



Contingency planning: A practitioner's guide drawing from lessons learned from dealing with bank failures

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ABSTRACT

A key responsibility for a depositor protection organisation is to be in a position, as soon as it

begins operating, to reimburse depositors when a bank fails. A basic requirement is for the deposit insurer to know when a bank failure is going to happen. But not all deposit protection agencies know when that is going to happen given the nature of their mandates, roles and responsibilities. If, for example, the agency is a pay-box, then it might be told by the bank supervisor that a pay out is required without any advance warning. Depositor protection organisations with broader mandates might have more advance warning and even play a key role in determining whether a troubled bank that accepts deposits might be closed. In these latter circumstances, more time can be given for advance preparations. When a bank fails it is often regarded as a crisis and indeed, banking problems can lead to very expensive overhauls of a country banking system. The purpose of this paper is to set out some practical considerations regarding the advance planning that deposit protection agencies should consider doing in order to fulfil their mandates — particularly with respect to reimbursing depositor claims in a timely fashion after a bank failure.

Journal of Banking Regulation (2006) 8, 51–65.
doi:10.1057/palgrave.jbr.2350041

WHAT IS CONTINGENCY PLANNING?

'Experience may be fine but testing is better.'^{1–13} Thinking something will work never takes the place of proving that it will.¹⁴ NASA did not just launch one Apollo Mission to enable Neil

Armstrong take his first steps on the moon on 20th July, 1969.¹⁵ Millions watched those small steps of the commander of Apollo 11 on television but we had to know that there were several practice sessions ('dry runs') and contingency plans were put into place to make that one giant leap for mankind possible.

Simply put, contingency planning is a process whereby an organisation undertakes a review of its mandate and powers to assess its capability to manage its business and affairs in an efficient and effective manner. Deposit protection organisations are responsible for making payouts or making sure that depositors have access to their deposits as soon as possible after a bank fails. Thus, a deposit insurer needs to understand the risks it faces and be ready to handle any significant risks that threaten its optimal performance. Without appropriate contingency planning, a deposit protection agency cannot ascertain if it is capable of dealing with the risks inherent in its mandate.

This paper offers practical advice to deposit insurers to help them prepare for a bank failure. It starts with a brief discussion of moral hazard, examines the different types of mandates of deposit insurers and underscores differences as well as similarities, and then there is a discussion of the risks that are faced by deposit insurers. The lessons learned from the experiences of CDIC are discussed throughout the paper and some conclusions are offered. Appendix A outlines an industry supplier perspective for deposit insurers that are organised as 'virtual organisations', while Appendix B presents a payout simulation based on an exercise that was performed by CDIC.

MORAL HAZARD AND FINANCIAL SAFETY NETS

It is common in the literature to link the existence of deposit insurance directly to moral hazard. In the absence of deposit insurance, the presumption is that depositors should have sufficient knowledge and information to know the financial condition of the banks with which they deal with. Based on that information, it is

surmised that they should be in a position to act on that information and move their funds before a failure occurs. In systems that have deposit insurance, it is maintained that the incentive for depositors to exercise such care and caution is taken away and hence moral hazard is created.

Deposit insurance practitioners do not dispute that moral hazard exists but they maintain that it is found in all parts of the financial safety net. Instead, they note that explicit depositor protection arrangements can be used to increase market discipline and thereby reduce moral hazard.¹⁶ Figure 1 outlines the prudential regulatory system that exists in Canada. It is, in many ways, typical to what is found in many other countries. Noteworthy are the roles played by the participants. The legislative branch (Parliament) in Canada decided that banks occupy a critical place in the economy and as such should receive special treatment when it comes to legislation, regulation and supervision. Indeed, specific responsibility is given to the federal Minister of Finance to propose measures to set out a prudential regulatory system for federally regulated financial institutions. The Minister then looks to the Department of Finance to provide policy advice on such matters and it often draws on the views of the others players in the financial safety net — the Bank of Canada; the Office of the Superintendent of Financial Institutions (OSFI), the primary supervisory authority; CDIC and the Financial Consumer Agency of Canada (FCAC), the agency responsible for providing information and overseeing financial institutions to ensure that they comply with federal consumer protection measures. Together, they are responsible for the proper functioning of the financial system. To suggest that moral hazard can be explicitly linked to the existence of deposit insurance seems to be taking the *Ceteris paribus* assumption a bit too far.

Having established that moral hazard exists in all parts of the financial system, safety net is therefore incumbent on all the players in the

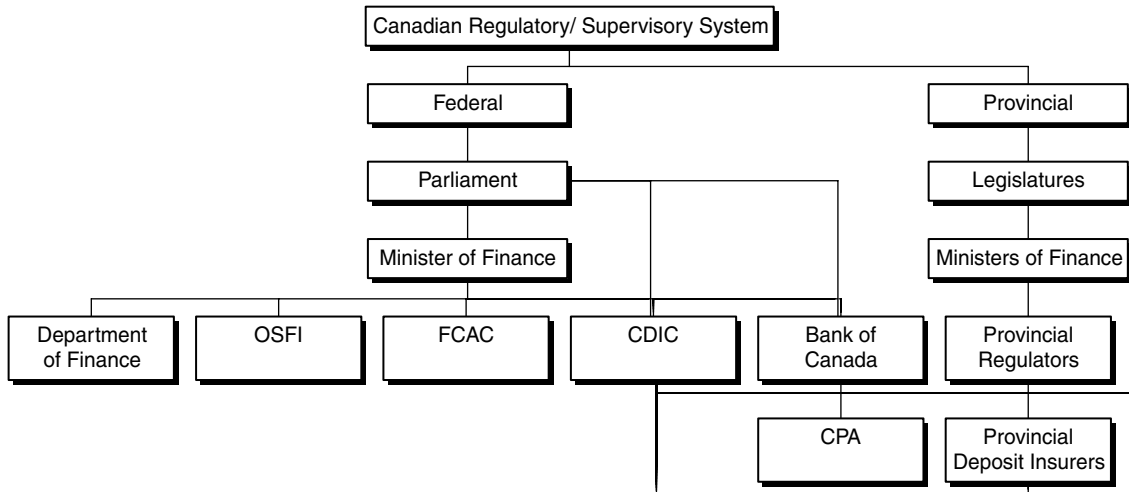


Figure 1 The prudential regulatory system in Canada.

safety net to devise measures to limit its adverse effects.

