Cross-border bank resolution: old demons, current progress, future challenges


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"As you set out for Ithaca
hope your road is a long one,
full of adventure, full of discovery”

Konstantinos Kavafis, *Ithaca*, 1911
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This work is the result of a four-year ‘journey’ in the passionate world of international banking practices and the cross-border aspects of financial crisis management. It has not been an easy task navigating past the ‘Laestrygonians’ and ‘Cyclops’ of financial crashes but I hope this work can shed some more light on the complexities of cross-border bank resolution.

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This work is dedicated to my family and friends: for always encouraging me to reach new limits, for pushing me to become a better person, for celebrating the good moments and for being there during every crisis.

Ilias Pnevmonidis
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INTRODUCTION

The 2008 financial meltdown

“When the music stops, in terms of liquidity, things can be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing”¹
Chuck Prince, former CEO of Citigroup, July 2007

Eventually the music did stop. And the repercussions from the ‘dance’ were not simply complicated but they almost brought international banking activities to a halt and the world economy to the brink of a total collapse.

Contrary to popular wisdom, financial crises occur regularly. For example, from 1970 to 2002 one can count 117 financial episodes.² Nevertheless, the 2008 systemic financial shock presents unique characteristics, which illustrate important lessons for the future of the banking sector.

The years before the explosion of the US subprime crisis in 2007, which transformed into a full scale systemic banking crisis in 2008, can be described as the years of credit excess and liquidity abundance. They had been years of intense developments in financial activities that resulted in profound changes within the old-fashioned banking business.

From 1998 to 2004 the world witnessed a rapid expansion of a new model of globalised banking activities, based on a European-style model of universal banking.³ This rapid growth of cross-border activities resulted in the creation of international mega-banks, which became alarmingly large compared to the GDP of many states. Not only did the operations

of the largest financial institutions expand significantly across borders but the traditional banking business model also underwent a significant transformation.

On the one hand, credit institutions expanded their services in investment banking and became highly involved in the process of securitisation, which had been introduced by investment bankers as a means of diversifying their portfolios and as an important strategy of risk hedging. Although they had been considered as a means of risk mitigation and diversification, securitisation products ultimately obscured investors’ ability to monitor risk and were prone to the volatility and to the sharp deterioration of the underwriting debt standards.

This involvement of commercial banks in trading activities through the substantial use of derivatives and other structured products required high expertise and constant monitoring of the volatility and risks of the underlying values. Nevertheless, the complexity and the opacity of the derivatives’ system made such monitoring extremely difficult.

By and large, this reflected a radical change in banking models, from the ‘originate to hold’ model (where banks keep in their balance sheets the risks they create) to an ‘originate to distribute’ model (where banks – through the process of securitisation – use highly sophisticated derivatives and other structured products to transfer their own risks to other market participants).

Furthermore, investment banks started behaving more and more like credit institutions. For example, Lehman Brothers and other investment firms were lending money to hedge funds in return for securities, which

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4 Securitisation can be described as the issuance of claims backed by a pool of default-risky instruments where the new claims frequently have varying exposures to the underlying pool of collateral. The final tranches of debt resulting from this procedure are sold to various investors, private individuals or other financial institutions and would normally receive AAA credit ratings by the rating agencies, David Marques Ibanez & Martin Scheicher, Securitisation: Instruments and Implications, in Berger, Molyneux & Wilson, 2010, p.599.

5 For example, Gorton describes how this theoretically informationally-insensitive debt classes (a category of debt that no one need devote resources to investigating) through the securitisation channels can become informationally-sensitive during a systemic shock, Gorton, 2009, pp.7–10.

were used for collateral, and were then lent to other financial participants in order to increase their access to liquidity.\textsuperscript{7} This process was similar to credit lending from traditional banking institutions.

In the meantime, most banks, amassing debt through the process of securitisation, started becoming highly leveraged. Banks in general are considered the most leveraged of any type of firm.\textsuperscript{8} It is estimated that in the years before the 2008 crisis, many banks presented leverage ratios (debt-to-equity ratios) that ranged between 30 and 50 times more debt than equity.\textsuperscript{9} These high levels of debt resulted in significant proportions of accumulated risks.

All in all, leading up to the crisis, banking was becoming concentrated and highly interconnected globally.\textsuperscript{10} Leveraging their capital to unprecedented heights in order to bet on extremely risky products, banks were exposing their balance sheets to the possibility of deep shocks.\textsuperscript{11} Furthermore, as their portfolios, instead of being diversified began presenting substantial similarities, and the interbank funding channels resulted in a highly interconnected market. Such banking activities set the foundations for the onset of a systemic crisis.

It seems reasonable to question how the banks ended up being exposed to such substantial amounts of debts and risks. But banks were operating in a highly deregulated financial environment with insufficient oversight.

At the end of the 1990s, governments in many states began to drastically reduce the extent to which they intervened in the financial system, adopting instead what the Financial Services Authority (FSA) – the former UK financial supervisory authority – referred to as a ‘light touch’ approach to bank regulation. On both sides of the Atlantic, the largest financial centres endorsed the concept of market efficiency and self-regulation of the financial system. It was this paradigm of market efficiency that had been considered the backbone of financial deregulation across financial

\textsuperscript{7} De Grauwe, 2008, p.5.
\textsuperscript{8} The term leverage is used to describe the amount of debt that is normally used in order to finance a bank’s assets. The debt-equity ratios of banks are normally 15:1–30:1, Sommer, 2014, p.4.
\textsuperscript{9} Cumming & Eisenbeis, 2010, p.4.
\textsuperscript{10} Krimminger, 2005, p.1.
\textsuperscript{11} Carmassi, Luschetti & Micossi, 2010, p.4.
markets.\textsuperscript{12} Moreover, according to the principles of self-regulation, the intervention of authorities was minimal as the markets could auto-correct any existent deficiencies.\textsuperscript{13}

This period of financial frenzy and minimal state supervision reached its limits in the years of 2005–2006. Buckley and Arner highlight that “borrowers, lenders, arrangers of transactions, credit support providers, investors and credit rating agencies came together in an environment of low interest rates, freely available capital and regulatory distraction”.\textsuperscript{14} The financial system had become highly combustible. The spark came from a single domestic event, the collapse of the US subprime mortgage market.

Prior to 2006, the US had experienced a period of rapid credit growth. This period was characterised by the massive extension of mortgage loans to creditors who, under normal circumstances, would not meet the criteria of creditworthiness.\textsuperscript{15} This imprudent and exaggerated lending to large classes of the population resulted in a real estate bubble. Due diligence from the banks went from tolerable to notional and finally, it became virtually non-existent close to the bursting of the bubble.\textsuperscript{16} In the summer of 2006, the US subprime mortgage market began collapsing, with real estate assets becoming practically worthless, a large number of creditors being unable to service their mortgages and US banks being confronted with the results of their reckless lending practices.\textsuperscript{17}

The fundamental problem was that these mortgage credits had been part of the securitisation process and, after being transformed into mortgage-backed securities, they had been resold en masse to a vast number of banks, hedge funds and other financial intermediaries all over the world. Numerous financial institutions were the holders of these securities, whose underlying values were rapidly deteriorating. Thus, a

\textsuperscript{12} The paradigm is based on the idea that markets are at any point ‘informationally’ efficient and hence, stock prices always reflect all available, relevant information. Consequently, the investors cannot beat the markets as they cannot possess more information than that already reflected by a stock price.


\textsuperscript{14} Buckley & Arner, 2011, p.117.


\textsuperscript{16} House of Commons – Treasury Committee, 2009, p.36.
domestic credit crunch quickly transformed into a full-blown global financial crisis.

At first, banks initiated the process of deleveraging of their balance sheets through massive debt write-downs, which resulted in unprecedented losses. The fact that the majority of these banks, however, did not hold adequate liquidity buffers quickly exposed them to severe short-term financing problems.

Paradoxically, the first victim of the US subprime crisis – in September 2007 – was a British bank, Northern Rock. The slow and uncoordinated response from the BoE and the FSA triggered a run on the bank, the first experienced in the UK since the Victorian era. On the other side of the Atlantic, Bear Stearns received state aid in March 2008 and was ultimately acquired by JP Morgan Chase.

These first cases of bank collapses sent waves of distrust across the markets, and systemic risk started to materialise through the interconnectedness and interdependencies of the global financial system. All over the world depositors and bank creditors were losing confidence in the banking industry and in the troubled financial institutions. This lack of confidence resulted in massive deposits’ and clients’ funds’ withdrawals from those banks that were rumoured to be the next in line for default.

As in every financial crisis, in 2008 too there had been a tipping point. The US government’s decision to allow Lehman Brothers – the fifth largest US investment bank – to enter a Chapter 11 bankruptcy procedure on September 15, 2008, instantly transmitted panic to market participants. Those financial institutions exposed to Lehman ended up recording massive losses: for many of these institutions, the interbank funding had become inaccessible and their liquidity shortages were threatening their survival. Most of these financial institutions entered a frenzy of ‘fire sales’ of their assets in order to draw more liquidity. However, these practices ultimately contributed to a significant erosion of their equity base. At this stage, the liquidity crisis was turning into a deep solvency crisis.

Most states found themselves in a state of acute dilemma. On the one hand, intervention would be extremely expensive and would contribute to

17 Giovanel & Devos, 2010, p.6, footnote 16.
18 The IMF estimated that the global write-downs could reach an aggregate amount of $4,100 bn over the period 2007–2010, IMF, 2009, p.69.
a significant increase in moral hazard. On the other hand, some international banks had grown so large, that their collapse would jeopardise the survival of entire national economies. Confronted with this pressing dilemma, many governments considered themselves compelled to intervene in order to stabilise the banks and financial markets.

In most cases, the liquidity and capital injections to the banking sector were based on *ad hoc* solutions and piecemeal decisions for each troubled financial institution. Generally speaking, the majority of Western states took the decision to recapitalise and – in certain cases – nationalise failing banks, as well as to issue blanket debt and asset guarantees in order to provide aid to the banks in their process of deleveraging.\textsuperscript{21} Since the interbank markets were closed, the governments would now play the primary role in supplying liquidity to the troubled financial institutions.

One of the biggest challenges for state governments was to be able to evaluate with precision the exposure of financial institutions to the ‘toxic’ subprime financial products. The obsolete risk assessment management schemes of most international banks and the rapid deterioration of the ‘toxic’ assets allowed for only a vague estimation of their total amount of liabilities. Consequently, it was the taxpayers – supporting these failing financial institutions with their own money – who assumed the unknown costs of the rescue process.

By and large, the public support pledged by the G-20 economies averaged a total of 25% of their respective GDPs, and has been expected to contribute to a high rise of their government debt levels in the years to come.\textsuperscript{22} The BIS conducted an assessment of the financial rescue programmes across the 11 most important economies. The survey concluded that the overall amount of the public money committed to support the ailing banking sector during the 2008 crisis totalled €5,000 bn.\textsuperscript{23}

The financial crisis has been a ‘slap in the face’ for regulators and financial institutions: after experiencing a period of abundant liquidity, financial deregulation and general excess, they were all caught off guard by an economic shock, which could have been normally limited in the US. For a decade the global banking sector was operating far beyond its limits

\begin{footnotesize}
\footnotetext[20]{It became clear that market efficiency did not necessarily imply market rationality, FSA, *The Turner Review*, 2009, p.40.}
\footnotetext[21]{Panetta et al., 2009, pp.7–8.}
\footnotetext[22]{IMF, 2010a, p.4.}
\footnotetext[23]{Panetta et al., 2009, p.1.}
\end{footnotesize}
and everyone was under the illusion that nothing could bring the economy down. Yet, as Warren Buffett insightfully observed “you only learn who has been swimming naked when the tide goes out”.

The development of bank resolution regimes as an antidote to the TBTF problem

Overall, rescue measures put in place by respective states were far from flawless and coordinated across jurisdictions. Ignoring the interconnectedness of the global financial system and the cross-border business lines of many international banking groups, numerous jurisdictions focused on the impacts of the crisis in their domestic economies. These ill-conceived domestic policies contributed to significant value destruction, chaotic liquidation procedures with ring-fencing of assets, and further destabilisation of the system due to the blanket guarantees issued by many states, which in turn resulted in the outflow of deposits and funds from certain financial institutions. Indeed, the 2008 experience highlighted very clearly that the more interconnected and integrated a financial system becomes, the more counter-productive lone state initiatives can be, when poorly coordinated.

With their hands tied, most governments were unable to react effectively to the risky business practices and the failure of numerous financial institutions. In the process of recovery from the crisis, regulators were determined to turn the page. Prior to the crisis, most governments lacked

25 As the former Chairman of the IMF, Dominique Strauss-Kahn, put it, the measures implemented during the crisis were “locally reasonable but globally myopic”, Dominique Strauss-Kahn, Reject Ad Hoc, National Financial Reforms, Financial Times (17/02/2010), cited in McCormick, 2010, p.36.
26 IMF, 2010b, p.12.
27 The G20 Summit in London in 2009 called the 2008 financial turmoil “the greatest challenge to the world economy in modern times”, G20, London Summit Statement, 2009, p.1. In the same year in Pittsburgh, the G20 leaders expressed their determination to uphold bold reforms and policies in order to recover from an “era of irresponsibility”, G20, Pittsburgh Summit statement, 2009, p.1.
resolution powers. Acknowledging that they could not afford to be ‘taken hostage’ again by troubled banks, which are simply ‘too big to fail’, leading economies have therefore subsequently developed resolution regimes for distressed financial institutions i.e. regimes that will allow banks to fail while preserving at the same time the continuity of their crucial functions. These regimes have become part of a three-pronged consolidated approach to crisis management; the other components being supervision and early intervention. Once these regimes become fully functional, large bank failures will be subject to special measures outside classic insolvency procedures, thus minimising the risk of financial disruption in the markets, and safeguarding public money.

There is no one single definition for the term bank resolution, often interpreted in incoherent manner between scholars and legal practitioners. Deriving from the recent developments in the fields of banking and insolvency law, the term has been mainly brought to the forefront after the 2008 financial crisis, although in the US it has already been applied with success by the FDIC in relation to domestic credit institutions. As the body of research undertaken by international bodies on the subject of the financial crisis has grown, so too has the use of this term, and this has not only raised awareness of the term among the general public but it also helped to ensure greater clarity around its primary characteristics. The development of bank resolution alternatives has been promoted as a vital tool within a legal arsenal against the dangers posed by Systemically Important Banks (SIBs) for the global economy.

Almost seven years after the financial meltdown, there seems to be a good degree of consensus on what exactly constitutes sound bank resolution practices. Most often described as a special insolvency regime for SIBs, bank resolution covers a broad range of radical restructuring measures (such as the establishment of a bridge bank, the sale of business to third parties, bail-in, asset separation), implemented either in isolation or cumulatively by a domestic resolution authority (preferably a public administrative authority), when a financial institution faces serious viability issues but has not yet reached the point of genuine insolvency. The aim of such resolution regimes is to maintain the essential functions of the bank, safeguard financial stability and the general public interest by avoiding the spillovers of common – often complex and time-consuming – liquidation procedures. It should be highlighted that bank resolution will impose losses to shareholders and creditors of the failing financial institution, and
will result in a significant curtailment of their property and other rights, as established under corporate, banking and insolvency law.

However, precise definitions are lacking: most legal systems seem to use the term within broader legal categories such as bank reorganisation or bank winding-up. In certain cases, bank resolution falls under the more general term of bank insolvency. Linguistic differences between leading jurisdictions further complicate the task of defining the resolution concept.

International organisations, such as the IMF, for example, have used the generic term ‘resolution’ in order to describe “the full range of recovery and resolution activities that involve public intervention (whether privately or publicly funded) including mergers and acquisitions, equity capitalisation, debt for equity conversions, transfers of assets and liabilities, temporary administration, reorganisation and liquidation”.

Consequently, the main stated objectives and procedures of any given resolution regime may often encompass a wide variety of legal provisions and standards, yet still fail to adequately capture all of the aspects that are essential to an efficient bank resolution scheme.

Given the complexity and broadness of the problems posed by SIBs, developing definitions and solutions that are too rigid may prove counter-productive, since they may hamper the ability of an authority to intervene during a crisis. On the other hand, if the concept of bank resolution remains too vague, this can contribute to growing legal uncertainty, especially for third stakeholders such as bank creditors and shareholders. A concept that is poorly defined or understood can also create confusion, and lead to divergent solutions with regard to the triggering point.

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28 It is true that numerous jurisdictions do not use the specific term ‘resolution’ when referring to such practices. As a result, there is no clear term in other foreign languages to fully describe the term bank resolution. For instance, in French the most frequent terms are liquidation or réorganisation (although the EU Bank Recovery and Resolution Directive as well as the new bank resolution provisions in France use the neologism résolution, which fails, however, to capture and reflect the basic ideas of the English term) and in German the terms Reorganisation or Abwicklung (both of them best translated in English as reorganisation or winding-up). In Switzerland, resolution measures are described under the chapter ‘Assainissement’/‘Sanierung’ of the FINMA Banking Insolvency Ordinance, terms, which could be closer to the notion of recovery in English. Although they may reflect the basic notions instituting a resolution regime, they often fail to provide critical details or draw the line between a bank resolution and e.g. a bank winding-up procedure.

29 IMF, 2010c, p.6.
of a crisis management procedure. Therefore, the first section of chapter 2 groups together the most fundamental and essential elements of a definition of bank resolution.

**The purpose and the interest of this contribution**

This contribution focuses on the development of bank resolution regimes as a credible alternative to existing bank insolvency procedures. Cross-border considerations lie at the heart of the analysis with regard to the rapid proliferation of this legal scheme. Following the development of comprehensive domestic bank resolution regimes, the next necessary step is the establishment of cross-border mechanisms for the resolution of large international banks.\(^{30}\)

It is important to stress that the scope of this contribution is limited only to the discussion of bank resolution. Consequently, concepts such as bank recovery or ordinary winding-up procedures are discussed only where there is a need to (i) make a clear distinction between these latter terms and the notion of bank resolution, or (ii) highlight where such alternative procedures might pose obstacles to subsequent or parallel resolution proceedings.

Regarding domestic resolution regimes, the focus of this research is on the US, British and Swiss bank resolution systems and the relevant rules currently into force. However, the analysis does not follow a comparative method. The EU Bank Recovery and Resolution Directive, as well as the Regulation on a Single Resolution Mechanism, are also central in this contribution. In addition, the text touches upon aspects of other domestic legislations that present noteworthy elements and striking examples linked to the issue of bank resolution.

Moreover, policy documents published by international bodies such as the BCBS, the FSB and the IMF also serve as starting points for this research and provide considerable guidelines to this analysis. These

\(^{30}\) The G20 leaders in the London Summit of 2009 reiterated their support for the “continued efforts by the IMF, FSB, the World Bank and the BCBS to develop an international framework for cross-border bank resolution regimes”, G20, *London Summit Statement*, p.2.
documents are presented, however, through a critical eye, identifying potential weaknesses and controversial approaches.

The overarching objective of this analysis is to demonstrate the repercussions and challenges resulting from the implementation of bank resolution schemes on a cross-border level. The EU is an example of great importance in this regard: the EU adopted the Bank Recovery and Resolution Directive in the spring of 2014, and the final text of the Regulation for the creation of a Single Resolution Board shortly after that, as a common resolution authority for the Eurozone member states.

The present analysis is not exhaustive with regard to all legal issues concerning cross-border bank resolution. Rather, the core of this work is a selective and coherent survey of specific legal questions that remain relatively unaddressed or still problematic, especially when applied on a cross-border context. Despite the fact that bank resolution has remained in the spotlight ever since the 2008 financial crisis, there has been insufficient research on the cross-border complexities of such legal procedures or the potential implications of controversial resolution tools such as bail-in.

For certain, the ‘too-big-to-fail’ issue has been adequately addressed and resolved, following the legal developments in numerous jurisdictions. Bank resolution schemes – coupled with far-reaching mandatory capital requirements and new provisions on liquidity funding – seem to have provided the exit from the financial nightmare experienced in 2008.

In fact, the reality is somewhat different. As demonstrated through the current sovereign debt crisis of the Eurozone peripheral economies, the banking sector remains quite fragile. Additionally, international banks have grown even larger and more complex as a result of the recapitalisations, bail-out interventions and forced mergers and acquisitions that took place in the midst of the financial crisis.

Therefore, it is vital that further research is conducted with regard to the intricacies of the cross-border operations and failure of global banking groups, as well as the responses to these challenges through bank resolution in order to contribute to a better understanding of the complex externalities of cross-border bank resolution.
Plan of the analysis

First of all, this contribution begins with three case studies, which vividly illustrate the complex legal and financial impediments posed by the collapse of large cross-border banking groups under the pre-crisis bank insolvency regimes: (i) the collapse of Fortis demonstrates that even between states with common traditional banking bonds, operating within the harmonised EU financial environment, cooperation among bank resolution authorities cannot be considered guaranteed; (ii) the bankruptcy of Lehman Brothers presents unquestionably the most high profile example of the far-reaching impact of the failure of an international bank on the world economy in the absence of efficient cross-border crisis management mechanisms; (iii) the near collapse of UBS demonstrates how a purely domestic issue (the collapse of the US subprime market) can threaten the stability of an entire foreign banking sector through the channels of crisis contagion. A fourth and final case study considers the recent resolution measures implemented for the bank Espirito Santo in Portugal. Although this case study demonstrates success in terms of a certain change of regulatory mentality with regard to systemic banks, it also highlights the need to move quickly with regards to the development of efficient resolution rules.

Chapter 2 briefly reviews and comments on the definition of bank resolution and the recent legal developments in this field – not only at the domestic level but also with regards to the work of certain international bodies. The focus of this chapter will be on the US, British and Swiss bank resolution systems, as well as on the documents published by the BCBS, the FSB and the developments within the EU regarding the Bank Recovery and Resolution Directive and the Regulation on a Single Resolution Mechanism.

In Part II, the text elaborates on the basic elements that characterise a bank resolution procedure and set it apart from traditional bank insolvency. The analysis takes place on a comparative legal basis with frequent references to existing domestic resolution regimes and international resolution standards. The chapters of this Part touch upon: the objectives of bank resolution; the dilemma of resolution triggers; the choice of resolution authorities; as well as the main resolution powers. In addition, one
will find an analysis of the role of courts and the potential impact of resolution procedures on shareholders’ and bank creditors’ rights. Finally, this research delves into two essential prerequisites for efficient resolution regimes: resolution planning and resolution funding.

The objective of Part II is not to provide an exhaustive catalogue of rules with regard to how bank resolution should be organised and implemented. Rather, the goal is to consider, group and propose the main characteristics that must be present in an efficient resolution procedure capable of addressing the modern challenges posed by international banks.

In Part III, the analysis presents some of the main institutional deficiencies that contributed to the 2008 crisis, namely: the lack of legal and regulatory comprehension of the structure and activities of international banks; the legal confusion still resulting from the concept of the banking group; and, finally, the inability of regulators and supervisors to effectively monitor SIBs and address their failures on a cross-border level. The text demonstrates how these issues can shape bank resolution regimes and how important they remain for future cross-border resolution efforts.

Given that the efficient treatment of cross-border intricacies will be of utmost importance for the success of bank resolution schemes, the cross-border considerations for the resolution of banking groups will be highlighted throughout this analysis.

In conclusion, there is a summary of the outcomes of this research and analysis on cross-border bank resolution while trying to answer to the fundamental question: have we put an end to the ‘too big to fail’ problem?
PART I

THE INTERNATIONAL PROLIFERATION OF BANK RESOLUTION SCHEMES
Chapter 1

THREE STORIES OF HORROR AND ONE STORY OF HOPE ON BANK FAILURES

1.1 The Fortis case: the story of a disorderly cross-border resolution

Fortis was a financial conglomerate offering banking and insurance activities. It owned systemic subsidiaries in the financial markets of all three Benelux countries. It was a dual-listed company with activities operating under a bi-national holding structure. This presented important complexity within its legal corporate organisation.1 The insurance activities of the group were operated under Fortis Insurance N.V., incorporated under Dutch law, which also owned three additional subsidiaries.2

Aside from the Benelux subsidiaries, the group also operated a wide range of banking and insurance activities in various countries such as the United Kingdom, France, Germany and the Russian Federation.

1.1.1 The liquidity crisis

Before the serious financial turmoil in 2008, Fortis enjoyed a stable and leading position in the European financial market. Its role as a crucial financial actor was further reinforced in the spring of 2007 with its decision to participate in the acquisition of the Dutch bank ABN AMRO Holding NV.3

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1 Cihak & Nier, 2009, p.23. The principal banking entity of the group, Fortis Bank SA/NV, was incorporated under Belgian law, with its headquarters in Brussels. Fortis Bank SA/NV established also banking subsidiaries in the Netherlands and in Luxembourg, under the registered company names of Fortis Bank Nederland (Holding) N.V. and Fortis Banque Luxembourg SA.
2 Fortis Insurance N.V. (registered in the Netherlands), Fortis Insurance International SA/NV and Fortis Insurance Belgium SA/NV (both registered under Belgian law).
3 Fortis along with the Royal Bank of Scotland Group and Banco Santander established a consortium on the 13th of April 2007 and ten days later they launched their public offer for the acquisition of ABN AMRO, Fortis, 2008, p.7.
The first signs of distress appeared in May 2008, with the start of a sharp global decline in the group’s share prices.\(^4\) This fall in share prices further impacted sharply on the value of the whole of Fortis’ portfolio, affecting a great number of its financial instruments. The negative rumours that began to circulate regarding the solvency of the group and the general adverse evolutions in the equity markets since the beginning of 2008 led to a worldwide crisis in confidence in Fortis within the markets.

The events escalated during the summer of 2008. The accelerated capital plan that had been put into place via an announcement during late June failed to achieve the desired recapitalisation goals. In addition, the group started selling parts of the ABN AMRO Group in order to achieve a certain solvency relief.\(^5\)

The week of the 16\(^{th}\)–28\(^{th}\) of September 2008 was the most crucial with regards to the unfolding of the liquidity crisis within Fortis. The group came under extreme pressure from the interbank credit market due to the rumours circulating around its ability to meet its liabilities. After the collapse of Lehman Brothers and under the influence of the global credit crisis, Fortis’ share prices plummeted. The tipping point came on the 26\(^{th}\) September 2008 when the rumours around a forthcoming bankruptcy prompted many of the group’s institutional clients to proceed to massive withdrawals drying up the liquidity of Fortis.\(^6\) At the end of that day, after exhausting almost all of its collateral and in an effort to obtain some liquidity relief, Fortis had to turn to the Marginal Lending Facility of the National Bank of Belgium.\(^7\)

### 1.1.2 Government intervention

On the 26\(^{th}\) September 2008, it became clear that there would be no private purchasers able to return financial stability to Fortis. Therefore, since no other legal measures were available aside from traditional bank insolvency proceedings, the only solution was an intervention on the part of the three Benelux governments.

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\(^5\) Fortis, 2008, p.11.
\(^6\) At a speed of € 25 bn per day, Čihák & Nier, 2009, p.23.
In an agreement reached at the morning of Sunday, 28th September 2008, the three governments decided to partially nationalise Fortis. An emergency injection of €11.2 bn was effectuated, leading to a subsequent capital increase.\(^8\) However, this significant sum was provided not at the level of the group as a whole, but instead each national authority decided to support the Fortis subsidiaries that were active within their respective territory.\(^9\)

Despite the significant capital injection provided by the three governments, Fortis’ share prices continued to decline sharply and important clients continued to withdraw their funds.

Fortis Bank SA/NV resorted immediately to the Emergency Liquidity Assistance Agreement that it had reached with the National Bank of Belgium.\(^10\) The supplement of €7 bn that had been provided under the Emergency Liquidity Agreement with the Dutch National Bank was insufficient to pull Fortis out of its continued decline.\(^11\)

On the 3rd October 2008, panicking in light of the group’s deteriorating situation, the Dutch authorities entered into negotiations with both the Belgian state and Fortis regarding the Dutch government’s acquisition of the Dutch entities of the group.\(^12\)

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\(^8\) Belgium and the Netherlands invested €4.7 and 4.5 bn respectively, whereas the government of Luxembourg provided €2.5 bn.

\(^9\) Consequently, Belgium acquired 49.93% interest in the Fortis Bank SA/NV through its Federal Participation and Investment Corporation (SFPI/FPIM), a public company whose sole shareholder is the Belgian federal government. The National Bank of Belgium also proceeded to the conclusion with the bank of an Emergency Liquidity Assistance Agreement, in order to remain a source of further liquidity for the bank in case another financial shock would follow, Fortis, 2008, p.15. The Netherlands acquired on their turn 49.9% of the shares of the Fortis Bank Nederland (Holding) N.V., the Dutch subsidiary of Fortis Bank SA/NV, ibid, p.16. Finally, after the respective capital injection, the Grand Duchy of Luxembourg now held 49.9% of the total capital of the Fortis Banque Luxembourg S.A. through the convertible loan that had been signed with the bank, Cihak & Nier, 2009, p.23.

\(^10\) Three days after the capital increase undertaken by the Belgian government, the bank utilised for a liquidity boost €51.3 out of the €57.7 bn that were available under the Agreement, Kudrna, 2011, p.11.


\(^12\) The final price for the acquisition of all the Dutch banking and insurance subsidiaries of the Fortis group was fixed at €16.8 bn, a price significantly lower from the €22 bn that Morgan Stanley valued the Dutch operations of the group, ibid, p.18.
As a result of these events, the resolution of the Fortis group continued entirely along national lines with the Netherlands leaving the hard decisions for the safeguard of the remaining parts of the group to the Belgian and Luxembourg authorities.

In the end, Luxembourg increased its share in the Fortis Banque Luxembourg SA to 52%, thereby becoming the principal shareholder. On the 10th October, the Belgian authorities through the SFPI/FPIM acquired the remaining 50% + 1 shares of the Fortis Bank SA/NV (Share Purchase Agreement), thereby having the complete control of the Belgian banking activities of the group.\textsuperscript{13}

\subsection*{1.1.3 The acquisition by BNP Paribas and the shareholders’ objections}

Following the nationalisation of the Belgian banking and insurance activities of the group during the first stage of the crisis, the Belgian government intended to sell the majority stake of those activities to the French banking group of BNP Paribas. An agreement (\textit{Protocole d’Accord}) was reached with the Belgian authorities on 10th October 2008, which laid out the terms for future developments within Fortis.\textsuperscript{14}

Fortis’ shareholders, however, decided to challenge BNP’s acquisition and resorted to the Belgian courts, with the latter invited to examine whether the transfer of the shares under the \textit{Protocole d’Accord} between

\textsuperscript{13} Cihak & Nier, 2009, p.23.

\textsuperscript{14} This agreement provided for: a) a transfer of almost 75% of the shares of Fortis Bank SA/NV from the Belgian state to BNP Paribas in exchange for shares representing 11.6% of the total BNP shares. The agreement touched upon the acquisition of the Belgian banking subsidiary and not of the holding company of the group. The Belgian government and certain Belgian and Dutch minority shareholders would remain the owners of 25% interest of the bank, b) an acquisition of BNP Paribas of the totality of the shares of the Belgian insurance subsidiary of the group, Fortis Insurance Belgium SA/NV for a total of € 5.5 bn, and finally c) the creation of a special purpose vehicle funded at 66% by Fortis (the two main holding companies of the group), 24% by the Belgian government and 10% by the BNP Group in order to acquire the portfolio of structured products of Fortis Bank SA/NV. BNP had also concluded a special agreement with the Grand Duchy of Luxembourg, the majority shareholder of Fortis Banque Luxembourg S.A., regarding the acquisition of 66% of shares of the bank in exchange for 1.1% of the BNP shares, \textit{Fortis}, 2008, pp.23 and 25.
the Belgian government and BNP – without the approval of Fortis’ general assembly – was legal.

A judgement passed by the Tribunal de Commerce de Bruxelles on 18th November 2008 confirmed the legality of the Protocole d’Accord.\footnote{The president of the Tribunal considered that Fortis’ Articles of Association did not require an official approval by the shareholders’ general assembly for the transfer to BNP to occur, IMF, 2010c, p.13.}

At the beginning of December 2008, the group convened a meeting of shareholders in the Netherlands and in Belgium. Some important minority shareholders were threatening to continue with their legal action and challenge the acquisition, despite the fact that both Belgian and Dutch law provided the possibility to circumvent shareholders’ approval for the transactions with BNP.\footnote{Reading in the Shareholder Circular, ”the Belgian law does not require approval of the shareholders’ meeting of Fortis SA/NV for significant divestment of assets by subsidiaries of Fortis SA/NV. By the same token it is considered that even if relevant Dutch law rules would prescribe a shareholders’ meeting of Fortis N.V., such rules would be set aside by article 2:8 of the Dutch Civil Code if justified by reasonableness and fairness taking account of specific and pressing circumstances”, Fortis, 2008, p.25.}

The Cour d’Appel de Bruxelles on 12th December 2008, however, entirely reversed this ruling. The initial Share Purchase Agreement entered into between the Belgian government and Fortis, as well as the Protocole d’Accord with BNP was suspended: according to the Court’s decision, BNP’s acquisition had to be reviewed and approved by the general assembly of shareholders.\footnote{The Court considered that in casu there was no reasonable justification in order to put aside the national rules regarding shareholders’ approval, Fortis, 2009a, p.13.} The Belgian state’s acquisition of Fortis via the SFPI/FPIM was subsequently suspended for sixty-five days, and the government could in no way dispose of its shares in Fortis.\footnote{Otherwise, it would risk a fine of € 5 bn.} Hence, the closing of the agreements with BNP was aborted. The Court also appointed a Committee of five Belgian Experts in order to review the transactions and propose a course of action for the shareholders.

The Committee advised the shareholders to vote in favour of the acquisition, since the group was in a critical financial situation and there was no viable alternative solution in the immediate term. Based on this report, negotiations between the principal actors recommenced at the beginning of January 2009 in order to review the Protocole d’Accord.
The parties entered into a final stage of negotiations after February 2009. The revised and final agreement was reached between Fortis, the Belgian government and BNP on 12th March 2009.\(^{19}\)

73% of the shareholders present at the meeting of shareholders held on 28th April 2009 approved the aforementioned agreement. The sale to BNP Paribas was officially made final on 12th May 2009, following the EC Commission’s decision that the involvement of the Benelux states in the Fortis crisis did not violate any EC Regulations.\(^{20}\)

Today, those parts of the Fortis group that the Dutch government nationalised remain part of ABN AMRO, and the remaining insurance activities of the Fortis group that had not been acquired by BNP Paribas now operate under the new name of Ageas.

### 1.2 Lehman Brothers: the bank collapse that shook Wall Street and the global financial system

#### 1.2.1 The sparks that set a Wall Street fire

In 2006, Lehman Brothers entered into a very aggressive and high-risk business strategy.\(^{21}\) This business policy change resulted in the bank’s increased practice to use its balance sheet to acquire assets that would then be used for the firm’s own investments. Lehman’s managers claimed that most banks at the time were focusing on proprietary investments. Whilst these types of investment exposed the banks to high risk, they were

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\(^{19}\) The final agreement provided for the following: a) the transfer of 74.94% of Fortis Bank SA/NV shares by the Belgian state to BNP Paribas in exchange for 11.6% of the BNP shares (as provided in the first Protocole d’Accord), b) the acquisition by Fortis Bank SA/NV (through funding from its now majority shareholder BNP Paribas) of 25% + 1 share of Fortis Insurance Belgium SA/NV, and, finally, c) the creation of a special purpose vehicle (incorporated on the 20th of November 2008 under the name ‘Royal Park Investments SA/NV’) funded by Fortis (44.7%), the Belgian state (43.5%) and BNP Paribas (11.8%) in order to purchase the portfolio of Fortis’ structured products, Fortis, 2009b, pp.4–6.

\(^{20}\) BNP PARIBAS, 2009.

\(^{21}\) VALUKAS, 2010, p.59.
nonetheless extremely profitable in the booming financial environment of that period.\textsuperscript{22}

For investment banks such as Lehman – with a small equity base and high leverage – the acquisition of such assets resulted in a serious capital erosion. Nonetheless, Lehman remained determined to continue its risky and aggressive growth policy throughout 2007, despite the fact that the subprime crisis was already showing its teeth.\textsuperscript{23}

The main problem was that in such a challenging financial environment those assets were incapable of safeguarding the solvency of the bank.\textsuperscript{24} Furthermore, Lehman was unable to limit its leverage and its risk exposure, since the risks associated with these highly illiquid assets were either not properly recalibrated or evaluated or they could not be successfully hedged without aggravating the already precarious situation of the bank.\textsuperscript{25}

Lehman’s management engaged in a much more questionable process in order to limit the bank’s balance sheet; namely, the firm augmented the frequency of its repo 105 transactions.\textsuperscript{26} Whereas a normal repo transaction is qualified as a ‘financing’, Lehman’s accountants classified repo 105 agreements as a ‘sale’.\textsuperscript{27} By doing so, some $50 bn disappeared

\textsuperscript{22} As mentioned by David Goldfarb, the then Lehman’s Global Head of Strategic Partnerships, “\textit{Lehman was pursuing a 13\% annual growth in revenues}” and “\textit{to support this revenue growth it was targeting an even faster increase in the firm’s balance sheet, total capital base and risk appetite – each of which projected to increase by 15\% per year}”, \textit{Valukas}, 2010, p.62. At the end of the day, Lehman owned a portfolio of assets deriving from investments made mainly in the fields of commercial real estate, leveraged loans and private equity, \textit{ibid}, p.60.

\textsuperscript{23} FDIC, 2011b, p.31.

\textsuperscript{24} As they could hardly be liquidated or sold or used as collateral, they could not be of help for Lehman in order to advance its efforts of raising cash and covering its growing losses.

\textsuperscript{25} \textit{Valukas}, 2010, p.65.

\textsuperscript{26} The classic definition of an ordinary repo (sales and repurchase agreement) involves the “\textit{transfer of assets to another party in exchange for cash, while agreeing to repay the money and take back the assets at a later date}”. The particularity in Lehman’s repos was that the securities that the bank would pledge in its agreements would worth 105\% of the cash it received in exchange. In addition, Lehman repaid this money with an interest to its counterparties in these Repo 105 agreements. Although very expensive as a practice, the Repo 105 transactions had significant accounting results in the bank’s balance sheet and, at that point, were considered an acceptable accounting technique, \textit{Kennedy}, 2010.

\textsuperscript{27} \textit{De la Merced \\& Werdigier}, 2010.
from the bank’s balance sheet, thereby creating the illusion that the bank had significantly reduced its leverage.

Following the Federal Reserve’s intervention in Bear Stearns, lenders – fearing that Lehman would be the next in line – resorted unwilling either to extending liquidity to the bank or demanding increased collateral. Important counterparties began to withdraw their capital deteriorating Lehman’s financial hemorrhage: the bank’s stock price continued to plummet and since the start of the crisis in February 2007 it lost 91% of its original value, with the losses for the shareholders reaching $40 bn.\textsuperscript{28}

2008 would not be a better year. Lehman’s losses for the third quarter of 2008 reached $3.9 bn. The bank also decided to sell the majority stake of Neuberger Berman, its asset management branch for high net worth individuals.\textsuperscript{29}

With the US government stepping in once again – this time to bail out Freddie Mac and Fannie Mae – it was widely assumed by the markets that the federal authorities would react similarly should Lehman suffer the same fate. However, this proved to be far from the case.

### 1.2.2 Efforts to work out a solution

Before attempting a direct intervention, the US authorities explored the possibility of Lehman’s merger with a foreign bank. The Korea Development Bank (KDB) jumped first at the opportunity of acquiring Lehman’s global services.\textsuperscript{30} However, realising the extent of Lehman’s losses and its risk exposure, KDB found it extremely difficult to attract other partners to the deal. Simultaneously, Korean banking regulatory authorities began expressing their misgivings about this acquisition fearing that Lehman’s deteriorating financial situation could also destabilise the Korean banking market.\textsuperscript{31}

As the negotiations with KDB finally broke down in early September 2008, Lehman Brothers – as well as the regulators involved, the FRBNY

\textsuperscript{28} Anderson & White, 2008.

\textsuperscript{29} Lehman Brothers, 2008\textsuperscript{a}, p.5.

\textsuperscript{30} Morcroft, 2008.

\textsuperscript{31} Jung-a, 2008.
and the US Treasury – entered a final stage of talks in order to try to find a buyer for the collapsing group.

Lehman, however, had already used public money for its survival. In the aftermath of the Bear Stearns bail-out, the Board of Governors of the Federal Reserve decided to activate Section 13(3) of the Federal Reserve Act.\textsuperscript{32} In response to this decision, in early 2008 the FRBNY put in place the Primary Dealer Credit Facility (PDCF), as a source of collateralised loans for investment banks.\textsuperscript{33} Hence, investment firms considered the FRBNY as a lender of last resort. Only after Lehman filed for bankruptcy was it discovered that the bank had actually accessed this mechanism seven times prior to its final demise.\textsuperscript{34}

In this hostile environment, the negotiations around Lehman’s survival entered into their final stage in what was dubbed the ‘Lehman weekend’. The last potential buyers on the horizon were Barclays and the Bank of America.\textsuperscript{35} However, there were numerous challenges associated with the final sale. The regulatory authorities were trying to negotiate the sale of the Lehman group as a whole – a transaction that was considered quite expensive and very risky. However, the US government was unwilling to intervene in order to facilitate the sale.\textsuperscript{36}

Between 12th–14th September 2008, a series of intense meetings took place to discuss the rescue of Lehman. The US authorities had the idea of inviting the representatives from all major Wall Street banks, so that they could then create a jointly-funded liquidity consortium in order to save the bank.\textsuperscript{37}

Unfortunately, however, there was limited appetite to be exposed to risk associated with this ‘bad bank’.\textsuperscript{38} Despite an emerging consensus, the

\textsuperscript{32} Under this Section, the Federal Reserve Banks were authorised to grant secured loans to “any individual or corporation in unusual and exigent circumstances, when the borrower is unable to secure adequate credit accommodations from other banking institutions”, \textit{Federal Reserve Act}, § 343.

\textsuperscript{33} \textit{Valukas}, 2010, p.1389.

\textsuperscript{34} \textit{Ibid}, p.1398.

\textsuperscript{35} \textit{Anderson & Sorkin}, 2008.

\textsuperscript{36} As Timothy Geithner repeatedly told Lehman’s CEO, “Government cannot solve this problem for you”, \textit{Valukas}, 2010, p.1497.

\textsuperscript{37} As a result, the ‘bad bank’ with the majority of Lehman’s illiquid and toxic assets would be financed by its Wall Street competitors, who were also feeling the extreme pressure of the circumstances, \textit{ibid}, p.1523.

\textsuperscript{38} \textit{Guerrera & Guha}, 2008.
surprise, which brought the discussions to a stalemate, came from the other side of the Atlantic: Barclays announced to the US authorities that it would be unable to provide the guarantees they had asked for with regards to the approval of the take-over of Lehman’s outstanding trades. With Barclays out of the picture, the US authorities were faced with little choice. Their worst fears were now crystallised and bankruptcy was the only viable option for Lehman.

### 1.2.3 Chapter 11 Bankruptcy filing

Under a staggering total debt of $613 bn and with $639 bn of total assets, early morning on Monday, 15th September 2008, Lehman Brothers filed a Chapter 11 bankruptcy petition. To this day, Lehman remains the largest ever bankruptcy case in US history – followed by Washington Mutual with approximately $328 bn of debt.

As it was explicitly mentioned in the press release circulated that Monday morning, only the holding bank, Lehman Brothers Holdings Inc. (LBHI), was subject to the Chapter 11 bankruptcy process and the subsequent liquidation. Its broker dealer subsidiaries in the US continued their operations and were not part of the bankruptcy procedures. The bank appeared to have a total of 100,000 creditors.

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39 The problem was in fact created by the former British supervisory authority, the FSA, which considered that for this outstanding matter of the guarantees for Lehman’s acquisition British law imposed the requirement of a preliminary shareholder vote on the issue. Barclays could not rapidly receive this waiver in order to seal the deal, Valukas, 2010, pp.1527–28.
40 Mamudi, 2008.
41 Chapter 11, part of the US Bankruptcy Code, allows the protection of the debtor from the actions of its creditors during its reorganisation process. A trustee is appointed and is responsible for the debtor’s business, as well as its relationship with its creditors, US Bankruptcy Code, Chapter 11, §1104, §1106. Should a plan for reorganisation not be approved or never be submitted, the debtor enters the final stage of liquidation, ibid, §1174.
42 The US had not experienced such a large, complicated and expensive investment bank failure since the collapse of Drexel Burnham Lambert in February 1990, Sorkin, 2008b.
43 Lehman Brothers, 2008b.
44 Citigroup Inc. and the Bank of New York Mellon Corp. were the most important ones, Mamudi, 2008.
The announcement of the Chapter 11 bankruptcy filing caused Lehman’s share prices to crash.\textsuperscript{45} The Dow Jones industrial average fell 504.48 points – the most substantial one day point drop witnessed since the 17\textsuperscript{th} September 2001 – and the Standard and Poor’s 500-stock index hit its lowest level in the period 2007–2008.\textsuperscript{46} Approximately 100 hedge funds that relied on Lehman Brothers for their prime brokerage operations saw their positions frozen due to the automatic stays imposed by the bankruptcy administrators.\textsuperscript{47} It is estimated that Lehman’s counterparties in the derivatives markets cancelled as much as 700,000 derivatives contracts entered into with the investment bank.\textsuperscript{48}

Whilst Lehman’s numerous subsidiaries appeared solvent, this was nonetheless not enough to prevent their final collapse and subsequent insolvency procedures.\textsuperscript{49} Hundreds of insolvency procedures were initiated under numerous jurisdictions around the globe, as Lehman’s subsidiaries were collapsing one after the other.\textsuperscript{50}

A week after Lehman’s bankruptcy filing, Nomura Holdings announced its decision to acquire Lehman’s Asia Pacific franchise – trading assets or trading liabilities excluded.\textsuperscript{51} In early October 2008, Nomura also struck a deal regarding the acquisition of Lehman’s investment banking and equities businesses in Europe and the Middle East.\textsuperscript{52}

\subsection*{1.2.4 The fate of LBI}

LBI was a wholly owned subsidiary of LBHI and the most significant entity for Lehman Brothers in the US. A broker dealer, registered under US law, it offered mainly prime brokerage services for a large number of hedge funds.

\begin{itemize}
\item \textsuperscript{45} Kennedy, Morcroft & Schroeder, 2008.
\item \textsuperscript{46} Berenson, 2008.
\item \textsuperscript{47} Gangahar, 2008.
\item \textsuperscript{48} Ayotte & Skeel, 2010, p.494.
\item \textsuperscript{49} By the time of its bankruptcy filing, the firm operated a vast and complicated network of some 2,985 legal, both regulated and unregulated, entities in approximately fifty nations, BCBS, 2010c, p.14.
\item \textsuperscript{50} Various Lehman entities have been wound down in jurisdictions like the United Kingdom, Hong Kong, Germany, Luxembourg, Bermuda, Japan and Australia, \textit{ibid}, p.15.
\item \textsuperscript{51} Nomura, 2008a.
\item \textsuperscript{52} Nomura, 2008b.
\end{itemize}
LBI had a central position in Lehman’s corporate structure as it entered into transactions with other Lehman’s subsidiaries and affiliates.\textsuperscript{53} It was considered a focal point within the firm regarding operations and information regarding the brokerage business. Most importantly, it operated a vast network of its own subsidiaries, which were part of Lehman’s daily business and were financed through liquidity infusions from LBHI.\textsuperscript{54}

Despite the LBHI collapse on 15\textsuperscript{th} September 2008, LBI remained solvent and continued its operations with the FRBNY providing the necessary liquidity for its business. The FRBNY, as well as the SEC, stepped in to reorganise LBI. The US authorities were determined to protect LBI from bankruptcy; thus, the FRBNY provided LBI with $48 bn via the PDCF mechanism, which has been established earlier that year during the Bear Stearns crisis.\textsuperscript{55} This secured funding would remain at LBI’s disposition for a period of no longer than two weeks.\textsuperscript{56}

Barclays, which remained interested in expanding its North American brokerage operations, began to reconsider the deal regarding the acquisition of the LBI. Negotiations for the acquisition of LBI started soon after Lehman’s bankruptcy filing, and resulted in the terms of an agreement signed on the 17\textsuperscript{th} of September 2008 – known as the ‘Asset Purchase Agreement’ (APA).\textsuperscript{57}

Meanwhile, the FRBNY requested Barclays to substitute the bank in its role regarding LBI’s overnight financing. On 17\textsuperscript{th} September 2008, the two parties signed the so-called ‘Replacement Transaction’.\textsuperscript{58}

Two days after the signature of the APA, Barclays and LBI entered into new negotiations alone, without the involvement of the authorities. These negotiations culminated in the transfer of two additional sets of assets to

\textsuperscript{53} It cleared transactions for the hedge fund business of Lehman’s UK broker dealer, LBIE, and it was also the clearing broker for Neuberger Berman, GIDDENS, 2010, p.40.

\textsuperscript{54} Ibid, p.54.

\textsuperscript{55} Regarding the creation and role of the PDCF mechanism see p.35.

\textsuperscript{56} VALUKAS, 2010, p.2118.

\textsuperscript{57} Asset Purchase Agreement, 2008, p.45.

\textsuperscript{58} According to the agreement, Barclays was now the sole responsible for LBI’s financing, despite the fact that the deal for the acquisition had not been yet approved by the Bankruptcy Court. As compensation for taking its position and in order to sweeten the deal, the FRBNY would provide to Barclays all of the LBI’s securities that had been pledged as collateral to the FRBNY, VALUKAS, 2010, pp.2161–62.
Barclays. These transactions, called the ‘Barclays Repurchase Agreement’, provided the basis for the conclusion of a ‘Clarification Letter’ regarding the APA, which was executed by the parties on 22\textsuperscript{nd} September 2008.

Under pressure in light of the situation facing the US financial markets, the Court issued a sale order on 20\textsuperscript{th} September 2008, approving Barclays’ acquisition of almost all of LBI’s assets and liabilities transferred to Barclays. The remaining parts of Lehman’s broker dealer were subject to the proceedings under the Securities Investor Protection Act (SIPA) and a trustee was appointed to manage the liquidation.

\textbf{1.2.5 Litigation regarding the sale to Barclays}

The frantic negotiations of the US authorities to hastily conclude the transfer of LBI’s business to Barclays and to ensure the orderly winding-up of the remaining parts of the broker dealer led to contentious debates. The litigation before the New York Bankruptcy Court between the debtors, the SIPA trustee and Barclays is an illustrative example that the sale of LBI cannot be considered an outright success.

Given the short time frame within which the agreements with Barclays were drafted, and the ongoing bankruptcy process for LBHI, important mistakes occurred. As a result, the Valukas Report mentioned explicitly that limited assets belonging to specific LBHI’s subsidiaries and not to LBI were swept up in the transfer to Barclays.\textsuperscript{60} Given that the management of clients’ assets was organised along complex business and corporate structure lines, it was simply not possible, even for Lehman Brothers, to identify and separate its subsidiaries’ assets at such short notice.

The principal ongoing legal conflicts between LBI and Barclays focus, however, on the assets that had been transferred under the ‘Clarification Letter’, as well as the compensations due to certain LBI employees.

In effect, Lehman was requesting that the Court force Barclays to hand over “the immediate, undisclosed, multi-billion dollar windfall gain” – a total of $13 bn, which the British group had received under the

\textsuperscript{59} These assets were the excess amounts in Lehman’s 15c3-3 customer reserve accounts and a mix of additional securities, \textit{Barclays, Letter Agreement}, 2008, p.4.

\textsuperscript{60} Valukas, 2010, pp.1963–64.
‘Clarification Letter’ Agreement.\textsuperscript{61} It was Lehman’s view that it had sold its assets to Barclays at a severely discounted rate, well below their fair value. Moreover, the content of this ‘Clarification Letter’ had never been submitted to the Court for approval, thus, Barclays could not impose any alterations to the initial APA.

The Court proceeded to examine Lehman’s claims regarding Barclays’ windfall gain from the sale.\textsuperscript{62} It accepted that “errors, omissions and miscommunications were bound to occur” and that “it was impossible to precisely determine the fair value of all of the assets that were being transferred”.\textsuperscript{63}

Furthermore, despite the fact that the ‘Clarification Letter’ had never been brought before the Court for formal approval, Judge Peck concluded that since “the parties have relied on the Clarification Letter as a binding and enforceable transaction document, and so despite the lack of formal approval, the Court is willing to do the same”.\textsuperscript{64}

All in all, LBI’s motion for Barclays to pay back the $13 bn in assets was rejected.

On 6\textsuperscript{th} June 2011, the New York Bankruptcy Court issued a new ruling with regard to the aforementioned matters, further clarifying its February 2011 judgment: Barclays was ordered to return a total of $2 bn in assets to the SIPA trustee, and also pay a 5% annual interest on this sum.\textsuperscript{65} Barclays immediately initiated an appeal to this decision.\textsuperscript{66}

In June 2012, Judge Forrest of the US District Court for the Southern District of New York ruled on Barclays’ appeal. Although she rejected

\textsuperscript{61} Demos, 2010.
\textsuperscript{62} As mentioned above, when Barclays stepped in FRBNY’s shoes concerning LBI’s liquidity financing, the British bank achieved an agreement so as to take out LBI’s liabilities from the FRBNY. Under this ‘Repurchase Agreement’ Barclays secured a $5 bn ‘buffer’ gain, between the $45 bn of LBI’s liabilities to the FRBNY and the $50 bn of collateral it asked LBI to pledge.
\textsuperscript{63} United States Bankruptcy Court Southern District of New York, 2011, p.17.
\textsuperscript{64} Ibid, p.27. He went on to clarify that “reliance is not, and ordinarily should not be, a substitute for actual approval, but the combination of circumstances surrounding the execution of the Clarification Letter leads to the conclusion that it is appropriate to treat this document as if it had been approved”.
\textsuperscript{65} Demos, 2011. After a set-off with assets owed by LBI, the British bank had to finally pay a net $1 bn.
\textsuperscript{66} Foley, 2011.
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Barclays’ claims regarding LBI’s customer reserve accounts, she over-turned Judge Peck’s judgment relating to approximately $ 3.5 bn in margin and other assets, as well as the previous ruling with regard to the sum of approximately $ 2 bn that Barclays had been condemned to pay back to the SIPA trustee. The SIPA trustee filed a notice of appeal regarding this latest ruling. The US Court of Appeals for the Second Circuit, however, rejected this appeal in August 2014, thereby affirming the US District Court’s ruling. Lehman’s trustee and Barclays decided to finally settle and end all ongoing litigations on 5th June 2015.

1.3 UBS crisis: the orchestrated intervention that rescued the Swiss banking sector

1.3.1 The model student that became a financial time bomb for the Swiss authorities

Up until 2005, UBS remained loyal to the conservative business style for which it was known, and which had allowed it to become one of the most respectable and successful actors in the international banking sector. The bank’s risk management methods were considered superior to those adopted by most market participants.

Determined to take over Wall Street, UBS invested $ 3.5 bn in June 2005 to create the Dillon Read Capital Management. This new venture – an in-house Wall Street hedge fund – heralded the start of a brand new banking era for UBS. The hedge fund soon started making significant bets on the booming US subprime mortgage industry. US mortgage securities

68 United States Court of Appeals for the Second Circuit, 2014. The Trustee highlighted that he has “appropriately reserved for the Appeals Court decision” and that the decision will not “impact distributions already completed” or “the planned first interim distribution to unsecured general creditors with allowed claims”, Giddens, 2014.
69 Despite the fact that UBS was occasionally criticised by the markets for its risk aversion practices, FINMA, 2009, p.22. In general, the limited risk appetite of the bank had always been an obstacle for more competitive growth strategies, Swiss Federal Banking Commission, 2008b, p.6.
70 Clark, 2008.
were offering very high yields, and most importantly, they were guaranteed by high credit ratings. Hence, they represented an excellent profitable investment opportunity, despite their inherent risk and the slow but considerable shifts in the US housing market.\footnote{Eventually, UBS’ portfolio included a high volume of mortgage-based assets, as well as asset-backed securities (ABSs) and collateralised debt obligations (CDOs) from the secondary market. At the onset of the crisis it was valued beyond $100 bn, \textit{Schwartz \& Werdigier}, 2008.}

After the second quarter of 2007,\footnote{Which proved to be the most profitable period for UBS’ Investment Bank division, \textit{Luc Thévenoz, The Rescue of UBS}, in \textit{Giovanoli \& Devos}, 2010, p.380.} the bank started facing massive losses and write-downs due to its huge subprime mortgage market exposure. UBS turned into the “\textit{worst-hit European firm in the credit crisis}”\footnote{\textit{Kennedy}, 2008.} and entered into a battle for survival with the support of the Swiss authorities – with both parties trying to work out the most suitable but also the most politically acceptable solution.

\subsection*{1.3.2 ‘Storms over the Alps’: The signs of an imminent disaster}

Looking at the events of 2007 and 2008, it is evident that the overall exposure to the US subprime market – mainly through the creation of the Dillon Read Capital Management hedge fund and serious management and information-sharing mistakes – resulted in the massive write-downs that brought UBS to the brink of collapse. With a huge portfolio of ‘toxic’, highly illiquid assets, UBS failed to adequately interpret the signs of the abrupt change and aggravating conditions in the markets in a timely manner.

Firstly, the creation of the Dillon Read Capital Management – a duplicate to UBS’ Investment Bank division activities – proved to be a vital strategic error: the bank had underestimated the complexities associated with the creation of this new entity. Its aggressive business strategies were in sharp contrast with the bank’s conservative risk-taking tradition.\footnote{In retrospect, it became clear that the hedge fund was very hastily established, without being equipped with sophisticated risk detection and risk management mechanisms, \textit{UBS, Report on Write Downs}, 2008, p.33.} Moreover, this ambitious but legitimate strategic decision of UBS considerably
weakened its Investment Bank division, with numerous staff members as well as funds drawn to the new entity.\textsuperscript{75}

In addition, the bank was suffering – unaware – from vital structural deficiencies, primarily with regards to its risk assessment and risk management systems. The management of UBS relied heavily on the bank’s traditional risk control mechanisms; these had been largely focused on credit risk, much less so on general market risks.\textsuperscript{76} Furthermore, as was the case for most banks at the time, UBS attributed too much weight to classic risk evaluation practices. Most of these mathematical financial models failed to capture all the risks inherent in the mortgage-based products, and produced misleading impressions of the financial condition of many credit institutions.\textsuperscript{77}

As a result, the risks that had been inherent in or associated with betting on mortgage and other mortgage-based products were never adequately assessed. The aggressive growth strategies followed by UBS involved large transaction volumes of the aforementioned products, which also proved to be highly volatile following the sudden shifts in market trends. Over-confident with the fallacious robustness of the bank’s risk control mechanisms, and over-reliant on the excellent yet superficial ratings of the mortgage products, UBS was unwittingly incurring incalculable risks.

By late spring 2007, the possibility of important asset write-downs and further losses caused by the collapsing US subprime market had become a reality. In an unexpected – and considered by many to be embarrassing – move in May 2007, UBS decided to shut down the operations of the Dillon Read Capital Management despite fears of causing general disruption to the bank’s overall asset management activities.\textsuperscript{78} The hedge fund was then integrated into the division of the Investment Bank of UBS and its assets

\textsuperscript{75} During the period of the hedge fund’s operations, the risk control resources for the Investment Bank were steadily diminished, FINMA, 2009, p.30.

\textsuperscript{76} Due to its vast portfolio of ABSs and CDOs, UBS was severely exposed to independent macro-economic risks, which remained undetectable, Swiss Federal Banking Commission, 2008b, p.13.

\textsuperscript{77} FINMA, 2009, p.13.

were transferred to its sister company. Consequently, its huge financial problems weighed down on the activities of the Investment Bank.

With its shares declining steeply, at the end of 2007 the bank recorded staggering losses of CHF 4.4 bn.\(^7^9\) The bank also initiated a process of writing-down mortgage-based products – worth an estimated CHF 12.5 bn at the end of 2007.\(^8^0\)

In order to restore confidence to the markets, UBS decided to recapitalise its balance sheet in December 2007.\(^8^1\) However, these measures were insufficient in resolving the bank’s internal crisis.

In April 2008 the bank announced a net loss of CHF 12 bn and write-downs of $ 19 bn for the first trimester of 2008.\(^8^2\) Compared to their record high in 2007, UBS’ share prices had fallen more than 60% since the beginning of the year.\(^8^3\)

From early 2007 and up to September 2008, UBS recorded $ 42.8 bn of write-downs due to its subprime market exposure and faced continued liquidity hemorrhage.\(^8^4\) As it became clear that private investors were unwilling to invest fresh capital in the bank, UBS formally requested the assistance of the Swiss authorities on 14\(^{th}\) October 2008.\(^8^5\) The measures were finalised and approved the following day, and were made public on 16\(^{th}\) October 2008.

1.3.3 ‘Kein Grounding’: the rescue of UBS

The rescue of UBS was innovative in the sense that the authorities avoided intervening directly or having to subsequent nationalise the bank, as it had been the case for most European or US financial institutions in distress. On the premise that the nationalisation of UBS would have been

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\(^7^9\) BNS, rapport sur la stabilité financière, 2008, p.20.

\(^8^0\) Ibid.

\(^8^1\) The bank created conditional share capital for the issuance of mandatory convertible notes with a value of CHF 13 bn acquired by the Government of Singapore Investment Corporation Pte Ltd and an undisclosed investor from the Middle East, UBS, 2008.

\(^8^2\) BNS, Rapport Sur La Stabilité Financière, 2009, p.21.

\(^8^3\) Kennedy, 2008.

\(^8^4\) Swiss Federal Banking Commission, 2008b, p.4.
unacceptable for both Swiss politics and the public, the Swiss authorities had to adjust their plans for rescuing UBS.

The rescue package that was finally implemented followed two main axes: a) a recapitalisation of the bank with the injection of CHF 6 bn in Mandatory Convertible Notes (MCNs) by the Swiss Confederation and b) the transfer up to $60 bn of the bank’s mortgage-based and other highly illiquid assets to a separate fund that would be guaranteed by the SNB.\(^{86}\)

UBS signed a term sheet with the SNB that laid out all of the clarifications and requirements with regards to the purchase of its toxic assets portfolio. This Stabilisation Fund (StabFund)\(^{87}\) acquired the aforementioned assets according to their value on 30\(^{th}\) September 2008.\(^{88}\) Despite the initial will to transfer as much as $60 bn of assets to the StabFund, the final value of the portfolio was estimated at $38.7 bn.

UBS contributed 10% to the StabFund, with the SNB contributing the remaining 90% under the form of a loan. UBS’ minor contribution was regarded by the SNB as a first guarantee against potential losses. The duration of the loan was fixed at eight years, with the possibility for an extension to ten or twelve years. As a second safety measure in case of losses following the liquidation of the fund, the SNB received a warrant of 100 million UBS shares.\(^{89}\)

The SNB retained the complete control of the StabFund, which it acquired for the nominal price of one US dollar. The operational management

\(^{85}\) NZZ, 2008.
\(^{86}\) The concept of the recapitalisation was combined with that of a ‘bad bank’. As a result, UBS would be able to dispose of its toxic portfolio, deleverage its balance sheet, minimise its risk exposure and consequently regain the confidence of the markets.
\(^{87}\) The initial goal for the StabFund was for it to be incorporated as a limited partnership company in the Cayman Islands. However, and mainly due to political reasons, the StabFund was incorporated as a limited partnership company for collective investment under Swiss law, although such a legal form had been untested to that point under the 2006 Federal Act on Collective Investment Schemes, Luc Thévenoz, The Rescue of UBS, in Giovanoli & Devos, 2010, p.383. The new entity was licensed on the 25\(^{th}\) of November 2008 and its constituent partners were two Swiss companies, StabFund GP AG Berne and LiPro LP AG Berne, BNS, 101\(^{e}\) rapport de gestion, 2008, p.79.
\(^{88}\) The value of the assets to be transferred was determined according to the evaluation standards used by UBS and an independent expertise followed by the SNB, BNS, 101\(^{e}\) rapport de gestion, 2008, p.78. This transfer was to be effectuated in three tranches from December 2008 until April 2009.
\(^{89}\) BNS, 101\(^{e}\) rapport de gestion, 2008, p.78.
of the fund’s portfolio had been delegated to UBS, with the bank subsequently passing this responsibility on a group of London- and New York-based specialists.\textsuperscript{90}

In August 2013, the SNB disclosed that the StabFund repaid in full the loan that been initially provided.\textsuperscript{91} Consequently, in November 2013, UBS exercised its right to repurchase the StabFund from the SNB. The latter made a final profit of $ 3.7 bn.\textsuperscript{92}

However, probably one of the most important guarantees for the SNB was the second part of UBS rescue plan; namely, the Swiss Confederation’s decision to directly participate in the recapitalisation of UBS with a contribution of CHF 6 bn. The Federal Council had maintained a limited role in the elaboration of the rescue package for UBS, since the process was directed mainly by the SNB and the SFBC. Nonetheless, and in an urgent manner, the Confederation also assumed its responsibilities regarding the Swiss financial system and offered fresh Tier-1 capital to UBS.

On 15\textsuperscript{th} October 2008, UBS entered into a Letter Agreement with the Confederation in order to define the terms concerning the receipt of the notes. The Confederation subscribed sixty Mandatory Convertible Notes (MCNs), each one denominated for CHF 100 mn, mandatorily convertible into registered shares of UBS.\textsuperscript{93} If the notes were finally converted to common shares, the Confederation would acquire a stake of 9\% in the bank.\textsuperscript{94} The Term Sheet – undersigned by the two parties – also established an explicit process regarding how to evaluate conversion price of the notes in the event of their maturity.\textsuperscript{95} The parliamentary decree approving the transaction was issued on 15\textsuperscript{th} December 2008.\textsuperscript{96}

\textsuperscript{90} The US company Northern Trust had been designated as the custodian of the portfolio. The board of directors of the fund tried to dispose of any assets for which liquidation would be possible. Otherwise, it would continue their management until they reach a maturing point, BNS, 102\textsuperscript{e} rapport de gestion, 2009, p.84.

\textsuperscript{91} Swiss National Bank, 2013a.

\textsuperscript{92} Swiss National Bank, 2013b.

\textsuperscript{93} The Swiss Confederation/UBS, 2008, p.1. The maturity of the MCNs was fixed at thirty months. The payable annual interest was set at 12.5\%, high enough so as to take into consideration the risk of the Confederation in case of the notes’ conversion during a possible adverse future financial situation for the bank.

\textsuperscript{94} Panetta et al., 2009, p.22.

\textsuperscript{95} Ibid.

\textsuperscript{96} Assemblée fédérale, 2008.
Without the well-orchestrated intervention plan of the SNB, SFBC and Swiss Confederation, UBS would have most likely been doomed to financial collapse. From the beginning of 2007 to the middle of 2009, the bank recorded total losses and write-downs up to $53.1 bn.\textsuperscript{97}

1.4 Banco Espirito Santo: when bank resolution works reasonably well

1.4.1 Family liaisons that destroyed an empire

The Espirito Santo family was operating a corporate dynasty, established in 1869. This business empire comprised banking and industrial companies with interests in US real estate, energy, agriculture and African mines. The two ultimate holding companies of the group – Espirito Santo International and Rioforte Investments SA (the industrial part of the group) – were headquartered in Luxembourg. These holding companies fully owned Espirito Santo Irmaos SGPS SA, which in turn had a 49% stake in Espirito Santo Financial Group SA – another group entity established in Luxembourg.\textsuperscript{98} Finally, Espirito Santo Financial Group SA was the majority shareholder and held 25% in shares of Banco Espirito Santo, the second largest bank in Portugal.\textsuperscript{99}

Beginning in 2009, the entities of the Espirito Santo group entered into suspicious transactions with each other and began applying questionable accounting practices that amounted to what the Governor of the Banco de Portugal called “a fraudulent funding scheme”.\textsuperscript{100} Intertwined into this group scheme was a Swiss financial company, now called Eurofin Holding.\textsuperscript{101} Eurofin was essentially managing assets for the Espirito Santo

\textsuperscript{97} BNS, Rapport sur la stabilité financière, 2009, p.23.
\textsuperscript{98} Reis & Lima, 2014.
\textsuperscript{99} Johnson & Wise, 2014.
\textsuperscript{100} Da Silva Costa, 2014, p.5. The Governor of the central bank also highlighted that “international experience shows that these frauds are very difficult to detect before they collapse, in particular when activities are carried out in various jurisdictions”.
\textsuperscript{101} The Espirito Santo group used a group entity, Espirito Santo Resources, in order to acquire 23% of Eurofin in 2008, Kowsmann, Enrich & Patrick, 2014.
group, but was also involved in moving money between the different group entities, as well as selling billions of the group’s risky short-term debt to Banco Espirito Santo’s retail customers in Portugal.  

The explosion of the Eurozone sovereign debt crisis in 2009 and the subsequent bail-out of Portugal in 2011 resulted in additional capital and liquidity issues for the Espirito Santo group. The Banco Espirito Santo faced significant challenges in raising capital and debt from the financial markets. Consequently, the group entities – with the help of Eurofin – developed substitute solutions for their capital and liquidity needs.

From 2009 to 2011, Eurofin used two British Virgin Island-registered investment funds, which regularly bought debt issued from Banco Espirito Santo and then sold it to clients of the bank at double or triple the initial purchase price. At a certain point, Banco Espirito Santo began placing debt issued by other companies of the group into its own investment funds. One of these funds – Espirito Santo Liquidez – became the largest investment fund in Portugal, holding €1.7 bn of debt issued by different entities of the Espirito Santo group. At the same time, Banco Espirito Santo extended credit lines to other group-linked companies through a sister entity in Panama, transferring as much as €5 bn.

In this manner, Banco Espirito Santo and other entities of the same group received a continuous stream of liquidity when other Portuguese companies were struggling to survive amidst the on-going financial crisis. However, these voluminous transactions eventually started attracting the attention of the regulatory authorites.

In August 2013, the Portuguese Securities Market Commission, alarmed by the total amount of group-linked debt Banco Espirito Santo was selling to its clients, published a ban on groups placing more than one fifth of their own securities in fully-owned funds. The Banco de Portugal followed suit in December of the same year, requiring Banco Espirito Santo to limit its exposure to other Espirito Santo group-owned companies.

Following this requirement – and as the shareholding of Espirito Santo

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102 Ibid.
103 EG Premium and Zyrkan funds, ibid.
104 Johnson & Wise, 2014.
105 Ibid.
106 Ibid.
Financial Group SA in Banco Espirito Santo declined – Banco de Portugal limited its powers of consolidated supervision exclusively to the Banco Espirito Santo level.\textsuperscript{108}

From spring 2014 onwards, a full-scale audit had been implemented with regard to the accounting practices and irregularities of the Banco Espirito Santo. On 10\textsuperscript{th} July 2014, Banco Espirito Santo and KPMG announced that the exposure of Banco Espirito Santo to other group companies amounted to € 1.24 bn and, as a result, the potential negative impacts of this exposure could be sufficiently absorbed by the capital buffer of € 2.1 bn of the bank.\textsuperscript{109} In fact, the reality had been somewhat different.

New areas of exposure had been disclosed as Banco Espirito Santo could be eventually forced to buy back debt of group-linked companies that had been sold to its retail customers at inflated prices.\textsuperscript{110} Hence, on 30\textsuperscript{th} July the bank was forced to announce an additional loss of € 1.5 bn, ceasing to comply with the minimum solvency ratios in force under Portuguese law and losing liquidity access to the Eurosystem.\textsuperscript{111}

On the next day, growing uncertainty regarding the future of Banco Espirito Santo raised alarm among both the markets and the depositors of the bank leading to a decision to suspend its transactions. In order to avoid general panic and potential instability of the domestic financial system, Banco de Portugal decided to implement resolution measures against the bank on 3\textsuperscript{rd} August 2014.

The ring-fencing practices of Banco de Portugal implemented for Banco Espirito Santo since the spring 2014 and the resolution decision became the nail in the coffin of the Espirito Santo empire. Espirito Santo International, the ultimate holding of the group, asked for creditors protection under Luxembourg law in July 2014.\textsuperscript{112} Espirito Santo Financial Group SA, once the majority shareholder of Banco Espirito Santo, filed for bankruptcy in October 2014 also in Luxembourg.\textsuperscript{113} Sister entities of Banco

\textsuperscript{108} \textit{Banco de Portugal}, 2014a, p.11.
\textsuperscript{110} \textit{Kowsmann, Enrich & Patrick}, 2014. In addition, Banco Espirito Santo issued a comfort letter to creditors of another group entity, Banco Espirito International, amounting to € 267 mn, \textit{Banco de Portugal}, 2014a, p.5.
\textsuperscript{111} \textit{Banco de Portugal}, 2014b, pp.1–2.
\textsuperscript{112} \textit{Reis & Lima}, 2014.
\textsuperscript{113} \textit{Lima}, 2014.
Espírito Santo in Panama, Dubai and Switzerland have been since subject to local liquidation proceedings.

### 1.4.2 Resolution measures against Banco Espírito Santo

Portugal has had a bank resolution framework in place since 2012. Modifications with regard to bank resolution in the main banking act, the Legal Framework of Credit Institutions and Financial Companies were introduced under Decree Law No.31-A/2012. Further amendments concerning the operation of a resolution fund in Portugal were introduced under the Executive Order No.420/2012.

Under articles 145-G to 145-I of the Legal Framework of Credit Institutions and Financial Companies, Banco de Portugal opted for the establishment of a bridge bank. The new entity called Novo Banco has received Banco Espírito Santo’s main business and will manage the assets and liabilities transferred, until eventually sold to an interested third party. Prior consent of Banco Espírito Santo’s shareholders was not required for the implementation of bank resolution, although they were allowed to appeal the decision of Banco de Portugal before Portuguese tribunals.\(^{114}\)

Novo Banco has been duly capitalised through a capital provision of € 4.9 bn by the Portuguese resolution fund. Nevertheless, the fund had limited resources as it has only been operating since 2012. As a result, € 377 mn was transferred from the fund, with the remainder provided by the Portuguese government.\(^{115}\) It is important to highlight, however, that this sum represents a loan from the government and must be subsequently repaid through future contributions made by Portuguese financial institutions to the resolution fund, as well as through funds from the eventual sale of Novo Banco.

Banco Espírito Santo’s previous management was removed and, new management was appointed by Banco de Portugal.

The principal losses – estimated at € 10 bn\(^{116}\) – will be borne by shareholders and subordinated creditors. Shareholders may only be paid through the judicial liquidation proceedings that are currently taking place for that

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\(^{114}\) [Banco de Portugal, 2014a, p.20.]

\(^{115}\) [Ibid, p.12.]

\(^{116}\) [Johnson & Wise, 2014.]
part of Banco Espirito Santo’s business that was not transferred to Novo Banco. By and large, all of Banco Espirito Santo’s assets, licenses and property rights have been transferred to Novo Banco – with the main exception of shareholdings in Banco Espirito Santo subsidiaries in Angola, Miami and Libya, own shares of Banco Espirito Santo and credit claims of Banco Espirito Santo on specific sister entities of the Espirito Santo group. Deposits have been transferred in full to Novo Banco with the same balance, maturities and conditions; and all contractual conditions of credit formerly granted by Banco Espirito Santo remain unchanged.

