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The Polish Bank Insolvency Regime

Issues and Assumption Paper for the

Design of an Upgraded Bank Resolution Framework

John D. Pollner

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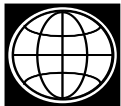

Private and Financial Sector Development Department
Central Europe and the Baltics Country Department
Europe and Central Asia Region
The World Bank

ABBREVIATIONS AND ACRONYMS

AMC	Asset Management Company
BFG	Bankowy Fundusz Gwarancyjny (Polish Deposit Insurance Fund)
BGK	Bank Gospodarstwa Krajowego (Polish Development Bank)
CAMEL	Capital, Assets, Management, Earnings, Liquidity
CAR	Capital Asset Ratio
CDIC	Canadian Deposit Insurance Corporation
EBA	European Banking Authority
EC	European Commission
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FSA	Financial Supervisory Authority
FSB	Financial Stability Board
FSC	Financial Stability Committee
IOU	A non-negotiable debt obligation ("I owe you")
KNF	Komisja Nadzoru Finansowego (Polish FSA)
MDIC	Malaysian Deposit Insurance Corporation
MOF	Ministry of Finance
NBP	National Bank of Poland
P&A	Purchase and Assumption
RRP	Resolution and Recovery Plan
SIFI	Systemically Important Financial Institution

Based on a request from the Government of Poland, this report was prepared by a World Bank team led by John Pollner, Lead Financial Officer, in collaboration with the Polish Deposit Guarantee Agency (BFG) led by Jerzy Pruski, President of BFG, and guidance from the Polish Working Group on Bank Resolution.

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The Polish Bank Insolvency Regime

Issues and Assumptions Paper for the

Design of an Upgraded Bank Resolution Framework

EXECUTIVE SUMMARY

a. **The bank insolvency framework in Poland should be modernized to ensure financial stability, maintain the continuity of critical functions in the banking system, protect depositors and creditors, while assigning losses according to a pre-established creditor hierarchy.** For this purpose, potential banking failures should be addressed with speed and effectiveness to preserve an institution's asset value, contain any losses (to the benefit of depositors and creditors) and minimize the use of public funds. Traditional bankruptcy procedures involving the judiciary do not permit action until an institution is balance-sheet insolvent and do not contemplate swift resolution tools. Resolving a bank at such a late stage increases depositor and creditor losses of confidence and a fast erosion of the bank's value. The new resolution law should replace the current standard insolvency procedure. The Polish Bankruptcy Act is quite modern but unsuitable for bank insolvency because of its complex procedures compared to administrative resolution. It also has inadequate provisions relating to transactions in payments or securities clearing and settlement systems that have systemic implications.

b. **Several country experiences in Europe and elsewhere have demonstrated the effectiveness of new bank resolution measures now being proposed by the European Commission.** Some of the key features involve early intervention in banks when their critical financial indicators or ability to pay their obligations fall below threshold levels. This usually occurs before a bank has negative net worth, thus giving the authorities the possibility of preserving the value of its assets by selling them in part or whole to other banks. For such a process to be effective it must supersede existing bankruptcy practices and allow the resolution authorities through administrative procedures to assume the rights of shareholders and management. This preserves and maximizes asset values for the benefit of creditors while recognizing losses without requiring liquidation. Effective resolution processes should incorporate several attributes recommended by the Financial Stability Board listed in Table 1.

c. **Within a modernized resolution framework the resolution authority would have several new powers and instruments to deploy.**[1] These include a "sale of business" tool (selling a bank in whole or in parts to third party buyers who may also assume the bank's liabilities), an asset separation tool to remove bad 'toxic' assets prior to putting the bank up for sale, a bridge bank option for the creation of a temporary bank for eventual sale, a debt-write down tool for potentially systemically important banks requiring forced capital injections by subordinated creditors, and a public ownership option to seek to prevent systemic disruptions. The resolution authority may also sell assets by securitization to a wider range of buyers. The triggering of the resolution phase should be done by the supervisory authority based on well-

[1] The deposit guaranty agency (BFG) would be the resolution authority under the new framework.

defined indicators of actual or imminent insolvency and the legal breach of these or other pertinent thresholds, or an assessment by the authorities on the likelihood of the failure of a bank.

d. **Once a resolution is triggered, actions must be taken swiftly to transfer bank assets and liabilities or ownership to voluntary buyers.** Resolution operations should also abide by a no-creditor-worse-off rule meaning that in conducting resolution transactions the recovery by creditors would be at least as much as what creditors would receive in a liquidation of the assets of a bank and distribution of such proceeds. If asset and deposit transfers can be effected via an asset gap funding contribution from the deposit insurance fund to facilitate other banks' assumption of liabilities, this should be done provided that such a contribution is smaller than what would have been paid to insured depositors if they had not been assumed by another institution. The deposit guarantee fund would open a resolution sub-account to be funded ex ante by the industry to support these operations. As a last resort, gap funding could be sought from the Ministry of Finance (MoF) if required to meet resolution objectives or in the case of a systemically important institution. Compensation to all creditors should be dictated by a hierarchy pre-defined according to the seniority and priority of creditor claims.

e. **A key aspect of the resolution process is for the authorities to swiftly assess and revalue the balance sheet of the intervened bank.** Once assets are adjusted for required provisions, application of accounting rules, and write-offs, this provides a truer value of the bank's assets for potential buyers to more accurately bid to purchase viable assets and the assumption of liabilities. If assets and liabilities are transferred promptly, the bank can remain open under the stewardship of the resolution authority to continue basic operations and maintain the confidence of the public. While the bank's license can be revoked at any time, the resolution authority exercises its powers to act for the bank as a going concern before it is closed, given the bank's loss of qualification for retaining a license because of its imminent insolvency.

f. **Other particularities of modern resolution procedures relate to maintaining the integrity of secured financial contracts to prevent disruptions in financial market transactions including in payments and settlements systems.** Contractual arrangements between the bank and a counterparty will be respected under pre-existing closeout, asset-liability netting, and set-off agreements. Instruments that are secured such as collateralized bonds, structured securities, or derivatives will be maintained intact but may be transferred to another institution, or left for liquidation, depending on their rank in the creditor hierarchy.

g. **The treatment of systemically important institutions should rely on extraordinary resolution tools which are necessary if a bank is too large to be purchased or for its liabilities to be readily assumed.** Additional crisis management contingency measures may also be enacted as temporary tools for emergency situations. If banks have parent or subsidiary funding or lending relationships with overseas banks, the resolution procedure requires tight coordination and exchange of information on crisis resolution measures that minimize losses for both affected jurisdictions. These coordination issues are currently in discussions among EU members, the European Commission and the European Banking Authority.

Table 1. FSB Key Attributes of Effective Resolution Regimes for Financial Institutions and the Assumption/Issues Paper Proposals

Key Attribute	Elements	Issues Paper Reference
Scope	The institutions included within the scope of the assumption paper include commercial banks including domestically owned banks, holding companies, subsidiaries of foreign banks, non-EU branch banks, and cooperative banks.	Section I
Resolution authority	The BFG is proposed as the resolution authority. The resolution authority will have operational independence, transparent processes, sound governance and adequate resources. The resolution authority and its staff will be protected against liability for actions taken and omissions made while discharging duties in the exercise of resolution powers in good faith. The resolution authority will seek to maximize recoveries to creditors and minimize public costs in the use of deposit insurance funds.	Sections III and XIII
Resolution powers	The resolution authority will have the authority to transfer or sell assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares of the failed bank, to a solvent third party institution or to a newly established bridge bank, without the consent of management or shareholders once the resolution triggers are invoked. The resolution authority will have the power to use the "sale of business tool," to transfer/sell a bank in whole or part to purchasers, an asset separation tool to be used in conjunction with other resolution tools, a bridge bank tool, a debt write down tool and a state ownership option.	Sections IV, V, VI and VII
Set-off, netting, collateralization	Upon the commencement of resolution or insolvency proceedings, the contractual provisions involving pre agreed set-off or netting rules will be maintained. For dual-asset claims under collateralized or derivative contracts (e.g., repos, structured finance contracts, or securitized bonds with an underlying collateralization pool), the separation of claims within the creditor hierarchy should not split off the two parts of such contracts into separate instruments as they are contractually linked assets.	Section IX
Safeguards	The compensation received by non-depositor / uninsured creditors will be in the order of their hierarchy under the resolution procedures. The resolution transactions will ensure that any compensation (or loss) to creditors represents a better outcome than making the subject bank go through liquidation. The ex post judicial review of decisions taken by resolution authorities should be limited to legality of actions taken but courts must not reverse a resolution process ex ante, nor halt a resolution action.	Sections III, VIII, IX and XIII

Funding of firms in resolution	The guarantee fund and the resolution fund would be the same, as incentives to minimize outlays under the guarantee fund are strong. An additional bank levy could be charged to bolster the assets of the fund. Deposit insurance resources may be used to fund gaps in new balance sheets from resolved banks provided they reflect the least cost option.	Section XIII
Legal framework conditions for cross-border cooperation	The resolution authority will have the right to enter into agreements with resolution authorities of other jurisdictions and explicitly be provided with the legal powers necessary to establish effective arrangements for cooperation and communication of information with foreign financial supervisors and other responsible authorities.	Section XII
Crisis Management Groups	At the point of entering the resolution phase, KNF will inform the Financial Stability Committee (defined as including MoF, NBP, KNF and BFG) and KNF will share on-site inspection reports, analysis and other information with BFG if this had not been done so previously. The FSC will also be the consultative body for exceptional mechanisms during systemic crises. Cross border arrangements will be defined ex ante.	Sections V, XII and XIV
Institution-specific cross-border cooperation agreements	For both branches as well as subsidiaries located in Poland, the resolution authority, upon entering into a resolution phase, should notify the group level (home) resolution authority of actions or other measures being considered and propose burden sharing arrangements. Access to EBA as final arbiter is proposed if resolution plans are not agreed within EU area institutions.	Section XII
Resolvability assessments	Resolution plans will be assessed to determine their adequacy from time to time and whether they must be modified. Procedures used by the authorities will follow set financial/cost criteria and time bound phased actions to achieve optimal solutions. In the case of cross-border cases procedures will include the same criteria at a group level with decision process involving foreign authorities.	Sections VI, VII and XII
Recovery and resolution planning	Resolution and Recovery Plans will be required for systemically important institutions covering prescribed areas for such plans and subject to agreement and approval by KNF and BFG.	Section XI
Access to information and information sharing	The resolution authority will have the right to receive information from the supervisor prior to and after a resolution procedure begins. It will have authority to enter into agreements with resolution authorities of other jurisdictions and will explicitly be provided with the legal powers necessary to establish effective arrangements for cooperation and redress.	Sections V and XII

The Polish Bank Insolvency Regime

Issues/Assumption Paper for

Specifying the Design of an Upgraded Bank Resolution Framework

I. Background, Rationale and Scope

1. In the current Polish Banking Act, as in other European countries, the use of instruments such as partial transfers of loan assets (as well as other assets) along with matching deposits from failing banks to stronger banks, is not usually an accepted or authorized procedure. Instead, once a bank is considered to have failed, following a phase of attempted rehabilitation including via a government appointed temporary administrator (conservator, trustee, or receiver), the bank is attempted to be sold or merged with another bank. Otherwise it enters into an administrative liquidation stage or is subject to the bankruptcy law where insured depositors are paid, and the proceeds from the sale of the bank's assets are used to pay other creditors including the deposit insurance fund and potentially other government or central bank claims.

2. The existing framework implies that insured deposit payouts can have immediate repercussions on the fiscal purse if the deposit insurance agency has insufficient funds to pay insured depositors up to the guaranteed limit. As well, it implies that the failed bank enters a period where its assets can lose valued as the bank is no longer an operating entity when closed under administrative liquidation or as part of a bankruptcy law proceeding. These factors, among others, result in a higher potential government burden in resolving failed banks and do not sufficiently exploit market burden-sharing solutions.

3. The proposed resolution frameworks (both emerging from the European Commission as well as from other EU and non-EU countries that have implemented alternative models), aim at minimizing fiscal outlays by preserving the value of assets of failing banks to the maximum extent. To implement such tools and powers, changes in the conceptualization of winding up of banks, of bank net worth, of shareholders' rights, and of supervisory powers, need to be put in

place. These should apply the principles as recently communicated by the Financial Stability Board[2] which would ensure an effective resolution regime, including its ability to:

(a) ensure continuity of systemically important financial services, and payment, clearing and settlement functions;

(b) protect, where applicable and in coordination with the relevant deposit insurance schemes , such depositors, insurance policy holders and investors as are covered by such schemes and ensure the rapid return of segregated client assets;

(c) allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;

(d) not rely on public solvency support and not create an expectation that such support will be available;

(e) avoid unnecessary destruction of value, and therefore seek to minimize the overall costs of resolution in home and host jurisdictions, and, where consistent with the other objectives, losses for creditors;

(f) provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;

(g) provide a mandate in law for cooperation, information exchange and coordination domestically and with relevant foreign resolution authorities before and during a resolution;

(h) ensure that non-viable firms can exit the market in an orderly way; and

(i) be credible, and thereby enhance market discipline and provide incentives for market-based solutions.

4. The new proposals from the EC address several new instrumentalities and supervisory powers that should be used. As well, global practices from other OECD and G20 members demonstrate important lessons on how to align the new powers and instruments with other priorities in national legal frameworks (such as property rights and financial stability needs in the public interest).

[2] "Key Attributes of Effective Resolution Regimes for Financial Institutions," Financial Stability Board, October 2011.

5. The purpose of this paper is thus to describe and recommend new features that could be added to strengthen the Polish legislation for handling commercial bank insolvencies. The paper focuses on the legal issues related to insolvency of banks (including commercial banks and cooperative banks). The banking sector's share in the total assets of the credit sector amounts to 89% while cooperative banks control 6%.[3] The only wholly-owned state bank is the development bank *Bank Gospodarstwa Krajowego* (BGK) which is subject to supervision by the Polish Financial Supervisory Authority (KNF).

6. The cooperative banks' market share for loans is small as explained, at 6%. These banks, however, play an important role in providing citizens with access to credit. The cooperative banking sector comprises over 550 cooperative banks with links to two associating banks and they have around 2.5 million members though a countrywide network of 4000 branches (nearly 28% of the total number of bank offices in Poland). Thus in sheer numbers they represent a significant sector whose institutional failure could have serious social consequences. They are supervised by KNF and count on deposit insurance from BFG.

7. Branches of credit institutions (branches of EU foreign banks) are treated differently from commercial banks in relation to insolvency. The Bankruptcy and Rehabilitation Law (BRL) [4] provides for a separate regulation of bankruptcy proceedings in respect of branches of foreign banks and credit institutions.[5] Therefore, for foreign banks the focus in this paper will be on the subsidiaries of foreign banks and other locally-incorporated banks since they are domestic legal entities, and branches of non EU banks. The cross border issues related to EU branches will be briefly discussed.

The Case for a New Bank Resolution Regime

8. The inadequacies of existing bank insolvency regimes have their origins in legal frameworks that do not distinguish between corporate failures and banking failures, as both are

[3] NBP Financial Stability Report July 2011
[4] BRL Articles 451 to 459.
[5] Pre-insolvency/early intervention, Reorganization measures and winding up proceedings of banking groups, National Report for Poland, Dr Marcin Olechowski.

subject to a form of commercial insolvency law. In a number of respects, the commercial insolvency law model is ill-suited to deal with the failure of banks because:

(a) The corporate insolvency framework does not recognize that banks and other financial companies, unlike industrial and commercial companies, can be prone to sudden losses of confidence, runs, contagion and other wider systemic consequences jeopardizing the public interest in financial stability. Speed in resolution is crucially more important than for non-financial companies, as even solvent banks can rapidly become insolvent once they experience losses of confidence due to real or perceived difficulties.