SETTING MANDATES FOR DEPOSIT INSURANCE ORGANISATIONS

The public entrusts its funds with banks and they expect to have ready access to their funds even after a bank fails. It is, therefore, necessary for agencies within the financial safety net to engage in contingency planning to ensure that the public can access their funds after a failure and thereby maintain confidence in the financial system to promote financial stability. This is why contingency planning is so important. It involves identifying and assessing the risks an organisation faces, assessing the systems, policies and practices that exist to mitigate those risks and assessing the residual risk to ensure that the level of risk remaining is at an acceptable level.

From recent surveys,¹⁷ we know that there are many different types of deposit protection organisations around the world. The mandates range from pure ‘pay-box’ type of structures to ‘risk managers’. From a deposit insurer’s perspective, there exist a number of risks inherent in mandates. For example, the risk faced by a ‘pay-box’ is different from the risk faced by a ‘least-cost’ deposit insurer or a ‘risk manager’. It is important to start from the

beginning — understanding the legislative mandate, the powers and the roles and responsibilities under which a deposit insurer is established.

The first step of contingency planning, therefore, involves a full review of the legislation under which the deposit insurer is established. A risk manager would be required to mitigate its exposures and would necessarily need to undertake risk assessment and management and have appropriate systems and practices in place to fulfil that function. This is seen by first looking, in Table 1,¹⁸ at the relationship between the mandate of a deposit insurer and its powers, interaction within the life cycle of a bank, impact on cost minimisation, interrelationship arrangements and the management of those relationships.

Deposit insurers with a pure ‘pay-box’ mandate are largely confined to paying the claims of depositors after a bank has been closed. Accordingly, they do not have intervention powers and are mainly reactive. Nevertheless, pay-box systems still require appropriate authority, as well as access to deposit information and adequate funding, for the timely and efficient reimbursement of depositors when a bank fails. It should be understood that while the administrative costs associated with a pay-box may be low

Table 1 Mandates of deposit insurers in relation to powers, interaction and effectiveness

<i>Mandate</i>	<i>Powers</i>	<i>Interaction within the life cycle of a bank (beginning, midlife, end)</i>	<i>Effectiveness and cost minimisation</i>	<i>Inter-relationship issues</i>
<i>Pure pay-box</i>	Reactive (eg clean-up, liquidation)	Failure	Low	Mainly information sharing
<i>Cost-reducing objective</i>	Mainly reactive, some proactive features (eg clean-up but some risk assessment and limited role in failure resolution)	Approaching failure (but some interaction upon failure)	Low–Med	Requires well-defined roles, responsibilities, information sharing and coordination
<i>Full risk managers</i>	Proactive (eg risk identification risk assessment and management)	Beginning, midlife, failure	High	Requires well-defined roles, responsibilities, information sharing and coordination

so is their ability to minimise costs to the financial system.

Some systems have been given the added responsibility to minimise costs associated with the closure of a bank. That is, while they are mainly reactive, they may have some proactive features, such as access to risk assessment information and they may play a role in decisions on failure resolution. This gives the insurer more of an ability to address costs compared to a pure pay-box. Nevertheless, it still requires well-defined roles, responsibilities, information sharing and coordination to be effective at fulfilling its mandate and cost minimisation.

Deposit insurers with a ‘risk-management’ mandate have a very strong incentive to minimise exposure to losses. It must, therefore, be proactive in terms of taking on the risk identification, assessment and management. It will need access to timely and accurate information so it can assess the financial condition of individual banks, as well as the banking industry. It also must anticipate the financial troubles of individual banks and deal with them effectively when they arise. This requires appropriate powers and well-defined roles, responsibilities, information sharing and

coordination. When this is accomplished the result can be a high level of effectiveness and minimisation of losses for the deposit insurer and the financial system.

Contingency planning is essential for a deposit insurer especially one that expects to have to deal with the consequences of a bank failure. Failures are costly, and they can be unexpected. Effective deposit insurers must develop contingency plans to deal with the risks they face and to mitigate these risks — there is no substitution for advance preparation. What could cause a bank to fail? What options might be available to respond to such possibilities? These questions need to be answered. And, they need to be answered *before* a problem occurs. Equally important is to break apart the common supposition that the next failure will necessarily resemble the last.²⁰ This line of thinking is usually wrong, and could be devastatingly so in today’s increasingly integrated and internationalised financial environment.

MANAGING RISKS FACED BY DEPOSIT INSURERS

Managing the risks faced by deposit insurers can best be examined by looking at a specific

example. CDIC is a well-established deposit insurer with a loss-minimising mandate. It undertakes contingency planning and its approach focuses on:

- understanding its mandate and powers;
- limiting exposure to loss through early intervention;
- undertaking an assessment of its resources and capabilities — both internally and externally;
- conducting scenario planning and simulations for failures;
- communications;
- attention to the latest development in contingency planning – business continuity planning and
- documenting lessons learned.