Finally, with regard to the cross-border effects of the resolution measures put in place, there will be no implications for foreign depositors and customers of all Banco Espirito Santo’s branches and foreign subsidiaries (with the exception of the three subsidiaries in Angola, Miami and Libya). Novo Banco has become the new parent company of these entities.

1.4.3 Lessons for the future

With the resolution of the Banco Espirito Santo still ongoing (nine financial institutions demonstrate interest for an acquisition and seven of them submitted non-binding offers), it might be too early to draw conclusions concerning the actions of the Portuguese authorities or to talk about important lessons for the future. Nonetheless, the developments of the last months call for the following comments.

Banco de Portugal’s resolution decision has been a significant blow to the ‘too-big-to-fail’ regulatory approaches adopted in Europe following the explosion of the 2008 financial crisis and the sovereign debt crises in 2009. The Portuguese supervisor and competent resolution authority remained determined not to save the bank, despite its systemic importance for the domestic economy. The actions of Banco de Portugal should be hailed as the first signal of a shift in traditional regulatory approaches to systemic banks, and could serve as an example on future decisions regarding failing banks in Europe.

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117 Banco de Portugal, 2014a, p.8.
119 Banco de Portugal, 2014b, p.3.
Notwithstanding the fact that Portugal became subject to a bail-out in 2011, the collapse of Banco Espirito Santo did not spread panic to European markets: following the announcement of the resolution, Portuguese sovereign bonds remained stable and European stock indexes remained relatively unchanged.\textsuperscript{120} Therefore, the resolution of Banco Espirito Santo can become an example for the new Eurozone resolution mechanisms, demonstrating that rapid, robust and confident decisions are necessary amidst a crisis. If a bank is failing, regulatory forbearance should not be an option; rather swift actions will be required.

Furthermore, despite the international presence of Banco Espirito Santo, the repercussions have been minimal in other jurisdictions following the resolution decision. All branches and most subsidiaries have not been involved in the resolution procedure, and their business continued without no operational disruptions. Consequently, the resolution of Banco Espirito Santo could be viewed as a case in support of advocates of the Single Point of Entry resolution actions.

On the other hand, it is important to stress that the resolution of Banco Espirito Santo has not been entirely flawless. Once again, this case highlighted the questionable economic and accounting practices taking place in some modern groups; practices that contribute to contagion and may become the source of a financial collapse. Banco de Portugal only became aware of the financial troubles of Banco Espirito Santo and its majority shareholder, Espirito Santo Financial Group SA, very late on, despite having exercised the consolidated supervision of these two entities over a long time. Moreover, one week before the Banco Espirito Santo’s announcement of the projected losses jeopardising its survival, Banco de Portugal expressed its confidence that the bank would be able to raise the funding it required from the financial markets.\textsuperscript{121} This highlights the importance of effective supervision so that bank resolution procedures can be triggered appropriately.

In addition – and taking into consideration the origin of the funds – the financing of the resolution procedure represents a classic bail-out intervention. Certainly, it is encouraging that the newly created Portuguese resolution fund managed to raise €377 mn in only two years. Nonetheless,

\textsuperscript{120} The primary Portuguese index even rose 1\%, \textsc{Ewing}, 2014.
\textsuperscript{121} \textsc{Banco de Portugal}, 2014c.
the Portuguese state had to draw on the funds, which had been part of its
bail-out by EU and the IMF. One can only wonder how the situation
might have evolved, if the government had not had access to these funds.

In conclusion, despite the positive aspects of this resolution procedure,
the collapse of Banco Espirito Santo highlights the urgent need to move
more rapidly with regards to the development and implementation of bank
resolution rules.

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122 Portugal exited in May 2014 from a three-year bail-out program of € 78 bn, Bray, 2014.
Chapter 2

BANK RESOLUTION DEFINITION AND REGULATORY DEVELOPMENTS WITH REGARD TO BANK RESOLUTION REGIMES

2.1 Defining bank resolution

2.1.1 The existing definition on bank resolution

Most leading jurisdictions claim to be endowed with specific resolution mechanisms regarding the treatment of failing financial institutions. Notwithstanding the lack of a clear-cut definition on bank resolution in most cases, these resolution regimes seem to share certain similar characteristics. When one also considers the growing academic literature on bank resolution, one can get a basic description of bank resolution practices. However, it is a common feeling that most authors follow the current regulatory practice and almost voluntarily avoid a succinct or more elaborate definition on bank resolution. Instead, they limit themselves to a description of bank resolution characteristics or standards.

Recognising the complex issues that can arise from divergent practical and theoretical approaches, and in an effort to promote better harmonisation of rules, the Basel Committee on Banking Supervision provided in 2011 a definition on bank resolution. According to the Basel Committee, “the terms resolution and resolution regime are understood as referring to any action by a national authority, with or without private sector involvement, intended to maintain financial stability and/or address serious problems in a financial institution that imperil its viability (e.g. a substantive condition of authorisation) where, absent resolution, the institution is no longer viable and there is no reasonable prospect of it becoming so”.

1 BCBS, 2011, p.7. The FSB avoided presenting a common definition on resolution best practices. It rather limits its role to recommendations for the necessary elements of the resolution regimes. The EU considers bank resolution as a single element integrated in its more general efforts to establish a coherent cross-border framework of crisis management for banks. Consequently, it uses broad terms to define the
Based on these general conditions, and after having introduced more specific recommendations for the detailed characteristics of resolution practices, it became evident to the Basel Committee that few jurisdictions had actually put in place fully functional bank resolution regimes. It is clear that the definition put forward by the Basel Committee does not encompass all of the aspects that are necessary to distinguish a resolution procedure from any other crisis management regime. Despite the fact that the Committee provides a detailed framework of resolution characteristics through its consultation documents, the overall definition remains, by and large, incomplete, with several critical notions not mentioned.

On the other hand, it is inevitable that the Basel Committee or the FSB do not introduce an exhaustive resolution definition grouping all necessary characteristics. This would allow for a margin of flexibility that could result in the most efficient case-by-case treatment of ailing banks. State authorities could thereby better assess which solution from their legal arsenal would be the most suitable for each resolution case.

One might argue against the need for a clear-cut definition, so long as international bodies set general standards with regard to resolution practices – and, indeed, the Basel Committee and the FSB do so exceptionally well. However, it is important to always bear in mind that the general standards provided by these international bodies do not necessarily provide an exhaustive catalogue of what resolution should actually cover. In general, they should focus their efforts on creating a more detailed, commonly accepted international universal definition of bank resolution against which domestic or regional crisis management legislations can be formulated. The development of such a definition would help to overcome the challenges associated with differences between terminologies on bank resolution across jurisdictions. The failure to create a universal definition – and quickly – could hamper efforts to better align and harmonise rules.

The next sections touch briefly on those elements considered essential for the development of a common definition on bank resolution. It is argued that the core components of a revised definition on bank resolution should be: an efficient response to the puzzle of crisis management triggers as well as an emphasis on the administrative nature of the procedure, the

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2 The failure to create a universal definition – and quickly – could hamper efforts to better align and harmonise rules.

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specificities of resolution objectives such as financial stability and general public interest and the cross-border focus with regard to resolution consequences and spillovers. The unique characteristics of each of these elements are further elaborated upon in Parts II and III.

2.1.2 Fundamental elements of a definition on bank resolution

2.1.2.1 The administrative nature of bank resolution

First of all, for the majority of scholars and legal practitioners, the most distinctive characteristic of a resolution regime should be the presence of administrative authorities triggering and overseeing the resolution procedure. The term ‘national authority’ – which features in the Basel Committee’s definition of bank resolution – is very broad, to say the least.

According to the traditional approach influenced by corporate law, it remains common practice in numerous states to rely on the courts to initiate and implement a resolution procedure, since the latter are considered to be most competent authorities. With the judicial authorities being able to introduce elements of uncertainty and complexity at the resolution process, it is crucial to highlight the pre-eminence of the role of administrative authorities – most notably, the financial supervisory authorities; the central bank; the ministry of finance; or the deposit protection guarantee scheme. Depending on the resolution procedure, these aforementioned authorities may each have their own distinct role to play, or they may act collaboratively in order to achieve the desired result.

2.1.2.2 The specificity of bank resolution objectives

The Basel Committee’s definition is also somewhat ambiguous with regards to the objectives of bank resolution. Whilst specific crisis management

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3 A notable example in Europe has been Luxembourg, where, according to the art. 61 and 61-1 of the Financial Sector Act of 1993, the authority responsible for the process of the liquidation of a financial institution has been the court, Loi luxembourgeoise relative au secteur financier, art. 61-1. In addition, in Germany a higher court (Oberlandesgericht) is the last competent authority in line approving the implementation of the proposed resolution procedure, German Bank Reorganisation Act, §§ 7(3) & (4). Both EU member states will need to review their practices following the transposition of the EU Bank Recovery and Resolution Directive.
regimes aim to achieve financial stability, the primary concern of insolvency regimes is to protect creditors. However, the objectives of acting in the ‘public interest’ more broadly are far more wide reaching than the achievement of financial stability. For example, under this notion one may include the current trend to shift the attention from systemic financial institutions to systemic functions. Only such critical functions should be subject to bank resolution rules and be eventually safeguarded from the collapse of a failing financial institution.

Additionally, bank resolution should seek to promote solutions that will ultimately minimise the losses for the participating deposit guarantee schemes. For instance, depositors will maintain a privileged position compared to other bank creditors, despite the fact that their rights might be partially subject to resolution practices such as bail-in.

It is important to bear in mind that – once implemented – a resolution procedure can result in serious limitations regarding the full exercise of creditors’ and shareholders’ rights. Although the objectives of bank resolution are dissimilar to those of corporate insolvency, resolution measures should not result in arbitrary or disproportionate restrictions of such rights. A transparent and complete definition should also take into due consideration the necessary safeguards against resolution authorities potentially violating their mandate.

### 2.1.2.3 The triggering point of resolution procedures

The triggering points signaling when resolution authorities should intervene are not adequately described. A definition on resolution should draw a clear line between resolution practices and bank insolvency more generally – the latter leading to ordinary bankruptcy procedures. The wording “the institution is no longer viable” – in particular – can create serious confusion, since the term viability may be open to misinterpretation. It is not clear, for example, if this refers to a financial institution in the pre- or post-insolvency stage. Resolution thresholds should provide legal certainty, transparency and predictability for market participants and resolution authorities. Furthermore, if the authorities hold off intervening until the financial institution in question no longer has any reasonable prospect of becoming viable in order to implement resolution, their intervention will
inevitably come at a very late stage.\textsuperscript{4} At that point, the financial institution might have become already insolvent and resolution will be an unnecessary process instead of actual liquidation.

The corollary statement provided by the FSB regarding the BCBS’ definition of bank resolution contributes to additional frustration, highlighting that “the resolution regime should provide for timely and early entry into resolution”.\textsuperscript{5} Such an element of the definition could result in confusion between the notion of resolution and the legal concept of recovery.\textsuperscript{6} Consequently, the line between distinct legal phenomena remains ambiguous.

Whilst there are important differences between bank resolution procedures versus bank recovery and bank insolvency measures, these concepts are not mutually exclusive. Rather, each of these three crisis management stages – as the tools available for the holistic treatment of any financial challenge jeopardising financial stability – should be viewed as linear in nature. With the onset of initial financial troubles, financial institutions should put into place appropriate recovery and stabilisation measures. If these measures fail to safeguard the stability of the banking business, and the financial institution approaches the point of non-viability, bank resolution measures should be called into action in order to shield the existing concern and protect any systemic functions. Any other residual, non-systemic parts of the failing financial institution should be subject to winding-up procedures. Such procedures should, however, be initiated immediately if the financial institution has already reached a point of genuine insolvency and it will be impossible to safeguard any of its business parts as a going concern.

A sharper distinction is required, however, between bank resolution and the phenomena of bank recovery and winding-up. This is a great challenge for most jurisdictions as the issue is narrowly correlated with the moment of initiation of the various crisis management triggers. A clear response to the puzzle of crisis management triggers will greatly facilitate the process of setting the boundaries for the bank resolution definition. The FSB and the Basel Committee should provide more straightforward

\textsuperscript{4} Goodhart, 2012, p.603.
\textsuperscript{5} FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.7.
\textsuperscript{6} Institute of International Finance, 2012, p.37.
guidelines regarding where one should draw the line between the different crisis management stages.

2.1.2.4 No public funding

The Basel Committee’s definition mentions that resolution can take place “with or without private sector involvement”. In reality, however, this statement is not entirely true. On the one hand, one cannot always guarantee a private sale or merger of a failing bank or certain of its entities. In this scenario, the state resolution authorities will be obliged to create a bridge bank or to split the troubled financial institution into a ‘good’ and ‘bad’ bank without any private sector involvement. On the other hand, even in these two cases, the solution adopted by the resolution authorities will be temporary: the bridge – or ‘good’ – bank should eventually be sold to a private third party with an interest in acquiring them.

The fundamental role of the private sector in bank resolution will be much more dominant regarding the financing needs of the procedure. Following the extensive bail-out ‘fatigue’ of national treasuries and taxpayers worldwide, it has been maintained that the banking sector itself should bear the cost of its failures entirely. Bank resolution procedures will materialise such declarations through the suggested resolution funding mechanisms. Ideally, then, bank resolution should become entirely independent from public financing.

First and foremost, the failing bank in question – and in particular its shareholders and creditors – will cover a significant part of its losses. The introduction of bail-in mechanisms (described in chapter 6) will result in the wipe out of shareholders and the conversion or write-down of important parts of the debt of the bank under resolution. In this way, the financial situation of the bank can be stabilised and the resolution authorities will gain valuable time in order to organise their subsequent actions. In addition, bail-in will become a crucial recapitalisation mechanism for a bridge bank or ‘good’ bank resulting from a resolution procedure.

At a second level, since resolution costs may prove quite onerous, resolution funds should contribute to the financing of resolution schemes. These funds will be financed exclusively through contributions made by the banking sector. Partial contributions under specific conditions from the domestic deposit guarantee schemes may be also envisaged.
Consequently, the funding of resolution procedures will be dissociated from public finances. Such an element should be explicitly included as part of the definition in order to highlight the importance of private sector involvement. As demonstrated in chapter 9, state financing should be a last resort measure, especially during the phase-in period of resolution funds. It is important, however, that this should not reduce the significance of the role of bail-in and resolution funds. One should take into consideration that the current legislative developments under bank resolution regimes have already resulted in a shift in regulatory and market mentalities away from unrestricted bail-outs and towards a broad endorsement of the ‘polluter pays principle’.

2.1.2.5 Cross-border considerations

Reflecting on the cross-border structure of many financial institutions, and the significant cross-jurisdictional spillover effects from the reactions of many state authorities in 2008, it would be wise – when developing a definition of bank resolution – to make reference to cross-border externalities. The omission of such a reference tends to underplay the importance of the challenges posed by such cross-border externalities. In most cases, all resolution objectives will be subject to interpretation and prioritisation according to domestic considerations. Neglecting to adequately consider cross-border factors could become once again a basis for the justification of ring-fencing practices and isolated solutions, which disregard the overall impact of resolution practices.

It is true that not all banks have cross-border activities, or that bank resolution is a concept applicable for every (domestic and international) financial institution. Notwithstanding this fact, bank resolution regimes are destined to bring about a new era in cross-border coordination, cooperation and information exchange policies prior to – as well as amidst – financial crises. For this reason, cross-border considerations should be reflected in the definition of bank resolution regimes.
2.2 Domestic bank resolution regimes

2.2.1 The US resolution system

2.2.1.1 The Dodd-Frank Act

“Never again will the American taxpayer be held hostage by a bank that is too big to fail”?

Barack Obama, January 2010

During the 2008 financial crisis, it became clear to the US authorities that they lacked the ability to step in and resolve investment banks like Lehman Brothers or Bear Stearns. Whilst the FDIC had some 75 years of experience in bank resolution, its role and mandate were limited to failed depository institutions. Operating under the FDIA, the FDIC has been a credible mechanism for the resolution of credit institutions, although its powers have never been called into action during a cross-border crisis.

Efforts on the part of the US government to better regulate Wall Street and establish a credible resolution regime for non-depository banks resulted in the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (herein referred to as the Dodd-Frank Act, or Dodd-Frank). Signed into federal law by President Barack Obama on 21st July 2010, Title II of this Act (‘Orderly Liquidation Authority’) represents the core of the proposed bank resolution procedure for investment banks.

8 FDIC, 2011a, p.31.
9 Prior to 2008, the largest resolution in the US history was the failure of Continental Illinois in 1984, which sparked the debate concerning SIFIs in the US and called for significant amendments to the FDIA, Heidi Mandanis Schooner, U.S. Bank Resolution Reform: Then and Again, in Lastra, 2011, p.404. These reforms regarding US credit institutions were largely untested before the crisis, as until 2007 there have been a few but rather minor cases of bank failures.
10 The main policy goal of Title II of the Dodd-Frank is “to provide the necessary authority to liquidate financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimises moral hazard”, Dodd-Frank Act, Title II, § 204(a).
Without entering into much detail regarding the proposed resolution rules, we should focus on certain key elements of the Act.

The scope of application of this Act – as defined in Section 201(a)(11) – covers financial companies that are organised under US federal or state law. As such, it can apply to bank holding companies, non-bank financial companies, broker/dealers as well as certain subsidiaries of the latter. The Secretary of the Treasury is responsible for determining the systemic risk, and will decide whether the resolution triggers introduced under the Act are fulfilled in order to allow the commencement of the process.\textsuperscript{11} Once the decision is taken to enter into resolution proceedings, the FDIC will be appointed as a receiver and will have the power to exercise full resolution powers and impose losses on creditors and shareholders.\textsuperscript{12}

According to the Dodd-Frank Act, the FDIC can impose: a merger with a sound financial institution; organise a sale of business assets to third-party private purchasers; or create a bridge bank. Any judicial action against the covered financial company can be suspended,\textsuperscript{13} and early termination rights under set-off and close-out netting contractual clauses could be subject to a temporary stay.\textsuperscript{14}

Regarding resolution funding, the FDIC – upon its appointment as a receiver – may make available to the receivership funds for the orderly liquidation of the financial company.\textsuperscript{15} The exceptional element of resolution funding has been the creation of an Orderly Liquidation Fund (OLF) under Section 210(n) of the Act. The OLF has broad funding discretion covering: payment of administrative expenses; purchase or guarantee of assets; provision of loans; taking liens on assets; and making additional payments to certain creditors. During the first 30 days immediately following the appointment of the FDIC as a receiver, the US Treasury can provide funding for up to 10\% of the total consolidated assets of the firm.\textsuperscript{16} As soon as the fair market value of the total consolidated assets is determined, the

\begin{itemize}
  \item[$\textsuperscript{11}$] Ibid, § 203(b).
  \item[$\textsuperscript{12}$] Ibid, § 204(b).
  \item[$\textsuperscript{13}$] Ibid, § 210(a)(8)(A).
  \item[$\textsuperscript{14}$] Ibid, § 210(a)(10)(B).
  \item[$\textsuperscript{15}$] Ibid, § 204(d). These funds will be given priority as administrative expenses of the receiver or as amounts owed to the US when used for the orderly liquidation.
  \item[$\textsuperscript{16}$] Dodd-Frank Act, Title II, § 210(n)(6)(A).
\end{itemize}
funding from the Treasury can be equal to 90% of the aforementioned amount.\(^{17}\)

Under the requirements of the Dodd-Frank Act, payment to financial institutions is subject to prior agreement between the FDIC and the Secretary of the Treasury concerning the elaboration of a plan for the resolved financial institution. This plan must outline a five-year timeframe for repayment of the Fund.\(^{18}\) Thus, the Act has introduced a safeguard for the pledge of public money – although a plan might not always develop over a five-year period as expected.

All in all, the Act has been promoted as the key to an orderly resolution of investment firms and bank holding companies, thereby safeguarding US financial stability.\(^{19}\)

### 2.2.1.2 An incomplete reform

The significant changes to financial regulation in the United States brought about by Dodd-Frank affect a vast array of financial activities. The implementation of the Act will lead to significant changes on the daily operations and business lines of Wall Street banks and other intermediaries. The Act complements the existing broad resolution powers that the FDIC already enjoyed under the FDIA. Consequently, the US system is now endowed with a consolidated resolution system covering any financial company – from credit institutions to broker/dealers, and even their non-bank subsidiaries: the only domestic resolution regime to date regulating such a broad array of financial companies. The FDIC remains the head of resolution procedures, possessing a great variety of legal powers.\(^{20}\)

\(^{17}\) Ibid, § 210(n)(6)(B).

\(^{18}\) Ibid, § 210(n)(9)(B).

\(^{19}\) FDIC, 2011b, p.48. As the US President Barack Obama stressed out, the Dodd-Frank has been a “sweeping overhaul of the US financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression”, Remarks by the US President on the 21st Century Financial Regulatory Reform, The White House (17/06/2009), cited in Buckley & Arner, 2011, p.185.

\(^{20}\) FDIC’s former chairman, Sheila Bair, insisted that she maintained the legal power and the resources to shut down any financial institution, no matter how big, The Economist, 2011, p.23.
Nonetheless, Dodd-Frank is considered an incomplete regulatory reform: certain provisions of the law remain cursory, nonspecific or obscure and critics have raised questions around their implementation in a future crisis.

One of the most fundamental criticisms of the law is that it has failed to simplify the complex US regulatory system. To the contrary, it maintained the multiplicity of regulators for the different financial companies.\textsuperscript{21} The overall multi-layered regulatory structure upheld by the Act has been criticised as cumbersome and extremely complex, and as providing the potential for extensive areas of overlap.\textsuperscript{22} This overlap might lead to challenges with coordination and cooperation; one of the basic drawbacks of the financial regulatory schemes during the crisis.

Moreover, the final implementation of all Sections of the Act has proved no easy feat. The Act required 533 rules and 60 studies to be written, as well as 93 Congressional reports to be completed in order to achieve full implementation.\textsuperscript{23} This process of rulemaking and studies’ preparation – involving the FDIC, the SEC, the Congress and the Federal Reserve – has proved to be a complex and time-consuming experience.

Furthermore, although the fundamental role of the FDIC guarantees the administrative character of the resolution proceedings, the courts will also remain present during the initial stage of resolution proceedings. In the event that the board of directors of the covered financial company does not provide its consent regarding the appointment of the FDIC as a receiver, the Secretary of the Treasury will be forced to petition the US District Court for the District of Columbia for an order establishing the receivership.\textsuperscript{24} The court should issue the order in 24 hours. The covered financial company, however, will be able to appeal, thus creating the potential for a protracted judiciary process.

One of the most significant weaknesses of the Act relates to cross-border crisis management and resolution. Specifically, Title II fails to capture the

\textsuperscript{21} The US regulatory system distinguishes between depository institutions, futures, securities and insurance. For the first three, regulation is exercised both on federal and state level, Giani & Crivellaro, 2014, p.101.

\textsuperscript{22} Buckley & Arner, 2011, p.199.

\textsuperscript{23} Title II on resolution is one of the less complex parts of the Act requiring 15 rules, 1 study and 2 Congressional reports, Center for Capital markets, 2012.

\textsuperscript{24} Dodd-Frank Act, Title II, § 202(a).
fundamental legal intricacies that can result from the cross-border implementation of the Act: it is overly concise with regards to the main elements of cross-border resolution – such as cooperation, information exchange, recognition and enforcement of foreign resolution measures.\textsuperscript{25} For example, only one brief subsection is devoted to the issue of coordination with foreign authorities. Whilst the FDIC is encouraged to cooperate as fully as possible in the resolution of any US financial company that has foreign assets or operations,\textsuperscript{26} the Act does not elaborate on the specifics of how the FDIC should fulfil this obligation in practice. There is no provision whatsoever under the Dodd-Frank Act that provides guidance on the recognition of foreign proceedings.\textsuperscript{27}

According to the final part of Title II, the Board of Governors of the Federal Reserve was asked to prepare a study on international coordination relating to the bankruptcy process for non-bank financial institutions. This study – published in July 2011\textsuperscript{28} – did not identify any comprehensive international cooperation mechanism designed to deal with the bankruptcy of non-bank financial institutions. It went on to present the legal loopholes impeding cross-border cooperation. Although the study did acknowledge that substantial efforts have been made at both domestic and international levels to correct these deficiencies, the text failed to put forward any proposals that could result in improved cross-border coordination.

Resolution funding will also remain an important issue. Despite the FDIC’s confidence regarding the institution’s powers and resources, it is debatable whether the funding provided by the FDIC – or the financing through the OLF – will prove adequate in providing stability to a failing cross-border US bank during resolution: many consider the FDIC’s estimations to be overly optimistic, creating a false illusion regarding its competences.\textsuperscript{29}

\textsuperscript{25} As Mandanis Schooner puts it, the Dodd-Frank provides only “a nod to international cooperation but nothing material”, Heidi Mandanis Schooner, U.S. Bank Resolution Reform: Then and Again, in Lastra, 2011, p.423.
\textsuperscript{26} Dodd-Frank Act, Title II, § 210(a)(1)(N).
\textsuperscript{27} The US Bankruptcy Code has useful regulations on this matter but it cannot be applied to the liquidation of banking institutions, BCBS, 2010c, p.28.
\textsuperscript{28} The study highlighted the fact that the primordial US based bank holding companies own over 6,000 foreign entities, Board of Governors of the Federal Reserve System, 2011, p.2.
\textsuperscript{29} The Economist, 2011, p.23.
Finally, the US resolution system seems conservative with regards to more radical resolution methods such as the use of contingent convertible debt or the bail-in schemes. US regulators have been notoriously reluctant to adopt such instruments.\footnote{Hansen, 2011.} Pursuant to Section 115(c) of the Dodd-Frank, the Financial Stability Oversight Council prepared a report for the Congress summarising its study on the feasibility, benefits, costs and structure of contingent capital requirements for nonbank financial companies and large, interconnected bank holding companies. In thirty pages, the Council highlighted its considerations regarding the characteristics of these financial instruments; the potential benefits and drawbacks from their use; as well as their constituent elements (pricing, conversion ratio, triggers, tax and accounting treatment). It concluded that “the issuance of contingent capital instruments could provide a useful tool for strengthening financial institutions’ capital positions and ability to withstand losses during times of financial stress”, as these instruments “have the potential to provide these benefits at a lower cost of capital than additional common equity issuances”.\footnote{Financial Stability Oversight Council, 2012, p.19.} Nevertheless, the Council stressed in this study that the US financial regulatory bodies should continue to conduct further research into the potential advantages and shortcomings of contingent capital instruments before deciding on their use by the US financial sector.\footnote{Ibid.}

Considering that the process of rulemaking and preparation of various studies is ongoing, the Dodd-Frank has consequently been described as nothing more than ‘a statement of intent’.\footnote{The Economist, 2011, p.3.} Whilst the Act extended the FDIC’s resolution powers over any financial company in the US, US financial regulatory and resolution practices continue to constantly transform and evolve. The Orderly Liquidation Authority affected the business model of US bank towards lower risk but its disciplining effect has been minimum for US SIBs.\footnote{Ignatowski & Korte, 2014, p.3.}
2.2.2 The UK Special Resolution Regime

2.2.2.1 The UK Banking Act

In the aftermath of the 2008 financial crisis, the UK authorities were confronted with the limitations of the UK Insolvency Act to effectively deal with the failure of financial institutions. This Act – in force since 1986 – had proved to be a useful tool, but it dealt exclusively with corporate insolvencies.\(^{35}\) The central role of the courts in the insolvency proceedings had been the main obstacle to rapid and efficient crisis management during a banking failure.\(^{36}\)

In the context of an ever-evolving regulatory landscape of international banking activities, the UK authorities were determined to swiftly address the deficiencies of the existing UK insolvency regime. The collapse of Northern Rock triggered discussions and lengthy negotiations among the authorities, which culminated in a proposal being put forth for a new Banking Act.\(^{37}\) The new UK Banking Act officially entered into force in February 2009 and established a Special Resolution Regime (SRR) for UK banks. The Act is considered to have a complementary position to the Financial Services and Markets Act of 2000.

It would be useful to highlight the most critical aspects of the first domestic bank resolution regime within the EU.

The UK Banking Act of 2009 has been one of the few examples of bank resolution legislation that actually offers a complete list of statutory special resolution objectives. The UK authorities will have to consider seven objectives prior to intervening and choosing a specific resolution power. These objectives refer – among others – to the financial stability of the UK; the protection of public confidence in the stability of the domestic banking

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\(^{35}\) Consequently, it failed to capture the specific challenges posed by bank insolvency, inhibiting an early and decisive preemptive action by the authorities, \textit{Campbell}, 2011, p.41.

\(^{36}\) As Mervyn King, the former governor of the BoE highlighted, the UK system for dealing with bank insolvencies was “\textit{markedly inferior to other countries and inadequate}”, \textit{House of Commons – Treasury Committee}, 2008, p.83.

\(^{37}\) Before the Banking Act of 2009, the UK authorities had adopted the Banking Special Provisions Act in February 2008 as a temporary measure, introducing resolution tools, that most of them were later reintroduced in the final Banking Act, IMF, 2011, p.21.
Despite being home and host to a large number of investment banking entities, the UK decided to limit the scope of application of the Banking Act. The financial institutions, which are subject to the SRR, are exclusively credit institutions, building societies and bank holding companies incorporated in the UK. Investment banks have been subject to a Special Administration Regime established in 2011 and focusing on the return of money and property held for clients. This procedure takes place following a special administration order issued by a court whereby a person is appointed as the administrator. As such, it is closer in nature to traditional reorganisation and insolvency proceedings and should not be confused with bank resolution schemes.

The most important aspect of the SRR is the entirely administrative procedure that it introduces for resolving banking failures. The three authorities responsible for the resolution scheme are the Prudential Regulation Authority (PRA), the BoE and the UK Treasury. Contrary to the previous proceedings under the UK Insolvency Act of 1986, there is no element of judiciary action.

Moreover, the role of each authority in resolution management is clearly circumscribed: the PRA is responsible to determine whether a bank is likely to default and to trigger the bank resolution proceedings; the BoE decides which resolution tools will be implemented in each case; and the UK Treasury is involved if public funds will be needed, mainly under the scheme of temporary public ownership. Although they each have distinct roles, the Act repeatedly calls upon the authorities to cooperate and exchange information during bank resolution.

In order for the UK authorities to exercise resolution powers, the UK Banking Act imposes two cumulative requirements: a) fulfilment of the general pre-conditions for any stabilisation power and b) fulfilment of

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38 UK Banking Act, §§ 4(4)–(8B). There is no explicit ranking among the objectives but each one should be balanced separately during a banking crisis.

39 For these last the only possible resolution tool is that of temporary public ownership.

40 It is interesting to notice that under Section 75 of the Banking Act, the Treasury has the power to modify, if necessary, UK legislation in order to enable the best use of the resolution powers under the Act. The Treasury made use of this option in the resolution of the Dunfermline Building Society in 2009, HM Treasury, 2010, p.25.

41 UK Banking Act, § 7.
specific pre-conditions regarding each of the available resolution tools.\textsuperscript{42} The choice of a specific resolution method by the authorities will therefore heavily depend on the actual financial condition of each bank.

The primary requirement for exercising a stabilisation power is the possibility of a likely default by the credit institution in question. This requirement has been criticised as overly vague and open to various interpretations.\textsuperscript{43} It is also interesting to note that Section 7(4) of the UK Banking Act might eventually influence and transform the concept of the LOLR: the PRA will be able to initiate resolution proceedings as soon as a bank resorts to financial assistance from the BoE or the UK Treasury, beyond the typical market assistance offered on general terms. This condition might force banking institutions to become extremely reluctant to resort to funding support by the BoE, as they might be confronted with an eventual resolution procedure.\textsuperscript{44}

When it comes to its resolution powers, the SRR was heavily influenced by the resolution tools already applied by the FDIC in the US under the FDIA.\textsuperscript{45} In general, the Act established provisions offering detailed information regarding property or shares’ transfers under each resolution method. Another element enhancing the continuity of systemic functions is the possibility for the UK authorities to impose a stay on the early termination of contractual rights that could otherwise jeopardise the outcome of the resolution process.\textsuperscript{46}

Finally, the Act offers explicit and broad protection to creditors’ rights through a transparent set of safeguards subject to various provisions. The UK authorities are obliged to avoid any cherry-picking practices of contractual arrangements during partial property transfers\textsuperscript{47} and creditors might even receive compensation if they received a less favourable

\textsuperscript{42} Ibid, §§ 8 and 9.
\textsuperscript{43} As highlighted by Attinger, this provision under Section 7(2) calls for swift, anticipatory actions by the authorities, Attinger, 2011, p.21.
\textsuperscript{44} Colin Bamford, Transparency and the End of Doing Good by Stealth, in LaBrosse, Olivares-Caminal & Singh, 2009, p.87.
\textsuperscript{45} The Act recognises the options of a sale to a private purchaser, the creation of a bridge bank and temporary public ownership. There is no explicit hierarchy among the resolution tools but the international debates and a comparison among the costs of the different options hint at a subtle preference for the private sale solution.
\textsuperscript{46} UK Banking Act, § 48Z.
\textsuperscript{47} Ibid, § 48.
treatment under resolution than they would have done if the bank had entered insolvency.\textsuperscript{48}

2.2.2.2 UK financial regulation and crisis management: a moving target

Peter Brierley expressed the view that the “\textit{SRR is at the forefront of best practice internationally}”.\textsuperscript{49} It is true that the UK was the first EU member state to react rapidly to the catastrophic consequences of the 2008 financial crisis, and in doing so laid the foundations for a new legal regime around bank resolution. The SRR was at one point even considered a piece of potential model legislation impacting the efforts for the creation of a consolidated EU resolution framework.\textsuperscript{50} However, the SRR is far from perfect: one might even argue these days that international developments in the field of bank resolution have surpassed it.

Home to a large volume of international investment banking activities, the UK decided to restrict the scope of application of the SRR: only credit institutions, building societies or bank holding companies (under specific conditions) have been subject to bank resolution under the UK Banking Act. Whilst it became clear – in 2008 – that investment firms can represent significant sources of systemic risk, these firms nonetheless remained subject to specific insolvency schemes in the UK (at this point in time, they cannot be regulated by the UK Banking Act).\textsuperscript{51}

The UK Banking Act might also be described as somewhat conservative, given that it was based on classic US resolution approaches. For example, resolution tools such as asset separation or bail-in instruments were absent from the legislation. The Act opted for temporary public ownership; a decision that has been met with much criticism, given that this resolution method not only has the potential to become a substantial moral hazard source, but also fails to provide the UK Treasury with a clear exit strategy following its involvement in the public ownership of a financial institution.

\textsuperscript{48} \textit{Ibid}, § 60.
\textsuperscript{49} Brierley, 2009, p.13.
\textsuperscript{50} IMF, 2011, p.22.
\textsuperscript{51} The IMF urged the UK authorities to contemplate an expansion of the SRR in order to cover the resolution of other potential SIFIs, not classified as credit institutions, \textit{ibid}, p.5.
Furthermore, some have criticised the Act for its soft threshold of imminent insolvency as a trigger for the commencement of resolution proceedings. Section 7(2) could provide important flexibility to the UK authorities, and more specifically to the PRA, which might unfortunately turn to arbitrary discretion. Hence, in order to avoid preoccupations of regulatory forbearance the PRA might decide to pull the plug too early. Soft thresholds might be much more practical during crisis management, but they need to be accompanied by appropriate safeguards that limit authorities’ discretion.

The simultaneous involvement of three authorities in bank resolution could potentially become a source of conflicts. Although their respective roles are clearly circumscribed, effective coordination between these authorities will be paramount. Yet the previous efforts of these three UK authorities to cooperate with one another – especially during the Northern Rock crisis – serve to illustrate how complicated such relationships can be. The old Tripartite arrangements between the UK authorities can be an indicator of the future problems that might result from the pluralistic structure of the current SRR.

Finally, the UK Banking Act has also proved deficient when it comes to cross-border bank resolution. For instance, although the Act applies explicitly to the resolution of the subsidiaries of foreign institutions that are incorporated in the UK, the text does not mention cooperation with foreign authorities at all. The SRR also includes the transfer of foreign property or rights and liabilities of a UK bank under foreign law, but it does not enter into any detail regarding how such transfers should be made in practice. Without introducing a process of cross-border cooperation,

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52 Andrew Campbell and Rosa Lastra, Definition of Bank Insolvency and Types of Bank Insolvency Proceedings, in Lastra, 2011, p.55.

53 Similar reservations about the complexity of the UK Resolution System have been voiced by the House of Commons Treasury Committee which noted: “We have some doubts about a system in which one authority decides whether or not to put an institution into resolution, another related institution decides what form such a resolution arrangement should take and a third is responsible for the decision to use public funds”, cited in Charles Randell, Triggers for bank resolution, in Kenadjian, 2012, p.121.


55 UK Banking Act, § 39.
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information exchange or recognition and enforcement of foreign resolution procedures, such provisions risk creating significant legal conflicts in the context of a cross-border crisis.

The transposition of the EU Bank Recovery and Resolution Directive by the UK has brought about important modifications to the UK Banking Act, and will address some of the aforementioned challenges. The main changes concern the introduction of two additional resolution tools: asset separation and bail-in.

With regard to the first, all or part of a failing bank or new bridge bank’s business will be transferred to an asset management vehicle that is wholly or partially owned and controlled by the BoE.\(^{56}\)

With regards to bail-in, the new provision of the UK Banking Act will follow the requirements of the EU Bank Recovery and Resolution Directive to the letter.\(^ {57}\) However, the UK government highlighted that it will not take advantage of the option provided in the EU Bank Recovery and Resolution Directive regarding the application of the bail-in provisions from the 1\(^{st}\) January 2016. UK bail-in rules are, therefore, likely to be realised by the 1\(^{st}\) January 2015.\(^ {58}\) On the contrary, the UK government is determined to delay the application of the rules on minimum requirements for eligible liabilities, which are part of the loss absorbing capacity of banks in resolution.\(^ {59}\)

The conditions necessary for triggering a resolution procedure will remain materially unchanged. The PRA (with regard to credit institutions and PRA-designated investment firms) or the FCA (for FCA-regulated firms) will determine whether a bank is failing or likely to fail.\(^ {60}\) The provisions of the EU Bank Recovery and Resolution Directive on the interpretation of the likely failure will be inserted in order to assist the authorities with their decision.\(^ {61}\) The BoE will decide whether any other private sector solution could be applicable for the failing bank.\(^ {62}\) The existing requirement for the PRA (or the FCA as the case may require), the BoE and the

\(^{56}\) The Banking Act Amendment Order 2014, § 12ZA. The asset separation tool may only be used in conjunction with another resolution tool.

\(^{57}\) Ibid, §§ 12AA, 48B and 48L.

\(^{58}\) HM Treasury, 2014, p.31.

\(^{59}\) Until the 1\(^{st}\) of January 2016, ibid, p.35.

\(^{60}\) The Banking Act Amendment Order 2014, §§ 7(1)(a) and (2).

\(^{61}\) Ibid, § 7(5A).

\(^{62}\) Ibid, §§ 7(1)(b) and (3).
Treasury to consult with one another before any resolution action can be taken will be maintained.\textsuperscript{63} All in all, the BoE will remain responsible for the exercise of any resolution tool.

Last but not least, resolution planning will become an exercise implemented exclusively by the BoE. The UK government will publish secondary legislation so that the UK resolution planning regime will become compatible with the requirements of the EU Bank Recovery and Resolution Directive.\textsuperscript{64}

2.2.3 The Swiss resolution package

2.2.3.1 Overcoming the ‘too big to fail’ problem

Switzerland received international praise for its response to the UBS crisis.\textsuperscript{65} During the 2008 crisis the odds were, however, stacked in favour of the Swiss authorities: that fact that they were confronted with an isolated crisis, affecting just a single financial institution, meant that they were able to contain the situation and its systemic implications more easily. The Swiss authorities actually possessed the resources necessary to absorb the costs associated with saving one bank. One can only wonder, however, how the situation might have played out had the situation within UBS been more critical when the authorities first became aware of it, or had another systemic bank been subject to the same – or worse – financial troubles.\textsuperscript{66} The rescue of UBS brought to the surface endogenous problems of the Swiss banking system and of the bank supervision regime. The Swiss authorities

\textsuperscript{63} Ibid, § 7(5E). The three authorities signed a new Memorandum of Understanding on Crisis Management in 2012 in order to better coordinate their actions for the stability of the UK financial system and avoid any fiasco similar to the Northern Rock crisis, HM Treasury, BoE & PRA, 2012.

\textsuperscript{64} HM Treasury, 2014, pp.7–8. For the time being, resolution planning requirements are not regulated under legislation but they are subject to supervisory practices. The PRA published policy statement PS8/13 and supporting supervisory statement SS19/13 on the issue of resolution planning, PRA, 2014, p.10.

\textsuperscript{65} Eckert & Ruetschi, 2009.

\textsuperscript{66} In such a scenario, the cost could overcome the fiscal capacities of the country, with certain analysts predicting significant financial depression or even a crisis as the one, which took place in Iceland, Tille & Wyplosz, 2010, p.23.
decided to respond with bold reforms, establishing a very comprehensive package of resolution measures.

A major error committed by the Swiss authorities in the period preceding the crisis had been an overreliance on the part of supervisory bodies on the financial data provided by the supervised financial institutions. In part, this was due to the fact that UBS was regarded as a ‘model student’ before the crisis.67 Moreover, the authorities did not question the risk evaluation and risk management systems of the bank sufficiently. Confident that UBS was in control of its subprime exposure, the supervisor as well as the central bank only became aware of the real risks that the bank was incurring at a very late stage.

Financial surveillance was strengthened with the creation of FINMA. This new Swiss supervisor stepped into the shoes of the SFBC, albeit with a reinforced mandate and stronger organisational structure, in order to harmonise the supervisory practices across the various Swiss financial sectors.68

Concerning the substantial changes in banking legislation, Switzerland introduced general reforms. These reforms were mainly in the field of capital requirements, but also included various special provisions covering exclusively SIBs.69

Recognising the systemic importance of the financial institutions deemed ‘Too Big to Fail’, the Federal Council issued a message three weeks after the UBS rescue highlighting its intentions for a new series of measures aimed at strengthening the Swiss financial system.70 Debates, information exchange and continuous redrafting by a commission of experts resulted in a final report that proposed amendments to the Federal Banking Act and the Capital Adequacy Ordinance so as to better cover the operations and potential financial problems within SIBs.71 The report was endorsed by the Federal Council on 13th October 2010 and was submitted for discussion to the two Chambers of the Houses of Parliament for discussion. The project was finally approved by the Swiss Houses of Parliament in September 2011,

69 Due to the particular characteristics of its domestic banking sector, with a large number of small banks and two international banking groups, it would have been impossible for the Swiss system to establish a ‘one size fits all’ solution.
70 Conseil Federal Suisse, 2008a.
Despite their divergent opinions on the matter. The modifications entered into force in March 2012.

The legal amendments to the Banking Act related exclusively to Swiss SIBs. Unlike most other domestic resolution regimes, this Banking Act provides a definition of systemically important banks as well as general criteria based on size, interconnectedness and substitutability in order to identify systemic importance. FINMA is the lead resolution authority but is obliged to work with the SNB in order to establish a coherent flow of information regarding its actions. It is stressed that SIBs should be subject to specific capital adequacy requirements so as to be able to maintain their systemic functions during a liquidity crisis, coping with any counterparty or systemic risk. FINMA specifies the particular measures that a SIB must adopt and will regularly evaluate the SIB’s ability to cope with a crisis. In the event that the SIB is unable to convince FINMA that the crisis management mechanisms it has in place are adequate, FINMA will apply the measures necessary to improve the SIB’s resolvability.

Switzerland was also the first jurisdiction to introduce statutory rules on bail-in. The modified Banking Act describes this possibility to implement debt-to-equity conversion or debt write-down with regard to a failing bank.

The most recent legislative proposal envisages the repeal of the Swiss Banking Act and the introduction of a new Act on Financial Institutions (LEFin/FINIG). All relevant provisions on Swiss SIBs will be included in this new Act.

A very interesting element of the new regime is the introduction of complementary capital buffers that will consist entirely of contingent convertible bonds (CoCos). CoCos can result either in debt conversion or debt write-down, and, consequently, new equity for the company in order to be able to confront the initial shock of a financial crisis.

It is also noteworthy that, although the creditors of a SIB will be able to challenge before a court the reorganisation plan for the bank approved

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72 Minsch, 2011.
73 Swiss Banking Act, art. 7(1) and 8(2).
74 Ibid, art. 9.
75 Ibid, art. 31(3).
76 Project for a Federal Act on Financial Institutions, art. 47–51 and 87–100.
77 Swiss Banking Act, art. 11.
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by FINMA, their actions will not suspend the procedures undertaken by the authorities.\textsuperscript{78} Hence, the resolution procedure will remain entirely administrative.

The Banking Ordinance also underwent modifications in order to accommodate resolution planning. Regarding these aspects, the Swiss resolution system differentiated slightly from the proposed international standards. Emergency plans (plans d’urgence) form the basis of resolution planning. In such plans, the SIB enumerates those measures, which must be adopted during a crisis in order to safeguard the continuity of its systemic functions.\textsuperscript{79} The plan is elaborated by the SIB but submitted to FINMA for evaluation. If FINMA considers a plan to be inefficient, it will fix an additional time period for modifications. If the SIB fails again to amend the plan, the regulator can enact various measures imposing even the divestiture of certain group entities or business lines.\textsuperscript{80}

Moreover, FINMA is entirely responsible for approving a recovery plan for each SIB and for creating a resolution plan, based on the detailed information provided by the bank regarding its corporate structure and business practices.\textsuperscript{81} The creation of recovery and resolution plans is a continuous exercise undertaken under the supervision of FINMA. The requirements of the Banking Ordinance on recovery and resolution planning entered into force in January 2013.

Furthermore, in early 2012, FINMA entered in consultations regarding the content of its Banking Insolvency Ordinance, which finally entered into force in November 2012. The Ordinance is not restricted to SIBs only, but applies to every Swiss bank. FINMA, when confronted with a future banking failure, now has a large arsenal of legal solutions at its disposal: among which is the option of a transfer to a private purchaser or the creation of a bridge bank.\textsuperscript{82} Besides the contractual conversion or write-down of CoCos under the Capital Adequacy Ordinance, the Banking Insolvency Ordinance puts into practice FINMA’s statutory bail-in powers.\textsuperscript{83}

\textsuperscript{78} \textit{Ibid}, art. 24(3) and (4).
\textsuperscript{79} \textit{Swiss Banking Ordinance}, art. 60(2). It is important to note that these plans will only cover the systemic functions and services of the bank located in Switzerland and not abroad.
\textsuperscript{80} \textit{Ibid}, art. 62(2). The list of measures proposed under the Ordinance is not exhaustive.
\textsuperscript{81} \textit{Ibid}, art. 64.
\textsuperscript{82} \textit{FINMA Banking Insolvency Ordinance}, art. 51.
\textsuperscript{83} \textit{Ibid}, art. 48 and 50.
In addition, appropriate safeguards for creditors’ rights were established in order to avoid arbitrary actions by the resolution authority. Certain classes of debt are not to be subject to bail-in powers and no cherry-picking of contractual obligations with a specific counterparty is allowed during the transfer of business of a failing bank. It is also interesting to note that during the transfer of business, FINMA is able to impose a maximum 48 hours stay on contractual early termination arrangements, thereby limiting any spillover effects from close-out netting and set-off agreements.

Finally, bold reforms were adopted with regard to the Capital Adequacy and Risk Diversification Ordinance. The new ‘Swiss finish’ imposes stricter capital requirements on Swiss banks than the conditions under Basel III. The Ordinance adopted the same minimum Common Equity Tier 1 (CET1) capital base as Basel III consisting exclusively of at least 4.5% of RWAs. SIBs should also maintain a capital conservation buffer of 8.5% of RWAs, 5.5% of which must be held in CET1 capital. 3% of the buffer can be held in the form of CoCos that have a relatively high conversion trigger, which will be activated as soon as common equity falls below 7% of RWAs. Additionally, SIBs also hold a progressive capital component that is fixed by FINMA once per year according to measurements of the size and market share of the entire banking group. The progressive capital component consists exclusively of CoCos, which have a low trigger and will be activated if common equity falls below 5% of RWAs.

In summary, Swiss SIBs will be obliged to hold capital of up to 19% of RWAs; 8.5% more than that required under Basel III. The transition to the new capital requirements will be in accordance with the Basel III timeline, with Swiss SIBs having to fully comply by January 2019.

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84 Ibid, art. 49(2) and 51(1)(h)(1).
85 Ibid, art. 56.
86 Swiss Capital Adequacy Ordinance, art. 128.
87 Ibid, art. 129(2).
88 Ibid, art. 130(1)–(2).
89 Ibid, art. 130(2).
90 According to the latest estimations, in 2019 UBS should have a total minimum capital of 19.2% of RWAs whereas Credit Suisse’s minimum capital should be around 16.7% of RWAs, FINMA, 2014, p.1.
Switzerland might also choose a stricter path with regards to the implementation of the leverage ratio. Although the Basel III proposal sets the leverage ratio at 3% of a bank’s assets, current discussions contemplate the introduction of a much higher leverage ratio for Swiss banks.  

2.2.3.2 Swiss banking: Crash-proof or handicapped?

Switzerland is a rare example of a country that was able to rise quickly from the ashes of the 2008 financial meltdown, and translate clear lessons learned from the crisis into radical reforms for the banking sector. Clearly, as a small state that is home to a vast spectrum of banking activities, Switzerland was forced to rapidly hedge its market from future shocks. The Swiss authorities have been highly successful in turning vague theoretical international standards into real life legal provisions, extensively and decisively regulating a broad array of aspects – from capital requirements, to bank resolution, and insolvency. Certain more radical ideas – such as calls for big banks to be dismantled, or for requirements imposing direct size restrictions – were finally rejected as disproportionate. The international community reacted positively to the Swiss regulatory measures.

Crucial to the smooth application of potential resolution proceedings is the choice of a single resolution authority. Switzerland decided that FINMA – its financial supervisory authority – should continue to be the lead authority with regards to all aspects of bank resolution. Although FINMA will have to consult with the SNB and the Federal Council on such serious matters, it will nonetheless have the ultimate authority on making the final decisions and ensuring their implementation. In this way, Switzerland was able to circumvent the complexities often associated with the coexistence of multiple authorities with different mandates (as manifested, for example, in the problematic cooperation between the UK

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91 The Socialist Party demanded an increase to 10% (Parliamentary Motion 13.3744) whereas Swiss People’s Party (the largest party) suggested a Supplementary Leverage Ratio of 6% (Parliamentary Motion 13.3740), Rochet, 2014, pp.29 and 32.
93 The FSB commended the Swiss authorities for rapidly developing such a comprehensive package of solutions for the ‘too big to fail’ problem, FSB, Peer Review of Switzerland, 2012, p.6.
94 The three Swiss authorities signed a trilateral MoU in January 2011.
It is also important that the resolution proceedings remain a purely administrative procedure, with no involvement whatsoever of the courts.

Moreover, Switzerland has been one of few jurisdictions to introduce provisions on resolution planning under its banking legislation; Swiss SIBs have been able to use the detailed information included under the articles of the Banking Ordinance as guidance when elaborating their emergency plans, for instance. However, there are some key differences between Swiss crisis management planning and the international standards proposed by the Basel Committee and the FSB. Namely, by focusing primarily on the creation of emergency plans to safeguard systemic banking functions, the process places much less emphasis on the actual resolution plans. However, resolution plans are of equal importance, since they will prepare a failing bank for the next day, following the implementation of resolution proceedings.

CoCos are undeniably the most innovative feature of the Swiss resolution package. Given that these financial instruments are relatively untested, it is too early to predict the reaction of the markets during a crisis. However, one should note that there is a risk that these instruments may add further complexity, since they will need to be compliant not only with Swiss regulations but also with Basel III standards.

In addition, one should not forget that the new Banking Insolvency Ordinance allows FINMA statutory bail-in powers. Article 50 of the Ordinance regarding debt write-down creates sweeping powers for FINMA that can even decide on a total write-down of a bank’s debt. The broad formulation of the article and the lack of any hints on safeguards against the potential actions of FINMA could become problematic, turning flexibility into arbitrary discretion.

Furthermore, in an era of globalised banking services, it is disappointing that the Banking Insolvency Ordinance touches cursorily upon the issue of cross-border cooperation.\(^{95}\) Hence, the Swiss resolution system reflects the classic single legal entity approach on bank resolution. Any consideration of resolution planning applied on a group basis is absent.\(^{96}\) It

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\(^{95}\) There is only a slight and very general mention to cross-border coordination, FINMA Banking Insolvency Ordinance, art. 9.

\(^{96}\) Actually, a rare legal provision where the notion of the group is highlighted can be found in the Swiss Capital Adequacy Ordinance, art. 123b.
is encouraging, though, that the Banking Insolvency Ordinance allows for a full application of its provisions for the Swiss property and assets of a foreign bank being subject to insolvency proceedings in its home state.\(^\text{97}\)

Another crucial issue that the latest legal amendments to Swiss legislation fail to adequately address is that of resolution funding. CoCos and bail-in are limited solutions providing temporary solvency relief to a bank in financial distress. They will not, however, generate additional liquidity. The actions of FINMA involving a transfer to third purchasers or the creation of a bridge bank will require substantial funding that cannot be met by taxpayers’ money. The search for a solution to the problem of inadequate funding is currently one of the hottest international debates and EU Member States will enter a process of creating domestic resolution funds. Taking into consideration that bank resolution can turn into a lengthy and costly process, Switzerland should be more actively involved in the debate.

Finally, it is important to highlight the new capital requirements that will be gradually imposed upon the Swiss SIBs. Holding more capital than their foreign counterparts under Basel III should make UBS and Credit Suisse crash proof. After all, a small state such as Switzerland cannot afford to be taken hostage once again by the problems of a big bank and risk financial collapse.

On the other hand, there are fears that the new capital adequacy rules might – in fact – hinder the profitability of the Swiss banking sector: some argued that it will prove too difficult to sustain such strict capital standards and that the investment banking arms of the two big Swiss banks might be forced to shrink or relocate as a result.\(^\text{98}\) In addition, Swiss SIBs might suffer from a severe international competitive disadvantage, since their foreign peers will be operating under less rigorous capital requirements.\(^\text{99}\)

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\(^{97}\) FINMA Banking Insolvency Ordinance, art. 10(1). The recognition of the foreign insolvency decision by FINMA is a preliminary condition.

\(^{98}\) The Economist, 2011, p.4. As identified by the OECD, both Swiss G-SIBs have reduced their balance sheets substantially following the financial crisis. In 2010, total assets of UBS declined more than 40% whereas Credit Suisse implemented a downsizing of 25%. In total, they reduced their balance sheets from almost 7 times GDP in 2007 to 4.26 times GDP in 2010, OECD, 2012, pp.17 and 51.

\(^{99}\) It has been demonstrated in practice that CoCos issued by Swiss banks present a risk cost difference of 200 additional basis points when compared with similar instruments issued by EU banks under Basel III capital requirements, Bätz, 2014.
The final choice of the Swiss authorities for the new ‘Swiss finish’ seems prudent. As a future banking failure cannot be excluded, Swiss SIBs should be properly hedged in order to avoid dragging the Swiss economy into new mishaps. It is too early to predict what impact – if any – the introduction of CoCos and very strict capital requirements will have on the competitiveness of Swiss SIBs.\textsuperscript{100} In any event, the results of the Swiss experience with CoCos has been welcomed by the international community. Initial indications were favourable.\textsuperscript{101} It will be interesting to see if Switzerland will become viewed as an international example, prompting bolder reforms in other jurisdictions – or if it will remain ‘a remote island in the risky waters of international finance’.

\textbf{2.3 Transnational debates on bank resolution}

\textbf{2.3.1 The Basel Committee on Banking Supervision}

\textbf{2.3.1.1 The Cross-Border Bank Resolution Group}

The Basel Committee has been a pioneer among international bodies regarding the development of substantive proposals in the field of financial crisis management. Although the recommendations issued by the Committee are in the form of soft law, and therefore not binding for its members, the Basel Committee in cooperation with the FSB has set crucial resolution standards that have led to substantial legislative changes in various jurisdictions.

The Committee first began exploring the use of bank resolution practices prior to the 2008 financial crisis, establishing its Cross-Border Bank Resolution Group in December 2007.\textsuperscript{102} The 2008 financial collapse called

\begin{footnotesize}
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  \item \textsuperscript{100} The Federal Council estimated that more stringent capital requirements will probably result in a diminution of credit provided by the two big banks, but the overall long-term benefits will be more significant for the Swiss market than the intermediate cost, \textit{Fischer}, 2011.
  \item \textsuperscript{101} FSB, \textit{Peer Review of Switzerland}, 2012, p.6.
  \item \textsuperscript{102} The clear aim of the Group was to “analyse the existing resolution policies, the allocation of responsibilities and the legal framework of relevant countries as a foundation to a better understanding of the potential impediments and possible improvements to
\end{itemize}
\end{footnotesize}
for urgent developments in the area of bank resolution and the Basel Committee responded rapidly to this challenge. It expanded the mandate of its Cross-Border Bank Resolution Group and required an analysis in developments and procedures of crisis management and resolution during the financial crisis.

The results of this analysis were published in a document in March 2010, in which the Cross-border Bank Resolution Group reported on and made recommendations concerning the evolution of bank resolution policies. Whilst touching upon different aspects of resolution proceedings, the clear focus of this document is on policies that could eventually minimise the existing impediments for the resolution of cross-border banking groups.

In this report, the Group highlighted that the “scope, scale and complexity of international transactions expanded at an unprecedented scale in the years preceding the crisis, while the tools and techniques for handling cross-border crisis resolution have not evolved at the same pace”. Based on the particular complexities posed by the failure of a cross-border bank failure, the Group formulated ten recommendation, which, if implemented effectively, could result in more rapid and efficient cross-border bank resolutions.

For each of the ten recommendations, the Group provided a concise analysis, with the cross-border elements remaining always at the core of its considerations. This report was the first document to elaborate on the issue of bank resolution, and greatly influenced the work of the FSB regarding the drafting of its Key Attributes. The ten recommendations were subsequently endorsed by the G20 heads of government at the 2010 G20 Toronto Summit, as providing the basis for future developments in bank resolution.

2.3.1.2 Basel III

Although the topic of this contribution is on cross-border bank resolution, the modifications of capital requirements introduced by the Basel
Committee are also of significant importance. After all, these regulatory standards, along with bank resolution policies, form a consolidated package of crisis management for the banking sector across all jurisdictions.

During the 2008 financial crisis, it became apparent that numerous global banks had built up excessive balance sheet leverage, were holding insufficient liquidity buffers and due to the massive contraction of liquidity and credit availability, they were confronted with a gradual erosion of the level and quality of their capital base. In December 2010 the Basel Committee issued detailed rules of new global regulatory standards on bank capital adequacy and liquidity that collectively are referred to as Basel III. Basel III represents a comprehensive set of reform measures to strengthen the global regulatory framework to ensure more resilient banks and banking systems. Its five principals are: a) to raise the quality, quantity, consistency and transparency of the capital base; b) to strengthen counterparty credit risk exposures and reduce pro-cyclicality so that the banking sector will work as a shock absorber and not as a transmitter of risk; c) to revise the leverage ratio (in order to constrain leverage); d) to introduce capital buffers built-up in good times that can be drawn upon in periods of stress; and e) to establish a global minimum liquidity standard. Basel III did not replace Basel II but it aims to fix the deficiencies of the previous capital regulatory schemes.

Essentially, the quantity, as well as the quality, of the regulatory minimum capital requirements (Tier 1 capital) have been improved; the Tier 2 capital instruments have been harmonised; and Tier 3 capital instruments have been abolished.

More specifically, the regulatory capital that banks must hold at all times consists of the Tier 1 and Tier 2 capital instruments. Tier 1 capital must be at least 6% of RWAs (out of which Common Equity Tier 1 must

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104 These recommendations cover 1) effective resolution powers, 2) frameworks for a coordinated resolution of financial groups, 3) convergence of national resolution measures, 4) cross-border effects of national resolution measures, 5) reduction of complexity and interconnectedness of group structure and operations, 6) planning in advance for orderly resolution, 7) cross-border cooperation and information sharing, 8) strengthening of risk mitigation mechanisms, 9) transfer of contractual relationships and 10) exit strategies and market discipline, ibid, pp.1–3.

105 Barfield, 2011, p.11.

be at least 4.5%) and the total minimum capital requirements (Tier 1 plus Tier 2 capital) must be at least 8% of RWAs.\textsuperscript{107} With regards to reforms of the quality of regulatory capital, the predominant form of Tier 1 capital must be common shares and retained earnings.\textsuperscript{108}

In addition, banks outside periods of stress should build capital conservation buffers above the regulatory minimum presented above. This capital conservation buffer must be at least 2.5% of RWAs and must comprise mainly of Common Equity Tier 1.\textsuperscript{109} If these buffers are drawn down during a severe financial stress, banks should immediately rebuild them through a reduction of dividend payments or staff bonus payments among various proposed solutions.

Finally, another prudential tool introduced by Basel III is the countercyclical buffer. The purpose of this buffer is to counteract the effects of the economic cycle on bank lending activity, i.e. to ensure that the capital requirements imposed on a bank take into consideration the macro-financial environment in which that bank is operating. It will be left to national regulatory authorities to determine the exact size of this buffer, which might vary from 0% to 2.5% of RWAs.\textsuperscript{110}

The domestic implementation of the transitional arrangements with regard to the new capital regulatory standards began by member states on the 1st of January 2013 and will become fully effective on the 1st of January 2019.\textsuperscript{111}

Along with modified capital requirements, in December 2010 the Basel Committee published a second document on an international framework for liquidity risk measurement, standards and monitoring. The main objective of this framework – which also forms an integral part of the Basel III regulation – is to introduce reforms that will allow the banking sector to

\textsuperscript{107} BCBS, \textit{Basel III}, 2010a, p.12.
\textsuperscript{108} \textit{Ibid}, p.13.
\textsuperscript{109} \textit{Ibid}, p.55.
\textsuperscript{110} \textit{Ibid}, p.58.
\textsuperscript{111} Regarding banks, the minimum Common Equity Tier 1 and Tier 1 capital requirements will be phased in between the 1st January 2013 and the 1st January 2015, \textit{ibid}, p.28. The capital conservation buffer will be phased-in between the 1st January 2016 and the end of year 2018 and it will become fully effective on the 1st January 2019, \textit{ibid}, p.57. Finally, the countercyclical buffer will be phased in along with the capital conservation buffer and will become fully effective on the 1st of January 2019, \textit{ibid}, p.60.
absorb liquidity shocks that arise in periods of stress, in order to minimise the risk of spillover effects upon the real economy.

The Committee developed two minimum standards for liquidity funding. The first one, termed Liquidity Coverage Ratio, aims to ensure that a bank maintains an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario.\textsuperscript{112} The second, called the Net Stable Funding Ratio, is defined as the portion of those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress.\textsuperscript{113}

In early 2013, the BCBS revised its rules concerning the LCR by broadening the definition of high-quality liquid assets, which banks will be obliged to hold. It also introduced new calculation methods for the expected cash outflows, an element of importance for the estimation of the LCR.\textsuperscript{114} In addition, the BCBS proposed a new phase-in period, extending the deadline for banks to fulfil the requirements of the LCR from 2015 to 2019.

The Basel III liquidity rules have, however, attracted their fair share of criticism. The rules on a liquidity requirement have been considered an oxymoron. When a bank is called to continuously hold an asset in order to satisfy the ratio, this asset can no longer be considered liquid.\textsuperscript{115}

The latest addition to Basel III prudential standards has been the introduction of a leverage ratio. The leverage ratio is defined as the capital measure (the numerator), divided by the exposure measure (the denominator) and resulting at a minimum requirement of 3\%.\textsuperscript{116} Whilst the capital

\textsuperscript{112} BCBS, \textit{Basel III}, 2010b, p.3. The Basel Committee provides a detailed list of the fundamental characteristics of these highly liquid assets, \textit{ibid}, pp.4–5.

\textsuperscript{113} \textit{Ibid}, p.25.

\textsuperscript{114} BCBS, \textit{Basel III}, 2013. The latest document considers corporate debt securities with a rating from AAA to BBB–, as well as certain residential mortgage-backed securities as high-quality liquidity assets, pp.14–15. For the calculation of total expected cash outflows refer to pp.20–34.

\textsuperscript{115} Charles Goodhart highlighted this argument through an anecdote: “There is a story of a traveler arriving at a station late at night, who is overjoyed to see one taxi remaining. She hails it, only for the taxi driver to respond that he cannot help her, since local bye-laws require one taxi to be present at the station at all times!”, \textit{Goodhart}, 2010, p.175.

measure will be made up Basel III Tier 1 capital, the exposure measure will include on-balance sheet assets, derivative exposures, securities finance transactions and other off-balance sheet exposures.\textsuperscript{117} By and large, the leverage ratio will become applicable from the 1\textsuperscript{st} of January 2015.

The leverage ratio has been proposed as a complementary standard to the existing capital measurements based on RWAs. Following criticism of the latter,\textsuperscript{118} regulators called for a ratio covering all assets of a financial institution, which would better express the totality of its exposures. Expressing the total exposure of a financial institution is the principal advantage of the leverage ratio, but also a weakness: since it will not be sensitive to market assessments of risk, it will weigh all assets equally and, consequently, will remain a poor measure of bank riskiness.\textsuperscript{119}

Reforms in the field of regulatory capital requirements and liquidity standards have been at the heart of the ongoing efforts to establish better crisis management policies in the banking sector in order to avoid future financial crises. They have sparked a fierce debate: on the one side there are the state authorities, demanding tighter prudential regulations; and on the other, the banking community has expressed disquiet about the potential costs arising from complying with new regulations, arguing that the massive capital increase is excessive and that such regulation may stifle banking progress.\textsuperscript{120} Hence, it is evident that for banks the way to transition will not be full of roses.

At the present time, and according to the latest report, the majority of BCBS members have published regulations successfully implementing the Basel III capital and liquidity rules.\textsuperscript{121} Although the new Basel III standards have not yet been fully implemented, many have already expressed

\begin{itemize}
\item \textsuperscript{117} I\textit{bid}, pp.2–9.
\item \textsuperscript{118} RWAs have been considered as the result of weird accounting practices, “\textit{determined by a mixture of politics, tradition, genuine and make-believe science and the banks’ self-interest...relying on mad-made assumptions about human behavior}”, AD\M\ATI & HELLWIG, 2013, p.184.
\item \textsuperscript{119} As eloquently put by Rochet, although a meaningful accounting exercise, the leverage ratio will amount to adding apples and oranges, \textit{Rochet}, 2014, p.34.
\item \textsuperscript{120} Although the Basel Committee stresses that the new capital requirements will create substantial but acceptable costs for the banking sector, it is estimated that European banks will have to raise € 1.1 tn and US banks $ 870 bn respectively in equity by 2019 in order to comply with the new rules, \textit{The Economist}, 2011, p.11.
\item \textsuperscript{121} BCBS, \textit{Seventh Progress Report on Basel}, 2014.
\end{itemize}
grave reservations regarding their potential efficiency and future practical value.\textsuperscript{122}

\section*{2.3.2 The Financial Stability Board}

\subsection*{2.3.2.1 Early efforts in setting resolution standards}

The FSB, along with its predecessor, the Financial Stability Forum (FSF), has been the main international body responsible for publishing policy documents and setting the standards for the resolution of SIFIs. The FSB is currently the most active forum on the issue of bank resolution, despite the fact that it was the Basel Committee who took the lead in first elaborating a document on cross-border bank resolution.

The FSF introduced its first policy document on bank resolution in April 2009. The document focused on cross-border cooperation during crisis management and put forward fifteen precise high-level principles for identifying strategic preparations and prospects for cross-border cooperation. These principles became known as the FSF Principles. Their main objective was to encourage states to remove any barriers that might prevent the efficient resolution of international banks, to maintain a contingency planning (predecessor of the resolution plans) and, during a crisis, to reach only internationally-coordinated solutions.\textsuperscript{123} The FSF advocated that public sector interventions should be used only when absolutely necessary to preserve financial stability.\textsuperscript{124} The purpose of the document was not to provide elaborate standards on domestic bank resolution legislations but rather to introduce certain basic principles of bank resolution and to enhance the need for international cooperation.

Following the 2009 G20 London Summit, during which the FSF presented its principles, the G20 heads of state decided to establish a successor to the FSF, the FSB: an international body to monitor and make

\begin{itemize}
\item\textsuperscript{122} As summarised by Admati and Hellwig, “\textit{Basel III requirements are still considered low and reflect the political impact that the banks had on the policy debate and the flawed and misleading claims that are made in discussions about banking legislation}”, \textsc{Admati \\& Hellwig}, 2013, p.180.
\item\textsuperscript{123} FSF, \textit{Principles for Cross-border Cooperation in Crisis Management}, 2009, p.3.
\item\textsuperscript{124} \textit{Ibid}, p.2.
\end{itemize}
 Recommendations about the global financial system. Since its creation, the FSB has been assigned a number of important tasks, with crisis management and the creation of effective resolution regimes remaining at the heart of its work.

The first policy document published by the FSB – in October 2010 – was its recommendations for the resolution of SIFIs. In this document, the FSB stressed that any effective approach to addressing the ‘too big to fail’ problem needs to have effective resolution at its base.\textsuperscript{125} In order for states to achieve progress in the area of bank resolution, the document formulates nine recommendations.\textsuperscript{126} The FSB completed its proposals with a further seven recommendations with regards to SIFI supervision.\textsuperscript{127}

The aforementioned document was followed in November 2010 by a detailed report focusing exclusively on the deficiencies of the supervisory practices during the 2008 financial crisis. The document on the Intensity and Effectiveness of SIFI Supervision identified the urgent need for policy changes regarding supervisory powers; risk assessment methods; models on financial statements; products and business analysis; risk management; and consolidated cross-border information sharing and cooperation. Anticipating the impacts from the later presentation of the new provisions of Basel III, the document also highlighted that policy changes should be complemented with reforms regarding capital requirements.\textsuperscript{128}

Consequently, it became apparent that the FSB’s work in the field of SIFI resolution and supervision would be closely interrelated with that of the BCBS around capital and liquidity requirements.

\subsection*{2.3.2.2 Progress on bank resolution}

2011 proved to be a very fruitful year for the FSB, evidenced by the publication of a total of three comprehensive policy documents on bank resolution.

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\textsuperscript{125} FSB, \textit{Reducing the Moral Hazard Posed by SIFIs}, 2010, p.3. \\
\textsuperscript{126} These recommendations can be grouped under three broad categories: a) resolution regimes and tools, b) effective cross-border coordination mechanisms (with the focus on specific cooperation agreements) and c) sustained recovery and resolution planning, \textit{ibid}, pp.4–5. \\
\textsuperscript{127} \textit{Ibid}, p.7. \\
\textsuperscript{128} FSB, \textit{Intensity and Effectiveness of SIFI Supervision}, 2010, p.1. \\
\end{flushleft}
In July 2011, it presented its consultation document on the effective resolution of SIFIs, submitting to its members a package of proposed policy measures with regard to a broad range of issues covering bank resolution, and soliciting their views on these recommendations. In this way, by opening up the process to public consultation, the organisation tried to actively involve its members in the process of developing future reforms in the area of bank resolution.

As previously, the issues of resolvability, recovery and resolution planning were at the core of this document. The FSB set out an actual timeline for its members regarding the implementation of global SIFI-related recommendations.129

At the Seoul Summit in November 2010, the G-20 leaders asked the FSB to elaborate on specific Key Attributes of Effective Resolution Regimes for Financial Institutions, which would allow the states to put in place a solid crisis management framework comprising various resolution tools and powers. The FSB responded in October 2011 by publishing a document that set out the core elements that the FSB considered to be necessary for an effective resolution regime, and presented twelve minimum standards / essential features that should be part of the resolution regimes of all jurisdictions in order to allow authorities to resolve financial institutions in an orderly manner, without severe systemic disruption and without exposing taxpayers to losses.130

With the debates on cross-border resolution gaining momentum, the Key Attributes focused on international cooperation and cross-border

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129 Regarding recovery and resolution planning, FSB members were expected to complete by December 2011 the first drafts of the recovery plans and by June 2012 the first drafts of resolution plans. By December 2012, they were expected to provide a consolidated picture of the implementation of recovery and resolution plans. Regarding the issue of resolvability, by June 2012 the home authorities of global SIFIs were expected to enter into discussions with the respective firms as well as the member of the Crisis Management Groups in order to establish preliminary assessments of their resolvability, FSB, EFFECTIVE RESOLUTION OF SIFIS, 2011, p.19. The final point of the exercise had been the completion and evaluation of such resolvability assessments by December 2012.

130 They cover among others continuity of systemically important functions, allocation of losses to shareholders and creditors, speed, transparency, and predictability, enhancement of market discipline, incentives for market-based solutions and cross-border cooperation and information exchange, FSB, KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS, 2011, p.3.
In order to achieve this crisis preparedness and crisis management on a cross-border level, the FSB called for the creation of Crisis Management Groups (CMGs) that would group home and key host authorities of all global SIFIs, including supervisors, central banks, resolution authorities and finance ministries. In addition, home and host authorities for all global SIFIs should put in place and regularly update institution specific cooperation agreements in order to organise crisis planning resolution stages.

Furthermore, the FSB provided – in three special annexes – detailed information and suggestions on three rather new and contentious issues: resolvability; recovery and resolution planning; and temporary stays on set-off and close-out netting contractual clauses.

The document of the Key Attributes remains a point of reference on the topic of bank resolution. The FSB issued an update in October 2014, although the main standards remained largely unchanged, with the exception of additional information added to the topics of information exchange; resolvability assessments; recovery and resolution planning; the resolution of non-banking entities; and client asset protection.

In November 2011, the FSB took the unprecedented step of publishing a list of 29 global SIBs (G-SIBs) that needed to meet the resolution-related requirements by the end of 2012. Although this was universally considered to be useful as an identification tool, there were divergent opinions concerning the FSB’s decision to render this information public. On the one hand, it greatly enabled the competent authorities to rapidly focus their attention on necessary reforms. On the other hand, however, some feared that it could simply contribute to future moral hazard risks, given that inclusion on this list effectively guaranteed – albeit indirectly – that those financial institutions would not be allowed to fail. An additional concern was that the decision taken by the FSB to make this information publicly available might even lead to serious impacts regarding the competition

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131 It is stressed that “jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures…should have the capacity in law to share information…enhance preparedness for, and facilitate the management and resolution of a cross-border financial crisis”, ibid, pp.13–14.

132 Ibid, for Resolvability see Annex II, pp.27–32, for recovery and resolution plans see Annex III, pp.33–40 and for set-off and close-out netting see Annex IV, pp.41–43.

