developments.** Key changes enacted include (a) an increased coverage of EUR 100,000 per eligible person per bank;<sup>48</sup> (b) a shortening of the payout period to 20 days; (c) an increase of the quarterly premiums paid by banks and credit unions; and (d) a discontinuation of co-insurance and the right of set-off. The authorities are actively monitoring developments with regard to the EC's proposal on deposit guarantee schemes.<sup>49</sup>

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<sup>45</sup> <http://www.fpv.cz/data/files/annual-report-2010-fpv.pdf>.

<sup>46</sup> Article 41d(1) of the Act on Banks.

<sup>47</sup> Article 41d (3) of the Act on Banks. Under preceding legislation, the DIF was obliged to pay compensation within three months from receipt of the relevant notification from the CNB, with the possibility of two extensions of three months each. Nowadays, the Act of Banks only allows one extension of maximum 10 working days, which is (in line with current EU legislation) only to be granted "in wholly exceptional circumstances." Data transfer tests that were ongoing at the time of the mission suggested that insured institutions would largely also be able to facilitate the seven-day timeframe that is currently being contemplated by the EC.

<sup>48</sup> The equivalent in CZK is to be calculated using the foreign exchange market rate announced by the CNB at the date on which the DIF receives the CNB's official notification.

<sup>49</sup> Press release of the EC dated July 12, 2010, aimed at boosting consumer protection and public confidence in financial services. <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/918>.

## Funding arrangements

**49. The DIF is funded by ex ante contributions, to be paid on a quarterly basis.**

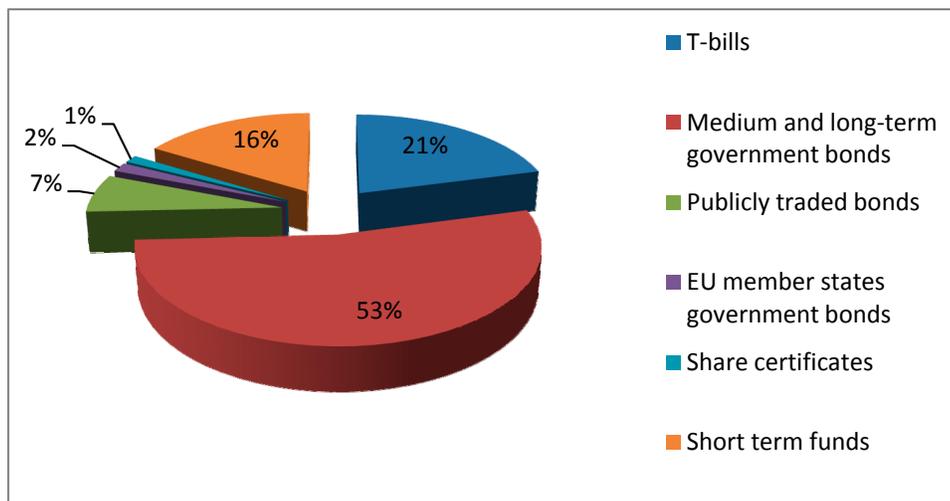
Beginning in July 2010,<sup>50</sup> the mandatory contributions for banks and credit unions were increased to 0.04 percent of the average volume of insured deposits over the relevant quarter, and to 0.02 percent for buildings societies. In connection with the increase, a target level of 1.5 percent of the total volume of deposit claims insured was established for the fund. The law provides for a reduction of the contributions when this target is reached. At the time of the mission, the DIF amounted to approximately CZK 22 billion (representing approximately 1 percent of total insured deposits). The DIF is required to immediately inform the CNB of nonpayment of the required contributions by a regulated entity, allowing the CNB to take proper action; to date, however, nonpayment has not occurred.

**50. The investment policy of the DIF is predicated on its low risk tolerance and potential liquidity needs.** The DIF seeks to limit the impact of market volatility on its reserves by primarily investing in treasury bills and medium and long-term domestic government bonds, supplemented by investments in government bonds issued in foreign currencies and bonds issued by banks and corporations in CZK and selected foreign currencies, with a minimum rating requirement for bond issuers of “single A” (S&P) (Figure 2). Under normal market circumstances, the DIF is expected to be able to liquidate its investments without incurring losses within the 20 day payout timeframe. To enhance portfolio liquidity, the DIF can enter into repo transactions with Czech banks or, if necessary, with the CNB.