Contingency planning plays a key role in helping to understand the risks faced by a deposit insurer and it is advisable that it be looked at from an enterprise risk management (ERM) perspective. The objective of ERM is to demonstrate that the deposit insurer has identified, understands and is managing its significant risks. Indeed, risks decisions need to be explicitly integrated into strategic day-to-day decision making, be subject to good corporate governance and be supported by an appropriate control environment. Contingency planning should also help provide assurance to the Board of Directors and senior management of the organisation that risks are being identified and managed effectively and efficiently.

Mandate and powers

As noted earlier, a full review and understanding of the mandate, powers and legislation under which a deposit insurer is established is required. We know that deposit insurance systems are difficult to compare as they have varied mandates and powers that depend on their stated public policy objectives. But, it is these mandates and powers that will determine the risks faced by a deposit insurer and its capabilities to address and mitigate those risks.

A risk-manager deposit insurer sets conditions of membership, assesses deposit insurance premiums and takes necessary insurance action — such as risk assessment and management, and it may impose financial sanctions, cause the termination of a policy of deposit insurance and engage in early intervention. This form of mandate requires that there be a strong collaborative relationship among safety net participants, a free flow of information and a number of checks and balances between the supervisor and deposit insurer. Contingency planning must take all of this into account.

CDIC has a range of powers that can be used to address problems at member institutions from the first incidence of a problem to a formal winding up and liquidation. It is critical to be aware of existing powers and the governing legislation as this creates the framework within which the deposit insurer must work during any situation that may arise. Moreover, contingency planning can help determine what the limitations under the current legislation are and help identify what additional powers could be useful in responding to various hypothetical situations.

Past experience provides a base of strength on which CDIC can draw in exercising judgement about how to deal with future problems. When a member is experiencing serious difficulties CDIC, for example, conducts a ‘two-track’ analysis. The two-tracks compare the cost of a formal winding-up and liquidation with the cost of CDIC assistance to achieve a going-concern solution (when this is a real option) or an orderly exit of the institution from the market. This approach reflects the fact that CDIC is enjoined to minimise its exposure to loss and that its powers to render financial assistance are to be deployed in order to reduce a loss, or avert a threatened loss, to CDIC. Historically, therefore, CDIC has sought to be satisfied that any assistance provided will likely prove to be, in comparison to a formal winding-up and liquidation, its ‘least-cost’ solution.

Throughout any intervention one of the deposit insurer's most important needs is for information. CDIC can obtain information about a member from the bank supervisor and the Bank of Canada. CDIC can also conduct a 'special examination' of a member. Special examinations have been targeted at particular aspects of a member's business or used to obtain a more comprehensive evaluation. Obviously, the larger the institution, the greater the need would be to focus on the most critical areas of concern.

At a later stage of intervention, in anticipation of a payout, CDIC can conduct a preparatory examination of the deposit liabilities of a member. To do so, it must hold the opinion that a payout is imminent and it requires the Superintendent's concurrence (for a federal institution²¹). At the end stages of an intervention, CDIC can terminate or cancel the policy of deposit insurance of a member and can petition for the formal winding-up and liquidation of an insolvent member.

Coordination of safety net participants in their activities and functions is critical when intervention to close a troubled bank is required. There are important issues to be clarified, such as how, when and who commences procedures to formally liquidate or restructure the bank. Who pays the cost? What actions should the lender of last resort, the supervisor and the deposit insurer take in concert or individually to ensure that their mandates and obligations are fulfilled? These are important questions that need to be answered before a failure occurs.

Limiting exposure to loss through early intervention

CDIC focuses on the risk of insuring deposits accepted by its members so as to minimise CDIC's exposure to loss in such a manner to act in the best interest of depositors. In contrast, regulators have a mandate to protect the interests of depositors, other creditors and shareholders. The difference in mandates leads to potential differences in the incentive to act

in different circumstances. This, not surprisingly, requires that CDIC and regulators share information and communicate effectively. This cooperation is of particular importance given that CDIC does not usually perform audits or examinations of its member institutions. OSFI acts as CDIC's agent in examining the affairs of federally incorporated members annually. Provincially incorporated members are inspected annually either by CDIC or by an agent.

To ensure close coordination and cooperation, the Deputy Minister of Finance, the Governor of the Bank of Canada, the Commissioner of the FCAC, the Superintendent and one Deputy Superintendent of OSFI are full members of the CDIC Board of Directors. In total, they make up five out of the 11 directors. The remaining six directors, including the Chairperson, are from the private sector. Therefore, CDIC decisions requiring Board approval, such as interventions and liquidation of an institution, are made with the input of the public sector directors. This ensures full coordination between the safety-net players that make up the prudential supervisory system.

Information sharing at the federal level is generally facilitated by the Financial Institutions Supervisory Committee (FISC). In terms of policy coordination, CDIC is represented by its Chairperson as a member of the Senior Advisory Committee²² (SAC) chaired by the Deputy Minister of Finance. The mandate of this Committee is to discuss and establish the policy direction pertaining to the financial services legislative framework in Canada. CDIC and OSFI have also established other mechanisms such as the Guide to Intervention for Federal Financial Institutions depicted in Figure 2.

A Strategic Alliance Agreement has been implemented by CDIC and OSFI to enhance the ability of both agencies to perform their mandates efficiently and to coordinate their activities. OSFI and CDIC established a committee of senior officers to provide a forum for communication with respect to all matters



of mutual interest — this is called the OSFI/CDIC Liaison Committee. Issues respecting the activities of OSFI and CDIC are also addressed during regular monthly meetings.