133 FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions – Update, 2014.
field, with depositors or other bank clients moving their business to those banks perceived to be immune, under the ‘blanket’ of systemic importance and close state attention.

Whilst it might be too early to assess the consequences of having produced such a list, its creation was practically inevitable, as numerous new regulatory or capital requirements will be applied only regarding global SIBs, which as a result had to be identified. The decision to make this list public could, however, be questioned.

The list was updated in November 2012: two banks were added to the new list and three removed from it, thus reducing the total number of G-SIBs included on the list from 29 to 28. All 28 were expected not only to meet higher supervisory requirements for risk management, risk governance and internal control but also to become subject to higher additional loss absorbency requirements. The FSB grouped the 28 SIBs according to four different categories, corresponding to their additional loss absorbency needs. These requirements should be phased in starting from 2016 onwards. The FSB also introduced a detailed timetable for fixing the implementation of resolution planning requirements for any newly designated SIFI.

A subsequent – 2013 – update included 29 G-SIBs. No material changes were made in this update with regards to the regulatory requirements that these financial institutions should comply with. The number of G-SIBs included in the latest update has risen to 30.

At the end of 2012, the FSB also published its progress reports on the supervision and resolution of SIFIs. In terms of supervision, despite the clear improvements in supervisory approaches issues concerning the fundamental requirements for effective supervision still remain, as well as weak risk control practices within certain financial institutions.

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134 FSB, Policy Measures to Address SIFIs, 2011, Annex, p.4.
135 From 1% to 2.5% required level of additional common equity loss absorbency as compared with the total RWAs, FSB, Update of Group of G-SIBs, 2012, p.3.
136 Ibid, p.4. Globally, the SIFIs subject to resolution planning requirements since the end of 2011 should have (ideally) produced their first credible and operational resolution plans in the course of 2013.
137 FSB, Update of Group of G-SIBs, 2013.
138 The organisation added to the list the Agricultural Bank of China whereas UBS and Credit Agricole fell to category 1, FSB, Update of List of G-SIBs, 2014, p.3.
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biggest challenges relate to: the prioritisation of supervisory objectives and activities; striking the right balance between more intensive and more intrusive approaches regarding global SIFIs; the ability of the regulators to focus on the macro-prudential situation of a bank; and the effective operation of supervisory colleges established for international banking groups.

As far as bank resolution is concerned, the FSB closely followed the progress of domestic jurisdictions in implementing the ‘Key Attributes’, and expressed its satisfaction at the encouraging developments. Nevertheless, it stressed that “considerable but uneven progress” has been made in specific relation to the implementation of requirements around recovery and resolution planning. By and large, significant steps have been taken to enhance cross-border cooperation, but particular hurdles may still exist due to differences in the terms and conditions for information sharing across jurisdictions.

In the autumn of 2013, the FSB published a summary report concerning its ambitious initiative to finally deal with the ‘too big to fail’ issue. It called upon the G20 leaders to renew their commitments to legislative reforms in the field of bank resolution, and to be more proactive in particular with regards to rules around bail-in implementation. Moreover, it encouraged the participating jurisdictions to rapidly introduce cross-border cooperation agreements and to remove any obstacles to information sharing.

An important part of this effort is the standardisation of the rules concerning the loss-absorbing capacity of G-SIBs. Such standards will complement Basel III rules and will require from the entities of G-SIBs potentially subject to resolution to hold as much as 16–20% of RWAs in total absorbing capacity (TLAC), and twice the Basel III leverage ratio. TLAC should

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140 For a brief summary on the status of reforms of national resolution regimes see FSB, Resolution of SIFIs, Progress Report, 2012, pp.5–7.
142 FSB, Ending Too-Big-to-Fail, 2013, p.3.
143 Ibid, p.4.
144 FSB, Adequacy of loss-absorbing capacity of G-SIBs, 2014, p.13. Consequently, a G-SIB with a 1% G-SIB surcharge would therefore need to maintain overall TLAC, including combined capital buffers, of at least 19.5% – 23.5% of the RWAs of the resolution group and a G-SIB with a 2.5% G-SIB surcharge would need to maintain TLAC, including combined capital buffers, of at least 21% – 25% of RWAs, assuming that all applicable countercyclical buffers were set to zero and that no other buffers applied. The Basel III leverage ratio denominator will be set at least at 6%.
consist only of liabilities that can be effectively written down or converted during a resolution procedure. Material subsidiaries located outside the home jurisdiction of the G-SIB will be also subject to an internal TLAC requirement in proportion to their size and risk exposures. \(^{145}\) All G-SIBs will be required to comply with the TLAC requirement by 1\(^{st}\) January 2019, with the exception of G-SIBs headquartered in emerging markets. \(^{146}\)

It is clear from this presentation of facts that the FSB is currently leading the way with regards to international reforms in the field of bank resolution. The FSB is a forum for debates that can eventually enrich international dialogue, and contribute to the progress of cross-border cooperation. It remains to be seen, however, how Member States will react to the FSB’s policy proposals, and if the detailed timelines that the FSB has proposed will actually be respected, due to the complexity of G-SIBs.

**2.3.3 The European Union**

**2.3.3.1 The European Union in the 2008 financial crisis**

This section focuses on the developments regarding crisis management and resolution that have taken place in Europe since the 2008 financial turmoil. In the context of bank resolution, the EU’s particularity as a highly integrated market may serve as an important example of cross-border consolidation. Since late 2008, numerous ‘Communications’ and ‘Proposals’ on Directives and Regulations have been issued by the European Commission, with the ultimate objective of establishing a coordinated crisis management framework (covering banking supervision, crisis preparedness, resolution, and insolvency) for the EU banking sector.

The EU banking sector had experienced substantial financial growth in the years before 2008. Historically, in comparison to their business competitors, European banks were rather conservative: focused mainly on

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\(^{145}\) *Ibid*, p.20. Each material subsidiary should hold internal TLAC of 75 to 90% of the minimum TLAC requirement that would apply to the subsidiary if it were an entity subject to resolution, as calculated by the host authority. This amount of internal TLAC must be pre-positioned on-balance sheet following an agreement between the home and host authorities.

retail clients, and not truly universal. The accession of numerous new states in the European Communities, especially from Eastern Europe, resulted in a rapid expansion of Western European banking groups in the East in the search of high profits in new markets. However, despite the use of numerous branches, most European banking groups expanded through the creation of a broad network of subsidiaries, with the latter becoming the predominant form of cross-border banking business – not only for their activities within the EU but also in numerous other third states.

The increased financial integration of the EU banking business was hailed before the financial crisis as a ground-breaking achievement. The Second Banking Directive – adopted in 1988, and modified in 1995 – had laid the foundations for this successful integration, and the introduction of the concept of the single license via this Directive represented a breakthrough for the banking business within the European Communities. A

147 The Financial Times, 2011.

148 It is estimated that out of 12,000 European banks, 50 of them represent banking groups with such a significant volume of cross-border activities so as to be called universal banks, Hüpfes, 2011. Until 2008, these banking groups with important cross-border activities represented almost 2/3 of the European banking sector, Cotterli & Gualandri, 2009, p.3. The majority of the aforementioned banking groups combined a broad range of activities covering retail, investment and commercial banking along with securities dealing and asset management operations, Fonteyne et al., 2010, p.10.

149 Commission of the European Communities, Communication for an EU Framework for Cross-border Crisis Management in the Banking Sector, 2009, p.7. These subsidiaries are estimated to hold a total of € 4,000 bn in assets, Sester, 2010b, p.537.

150 The institutional right for a credit institution to operate under branches anywhere in the Communities without the necessity of an authorisation by host regulators, once it had received a banking charter from a member state, Second Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1989, art. 6. One should not also forget the introduction of the institution of Societas Europaea, giving the option to corporations to form a European Company. Under this legal instrument, one can form a limited liability company (LLC) established under two distinct pieces of EU legislation, a) the Council Regulation 2157/2011 regarding company rules and b) the Council Directive 2001/86/EC regarding worker involvement, Jean Dermine, European Banking Integration and the Societas Europaea: from Host-Country to Home-Country Control, in Caprio, Evanoff & Kaufman, 2006, p.53. Thus, these financial companies can operate on a European-wide basis governed by a single set of common rules for all member states.
decade later, the creation of the European Monetary Zone with the establishment of a common currency for the majority of Member States further accelerated the process of integration.

This expansion towards the East, as well as the general globalisation of financial markets has been a significant factor in financial growth: the majority of EU banks were earning close to 40% of their yearly income from foreign sources (within and outside the EU), outside of their home state operations. Yet, even within each EU domestic banking market, the largest share of the pie is owned by just a limited number of banking groups. Added to all of these factors was the growing deregulation of domestic banking markets and the concomitant removal – mainly under state legislation – of important restrictions for banking activities.

Consequently, European banks became much more international than their counterparts in the US, Japan or China and, as a result, were much more exposed to the financial crisis.

During the 2008 financial collapse, the European banking sector was the second hardest hit, after the US. Faced with a growing crisis in most global banking groups, the national authorities of the 27 Member States panicked, eventually adopting piecemeal, bank-to-bank solutions and failed, in most cases, to adequately consider the repercussions of their actions on other foreign group entities – or, indeed, the entire banking sectors of other states. Most efforts to apply coordinated solutions collapsed; the most prominent example of this being the collapse of Fortis, which had been operating out of the Benelux countries. Generally speaking, even in cases where there had been cooperation among authorities, this cooperation relied on ad hoc structures, and was characterised by insufficient

151 Before the crisis, the foreign bank ownership in the ten newest EU member states averaged 58% (with Estonia presenting the highest level at 98%), when at the same time foreign bank ownership in the old member states averaged only 16% (with Luxembourg being a notable exception due to foreign ownership of approximately 95%), Eisenbeis & Kaufman, 2006, p.1.

152 Krimminger, 2005, p.5.

153 A classic example is Belgium and the Netherlands, where five banks control 80% of the banking assets, Dhafer Saidane, Concurrence et concentration des activités bancaires: ce que la crise financière de 2007 remet en cause, in Grard & Kauffmann, 2010, p.18.

154 Menoud, 2010, p.28.

information – and burden-sharing or policy coordination – with the latter very slow to materialise.  

Prior to 2008, any cross-border cooperation efforts among the national authorities of the Member States were based on a specific Memorandum of Understanding (MoU). The basic objectives of the 2008 MoU were: crisis preparedness; open, timely, full and constructive cooperation during financial crises; and the establishment of Cross-border Stability Groups and of Voluntary Specific Cooperation Agreements that promoted cross-border crisis management.

This MoU appeared promising, since detailed guidelines for crisis preparedness, assessment, alert and management were provided in its Annexes. However, since it was not a binding document but a soft law instrument providing general guidelines for the management of a financial crisis, and as it was built on the ideas of minimal harmonisation and only mutual recognition, it was destined to fail. And, as was the case with the practices of most states during the first stages of the crisis, it failed to promote cross-border cooperation. Member States opted, instead, for unilateral actions thus the MoU effectively played no operational role during the management of the crisis.

Besides the Fortis crisis, there are numerous other examples of significant financial spillovers in various Member States that resulted as a consequence of the unilateral actions undertaken by certain jurisdictions. The most prominent example is that of Ireland, which in October 2008 issued a blanket guarantee for the deposits held by Irish banks. This

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156 Fonteyne et al., 2010, p.8.

157 The first MoU had been signed in March 2003 and it was subsequently updated in May 2005 in order to cover issues such as information exchange and the development of contingency plans. While the subprime crisis was reaching its full scale on the other side of the Atlantic, at an ECOFIN meeting in Luxembourg the member states decided to renew their commitments for enhanced cross-border crisis management cooperation and follow a roadmap of reforms. The result of these consultations was another (final) version of this initial MoU, adopted finally in June 2008. Fifty seven financial supervisory authorities from the member states, the European Central Bank as well as the twenty seven national central banks and ministries of finance participated in the drafting and conclusion of the Memorandum, whose principal goal was not to prevent banking failures but to simply minimise their negative spillovers.


159 It is noteworthy that the first Voluntary Specific Cooperation Agreement among EU members first appeared after the crisis, in August 2010, Kudrna, 2011, p.9.
unilateral decision contributed to a substantial outflow of deposits from other EU Member States and mainly the UK towards Irish banks, resulting in the destabilisation of other financial systems and significant financial contagion. Similar uncoordinated measures resulted in increasing concerns around the concept of a ‘level-playing field’, and a subsequent fall in the volumes of cross-border banking activities.

All in all, the state aid measures used during and after the 2008 financial crisis resulted in a massive support, equal to 13% of the total GDP of all Member States. From 2007 to October 2008, the largest EU banking groups were forced to accept total losses and write-downs of $252 bn and received $290 bn in capital injections. Prospects for financial growth seemed weak, with EU banks divesting from a significant number of their foreign units, and financial integration in the field of EU banking lost its momentum. Furthermore, the financial crisis took a new turn; the explosion of sovereign debts in the periphery of the EU put extreme pressure on Member States regarding their future financial policies.

2.3.3.2 Policy measures against the ‘Too Big to Fail’ problem

The European Commission realised that the catastrophic consequences of the 2008 financial crisis had unveiled a number of shortcomings of the existing regulatory framework, which called for the expedient introduction of extraordinary measures. It therefore focused its attention on four crucial crisis management elements: a) the regularisation of state aid measures for the banking sector in order to avoid further financial spillovers

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160 Another case is that of the collapse of the bank Parex in Latvia due to a massive outflow of deposits towards Swedish banks, after Sweden had issued a similar blanket guarantee as Ireland, Kudrna, 2010, p.17.
161 The total amount pledged by the EU members for banking sector support reached 30% of their total GDP, European Commission, Communication on an EU Framework for Crisis Management in the Financial Sector, 2010, p.2. In total, between 2008 and 2012, €1,500 bn of state aid was used for the safeguard of the European financial system, European Commission, A Reformed Financial Sector for Europe, 2014, p.3.
163 Mainly in non-EU countries, ECB, 2011, p.33.
from unilateral state actions, b) the recapitalisation of financial institutions, c) financial supervision and d) bank resolution.

The first EU Communication regarding state aid to financial institutions in the context of the global financial crisis was issued in late October 2008.\textsuperscript{164} Although state aid to individual institutions was normally regulated under the article 87(3)(c) of the EC Treaty, the Commission recognised that the 2008 crisis called for exceptional and urgent measures. Any support measure had to be well-targeted, proportionate and designed in such a way as to minimise negative spillover effects.\textsuperscript{165} The Commission – as the decision-making body – had to receive prior notification of intention to implement any state aid measures.\textsuperscript{166}

In April 2009, the Commission introduced a Temporary Community Framework for state aid measures, which maintained that state aid measures should be temporary, should swiftly stimulate demand and should boost confidence.\textsuperscript{167} Pursuant to article 83(3)(b) of the EC treaty, the Commission remained the body responsible for declaring any aid designed “to remedy a serious disturbance in the economy of a member state” compatible with the internal market rules.\textsuperscript{168}

Following the adoption of the Lisbon Treaty, this Temporary Community Framework for state aid measures became a Temporary Union

\textsuperscript{164} The Commission had been first confronted with a bank rescue in 1995 regarding the state aid from France to Crédit Lyonnais. In order to justify the state intervention, the Commission applied the principle of the private investor in market economy i.e. it assessed whether a comparable private investor acting under the normal conditions of the market economy would have undertaken a similar operation to save the bank, Christos Hadjiemmanuil, Bank Resolution Policy and the Organisation of Bank Insolvency Proceedings, in Mayes & Liuksla, 2004, p.317.

\textsuperscript{165} Commission of the European Communities, Communication on the Application of State Aid Rules, 2008, art. 2(15). More specifically, regarding the sale of a bank, the competent authorities needed to organise an open and non-discriminatory sale process, that would take place in market terms and they also had to try to maximise the sale price for assets and liabilities involved, \textit{ibid}, art. 5(49).


\textsuperscript{167} Commission of the European Communities, Communication on a Temporary Community Framework for State Aid Measures, 2009, art. 1(3) and (2).

\textsuperscript{168} \textit{Ibid}, art. 4(1).
The power of the Commission to identify whether state aid measures are compatible with the internal market is now regulated under article 107(3)(b) of the Treaty of the Functioning of the EU (TFEU).

Given that state aid measures, in certain cases, were developed as recapitalisation schemes, the Commission had to issue a policy document in order to set certain standards and avoid any unnecessary distortion of competition law. In early 2009, it published a Communication that clarified the nature, the scope and the conditions of recapitalisation initiatives to be applied both on a general and on an individual basis. The core principle for the Commission is that any bank recapitalisation must not provide undue competitive advantage to a distressed or less-performing bank over other banks operating in the same or other Member States that are considered fundamentally sound. The Communication sets the principles, conditions and level prices for the recapitalisation measures.

The Commission issued a separate Communication in February 2009 that covered regulatory practices introducing asset-separation schemes. In order to enhance a coordinated community approach, the Commission provided guidelines regarding: the appropriate identification of asset-related problems; a procedure of burden-sharing among the state, the shareholders and the creditors; the eligibility and valuation of the impaired assets; as well as proposals regarding the management of the assets subject to relief measures.

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169 The Commission highlighted once again that state aid measures should target long term sustainable investments providing support exclusively to viable firms in order to put them on a sound footing after their financial troubles, European Commission, Communication on a Temporary Union Framework for State Aid Measures, 2011, art. 1(2).

170 Ibid, art. 2(1). We need to bear into consideration that under normal circumstances any state aid is incompatible with the principle of the common market according to art. 107(1) of the TFEU.


172 It is indicated that recapitalisation measures should be subject to regular review and that member states should submit a report to the Commission regarding their implementation six months after their introduction, ibid, point 40.

173 The Commission should evaluate these measures and provide its authorisation for their implementation for a period of 6 months, subject to a conditional commitment of the states to present either a restructuring plan or a viability review within 3 months after the authorisation, Commission of the European Communities, Communication on the Treatment of Impaired Assets, 2009, Annex 5, p.28.
With rising tensions in the sovereign debt markets putting the banking sector under enormous pressure, the European Commission made the decision to keep its 2008 state aid Communication in place and presented a recast version implemented since August 2013.\textsuperscript{174} It is noteworthy to highlight that the aid beneficiary will be obliged to participate at the burden-sharing of its restructuring costs.\textsuperscript{175}

A far more complicated issue for the EU was its decision to make large-scale modifications of its crisis management framework so as to comply with the new international standards regarding bank resolution.

On the matter of corporate insolvency, the EU has been leading the way since 2000 on the consolidated treatment of insolvency proceedings of companies for whom the centre of main interests is situated within the territory of a EU Member State.\textsuperscript{176} Although it applies exclusively for corporations, the Regulation on Insolvency Proceedings could provide important lessons for bank resolution especially regarding the consolidated treatment of a cross-border group.

Of much more relevance for the banking sector has been the so-called Winding-Up Directive. It took 15 years for the Member States to agree on the elements of this Directive, which finally embraced a universalistic cooperative approach of cross-border insolvency. The basic principle of the Directive is that when the judicial or administrative authorities of a Member State initiate a winding-up procedure in relation a credit institution, such a procedure should also include branches of this institution established in other Member States.\textsuperscript{177} In this way, the Directive aims to achieve improved coordination between the actions of the different judicial or administrative authorities of various Member States that might be involved in bank winding-up procedures.

Although promising, the Winding-Up Directive suffers from some crucial deficiencies that will render it ineffective in managing future banking crises. First of all, it applies only to credit institutions and fails to include the activities of investment banking. Secondly, it only covers winding-up

\textsuperscript{174} European Commission, Communication on the Application of State Aid Rules, 2013.

\textsuperscript{175} Prior to any injection of public funds, not only shareholders but also junior creditors will be subject to write-downs or debt-to-equity conversion in order to minimise the need for state aid, \textit{ibid}, recitals 15–20.

\textsuperscript{176} EC Regulation on Insolvency Proceedings, 2000, art. 3(1).

\textsuperscript{177} EC Winding-Up Directive, 2001, art. 3(1).
procedures with regards to the branches of a credit institution.\textsuperscript{178} As already noted, the reorganisation proceedings under the Directive will only be implemented for branches within EU Member States. Hence, while EU banks are internationally active, the Directive does not provide any hints regarding international cooperation in an era of globalised finance. Finally, the early termination of contracts under set-off and close-out netting clauses (which pose significant problems in bank resolution and can contribute to financial contagion) is always possible under the Directive.\textsuperscript{179}

As highlighted by Hüpkes, the main purpose of the Winding-Up Directive is to enhance judicial and regulatory cooperation without contributing to the emergence of a European insolvency law.\textsuperscript{180} In actual fact, the Directive is based on the theory that national insolvency regimes are sufficient: the intention was never to harmonise insolvency proceedings.\textsuperscript{181}

To help address the deficiencies of the past crisis managements rules, in 2009 the EU entered a period of consultations aimed at eventually establishing an integrated EU crisis framework for the banking sector.\textsuperscript{182} At the core of this comprehensive set of rules were precise bank resolution procedures intended to effectively address the ‘too big to fail’ problem. Essentially, the EU-level reforms focused on: the continuity of core banking services; efficiency; speed; and flexibility during crisis management and moral hazard containment.\textsuperscript{183}

The Commission’s first communication in 2009 focused on crisis management in the banking sector.\textsuperscript{184} The Communication highlighted

\textsuperscript{178} As previously mentioned, European banks operate through a vast network of subsidiaries, for the insolvency of which the Winding-Up Directive cannot be applied.

\textsuperscript{179} EC Winding-Up Directive, 2001, art. 23.

\textsuperscript{180} Hüpkes, Insolvency – What Is Different about Banks?, in Peter, Jeandin & Kilborn, 2006, p.379


\textsuperscript{182} Due to the fear of highly probable political defeat, the Commission was reluctant to initiate at an earlier point its consultations for future legislative changes on the European level, Kudrna, 2011, p.8.

\textsuperscript{183} Fonteyne et al., 2010, pp.28–29.

\textsuperscript{184} It identified a double objective: a) to ensure that national supervisors have adequate tools in order to identify problems in banks at a sufficiently early stage and to intervene to restore the health or prevent further decline and b) to make it possible for cross-border banks to fail without serious disruption to vital banking services or contagion to the financial system as a whole, Commission of the European Communities, Communication for an EU Framework for Cross-border Crisis Management in the Banking Sector, 2009, p.3.
early recovery and resolution as key to an effective crisis management procedure. By and large, it referred to issues of early intervention, resolution, resolution funding, cross-border cooperation, impact on shareholder rights, intra-group transfers and insolvency.\textsuperscript{185} International bodies such as the European Central Bank and the IMF reacted quite positively, while simultaneously pointing out potential challenges with regards to implementation.

Taking into account this feedback, along with the recommendations put forward by a group of experts formed in May 2010, the Commission issued its second Communication in October 2010. This time the Commission decided to expand the scope of its Communication and proposed the foundations necessary for a consolidated crisis management framework for the financial sector as a whole. The document started off by mentioning preparatory and preventative measures, and then went on to make reference early intervention initiatives. The bulk of the Communication was devoted to resolution policies, powers and triggers. With regards to cross-border supervision and coordination of the resolution of EU banking groups, the Communication introduced the concept of ‘resolution colleges’, which would group home and host resolution authorities and would complement the tasks of the existing supervisory colleges.

The Commission also dedicated a substantial part of the Communication to addressing the issue of resolution funding. The establishment of national resolution funds (which might operate in coordination with deposit guarantee schemes) was promoted, and the possibility of establishing a common European Resolution Fund in the future was not ruled out.

Endorsing strongly the work of the FSB and of the Basel Committee, the EU set very high standards for the future in this second Communication. One might suggest that the text was very ambitious, and transforming the rhetoric into EU law has certainly been challenging, given the need to satisfy the different domestic legal and political demands of all 28 Member States.

\textsuperscript{185} Regarding this last element, it was stressed that the coordination between domestic insolvency regimes would be crucial so as to support and complement bank resolution measures, \textit{Commission of the European Communities, Staff Working Document Accompanying the Communication for an EU Framework for Cross-Border Crisis Management in the Banking Sector}, 2009, p.46.
2.3.3.3 The European supervisory authorities

In November 2008 Jacques de Larosière was mandated by the Commission to establish a research group in order to explore and propose reforms to strengthen the supervisory arrangements between the EU Member States. The Commission’s ultimate aim was the transformation of the existing supervisory committees – created under the Lamfalussy framework – into supervisory authorities.

Following a brief presentation on the causes of the 2008 financial meltdown, the basic institutional problems regarding financial supervision and crisis resolution in Europe were identified and reported on in the de Larosière Report, and proposals for comprehensive reforms in a variety of different sectors (from rating agencies to bank resolution) were made.\textsuperscript{186}

With European financial stability reform suffering from what has been dubbed as ‘\textit{institutional hysteresis}\textsuperscript{,187} the Union was ill-prepared for any future financial crisis. Consequently, the Commission was determined to adopt the majority of the de Larosière proposals and move forward with the transformation of the Lamfalussy committees into true European supervisory authorities.

In November 2010, four new regulations were published. These set the foundations for the establishment of the three supervisory authorities: a) the European Banking Authority (EBA);\textsuperscript{188} b) the European Securities and Markets Authority (ESMA);\textsuperscript{189} and c) the European Insurance and Occupational Pensions Authority (EIOPA);\textsuperscript{190} – as well as for a new authority, the European Systemic Risk Board (ESRB).\textsuperscript{191}

The four authorities became fully operative in January 2011. Their principal tasks can be summarised as follows: a) legally binding mediation between national supervisors; b) adoption of binding supervisory standards;

\textsuperscript{186} It concluded that “\textit{the lack of consistent crisis management and resolution tools across the single market places Europe at a disadvantage vis-à-vis the U.S. and these issues should be addressed by the adoption at EU level of adequate measures}”, Hüppkes, 2011.
\textsuperscript{187} Fonteyne et al., 2010, p.8.
\textsuperscript{188} EU Regulation 1093/2010 Establishing a European Banking Authority.
\textsuperscript{189} EU Regulation 1095/2010 Establishing a European Securities and Markets Authority.
\textsuperscript{190} EU Regulation 1094/2010 Establishing a European Insurance and Occupational Pensions Authority.
\textsuperscript{191} EU Regulation 1092/2010 Establishing a European Systemic Risk Board.
c) adoption of binding technical decisions applicable to individual institutions; d) oversight and coordination of the colleges of supervisors; and, finally, e) playing a strong coordination role in crisis situations.192

EBA was designed as the 28th regime of supervision in the EU, introducing the first common European banking supervisor.193 Its basic mission is to establish a coordinated view of European financial supervision in the banking sector and promote convergence in the fields of crisis prevention and crisis management.

It is important to note that the spectrum of EBA’s supervision is broad, covering not only credit institutions but also investment banks and financial conglomerates.194 In summary, EBA contributes to the establishment of high quality common regulatory and supervisory standards and practices, issues guidelines and recommendations addressed directly to national regulators or financial institutions, investigates alleged breaches of non-application of Union law, coordinates the actions of national competent supervisory authorities during a crisis, participates in the development and coordination of effective recovery and resolution plans and finally contributes to developing methods for the resolution of SIBs.

It is important to note that day-to-day supervision remains the responsibility of the 28 national supervisory authorities, with the heads of the latter each having a position on the EBA’s Board of Supervisors. Hence, the role of EBA is to enhance convergence and improve supervisory practices through the publication of standards and guidelines. In addition, it plays the role of coordinator in the colleges of supervisors, allowing a swift settlement of cross-border regulatory disputes and a more efficient crisis management. Although the recommendations that it makes to – and guidelines that it sets for – national authorities or financial institutions are not binding, the latter should provide adequate reasons for not complying with them and EBA is responsible for notifying the European Parliament, the Council and the Commission of states’ or banks’ decisions. Peer review – or ‘naming and shaming’ – processes have the potential to

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193 As Jacques de Larosière stressed regarding the two possible alternatives for the future of supervision in Europe: “either the first chacun pour soi beggar-thy-neighbour solution; or the second – enhanced, pragmatic, sensible European cooperation for the benefit of all to preserve an open world economy”, EU Regulation 1093/2010 Establishing a European Banking Authority, recital 35.
194 Ibid, art. 1(3).
significantly influence the current attitudes among the Member States towards supervision.

On the other hand, the ESRB is fully responsible for the macro-prudential analysis of the EU financial market, which until 2011 remained significantly fragmented among various authorities and various levels. The core mandate of this newly-created EU body is to effectively identify and prioritise macro-economic risks, and to react accordingly. The regulation establishing the ESRB was the first official EU document in which a brief list of criteria for the identification of SIFIs was provided, and the first document in which a definition for systemic risk was proposed. It is also encouraging that the ESRB can identify any type of financial institution and intermediary as a potential source of systemic risk.

The ESRB should be regarded as an integral part of the new European Supervisory System, and it will operate in close coordination with the three European supervisory authorities, as well as with the European Central Bank. When significant risks for the financial stability of the Union are identified, the Board should first issue warnings and, subsequently, make recommendations for remedial actions or for legislative initiatives to be taken by the Member States. The regulation also introduced a follow-up procedure for the recommendations, which allows the ESRB to directly inform the Council or the European supervisory authority concerned in the event that the addressee does not react to the ESRB’s warnings. As is the case for the EBA, the ESRB does not have the power to issue binding decisions. However, through its powers of information and consultation it is able to initiate a Commission action against a Member State should the latter disagree or fail to comply with one of its recommendation. Its role is consultative, but it derives its authority from its reputation and expertise in rapidly identifying macro-economic risks.

To conclude, national authorities will continue their supervisory practices, which will eventually become highly influenced by the guidelines and standards issued by the European supervisory authorities. The latter authorities will effectively become ‘whistleblowers’ – reporting states or financial institutions unable or unwilling to comply with recommendations.

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195 EC Regulation 1092/2010 Establishing a European Systemic Risk Board, recital 9 and art. 2.
196 Ibid, art. 16(1).
or guidelines to the Commission and the Council. While they should enhance micro-prudential supervision, the ESRB will watch over systemic risks that might endanger the financial stability of the Union. It is estimated that the overall package of these recommendations, standards, warnings and guidelines will have positive results in supervisory attitudes across the Union and will eventually contribute to a certain degree of harmonisation of rules.

2.3.3.4 Quo vadis Europe?

The EU was quick to acknowledge the substantial errors that resulted in the catastrophic events of 2008. The Commission has since shown the way forward regarding financial regulation. The two Communications on crisis management and the Regulations modifying European financial supervision were positive examples of a change in mentality, which called for fewer unilateral action and greater decision-making at the European level.

Despite its traditional strategy of prioritising market integration to the formulation of the underpinning institutional framework, the EU has been ready to design its crisis management framework from scratch. However, the evolution is not over and especially in the field of bank resolution the EU will have to address significant challenges before it can create a consolidated European framework. It will take time, for instance, for Member States to move away from a reliance on state aid and debt restructuring of the financial institutions as commonly used solutions to banking crises, and to explore instead the new options that are presented under resolution legislations.

However, whilst the important developments that took place at the EU level were well received and boosted optimism, they were also subject to important criticisms.

Certainly, the changes introduced at the supervisory level were by no means radical and national authorities’ discretion in supervisory action was maintained. In addition, different supervisory regimes along the

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198 Kudrna, 2011, p.29.
199 As highlighted by Schoenmaker, “this interaction between highly penetrated banking systems and national financial supervision and stability management might be a dangerously weak institutional feature”, Schoenmaker, 2010, p.4
Union could provide opportunities for regulatory arbitrage. The European supervisory authorities could have been granted much more direct powers regarding crisis management, regardless of the fact that they lacked familiarity with the specific local circumstances of each banking sector. It was evident, though, that Europe was not ready for a common supervisor at that point.\footnote{200}

The ESRB has been considered a unique new body, which enables a rapid identification of macro-economic risks and swift action against future shocks. However, it is reliant upon a substantial flow of micro-prudential information from the three supervisory authorities in order to conduct its daily operations – and subsequently identify risk; if the supervisory authorities are only able to provide the ESRB with limited information directly from states or financial institutions, then the role of the Board might be compromised.

The Commission’s Communication on crisis management for the financial sector was a very ambitious document; despite the unquestionable progress, many questions were left unanswered by the EU. Notably, the Commission avoided redefining the concept of the ‘too big to fail’ on a supranational level or providing elements on the identification of SIFIs.\footnote{201}

The biggest challenge for EU Member States would be to decide on the systemic importance of banks based on home and host state considerations. After all, a branch or subsidiary providing systemic functions in a small EU state (and, thus, considered a SIFI for that specific jurisdiction) might not present any particular significance within the context of a banking group according to the home state considerations. In such a case, should the home authorities decide to ‘pull the plug’ without first consulting with the host authorities, the final cost for the host state will be substantial.

Moreover, although the Commission began exploring the possibility of intra-group asset transfers as a measure of early recovery amidst a crisis, the EU law still lacks any notion of group or group interest.\footnote{202}

\footnote{200} The power of the authorities to issue recommendations has been considered a compromise solution between those states in favor of a more, robust and better structured centralised EU supervisory system and those wishing to maintain their supervisory independence, Cotterli & Gualandri, 2009, p.12.


\footnote{202} Nevertheless, Attinger reminds that the EU should be extremely cautious when it touches upon issues of intra-group asset transfers as procedures of piercing the
It is clear that the EU still has a long way to go before a fully coordinated European crisis management framework can be introduced. It is of vital importance that future solutions reflect what is in the best interests of the financial stability of the Union as a whole, and do not simply reflect an amalgamation of 28 separate national crisis management views. Reaching a consensus between all 28 Member States, however, will necessitate a lot of compromise, and no doubt a lengthy timescale. The implementation of the EU Bank Recovery and Resolution Directive, as well as the introduction of the Single Supervisory Mechanism and of the Single Resolution Mechanism represent important steps towards greater European consolidation. Hopefully, these newly-created instruments will not merely burden an already heavy and bureaucratic EU framework.

2.3.3.4.a The Bank Recovery and Resolution Directive and the Regulation on a Single Resolution Mechanism

In 2012, as the conditions surrounding the sovereign debts of certain Eurozone Member States of the European periphery worsened, and discussions on the feasibility and form of a future Banking Union continued, the Commission was forced to advance its actions rapidly. The new proposals around EU-level supervision and crisis management could become the basis of the first true cross-border resolution scheme.

With regards to the recovery and resolution of all European banks, the Commission opted initially for a Directive, which established the common standards and fundamental rules to then be translated into state legislation by domestic regulators. The proposed text of the Bank Recovery and Resolution Directive – which established a framework for the recovery and resolution of European banks – was published in June 2012. The Directive covers any European financial institution and not only SIBs, coordinating the recovery and resolution of credit institutions, investment firms and financial holding companies.203

Generally speaking, the Directive is a very bold document, in that it regulates practically all aspects of bank recovery and resolution. It covers corporate veil and intermingling of assets lack an adequate basis under EU law, Attinger, 2011, p.41.

rules on: recovery and resolution planning; intra-group financial support; early intervention; objectives and conditions of resolution; resolution tools – ranging from the sale of banking business to bail-in; general resolution powers; safeguards for third parties; interaction with non-EU countries; and resolution funding through a European System of National Financing Agreements. In addition, in order to guarantee the smooth implementation of future resolution procedures, the Directive introduced various amendments to numerous other instruments of EU law.\footnote{For example, art. 17(1), 25, 29(1), (3) and (4), 30 and 40 of the Second Company Directive 77/91/EEC, art. 5 of the Take-Over Bids Directive 2004/25/EC, the Directive 78/855/EEC on mergers of public limited companies, the Directive 2007/36/EC on shareholders rights. Amendments to art. 1 of Protocol 1 of the ECHR should, in our opinion, also be envisaged.}

The official text of the Directive was adopted in June 2014, and Member States had until the end of 2014 to translate it into national law.\footnote{However, in early summer 2015, eleven Member States have not yet fully implemented the Directive into domestic rules, causing the Commission to issue an official request that, if ignored, may result in a referral of these Member States to the ECJ.}

The basic elements of the Commission’s second proposal regarding the creation of the Single Resolution Mechanism (SRM) by a EU Regulation were finalised in July 2013. It should be stressed that the SRM will operate exclusively within the limits of the Eurozone. By and large, the text of the Regulation adopts a similar approach to the principal elements of bank resolution as the Bank Recovery and Resolution Directive.

The SRM will not adopt the form of a stand-alone entity, but rather its critical functions will be carried out by a number of different actors. Firstly, the ECB – granted responsibility for centralised banking supervision under the SSM – will signal if a bank faces severe financial difficulties and should be resolved.\footnote{EU Regulation on a Single Resolution Mechanism, art. 18(1)–(2).} Secondly, the principal body defining the resolution approach will be a Single Resolution Board, consisting of representatives from the ECB, the European Commission and the relevant national resolution authorities. The main duty of this Board will be to issue the final decision regarding the opening of a resolution procedure and the organisation of the resolution framework.\footnote{\textit{Ibid}, art. 18.} The legal nature of the Board’s decision remains vague in the text of the proposal. Finally, responsibility
for the execution of the resolution plan will remain with national resolution authorities.  

Additionally, a Single Resolution Fund will operate under the control of the Single Resolution Board. This Fund is intended to gradually replace the national resolution funds of the Eurozone Member States, established under the requirements of the Bank Recovery and Resolution Directive. It should reach a target level of 1% of covered deposits over an eight-year period.

The Single Resolution Board has become operational in January 2015, but most provisions of the Regulation will be applicable from the beginning of 2016.

2.3.3.4.b The creation of the Single Supervisory Mechanism

At the end of June 2012, the president of the Council of the EU, Herman Van Rompuy, presented a report setting out the visions of the Commission, of the Eurogroup and of the ECB for a genuine Economic and Monetary Union. According to the report, an integrated financial network should cover all Member States and regulate single European banking supervision, common deposit insurance and a European resolution scheme. Differentiations will be plausible under this framework between Eurozone member and non-member states.

On the basis on these proposals, in early December 2012 the Council formulated its final report, grouping the conclusions towards a genuine EMU. The report established a timeframe and a stage-based approach for the completion of the EMU. The first stage – from the end of 2012 to early 2013 – provided for the creation of a SSM for banks under the aegis of the ECB. This mechanism would effectively be a “guarantor of strict and impartial supervisory oversight” for the banking sector.

The proposals of the President of the Council and the subsequent discussions among the Eurogroup Member States led to the Commission putting forward a proposal in September 2012 for a Council Regulation, establishing a European supervisory framework under the leading position

208 Ibid, art. 18(9).
of the ECB. The basis of this proposal was article 127(6) of the TFEU.\textsuperscript{211} A compromise was achieved at the special ECOFIN meeting of 12\textsuperscript{th} and 13\textsuperscript{th} December 2012, whereby the Eurozone Member States endorsed the Council’s proposal to negotiate with the European Parliament on two Regulations: firstly, establishing the SSM by conferring unique supervisory tasks to the ECB\textsuperscript{212} and, secondly, amending Regulation 1093/2010 on EBA.\textsuperscript{213} Both regulations were adopted on the 29\textsuperscript{th} of October 2013.

The first Regulation allowed the transformation of the ECB into the competent supervisory authority regarding all systemic Eurozone banks, assessing their compliance with the minimum capital requirements, conducting supervision on a consolidated basis and carrying out early intervention measures amidst a crisis.\textsuperscript{214} The ECB is not intended to take over the role of national supervisory authorities, but rather to complement it. Whilst the latter continue with their day-to-day supervisory tasks regarding small and medium-sized banks, they are obliged to keep the ECB informed and assist the ECB with its consolidating supervisory tasks.\textsuperscript{215} Moreover, the ECB is entitled to submit requests for information, conduct general investigations and on-site inspections, oversee authorisation procedures and impose administrative measures to credit institutions in breach of regulatory requirements.\textsuperscript{216}

\textsuperscript{211} The article confers specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions and other institutions with the exception of insurance undertakings.

\textsuperscript{212} EU Regulation No.1024/2013 on ECB Prudential Supervision of Credit Institutions.

\textsuperscript{213} EU Regulation No.1022/2013 Amending Regulation No.1093/2010.

\textsuperscript{214} EU Regulation No.1024/2013 on ECB Prudential Supervision of Credit Institutions, art. 6(4). A bank will be considered systemic if its assets exceed € 30 bn or the ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20 % or following a notification by its national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB takes a decision confirming such significance, following a comprehensive assessment, including a balance-sheet assessment, of that credit institution.

\textsuperscript{215} Ibid, art. 6(6). Certain EU national supervisory authorities (such as those of Germany, Italy, Spain and the Netherlands) expressed their doubts regarding the process of convergence of different national supervisory approaches within the SSM, FSB, 2015, pp. 69, 71, 73 and 75.

\textsuperscript{216} EU Regulation No.1024/2013 on ECB Prudential Supervision of Credit Institutions, art. 9–13, and art. 16.
In order to avoid any potential conflict of interests, there is a strict division between the supervisory tasks of the ECB and its monetary policies. In addition, included within the ECB’s overall budget is a separate budget line with funds specifically earmarked for its supervisory tasks and the ECB is fully accountable for its actions to the European Parliament and the Council. Credit institutions will be subject to annual supervisory fees – structured according to the importance and risk profile of each institution – to cover any expenditures related to the ECB’s supervisory tasks.217

What is noteworthy about the SSM is that this supervisory framework is not limited to the Eurozone Member States; EU member states, which did not adopt the common currency, will be allowed to opt-in to close supervisory cooperation with the ECB. In such an event, the relevant national authorities will be obliged to abide by any guidelines or requests issued by the ECB, as well as provide the ECB with information necessary for the latter to carry out comprehensive bank assessments.218

On the other hand, according to the Regulation amending the role of EBA, EBA will continue developing a Single Rulebook in order to ensure harmonisation among European supervisory practices. At the same time there will be changes regarding voting modalities and decision-making procedures. An independent panel will be established – comprising six members of EBA’s Board of Supervisors – and, along with the Chairman of the Board, will put forward a decision concerning any breach of Union law or the settlement of a disagreement for final adoption by EBA’s Board of Supervisors.219 This final decision of EBA’s Board of Supervisors of EBA will be taken by simple majority of its members.220

The SSM has been fully operational since November 2014 and covers all Eurozone credit institutions.

217 Ibid, art. 30.
218 Ibid, art. 7.
219 EU Regulation No.1022/2013 Amending Regulation No.1093/2010, art. 41(1a)–(4).
220 Ibid, art. 44(1).
PART II

THE MAIN ASPECTS OF BANK RESOLUTION PRACTICES
Chapter 3

BANK RESOLUTION OBJECTIVES

The previous chapter highlighted that what primarily distinguishes bank resolution from other common insolvency procedures is the objectives that state authorities need to keep into consideration when faced with ailing banks. This chapter elaborates on these objectives that make bank resolution unique. Furthermore, it touches upon the need for bank resolution regimes to introduce a method for prioritising – to a certain degree – these objectives.

3.1 Distinctive characteristics of bank resolution objectives

Whilst corporate insolvency or bank liquidation treat a financial institution as a gone concern and serve the ultimate interests of bank creditors, bank resolution deals essentially with public policy objectives. The principles of classic insolvency focus on the maximisation of financial recovery for creditors without substantial consideration of issues such as the continuity of systemically important financial services, the unnecessary value destruction, the overall safeguard of financial stability or the minimisation of losses for the deposit guarantee schemes. On the contrary, bank resolution practices are unique in that they should pursue a variety of institutional and broader public policy objectives. From a bank resolution perspective, resolution authorities must focus their attention more widely than on the collapsing financial institution itself, taking into account macro-prudential considerations, and the safeguarding of general market confidence.¹

When going through the relevant international standard-setting documents as well as the majority of domestic bank legislations, one usually

¹ Attinger, 2011, p.8.
reads first about the need to maintain financial stability\(^2\) through the establishment and implementation of resolution regimes. Given that the external costs of a bank’s collapse and disorderly liquidation can be severe, these documents underscore that a core objective of bank resolution procedures should be to restore financial stability, for the greater public good.\(^3\)

Nonetheless, in the context of modern globalised financial markets, the extent to which state authorities can safeguard the public good of financial stability at the national level – and how – is questionable, given the vast amount of international links in payment systems and capital transfers.\(^4\) In fact, each jurisdiction might interpret this need to safeguard financial stability differently; after all, the achievement of ‘financial stability’ is a less objectively quantifiable goal – i.e. one that is more reliant on a subjective judgment – than, say, the achievement of monetary or price stability.\(^5\) One is likely to see even greater variances in the interpretation of the concept of ‘financial stability’ with regards to bank resolution regimes that have a domestic focus: uncoordinated national responses, including ‘ring-fencing’ approaches to bank insolvency and territorial approaches to resolution have been repeatedly justified in the name of domestic financial stability.

In any case, financial stability is usually complemented by the need to safeguard public interest. Whilst acting in the public interest should be

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\(^2\) “Financial stability is a situation in which the financial system is capable of satisfactorily performing its three functions simultaneously. First, the financial system is efficiently and smoothly facilitating the intertemporal allocation of resources from savers to investors and the allocation of economic resources generally. Second, forward looking financial risks are being assessed and priced reasonably accurately and are being well managed. Third, the financial system is in such condition that it can comfortably if not smoothly absorb financial and real economic surprises and shocks”, François Gianviti, The Objectives of Central Banks, in Giovanoli & Devos, 2010, p.475.

\(^3\) For instance, the German Bank Reorganisation Act requires for any authorities’ intervention for the purposes of a reorganisation or the winding-up of a financial institution a threat on the greater stability of the financial system, German Bank Reorganisation Act, 2011, § 1(1). The UK Banking Act maintains that a special resolution regime should not only protect the stability of the financial system of the United Kingdom but also “protect and enhance public confidence in the stability of the banking systems of the United Kingdom”, UK Banking Act, §§ 4(4)–(5).

\(^4\) Schoenmaker, 2010, p.4.

\(^5\) De Haan & Oosterloo, 2006, p.268. As a result, financial stability objectives are often expressed in directional rather than absolute terms e.g. “to promote” or “to achieve”, Study Group of the BIS, 2011, p.28.
an essential consideration when making the decision whether or not to initiate resolution procedures, it is nonetheless believed that – rather than adopting a purely domestic angle – a cross-border perspective should be adopted when analysing this multifaceted notion. The fragmented, *ad hoc* responses to the 2008 financial meltdown, however, revealed that the safeguard of domestic public interest does not necessarily take into account cross-border considerations.

Clearly, the notion of financial stability is complex; the fact that it is subject to diverse and even conflicting interpretations can result in the formulation of vague, inefficient and uncoordinated resolution objectives under domestic resolution regimes. A coherent interpretation of financial stability – a concept that implies not only significant economic, but also legal and political repercussions – will be crucial to facilitate cross-border crisis management. Indeed, the elaboration of common global standards on financial stability should be an essential prerequisite for the international coordination of resolution practices for SIBs. Although global markets have increasingly acknowledged the fundamental importance of financial stability as ‘a common good’, it is still regarded as a state concern, and remains subject to interpretation on a case-by-case basis. However, it is argued here that the definition of financial stability in the context of bank resolution requires a cross-border focus; currently this is only implicit, or absent altogether.

The 2008 financial crisis demonstrated that the cross-border corporate organisation and activities of many international banks could result in great complexities, rendering, thus, the efforts for resolution nearly impossible. Accordingly, the FSB acknowledged the importance of cross-border cooperation, coordination and information exchange as critical aspects of bank resolution. Nonetheless, whilst one would expect the majority of policy documents and legal provisions dealing with bank resolution to set clear guiding objectives and principles concerning the collapse of

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6 For example, the Turner Review in the UK stressed that a definition of public interest takes account of consumers’, investors’, shareholders’, managers’ and above all taxpayers’ interests. Such a holistic definition influencing the approach to bank regulation is currently lacking under the majority of domestic regulatory systems, John McEldowney, *Defining Public Interest: Public Law Perspectives on Regulating the Financial Crisis*, in Labrosse, Olivares-Caminal & Singh, 2009, p.125.

7 FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2011, p.3.
cross-border banking groups, modern domestic bank resolution regimes rarely accommodate such cross-border considerations. Most documents simply scratch the surface of this issue; others do not address it at all.\(^8\)

Furthermore, the main difference from corporate insolvency stems from the necessity to maintain the systemically critical functions of a financial institution. The core notion of bank resolution lies within the fact that authorities will intervene in case of financial distress in order to save critical operations and not institutions.\(^9\) This issue relates to the ‘too big to fail’ problem and is also linked to the crucial issue of the powers held by resolution authorities. These systemic operations might concern retail banking, clearing and settlement services and/or other functions provided by a bank. According to the Basel Committee, the granting of extensive powers to authorities during a resolution procedure – powers that might lead to significant restraints for creditors’ and shareholders’ rights – can be justified on the grounds of this need to preserve vital operations and services.\(^10\)

Ongoing concerns around saving a bank’s core activities and minimising losses for the public form the basis for further important policy objectives of bank resolution procedures; namely, the need to restore confidence in the markets and to avoid widespread panic and financial contagion. Systemic risk is subject to certain substantial behavioral aspects.\(^11\) Along

\(^8\) For example, although the EU highlighted in its initial documents the need for a “smooth resolution of cross-border groups” among its principal resolution objectives (European Commission Communication on an EU Framework for Crisis Management in the Financial Sector, 2010, p.4), such an objective is notably absent from the list of resolution objectives under its Bank Recovery and Resolution Directive, EU Bank Recovery and Resolution Directive, art. 31.

\(^9\) As explained by the Cross-Border Bank Resolution Group of the BCBS, competent authorities need to have at their disposal a variety of powers so as to “facilitate the continuity for essential operations”, BCBS, 2010c, p.23.

\(^10\) BCBS, 2011, p.9.

\(^11\) One should always bear into consideration that the entire banking business is confidence based, with the psychological element of trust being a principal aspect of the banking relationship with every client and contractual counterparty, Attinger, 2011, p.8. Once trust is lost, leaving its place to rumours, not only individual institutions but also the banking system as a whole can become prey to panic and financial contagion. It is true that amidst a crisis, information regarding an individual bank’s risk exposure is never immediately accessible. Hence, bank clients and creditors might need substantial time and analysis in order to ‘navigate’ through the rumours and maintain their sangfroid. However, during a crisis with little known causes, magnitude and
with the increasing integration in the markets, which relates to the ‘too interconnected to fail’ problem, confidence is of paramount importance. Financial contagion can spread rapidly, turning troubled banks into insolvent entities. A crucial objective of any resolution regime should be to allow authorities to take control of a distressed financial institution in a rapid and decisive manner in order to avoid a disorderly liquidation, which could spread more panic in the markets.

Speed and efficiency, then, are also key to – and should be important policy objectives of – effective bank resolution. If loss of value is to be minimised, and market contagion restricted, authorities must act swiftly and efficiently. As highlighted by the FSB, “legal and procedural” clarity is therefore essential when putting in place a resolution mechanism, along with “advanced planning”. The former can be satisfied through the establishment of sophisticated and transparent domestic resolution regimes; the latter through the creation of recovery and resolution plans for every SIB. Such plans should contain detailed descriptions of the organisational structure, the corporate governance, the legal entities and the business lines within a group, along with a road map for its efficient resolution.

Nonetheless, while resolution plans and resolvability assessments would be an important first step towards achieving the simplification of complex corporate structures and business activities, questions remain around the efficiency of such tools at this moment in time. Moreover, the speed with which authorities can respond to a cross-border crisis may be slowed by the fact that such tools are domestic in focus. One should also

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12 As eloquently described by Wolf, “panic may turn a solvent but illiquid bank into an insolvent one. The panic is then likely to spread throughout the banking system, partly because the insolvency of one bank directly affects that of others, but mainly because the same uncertainty about the true value of one bank’s assets also applies to those of the others”, Martin Wolf, Fixing Global Finance, cited in McCormick, 2010, p.63. On the same issue of loss of confidence and crisis contagion, Kaufman and Scott noted that “the initial domino does not fall on other dominos but it causes players to examine nearby dominos to see if they are subject to the same destabilising forces that caused the initial domino to fail”, Kaufman & Scott, 2003, p.374.

13 FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.3.
note that the implementation of certain resolution tools such as bail-in remains subject to legal uncertainty and unpredictability, potentially jeopardising the performance of resolution authorities. It is also arguable if the period of 48 hours – established in certain domestic resolution regimes in connection with the transfer of systemic banking services or the stay on specific contractual obligations14 – will prove sufficiently long in order to successfully conclude a resolution procedure; speed is essential, but it could also become the source of major legal issues and future litigations.15

In addition, taking into consideration the specific nature of banking activities, resolution regimes should maintain a focus on the rights and interests of depositors rather than (as in a typical corporate insolvency) other bank creditors or shareholders. Most legal texts concur.16 However, it is important here to make a clear distinction between insured and uninsured depositors. This regulatory choice to discriminate among depositors is not entirely convincing: the implementation of bail-in schemes, for example, would have far-reaching impacts on the rights of the latter. Mere rumours about a collapsing bank and its disastrous consequences can potentially lead to a bank-run. Possessing far less financial knowledge, and much less able to accurately predict movements in the markets than, say, a multinational company, an investment or a pension fund, depositors would therefore be at a huge disadvantage. Hence, being subject to the same treatment as other categories of financially apt creditors might prove problematic.17

14 For example, in Switzerland FINMA can impose a 48 hours stay on the exercise of certain rights and certain contractual agreements in order to avoid any spill-over effects from the opening of a resolution procedure, FINMA Banking Insolvency Ordinance, art. 56. Within this time period, the resolution authority should be able to disentangle all contractual obligations and decide which should be transferred to the post-resolution entity and which should remain with the residual entity.

15 For the issues raised from the litigation between the Lehman trustee and Barclays due to the errors committed from the rapid sale of Lehman’s subsidiary LBI to the British bank see pp.39–41.

16 For the IMF, effectiveness during a resolution is linked with “no losses to insured depositors and minimal losses to deposit guarantee schemes”, Fonteyne et al., 2010, p.28. The FSB elaborates more on the topic, adding that the protection of depositors and other insurance policy holders should always take place “in coordination with the relevant insurance schemes and arrangements”, FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.3.

17 With regard to this particular question of the treatment of depositors during a bail-in procedure, one may find an analysis in section 6.4.
Furthermore, all political declarations relating to the eradication of the ‘too big to fail’ problem emphasise that, in future, taxpayers should not be expected to bear the financial and fiscal cost of regulatory interventions in the banking sector. Rather, the banking sector – by contributing to resolution funds – should directly bear the cost of the implementation of resolution procedures. Given the likely impacts of instruments such as bail-in on uninsured depositors, however, part of the overall costs of bank resolution will still inevitably be borne by taxpayers.

By and large, resolution policies will result to practices allocating the majority of losses between unsecured creditors and shareholders. This principle should not allow, though, for unrestricted powers exercised by the resolution authorities. The appropriate allocation of losses between shareholders and creditors should remain a vital resolution objective, subject to fair and transparent rules safeguarding the hierarchy of the different creditors’ classes and the doctrine of the *pari passu* treatment of equally ranking creditors.

This issue of how to treat shareholders and creditors under a bank resolution procedure has the potential to create immense complexities, and it will be analysed separately under chapter 7. However, it should be mentioned here that the involvement of shareholders and creditors in the allocation of losses, as well as the imposition of certain restrictions on their rights, are important characteristics of bank resolution. Although these stakeholders enjoy a much more cardinal role in a classic insolvency procedure, their fundamental rights – not only property, but also governance rights – need to be subject to specific restrictions in order to promote the objectives of bank resolution.

Nonetheless, these restrictions should be also subject to certain limits: while creditors and shareholders might be penalised, their key rights should be also subject to protection and/or compensation from any actions on the part of resolution authorities that are deemed arbitrary or unjustifiable. Hence, it is also vital that appropriate safeguards are established for the parties suffering losses as a result of a bank resolution: discretion and

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18 For example the Dodd-Frank Act is very straightforward on its intentions during bank resolution by mentioning that “creditors and shareholders will bear the losses of the financial company”, Dodd-Frank Act, Title II, § 201(a)(1). The FSB also upholds that losses should be borne by those “with whom the risks properly reside”, FSB, Effective Resolution of SIFIs, 2011, p.9.
flexibility for resolution authorities should not be transformed into broad arbitrary actions. Most legal documents, however, fail to explicitly recognise this.\(^{19}\)

The aforementioned innovations and restrictions under bank resolution in connection with the rights of certain stakeholders are considered necessary in order to reduce the moral hazard risks posed by SIBs. In fact, bank resolution has been conceived as one of the antidotes to the problem of moral hazard, which the unconditional bail-outs during and after the 2008 financial crisis created. With the costs of the procedure being borne not by the taxpayers but mainly by creditors and shareholders – or even, according to the most ambitious plans for the creation of resolution funds, by the banking industry – banks will not be likely to take public solvency support for granted.\(^{20}\)

Through the containment of the moral hazard problem, bank resolution could foster better market discipline. This will eventually result from the ‘Darwinian’ survival of the most financially healthy banks or simply their most critical financial functions.\(^{21}\)

### 3.2 Prioritisation of resolution policy objectives

All in all, the creation of a bank resolution regime, whether on a domestic or a cross-border scale, should be in the pursuit of a wide variety of

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\(^{19}\) The UK Banking Act is the only national law highlighting the importance of safeguarding property rights according to their interpretation under the UK Human Rights Act, *UK Banking Act*, § 4(9). The UK Human Rights Act of 1998 is the domestic act adopted in the United Kingdom in order to ensure the implementation of the European Convention of Human Rights. Moreover, as claimed by the EU Commission, “*any interference with property rights*” should be restricted to “*what is necessary and justified in the public interest*”, [European Commission, Communication on an EU Framework for Crisis Management in the Financial Sector, 2010, p.4](#).

\(^{20}\) The UK Banking Act makes an implicit reference to the need to limit moral hazard by citing the protection of public funds as a resolution objective, *UK Banking Act*, § 4(6). Regarding the objective of protection of public funds, a resolution procedure for the IMF should entail “*minimal or no costs to government budgets*”, [Fonteyne et al., 2010, p.28](#).

\(^{21}\) As the FSB puts it, “*an effective resolution regime should ensure that non-viable firms can exit the market in an orderly way*”, [FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.3](#).
objectives. Some of these objectives are vital; others less so, yet all can nevertheless influence how one approaches the task of resolving a failing bank.

The major challenge for competent resolution authorities will be how best – amidst a financial crisis – to strike the perfect balance between all of these objectives. It is common ground that the successful future of bank resolution projects relies on the standardisation and prioritisation of these objectives and considerations (which group legal, political and financial aspects.) In the end, domestic resolution regimes – sharing common values, objectives and incentives – will contribute more actively to cross-border bank resolution schemes.

Bank resolution frameworks commonly present a full – or illustrative – list of resolution objectives, and decisions around which of these are considered the most appropriate for their policies are made entirely at the discretion of the resolution authorities. Although useful as a starting point for the implementation of resolution practices, the use of broad lists fails to provide resolution authorities with essential guidance. A progressive prioritisation of resolution objectives would be much more preferable in order to minimise differences in interpretation. Whilst it is practically impossible to ‘quantify’ resolution objectives, it is accepted that the 2008 financial crisis, and the regulatory responses that were adopted, demonstrated the primacy of specific objectives, especially those related to financial stability and cross-border impacts. However, standard-setting documents failed to transform these lessons into specific regulatory proposals.

The consequences of the failure to prioritise resolution policy objectives, in particular with regards to potential conflicts of interpretation, will be demonstrated with an example from the EU Bank Recovery and Resolution Directive.

It is stressed in the EU Bank Recovery and Resolution Directive that “resolution objectives are of equal significance”. At the same time, however, it is important to note that state discretion will be allowed in order to “balance them as appropriate to the nature and circumstances of each

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22 For instance, see UK Banking Act, §§ 4(3A)–(9) and EU Bank Recovery and Resolution Directive, art. 31.

23 The Key Attributes of the FSB did not simply avoid any standardisation or prioritisation of resolution policy objectives but they failed to provide even an indicative list.

24 EU Bank Recovery and Resolution Directive, art. 31(3).
In the context of a cross-border crisis, therefore, lack of coordination due to conflicting objectives cannot be ruled out.

Most of the objectives cited in the EU Bank Recovery and Resolution Directive are not necessarily mutually exclusive. This will depend greatly, however, on the specific circumstances of each financial crisis. For instance, if resolution authorities prioritise domestic concerns, they might opt for actions that favour domestic depositors or bank creditors over cross-border financial stability or the minimisation of value destruction across a European banking group. The example of blanket guarantees issued by certain EU Member States such as Ireland or Sweden during the 2008 crisis illustrates such potential hazards.

All in all, resolution objectives were formulated as broad standards, subject to case-by-case interpretation on a rather arbitrary basis. The task of striking the right balance between these diverse points of reference, and minimising their domestic focus will not be a straightforward one for domestic resolution authorities. One cannot deny that flexibility is a necessary element of bank resolution. Nonetheless, standardisation and prioritisation of resolution policy objectives by the relevant international standard-setting bodies will significantly improve cross-border crisis management. Clear objectives around the evaluation of the efficiency of domestic resolution regimes will also be essential. As summarised by Sjörberg, “we need to identify and set clear objectives to resolution as otherwise it will be difficult for policy makers or legislators to handle the decisions arising later in a rational and consistent manner. For academics it will be impossible to evaluate a system without the analytical base of clear objectives...There will be no means to say if a system is good or bad if there is no clear yardstick”.

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25 Ibid.
Chapter 4

RESOLUTION TRIGGERS

One of the key factors contributing to the latest global financial crisis was the inefficiency of the divergent state approaches, which hampered the timely and correct initiation of crisis management procedures.

The creation of clear-cut and transparent resolution triggers, as well as the achievement of a certain degree of harmonisation and coherence in how these are implemented, will be fundamentally important to the future success of resolution planning and effective functioning of cross-border cooperation agreements. In the case of group resolution plans, it is essential that participating jurisdictions adopt a consistent approach with regards to resolution triggers. Consistent rules will help to ensure that a level playing field is maintained across jurisdictions, and should facilitate cross-border cooperation and the coordination of crisis management efforts.

This chapter aims at demonstrating the necessity of triggers’ appropriateness and possibly standardisation. Appropriate because they are an essential part of the process. Through standardised triggering mechanisms, states will create a predictable environment regarding the legal impacts of bank resolution.

Nevertheless, the design of the optimal resolution trigger is not an obvious and simple task, as regulators should group legal, economic and political considerations in order to ensure its proper functioning. The purpose of this chapter is to highlight the existing regulatory discrepancies, as well as put forward some suggestions with regards to the crucial factors that should influence the elaboration of fully operational triggers (all the while keeping in mind the necessity to promote cross-border consistency).

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1 This chapter has been the basis for the article “Triggering events for recovery and resolution plans: towards better financial crisis management” published with Prof. Henry Peter in RSDA/SZW, 6/13, pp.536–553.
4.1 Definitions

4.1.1 Triggering events and crisis management stages

Based on FSB’s fundamental definition, triggering events can be described as “quantitative and qualitative criteria for identifying when an event has occurred or a situation is developing that requires senior management or supervisory authority attention, designed to prevent undue delays in addressing a recovery, resolution or winding-down situation”. There is an important distinction to be made between such triggers and ‘early warning indicators’, which are normally calibrated so as to alert financial institutions of oncoming adverse circumstances at an earlier stage than recovery triggers.

Consequently, triggering events should be regarded as crisis backstops, covering a broad range of crisis management scenarios, and ensuring the timely implementation of recovery and resolution plans. The specific characteristics of such triggers are often influenced by both the particular regulatory attitude of the jurisdiction in question, and the severity of the crisis tests they must address. By and large, legal statutes provide for the general lines and elements of the initiation of a crisis management trigger. Recovery and resolution plans are expected to establish a more detailed frame for each triggering event according to the potential options of crisis management strategies.

The principal objective of coherent triggering approaches would be to avoid or minimise the structural flaws that played such a significant part in the onset of the latest banking crisis. Back in 2008, constructive ambiguity had been described as a limit to moral hazard; nevertheless,
it contributed significantly to market panic and contagion. In fact, the development of efficient triggers – quantitative, as well as qualitative – will be a necessary step towards greater transparency and legal certainty. In addition, clear triggers will provide an essential safeguard for shareholders, creditors, investors and depositors (all of whom would be affected by a resolution procedure), and financial market stability more generally. It should be also stressed that triggers are expected to act as an incentive to banking management to proactively set in motion adequate initiatives that might avoid future situations that call for regulatory intervention or – even worst – liquidation.

In terms of the specific characteristics of each triggering event, it should be able to initiate one of the following three distinct crisis management hypotheses by order of severity: a) a recovery procedure, b) a procedure of bank resolution and c) a winding-up procedure.

Recovery is considered the first effective backstop into a bank’s overall risk management framework. It will consist of measures adopted by the financial institution itself aiming at restoring financial strength and viability when the bank comes under severe stress but it has not yet reached the point necessitating a regulatory intervention.6

If, however, recovery fails to deliver the expected results, as a second step the regulatory authorities will step in and implement a bank resolution procedure. Since the purpose of a resolution regime is to safeguard the systemic functions of a failing financial institution, a resolution regime should be initiated sufficiently early, i.e. at the pre-insolvency phase. As a rule, resolution measures place severe restrictions on the exercise of various shareholders’ and creditors’ rights and are based on far-reaching legal concepts such as the creation of bridge financial institutions or a bail-in implementation.

Finally – if the financial institution is no longer viable – the only option remaining would be to implement a classic winding-up procedure. Under this scenario, the regulator will close and liquidate the failing financial institution. This must be done in conformity with the relevant rules of bankruptcy legislation but here again with a view to implement the least prejudicial solution in the well-understood interest of all stakeholders.

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Although these definitions might seem logical and straightforward, the reality of interpreting and implementing such procedures is somewhat more complex: often, a poor, and sometimes conflicting, understanding of crisis management terminology can have significant impacts on the elaboration and implementation of triggering events.

4.1.2 The necessity of well-understood and defined crisis management concepts

If efficient triggers are to be created, it is vital that there is a common understanding of each of the potential crisis management stages and that the differences between each of these stages are sufficiently explicit. Despite the traditional distinction regarding an ailing financial institution between going and gone concern, in practice regulators are often understandably faced with an ambiguous gray area of financial viability. As a result, and due to the growing use of ‘soft’ triggers from state legislations, one can come across a variety of terms, all of which claim to adequately describe recovery, resolution and winding-up. This terminology might cover broad notions such as apparent solvency, non-viability, likely failure or a danger of default.

Supranational bodies such as the BCBS, the FSB and the EU Commission are currently working on the elaboration of fundamental standards, which could enhance harmonisation regarding the available crisis management terms. Despite progress in this field, at the end of the day, they bear part of the responsibility with regard to the existing regulatory confusion.

As mentioned in section 2.1, the definition on bank resolution is a useful example in support of this argument. In fact, this definition needs to draw clearly the line between resolution practices and the more general state of bank liquidation, which will lead to ordinary bankruptcy procedures. However, the wording “the institution is no longer viable” can create serious confusion as it can allow misinterpretations of the term viability. It is not evident if it refers to a pre- or post-insolvency stage of a financial institution. In any event, insolvency remains itself a grey area concept. In

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7 E.g. UK Banking Act, § 7(2).
8 E.g. Dodd-Frank Act, Title II, § 203(b)(1).
addition, if the authorities wait until the financial institution will have no reasonable prospect of surviving before implementing resolution measures, their intervention will come inevitably at a very – too – late stage. At that point, the financial institution might even have become insolvent and resolution will be an unnecessary process.

The corollary statement provided by the FSB regarding the BCBS’ definition on bank resolution contributes in additional frustration. The FSB highlighted that “the resolution regime should provide for timely and early entry into resolution”. Such a component of the definition could result in confusion of the notion of resolution with the concept of recovery.

Thus, there is a great deal of ambiguity around the various stages and concepts. Whilst one might reasonably argue that the primary task of supranational standard-setting bodies is to introduce guidelines that are suitably broad so as to leave states a margin of discretion in defining each of the concepts contained within, in the following section it is argued that relying too heavily on states to use their discretion has the perverse effect of leading to regulatory divergence, which might become a significant obstacle to cross-border coordination.

### 4.2 Current regulatory approaches to triggering events

An overview of the solutions currently adopted by domestic legislations provides a clear image of the growing fragmentation of resolution triggers. Certain jurisdictions focus, for example, on traditional over-indebtedness concepts; others establish triggers relating to qualitative criteria; meanwhile other jurisdictions prefer a more discretionary approach, one that is based on non-viability tests.

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10 FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.7.
12 According to the BCBS, most jurisdictions have the tendency to adopt pre-insolvency qualitative regulatory triggers, exercised within the discretion of the authorities, with the examples of jurisdictions introducing quantitative prudential thresholds being much fewer, BCBS, 2011, pp.13–14.
**4.2.1 Quantitative triggers**

Triggers tend to be predominantly quantitative. They can be further classified according to three distinct categories: a) those based on the traditional notion of over-indebtedness, b) those following a prospective liquidity test and c) those linked exclusively to regulatory capital criteria.

**4.2.1.1 Over-indebtedness / balance sheet test**

The balance sheet determination of over-indebtedness has been part of the two-pronged classic evaluation of non-viability of a financial institution. This test determines a situation whereby the bank’s liabilities exceed the assets and, consequently, its equity is depleted.\(^{13}\)

The balance sheet test of non-viability has come under severe criticism and is considered relatively outdated. First of all, it can provide a misleading image of an institution’s financial health. The variety of accounting standards and valuation techniques used can lead to different interpretations and results, allowing for arbitrariness and uncertainty. In addition, as this evaluation is based on information that the authorities cannot easily access and as this approach is by essence backward-looking, the regulator’s intervention will normally come at a very late stage limiting the efficiency of his actions. In other words, it could be considered as inherently flawed because it amounts to a retrospective test of financial viability.

Among the various jurisdictions, Switzerland has maintained the balance sheet test as part of bank insolvency interpretation.\(^{14}\) More recently, the EU introduced a broad test for triggering resolution in its Bank Recovery and Resolution Directive, cumulatively grouping non-viability, the absence of any private sector alternative or supervisory action and the protection of public interest.\(^{15}\) The notion of non-viability – referring to a situation when the institution is deemed failing or likely to fail – will be interpreted through additional requirements including balance sheet analysis, among others.\(^{16}\)

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\(^{13}\) UNCITRAL, 2005, p.46.

\(^{14}\) Swiss Banking Act, art. 25(1).

\(^{15}\) EU Bank Recovery and Resolution Directive, art. 32(1).

\(^{16}\) Ibid, art. 32(4)(b).
4.2.1.2 Liquidity / cash flow test

One of the key lessons learnt following the latest financial crisis is that within international banks – with their complex corporate structures, important counterparties’ exposure and significant interconnectedness within the financial markets – a liquidity crisis is the primary source of financial distress. It is surprising to think that, prior to 2008, financial viability assessments had largely neglected to take account of liquidity factors: by comparison, since the crisis regulators have shown growing interest in the role of liquidity as a key element of interpretation of the deteriorating financial condition of a bank. This marks a significant change in regulatory mentality, which helped to shape the Basel III framework and the legal developments that followed.17

The cash flow / liquidity test describes the case when a bank will not be able to service its existing obligations as they will fall due.18 This approach of insolvency evaluation seems much more appropriate as it is well known that businesses die of lack of liquidity rather that of lack of capital. More importantly still, it is essentially a prospective – as opposed to retrospective – viability test.19

Cash flow is therefore a key indicator, which can – and should – be used as an early warning of potential liquidity problems. Nonetheless, it remains a forecast based on plausible scenarios rather than facts, predicting what might happen given a particular set of circumstances.20 Even so, notwithstanding the fact that this methodology was originally conceived for business failures within a normal economic environment and not systemic financial crises,21 it should be regarded as the preferred method of assessing/predicting potential distress.

Under the Swiss Banking Act, for example, every bank is obliged to perform stress tests for its liquidity position before FINMA decides to impose a winding-up procedure.22 The EU will also resort to liquidity analysis

17 See section 2.3.1.2.
19 Henry Peter, Bankruptcy and Reorganisation Trigger Criteria: From a Retrospective (Balance Sheet) to a Prospective (Cash Flow) Test, in Peter, Jeandin & Kilborn, 2006, p.35.
22 Swiss Banking Act, art. 25(1).
for the interpretation of financial viability, either on an isolated basis or cumulatively with a balance sheet test.\textsuperscript{23}

4.2.1.3 Regulatory capital criteria

Along with the traditional balance sheet and cash flow tests, it has become a common practice to use capital ratios as a basis for triggering interventions in failing banks. Following the 2008 financial collapse and the severe new rules under Basel III, banks are now required to hold more – and qualitatively better – capital. The underlying assumption is that financial institutions that are ‘better capitalised’ are better protected against financial collapse. On this basis, financial markets and policy-making bodies have entered into a regulatory race over the last few years.

In the US, the FDIC has had a long tradition of using quantitative capital requirements for the exercise of its crisis management powers. The capital ratio of each bank remains the most critical indicator of financial viability with severe restrictions imposed in a progressive manner on under-capitalised, significantly under-capitalised and critically under-capitalised institutions.\textsuperscript{24}

Moreover, one of the direct and innovative responses to the last financial crisis has consisted in the broad recourse to various contingent convertible capital instruments, focusing by essence on the recapitalisation of financial institutions and not on their liquidity needs.\textsuperscript{25} The triggering events of these instruments, resulting in this debt-to-equity conversion or debt write-down, are directly linked to the safeguard of specific capital ratios.

In the latest amendments to its Capital Adequacy Ordinance, Switzerland introduced for systemic banks two capital buffers, the breach of

\textsuperscript{23} EU Bank Recovery and Resolution Directive, art. 32(4)(c).

\textsuperscript{24} The capital ratios created are the following: well-capitalised (capital ratio > 10%), adequately capitalised (capital ratio > 8%), under-capitalised (capital ratio < 8%), significantly under-capitalised (capital ratio < 6%) and critically under-capitalised (capital ratio < 2%), Mathias Dewatripont & Xavier Freixas, Bank Resolution: Lessons from the Crisis, in Dewatripont & Freixas, 2012, p.118.

\textsuperscript{25} One should point out here that such hybrid instruments remain highly untested and during the 2008 financial collapse did not behave as expected by failing to absorb widespread losses, Pazarbacioglu, Zhou, Le Leslé & Moore, 2011, p.8.
which will initiate a recovery or resolution procedure: a) a capital conservation buffer, which will serve the objectives of recovery and will impose a debt-to-equity conversion once the regulatory capital falls under 7% of RWAs and b) a progressive capital component, which will be used for the purposes of resolution resulting in a debt-to-equity conversion as soon as the regulatory capital falls under 5% of the RWAs.

Overall, the entirety of hybrid contingent convertible bonds in today’s market, in as well as outside Switzerland, is based on capital ratios.

### 4.2.2 Qualitative triggers

Unlike quantitative triggers, qualitative triggers will not be directly related to any specific capital or liquidity ratio. Under this approach, the financial aspects of the bank will remain crucial for the initiation of the trigger but a certain degree of discretion applies for the interpretation of the bank’s viability. As highlighted by the FSB, qualitative triggers may include criteria such as an unexpected loss of senior management, adverse court rulings, significant reputational damage or requests from counterparties for early redemption of liabilities.