(b) It is also highly problematic that in most cases, implementation of corporate insolvency law provisions (applicable in part to banks under the Polish Banking Act) can only be initiated at the point of economic insolvency, inhibiting early and decisive pre-emptive intervention designed to forestall potential problems with broader macro-financial impacts.

(c) The corporate insolvency framework is not well suited to ensuring the continuity of key banking functions, especially payments to and from customer accounts and access to overdraft and other credit facilities, all of which will be frozen by the total moratorium that generally comes into effect as part of a corporate insolvency proceeding.

(d) Traditional insolvency frameworks do not recognize the particular position of bank depositors, who – unlike the creditors of industrial companies – are numerous in number, are not professional market participants, and their claims on a bank have a major role in the wider functioning of the economy and the financial system's stability.

(e) The corporate insolvency model uses judicial instead of administrative proceedings with all the procedural and temporal inefficiencies of court proceedings.

9. Hence the justification for a reformed resolution regime for failing banks and other financial institutions. A banking resolution regime thus creates a set of separate rules and procedures for insolvency of banks, exempting them from the corporate insolvency framework.

The key purpose of the new regime is to enable an orderly resolution of a failing bank in a manner preserving the public interest, particularly by maintaining financial stability, preserving confidence in the banking sector, and protecting both depositors and taxpayers from unnecessary losses or costs. In the event of the failure of systemically important financial institutions, these objectives are nearly impossible to achieve within the context of traditional commercial insolvency laws.

II. Other Country Experiences in Applying Advanced Resolution Frameworks

10. New resolution tools contained in the proposed legal reform would be fully consistent with EC proposals. The EC has proposed a formal Directive and its features will be incorporated in the new Polish framework. This paper interprets the EU recommendations based on earlier EC White Papers and guidelines and the Commission's proposed new Directive. Nevertheless, even including all the features of the Directive, there are issues which the Directive itself may not cover or provide in sufficient detail and which this paper addresses. These include issues such as actual or virtual license revocation and suspension of shareholder rights, prioritizing special resolution tools for systemic as well as non-systemically important financial institutions, rescission of transactions prior to resolution of an institution, preservation of contractual relationships to enhance and preserve asset values that are traditional features of insolvency law, closed versus open bank operations, and other critical matters.

11. Other EU countries such as the U.K., Spain and Germany have already adopted special resolution powers. Several non-EU countries also have adopted modern resolution instruments. The institutional framework varies across countries, where resolution authorities are sometimes deposit insurance agencies, supervision agencies, central banks, or other specialized agencies. The German bank restructuring Act allows BaFin to utilize several asset/liability transfer and bridge bank tools to resolve a failing bank. A creditor cram-down tool to write-off debt exists for establishing a restructured balance sheet and has features for converting some types of debt to equity.

12. In Spain, the resolution authority is the Fund for Restructuring and it coordinates closely with the Central Bank. License revocation is immediate upon the start of resolution proceedings (e.g., versus the U.S. and other countries where the bank can remain as a going concern). In Spain, resolution authority funding even when small but as part of a balance sheet gap-filling for a bank to be resolved, allows the authority to gain majority ownership of the bank.

13. The new U.K. resolution framework is very comprehensive and provides a wide range of resolution options but also includes a temporary public sector ownership option involving investing by government in shares in a bank (vs. transferring assets and liabilities to a bridge bank under government control but without immediate public sector ownership). Clear redress or compensation for shareholders and creditors features are built in, based on ex post evaluation of financial results following a pre-insolvency resolution process – such a feature is not present in similar laws in Switzerland, Germany or Italy. The U.K. law is precise in its objectives, tools, powers and processes, and in defining the certainty of legal transactions, albeit it is more complex than other models.

14. Under Canadian legislation, the Canadian Deposit Insurance Corporation is the resolution authority. The supervisor (FSA equivalent) must trigger the process of resolution and the criteria for triggering are mostly qualitative, including (a) an excessive dependence by the subject bank on loans to sustain operations, (b) loss of depositor confidence, (c) a situation where regulatory capital is about to become substantially deficient, or (d) the bank has failed to pay or will not be able to pay its liabilities.

15. Under the Turkish resolution framework, the Deposit Insurance Fund conducts resolution transactions. The Fund is a privileged creditor in the process. It has authorization to provide financial support, take over losses, and own shares following such procedures, provided that such support falls below the amount of insured liabilities. The Fund may transfer assets as well as personnel to a new bank or to existing banks. It can fill asset gaps to complete a transfer as long as such funding is less than what would have been insured deposit payouts (a least cost rule).

16. In Malaysia, the bank resolution system is operated by the Deposit Insurance Corporation (the MDIC). In this case, the Malaysian Central Bank would inform the MDIC that a bank is non-viable or will be so shortly. The MDIC has powers to make the bank cease certain operations, and MDIC can acquire shares, assume managerial control and dispose of the whole of, or parts of assets and liabilities. MDIC must apply to the High Court to appoint a receiver for winding up. It can also set up a bridge bank with approval of the minister of finance. However, MDIC needs no approval from shareholders or creditors to conduct resolution operations. During the resolution process, no lawsuits are permitted against MDIC or the subject bank.

17. The banking legal framework of Japan has several interesting features including purchase and assumption operations, a bridge bank option, temporary public ownership option, and liquidation tools, that are carried out by the Japan Deposit Insurance Corporation (JDIC). As with the case of the U.K., temporary public ownership can only be invoked as a last resort in exceptional systemic risk cases.

18. The United States through the Federal Deposit Insurance Corporation (FDIC) has a long tradition of using modernized resolution tools including several methods for applying asset purchase and liability assumption transactions with gap-filling funding by the FDIC to expedite resolution transactions which are completed in short time periods while maintaining the going concern value of a bank.[6]

III. Overall Design Parameters for Poland's Bank Resolution Framework

19. The design of the proposed reform should be based on a new law on resolution which may be part of a revised act for BFG, or a separate resolution law. Either approach would require amendment of Chapter 12 of the Banking Act entitled Bank Reorganization Proceedings, Liquidations and Bankruptcies. A broader resolution phase would be defined where liquidation would only be used as a final option to dispose of residual assets that cannot be transferred as a purchase and assumption or other resolution operation. The resolution phase will sequentially follow the early intervention phases in the Banking Act as executed by KNF, but will precede the

[6] Details on FDIC regulations, procedures, tools and documentation are analyzed and discussed in: Mcguire, Claire, "Simple Tools to Assist in the Resolution of Troubled Banks," World Bank.

liquidation phase.[7] Its primary purpose will be to maximize the recoveries to the largest number of creditors of a failed bank, while minimizing the losses and cost outlays borne by the deposit insurance fund and/or any other public resources.

20. The basic criteria for financial institution resolution are actual or imminent insolvency of a financial institution. As indicated, the Financial Stability Board's Key Attributes of Effective Resolution Regimes in Section 3.1 speaks of "suitable indicators of non-viability" and the criteria in Article 27(2) of the EC Directive on establishing a framework for the recovery and resolution of credit institutions and investment firms, also relate to insolvency. In Poland's banking law, Part B of Chapter 12 on Liquidation of a bank and Part C on Bankruptcy of a bank are also based on indications of prospective insolvency of a bank and therefore should be superseded via the new legal regime on resolution. The initiation of resolution would be based upon a determination of insolvency-type criteria by the KNF. To maintain these other parts in Chapter 12 would create confusion as to the applicable rules when bank capital is seriously impaired.

21. Therefore in Chapter 12, Articles 147-169 should be repealed except for Articles 157(c)), (d), and (e) relating to liquidations initiated by authorities of Member States of the EU that have effects in Poland and Article 156(a)(1) relating to voluntary liquidations of a bank. Article 169 on loss of rights by members of bank's management bodies should also remain without reference to Article 147. With these amendments there would be a more coherent framework for supervisory action with respect to financially distressed banks.

22. To make the Banking Act and the new resolution law fully congruent, consideration should also be given to consolidating the provisions on appointment of a trustee in Article 144 and receivership in Article 145 of the Banking Act since there are similarities in these two articles regarding the purposes for the appointments and the objectives to be accomplished – implementation of a reorganization program – and the effect of appointment of a trustee or receiver – intervention in the private control of a bank. A consolidated article might be called

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[7] There may, however, be justification given specific circumstances where the resolution phase occurs prior to an earlier phase if earlier interventions are deemed by the authorities to be too late for effectively addressing an imminent bank failure.

"provisional management" for serious violations that cannot be adequately addressed by ordinary enforcement measures but are not directly or indirectly related to actual or imminent insolvency.[8] If there were such consolidation, there would be a clear distinction between three phases of supervisory action that are common in many countries: (i) ordinary enforcement proceedings (which would include, in appropriate cases, license revocation); (ii) provisional management; and (iii) resolution.[9]

23. It is proposed thus that Chapter 12 of the Banking Act be re-titled as: *Bank Reorganisation, Bank Resolution and Bank Liquidation Procedures* since it will include the resolution tools to be invoked, and which will be elaborated in the separate law. As per above, under article 147 of Chapter 12, Part B, the appointment of an administrative liquidator under the new proposed framework would occur later within the new resolution phase if needed. KNF's current powers to liquidate a bank at this stage would thus be incompatible with the new resolution regime and any such action by KNF under the new framework should no longer exist at this phase and occur only as a voluntarily action at earlier intervention phases (Articles 142 to 146, or prior). The resolution phase under the new procedure will thus include liquidation as the last option in the sequence of official interventions – therefore that section in the Banking Act will make reference to the resolution procedure under which administrative liquidation would be subsumed.

Treatment of a Bank under the Bankruptcy Act

24. Articles 426-441 of the Bankruptcy Act govern bankruptcy of a bank. Even though a case may currently be initiated only by KNF and even if KNF designates the court receiver, the provisions of this Act are unsuitable for a situation of insolvency of a bank for several reasons.

[8] Under provisional management, the manager would assume control over all or some of the operations, departments, units, or corporate bodies of the bank as KNF may direct. For example, the manager might assume control over the types and terms of the institution's taking of deposits or extending some or all types of credit, issuance of obligations, acquisition of capital or non-capital assets, or engagement of services. The rights and activities of the board of directors and the shareholders of an institution during provisional management would be only those authorized by the provisional manager.

[9] Reportedly in practice supervisory action under Article 138 also has resulted in a remedial action plan rather than the more punitive types of measures described in paragraphs 1, 2, 3a, and 4 of this article. For transparency and coherence with respect to reorganization plans, this article might benefit also from some amendment.

First, there is no criterion related to minimization of the cost to public funds for a proceeding. Second, there are no resolution tools of purchase and assumption transactions, establishment of a bridge bank, adjustment of the bank's balance sheet resulting in debt write-down, or use of an asset separation tool. In addition, ordinary bankruptcy proceedings by their nature are cumbersome and less efficient than administrative actions designed specifically for bank insolvency often found in commercial banking laws.[10]

25. Some problematic provisions of the Bankruptcy Act with respect to a bank insolvency that make it unsuitable for expedited payment of claims of bank creditors who are uninsured depositors, or for maximization of recoveries from bank assets include: (i) the debtor may seek an arrangement with creditors in lieu of liquidation of assets, that would delay the liquidation and would undermine the credibility of supervisory action that initiated the proceeding; (ii) the procedures under the Act are complex and are also subject to the Civil Procedure Code; (iii) a court's final decision on a case is subject to appeal; (iv) a creditors' meeting may be organized that could decide on the course of the proceedings; (v) if an arrangement with creditors is attempted instead of liquidation of assets, the debtor entity may assume control over the estate that might conflict with control over assets by KNF; (vi) a court's interim decision on a case may be appealed with attendant delay; and (vii) there are inadequate provisions regarding a bank's obligations related to clearing and settlement systems during the period between the filing of a bankruptcy petition to initiate a case and the declaration of bankruptcy, during which considerable time could elapse.

26. ***Administrative versus Judicial Powers.*** The resolution law will be conducted as an administrative proceeding rather than with the courts but with the right of aggrieved parties to appeal to the courts in ways that will not interfere with the resolution. This will provide for a more effective and nimble resolution regime. Thus the formal bankruptcy stage would become unnecessary given that the assessment of insolvency preceded it at the resolution stage and so any previously available bankruptcy actions would be supplanted by resolution actions triggered much earlier. The new law would provide the resolution authority with the requisite administrative powers, given the special nature of the bank resolution regime that requires

[10] One Polish lawyer who has considerable experience in bankruptcy cases in Poland indicated that it was "inconceivable" that a bankruptcy of a bank could be administered efficiently under the Bankruptcy Act.

special expertise that judges generally do not possess and speed to prevent financial sector instability and contagion effects. In this context, the resolution authority will exercise its powers to effect transactions and operations without any authorization needed from the judicial authorities.[11]

27. ***Objective of the Resolution Proceeding.*** The main guiding objectives of a resolution proceeding will be to (a) ensure financial stability, (b) maintain the continuity of critical functions in the banking system, and (c) protect depositors and other creditors. As operational criteria in applying resolution tools, the key objectives will be to (i) maintain and maximize the value of the assets of the failed bank for the benefit of depositors and creditors, and (ii) minimize the use of public funds.

28. ***The Resolution Authority.*** The current Banking Act assigns all powers related to trusteeship, receivership[12] and liquidation, to KNF, the supervisory authority. In some jurisdictions the supervisory authority is also the authority in charge of resolution given its in-depth knowledge of banks under its supervision. However, the literature on resolution also has argued for a different institution than the supervisory authority in order to remove the potential for regulatory forbearance if the supervisory authority continues supervising the improvement of a bank under its existing management, or extends this process, as a demonstration that recovery and rehabilitation plans must be given all the possible chances. It may not be the case that supervisory authorities will forbear, but there is an argument to be made for a separation of duties once a bank has to be sold or dismembered in resolution.[13]

29. BFG has incentives to conduct resolution operations that maintain or maximize the value of the subject bank's assets and minimize the use of public funds since BFG is the custodian for deposit insurance funds and using them too quickly might erode confidence in deposit insurance.

[11] In the draft EU Directive on Resolution, the proposal is that the resolution authority also has powers to take action without being required to establish that an institution is balance sheet insolvent, and much before all equity has been depleted.
[12] Within the Polish Banking Act, the term "receivership" as translated refers to what is commonly understood as a conservatorship phase, i.e., active official management of a bank.
[13] This issue is also discussed in Brierly, Peter, "The UK Special Resolution Regime for failing banks in an international context," July 2009; and other literature.

BFG should become an effective resolution authority given its capacity but may need some specialized skill and personnel upgrading to carry out new resolution responsibilities, though in many instances it could contract specialists on a temporary basis. BFG as the resolution authority should be prepared to act after the point where, under the current Polish Banking Act, actions under the Reorganization stage (chapter 12, part A) have not restored financial soundness to a bank.

30. The resolution authority needs to have all the expertise, resources and the operational capacity to implement resolution measures with respect to even the largest and most complex banks. Consequently it must be able to attract and retain experienced and skilled staff. It should also have sufficient funding to ensure that its staff receives adequate ongoing training.[14] For these reasons it is important that the resolution authority is allowed to pay salaries comparable to the salary levels in the private sector.[15] The legal framework should exempt the resolution authority from any legislation on public services that may prevent it from freely setting appropriate salaries for its officers and employees.