Contingency planning is also very important from a funding perspective and plans need to be in place to deal with future events whatever these might be. The deposit insurer should also look at understanding the criteria under which funding might be required. Since deposit insurers are expected to deal with a bank failure, or a wave of failures, plans need to provide for access to funding to deal with such events. However, it should be noted that deposit insurers are not responsible for dealing with a financial system crisis. That is the role of governments as deposit insurers do not have access to the level of funding required to deal with a systemic crisis.

Undertaking an assessment of resources and capabilities

Although each and every failure confronting a deposit insurer will likely pose its own unique challenges, the basic resource framework and structure that guide the deposit insurer's response should already be in place. Nevertheless, contingency planning can help in identifying: what resources are available (internally and externally^{25,26}) determine if there are enough resources to deal with significant risks and, identify if there are serious gaps which need to be addressed. Some of the critical resources that the deposit insurer must evaluate include:

- financial;
- human;
- communications;
- legal/corporate;
- technological.

One of the most important resources available to an insurer is funding. Sufficient funding and access to funds on a timely basis is critical when dealing with troubled banks. It is generally understood that deposit insurers require a large fund at their immediate disposal to deal with

eventual failures. However, the issue of funding is often misunderstood as it is necessary to separate liquidity needs of a deposit insurer to deal with an intervention, such as a payout, and the funding of the eventual losses arising from a bank failure.

Aside from traditional sources, there may be opportunities to find innovative approaches to dealing with liquidity needs and the cost of failures. One example that can be cited is how CDIC dealt with some failures in the past. CDIC realised that to fund depositor's claims required a large amount of liquidity at the beginning of the failure until distributions were received from the liquidator. CDIC also understood that its losses were affected by the time value of money — the longer it took to recover funds from the estate, the larger were the losses taking into consideration the opportunity cost of investing those funds or the cost of borrowing from the government. It, therefore, looked at different approaches to liquidations and developed a process where CDIC worked with liquidators to put in place a plan whereby the 'good assets' of the failing bank could be tendered quickly. The franchise value (mainly the branches and banking relationships) and deposits would also be transferred by CDIC at the same time to another institution, which had the capacity and capability to undertake such a transaction on the day of the formal liquidation. CDIC also developed a list of criteria under which it would undertake such transactions with institutions.

An important aspect of communications issues is the timeline for dealing with an institution that moves from becoming a 'no problem' to a troubled institution (ie moving from Stage 0 to another more severe stage as shown in Figure 2). But first it should be remembered that bank supervisors and deposit insurers need a clear separation of their responsibilities as this will help curtail overlaps and provide a clear basis for intervention. In short, this is setting out 'the rules of the game'. Thus, information sharing is a basic need for

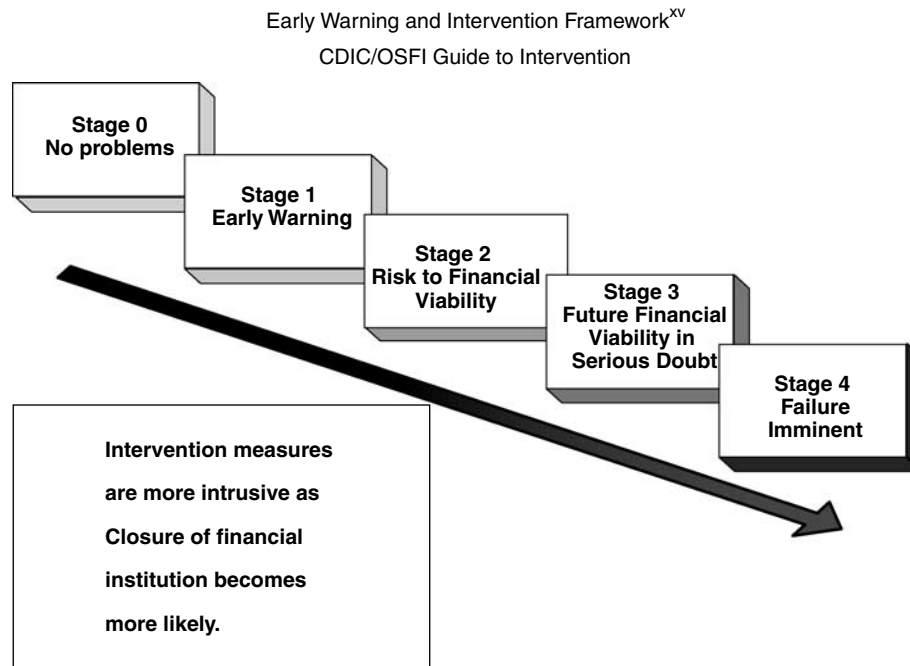


Figure 2 Early warning and intervention framework^{23,24} CDIC/OSFI Guide to Intervention.

the proper functioning of the financial system safety net.

Human resources are another critical issue to consider in contingency planning. Having access to the right people — both inside the organisation and externally — must be addressed in contingency planning. CDIC, for example, operates a form of a ‘virtual organisation’ (see Appendix A) that allows it the flexibility to maintain a core staff and then draw heavily on external resources when dealing with a problem bank.

CDIC’s past experience in dealing with failures is to some extent captured in a number of legal and corporate precedents that might be utilised in a failure. Thus, it is important to have ready access to copies of past agreements regarding specific transactions. In addition to legal precedents, there are a number of historic Board resolutions that can be very useful. In a crisis the CDIC Board of Directors will be required to act quickly and decisively — there is no time to reinvent the wheel. Consideration should also be given to maintaining a contin-

uous improvement process that allows policymakers the opportunity to implement lessons learned from dealing with problem banks in legislation.²⁷

Information Technology has become a mission critical resource. In this respect, CDIC has invested heavily in developing independent Information Technology resources such as risk assessment, evaluation and payout systems.