With regards to credit institutions, the FDIC can, for example, use a variety of qualitative triggers in order to determine the need for regulatory intervention. These triggers range from violations of regulations that are likely to cause insolvency, the cessation of insured status, an unsafe and unsound condition to transact business, concealment of the institution’s books, records or assets, as well as money laundering offences. Such qualitative infringements do not need to take place on a cumulative basis with quantitative breaches in order to cause the intervention of the FDIC.

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26 **Swiss Capital Adequacy Ordinance**, art. 129.
27 *Ibid*, art. 130.
28 For instance, Lloyds had issued CoCo bonds in late 2009 providing for an automatic debt-to-equity conversion if the core capital of the bank falls under 5%. Rabobank’s CoCos, issued in January 2011, will be written down once they hit a trigger, below an equity capital ratio of 8%. Finally, Barclays issued twice such financial instruments, which will lead to a write-down to zero if the common equity Tier 1 ratio of the bank falls under 7%.
29 **FSB, Recovery and Resolution Planning for SIFIs**, 2013, p.5.
30 **FDIA, §§ 11(5)(C), (E), (H), (J) and (M).**
Under the new requirements of the Swiss Banking Act, designed to improve resolvability and facilitate the process of recovery and resolution planning, systemic banks will have to satisfy qualitative conditions relating to risk diversification, corporate organisation (i.e. corporate governance) and the safeguard of systemic financial services.31 If the bank is unable to demonstrate that it can fulfil these requirements in case of an insolvency threat, then FINMA will intervene and impose appropriate measures to improve resolvability.32

4.2.3 Discretionary triggers

Discretionary or so-called ‘soft’ triggers are designed to be “less rules focused and more judgment based”.33 Regulatory authorities will not mechanically base their intervention on the breach of thresholds referring to capital, liquidity or any relevant business performance parameters. On the contrary, discretionary triggers provide state regulators with broad powers to assess if, when and which measures should be adopted.

Discretionary triggers are suggested to be the most popular current solution to the enigma of suitable triggering events, with almost the totality of new bank resolution regimes having introduced at least some degree of discretionary powers for resolution authorities regarding the interpretation of the appropriate moment of their intervention.34 The following examples show this current trend.

New resolution triggers were introduced in the US under the Dodd-Frank Act in 2010. Under this Act, a much broader definition of resolution thresholds was adopted; one which allowed for an interpretation of the potential danger of default and the potential resultant consequences for US financial stability.35 Whilst the triggers proposed under Dodd-Frank grant

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31 **Swiss Banking Act**, art. 9(2).
32 *Ibid*, art. 10(2).
35 The authorities can intervene when among others, a) a financial company is in danger of default, b) its failure would have serious adverse effects on the financial stability of the US, c) no viable private sector alternative is available to prevent this default and d) any resolution action by the authorities would avoid or mitigate such adverse effects, **Dodd-Frank Act**, Title II, §§ 203(b)(1)–(7).
the authorities even greater discretion in determining the appropriate timing for an intervention, they need to be cumulatively satisfied before the authorities decide to intervene.

On the other side of the Atlantic, the following two general conditions were introduced in the UK Banking Act, under which the UK authorities should exercise their resolution powers: a) the failure or likely failure of the bank to meet the threshold conditions so as to carry regulated activities and b) the unlikelihood that action will be taken by or in respect of the bank that will enable it to satisfy the threshold conditions. The evaluation of this likely failure is subject to the appreciation of the financial regulator.

Finally, the introduction of the point-of-non-viability trigger in the Swiss Capital Adequacy Ordinance grants both broad and discretionary intervention powers to FINMA with regards to evaluating a bank’s insolvency risk.

4.2.4 Potential problems relating to current regulatory approaches

The above overview of current regulatory approaches with respect to triggering events substantiates the opinion that regulatory inconsistency remains a significant obstacle to the standardisation of bank resolution practices.

First of all, it is observed that it has become a common practice to base triggers on regulatory capital ratios. But such tests result from complex accounting standards and tend to focus on the current rather than the prospective financial health of a bank. As such, regulators tend to forget that back in 2008 it was a shortage of liquidity – not capital – that brought international banks to their knees. In the case of most failing banks, capital triggers had been inefficient, as they could not reflect the growing cash adequacy problems within the financial institutions. Some of the banks

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36 And that despite the interpretation of terms such as default or danger of default by the Act, ibid, § 203(c)(4).
37 Within the meaning of § 41(1) and schedule 6 of the UK Financial Services and Markets Act.
38 UK Banking Act, § 7.
39 Swiss Capital Adequacy Ordinance, art. 29.
– even those successfully recapitalised through the intervention of state authorities – were unable to reassure the markets of their financial health; they continued to face liquidity pressures, which eventually pushed them to collapse.41

Illiquidity remains the broadest financial risk for modern financial markets.42 Consequently, regulatory focus has gradually shifted to liquidity risk. Questions remain, however, around the potential effectiveness of capital adequacy standards to avert a future large-scale financial crisis.43 For these reasons, the debate around triggering events should also – or perhaps essentially – focus more on cash adequacy.

Furthermore, the implementation of discretionary triggers might prove problematic. It is true that, on the one hand, such triggers will ensure flexibility, as they will allow regulators to adapt to the rapidly evolving and multi-factor reality amidst a financial crisis. On the other hand, however, discretionary triggers include an inherent danger of regulatory forbearance.44 A broad margin of judgment before an intervention might result in untimely crisis management actions, raising serious concerns in the markets, condemning a financial institution and potentially contributing to market contagion. They also lack any predictability, which is so essential for financial markets.

One should also stress that regulatory divergence might become a considerable obstacle to cross-border cooperation. If various – national or supranational – authorities opt for diverse, uncoordinated and sometimes conflicting triggering criteria, it is highly unlikely that will result in a consistent approach with regard to the resolution of international banks, which are often crucial because of their systemic relevance.

41 Fortis is an interesting example corroborating this argument. Despite an urgent bailout by the BENELUX governments on the 28th September 2008 for a total of € 11.2 bn recapitalising the bank, Fortis faced continuous market and liquidity pressures and was eventually broken up along national lines and acquired by the Dutch government and the French group BNP Paribas.


44 Regulatory forbearance describes a situation when a financial regulator decides to postpone an intervention, despite being fully aware of the financial distress of an ailing bank.
Chapter 4: Resolution triggers

With this in mind, the following section suggests what the main constituent features of a desirable resolution triggers approach might (or should) be.

4.3 The quest for a suitable trigger

The section begins by touching upon the issue of the timing of regulatory intervention. There seems to be in fact notable confusion regarding when crisis management should kick-in and what can be done depending on the point in time at which it does. It then addresses the nature of the criteria that could be used in order to efficiently determine the need for regulatory intervention. The final proposal highlights the need for a transition of solvency evaluation from accounting standards to risk and market-value based models. Finally, this section explores how the existing clash between ‘soft’ and ‘hard’ triggers could be solved.

4.3.1 Appropriate timing of the intervention

As already discussed in section (4.1.2), the lines between the terms used to define the distinct phases of crisis management seem to have become blurred, with the use of ‘soft’ triggers further contributing to this growing confusion around concepts such as recovery, resolution and winding-up. State legislators should develop – and include in bank insolvency rules – more precise definitions, as well as clarify the most appropriate moments of intervention in order to promote predictability and facilitate the work of regulators amidst a financial crisis.

The establishment of a sequence of crisis management triggers, which will allow for a progressive intervention of the financial regulator, should be favoured. The intensity of the regulator’s intervention will increase with the severity of the ongoing crisis. The choice of a high (i.e. early stage) trigger would focus on recovery whereas a low (i.e. later stage) trigger would focus on resolution.45 The final stage of triggers would be designed for the

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45 An interesting example is the Swiss Capital Adequacy Ordinance regarding the triggers of contingent convertible capital instruments maintained by a systemic bank in its capital buffers, see p.135.
initiation of a winding-up procedure. Each trigger and the resulting measures must be conceived as a whole. Appropriate measures should be adopted under each scenario to address the specific needs of the financial institution at any given stage of a crisis.

Such a progressive approach will safeguard the principle of proportionality. Especially in the case of bank resolution, the decision of regulatory authorities to intervene might eventually deprive shareholders and creditors from their governance, as well as from fundamental property rights. As a result, such measures should kick in at an appropriate time following the evolution of a crisis and only if previous measures addressing recovery have already failed.

As most jurisdictions opted for broad, discretionary triggers or traditional solvency tests that do not necessarily distinguish between the separate phases of crisis management, there are few examples in the field of banking regulation endorsing such a progressive approach in respect of triggering events and the measures they lead to.

An interesting exception to the current regulatory practices is the system of Prompt Corrective Action operated by the FDIC concerning the treatment of failing US credit institutions. The US authority applies a progressive course of action using regulatory capital as a factor of determination of the severity of a bank’s crisis. The law grants authorities no powers of intervention as far as ‘healthy’ or adequately capitalised banks are concerned. If a bank is deemed under-capitalised, however, the regulator will initiate a process of close monitoring, and place upon the bank an obligation to submit – and implement – a capital restoration plan, in accordance with the Federal banking agency’s instructions. Should the bank fail in any material respect to implement this restoration plan and should it become significantly under-capitalised, the available measures in the arsenal of the FDIC include a forced recapitalisation, restrictions of assets’ growth, of specific activities and of transactions with affiliates, the appointment of new directors, as well as a procedure of divestiture. The same regulatory measures are applicable with regards to the final stage of crisis management; in other words, when a bank is considered critically under-capitalised. In addition, the FDIC may appoint a receiver, thus initiating a resolution procedure for the credit institution.

46 FDIA, § 38(e).
48 Ibid, § 38(h)(3).
In Switzerland, after the 2008 crisis FINMA put in place a similar progressive intervention framework with respect to insurers. This example is also of interest; after all, cross-fertilisation, as well as a unified approach between the two sectors, is actually desirable.

The FINMA Circular 2008/44 regulates the so-called Swiss Solvency Test, which applies in Switzerland to insurance companies. In its Appendix 4, it sets out the actions that FINMA may progressively initiate, when an insurance company does not satisfy the requirements of a test which is based on various thresholds. The criterion is the Risk Bearing Capital (RBC) of the company compared to its Target Capital (TC) as defined in the Circular. If the company operates within a green zone (RBC > 100% of TC), FINMA will initiate no action.\(^{49}\) Should the company enter the yellow zone (RBC = between 80% and 100% of TC), FINMA will “intensify the risk dialogue” with the company and will order it to perform a causal analysis for the drop of its RBC.\(^{50}\) Further restrictions concerning for example dividend payments and intra-group transactions are not excluded. In case the insurance company is in the orange zone (RBC = between 33% and 80% of TC), FINMA will tighten its intervention measures requiring the creation of a restructuring plan and imposing restrictions linked to liquidity and risk management.\(^{51}\) Finally, if the company reaches the red zone (RBC < 33% of TC), FINMA will take immediate steps in order to increase the RBC or transfer part of the insurance portfolio to a third – sounder – company.\(^{52}\) The revocation of the insurance license is the measure of last resort.

### 4.3.2 Appropriate elements

#### 4.3.2.1 Towards an economic model of financial standards

Triggers based on the value of equity and other regulatory capital ratios have been repeatedly criticised as representing a solvency image of a financial institution based purely on traditional accounting standards.

\(^{49}\) FINMA Circular 2008/44, Appendix 4, n. 13.
\(^{50}\) Ibid, n. 14–27.
\(^{51}\) Ibid, n. 28–36.
\(^{52}\) Ibid, n. 37–40.
On the one hand, the initiation of the trigger frequently relies on the evolution of equity to assets ratios. The evaluation of equity under this scenario is influenced by numerous accounting principles, which are subject to application bias and cross-border divergences. Consequently, capital ratios resulting from the comparison of the value of equity to the financial institution’s assets might be prone to discretion and, sometimes, manipulation. Many cases demonstrated the limits of such an approach, such as the Japanese banking crisis in the 1990s and the example of certain US banks during the 2008 financial meltdown. Moreover, the valuation of assets, especially amidst a rapidly evolving financial crisis, might be extremely difficult and reasonable certainty cannot be achieved.

Also, not only can the value of equity be potentially manipulated, but in 2008 it was also a lagging indicator regarding the financial condition of most banks. It is therefore understandable that the markets have treated these reported book values with increasing scepticism since the 2008 crisis.

The Basel Committee has also endorsed the option of using indicators based on the level of RWAs of the banks for the evaluation of regulatory capital requirements. Nevertheless, such a concept is subject to divergent methods of risk assessment implementation among different financial institutions and across jurisdictions. For instance, the accounting mechanisms employed by Northern Rock for its risk weight computations had an impact on the final collapse of the bank.

53 Among these standards, obviously the IFRS and US-GAAPs.
54 The Japanese banking system was practically insolvent for almost a decade, however, the accounting manipulation of capital ratios allowed Japanese banks to fulfill their minimum book value capital requirements under the Basel accords, Claessens, Herring & Schoenmaker, 2010, p.72.
55 Certain US financial institutions, which were eventually shut down or forced into government-assisted mergers, had maintained strong regulatory capital ratios, which were not near the under-capitalisation threshold necessitating an intervention of the authorities. This had been the case for Bear Stearns, Washington Mutual, Lehman Brothers, Wachovia and Merrill Lynch, which presented capital ratios ranging from 12.3% to 16.1%, Dewatripont & Freixas, 2012, p.118.
56 In 2008, Morgan Stanley, an expert financial institution on assets’ valuation, entered into negotiations with Wachovia for a potential acquisition by the latter. After two weeks, Wachovia became insolvent, Herring, 2011, p.27.
58 Herring, 2011, p.27.
59 Northern Rock, after receiving the accord of the FSA, used Basel II’s advanced risk weight approach, which resulted in a reduction of its mortgage portfolio from 50% to 15%. As the bank was considered being well in excess of its regulatory capital
Le Leslé and Avramova were among the first to demonstrate how variations in the calculation of RWAs across banks and jurisdictions could actually undermine the implementation of Basel III capital standards. In a study that focused on 14 banks from Europe, Asia Pacific and North America, they highlighted significant variations both across and within regions in the RWA density (the percentage of RWAs over total assets).\(^{60}\) The principal factors behind such variations are differences in the regulatory (reporting under the Standardised Approach versus the Foundation Internal Rating Based or Advanced Internal Rating Based Approach), supervisory (validation of RWA calculation models, RWA classification methodology) and accounting framework (IFRS versus US GAAP or other local accounting standards). Average risk weights for non-IFRS banks are higher than those for IFRS banks) as well as in the business models (retail banks tend to have higher RWA densities than universal or investment banks) and portfolio of banks.\(^{61}\) The variations arising from such factors are a matter of important concern for regulators, investors and financial institutions.\(^{62}\)

In July 2013, the Basel Committee conducted a study using a hypothetical portfolio of 31 banks to assess regulatory consistency around the evaluation of RWAs for credit risks. The study – in which participating international banking groups were asked to evaluate the risk of a common set of (largely low default) wholesale obligors and exposures – revealed notable dispersion: capital ratios could vary as much as 15% or 20% in relative terms (1.5 to 2 percentage points) in either direction around the capital requirement benchmark of 10% used for the study.\(^{63}\)

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\(^{60}\) The level of variation went from 23% (Europe) to 77% (North America), Le Leslé & Avramova, 2012, pp.9–10.


\(^{62}\) The main concern of regulators is that inaccurate risk measurements could lead banks to under-estimate risks, over-estimate their capital adequacy and send wrong signals about their true solvency and resilience. In addition, pro-cyclicality could be another unwelcome result. Due to the subjective nature of RWAs calculation, investors worry that capital ratios comparison both cross-border and within a specific country could be challenging resulting in a potential confidence crisis and reciprocate distrust. Finally, banks fear that financial institutions with lower RWAs might benefit from an undue competitive advantage, ibid, pp.7–8.

\(^{63}\) BCBS, Regulatory Consistency Assessment Programme, 2013, p.8.
The Basel Committee identified three principal explanations for this considerable variation: a) varying Internal Ratings-based approaches by the financial institutions regarding credit risk assessment, b) diversity in supervisory choices and c) supervisory deviations in the national implementation of the Basel standards.\textsuperscript{64}

By and large, and following the progressive implementation of the new Basel III standards relating to regulatory capital, it is estimated that capital ratios will continue playing an important role in the final determination of crisis management triggers.\textsuperscript{65} However, they should be based more on a synergy of economic, risk and market-value approaches. A marked-to-market evaluation model will obviously provide a fair and more realistic assessment of the financial health of a bank compared to a static book value of equity appraisal, provided there is a reliable liquid market. The constant value changes not only of the assets, but also of the institution’s liabilities due to the shifts in market conditions will, in any event, be better reflected through such a model. Moreover, with regard to risk assessment and its impacts on regulatory capital, although some diversity is desirable,\textsuperscript{66} the Basel Committee should probably better identify the areas that require further clarification, guidance, potential constraints to flexibility and discretion, as well as enhanced cross-border disclosure.\textsuperscript{67}

4.3.2.2 Forward-looking elements

The desirable approach towards efficient resolution triggers should include more forward-looking elements able to proactively detect whether

\textsuperscript{64} Ibid, p.7.

\textsuperscript{65} Capital ratios triggers are objectively less prone to manipulation than stock prices or ratings. Moreover, they are not significantly affected by market contagion as liquidity is, Pazarbacioglu, Zhou, Le Leslé & Moore, 2011, p.19. They will also incentivise shareholders and management to follow more prudential business practices and explore private sector options for recapitalisation, so as to avoid the activation of the trigger.

\textsuperscript{66} As stressed by Le Leslé and Avramova “some variations among estimates of RWAs for similar risks may be acceptable and contribute to financial stability, through the co-existence of different business choices, models and risk appetites. A uniform risk measurement might lead to herd behavior and be detrimental to some asset classes, while others could become over-crowded”, Le Leslé & Avramova, 2012, p.28.

\textsuperscript{67} BCBS, Regulatory Consistency Assessment Programme, 2013, pp.8–10.
a banking venture is likely to fail or be distressed. Such triggers could encompass both quantitative and qualitative criteria. One could cite a long list of such features, admitting however that not all of them are adequate to address the challenges of a financial crisis.

First of all, one could resort to the use of ratings downgrades. When evaluating the financial health of a bank, rating agencies take into consideration a variety of accounting, market-based, as well as qualitative standards. Consequently, their rating estimation could become a useful proxy for the identification of future financial problems. Unfortunately, the 2008 financial crisis disproved this theory; rating agencies failed to adequately identify – or reveal – the deterioration in global financial markets in a timely manner.

Moreover, triggers could be based on stock prices. It has been noticed that, in various cases of collapse of both financial institutions and mega-corporations, a severe and persistent decline in the market value of their equity had taken place, before they entered the final stage of insolvency. Nonetheless, relying on stock prices as a basis for identifying financial problems is not without risk: stock prices might be prone to manipulation. Furthermore, stock prices might not be the most reliable source of timely information since they are thought to only be able to reflect small valuation changes over small periods of time. Finally, a trigger linked to the stock price movements might contribute to panic during crisis situations. Fearing that the sale of shares by exiting shareholders might eventually activate the trigger, existing shareholders may be panicked into following suit and selling their own equity so as to have exited the bank before an anticipated resolution procedure.

Furthermore, as mentioned above, the importance of liquidity management in the post-2008 era is underscored by the new liquidity ratios introduced by the BCBS, and the various requirements under domestic legislations for systemic banks to hold liquidity buffers. Hence, forward-looking triggers should reflect such considerations. The inability of a bank

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68 See the examples of Lehman Brothers and Enron, Claessens, Herring & Schoenmaker, 2010, p.73.
69 In recent years, the stock market values of Citigroup and Bank of America have often been less than half of their book values, Admati & Hellwig, 2013, p.87.
70 Claessens, Herring & Schoenmaker, 2010, p.73.
to fulfill its cash requirements could call for an intervention of the authorities. This action should allow an intervention before a liquidity squeeze deteriorates and results into a further solvency crisis.

The main concern is that the use of liquidity triggers might give rise to conflicting interpretations of recovery versus resolution. To date, liquidity problems, especially in their most severe form, have been addressed by central banks under the LOLR function. Yet the link between a liquidity crisis and the role of state authorities with respect to the opening of a resolution procedure might be in conflict with this fundamental role of the central banks and result in a situation whereby banks with urgent liquidity assistance will be considered insolvent. Nevertheless, many of those financial institutions relying repeatedly on central banks for liquidity already face growing solvency problems, and might have already passed the threshold for recovery.

One should also note that state regulators should apply caution when fixing the level of such liquidity ratios as certain features of liquidity regulation remain potentially controversial. A primary example of potential controversy is the definition of liquid assets, which is currently much broader under the Basel standards than under most domestic regulatory regimes. To help overcome such potential controversies, liquidity ratios could be complemented by qualitative evaluations under stress tests and other supervisory exercises; the results of such stress tests or crisis management scenarios would precipitate the initiation of these types of triggers, emphasising the financial vulnerability of a bank.

Finally, the credit default swaps (CDS) spreads of a financial institution could also provide crucial information that might be used as the basis for activating a trigger. A CDS refers to the possibility of a given firm’s failure; in fact, its price reflects the market’s estimation of how likely it is that the firm will not to be able to repay its debt in full. In the case of the US financial institutions, the evolution of their CDS spreads took an abrupt turn after the summer of 2007. Based on figures provided on key

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72 Andrew Campbell & Rosa Lastra, Definition of Bank Insolvency and Types of Bank Insolvency Proceedings, in Lastra, 2011, p.31.
74 Charlie Beach & Claire Rieger, Liquidity and Funding, in Barfield, 2011, p.159.
dates between August 2007 and September 2008, it turns out that the CDS market provided a remarkably accurate indicator of the forthcoming collapse of certain troubled US banks. The following table summarises these findings.\(^{76}\)

<table>
<thead>
<tr>
<th>Financial Institution</th>
<th>15/08/2007</th>
<th>31/12/2007</th>
<th>14/03/2008</th>
<th>29/09/2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>11</td>
<td>29</td>
<td>93</td>
<td>124</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>23</td>
<td>45</td>
<td>113</td>
<td>113</td>
</tr>
<tr>
<td>J.P. Morgan</td>
<td>19</td>
<td>32</td>
<td>141</td>
<td>103</td>
</tr>
<tr>
<td>Citigroup</td>
<td>15</td>
<td>62</td>
<td>225</td>
<td>462</td>
</tr>
<tr>
<td>Wachovia</td>
<td>14</td>
<td>73</td>
<td>229</td>
<td>527</td>
</tr>
<tr>
<td>Washington Mutual</td>
<td>44</td>
<td>422</td>
<td>1,181</td>
<td>3,305</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>28</td>
<td>78</td>
<td>262</td>
<td>715</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>31</td>
<td>129</td>
<td>403</td>
<td>1,748</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>29</td>
<td>159</td>
<td>410</td>
<td>666</td>
</tr>
<tr>
<td>Lehman Brothers</td>
<td>38</td>
<td>100</td>
<td>572</td>
<td>1,128</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>113</td>
<td>224</td>
<td>1,264</td>
<td>118</td>
</tr>
<tr>
<td>AIG</td>
<td>31</td>
<td>59</td>
<td>289</td>
<td>821</td>
</tr>
</tbody>
</table>

Based on the same approach, the following table presents the CDS prices for the two Swiss systemic banks on the same dates as cited above for certain key US financial institutions. The result is as follows: \(^{77}\)

<table>
<thead>
<tr>
<th>Financial Institution</th>
<th>15/08/2007</th>
<th>31/12/2007</th>
<th>14/03/2008</th>
<th>29/09/2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>UBS</td>
<td>33</td>
<td>46</td>
<td>209</td>
<td>308</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>50</td>
<td>49</td>
<td>188</td>
<td>157</td>
</tr>
</tbody>
</table>

As this table illustrates, UBS’ CDS rates rose progressively during this selected one-year period (August 2007 – September 2008). It was in August 2007 that the bank first became aware of its true exposure to the sub-prime market, with the SFBC ordering an immediate increase in capital requirements. As UBS continued to deteriorate, the SNB, the SFBC and

\(^{76}\) Oliver Hart & Luigi Zingales, Curbing Risk on Wall Street, in Claessens, Evanoff, Kaufmann & Kodres, 2012, p.326. All figures are in basis points per year.

\(^{77}\) Source: Bloomberg.
the Federal Department of Finance (FDF) started working in early 2008 on a possible worst case scenario for the bank. In March 2008, the SFBC required a change of management and, by early September 2008, all three Swiss authorities were confronted with the necessity of a massive state intervention in order to save UBS, an intervention that was implemented in October 2008. This evolution is reflected in the CDS rates’ evolution in a manner, which is rather anticipatory compared to most other sources of information.

Credit Suisse had also been subject to close monitoring during this same time period, although had maintained a better CDS rate performance than UBS. As of August 2007, Credit Suisse was subject to stricter capital requirements; as the bank had been exposed to the subprime market, the SFBC implemented specific measures from March 2008 onwards forcing Credit Suisse to significantly limit its global exposure in the field of Leveraged Finance products. The bank needed to be recapitalised, but was able to achieve this in October 2008 with funds from private sources.

It is interesting to compare the CDS spreads of the two Swiss banks during the relevant time period: in hindsight, they appear to be quite accurate indicators of the respective bank’s strength.

That said, there have been two principal arguments against the use of CDS spreads as a future crisis indicator. Firstly, the pricing of the risk through such financial instruments is not constant over time. Therefore, they might send conflicting signals to financial markets and regulators. Secondly, they developed a negative reputation during the 2008 crisis as being potentially subject to manipulation and perhaps one of the causes of the crisis. However, one should highlight that what was problematic in 2008 was not the CDS instruments per se, but rather the way in which they were traded, and the complete absence of collateralisation by most financial institutions selling CDS insurance.

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78 It has been observed that “a CDS spread at one point of the business cycle, under one set of market conditions, can be indicative of a higher level of risk than that same spread observed at another time under a different set of business conditions”, Claessens, Herring & Schoenmaker, 2010, p.72.

79 When entering into a CDS transaction, the seller of CDS will have to post collateral, primarily cash, to the buyer of CDS in an amount equal to the marked-to-market value of the total CDS trades. The seller, thereafter, has to update its collateral position daily and post more collateral if the likelihood of default and, thus, the value of the CDS contract increases. Before the 2008 crisis, the CDS market did not require
In the end, it appears that there exists no ‘silver bullet’ solution when choosing from among all of the forward-looking instruments available in terms of their effectiveness as acting as early warning indicators of the potential need for a crisis management procedure. To the contrary, each option has its own unique strengths and weaknesses. The final choice should be based on a combination of all – or some – of the factors highlighted above. A critical evaluation of these parameters by regulatory authorities, according to a certain degree of discretion, will be a necessary component.

4.2.3.3 ‘Hard’ vs ‘soft’ triggers

A core aspect of the current debate regarding the suitable form of resolution triggers relates to the conflict between ‘hard and ‘soft’ thresholds. The first could be described as encompassing all triggers which are based on purely objective, mostly quantitative parameters and which, as a consequence, kick in automatically whenever the relevant limit is superseded. The resolution mechanism will thus be activated without any further evaluation from the bank’s management or supervising authorities. By contrast, ‘soft’ regulatory triggers have a subjective component and the non-viability test is, at least in part, based on a qualitative analysis. Thus, the regulatory authorities enjoy a certain degree of discretion in deciding which measures to take, and when.

4.2.3.3.a Main features of ‘hard’ triggers

The need for the creation of automatic triggers stems from the demands for more certainty and transparency in a banking crisis. Regulatory interventions will have significant impacts for a variety of markets’ participants. Shareholders and creditors might in particular see their rights severely restricted and, as a consequence, call for foreseeability regarding the thresholds, which will enable the authorities to exercise their powers. Investors such protection through collateralisation. Consequently, as AIG had sold enormous amounts of CDS ‘insurance’ without posting adequate collateral, it was unable to satisfy CDS buyers when the risk of failure of numerous firms increased and the buyers began demanding the collateral, Oliver Hart & Luigi Zingales, Curbing Risk on Wall Street, in Claessens, Evanoff, Kaufmann & Kodres, 2012, p.323.
require predictability not only about the beginning of the process but also about the effects thereof.\textsuperscript{80}

Simultaneously, it has been claimed that the use of ‘hard’ resolution thresholds will make the task of achieving harmonisation and consistency across jurisdictions easier, by preventing divergent discretionary actions.\textsuperscript{81}

Furthermore, without the use of automatic triggers, the marketability of contingent convertible financial instruments might also be at stake; it is practically unthinkable that investors will become subject to potential debt-to-equity conversion, or debt write-down policies, without rigid thresholds in place to enforce such policies. After all, the pricing and demand of such instruments will heavily depend on these events.\textsuperscript{82}

The arguments in favour of ‘hard’ triggers are therefore certainly convincing; hard rules may indeed increase \textit{ex ante} efficiency, certainty and transparency, all of which are critical for shareholders, creditors and investors.\textsuperscript{83} Those rules can limit regulatory forbearance and arbitrariness, as well as become an effective stopover to the propagation of moral hazard.\textsuperscript{84} Yet there are nonetheless potential drawbacks to these triggers, when compared to discretionary triggers.

Notably, regulatory authorities may find ‘hard’ triggers – where the adjustment is automatic – somewhat lacking in flexibility; a characteristic that is important – some may even argue necessary – with regards to regulatory intervention, especially in the context of broad financial crises, when unforeseen events often unfold rapidly. Rather than a ‘one-size-fits-all’ solution, regulatory authorities would much prefer to be granted powers that allow them to address a crisis according to the specific conditions of each financial institution. Hence, there is some reluctance on the part of these authorities to commit themselves to automatic triggers that do not allow for a certain degree of discretion and constructive ambiguity.\textsuperscript{85}

\begin{itemize}
\item \textsuperscript{80} *Institute of International Finance*, 2012, p.56.
\item \textsuperscript{81} *Institute of International Finance*, 2011, p.21.
\item \textsuperscript{82} Hence, speculative investors will be interested in high trigger contingent convertible capital instruments, which present important risk but at the same time they offer a high yield, Pazarbacioglu, Zhou, Le Leslé & Moore, 2011, p.12.
\item \textsuperscript{83} Cihak & Nier, 2009, p.14.
\item \textsuperscript{84} As the majority of creditors of international banks are other financial institutions and intermediaries, any disruption of their expectations by discretionary state powers might contribute to crisis propagation and systemic issues, *Institute of International Finance*, 2012, p.38.
\item \textsuperscript{85} Goodhart, 2012, p.603.
\end{itemize}
More specifically, rigid triggers might not be the most appropriate choice of triggering event to reflect macro-prudential considerations and adequately respond to the challenges of a systemic event. With regards to a financial crisis, market participants might grow nervous and uncertain if they consider the fixed capital or liquidity requirements to be insufficient. In such a case, an automatic low trigger might be reached too late, resulting in the financial implosion of an international bank.

A final drawback of ‘hard’ triggers is that it is unclear whether such triggers could facilitate cross-border coordination; on the contrary, should the various authorities involved apply different levels of thresholds with regards to their intervention, this might result in a stalemate in resolution planning negotiations.

4.2.3.3.b Advantages and drawbacks of a ‘soft’ triggers approach

When opting for a ‘soft’ trigger with respect to bank resolution, the decision on whether or not a regulatory intervention should occur will be based on: a) the likelihood that a given financial institution will fail; and b) the findings of a tailor-made analysis of the probable final non-viability of the institution should no action be taken. In this latter analysis, authorities will examine multiple (quantitative and qualitative) factors, taking into account the specificities of the particular financial crisis in question. Hence, regulators will have to accommodate a certain degree of uncertainty regarding their final decision, and what form this decision will take.

The principal advantage of such a regulatory approach is that it will offer flexibility. Whilst this fact may be intellectually reassuring, in reality it is unrealistic to think that designing triggers that adequately cover every case and potential financial emergency is an achievable goal.

Furthermore, by granting regulatory authorities broader powers regarding resolution triggers, this will increase the likelihood of these authorities cooperating in the drafting of resolution plans and the implementation of cross-border resolution procedures. Thus, whilst granting

86 Herring, 2011, p.27.
authorities too much discretion is considered controversial as it might
give rise to conflicts, the ex post efficiency of cross-border bank resolu-
tion practices adopting a ‘soft’ trigger approach is nonetheless expected to
increase.\textsuperscript{89}

Nonetheless, if combined with regulatory forbearance, constructive
ambiguity can become a source of confusion and market agitation. For
instance, in 2008, in order to attenuate any further moral hazard issues,
various regulators deliberately refrained from making any disclosures re-
garding their likely actions with regard to troubled financial institutions.
This decision, however, had the perverse effect of further contributing to
panic within the markets and crisis contagion with the result that states
were ultimately forced to intervene on a much larger scale, thus incurring
huge financial obligations.

One of most sensitive issues at stake is definitely regulatory forbear-
ance. ‘Soft’ triggers and a broad margin of judgment before a possible inter-
vention might, in fact, result in untimely – too late – actions, condem-
ning a financial institution in insolvency. It is a known fact that regulatory
forbearance had been one of the main reasons behind the deterioration of
the financial conditions of numerous banks during the 2008 crisis.\textsuperscript{90} Not-
withstanding the fact that certain regulators lacked the necessary infor-
mation that would have allowed them to step in more rapidly, regulatory
forbearance might nonetheless be used as a convenient excuse for regula-
tors’ failure to adequately monitor the activities and financial condition of
banks and predict the crisis.\textsuperscript{91}

Finally, the successful use of discretionary triggers implies a signifi-
cant workload for the supervisory authorities, demanding sufficient co-
operation and information exchange with the financial institutions under
supervision; such triggers will only be efficient so long as the latter are able,
and willing, to identify early warning signs of financial difficulties and to
duly inform the authorities in a timely manner.

\textsuperscript{90} Oliver Hart & Luigi Zingales, Curbing Risk on Wall Street, in Claessens,
Evanoff, Kaufmann & Kodres, 2012, p.323.
\textsuperscript{91} Dewatripont & Freixas, 2012, p.121.
4.2.3.3.c A solution to the clash between ‘hard’ and ‘soft’ triggers

In summary, the optimal resolution triggers are likely to reflect a compromise between the need for both rules and discretion.\(^{92}\) While discretionary triggers seem preferable, certain aspects of ‘hard’ triggers are also appealing; in particular, the protection such triggers offer to shareholders and creditors, as well as to the marketability and risk pricing of contingent capital instruments. Given the objectives of bank resolution, such protections are essential. Consequently, a satisfactory solution to this puzzle might be the adoption of ‘progressive triggers’, which could accommodate elements of various triggers designs.\(^{93}\)

As a first step, regulators could use ‘hard’ triggers based on purely quantitative data. In the event that these fixed thresholds are surpassed, however, intervention would not be automatically triggered; rather, the competent authorities would need to undertake a thorough assessment of the bank’s financial condition,\(^{94}\) and a full resolution procedure will only be implemented if the findings of such a prospective viability assessment deem the failure of the bank likely.

This could help to address the need for legal certainty: shareholders and creditors could be satisfied in the knowledge that authorities are only able to intervene if and when certain well-defined and transparent thresholds have been reached and a review of the failing bank’s viability has been subsequently conducted. Meanwhile, resolution authorities should be able to maintain an element of discretion and judgment, as their final decision will be the result of an interim, cautiously tailored solution for each troubled bank.\(^{95}\)

One should stress, though, that such a system of progressive triggers will require an open, straightforward and constant exchange of information between the financial institutions under supervision and resolution authorities. Appropriate risk warnings should be established within financial institutions, which would allow the management and/or financial

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92 As stressed by Cihak and Nier, “a rule can increase commitment to take resolution action and therefore reduces the scope for forbearance. Increasing a degree of discretion can lead to a fuller appraisal of the situation at hand and can make it easier to incorporate an element of judgment”, Cihak & Nier, 2009, p.14.


auditors to rapidly identify any breaches of a trigger and immediately inform the authorities, so that the latter could conduct their assessment in a timely manner.96

4.4 Competent ‘whistleblowers’ of an imminent crisis

Under the majority of current regulatory approaches, resolution authorities are responsible for identifying cases of threshold breaches and, more generally, the need to implement appropriate measures. There may, however, be significant exceptions to this principle, even in certain major jurisdictions; indeed, some have argued that other stakeholders such as creditors or the bank’s management should also be able to have some degree of involvement in the initiation of anti-failure processes.

In the US, for instance, creditors are authorised – under Chapter 11 section 303 of the Bankruptcy Code – to request the initiation of an involuntary bankruptcy procedure against an insolvent company. To date, however, this authorisation has rarely been used in practice, and does not apply to financial institutions in any case.97

The decision to confer such a powerful right to a bank’s creditors would probably be ill-judged: firstly, outsiders are seldom likely to have a clear picture of the true financial condition of a financial institution, given that they typically rely on external reports and communications.98 Given that even bank supervisors have proven incapable, in certain cases, of timely detection of a financial crisis due to the insufficiency of available information, there is no reason to believe that creditors would be able to dispose of a better inside view. Furthermore, there is the risk that creditors might misuse such powers in order to threaten a competitor (to selfishly exhort the payment of their debts) or to push a competitor out of the market altogether.

In addition, creditors would become subject to potential measures such as bail-in, and might experience a change of their legal status or suffer

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98 Herring, 2011, p.28.
a more or less radical write-down of their claims. Thus, it might become in their interest to either (i) push for a swift recovery procedure, so as to avoid upcoming resolution measures or (ii) push back/delay a resolution decision, in order to avoid any prejudice in respect of their present claims. The consequences of either of these scenarios – i.e. ‘blowing the whistle’ too early or too late – could be disastrous for a financial institution.

Another option would be to allow financial institutions to apply voluntarily for bank resolution procedures, if they consider that they are on the brink of financial insolvency and that an intervention of the authorities is indispensable. This scenario would differ substantially from the progressive trigger scenario outlined above in that the financial institution itself would be entirely independent to decide if its financial survival is at stake (and, should it make such a determination, petition the competent authorities for the initiation of an intervention.) A bank should, by definition, have mechanisms in place that allow the early identification of a potential financial threat; and its management should be aware of the bank’s true financial condition at any given moment in time. This fact notwithstanding, relying too heavily on financial institutions themselves to autonomously interpret a likely failure might be problematic.

The 2008 financial crisis highlighted that various financial institutions were simply unaware of the potential consequences of their hazardous business activities, and had a tendency to ignore or underestimate the progressive deterioration of their liquidity and capital ratios. Moreover, not all banking groups are well prepared for a financial crisis. The risk assessment mechanisms and capital requirements in place might prove insufficient in providing early warnings, especially in the case of a systemic

99 Such was the case under the German law regarding the reorganisation of credit institutions. In case of severe financial troubles and if a recovery was not possible, a German systemic bank could voluntarily petition the German Federal Supervisory Authority (BaFin), by submitting a reorganisation plan and by nominating a reorganisation trustee. BaFin would review the petition and if it deemed that the bank was likely to fail, it would forward the petition to the competent court, which would take the final decision, German Bank Reorganisation Act, § 7. Moreover, under the procedure of Chapter 11 of the US Bankruptcy Code, any company might submit a voluntary petition without even being financially insolvent.

100 The near collapse of UBS is an interesting example stressing that there can be lagging communication mechanisms with the management, which might become fully aware of an imminent insolvency at a very late stage, when any recovery is impossible.
event. But, above all, as has been highlighted with regards to regulatory forbearance of bank supervisors, a bank’s management might try to conceal bad news as long as possible. The infamous ‘gamble for resurrection’ could ultimately prove a fatal decision, effectively condemning the bank to financial collapse.\textsuperscript{101} The concept of limited liability within banking institutions could also become a source of hazardous judgments, which might prevail over risk-averse behaviors.\textsuperscript{102}

As a result – although not necessarily always ideal – the fundamental role of interpreting the likely failure of a financial institution and, subsequently, the activation of a trigger should remain within the powers of resolution authorities. The risk of regulatory forbearance notwithstanding, these authorities are better equipped to play this role than are the management of a bank, and can better ensure that impartiality, independence and productivity are protected. This is also preferable from a cross-border perspective. Authorities should, however, be assisted in this role by the supervised banks, whose contribution will be of great importance through close collaboration and information exchange with the competent authorities.

### 4.5 Concluding remarks on resolution triggers

Identification of the proper resolution triggers is a key part of the ongoing efforts to improve financial regulation. To the extent that this is possible, this process must be standardised, both in terms of the rules themselves, and also their (national and – increasingly – international) implementation.

Contrary to certain current regulatory approaches, regulators should opt for a prospective rather than a retrospective test. Such an approach should focus on an evaluation of financial viability and interpret a likely failure based on economic, market-based value models rather than classic retrospective accounting standards (IRS, US GAAPs, etc.). Capital ratios could remain a useful part of such determinations but should be complemented with forward-looking liquidity requirement diagnosis, both being

\begin{flushleft}
\textsuperscript{101} \textit{Herring}, 2011, p.28.
\end{flushleft}

\begin{flushleft}
\textsuperscript{102} \textit{Dewatripont & Freixas}, 2012, p.121.
\end{flushleft}
correlated to risk assessments and shifting market trends. For instance, CDS spreads could usefully act as crisis indicators.

This prospective test should necessarily rely not only on quantitative triggering criteria, but also on qualitative thresholds. A qualitative, i.e. to a certain degree discretionary, approach will also impact on the powers of the enforcing authority.

Furthermore, there should not be one single threshold, but a series of triggers’ levels, resulting in the progressive implementation of increasingly stringent measures. One-shot ‘black-and-white’ regulatory responses can, in fact, hardly address the specific circumstances of each particular crisis and financial institution.

Finally, cross-border harmonisation of crisis management procedures remains a serious challenge. Triggers that are transnational compatible – rather than domestic focused – will need to be an important feature of an effective response to the next major financial crisis.
Chapter 5

THE COMPETENT RESOLUTION AUTHORITIES

It is universally accepted that the effective implementation of bank resolution procedures will rely on efficient and robust resolution authorities. However, there is no broad consensus on the actual nature of these authorities. One may find divergent choices from the existing arsenal of regulatory authorities. Thus far, priority has been accorded to bank supervisors and central banks; but one can also find examples of deposit guarantee funds as well as tribunals possessing important decision-making powers in bank resolution procedures.¹

By and large, resolution authorities should have sufficient access to information regarding the financial condition of banks. At the same time, they should be granted sufficient authority to take any action necessary in order to address financial troubles and maintain general financial stability.²

The FSB formulated broad standards regarding the designation of resolution authorities, emphasising their administrative character, given the particular nature of bank resolution.³ Nevertheless, and influenced by traditional insolvency schemes, certain state orders introduced judicial elements to the procedure.⁴ This therefore adds a layer of complexity to the

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¹ For a brief list of the solutions adopted by major jurisdictions regarding resolution authorities see FSB, Resolution of SIFIs, Progress Report, 2012, pp.5–6.
² Mayes, 2006, p.67.
³ “Each jurisdiction should have a designated administrative authority or authorities responsible for resolution powers over firms within the scope of the resolution regime (resolution authority)”, FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, pp.5–6.
⁴ The most notable example has been the German Bank Reorganisation Act requiring a decision of the Higher Regional Court (Oberlandsgericht) with regard to the initiation of a reorganisation procedure and its approval for the reorganisation plan of the troubled financial institution, German Bank Reorganisation Act, §§ 7(3)–(4). In the US under the rules of the Dodd-Frank Act, if the board of directors of the ailing financial company do not acquiesce to the appointment of the FDIC as a receiver and the initiation of a resolution procedure, the Secretary of the Treasury shall petition the US District Court for the District of Columbia for an order authorising the
debate: the exclusively administrative nature of the bank resolution procedures cannot be guaranteed on all occasions.

It is important to stress that, according to the FSB, each jurisdiction may designate more than one competent authority to bank resolution. In this scenario, bank resolution rules should clearly define the exact responsibilities and mandates of each respective authority, as well as promote coordination.\(^5\)

This chapter focuses on describing the competent resolution authority with regard to the triggering and implementation of bank resolution procedures. It is argued here that bank supervisors should play this crucial role of competent resolution authority. Clearly, bank supervisors already perform specific functions in connection with financial stability; but they also possess unique characteristics that would allow them to play a pivotal role in bank resolution. Consequently, this chapter examines the positive contribution they could make to bank resolution processes through their special policy objectives and mandate.

In addition – and based on the popular current framework of involving multiple authorities in bank resolution – this chapter elaborates on the role of the lead authority in a bank resolution procedure. A crucial objective for cross-border bank resolution schemes should be the achievement of a certain degree of harmonisation regarding the form of this lead resolution authority.


appointment, *Dodd-Frank Act*, Title II, § 202 (a)(1)(A)(i). The board of directors of the financial company can, nonetheless, appeal this decision, *ibid*, § 202 (a)(2)(A)(i). The final stage is a petition for a writ of certiorari to the US Supreme Court to review the decision issued by the Court of Appeals, *ibid*, § 202 (a)(2)(B)(i). The EU allows member states to subject crisis management measures to a mandatory *ex ante* judicial approval, if the procedure relating to the application for approval and the court’s consideration are expeditious, *EU Bank Recovery and Resolution Directive*, art. 85(1).
Chapter 5: The competent resolution authorities

5.1 Bank supervisors as resolution authorities

Bank supervisors have come under considerable fire since the outbreak of the financial crisis in 2007. Specifically, the crisis cast doubt on the competence of bank supervisors to efficiently manage a financial crisis and, as a consequence, various traditional supervisory mechanisms became subject to subsequent reforms.

Many regard the inability of bank supervisors to interpret the early warning signs of the continuous downturn in the markets in a sufficiently expedient manner to be a key factor contributing to the 2008 meltdown. Supervisors had been operating in a state of ‘blissful euphoria’; neglectful or ignorant of the evolving complex market trends, they merely observed rapidly rising markets without questioning the true reasons behind this financial boom. Moreover, the previous mainly micro-prudential orientation of financial regulation and supervision meant that supervisors failed to see the broader picture of the interconnected financial markets. This resulted in the adoption of solutions that, in certain cases, ultimately exacerbated rather than attenuated the financial crisis.

Overall, the concept of ‘light touch’ bank supervision reached its limits through the events of 2008. Consequently, the tendency of supervisors today is to reconsider their practices in connection with the safeguard of financial stability, setting aside principles of self-regulation and ‘light touch’ supervision.

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6 All in all, arguments against supervisory efficiency include inadequate supervisory resources, weak institutional governance, poor supervisory interaction, no use of benchmarks regarding best practices, neglect of supervisory models, insufficient data, failure to understand the banking business and insufficient stress testing, FSB, Supervisory Intensity and Effectiveness, 2014, p.2.
7 Avgouleas, 2012, p.3.
8 The definition had been adopted by the former UK bank supervisor, the FSA, in order to reflect the philosophy that markets are self-correcting, risk responsibility lies with senior management and boards and customer protection can be ensured only through transparency and not through product regulation and direct intervention, FSA, The Turner Review, 2009, p.87.
While ‘regulation’ is restricted to the development of a set of rules and supervisory principles, ‘supervision’ concerns the extent to which the banking sector complies with these rules and regulatory practices. By and large, bank supervisors should be subject to the duties of prompt corrective action, the safeguard of efficient markets’ operation and of conscientious representation, through the promotion of public interest above theirs.

Bank supervisors should play a pivotal role in the organisation and implementation of bank resolution procedures; they are excellent candidates for such a role given their ordinary responsibilities in connection with the safeguard of financial stability, and the direct contact and flow of information they have with the supervised financial institutions. This makes them much better placed to interpret the potential insolvency and likely failure of a bank than a body completely detached from common supervisory tasks. Furthermore, being in possession of sensible information regarding the structure and operations of the troubled bank will better enable them to decide on the most appropriate resolution method; one that is specifically tailored to the needs of each financial institution.

Through the off-site analysis of bank related data, on-site inspection activities and frequent open communication and information exchange with bank management, bank supervisors can get a clear and accurate picture of the unique financial condition of each supervised bank. Hence, provided that supervisory tasks are conducted effectively, bank supervisors should be able to identify an ongoing or future crisis and apply the necessary measures, such as bank resolution if the bank is on the brink of insolvency.

However, the efficient exercise of supervisory tasks requires comprehensive cooperation with the management of the supervised financial institutions. The proposal for a progressive resolution trigger (previously

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10 Patrick Fell, Implications for Supervision, in Barfield, 2011, p.469. “A regulator promulgates and enforces rules” whereas “supervisors try to ensure that a financial firm is well run: with good operations, good risk management, good compliance, good management and a good business plan”, Sommer, 2014, p.16.


12 Parker, 2011, p.7.

13 According to the FSB, supervisors need “to engage in credible and skeptical conversation with the board and senior management on the institution’s business strategy and
outlined in chapter 4) cannot materialise without continuous, open and candid dialogue with the banking sector. It should be stressed, though, that the supervisory authorities should critically assess and interpret the data made available to them: the pre-2008 regulatory environment was characterised by supervisors relying entirely and unquestioningly on the data provided to them by the banks, which, in many cases, unfortunately failed to describe the true financial condition of the troubled banks.14

The role of bank supervisors will be crucial with regards to the initiation of resolution triggers. The most optimal solution for efficient resolution thresholds should be based on a combination of both ‘hard’ triggers and regulatory discretion for optimal performance. Following the breach of the ‘hard’ trigger, bank supervisors should be able to intervene rapidly, in order to make an assessment of the financial condition of the bank and take a decision on whether or not to implement bank resolution. The use of progressive triggers will make the role of bank supervisors’ tasks easier, as the latter will be able to apply a level of supervision commensurate with the potential risks and the evolving financial conditions of each bank.15 Stress tests and crisis management scenarios will be also helpful for determining whether or not a bank is under serious stress, and therefore if a bank resolution procedure might be necessary. That said, supervisors should also focus on the effectiveness of stress testing and not exclusively on the outcomes.16

Certain modifications to traditional supervisory functions will also need to be made in order to be able to safeguard the efficiency of resolution procedures. Notably, bank supervisors should gradually shift their supervisory focus away from one that is exclusively on individual institutions to...
take into account broader systemic and outcomes-based considerations.\textsuperscript{17} To achieve this, it will be essential to provide bank supervisors with adequate staff and for sufficient resources to be dedicated to the most common and significant market risks. Simultaneously, bank supervisors will need to concentrate on the larger market picture and periodically cover all of the aspects that might pose an \textit{ex post} risk during a systemic crisis.\textsuperscript{18} These tasks should not be confused with macro-economic considerations, which remain a traditional mission of central banks.

Focusing on the bigger picture will be a vital component in promoting information exchange and cross-border coordination within both cross-border supervisory colleges and crisis managements groups, where bank supervisors will be present as resolution authorities. We should note that bank supervision and bank resolution are intrinsically interconnected: the degree to which the former is being undertaken effectively will have an impact on the success of the latter. Yet, prior to 2008, most home country supervisory regulators took insufficient account how the externalities of a bank failure, and the way that it is resolved, may affect a host country.\textsuperscript{19} Safeguarding to their entirety the national interests of both home and host supervisors might be eventually problematic.\textsuperscript{20} Efficient cross-border resolution policies should improve broad supervisory practices, taking into account the priorities and concerns of both home and host countries.

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\textsuperscript{17} As eloquently described by Fell, “\textit{macro-supervision demands an approach that is alert to sources of systemic risk, coordinates an international response when needed and, is separate from national politics but sensitive to national economic needs}”, Patrick Fell, \textit{Implications for Supervision}, in Barfield, 2011, p.480. The FSB noted that “\textit{outcomes-based supervision is about the ability and willingness of experienced supervisors to focus on the big picture}”, FSB, \textit{Supervisory Intensity and Effectiveness}, 2014, p.6.
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\textsuperscript{19} Among the most prominent examples one could find the supervisory practices of the UK FSA, FSA, \textit{The Turner Review}, 2009, p.96. The asymmetry in the size of certain subsidiaries within a banking group made home supervisors less willing to safeguard host supervisors’ interests and consider their informational needs, Piotr Bednarski & Grzegorz Bielicki, \textit{Home and Host Supervisors’ Relations from a Host Supervisor’s Perspective}, in Caprio, Evanoff & Kaufman, 2006, p.213.
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Within the context of bank resolution procedures, regulatory forbearance is emerging as a fundamental supervisory risk: that is to say, the potential for a fully briefed regulator – amply aware of the true financial condition of a troubled bank – to decide not to take interventionist action, or to try to postpone such action in order to avoid a bank collapsing ‘on their watch’. Optimally designed ‘hard’ resolution thresholds – combined with the practice of frequent stress tests and crisis management scenarios – should result in mandatory action for bank supervisors, at the first signs of a financial crisis. However, the second segment of progressive triggers – based on discretionary powers and authorities making their own judgment on possible regulatory intervention – could potentially contribute to regulatory forbearance. Ultimately, whilst the risk of regulatory forbearance cannot be entirely eliminated, the need to protect broad financial stability and prevent another systemic crisis should be a sufficient deterrent and adequate incentive for supervisors.

Altogether, bank supervisors must be able and willing to make difficult decisions with regards to the potential initiation of a resolution procedure. Their close links and frequent interactions with the financial institutions under supervision should provide them with a valuable supervisory overview of the banking market, especially concerning the potential impacts of bank resolution on market participants. A key challenge for supervisors will be to balance the move towards more intense and more proactive supervisory practices with an ongoing need to incentivise banks to engage in open dialogue and information exchange.\(^{21}\)

### 5.2 Central banks exercising supervisory and resolution tasks

Central banks worldwide contributed significantly to the efforts to address the 2008 financial collapse.\(^{22}\) Indeed, central banks have been at the

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\(^{22}\) We should note, though, that central banks bear part of the responsibility for the 2008 financial crisis. Pre-crisis central bank policies encouraged the build-up of financial imbalances through unusually and persistently low policy rates and aggressive and prolonged easing of monetary policy via interest-rate and balance sheet measures, Borio, 2011, pp.4–5.
forefront of crisis management, whether through their emergency interventions regarding monetary policy, or their direct participation in bank rescue schemes (such as in the case of the Swiss National Bank with UBS). For the most part, these interventions were fruitful, even those that were considered controversial. On the other hand, numerous decisions were criticised on the grounds that the intervention of central banks further eroded confidence and contributed to moral hazard.\(^23\)

Given their strong involvement in the financial markets ever since 2008, central banks might also have crucial responsibilities during a bank resolution procedure. Leaving aside for the time being their traditional role concerning liquidity provision, numerous central banks today exercise pure supervisory functions. Consequently – and if the role of the resolution authority in a specific jurisdiction passes to the bank supervisor – central banks will be forced to pursue three different mandates: a) monetary policies; b) bank supervision; and c) bank resolution.

Historically, financial supervision fell outside of the sphere of expertise and responsibility of a central bank.\(^24\) Following the global financial crisis, however, the pendulum swung on favour of central banks playing a key supervisory role and over the last two years there has been a growing tendency to assign banking supervisory responsibilities to central banks.\(^25\)

These days, monetary policy and banking supervision are closely related and interdependent concepts, especially in European jurisdictions. This is best illustrated by (i) the establishment of the SSM in the Eurozone (with the ECB becoming a supra-national bank supervisor) and (ii) the abolition of the FSA in the UK (with banking supervision duties passing to the PRA, an institutional part of the BoE). Consequently, the functions of a central

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\(^{23}\) For example, the role of the BoE amidst the Northern Rock crisis had been questioned severely. Probably too concerned about monetary policy and analysis, the BoE failed to interpret the early warning of the crisis and despite the identification of important risks, it did not provide precise policy responses. In addition, and in combination with the failure of the FSA to monitor closely the financial condition of Northern Rock, the indecision and uncoordinated reactions of the two authorities gave place to the first bank run in the UK in the last century, FSA, *The Turner Review*, 2009, p.84.

\(^{24}\) For example, in the US the Federal Reserve became active in bank supervision only since the enactment of the Bank Holding Company Act in 1956, Goodhart, 2000, pp.9–10.

\(^{25}\) Overall, central banks are also the supervisory bodies for commercial banks in 40% of advanced economies and 75% of emerging and developing economies, Cihak, Demircüç-Kunt, Martinez Pería & Mohseni-Cheraghlo, 2012, p.44.
bank have become much broader and more dynamic to include: overall monetary policy; note issue; banking regulation and supervision; LOLR; management of gold and foreign reserves; debt management; government finance; and foreign exchange operations.\textsuperscript{26}

This regulatory decision to take an integrated approach to monetary policy and bank supervision has generated much debate. It is true that the existence of a unique entity regulating both bank supervision and monetary stability – covering institution-specific and macro-prudential considerations, and representing the financial system as a whole – could lead to more integrated and consistent crisis management approaches.\textsuperscript{27} Such an approach allows for more efficient macro-level decisions based on the available micro-level information. In addition, integrating these functions can greatly improve cross-border cooperation. Notwithstanding these potential benefits, it is questionable if this approach would be the most appropriate, given the weight of the arguments against such a consolidated approach.

A crucial concern is that by assigning both monetary policy and banking supervision to the same institution, conflicts of interest are inevitable. During a financial crisis, for instance, a central bank with additional responsibility for the supervision of the banking sector might be tempted to loosen, tighten or generally transform its monetary policies according to the changes in the financial health of the supervised financial institutions.\textsuperscript{28} According to an empirical research conducted by Ioannidou around the monetary and supervisory tasks of the Federal Reserve in the 1990s, all evidence suggests that “the central bank’s monetary policy responsibilities do alter its role in bank supervision”.\textsuperscript{29}

\begin{itemize}
\item \textsuperscript{26} Lastra, 2012, p.4.
\item \textsuperscript{27} As stressed by Kaufman, “the proper responsibility of the central bank – assuring the financial well-being of society – requires an intimate involvement in financial supervision and regulation. In fact, I have long believed that it is only the central bank – among the various regulatory agencies that share responsibility in this area – that can represent the perspective of the financial system as a whole”, Goodhart, 2000, p.5.
\item \textsuperscript{28} Briault, 1999, p.27.
\item \textsuperscript{29} Ioannidou, 2005, p.78. “The estimation results indicate that when the Fed tightens monetary policy, it becomes less strict in bank supervision. One explanation is that the Fed compensates banks for the extra pressure it puts on them, either because it views then as its constituency or because it is concerned about the microstability of the financial sector”, ibid, p.82.
\end{itemize}
Furthermore, undertaking micro-level supervisory tasks can become a time-consuming and daunting task during a financial crisis, stifling the central bank’s ability to sufficiently focus on the macro-monetary policies impacting the broader financial system.\textsuperscript{30}

Supposing that a central bank – in addition to its existing monetary and supervisory functions – is also then assigned with the task of bank resolution, its role will become increasingly complex.

In the event that a financial institution should eventually fail, the reputational cost to the central bank and its loss of credibility could be significant. In addition, banking failures will require broad accountability arrangements to be established with regards to the activities of a central bank. Accountability is an indispensable element of transparency: they are mutually reinforcing concepts. A central bank acting as a resolution authority will be obliged to make data and information relating to its policy decisions and the justification for these decisions available to the public in a comprehensible and timely manner.\textsuperscript{31} However, absolute transparency during a resolution procedure might contribute to market panic and, therefore, jeopardise the effectiveness of resolution policies.

The major risk would be an eventual transformation of the fundamental role of the central bank. Since supervisory and bank resolution decisions are inherently linked with general financial stability, such decisions tend to be more politically-sensitive than decisions around monetary policy.\textsuperscript{32} Monetary policy and financial stability are not mutually exclusive but their short-term interests can occasionally diverge.\textsuperscript{33} Thus, broadening the institutional mandate of central banks to include monetary policy, banking supervision and resolution might thrust central banks into an inherently political role and make their actions subject to political pressure or political control.\textsuperscript{34} After all, government involvement in a banking crisis cannot be excluded, especially with regards to resolution funding.\textsuperscript{35}

\textsuperscript{30} Goodhart, 2000, p.20.
\textsuperscript{31} De Haan & Oosterloo, 2006, p.256.
\textsuperscript{32} Andrew Crockett, Central Bank Governance under New Mandates, in BIS, 2011b, p.19.
\textsuperscript{33} Study Group of the BIS, 2011, p.29. Monetary policy is usually countercyclical, while supervisory and regulatory practices tend to be pro-cyclical, partially offsetting the objectives of monetary policy, Ioannidou, 2005, p.63.
\textsuperscript{34} Briault, 1999, p.27. Nonetheless, as the personnel appointments at the crucial posts of a central bank normally result from political deliberations and choices, we cannot
The exercise of resolution powers, especially regarding resolution thresholds, will inherently involve discretion and judgment. Thus, a central bank, thrust into a controversial political role and maintaining excessive discretionary powers, might be considered too powerful and potentially dangerous.\(^{36}\)

Therefore, whilst the solution of a central bank exercising both monetary and supervisory policies might be acceptable, the accumulation of three different functions at the same institution could become deeply problematic. Rather, in cases where central banks already exercise supervisory functions, responsibility for the implementation of resolution policies should be assigned to a separate authority if resolution is to be effective.

Undoubtedly, close cooperation between the central bank and this separate resolution authority will be an essential prerequisite for the timely triggering and successful implementation of resolution schemes. Ideally, cooperation and information exchange modalities between the two bodies should be clearly defined under legal statute, and not simply be the subject of declarations of intent or MoUs.

An interesting example corroborating this proposal is the crisis management approach adopted by the Eurozone Member States. The ECB, in addition to its traditional monetary policy functions, has also evolved into the first true European supervisor. However, and despite this significant centralisation of powers, it did not become the competent resolution authority for Eurozone banks; rather, whilst its role will be important during the triggering of a resolution procedure,\(^{37}\) a separate body, the Single Resolution Board, will be responsible for the organisation and implementation of resolution tools.

exclude government influence completely from the nature of central banks. It is crucial, hence, to distinguish between personnel independence (appointment procedures) and policy independence (independence in the formulation and execution of the tasks of the central bank), De Haan & Eijffinger, 2000, pp.394–395.

Alexandre Lamfalussy described eloquently this problem: “Once it appears that an initial liquidity problem is mutating into a solvency problem, and especially when the latter implies the risk of a systemic meltdown, the central bank has to operate hand in hand with the government. But hand in hand can mean very different things – this is why I am pleading for a reasonably well defined operational framework”, Alexandre Lamfalussy, Keynote Speech in BIS, 2011b, p.11.


EU Regulation on a Single Resolution Mechanism, art. 18(1)–(2).
The 2008 financial crisis exposed serious weaknesses in domestic banking regulation and bank insolvency procedures. In many cases, the lack of coordination and absence of sufficient exchange of information between domestic authorities became a source of significant concern, contributing to further stress – and even panic – to the financial markets and the public. The UK bank Northern Rock became the first bank to suffer a bank run in modern UK history, precipitated partly by the inability of the BoE and the FSA to decide promptly on a course of action and to coordinate their policies. In the case of UBS, although the Swiss authorities managed to save the bank, it is important to stress that the Federal Council only became aware of the bank’s perilous financial condition just days before the final intervention. Additionally, it has been demonstrated across various jurisdictions that the fragmentation of the financial regulatory structure among several authorities at the domestic level may also result in unnecessary regulatory competition.38

Approaches to bank resolution – including whether responsibility for bank resolution lies with one single authority or is shared between numerous administrative authorities – differ substantially across countries, depending on the legal tradition of each jurisdiction. In the US and the UK, for instance, bank regulation is highly fragmented. In comparison, most countries in continental Europe have only one bank regulator, responsible for initiating and implementing a bank resolution procedure.

Opting for an approach that requires the participation of multiple regulatory agencies might ultimately be more suited to the needs of bank resolution: relying on a single regulator runs the risk that this regulator might be forced to take decisions and undertake actions on issues around which it might lack the necessary expertise. Nevertheless, the roles and responsibilities of each of the participating authorities should be clearly defined and understood and the objectives and processes for cooperation and information sharing established in order to avoid any overlap, potential conflicts or regulatory forbearance that might arise from ambiguous institutional mandates. Each authority should also have suitable

arrangements in place to allow a clear separation between its principal and resolution functions.\textsuperscript{39} Finally, they should be equipped with the necessary expertise, financial resources and personnel in order to administer their resolution functions efficiently.

More importantly, the FSB recommends that if responsibility for the resolution of legal entities of the same group within a single jurisdiction is to be shared between different resolution authorities the resolution regime of that jurisdiction should identify a lead resolution authority to coordinate the resolution. The FSB also recommends the concept of lead regulators on a cross-border basis within CMGs for all G-SIBs, but it is equally important to apply the same scheme on a purely domestic level.

The role of this lead resolution authority would be to: oversee the procedure; keep the other authorities informed and prepare their interventions; provide answers to any potential legal or operational stalemate; and act as a mediator should a potential conflict arise.\textsuperscript{40} The identification of a lead regulator could help to ensure more consistent policy objectives, allow for explicit responsibilities to be exercised within a clearer system of accountability, and potentially reduce the number of conflicts in a domestic market.

This broad competence of the lead resolution authority should be meticulously regulated under the rules of a bank resolution regime or other relevant banking legislation. In any event, the legal independence of the other participating authorities in the resolution scheme should be guaranteed, and detailed legal provisions should govern the cooperation of these participating authorities with the lead resolution authority.\textsuperscript{41}

The creation of lead resolution authorities will also be vital for ensuring the efficient operation of the cross-border CMGs with regards to

\textsuperscript{39} DG \textit{Internal Market and Services}, 2011, p.13.

\textsuperscript{40} Centralisation of information will be a delicate issue. For instance, under the Dodd-Frank rules, certain regulators such as the OCC and the CFTC are not part of the Orderly Liquidation Authority decision-making. Consequently, crucial supervisory knowledge might not be taken into consideration and lead to misevaluations or wasteful decisions. Although the Dodd-Frank Act requires a mandatory consultation with non-involved supervisors in OLA (\S\S 204(c)(1) and (c)(3)), the potential challenges of information-sharing are not resolved, \textsc{Giani \& Crivellaro}, 2014, pp.123 and 125.

\textsuperscript{41} FINMA could be described as an illustrative example of a lead resolution authority under the current arrangements regulating bank resolution in Switzerland. For example, see \textit{Swiss Banking Act}, art. 10 and the \textit{FINMA Banking Insolvency Ordinance}.
international banking groups: one authority with a single voice will be much more effective on a cross-border level, when negotiating a cross-border resolution agreement and implementing a joint decision of a cross-border CMG.\textsuperscript{42} The political weight of a jurisdiction within a CMG will be enhanced through the participation of one competent and robust domestic resolution authority.

A key controversial issue is which of the competent resolution authorities should eventually act as the lead resolution authority. There is a certain preference for bank supervisors to assume this role, given their proximity to the supervised financial institutions, their vital role in resolution planning, and their tradition of ‘whistleblowing’ before imminent financial troubles. Nonetheless, it is very unlikely to have a ‘one size fits all’ solution for each and every jurisdiction. Ultimately, it is estimated that the role of lead resolution regulators will be taken on by the domestic authorities, which have traditionally been the most powerful regarding financial crisis management. Certainly, there will be instances where bank supervisors and central banks are engaged in such activities. Yet, one should not exclude more innovative approaches.\textsuperscript{43}

It could be argued that a certain degree of harmonisation would be advisable and more advantageous in relation to cross-border information sharing. Whilst the appointment of a lead resolution authority will not necessarily resolve all of the concerns surrounding cross-border coordination – indeed, obstacles to cross-border information sharing will almost certainly persist due to the differences in status between the authorities implementing resolution in different jurisdictions – within CMGs the common incentives and objectives surrounding the financial collapse of

\textsuperscript{42} In order to demonstrate the complexity of the problem one can cite the example of US authorities participating in CMGs. In the extreme case of a G-SIB with deposit-taking and investment banking activities, the Federal Reserve, the OCC (as banking licenses are issued by each US state authority), the FDIC, the SEC, the CFTC and the Treasury will exercise regulatory responsibilities and will require a seat around the table of the respective CMG, Mathias Otto, Living Wills – The In-House Perspective, in Dombret & Kenadjian, 2013, pp.103–104.

\textsuperscript{43} An interesting example is the Spanish bank resolution regime. The Fund for Orderly Bank Restructuring (Fondo de reestructuracion ordenada bancaria) was given powers to not only provide temporary financial assistance regarding a restructuring plan, but to also fully carry out the resolution of a failing bank, FSB, Resolution of SIFIs, Progress Report, 2012, p.6.
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an international bank might provide the necessary ground for the development of cross-border bank resolution practices, despite differences in the legal status of the participating lead resolution authorities.

Such cooperation, however, should not be taken for granted. For instance, domestic regulators usually place statutory restrictions on the amount of information that can be shared with a foreign authority, and the content of this information. Consequently, both domestic resolution regimes and international cooperation agreements should be guided by a clear framework, with clear rules set in place with regards to the cross-border level interactions of the lead resolution authorities. Such rules, along with a certain degree of regulatory harmonisation, could represent an important first step towards boosting cross-border information sharing and crisis coordination.

The most recent financial crisis highlighted the effects of multiple uncoordinated rescue efforts, as well as the need for legal reforms on a global scale. However – with the exception of a few isolated cases – the consequences of a lack of coordination between domestic authorities were somewhat downplayed. It is in this respect that more consideration should be given to each legal system, so as to guarantee substantial coordination of the authorities under the new bank resolution schemes. The next step should be the appointment under legislation of a lead domestic authority overseeing the resolution procedure and timely deciding on the thorniest issues.

For example in Switzerland the authorities that could potentially be involved in a resolution procedure signed MoUs, which circumscribe their responsibilities regarding crisis management, FINMA & SNB, MoU, 2010 and FDF, FINMA & SNB, MoU, 2011.
Chapter 6

MAIN RESOLUTION TOOLS

Resolution authorities have at their disposal a broad range of resolution powers with regards to resolving banks that are no longer viable. Bank resolution can therefore take a variety of forms, including: the creation of a bridge financial institution; an assisted merger/acquisition of all or parts of the failing business; a legal separation of a banking entity; or the more radical option of bail-in. Such resolution powers may either be explicitly articulated in bank resolution legislation, or based on descriptions that are vague in detail. Usually, resolution authorities will adopt a resolution scheme that includes a combination of relevant resolution tools in order to guarantee the successful implementation of the final procedure.

The main objective of this chapter is to describe the main resolution tools in more detail. The analysis covers three of the more traditional resolution instruments before moving on to consider the concept of bail-in, a resolution strategy that has gained in popularity in recent years, but is potentially problematic. The goal of this chapter is to outline the defining characteristics of these resolution tools, as well as highlight the main challenges and legal impediments associated with their use on a cross-border basis.

6.1 Bridge financial institutions

6.1.1 Creation and operations of a bridge bank

One of the most common resolution powers exercised by resolution authorities is the establishment of a temporary ‘bridge’ financial institution to take over and continue operating certain systemic financial functions and viable operations of a failed bank, and into which the viable parts of the failing bank (i.e. assets and liabilities) can be transferred.

This bridge institution may be defined either as a bridge bank (if it is established for a banking group with deposit-taking and/or investment activities) or, more generally, as a bridge financial company (when
established to take over the activities and functions of an investment firm or the non-regulated companies within a group).\(^1\)

Resolution authorities should have the power to transfer all or part of the business of the failing bank to this bridge institution, and to determine as appropriate which assets and liabilities should be transferred in order to safeguard the continuity of the critical financial functions of the resolved bank. The transfer can include: deposits, property, contracts, rights and liabilities. In certain jurisdictions, this transferable property might even include rights or assets that lie outside of the jurisdiction initiating the resolution procedure.\(^2\)

The Basel Committee identified early a large number of jurisdictions that had exercised their resolution powers under their respective resolution regimes to introduce bridge financial institutions.\(^3\) Presently, the FDIC leads the way in the use of bridge banks to address the collapse of credit institutions.\(^4\)

The most recent case of a bridge bank has been the resolution of Banco Espirito Santo. As described in section 1.4, the Portuguese central bank established a bridge bank, Novo Banco, which acquired the crucial functions of the resolved entity of Banco Espirito Santo.

Resolution authorities have the authority to establish a bridge financial institution as soon as resolution triggers are initiated. Thus, such banks or financial companies are organised exclusively by the resolution authorities, without the involvement of government.\(^5\)

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1 For the FSB, this resolution tool is based on the principle of having a “legally enforceable agreement by which the authority transfers, and the bridge institution receives, assets and liabilities of the failed firm as selected by the authority”, FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.8.
2 For instance, the UK Banking Act allows transfer of property outside the United Kingdom, UK Banking Act, §§ 35(1)(c)–(d) and 39.
3 Among them the US, the UK, Switzerland, France and the Netherlands, BCBS, 2011, p.16.
4 Bridge banks were used extensively – 32 times – by the FDIC in the period between 1987 and 1994, with the most notable case being the resolution of Indy Mac (although the procedure actually implemented in this case was that of pass-through conservatorship, which is similar but not identical to the creation of a bridge bank), John Raymond LaBrosse, International Experience and Policy Issues in the Growing Use of Bridge Banks, in LaBrosse, Raymond, Olivares-Caminal & Singh, 2009, p.222.
5 As upheld by the European Commission, “a bridge bank should mean a company or other legal person, which is wholly owned by one or more public authorities”, DG Internal
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The creation of a bridge bank (wholly owned by the competent resolution authorities) entirely from scratch may be the most familiar option but it is not, however, the only option available to resolution authorities. For instance, the US resolution regime grants powers to the Comptroller of the Currency – under specific conditions – to charter existing national banks and federal savings associations as bridge banks in order to take over the business of a defaulting deposit-taking bank.\(^6\) Taking this concept a step further, there is no reason why the use of a financially viable entity of a failing banking group as a bridge bank should be excluded.

One should also highlight that, in order to achieve the successful completion of their resolution policies, resolution authorities should be able to establish not only one but several bridge financial institutions; this will depend on the specific circumstances of each case.

Resolution authorities are required to use a certain amount of discretion in deciding which assets or liabilities are to be transferred to the bridge financial institution. Nevertheless, whilst flexibility is paramount, resolution authorities should be discouraged from taking arbitrary actions, i.e. ‘cherry-picking’ the best assets, contracts or creditors to be transferred.\(^7\) With regards to creditors in particular, the \textit{pari passu} principle should be respected to ensure the equal treatment of similarly situated creditors.\(^8\)

The valuation of assets, rights and liabilities to be transferred – especially during a broad financial crisis, when the market for a specific asset or liability will not function properly – remains an important challenge. Resolution plans could become a useful tool; but a drawback of these is

\begin{footnotes}
\item[6] FDIA, § 11(n)(2).
\item[7] For instance, under the Swiss bank insolvency rules, the entirety of liabilities owned by a failing bank to a specific counterparty and the totality of financial arrangements with it should be transferred to a bridge bank, FINMA \textit{Banking Insolvency Ordinance}, art. 51(h)(1).
\item[8] For instance, see the Dodd-Frank Act, which highlights that “the Corporation shall treat all creditors of a covered financial company that are similarly situated, in a similar manner in exercising the authority…to transfer any assets or liabilities of the covered financial company to one or more bridge financial companies”, Dodd-Frank Act, Title II, § 210(h)(5)(E).
\end{footnotes}
that since they will, in principle, be updated on an annual basis, they might fail to adequately reflect the value of the institution at the moment of resolution. Rather, it will be crucial to assess the market value of assets and liabilities at the moment at which the resolution tools are exercised, and attempt to provide the most fair and realistic valuation possible. Clearly, the possibility of errors or under-/over-estimations during a financial crisis cannot be excluded due to the urgency of the situation. However, such inaccuracies may result in long judicial battles, and ultimately undermine the efficiency of resolution procedures.\(^9\)

One solution for ensuring that impartiality is respected and the potential for conflicts is minimised would be using a person independent from the resolution authority or the failing financial institution to manage the valuation procedure.\(^10\) It would be false to assume, however, that an independent person could guarantee the fairness and accuracy of the procedure under every scenario. Consequently, it might be necessary to build into resolution regimes a process of review and compensation mechanisms in case of erroneous evaluations. In this case, decisions around compensation should be subject to swift explicit administrative/judicial procedures and/or negotiations with the competent authorities, rather than the result of lengthy judicial adjudications.