31. The resolution authority should be independent and its senior management, its management board and its Council members selected according to appropriate professional and experience criteria. The terms of office of the management board should be set in advance with fixed terms but with staggered overlapping terms among members. Being a resolution authority, participation of private sector representatives on the Board and on the Council would not be appropriate given resolution/insolvency cases pertaining to potential competitor banks. However, the resolution authority may benefit from private sector expertise on its Board and its Council so may consider members with such prior experience, or alternatively if members are sitting executives of banks, ensuring a protocol where they would recuse themselves from any active discussion of a bank undergoing resolution that might benefit them competitively.

32. The independence provided to the resolution authority must also be matched with corresponding accountability. The resolution authority should be subject to rigorous evaluation

[14] BIS Principle 1(2), from Basel Committee on Banking Supervision, Core Principles Methodology, October 2006.
[15] BIS Principle 1(2), from Basel Committee on Banking Supervision, Core Principles Methodology, October 2006.

and accountability mechanisms to assess the effectiveness of any resolution measures it implements, and it should present financial reporting in conformity with International Financial Reporting Standards (IFRS) and its accounts and operations should be subject to the auditing by a recognized qualified auditor to confirm the integrity of its operations and financial statements.

33. ***Legal Protection for Resolution Administrators.*** The resolution authority and its staff as well as any agents appointed by it, should have immunity for actions taken in the exercise of resolution powers in good faith, including actions in support of foreign resolution proceedings.[16] International best practice standards[17] requires that board members, as well as staff, are provided with adequate legal protection for the *bona fide* discharge of their governmental, regulatory and administrative functions and powers. With respect to personal liability, the scope of protection should not require the relevant officer(s) or agent(s) of the resolution authority to demonstrate that their conduct was "reasonable" or "not negligent." As a matter of principle and of legal practice, lawsuits should be permitted to be directed only at the resolution agency itself rather than individual officials or staff.

34. The new legal framework should exempt the board members and the staff from all prosecution – including being detained or arrested – if they have discharged their duties in a *bona fide* manner in conformity with the law. Any claimants filing civil damages following the conclusion of a resolution proceeding should be indemnified for any expenses incurred in successfully arguing a civil claim arising from actions or omissions taken by the resolution authority in good faith in the normal course of their official duties. Conversely, if claims are judged as invalid, the resolution authority will be reimbursed for expenses incurred in defending such claim. Any ex post judicial review of decisions taken by resolution authorities should be limited to legality of actions taken and the way in which they were implemented, and the adequacy of compensation for damages. Courts may not reverse a resolution process ex ante, nor halt a resolution action being undertaken.

[16] *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Financial Stability Board, October 2011, section 2.6.

[17] BIS Principle 1(5), from Basel Committee on Banking Supervision, Core Principles Methodology, October 2006.

35. ***Adjudication of Claims Arising from a Resolution Proceeding.*** The new law must contain the critical rule that all claims against or in connection with a financial institution that has become subject to a resolution proceeding will be settled in accordance with the new provisions. This would avoid the delay and inconsistencies that could arise, for example, in a proceeding under the ordinary civil law or if there were multiple lawsuits connected with a financial institution in a resolution proceeding. A corollary rule is that a resolution proceeding may not be stayed nor may a resolution administrator's actions be stayed by a court.

36. While there should be little justified cause for complaint if a proceeding is conducted by a qualified administrator, persons who feel their rights were infringed are not without recourse. After a proceeding is concluded, aggrieved persons may bring suit in the Administrative Court. A sum will be set-aside out of the proceeds from a sale or liquidation of a financial institution's assets or transfer of balance sheet items, to pay any court judgments that may result. If an institution is recapitalized, sold, or merged, there would otherwise be no identifiable source of funds to pay a judgment and indemnity provided to a person involved in a resolution. Aggrieved parties in the event of recapitalization, sale, or merger of the financial institution would likely be creditors whose claims were reduced or eliminated by virtue of the revaluation of the balance sheet. However, if conducted under the rules of the law, there should be no valid cause for complaint or redress.

37. Under the Administrative Law in Poland, if an action of a regulatory authority is challenged, there is reportedly no deference given to the decisions by the regulator as there is in some countries in recognition of the special expertise of regulatory authorities in their sectors. Therefore, the new law should contain rules for judicial review arising from resolution proceedings that are fair to claimants but protective of the resolution authority. Thus, the law should provide that the only questions before the court in determining whether the defendant acted unlawfully shall be whether: (i) the defendant did not have the legal authority to take the action in question; (ii) the defendant did not comply with procedures established for such action; or (iii) the action was not supported by substantial evidence.

38. ***Institutional Coordination.*** At the point of triggering a resolution, KNF will inform the Financial Stability Committee (composed of representatives of MoF, NBP, KNF and BFG).

KNF will provide all on-site inspection reports and bank financial information and analysis to BFG if this has not already been done. The new Act will also provide the authority for BFG to participate in inspection visits of banks at BFG's request, and obtain bank regulatory reports sent to KNF to ensure BFG is well aware of the situation of in banks with potential problems. Such visits and receipt of information should precede early intervention phases and intensify following the invoking of early intervention actions by KNF. At those points KNF will share with BFG information on developments in the bank's financial condition and actions taken and monitored by KNF.

39. The new law will provide for the establishment of a coordinating committee between KNF and BFG for a regular process of information sharing and to schedule the participation of BFG staff in inspection visits and any other arrangements to ensure that BFG is informed of the financial condition and developments of subject banks with the objective of better understanding what potential resolution actions, if triggered, could be viable. An illustrative formulation of such arrangements is listed below:

> There is hereby created a KNF-BFG Coordination Committee consisting of the [President of BFG], the [Chairman of KNF] [and their deputies] to coordinate matters of mutual interest with respect to the condition of banks that have insured deposits and requirements for bank resolution.
>
> KNF shall on a regular or on-request basis provide to BFG reports of condition of banks that have insured deposits, analysis prepared or reviewed by KNF, at the same time that KNF submits the same for review by its management board, and shall provide such supplemental clarifications or documents including working papers from inspections, and other information as BFG may reasonably request.
>
> BFG may request KNF that BFG staff participate in all or part of inspections conducted by KNF of banks with insured deposits, with staff for such purpose to be assigned by BFG.

40. ***Transfer of Certain Banking Act Provisions to the New Resolution Law.*** Once the article 147 triggers are invoked, the Banking Act currently provides for KNF to attempt to promote a sale of the subject bank in its entirety to another bank. It will not make sense to have different triggers for putting a bank up for sale versus triggers to conduct resolution as they both will be due to the same conditions and will imply the same result, that is, the non-viability and break-up of one bank to be incorporated by another (or others). It will thus be clearer and more

consistent if BFG conducts the sale of an entire bank to another bank as such is simply a 'whole bank sale' case of a resolution transaction.[18] KNF may only retain the power to effect the sale of a whole bank, when this takes place much prior to the invoking of the resolution phase and when the sale is conducted on a purely voluntary basis as proposed by the bank's shareholders before any resolution indicators are triggered.

IV. Transactional Powers of the Resolution Authority

41. The resolution authority will have powers to (a) operate and resolve a bank, (b) continue or assign contracts, (c) purchase or sell assets, (d) write down debt and (e) take other actions incidental to the powers ascribed to it to restructure or wind down the bank's operations (discussed further below). The new resolution law will authorize the resolution authority to terminate contracts in which the parties have not yet fully performed their obligations if this will increase the value of the estate. As part of having a bank enter the resolution phase the authority must, in particular, be able to renegotiate and terminate leases of property, dismiss employees, and adjust non-essential supply and service provision contracts. This power should be used by the administrator for the purpose of maintaining those contractual relationships which are beneficial for maximizing the value of the firm and its recovery value, for the benefit of creditors.

42. The resolution authority will also have powers to (a) request and obtain any information from any person (e.g., counterparty of an institution, borrower from an institution, manager of an asset mortgaged to an institution) that the administrator appointed by the authority deems necessary to prepare a resolution transaction, (b) continue or suspend any operation of the institution, (c) suspend or limit payment of an institution's liabilities, (d) cause an institution to issue new shares or other capital instruments including preference shares and contingent convertible instruments, (e) change the maturity of debt instruments issued by the institution, the amount of interest payable, or suspend payment on such instruments for a temporary period, provided that the restructured debt instruments have the same net present value.

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[18] In the United States, FDIC, the resolution authority is the agency responsible to conduct what is termed a "Whole Bank Purchase and Assumption."

43. The resolution authority will have the power to transfer or sell assets and liabilities, rights and obligations, including deposit liabilities of the failed bank, to a solvent third party institution or to a newly established bridge bank (details on bridge banks are discussed further below). The resolution authority should have complementary powers such that any transfer of assets or liabilities would:

(i) not require the consent of any interested party or creditor to be valid; and

(ii) not constitute an immediate default or termination event toward a claimant (in relation to any obligation relating to such assets or liabilities or under any contract to which the failed bank is a party).

44. ***The Recommended Resolution Approach.*** A key principle in the application of the new framework versus the existing one is that the proposed resolution framework provides options for both resolution and liquidation but does not give preference to liquidation as the "default" option. The latter would imply higher immediate costs to the State for systemically significant banks and to BFG, the Deposit Guarantee Fund, in most circumstances.

45. Chapter 12, Part B of the Banking Act should thus refer to the new resolution law's provisions for *"Resolution Procedures and Administrative Liquidation."* The same trigger will be used to effect either the sale of a bank, its resolution or its liquidation; where bank resolution or sale procedures are given a preference once the trigger occurs, and these options would all be included in the new law. Although article 147 of the Banking Act requires a six month period prior to taking a next decision under the earlier intervention stage, paragraph 2 of that same article also provides cause to override the six month period; which can be used to invoke resolution early, if needed.

V. Resolution Triggers

46. The triggers for resolution will be invoked by KNF. As discussed, the triggers would be the same for invoking sale of a bank, transfer of its assets and liabilities, or liquidation of its

assets, as they all pertain to cases of a bank not being able to continue operations in its present financial circumstances. BFG or the NBP will have the right, based on their opinion and analysis, to request KNF that it authorize putting the bank into resolution based on their assessment that key indicators have been triggered, while so informing the Financial Stability Committee (FSC).

47. As mentioned, the resolution phase would normally be expected to follow the early intervention phases described in the Banking Act under Chapter 12, Part A, but it should also be possible for it to be triggered independently or before a bank has gone through the trustee or receivership phases, provided that the resolution triggers have occurred.

48. In line with proper criteria for resolution, it is also recommended that the indicators for triggering resolution be actual or imminent insolvency by determination of the supervisory authority and be both quantitative and qualitative to ensure appropriate ability to intervene once a bank falls into a serious financial condition. In certain banking laws in the civil law tradition, the triggers are included within the law. The quantitative triggers recommended include an assessment that for the institution in question any of the situations described below materializes.

49. KNF, therefore, may authorize the commencement of a resolution proceeding for BFG to take possession and control of a financial institution, if KNF determines that:

a. there is no reasonable prospect that any alternative private sector or supervisory action other than a resolution action would prevent the failure of the institution; and the resolution action is in the public interest, and

b. The financial institution's solvency is compromised by one or more of the following conditions:

i. the financial institution is generally not paying its liabilities in full or can reasonably be expected in the next ninety days to be unable to pay its liabilities in full as they fall due;[19]

ii. the financial institution has incurred or can reasonably be expected to incur losses that will deplete all or substantially all of its regulatory capital;

iii. the financial institution's Tier 1 capital or its regulatory capital ratio, is half or less than the minimum regulatory requirements;[20]

iv. the financial institution's losses registered in its financial statements constitute more than half of its own funds; or

c. the financial institution has committed a material violation of an applicable law or rule or an order of the KNF that has had or can reasonably be expected to have a material adverse effect upon the capital or liquidity position of the institution or cause the institution to fail; or

d. the financial institution has not fulfilled an agreement entered into by the institution with the KNF for the restoration of the capital or liquidity of the institution that requires, in that event, the institution to be placed in bank resolution; or

e. the license of the financial institution is revoked.

50. The triggers give ample flexibility to the authority to avoid relying on a single indicator. It is important that judgment be used in cases where quantitative indicators have not yet materialized or would require an adjustment of the accounts of the bank to realize a triggering of the indicators. Thus, the quantitative indicators are supplemented by qualitative indicators so that any individual indicator, either quantitative or qualitative, if triggered, would allow KNF to invoke resolution.

[19] Excessive dependence on borrowing via special loans from the central bank to sustain its operations, will be criteria to be considered in this respect.
[20] A more conservative approach could set the CAR that triggers resolution at 2/3 of the minimum requirement.

51. ***Proportionality Principle in Applying and Justifying Resolution Actions.*** Since bank resolution is in effect an insolvency proceeding for a bank, and significant property rights are infringed with respect to shareholders, creditors, directors, employees and suppliers of banks, the rule of law requires that the principle of proportionality apply, whereby the remedial action taken be commensurate with the cause of the action. Procedural due process of law requires fair notice to those subject to the law of the consequences of the actions of an entity subject to the law. Immaterial breaches of law or regulation or indefinite criteria for initiation of a resolution proceeding do not observe these fundamental principles of law. Equally important, to initiate a proceeding based on immaterial infractions or those unrelated to insolvency or illiquidity could cause a run on a bank's deposits and the failure of the bank – the very consequences that bank regulation and supervision and a proper resolution law are designed to prevent.

52. ***Inter-Institutional Communication in Invoking Resolution***. Besides invoking resolution based on KNF's assessment that the relevant indicators have been triggered, resolution may also be based, as discussed above, on a recommendation communicated by BFG or NBP if these institutions assess that resolution triggers are deemed to have occurred. In any case, much before resolution is considered (including when KNF may be monitoring a bank either under standard procedures, or having assigned a Trustee to it, or assigned an official administrator/receiver to manage the bank) KNF will alert BFG if it considers that a resolution procedure comprises one of the set of potential outcomes for the bank and therein will collaborate with BFG in monitoring the bank's performance and under inspection visits allowing BFG to prepare contingency plans well in advance for possible resolution options. This may occur prior to any official interventions including as part of KNF's regular inspection process (in which case BFG as part of official bank visits will be permitted to raise such options). KNF will formally inform the management and Board of the bank of such allowance for BFG's assessment and contingency planning.

53. BFG will have flexible and active opportunities to work on resolution solutions during the early stages of intervention by KNF under the trustee/conservator or official administration/receivership phases where KNF will exercise more control over the bank and may

ask BFG to accompany such process (or BFG may request to do so if it considers that the subject bank is experiencing serious solvency or liquidity problems). KNF may also appoint BFG as Trustee in these early intervention stages as well and which would facilitate BFG's preparation of contingent resolution plans in advance, if these needed to be eventually executed.

54. When KNF intends to invoke the resolution phase it should inform BFG immediately of its intent to do so. However, as discussed above, BFG will already have had other channels to assess a bank's resolution probabilities and prospects before resolution is formally invoked. At the point of formal confirmation, KNF will issue an administrative order confirming that the resolution phase has begun and communicate such to members of the Financial Stability Committee (FSC). Once resolution is authorized and legally in effect, KNF will supply BFG (if not done so previously) copies of any recent working papers, sample portfolios audits of the subject bank, reports on the trajectory of any rehabilitation plan and/or officially administered bank management improvement plan and its results, and any other pertinent details regarding the financial and operational issues facing the bank; in the event BFG has not received such information previously.