The role of scenario planning

Failure resolution is a process involving the evaluation of the assets of a failed bank, finding acquirers for all or part of the assets, liquidating the assets and reimbursing depositors. Effective failure resolution mechanisms help deal with troubled banks early and facilitate orderly resolution options that in turn minimise disruptions and costs. To guide them, deposit insurers will have to assess the answers to two basic questions; first, what type of institution could fail? And second, what might be the circumstances leading to the failure?



As this paper has demonstrated, contingency planning is looking at different parts of the business and developing workable scenarios in case the problem occurs. But it must also be assessed from an enterprise-wide basis. That is why ERM is receiving the attention it deserves today by deposit insurers and, indeed, it would be advisable for all players in the financial safety net to undertake an ERM assessment.

Every deposit insurer should be well prepared to reimburse depositors when institutions fail. They should also understand the environment in which they operate, and keep abreast of developments in the financial sector. That means understanding new policies, new laws, new products, innovation, new information technology, new approaches to banking such as virtual banking and cross-border issues that directly affect how deposit insurers manage their business and affairs.

However, contingency planning requires buy-in by the Board of Directors and senior management of the organisation since appropriate resources (both human and capital) are required. It must be considered an investment that will bring benefits in the future. If done right, it also provides the Board of Directors and senior management with the assurance that the organisation is able to demonstrate that it can fulfil its mandate and that the organisation is managed efficiently and effectively, and that it is well governed.

At the heart of contingency planning through ERM is the ability to test how the deposit insurer may respond to failures and adverse events. A key component of contingency planning is, therefore, creating scenarios about the types and circumstances that may be encountered. In general terms, a simulation allows the insurer to replicate a situation or test the people, processes and technology associated with a particular activity such as a failure scenario (see Appendix B for a description of a payout simulation that was conducted by CDIC). It allows the insurer to control the timing, type and nature of a situation and other specific circumstances surrounding it.

In addition, a simulation can help: build teamwork for those unfamiliar with the activity; identify gaps in resources, processes and technology that need to be addressed and determine modifications required to process descriptions, plans and other documentation.

Different simulations have different objectives. They can be of a limited scope, such as those testing a specific process associated with a failure (eg a payout and liquidation of a small bank), or those involving extensive simulations which could look at all facets of a deposit insurer's operations involved in the failure of a large complex bank. The basic elements of a scenario plan are: a statement of purpose and objectives; a work plan; a simulation scope and parameters; timing; required resources (eg human resources, Information Technology); advance preparation; expected results and, at the end of the process, an independent review and assessment.

While it is not feasible to realistically simulate all aspects and activities of a failure, simulations can be helpful in assessing how existing or new systems and process actually work and can be helpful in uncovering unforeseen factors and problems. At CDIC, they found that such simulations were particularly helpful for their employees given that the last failure was in 1996. Over time, people lose practice in dealing with failures. It should be noted that simulations are not perfect. It is not possible to simulate all facets of an activity; they are costly, and not everything can be planned for as real life always has surprises!

Communications

Coordinated communications plans and activities are an essential element in all cases but more so in the event of a large bank failure. Confidence in the financial system must be maintained from the outset. It is imperative, therefore, that a deposit insurer establish a sound public awareness and communication programme before a failure occurs. A public that is well informed about the terms and conditions of deposit insurance helps to build

and maintain confidence in the system. It is critical also to meet with and work out a communication plan among all the key financial safety net players in the event of a problem. For instance, at CDIC they found that:

- communications activities were a ‘must-win’, particularly during the first 48–72 h, in order to maintain domestic and international confidence in the system;
- all agencies within the financial safety net must speak in a coordinated fashion, using the same themes and messages;
- all agencies should restrict themselves to their own areas of responsibilities and expertise and
- all agencies should coordinate their media relations activities and responses with a communications group composed of all the relevant agencies established for this specific purpose.

It has also been found that the media can be your best friend or your worst enemy — depending on how they are treated. Contingency planning must involve developing a communications plan that builds media relationships in good times that can be leveraged in the bad times.

It is vitally important to have a dialogue with depositors after a closure and during a payout. They will want to know when and how they can expect to receive their funds, what they are expected to do to receive their money and whom they can contact to get information. In preparation for the event, it is critical to have a well-thought-out crisis management communications plan. Some part of the plan can include such things as a ‘hidden’ website specific to the event and draft News Releases.

Business continuity planning

Contingency planning is not just about dealing with bank failures. A deposit insurer must also consider ‘Business Continuity Planning’ (BCP) to address unexpected events. BCP provides the processes to ensure continuous business

operations from a disruptive event (eg following the impact of a natural disaster). It is made up of two major elements:

- a Disaster Recovery Plan (DRP): The plan that provides the processes on how to recover critical business operations from a disruptive event and
- a Business Resumption Plan: The plan that provides the processes on how to resume business from a disruptive event or transition from the DRP to normal business operations.

There are four phases of CDIC’s Business Continuity Planning flow (which have actually been used to deal with an ice storm and an electricity grid failure) and the process flow can best be seen by examining the process depicted in Figure 3 overleaf.

The first phase is the point right after the event and it is the point of an immediate response. It is shortly followed by period of crisis management where there is a determination of the size of the event — major or minor. Phase 3 focuses on disaster recovery and it should begin within 48 h with the final phase, Business Recovery, occurring not long after that point.

Experience at CDIC has shown that the success factors of a BCP are: executive sponsorship (covering funding and priority of objectives); business units within the organisation must develop their own BCP; and, business continuity planning must be integrated into ongoing operations of the deposit insurer. It is vitally important to start with a Business Impact Analysis and then develop an Infrastructure Recovery Strategy that should be integrated with Contingency Planning on a continuous basis.