This transfer of assets, rights, liabilities and shares should – ideally – be made on more than one occasion. Thus, rigid rules should be avoided; resolution authorities should be able to adjust the procedure to suit the evolving specific circumstances during a financial crisis.\(^11\)

It is also crucial to add that a key feature of the bridge bank resolution tool is the power of the resolution authorities to reverse – if they consider it necessary – any asset and liability transfers that have already been made to the bridge bank. Decisions around such reverse transfers should be subject to appropriate safeguards, such as specific timelines and objective criteria, to safeguard against the arbitrary actions of resolution authorities and enhance legal certainty and financial stability.

\(^9\) See above, under section (1.2.5), the litigation saga between the Lehman trustee and Barclays for the assets of LBI transferred to the British banking group.

\(^10\) See the EU rules regarding the use of independent persons for the conduct of the preliminary valuation amidst resolution, EU Bank Recovery and Resolution Directive, art. 36(1).

The resolution authorities should have the power to select new management to run the bridge financial institution. This comes as a basic rule in all resolution regimes.\textsuperscript{12} Moreover, the Basel Committee highlights that whilst the previous management can still retain its powers at the residual bank (i.e. the parts of the business which will ultimately be subject to a winding-up procedure), it can exercise no power at the bridge financial institution.\textsuperscript{13} In reality, however, such provisions might prove problematic: since the process of creating and managing a bridge bank institution might prove quite long (and thus exceed the time restrictions and restrictions under existing resolution legislation), finding management with the appropriate expertise could be challenging for the resolution authorities.\textsuperscript{14}

Furthermore, resolution authorities should be responsible for establishing (through a charter, statute and articles of association) the terms and conditions under which a bridge bank has the capacity to operate. These conditions may refer to issues of: corporate governance; capital or operational financing; and regulatory and other prudential requirements under banking and financial legislation. When the authorities decide on these terms, or on the selection of the new management, they enjoy complete operational independence; restricted only by the relevant provisions regarding bridge financial institutions under resolution legislation. These specific resolution provisions might contradict and eventually circumvent other general provisions under banking or corporate rules and norms.\textsuperscript{15}

Hence, it is clear that the decision to create a bridge bank will have significant impacts on creditors’ and shareholders’ rights, and might call for important amendments to be made to banking or corporate legal statutes.

A notable characteristic of bridge financial institutions is their limited (temporary) lifespan. Bridge banks are not intended to represent a

\textsuperscript{12} For instance, see Dodd-Frank Act, Title II, § 210(h)(2)(B), EU Bank Recovery and Resolution Directive, art. 41(1)(b) and UK Banking Act, § 20.

\textsuperscript{13} BCBS, 2011, p.17.


\textsuperscript{15} The majority of resolution regimes explicitly confirm that transfers to a bridge financial institution, as well as decisions concerning its modus operandi, are effective notwithstanding domestic legislation rules or contractual provisions requiring preliminary approval or consent by shareholders or other interested stakeholders. For instance, see Dodd-Frank Act, (21/07/2010), Title II, § 210(h)(2)(E)(i), UK Banking Act, § 34(3), the FDIA, § 11(n)(3)(A)(iv) and EU Bank Recovery and Resolution Directive, art. 40(1).
permanent solution for a defaulting financial institution, nor should they be the final stage of resolution procedures. Rather, a bridge bank should be considered as a natural continuation of the systemically relevant functions of the resolved financial institution. As such, a key objective of its daily operations should be the safeguarding of these functions and financial services, which will be subsequently transferred to another legal entity. The principal objective for the resolution authorities is to manage the transferred business and, after a reasonable period, sell it to one or more interested private purchasers – or organise a merger with a financially sound entity.¹⁶

Most jurisdictions opted for a period of two years regarding the operation of bridge financial institutions.¹⁷ The lead resolution authority can always decide to extend this period.¹⁸ At the end of this additional period, and unless the bridge financial institution is sold as a going concern or merged with another financial actor, the resolution authorities should be free to wind it down.

6.1.2 Cross-border challenges

Despite enjoying a wide level of support, the creation and management of a bridge financial institution on a cross-border scale can give rise to a number of complex issues that have not been sufficiently addressed by either domestic legislations or international policy proposals.

The issue of resolution funding is a key challenge: significant levels of funding are required to cover the costs of establishing and operating a bridge bank to take over the business of a defaulting financial institution. If

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¹⁶ As put by the European Commission, “the purpose of a bridge bank structure is to facilitate continuous access to insured deposits or the preservation of essential banking functions for a limited period, with a view to onward sale to the private sector when market conditions stabilise”, European Commission, Communication on an EU Framework for Crisis Management in the Financial Sector, 2010, p.10.

¹⁷ For example, see the Dodd-Frank Act, Title II, § 210(h)(12) and FINMA Banking Insolvency Ordinance, art. 52(2).

¹⁸ However, there is significant divergence of opinions regarding the optimal duration of such an extension. For the Dodd-Frank Act this extension might reach three years (Dodd-Frank Act, Title II, § 210(h)(12)), the Swiss Banking Insolvency Ordinance allows flexibility and discretion (FINMA Banking Insolvency Ordinance, art. 52(2)) and the European Commission envisages one or more additional one year periods, only under duly justified circumstances (EU Bank Recovery and Resolution Directive, art. 41(6)).
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resolution funds are insufficient to cover these costs, government support will become indispensable. This was the case in Portugal, following the collapse of Banco Espirito Santo: since the newly created Portuguese resolution fund was unable to fully finance the creation of the bridge bank under resolution, the Portuguese government contributed the majority of the necessary funds. It is still questionable if and when the Portuguese state will fully recover this contribution.

This problem will become more acute within the context of a cross-border crisis: if explicit burden-sharing mechanisms are not in place within cross-border cooperation agreements and group resolution plans, resolution authorities will reach a dead-end. As in most legal orders resolution regimes are entirely independent from the use of public funds, in an attempt to mitigate the moral risks arising from potential future bailouts,\(^\text{19}\) cross-border negotiations might become almost impossible.

Moreover, although most of the resolution tools have been put into test in real crisis situations – some of them during the 2008 financial meltdown – up to now the use of bridge banks during a cross-border crisis remained more or less a theoretical concept.\(^\text{20}\) Thus, one can only speculate at this stage about how the authorities will put the theory into practice when faced with an international bank in danger of default.

Two additional problems are associated with bridge financial institutions, neither of which has been clarified or resolved at the international level yet. The first of these refers to the treatment of creditors, and the transfer of contracts, collateral and security agreements and other contractual

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\(^{19}\) For example, under the UK Special Resolution Regime, the creation of a bridge bank by the Bank of England can become quite complicated, if this action would be likely to have implications for public funds. In addition Treasury’s consent will be required. If the Treasury refuses such approval, then the Bank of England will be obliged to drop the bridge bank option and explore other solutions, which might negate resolution objectives, UK Banking Act, § 79.

\(^{20}\) As mentioned on p.176, note 4, the resolution tool of a bridge bank has been extensively used by the FDIC but exclusively on a domestic basis, concerning small or medium-sized banks but never a financial institution with international activities. In the UK, this resolution tool was used only once for the failure of a building society. This was the case of the Dunfermline Building Society, which was eventually sold to Nationwide Building Society. DBS was the twelfth largest UK building society with 34 branches, 500 employees and 300,000 customers and it had limited domestic financial activities, Campbell, 2011, p.54. In the case of Banco Espírito Santo, the resolution measures implemented by the Portuguese central bank concerned exclusively the Portuguese entity.
arrangements from the defaulting credit institution to the bridge bank in general. Although domestic resolution legislations and international policy documents insist on the importance of applying the *pari passu* clause or the ‘no creditor worse off than under liquidation’ (NCWL) principle, the rules around these principles remain vague.

Officially, whilst resolution authorities are forbidden to ‘cherry-pick’, they ultimately have the power to decide which creditor’s rights will be transferred to the bridge bank and which will remain within the residual bank under liquidation.\(^{21}\) Although considerations of financial or systemic importance will play a role in this final decision, state jurisdictions fail to provide elaborate rules safeguarding the process of a transparent and indisputable transfer. An international standard on these aspects is currently absent. As such, the application of regulatory discretion by the regulation authorities might lead to legal clashes within classes of creditors, and result in unfair differences in the treatment of those being transferred versus those subject to liquidation.\(^{22}\)

Secondly, the application of a bridge bank scheme on a cross-border basis could prove to be a daunting task given the divergence of domestic rules for the transfer of assets and liabilities across jurisdictions. In most cases, the preferred operational resolution strategy is the ‘single point of entry’ approach. This strategy applies to financial groups in their entirety, with the lead for resolution given to the home authority. However, it will be practically impossible to create in the near future a consolidated cross-border bridge financial institution that could take over the globally critical business functions of an international banking group and which could be financed from the states directly involved in the resolution procedure. A more plausible scenario would be the establishment of several bridge banks, one for each jurisdiction. This would necessitate increased cooperation and coordination between resolution authorities, and cross-border cooperation agreements and group resolution plans should set the rules for the implementation of such procedures.

\(^{21}\) “*Member states shall ensure that resolution authorities have the power to transfer to a bridge institution all or any assets, rights or liabilities*”, EU Bank Recovery and Resolution Directive, art. 40(1)(b).

\(^{22}\) For instance, German Law allowed BaFin to select among creditors or groups of creditors based on its opinion of the systemic relevance of each contractual liability and each creditor. Consequently, cherry-picking becomes legal, Dirk H. Bliesener, *Legal Problems of Bail-Ins under the EU’s Proposed Recovery and Resolution Directive*, in Dombret & Kenadjian, 2013, p.215.
Even then, resolution regimes should introduce additional provisions that elaborate on the issue of international cross-border coordination, and explore introducing rules that allow the transfer of foreign property for the needs of domestic resolution proceedings. Despite provisions highlighting the respect of foreign law provisions, rules calling for the transfer of foreign property might create confusion and legal controversies. Cross-border cooperation agreements should bring about a new era leaving ring-fencing practices aside, but, as they do not present a legally binding character, the decisions of domestic resolution authorities might be subject to unpredictable or capricious actions. Hence, hard rules under domestic resolution legislations should explicitly define the conditions under which cross-border transfers of assets and liabilities can be performed.

6.2 Sale of business tool

6.2.1 Conditions for mergers and acquisitions resulting from resolution procedures

The most popular resolution tool to be implemented to date has been, by far, the sale of business tool (i.e. the transfer of all or part of a failing bank’s business to one or several private sector purchasers.) The majority of state regulators tried to implement such solutions to save their troubled financial institutions during the 2008 financial turmoil. In numerous cases, however, legal or financial impediments did not allow the full exercise of such powers. Ultimately, the total number of mergers and acquisitions during 2008 and the first quarter of 2009 remained quite suppressed compared to the standards of the prior decade, Panetta et al., 2009, p.19. In the EU, M&A operations reached their peak in 2000 with a total of 140 and consistently remained above an annual rate of 100 until the crisis of 2008, Cotterli & Gualandri, 2009, p.3. Regarding cross-border mergers, their total number fell by 30%, from 362 in 2007 to 254 in 2008, Claudia M. Buch & Gayle L. DeLong, Banking Globalisation: International Consolidation and Mergers in Banking, in Berger, Molyneux & Wilson, 2010, p.512. These mergers took place mainly between developed economies, each within close regional proximity to the other, which shared already a common cultural and financial background, ibid, p.524.
Mutual (in September 2008) to JPMorgan Chase, however, as well as the sale of Lehman Brothers’ US subsidiaries to Barclays can be considered successful (despite the ongoing litigation in the case of the latter).24

Private sector purchases such as these are high on the list of resolution authorities since they might lead to mergers and acquisitions, altering the financial landscape of the banking sector.25 Under this scenario – as with the case of the creation of a bridge bank – the role of the resolution authorities is to single out the critical functions and financial services provided by the resolved financial institution and sell them as quickly as possible to a solvent third party with an interest in acquiring them. Regulators might be also willing to intervene in order to assist a merger between the financial institution subject to a resolution procedure and a second institution.26

This sale could involve assets, liabilities, legal rights and obligations, deposit liabilities (when there is a credit institution subject to bank resolution) as well as shares’ ownership.27 Ultimately, it falls upon each domestic resolution regime to decide on which parts of the banking business can be subject to this sale, and the conditions governing the actions of the competent authorities.

Obviously, any non-critical functions and services that are deemed to be systemically unimportant and that do not need to be maintained permanently will remain with the residual parts of the financial institution that will be eventually wound down.

It is interesting to note that none of the domestic resolution regimes stipulate the time period within which the prospective purchaser(s) must be identified and the sale of the business concluded. Nonetheless, they all require that this resolution tool be implemented swiftly. The ideal scenario would be to close down those parts of a bank’s business likely to default

\[24\] See section 1.2.5.
\[25\] For instance, the UK resolution system recognises the sale of business tool as the primary stabilisation option that the UK resolution authorities need to explore before exercising any other resolution method, UK Banking Act, § 11(1). In the FINMA Banking Insolvency Ordinance in Switzerland the option of a sale of business remains quite high in the categorisation of resolution tools, FINMA Banking Insolvency Ordinance, art. 51.
\[26\] For instance, see Dodd-Frank Act, Title II, § 210(a)(1)(G).
\[27\] FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.7.
by the end of the business week, and to complete the basic stages of the acquisition or the merger before the opening of the market the next business week. A period of two days, falling over a weekend, should theoretically be sufficiently long for the resolution authorities to be able to exercise their powers and avoid any major disruptions to business.

On the other hand, there is a broad consensus that such sales should not be subject to the ordinary conditions of corporate law applied to mergers and acquisitions under domestic or supranational legislation.\(^\text{28}\) Thus, these sales or mergers under a resolution procedure will have profound repercussions for shareholders’ and creditors’ rights.

The principal requirements that should be safeguarded throughout the use of the sale of business resolution tool refer mainly to competition law requirements and conditions. It is true that the implementation of this resolution tool will necessitate the very active involvement of resolution authorities who, in addition to organising the sale, making arrangements for the marketing of the failing banking business and soliciting potential purchasers, might also need to facilitate or actively assist the process of a merger or acquisition. State regulators might eventually be forced to provide guarantees to the prospective acquirer, in order to partially mitigate the risks that the acquisition of a troubled financial institution can pose.\(^\text{29}\) Furthermore, it will be for the authorities to set the terms and the price of the agreement. By and large, the purchaser should pay a fair price and

\(^\text{28}\) The European Commission highlights that such resolution powers should be put into practice “\textit{without requiring the consent of the shareholders or any third party other than the purchaser and without complying with any procedural requirements under company or securities law other than those included in article 39}, \textit{EU Bank Recovery and Resolution Directive}, art. 38(l).

\(^\text{29}\) In the case of the sale of Bear Stearns to JPMorgan Chase, the Federal Reserve Bank of NY had entered into a financing agreement (bridge loan) with JPMorgan Chase before the conclusion of the acquisition. It was providing, thus, funding to Bear Stearns via JPMorgan Chase, which decided to acquire the first, principally due to this government backstop. The mortgage debt of Bear Stearns was used as collateral. The Federal Reserve Bank of NY became responsible for any losses of up to $29 bn to the Bear Stearns mortgage portfolio, whereas JPMorgan Chase bore the responsibility for the remaining $1 bn. In addition, we should highlight that the agreement between the Federal Reserve Bank of NY and JPMorgan Chase had been signed on a non-recourse basis, i.e. in case the collateral became insufficient to repay the loan, the government could not seize any assets of JPMorgan Chase.
should not gain any competitive advantage due to the rapid conclusion of the agreement.\footnote{According to the European Commission the process of the sale should be organised in an open, transparent and non-discriminatory manner, avoiding any conflict of interest, even under very pressing and short time limits, during which a normal process of public tender will not be possible, EU Bank Recovery and Resolution Directive, art. 39(2).}

Consequently, when implementing the sale of business resolution tool it will be important to distinguish between ‘state support’ and ‘state aid’:\footnote{For example, the European Union, in the aftermath of the financial crisis of 2008, issued specifically detailed guidelines regarding state aid to the banking sector that should be respected at any point of a resolution procedure involving a sale of business, Commission of the European Communities, Communication on the Application of State Aid Rules, 2008, art. 2(10). For the evolution of the EU state aid rules see pp.99–101.} whilst temporary state guarantees could be acceptable, state aid measures would be subject to specific requirements, independent from the bank resolution framework.

Over a long period, a large number of jurisdictions applied the ‘failing firm defence’ in the context of mergers and acquisitions. As formulated by the OECD, this principle can be successfully defended and the transaction can gain clearance under competition law if the following three stringent criteria are all satisfied: a) in the absence of a merger, the failing firm would be forced out of the market in the near future due to financial difficulties; b) there is no feasible less anti-competitive alternative transaction or reorganisation than the proposed merger; and c) without a merger, the failing firm’s assets would inevitably exit the market.\footnote{OECD, 2009, p.11.} Although small or weak, the failing firm’s contribution to competition might nonetheless be beneficial for a state’s consumers.

Hence, the ‘failing firm defence’ results from a comparison between two scenarios with regard to competition law: a post-merger scenario versus its counterfactual scenario, whereby the firm would finally fail and exit the market if the merger did not take place. In certain circumstances, the post-merger scenario is less anti-competitive and, consequently, it should be approved by the authorities.\footnote{As Posner puts it, “failing firm defence is one of the clearest examples of a desire to subordinate competition to other values”, Ioannis Kokkoris, The Failing Firm Defence in Failing Markets: the Case for Bank Mergers, in LaBrosse, Raymond, Olivares-Caminal & Singh, 2009, p.241.}
Although prevalent, the ‘failing firm defence’ has been repeatedly challenged.\textsuperscript{34} It could provide useful guidelines for acquisitions resulting from bank resolution procedures, but at the same time it should not be considered a common principle.

To sum up, sales of critical parts of financial institutions to one or more private purchasers – which can lead to successful acquisitions or mergers, where this is feasible under the circumstances – could be a pivotal solution for resolution authorities. The use of the sale of business resolution tool could help to minimise disruption to the markets, and promote continuity of services within the banking sector. However, such a resolution method can become quite problematic if it is hastily organised, as explained in the following section.

\textit{6.2.2 Principal obstacles to the efficiency of mergers and acquisitions under bank resolution}

At first sight, this resolution tool seems very promising since it allows for resolution authorities to play a more limited role than other resolution methods do. It is also less costly, as the private purchasers will contribute significantly to funding in order to acquire the business parts that are of interest to them. However, there are also significant limitations to and challenges associated with this tool, which may jeopardise its efficiency.

As it has been repeatedly noted, it is vital that all resolution policies are organised and exercised in a swift manner in order to avoid further value destruction of the going concern of a failing financial institution. Ideally, the sale of certain parts of the business to third-party private acquirers, or the completion of a merger procedure, should be concluded over a weekend so as to minimise or avoid any further disruptions to the markets. Yet, it is unrealistic – perhaps even impossible – to expect that this process will be possible to achieve over a period of just 2–3 days given the highly complex nature of the corporate structure of most international banks (i.e. the

\textsuperscript{34} The EU Commission, preoccupied by anticompetitive effects, made it clear in the \textit{Kali und Saltz} decision that the ‘failing firm defence’ principle would be applied only as an exceptional situation. As stated in the decision, the Commission was more inclined to use the principle for the cases where, even if the merger had been prohibited, the acquiring entity would have taken over the market share of the failing firm after the exit of this last from the market, \textit{ibid}, pp.243–244.
intra-group interconnectedness and exposures and the number of assets, financial contracts and agreements), and the need for authorities to assess multiple potential purchasers and fulfil multiple regulatory requirements – sometimes in numerous jurisdictions.

Additionally, this would assume that the authorities have already completed – i.e. at an early intervention stage (if any) during a financial crisis – the marketing phase of the critical functions and financial services of a bank likely to default, and have already identified some potential acquirers. Even under normal conditions, the completion of a due diligence test of a possible target of a merger and acquisition procedure can take weeks, perhaps months. If not undertaken properly, this test can lead to critical mistakes. It is worth reiterating here that the purchaser of a failing institution will acquire not only its assets but also its liabilities, thus becoming responsible for any contentious issues linked with the former business of the acquired entity and subject to any future litigations.35

While resolution plans might assist with this exercise, they are not subject to the same form and requirements as a due diligence test conducted before a sale and acquisition. A financial institution might highlight in its resolution plan that it would be willing to sell specific group entities. Still, the potentially interested purchasers will be identified during an actual financial crisis and not during the process of drafting the resolution plan.

Moreover, it might be especially challenging in cases relating to the partial transfer of a business to numerous purchasers to properly disentangle the assets or financial contracts and establish a correct estimation and valuation of their price in such a short period of time. Given the cross-border corporate structure and activities of most modern banking groups, cooperation and sharing of information between jurisdictions will be necessary, which may further complicate and delay matters. A good

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35 In November 2013, JPMorgan Chase settled its disputes with the US Justice Department regarding the sale of high-risk mortgage based securities before the onset of the house bubble in the US and the subsequent financial crisis. The final sum of the settlement ($13 bn) concerned not only the actions of JPMorgan Chase but also the business deals of Bear Stearns and Washington Mutual, which, following their collapse, were acquired by the first. Moreover, in August 2014 BofA entered into the largest ever agreement of a US bank with US authorities ($16 to 17 bn) in order to resolve allegations of financial misconduct resulting mainly from the sale of faulty mortgage securities by Countrywide and Merrill Lynch, two companies absorbed by BofA with government assistance during the financial crisis, GROSSMAN, REXRODE & FITZPATRICK, 2014.
illustration of this is the rapid sale of Lehman Brothers – or, more specifically, the firm’s US broker dealer – to Barclays. The extent of the legal proceedings that followed this sale highlight how many issues can actually go wrong if sales are conducted too hastily, even to a single purchaser.

Whilst a resolution procedure should, in theory, be implemented rapidly, it should not result in a ‘fire’ sale – or a significant depreciation – of assets, both of which would result in a competitive advantage for the purchaser(s) and violate the principle of a fair price for the transferred business. In the case of the latter, this could also contradict fundamental competition rules of domestic legislations. Furthermore, as with bridge banks, attempting to undertake a valuation of assets within such a limited timeframe could be a rather daunting task, potentially resulting in further errors and misinterpretations if specific rules regulating this procedure are not in place.

Resolution plans can provide valuable indications of the value of assets and liabilities, and the corporate structure or the intra-group exposures of a failing bank. Nevertheless, they should not be regarded as an infallible roadmap to resolution; during a financial crisis, it is conceivable that such plans might fail to accurately reflect the rapidly changing financial conditions of an international bank.

In addition, one should not forget that finding a buyer during difficult financial times may be extremely challenging: as demonstrated by the 2008 financial meltdown, a systemic financial crisis can cause significant liquidity problems for the majority of financial actors, and few financial institutions are able to escape such a crisis unscathed. In 2008, many large financial intermediaries in trouble were unable to acquire their smaller competitors. Meanwhile, when these large intermediaries became subject to a merger and acquisition procedure, they became very expensive targets for potential acquirers.36 Identifying not just one but numerous purchasers to whom the viable business parts of an international bank can be sold – and running a due diligence test regarding the impacts of the crisis – will not be an easy task for resolution authorities. Thus, the option of implementing mergers and acquisitions might be most feasible in large and very competitive markets.37

36 Panetta et al., 2009, p.19.
Moreover, the greater the number of the potential acquirers and the smaller the amount of assets and liabilities transferred to each of them, the greater the risks of potential disruptions to the system.\(^{38}\)

As already alluded to, the entire or partial sale of an international banking group to one or more purchasers will be impossible without efficient cross-border cooperation and coordination. Information sharing between resolution authorities will be necessary with regards to the marketing of the sale of assets of group entities operating in foreign jurisdictions. Group resolution plans and efficient cross-border cooperation agreements will provide the main basis for the implementation of principles endorsing cross-border coordination. These instruments should define in a clear and straightforward manner the possible courses of action of each participating resolution authority with regards to those entities of the banking group operating within their borders that might eventually be subject to a sale procedure.

A critical aspect, but one that remains largely unaddressed with regards to cross-border exchange of information, is confidentiality. During a mergers and acquisitions procedure, confidentiality should be maintained during the stage of marketing the failing business and the due diligence control of potential acquirers. The involvement of multiple state authorities – as well as numerous interested third parties from the private sector – will necessitate the development of explicit rules governing the conditions of confidentiality. Although it will be difficult – if not impossible – to develop ‘one-size-fits-all’ approaches and rules, the relevant international standard-setting bodies should introduce broad guidelines on this critical issue: a potential leak of information during a crisis might contribute to market panic and further deterioration of the financial condition of the ailing bank. Ultimately, it could deter interested purchasers from proceeding with the acquisition.

It is important that even during the early stages of a bank resolution intervention, the competent resolution authorities have in place a ‘plan B’, in case the financial viability of a bank cannot be guaranteed. Regulators should become proactive, exploring their potential options in the event of serious financial troubles. For instance, although the recovery stage will usually involve recapitalisation or other regulatory measures aimed

at stabilisation, resolution authorities should resort to existing resolution plans to: identify the crucial functions of the likely-to-default bank; evaluate these functions properly; and explore the market for potential purchasers, scrutinising their financial situation and intentions. In this way, once the authorities reach the resolution phase they will be able to run due diligence tests for the acquirers and market them adequately. Alternatively, if all these considerations, tests and value estimations are left for the final stages of a resolution of a rapidly collapsing financial institution, important errors and judgments may be made, affecting both sides (state and private acquirers).

Moreover, the use of mergers and acquisitions as a tool to assist in the resolution of troubled banks should always be governed by the restrictions of competition law principles. That is to say, the use of this tool should always be guided by the principles of fairness, openness, transparency and non-discrimination. Any assistance provided by the authorities during the resolution procedure should not constitute unauthorised state aid, since this can distort competitiveness.39

Finally, the sale of business resolution tool should not be considered a panacea for the problem of banking failures, or be treated light heartedly by resolution authorities. On the contrary, one should take into consideration that the hasty transfer of SIBs’ critical business functions to other (viable) financial institutions following their resolution could ultimately amplify – rather than resolve – the ‘too big to fail’ issue: having acquired the business functions of failing financial institutions that will finally exit the market, those banking groups surviving the crisis will also be very large and more systemically important.40 Since it may take considerable time to effectively absorb the functions and services of the acquired financial institution, and to establish new financial positions, an element

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39 However, it debatable whether state support can be totally excluded in case of the collapse of a systemic bank. As stressed by the European Commission, if a financial institution is too large to be sold to other financial participants, the state authorities will be finally required to provide partial support, which may result in a significant competitive impact in the banking market, EUROPEN COMMISSION, COMMUNICATION ON AN EU FRAMEWORK FOR CRISIS MANAGEMENT IN THE FINANCIAL SECTOR, 2010, p.10.

40 In March 2012, the debt of JP Morgan was estimated at $ 2.13 bn and that of Bank of America at $ 1.95 bn, in total three times larger than that of Lehman Brothers in the summer of 2008, ADMATI & HELLWIG, 2013, p.12.
of future instability could potentially remain present within the financial markets.

### 6.3 Asset separation tool

One of the most innovative resolution tools broadly used during the 2008 financial crisis was the asset separation tool (i.e. the transfer of assets and liabilities of the failed bank to a separate asset management vehicle; or the separation of a financial institution into a ‘good’ bank and a ‘bad’ bank.) The intervention of the Swiss authorities in 2008 to save UBS provides a good illustrative example of this tool: a separate ‘bad’ bank (StabFund) was created to take over the management of the bank’s ‘toxic’ portfolio. In addition, the TARP program established by the US government and its UK equivalent, the UK Asset Protection Scheme, were also based on the principle of asset separation in order to assist troubled financial institutions in their process of deleveraging and stabilisation.

Before the 2008 crisis, the asset separation resolution tool had been exercised by certain jurisdictions as part of *ad hoc* solutions to the issue of ‘toxic’ assets on banking institutions’ balance sheets. The resolution

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41 See section 1.3.3.
43 The UK authorities established the UK Asset Protection Scheme in January 2009 in order to create a ring-fencing procedure of selected portfolios of illiquid assets. The basic principle of the scheme was that banks could pay a fee in return for having certain categories of illiquid assets insured by the state. The first loss risk and part of the secondary loss risk would be covered by the bank but any further losses would be covered by the state guarantee. The two UK banks participating in the scheme were Lloyds for an amount of assets up to £260 bn with a fee of £15.6 bn and the Royal Bank of Scotland, which insured £325 bn of assets by paying a fee of £6.5 bn and after deciding to give up any existing UK tax credits, Panetta et al., 2009, p.27. In this way, both UK banks managed to ring-fence approximately 17% of their total banking assets.
procedures implemented by the Swedish government during the Scandinavian banking crisis of 1991–93, which attracted considerable international attention and were considered broadly successful, provides a good illustrative example. For each of the two major insolvent banks – Nordbanken and Gotabanken – the government created two bank asset management corporations (Securum and Retriva) that received the ‘toxic’ assets and took over the management of the two banks. The remaining viable parts of the two financial institutions (the ‘good’ banks) were merged into Nordbanken, and, following their successful privatisation, they emerged as Nordea, a systemic bank currently operating in Scandinavian states.

The process of asset separation can be described as the creation of a separate asset management vehicle by the resolution authority, with the objective of ‘cleansing’ the balance sheets of troubled banks. This asset management vehicle – fully owned by the resolution authorities – takes over the problematic assets jeopardising a bank’s financial stability. This vehicle can take various forms, including: a subsidiary of the distressed bank; an entity with a separate chapter; a trust; or an asset management company. This distinction between ‘clean’ and ‘toxic’ assets will generally include: non-performing or underperforming loans; assets presenting significant valuation challenges; or assets put the soundness of a financial institution in danger due to their performance or level of risk. Contrary to the resolution tool of a bridge bank, where the viable functions of a failing bank will be transferred to a separate entity, in this case, only the ‘toxic’ assets are removed from a financial institution and transferred to the special entity. The rest of the bank will continue its operations as a so-called ‘good’ bank.

This asset management vehicle will be operated by a special management appointed by the competent resolution authority. According to the objectives set by the resolution authority or resolution legislation, the managers will take over the oversight and control of the ‘bad’ bank, focusing their efforts on maximising the value of these assets and eventually selling them after a certain management period. Should these efforts prove fruitless, the managers – in cooperation with the resolution authorities –

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45 FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.8.
46 DG Internal Market and Services, 2011, p.54.
should wind down and liquidate this ‘bad’ bank in order to avoid any further losses that might be incurred from the continued management of such assets. It is important to stress that the prior consent of managers, shareholders and creditors of the affected financial institution is not a prerequisite for implementation of the asset separation resolution tool. Consequently, these stakeholders will have no rights to the assets transferred by the resolution authorities to the separate asset management vehicle.47

Implicit in the above description of this tool is that it cannot be used in isolation in order to resolve a financial institution; rather, this tool should form part of preliminary resolution measures undertaken by resolution authorities, in preparation for the final resolution phase. For instance, as soon as the separation between the ‘good’ and the ‘bad’ bank is complete, the authorities will be able to either: a) transfer the assets, rights and liabilities of the former to a bridge bank or b) sell them to interested private purchasers. The managers of the residual ‘bad’ bank should take over the administration of the ‘toxic’ assets, achieve eventual profits from their management and, finally, try to sell them. In case such a scenario is not plausible, the ‘bad’ bank should be wound down.

Despite its beneficial contribution to bank resolution, the exercise of asset separation can present significant legal complexities and practical challenges.

Firstly, the creation and management of an asset management vehicle (a ‘bad’ bank) requires significant funding resources; yet bank resolution must remain independent – and financed separately – from public finances. Consequently, the success of an asset separation procedure will be directly associated with the establishment and efficient performance of special resolution funds. Until these funds reach full operational independence, resolution authorities should be extremely cautious when organising a ‘bad’ bank: the exposure of the state to potential losses might be quite extensive due to the inherent risks related to ‘toxic’ assets (which are frequently not fully understood). After all, the profits generated by the management of the ‘toxic’ assets and/or the eventual sale of the ‘bad’ bank to private purchasers are, by no means, a guaranteed outcome of bank resolution.48

47 For instance see EU Bank Recovery and Resolution Directive, art. 42(12).
48 The Swiss National Bank took significant risks when it intervened to save UBS. Fortunately, this experiment resulted in a net profit of $3.7 bn, see p.46.
Moreover, the most obscure and complex issue of establishing a ‘bad’ bank will be the valuation of assets and risks. As noted by the Basel Committee, “the valuation of assets and liabilities can prove as much as an obstacle to private resolutions as the time constraints”. Under the pressing time schedules of bank resolution, locating and accurately valuating all ‘toxic’ assets in a timely manner will not be a straightforward task for the regulator. In the context of a rapidly evolving financial crisis, the depreciation of assets – and the bank’s subsequent risk exposure – can change quite rapidly. Yet, the often complex nature of international banks’ corporate structure and the fact their risk valuation mechanisms are sometimes outdated might impede the successful implementation of asset separation.

Resolution plans might prove useful in helping to address the challenges associated with the accurate and timely valuation of assets. Nevertheless, these plans may be updated too infrequently to be able to give an accurate picture of the true condition of particularly risky assets at any given point in a bank’s business circle.

The systemic crisis of 2008 is a case in point. Despite their sophisticated risk valuation mechanisms, most financial institutions were unable to calculate their overall risk exposure and place a precise value on the total amount of their ‘toxic’ assets. Generally speaking, in the pre-crisis era, there were considerable inconsistencies in the application of asset and risk valuation practices across the various global banking firms.

In addition, certain assets can depreciate suddenly and rapidly because of the level of risk they entail. Therefore, it is possible that the management of a ‘bad’ bank might not be able to achieve any profits from these assets, and could end up making substantial losses. Thus, there is a degree of insecurity and this potential for future instability has a knock-on effect on how creditors are treated: fearing that those creditors, whose contracts or financial arrangements will be transferred to a ‘bad’ bank in the case of an abrupt and significant depreciation in assets, might be discriminated against, and ultimately receive less than they would have had the financial

49. BCBS, 2010c, p.9.
50. Senior Supervisors Group, 2009, p.2. It is no surprise that the initial guarantee of the Swiss National Bank for UBS had been larger ($ 60 bn) than the final sum of ‘toxic’ assets that were finally transferred to the special purpose vehicle, used as a ‘bad’ bank ($ 38.7 bn).
institution been liquidated from the beginning. In any event, creditors will not have the right to intervene or exercise any power regarding the management of the assets transferred to the ‘bad’ bank.

As a potential solution to this problem, the creditors of the ‘bad’ bank could acquire a specific enforceable economic interest in the net proceeds of the resolution.51 Another option would be to provide compensation to these classes of creditors that would be worse off in the ‘bad’ bank than they would have been under liquidation.52 Nevertheless, comparing an actual resolution with a purely hypothetical liquidation is not a reliable method of evaluating the level of compensation that prejudiced creditors should potentially get.

Finally, the role of efficient group resolution plans and cross-border cooperation agreements will once again be critical. Cross-border information sharing and cooperation will be vital, as the assets to be transferred to a ‘bad’ bank might belong to group entities operating in a different jurisdiction than the one implementing resolution proceedings. Since it is impossible to conceive (at least for the time being) of a consolidated asset separation resolution scheme being implemented on cross-border basis, international cooperation between the authorities will be vital in order for ‘toxic’ assets found outside the limits of a jurisdiction to be located and transferred to a ‘bad’ bank. Rather than standardised solutions, group resolution plans and cross-border cooperation agreements should include specific and unambiguous guidelines around how to address the complexities of asset valuation and cross-border coordination. Since these instruments are unable to foresee the exact extent of a crisis and capture all its externalities, resolution authorities should maintain a degree of flexibility when implementing asset separation resolution practices, through the safeguard, though, of principles elaborated under group resolution plans and cross-border cooperation agreements.

52 This method of compensation is already applied under the UK Special Resolution Regime regarding the creditors ‘left’ in the residual bank after a partial sale of banking business, Cihak & Nier, 2009, p.16.
6.4 Bail-in within bank resolution

Due to widespread ‘bail-out fatigue’ among taxpayers, bank regulators have turned their focus in recent years away from *ad hoc* bail-out solutions for rescuing troubled banks towards ‘bailing-in’ bank shareholders and creditors. As in environmental and criminal law, legislations on bank resolution endorse the ‘polluter pays’ principle, according to which, financial institutions themselves should bear the financial and fiscal cost of their rescue.

The implementation of bail-in rules is considered both the most innovative and, by far, the most controversial bank resolution tool currently proposed. Discussions around the principal characteristics of this concept first began, however, within the markets and among regulators after the sovereign debt crises of the late 1990s and early 2000s.\(^{53}\)

The purpose of this section is to examine the principal legal challenges to the rights of bank creditors and depositors during the implementation of a bail-in procedure. The section begins with a presentation of the definition and main characteristics of this resolution concept, as well as of the current form of bail-in rules under selected jurisdictions. Secondly, it focuses on two recent examples of where bail-in has been implemented in order to address cases of bank failure (in the Netherlands and in Cyprus, respectively).\(^ {54}\) Finally, there is a discussion on certain potential deficiencies of the proposed rules in light of a broad use of bail-in schemes in future financial crises.

6.4.1 Definition and main elements of bail-in

The FSB has defined the principal elements of bail-in within resolution as “restructuring mechanisms to recapitalise a firm in resolution or effectively
capitalise a bridge institution, under specified conditions, through the write-
down, conversion or exchange of debt instruments and other senior or sub-
ordinated unsecured liabilities of the firm in resolution into, or for, equity or
other instruments in that firm, the parent company of that firm or a newly
formed bridge institution, as appropriate to legal frameworks and market
capacity.”

This definition makes clear that bail-in could take the form of: a) a
conversion of debt into new equity, resulting in a recapitalisation of a fi-
nancial institution subject to bank resolution or of a new bridge bank; and/
or b) a debt write-down, following which certain categories of debt will be
written off in order to ease market stress and safeguard the systemic func-
tions of the resolved bank. These two distinct powers could be imple-
mented either in isolation or cumulatively, according to the specific needs
and circumstances of each banking failure.

Thesepowers will be exercised on a statutory basis, emanating from
bank resolution statutes and banking legislation. Consequently, the reso-
lution authorities will have the power to intervene and either write off or
convert into equity a discretionary part of the resolved bank’s debt in order
to achieve a recapitalisation. These powers will be granted to the authori-
ties once the triggering conditions for the entry of a financial institution
into resolution are satisfied.

Bail-in is exclusively a recapitalisation mechanism within bank resolu-
tion procedures. As a result, the implementation of this tool will not gener-
ate additional liquidity for a failing bank.

Bail-in is expected to become an essential tool associated with the re-
capitalisation of a bank under resolution or a newly created bridge bank.
In particular, resolution authorities may resort to this option during the
context of a financial crisis when other, alternative resolution options
prove unfeasible or unviable. In the context of a systemic crisis, for in-
stance, authorities might not have sufficient time to create a bridge bank
if the failing institution is of a considerable size and its activities complex
and interconnected. Likewise, it might also be very challenging during a
crisis for the authorities to properly market a failing bank’s business and

56 By and large, both procedures could be described as a “creditor financed recapitalisa-
tion of systemically vital functions of an ailing financial institution”, FSB, Effective
Resolution of SIFIs, 2011, p.11.
to find potential purchasers interested in taking over this business. Thus, in such a scenario authorities may, instead, opt to exercise their bail-in powers, which could provide significant time for consultations between the competent authorities in order to adequately prepare their future actions within a resolution procedure.

### 6.4.2 Bail-in particularities compared to instruments of contingent convertible debt

It is important not to confuse the exercise of bail-in powers by resolution authorities with the contractual issuance of financial instruments of contingent convertible debt (CoCos) by financial institutions. The conversion or write-down of such hybrid instruments will be subject to specific contractual rules and precise contractual triggers, prior to resorting to bail-in procedures.

Contingent convertible debt – as a means of recapitalisation for troubled financial institutions through debt-to-equity conversion or debt write-down – will be used mainly during a recovery rather than a bank resolution procedure. In other words, contingent convertible debt will be used when a financial institution nears financial distress, whereas bail-in will be implemented when the bank reaches a point of non-viability.\(^{57}\)

Under this scenario, in the financial arrangements with third counterparties it is the bank that will introduce the power to mandatorily write off part or all of the issued debt or impose its conversion into equity at a given point set contractually and described in detail in the financial instrument issued. These conditions are commonly associated with capital requirements i.e. Tier 1 capital or additional capital buffers designed to absorb liquidity shocks.

Furthermore, the conversion of the contingent convertible bonds and the subsequent recapitalisation will result in the significant dilution of the existing shareholders. Bail-in, though, could become an instrument of infinite dilution as its implementation could wipe out entirely the original shareholders of the troubled bank.\(^{58}\)

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\(^{57}\) Chen, Glasserman, Nouri & Pelger, 2013, p.2.

\(^{58}\) Ibid. Consequently, CoCos can be used a means to exert market discipline against bank shareholders, Koziol & Lawrenz, 2012, p.91.
The first jurisdiction to introduce legislation on the issuance of CoCo bonds was Switzerland. The Swiss systemic banks can issue CoCos, which will be automatically converted into share capital or participation capital once the specific triggers are initiated. The board of the bank will be responsible for the issuance of such instruments, following a decision of the general assembly on this issue. When the triggers are activated, the board will be obliged to immediately issue an act describing the number and nominal value of shares, the type of shares, and participation notes newly issued after the conversion of the CoCos. Hard triggers referring to capital requirements under the revised Capital Adequacy Ordinance were also put into place. The high trigger is set at 7% and the low at 5% of Tier 1 capital. Once Tier 1 Capital drops below these thresholds with regard to the bank’s RWAs, the conversion of the CoCos will be automatically initiated.

The same rules will also apply with regards to debt write-downs resulting from CoCos. When a Swiss systemic bank issues any debt financial instrument, under the contractual terms of the instrument it must inform creditors that if specific events linked with capital requirements or the general solvency of the bank take place, its debt will be (partially or entirely) written off. According to the provisions of the Swiss Banking Act, the equity resulting from such contractual debt-to-equity conversion or debt write-down will be used exclusively to reinforce the capital adequacy of the bank or to manage a financial crisis.

The two largest Swiss banks have repeatedly issued CoCo bonds. Credit Suisse, for instance, issued CoCos twice in February 2011, twice in 2012, 59

59 Swiss Banking Act, art. 11(1)(b).
60 Ibid, art. 13(3).
61 Ibid, art. 13(5).
62 Swiss Capital Adequacy Ordinance, art. 129(2) and 130(2).
63 Swiss Banking Act, art. 11(2) and Swiss Capital Adequacy Ordinance, art. 126(1), 127(1)(a), 129(2) and 130(2).
64 Swiss Banking Act, art. 11(3).
65 On 14th February 2011 it issued CHF 6 bn for two Middle East institutional investors and on the 17th, $ 2 bn for the broader public. Both CoCo bonds qualify for the high trigger of 7% that could lead to debt-to-equity conversion. The issuance was met with great interest from the market.
66 CHF 750 mn in March and $ 1.725 bn in July, again in connection with the high trigger of 7% with a possibility for debt-to-equity conversion.
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and three times in 2013.\(^{67}\) Meanwhile, UBS first issued CoCo bonds on 15\(^{th}\) February and on 9\(^{th}\) August 2012, for a total of $4 bn in connection with the low trigger of 5\%, and leading to a debt write-down.

It is important to highlight that the initial issuances of CoCos in most states outside Switzerland have not been based on explicit regulatory schemes. Lloyds was the first EU bank to issue contingent convertible bonds in late 2009, in an effort to boost its core capital and avoid being subject to the UK government’s Asset Protection Scheme. The issuance was for a total of £7.5 bn and the CoCos provided for an automatic debt-to-equity conversion should the core capital fall below 5\%.\(^{68}\) Lloyds was followed by Rabobank in January 2011, which issued CoCos for a total of $2 bn. Rabobank’s CoCos will be written off once they hit a trigger below an equity capital ratio of 8\%. Another example relating to the issuance of CoCos has been Barclays. In November 2012, the banking group issued $17 bn of CoCos, which generated a huge amount of market interest. Barclays’ bonds will lead to a write-down to zero if the bank’s CET1 ratio falls below 7\%. A further $1 bn was issued in April 2013, maintaining the same principle of a total write-down in case of the initiation of the trigger.

All in all, it has been estimated that by 2018 a total volume of $400–500 bn of CoCos will have been issued.\(^{69}\)

Clearly, wide variations can be seen in the form that these instruments take (debt conversion or debt write-down); the level of the trigger; and the maturity and the extent of the results (partial or total write-down). What all bonds have in common, however, is that they all offer high and very attractive yields.\(^{70}\) The market’s appetite for such instruments remains

\(^{67}\) $2.5 bn, CHF 290 mn and €1.250 bn respectively, all leading to an automatic write-down to zero upon the occurrence of the triggering event.

\(^{68}\) In addition, the case of Lloyds was particularly interesting as the British government had already acquired, before the emission, a 43\% stake in the bank, Koziol & Lawrenz, 2012, p.90.

\(^{69}\) Myles, Varriale & Young, 2014, p.32.

\(^{70}\) For instance, in the case of Credit Suisse, the first CoCos issued in February 2011 offer a yield of 7.875\%; those of the second issuance in March 2012 a yield of 7.125\% and those of July 2012 a yield of 9.5\%. UBS CoCos, on the other hand, offer a yield of 7.25\%. The first CoCos of Barclays offer a yield of 7.6\%, whereas the second offer a higher yield of 7.75\%.
considerable.\textsuperscript{71} Due to the limited number of issuances, however, this tool remains relatively untested and potentially unpredictable, especially if a great number of financial institutions eventually begin issuing CoCo bonds.

It should be also stressed that such instruments should not be viewed as the panacea for all troubled financial institutions. Rather, the main objective of converting or writing-down CoCo capital is to safeguard banking solvency. These tools are not designed to create new money liquidity, nor are they a solution for any financial problem. Such instruments are based on the theory that by significantly reducing the liabilities of a financial institution, investors’ confidence in that institution will be quickly re-established.\textsuperscript{72} The recovery of financial stability is a key step towards rebuilding the confidence of the financial markets, which are normally the primary lenders for financial institutions. Nevertheless, a solvent bank with high liquidity problems will not necessarily enjoy a regular access to wholesale funding markets. CoCo bonds might not guarantee a swift change of view from the financial markets regarding a troubled financial institution.\textsuperscript{73} And if the financial institution cannot regain confidence and access to funding rapidly, its financial viability may be jeopardised, thus potentially nullifying any positive solvency gains arising from the contractual conversion or write-down.

\textbf{6.4.3 Current examples of bail-in rules}

In the years immediately following the 2008 crisis, legislators were relatively hesitant to adopt bail-in powers. The use of such instruments on a statutory basis was not widespread: the Basel Committee was able to identify only a few jurisdictions that had debt-to-equity conversion or debt write-down instruments at their disposal. However, these tools were normally implemented either following supervisory directives or under

\textsuperscript{71} Although the first buyers of such instruments were principally speculative investors such as private banks in Asia, high-net worth individuals and family offices, lately great interest has been demonstrated from London based multi-strategy asset managers, Myles, Varriale & Young, 2014, p.34.

\textsuperscript{72} Attinger, 2011, p.39.

\textsuperscript{73} In case of market asymmetric information, the conversion of CoCos might be interpreted as a negative signal by market participants and could put the financial condition of the bank in a death spiral, Koziol & Lawrenz, 2012, p.101.
provisions of corporate restructuring laws, and only after creditors’ or a court’s approval had been granted.\textsuperscript{74}

This situation changed rapidly from early 2012, and especially during the first months of 2013: a) the legislative developments regarding bank resolution in Switzerland, b) the EU proposal for a Bank Recovery and Resolution Directive, and c) the bail-in implemented in Cyprus all brought the issue to the forefront of international discussions.

From the brief following presentation, it is obvious that bail-in has been mainly a European concept in progress.

Switzerland was the first state to introduce a formal bail-in scheme. Bail-in powers of the Swiss resolution authorities will be exercised only after a bank’s contingent convertible debt is depleted and its share capital is reduced.\textsuperscript{75} The statutory debt-to-equity conversion will be discretionary and will touch upon the amount of debt, which will be required in order to recapitalise the bank under resolution.\textsuperscript{76} In principle, any debt can be converted into equity but the process will normally start from the subordinated creditors’ claims and could also reach deposits over the insurance ceiling of CHF 100,000.\textsuperscript{77} The process will need to safeguard creditors’ classes. Nevertheless, it will not be applied for certain categories of debt that are explicitly excluded from the scope of application of the FINMA Banking Insolvency Ordinance.\textsuperscript{78}

Otherwise, or as an additional complementary action to the debt-to-equity conversion, FINMA might also impose a partial or total write-down of the bank’s debt.\textsuperscript{79} In this scenario, the aforementioned rules will also apply. However, the safeguard of creditors’ classes during the implementation of debt write-down measures cannot be guaranteed.\textsuperscript{80}

In Spain, bail-in powers have been applied in relation to subordinated liabilities only.\textsuperscript{81} The Fund for Orderly Bank Restructuring (\textit{Fondo de reestructuracion ordenada bancaria}) was granted powers to fully carry out

\textsuperscript{74} BCBS, 2011, p.18.
\textsuperscript{75} FINMA \textit{Banking Insolvency Ordinance}, art. 48(b) and (c).
\textsuperscript{76} \textit{Ibid}, art. 48(a).
\textsuperscript{77} \textit{Ibid}, art. 48(d).
\textsuperscript{78} Mainly collateralised debt, guaranteed deposits, as well as first and second class creditors, \textit{ibid}, art. 49.
\textsuperscript{79} \textit{Ibid}, art. 50.
\textsuperscript{80} \textit{Ibid}, art. 50 \textit{in fine}.
\textsuperscript{81} FSB, Review on Resolution Regimes, 2013, p.24.
the resolution of a failing bank and to implement bail-in measures on a much more limited scope than its Swiss counterpart.82

France and Slovenia have been also some of the first EU Member States introducing bail-in rules. France modified its Monetary and Financial Code in July 2013 so as to accommodate rules allowing the implementation of bail-in.83 In October 2013, Slovenia introduced amendments to its banking act that enshrine bail-in rules applicable exclusively for shareholders and junior bondholders.84

Currently, all EU Member States are in the process of gradually introducing bail-in rules in order to transpose the requirements of the EU Bank Recovery and Resolution Directive into domestic law. The EU Commission envisages putting into place for all Member States an elaborate bail-in scheme with explicit rules governing: the categories of debt subject to such powers; the amount of debt required for bail-in; the hierarchy of claims; the rate of conversion; and other measures accompanying such powers.85 Similar rules have been proposed under the regulation that will govern the uniform bank resolution procedures of the Single Resolution Mechanism among the Eurozone Member States.86 The rules on bail-in are expected to enter into force on the 1st of January 2016.

In the US, the FDIC – whilst having no formal legislative bail-in powers – has reported that it will be able to use other available powers to convert equity or write off debt under resolution.87 Likewise, several other jurisdictions have maintained that they could use their existing resolution powers in order to achieve (at least to some degree) the same economic effect as bail-in.88

82 Law 09/2012 of the 14th of November on the Recovery and Resolution of Credit Institutions, Chapter VII.
83 Monetary and Financial Code, art. L613-31-16(9).
84 The Slovenia Times, 2013.
86 EU Regulation on a Single Resolution Mechanism, art. 17, 21 and 27.
6.4.4 Recent cases of bail-in implementation

6.4.4.1 The failure of SNS Reaal

SNS Reaal was the fourth largest banking group in the Netherlands and struggled for years to overcome the consequences of the financial crisis, due to its broad exposure to a weak real estate portfolio. Confronted with an ultimatum by the Dutch central bank – to either find (in a timeframe of just 4 days) the capital necessary to safeguard its solvency or declare itself bankrupt – the bank finally became nationalised on 1st February 2013 following an injection of €3.7 bn. Interestingly, €1 bn of the recapitalisation originated from the expropriation of shareholders’ and subordinated bank creditors’ rights.

The nationalisation was the result of the first application of the Dutch Intervention Act, which had entered into force in July 2012. The Act introduced sweeping powers of intervention for both the Dutch central bank and the Minister of Finance within the financial sector. Such powers included expropriation in order to save a financial institution and avoid any systemic repercussions for the Dutch banking system.\(^9^0\) The expropriation covered all outstanding shares, all subordinated bonds issued by the bank and all subordinated loans taken up by the bank.\(^9^1\)

Almost 700 parties from numerous countries appealed this decision before the State Council, as provided by the Dutch Intervention Act. The State Council, in its decision of 25th February 2013, considered the expropriation as a lawful act, but it emphasised that investors should be entitled to compensation subject to an evaluation conducted by the Amsterdam Court of Appeal.\(^9^2\) Thus, the State Council effectively invalidated part of the decree of the Minister of Finance, which impeded future claims of creditors seeking compensation against SNS Reaal.\(^9^3\)

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89 Steinglass, 2013.
90 Act on Special Measures for Financial Corporations (Intervention Act), Section 6:2.
91 Allen & Overy, 2013.
92 The Finance Minister of the Netherlands, Mr. Dijsselbloem, intimidated that this compensation will be equal to zero, as in any case without this intervention SNS Reaal would surely have been bankrupt, Van Gaal, 2013c.
93 Van Gaal, 2013b.
At its initial ruling the Amsterdam Court of Appeal highlighted that the Dutch government might be obliged to compensate investors for their losses, and appointed investigators to define the level of such compensation. The presiding judge stressed that the “government’s valuation of zero for the assets appeared to be incorrect and was not sufficiently substantiated”. The final judgment of the court – which is still pending – will be significantly important; any adverse ruling to the governmental actions might set an important precedent for the evolution of the bail-in concept within the EU.

It is worth noting that if the bank’s creditors are disappointed with the final compensation provided by domestic courts, they can always resort to the European Court of Human Rights in a claim for unlawful deprivation of their property.

6.4.4.2 The banking crisis in Cyprus

Following a long period of financial mismanagement and significant exposure to Greek sovereign debt, the two largest banks in Cyprus – the Bank of Cyprus and the Laiki Bank – came to the brink of financial collapse in early 2013. An oversized banking sector presented great risks to the stability of this small island republic. Thus, the government was compelled to resort to European funding in order to avoid an explosion of the Cypriot national debt and a potential state bankruptcy. Although the Euro-group was willing to put in place a bail-out for Cyprus, it was determined to require a direct contribution from the banking sector itself in order to limit the amount of its own financial assistance. The total sum of the contribution had been assessed at €17 bn, €10 bn of which was provided by other Eurozone economies.

The first decision on Cyprus was adopted on 16th of March 2013 and included an upfront one-off stability levy that was applicable to both resident and non-resident depositors. Those depositors holding deposits in either of the two troubled Cypriot banks below the insurance ceiling of €100,000 would be subject to a reduction of 6.75% of their deposits, whereas those with deposits over the insurance threshold would face a levy

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94 Van Gaal, 2013a.
95 European Convention on Human Rights, Protocol 1, art. 1.
96 Euro-group, 2013a.
on their deposits of 9.9%. The first Euro-group decision came as a shock for Cypriot and foreign depositors and resulted in a political ‘earthquake’ on the island. After lengthy and tumultuous deliberations, the Cypriot parliament rejected this proposal on 19th March 2013.

The situation continued to deteriorate and the need for a solution became urgent. For almost two weeks, the government negotiated with its European partners while keeping the banks closed in order to avoid a full-scale bank run. The final decision came on 25th March 2013 with the Euro-group maintaining a broad restructuring of the Cypriot banking sector and a safeguard only of insured deposits. In order to be able to implement these far-reaching measures, three days before the Euro-group decision the Parliament enacted the Resolution of Credit Institutions Law, which introduced bail-in powers for the competent Cypriot authorities.

The Bank of Cyprus – the largest bank on the island – was subject to a significant reorganisation by bailing-in shareholders, junior and senior bondholders, as well as uninsured depositors. The reduction imposed on uninsured deposits reached 60%.

As far as Laiki bank was concerned, its assets and liabilities were separated into a ‘good’ bank and a ‘bad’ bank. The Bank of Cyprus acquired all insured deposits, as well as loans and credit facilities. The ‘bad’ bank consisted mainly of Laiki’s uninsured deposits, and was wound down. These uninsured deposits were, finally, written off in their entirety.

All in all, one should highlight that the implementation of bail-in was far from straightforward; numerous personal accounts were made

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97 The Economist, 2013.
98 In the aftermath of these first days of the crisis, the president of the ECB, Mario Draghi, described the proposal as “a mistake”, which was “not smart, to say the least”, Steen, 2013.
99 Eurogroup, 2013b.
100 Resolution of Credit and Other Institutions Law 17(I)2013, Section 12.
101 37.5% of this 60% was automatically converted into Class A shares of the bank, with voting rights and dividends. 22.5% has been temporarily ‘frozen’ with the possibility to be also converted into Class A shares. Moreover, the remaining 40% was temporarily ‘frozen’ for liquidity purposes, but interest continued to accrue, plus an increment of 10 basis points, Central Bank of Cyprus, 2013a. On 29th July 2013, the Central Bank of Cyprus converted a further 10% of the temporarily 22.5% of ‘frozen’ deposits into Class A shares and also released 5% of the deposits temporarily ‘frozen’ for liquidity purposes, Central Bank of Cyprus, 2013b.
102 Central Bank of Cyprus, 2013b.
inaccessible to their owners for weeks on end, and the limitations regarding capital movements until April 2015 meant that the situation remained quite precarious for the banking sector. In addition, it should be noted that, in the end, the uninsured depositors of the Bank of Cyprus economically assumed the liabilities of the Laiki Bank. The burden of the insured deposits of the latter, as well as of the Emergency Liquidity Assistance that it had received from the Central Bank of Cyprus before its failure, were passed to the creditors of the Bank of Cyprus. Hence, a violation of the ‘no creditor worse off’ principle resulting from the comparison between resolution and liquidation cannot be excluded.

6.4.5 A potential legal and financial nightmare?

6.4.5.1 In search of legal certainty

This rapid proliferation of bail-in practices, based on rudimentary legal schemes and ad hoc solutions, poses significant challenges to legal certainty and this could undermine the future efficacy of this resolution tool. Specifically, bail-in methods are increasingly controversial since they still seem to lack certain theoretical foundations, and their implementation could severely contradict fundamental legal principles.

The principal debate around the bail-in tool centres on the lack of explicit rules in numerous jurisdictions regarding the implementation of such schemes under bank resolution. In certain cases, hastily drafted legislation ignores the potential risks and far-reaching consequences for a domestic banking sector and the interconnected global financial markets. Legal certainty remains a crucial preoccupation.

First of all, resolution systems should define in detail the classes of liabilities potentially subject to bail-in measures. Rather than granting broad discretionary powers to resolution authorities to design their intervention as they consider appropriate during a crisis, the definition of such classes should be subject to the principle of numerus clausus. The extent of state

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103 Stakeholders of one corporate entity were obliged to assume the liabilities of another corporate entity, for which originally they bore no responsibility, Jack & Cassels, 2013, p.454.

104 For instance, the possibility under EU rules to exclude certain liabilities from bail-in (although subject to such procedures) if bail-in cannot be implemented within
authorities’ powers should be fully illustrated under legal statutes, as bail-in measures can become so drastic, leading even to a total expropriation. The scope of application should precisely define not only the classes of bondholders subject to bail-in, but also all of the types of financial agreements that could be affected by its implementation.

Moreover, resolution statutes should safeguard the hierarchy of claims within bail-in, in reverse order of priority. Thus, shareholders should be bailed-in first, followed by subordinated and then senior debt, and finally uninsured deposits (if the latter are also subject to the procedure.) Despite the obvious flexibility considerations, there is no clear legal reasoning behind the Swiss FINMA Banking Insolvency Ordinance’s decision to allow bail-in write-down powers without respecting the hierarchy of creditors’ claims.¹⁰⁵

In addition, it remains unclear how the claim of a central bank, offering emergency liquidity assistance to a failing bank before a bail-in implementation, will be treated according to creditors’ hierarchy; so far, there has been no clear response. It is worth noting, however, that in the EU emergency liquidity assistance could be granted priority status over senior, and even secured, debt.¹⁰⁶

Finally, it will be crucial to safeguard the pari passu principle in the treatment of same class creditors. Resolution authorities, when converting or writing-down, liabilities of the same class should allocate the losses equally between liabilities of the same rank to the same extent pro rata to their value. Otherwise, differential treatment of liabilities of the same class – whilst providing flexibility to resolution authorities – can open the door to numerous controversies and potential appeals against their actions.

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¹⁰⁵ FINMA Banking Insolvency Ordinance, art. 50.
¹⁰⁶ That was the case in Cyprus, despite the absence of a legal rule on this matter. One should cite Mario Draghi who highlighted that “there is nothing in the market that says that ELA is senior but if you want to remain as a counterparty in the ECB’s monetary policy operations, it should certainly be treated as such”, Draghi, 2013.
6.4.5.2 The challenging dilemma of the treatment of depositors

It is generally accepted that certain claims – mainly guaranteed deposits, secured and short term liabilities – should not be bailed-in. Dealing with uninsured depositors, though, remains the most challenging issue with regard to the classes of liabilities subject to bail-in. Discussions around this issue are still nascent, and the full complexities are still not entirely clear. When SNS Reaal was nationalised, for instance, the Dutch government did not bail-in any deposits; whereas in the case of Cyprus, uninsured depositors suffered significant losses. Whilst European officials emphasise that Cyprus was an isolated case, they nonetheless still seem to consider bailing-in deposits as an interesting alternative.

On the one hand, banks with large deposit bases could rapidly seek their recapitalisation under resolution in uninsured deposits. It has been maintained that depositors should assume the risks they took when they invested in risky banks with opaque business practices and high deposit rates.\textsuperscript{107}

In the case of a bank failure, it is a common rule in every jurisdiction that only insured deposits are covered by the deposit guarantee protection; uninsured depositors, on the other hand, will be obliged to participate in the insolvency procedure and suffer losses. Thus, one argument is that, since these uninsured depositors would have been subject to a liquidation procedure if the bank had been wound up, they should also participate in a bail-in procedure under bank resolution. In actual fact, in most cases this is likely to be more beneficial for such depositors than the alternative of traditional bank insolvency.

On the other hand, it is still questionable which level of due diligence we could require from depositors when trusting their savings to a financial institution. They have been traditionally considered as the weakest party in this business relationship and a great number of rules under banking legislation cater for their protection from illicit commercial practices. Creating categories of depositors based on the total volume of their savings could result in ambiguous discretionary decisions, subject to fierce debates.

Furthermore, putting uninsured deposits on the line could run counter to the principal objective of bank resolution:\textsuperscript{108} resolution policies are

\textsuperscript{107} Gumbel, 2013.

\textsuperscript{108} Huertas, 2013.
intended to safeguard the continuity of critical functions, and this includes the protection of depositors. It will be a bitter pill for uninsured depositors to swallow, knowing that their savings will be subject to bail-in while a significant part of the debtor’s business will be safeguarded and will survive the procedure. This is the principal argument raised in relation to the current situation in Cyprus, where the Bank of Cyprus was not entirely resolved and has continued its operations.

The issue of the treatment of uninsured depositors relates also to the amount of bail-inable debt that banking groups hold around the world. This issue came to the forefront during the crisis in Cyprus, where, despite the economic rationale for the implementation of broad bail-in measures, the two troubled banks had few bondholders but enormous deposit bases. In a report jointly produced by the FDIC and the BoE regarding the coordination of their resolution measures, the UK authorities concluded that the implementation of bail-in powers at the level of the holding company of a UK banking group could be particularly difficult, as holding companies of UK systemic banks do not hold sufficient debt.

As a result, resolution authorities might be confronted with a situation whereby – if the bank does not have enough subordinated or senior debt – uninsured depositors will be forced to bear significant loss in the event of the bank’s collapse, and see their deposits seized. The existence of sufficient buffers of bail-inable assets could guarantee the safeguard of the principle of proportionality. For the time being, however, the EU seems to be one of the few actors to have grasped the complexities of this issue.

Following on EU’s steps, the FSB recently issued a consultative document that defines a global standard for minimum amounts of TLAC to be held by G-SIBs. According to this document, G-SIBs may be required to hold as much as 20% of their group RWAs in TLAC in order to efficiently address the needs of debt write-downs or debt-to-equity conversion during a resolution. Although a very encouraging initiative towards the ending of the ‘too-big-to-fail’ problem, every financial institution and not only G-SIBs should eventually be equipped with adequate loss-absorbing cushions of debt.

111 EU Bank Recovery and Resolution Directive, art. 45.
Ultimately, bank resolution schemes should make a critical choice on the issue of uninsured deposits. Given that such deposits constitute an important part of a bank’s liabilities, it is almost inevitable that they become subject to bail-in measures. Yet, this solution does not seem entirely convincing. Rather, specific safeguards should be established for the fair treatment of such parties; these might include, principally, the introduction of a depositors’ preference rule, offering a preferential claim to uninsured depositors in the event of a banking failure. To date, this principle has only been recognised in a few jurisdictions, including the US, Switzerland and Australia. Such a rule could not only help to increase the predictability of the final results of bail-in, but also reduce the incentive for uninsured depositors to withdraw their deposits – in turn, significantly reducing the risk of a bank run. The introduction of a deposits’ preference rule might also, however, have adverse impacts that must also be considered. Notably, such legislation might push other creditors to secured or short-term lending (the latter decreasing the maturity of the funding of banks) or might even raise the cost of senior unsecured funding.

6.4.5.3 The danger of market contagion

Since bail-in resolution tools have not yet been broadly used, it still remains to be seen how the financial markets will behave following the implementation of these tools in connection with the failure of an international bank. The absence of clear rules, and the use of discretionary provisions, might bring about severe consequences for the financial markets. Market contagion and systemic risk, for example, remain serious concerns and could jeopardise the efficiency of such measures.

Firstly, one should not forget that financial institutions are among the principal debt-holders in the inter-bank market. During the 2008 crisis, this growing interconnectedness and exposure was one of the main causes of the financial turmoil: unhindered debt write-downs could spread panic and aggravate the financial losses of numerous financial actors. Such actions could potentially contribute to financial contagion, and result in a cascade of defaults across the system.

113 Huertas, 2013.
114 Cœuré, 2013, p.4.
Chapter 6: Main resolution tools

According to the research conducted by the Basel Committee, some of its members have been quite preoccupied by this matter.\(^{115}\) The first wave of resolution plans submitted by global systemic banking groups seem to have ignored this fact, as well as the negative repercussions that bail-in instruments might have on inter-bank exposures in the context of a financial crisis.\(^{116}\) The FSB urged its members to deploy policies that will disincentivise internationally active banks from holding instruments issued by G-SIBs, which are part of their total loss-absorbing capacity and, subsequently, subject to write downs or conversions.\(^{117}\)

Secondly, disrupting creditors’ rankings or deviating from the *pari passu* principle could exacerbate uncertainty among market forces. Market participants potentially interested in providing fresh liquidity to a troubled bank might be discouraged from doing so, for fear of ultimately seeing their claims written off entirely, or their seniority rankings left unsafeguarded during bank resolution.

It is also highly probable that the drafting of bail-in regulations that are too broad would drive funding into areas that are of secondary importance for a bank’s financing – such as short term debt (so that creditors will be able to pull their money rapidly out of the bank) or secured debt (which would inflict additional losses to the unsecured creditors).\(^{118}\)

In addition, it has been maintained that bail-in tools might interfere significantly with debt pricing. Financial institutions already pay greater sums in order to be able to borrow than do non-financial corporate entities, and the cost of banking debt is expected to rise even more.\(^{119}\)

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\(^{115}\) Switzerland have supported the view of a total ban on cross-holdings of debts between systemically important banks, and Mexico explicitly prohibits cross-holdings of convertible subordinated debt between its banks, BCBS, 2011, p.19.


\(^{118}\) DG Internal Market and Services, 2011, p.88. We should also highlight that short-term obligations had proved extremely fragile amidst the 2008 financial crisis, Jackson & Skeel, 2012, p.454.

\(^{119}\) The Economist, 2012. The example of bail-in implementation in February 2011 in Denmark illustrates vividly this problem. Following an intervention of the Danish government, Amagerbanken’s creditors and uninsured depositors were subject to bail-in measures and accepted a write-down of 41% on their claims. From February to May 2011, small and midsized Danish banks saw their costs of funding rising constantly and felt, thus, penalised and disadvantaged from regulatory actions that concerned exclusively Amagerbanken, Alloway, 2011.
Moreover, there are no explicit rules around the issue of the conversion rate of debt into equity.\textsuperscript{120} Consequently, it cannot be excluded that the existing creditors of the troubled bank might attempt to take advantage of this legal vacuum in order to gain significant profits from the conversion, to the detriment of existing shareholders.\textsuperscript{121}

Insufficient consideration has also been given to the potential future plan of action of debt-holders (who will become equity holders).\textsuperscript{122} In the context of a financial crisis (i.e. when the viability of an ailing financial institution is still at stake), the newly converted equity holders, feeling unsettled by this change of situation and apprehensive about the financial future of the bank, might decide to exit rapidly and sell their equity holdings. A significant sale of newly converted equity will destabilise the troubled financial institution, and jeopardise the authorities’ efforts to safeguard its systemic functions through resolution.\textsuperscript{123}

Finally, a negative reaction of depositors – even the insured depositors – to bail-in resolution tools could have significantly destabilising consequences; not only for the resolved financial institution, but also for other troubled banks.\textsuperscript{124} A withdrawal of funds on a huge scale could be an early

\textsuperscript{120} The Swiss FINMA Banking Insolvency Ordinance is the first legal instrument to have introduced a formal bail-in tool within resolution. Nevertheless, the text remains silent on the actual conditions of the conversion of debt-to-equity, once the trigger is activated, FINMA Banking Insolvency Ordinance, art. 48. In the case of the EU, the Bank Recovery and Resolution Directive does not fix a conversion rate for the implementation of the bail-in tools but introduces general principles (“the conversion rate shall represent appropriate compensation to the affected creditor for the loss incurred by virtue of the exercise of...conversion power” and “the conversion rate applicable to liabilities that are considered to be senior under applicable insolvency law shall be higher than the conversion rate applicable to subordinated liabilities”) and creates a mandate for the European Banking Authority to develop precise standards on this issue, EU Bank Recovery and Resolution Directive, art. 50(2) and (3).

\textsuperscript{121} It has been maintained that, as the crisis within a bank approaches the activation of the conversion trigger, creditors’ groups subject to potential debt-to-equity conversion might engage in short-selling practices in order to drive the share prices much lower and consequently receive more shares in exchange for the conversion of their claims, Böckli, 2012, p.192.

\textsuperscript{122} An illustrative example concerns large institutional investors, who are not allowed to hold shares and, thus, might be forced to sell directly their converted bonds. Such actions might exacerbate the decline of share prices and raise rumours regarding the financial stability of the bank in question, Koziol & Lawrenz, 2012, p.91.

\textsuperscript{123} DG Internal Market and Services, 2011, p.90.

\textsuperscript{124} The Economist, 2013.
warning sign of a bank run. Interestingly, such signs of widespread panic among local and foreign depositors have not materialised in the case of Cyprus. One should point out, though, that stringent capital controls were in force until April 2015 that limited capital movements between financial institutions in the country or from Cyprus to foreign banks.

A potential outflow of deposits from troubled banking sectors to more robust economies presents a key challenge for the Eurozone. A flight of deposits such as this could become an important impediment for the financial growth of troubled economies, contribute to a credit crunch, and spread further fear among depositors. And the financial crisis in the Eurozone’s peripheral economies is far from over.

6.4.5.4 Cross-border complexities

It should be noted that bail-in tools will present considerable legal complications when applied on a cross-border basis for an international bank. In numerous cases, the law of a different jurisdiction than the one in which a bank is incorporated governs the contractual agreements creating a liability for a financial institution. Furthermore, if the debt is issued out from an entity of the group that is incorporated in a foreign jurisdiction, it is the foreign resolution authorities (either administrative authorities or a court, depending on the resolution regime already in place in this foreign jurisdiction), who must recognise or execute the resolution authorities’ decision. Thus, there is the risk that a jurisdiction that does not favour the use of this kind of resolution tool, might prove uncooperative; this might be especially the case with regards to ensuring the protection of the rights

125 For instance, until the summer of 2012, a total of €326 bn was pulled from Spanish, Greek, Portuguese and Irish banks and during the same period financial institutions in Northern Europe reported an increase of their deposit bases up to €300 bn, Onaran, 2012.

126 A great number of derivatives agreements have been governed by UK law, which began contemplating the introduction of a bail-in mechanism only recently with potential application from January 2015.

127 For instance, FINMA communicated that a significant amount of debt of UBS and Credit Suisse is issued out of foreign branches in the UK, the US and the Channel Islands and is, consequently, governed by non-Swiss law. During bail-in implementation FINMA will not have any responsibility on these branches and might not be able to execute its resolution decisions adopted in Switzerland, FINMA, 2013, p.11.
of it domestic creditors’ and depositors’, who may be impacted by such actions. At this moment in time, given that only a few jurisdictions have introduced or contemplated introducing bail-in powers, it is difficult to imagine how approaches on this issue could be cooperative.\textsuperscript{128}

The EU aims to address this concern through the introduction of ‘carve-out’ clauses in those contractual agreements governed by non-EU law that concern debt issued by EU banks and might therefore be subject to EU bail-in procedures.\textsuperscript{129} Even if the financial institution fails to introduce the necessary clause in the contractual provisions with its counterparties, the resolution authorities of the EU Member States should still be able to exercise their bail-in powers.\textsuperscript{130}

Whilst representing an interesting alternative to the challenges of cross-border contractual recognition of resolution powers, this aforementioned option for the EU resolution authorities could prove problematic in practice. The counterparties of EU banks will be required to contractually accept the prospect of the implementation of bail-in. If unwilling to do so, EU banks might experience serious issues with regards to their debt refinancing needs.