55. Once resolution is in effect, BFG will inform the board of directors and management of the bank of this event and appoint special administrators (including the option of contracted experts) to conserve the bank's assets as a going concern and indicating which operations are suspended and which are authorized. Notification of the resolution will be communicated to the bank's shareholders and bondholders so they are fully informed. BFG will be authorized, within this period, if not already done prior to entering resolution, to call for an operational transition meeting with KNF to identify key areas of control in the bank's activities that need to be transferred from the supervisor to the resolution authority.

VI. Commencement of the Resolution Process

56. The process described in this section may be included as a set of procedures documented in an operational manual developed by the resolution authority. It can also be reflected in regulations in implementation of the resolution law. Given the detailed nature of the steps, it is

not recommended that they be part of the law unless a legal opinion indicates that such detail must be included in the law.

57. ***Administrative Takeover and Suspension of Activities.*** Unless previously put into effect under a trustee or receivership phase, BFG via its appointed experts will take over all the branches, books, registers, and documents of the bank. At this point BFG will have the power to pay or suspend payment of claims against the institution. After resolution begins, actions taken by the bank's board, management, staff or control functions will be null and void unless authorized by the resolution authority.

58. ***Fixing the Net Capital Position of the Bank.*** Based on the bank's latest financial statements, within a period of 5 working days, the resolution authority should begin registering in the bank's accounting books its updated and assessed provisions, required loss reserves, write offs or other asset account adjustments deemed proper to ensure an accurate rendition of the bank's actual financial condition. Salary and social benefit obligations to bank employees will be calculated (with the exception of any claims from members of the management board, supervisory board and senior management). The valuation of all other assets and the value of all liabilities will be computed. For liabilities, a ranked list by creditor hierarchy will be generated. The result of this exercise would be to estimate the negative equity of the bank in order to assess its capital deficiency. Such work as well as the next steps below may have already been conducted as part of BFG's pre-resolution phases in conjunction with KNF.

59. ***Revaluation of the bank's balance sheet.*** The resolution authority will conduct the revaluation of the bank's balance sheet to estimate its capital deficit. To value the institution's assets, the resolution authority will adjust the bank's reported accounting values based on sampling of the portfolio and adjusting the value of assets based on, inter alia, criteria such as (a) adjustment of provisions based on deficient levels according to current loan classifications based on regulatory criteria, (b) reclassification of loans misclassified, requiring additional allocation of new loss provisions, (c) requirements for additional loan loss provisions based on insufficiency or lower value of collateral than reported on the bank's books, (d) revaluation of loan collateral based on sampling and market comparators, requiring assignment of incremental

loss provisions to make up for the gap, (e) reclassification of asset risk weight on assets not properly assigned to the proper risk category, requiring commensurate increases in capital charges, (f) assignment of incremental capital charges for market risks not identified, (g) assignment of incremental capital charges for operational risks or counterparty credit risks not recognized or identified, (h) verification and adjustment for any remaining equity and its valuation, (i) and any other applicable adjustments required by regulation or accounting rules.

60. Following this phase, the resolution authority will contact potential qualified bidders for expressions of interest in purchasing the bank or its assets and prepare marketing information for this purpose. The resolution authority will prepare a detailed information package and set up a data room for potential bidders to examine accounts and provide offers for the purchase of the bank or all or parts of its assets along with assumption of matching liability amounts consistent with maintaining an adequate solvency ratio of the purchaser.[21]

61. Qualifying bids would be accepted from banks whose absorption of assets from the failed bank represents a maximum of 50% of the acquiring bank's original balance sheet asset value, unless the resolution authority determines that the acquiring bank has extremely strong capacity and a robust asset integration plan with requisite personnel and internal systems to effectively manage a higher level of new assets (and liabilities) acquired. The acquirer will have to be accepted by KNF based on its legal and regulatory requirements. Qualifying banks should have Capital Adequacy Ratio of at least 2 percentage points above the minimum required and a Tier 1 ratio of 2 percentage points above the regulatory minimum. The acquiring bank should also have a composite supervisory rating (CAMEL equivalent) in the top 1st or 2nd category.

62. The resolution authority will disclose to bidders its findings, as needed, on the revaluation of balance sheet assets in order to encourage better informed bids from interested investors based on realistic asset values. The bids may be expressed as bids for the bank in its entirety and/or its assets separately, or as bids for the assets along with proposed loss-sharing

[21] This work as well as the that relating to marketing to potential bidders, may already have been conducted on a contingent basis during the earlier intervention stages prior to the resolution phase being formally invoked, for example, as part of contingent plans and measures considered by KNF within article 138 of the Banking Act.

agreements between the bidder and the resolution authority or government. The bids will represent the estimates of the market value of the assets.

Options for and Application of Resolution Tools

63. ***Separation of Assets and Technical Advisory Assistance.*** For the purposes of the above adjustments and for ongoing resolution activities, the Resolution Authority may contract expert assistance from its own resources. The cost of such technical assistance would be for the account of the institution in resolution and unless paid on a current basis, would constitute a high priority creditor claim in the hierarchy for payment of claims once a resolution solution is effected. Assets would be evaluated and separated based on their net assessed values. The authority may wish to exclude assets equivalent to "doubtful" or "loss" assets as these will be more difficult to purchase by a buyer.

64. ***Implementation of Resolution Process.*** During the initiation of the resolution phase, the banking license should not be revoked if the resolution authority has had ample time to pre-plan for a resolution solution during prior visits to the subject bank or during the early intervention stages by KNF, and where the resolution can be effectively implemented quickly within the following 10 working days and finalized without a run on deposits materializing. In such a case, it would be less optimal to close a bank as that might cause unnecessary deposit panic in itself and result in a liquidity drain and eventually having BFG to pay out the rest of insured depositors shortly thereafter. Such an act of closure would thus be highly costly to BFG when a resolution plan was otherwise quickly implementable and in such case, an open bank operation which maintains its going concern value would be beneficial.

65. However, if a resolution solution will take a longer time to assess and implement and depositor withdrawals accelerate, the bank should be closed quickly via a license revocation by KNF so that the bank does not lose further liquidity. This entails, however, the eventual prompt full payment to insured depositors of their claims. In such an instance, having a closed bank, the resolution authority will need to act fast to prevent a deterioration of its asset values and its going concern value for those viable parts of the bank. Thus revocation of the license should be a

judicious decision considering the operational parameters and objectives or resolution, i.e., how to best maintain and maximize asset value while minimizing the use of public funds including BFG funds.

66. The bank would conduct business within the limitations imposed on it by the authority and the law, including those described in the section on *Transactional Powers of the Resolution Authority*. In the case of an open bank, requests for withdrawals of deposits would have to be honored in most circumstances since nonpayment could trigger a bank run. If a bank is closed, deposit withdrawals could be halted but such action would cause a quick erosion of the perceived market value of the bank. Thus it is incumbent on the resolution authority to attempt to have pre-arranged voluntary resolution solutions with other banks or investors, before the resolution phase is triggered or to exert "moral suasion" on financial system participants to engage in purchase and assumption transactions. If a market-based or moral suasion resolution solution is not found within a reasonable time period, BFG would invoke the additional resolution tools available including the creation of a bridge bank.

67. To assess within a prescribed time period what the least loss and lowest cost solution is for conducting resolution, the procedure chosen should be completed within the short term from the time the resolution action is triggered until the transaction is completed. This includes completing the available P&A transfers, setting up a bridge bank, completing a debt write down procedure that capitalizes a bank, nationalizing a bank, setting up an asset management entity to liquidate any residual assets, or a combination of these measures. The final disposition of a bridge bank and asset management company or any liquidation of residual assets, however, are not subject to a short term time limit for cost assessment by the nature of their operations.

VII. Resolution Instruments

68. The specific tools and measures, to apply in the above process will include the new resolution tools, which may be used separately or in conduction with each other. They are:

(i) Arranging an ***acquisition or merger of the bank by or with another bank***.

(ii) A ***sale of business tool*** that would enable resolution authorities to effect the sale of the bank, or the whole, or part of its assets and liabilities to one or more banks on negotiated terms, that would not require the consent of the shareholders or procedural requirements from Company Law or Securities Law that would otherwise apply.[22]

(iii) A ***bridge bank tool*** that authorizes the resolution authorities to transfer all or part of the business of the bank to a bridge bank that is awarded a new license and is under control of the resolution authority to be able to: (a) transfer rights, assets or liabilities from the affected institution to the bridge bank; and (b) transfer rights, assets or liabilities back from the bridge bank to the institution or an asset management company, if this is necessary in view of the resolution objectives.

(iv) An ***asset separation tool*** which may only be used in conjunction with one or more of the tools listed above, that enables the resolution authorities to carve-out and transfer certain toxic assets of an institution to an asset management vehicle for the purpose of facilitating the use of another resolution tool. In this context, an "asset management vehicle" refers to a legal entity which may be owned by the resolution authority. The asset management vehicle may also be managed by a third party under resolution authority oversight. The authority should be able to: (a) transfer assets from the affected credit institution on more than one occasion; and (b) transfer assets from the asset management vehicle (if recoveries rise) to the institution or other acquiring institution or bridge bank, if advantageous.

(v) A ***debt write down tool*** that authorizes the resolution authorities to write down the claims of some or all of the uninsured depositors and unsecured creditors of a failing bank to the extent of the reduced value of its assets. The resolution authority may also convert debt claims to equity, providing an additional tool especially for the failure of large, complex financial institutions. This would mitigate moral hazard that was seen during the recent global financial crisis and create an incentive for monitoring of the financial condition of banks by investors for more effective market discipline.

[22] As noted above, shareholder approval should be precluded in the law. For securities law registration and disclosure requirements, bank loans are usually not considered securities and securitization of bank loans should qualify as exempt transactions if they are offered to fewer than a certain number of prospective purchasers. There may also be an exemption for sales of securities to accredited investors.

(vi) A ***state ownership option*** which authorizes the government to invest in the majority of the shares of the bank or otherwise control it through using different classes of equity ownership and own it temporarily, as a last resort option in cases of system-wide financial distress and where private sector buyers are not available or qualified.

69. For the sections that follow, *Loss Sharing Agreements* and *Loan Servicing and Securitization-Based Transfers*, the legal text of the new Act may make include their description and the full detail of their application. Alternatively, if the Polish legal framework allows, such level of specification may also be included as part of an Operational Manual of the resolution authority which may be reviewed and endorsed a priori by the FSC and approved by the Board of BFG.

70. ***Loss Sharing Agreements and Put Backs.*** In cases where loans with a doubtful or loss category exist and after netting out the accrued loss provisions they may still have a realizable value, the resolution authority may decide to sell them with matching liabilities as part of a purchase and assumption transaction but with loss sharing features. Loss sharing features reflect contractual arrangements for specific assets, whereby, only for such assets, or a group of defined assets, or a securitized bond transfer representing such assets, a financial contractual agreement exists between the purchaser and the resolution authority whereby such assets will yield either a minimum gross return to the purchaser over a period to be defined (e.g., 1-5 years) or the eventual liquidation of such assets will provide a minimum recovery value as a percent of the net principal amounts transferred.

71. In a loss sharing P&A, instead of the resolution authoring selling such assets at a heavily discounted value, it may transfer them at a higher assessed value (e.g., by netting out fewer loss provisions from book value) along with a loss sharing agreement whereby the acquiring bank would have the right to claim from the resolution authority (within the following 1-5 years or a maturity period to be defined) any unrealized returns or compensation for losses incurred on such assets beyond an agreed threshold.

72. The loss sharing claims may vary depending on the initial quality of the assets and can be structured for example so that the acquiring bank has a guaranteed claim of 50% - 85% of the nominal principal value of assets and expected returns with a corresponding potential loss of 15% - 50% of those assets acquired during the contractual period. However, following the loss-sharing period (e.g., 1-5 years) the agreement typically includes an asset recovery period (e.g., 2 additional years) where the acquiring institution attempts to realize recoveries or collection of collateral on failed assets. During this period, any recoveries made on defaulted assets would be proportionately returned (net of expenses incurred) to the resolution authority based on its previously paid share of the losses (in this case they reflect any residual gains). While this tool can facilitate the resolution process in borderline asset cases and avoid overusing a liquidation option for such assets, the downside is that it involves administrative costs incurred both by the acquiring bank and the resolution authority over the period of the loss sharing agreement.

73. ***Asset recovery, termination and preservation of contracts***. The resolution law should contain various provisions that are traditional in modern insolvency laws similar to those included in Title III Section III of Chapter 4 of the Bankruptcy and Rehabilitation Act to rescind transactions prior to the resolution proceeding that were by their nature unfair to the financial institution and impaired its financial condition, for example, gratuitous transfers or loans to insiders at preferential interest rates. The law should also contain provisions for contract termination to preserve assets and practical rules for utility services to continue to be provided to the financial institution as long as it provides a deposit to secure payment in the future. Without electricity, water, or telecommunications services, it would be difficult for the financial institution to be resolved in an orderly fashion. These provisions are also traditional in modern insolvency laws and provide more opportunity for a sale of the business or a reorganization, as a realistic alternative to a liquidation.

74. ***Loan Servicing and Securitization-Based Transfers.*** The resolution authority may utilize other supporting legal, financial, and commercial instruments and arrangements so that it may ease the execution of resolution procedures, including tools to assist in broadening the number of potential market participants to share in asset purchases. Such tools and arrangements may include, but not be limited to:

(i) The use of plain vanilla (i.e., only one level of an underlying set of assets) loan portfolio securitizations to convert to bonds sold to interested acquiring banks with varying risk appetites, allowing a broader range of potential bank investors/buyers;

(ii) Contractual arrangements for off balance sheet loan servicing contracts executed by financial institutions or qualified banks with an interest in asset recovery "success fees" versus managing on-balance sheet new portfolios. Such agent contracts may manage the underlying loan assets assigned to the securitizations listed above. Besides managing active portfolios they can also be deployed as asset management companies to manage any residual assets not transferred (either via securitization or outright) to purchasing banks.

75. If the resolution authority decides to utilize securitization structures to make the resolution process more effective and to maximize the transfer of assets and protection of creditors, it will require setting up a special purpose vehicle under a trust. Such special purpose vehicle would have its own legal identity and would issue securities based on underlying groups or pools of assets 'separated' from the problem bank. For any such arrangements the resolution authority will keep KNF's securities market supervisory Unit and MoF's financial regulation department informed of any transactions set up via these instruments and seek their advice on such, as needed.

76. The securities may be issued separately for purchase by different financial institutions, and may each reflect the entire composition of the underlying pool of assets to be transferred (i.e., equal asset risk levels for all participants) or they may be structured with different underlying pools of assets so as to provide different risk gradations of each security. Acquiring institutions would purchase the securities and assume corresponding liabilities on their balance sheets according to a competitive bidding process.

77. If the securities issued each had varying levels of risk based on different underlying portfolios (e.g., some securities backed with highly performing loans, others with medium performing loans and other with low performing loans), the transfer with corresponding

liabilities should be defined in a way that respects the creditor hierarchy. For example, securities backed by highly performing assets should be matched by insured deposit liabilities while securities with low performing assets should be matched with subordinated creditors. Using this approach (provided that there are sufficient buyers of all such securities) the resolution authority may seek to maximize the sales of assets along with corresponding creditor liabilities.