Lessons learned

Contingency planning is essential for any deposit insurer because failures are costly — and they are often unexpected. Effective deposit insurers must develop contingency plans and conduct regular simulations to keep

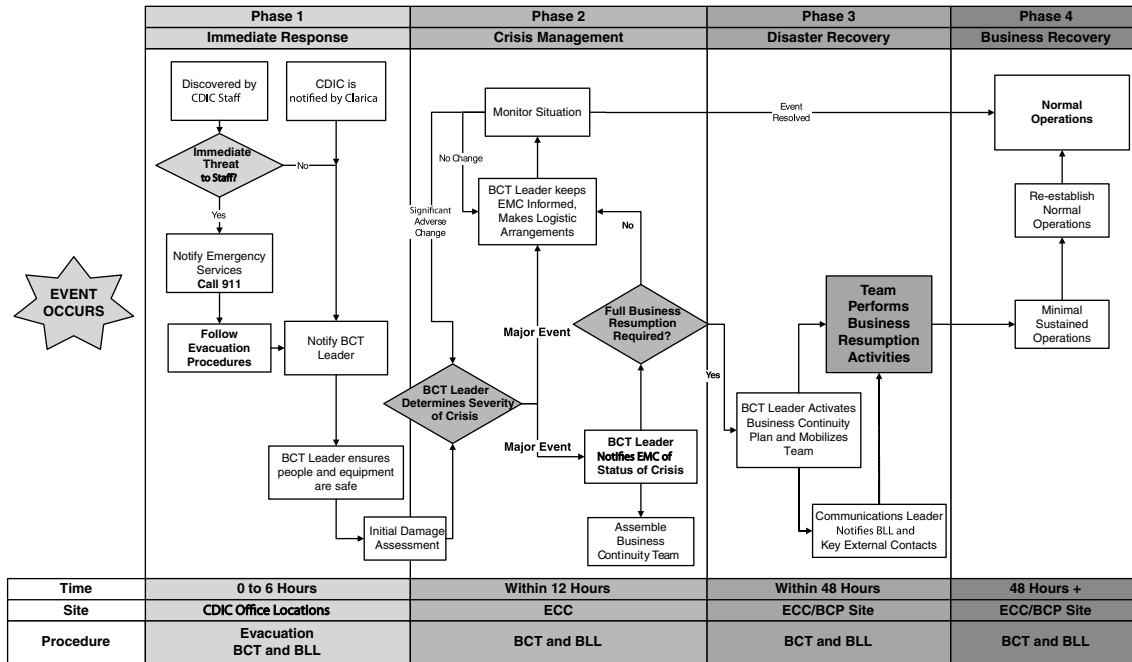


Figure 3 Procedure flow for business continuity plan.

employees skills sharp. Equally important is to break apart the common supposition that the next failure will necessarily resemble the last. This line of thinking is usually wrong, and could be devastatingly so in today’s increasingly integrated and internationalised financial environment.

Based on the experiences at CDIC, it is important to build relationships with the media in ‘good times’ so that they can be leveraged in other circumstances. Deposit insurers should also secure a reliable supply of resources (internally or externally) and have a network of suppliers in place. It is important to remember that each problem bank is unique requiring a customised approach; however, scenario planning and simulations allow the deposit insurer to test its systems and practices overall. It is vital to be aware of emerging issues and how they may affect future failures (eg cross-border banks, internet banks, etc) while globalisation and technology create many new opportunities, the implications of them can be far-reaching and present new challenges.

CONCLUSIONS

This paper has focused on practical advice to deposit insurers in undertaking contingency planning. It has demonstrated that deposit insurers need to know their mandates and fully understand their roles and responsibilities. In the preparation of plans to deal with failing and problem banks, it is highly advisable to set up a team and do contingency planning before it is needed. The underlying expectation should be that the next failure will be quite unlike the last one and attention needs to be given to the establishment of a clear communication process with the other players in the financial system safety net.

Experience has shown that the cost to the financial system of a failure, even just to the deposit insurer, far outweighs the cost of doing effective contingency planning. Having a private-sector perspective on a deposit insurance board is a highly valued tool in dealing with problem banks as the market is often a very good source of information concerning new techniques and approaches. Deposit

insurers can also look to the private sector and other deposit protection organisations for models of efficiency and practices to help build in good incentive systems.

In conclusion, the CDIC experience has shown that active mandates lead to independence, facilitate innovation, improve accountability, enhance integrity and reduce costs and the investment in contingency planning that was made was worth the cost and effort.

APPENDIX A

INDUSTRY SUPPLIER PERSPECTIVES²⁸

Deposit insurers face many challenges in attracting and retaining qualified personnel. For this reason, some organisations have decided to engage the services of outside consultants and professionals, such as lawyers and accountants. CDIC, for example, has been set up as a 'virtual organisation' with access to a large base of expertise and knowledge. In running a virtual organisation, it is essential to establish relationships and agreements with external suppliers. CDIC has in place processes and back-up documentation, as well as relationships with various staffing agencies that would ensure the staffing needs of the various functions could be met on a timely basis (Figure 4).

The diagram below represents an idealised sequence for undertaking the liquidation of a significant troubled bank. While possession is an essential first step, all remaining elements of the sequence will likely have to be executed concurrently. Each element is discussed in turn.