Furthermore, the application of bail-in instruments in the context of a banking group raises concerns when each of the various entities of the group possesses different creditors. Specifically, if the debt conversion or debt write-down is to only be implemented for certain entities (branches or subsidiaries) of the group, the authorities should make sure that those creditors from solvent parts of the group will not be exposed to the bail-in instruments applied to the troubled parts. Due to the growing

\textsuperscript{128} FSB, 2013, p.24.

\textsuperscript{129} The EU Bank Recovery and Resolution directive envisages introducing “a contractual term by which the creditor or party to the agreement creating the liability recognises that the liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority”, \textit{EU Bank Recovery and Resolution Directive}, art. 55(1). For the time being, EBA highlighted that it will not draft a specific clause on this issue. In its proposal for draft regulatory technical standards, EBA notes five elements as integral parts of this type of contractual agreements, the main one being the acknowledgement, agreement and consent of each counterparty that it will be bound by any reduction or conversion of its liability, EBA, \textit{Consultation Paper on DRTS on the contractual recognition of write-down and conversion powers}, 2014, p.17.

\textsuperscript{130} \textit{Ibid}, art. 55(2).
interconnectedness and intra-group guarantees among the entities of a banking group, the situation will be much more complicated for the different creditors.

By and large, regulatory divergence – combined with cross-jurisdictional financial spill-overs – could result in significant cross-border challenges for the implementation of bail-in tools. The work of both the FSB and the ISDA will be crucial in order to achieve harmonisation (statutory and contractual) of rules on this controversial topic.

6.4.6 Concluding remarks on bail-in

If subject to precise legal rules, bail-in could be a useful tool to consider before other resolution tools are implemented for the rapid recapitalisation of a financial institution so that it can continue as a going concern; this would limit the need for financial assistance from the government during bank resolution, thus cutting the nexus between banks and sovereigns. However, it would appear that there remain substantial legal, financial and regulatory challenges to overcome before such a tool can be widely implemented. Recent examples of where bail-in has been implemented – especially in the context of the banking crisis in Cyprus – can help us to learn some important lessons about the potential benefits, but also drawbacks of this resolution tool.

Achieving legal certainty during the exercise of bail-in powers remains a major challenge for resolution authorities. From the design of straightforward resolution triggers limiting authorities’ discretion to a clear scope of application of bail-in powers regarding the various classes of bondholders, depositors and contractual agreements, further clarifications are necessary in order to fully understand every potentially complex aspect. The existing regulatory divergence between different jurisdictions with regards to bail-in rules can only contribute to, rather than attenuate, confusion among markets and depositors.

Despite the general optimism around – and growing confidence in – such resolution tools, the legal obstacles to their implementation on a cross-border could become a significant factor jeopardising their efficiency, along with regulatory unpredictability and the risk of systemic contagion during a financial crisis. Bail-in has been frequently described as the silver-bullet to addressing financial crises. Yet, it is possible that the
negative side effects and spill-overs of bail-in implementation have been downplayed, giving rise to the potential for this bank resolution tool to turn out to be a Pandora’s box for resolution authorities, with far-reaching consequences for creditors’ and depositors’ rights.
Chapter 7

SHAREHOLDERS’ AND CREDITORS’ RIGHTS UNDER BANK RESOLUTION

The 2008 financial crisis put the spotlight on the role of shareholders and investors in the banking business, as well as on the general operations of corporate governance. Both of these parties have been subject to severe criticism due to their actions prior to the financial crash, as well as their reactions to the first signs of financial distress.

The measures undertaken in 2008 interfered insignificantly with the rights of shareholders. This is in spite of the precedent of previous financial meltdowns, such as the Scandinavian banking crisis in the early 1990s, where shareholders’ rights were entirely wiped out.¹ The majority of jurisdictions – confronted with rigid legislations and the pre-eminence of shareholders’ rights under corporate law – rapidly identified the urgent need for reforms through new or amended bank resolution regimes. These reforms would allow them to swiftly circumvent legal provisions on shareholders’ powers, or to even impose the divestiture of shareholders’ rights during a financial crisis.

During the 2008 crisis, taxpayers bore the cost of bailing out not only the shareholders, but also the creditors of failing banks. In most of the cases of collapsing financial institutions, senior debt-holders were repaid in full.² Legal restrictions regarding the ranking and the treatment of creditors under insolvency, the lack of sufficient loss-absorbing debt cushions, and concerns that a wave of panic might spread across the financial system encouraged state authorities to take this conservative approach to debt-holders.

However, since the crisis the pendulum has swung back; under the new bank resolution regimes, creditors will become subject to harsher

¹ Besides the cases of imposed de facto nationalisations or considerable dilution resulting from substantial recapitalisations, Hüpkes, 2009b, p.278.
² The Economist, 2012. One should highlight the example of Ireland, which undertook to repay all bondholders of its banking institutions by expanding its national debt to unprecedented levels, and finally resorting to EU financing mechanisms so as to avoid an imminent financial collapse.
rules affecting their rights and claims against a failing bank. As we move rapidly from an era of bail-outs towards legal frameworks promoting bail-in, creditors will no longer enjoy the privileged position they previously did, and may suffer substantial losses and even experience a transition towards shareholder’s status.

By and large, third parties are subject to an insolvency procedure according to their rankings of participation to the capital structure of the bank. At the bottom one finds the shareholders, followed by various layers of junior unsecured debt. Above them, come the layers of senior unsecured debt and uninsured deposits, to be topped only by the category of secured debt and insured deposits. Once all the creditors belonging to a specific debt layer have suffered losses according to the specific insolvency rules, regulators can move on to those creditors of a higher debt class in order to continue with the insolvency procedure. In addition, it is an essential rule that certain categories of debt – mainly covered deposits and secured debt – will be exempted from the procedure and fully repaid.

A variety of new bank resolution measures have introduced precise rules that could solidify the actions of the authorities against creditors and shareholders. Whilst these rules show promise, they may also bring unavoidable unwelcome consequences. The purpose of this chapter is to present these new regulations – along with the problematic situations that might arise as a result of their application – as well as the safeguards that can become efficient stopovers to resolution authorities’ actions.

Firstly, there is a presentation of shareholders’ rights under the pre-crisis legal regime and of the impact that bank resolution procedures may have on these rights. The chapter focuses also on the general duties of shareholders, which, under the threat of potential resolution procedures, could contribute to better corporate governance practices.

Additionally, this chapter touches upon specific measures that can significantly curtail creditors’ rights and analyses the basic complexities of implementing such resolution tools.

Finally, one will find a discussion on resolution safeguards, which can guarantee the fair treatment of shareholders’ and creditors’ rights under bank resolution. A separate section is devoted on the role of courts in safeguarding these rights within a bank resolution framework.
7.1 The role of shareholders in bank resolution

7.1.1 The preponderance of shareholders’ rights in the pre-crisis legal environment

Many states, when striving to save their banking sectors and the global financial system from total collapse, were confronted with corporate and insolvency law provisions that were obsolete. State decisions around bank restructuring, recapitalisation or resolution had been subject to the prior scrutiny of shareholders; in certain cases leading to shareholders blocking the successful implementation of the legal procedures. In some cases, shareholder activism resulted in significant value destruction; some procedures became very lengthy, others were disrupted entirely.

As demonstrated in chapter 1, in the case of the resolution of Fortis, minority shareholders challenged the initial agreement between the Belgian government and BNP Paribas for the transfer of the business of the bank to the French group before the Belgian courts. Without the approval of the general assembly, the Court of Appeals of Brussels was unable to conclude the transaction. As a result, the negotiations dragged on for months, and were finally concluded only following the issuance of threats by BNP Paribas that it would withdraw its offer.

The negotiations between Barclays and the US authorities around the transfer of the US business of Lehman Brothers to the former came to a sudden halt due – to some extent – to the requirements of UK law: UK rules required Barclays to hold a shareholder vote on the deal before Barclays could formally complete the takeover. However, given the enormous time pressure of the circumstances and the fact that organising such a vote could take a considerable amount of time, getting this approval rapidly was out of the question for the UK authorities.

In another case, the shareholders of Northern Rock refused for several months to cooperate with the UK authorities in negotiations around a potential deal to sell the bank, because of their dissatisfaction with the offers for the acquisition.

The 2008 financial crisis highlighted the, sometimes, contradictory objectives of shareholders exercising their rights (representing private interests) and the efforts of state authorities (to safeguard financial stability and public interest in general). The limitations of corporate law regarding
shareholders’ rights were now evident, and the argument in favour of making substantial changes to such legal provisions became compelling.

Shareholders’ rights are firmly anchored in the corporate law tradition on either side of the Atlantic. They can be categorised as a) pecuniary rights (which concern the receipt of dividends or any residual value upon the liquidation of their company) and b) various governance rights (which relate, for example, to decisions around the election of the board members; changes of status; and voting on major transactions such as the sale of assets, mergers, a restructuring of the company or further acquisitions, whether to alter or raise the company’s capital etc.).

In the example of the US, shareholders’ rights result from the different state laws, with the Delaware law being the most popular choice regarding the incorporation of US corporations. In the case of most US state legislations, the board of the company is responsible for any business decision, whereas shareholders decide on structural or governance decisions.³

In the main provisions regarding shareholders’ rights under the Delaware General Corporation Law, the significant limits to the substantive powers of the shareholders are implicit. It is stressed, for example that “the business and affairs of every corporation organised under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation”.⁴ Furthermore, the certificate of incorporation of the company “may also contain any provision creating, defining, limiting and regulating the powers of the corporation, the directors and the shareholders”.⁵ As such, the board may hold any powers “that are not explicitly reserved for the shareholders”.⁶

On the other hand, European corporate law is more ‘shareholder friendly’ – providing a more sound, straightforward and extensive legal framework for the safeguard of shareholders’ rights. The basis of the European regulation has been the Second Council Directive, which a) establishes an exclusive right for the shareholders to decide upon any increase in capital⁷ and b) allows, whenever the capital is increased, for the shares to be pre-emptively offered to current shareholders of the company.⁸

⁴ Delaware General Corporation Law, § 141(a).
⁵ Ibid, § 102(b)(1).
⁶ Hüpkes, 2009b, p.279.
⁸ Ibid, art. 29(1).
Chapter 7: Shareholders’ and creditors’ rights under bank resolution

The jurisprudence of the European Courts, too, held ‘sacrosanct’ the notion of shareholders’ rights under European law. The case of Panagiotis Pafitis is considered the cornerstone of this jurisprudence by the ECJ.\(^9\) The ECJ upheld the arguments of the plaintiffs by emphasising that “the Second Directive seeks to ensure a minimum level of protection for shareholders in all the Member States”.\(^10\) It went on to add that “that objective would be seriously frustrated if the Member states were entitled to derogate from the provisions of the directive by maintaining in force rules...under which it is possible to decide by administrative measure, separately from any decision by the general meeting of shareholders, to affect an increase in the company’s capital”.\(^11\) Furthermore, the ECJ stressed that “Article 25(1) of the Second Directive precludes the application of rules which, being designed to ensure the reorganisation and continued trading of undertakings that are of particular

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9 **European Court of Justice**, Pafitis and Others v. TKE and Others, 1996. The case concerned BCG, a Greek bank, which had been placed under temporary administration by the Governor of the Bank of Greece, due to its inability to increase its capital base so as to reinstate its capital erosion. A Greek presidential decree provided that all the powers and competencies of the organs of the bank were to be vested in the temporary administrator. This last decided a capital increase and, following the failure of the existing shareholders to exercise their pre-emptive rights, he allotted the new shares to third parties. Due to contraventions of the law regarding the allotment of the shares to one of the parties, a new temporary administrator had been appointed rescinding the decision of his predecessor and transferring the shares to a new party. Subsequently, the general assembly of the bank, consisting now of new shareholders, passed three resolutions authorising further capital increases. The old shareholders resorted first to national courts. They objected a) the decision of the first temporary administrator to increase the capital of the bank without a preliminary authorisation by the general meeting on this issue and b) the allotment of the shares to new parties. They also sought the annulment of the decisions of the new general assembly of the bank concerning the three subsequent capital increases. The national court referred these issues to the ECJ for a preliminary ruling. The ECJ had also issued rulings regarding shareholders’ rights in the cases of Karella and Karellas v. Minister for Industry, Energy and Technology and Organismos Anasygkrotiseos Epicheiriseon AE (1991), Syndesmos Melon tis Eleftherias Evangelikis Ekkliasis and others v. Greek State and Others (1992) and Kefalas and others v. Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon Ae (OAE) (1998). However, the Pafitis case enjoys a core position in European jurisprudence regarding the safeguard of shareholders’ rights and the interpretation of these rights under the rules of the Second Council Directive.

10 **European Court of Justice**, Pafitis and Others v. TKE and Others, 1996, para.38.

importance to the national economy and are in an exceptional situation by reason of their debt burden, allow an increase in capital to be decided upon by administrative measure, without any resolution being passed by the general meeting”.

In the same preliminary ruling, the ECJ also highlighted the importance of safeguarding the pre-emptive rights of existing shareholders to an offer of subscription for new shares, in accordance with article 29 of the Second Council Directive.

Moreover, the shareholders resorted to the European Court of Human Rights (ECtHR) regarding an alleged violation of article 6§1 of the European Convention of Human Rights (ECHR). The ECtHR emphasised the importance of shareholders’ rights, albeit in a less striking manner than the ECJ: it admitted the applicability of article 6§1 of the ECHR by declaring that the right of the shareholders to vote on the increase in the bank’s capital is considered a civil right under the Convention.

However, the majority of the ECtHR jurisprudence examines the interpretation of shareholders’ rights in the light of article 1 of the Protocol No.1 to the ECHR, in connection with the protection of property rights. The court had already reiterated – in 1982 – that this article guarantees the rights to property, and comprises three distinct rules. In a later ruling, the Court clarified that these rules “are not distinct in the sense of being unconnected: the second and third rules are concerned with particular instances of interference with the right to peaceful enjoyment of property”.

The most noteworthy case is that of Olczak v. Poland, regarding a shareholder of a Polish bank. The Court observed that “a shareholder has

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12 Ibid, para.40.
13 Ibid, para.61.
15 “The first rule, which is of a general nature, enounces the principle of peaceful enjoyment of property; it is set out in the first sentence of the first paragraph. The second rule covers deprivation of possessions and subjects it to certain conditions; it appears in the second sentence of the same paragraph. The third rule recognises that the States are entitled, amongst other things, to control the use of property in accordance with the general interest, by enforcing such laws as they deem necessary for the purpose; it is contained in the second paragraph”, European Court of Human Rights, Sporrong and Lönnroth v. Sweden, 1982, pp.17–18, para.61.
16 European Court of Human Rights, OLCZAK v. POLAND, 2002, p.15, para.73.
17 Following the negligence by the board of the bank to take all the appropriate recovery measures to avoid an imminent insolvency, the President of the National Bank
locus standi to complain of a violation of his property rights distinct from those of the company in which he holds shares”. It also emphasised that “shares in a public company have an economic value and, therefore, are to be regarded as possessions within the meaning of Article 1 of Protocol No.1 to the Convention”. The Court finally concluded that the applicant undeniably lost his property as a result of the measures undertaken by the receivers of the bank and thus, he “may claim victim status regarding his complaint under Article 1 of Protocol No.1”.

In the broader context of this legal environment, at the onset of the financial crisis in 2008 the EU Member States were confronted with the limitations of their corporate and banking law legislations, which, although consistent with the lines of the EU rules and jurisprudence, proved to be extremely rigid. Only a limited number of Member States had the power to intervene under legal statutes in order to suspend certain actions of shareholders during a financial crisis. These powers were nonetheless still relatively limited.

of Poland placed the bank under compulsory receivership, according to the rules of Polish banking law. The board of receivers had the power to decide on any matter concerning the bank. Consequently, they first reduced the bank’s share capital by cancelling a great number of shares, and then increased it by issuing new shares, with extra voting rights. The existing shareholders were prevented from acquiring these new shares, in order to protect the bank’s interests, as the receivers realised that both the former board and the principal shareholders had conducted business in an unprofessional manner, causing considerable losses to the bank. Hence, the plaintiff’s shareholding had decreased from 45% to 0.4% and he resorted to the ECtHR claiming an expropriation of his property.

18 European Court of Human Rights, OLCZAK V. POLAND, 2002, p.11, para.54, in fine.
19 As it had been also maintained in the case SOVTRANSAVTO HOLDING v. UKRAINE (2001), ibid, p.12, para.60.
21 E.g. the Italian Special Administration regime allowed the appointed special administrators, authorised by the Bank of Italy, to suspend specific functions of the general assembly, which, in any event, did not include decisions relating to the capital structure of a company. In France, the Autorité de contrôle prudentiel could appoint a special administrator to manage and represent the financial institution, HÜPKNES, 2009b, p.284.
22 As stressed by Hüpkes, “many jurisdictions provided for special administration or conservatorship under which all corporate bodies were suspended and an appointed official temporarily took control of the bank’s operations; the powers of temporary administrators however did not extend to the shareholders’ power to determine changes to the bank’s capital structure”, ibid, p.293.
As a result, when confronted with the supremacy of shareholders’ rights, EU jurisdictions were considered ‘handicapped’, especially when compared to the US system\textsuperscript{23} or the legislation of other states such as Switzerland.\textsuperscript{24} Both the establishment of new bank resolution regimes and the amendments introduced to the existing bank resolution statutes called for a more radical treatment of shareholders’ rights, to place greater emphasis on the protection of depositors and the pre-eminence of financial stability in the interest of the public.

7.1.2 Impact of resolution tools on shareholders’ rights

Although equity represents only a small proportion of a bank’s funds, bank resolution regimes adopted the same system of ‘participation to losses’ as did bank insolvency regimes. In other words, both regimes maintain the principle that it is wiser to penalise shareholders before – and more harshly then – creditors: resolution regimes are therefore designed to interfere with shareholders’ property rights and wipe out shareholders before any further bail-in powers are exercised against the bank’s creditors.

In a great number of jurisdictions, shareholders are considered owners of the company.\textsuperscript{25} Although this idea is not universally endorsed, and could prove problematic in connection with the legal framework of their limited liability, it could provide justification for these parties bearing losses before any other should ‘their’ bank collapse.

Shareholders should also be deprived of any governance rights with regards to the election of the board – voting through the general assembly for matters pertaining to banking business and decisions concerning capital issues. Resolution authorities need to be able to take control of a failing

\textsuperscript{23} Under US federal banking law, the FDIC has the power to impose a forced recapitalisation to an ailing bank, without any prior shareholders’ approval, under the ‘prompt corrective action’ framework, Kern, 2009, p.77.

\textsuperscript{24} According to the Swiss Federal Banking Act, a restructuring plan for an ailing bank is subject to the approval by FINMA, circumventing any prior decision of the general assembly of the bank, Swiss Banking Act, current art. 31(2) and previous art. 29(3).

\textsuperscript{25} For instance, the Cadbury Report of 1992 in the UK refers to shareholders as ‘owners of the company’, Report of the Committee on the Financial Aspects of Corporate Governance, 1992, p.47, para.6(1). The Swiss Federal Banking Act also employs the term owners (propriétaires) when it makes reference to shareholders, e.g. Swiss Banking Act, art. 24(2) and (4) and art. 31(1)(c).
bank rapidly, unrestrained by the involvement of shareholders; thus, the former should become the sole competent body implementing resolution actions, through the appointment of temporary administrators or a board of receivers.

Certain jurisdictions already have at their disposal legal provisions that allow for shareholders’ rights to be drastically curtailed in the event of a crisis within a financial institution. Others are in the process of amending their corporate and banking legislations accordingly.

Under the Swiss Banking Act, FINMA – the Swiss supervisor – has been able to implement any measure necessary to stabilise, restructure or liquidate an insolvent bank or a financial institution suffering from a severe liquidity stress, effectively circumventing the shareholders. In specific relation to bank restructuring, FINMA has ultimate responsibility for approving the restructuring plan; prior consent of the bank’s shareholders is not mandatory. Under the most recent amendments, which address the ‘too big to fail’ issue, shareholders will be able to resort to the civil courts to oppose the plan, but whatever the court decides, it will not affect any resolution actions already implemented by FINMA.

The most noteworthy changes to the status of shareholders have been introduced following the substantial issuance of contingent convertible capital instruments by the Swiss banks. The eventual conversion of CoCos into equity could result in significant dilution of the existing shareholders. It is stressed that the pre-emptive rights of the existing shareholders for an offer of subscription of new shares can be suspended so as to achieve speed and simplicity. The same solution can be applied during bail-in in order to guarantee a successful outcome of the resolution procedure. In any case, once bail-in is implemented, creditors’ interests must outweigh those of the bank’s existing shareholders.

Under the US regime for the resolution of credit institutions, during a bank receivership or conservatorship procedure the FDIC has been allowed to assume all of the rights, powers and privileges of the shareholders.

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26 Swiss Banking Act, art. 25 and art. 28(2).
27 Ibid, previous art. 29(3) and current art. 31(2).
28 Ibid, art. 24(3).
29 Ibid, art. 13(4).
30 FINMA Banking Insolvency Ordinance, art. 47(2).
31 Ibid, art. 47(1)(a).
and exercise all of their rights concerning the ailing bank. The shareholders cannot resort to courts in order to limit or influence the powers of the FDIC when implementing a bank resolution procedure. Even if the FDIC’s intervention has a negative impact on the rights of the shareholders, the latter will only be able to maintain a claim for damages against the insolvent bank, and not against the FDIC. In addition, shareholders are at the bottom of the priority chain; any amount resulting from the resolution of the bank will primarily be used to cover any administrative claims made by the FDIC, deposit liabilities of the bank, and any other claims of senior and subordinated creditors.

The Dodd-Frank Act complemented this legal framework by imposing severe restrictions on shareholders’ rights under resolution. This compulsory curtailment of shareholders’ rights and claims is considered appropriate given the impact that a resolution procedure can have to the financial stability of the US. It rests on the assumption that, since shareholders are deemed responsible for the financial health of a financial institution, they should bear its losses and receive no payment until after all other claims have been fully paid. The FDIC can: take over all of the assets of the covered financial company; exercise all of the powers of the shareholders; terminate all rights and claims of the latter; and implement resolution actions without any prior approval, assignment or consent of the shareholders that might otherwise be required under federal or state law.

Finally, the EU has also undertaken a harsher approach with regards to shareholders’ rights during a financial crisis, with its Bank Recovery and Resolution Directive. The core principle of the Directive is that all losses should be allocated in full first to the shareholders and then to the creditors. Furthermore, in order to ensure the successful implementation

34 Ibid, § 11(j).
35 Brierley, 2009, p.11.
37 Dodd-Frank Act, § 203(b)(4).
38 Ibid, § 204(a)(1).
39 Ibid, § 206(2).
41 Ibid, § 210(a)(1)(M).
42 Ibid, § 201(h)(5)(D).
43 For instance, see EU Bank Recovery and Resolution Directive, art. 44(9).
of the bail-in tool, resolution authorities should be able to cancel existing shares and/or convert liabilities into shares of the ailing bank at a rate of conversion that will dilute severely existing shareholders.\footnote{Ibid, art. 47(1).} The current document has also introduced significant amendments to a certain number of existing directives with the aim of lifting any remaining obstacles under EU corporate and insolvency law to the efficient exercise of resolution actions by state authorities.\footnote{Among them the Winding-Up Directive (2001/24/EC), the Takeover Directive (2004/25/EC), the Cross-border Mergers Directive (2005/56/EC) and the Shareholders Directive (2007/36/EC), ibid, art. 116–126.}

7.1.3 Bank resolution and shareholders’ duties

7.1.3.1 Blameworthy or scapegoats?

“We cannot avoid asking ourselves what you, shareholders, have done to prevent and manage the crisis. Unfortunately, and I know you do not like to hear this, the answer is almost nothing.”\footnote{Wouter Bos, Former Minister of Finance of the Kingdom of the Netherlands, Speech to the ICGN, cited in OECD, 2009a, p.47.}

A closer inspection of shareholders’ duties within the banking business might provide valuable insights into their role in the 2008 financial crisis. The implementation of resolution measures that can have far-reaching consequences for shareholders’ rights has been justified on the grounds that shareholders played a key active role in the crisis. However, there is considerable debate around whether shareholders should bear a significant part of the responsibility of the financial meltdown, or whether they were simply used by state authorities as scapegoats to blame for the problems that they could not predict or control.

According to the fundamental principles of corporate law, bank shareholders have very limited powers regarding the everyday conduct of banking business: the directors run the company and organise the business relationships with third parties, and shareholders cannot exert direct control on the actions and decisions of the direction.
On the other hand, since they have a financial involvement in the bank, they obtain benefits in the form of dividends and ultimately own the company. In addition, shareholders have specific duties that allow them to ensure their control over the company: notably, they are able to influence crucial aspects such as a recapitalisation of the bank, amendments to the bank’s statutes or the approval of the annual financial statements through their participation in the general assembly, as well as special meetings.

The circle of responsibilities of bank shareholders has become larger, including – in certain cases – not only the typical duty of board appointment, removal or discharge, but also a say on executives’ remuneration. Thus, in the post-crisis legal and financial environment, the role of the general assembly is transformed with more shareholder activism required.

However, with regards to the controversial issue of executives’ and directors’ remuneration, shareholders’ voting has usually a consultative nature. It might become compulsory in certain jurisdictions under specific circumstances, whereas others opted for a non-binding vote. There are rare examples of states where corporate legislation introduced a mandatory and binding vote of the general assembly with regards to executive remuneration.

An interesting study conducted by Erkens, Hung and Mato shed light to the business routine of 296 large financial institutions across 30 countries, presenting significant institutional ownership. In their research, they identified a notable consistency between institutional ownership of a bank and significant pre-crisis risk-taking. In general, prior to 2008 stock markets tended to reward the shares of those banking groups taking excessive risks; thus, institutional shareholders encouraged such risky business policies, rarely engaging into decisive monitoring of the firms in which they invested.

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47 Such a case is Japan, where voting becomes compulsory when there is a change in the total level of remuneration allowed. Countries like Germany, the UK and Australia introduced non-binding voting, OECD, 2011, pp.20–22.

48 Norway, the Netherlands, Switzerland, Sweden, Brazil and Korea are among the principal examples, ibid, p.22. In the US, the ‘say on pay’ principle of the Dodd-Frank Act requires a shareholder vote approving the company’s executive compensation, at least every three years, Dodd-Frank Act, Title IX, Subtitle E, § 951.


51 OECD, 2009a, p.52.
Institutional shareholders comprise mainly of pension, sovereign wealth and other charities’ funds, insurance companies and investment trusts, as well as other collective investment vehicles. They tend to invest principally according to long-term perspectives but a few also operate under more short-term considerations, focusing, thus, on their short-term profits rather than the long-term prosperity of financial institutions. In order to achieve short-term yet high returns on their investments, these shareholders turned their attention *en masse* to a variety of new types of complex financial products. These innovative products, arising from complex financial securitisation procedures, displayed a new level of financial obfuscation. This focus on short-term profit encouraged excessively risky behaviours, which contributed to the build-up of a full-scale financial crisis.

In their defence, some have stressed that the management of the financial institutions did not provide the institutional investors with valuable, confidential information that would have otherwise allowed them to better understand the risks of securitisation, or foresee the pending crisis. The counter-argument is that they possessed sufficient financial expertise to be able to make a better assessment of the situation and therefore better investment decisions; or to simply exercise more pressure on the banking management.

On the other hand, it can also be argued that individual shareholders – by remaining passive and non-reactive to the first signs of changes in the financial environment – also contributed to the 2008 financial meltdown. In certain cases, these shareholders also significantly impeded the implementation of resolution procedures by state authorities. Certain European banks such as Fortis, for example, presented an important base of individual shareholders. Since the majority of these shareholders held only very small shares in the equity of the bank, they often lacked the incentive, and also the expertise, to apply effective monitoring practices within the financial institution.

55 Blanaid Clarke, *Is Corporate Governance an Oxymoron? The Role of Corporate Governance in the Current Banking Crisis*, in *ibid*, p.256.
56 OECD, 2009a, p.53.
Consequently, a certain distinction should be made regarding the types of shareholders in question. Specific amendments to existing legislation should be introduced (especially with regard to corporate law provisions) in order to better distinguish between – and highlight the responsibilities of – the different categories of shareholders. Given the level of financial expertise that institutional shareholders and majority individual shareholders possess, they should be required to maintain a more active role than the numerous small shareholders. Nonetheless, even the latter should not be exempt from their liabilities: when acting as a group, they are also capable of blocking major decisions in connection with a necessary reorganisation or resolution.

All in all, one could argue that shareholders – both individual and institutional – relied too heavily on complex securitisation practices, annual reports and company announcements. Shareholders did not dissent to managerial decision-making, remuneration policies and the modus operandi of banks.

To sum up, shareholders played an important role in the 2008 financial crisis, alongside the regulatory failures, the credit boom and the opaque securitisation policies. Therefore, it should not come as a surprise that bank resolution regimes endorse the insolvency principle – according to which shareholders are wiped out first before any creditor suffers losses – as a natural consequence of their enhanced corporate duties.

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57 Sants, 2009.
58 OECD, 2009a, p.47. As eloquently put by James Gifford, executive director of the UN Principles for Responsible Investment, “shareholders have to take some responsibility for this, if only because their capital was being used by their agents and investee companies in ways that have clearly caused the meltdown; clearly they could have been more diligent, supervised these agents better and ensured that executive remuneration reflected real performance and long term thinking”. Charlotte Villiers, Has the Financial Crisis Revealed the Concept of the Responsible Owner to Be a Myth?, in McNeil & O’Brien, 2010, p.287.
7.1.3.2 Bank resolution and better corporate governance

“When a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully”\(^{59}\)

Shareholders may enjoy a variety of rights and benefits. These may include property rights, but under law shareholders also have rights to participate in governance issues of the bank they have invested in and to exercise numerous control duties (such as endorsing the management’s strategic decision-making and voting on any significant changes to the structure or business direction of the company). Thus, shareholders have the potential to influence corporate governance within banks.

In the 1970s, the notion that shareholders’ interests should be paramount (i.e. that corporations exist only to serve the interest so shareholders/shareholders are the only group to which the firm must be socially responsible) became dogma, based on the doctrine of Milton Friedman and his colleagues at the Chicago school of economists. The fallacy in this theory is that a company’s managers should focus their energies solely on maximising shareholders’ wealth. This erroneous belief contributed to the establishment of corporate law frameworks that granted a great amount of decisional power to the boards of financial institutions. Under the myth of this new corporate mentality, institutional shareholders became highly reluctant to monitor or challenge the board’s business decisions or remuneration policies. By being “too passive and reactive rather than proactive”\(^{60}\), shareholders must bear their own share of responsibility regarding the failure of corporate governance in the recent financial crisis.

It has been argued that shareholders have been repeatedly confronted with their inability to command and control the board or block its decisions due to the paramount rule of separation between ownership and control within a company.\(^{61}\) This rule, which had been transformed into a component of corporate law, did not allow a broad margin of action to bank shareholders.


\(^{60}\) OECD, 2009a, p.53.

The concept of limited liability – which has become the legal basis for the organisation of banks – might also be described as a further obstacle to the development of more active and responsible shareholders.62

The role of bank supervisors might also have contributed to a lack of shareholder activism. Although the question around whether or not bank supervisors and regulators can actually substitute or complement board-level governance remains ambiguous, one might recognise a perverse substitution effect perceived by shareholders and boards.63

As a result, it has been argued that shareholders were unable to significantly influence matters of corporate governance in order to help prevent their financial institution from potentially collapsing. The findings of academic research conducted on the relationship between corporate governance and the 2008 financial collapse have been rather inconclusive. Beltratti and Stulz, for example, stressed that banks with more ‘shareholder friendly’ boards – unlike conventional wisdom regarding the safeguard of shareholders’ values – took more risk and performed more badly than did their counterparts with much more independent boards. Thus, they concluded that better governance does not necessarily lead to less risk-taking.64 Meanwhile, John, Litov and Yeung argue that in an environment of poor corporate governance and low investor protection, managers tend to take on less risk in order to protect their private benefits from control.65 Finally, Adams found that governance is generally no weaker in financial firms than in non-financial firms. However, she concludes that board independence might not always be beneficial for banks (due to the directors’ lack of expertise), and her analysis suggests that board level governance may have played a part in the crisis.66

Bearing in mind the multifaceted nature of the 2008 financial crisis, as well as the numerous facets of ‘corporate governance’,67 it would be

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63 ADAMS, 2009, pp.14–15. Even if bank boards and managers do not fully understand the inherent risks of a financial product or business transaction, they might, nonetheless, agree to it because they assume that it is the responsibility of the supervisor to anticipate and identify any potential problems related to it in a timely manner.
66 ADAMS, 2009, p.15.
67 “Corporate governance encompasses all the mechanisms, decision-making processes and contracts that help to ensure that the objectives of the shareholders and in some cases
illogical to claim that better corporate governance practices will necessarily lead to better business decisions that minimise excessive risk-taking. But one should mainly stress the role of corporate governance as a fundamental basis for an alignment between managers’ and shareholders’ incentives and for a better pricing of financial risk, safeguarding the future value of the bank and covering any social costs.\(^6^8\)

Consequently, shareholders have an interest to promote better corporate governance practices through more effective oversight of the boards’ decisions and actions, by opposing poor management performance, and exercising more vigorously their rights to remove board members. This should become the object of precise legal rules; shareholders should be obliged to act responsibly, as opposed to leaving it to the discretion of individual shareholders to voluntarily choose to do so out of a sense of social responsibility.\(^6^9\) Soft law rules and codes of conduct are welcome but only on a complementary basis.\(^7^0\)

Bank resolution rules could make a significant contribution to improved corporate governance practices. Specifically, given that resolution proceedings may result in the significant curtailment of shareholders’ rights (as guaranteed under corporate and banking law) and the deprivation of their property claims (in the event of a collapse of their financial institution, for the public good), this should incentivise shareholders to be more proactive, and closely monitor the business practices of the boards of financial institutions. The issuance of hybrid financial instruments by of other stakeholders are met while also directing how the various claims are settled within a corporation i.e. steps that shareholders take to protect their interests, the role of the board of directors in setting the policies and direction of the firm, the incentives and constraints provided to managers and other employees in order to implement such policies and influence that creditors and customers might exert over the firm’s behavior”, Kenneth R. Spong & Richard J. Sullivan, Bank Ownership and Risk Taking: Improving Corporate Governance in Banking after the Crisis, in Barth, Lin & Wihlborg, 2012, p.164.

68 Kern, 2009, p.64.


70 For example see the Code on the Responsibilities of Institutional Investors of the Institutional Shareholders’ Committee introducing principles for an efficient monitoring of the investee companies, a proper intervention or collective actions when necessary, clear policies on voting and disclosure activities and an effective opposition to the board’s decision, Institutional Shareholders’ Committee, 2009.
banks, as well as the exercise of bail-in powers by the resolution authorities, could play an important role in promoting real market discipline.\textsuperscript{71}

Thus, it is reasonable to assume that bank resolution rules, looming over shareholders like the sword of Damocles, will force shareholders to re-evaluate their corporate governance duties and adopt a different approach; one that is much more responsible that the simple ‘ticking the box’ approaches typically applied before the events of 2008. Indeed, the first signs of a swift change in mentality among shareholders are already evident.

7.2 The treatment of creditors’ rights under bank resolution schemes

Chapter 6 described the main resolution tools and analysed their impacts for creditors and depositors (especially the impacts of bail-in), as well as the potential challenges of implementing these tools. This section focuses on another controversial bank resolution measure: a possible temporary stay on creditors’ contractual rights to early termination. In addition, it explores the potential legal challenges that might arise from the implementation of resolution methods that curtail bank creditors’ rights.

7.2.1 Temporary stay on early termination rights

One of the key preoccupations of resolution authorities when exercising their powers is how to treat contractual arrangements between a financial institution and its counterparties that allow the activation of early termination rights during an insolvency procedure.

The two main types of contracts that can pose a problem for resolution authorities are the set-off and close-out netting agreements. The first describe a contractual agreement according to which, on the occurrence of a specific event (in this case the opening of an insolvency procedure for a financial institution) debts, claims and obligations between the financial

\textsuperscript{71} As stressed by Huertas, “to the common shareholder, contingent capital holds out the prospect of death by dilution and it can be anticipated that shareholders would task management to undertake the necessary measures to avoid dilution”, Huertas, 2009.
institutions and its counterparties can be set off against each other. The latter indicate a financial situation under which, upon the occurrence of an enforcement event (however and wherever it is defined between the parties in the agreement), the obligations of the parties are accelerated so as to become immediately due or are terminated, and in either case they are converted into or replaced by a single net claim.\footnote{DG Internal Market and Services, 2011, p.69.}

Although resolution measures are typically implemented during the pre-insolvency phase, the intervention of the resolution authorities will be commonly considered a triggering event for set-off and close-out netting arrangements. This perspective calls for the possibility of imposing a temporary stay on such early termination rights; which might otherwise endanger the financial viability of a troubled financial institution, at a point when stability will be vital for its future.\footnote{As summarised by the FSB, “the entry into resolution and the exercise of any resolution power should not constitute an event that entitles the counterparty of the firm in resolution to exercise early termination rights…Should early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the use of resolution powers and provided that the substantive obligations under the contract…continue to be performed”, FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.40.}

Set-off and close-out netting contractual agreements are part of an extensive group of protected arrangements under insolvency, which also includes security agreements, financial collateral agreements, and structured finance arrangements. The UK Banking Act dedicates a section to the protection of interests under these kinds of agreements.\footnote{UK Banking Act, § 48.} In the US bank resolution system, the Dodd-Frank Act included a special provision for set-off agreements,\footnote{Dodd-Frank Act, Title II, § 210(b)(12).} as well as for a large number of other qualified financial contracts (securities, forward, repurchase, swaps etc.) that will be subject to a special status under any resolution procedure.\footnote{Ibid, § 8(D). The exact same provision can be also found under the FDIA applied for the resolution of credit institutions, FDIA, § 11(e)(8)(D).}

According to the FSB, the majority of jurisdictions have not yet introduced legal provisions under their resolution regimes that provide for the imposition of restrictions on the exercise of close-out netting or set-off rights in contractual agreements.\footnote{FSB, Review on Resolution Regimes, 2013, pp.25–26.}
The general rule has been that any counterparty should be able to exercise freely its rights with regard to the termination of any contractual agreement with a financial institution. Nevertheless, the resolution frameworks of certain jurisdictions provide for explicit exceptions to this general rule. The competent resolution authority should, thus, have the power to impose a temporary stay, once a resolution procedure has been initiated. Following this period, and should the contract of a counterparty be transferred to a private purchaser, bridge bank or other public entity, the close-out netting or set-off clauses will not be activated. However, if the contract remains with the residual bank that will eventually become subject to liquidation close-out netting and set-off powers will be perfectly exercised as previously determined.

Regarding the case of the EU, the main obstacle against such rules had been the application of its Financial Collateral Directive, prohibiting

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78 For example, both under the Dodd-Frank and the FDIA, it is maintained that “no person shall be stayed or prohibited from exercising any right that such person has to cause the termination, liquidation or acceleration of any financial contract...or any right to offset or net out any termination value, payment amount or other transfer obligation”, Dodd-Frank Act, Title II, § 210(b)(8)(A) and FDIA, § 11(e)(8)(A).

79 Regarding the US resolution system, both Acts highlight that “a person who is a party to a qualified financial contract...may not exercise any right that such person has to terminate, liquidate or net such contract...solely by reason of or incidental to the appointment under this section of the Corporation (FDIC) as a receiver for the covered financial company”, ibid, §§ 210(b)(10)(B) and 11(e)(10)(B) respectively. In the UK, the Banking Act mentions that the UK authorities will be authorised to issue a property transfer instrument under their resolution powers, which can provide that any default event provisions related with early termination rights “are to be disregarded”, UK Banking Act, §§ 48Z(8)–(9). In addition, the UK Banking Act enlists numerous situations in order to describe different types of default event provisions that can result in the exercise of early termination rights, without providing any specific details on the characteristics of this stay or on its duration, ibid, §§ 48Z(2)–(3). The legal provisions in Switzerland allow FINMA to impose a temporary stay on any contractual early termination rights, FINMA Banking Insolvency Ordinance, art. 57(1)–(2). The FINMA Banking Insolvency Ordinance defines that contracts covering securities and commodities, futures and forwards, swaps and other financial contracts presenting similar financial results will be subject to the provision regarding the temporary stay, even when they take the form of master agreements, ibid, art. 56.

80 The exception being Switzerland, where the counterparty will be able to exercise his early termination rights, even against the third purchaser or the bridge bank, upon the expiry of the stay imposed by FINMA, ibid, art. 57(5)(a). We do not encourage similar approaches, as they may seriously hamper contractual continuity and neutralise the positive effects of the temporary stay introduced under a resolution regime.
Member States from imposing such temporary stays regarding close-out netting arrangements.\textsuperscript{81} Despite the fact that bank resolution should not be characterised as a classic reorganisation or winding-up procedure, the Financial Collateral Directive would be applied if member states tried to impose such temporary stays.

The EU Bank Recovery and Resolution Directive stresses that Member States shall ensure that their respective resolution authorities have the necessary power to impose a temporary suspension to the termination rights of any party under a financial contract with a failing bank, arising solely by reason of the initiation of a resolution procedure.\textsuperscript{82} Furthermore, the Directive introduces an amendment to the Financial Collateral Directive in order to allow the restriction to the effects of close-out netting and other analogous arrangements.\textsuperscript{83}

If the financial contract with a specific counterparty will not be transferred to the successor entity, the creditor will be able to exercise his early termination rights immediately.\textsuperscript{84} At the end of the suspension period, and if notified that its contractual agreement has been transferred, the creditor will not be allowed to effectively exercise any early termination rights.\textsuperscript{85}

Nevertheless, it should be stressed that creditors should be able to exercise their rights, in the event that the entity acquiring the business of the failing bank (whether a bridge bank or a third party purchaser) subsequently defaults.\textsuperscript{86}

In conclusion, authorities’ decision to initiate a resolution procedure and exercise their resolution powers can interfere significantly with creditors’ rights under close-out netting, set-off and other protected financial arrangements. The early termination of such rights at the beginning of

\textsuperscript{81} Art. 7 of the Directive provides that Member States should ensure that close-out netting provisions should take effect regardless of the commencement or continuation of reorganisation or winding-up procedures, EC Financial Collateral Directive, 2002, art. 7(1)(a).

\textsuperscript{82} EU Bank Recovery and Resolution Directive, art. 71.

\textsuperscript{83} Ibid, art. 118.

\textsuperscript{84} For instance, FINMA Banking Insolvency Ordinance, art. 57(5)(b) and EU Bank Recovery and Resolution Directive, art. 71(4).

\textsuperscript{85} For instance, Dodd-Frank Act, Title II, § 210(b)(10)(B)(i)(II) and EU Bank Recovery and Resolution Directive, art. 71(2)(c).

\textsuperscript{86} For instance, EU Bank Recovery and Resolution Directive, art. 71(5)(a).
a resolution procedure could play an important part in jeopardising the financial stability of the troubled financial institution, and contributing to further financial contagion. The Basel Committee identified national law reforms – as well as mandatory change of the terms of financial contracts – as a necessary policy priority, in order to address the early termination of contractual rights under resolution procedures. However, this will not be the end of the required changes: as demonstrated in the last section of this chapter, resolution regimes also need to introduce precise safeguards related to actions of resolution authorities that lead to a suspension of early termination rights.

### 7.2.2 Obstacles and challenges regarding resolution methods curtailing creditors’ rights

#### 7.2.2.1 Creditors’ rankings

The safeguard of creditors’ rankings has been a central issue in bank resolution, especially with regards to the resolution authorities’ exercise of statutory bail-in powers. On the one hand, it has been argued that a very rigid and academic approach to creditors’ rankings during bank resolution could support domestic ring-fencing practices and result in value-destructive consequences, as well as in a discriminatory treatment for the whole group of creditors.

On the other hand, the majority of bank resolution schemes have pushed for the guaranteed protection of bank creditors’ rankings during the implementation of bail-in resolution instruments. Consequently, debt-to-equity conversion or debt write-down powers should be designed and executed in such a way as to respect the ranking of creditors’ claims as they exist under insolvency regimes. In the case of the debt write-down

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87 BCBS, 2011, p.40.
89 For example, see the Dodd-Frank Act, Title II, §§ 206(3) and 210(a)(1)(M). In addition, as highlighted by Brierley, one of the fundamental elements of the UK Banking Act is that the normal priority ranking of creditors remains unaltered, Brierley, 2009, p.11. As stressed by the FSB, “resolution powers should be exercised in a way that respects the hierarchy of claims”, FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, pp.11.
90 DG Internal Market And Services, 2011, p.88.
tool, equity should be entirely wiped out before any subordinated debt is written-down; upon its exhaustion, this should be followed by losses suffered by senior debt holders and, finally, uninsured depositors.\(^{91}\)

Switzerland is a notable exception to this rule. The Banking Insolvency Ordinance establishes a straightforward safeguard for creditors’ rankings only in connection with the exercise of bail-in powers that will result in debt-to-equity conversion.\(^{92}\) When FINMA implements debt write-down tools, it will not be obliged to wipe out the junior classes of creditors entirely, before imposing losses to the next senior category.\(^{93}\) Thus, the Swiss supervisor will be able to distribute losses across a broad range of creditors’ groups.

The appeal of such a policy decision is that it can significantly boost the flexibility of resolution powers during a financial crisis. Nonetheless, it remains highly controversial. One should bear in mind that, for investors and creditors the world over, predictability and foreseeability – not only regarding the bank resolution process but also its outcomes – remain core concerns.\(^{94}\)

The approach of the FINMA Banking Insolvency Ordinance fails to provide more elaborate rules regarding the actual implementation of these debt write-down tools across all creditors’ groups. Such broad and discretionary provisions could result in extremely incoherent approaches to bank resolution procedures. In addition, they might raise significant obstacles rendering cross-border coordination deeply problematic. After all, the safeguard of core creditors’ rights remains a principal preoccupation of state authorities during cross-border insolvencies. Ambiguous provisions allowing deviations from precise rules could end up interfering with international cooperation and, finally, encourage ring-fencing practices in order to avoid a detrimental treatment of one’s domestic creditors. This ambiguity remains questionable, as, in principle, any curtailment of creditors’ claims should be based on precise, \textit{ex ante} laid down rules that will allow legal certitude and will safeguard the fundamental rankings under insolvency.

\(^{91}\) For a detailed description of this procedure see, for example, \textit{EU Bank Recovery and Resolution Directive}, art. 48.

\(^{92}\) \textit{FINMA Banking Insolvency Ordinance}, art. 48(d).

\(^{93}\) \textit{Ibid}, art. 50 \textit{in fine}.

\(^{94}\) \textit{Institute of International Finance}, 2012, p.57.
7.2.2.2 The pari passu principle

The *pari passu* principle requires that all creditors of the same class under insolvency should be treated equally. Their claims should be satisfied without preference, and in a proportionate manner, respecting fair treatment and legal certitude. However, various bank resolution rules have called this fundamental principle of insolvency law into question; an increasing number of voices have been calling for the differential treatment of creditors situated in the same debt layer, in order to maximise the beneficial returns of a resolution procedure.

Whilst the FSB advocated that resolution authorities should have the power to depart from the general principle of *pari passu*, the majority of bank resolution regimes opted to adopt softer approaches to creditors’ rights; approaches that will not contradict the principle of equal treatment.

The differential treatment of equal classes of claims, however, should be based not on the discretion of the resolution authorities but on objective, precise and transparent rules and standards, laid down *ex ante* and well understood by the different creditors. Such exemptions legitimising the differential treatment of equally situated claims purport to safeguard public interest, maximise the value of the resolution procedure for the benefit of creditors as a group, and protect financial stability. In any event, creditors whose rights have been unlawfully infringed will have a future right to compensation. The differential treatment of creditors’ claims will also allow greater flexibility, and lead to a more favourable implementation of resolution procedures for the going concern of a bank. This factor of flexibility will be especially appreciated during a financial crisis.

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95 Attinger, 2011, p.12.
96 FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2011, p.11.
97 An important exception is the US resolution regime, according to which the FDIC has the power to treat similarly situated creditors differently, BCBS, 2011, p.21 and Dodd-Frank Act, Title II, § 210(b)(4). In addition, the SRM allows a differential treatment of creditors of the same class on grounds of public interest but prohibits any discrimination on the ground of nationality, EU Regulation on a Single Resolution Mechanism, art. 6.
Nevertheless, the recommended safeguards seem inadequate to be able to achieve legal certainty, or ensure that creditors' rights are sufficiently protected. There may be wide variations, for example, in how different resolution authorities interpret conditions that are overly broad (such as those that refer to vague notions such as 'public interest' or 'general financial stability'), and this might result in arbitrary decision-making. Furthermore, the relevant international bodies have put forward no satisfactory proposals so far regarding how such policies that circumvent the *pari passu* principle should actually be implemented. Therefore, it is not clear which creditors of the same class will receive more beneficial treatment from resolution authorities than their counterparts, or on what grounds.

In fact, even the public policy argument cannot warrant the arbitrary deprivation of certain creditors' property claims, thus curtailment of their private rights. Whilst creditors will inevitably be penalised under bank resolution procedures, the extent to which this is the case should not be based purely on arbitrary assessments. After all, subjective interpretations of public policy interests, if not complemented with more transparent legal provisions, might result in inconsistent crisis management responses; and the latter could prove problematic with regards to cross-border cooperation.

Therefore, whilst introducing a degree of flexibility, resolution provisions that bypass the *pari passu* principle could be challenging to implement and potentially jeopardise the legitimacy of resolution procedures.

### 7.2.2.3 Cross-border complexities regarding the temporary stay on early termination rights

An additional challenge will be how to exercise the suspension of contractual early termination rights on a cross-border basis. Even within a domestic context, netting agreements can become a significant source of confusion for resolution authorities. In the case of the resolution imposed at the Dumferline Building Society, a relatively small financial institution, in March 2009 in the UK, the Bank of England had been confronted with an extremely complex situation regarding the transfer of netting arrangements and the splitting of the underlying assets and liabilities to these contracts. These complications arose mainly from the mismatch between the location of the swap contracts, subject to netting agreements, and the exposures they hedged within the different parts of the business, *Davies & Dobler*, 2011, p.220.

As previously mentioned, most...
states lack the necessary powers to suspend such contracts; when they are allowed to impose a stay, there may be considerable divergence from one state to another between the rules governing the conditions under which they can do so. The Basel Committee noted that the biggest challenge would be the temporary suspension of close-out netting or set-off rights under master financial agreements or of financial arrangements that are governed by a foreign law.\textsuperscript{102}

On the whole, questions around how to recognise – and, crucially, how to enforce – a decision regarding a temporary stay on early termination rights in a foreign jurisdiction remain unresolved; for the time being, they will be examined on a case-by-case basis.\textsuperscript{103} It is obvious that the recognition of an administrative decision by a foreign court will be neither smooth nor rapid, nor can be taken for granted. The same applies to a judicial decision, addressed to a foreign administrative resolution authority. Since there are no concrete examples from the last financial crisis on which to draw, one can only speculate how state regulators and tribunals might react to foreign requests with regard to the suspension of early termination rights. Given the existing lengthy (administrative or judicial) procedures and numerous diverse legal requirements in connection with the recognition and enforcement of foreign decisions, however, one can reasonably assume that cross-border cooperation is likely to be particularly slow and problematic.

In an effort to address this important challenge, ISDA published a resolution stay protocol relating to OTC derivatives trading.\textsuperscript{104} This novel instrument will help to ensure greater transparency with regards to the exercise of the stay on early termination rights. The clauses of the protocol remain generic, so as to allow the possibility of covering minor conceptual differences among the various jurisdictions.

By adhering to the protocol, a bank undertakes to modify all its master agreements to effectively allow the implementation of a temporary stay on all early termination rights in case of resolution. At the same time, all

\textsuperscript{102} BCBS, 2011, p.24.
\textsuperscript{103} According to the Basel Committee, most of its members were not determined to accept an automatic recognition of a temporary stay imposed by a foreign authority but were basically disposed to allow recognition on a case-by-case basis, provided that certain conditions are met, \textit{ibid}, p.26.
\textsuperscript{104} ISDA, \textit{Resolution Stay Protocol}, 2014.
counterparties of the bank (even if they themselves are not adherents to the protocol) will be made aware of the consequences of a future bank resolution procedure on the close-out netting and set-off clauses of their contracts.

The banking industry has responded swiftly to this initiative; eighteen major international banks adhered immediately to the protocol on the day that it was announced. The protocol has become effective for the adhering parties on 1\textsuperscript{st} January 2015, and will relate to both their existing and all future derivatives contracts.

The ultimate objective will be to encourage the majority of financial institutions, systemic or not, to become parties to this protocol. This would represent a significant success for the FSB, which promotes the recognition and enforcement of resolution procedures not only on a statutory but also on a contractual basis.\textsuperscript{105} Nonetheless, one should bear in mind that such contractual provisions should complement – not replace – statutory rules. Indeed, if contractual agreements deviate substantially from existing resolution rules, this might hamper international efforts for greater harmonisation of state resolution regimes. Finally, as highlighted by the FSB, their effectiveness and enforceability before tribunals is still to be seen.\textsuperscript{106}

### 7.3 Essential safeguards under bank resolution for shareholders’ and creditors’ rights

The previous sections identified certain resolution actions that could result in an important curtailment of fundamental shareholders’ and creditors’ rights, as well as the potential challenges that the implementation of such action might lead to. In the last section of this chapter, there is a brief discussion on the primary safeguards covering these aforementioned rights. Such safeguards have been introduced as minimum standards, guaranteeing a fair treatment for shareholders and creditors. Whilst they may differ in detail between jurisdictions, there are some key commonalities between such safeguards.

\textsuperscript{105} FSB, \textit{Cross-border recognition of resolution action}, 2014, p.11.

\textsuperscript{106} \textit{Ibid.}
Shareholders will be expected to be the first to bear any losses from the full-scale collapse of their financial institution with creditors the next in line. Since a financial crisis can be multifaceted, a certain degree of flexibility will be necessary on the part of state authorities when intervening.\textsuperscript{107} That said, allowing state authorities absolute discretion in how they apply their powers risks ultimately leading to unlawful property deprivation. Thus, bank resolution regimes need to put in place efficient safeguards that justify the curtailment of shareholders’ and creditors’ rights; limit state discretion; and enhance proportionality. The requirement for judicial review at the end of a resolution procedure could provide additional legitimacy to resolution actions.

\textbf{7.3.1 Limiting authorities’ discretion}

First of all, restrictions of shareholders’ powers and creditors’ claims and privileges should not be decided on a \textit{de facto} case-by-case basis. Rather, such decisions must result from provisions introducing straightforward exceptions to the current statutes of corporate, banking and insolvency law. State jurisdictions therefore ought to introduce \textit{ex ante} straightforward, transparent rules regulating any interference with shareholders’ and creditors’ rights during a bank resolution procedure. It is true that time is of the essence during bank resolution, and resolution authorities will inevitably need to implement procedures expediently.\textsuperscript{108} At the same time, such procedures should be the result of precise legal provisions.

\textsuperscript{107} “It is thus for the national authorities to make the initial assessment both of the existence of a problem of public concern warranting measures of deprivation of property and of the remedial action to be taken; the national authorities accordingly enjoy a certain margin of appreciation”, \textbf{European Court of Human Rights, James and Others v. The United Kingdom}, 1986, p.20, para.46. Also, “in order to implement social and economic policies, the legislature must have a wide margin of appreciation both with regard to the existence of a problem of public concern warranting measures of control and as to the choice of the detailed rules for the implementation of such measures”, \textbf{European Court of Human Rights, Mellacher and Others v. Austria}, 1989, p.22, para.45.

\textsuperscript{108} The European Court of Human Rights stressed that access to a court procedure can be subject to limitations, especially in the case of the expedited sale of an insolvent bank without court approval (contrary to the national law \textit{in casu}) so as to achieve a higher return for creditors and safeguard financial stability, \textbf{European Court of Human Rights, Camberrow MM5 AD v. Bulgaria}, 2004, pp.20–21, para.6.
Regarding shareholders, these provisions should not only cover property claims but also the whole spectrum of governance rights within a financial institution. These rules will also contribute in additional foreseeability, as in that way shareholders will become clearly aware of the repercussions of their lack of action (especially with regard to the conversion of contingent convertible capital instruments issued by the banks and the exercise of bail-in by resolution authorities).

In addition, the respect of the principle of legal certainty is closely linked to the discussion regarding the establishment of efficient and clear-cut resolution triggers. As highlighted in chapter 4, the standardisation of resolution triggers will require mainly quantitative but also specific qualitative elements, which should provide a precise idea with regard to regulatory intervention and regulatory action.

The deliberations on suitable resolution triggers are still subject to a heated debate. Considerations regarding shareholders’ and creditors’ safeguards could only nourish the dialogue towards the elaboration of the most efficient solutions.

Regarding creditors, it should be noted that certain classes of debt will be exempt from any bail-in procedure undertaken by the resolution authorities. Specifically, such exemptions will mainly concern guaranteed deposits; secured and short-term liabilities; claims from employees; tax; and other public authorities. This *numerus clausus* of guaranteed creditors’ claims will promote foreseeability as well as legal certainty among creditors’ groups.

Moreover, it is a common principle that, during the exercise of transfer powers to a bridge bank or a third party acquirer, resolution authorities are officially forbidden to ‘cherry-pick’ between the contractual agreements with a specific counterparty. Consequently, they will be obliged to transfer all of a specific creditor’s covered contracts; this helps to ensure continuity and avoid major disruptions – especially in connection with collateral, set-off and netting arrangements.

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109 For instance, see FINMA *Banking Insolvency Ordinance*, art. 49 and 50, as well as *EU Bank Recovery and Resolution Directive*, art. 44(2).

110 See *UK Banking Act*, § 48(2) and FINMA *Banking Insolvency Ordinance*, art. 51(1)(h)(1). A notable exception was found under German law, where BaFin was able to cherry-pick contractual obligations among different creditors’ groups or creditors of the same group based on its opinion of the systemic relevance of every single claim and/or creditor, *German Banking Act*, art. 48(j)(3) and 48(k)(2).
It should be also stressed that the entity acquiring the transferred financial contracts (i.e. bridge bank, third viable bank or public entity) will become responsible to the respective counterparties for the execution of those contracts. The change of contractual counterparty should not imply any change to the rights that can be exercised by these counterparties under such agreements: if the entity acquiring the transferred contracts falls into default, the rights of these counterparties will be automatically exercised.

Furthermore, it has been emphasised above that a stay on contractual early termination rights of creditors (for example resulting from set off and close-out netting agreements) should be an indispensable resolution tool. By and large, this should be a temporary and time-bound resolution option; preferably a stay should be in place for no longer than a period of 24 to 48 hours maximum.\footnote{The US resolution regime provides for a stay until 5 pm on the business day, following the date of the appointment of the FDIC as a receiver for a covered financial institution, \textit{Dodd-Frank Act}, Title II, § 210(b)(10)(B)(i)(I). The EU has endorsed a stay policy until midnight on the business day following the publication of the suspension, \textit{EU Bank Recovery and Resolution Directive}, art. 71(2). On the other hand, Switzerland opted for a maximum stay of 48 hours, \textit{FINMA Banking Insolvency Ordinance}, art. 57(3).}

It has been rightfully argued that such a short period of suspension might not suffice in order to allow resolution authorities to disentangle all contractual arrangements of a financial institution and decide on which ones should be subsequently transferred. Whilst this discussion is still ongoing, a stay of one or two days is probably over-optimistic; it is true that the stay should not become subject to absolute state discretion, and should not exceed a specific period provided under law. Otherwise, resolution authorities would risk causing major disruptions to the continuity of contractual and banking business, as well as contributing to legal uncertainty; in the context of a broad systemic crisis, the latter could result in panic.

The international standard-setting bodies have repeatedly maintained that a bank resolution procedure should ideally be completed within a weekend. Up-to-date resolution plans should help the resolution authorities to make their final decision concerning the contractual agreements to be transferred to a third entity. However, such measures will not necessarily guarantee the smooth implementation of a resolution procedure, especially with regards to a failing international bank: in the case of Cyprus,
for example, state authorities were compelled to keep the banks closed and accounts frozen – thus suspending any contractual obligation – for a much longer period than a simple weekend. One can only wonder how such a situation might evolve in the case of a G-SIB. Consequently, we believe that the issue of the maximum duration of a suspension of early termination rights deserves additional consideration, focusing on the optimal time period of an efficient stay.

### 7.3.2 Enhancing proportionality

In general, any decision taken by the resolution authorities to deprive creditors and shareholders of their property and governance rights should be proportionate and founded on reasons of public interest. The element of proportionality should be central in a resolution procedure. Proportionality, though, will always be interpreted according to the severity and the specific characteristics of each crisis.

It will be left to the discretion of state regulators to define ‘public interest’ which, broadly speaking, comprises political, economic and social considerations – such as the protection of depositors, and the safeguard of state financial stability. Striking the right balance between public interest and private rights will not always be a straightforward task, and resolution

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112 As stressed by the European Court of Human Rights, “there must be a reasonable relationship of proportionality between the means employed and the aim sought to be realised”, European Court of Human Rights, OLCZAK v. Poland, 2002, p.15, para.74.


114 For instance, according to the European Court of Human Rights, “the notion of “public interest” is necessarily extensive. In particular (...), the decision to enact laws expropriating property will commonly involve consideration of political, economic and social issues on which opinions within a democratic society may reasonably differ to a large extent. The Court, finding it natural that the margin of appreciation available to the legislature in implementing social and economic policies should be a wide one, will respect the legislature’s judgment as to what is “in the public interest”, unless that judgment is manifestly without reasonable foundation”, European Court of Human Rights, OLCZAK v. Poland, 2002, p.16, para.77. The UK Banking Act describes also seven distinct objectives that could legitimise the authorities’ decision to trigger a resolution procedure; These objectives could be subject to this broad concept of public interest, UK Banking Act, § 4.
authorities should always provide reasonable arguments in support of their final decision.

Losses should be allocated equally between the liabilities of the same class, respecting fully the *pari passu* treatment of creditors.\(^{115}\)

By and large, these restrictions should not result in disproportionate or illegitimate deprivation of private property. An element of discretion will be necessary present in the interpretation of the aspect of proportionality of the implemented measures. Hence, the decisions and actions of resolution authorities should be rightfully subject to sufficient judicial control.\(^{116}\) This judicial review can become a safeguard for shareholders’ and creditors’ rights, drawing a line in the sand with regard to state discretion.

### 7.3.3 The role of courts in bank resolution

“Soundness of legal reasoning is often like beauty, in the eye of the beholder; not an easy tool for meaningful objective assessment”\(^{117}\)

The role of courts in bank resolution is of significant importance, mainly in regard to the safeguard of shareholders’ and creditors’ rights: courts can – and should – review, *ex post*, actions taken by the resolution authorities in order to determine whether the authorities have acted legally, thus ensuring transparency of the process.

To a great extent, standard judicial insolvency regimes are not well suited to coping with the challenges associated with modern bank failures: they are not necessarily designed to take into account financial stability concerns, and they are typically costly, slow and cumbersome, and thus unable to provide rapid crisis management responses required in the context of modern financial crises.\(^{118}\) Besides, given the increasingly

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\(^{115}\) As analysed above in section (7.2.2.2).

\(^{116}\) The European Court of Human Rights stressed that civil courts should be able to review administrative decisions, which determine civil rights and obligations and which are normally not subject to judicial appeal, *European Court of Human Rights, Credit and Industrial Bank v. The Czech Republic*, 2003, p.20, para.68.

\(^{117}\) JHH Weiler, Epilogue: Judging the Judges – Apology And Critique, in Adams, Waele, Meensen & Straetmans, 2013, p.238.

\(^{118}\) Andrew Campbell & Rosa Lastra, Definition of Bank Insolvency and Types of Bank Insolvency Proceedings, in Lastra, 2011, p.50.
cross-border nature of banking, ensuring that decisions made by foreign courts are recognised and enforced on a cross-border basis is particularly challenging, and often subject to lengthy procedures and numerous diverse legal requirements that can hamper cross-border cooperation.

In fact, not all courts have extensive experience of dealing with banking matters; especially in the context of systemic bank failures, which can have considerable repercussions both within but also outside of national borders. The majority of judges tend to lack a fuller appreciation of wider market practices and interests.\textsuperscript{119}

The active involvement of courts in bank resolution can have considerable drawbacks: courts seem ill equipped to predict a likely banking failure, to know when to initiate a resolution trigger, or to make a final decision based on the available resolution options. Rules similar to those under the German Bank Reorganisation Act\textsuperscript{120} could jeopardise and even nullify the objectives of bank resolution. The broad mandate provided to these courts lacks precise conditions regarding the exercise of their powers; and the broader the scope of judicial review, the more powers the courts have to choose among potential alternatives, and the higher the possibility that judges may go beyond their legitimate judicial function.\textsuperscript{121}

The EU has also endorsed a broad approach regarding the role of courts in resolution proceedings, vindicating the classic insolvency rules. Member States are free to introduce \textit{ex ante} judicial approval of crisis management measures.\textsuperscript{122} The only condition for the establishment of such rules is that court approval should be expeditious,\textsuperscript{123} without providing any further clarifications on the interpretation of this requirement. As a result of this lack of clarity, significant discretionary powers are left to Member

\begin{itemize}
\item\textsuperscript{120} Allowing the Higher Regional Court to have the final word on the initiation of the procedure and on the approval of a reorganisation plan, \textit{German Bank Reorganisation Act}, §§ 20–21.
\item\textsuperscript{121} However, as their mandate remains imprecise, “\textit{the charge of illegitimate action is correspondingly harder to pin on the judges involved}”, Stephen Weatherill, \textit{The Court’s Case Law on the Internal Market: a Circumloquacious Statement of the Result, Rather Than a Reason for Arriving at It?}, in Adams, Waele, Meensen & Straetmans, 2013, p.90.
\item\textsuperscript{122} EU Bank Recovery and Resolution Directive, art. 85(1).
\item\textsuperscript{123} \textit{Ibid}.
\end{itemize}
States regarding the court approval of resolution actions. This potentially jeopardises effective cooperation between those states who encourage court involvement and those adopting purely administrative procedures.

The greatest challenge for courts is to avoid crossing the line between law and politics. The biggest concern is that in the field of bank resolution, where law and economics meet politics and legislation is frequently vague, powerful courts with broad decision-making powers might feel compelled to venture into a political process. This risks undermining the legitimacy of these courts, especially when resolution schemes lack precise accountability mechanisms.

On the other hand, since the implementation of a bank resolution scheme might lead to significant restrictions on shareholders’ property rights, it would be unthinkable for the courts to be excluded entirely from bank resolution procedures if they are to be legitimate. Furthermore, the involvement of the courts in such procedures will be necessary in order to ensure that resolution authorities can be held to account for any arbitrary, discriminatory or unfair decisions and actions.\(^\text{124}\)

Consequently, it is argued here that courts should be limited to an exercise of judicial review and not interfere with the approval of resolution decisions or the triggering of resolution measures. Judicial review should include ensuring the legality and legitimacy of any decisions taken by resolution authorities and the subsequent implementation of these decisions through the available resolution mechanisms. Should the courts judge that resolution authorities have performed arbitrary or unfair practices, compensation should be the available option for the competent court.\(^\text{125}\)

It should be stressed that this judicial review process should be regarded not as part of a bank resolution procedure, but as an entirely separate proceeding.\(^\text{126}\)

The role of courts is appreciated but the exercise of their powers should not be directly linked with the exercise of resolution procedures. The task of the courts could become quite challenging, in an effort to find the right balance between “ensuring the right to a fair hearing and not undermining

\(^\text{124}\) Andrew Campbell & Rosa Lastra, Definition of Bank Insolvency and Types of Bank Insolvency Proceedings, in Lastra, 2011, p.50.

\(^\text{125}\) BCBS, 2011, pp.20–21.

\(^\text{126}\) Cihak & Nier, 2009, p.18.
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*the effectiveness and credibility of banking authorities’ actions*. One cannot rule out the possibility of a certain degree of judicial activism. Although judicial review will be limited to compensation, decisions that call into question the legitimacy of resolution actions might still set a serious precedent in by casting doubt over the credibility of resolution authorities (both domestic and international) as well as the future performance of bank resolution schemes.

7.3.3.1 Judicial review

The *ex post* judicial review of the legality and proper implementation of bank resolution measures ensures accountability. It represents the ultimate safeguard for shareholders and creditors, since actions taken by the authorities will typically have a bearing on the property rights afforded to these stakeholders.

It is important to note that judicial proceedings should only be allowed to take place once a resolution procedure has already been implemented, so as to avoid any disruption to the effective implementation of resolution measures. In order to guarantee business continuity and stability, as well as to avoid market confusion, it should be noted that this *ex post* judicial review – which might eventually rule against a resolution decision – must not entail any suspension of the decision or reverse any administrative acts.

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127 Attinger, 2011, p.15.

128 Such a risk will be higher within the EU, due to the influential role of the ECJ, which is frequently called to interpret secondary EU law. On the one hand, following a number of decisions (Geraets-Smits and Peerbooms, Carpenter, Mangold, Metock, Soysal), it could be said that the ECJ “improperly substitutes itself as legislature in place of the competent national or EU political institutions regarding deeply contested economic and/or social questions”, Michael Dougan, *The Bubble that Burst: Exploring the Legitimacy of the Case Law on the Free Movement of Union Citizens*, in Adams, Waele, Meensen & Straetmans, 2013, pp.128–129. On the other hand, it could be also argued that “judicial activism debates normally depend upon a highly selective analysis of a small number of rulings, sometimes taken inappropriately out of their broader legal and political contexts”, ibid, p.153.

129 As stressed by the FSB, “resolution powers should be subject to constitutionally protected legal remedies and the principle of due process”, FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2011, p.11.
or transactions that have already been implemented by the authorities in conformity with the resolution decision in question.\textsuperscript{130}

If it is deemed that the actions of banking authorities have unjustifiably inflicted damage on shareholders and creditors, such that they are worse off than they would have been in insolvency, these stakeholders may be entitled to monetary compensation (‘damages’).

However, clear limits must be established with regards to the circumstances in which such damages may be awarded. First and foremost, the NCWL principle will apply: i.e. compensation will cover any losses suffered by the parties greater than those they would have suffered if the bank had been liquidated directly through a traditional insolvency procedure. In order to determine whether compensation is due, and if so how much, an independent valuer must be appointed to undertake a no creditor worse off valuation; in other words, assess the potential shortfall between the amounts actually recovered under bank resolution and the amounts that would have been distributed to creditors had the bank entered insolvency immediately prior to bank resolution proceedings. The valuer’s final report should form an integral part of the judicial review. In order to facilitate the independent valuer’s task, resolution authorities should develop detailed guidelines regarding the valuation method to be used; the time periods on which the valuation should be based; and all the complementary elements that could be taken into consideration.\textsuperscript{131}

Secondly, creditors should be entitled to compensation not only for violations to the NCWL or the \textit{pari passu} principle, but also for any other improper actions taken by banking authority officials in bad faith, which might have resulted in an illegitimate or disproportionate infringement of creditors’ rights. The same principle should apply to shareholders. Besides any interference with their property rights, they should also be able to receive compensation for any other action or improper conduct of the resolution authorities that may have caused them significant damage.

\textsuperscript{130} The FSB highlighted that “the legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith”, ibid, pp.11–12.

\textsuperscript{131} The actual qualifications of the valuer are still open to discussion, \textit{Athanassiou}, 2014, p.20.
The FSB emphasised that the majority of existing resolution regimes do not provide for compensation schemes for shareholders and creditors.\footnote{FSB, Review on Resolution Regimes, 2013, p.28.} It should be stressed, though, that the most elaborate resolution schemes – i.e. those introduced under US, UK and Swiss law – do include provisions introducing the right to compensation through judicial proceedings for shareholders and creditors whose rights are unlawfully compromised under bank resolution.\footnote{In the case of the US, see Dodd-Frank Act, § 205(c) and FDIA, § 11(j). Under US law, “the maximum liability of the Corporation, acting as receiver or in any other capacity, to any person having a claim against the receiver or the insured depository institution for which such receiver is appointed shall equal the amount such claimant would have received if the Corporation had liquidated the assets and liabilities of such institution”, FDIA, § 11(i)(2) and Dodd-Frank Act, § 210(c)(3)(B). The UK Banking Act authorises resolution authorities to make a third party compensation order, UK Banking Act, §§ 59–62. Finally, the shareholders of Swiss banks can resort to courts against the decisions and actions of FINMA but they are only entitled to compensation, should the court decide that their rights have been violated under a resolution procedure, Swiss Banking Act, art. 24(4).}

The EU Bank Recovery and Resolution Directive follows along the same legal path.\footnote{EU Bank Recovery and Resolution Directive, art. 85(3).} Whilst the ECtHR had previously repeatedly stressed the possibility to deny compensation for the deprivation of property rights under exceptional circumstances,\footnote{For instance, see European Court of Human Rights, Lithgow and Others v. The United Kingdom, 1986, p.45, para.121, European Court of Human Rights, The Holy Monasteries v. Greece, 1994, p.30, para.71 and European Court of Human Rights, Jahn and Others v. Germany, 2005, p.23, para.94.} the proposed changes within the overall framework for bank recovery and resolution in the EU mean that compensation will always be available as a remedy for any wrongful decision or action of resolution authorities.

The task of assessing compensation entitlements could prove extremely challenging for resolution authorities. Whilst data regarding the financial condition of a bank gathered during a rapid valuation conducted by an independent third party upon the entry on resolution could provide a useful proxy,\footnote{See for example EU Bank Recovery and Resolution Directive, art. 74.} it must be noted that the financial condition of an international bank can deteriorate rapidly during a financial crisis. Consequently, the extent to which an independent valuer is able to accurately determine
‘actual treatment’ under resolution versus ‘hypothetical treatment’ under insolvency in such circumstances is uncertain.

It has been argued that efficient resolution plans could simplify this procedure by establishing an estimate of the losses to be borne by shareholders and creditors under resolution and under insolvency.\(^{137}\) Nonetheless, it will never be possible to fully and accurately predict with certainty the potential costs of a future financial crisis, and thus resolution plans should only ever be considered an approximate assessment.

It is important to highlight that the affected parties will have no influence on the decision regarding the final form of the available compensation. In addition, since bank resolution can become a lengthy procedure, considerable delays might be inevitable, thus meaning that compensation may not be granted swiftly.

Although compensation through judicial review is considered the ultimate step for the safeguard of shareholders’ and creditors’ claims, it should not be regarded as a panacea for every challenge resulting from the implementation of bank resolution. In fact, it may not counterbalance the increased legal uncertainty and its potential unintended consequences regarding future creditors’ market attitude and overall debt pricing.

It should also be stressed that, if compensation decisions are to be made solely at the discretion of the courts, resolution authorities will have no influence over the adjudication procedure. Courts will be obliged to interpret the actions of the authorities in bank resolution according to the conditions of each individual case so as to reach a fair and impartial judgment. Although this margin of interpretation will – to a certain degree – be unavoidable and reasonable, a situation whereby the court’s decision contradicts the resolution authorities’ decision might ultimately arise. And, as far as the authorities are concerned, such a decision might set an unwelcome precedent.