78. The advantage of such approaches is that the insolvent bank's assets may be spread more easily across the financial system if a unique buyer does not become available or in cases where the failed institution might be a SIFI. As well, the securities purchased by institutions can be sold to other institutions at an "arms length" market value. Such securities would be exempt from the provisions for securities structuring, disclosure and issuance under the Securities Law but should nevertheless follow transparent and competitive practices in setting them up and marketing them. The resolution authority may also purchase such securities in exchange for an asset placement on a purchasing bank's balance sheet if this assists in finalizing a transfer of liabilities. In such a situation, the resolution authority effectively is engaging in a loss sharing agreement with the purchasing institution which will have a safer "resolution authority asset" on its books instead of the asset-backed security.

79. ***Balance Sheet Transfers and Resultant Capital Adequacy.*** Any purchase-and-assumption transaction should be able to meet the requisite prudential criteria, particularly in terms of the requisite resultant solvency ratio(s) of the acquiring bank(s). Under limited time-bound conditions, not to exceed one year, the authority may, following consultation and agreement with the supervisory authority, decide that an acquiring bank may absorb the failed bank's balance sheet, or part thereof, without immediately meeting a target solvency ratio, provided that in the joint assessment of the supervisory and resolution authorities, such acquiring bank has likely prospects to increase its solvency capital in the short term without foreseeable obstacles.

80. For the section that follows (Asset Separation Procedure) as well as the following section on the elaboration of the Bridge Bank Tool, the prescriptive procedures are not required to be reflected in detail in the Legal Act. Unless legal traditions strictly require it otherwise, such

description of procedures and techniques may be documented as part of the resolution authorities' approved Manual of Operations. Alternatively they may be specified under regulation subsidiary to the Legal Act.

81. ***Elaboration on the Asset Separation Procedure as a "Good-Bank/Bad-Bank" Approach.*** The law should explicitly allow the official administrator to reorganize the insolvent bank through an asset separation procedure, which essentially results in what is at times termed a "good-bank/bad-bank." Under the so-called "good-bank/bad-bank" asset separation technique the official administrator will transfer the nonperforming loans and other substandard assets to a separate company or entity (the so-called "bad bank") for collection. The bad bank can be a subsidiary, an asset-management company (AMC), a collection fund or other special-purpose vehicle, or an ordinary liquidation proceeding, with a view to ensuring more effective handling and asset recovery in the hands of specialists, thus permitting the good bank's management to concentrate on returning the bank's operations to profitability.

82. An AMC may not be required if residual assets are few and can be processed via an administrative or ordinary liquidation procedure, as an AMC involves setting up a new institution with legal personality. However, for more substantial asset amounts to be disposed of, an AMC can operate with more commercially-oriented incentives than ordinary liquidation specialists (e.g., earning a percentage of recoveries made), and can thus preserve and realize more optimal levels of asset value recoveries to better compensate creditors. Thus, the volume of assets, cost considerations, and time elapsed for liquidation should be considered in determining which modality to utilize for the residual bad assets as per the objective of "maintaining and maximizing asset value." The viable or good portion of assets, as per the earlier tools discussed, should be transferred to other institutions via P&As or in the case of using a bridge bank, to a new "good bank."

83. The transfer of assets to the bad bank can take place in a variety of ways, such as "portfolio" sales, asset-by-asset sales, securitizations, or an outright transfer if the asset management company is set up for the sole purpose of supporting resolution. Typically, the "bad bank" is not actually a bank, because it does not conduct any banking business (i.e., no

deposit taking or lending); rather, it is established only as an entity of a temporary nature which is wound up once the assets are liquidated, and is therefore more accurately called an asset management company. While the AMC/bad bank is making recoveries from the assets under its management, it may make transfers to the official liquidator under the receivership process allowing creditors to be paid on a pro-rata basis and respecting the creditor hierarchy, any income and/or proceeds received from those assets under liquidation, as interim payments to satisfy such creditors' claims.

84. The "bad bank" should be required to adhere to the principles of good governance and accounting, sound and transparent management and effective collection of the transferred assets. Private specialists contracted to conduct loan collection are typically paid a combination of modest fixed fees plus success fees to incentivize them to maximize the level of collections.

85. ***Elaboration on the Bridge Bank Tool.*** Under the bridge-bank technique, a problem bank's assets which are not toxic are transferred to a temporary institution, by setting up a new licensed bank (the so-called "bridge bank") under the control of the Resolution Authority or an expert team or specialist contractor appointed by the authority to carry on the bank's operations.[23] The bridge bank would receive a transfer of the problem bank's performing assets and some or all of the deposits and other liabilities provided that the bridge bank's balance sheet would comply with the minimum regulatory solvency requirement. In exceptional cases the resolution authority may establish a bridge bank without meeting the solvency test, with the aim of selling of viable portions of its assets and liabilities in the short term.[24] A bridge bank should not be an ordinary practice since a sale of assets via P&As should ideally be effected directly to other banks without a bridge bank. Setting up and maintaining a bridge bank entails much larger

[23] KNF awards the new license upon the request of the resolution authority –conditional, on meeting key requirements including minimum capital and regulatory solvency indicators. To implement this consistent with Polish law, the resolution authority, prior to the date of the execution of the bridge bank's financial structure and transfer of assets and liabilities, would obtain the license approval from KNF for such bank, following which BFG would apply to the court to register the bank. In the interim period up to when the court registry is confirmed, BFG would not yet set up the bridge bank balance sheet, but would meet any initial capital required under other laws for stock companies. Once the court registration is approved, BFG finalizes the financial structure of the bank effecting the transfer of assets and liabilities, and meeting the conditions agreed previously with KNF regarding, inter alia, the requisite bank capital and minimum solvency requirements (at least 8% CAR). Within an agreed period following, BFG would submit to KNF, the requisite documents on the bank's financial structure and operations.

[24] Banks that have sufficient capital could purchase an under-capitalized bridge bank.

costs than undertaking P&As. Refer also to footnote 23 which provides additional detail on the set-up process for the bridge bank within Poland's legal and regulatory environment.

86. The bridge bank option should thus only be used once prior resolution options have failed to yield solutions (including sale of bank, P&A, or other modes of transferring ownership directly to other qualified banks). The resolution authority will prepare and specify the constitutional documents of the bank and specify its board of directors and management, as well as a proposal for its licensing, for authorization from KNF to establish a bank. The balance sheet of the bridge bank would be set up as an operating structure following confirmation of the bank's registration by the court, and meet the ex ante agreed KNF requirements (e.g.: solvency ratio).

Box 1. Bank Liabilities/Creditors Transferred to the Bridge Bank

There are a number of possible approaches depending on the design of the bridge bank and on whether or not it is an assisted or unassisted transaction. For example, the transfer may extend to (a) all liabilities, (b) all deposits including uninsured deposits (and possibly other liabilities), or (c) only insured deposits. To the extent that only some but not all liabilities are transferred, concerns regarding equal treatment of depositors and creditors may arise – this is discussed in the section on the "no creditor worse off" principle. The impaired assets and remaining portion of residual liabilities will stay with the problem bank being resolved and subsequently closed down with its residual assets (not transferred) to be liquidated. This technique allows the operations to continue without interruption in the bridge bank, pending a permanent solution, for example, through the purchase of the bank by new owners.

87. The bridge bank shall exist for no longer than two years (with exceptional extensions of three additional one year periods beyond that) before it is wound up or nationalized into a state-owned bank (which may still be subsequently privatized) if no viable solutions or new buyers/investors have been found. In exceptional systemic risk cases, the State may invest in the bank's shares as the shareholder of record effectively converting this to a state-owned option rather than a classic bridge bank. While the bridge bank is in operation, KNF will supervise it according to supervision norms established by law. The resolution authority will terminate the operation of a bridge bank if it merges with another bank, or the majority of its capital is acquired by a bank, or if another bank assumes a substantial part of its assets and liabilities. If this occurs and residual assets remain, the resolution authority may transfer these back to the

asset management company ('bad bank') or to another party if there is a willing buyer, prior to consider liquidating them.

88. The bridge bank solution does not imply government ownership of the bank's shares, which is explicitly allowed under the public sector share-ownership tool. This latter tool should be reserved for extreme systemically important cases where official public sector ownership of shares is the only foreseeable option in the short term. Under a typical bridge bank approach the resolution authority would take over the property rights of the assets transferred, and this would mean it would record its shares under the resolution authority's name. The shares of the problem bank being resolved will have been extinguished (including on securities depository records) and the new equity of the bridge bank will have shares issued to the resolution authority who will take title of such, and correspondingly of the balance sheet assets along with assumed liabilities.

Box 2. Balance Sheet Gap Filling Measures, Creditor Classes and Cost Criteria

Only if an asset/liability transfer results in a lopsided split between a same class of creditors (e.g., some depositors transferred and others of the same class not able to), should a capital injection (e.g., via posting of an interest bearing bond asset) by the resolution authority be used. In the event that a same class of creditors cannot be transferred in whole to the bridge bank, and in order to preserve the equal treatment for a same class, the resolution authority may contribute capital funds to the bridge bank to increase the asset value so as to result in an acceptable net equity position of the bridge bank. Normally, the asset values transferred should be sufficiently larger than the liabilities transferred so as to allow a healthy net equity and C.A.R.[25] position of the bridge bank. In this manner, the official ownership of the newly formed equity is first assigned to the resolution authority and sufficient equity exists in the bridge bank to make it viable for resale. The property/assets transferred now belong temporarily to the resolution authority having rights to such property and recording shares in its name.

While the resolution authority may hold in its name the property of assets and rights transferred, the intent of the bridge bank is to assign/sell the shares of newly created equity to qualified purchasers/investors, providing a strong incentive to sell the bridge bank, with its proceeds used to complete the resolution process and contribute to the compensation of residual creditors. Thus, as per above, if the resolution authority determines that a viable bridge bank can be constructed at a lesser cost to itself and to creditors by having the authority add capital to the bridge bank's balance sheet (versus leaving more creditor claims behind in the original bank) it may do so provided that this meets the maintenance/maximization of asset value and applies an implicit least cost test rule in using BFG funds, making a larger share of creditors "whole" via this process.

[25] The solvency capital adequacy ratio (permissible capital / assets weighted by risk category)

89. However, if the bridge bank approach implies transferring toxic assets to the bank along with BFG funds, this may not maximize asset value nor imply a least cost solution. Instead it might be more beneficial to transfer fewer good assets with fewer matching liabilities to the bridge bank. While this would leave more residual assets and residual creditors it could be a viable option if the good bridge bank maximized asset value and sold quickly and the residual assets obtained recoveries via an asset management entity. The resolution authority will thus have to consider all options therefore, in line with its estimates of which structure or set of structures best maximizes sellable asset values while minimizing BFG/public outlays. A final option to be considered, if the bank cannot become viable, is its liquidation. This option should be very carefully considered since liquidation will realize lower asset values and could constitute major losses for BFG's own operations and funding.

90. The Resolution Authority is provided with additional powers to establish one or more bridge banks, and continue operating certain critical functions and viable operations taken over from a failed bank. These include:

(i) the power to enter into legally enforceable agreements by which the resolution authority transfers, and the bridge bank receives, assets and liabilities of the failed bank (or its residual assets) as selected by the authority following the initial resolution;

(ii) the power to reverse, if necessary, asset and liability transfers to a bridge bank subject to appropriate safeguards, such as time restrictions; and

(iii) the power to arrange the sale or wind-down of the bridge bank, or the sale of some or all of its assets and liabilities to a purchasing institution, so as best to effect the objectives of the resolution process.

91. Bridge banks should be operated in a conservative manner, while serving the specific needs of their customers. Such banks are normally allowed to accept deposits and make low-risk

loans to regular customers. A bridge bank's management goal is to preserve the franchise value of the bank and to minimize any disruption to the financial system. The Resolution Act should incorporate the needed legal and regulatory framework for the setting up of the bridge bank and its interim operation under the control of the official administrator, as well as the requirement for its transparency in its governance decisions and financial reporting.

92. ***Elaboration on Debt Write Down and Bail-in Instruments.*** The resolution authority should be provided with the authority to carry out debt write-down and bail-in operations within the resolution regime as a means to achieve or help achieve continuity of essential functions by:

(i) writing down in a manner that respects the hierarchy of claims in liquidation, equity or other instruments of ownership of the bank, including subordinated, unsecured and uninsured creditor claims to the extent necessary to absorb balance sheet losses;

(ii) converting into equity or other instruments of ownership of the bank under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation;

(iii) upon entry into resolution, convert or write-down any contingent convertible or contractually pre-defined bail-in instruments whose terms were triggered upon entry into resolution and treat the resulting instruments in line with (i) or (ii).

93. The debt write down tool will not be applied to senior creditors and liabilities that are secured, guaranteed by collateral or other title transfer agreements, guaranteed by the State (as in insured deposits), or protected under a fiduciary/trust arrangement. The write down tool will not be applied to accrued salaries of employees or pension benefits, or commercial and trade creditors who have supplied the bank with critical goods and services such as essential site property, utilities and IT services. However, the resolution authority has the powers to halt or restrict secured creditors from exercising their security interests while it seeks to complete its resolution objectives.

94. Once the debt write down tool is applied to specific liabilities, the resolution authority will proceed to amend the relevant contractual registers based on such actions, where applicable delisting or removing from trading any affected shares or debt instruments, and listing any new securities that may result from a debt write down operation. The debt write-down tool may be used in combination with other resolution tools including balance sheet gap filling measures by the resolution authority (subject to its implied least cost rule) to reach improved bank solvency and generate a viable solution via the use of resolution tools.

95. ***Benefits and Costs of Debt Write Down Tools.*** The benefit of the debt write down tool is that, for large or SIFI institutions, the debt write down process may be the only method to 'create' new bank capital by writing down bank liabilities beyond equity, based on unviable assets, or generating capital resulting from subordinated debt write downs. For large banks in the financial system there may be no viable way to transfer its assets and liabilities in a significant way to other institutions, or to create a bridge bank or temporary public ownership option that can be unwound in a reasonable amount of time. As such, the debt write down tool may the only viable tool to deal with SIFIs or very large banks, as an immediate solution or an interim solution (e.g., a bridge bank) that allows another resolution tool to be more effective.

96. The downside of the debt write down tool pertains to how creditors will perceive the riskiness of their funding knowing that their assets may be written down or converted to common equity. This knowledge of creditors may very well deprive banks under "debt write down jurisdictions" from obtaining sufficient funding, particularly in times of distress. It may also lead to much higher risk spreads charged by creditors of such banks to compensate for the non-zero probability that their claims will be written down. This effect can be to some extent alleviated by stating in the Law that the tool will be used only once other tools are exhausted something which may be viable and credible in the EU financial space if larger third country banks in the EU are willing to purchase the failing bank or its assets.

97. In terms of the usefulness of each instrument there are trade offs. COCOs, or debt with a contingent possibility of converting to equity are *a priori* contractually agreed therefore the

pricing is set in advance and the investor is fully cognizant of the risk. However, the spreads will be high and there will be a limited class of investors willing (based on their charters) to allow conversion of bond securities into equity shares which will keep the spreads high on such securities.

98. Outright general debt write downs (not COCOs) entail some discretion by the authorities and as such may also raise the spreads on such bonds. This uncertainty can be mitigated by specifying that debt write-downs will only be triggered by quantitative capital deficiency indicators and that write downs will only occur according to the established hierarchy of creditors (e.g., shareholders written down before affected bondholders). Thus they can be priced more easily according to estimates of default of the institution.