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<sup>50</sup> Prior to this date, the annual contributions were 0.1 percent of the average volume of insured deposits on for banks and credit unions, and 0.05 percent on an annual basis for building societies.

Figure 2. Czech Republic: Composition of the Financial Reserves of the DIF (end-2010)



Source: DIF, Annual Report 2010.

**51. The mission recommends augmenting the financial resources of the DIF.**

Notwithstanding the recent increase of the banks' contributions to the DIF and the establishment of a target level in the Act on Banks, the fund is relatively small in comparison to total insured deposits. At present, there are concerns that a significant event in the credit union sector (but holds almost CZK 20 billion of insured deposits) or the failure of a single mid-size bank could already largely deplete the resources of the fund. Box 2 below provides considerations for determining the appropriate size of a deposit guarantee fund. As part of its necessary steps to increase the financial means of the DIF, the mission suggests that the authorities investigate the possible implementation of risk-based premiums, which could—amongst others—ensure that the elevated risk profile of the credit unions (which typically tend to focus on riskier clients) is properly reflected in their contributions.<sup>51</sup>

<sup>51</sup> The indicators included in the proposal for a recast Directive on deposit insurance funds, released by the EC in July 2010, could serve as a useful benchmark. See [http://ec.europa.eu/internal\\_market/bank/docs/guarantee/comm\\_pdf\\_com\\_2010\\_0368\\_proposition\\_de\\_directive\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/guarantee/comm_pdf_com_2010_0368_proposition_de_directive_en.pdf).

### **Box 2. Determining the Appropriate Size of a Deposit Guarantee Fund**

**Determining the appropriate size of a deposit guarantee fund is more an art than a science.** Historic losses may provide some guidance but cannot be decisive, as other factors also need to be taken into account. Setting a range, rather than a legislatively mandated fixed target, can mitigate the need to drastically increase contributions during difficult economic times when the fund may need to be replenished because of one or more bank failures. This can help to avoid procyclical contribution increases and offers more flexibility in managing the fund depending on need and economic conditions.

**Cross-country experience shows that a number of considerations should be taken into account when determining the target size.**

- **Factors related to the banking system.** Items to consider are the amount of insured deposits, probability of banking failures, and the degree of concentration. Typically, a DIF should be large enough to support a simultaneous default of 2–3 midsize or 4–5 small banks,
- **Factors related to the deposit insurance mechanism.** Items to consider are the risk aversion of the depositors, the availability of alternative financial resources supporting the fund in the case of losses, and the riskiness of the fund’s investment strategy.
- **Other factors.** Macro economic and financial market stability, as well as effective supervision and early intervention, may provide valid reasons for limiting the target size of the deposit insurance fund.

52. **The backstop funding arrangements of the DIF should be improved, particularly in light of the current limited resources.** The Act on Banks mandates the DIF to raise additional funds on the market, should its own resources prove to be insufficient for a payout. As a subsequent step, should efforts to raise additional funds prove unsuccessful, the DIF can request the MOF to provide financial support—but it is not certain that the MOF would be able to immediately meet such a request.<sup>52</sup> While the inclusion of backstop funding arrangements in the Act of Banks is useful, the current structure raises concerns, as the requirement to first raise additional funds on the financial markets may have adverse signaling effects and the timely availability of funding support from the MOF is not certain. Given the short payout period of 20 working days and the EC proposals to further accelerate payouts to 7 working days, it is important to establish a concrete mechanism that allows for the immediate disbursement of funding support in case of a shortfall; to the extent necessary, the MOF should obtain a standing budgetary authorization that allows for such immediate support.<sup>53</sup> As part of its necessary steps to increase the financial means of the DIF, the

<sup>52</sup> Article 41i of the Act on Banks.