Since courts will remain the point of reference regarding judicial review – interpreting legality in the context of bank resolution according to their legal tradition and well-established standards of jurisprudence – this may create problems in the context of cross-border resolution procedures: certain jurisdictions may interpret the law differently to others, and some

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\(^{137}\) FSB, **Key Attributes of Effective Resolution Regimes for Financial Institutions**, 2011, p.39.
may be more open to certain actions while others might demonstrate a more rigid attitude.

For instance, judicial activism will remain a key concern for the European bank resolution regime.\textsuperscript{138} Although wrongful decisions and actions cannot be suspended, the reputational cost for the resolution authorities involved vis-à-vis their foreign peers and the domestic public could be significant. Ultimately, this can hinder cross-border coordination: inconsistencies between bank resolution jurisprudence between Member States will contradict efforts to harmonise European approaches to bank resolution.

Therefore, it is vital that the scope for judicial review in the context of bank resolution should be clearly circumscribed. Yet, the impact of judicial review on bank resolution (at either the domestic or European level) is not considered in the EU Bank Recovery and Resolution Directive. Nor is the specific role of the ECJ made clear. However, through the references from domestic courts for a preliminary ruling, there is the potential for the ECJ to become involved in shaping an effective and uniform application of bank resolution legislation.\textsuperscript{139} The Strasbourg Court of Human Rights might also play an active role in the judicial interpretation of the impact of bank resolution procedures. Consequently, its future rulings on the curtailment of property rights (especially with regard to bail-in measures or compensation for wrongful actions) might influence the developments in EU bank resolution law, or become a significant obstacle to the proliferation of bank resolution practices.

\textsuperscript{138} On this issue see p.253, note 128.

\textsuperscript{139} The ECJ “sees its role primarily as one of upholding the checks and balances built into the EU constitutional legal order of states and peoples, including the protection of fundamental rights. This does not prevent though the ECJ from taking a more proactive role in some areas of EU law, yet it displays greater deference to the preferences of the EU legislator or those of member states. The ECJ thus favours both continuity of its role as a constitutional umpire and change in the substantive EU law achieved by the traditional interaction between the political and judicial processes”, KOEN LENAERTS, The Courts’ Outer and Inner Selves: Exploring the External and Internal Legitimacy of the European Court of Justice, in ADAMS, WAEL, MEENSEN & STRAETMANS, 2013, p.16.
7.3.3.2 ‘No creditor worse off than under liquidation’ principle

As previously discussed, given that bank resolution has the potential to interfere with shareholders’ and creditors’ rights, there is an explicit safeguard built in to resolution procedures that shareholders and creditors shall be left no worse off following the implementation of these procedures than they would have been if the bank had been liquidated. This ensures that even when resolution authorities are required to act quickly, shareholders and creditors are provided with an appropriate degree of certainty. Thus, a comparison must be made between the expected outcome of the bank resolution procedure and the potential outcome in the case of bank liquidation. The result of this analysis should have a significant bearing on authorities’ decisions regarding the possible plan of action for the troubled financial institution. As eloquently put by Athanassiou, the introduction of this principle “obviates the need for more disruptive procedural safeguards in resolution, namely the ex ante judicial review of resolution decisions”.

The NCWL principle has been transformed into a major safeguard for creditors’ rights under bank resolution, although it may prove challenging in practice. This exercise of estimating the assets and liabilities of the bank and the amounts that the creditors would receive under an insolvency proceeding, before any actual resolution procedure will be implemented, could prove a daunting task for resolution authorities. An ex ante assessment of the two future plausible scenarios (under resolution and under insolvency) will not necessarily prove to be straightforward.

According to the FSB, a possible answer to this puzzling issue could be the creation of credible resolution plans establishing an estimate of the losses to be borne by creditors under resolution and under traditional

140 For instance see Dodd-Frank Act, Title II, § 210(d)(2)(B), FDIA, § 11(i)(2), UK Banking Act, § 60(2) and EU Bank Recovery and Resolution Directive, art. 34(1)(g).

141 Athanassiou, 2014, p.16.

142 However, as stressed by Attinger, “the mere fact that this task is challenging does not devalue the approach”, Attinger, 2011, p.11.
insolvency.\textsuperscript{143} Resolution plans, though, cannot guarantee the accuracy of such estimates.

In another example, EBA proposes that the independent valuer drafts an inventory of all identifiable and contingent assets owned against a bank, as well as all identifiable and contingent claims against the bank.\textsuperscript{144} This classification should include all associated cash flows demonstrated or reasonably expected with regard to each asset and the rights and priority of each claim under normal insolvency.\textsuperscript{145}

It is estimated that resolution authorities will ultimately have a lot of leeway with regards to the approach to valuation that is taken and that this will depend to a large extent on the context. Comparing resolution procedures implemented in the UK, Greece, Spain and Cyprus, for instance, Athanassiou highlights that numerous factors might be taken into consideration when such a valuation exercise is conducted, including: the balance sheet value of assets/liabilities; the prevailing conditions in the markets and the financial system; the deduction of any increase in value resulting by external (state) support; and further broad prudent and realistic assumptions.\textsuperscript{146}

On this issue of valuation, EBA distinguishes between those assets traded in an active markets and those that are not: with regard to the former, the valuer should use the observed price of the asset in the market, except where specific circumstances hamper the marketability of the asset in question. For the latter, a number of factors should be taken into consideration including (but not exclusively): prices observed in active markets where similar assets are traded, or in insolvency proceedings involving assets of similar assets; the expected market conditions within a given asset disposal period; and the length of such a disposal period.\textsuperscript{147}

The valuation exercise might be more problematic in contexts where precise rules interpreting such general market conditions and prudent regulatory assumptions are absent. In this case, one valuation method might

\textsuperscript{143} FSB, \textit{Key Attributes of Effective Resolution Regimes for Financial Institutions}, 2011, p.39.
\textsuperscript{144} EBA, \textit{Consultation paper on DRTS on Valuation}, 2014, p.28.
\textsuperscript{145} \textit{Ibid}. Encumbered assets and claims secured on those assets should be identified separately.
\textsuperscript{146} Athanassiou, 2014, pp.17–18.
be favoured over another, although the latter could be also legitimately applied.\footnote{148}

Fixing the exact point of the valuation poses an additional challenge. Resolution regimes will normally have to make a choice between two main policy alternatives: (i) accepting a valuation that is based on the date on which the resolution was triggered (i.e. according to the financial statements available at that point in time) or (ii) endorsing a valuation based on financial considerations on the date when resolution measures will actually become implemented and effective.

Option (i) would be easier to put into practice than option (ii), since the independent valuer would have immediate access to the bank’s financial statements, as well as the information contained in the resolution plan. Yet, the downside of option (i) is that the financial situation of a failing bank changes rapidly; in the time intervening between the triggering of a resolution procedure and its actual implementation, the data upon which such a valuation relies may well become out of date.

Option (ii), on the other hand, is likely to result in data that more accurately reflects the financial condition of the bank under resolution. Nonetheless, undertaking this type of valuation would undoubtedly be more complex, and time consuming and, as a result, the valuer may ultimately have no other option but to follow estimates rather than be in a position to make a solid expert judgment. With this in mind, EBA, for example, while recognising the clear advantages of option (ii), considers that in reality option (i) (i.e. valuation on the resolution date) is likely to provide the more objective result.\footnote{149}

\footnote{148} Normally, the applicable insolvency practices and the existing accounting and solvency rules in the jurisdiction in question will play an important role. An illustrative example of this problem was the litigation resulting from the valuation implemented regarding the claims of Northern Rock shareholders. The European Court of Human Rights endorsed the approach of UK regulators denying any compensation to shareholders, following the assumption that, as no government financial support would ever again be provided to the bank, Northern Rock was unable to continue as a going concern. Concerning the valuation leading to no compensation, the Court admitted that “legitimate objectives in the public interest, such as those pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value”, \textit{European Court of Human Rights, Dennis Grainger and others v. United Kingdom}, 2012, par.37.

There are considerable concerns that the NCWL principle will fail to stand up in practice. A fundamental issue is that, ultimately, creditors remaining in the residual bank could potentially be subject to prejudice. In the case of a partial transfer of the business of a failing bank to a third party acquirer, for instance, creditors will normally be required to pay a premium for the acquisition of the franchise and the troubled bank’s customers. Any potential shortfall between the liabilities and the high-quality assets transferred to the third party will be borne by the creditors of the residual bank, effectively penalising them in the subsequent insolvency.\(^{150}\) As Davies and Dobler stress, residual creditors might end up eventually subsidising the depositors and creditors transferred to a third party acquirer.\(^{151}\)

Furthermore, most current resolution regimes do not include explicit requirements to guide the resolution authorities’ final decision regarding the choice among the contractual arrangements of the different creditors. It is, thus, not clear which creditors should be subject to a transfer of their rights to a third party entity, or on what grounds. Although the selection of the claims to be transferred will eventually have to be economically justifiable,\(^{152}\) an abstract margin of discretion for the resolution authorities cannot be excluded.

It should be also mentioned that the issuance of hybrid financial instruments by the financial institutions, as well as the use of bail-in tools by the resolution authorities, could effectively undermine the NCWL principle. Böckli demonstrated this problematic situation, for example, in reference to the Swiss bank resolution regime.\(^{153}\) If the troubled bank had entered directly into an insolvency procedure, then the subordinated debt holders would have been called upon to participate in the losses from the fourth insolvency class. Upon resolution, FINMA might decide to impose a debt-to-equity conversion through bail-in powers resulting in a transformation of the debt holders to shareholders of the bank. In an extreme


\(^{151}\) *Davies & Dobler, 2011, p.217.* The authors of the article analyse under a brief mathematical example regarding the UK resolution system how a partial property transfer involving a shortfall between deposit liabilities and assets transferred could damage the creditors remaining in the residual bank and derogate from the NCWL principle.

\(^{152}\) It will be difficult to avoid a differential treatment of trading vs. financial claims, with a final choice based on evaluations of systemic purposes, *Institute of International Finance, 2012, p.24.*

\(^{153}\) *Böckli, 2012, pp.189–190.*
scenario, the failing bank, despite the temporary beneficial results of the bank resolution procedure, might not avoid a final insolvency. Upon that event, the previous debt holders – now actual shareholders of the bank – will be obliged to suffer losses first, and participate in the procedure from the fifth insolvency class. Consequently, the overview of the whole chain of events indicates a violation of the NCWL principle and a detrimental treatment of creditors’ claims.

In addition, the powers of the resolution authorities to impose a statutory write-down of certain creditors’ claims might contradict the basic contractual principle of *pacta sunt servanda*. It will be hard for these categories of creditors to accept that their contractual agreements cannot be entirely fulfilled, especially given that the actual debtor, meanwhile, might continue to exist (even in a different form) following the resolution procedure.\(^{154}\)

Such a form of pecuniary compensation based on the comparison of an actual situation (bank resolution) with a hypothetical scenario (insolvency) does not seem to present a realistic solution: attempting to make an accurate comparison between resolution and insolvency could be described as an overly complex task, which is likely to result in cases of under- or overestimation of damages. It is also surprising that few domestic bank resolution rules provide further clarification with regards to the assessment of compensation claims.\(^{155}\) A more innovative approach to this is necessary, entailing either the development of precise valuation standards or an alternative method of compensation.

The proposed rules for compensation provided to the affected parties from a bank resolution procedure might not necessarily guarantee all aspects of the NCWL principle. Although judicial review scrutinises the legality of decisions and actions taken by the resolution authorities, compensation will not be provided by these authorities or directly by the state in question. Although judicial review will concern decisions and actions of the resolution authorities, compensation will not be provided by these authorities or directly by the state in question. Resolution schemes are free to pick between purely administrative procedures or having courts issuing decisions and administering compensation procedures.

\(^{154}\) Attinger, 2011, p.9.

\(^{155}\) The EU being a rare example through the elaboration of technical standards on this issue by EBA.
One credible alternative could be the use of the existing resolution fund; a solution adopted by the EU Bank Recovery and Resolution Directive. In this case, the resolution financing arrangement of each Member State may be used to fund the compensation claims of shareholders and creditors in the event that the NCWL principle is not respected. Under this scenario, shareholders and creditors would direct their compensation claims to the resolution fund, rather than the actual resolution authorities.

A second option would be for shareholders and creditors suffering damages to file their compensation claims against the failed bank. Such is the requirement in the US resolution regime. Thus, responsibility for compensation is dissociated from the actions of the FDIC – a governmental body.

Clearly, if there are insufficient resources available in the resolution fund, or if the liquidation proceeds of the residual bank are not sufficient to cover the settlement of these payments, the question remains – who should eventually provide compensation? It can be suggested that in such a scenario, it is the state mechanism that will need to come to the rescue.

It is important not to rule out more innovative approaches; especially for such cases when a compensatory mechanism might be unable to provide direct monetary reparations. For example, compensation may take the form of shares or debt instruments (including hybrid CoCo bonds with a high yield for a fixed time period) of a new financial institution or participation to the proceeds from the sale of still functional entities of the group to a third party acquirer. Yet, it is highly disputed if such forms of non-pecuniary restitution could fall under the definition of compensation in the context of bank resolution procedures.

Everything considered, additional thoughts should be given to these details, which might eventually put the NCWL safeguard in jeopardy and expose creditors to additional losses, beyond those they might expect to incur under bank resolution. Such a detrimental consequence will allow for a disproportionate and illegitimate curtailment of creditors’ claims,

157 Brierley, 2009, p.11.
158 Such as the example of the bail-in implementation in Cyprus can demonstrate. Depositors of the Bank of Cyprus that were subject to a 60% write-down of their claims received A class shares (equal to almost 47.5% of their pre-resolution deposits) in the post-resolution entity. See p.207, note 101.
contrary to fundamental concepts of insolvency law. The NCWL might, thus, remain dead letter and a mere procedural requirement rather than a substantial principle of bank resolution.

### 7.4 Concluding remarks

In conclusion, bank resolution regimes will not only maintain the traditional impacts of insolvency law on shareholders and creditors of financial institutions but they will also introduce additional (and frequently far-reaching) restrictions. Following the 2008 financial meltdown, there has been a rapid transformation of regulatory mentalities – especially in Europe – with regards to the supremacy of shareholders’ rights and creditors’ claims.

During the implementation of bank resolution, losses (i.e. to property and governance rights) should be absorbed in the first place by shareholders and then by bank creditors (i.e. through the exercise of bail-in powers), consistent with the statutory hierarchy of creditor claims. In addition, the early termination rights of creditors – resulting from contractual clauses – can become subject to a temporary resolution stay in order to safeguard the continuity and stability of resolution authorities’ actions.

However, resolution actions that interfere with creditors’ rights are controversial. The safeguard of creditors’ rankings and protection of the general *pari passu* (i.e. equal treatment of creditors of the same class) principle might not be guaranteed under bank resolution. A resolution authority may depart from the *pari passu* treatment of creditors in the same class if this is deemed necessary to contain the systemic effects of a bank’s failure.

Moreover, the implementation of stays on early termination rights on a cross-border basis could prove highly challenging. The ISDA Resolution Stay Protocol has been a crucial initiative addressing this complexity on a contractual basis; however, modifications/amendments will also need to be made to statutory rules under domestic laws.

The new bank resolution regimes provide a limited arsenal of safeguards for shareholders and creditors, designed to provide these stakeholders with greater certainty with regards to how they would be treated in a resolution. It becomes clear from the above analysis, however, that
although the basic principles underlying these safeguards have been crystallised, this particular legal field of bank resolution remains a moving target. It is expected that the focus of future discussions will be on the potential flexibility and legitimacy of resolution authorities to use their powers to circumvent – if necessary – fundamental principles of corporate and insolvency law such as the NCWL or the *pari passu* principles. Specifically, there are concerns that flexibility during a crisis might ultimately morph into unconstrained discretion.

Altogether, the will to penalise shareholders and creditors for the collapse of financial institutions should not be confused with unrestricted discretionary state actions leading to an unlawful curtailment of private rights. The respect of the principle of proportionality, complemented with a judicial review of resolution proceedings that might lead to compensation in case of disproportionate or unlawful violations of shareholders’ and creditors’ rights, could become the basis for the protection of these rights during bank resolution. The evaluation of such compensation remains, however, a thorny issue, as the current rules on the comparison between an actual resolution and a hypothetical insolvency cannot be considered a credible compensation formula.
Chapter 8

RESOLUTION PLANNING

8.1 ‘Know thyself’ and ‘prepare your own funeral’

One of the most decisive legal innovations that resolution regimes introduced has been the concept of resolution plans, initially known as ‘living wills’.

A resolution plan can be described as a detailed outline containing vital information on the structure, systemic functions and crucial business activities of a specific financial institution, and describing the main actions that should be implemented by resolution authorities for orderly resolution in the event of financial distress of the institution.1 In most cases, these plans will be drafted and reviewed by the competent resolution authorities on the basis of information that has been provided to them by each financial institution.

The development of resolution plans is considered to be an integral component of the broader crisis management/regulatory framework, which is founded on: resolvability; early intervention (recovery); and resolution. Each of these action plans will address a specific stage of a financial crisis, and the interventions that regulatory authorities would need to make developed on a progressive scale.

Resolution plans focus on the final stage of a consolidated crisis management framework for the banking sector. At this ultimate stage, if the solvency of a financial institution is at stake (and all other regulatory measures have failed), resolution authorities will intervene and take steps

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1 Resolution plans were first described by the Cross-Border Resolution Group of the Basel Committee when it issued a special recommendation highlighting the need to create “contingency plans for all SIFIs to address as a contingency a period of severe financial distress or financial instability and provide a plan, proportionate to the size and complexity of the institution’s and/or group’s structure and business, to preserve the firm as a going concern, promote the resiliency of key functions and facilitate the rapid resolution or wind-down should that prove necessary”, BCBS, 2011, p.31.
to ‘resolve’ the institution, according to a predetermined, individualised resolution plan. This type of contingency planning will act as a blueprint for the resolution authorities for implementing a successful and rapid resolution (i.e. saving, separating or safely winding down activities.) Whilst resolution plans should facilitate the process of resolution, they should not become the sole mandatory crisis management instrument for resolution authorities. Rather, as a crisis unfolds, regulators might need to adopt a different strategy if they consider it more appropriate than the scenarios envisaged under the institution’s resolution plan.²

Resolution plans should be drafted either by the supervised financial institutions directly (with the active contribution of the competent resolution authorities), or exclusively by the resolution authorities (according to the information provided to them by the bank.) In the former case, financial institutions should base their resolution plan on the specific characteristics and challenges that a financial crisis can pose.³ This plan will be submitted to the resolution authorities, which will need to confirm the credibility and the feasibility of the resolution options proposed.

In the latter case, resolution authorities – taking into consideration the corporate structure, business lines, intra-group exposures, the existence of systemic functions and critical interdependencies – will identify the most suitable potential resolution strategies, as well as the operational requirements/changes that will be necessary to deliver effective plans.⁴

If the financial institution will be unable to address these requirements, resolution authorities will be obliged to ask for a revision of the plan and the adoption of measures that will improve resolvability and will allow the better implementation of the necessary resolution strategies. In addition, the financial institution in question might be subject to sanctions or numerous operational restrictions if it fails to comply with regulatory requirements on resolution planning. Once resolution triggers are

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² FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.33.
³ This is the particularity of the US system, where the financial institutions will be solely responsible to create the plans without an intervention of the authorities. They will be only obliged to periodically report the state of the plans to the Board of Governors of the Federal Reserve and the FDIC.
⁴ FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.38.
initiated, resolution authorities will intervene and the resolution plan will be implemented.

The FSB identified few jurisdictions to date in which formal statutory requirements regarding resolution plans were introduced and developed.\(^5\) Certain other jurisdictions highlighted that they are on the process of developing resolution plans under their existing supervisory powers.\(^6\)

More commonly in numerous other jurisdictions, financial institutions have been legally required to create contingency plans that draw attention to issues of business resilience and the preservation of critical functions during times of stress.\(^7\) While the development of such contingency plans might be a positive starting point, they do not reflect the basic objectives of a resolution procedure and as such are insufficient for guiding resolution authorities in the implementation of bank resolution measures. Nonetheless, whilst the resolution plan process is still in its infancy, we view a growing interest on the part of states to improve and evolve these practices under their existing resolution regimes.

In the wake of the 2008 financial crisis, the ‘know thyself’ principle has become increasingly important as banks strive to improve their risk-management strategies. The development of accurate and credible and resolution plans represents a core element of resolution proceedings, intended to ensure the accuracy and timeliness of resolution interventions. The resolution plans development process, however, is not without its challenges; some of these are highlighted in the following sections.

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5 Spain, Switzerland and the UK, FSB, Review on Resolution Regimes, 2013, p.33. In the US, the obligation for the creation of resolution plans by covered financial companies has been activated in September 2011, after the FDIC and the Federal Reserve Board issued jointly the final rule issued regarding the implementation of Section 165(d) of the Dodd-Frank Act, FDIC, 2011b. Nevertheless, the elaboration of resolution plans is still based on policy and not statutory requirements.

6 Among them Canada, Japan and China, FSB, Review on Resolution Regimes, 2013, p.33. The EU jurisdictions will be obliged to establish resolution plans under the requirements of the EU Bank Recovery and Resolution Directive and the EU Regulation on a Single Resolution Mechanism.

7 BCBS, 2011, p.36.
8.2 Distinction from analogous crisis management requirements

8.2.1 Resolvability assessments

According to the FSB, resolvability assessments “evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm’s failure on the financial system and the overall economy”\(^8\). The main objective of a resolvability assessment is to evaluate if a bank is ‘resolvable’, in other words if “it is feasible and credible for the resolution authorities to resolve it in a way that protects systemically important functions without severe systemic disruption and without exposing taxpayers to loss”\(^9\). Through such an assessment, resolution authorities, as well as the bank in question, will become aware of potential endogenous and exogenous factors, which might interfere with and delay their resolution actions, will identify the probable impacts of their decisions on the domestic banking sector, as well as the international markets, and finally, develop precise actions in order to address the aforementioned challenges and improve resolvability.

Resolvability assessments are qualitative in nature, focusing on elements such as: the corporate structure of a firm; the intra-group dependencies; a firm’s systemic functions; the main characteristics of a resolution regime; or the level of cross-border cooperation liabilities. Such elements, if not properly identified, can become significant obstacles to the drafting and implementation of resolution plans. Thus, in the absence of resolvability assessments resolution plans could remain a mere theoretical exercise and potentially have the perverse effect of causing alarming financial repercussions.

An assessment of the operational and financial capacity of a resolution authority to exercise its powers (according to the domestic legislation on bank resolution in place) is outside the scope of a resolvability assessment.\(^10\) Such assessments conducted by the home authority should

\(^8\) FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.15.

\(^9\) Ibid, p.27.

\(^10\) DG Internal Market and Services, 2011, p.37.
be shared with the principal host jurisdictions within a Crisis Management Group, in order to maintain a clear image of the group resolvability and of the impact of resolution actions on every group entity.

Switzerland is one of the few jurisdictions to have introduced a formal statutory requirement for the development of resolvability assessments.\(^\text{11}\) Only a handful of other jurisdictions may establish resolvability assessments on a policy basis using their supervisory powers.\(^\text{12}\) Due to this broad absence of formal rules, it is not clear how the authorities plan to carry out this exercise; specifically, how they will address potential problems regarding resolvability. For the time being, there is no legal certainty regarding the form that these intervention measures will take, or how far-reaching they can be. Even in the case of Switzerland, the legal text remains quite vague, highlighting only that FINMA should be able to impose the measures necessary to address resolvability concerns.\(^\text{13}\)

State authorities have actually failed to understand the importance of these tools for effective crisis management; since resolvability assessments remain a crucial prerequisite for fully operational resolution plans, further development of rules governing how they should be drafted and implemented is essential, particularly with respect to the enforcement of authorities’ actions intended to enhance resolvability. Since extensive regulatory interventions may impact organisational structures and business lines, it is essential that such interventions are determined by solid legislated rules and not solely by a state’s discretion.

### 8.2.2 Recovery plans

At the early signs of financial distress, financial institutions will be called to implement recovery plans that have already in place and that set out the necessary measures that should be exercised in order to restore financial viability.\(^\text{14}\) These preventive measures focus mainly on addressing liquidity

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\(^\text{11}\) **Swiss Banking Ordinance**, art. 61.
\(^\text{12}\) For instance, the UK, the US and Japan, FSB, *Review on Resolution Regimes*, 2013, p.32.
\(^\text{13}\) **Swiss Banking Ordinance**, art. 62.
\(^\text{14}\) Recovery planning will “enable firms to maintain or restore financial strength and viability by preventing undue delays in the implementation of recovery measures”, FSB, *Recovery and Resolution Planning for SIFIs*, 2013, p.5.
problems, imposing a recapitalisation, reducing the risk profile or restructuring liabilities, while at the same time they reflect the size of the financial institution, its structure and its funding sources.\textsuperscript{15} At this point of a financial crisis, there is no need for the competent authorities to exercise their resolution powers: the prospects for the recovery of a financial institution should be reasonable upon implementation of the recovery plan.

A principal difference between recovery and resolution plans – aside from their content – lies with the entity responsible for drafting and final implementation of the plan. Recovery plans will be developed directly by each financial institution. During the exercise of their supervisory powers, financial regulators should be able to review the recovery plan at any point in time and assess its effective implementation. If there is a crisis that places the stability of the firm into jeopardy, the financial institution should automatically enforce the measures described under the recovery plan. Nonetheless, if the reaction of the firm to the crisis is slow, supervisory authorities must be able to intervene and demand that the recovery plan be implemented with immediate effect.

Resolution plans, on the other hand, are usually drafted by resolution authorities; with the exception of certain jurisdictions that allow financial institutions to undertake this exercise, subject to a final ratification by the competent authorities.\textsuperscript{16}

Both recovery and resolution plans will be subject to a process of continuous review and revision, particularly to reflect any material changes to corporate structure, business operations or risk exposure.\textsuperscript{17} Stress scenarios, as well as strategy analysis, are essential complementary tools that can help supervisors assess the resilience of financial institutions to adverse market developments and facilitate the initiation and implementation of recovery plans.

As with the case of resolution plans, few jurisdictions introduced statutory requirements for the elaboration of recovery plans.\textsuperscript{18} For certain other jurisdictions, the obligation for financial institutions to produce credible

\textsuperscript{15} FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.38.
\textsuperscript{16} See p.268, note 3.
\textsuperscript{17} FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.34.
\textsuperscript{18} FSB, Review on Resolution Regimes, 2013, p.33.
recovery plans remains based on general crisis management and supervisory provisions applied for the banking sector.

### 8.3 Critical elements of resolution plans

The development of a resolution plan is based on two main aspects: firstly, the financial institution must provide a certain amount of information regarding its structure and activities. Secondly, resolution authorities – building on this information, and taking into consideration various crisis scenarios – will then be able to develop credible plans and strategies for resolution specific to that bank, and assess the possible impacts of their actions. This latter stage is the most crucial.

#### 8.3.1 Informational requirements for resolution plans

Resolution plans are drafted on the basis of the information available at the time and provided to the authorities by the financial institutions concerning a broad range of legal and business aspects.

The essential elements of a resolution plan include, first and foremost, details regarding the operational and legal structure of a financial institution. This kind of information is vital especially for the consolidated resolution plans, which will be drawn up for G-SIBs on a group basis. Resolution authorities need to remain well aware of the number of material legal entities, their operational independence (whether they operate as branches or subsidiaries), as well as of their respective form of organisation. In fact, big corporate structures can be problematic; hence, many jurisdictions envisage the possibility of imposing regulatory incentives in order to encourage financial institutions to adopt more simplified structures.

It is also important to provide information on the legal and regulatory framework in which each group entity operates. Since certain entities are subject to supervision by home authorities whilst others operate in host

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19 For instance, see **Barclays**, 2014, pp.6–8, **Deutsche Bank**, 2014, p.4, **Citigroup**, 2014, p.6, **UBS**, 2014, p.5.
jurisdictions, it is necessary for authorities to fully understand each legal regime and its potential impact on resolution in order to evaluate future crisis responses.\textsuperscript{20}

Moreover, it is essential to map the business lines between the various legal entities; thus, a financial institution should provide authorities with a transparent guide of the business activities exercised by each legal entity. In this way the authorities can match the systemically relevant functions with each of the companies exercising these functions\textsuperscript{21} in order to determine which entities within the overall group are of systemic importance.

In addition, it is crucial to identify the full extent of intra-group links and exposures. These elements might relate to interconnectedness by reference to business lines, intra-group contracts, guarantees and loans, trades booked on a back-to-back basis or dependencies on other group entities for liquidity or capital support.\textsuperscript{22} Having access to detailed information regarding these aspects during a resolution procedure is crucial, as complex corporate structures with ambiguous business lines can contribute to financial contagion and render the work of resolution authorities almost impossible. The uncoordinated actions of the US authorities during the Lehman Brothers crisis, for instance, and insufficient knowledge on their part regarding intra-group operations resulted in catastrophic consequences for legal entities of the group all around the globe. International standard-setting bodies, as well as most domestic resolution regimes, share the opinion that any undue intra-group guarantees – in particular, any use of blanket guarantees in a group context – should be minimised, or even totally excluded.\textsuperscript{23}

Resolution authorities should be conscious of the full extent to which each legal entity is exposed to its various counterparties.\textsuperscript{24} This pertinent information should include a description of the major counterparties, the

\textsuperscript{22} FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.39.
\textsuperscript{23} BCBS, 2011, p.37.
size of liabilities, the legal nature of the different contractual obligations (such as close-out netting, set-off, swap or repo arrangements whose enforcement can pose significant legal challenges), the existence of cross-guarantees, and the identification of ownership and location of the pledged collateral.\textsuperscript{25}

The potential systemic importance of a financial institution will be determined by its systemic functions and business activities. Thus, during resolution proceedings – and with the help of the resolution plan – the authorities will be prepared to rapidly identify and separate these critical functions.

Once these systemic functions have been identified, the financial institution will have to elaborate on the quantitative elements supporting these functions. This operational data should include relevant balance sheet information, market share, the amount of liquid assets, the extent of asset encumbrance, the number and geographical location of customers as well as the description of potential off-balance sheet activities.\textsuperscript{26}

Furthermore, a financial institution needs to designate the essential operational infrastructure in order to maintain a systemic function. Under this section of a resolution plan, we find information on human resources,\textsuperscript{27} real estate, intellectual property and IT systems.\textsuperscript{28}

The FSB illustrated how data on operations supporting specific resolution measures will also be indispensable. These issues could refer to dealing-room operations, trade booking practices, hedging strategies, custody of assets, clearing and settlement systems, accounting and position-keeping systems.\textsuperscript{29}

Finally, resolution authorities need to focus their attention on informational elements relating to crisis-management systems residing within each SIB. On this basis, the financial institution will have to describe the roles and responsibilities of each of its organs with regard to risk assessment, ‘whistle-blowing’ procedures, in-house crisis communication and

\begin{flushleft}
26 DG Internal Market and Services, 2011, p.32.
29 FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.39.
\end{flushleft}
decision-making, as well as communication strategies with the relevant regulatory authorities.

For most banks, this is a daunting task, and for large, complex and multinational financial institutions, the development of such plans presents even greater challenges. Yet, the development of such plans is important for providing financial institutions and resolution authorities with a first clear image of the structure, financial condition, exposures and management of each group entity. In addition, such crisis preparatory practices could become an instrument enhancing corporate governance. This collected information is the basis for resolution authorities in order to identify the most suitable resolution methods, the requirements and potential obstacles to their implementation, as well as their possible impacts.

As an incentive to cooperate, resolution authorities could confer some sort of benefit (a ‘carrot’) on those financial institutions who provide credible and up-to-date information. In Switzerland, for instance, rebates on capital requirements are provided to systemic banks that undertake to improve their resolvability. Conversely, ‘sticks’ – in the form of sanctions – will be important when financial institutions fail to follow the lines of their resolution plans.

Unfortunately, few states have thus far issued financial institutions with specifically-tailored data templates, fact sheets or data triage frameworks to facilitate the rapid collection of the information that is required for resolution purposes. Consequently, there may already be critical gaps with regards to the information that is needed for resolution authorities to be able to draft effective resolution plans.

30 Corporate governance failures and weaknesses were among the main reasons behind the 2008 financial collapse. As highlighted by the OECD Steering Group on Corporate Governance, “the financial crisis can be to an extent attributed to failures and weaknesses in corporate governance arrangements. When they were put to a test, corporate governance routines did not serve their purpose to safeguard against excessive risk taking in number of financial services companies. A number of weaknesses have been apparent. The risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board and even senior levels of management, while risk management was often activity rather than enterprise-based”, Roman Tomasic, Beyond Light Touch Regulation of British Banks after the Financial Crisis, in McNeil & O’Brien, 2010, p.115.

31 Swiss Banking Ordinance, art. 65.
8.3.2 Core resolution strategy

On the basis of the collected information on a broad range of conceivable crisis scenarios, resolution plans describe the available resolution options for the authorities when dealing with a failing bank. These scenarios should vary from a liquidity shock to a large systemic crisis like the 2008 financial turmoil. By and large, the analysis of these scenarios will be restricted along the limits of each bank resolution regime. Not every resolution option described under bank legislation will be appropriate given the unique characteristics of each financial institution and the varying context of different financial shocks. Therefore, an analysis of the suitability of each resolution option will be necessary. According to the gravity of the situation, the available funding sources and the potential repercussions of any given resolution intervention on the domestic banking sector as well as on the international markets, resolution authorities will identify the most appropriate resolution tool.

Furthermore, resolution authorities will need to identify the distinct regulatory thresholds and resolution triggers that will call for them to immediately intervene and exercise their powers of resolution. A preliminary planning on this issue will be mainly necessary in cases where the bank resolution regime grants a great flexibility and discretion to the resolution authorities around the interpretation of rules: notably, terms such as ‘possible default’, ‘likely to default’ or ‘likely to fail’ will need to be clearly and consistently defined in order to avoid arbitrary actions or – worse still – inaction on the part of resolution authorities. The notion of triggers, discussed in chapter 4, remains a crucial element of bank resolution. The issue should be clarified in detail under a resolution plan in order to eliminate the risk of the bank’s management omitting key information or lack of action on their part, and protect against regulatory forbearance.

Moreover, based on the information requirements described in the previous section, a resolution plan should set out the essential operations that will allow the troubled financial institution to ensure the continuity of its systemic functions. A resolution plan must identify all of the necessary preparatory measures, internal processes and systems that will enable the domestic authorities to swiftly undertake a legal and economic separation
of the financial institution’s critical functions, and preserve uninterrupted access to specific crucial financial facilities and trading platforms to safeguard the going concern of the bank.\footnote{DG Internal Market and Services, 2011, p.31.}

This procedure will be the heart of the exercise of resolution planning and will require a previous mapping by resolution authorities of the systemic functions. Absent this prior identification, resolution plans will be transformed into a theoretical concept lacking full operational capacities. Resolvability assessments will also play a significant role towards this direction by highlighting the available policies for the identification and separation of such systemic functions from a failing bank without further disruptions in the banking sector or significant cost for taxpayers.

Another crucial aspect of any resolution plan is the evaluation and distribution of resolution funding on the basis of the available financing sources for a troubled bank. Although this issue remains unresolved in most jurisdictions, and resolution funds based on contributions from the financial sector or directly from domestic deposit guarantee schemes have yet to be established, financial institutions should not consider government funding as guaranteed during a resolution procedure. In fact, in line with the core objectives of bank resolution, any funding from government sources should be limited to a minimum (if not prohibited entirely), both during the drafting of resolution plans and the implementation of resolution procedures.

As already discussed in previous chapters, a bank’s shareholders and creditors may be subject to restrictions that infringe upon their rights as a consequence of the implementation of new bank resolution proceedings, and will be expected to bear a significant portion of the relevant resolution costs. A detailed resolution plan should elaborate on these issues and provide guidelines under the different potential crisis scenarios regarding the treatment of the various classes of creditors and the potential distribution of losses. This will be of particular importance with regards to the implementation of bail-in practices: resolution strategies outlined in resolution plans should include a comparative estimate of the losses that might ultimately be borne by creditors.\footnote{FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.39.} One must keep in mind, however,
that the broader losses imposed on creditors may be much greater than those initially envisaged in the context of a financial crisis, given the rapidly evolving situation.

Finally, it is important to re-emphasise that resolution plans primarily impact systemically important banks with cross-border financial operations. Given the international scope of, and the sheer complexity associated with resolving such global banks, it is vital that issues relating to cross-border cooperation and communication are taken into consideration when such plans are developed: some of a financial institution’s assets might be located abroad, for example, or certain financial contracts might be subject to foreign law. Thus, resolution plans should identify these challenges, as well as the particularities of the foreign banking legislation rules that might be called into practice. Above all, it will be a positive and necessary step to explore the options for the recognition and enforcement of the decisions of domestic authorities abroad.

Cross-border cooperation and communication will be essential and resolution plans can show the way for the effective implementation of these vague notions. Domestic plans will provide a first ‘roadmap’ with regards to the treatment of a potential crisis and their conclusions should be borne into consideration for the development of group resolution plans.

Finally, one should not overlook the fact that resolution procedures, even when applied exclusively to a specific legal entity, can have broad impacts for other market participants with similar business lines or for the performance of financial contracts. If these impacts are not foreseen and timely explored, resolution proceedings can contribute to further financial contagion. Consequently, it is essential that resolution plans bear into consideration these critical interdependencies and analyse their potential progression amidst bank resolution proceedings.

Ibid.

For instance, the collapse of Lehman Brothers caused significant disruption to payment and settlement services when a large number of hedge funds lost access to their credit lines after Lehman’s bankruptcy, Cihak & Nier, 2009, p.4.
8.4 General governance and oversight of resolution plans

The debate regarding the actual scope of application for resolution plans remains open. It is argued here that the requirement of resolution planning should concern exclusively systemic financial institutions, both domestic and international, and not small or medium sized bank. Most financial centres accept the implementation of resolution planning policies only for SIBs. Due to their complex corporate structure, their important financial exposure and the significant interconnectedness resulting from the great number of counterparties and contractual obligations, SIBs should remain the basic target group for the establishment of resolution plans. Ordinary, small-sized financial institutions do not have the necessary financial and human resources in order to complete successfully such an exercise. In addition, their failure will not result in significant repercussions in the financial system or become the source of greater financial contagion.

A crucial element of resolution plans is their confidential nature. Only a small part of each plan can become public, presenting exclusively the basic principles of action of resolution authorities and drawing attention to the specific group entities that will play a central role in a resolution procedure.

State authorities involved in resolution proceedings form an integral part of the development process of resolution plans, and should have responsibility for the general oversight of such plans. It is important that resolution authorities are able to contribute their resources and expertise

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36 FSB, REVIEW ON RESOLUTION REGIMES, 2013, p.32. A notable exception is the Special Resolution Regime of the UK Banking Act covering any credit institution (not only those of systemic importance). In addition, the EU adopted a controversial approach on this issue. On the one hand, the EU Bank Recovery and Resolution Directive requires resolution authorities to draft individual resolution plans for each institution not part of a banking group as well as group plans for the parent undertaking and individual subsidiaries, parts of a banking group, EU BANK RECOVERY AND RESOLUTION DIRECTIVE, art. 10 and 12. On the other hand, it highlights that the individual plan should contain a description of the critical functions and core business lines and of the necessary actions ensuring their continuity amidst a crisis, ibid, art. 10(7)(c). It is questionable, though, how the resolution authorities should behave if the institution in question does not operate any systemic (critical) functions.
to the drafting of resolution plans. Ideally, national authorities should be empowered (according to clear criteria) to order a bank to make changes to its legal and operational structure, business practices, or risk assessment or decision-making policies to facilitate the implementation of resolution actions in the event that the bank’s resolution plan is deemed to be inadequate or lacking in credibility. In most jurisdictions, however, national authorities still lack the legal power to require such changes from financial institutions.\(^{37}\)

Such powers for resolution authorities – to intervene and address the problems that are identified under a resolution plan – are absolutely necessary. There is a growing consensus among international standard-setting bodies that resolution authorities should be able to correct these deficiencies highlighted through resolution planning. The proposed measures to a financial institution could involve restrictions to its individual or aggregate exposure, restrictions to existing or future activities, limits to the development of new business lines, changes of the legal or operational structure.\(^{38}\) Through such powers, resolution authorities may contribute to the establishment of a reasonable degree of consistency among the resolution plans of different financial institutions, respecting, however, the individual challenges that each one can pose.\(^{39}\)

Resolution authorities can intervene not only during the process of drafting a resolution plan, but also during subsequent reviews of the plan. Resolution plans should be maintained as ‘living documents’, which are updated and amended over time to take account of any material changes such as changes in the firm’s organisation and corporate structures or business operations that might impact their resolution plans. This relies on financial institutions providing timely updates to resolution authorities; ideally, reviews and updates of a resolution plan should take place at least once a year, to ensure that they accurately reflect the current financial condition of the institution.

Domestic resolution authorities can also decide at any point to verify that a resolution plan is up-to-date; financial institutions might therefore be expected to supply authorities with recent information on their

\(^{38}\) DG Internal Market and Services, 2011, p.35.
\(^{39}\) FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.35.
financial condition in a swift manner. Financial institutions must also engage periodically in simulation, stress tests or scenario exercises upon the request of resolution authorities in order to test the practical aspects of resolution plans. Based on current practices, scenario analysis is considered much more dynamic than simple stress-testing: while stress-testing is based mainly on quantitative criteria (most commonly focuses purely on projected losses), scenario analysis also involves a qualitative assessment (with the financial institution and the resolution authorities simulating their roles in various potential resolution scenarios and anticipating the reactions of other financial actors such as contractual counterparties and foreign authorities).

It is still unclear how resolution planning will be organised, once a plan has been reviewed by the authorities or modified by the concerned financial institution, but it is still believed that its implementation will not provide the expected outcomes. Resolution authorities should be able to impose potential changes to the structure and operations of the bank. The European Commission believes that the financial institution should be allowed to advance alternative measures to the proposals of the authorities. Consequently, during a certain limited time period, resolution authorities should explore the potential implementation of these alternative measures and their implications for a possible resolution.

However, resolution authorities should always maintain the last word. If they do not consider the proposed revised measures as credible, the financial institution should implement the changes required by them. In Switzerland and the US, resolution authorities will be able to impose supervisory and regulatory sanctions, if financial institutions fail to keep their resolution plans up-to-date, to submit a revised resolution plan or to address the weaknesses in their plans highlighted by the authorities.

Keeping resolution plans up-to-date will require a constant open dialogue between resolution authorities and the concerned financial institutions. The first remain responsible for the general oversight of this whole
process and they should be able to intervene actively, organise crisis simulation scenarios and participate in reviews of resolution plans. Such actions can eventually result in drastic changes for a financial institution that does not comply with the requirements of bank resolution legislation. The first stage of such interventions should be implemented through recommendations from resolution authorities and should allow financial institutions to counter-propose alternative measures. Sanctions should fall at the final stage, under the premise that a financial institution fails to comply with the instructions of resolution authorities and, as a result, its resolution could be subject to substantial impediments. If the authorities lack the power to compel necessary changes, the entire exercise risks becoming a senseless and costly ticking of boxes.44

8.5 Group resolution plans

National authorities are at different stages with the development of resolution plans. In general, however – as stressed in the previous sections – most jurisdictions have focused to date on developing resolution plans on a single legal entity basis, with each plan addressing the financial challenges and corporate organisation specific to each group entity. However, many G-SIBs are highly complex structures that operate on an international basis, comprising numerous entities and with a variety of cross-border activities and business lines. Such banking groups should therefore be required to prepare a group resolution plan. Such a group resolution plan must not simply be a patchwork of the resolution plans established separately for each entity;45 on the contrary, it should take into consideration the particularities of the group’s structure and operations and promoting the interests of cross-border coordination and sharing of information in bank resolution proceedings.

By and large, financial institutions are already required under state legislation to maintain information not only on a single legal entity basis

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44 Claessens, Herring & Schoenmaker, 2010, p.64.
45 As stated by Goodhart and Schoenmaker, banking groups should “have one overall living will rather than a string of national living wills lumped together”, Avgouleas, Goodhart & Schoenmaker, 2010, p.2.
but also on a group basis.\textsuperscript{46} Such regulatory norms and conditions can be used as the foundation for the establishment of broader group resolution plans.

Whilst a group resolution plan should be based on the information provided by each domestic legal entity, it should focus principally on issues related to: cooperation and information sharing between national authorities of the different jurisdictions; coordination of divergent resolution procedures; and the impact of these procedures on assets, financial contracts and counterparties that may be located in numerous jurisdictions and subject to a variety of national laws. Group resolution plans should primarily identify and assess: when a consolidated group resolution would be appropriate; the options and the resolution tools that would facilitate such group resolution; any potential legal and financial impediments to the implementation of such measures; the likely impacts of such a decision; and the rules that would enable coordination arrangements among the resolution authorities involved in the process.\textsuperscript{47}

On this basis, the choice of a suitable resolution strategy should be an integral part of the group resolution plan. It will be crucial to identify if the group should be subject to a single or multiple point of entry bank resolution procedure.\textsuperscript{48} There are unique advantages and challenges associated with either option, and each must be subject to specific requirements in order to be effective.

An additional important element concerns the source(s) of resolution funding. Although this issue is most likely to be dealt with on a domestic basis, and for each separate entity, it would be prudent to introduce in the plan basic agreements on a potential burden-sharing scheme relating to resolution costs between the participating resolution authorities. These agreements could essentially be in the form of guidelines, since the final resolution costs could exceed even the most rigorous planning.

Obviously, the preparation of group resolution plans demands a substantial degree of involvement by home and host supervisory, regulatory

\textsuperscript{46} BCBS, 2011, p.38.
\textsuperscript{47} DG Internal Market and Services, 2011, p.33.
\textsuperscript{48} According to the first scenario, the resolution powers will be exercised at the level of the holding or parent company; in the second case, multiple entities of the group will be subject to resolution tools implemented by more than one resolution authorities. For more information on the issue of the point of entry of cross-border bank resolution see section 12.3.
and resolution authorities. Due to the inevitable divergences between the existing resolution regimes of the different jurisdictions participating in resolution proceedings, the available resolution options under bank legislation and the different legal and corporate mentalities, a common decision for a group resolution plan will require enormous coordination and information exchange efforts. Without concrete standards and conditions on the conduct of such efforts, this aspect could become the Achilles heel of group resolution plans.

According to the rules regarding authorities’ cooperation elaborated through cross-border cooperation agreements, crisis management groups should be responsible for the drafting and review of group resolution plans for G-SIBs, as well as for assessing the overall resolution strategy. Financial institutions should provide crisis management groups with timely information concerning any material structural or operational change that might have significant impacts on the group resolution plan. The participating authorities should also be allowed to organise crisis simulation exercises in order to test the efficiency of the group resolution plans; such exercises should be conducted at least annually if not more frequently.

A lead authority should be identified and appointed to lead the drafting of a group resolution plan and – if the need arises – to oversee its implementation. According to current regulatory trends, home resolution authorities are responsible for taking the lead in terms of coordination with the other participating authorities.

One very delicate issue will be the adoption of measures improving the resolvability of the group and removing any impediments towards the operational implementation of the group resolution plan. The adoption of such measures will require coordination between the lead authority and the host resolution authorities, if the impediment is located within a group subsidiary. In any event, the participating authorities must come to a joint decision; however, no satisfactory proposals have been put forward to date for breaking a potential stalemate. After all, one cannot exclude that the host jurisdiction does not allow intervention powers to its resolution authorities in case the resolvability of a group entity or the efficiency of a resolution plan are questioned.

According to the EU Commission, if the resolution authorities are unable to reach a joint decision concerning controversial aspects of a group resolution plan within a period of four months, the home resolution
authority should have the ultimate power to decide on the appropriate measures to be taken on behalf of the entire group. The host authority will not be able to refer the matter to EBA after the end of this four-month period. Under no circumstances can it appeal to EBA the final decision of the home resolution authority.

A key weakness of the EU’s proposition is that enforcing such decisions in reality might be challenging, and controversial: whilst the group resolution authority has the authority to impose changes to the business lines or structure of the parent entity, the repercussions of such decisions for the subsidiaries might be substantial, and the enforcement of measures regarding foreign subsidiaries remains subject to foreign law, and will depend on the will of the host authorities. Therefore, allowing the home authority to ‘highjack’ the procedure and impose its solution on the other authorities is not the right way forward. Rather, decisions that might demand far-reaching structural or business changes for the whole banking group should be coordinated, and only be taken at the level of the EU resolution colleges.

The potential for conflicts of interest between national authorities during the elaboration of group resolution plans highlights the importance of establishing efficient dispute mediation mechanisms that could effectively play a mediation role in the event that there is disagreement around key decisions. The cooperation between the participating authorities should not be considered straightforward and occasional conflicts will definitely take place. Without a dispute resolution mechanism, there is the risk that national authorities will resort to ‘ring-fencing’ practices if they are unable to reach agreement.

Poor – or inexistent – cooperation between domestic crisis management authorities was a key factor that amplified the 2008 financial crisis. Furthermore, within most global banking groups there still exists a mismatch between their economic and legal realities. A change in mentality regarding cross-border cooperation is therefore essential. Current bank resolution regimes – and the resolution authorities involved in their design and implementation – should prioritise the development of group resolution plans rather than individual plans for each group entity. The

49 EU Bank Recovery and Resolution Directive, art. 13(5).
50 Ibid.
advantages of group plans in the context of modern banking are many: they allow for a better comprehension of group structures; improved interconnectedness between the constituent entities; and the possibility for participating authorities to share the burden of decision-making and responsibility during a financial crisis. Clearly, however, the development, review and implementation of such plans requires that the participating authorities have a certain level of expertise and are willing and able to commit substantial resources to such an exercise.

Ultimately, if the resolution planning process is to successfully expand to consider global resolution plans, and in order to ensure coherence and consistency between such plans, the development of straightforward standards aimed at fostering cross-border cooperation between resolution authorities will be essential. If successful, this should ideally result in an expansion in the number of global, coherent plans developed by resolution authorities for financial institutions operating on a cross-border basis, and a corresponding reduction in the number individual and unconnected resolution plans being filed by such financial institutions and each of their constituent entities operating in different jurisdictions.51

### 8.6 Concluding remarks: potential obstacles to resolution planning

Resolution planning has become a fundamental component of bank resolution regimes since the 2008 crisis as a means of improving financial institution’s crisis management strategies in order to reduce their reliance on government support and bailouts. Thus, resolution plans are intended to reduce moral hazard and to foster better market discipline with the ultimate aim of safeguarding the viability of the banking sector.52 They

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52 Hüpkes, 2009b, p.293. 79% of the major financial institutions participating in a global research conducted by Ernst & Young on the issue of resolution planning highlighted that they expect benefits from this procedure, which include “gaining a better operational understanding of the business overall, a reduction in the complexity of the business and greater insight into how to best use available capital and liquidity across the group”, Ernst&Young, 2012, p.3.
could also add to increasing the transparency and predictability of resolution proceedings, especially with regards to providing greater clarity and certainty about the treatment of shareholders’ and creditors’ rights in a resolution, and the impact of the resolution procedure on financial contracts.

Nonetheless, some key challenges to the wider rollout and implementation of resolution plans remain; such challenges could jeopardise the success of bank resolution efforts.

As highlighted by the FSB, resolution planning should be a continuing exercise for both financial institutions and resolution authorities.\(^{53}\) Keeping resolution plans up to date, however, could become a daunting task for banks and resolution authorities, requiring significant financial resources, personnel and expertise. Resolution plans should be updated not only according to specific timelines established by the authorities but also every time there is a substantial change in the structure, business lines or risk exposure of a bank, as well as during the first signs of a crisis.

Secondly, resolution plans are based on specific scenarios and analyse particular circumstances in a critical moment in time. Yet, the various micro- and macro-economic factors surrounding a crisis event can evolve rapidly and abruptly and this makes it very challenging to predict future conditions with any degree of certainty.\(^{54}\) The banking industry is a dynamic and rapidly evolving business, presenting important challenges for a resolution plan that has to remain updated and relevant during a future crisis situation.\(^{55}\) It therefore remains to be seen whether a resolution plan – based on a very substantial volume of information – can be rapidly modified in order to reflect the latest financial or risk exposure conditions of an international bank.

Another consideration is that, during the process of drafting a resolution plan, resolution authorities should treat the information provided by financial institutions with caution: since this information will be the basis for the establishment of the plan, it should always be critically evaluated. Blind trust on the part of national state authorities in the information

\(^{53}\) FSB, Reducing the Moral Hazard Posed by SIFIs, 2010, p.5.

\(^{54}\) Sester, 2010a, p.215.

provided by a bank could have catastrophic implications for bank resolution, if it subsequently transpires that the bank did not evaluate its business and financial status correctly. This could present a particular risk under the current US resolution system, where the financial institutions will draft directly their resolution plans, and the regulator’s role will simply be to approve these plans. Resolution authorities should therefore maintain a dialogue with the financial institutions, questioning and evaluating critical information; this is vital, to help shape the practice and future developments in the field of resolution planning.\(^{56}\)

An additional potential risk is that national resolution authorities might come to rely too heavily on resolution plans. Whilst these plans should serve as the principal guidelines during bank resolution proceedings, they have the potential to create the illusion that the resolution process will evolve exactly as described under the plan. This could lead to passivity on the part of resolution authorities.

There are also challenges related to stress-tests and scenario analysis, which accompany resolution planning. The 2008 financial crisis revealed fundamental weaknesses in simple stress testing models, which were unable to uncover highly adverse and low probability scenarios.\(^{57}\) Thus, such tests should be accordingly modified to fulfil the current, more demanding requirements of bank resolution regimes. Scenario analysis, for example, will play a much more integral part in future resolution plans and should, therefore, be subject to stricter conditions.

Another important aspect that has become a source of preoccupation for financial institutions is the confidentiality of resolution plans. Confidentiality has been repeatedly stressed as a basic element of resolution plans.\(^{58}\) Yet, straightforward standards on this issue have yet to be developed under domestic bank resolution legislation. Since resolution plans will contain sensitive information concerning a banking group, direct sharing of information between the competent authorities could become

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\(^{57}\) James Fanto, Stress Testing and Scenario Analysis in Risk Management: Preparing for the Worst, in Mitchell & Wilmarth, 2010, p.82. Due to such critiques, the FSB called supervisors to “steer institutions to be creative in their macroeconomic scenarios, i.e. expand their scale and enlarge their scope by including more scenarios and more risk factors with selected scenarios”, FSB, Supervisory Intensity and Effectiveness, 2014, p.11.

\(^{58}\) For instance, IMF, 2010b, p.12.
problematic. If confidential material is leaked to the public, this could have substantial competitive or financial consequences for a bank; especially so if there is any suggestion that the bank is significantly exposed to risks, highly leveraged, or excessively complex. Moreover, the duty to safeguard confidentiality will need to be intensified amid a financial crisis, when basic elements of the resolution plan could become subject to substantial changes.

Clearly, these issues around confidentiality are heightened further in relation to group resolution plans, which necessitate the sharing of information on a cross-border basis. The greater the number of authorities involved, the greater the potential for confidential information to be leaked; or, indeed, for information to be withheld with the prospect of potential ring-fencing practices during resolution.

Finally, it will be important to have a transition from resolution plans on a solo legal entity basis to consolidated cross-border group resolution plans. The issue of cross-border resolution plans is interrelated with the developments in the field of cross-border information exchange and cooperation, as well as with the harmonisation of domestic bank resolution legislations. The collection of information on a cross-border basis in order to establish a cross-border resolution plan can be a dissuading exercise for resolution authorities. Resolution regulators will hit a dead-end if more solid international cooperation standards will not be in place.

Many financial institutions are preoccupied due to the great number of existing domestic provisions on the establishment of resolution plans. Cross-border groups will be obliged to use substantial resources and expertise in order to comply with this variety of, sometimes, diverging requirements. Hence, the focus of regulators should shift towards the elaboration of consolidated group resolution plans.

Further ambiguity exists regarding the ability of a national resolution authority to intervene in situations whereby a financial institution is

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59 UK firms estimated spending each $ 20 mn on average, US banks estimated $ 13 mn on average and Japanese banks estimated an average of $ 4 mn, ERSNYOUNG, 2012, p.3. These estimates do not include any costs that banks may have to incur in order to overcome barriers to resolution. European and Japanese banks were also more optimistic in their responses regarding the final cost of the procedure as, at the time the research was conducted, they were at the earlier stages of the process and, consequently, less aware of the cost implications that may arise, ibid, p.6.
unwilling – or unable – to introduce the reforms that are necessary in order to render its resolution plan feasible and improve its resolvability. There are concerns that some reforms imposed by authorities – such as those, for example, that would require a financial institution to downsize or change its business lines – could have important cross-border financial spillover effects. In the absence of international consultations, unilateral actions could do more harm than good. The EU, for instance, has warned that any measures affecting a bank’s business models or undermining the single market principles should not be adopted without serious consideration, as such measures might reverse the integration trend in the internal market and force banks to reconsider the centralisation of key management functions currently found across different business lines.60

Under the rules of the EU Bank Recovery and Resolution Directive, EU banking groups should develop formal resolution plans from 2015 onwards. All US systemic financial institutions, as well as the two Swiss G-SIBs, already completed this exercise. This first experience is of great importance in testing whether resolution planning will simply remain an administrative exercise, or whether it can actually become part of a credible bank resolution regime.61

The general ongoing regulatory developments in the field of bank resolution will be highly influential on resolution planning too. It is uncertain, though, how the requirements for the establishment of resolution plans will be fulfilled within resolution regimes, which are either still incomplete or already under reform; 62 it has been stressed repeatedly that resolution regimes in their current form present weaknesses and their efficiency could be questioned. Furthermore, their, frequently, significant divergences could undermine the process of establishing fully operational

61 Guynn stresses that “regulators are still in learning mode and standards are still evolving”, hence, resolution plans will continue to evolve especially after their first submission, Randall D. Guynn, Resolution Planning in the U.S., in Dombret & Kenadjian, 2013, p.154.
resolution plans on a cross-border group basis. One could, therefore, argue that, regarding resolution planning, regulators may have actually put the cart before the horse.

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63 The responses of the interviewed financial institutions to the research conducted by Ernst & Young demonstrated “lack of clarity over what is required in a resolution plan” and “varying positions that individual regulators are taking toward their development”, Ernst&Young, 2012, p.5.
Chapter 9

RESOLUTION FUNDING

“We need to build a system which ensures that the financial sector will pay the cost of banking crises in the future. That is why I believe that banks should be asked to contribute to a fund designed to manage bank failure, protect financial stability and limit contagion – but which is not a bail-out fund”

Michel Barnier, former EU Internal Market and Services Commissioner

The issue of funding has sparked a lively debate around the efficiency of resolution proceedings. There is a broad consensus that the era of bailing out financial institutions is well and truly over. Following the widespread bail-out fatigue among taxpayers, attention turned towards the possibility of creating special mechanisms to deal with future banking failures.

Similar to environmental and criminal law, new rules on bank resolution endorse the ‘polluter pays’ principle; financial institutions should be held solely responsible for bearing all financial and fiscal costs associated with their rescue. In other words, instead of a bank being bailed out by taxpayers or the government, it should be the shareholders and creditors who accept the losses of an ailing bank, just as in any other failing business. However, bank resolution procedures – applied by resolution authorities in order to stabilise a failing bank – can have very significant cost implications.

The establishment of a bridge bank, for example, will call for the use of significant sums; the procedure of an asset separation will require funds for the creation of a special purpose vehicle to purchase and take over the management of ‘toxic’ assets and for the losses that their administration

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2 The 2008 bailout and the other indirect support measures for the financial systems of the G-20 countries resulted in fiscal costs that averaged 2.8% of their total GDP, from the initial 6.2% of GDP that had been pledged for direct government support, IMF, 2010a, p.7.
can produce; and, finally, a sale of the business (even a partial one) to third party private purchasers may also require financing, mainly in the form of guarantees for the financial institution on sale. Additionally, one must not forget the range of legal and administrative fees that bank resolution procedures might also give rise to. Therefore, this highlights the importance of developing credible funding mechanisms on which resolution authorities can rely in order to fund a resolution process.

This chapter examines the various types of funding mechanisms that have been proposed to support the financing of a resolution procedure. The issue of resolution funding is extremely complex and could indeed form the subject of an entirely separate work in itself. Therefore, the objective of this chapter is not to examine this topic exhaustively, but rather to touch upon the main aspects that are currently being discussed at the international level. The first section outlines some of the more popular approaches to funding resolution processes and bail-in, and also introduces more innovative ideas to funding – such as those based on financial taxes and private sector arrangements. It also outlines the role of central banks with regards to liquidity financing. The second section highlights the potential challenges in relation to cross-border resolution funding.

### 9.1 Forms of resolution funding

The Basel Committee makes a broad distinction between three main types of bank resolution funding arrangements, as follows: (i) voluntary (private sector) arrangements; (ii) institutionalised arrangements; and (iii) discretionary funding options.\(^3\) The latter has been excluded from this analysis, however, since these options will be based entirely on *ad hoc* arrangements elaborated on an *ex post* basis by resolution authorities; thus they could not serve the principal objectives of bank resolution (i.e. the mitigation of moral hazard and the elimination of bail-out practices).

The analysis begins by considering the second of these three options: this option seems to be the most common – as well as the most preferable – solution for resolution financing. To clarify, ‘institutionalised
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arrangements cover: the creation of resolution funds; the use of taxes on banking and other financial operations; and the exercise of statutory resolution powers through the bail-in tool.

The role of central banks and treasuries within resolution funding mechanisms is also highlighted: the contribution of central banks will be vital in terms of providing the capital needed to facilitate the liquidity of a new banking entity or a bridge bank resulting from bank resolution. Treasuries may also need to intervene, but only if and when all other available resolution funding mechanisms have proved insufficient.

9.1.1 Resolution funds

9.1.1.1 Sources of financing

The establishment of a network of national bank resolution funds has become the principal option for ensuring that individual jurisdictions have sufficient funds to manage a bank’s failure in an orderly way, so that the cost of future bank failures are not met by the taxpayer. The international standard-setting bodies identify resolution funds as the most credible solution for the sizeable gross financing needs of bank resolution.4 Ultimately, imposing a statutory requirement on the financial sector to contribute to a fund designed to manage bank failure would form part of a broader regulatory framework aimed at protecting financial future stability and minimising moral hazard risks.

It is important to make a distinction between resolution funds and privately funded protection funds: whilst the latter have been also popular, they can only be used to fund the implementation of resolution actions, excluding the cases of payouts under resolution.5

Numerous jurisdictions already provide the framework for the operation of dedicated pre-funded mechanisms that can be used to support the resolution of individual banks. In the US, for example, both the FDIA

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4 The European Commission maintained that “resolution funds must not be used as an insurance against failure or to bail out failing banks, but rather to facilitate an orderly failure”, European Commission, Communication on Bank Resolution Funds, 2010, p.3.

5 This is the case for the funds established in the UK, France, Canada, Italy and the Netherlands, FSB, Review on Resolution Regimes, 2013, p.79.
and the Dodd-Frank Act require the establishment of *ex ante* resolution funds.\textsuperscript{6} Within the EU, Sweden and Germany were the first EU Member States to have built up dedicated resolution funds – the Special Stability Fund in the case of Sweden, and the Special Financial Market Stabilisation Fund (SoFFin) in Germany – that may be drawn on to fund the resolution of SIBs in the future.\textsuperscript{7} A centralised Single Bank Resolution Fund is also planned to be established for participating Member States in the Eurozone as an essential part of the SRM.\textsuperscript{8} Elsewhere, Japan is one of the few other jurisdictions to have introduced detailed requirements for the operation of a resolution fund.\textsuperscript{9}

Nonetheless, the most complicated – and potentially contentious – aspect regarding resolution funds is how they should be financed; specifically, on what basis they should be financed, and by whom. Two main alternatives have been proposed: (a) contributions by deposit guarantee schemes and/or (b) direct levies from the banking sector. A comparison of the salient features of each of these alternatives can be found below.

9.1.1.1.a *The contribution of deposit guarantee schemes*

Deposit guarantee schemes (DGS) can, under specific conditions, be used to fund bank resolution. Such partial contributions could provide a rapid source of solvency financing. A number of jurisdictions can already use their DGSs in order to fund bank resolution,\textsuperscript{10} and in principle such an option should be feasible.

In the US, one of the main tasks of the FDIC – as the leading US authority appointed as a conservator or receiver in connection with any bank resolution procedure\textsuperscript{11} – is to offer deposit insurance in the event of the

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\textsuperscript{6} The FDIA has created for depository banks a resolution fund under its Section 11A whereas the Dodd-Frank has established an Orderly Liquidation Fund under the US Treasury, available to the FDIC for the resolution of all financial companies covered by the Act, *Dodd-Frank Act*, Title II, § 210(n).

\textsuperscript{7} European Commission, *Communication on Bank Resolution Funds*, 2010, p.10.

\textsuperscript{8} EU Regulation on a Single Resolution Mechanism, art. 67.

\textsuperscript{9} FSB, *Review on Resolution Regimes*, 2013, p.79.

\textsuperscript{10} For instance, Brazil, Canada, Japan, Korea, Mexico, Russia, Spain and the US, Burke, 2015, p.6.

\textsuperscript{11} See FDIA, §§ 11(c)–(d) and *Dodd-Frank Act*, Title II, §§ 202, 204 and 210.
failure of any US deposit-taking financial institution.\textsuperscript{12} In relation to the resolution of investment firms and holding companies, the FDIC may obtain credit or incur debt on behalf of the covered financial company if it is unable to receive credit from commercial sources.\textsuperscript{13} In particular, the FDIC may provide funding to a bridge financial institution in order to facilitate the latter’s acquisition of any assets or liabilities of a resolved financial company.\textsuperscript{14} The funds provided by the FDIC are guaranteed through the Orderly Liquidation Fund.\textsuperscript{15}

Insuring and protecting depositors from the failure of a financial institution is the primary objective of a DGS; this is in contrast to bank resolution, which has a range of objectives, of which the safeguard of deposits is just one. Thus, while the objectives of both may overlap, deposit insurance and resolution are, in principle, separate functions. Specific conditions should, therefore, be imposed on the role of DGS in resolution funding. The main restriction covers the requirement for DGS to contribute up to the amount of covered deposits of the troubled bank and only for the amount of losses that the DGS would have suffered were the bank to have been subject to an insolvency procedure. A contribution over these limits would go far beyond the institutional role of DGS, and could even jeopardise their financial health, especially amidst a broad financial crisis. Using DGS for resolution funding purposes in this way would necessitate significant legal amendments to the banking legislation of many states where the use of DGS is currently restricted to the direct repayment of retail depositors.\textsuperscript{16}

A clear illustration of this argument can be found in the context of the EU. For the European Commission, the funds of DGS could be used for bank resolution provided the following two conditions are met: (i) DGS funds are used only for the resolution of depositary institutions and regarding resolution methods that safeguard the access to deposits; and

\begin{itemize}
  \item \textsuperscript{12} \textit{FDIA}, § 11(a).
  \item \textsuperscript{13} \textit{Dodd-Frank Act}, Title II, § 210(b)(2). In this scenario, the expenses of the FDIC shall have priority over any or all administrative expenses incurred during the resolution procedure.
  \item \textsuperscript{14} \textit{Ibid}, § 210(h)(9). The funding provided by the FDIC is subject to the establishment of an orderly liquidation plan by the FDIC deemed acceptable by the Secretary of the Treasury, \textit{ibid}, § 210(n)(9).
  \item \textsuperscript{15} For the functions of the OLF see p.63.
  \item \textsuperscript{16} For instance Switzerland, Sweden and Belgium, BCBS, 2011, p.23.
\end{itemize}
(ii) the amount of DGS funds should not exceed the amount that would have been necessary to repay depositors if the bank had been wound up under normal insolvency proceedings.\textsuperscript{17}

The Internal Market and Services division of the European Commission had been of the opinion that “states should be permitted to merge the DGS and the Fund into a single legal entity”.\textsuperscript{18} The Commission nonetheless remained cautious with regards to such a proposition, expressing concern that a resolution financing system funded purely on the basis of insured deposits would unfairly favour larger, international banks with diversified portfolios of activities at the expenses of smaller depositary banks.\textsuperscript{19}

A further challenge is that resolution aid provided through DGS might fall under the category of state aid; and as such, may subsequently be scrutinised under competition law. This will be the case for EU resolution practices.\textsuperscript{20} The EU Commission considers that such resolution funds may constitute state aid if “they come within the control of the State and the decision as to the funds’ application is imputable to the State”.\textsuperscript{21}

If a deposit guarantee scheme becomes eventually involved in resolution funding, it should receive a privileged position regarding its

\textsuperscript{17} \textit{EU Bank Recovery and Resolution Directive}, art. 109(1) and \textit{EU Regulation on a Single Resolution Mechanism}, 2013, art. 79(5).

\textsuperscript{18} \textit{DG Internal market and services}, 2011, p.85.


\textsuperscript{20} “\textit{State aid may be involved, inter alia, where resolution funds or deposit guarantee funds intervene to assist in the resolution of failing institutions}” and “\textit{the use of extraordinary financial support or resolution funds, including deposit guarantee funds, to assist in the resolution of failing institutions should be assessed in accordance with relevant State aid provisions}”, \textit{EU Bank Recovery and Resolution Directive}, recitals 47 and 55. Grünewald presents two examples regarding the use of DGS in order to complete the resolution of failing financial institutions. The first concerns the Italian public sector bank \textit{Sicilcassa} and the second refers to the failure of Bradford & Bingley in the UK. The argumentation of the Commission in these two cases (accepted the first intervention on the ground of the independent decision-making of the Italian DGS – \textit{Fondo Interbancario di Tutela dei Depositi} – but rejected the second as in its opinion the UK Financial Services Compensation Scheme acted under the predominant influence of the State, through a parliamentary act and a backing from the UK Treasury) could provide some elements of interpretation regarding the proper use of DGS in future resolution actions, Grünewald, 2014, pp.130–131.

\textsuperscript{21} \textit{European Commission, Communication on the Application of State Aid Rules}, 2013, par.63.
reimbursement, with a priority ranking over any other unsecured creditor. The solution for a pari passu ranking of deposit guarantee schemes with secured preferred claims in the case of the EU Bank Recovery and Resolution Directive\(^\text{22}\) seems appropriate. Moreover, it might be interpreted as an incentive for the participation of DGS in resolution funding.

Ultimately, such a form of financing will only be possible in connection with depositary financial institutions, and will not be appropriate with regards to pure investment banks or investment firms, since only the former contributes to the funding of DGS. Thus, alternative sources of funding will be necessary for the latter investment entities.

Consequently, if DGS financing is to play any role, it must be a secondary one; or else it must operate in combination with levies from the financial sector, introduced as a means of financing resolution funds and covering the direct and other fiscal costs associated with future financial failures.

### 9.1.1.1.b Levies from the banking sector

The imposition of levies on banks to fund the cost of future failing banks is entirely in keeping with the ‘polluter pays’ principle. Banks would be required to pay a levy into a resolutions fund, with the main objectives being: (i) to reduce the probability and costliness of future financial crises; (ii) to mitigate the ‘too big to fail’ risk; (iii) to ensure that the financial sector itself contributes to the wider fiscal and economic costs of any future financial crises, should they occur; and (iv) to ensure that any support that a financial institution receives during a crisis is repaid in full.\(^\text{23}\)

In 2009, Sweden became the first jurisdiction to introduce levies on the financial sector, which are allocated to a stability fund, managed by the National Debt Office. The government plans to continue to collect an annual ‘stability fee’ from banks and other credit institutions until the fund has reached 2.5% of GDP (the estimated amount that a full-blown banking crisis would normally cost the economy) in 15 years.\(^\text{24}\) Elsewhere

\(^{22}\) EU Bank Recovery and Resolution Directive, art. 109§1.

\(^{23}\) IMF, 2010a, pp.9–10. The European Central Bank considers the involvement of the private sector financing as beneficial element contributing to the significant reduction of future moral hazard, ECB, 2010, p.9.

\(^{24}\) Swedish Ministry of Finance et al., 2010, p.15.
in Europe, Germany introduced a levy exclusively on depositary banks in 2011, with the aim of building a dedicated Restructuring Fund to be drawn upon in the event of a financial crisis. The target for this resolution fund is € 70 bn.\footnote{German Restructuring Fund Act, § 2 and § 12(10).

The EU aims to introduce a European system of national financing arrangements that could be either exclusively or partially funded through direct contributions from the financial sector, EU Bank Recovery and Resolution Directive, art. 99–100. The available financial means of each financing arrangement should reach in a period of 10 years at least 1% of the amounts of deposits of all the credit institutions authorised in the territory of each Member State, ibid, art. 102(1). Regarding the Single Resolution Fund established for the Eurozone member states, its financial means should also reach in period of 8 years (starting from the 1\textsuperscript{st} of January 2016) at least 1% of the amounts of deposits of all the credit institutions authorised in the participating Member States, EU Regulation on a Single Resolution Mechanism, art. 69(1).} Under the guidance of the European Union for the creation of a consolidated crisis management framework, the initiative for the financing of resolutions funds by the financial sector is gaining momentum.\footnote{EU Bank Recovery and Resolution Directive, art. 103(2), (3) and (7) and EU Regulation on a Single Resolution Mechanism, art. 70.}

A key challenge, however, is deciding upon which financial institution should contribute to such funds. Broadly speaking, the design of the levy will depend heavily on the broadness of the resolution policies and the scope of application for the resolution fund. Ideally, the fund should be financed by all financial institutions and not just by depositary banks: if the fund will be used generally for the resolution of any domestic financial institution, then all banks and not just SIBs should pay the levy. Clearly, whatever form the levy takes, it must be designed with extreme caution and in accordance with clear and transparent rules.

Calculating the base for the levy is an even greater challenge: this varies greatly from one jurisdiction to another, and is a topic that continues to be hotly debated. The European Commission favours a levy based on a valuation of liabilities, payment commitments and the risk profile of each institution (excluding own funds and covered deposits).\footnote{European Commission, Communication on Bank Resolution Funds, 2010, p.8.} However, such a valuation might not be entirely accurate since liabilities do not provide a full image of the risk profile of a financial institution.\footnote{The IMF envisaged a levy based on other calculations such as a broad balance sheet test, excluding Tier 1 capital but covering some off-balance sheet items that can represent an important source of systemic risk, as well}
as insured liabilities (excluding equity). In Sweden, the levy takes into consideration all liabilities (excluding equity capital, junior debt securities, and group internal debt transactions).

It is clear that different jurisdictions hold widely divergent views on the matter. Therefore the elaboration of a regional or international standard will be an important next step in order to help reduce fragmentation of such policies at the national level, and avoid the creation of competitive distortions and tensions between national legislative bodies when it comes to the resolution of failing multinational banks.

In any event, the levy should reflect the degree to which any given financial institution contributes to systemic risk. For instance, the Swedish Ministry of Finance plans to introduce a risk-differentiated levy at a future stage as part of its Special Stability Fund.