99. Since write-downs imply a form of residual "left over" creditors that cannot be paid with bad residual left over assets, the creditors of the written-down debt may also recover small amounts if the liquidation of the bad assets yield any returns (i.e., "put backs" after the debt write-down has occurred). Thus, based on recovery estimates if such an event is deemed probable, this would also factor into the initial spread they would demand. While the bad assets would be kept on the bank's books as write-offs,[26] they could also be transferred to a 'bad bank' along with the creditor write-downs, leaving only the good assets under a bridge bank structure. Therefore, write downs limited to subordinated debt and based on quantitative triggers, and given priority over equity holders, would be a more viable instrument to utilize for bail-in procedures.

100. ***Elaboration on the State Ownership Option.*** The state ownership option should be used as the last resort measure as it implies full and direct capital support by the state. This should be limited to SIFIs when their break-up and/or purchase in part of in whole cannot be conducted in an orderly manner or viable investors cannot be found. A state ownership option may (a) precede and be independent or unrelated to the creation of a bridge bank or (b) may be invoked following the creation of a bridge bank that cannot be sold off within a prescribed time period.

[26] Technically, once written-off, such bad assets would no longer be on the bank's active balance sheet (but could be reported in non-binding memorandum accounts). Matching creditor liabilities that were written-down (bailed in) would also no longer be shown on the bank's active balance sheet either, as they would have been extinguished.

101. Under the state ownership option the Ministry of Finance should agree to provide the necessary capital for the bank that is proposed to be "nationalized" and to own it on behalf of the state according to separate provisions under the Recapitalization Act. The resolution authority should not be the owner nor be used to capitalize the bank under this option, as it is an independent entity for the purposes of conducting resolution. The resolution authority thus cannot represent the state as the bank's owner under this option given the authority's specialized defined function. It may assist along with other financial authorities in setting up a state-owned bank, transferring ownership, and accounting for and transferring the state supplied funds as capital for such bank.

102. In the case where the state ownership is invoked after a bridge bank has been formed, BFG, being the manager of the bridge bank and temporary owner, should be the party that proposes that such bank to be converted to state ownership based on the bank's prospects. Thus, the state (e.g.: MoF or other Government qualified body) would not be able to nationalize such bridge bank without BFG's consent. Members of the financial safety net, including MoF or NBP, however, should be able to recommend to BFG that an established bridge bank be converted to state ownership. Once agreed, the change to government ownership would be carried out on the basis of a contract concluded between the resolution authority and the Ministry of Finance.

Timing and Conservation of Value, and Open/Closed Bank Operations

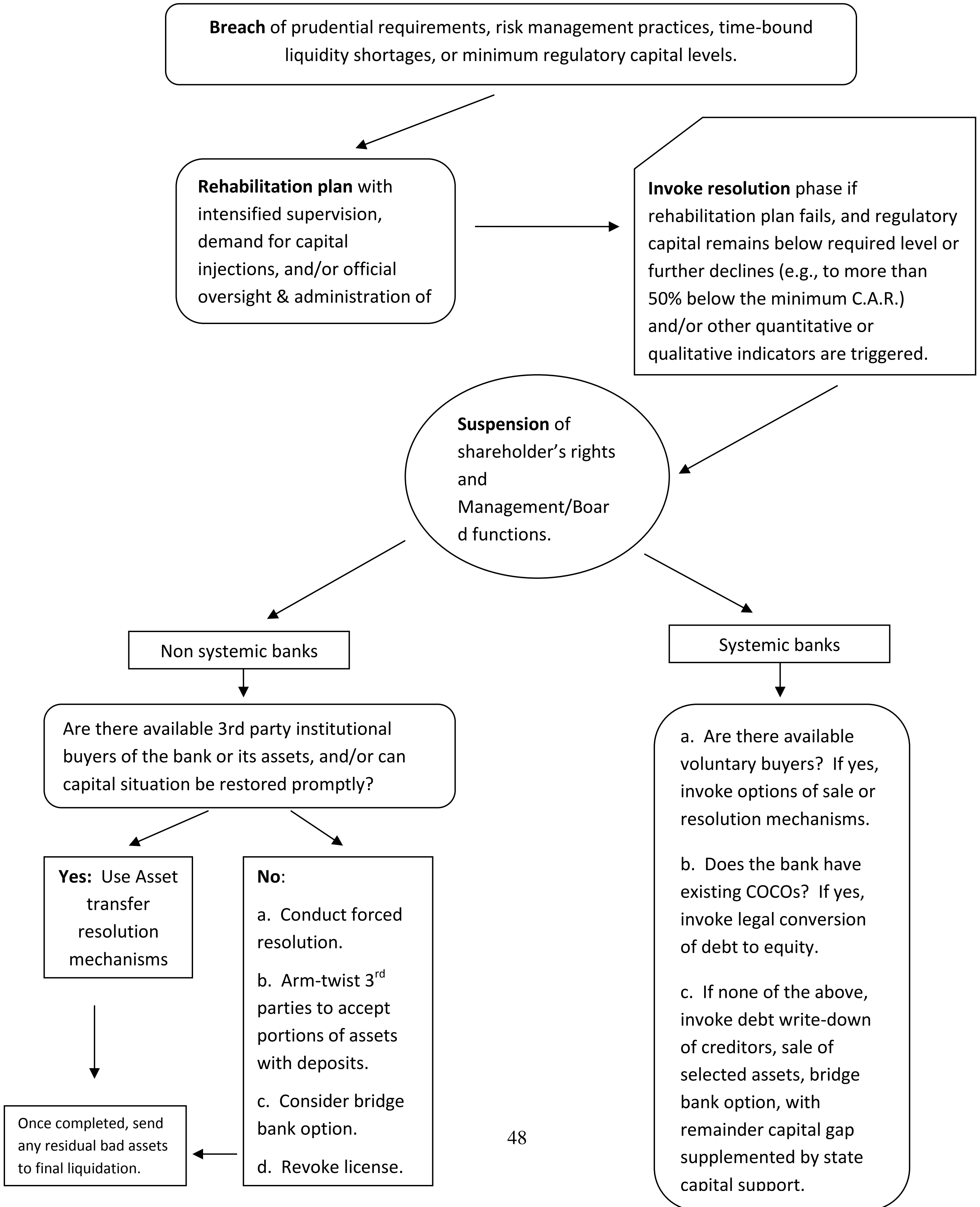
103. The existing early intervention functions provide substantial periods of time for the rehabilitation of a bank, either under trusteeship or official administration. In the current Banking Act, prior to the Liquidation options, the Act allows six months of a potential unsustainable financial condition before the authorities invoke some sort of liquidation. If the bank was already under official administration such time allowance should be superseded as allowed for in the Act, and the period should be shortened to permit under the new proposed framework for resolution options to proceed sooner. The erosion of bank assets should not be left to a critical unrecoverable point – rather, the new resolution regime always intervenes earlier

rather than later to maximize financial assets and financial stability when the key thresholds (which can be accelerated via the resolution authority's aggressive revaluation of the bank's balance sheet) are triggered.

104. In the above context, trustee and receiver (or together, the conservatorship of the early phases of official management) should be minimized to prevent increases in potential liabilities to the State for a bank bail-out. Once a recovery or rehabilitation/reorganization plan fails, the resolution phase should be invoked. As a matter of internal guidelines and procedures, the resolution phase may be seen as having a "voluntary purchases" option and a "managed purchases" option (both typically planned in advance prior to invoking resolution). Voluntary purchases refers to the option of selling the subject bank in its whole or in parts to interested third party bank buyers. Typically this phase is limited in time. In some countries as in the U.S., once agreed, it is less than a week to execute. The idea is to keep the bank operating with a valid license to preserve asset values and to find a buyer promptly to transfer such assets (and matching deposit liabilities).

105. As a matter of internal guidelines and procedures on resolution operations, if voluntary purchasers fail to materialize, the resolution authority has two options if the bank is not systemically important: (a) attempt a forcible or "moral suasion" sale of the bank or its parts to other strong banks in the system in the "public interest," and with potential burden-sharing, loss sharing features if the assets transferred perform below estimates, or (b) set up a good bridge bank in order to sell it at a later stage (this carries the risk that it does not get sold). In any of the above options, the authority must ensure that once a solution is found, KNF revokes the license and closes the bank so as to avoid runs on deposits once the public realizes that the bank will change ownership and structure. Once the license is revoked, the authorities may still allow the closed bank to undertake certain critical payment system functions until these are fully transferred to another bank.

Figure 1. Illustration of a Context and Sequence for Applying Bank Resolution Actions



VIII. Categorization and Ranking of Bank Liabilities by Creditor

106. The ranking of liabilities for payments of claims under the resolution procedure by type of creditor, should distinguish among obligations/creditors of first, second, third and fourth rank (with sub-ranks under each category). This ranking will assist in structuring solutions more systematically by grouping creditors into classes and avoiding more favorable treatment within a same class of creditors. The recommended ranking for the purposes of assigning viable assets is:

First order claims

(i) Cost of conducting the resolution. This is the contractual price of technical assistance and expert services to conduct resolution proceedings.

(ii) Private sector insured deposits.

(iii) Secured senior creditors (i.e., covered by fully assigned collateral as per contractual covenants).

(iv) Cash-based contracts, pre-payments for short term external trade transactions, sums withheld from salary payments for tax purposes, labor contract obligations, and other short term cash obligations.

(v) Advances or loans from the deposit insurance agency[27]

[27] In some countries, unsecured senior creditors and bondholders rank ahead of the deposit insurance agency/resolution authority as relating to its advances/payouts to depositors, gap filling measures in lieu of depositor payouts, and/or loans extended.. This provides a greater chance that they will obtain compensation and thus feel that their rights are more protected. However, this would result in higher potential outlays/losses to deposit insurance with more recoveries of costs to be made during liquidation. Thus, the Government should select based on its legal framework which option is preferred. This paper selects the option where the deposit insurance advances and loans rank earlier.

Second order claims

(vi) Loans from the Central Bank

(vii) Other senior creditors

(viii) Other retail private sector deposits or non-financial institution deposits. Resolution authorities typically wish to optimize the protection of all deposits (insured and uninsured). These should be ranked starting from insured deposits as priority creditors to other size-categorized deposits, for example based on a multiple of the minimum wage or a fraction of the per capita GDP.[28] Thus a ranking for all deposits could include for example, those equal to the latest per capita GDP level followed by those constituting a multiple of 2 times such amount, followed by those 4 times that amount and followed by 6 times the amount (or using coefficients calibrated to the largest depositor size). In the event that all deposits cannot be assumed under a resolution transaction because they cannot be matched with viable assets for transfer to another bank, those above one of the per capita GDP thresholds listed (where all such deposits cannot be included), would be left in the residual bank and constitute creditors' claims to be paid from the proceeds from liquidation. This is an important distinction between depositor classes to be included in the law, as it provides flexibility to the resolution authorities to transfer an optimal block of liabilities while simultaneously treating a sub-block of creditors consistently.

(ix) Unsecured creditors including bondholders according to their contractual seniority

(x) Loans or deposits from commercial banks

[28] The rationale for placing non insured retail private deposits in this ranking is the role they have in stability and avoiding bank runs when deposits are withdrawn quickly. Thus provisions for protection of all depositors are cost effective. Another rationale is that depositors, unlike other creditors, typically have less of a role of overseeing the finances of a bank and are thus less well placed to impose any sort of governance on a bank. Deposits from banking institutions are not included in the above category and are included in other bank creditors.

Third order claims

(xi) Deposits from public sector or government entities

(xii) Subordinated loans

(xiii) General tax obligations to the government

Fourth order claims

(xiv) Other claims not included in the above categories.

(xv) Claims of shareholders or owners of the institution being resolved.

107. The ranking is critical to provide guidance on structuring the resolution transactions. Sub-classes of creditors are needed to execute both the resolution principles properly and to meet the no-creditor-worse-off rule applied consistently to each sub-class of creditor. For example, while a broad creditor class would be depositors, a sub-class would be insured depositors versus non insured depositors. As sub-class, insured depositors would have a higher priority in terms of matching against available assets in a resolution transaction. As listed above, within the class of all depositors these can be stratified by the size of each deposit per owner, in order to establish objective cut-off points for transferring assets in an efficient and fair pre-defined manner.

108. ***Shareholder Challenges***. Following the list of resolution tools the new law should emphasize that "*No consent from shareholders, boards or management of the bank will be required for the resolution authority to implement the resolution procedures.*" Legal challenges (for example by shareholders) to the above actions should be recognized, however, they will not be allowed to halt ("stay") the process as earlier discussed. The legal challenge would be disputed ex post, once the resolution (and liquidation) procedures are completed, in order to determine if the shareholders were unduly inconvenienced versus what they might have obtained as 'creditors' in a liquidation procedure.

IX. Asset Value Adjustments, Set-off, Netting and Termination Rights

109. ***Valuation and Adjustment of Bank Assets.*** An important power to allow the resolution authority to implement the requisite tools, is its ability to adjust the balance sheet value of the subject bank (e.g., via downward loan reclassification, invalidation of non-effective loan collateral, increase in loan loss provisioning requirements, revaluation of marketable securities or assets held at book value, and other measures). In some cases such re-valuations of the balance sheet may result in a negative equity position or a "below safe" capital adequacy ratio. Thus the valuation of assets conducted in a short time period (2-5 days) is an essential capability that the resolution authority and KNF must retain to be able to support the invoking of resolution powers. Therefore, a clause to this effect is included in the new law at the outset of the sub-section on resolution to justify action based on an explicit power by both KNF and the resolution authority to revalue assets based on reasonable regulatory criteria.

110. ***Set-off, Netting and secured claims within banks under resolution/liquidation.*** The impact of the freezing effect on contracts during a resolution is particularly significant in relation to a failed bank's unwound transactions under the payment and securities settlement systems. The new legal framework should specify that upon the entering of the resolution phase, the contract moratorium takes effect for any such transactions (also see early termination rights below). The Act should stipulate the "settlement finality" provisions, whereby, in so far as transactions processed through payment and settlement systems are concerned, the commencement of resolution proceedings against a bank cannot lead to the reversal of payment orders that precede the commencement of proceedings.

111. The Act needs to address the treatment of contractual arrangements in financial contracts that allow for the set-off of mutual and opposite claims upon the commencement of insolvency proceedings of one of the parties. Concerns regarding the effects of insolvency proceedings arise particularly under payment and securities settlements systems that operate on a net-settlement basis or allow for asset and liability set-off arrangements. Such arrangements ensure that only

the balance owed by a bank to a counterparty or vice versa is ultimately due, thus reducing substantially the number and overall value of actual transactions.

112. Netting, set off, and/or close-out arrangements are found in a variety of other financial contracts, such as foreign-exchange contracts, securities trades, and interest rate and currency swaps, among others, frequently in the form of provisions in master agreements. Upon the commencement of resolution or insolvency proceedings, therefore, the contractual provisions involving pre agreed set-off or netting rules should be maintained so that the resolution authority would need to (i) either transfer all such asset-liability linked contracts to another bank (or a bridge bank) or (ii) have them all remain in the residual failed bank. Thus, the resolution law should allow for and recognize contractual set-off and netting under resolution/insolvency balance sheet restructuring.