<sup>53</sup> In Russia, for example, the Deposit Insurance Agency has a line of credit with the government that can immediately be drawn on when its own resources are insufficient. If the amount of shortfall of the resources of the Deposit Insurance Agency exceeds the amount of the line of credit, additional funding can be obtained upon seeking expedited approval by parliament.

mission also suggests that the authorities investigate the possible implementation of risk-based premiums, which could—amongst others—ensure that the elevated risk profile of the certain institutions is properly reflected in their contributions.<sup>54</sup>

### **Depositor preference**

53. **The authorities are recommended to consider amending the insolvency act to allow for preferential treatment for claims of insured depositors.** As the insolvency act already allows for the subrogation of the rights of insured deposits to the DIF, providing depositors with priority rights would facilitate more effective recovery by the DIF. This may be particularly useful for the DIF, given its low average recovery rate (approximately 21 percent<sup>55</sup>). In addition, preferential treatment of depositors would enable the transfer of insured deposits to another bank (possibly a bridge bank) through purchase and assumption agreements, by providing a legal basis for differential treatment between depositors and other unsecured creditors. However, the authorities should ensure that in determining priorities, national laws and regulations do not discriminate against creditors on the basis of their nationality, the location of their claim, or the jurisdiction where it is payable. Also, the treatment of creditors and ranking in insolvency should be transparent and properly disclosed to depositors, insurance policy holders, and other creditors.<sup>56</sup>

### **Use of deposit insurance funds in bank resolution**

54. **Widening the mandate of the DIF would facilitate bank resolution and conserve its resources.** Currently, Czech legislation does not allow the DIF to provide financial support to a nonliquidation resolution, that is, a transfer of insured deposits to another bank (possibly a bridge bank) through a purchase-and-assumption. Such a transaction would occur through the transfer of deposit liabilities and good assets, supplemented by sufficient resources from DIF to close the gap between the assets and liabilities. Providing the DIF with the authority, as other European member states have done,<sup>57</sup> to lend support on a least-cost basis to a potential transfer of deposits from a “failed” to a healthy bank would remove the

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<sup>54</sup> The indicators included in the proposal for a recast Directive on deposit insurance funds, released by the EC in July 2010, could serve as a useful benchmark. See [http://ec.europa.eu/internal\\_market/bank/docs/guarantee/comm\\_pdf\\_com\\_2010\\_0368\\_proposition\\_de\\_directive\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/guarantee/comm_pdf_com_2010_0368_proposition_de_directive_en.pdf).

<sup>55</sup> Staff notes that most insolvency proceedings started-up in the '90 are still ongoing today. The estimated recovery rate at the time of the mission was 35 percent in aggregate.

<sup>56</sup> Key Attributes of Effective Resolution Regimes, published by the FSB on November 4, 2011. [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

<sup>57</sup> As an example, reference is made to the United Kingdom where the Financial Services Compensation Scheme (FSCS) is allowed to contribute to the funding of bank resolution transactions under the Special Resolution Regime, which was introduced in the Banking Act 2009 as a permanent framework, providing tools for dealing with distressed banks and building societies. Funding provided by the FSCS may not exceed the costs, net of recoveries, or paying out insured deposits in an insolvency.

need to make actual payouts to insured depositors and can contribute to more effective bank resolution.<sup>58</sup> In addition, such a transfer ensures that the provision of banking services to depositors is not interrupted. Typically, the support that a deposit insurance scheme would provide in the context of a purchase and assumption would be lower than the amount it would pay out to insured deposits.

### **Core Principles for Effective Deposit Insurance Systems**

55. **The findings of the mission were consistent with a recent detailed assessment of the Core Principles for Effective Deposit Insurance Systems.**<sup>59</sup> An assessment undertaken in September 2010 as part of a field test of the Assessment Methodology for the aforementioned principles found, inter alia, that (a) the governance structure of the DIF should be improved to minimize the potential for conflicts of interest, which may stem from the presence of active bankers on its Board; (b) information gathering by the DIF should be enhanced by providing it with sufficient legal powers to obtain information about the condition of banks in advance; (c) interagency coordination should be strengthened, allowing the DIF to participate in crisis management arrangements, simulation exercises, and contingency planning with the CNB and the MOF; and that (d) the back-up funding arrangements of the DIF require improvement. At the time of the mission, remedial efforts, coordinated by a joint DIF-MOF-CNB working group, were ongoing (Annex II).

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<sup>58</sup> Also, see the consultation document of the European Commission on a possible EU framework for bank recovery and resolution, issued on January 6, 2011.  
[http://ec.europa.eu/internal\\_market/bank/crisis\\_management/index\\_en.htm#consultation2011](http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#consultation2011).

<sup>59</sup> <http://www.bis.org/publ/bcbs192.htm>.