Possession

Planning the possession process requires a detailed situation analysis. The questions that need to be answered are: Where are the branches? Where is the controlling mind? What are the liquidator's powers? How will action be coordinated with the Board of Directors, management/Bank Restructuring

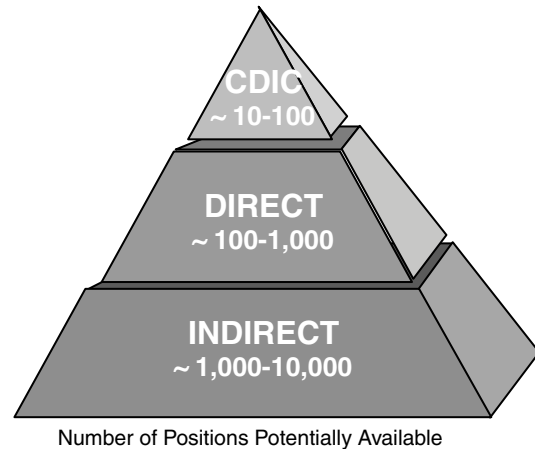


Figure 4 CDIC as a 'Virtual organisation'. Number of positions potentially available.

Committee, banking supervisors and the deposit insurer?

Physical seizure will require implementing a 'Day One' procedures manual. Tasks include physically securing properties, dealing with cash and transactions in process/clearing and recording all assets and liabilities.

In terms of control of information and communication systems, there will be initially a lock-down and cut-off is normally required to secure proper backups of information obtained and to prevent unauthorised initiation of funds transfers, changes to loan balances, etc. Following the implementation of initial procedures, ensuring adequate security over information and communication systems is of key importance, including changing access codes and over-rides.

Realisation

The setting of realisation approaches requires the liquidator to consider both assets and liabilities. The Claims Profile will identify priorities, set-off, maturities, deposit insurance entitlements and other guarantees.

Where a sufficient quantity of good quality assets are identified, a 'Good Bank' strategy may be appropriate, maintaining near-normal



operations, perhaps pending a sale/transfer of assets and liabilities. This stage requires the separation of saleable portfolios from non-standard loans, setting portfolio management strategy and policy, and re-establishing appropriate credit committee and other internal review and control procedures.

For non-standard loans and other assets, and potentially suspect liabilities, a 'Bad Bank' Strategy can be implemented, comprising 'non-standard' asset management policies and asset tracing and collection. In this area, insolvency expertise is likely to be important.

Both the 'good bank' and sundry or surplus assets will need to be disposed of *via* an Asset Sales Strategy. This may be partly determined by economic/maximum realisation issues and partly by other policy issues, such as deadlines for ensuring liquidity of deposits and the need to minimise systemic risks. However, caution needs to be exercised in combining weak banks as this can lead to increasing rather than decreasing systemic risk. Implementing the Asset Sales Strategy requires various activities, such as: matching saleable asset portfolios with customer deposits, ensuring Deficiency Coverage Agreements are in place and facilitating the sales process and subsequent due diligence, as well as undertaking auctions or securitisation.

Under Loan Administration attention must be focused on funding commitments (contingent), debt maturities, portfolio risks and loan linkages between banks. Restructuring organisations have developed various proprietary software and templates to deal with Statements of Affairs, Loan status and Reporting System, Litigation Management and Creditor claims. These reports feed into larger reporting exercises normally required by Steering Committees, Creditors' Committees and the Courts.

There are many attributes of quality reporting. Use of structured reporting frameworks will ensure appropriate confidentiality together with consistency, timeliness, completeness and accuracy. Also of significance is the proper

coordination between banks and regulatory organisations.

In terms of administration and distribution, methodologies need to be developed to deal with such issues as settling foreign exchange claims, updating interest calculations, dealing with powers of attorney and death claim procedures, set-offs and liability verification.

Payment planning comes next once the claims have been identified, verified and prioritised. This requires management of advertising for claims, the proof of claim process, identifying the best method of distribution, ensuring procedures are in place to facilitate reconciliation of payment account, coordination of debtor/creditor accounts at different banks and dealing with accounts on hold.

Claims will come in many types and will normally require differing treatment. Thus, it will be necessary to identify, consolidate and manage various types of claims, including: depositors, creditors, subordinated debt, shareholders; customer trading accounts (domestic/offshore); counter-parties, letters of credit, traveller's cheques; forward contracts, swaps, options; and contingent claims.

APPENDIX B

A PAYOUT SIMULATION: RESULTS FROM A SIMULATION PERFORMED BY CDIC

The scenario outlined in this appendix involved the imminent closure of a hypothetical institution with only minimal preparations for the specific event on the part of the staff working on the payout team (ie assuming no preparatory examination is conducted). The simulation was designed not only to test a software payout tool CDIC developed called ROADMAP, but also processes outside of ROADMAP and their links to the application such as interactions with brokerages, deposit brokers, counsels legal opinions, liquidator holds and set-off.

Deposit account aggregation processes were performed both manually and by automation to arrive at an insured and uninsured portfolio upon which a payout could be performed. Historical information was used from preparatory examination files from a previous CDIC member named *Income Trust*.

The simulation was conducted over a three-day period and involved 11 staff members and the exercise was overseen by the CDIC's internal auditor. It included information on over 15,000 depositors and, in some cases, the information was not complete in order to test the verification procedures.

The overall results of the simulation were positive. But, CDIC did find areas on which it could improve in terms of timeliness and accuracy. The main lessons learned were: each payout is unique requiring a customised approach; it is important to secure reliable resources and build a network of suppliers; it is necessary to ensure coordination between accounting, legal, I.T. and communications; the deposit insurer must determine in advance what is a deposit, who is the depositor; a consistent application of rules builds confidence and trust; there is a need to involve experienced counsel early on to avoid delays in closure proceedings; the organisation must commit to a delivery date and meet it whatever the costs; consideration should be given to using immediate advance payments to reduce pressure on payouts of small balances; and there must be coordination with the liquidator so they know what is needed and when it is required.