113. The government may consider as an option (but not commonly used) whether or not the authorities have the right to set off deposits against outstanding loans of the same legal customer of the bank, and, if so, under what conditions. Establishing the net claims for each individual depositor is a cumbersome exercise and may delay payments to depositors. Therefore, it is suggested to not permit the set off of any insured part of deposits against outstanding loans. Not only does it take time to calculate the net claims, the setting-off of insured deposits against outstanding loans may frustrate another purpose of deposit insurance, which is to provide small depositors with liquidity.

114. For dual-asset claims under collateralized or derivative contracts (e.g., repos with securities as collateral, structured finance contracts, securitized bonds with an underlying collateralization pool), the separation of claims within the creditor hierarchy should not split off the two parts of such contracts into separate instruments as they are contractually linked assets. Disentangling or netting out such contracts before their expiration could be systemically disruptive within the payments and securities settlement systems and with counterparty obligations.

115. ***Early Termination Rights.*** In a related context, creditors may invoke early termination rights on contracts in order to cash in before a resolution procedure begins. As per FSB recommendations, the resolution authorities should have powers to freeze and suspend any early termination right clauses to allow an orderly resolution to proceed without allowing opportunistic creditors to "run for the exit door first," which would result in contracts changing value and scope while an institution was being resolved. The *Key Attributes of Effective Resolution Regimes for Financial Institutions*, stipulate that, subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not constitute an event that entitles the counterparty of the bank in resolution to exercise early termination rights, provided that the substantive obligations under the contract including payment and delivery obligations and provision of collateral, continue to be honored.

116. Should early termination rights nevertheless be exercisable, the resolution authority should have the power to temporarily "stay" such rights where they arise by reason solely due to entry into resolution or in connection with the use of resolution powers, and provided that the substantive obligations under the contract including payment and delivery obligations and provision of collateral, continue to be performed.

117. Limited in this way, the restrictions on early termination rights do not affect other rights of counterparties under netting and collateralization agreements and do not interfere with payment or delivery obligations to the bank. If a bank in resolution fails to meet any margin, collateral, or settlement obligations that arise under a financial contract, its counterparty would have the immediate right to exercise an early termination right against the bank in resolution. The counterparty could not terminate and close-out the contract based ***solely upon the entry into resolution or the exercise of resolution powers.*** They would have such right if the bank in resolution or the resolution authority failed to meet any margin, collateral or settlement obligations that arise under a financial contract.

X. Equivalency of Resolution Action versus Revocation of a License, and Suspension of Shareholder Rights

118. Although the revocation of a bank's license is one basis to institute a resolution proceeding to seek an efficient sale of assets and assumption of liabilities of the bank or liquidation of its assets, when an institution becomes subject to a resolution proceeding for reasons related to insolvency, illiquidity, or a supervisory agreement, the license should generally not be revoked so an institution can be sold to another institution or to new investors and/or to effect certain resolution transactions where the counterparty would expect to conduct a transaction with a licensed bank. For example, in a purchase of loan assets, the loan contract between the bank and a borrower would be assigned to the purchasing bank. If the selling bank no longer exists because its license was revoked, that might become an issue as a practical if not a legal matter regarding the legitimacy of a proposed transaction.

119. It was noted earlier that if a voluntary resolution cannot be first accomplished speedily, the withdrawal (revocation) of the license will follow. This does not mean that this is the preferred option as prior options are preferred and the sequencing will rely on the circumstances. When a resolution transaction proceeds and voluntary buyers of assets are being sought, the license should remain so that the bank remains as a "going concern" and continues operating so as to maintain maximum asset value. The license should not be revoked unless it is seen that a resolution plan will take longer than anticipated and a deposit run is likely.

120. The main financial indicator triggers for invoking the resolution tools (quantitative or qualitative and related to insolvency) are criteria that could result in revocation of a bank's license. Thus, the powers under resolution of suspending shareholders' rights are based on the same circumstances as when a bank would have had its license terminated. This reasoning should be understood in the new law to provide supporting justification for providing the resolution authority with the power to suspend shareholders' rights and undertake administrative actions even while a bank remains open.

121. As stated earlier in this paper, the primary justification for resolution pertains to the public interest, depositor protection and financial stability concerns where a traditional corporate insolvency procedure contains severe limitations and risks. Another legal reason pertains to the above argument, i.e., that the conditions for entering into resolution are the same as those qualifying to revoke a license of a bank to treat an insolvency. Thus, if a bank is not meeting its obligations required to be licensed, the resolution authorities are fully authorized to suspend all governance arrangements and rights in the public interest and to prevent losses to depositors and taxpayers.

122. ***Extinction of Property Rights; European Convention for the Protection of Human Rights and Fundamental Freedoms.*** The Constitution in some countries requires that action taken by the bank supervisor involving the limitation or extinction of property rights needs to be sanctioned by a court and or accompanied by appropriate compensation. In the banking area, precedent in Poland under the Banking Act gives KNF (and presumably any new resolution authority) power to take over the ownership decision rights of a bank in respect of its shareholders without first requiring permission from a court. Article 145 in the Banking Act currently gives the KNF the power put a bank into receivership which would result in the power to pass resolutions and take decisions in all matters passing from shareholders to the receiver. This precedent as well as the key issues listed above on financial stability, intervention in the public interest and the license revocability equivalency, should permit any resolution authority to have the same powers including added flexibilities in applying resolution tools.

123. In the EU, precedent has already been established for the taking over of shareholder rights in the legal frameworks of the U.K., Spain and Germany and the new EC Directive states precisely the same principle. Utilizing the "no creditor worse off principle" which would also apply to shareholders, and the existing precedent in EU countries including ex-post redress mechanisms, the new resolution framework would not pose inconsistencies with the Charter of Human Rights in relation to property issues.

XI. Systemically Important Financial Institutions

124. Poland may not have globally systemically important financial institutions (G-SIFIs) but at a domestic/local level some banks may be considered systemically important. The failure of such banks poses a broader challenge in their treatment. Domestic SIFIs as they will be named in this paper, should of course be subjected to the voluntary buyer option if such banks become subject to resolution. Not being G-SIFIs there are possibilities of asset sales. In the absence of such, however, and given that "moral suasion" sales may also not come to fruition, the resolution authority should attempt to minimize the state outlay of capital. This can be done first via the power to convert certain classes of subordinate creditors to equity holders (using the debt write-down tool).

125. The resolution law and related laws on creditor rights need to refer to the above powers, under financial distress conditions of "bailing in" capital by converting creditor claims to shareholder claims or writing down subordinate claims based on asset write-offs. Even with such mechanisms, as well as other options such as setting up bridge banks and banks under public ownership, it may not be possible to save a "too big to fail" bank by these means alone. The Government may need to make a capital contribution if this is the only way to prevent a wave of contagion and spiraling financial distress. For this reason, the options under Resolution in the proposed new framework allow a state ownership option as such a situation cannot be ruled out altogether. While this is a last resort option, such option is needed as it would obviate the need to create new legislation authorizing such under conditions of financial distress.

126. ***Bank Resolution and Recovery Plans (RRPs).*** The KNF will require that banks of systemic importance to the financial system submit a recovery plan, to plan for a course of action in the case of insolvency, illiquidity or financial distress. The RRP will be jointly approved by KNF and BFG who as the resolution authority will prepare the resolution plan and seek any information needed for this purpose, from the subject bank. Banks not deemed to be of systemic importance will not be required to have a RRP. RRPs should be updated annually and material changes in the institution's financial condition reflected in any updated plans. The plan should

also include a public communications and information strategy for use when invoked, designed to mitigate any adverse market reactions or escalation of the problem.

127. The RRP should include contingency plans for obtaining emergency sources of capital or liquidity, or actions to maintain critical functions and business operations, where critical functions should be well identified. It should identify usable collateral, arrangements to reduce leverage, arrangements to restructure debts, existing or new contingent shareholder arrangements, and other mechanisms to enhance capital and liquidity. The RRP should identify potential impacts on counterparties, customers or related entities as well as possible impediments to the carrying out of the RRP. Finally, the RRP should provide detail on how the plan is organized internally with authorities, roles and responsibilities, including the requisite procedural steps and time bound action plans.

XII. Cross Border Insolvency Coordination, Information and Burden Sharing

128. The treatment of intra- and inter-group cross border liabilities and crisis coordination is elaborated in the new EC Directive and FSB pronouncements, nevertheless, it is recommended in the resolution law to differentiate the treatment of host versus home incorporated banks (i.e.: locally owned or subsidiaries versus branches). Subsidiaries of a larger banking group but incorporated locally, are separate legal entities, and thus any funding arrangements with parent banks or other market players represents an issue of market choice. For branch banks it is another matter as they are not legally autonomous and therefore funding flows from the parent banks can be potentially advantageous to the home country.

129. The issues of deposit insurance burden sharing remain controversial and still debated even if legally, home countries should cover insured deposit liabilities of branches in host countries. In terms of deposit insurance coverage of branch banks, the resolution law may consider the conditional subrogated coverage by the host authority based on domestic financial stability concerns, while seeking to clarify home/host accountabilities including cross border supervisory action and insured depositor compensation in cases where branch funding has been depleted based on parent bank capital or liquidity linked actions. For stability concerns and

maintenance of critical functions, the Polish resolution agency with the cooperation of the financial safety net participants, would in any case, have the prerogative to compensate branch bank depositors without prejudicing the ability to recuperate funds from the home jurisdiction if the cause of the branch bank failure was determined to emanate directly from actions taken by the parent bank.

130. In the case of bank subsidiaries the host supervisor has more direct normative power as such a bank is fully incorporated domestically and any funding changes would presumably be voluntary (even if done to favor the parent bank based on ownership relationships) but not compulsory within a group corporate structure. Thus sanctions on the subsidiary could be imposed based on imprudent balance sheet management. In such cases the supervisor (or the resolution authority, if already at the resolution phase) would have the power to restrict or prohibit transfers of assets including to parent banks, if such threatens the liquidity or solvency of the bank or if such is proposed under a home-initiated group resolution exercise without the prior consent of the local authorities.

131. The case of branches is more complex as they are not legally autonomous which is why depositor coverage or resolution operations will rely on a diagnosis of changes in funding flows in relation to parent bank movements. The revised law may not be able to impose a conditional rule prior to a pan-EU agreement on the matter. But under the sections on supervision of financial groups it should add provisions for cross border coordination and diagnostics relating to the capital and liquidity stability of bank branches.

132. The resolution authority should as well have the authority to enter into agreements with resolution authorities of other jurisdictions. Currently KNF has[29] the power to cooperate and exchange information with foreign financial supervisors, but should also explicitly be provided with the legal powers necessary to establish effective arrangements for cooperation and communication of information with foreign financial supervisors and other responsible authorities.[30]

[29] Financial Market Supervision Law, Article 56.
[30] BIS Principle 1(6).

133. The legal framework should provide the resolution authority to enter into exchange of information agreements with other foreign or domestic financial supervisors, resolution authorities, law enforcement agencies, and anti-money laundering agencies (Financial Intelligence Units)[31] to share relevant supervisory information and to exchange: (1) off and on-site information, including specific information requested and gathered from a supervised entity, a listed company or a company that is going public; (2) matters of investigation and enforcement; and (3) information in connection with authorizations, licensing and approvals. The authority must take reasonable steps to ensure that any information released to another jurisdiction will be treated as confidential by the receiving supervisor and will be used only for supervisory purposes.

134. For both branches as well as subsidiaries located in Poland, the resolution authority, upon entering into a resolution phase, should also notify the group level (home) resolution authority of resolution actions or other insolvency measures being considered. For subsidiaries, the decision making on resolution actions at the domestic level will be more straightforward and autonomous (unless the parent bank is simultaneously failing in which case intensive group-level coordination will be required with the home authority to minimize cross-border contagion and understand the home authority strategy). In subsidiary crisis cases, however, "ring fencing," should be avoided, for example where the host authority halts regular contracted flows to the parent from the subsidiary; unless this is consulted a priori with the home authority.

135. If a branch bank normally subject to group resolution, however, is threatening financial stability in Poland, under the resolution law BFG as the authority (and where relevant to their specific functions, the other members of the financial safety net) should have the prerogative to take immediate actions to stem further deterioration of such bank while communicating with the home authority about causes of failure, burden-sharing arrangements, and follow-up resolution actions. If the home/group resolution authority does not consider that the proposed resolution actions will impact the group or parent firm, it should notify BFG within 24 hours in line with

[31] *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Financial Stability Board, October 2011, section 2.4 page 6.

the EC Directive. In the converse, if within 24 hours the home authority considers that the Polish resolution actions will significantly impact the financial group, it should propose a broader resolution scheme to the appropriate resolution college (which is yet to be established).

136. Exceptions to this process will pertain to cases of significant financial instability generated domestically (or domestically but significantly impacting other neighboring EU countries) in which case the Polish resolution authority, immediately prior to finalizing resolution actions will directly inform the assigned resolution college. If any objection emerges henceforth, the case should be referred to the EBA for a binding decision within a 24 hour period as per the EC Directive. The above provisions are subject to confirmation of the interpretation of the Directive and may not take effect until the specification of roles, responsibilities and time lines, is approved in final form by the European Parliament in the Directive and subsequently adopted into national laws.

137. For non EU member states the Polish resolution authority will enter into agreements or memoranda of understandings with corresponding jurisdictions and inform the EBA of such arrangements and the applicable resolution college, if existent.

138. For resolution actions determined by the Polish resolution authority to be directly triggered by: (a) parent bank actions, (b) home institution shareholder actions, or (c) changed policies of home country authorities, the resolution authority will propose to involve home country resolution authorities in the financing of the proposed solution. For example, in cases of branch bank liquidity shortage issues affecting depositor confidence, or shareholder decisions adversely affecting the level of capital of subsidiary banks, the resolution authority will propose contributions from the home or other affected jurisdictions, for financing to carry out the resolution process at the least cost in line with a “group level” approach. As with the above process, the pertinent resolution college and the EBA will provide endorsement or rejection of such plan with EBA’s decision being binding.

XIII. Resolution Cost Alternatives and Funding Issues

139. ***Government / BFG Contribution of Funds to fill Balance Sheet Gaps.*** This section of the Assumption paper covers four key issues: (a) Open bank assistance, (b) Lowest cost/loss criteria, (c) No creditor worse off principle, and (d) Resolution fund. The resolution tools specified should work without government contributions. However, in some cases and in the interest of financial stability, some gap-filling contribution of BFG funds may be justified. For example, an asset transfer including all insured deposits of a particular bank may be completed, but it could leave several non insured depositors out, along with some remaining viable assets. Therefore it may be cost effective for BFG to provide gap-financing to top up the remaining assets and transfer the remaining depositors to an acquiring bank, without having to go into partial residual liquidation. If required to meet these objectives while still meeting the least cost criterion, in exceptional circumstances BFG will have the authority to request and obtain a loan from the Government if its funds are insufficient at the time, provided that it can repay such a loan via ongoing premiums or additional future industry assessments.

140. Another case may be where the transfer of viable assets is insufficient to carry along with it, all insured depositors. In such an instance, it may be more productive for BFG to fill the gap on the asset side (e.g., with an interest bearing IOU) so as to bring in more of the insured depositors, rather than to pay such depositors in cash directly.

141. BFG may also provide guarantees of an institution's assets or liabilities; extend loans for an institution; purchase assets of an institution; make deposits in an institution; or contribute debt or equity to a bridge institution to achieve the defined resolution objectives. BFG should be authorized under the resolution law, not only to borrow from the Government for such purposes, but to also request debt or equity financing to support a systemically significant failing institution and be authorized to borrow from the market. As listed above, BFG may levy assessments *ex ante* and *ex post* for funding institutions under resolution and bridge institutions, and for the costs of maintaining essential services.