**ANNEX I. KEY RECOMMENDATIONS ON THE CZECH CRISIS MANAGEMENT AND BANK  
RESOLUTION FRAMEWORK<sup>60</sup>**

	Recommendations	Priority	Time frame
<b><i>Crisis prevention</i></b>			
(i)	Continue closely monitoring (via reporting and on-site visits) of domestic operations of foreign banking groups (CNB).	High	Ongoing
(ii)	Encourage further cross-border cooperation with relevant home-country supervisors.	High	Ongoing
<b><i>Crisis preparation</i></b>			
(iii)	Strengthen cooperation in the area of crisis management and conduct periodic crisis simulation exercises (CNB, MOF, and DIF).	High	Near term
(iv)	Operationalize the framework for providing public support to banks and consider establishing an industry-funded resolution fund (CNB and MoF).	High	Near term
(v)	Prepare contingency plans that allow for prudential measures to be deployed in response to material cross-border contagion (CNB).	High	Near term
<b><i>Crisis management</i></b>			
(vi)	Adjust the threshold for imposing conservatorship (MoF).	High	Near term
(vii)	Amend liquidation and insolvency framework to allow for the rapid transfer of insured deposits and critical banking functions to a bridge bank or private institution(s) (MoF).	Medium	Medium
(viii)	Strengthen the DIF by limiting involvement of active industry representatives; increasing the size of the fund and improving the provisions for the financing of possible shortfalls; clarifying the trigger for payout of insured deposits; allowing the DIF to fund the transfer of deposits via purchase and assumption agreements; and by providing depositors with priority rights (MOF and DIF).	Medium	Medium term

<sup>60</sup> Recommendations with regard to Czech regulatory and supervisory framework can be found in the detailed assessment report on the Core Principles for Effective Banking Supervision.

**ANNEX 2. STATUS OF RECOMMENDATIONS FROM ASSESSMENT OF CORE PRINCIPLES FOR  
EFFECTIVE DEPOSIT INSURANCE SYSTEMS (2010)**

<b>Reference Principle</b>	<b>Recommended Action</b>	<b>Status</b>
4. Powers	The DIF should be provided with powers to access the information required from the CNB to ensure prompt reimbursement of depositor's claims and for sharing information with other safety-net participants.	MOF to specify the information sharing and coordination mechanism in legislation. In anticipation thereof, the working group will serve as a basis for information sharing.
5. Governance	It is recommended that the following reforms be made to the governance structure of the DIF: the introduction of a clear accountability framework; the establishment of a conflict-of-interest code for the Board; consideration for the replacement of active bankers on the Board; and that the Act on Banks be amended to protect Board members from being dismissed without cause.	MOF to specify the accountability of the Board in legislation. DIF already incorporated into its Rules of Procedure a procedure for Board members and DIF employees on how to deal with potential conflicts of interest.
6. Relationships with other safety-net participants	Formal information sharing and coordination arrangements need to be developed and implemented, on a routine basis as well as in relation to particular banks, among the DIF and other safety-net participants.	MOF to specify coordination agreements in legislation.
8. Compulsory membership	Laws or administrative procedures should be established to describe a clear timeframe in which the DIF is consulted about or informed in advance of "newly licensed" banks.	MOF to specify the duty for CNB in legislation to inform DIF about granting a new license.
11. Funding	The DIF should be given the option to secure emergency backup liquidity from either the private capital markets or state funds. Access to the state for emergency liquidity needs should be made explicit.	DIF will pursue repo agreements with commercial banks and MoF for the possibility to repo government securities from its reserves. Further, DIF is to establish a program for the issuance of government guaranteed bonds, as well as a syndicated loan facility with commercial banks. The MOF is to investigate the possibility of providing a short-term bridge loan to DIF from the state budget.
12. Public awareness	To enhance public awareness further, the DIF may wish to consider distributing brochures to branches and require banks to display signage (e.g., decal) indicating membership in the DIF.	DIF has intensified public awareness campaign. MOF and CNB are to investigate a possible obligation on banks to periodically issue a list of insured products.
17. Reimbursing depositors	In order to ensure prompt reimbursement of depositors' funds, the DIF should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance (see also CP4 and 6).	MOF to specify in legislation the access of DIF to depositor records.