REFERENCES AND NOTES

- (1) The views expressed in this paper are those of the authors and do not necessarily represent those of the International Association of Deposit Insurers nor the Canada Deposit Insurance Corporation. The paper is based on a presentation delivered by Jean Pierre Sabourin, Michael W. Mackey, David K. Walker, and John Raymond LaBrosse at the *Fourth Annual IADI Conference* that was held in Taipei, Taiwan from 27–29 September, 2005. This is a preliminary version and should not be quoted without permission.
- (2) International Association of Deposit Insurers *Annual Report 2003/04*, Basel, Switzerland.
- (3) Canada Deposit Insurance Corporation. Annual Report, Ottawa, Ontario, various issues.
- (4) Canada Deposit Insurance Corporation (2003): Survey (see: <http://www.cdic.ca?id=285>), Ottawa.
- (5) International Association of Deposit Insurers *Fourth Annual Conference*, 27–29 September 2005, Session V (b), Taipei, Taiwan.
- (6) The authors would like to thank Ken Mylrea and Scott Hayes of the Canada Deposit Insurance Corporation, Andrew Lee of the Financial Advisory Services of KPMG, Michael W. Mackey, Deloitte and Touche, and Gregory Zimmnicki for their helpful comments on an earlier version of this paper.
- (7) In this paper, a 'bank' is defined to include all forms of financial institutions that accept deposits from the public.
- (8) A pay-box deposit insurer is one which has relatively limited responsibilities such as the collection of premiums and the payment of claims to depositors. See Working Group on Deposit Insurance: Background Paper June 2000. Financial Stability Forum 2001, 'Guidance for Developing Effective Deposit Insurance Systems'.
- (9) Financial Stability Forum (June 2000). *Consultation Process and Background Paper of the Study Group on Deposit Insurance*, Basel, Switzerland.
- (10) Financial Stability Forum Working Group on Deposit Insurance (September 2001). *Guidance for Developing Effective Deposit Insurance Systems: Final Report of the Working Group on Deposit Insurance*, Basel, Switzerland.
- (11) Financial Stability Forum Working Group on Deposit Insurance *Guidance for Developing Effective Deposit Insurance Systems: Final Report of the Working Group on Deposit Insurance*, Vol. II, especially Resolution of Failed Institutions URL: <http://www.iadi.org/html/App/SiteContent/CDIC%20Volume%20II.pdf>.
- (12) See Claudia Dziobek and Cecyla Pazarbasioğlu, Lessons Learned from Systemic Bank

- Restructuring, April 1998 International Monetary Fund, Washington, D.C.
- (13) Claudia, D. and Cecyla, P. (1998). *Lessons Learned from Systemic Bank Restructuring*, April 1998, International Monetary Fund.
- (14) Rules for NASA project managers.
- (15) A TV camera automatically deployed after Armstrong pulled on a special ring. As he stepped onto the moon's surface he proclaimed, 'That's one small step for man, one giant leap for mankind', see <http://www.historyplace.com/unitedstates/apollo11/>.
- (16) Study Group Report June 2000.
- (17) See IDIS found at www.cdic.ca and www.iadi.org.
- (18) See INSOL International, Bank Insolvency, *An International Guide for Deposit Insurers*, January 2005 at p. 19.
- (19) There are many different types of deposit insurance systems in operation. Their mandates range from so-called pure 'pay-box' type of structures to 'risk minimisers' or 'risk managers'. A 'pay-box' insurer is generally focused on paying out the claims of protected depositors after a bank has been closed. They typically do not have intervention and examination powers. Some pay-box systems have been given the added responsibility to minimise costs associated with the closure of a bank. That is, while they are mainly reactive they may have some proactive features such as access to risk assessment information and they may play a role in decisions on failure resolution. These have been referred to as 'pay-box-plus' or 'least cost resolution' systems. Deposit insurers with a full 'risk minimisation' or 'risk management' mandates are usually required to minimise their exposure to loss and therefore, be proactive in terms of taking on the risk identification, assessment and management.
- (20) The first experience in bank liquidation for the Nigeria Deposit Insurance Corporation came on 21st January, 1994 when the licenses of two merchant banks were revoked. Two other banks were closed the following September, another one was closed in June 1995 and in January 1998, the licenses of 26 banks were revoked in one fell swoop. See *Bank Liquidation in Nigeria (1994–2004)*.
- (21) Federal institution is usually meant to include a bank under the Bank Act or a federally regulated financial institution such as a trust company.
- (22) The SAC is a policy advisory group which was set up by the Department of Finance in 1976. It meets as needed to discuss policy issues described in White papers. Mr LaBrosse was the Secretary to that group for many years.
- (23) This framework was first presented in the 1995 White Paper entitled 'Enhancing the Safety and Soundness of the Canadian Financial System'.
- (24) White Paper (February 1995). *Enhancing the Safety and Soundness of the Canadian Financial System, Department of Finance*, Ottawa, Canada.
- (25) See Appendix A for a full description of how the firm Deloitte & Touche LLP assisted CDIC in the preparation of a payout in the event of a failure.
- (26) Presentation of Frank Brown, Deloitte & Touche, and Wayne Acton, Canada Deposit Insurance Corporation, . Seminar on Liquidating Financial Institutions at the Asian Policy Conference on Deposit Insurance, 17–18 January 2000, Kuala Lumpur, Malaysia.
- (27) The authors are indebted to Andrew Lee of KPMG for offering this suggestion.
- (28) This Appendix is drawn from the part of the presentation delivered by Michael W. Mackey, Global Leader, Financial Institutions, *Deloitte & Touche LLP*.

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