142. Borrowing from the NBP for resolution transactions would typically not be appropriate under the central bank's mandate and may breach monetary financing prohibitions. But BFG would be authorized to request on behalf of a bridge bank for central bank liquidity support, according to the standard terms and collateral requirements of such NBP loans as well as NBP's requirements for the subject bank to meet the requisite solvency and prudential criteria. Other emergency short term financing may be provided by NBP in the interest of financial stability, for example, if BFG wished to speedily pay insured depositors that could not be absorbed within a resolution transaction and assure immediate liquidity for such purpose. Such borrowing of BFG from NBP would be permitted only under the condition that the State provided a guarantee of such a loan obligation of BFG to NBP.

143. Under the current Polish framework, BFG is permitted to provide low-cost "solvency support loans" to financial institutions, a form of open bank assistance. While international practice normally does not deploy such instruments any such future use should be subject to situations justifying such instruments for (i) a resolution support measure (ii) in cases of systemic importance, and (iii) where application of the least cost principle was demonstrated.

144. The open bank lending instrument for (non-resolution) solvency purposes is akin to a continued bank rehabilitation process. Failure of a bank under such a process would violate the least cost principle. If the bank were to continue as a sustainable going concern, such assistance will have been deemed a least cost method. However, any forsaken interest yields on open bank assistance loans would also have to be factored in as a cost of the measure.

145. The above paragraphs raise the issue again of what criteria should be used in conducting resolution transactions. The typical criteria assumed (as used in the U.K, Spain and U.S. systems) is to: (a) minimize the outlay when comparing the deposit insurance/government payouts to insured depositors versus alternative balance sheet gap-filling measures. If the latter is smaller, such option should be used. In terms of legal challenges, the key metric is: (b) the compensation received by non-depositor / uninsured creditors in the order of their hierarchy under resolution procedures, versus the potential compensation available under standard liquidation procedures, net of funds paid out to insured depositors (the no creditor worse off

principle). The deposit payouts are netted out first since, under the hierarchy of creditors, assets available to all creditors including depositors should be used to pay back any BFG outlays/payments where BFG ranks high in the hierarchy of creditors.[32]

146. ***Maintaining/Maximizing Assets and the No Creditor Worse Off Principle.*** A key resolution test besides considering the cost of insured depositor payouts versus public funds expended during resolution, is the "No Creditor Worse Off Principle." In this case, resolution transactions should attempt as much as possible to ensure that any resultant compensation (or loss) to creditors represents a better outcome than the alternative of making the subject bank go through traditional liquidation or bankruptcy. The key variable is thus maintaining or maximizing the asset value of the subject institution, for the benefit of the creditors. Calculating the alternative outcomes is subject to several assumptions regarding what value might have been realized by creditors under a traditional insolvency procedure.

147. Under a resolution procedure the outcome is clear as assets and liabilities transferred via a purchase and assumption or similar procedures that maintain the latest adjusted book value of assets for those creditors transferred. Under resolution, the residual creditors are those that may suffer losses (either because there are insufficient performing assets to compensate them, or due to debt write downs).

148. It must be remembered that the hierarchy of creditor rights under resolution versus traditional insolvency is similar if not the same. Therefore, precluding any changes in such a hierarchy (such as for example, a different order of rights for pay back of any disbursements from the deposit insurance fund) the result of creditor compensation via liquidation versus via resolution should be the same and most likely less compensation received via liquidation (or for that matter traditional bankruptcy) as the entity is no longer a going concern. However, some creditors may also argue that by being left in the "residual bank" from a resolution process, they

[32] In some jurisdictions as in the U.K. (in contrast to the U.S.), the deposit insurance funds rank somewhat lower thus providing non insured depositors and other higher ranking creditors first bids for assets identified under resolution. This means that the deposit insurance fund outlays may be at higher risk of recovering its funding if gap-filling balance sheet measures were utilized. This paper recommends to maintain the funds from deposit insurance at a higher rank level and thus to ensure prompter reimbursement in line with longer term financial stability objectives.

will receive less compensation than if they were pooled among all creditors under a traditional full liquidation. This is not the case, because such creditors, based on their position in the creditor hierarchy would have anyway have had those same assets assigned to them under liquidation.[33] And under liquidation such lower quality assets would be the most difficult to collect versus other higher quality assets which not being part of a going concern, would be the first to liquidate.

149. Thus under a residual "bad bank" such separated bad assets would have an equal or higher likelihood of collection as they would be managed by a dedicated specialist team or asset management company. For all other assets, it is obvious that having them transferred to another sound bank will maximize their value versus them put under liquidation. The test to use therefore, is to simulate the values of assets under a traditional bankruptcy/liquidation process versus "residual" assets matched to left-over creditors under a resolution process. A key factor to take into account is that a slow traditional bankruptcy or liquidation procedure can generate public confidence concerns and at times systemic effects which can significantly reduce the value of assets processed under such a procedure.

150. It is thus unlikely that even good performing assets under a liquidation process will generate higher values than assets transferred under a resolution process since the former assumes a closed bank situation without any going concern business which is likely to demand a discount on assets and at times close to foreclosure value. The baseline asset valuation methods should apply methods based on valuations of assets listed in regulated exchanges, assets that are valued by virtue of their fixed income contractual payments or credit ratings, appraised fixed assets (real estate, etc.) and loan assets. However, these will all be subject to higher discounts under a bankruptcy auction bid which will command "liquidation values" versus under an open bank P&A bid.

[33] This logically assumes a unified and consistent resolution and liquidation framework under which BFG's claims against insured deposit pay-outs already effected, would be collected from assets under liquidation within a creditor class following the creditor status/position of the insured depositors. Secured senior creditors (to the extent of the value and availability of their collateral pledged via special legal covenants) as per the creditor hierarchy, would have claim rights before BFG's advances, loans or contributions, however, BFG would have claimant rights before other senior unsecured creditors.

151. In the case of loan assets, the book value minus loss provisions (following any further adjustments) would be the baseline “market” value. However, such a loan market value under traditional liquidation could command a higher discount if paid for in cash or cash-like instruments versus under the resolution approach where corresponding bank liabilities are assumed by the purchaser. Thus any cash based payment under a liquidation process would command a much higher discount based on the difference between liquidity risk premiums (of cash versus the liquidity of the asset to be purchased) and such liquidity premium might be used to obtain a market value for assets that are not priced, versus those that are priced on regulated markets or using other standard financial valuation methods (such as bonds traded on secondary markets). The value obtained thus will likely be between market and foreclosure value.

152. A liquidation discount, however, needn’t be a “fire sale” price level for performing assets, although purchasing investors will have many more incentives under such a process to bargain for a price rather than accept an asset price at its fair going concern value. Thus, under a bankruptcy/liquidation process the value of assets to be sold or liquidated must be based on adjusted book value (net of provisions and charge offs) plus a liquidation/bankruptcy discount. These can be estimated based on prior empirical experiences in Poland as well as in other countries under analogous situations, where data is available.

153. In valuing the price to be paid for assets in liquidation, consideration of pooled asset sales also needs to be taken into account. This means that purchasers under liquidations may also decide to buy a pool of assets of both good as well as doubtful performance. The marginal price paid for the doubtful assets under liquidation can therefore be compared to the prices expected to be paid under resolution for those “residual” and left behind assets. These are the assets of most concern to creditors (and shareholders) as their “left behind” status makes them particularly vulnerable to price discounts under a resolution procedure. However, as mentioned, since under resolution, asset management and recovery vehicles (AMCs) are recommended to recover the value of such assets under incentive-based contracts (such as success fees earned based on the level of recoveries) this provides opportunities for value creation through more aggressive liquidation of underlying collateral. Since those left behind creditors will be on the same

position of the creditor "pecking order," they would be compensated via the liquidation of the same group of (bad) assets.

154. The outcome is less favorable under traditional insolvency methods, where typically liquidation specialists who are compensated in large part with fixed fees and appointed by a court, manage a much larger asset base, making it less likely that the success of recovery will yield optimal returns for all assets under management. Thus a significantly higher recovery rate using AMCs or specialist teams can be assumed, versus administrative liquidation or ordinary bankruptcy. All these instances/models/assumptions should be listed in a matrix of options to estimate which method(s) will yield the higher eventual asset values.

155. The above parameters must also be modeled in terms of value recovery given existing market conditions. If market conditions are depressed, a traditional insolvency approach will yield much lower asset values if purchasing investors are not available. The same can be argued under resolution procedures but in such case the asset values are set prior to P&A transfers which carry confirmations by the resolution authority, a process that is more deliberate and planned than under traditional asset insolvency procedures. Thus, market and economic conditions play a key factor.

156. For residual assets (and residual creditors) under resolution, market conditions will be equally important and since most of such assets will be in the non performing category, their value will trade at deep discounts. Thus the size of the residual "left over" pool of assets in resolution becomes a crucial factor in determining if creditors are better or worse off than under traditional insolvency. Minimizing the pool of left over assets or alternatively including strong and pro-active asset management recovery companies or specialists is crucial in ensuring that creditors will at least be better off than under traditional insolvency procedures. Thus, the creditors' losses from non-performing residual assets under resolution procedures should be first estimated. Then, total asset losses under traditional liquidation should be estimated using both the investor discounting incentives as well as the institutional/behavioral incentives of traditional liquidators.

157. As mentioned earlier, the position of the deposit insurance funds within the hierarchy of creditors makes a difference in the recovery of funds by private creditors. The new resolution law should thus ensure that the order of such a hierarchy must position the deposit insurance fund earlier in the hierarchy (as per section VIII) so that a comparison of a resolution versus a traditional insolvency process will be based on the same order of creditor rights. In such a case, under traditional liquidation or bankruptcy, uninsured creditors will most likely be worse off since the deposit insurance fund will have already made payouts to all insured depositors thus earmarking recoveries to it that might otherwise be available to more subordinate creditors. Alternatively, under matched P&A transactions, other creditors could benefit earlier if P&As as a going concern, commanded higher value.

158. Finally, on an elapsed time basis, the resultant final compensation to creditors under resolution should be measured within the same time period as would take to compensate all creditors under a liquidation process. This can imply a number of years since liquidation processes are typically slow. In this respect resolution procedures aim to avoid such processes as much as possible by utilizing the new tools for balance sheet transfers, and the disposition of residual assets is set up using better aligned incentives for quicker recovery and compensation to specialists or AMCs directly linked to such recoveries.

159. ***Resolution Fund.*** The above raises the issue of creating and/or funding a special resolution fund for this purpose. As indicated immediately above, the logic of the resolution least cost approach shows that the deposit guarantee fund plays a key role in resolution options. As such it is recommended that the guarantee fund and the resolution fund be the same, as the incentives to minimize outlays under the guarantee fund are strong.[34] If desired, an additional bank levy could be charged to finance the fund better. This design would be clearer and have more unified criteria including the use of separate funded accounts for ordinary resolution procedures versus for systemic cases. This is preferable than setting up a parallel resolution fund which could lead to a less integrated approach to the least cost/least loss criteria under resolution options. A separate resolution fund may also lead to moral hazard issues if the industry

[34] This point is also emphasized in the draft EU Resolution Directive.

perceives that a unique fund to handle systemic solvency problems will be available exclusively for bank bail outs.

XIV. Standing Financial Stability Committee Role and Other Crisis Management Measures

160. The legal framework may wish to optionally include or renew provisions in the event that the banking sector is subject to a systemic banking crisis as occurred in 2008-09 so as to avoid the need to approve new ad hoc legislation. The upside of including such, is legal clarity in the event such a scenario materializes. The downside is the generation of market expectations of broader government bail-outs. Thus, these following provisions are optional and not "a must" for inclusion in the resolution law. However, a systemic banking crisis is typically characterized by financial sector distress of such a magnitude that it is clearly not limited to one or a few institutions, and has an adverse effect on the real economy as a whole. It will usually include at least some of the following elements: (i) severe financial problems in large segments of the banking system; (ii) a system-wide loss in bank asset quality; (iii) a widespread loss of credit discipline; and (iv) a danger of collapse of the payment and settlement systems.

161. The legal framework for systemic crisis, although it can utilize resolution/insolvency tools as well, is nevertheless different and must aim at: (i) protecting the payment system; (ii) limiting the loss of widespread depositor and creditor confidence; and (iii) restoring solvency, liquidity and stability to the banking system. The pertinent authority will have to determine quickly and, in most instances, with limited information, whether the risks to the system are substantial enough to justify the use of exceptional systemic tools.

162. Even though the suggested legal framework for bank resolution sometimes will be sufficient, it is necessary to expand the tools available to the government to deal with a more systemic crisis. Four sets of measures have particularly been employed to contain creditor runs: (i) emergency liquidity assistance; (ii) blanket guarantees; (iii) administrative regulatory measures; and (iv) exchange/capital controls. Each measure has different institutional and regulatory conditions for successful implementation. It should be considered to include such in

the amended legislation to provide powers to the FSC to promulgate regulation relating to these four different issues.

XV. Amendments and References to other Laws

163. To make the resolution powers effective and consistent with other legislation in Poland, amendments to – or references to – other laws will be required. The Banking Act will have to be amended as discussed in this paper, in relation to Chapter 12, Parts B and C. Where Article 147 currently exists, the resolution phase specified under the new resolution law should be referenced. Articles 426-441 of the Bankruptcy Act should largely be repealed, with bank insolvency proceedings specified as being subject to the new resolution law that should state that its procedures and its priority of creditors for bank insolvencies, supersede those used in the Bankruptcy Act.

164. The new administrative legal powers given to the resolution authority may also need to be aligned with other laws on the functioning and scope of the judiciary so that the exercise of resolution powers by the resolution authority are not subject to judicial authorization nor executed via the judicial system.

165. The Companies Law, Corporate Law, Property Law, and/or the Commercial Law that refer to the powers and rights of owners, shareholders or contract rights, should be analyzed with respect to their conformity to the new resolution law which should refer to these laws and the different legal framework applied within the resolution law toward the treatment of shareholders, owners and creditors.

166. The Acts on the Trading in Financial Instruments, the Bonds Act, the Securitization Act and any other securities transactions related Acts should be referenced in the Resolution regime's special treatment of securities when these pertain to liabilities to creditors and the rights/property assignments of any such securities defined under the resolution law. Regarding securities registration, trading, disclosure, and securitization, the pertinent Acts should be referred to under the resolution law in terms of exempting securities that are issued as part of a resolution asset

transfer, such that they be exempt from certain procedural requirements required for compliance under securities issuance and trading, and securitization laws. These Acts and any other securities transaction related legislation should be analyzed with respect to needs for their amendment with respect to the resolution regime’s treatment of securities as per above.

167. If the Bank Recapitalization Act is still in effect, it should be referenced in the resolution law with respect to any prior crisis or systemic measures included in the resolution law, as modified public intervention measures that may affect the sequence of execution of the tools and provisions in the Recapitalization Act.

168. The Law on Takeover Bids needs to be referenced with regard to the special takeover bid situations and conditions under the resolution law when applied to financial industry participants or investors bidding for all or part of a failed bank.

169. The Law on Settlement Finality perhaps needs be amended and referenced regarding the special conditions under resolution for suspending the early termination of contracts at the outset of resolution while respecting set-off, netting and collateral-based asset/liability agreements when a bank in resolution is a counterparty, as well as the treatment of senior ranked instruments available for trading but which may be temporarily suspended while resolution proceeds.