There is a consensus that financial institutions should be granted a phase-in period, so that they can adjust to such new regulatory requirements. However, this presents yet another risk: this phase-in period can be quite long, thus leaving resolution authorities exposed should a banking crisis occur before the resolution funds have been established. It is therefore imperative that state authorities have clear plans in place regarding the financing of resolution funds in this interim period.

The option of using supplementary funds should not be excluded, especially in the event that a very broad systemic crisis – such as the one of 2008 – should occur. In this case, state jurisdictions need to set specific transparent rules that would be called into action should the amounts of a resolution fund prove inadequate. Treasuries might be obliged to intervene in order to cover part of the resolution costs, and to guarantee the operational implementation of the procedure. The resolution of Banco Espirito Santo, for instance, is a particularly pertinent example of where this has previously been the case.

Nonetheless, the fact that most jurisdictions have not yet developed efficient mechanisms for the recovery of public funds used for bank resolution purposes – or that conditions on the use of such recovery mechanisms are largely absent – is quite alarming.

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30 Swedish Ministry of Finance et al., 2010, p.15.
31 Ibid.
The current US system allows the US Treasury to intervene if the resolution fund is unable to fulfil its tasks regarding the resolution of depositary banks.³³ Recovery charges could be enforced against the resolved financial institutions. Yet, simultaneously the Dodd-Frank Act explicitly prohibits the use of any taxpayers’ money during the exercise of resolution powers by the authorities.³⁴ It is unclear how the resolution costs will be covered if the Orderly Liquidation Fund becomes unable to finance the procedure sufficiently.

In Germany, the resolution fund can impose special contributions on banks to recover any temporary use of public money in case the funds prove insufficient.³⁵ By and large, the EU envisages a recovery mechanism through an allocation of the costs between the financial institutions receiving public financial support.³⁶ These rules remain particularly inconclusive and vague, without precise standards surrounding their implementation.

Seven years after the 2008 crisis, such recovery practices are still subject to significant drawbacks, mainly because of a very slow recovery rate of the cost for government support measures (and that exclusively from the survivors of the crisis).³⁷

The establishment of resolution funds could enhance the resilience of the banking sector and avoid the need to revert to taxpayer funds. However, it is only in recent years since the financial crisis that there has been a significant increase in the number of bank levies being introduced, and the development of resolution funds remains relatively nascent in most jurisdictions. It therefore seems highly probably that were a banking crisis to unfold at this moment in time, the burden of financing bank resolution would still fall largely on the shoulders of state treasuries; especially considering the phase-in period that is required in order to establish such funds, and the size of the current projects on resolution funds. Nevertheless, clear rules on recovery mechanisms of such sums should already be in place in order to limit moral hazard and enhance the bank resolution objectives of public interest.

³³ FDIA, § 11A(c).
³⁴ Dodd-Frank Act, Title II, § 214.
³⁵ FSB, Review on Resolution Regimes, 2013, p.80.
³⁶ EU Bank Recovery and Resolution Directive, art. 104(1) and EU Regulation on a Single Resolution Mechanism, art. 71(1).
³⁷ IMF, 2010a, p.16.
9.1.1.2 A cap on contributions

A particularly controversial issue concerning resolution funds is the optimum size of such funds, in order to ensure financial stability. Specifically, whether the levies imposed on banks should be ‘capped’, such that banks continue to contribute to the fund only until a pre-defined target has been met or whether authorities should leave the resolution funds to grow in perpetuity.

It is argued here that state authorities need to limit the size of the fund rather than allow contributions from the financial sector to accumulate on an unrestricted basis. On this issue, it is positive to view that the Swedish and German authorities have set a limit regarding the future growth of their resolution funds. As highlighted by the European Commission and the IMF, if a resolution fund is allowed to grow beyond the level of what would be required to finance resolution proceedings, there is a risk that the fund could end up being used to finance various other (irrelevant) government policies. Any such deviations from the original purpose of bank resolution could be detrimental to the image of a domestic resolution regime and might raise concerns among those financial institutions who have contributed to the fund regarding how their contributions have been used.

This also relates to the importance of operational independence and the establishment of a transparent mandate for each resolution fund. It should be clear to both the financial institutions contributing to the resolution fund and the resolution authorities that the fund will be used exclusively for the purposes of bank resolution and will remain a constituent part of an efficient resolution regime. Stating the objectives of the fund in such an explicit manner will reduce the potential for improper use of the budget for other government purposes. Conversely, if the fund is not directly connected with the operations of a resolution regime, moral hazard issues will be increased as financial institutions might once again become dependent on public solvency support at the onset of a new financial crisis.

Obviously, placing a cap on the size of the resolution fund is not without its own challenges. Principally, it is virtually impossible to predict the

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39 IMF, 2010a, p.18.
size of a potential future crisis, and there is always the risk that the costs associated with implementing a resolution procedure, especially during a systemic banking crisis – and particularly in the case of a highly adverse scenario – might exceed the limits of the funds available in the resolution fund. In such a scenario, resolution authorities would be forced to resort to public funding to guarantee the completion of bank resolution procedures. The policy strategies surrounding resolution funds would become counterproductive, as moral hazard would still be present in bank rescues.

Consequently, reaching the cap might offer a false sentiment of safety to resolution authorities. It is inherently difficult (if not impossible) to assess the elements and the severity of each financial crisis and, as a result, the size of the fund will be only an approximate estimation.

A potential middle ground should therefore be sought; for example, once the cap has been reached, rather than reducing the contributions made to the fund by the financial institutions to zero, resolution regimes might instead provide clear rules regarding an ongoing limited contribution (in excess of the limit already fixed for the fund).

Therefore, the arguments put forward in favour of introducing a cap on the size of the resolution fund seem compelling, and it would be prudent to set a specific target for the size of each resolution fund. In order to identify these limits, resolution authorities should take into consideration elements such as: the cost of resolution practices or other government support measures for the financial sector during recent crisis events; the impact of reforms with regard to increased capital requirements or the creation of special shock-absorbing capital buffers; whether or not the DGS is contributing to the fund; as well as the direct recovery of certain sums following the completion of certain resolution practices (such as a direct sale of business or the transfer of a bridge bank to private purchasers).

Based on the expected size of the fund, the authorities should fix the contributions of each financial institution. Nonetheless, they should adjust the amounts of contributions, if the fund falls short of its projected size or in the light of new experience resulting from the treatment of a more recent financial crisis.

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41 Schoenmaker, 2010b.
43 DG Internal market and services, 2011, p.84.
9.1.1.3 Ex ante or ex post contributions?

The exact timing of the contributions by the banking sector also remains subject to debate. The current examples indicate, though, a certain preference for ex ante bank levies – i.e. recurrent, charges that fund the cost of future resolutions.\footnote{This is the case for the US and the EU. On the other hand the protection fund created under the UK Banking Act (which is not \textit{stricto sensu} a resolution fund) is based on ex post contributions, \textit{UK Banking Act, §§ 50, 51, 52 and 58.}}

Despite the diversity of solutions adopted by different jurisdictions to date, the adoption of an \textit{ex ante} funding structure would be the most suitable option. In this case, resolution authorities will be better able to use the funds to address the challenges of a financial crisis; especially during its first stage, when panic spreads rapidly and authorities need to make measured yet swift and decisive decisions. \textit{Ex ante} levies could also prove important in safeguarding taxpayers’ and government’s money that would otherwise have to be used until the collection of the ex post funds is complete.

It has been argued that \textit{ex post} funding is a more preferable option in order to minimise risks of moral hazard. Such policies are part of the dogma of constructive ambiguity with regards to the final course of actions of resolution authorities. On the contrary, it is estimated that moral hazard will be better mitigated by the rapid intervention of the authorities and the minimisation of spillover effects and contagion risks for financial stability.

It has been also stressed that an \textit{ex post} funding system could result in a much more fair allocation of the costs, since the actual cost of the recovery will be known, and thus the exact contribution required from each financial institution can be fixed accordingly. Whilst there is a certain degree of logic to this argument, given the complexity of modern interconnected global markets it would be very difficult, even after the event, to calculate with any precision the exact negative externalities that each bank can pose to the domestic and global economy and thus the size of the \textit{ex post} contributions each institution should be expected to pay. The size, risk exposures and third party commitments of a financial institution could draw a general picture but cannot guarantee accuracy.
In addition, establishing a reasonable account of every potential impact of each bank failure would be a very lengthy exercise; during this time, the financial sector might continue to face ongoing problems and the use of public money will remain essential. Following the 2008 collapse, it took years to properly evaluate the overall cost of public bail-outs. In addition, the rate of recovery of such public funds was very slow following the 2008 crisis, which further supports the argument in favour of \textit{ex ante} funding. As a great number of banks still struggle to overcome the nearly disastrous repercussions of the financial meltdown, and certain among them have been also facing new challenges, \textit{ex post} banking levies could become once again tantamount to blank checks from state authorities.

\textit{Ex ante} contributions to resolution funds seem to be the preferable option. Their implementation requires detailed rules on the criteria used for their valuation in order to address regulatory uncertainty and minimise the potential unfairness regarding distribution of the eventual costs of a crisis. Moral hazard will be significantly reduced as banks will be reluctant to take excessive risks knowing that they will not be bailed out by public funding. Additional contributions to the fund should nonetheless not be excluded in case a financial crisis surpasses the capacities of the resolution fund; for instance in the event of a broad systemic crisis affecting multiple financial actors. Nonetheless, clear-cut recovery mechanisms must be built into bank resolution schemes to mitigate any risks associated with such a scenario, and these must enter into force at the same time as the rules on domestic resolution funds.

\section*{9.1.2 Taxes on banking and financial activities}

Taxing financial transactions or specific financial activities is another – more radical – proposal to support the financing of bank resolution procedures. Some of the G-20 members such as Turkey and Argentina already apply taxes to a limited range of financial activities, and the UK and France have introduced temporary taxes on executive bonuses.\footnote{However, such taxes do not intend to recover any amount of the government support provided to the financial sector during and after the 2008 crisis IMF, 2010a, pp.8 and 19.} Following a decision of 11 EU Member States under the enhanced cooperation
procedure in 2013, the European Commission published a proposal for a directive imposing a tax on financial transactions.\textsuperscript{46}

The proposed fiscal measures normally have the form of ‘Tobin’ taxes, covering exclusively speculative and other risky financial activities, but a ‘Pigovian’ tax, imposed on the negative externalities generated by financial activities, could become another potential alternative.\textsuperscript{47}

One should remain cautious, however, with regards to the use of such taxes as a source of resolution funding. Most international bodies – with the exception of the IMF – remain negative regarding the integration of such taxes in domestic resolution regimes. The European Commission, for example, whilst advocating for their implementation in general, does not consider such taxes as a source of resolution funding.

First of all, it would be highly complicated to develop the valuation basis of such taxes in order to efficiently serve the principles of bank resolution. In most of the cases, and especially regarding taxes on executive remuneration, it will be difficult to capture and express considerations on systemic risk or the safeguard of broader financial stability.

Bank assets, and especially bank liabilities, and the size or the interconnectedness of a financial institution can act as useful proxies for evaluating the size of a financial institution’s expected contribution to systemic risk and, hence, assessing what the size of its contribution to a resolution fund should be. However, taxes on financial transactions or financial activities fail to express this direct correlation between a SIB’s systemic role and the size of its contribution to a resolution fund. Thus, the introduction of such taxes might not be able to ensure that the core principles of transparency and legal fairness are upheld.

Furthermore, there is the fear that similar taxes will result in more expensive financial services for the individuals (as the burden might be passed on to them) or in the use of insecure channels and jurisdictions with minimum regulations for such transactions. The relocation of a significant degree of financial activities would negate most objectives introduced under such taxes.


\textsuperscript{47} Marteau, 2012. Economist James Tobin was the first to propose a currency transaction tax in 1972. On the other hand, Arthur Pigou had suggested in 1920 that a form of tax on industrial offenders could be used as an economic sanction and could provide them with an incentive to correct the negative externalities of their activities.
One should highlight IMF’s view that the creation of such taxes might have a corrective role for the operations of the global financial system, mainly through the mitigation of excessive risk-taking and the potential incentives towards down-sizing.\textsuperscript{48} Their use, though, for the purpose of resolution funding remains questionable. In any event, the discussions around the use of taxes for the financial sector are still at an infant stage and seem to have lost the momentum they gained in the aftermath of the 2008 crisis.\textsuperscript{49}

Taxes on financial transactions and activities currently lack political support, mainly due to potentially unwelcome impacts on the competitiveness of a financial sector. It is also true that there are substantial legal and economic obstacles when it comes to their use under a resolution regime. Further research and the development of global standards will be necessary if they are to become eventually part of the broader regulatory framework endorsing sounder financial practices.

\subsection*{9.1.3 Bail-in resolution tools}

As described under section (6.4), bail-in mechanisms will become recapitalisation tools within a bank resolution procedure following a debt-to-equity conversion or debt write-down of specific debt categories within a failing financial institution or a newly created bridge bank. These statutory powers will be exercised in accordance with the existing banking legislation and the mandate of resolution authorities. Despite the various controversies surrounding their implementation, bail-in practices can become a rapid source of solvency funding during the initial stages of bank resolution. At no means, they should be considered a source of liquidity for a financial institution in crisis.

Bail-in resolution mechanisms will impose losses to shareholders and bondholders according to precise rules. However, such measures should only be used for the stabilisation of the financial condition of a bank under resolution, in order to “restore the troubled entity as a going concern”.\textsuperscript{50} Such

\textsuperscript{48} IMF, 2010a, p.22.

\textsuperscript{49} With the EU being a rare exception, although Member States advance quite slowly on this controversial issue of a financial transactions tax.

tools could therefore be applied at the beginning of a resolution procedure and accompany the more substantial resolution measures implemented afterwards, i.e. by no means should they be considered a significant source of resolution financing.

The policies of jurisdictions being entirely dependent on such mechanisms in order to cover their resolution financing needs should not be endorsed. An illustration of such legal mentality is the current Swiss bank resolution regime. Switzerland rejected the proposal for the establishment of a financing mechanism based on bank resolution funds, financed through bank levies and/or through the contribution of the Swiss DGS.\(^ {51} \)
The legislation lacks any reference to resolution funding and there are currently no discussions on this matter or regarding the introduction of a resolution funding scheme in the near future.

In particular, FINMA considers that the existing convertible capital (CoCos) of Swiss G-SIBs, in combination with the subordinated and senior unsecured debt subject to bail-in, will be sufficient to cover very substantial losses.\(^ {52} \) Yet, FINMA also simultaneously identifies a potential risk to the execution of bail-in: namely that a great amount of bail-inable liabilities are governed by non-Swiss law.\(^ {53} \) Therefore, in the event that part of these risks will materialise, the Swiss resolution authority will not be able to resort to a resolution fund backstop, unlike its foreign peers. In such a scenario, the use of public funds may come into question.

Broad bail-in powers could create the illusion of ‘safety’ with respect to the funding needs of a bank resolution procedure. Yet this procedure will only generate the capital necessary for the survival of the bank and will only be beneficial at the first stages of bank resolution. A bank resolution procedure is, however, a far more complex chain of actions than a mere recapitalisation. In addition, in a rapidly evolving crisis event, resolution costs can easily and swiftly exceed initial evaluations or expectations outlined in a resolution plan. Thus, whilst bail-in may be beneficial, strongly funded mechanisms will be needed as a backstop of last resort, in order to turn resolution into a credible procedure to address future banking crises.

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\(^ {51} \) FINMA, 2011, pp.17–18.

\(^ {52} \) FINMA, 2013, p.11.

\(^ {53} \) Ibid.
9.1.4 Voluntary private sector arrangements

Aside from institutionalised arrangements based principally on resolution funds, resolution funding could be based on voluntary private sector agreements. The most notable examples are Germany and Australia, where certain banks and credit unions passed private arrangements according to which during a period of financial trouble they will be obliged to financially support another party to the agreement under specific conditions.  

The EU introduced a similar scheme under the Bank Recovery and Resolution Directive and the Eurozone Single Resolution Fund. In particular, if the contributions of a resolution fund prove insufficient in order to cover the costs of resolution, the fund should be able to enter into contractual borrowings or other forms of financial support with other financial institutions. The main difference between the EU proposal and the aforementioned national approaches lies with the fact that such private financial support will be considered as ‘loans’ rather than ‘contributions’. As such, the participating financial institutions should be repaid in full by the resolution fund after the crisis.

It is encouraging that under such private sector agreements, the private sector would bear the entire cost of a crisis and the public sector would not be expected to intervene or provide any capital support to the resolution funding scheme. Healthy financial institutions could intervene in order to avoid negative repercussions for the banking sector as a whole.

The use of such schemes, however, has been quite rare and there is a notable absence of precise rules with regards to their implementation. The principal ambiguity surrounds the criteria on the fair allocation of the contributions by each signatory. In addition, requiring banks to step in to rescue a financial competitor that did not manage to survive a crisis due to its inadequate policies is controversial; especially when the ‘strong’ bank is already contributing to a resolution fund through levies. Two days before the collapse of Lehman Brothers, a meeting took place between the Chairman of the FRBNY and Lehman’s main competitors to discuss the possibility of a private sector rescue. However, the fact that these talks failed illustrates the difficulties involved in elaborating such

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54 BCBS, 2011, p.22.
55 EU Bank Recovery and Resolution Directive, art. 105 and EU Regulation on a Single Resolution Mechanism, art. 73.
agreements. This will be a weak feature of the EU proposals too, as the conditions of contractual borrowings from the private sector will need to be established during and not before a crisis.

Financial institutions might also become reluctant to abide by such arrangements, particularly during a systemic crisis, when their own financial viability might be at stake. Finally, it would be legally unpalatable and practically impossible to elaborate such a scheme on a cross-border basis in the event of the failure of international banking groups.

Such schemes could provide an interesting supplementary and/or subsidiary funding mechanism to the already existing resolution funds. More research will be necessary, though, regarding the fair allocation of responsibilities under such schemes. It is imperative to define which financial institutions should be subject to such agreements (either as contributors or beneficiaries of financial assistance) and on what basis their contributions should be evaluated. Potential hazardous impacts on competition within a domestic banking sector should be always taken into consideration during the process of drafting such voluntary private sector agreements on resolution financing.

9.1.5 Liquidity provision and the role of central banks

Central banks will also have their part to play in a bank resolution procedure. As already stressed in chapter 5, if central banks exercise also supervisory mandates, they might end up as the competent resolution authorities triggering and implementing bank resolution. A core part of a central bank’s mandate is, though, to provide emergency liquidity to financial institutions that are solvent but in financial trouble when no other sources of liquidity are readily available (i.e. to be a lender of last resort). Probably the most noteworthy development with regards to the traditional role of central banks following the 2008 crisis was the transformation of this LOLR function.

To place this shift into context, it is important to consider the theoretical basis upon which the principles attributed to LOLR were founded – notably, the principles elaborated by Thornton and Bagehot. Traditionally,
a central bank could provide LOLR financial assistance (i) to financial institutions that are illiquid but solvent (ii) with an interest rate high enough so as to be considered a penalty (iii) to anyone capable of providing ‘good’ collateral, and (iv) the central bank could exercise its discretion to provide LOLR assistance or not, and should be held accountable for the use of its discretionary powers.\(^57\) The extreme conditions of the 2008 financial crisis, however, pushed this role to new limits.

First of all, the extent to which various financial institutions resorting to central banks for emergency liquidity during the crisis were ‘solvent’ was questionable. Fortis had been facing such intense pressure from the markets that it was practically insolvent at the point when it required liquidity assistance; as evidenced by the fact that it had failed to restore its financial condition despite having entirely exhausted the liquidity already provided by both the Belgian and the Dutch central banks.

Secondly, the form of collateral pledged in certain cases was significantly modified. Numerous central banks implemented complex liquidity schemes in order to facilitate the process of deleveraging of troubled banks or ring-fencing of ‘toxic’ assets.\(^58\)

The group of eligible financial institutions subject to LOLR powers became also much broader. The activation of the Section 13(3) of the Federal Reserve Act by the Board of Governors of the Federal Reserve during the Bear Stearns crisis paved the way for further interventions, which allowed investment banks to receive liquidity support.\(^59\)

The powers granted to central banks to provide liquidity will become of particular importance with regards to resolution liquidity financing. The implementation of resolution procedures, either through the transfer of assets and liabilities to a bridge bank or through the separation of a troubled institution in a ‘good’ and a ‘bad’ bank, will result in the creation of new legal entities. The successor entity will require liquidity in order to establish its business at this post-resolution stage; liquidity, which might

\(^{57}\) Andrew Campbell and Rosa Lastra, Revisiting the Lender of Last Resort – The Role of the BoE, in McNeil & O’Brien, 2010, p.166.

\(^{58}\) In this way, the failing financial institutions were able to exchange their high quality but totally illiquid assets with central bank liquidity.

\(^{59}\) In response to this decision of the Federal Reserve, the FRBNY introduced the Primary Dealer Credit Facility, as a source of collateralised loans for investment banks and was practically considered as a LOLR for brokers/dealers.
not be directly available from the banking markets. Central banks should be entitled to step in and provide this essential liquidity. The new entity resulting from a failed but resolved financial institution will be solvent. As a result, it should be eligible to receive an injection of financing through the LOLR function of central banks.\footnote{Institute of International Finance, 2012, p.40.}

This role of central banks regarding the liquidity financing of the successor entities to resolved banks will be critical for the efficient functioning of bank resolution regimes. The provision of central bank liquidity will be a clear signal of confidence towards the newly created financial entities. Although not a principal actor for resolution purposes (when not designated as a resolution authority), this traditional role of central banks will remain indispensable.

\section*{9.1.6 The role of treasuries}

In the 2008 financial crisis, national governments were compelled to step in and bailout their financial institutions in trouble in order to prevent international banking operations grinding to a halt. National treasuries undertook the difficult task of implementing bank rescue programmes, and made the contentious decision that taxpayers would shoulder the bill for these bailout programmes. These actions, in certain cases, resulted in the explosion of national budgets and soaring levels of sovereign debt; effects that are still felt today, seven years since the outbreak of the crisis. National treasuries have borne an important share of the responsibility for the moral hazard aspects of the ‘too big to fail’ problem.

National treasuries should be aware of resolution procedures in progress and participate in information exchange policies between the competent authorities. The safeguard of financial stability is a crucial objective for national treasuries, which will further keep the government informed regarding the evolution of a financial event. Contrary to the practices adopted in 2008, future decisions on bank resolution will become less subject to political influence. As a result, we believe that national treasuries could eventually maintain an important role exclusively in connection with resolution funding.
Whilst independent resolution funds will become increasingly important in the future, few jurisdictions, as previously noted, have made substantial progress on establishing credible resolution funds to assume the costs associated with the implementation of bank resolution procedures. Even in the case of EU Member States, where the necessary legislation has been – in most cases – put into place, it will still take many more years for their resolution funds to grow to a sufficient level to be able to finance the costs associated with recovery from a major bank failure. Therefore, the role of treasuries in introducing a financing mechanism for a troubled bank deemed to be resolvable will remain essential in the interim period.

Even in the case of resolution funds that are already operational, national treasuries may still need to monitor the operations of these funds closely. It is still open to debate whether responsibility for the overview of resolution funds and how they are used should fall to bank supervisors or national treasuries. Either way, it is important to stress that resolution funds must remain entirely independent and their resources used exclusively for the purposes of bank resolution. The statuses of treasury and resolution fund might be interrelated but they should not be confused.

Finally, there is always the possibility that even the most well-resourced resolution fund may prove inadequate to cover all of the costs necessary to resolve a collapsing financial institution, especially in the event of a systemic crisis. Under such a scenario, the treasury’s intervention will be inevitable.

Portugal is a case in point. Although Portugal established a domestic resolution fund in 2012, this fund was only able to cover 7% of the total cost associated with the implementation of a resolution procedure for Banco Espírito Santo in August 2014. The remaining 93% was financed via a government loan. This begs the question whether (and how) the resolution procedure could have been completed if the Portuguese state had not been in a position to provide the necessary funding.

61 European Commission, Communication on Bank Resolution Funds, 2010, p.10. Consequently, it is alarming that eight EU Member States (Austria, France, Hungary, Portugal, Slovakia, Slovenia, the Netherlands and the UK) direct the levies of the banking sector to the Treasury or their State budget, Burke, 2015, p.6.
62 For example, the US system provides for the intervention of the US Treasury if the resolution fund is insufficient to cover its liabilities regarding the resolution of deposit taking banks, FDIA, § 11A(c).
63 See section 1.4.2.
This treasury’s role should therefore be viewed as a complementary one, and the conditions under which the treasury is able to exercise its powers – especially with regard to the rules for the recovery charges to be enforced against the resolved banks – should be circumscribed in detail under resolution laws.

The 2008 financial crisis proved an unfortunate experience for national treasuries, as they were forced to overstretch their balance sheets and resort to public money in order to address the financial collapse of many large institutions. One can only look forward to treasuries taking a much less active role during future bank resolution procedures. It is anticipated, though, that regulating and restricting their intervention will not be an easy task; after all, the growth of the financial sector and the safeguard of financial stability remains also a fundamental political priority.

9.2 Resolution funding on a cross-border basis

Resolution funding could pose significant problems when applied during a cross-border crisis. The issue presents important legal, fiscal and political considerations and impediments and, for the time being, cross-border coordination on this matter might seem a utopia. At the same time, a solution to the puzzle of resolution funding could result in significant improvements on cross-border bank resolution schemes and boost the confidence regarding the practical aspects of their implementation. Cross-border market penetration and interconnectedness, along with informational deficiencies, can result in important cross-border contagion, transforming a domestic problem into a full-scale international crisis. Each financial institution adds its specific negative externalities within the banking system; externalities, which frequently have notable cross-border repercussions.

Under this new era of bank resolution, crisis management within the financial markets has become a growing international issue. Therefore, resolution funding for international banking groups should be ideally organised on a cross-border basis. The financial burden of an intervention

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64 Schoenmaker & Oosterloo, 2005, pp.7–9.
should not be carried by the home state alone, when there are massive financial implications for host jurisdictions too.\textsuperscript{65} Host jurisdictions also need to become part of the solution, particularly in the case of systemic subsidiaries or branches operating in a host state. States that will experience the benefits of a swift bank resolution procedure mitigating financial and social costs should contribute actively through resolution funding arrangements. After all, despite potential differences and particularities to the approach of the problem, it is estimated that there will always be good grounds for cooperation, on the premise that financial stability is a global objective for every state.\textsuperscript{66}

The establishment of a common resolution fund for international banking groups is currently legally and politically unpalatable. As a result, the coordination and burden-sharing of resolution funding should be founded on the general principles introduced under cross-border cooperation agreements and implemented through group resolution plans. These resolution instruments, which are institution-specific in nature, will facilitate collaboration between the participating resolution authorities by organising the principal sources of financing and developing a certain form of burden-sharing.\textsuperscript{67}

The efficiency of such instruments will evidently require a certain level of harmonisation of domestic resolution funding policies. Cooperation could be problematic between states with sophisticated financing mechanisms and others focusing on discretionary funding options. The existing legal divergences on this issue could undermine the efforts of cross-border cooperation. As upheld correctly by the IMF, domestic resolution funding measures do not necessarily have to be identical; but they should be founded, at least, on similar principles, while respecting different national circumstances.\textsuperscript{68}

\textsuperscript{65} Goodhart & Schoenmaker, 2006, p.4. The rescue operations implemented by the US authorities are an excellent example demonstrating how financial rescue measures undertaken by a state can benefit foreign institutions more than locally incorporated ones. The TARP Congressional Oversight Panel Report highlighted that “banks in France and Germany were among the greatest beneficiaries of AIG’s rescue, yet the U.S. government bore the entire $70 billion risk of the AIG capital injection program”, Avgouleas, Goodhart & Schoenmaker, 2013, p.213.

\textsuperscript{66} Freixas, 2003, p.113.

\textsuperscript{67} IMF, 2010c, p.24.

\textsuperscript{68} IMF, 2010a, p.24.
Chapter 9: Resolution funding

Whether these funding arrangements should require rigid or flexible burden-sharing criteria is currently the subject of debate. Both home and host jurisdictions should be part of a financing scheme. Assessing how to fairly allocate costs between jurisdictions, however, will be complex. The basic elements for this evaluation should result from determinations on systemic importance; size; substitutability; and, in the end, the share of a banking sector that each group entity represents. These factors should provide an approximate idea of the contribution each jurisdiction should be expected to make.

The general principles of burden-sharing should be established on an *ex ante* basis; this helps to overcome two potential problems identified with *ex post* agreements. Firstly, it has been illustrated that in case of *ex post* negotiations regarding the burden-sharing of a past financial crisis, each participating jurisdiction tends to understate the benefits for its individual market following a common intervention. In that case, it will be required to contribute less when other states will be eventually obliged to share larger costs.

Secondly, such understatement of benefits and final costs could result in a ‘free rider’ phenomenon; in other words, jurisdictions with weaker banking sectors might unduly benefit from such *ex post* agreements, even if the consequences of the crisis for their economy were minimal.

Nonetheless, it has also been argued that *ex ante* burden-sharing agreements might contribute to moral hazard and regulatory forbearance. Supervisory authorities, for example, might feel less inclined to adequately fulfil their mandates if they know that the costs of any supervisory failure leading to potential solvency troubles and a resolution procedure will be jointly covered by other jurisdictions. Whilst this may be the case, it is important to note that a banking crisis will generate significant costs for every jurisdiction involved and could put the future reputation of a banking supervisor at stake. It is therefore questionable if supervisory authorities will be willing to take such risks.

One should highlight, however, a concern regarding adverse selection. Such burden-sharing agreements will necessarily bring together economies that have traditionally been strong with jurisdictions that have

weaker or problematic banking sectors. It is possible, therefore, that the former may display a certain unwillingness to enter into *ex ante* burden-sharing arrangements with the latter.⁷¹ Nevertheless, it is anticipated that a strong incentive to act in the public good of financial stability will prevail and that this will foster cooperation between different legal systems and financial markets and could become the basis for their negotiations.

Cross-border cooperation agreements and group resolution plans should set out the parameters that would guide the burden-sharing process for cross-border resolution funding schemes. Such burden-sharing agreements should be used as ‘roadmaps’ during a financial crisis, and must include some flexibility. For example, it will be impossible to evaluate with precision *ex ante* the total costs of a banking crisis and therefore there will inevitably be cases where the participating national authorities will need to reach an agreement on burden sharing after a crisis has already occurred. This may entail entering into some form of post-crisis negotiations regarding costs not covered by the existing agreements. Even in this case, the systemic aspects resulting from the size and activities of each group entity used for the establishment of the *ex ante* arrangements, as well as the overall benefits for a domestic economy, should provide ideally a useful proxy, an initial basis for the fair allocation of such additional costs. The rules on such *ex post* negotiations should be clear and established *ex ante*.

The EU is leading the way in proposing the introduction of a more consolidated system of cross-border resolution funding. The political and financial integration of its participating Member States could allow such a development. The EU proposals are based on effective coordination and cooperation between the national financing arrangements that should be established in each EU jurisdiction for the purposes of bank resolution. In case of the collapse of a pan-European banking group, the participating financing arrangements should contribute to the mutual group resolution.⁷² It is the responsibility of the home authority to create a financing plan identifying the appropriate financial needs in case of a group resolution as well as the modalities and allocation of that financing.⁷³ A national financing arrangement should be able to borrow from all other financing

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⁷¹ *Ibid*, p.156.
⁷² EU Bank Recovery and Resolution Directive, art. 107(1).
⁷³ *Ibid*, art. 107(2).
arrangements of the Union, if its funds are inadequate to cover losses and other expenses.\textsuperscript{74}

Although a bold and promising initiative, the EU System of Financing Arrangements remains rather ambiguous. Many rules and standards are still absent and the Commission, as well as EBA, have a daunting task ahead of them to elaborate the essential practical aspects surrounding its implementation. The priority focus remains on the modalities of the allocation of costs between the different national arrangements. The form of the group financing plan, established by the home resolution authority, is also questionable. The text of the proposal indicates a slight preference for \textit{ex post} plans, despite the serious drawbacks and risks of such an option.

It is also noteworthy that the text of the directive does not introduce any dispute settlement mechanisms regarding the elaboration of the group financing guidelines. It is not clear if the home authority should work out the most plausible solution according to the needs of hosts jurisdictions or if it should be allowed to decide on a standalone basis in case of broad long-term disagreements.

In addition, the current text fails to sufficiently outline what should happen in the event that a national financing arrangement is unable to finance its part of contribution to the group resolution, the other national arrangements refuse to contribute on proper grounds and alternative private funding means are not available. Such an issue could jeopardise the common plan.

In any event, the full implementation of the proposed system will be quite lengthy, as it requires first the efficient functioning of financing arrangements on a purely domestic level. Future steps should also include closer coordination and compatibility between the European system and third jurisdictions, where European banking groups are also present. The proposal of the directive also fails to address the issue of consistency and coherence between EU group financing plans and international burden-sharing arrangements within cross-border cooperation agreements or international group resolution plans.

It is clear that there is still a long way to go before efficient burden-sharing agreements for international banks are fully developed and in place. The drafting of institution-specific cross-border cooperation agreements, as well as cross-border resolution plans, could form the basis for

\textsuperscript{74} Ibid, art. 106(1).
the future development of some form of financial burden-sharing between the involved authorities.\textsuperscript{75} The efforts of the EU, pushing for more consolidation on this issue, are more than welcome. The first real test of the efficiency of such cross-border resolution financing mechanisms will be the entry into force of the European System of Financing Arrangements as well as the establishment of the Single Resolution Fund among the Eurozone Member States.

### 9.3 Concluding remarks on resolution funding

An efficient answer to resolution funding challenges will provide increasing credibility to bank resolution regimes, especially when applied with regards to a cross-border bank failure.\textsuperscript{76} Most major jurisdictions are in the process of developing resolution funding mechanisms and the Eurozone Member States will eventually establish a common resolution fund for their respective economies. Notwithstanding this progress, such initiatives will require a long phase-in period before any results will be demonstrated. In the meantime, a great number of standards should be elaborated in order to allow for these mechanisms to become effective.

Resolution funds seem to be the fundamental answer to resolution financing needs. The banking sector should bear the entire burden of its potential failures on the basis of \textit{ex ante} levies contributed directly by financial institutions. States need to advance rapidly with the introduction of precise rules on the form, size and calculation method of such contributions. Deposit guarantee schemes could form part of such a funding system but only in relation to the resolution of deposit-taking institutions, and never at a greater level than the contributions they would have assumed under a classic insolvency.

Resolution funds may be complemented by financial taxes and/or voluntary private sector financing agreements. These two additional proposals could make a beneficial contribution to resolution funding, but there

\textsuperscript{75} IMF, 2010c, p.24.

\textsuperscript{76} As stressed by Krimminger, “who pays finally for resolution skews both the timing and nature of the chosen intervention”, \textsc{Krimminger, 2005}, p.9.
are significant practical challenges associated with their implementation. Consequently, they should maintain a secondary role.

The same could be said with regards to bail-in. Whilst bail-in could become a crucial stabilisation instrument of a failing bank or a recapitalisation tool of a bridge bank, it is highly unlikely that it could ever cover all of the costs associated with a bank resolution procedure. Resolution authorities must therefore be under no illusion that bail-in will provide all answers to funding challenges under resolution; such a regulatory approach could prove particularly risky.

One should also not forget the fundamental role of central banks with regard to liquidity provision. Central banks will, potentially, be the only source of short-term liquidity for new entities resulting from resolution procedures.

Finally, and until fully operational resolution funds are in place, treasuries will remain a last resort for addressing the challenges associated with resolution funding, as was the case in the resolution of Banco Espirito Santo in Portugal. Their potential interventions, though, must be subject to specific rules and restrictions, especially with regards to the recovery of resolution costs. The collapse of a national economy following a banking failure should not be allowed but bail-outs and blank checks cannot become common currency once again.

Obviously, the establishment of cross-border resolution funding mechanisms seems a utopia. The future elaboration of realistic burden-sharing standards under cross-border cooperation agreements as well as the role of the Eurozone Single Resolution Fund might become eventually the first true step towards more consolidated bank resolution procedures.
PART III

INSTITUTIONAL CHALLENGES FOR CROSS-BORDER RESOLUTION REGIMES
Chapter 10

SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS

10.1 ‘Too big / too interconnected / too complex to fail’

“There are advantages to size…In the case of the large international banks, the empirical evidence would seem to suggest that these institutions have long exceeded the size needed to make full use of these advantages”\(^1\)

Philipp Hildebrand, 2009

The 2008 banking crisis introduced to our legal and financial jargon the currently widely used terms of systemically important financial institutions (SIFIs) and systemically important banks (SIBs). These concepts have been employed in order to group the various expressions describing large banks considered as ‘too big to fail’, ‘too interconnected to fail’, ‘too complex to fail’ or ‘too many to save’. In effect, an issue that had been largely confined to academic discussion prior to 2008,\(^2\) emerged as prominent in public discourse since the global financial crisis: the resolution and crisis-management strategies targeting modern SIBs has attracted increasing international attention, given the potential adverse effects of the failure of such institutions on the real economy and on financial stability.

The activities of the mega-banks that came to be known as SIBs first began to take on global proportions during the early 1990s. Through a wave of mergers and conglomerations, banking groups started growing larger and more complex. The principal factors leading to such expansion were: a) financial innovation, b) banking industry deregulation and c) financial

\(^1\) Financial Times (19/06/2009), cited in McCormick, 2010, p.132.

globalisation. In the US specifically, the 1999 repeal of the Glass-Steagall Act, a law separating commercial and investment banking, at the behest of the big banks resulted in an explosion in the size of large banking groups.

Mega-banks started crossing national borders in search of growth and wealth opportunities in new emerging markets. The need to service key corporate clients with substantial cross-border activities and the opportunity to diversify their risk portfolios by gaining access to new markets contributed to a significant globalisation of financial services. As a result, they started operating a vast network of branches and subsidiaries across multiple jurisdictions.

At the same time, large banking groups also started crossing operational business lines. The era of financial liberalisation brought retail banks closer to investment banking activities. The use of complex derivative products obfuscated bank balance sheets and introduced new risks to commercial banks; risks that could not be evaluated through traditional risk assessment mechanisms, which became increasingly obsolete.

Moreover, while tax and regulatory arbitrage opportunities led to increases in financial innovation, they undermined market discipline and effective regulatory supervision.

Citigroup – one of the largest financial companies, operating a network of 101 banks, nearly 600 other subsidiaries and over 1,000 non-bank subsidiaries across the globe – provides a perfect illustration of just how big some financial groups had become. Indeed, before the crisis, the five largest banking groups controlled more than 16% of the global banking assets.
Meanwhile, state authorities remained blissfully ignorant of the particularities and complexities of SIBs and of their importance for the stability of their domestic economies until they were faced with the imminent collapse of some of these mega-banks. The case studies included in chapter 1 illustrated some of the ad hoc solutions that were implemented by states in an attempt to avoid the global economy grinding to a complete halt. Since these institutions were ‘too big to fail’ or simply ‘too many to save’ for certain jurisdictions, public rescue aid, based on taxpayers’ contributions, was the only option available.

Whilst the global banking system was safeguarded, the scale of the shock after the 2008 crisis was unprecedented and the effects are still evident today; for example, in the dramatic crisis-driven global central bank balance sheet growth, and the explosion of sovereign debt, especially in certain European states and in the US. State interventions killed market discipline and contributed to an unprecedented level of moral hazard. Certain solutions implemented to address the failure of the large banks – and in particular certain hastily-arranged mergers between financial institutions – had the perverse effect of contributing to the ‘too big to fail’ problem. The crisis therefore highlighted the need for more prudential regulation of the banking sector. It became apparent that domestic economies need to be better positioned to more effectively regulate SIBs in order to avoid the possibility of being taken hostage once again by large banks in financial trouble. Thus, the crisis became a distinct driver of regulatory reform. If bank resolution regimes that aim to limit the effects of the ‘too big to fail’ problem are to be effectively implemented, however, the notion of ‘systemic importance’ must first be clearly defined and understood.

This chapter begins with a mention of the unique characteristics of financial institutions that can render the implementation of traditional insolvency procedures particularly challenging. It then focuses on the complex notion of systemic importance, and the potential need to distinguish between global and domestic systemic banks. In conclusion, one will find

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9 As the former governor of the BoE, Mervyn King, put it, “the massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created possibly the biggest moral hazard in history”, Speech to Scottish Business Associations (20/01/2009), cited in Emilios Avgouleas, Breaking-up Mega-banks: a New Regulatory Model for the Separation of Commercial Banking from Investment Banking, in Delimatsis & Herger, 2011, p.183.
a brief reference to the suitability of bank resolution procedures for each type of bank.

10.2 Why are banks special?

The ‘too big to fail’ debate underscored the special role that banks enjoy within a financial system; in most developed economies, banks remain at the centre of the financial system and play a critical role in ensuring the proper functioning of the global economy.10 Banks are a special category of corporations that present significant particularities and their financial troubles should be subject to specific legal rules, separate from standard corporate legislation.

Banks are the primary direct source of credit and liquidity within the markets they operate. First of all, through credit allocation they promote economic growth: companies finance their daily operations and growth plans through bank credits, while the broader public can meet its everyday needs. Moreover, banks are responsible for the maintenance of complex payment systems that allow a swift flow of liquidity on an international scale.

In addition, they are the principal institutions offering deposit protection. This has been traditionally been considered the core role of banks; they receive deposits and, in turn, can use this accumulated wealth so as to fund their credit operations.

Yet, these typical banking practices make banks extremely vulnerable. Banks conduct their business on the basis of this imbalance between the long-term nature of their assets (credit allocation) and the short-term nature of their liabilities (represented mainly by deposits).11 The primary risk

10 If the banking sector within a financial system can be considered as the “brain of the economy, allocating capital, the lifeblood of economic activity, to its most productive uses by business and households”, then in 2008 amidst this acute financial crisis it experienced a strong “brain seizure”, Darrin Grimsey & Marvyn K. Lewis, Minimising Collateral Damage: Options for Financing Public-Private Partnerships in the Wake of the Financial Crisis, in Green, Pentecost & Weyman-Jones, 2011, p.249.

11 Andrew Campbell & Rosa M. Lastra, Definition of Bank Insolvency and Types of Bank Insolvency Proceedings, in Lastra, 2011, p.35.
for banks is that a large number of depositors may withdraw their savings in their entirety at any point, should they so wish, leaving the bank short of funds. Nonetheless, a bank ‘run’, however, is an extreme example of risk and is mitigated by deposit insurance policies implemented by state authorities.

Aside from traditional deposit liabilities, one should also mention additional bank liabilities; repos and commercial papers, for example, are extremely liquid and can also create a high potential for a bank run.

In general, banks are also considered to be more fragile than non-financial firms primarily because they tend to have low capital-to-assets ratios (i.e. they are highly leveraged), and this makes banks more vulnerable to sudden liquidity shortages. Since the majority of a bank’s assets are not highly liquid, this makes banks less resilient to failure since these assets cannot be used in the context of a rapidly evolving crisis in order to meet liquidity needs.

The interbank payment channels are responsible for the flow of liquidity across the globe and the diversification of bank portfolios. However, during a crisis these same payment channels can rapidly transmit risk and provide the foundations for the outbreak of a systemic event. It is true that as most banking institutions draw their capital funds from the interbank market, once there is system-wide lack of confidence and this market comes to a gridlock, liquidity can be drained and bank defaults will become highly probable.

It became clear in 2008 that, given this issue of interconnectedness, investment banking entities can also play systemically relevant roles in the global economy, as well as credit institutions. As evidenced by the collapse of Lehman and the repercussions of its bankruptcy on the global economy, the failure of investment/broker dealers also has the potential to cause severe disruptions to the markets, given that they are highly connected and exposed to other market participants.

Ultimately, it is the form and degree of the liabilities of financial institutions, which contribute to the particular nature of the latter and call for the use of special crisis management mechanisms. Financial liabilities have an additional value beyond their pure face value, as they also serve liquidity, insurance, payments or risk-shifting functions. This has

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potential implications in insolvency: classic insolvency procedures can result in an extra deadweight loss when affecting these functions, a loss that exceeds the impairment cost of other traditional liabilities.

Not only does the banking sector face much inherent vulnerability, many jurisdictions have also been confronted with a lack of insolvency regimes designed to deal specifically with the collapse of a bank. Normal corporate insolvency proceedings can take many years to complete, and this can have a knock-on effect on market confidence. Whilst a commercial company might continue to trade, this will be practically impossible for a bank if confidence has been lost as the markets will be unwilling to trade with it.\textsuperscript{13}

Consequently, ordinary corporate insolvency proceedings are unsuitable for banks as the implementation of such proceedings would effectively halt the operations of a bank, resulting in a freezing of access to assets and deposits, in turn giving rise to panic among depositors and other contractual counterparties and leading to a sudden gap in the market concerning liquidity.\textsuperscript{14} If the bank is systemically important, then one should also bear into consideration the knock-on effect this would have both on the stability of the domestic economy and the likely spillover effects on foreign markets.

*“The failure of a bank and the potential loss of access to banking services, even for a short time, could have a serious impact on the ability of people to live their lives, on top of the potential loss of their deposits held with that bank”.*\textsuperscript{15} It is essential that banks should be allowed to fail. Notwithstanding this argument, and due to their special characteristics, their failure requires special treatment.

\begin{itemize}
\item \textsuperscript{13} \textbf{Bates & Gleeson}, 2011, p.4.
\item \textsuperscript{14} Old bankruptcy lawyers used a joke in order to describe insolvency: “\textit{not only does the food taste awful, but the portions are too small}”. As explained by Sommer, “\textit{the portions are small}” because bank liabilities must be impaired and, as a result, certain creditors will receive less than the face value of their claims. In addition, “\textit{the food tastes awful}” because insolvency procedures result in significant value destruction, Sommer, 2014, p.6.
\item \textsuperscript{15} \textbf{House of Commons – Treasury Committee}, 2008, p.73.
\end{itemize}
10.3 What makes a bank systemically important

So far there have been rare examples of a formal legal definition on SIBs.\(^\text{16}\) Hence, there is only an approximate universally accepted definition. In one of its policy documents, the FSB defined SIFIs as “financial institutions whose disorderly failure because of their size, complexity and systemic interconnectedness would cause significant disruption to the wider financial system and economic activity”.\(^\text{17}\) However, different jurisdictions sometimes have different interpretations of what makes a bank systemically important and this divergence in interpretation between jurisdictions can complicate crisis management and resolution actions.

Nonetheless, there is an emerging international consensus that the systemic importance of a financial institution arises from the presence of a set of key functions.

In 2011, the Basel Committee introduced an indicator-based measurement approach in order to assess the systemic importance of global banking groups. This approach included five categories, which reflected the main aspects that generate negative externalities and make a bank systemic in a financial market: (i) size; (ii) interconnectedness; (iii) complexity; (iv) substitutability; and (v) cross-jurisdictional activity.\(^\text{18}\) Each element was given an equal weighting (20%) and additional indicators were identified for each category.\(^\text{19}\)

First of all, the size of a financial institution has been identified as an important factor in determining its systemic importance. Drehmann

\(^{16}\) The majority of jurisdictions do not provide precise elements under their domestic legislation facilitating the identification of a SIB. One exception is Switzerland. The amendments to the Swiss Banking Act introduced three criteria in order to classify a financial institution as a SIB: a) size, b) interconnectedness and c) lack of substitutability for the services offered by the financial institution, **Swiss Banking Act**, art. 8(2). Moreover, the Swiss Banking Act provides additional clarifications regarding the interpretation of these three criteria. The identification of a bank’s systemic importance is based on the amount of the deposits held by the bank, the ratio of its balance sheet to the Swiss GDP, the risk profile of the bank, the quality of its assets and its leverage ratio, as well as the part of the Swiss market that the bank’s systemic functions represent.


\(^{18}\) BCBS, **Global Systemically Important Banks Assessment Methodology**, 2011, pp.3–4.

\(^{19}\) For example, intra-financial system assets, intra-financial system liabilities and wholesale funding ratio as indicators of interconnectedness. For the full list, see ibid, p.5.
and Tarashev used data from twenty large internationally active banks and concluded that size can be an important indicator of systemic importance.\textsuperscript{20} For the analysts, size, as a very robust indicator of systemic importance, can exhibit the highest explanatory power in the ‘too big to fail’ problem.\textsuperscript{21} In a previous analysis conducted by Tarashev, Borio and Tsatsaronis, it had been also demonstrated how systemic importance increased over-proportionately to size and how large institutions could play a disproportionate role in systemic events.\textsuperscript{22}

There are conflicting opinions, however, regarding exactly which financial features should be taken into consideration when attempting to ‘measure’ the size of a bank, i.e. whether to only take into account a bank’s assets (including off-balance sheet items) or whether to also consider the bank’s liabilities. It is also questionable whether size should reflect the bank’s domestic exposures only, or the totality of its financial exposures, including those also from cross-border activities. Thus, assessing a bank’s size is problematic and remains subject to various interpretations.\textsuperscript{23}

Including size as one of the parameters for determining the systemic nature of a financial institution also runs the risk that certain banks whose size is close to the threshold established for SIBs might attempt to remain just below that size in order to avoid being subject to specific rules regulating SIBs. Such financial institutions might be considered individually small but collectively they will contribute to systemic risk and remain a threat for financial stability.\textsuperscript{24}

The 2008 financial crisis also exposed the high degree to which financial institutions have become interconnected and interdependent; this interconnectedness (i.e. which can result from inter-bank borrowing and lending) exacerbated the crisis\textsuperscript{25} and can be viewed as another key indicator of systemic relevance.\textsuperscript{26} For instance, whilst Lehman Brothers was

\begin{flushright}
\textsuperscript{20} \textsc{Drehmann & Tarashev}, 2011, p.30. \\
\textsuperscript{21} \textit{Ibid}. \\
\textsuperscript{22} \textsc{Tarashev, Borio & Tsatsaronis}, 2009, p.82. \\
\textsuperscript{23} For instance, in one of the latest contributions to the discussion, EBA considers that size should express the total exposure of a financial institution, i.e. the aggregate of total on-balance sheet items and of total derivative and off-balance sheet items, on consolidated basis, including entities consolidated only for accounting purposes, EBA, \textit{Draft Regulatory Standards for the Identification of G-SIIs}, 2014, p.12. \\
\textsuperscript{24} \textsc{Acharya et al.}, 2013, p.73. \\
\textsuperscript{25} \textsc{IMF/FSB/BIS}, 2009, p.7. \\
\textsuperscript{26} \textit{Ibid}. 
\end{flushright}
considered as one of the smallest banks on the List of Large Complex Financial Institutions established by the BoE and the IMF, it was the sixth major business counterparty in OTC derivatives markets.

Since modern banks rely heavily on capital market funding in order to draw day-to-day liquidity, it is natural that they establish vast complex networks involving a great number of financial counterparties. Through these operations they manage to diversify their portfolios and develop risk-hedging practices. Although interbank linkages allow better risk sharing and a faster flow of liquidity among financial institutions, they also create higher potential for rapid risk contagion amidst a crisis resulting in potential bank failures.

Large universal banks have been very active in the derivatives markets, using a vast array of sophisticated financial instruments in their financial operations. This use of derivative products was hailed as an excellent risk diversification strategy, since these financial instruments contain risks that could be distributed to a large number of investors. Unfortunately, however, derivatives have become a principal channel for crisis transmission due to the interconnectedness between financial institutions.

Despite the importance of interconnectedness, it will be hard to establish a clear-cut method of measuring the total exposures between financial institutions with any precision. Such assessment could potentially involve measuring the proportion of capital flows, of the size or distribution of counterparty risk capital requirements, of the provision of services to other financial institutions or of the level of involvement in OTC derivatives markets. The FSB required from banks identified as G-SIBs to

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27 Herring, 2009a, p.172.
28 As pointed out by Bryan Marsal, “Lehman was not too big to go bust, rather was too complex”, Handelsblatt, No.58 (24/03/2010), cited in Sester, 2010a, p.189.
30 Derivatives can “morph traditional risks into hard to understand and hard to monitor counterparty and funding risks”, Cumming & Eisenbeis, 2010, p.16.
31 For instance, EBA suggests the use of intra financial system assets (aggregate of funds deposited with or lent to other financial institutions and undrawn committed lines extended to other financial institutions, holdings of securities issued by other financial institutions, the net positive current exposure of securities financing transactions and OTC derivatives with other financial institutions that have a net positive fair value) and intra financial system liabilities (aggregate of deposits by financial institutions, securities financing transactions and OTC derivatives with other financial institutions that have a net negative fair value), EBA, Draft Regulatory Standards for the Identification of G-SIls, 2014, pp.13–15.
submit a common data template for counterparty credit and other common exposures to a new data hub at the BIS. For the time being, seven years after the crisis, “accurate reporting of counterparty exposures fails to meet either supervisory expectations or industry self-identified best practices”.

In addition, for regulators and insolvent administrators, size plus interconnectedness normally results in extreme complexity. Complexity can be interpreted through a variety of perspectives. As stressed by Cumming and Eisenbeis, “complexity has many dimensions but certainly includes the complexity of organisational structure, the complexity of financial instrument design and the complexity of dealing with overlapping jurisdictional and legal structures”. And modern international banking groups with their legal structures, business models, intra-group and inter-bank exposures, use of nonbank unregulated entities and transactions of sophisticated financial products have become extremely complex. For the Basel Committee an important indicator of complexity is the notional value of OTC derivatives (especially those not cleared through a central counterparty) entered into by a financial institution.

The fourth key-defining characteristic of ‘systemic importance’ is substitutability. Specifically, to be considered systemically important, a financial institution must provide certain functions to a market that – in the event of a default – cannot be quickly and cost effectively replaced by one of its business competitors without any significant market disturbance.

The issue of substitutability is closely related to the notion of a ‘systemic function’. There is no clear definition of what a systemic function actually consists of. A financial institution may be considered to offer a systemic function if: a) the provision of such services is concentrated in one or only a few financial institutions; b) a significant number of other market participants depends directly or indirectly on the provision of this function; and c) other financial institutions cannot easily substitute this function because of technical, legal or economic constraints.

32 FSB, Ending Too-Big-to-Fail, 2013, p.19.
33 According to an analysis of data collected by the Senior Supervisors Group, FSB, Supervisory Intensity and Effectiveness, 2014, p.10.
35 BCBS, Global Systemically Important Banks Assessment Methodology, 2011, p.9.
36 Eva H. G. Hüpkes, Too Big, Too Interconnected and Too International to Resolve? How to Deal with Global Financial Institutions in Crisis, in Delimatsis
Few international standards on the identification of a systemic function have been elaborated. The EU provided a rare example in its ill-fated MoU in 2008. In a more recent policy document regarding recovery and resolution planning, the FSB introduced certain criteria for defining a critical (systemic) function. For the existence of a critical function the FSB requires a three-pronged analysis based on: (i) the impact of the sudden discontinuity of the function; (ii) an evaluation of the market for that function; and (iii) an assessment of the impact of the failure of the specific SIB performing that function. It should be noted that the FSB undertook an analysis of the potential systemic importance of five broad categories of a bank’s operations: (i) deposit taking; (ii) lending; (iii) payments/clearing and settlement; (iv) wholesale activities; and (v) capital market services. Distinct characteristics and drivers of criticality have been considered for each of the aforementioned functions.

All in all, the following will impact greatly the existence of a systemic function: the type of depositors; the existence of credible depositor protection arrangements; the long or short term character and the standardisation of lending practices; the market concentration with regard to clearing and settlement services; and high interconnectedness with other financial institutions as borrowers or lenders.

Last but not least, cross-jurisdictional activities represent the fifth potential defining feature of systemic importance. This aspect will play an important role regarding the identification of G-SIBs and the separation of these institutions from those defined as domestic SIBs. Although the examination of the existence of cross-border financial operations is relatively straightforward, it might be challenging to quantify such activities and set a specific limit that an international bank must reach in order to

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37 The Commission introduced through a questionnaire limited brief criteria to allow member states to evaluate a financial function as systemic and to determine a firm’s substitutability within the domestic market, EU MoU, 2008, Annex 2.
39 Ibid, pp.37, 40–41, 43 and 47.
be considered a G-SIB. The current tables of G-SIBs prepared by the FSB every year could provide a useful indicator in this regard.

It is therefore clear that whilst the elaboration of specific international standards and guidelines defining systemic importance is vital, we are still a long way of having reached consensus on many of the issues. Consequently, decisions on whether or not a bank can be considered a SIB are currently made on a case-by-case basis, according to an analysis of the specific characteristics and operations of each bank. Furthermore, there are many challenges associated with ‘measuring’ characteristics such as size / interconnectedness / complexity / substitutability / cross-jurisdictional activities so that regulators can ‘quantify’ systemic importance.\footnote{As stressed by Petitjean, “models for quantifying the systemic dimension of banks are indeed at an early stage of development and the robustness of their results has not been seriously tested yet”, Petitjean, 2013, p.30.} Whilst resolution planning could contribute to a better comprehension of criticality, and the identification of systemic functions,\footnote{Under recently established resolution plans, various international banks identified their core business lines that could contain critical functions. For instance see Barclays, 2014, pp.8–9, JPMorgan Chase & Co., 2014, pp.7–10 or Credit Suisse, 2014, pp.5–7.} it will nonetheless be a poor substitute for efficient rules that clearly define systemic importance and systemic functions.

Consequently, it is important to note that the definition of systemic importance might ultimately be subject to certain conflicting considerations. The final determination of whether a financial institution is systemically important or not will take place according to the special market characteristics of each jurisdiction. Hence, the notion of ‘too big to fail’ will most likely have to be evaluated on two levels: the domestic level and international level.

Evidently, it would be much more straightforward if most international banking groups as a whole were defined as G-SIBs, since their size and complexity affords them an important market position not only within their home state but also within host jurisdictions. It is questionable, though, how their branches and subsidiaries would be treated in different domestic markets, each with different needs and sizes.

While branches are considered an extension of the parent institution, subsidiaries – although they form part of a group – remain separate legal
entities, maintain their own capital base, and operate through a board of directors established in the host state. Determinations around their systemic importance will depend on the characteristics of the host market: a banking branch or a subsidiary might provide crucial functions to the banking sector of its host jurisdiction and be considered systemically important, despite the fact that its role might be immaterial from a group perspective. In such a scenario, the home authority might decide to allow the default of the subsidiary without taking into consideration the potential financial disruptions for the host market.

The discussion around systemic importance needs to be put on a new footing, based on crucial factors resulting from market needs and considerations of both home and host jurisdictions. Especially for an integrated market such as the EU, the elaboration of clear-cut standards for the determination of systemic importance, both on domestic and supranational level, will be of great importance. Although quantifying the constituent elements of a potential definition on systemic importance will be a challenging task, certain concrete parameters will be welcome in order to restrict authorities’ discretion and cross-border interpretational heterogeneity. In the end though, the definition of systemic importance should not simply result from a ‘quantitative’ measurement of certain elements, but the public perception of the specific circumstances in question also need to play an important role. Thus, qualitative factors should complement quantitative indicators regarding the systemic nature of a financial institution.

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43 This phenomenon can be described as an “asymmetry in the relative size of a branch or subsidiary within its banking group and in the host country”, Piotr Bednarski & Grzegorz Bielicki, Home and Host Supervisors’ Relations from a Host Supervisor’s Perspective, in Caprio, Evanoff & Kaufman, 2006, p.213.

44 As highlighted by Otto, “if the potential collapse of a small bank is perceived as the signal that a bigger problem might be looming, the firm becomes of systemic relevance and its rescue becomes a must”, Mathias Otto, Living Wills – The In-House Perspective, in Dombret & Kenadjian, 2013, p.94.
10.4 A potential distinction between global and domestic SIBs

The identification of a SIB will greatly depend on the context or size of the market in which it operates. This situation is quite frequent, for example, among the old and new Member States of the European Union. The view of the home authority is of extreme importance as, in case of financial distress of the subsidiary, it can decide to apply a resolution process or impose a liquidation procedure. Each decision can have a significant impact at the host state.

It could be prudent to establish a clear separation between domestic SIBs and G-SIBs, with the latter subject to special rules, stricter resolution requirements and cross-border cooperation agreements regulating the exchange of information and coordination of cross-jurisdictional policies. It has been also argued that additional rules should apply in connection with domestic SIBs. The creation of an exclusive resolution framework for domestic SIBs could help mitigate any potential conflict between home and host jurisdictions regarding the treatment of group subsidiaries. For example, although such subsidiaries are immaterial from the group’s business perspective, they present a systemic role for the host economy. Even banks with exclusively domestic operations can become a significant source of risk for financial stability. Hence, the FSB has developed a consultative document on a draft framework setting forth criteria to identify institutions that are systemically important at the domestic level. The document sets forth seven common principles for assessing the systemic importance of domestic banks, and five principles with regard to higher loss absorbency.

Nonetheless, discussions around the particular characteristics that an exclusive resolution framework for domestic SIBs should exhibit are still at an early stage. One should highlight, however, some of the key potential drawbacks and obstacles regarding the elaboration of such additional resolution rules.

First of all, there is no commonly accepted definition of systemic importance from an exclusively domestic focus and the FSB has yet to identify the main characteristics of how to measure domestic systemic importance (size/interconnectedness/substitutability/complexity) or how the systemic risk of a domestic institution could be measured by domestic regulators. Yet, it is crucial to demonstrate how these elements could be distinguished from the aspects that describe G-SIBs.

Due to the particularities of each domestic market, there will be challenges associated with trying to adopt a one-size-fits-all solution regarding domestic systemic importance. For instance, it will be virtually impossible to reach a mutual agreement on a certain fixed cap defining the size of a domestic SIB. In such a scenario, phenomena of under- or (more often) over-inclusiveness will become the rule. The use of broad policy standards would be fruitless as they may fail to capture the specific characteristics of each market.

As a global regulation of this issue will be quite challenging, state discretion will become a prerequisite for the determination of domestic systemic importance. Hence, as in the case of global SIBs, too much state discretion could result in cross-jurisdictional divergence in connection with the implementation of the FSB proposals for domestic SIBs.

Furthermore, the FSB did not deal with the issue of a potential conflict or overlap between the rules applied exclusively for domestic SIBs on the one hand, and the principles covering the regulation of G-SIBs on the other. In any event, there are numerous examples of financial institutions that present a domestic as well as global systemic importance, which gives rise to questions around which rules related to resolution planning or loss absorbency should be applied in the case of such institutions.

Finally, guidelines on domestic SIBs will add yet another layer of regulatory rules regarding bank supervision, capital requirements and crisis management to those that exist already. This could lead eventually to ‘over-regulation’, which might eventually stifle economic activity if the excessive burdens outweigh any potential benefits. Adding new loss absorbency requirements to the existing Basel III rules and the FSB special loss absorbency regulations for G-SIBs might result in a financial nightmare for financial institutions. The FSB should conduct a future impact analysis of the proposed standards on the regulation of domestic SIBs.
To sum up, although one may agree with the general trend to single out G-SIBs for which special resolution rules should apply, the FSB's proposal for an additional framework on domestic SIBs is not particularly convincing (at least, not in its current form). It will be interesting to see how this issue progresses, especially with regards to the evaluation of the likely benefits of a further special regulation exclusively for domestic SIBs.

10.5 Scope of resolution regimes: any bank or only SIBs?

There are conflicting opinions regarding whether bank resolution regimes should apply to all banks, or only SIBs. Certain domestic legislations specify that the various resolution methods should apply only in connection with financial institutions whose collapse would present a significant risk for financial stability.47

A notable exception to this trend is Switzerland. Although the latest amendments to the Swiss Banking Act only concern Swiss SIBs, the FINMA Banking Insolvency Ordinance – which regulates the details of bank resolution and the powers of FINMA when implementing such practices – will apply to any Swiss financial institution.48

Similarly, the EU’s new framework for the recovery and resolution of credit institutions is applicable to all institutions that are established in the EU, i.e. all banks (and investment firms), irrespective of their size or impacts on domestic financial stability. In other words, according to this resolution regime, systemic importance is not a mandatory condition for the initiation of a bank resolution procedure.49

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47 For instance, see Dodd-Frank Act, Title II, §§ 203(a)(2)(B) and (b)(2) (serious adverse effects from the failure of the financial company on the financial stability of the US). On the contrary, the resolution rules of the FDIA apply to any credit institution, irrespective of its size and systemic stability, FDIA, § 11(c).

48 FINMA Banking Insolvency Ordinance, art. 2(1)(a).

49 EU Bank Recovery and Resolution Directive, art. 1, 32 and 33.
Overall, there is no particular reason why the scope of application of bank resolution should be limited to SIBs exclusively. In the US, the FDIC’s long tradition of dealing successfully with the failure of every deposit-taking institution provides clear evidence that it is possible for bank resolution to have a broad scope of application. In any event, this legal regime has been established as the antidote to corporate liquidation, which can have disastrous effects on any banking institution, irrespective of its size.

The counter-claim is that bank resolution can result in far-reaching consequences for shareholders’, creditors’ and, potentially, even uninsured depositors’ rights. For instance, the implementation of bail-in for any banking institution has been a particularly contentious issue. Therefore, it could be argued that such radical resolution powers should be limited to SIBs, whose collapse would necessitate severe urgent measures commensurate with their importance for a state economy.

Taking into consideration the economic rationale for – and the benefits arising from – the implementation of such measures, they should not be limited to SIBs. Bail-in, asset separation procedures, or the creation of a bridge bank, complemented with a stay on early termination rights, could become sufficient alternatives to insolvency and liquidation even for the smallest bank.

Nonetheless, one should stress that specific complementary requirements to bank resolution – such as resolution planning and resolvability assessments – should be imposed exclusively on SIBs. Such tools are specifically intended to support resolution authorities to respond to the peculiar challenges in resolving large financial institutions, which have a complex organisational structure, operate on a cross-border basis, and have a broad network of counterparties. As such, they will be irrelevant for resolving small-sized banks, whose activities are limited and focused solely at the domestic level. It is unlikely that small banks would have the resources (financial as well as organisational) necessary to comply with such excessive regulatory demands in any case.

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Confronted with bail-out fatigue, unprecedented moral hazard risks, and the existence of systemic banks whose failure can have a severe negative impact on national economies, many states have decided to put in place legislative measures aimed at simplifying and downsizing SIBs, as well as facilitating their orderly default. These new legislative amendments reflect what Hüpkes has referred to as a ‘functional’ approach of insolvency; in other words, states will have the opportunity during a crisis to a) identify systemic functions and b) to take all necessary actions to protect these functions and not the financial institution as a whole. When implementing a bank resolution scheme, state authorities should be able to carve out the critical functions and let the residual bank fail orderly through traditional liquidation proceedings.

In practice, however, implementing this functional approach will not be always straightforward: in most cases, SIBs maintain a complex corporate structure, and often there is a mismatch between the way institutions are organised and the way they operate in practice (i.e. between their legal form and their business functions). As such, it might be difficult for regulators to disentangle and safeguard systemic functions along a vast complex network of branches and subsidiaries. Through bank resolution regimes and amendments in banking legislation, state authorities should provide legal and regulatory incentives to banks so that their legal forms will eventually comply with the distinctive features of their business functions.

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50 "Banking is essential, banks are not"

51 As the former Governor of the central bank of Belgium, Guy Quaden, mentioned, “the size of the banks is something that should be reviewed. If a bank is too big to fail, then it is simply too big”. La Libre Belgique (24/06/2009), cited in Dermine & Schoenmaker, 2010, p.4.


10.6 Concluding remarks: from systemic banks to systemic functions
Bank resolution will require, though, a coherent interpretation of systemic functions across jurisdictions in order to ensure their timely identification before the outbreak of a financial crisis. One should welcome the initiative of the FSB to provide more information on certain banking operations that could potentially become a source of systemic importance.\textsuperscript{54} It has been a crucial step endorsing the functional approach and stressing that any SIB can become resolved provided that its critical functions will be safeguarded. Additional future analysis of these standards will be essential in order to aid regulators to identify and resolve banks that potentially pose a systemic risk in a timely manner.

Additional standardisation will be also necessary with regard to elements of systemic importance. Of course, no approach to determining a bank’s global systemic importance will succeed in perfectly measuring systemic importance across all global banks. This, such as assessment must be relative, taking into account the specific considerations and particularities of each domestic market. On this basis, it would be probably useful to operate a distinction between global and domestic SIBs.

Finally, and although systemic banks present specific risks and challenges, the scope of application of resolution regimes should not be narrowly restricted to this type of financial institutions only. Rather, since classic insolvency procedures are unsuited to the resolution of financial institutions, all banks, irrespective of their systemic importance, will need to be resolved in a special way should they fail. The implementation of bank resolution rules (with the exception of requirements relevant to systemic importance) will also be beneficial for small- and medium-sized banks.

Chapter 11

BANKING GROUPS UNDER RESOLUTION

Following the 2008 financial crisis, the limitations of the concept of the ‘individual legal entity’ for efficient bank resolution in an era of global banking became clear. This safeguard for the legal autonomy of each entity within a banking group has been deeply rooted in the legal traditions of most jurisdictions. A variety of rules resulting from this theory lie at the core of the legal treatment of banking groups under corporate, banking and insolvency law. The ‘individual legal entity’ principle has been considered the basis for the exercise of ring-fencing practices by state authorities during insolvency, and has been transformed into a fundamental obstacle to the improvement of cross-border cooperation and coordination during bank failures.

During the 2008 financial collapse, hastily organised, piecemeal legal procedures resulted in most cases in significant destruction of business value and a complete disregard for the integrated organisational and operational models of modern banking groups.

Confronted with a complex financial environment and the legal impediments under insolvency law regarding banking groups, state jurisdictions entered into a rapid process of development of bank resolution regimes. In addition, they began contemplating an operational separation of banking business activities.

This chapter examines how a clear shift away from traditional crisis management practices (i.e. focused on the resolution of individual legal entities) towards more consolidated approaches (i.e. capable of dealing with financial crises of banking groups) will impact the efficient implementation of these bank resolution and bank separation schemes. The analysis begins by exploring the notion of banking groups and the impact of this definition on the proposals put forward by certain jurisdictions concerning structural reforms to the banking sector. It also highlights the discrepancies that exist between the legal structure and the economic operations of most modern banking groups. The chapter also examines the issue of asset transferability and asset consolidation within a banking group prior to or during a bank resolution procedure.
11.1 The notion of the banking group

In most legal statutes, the concept of the banking group is poorly or vaguely defined. This gives rise to conflicting definitions across jurisdictions. Given the lack of coherent guidelines around this definition, the provisions on banking groups are often overly broad (and over-inclusive) or else too narrowly formulated (under-inclusive). More typically, notions of banking groups are outdated, ignoring the economic reality and business practices within modern financial institutions.

The traditional concept of the banking group is founded on the existence of a parent entity, operating through a broad network of branches and subsidiaries. Although branches do not enjoy a separate legal character, and could therefore be better described as an extension of the parent institution, subsidiaries are legally and operationally independent entities that maintain their own capital base and conduct their activities through their own board of directors.

The term banking group should not be confused with the concept of a financial conglomerate. The latter describes a group of companies that are

1 For instance, in Switzerland, the Banking Act speaks of a financial group in case there is economic unity (unité économique) between the constituent entities or a de facto or de jure obligation of financial assistance between the different entities, without further elaborating on this obligation, Swiss Banking Act, art. 3(c)(1). In Germany, the Banking Act presupposes a relationship of control between a parent and another enterprise but, at the same time, describes the connection between a parent and a subsidiary as a relationship of close association, German Banking Act, art. 1(8) and (10). Even under supranational law, the definition of banking group remains vaguely defined. For example, under EU law, the concept of a group requires either the existence of a relationship of control (majority of the shareholders’ or other members’ voting rights / right to appoint or remove a majority of the members of the administrative, management or supervisory body / right to exercise a dominant influence) or of a similar relationship or of close links (participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital / control / a permanent link to the same third person by a control relationship) between those entities, EU Capital Requirements Regulation, 2013, art. 4§1(37)–(38). This broad definition could foster over-inclusiveness and result in conflicting interpretations amidst a financial crisis, clashing with the still existing prevalent idea of legal separation of corporate entities.

active in at least two distinct financial sectors (e.g. banking and insurance), offering different forms of financial activities but forming a single large business structure.³

The first references to banking groups reflected the traditional image of credit institutions with numerous branches in one or numerous jurisdictions. The boom in banking activities in the early 1990s resulted in the rapid expansion of banking groups through the establishment of subsidiaries.⁴ Subsidiaries have since become the predominant legal form in the banking business for a variety of reasons relating to tax incentives, avoidance of business restrictions, reduction in capital and supervisory requirements, and general regulatory arbitrage.⁵

This straightforward concept of the banking group became broader in scope in the following years in order to cover the investment banking operations, which were by that point also being offered by international financial institutions. The globalisation of financial markets, along with the removal of domestic regulatory restrictions that resulted in a deregulation of domestic markets were the key driving forces behind the expansion of group structures. However, whilst banking groups began to undergo radical transformations with regards to their organisational structure and the types of financial activities they were engaged in, the legal concept remained unchanged.

Modern banking groups have long overcome the traditional structure of the parent bank with its branches and banking subsidiaries. Investment firms and asset management companies are part of their organisational structure and, in many cases, these non-bank financial entities are not subject to ordinary banking supervision.⁶ Financial intermediaries are frequently involved in the so-called ‘shadow banking’ operations, outside the balance sheets of commercial banks.

⁴ European banking groups were the pioneers of this rapid cross-border expansion. Up until this day, European SIBs prefer subsidiaries to branches for their cross-border business activities, Commission of the European Communities, Communication for an EU Framework for Cross-border Crisis Management in the Banking Sector, 2009, p.7.
⁵ Cumming & Eisenbeis, 2010, p.23.
⁶ In 2008, numerous banks faced significant financial pressures following their decision to provide support to money market funds and other entities that they had kept off their balance sheets, Admati & Hellwig, 2013, p.84.
Furthermore, the parent does not necessarily need to be a banking entity; it could also be a holding company. This company, although not operationally active as a standalone entity, holds significant interests in the subsidiaries of the group. Even within the relatively harmonised and standardised legal environment of the EU banking sector, cross-border SIBs consist of a variety of business entities, combining retail and investment banking, securities trading and asset management activities.7

As a consequence, there is an urgent need for a radical reform of traditional definitions relating to banking groups, which are no longer relevant in the context of this changing landscape. Specifically, this calls for a clear legal differentiation between the concept of a group when described under company and banking law, currently poorly illustrated in many banking legislations. Despite the fact that the former might carry on with a much stricter and more formalistic approach regarding the legal separation of the various group entities, the latter should focus on the actual economic reality of integrated business activities of financial institutions operating as parts of a group.8

The new bank resolution regimes require legal certainty and clear limits with regard to their scope of application. These requirements underscore the importance of developing a more explicit and more uniform definition of banking groups. This definition should reflect the size of modern SIBs, include a maximum of their potential constituent entities (some of them certainly problematic from the viewpoint of financial supervision)9 and minimise the risks resulting from regulatory loopholes. The criterion of banking activity should remain an indispensable element of the definition, along with a more detailed description of the intra-group linkages between the group entities and of the notion of control exercised by the parent.10

7 Fonteyne et al., 2010, p.34.  
9 The EU recognised that entities specialised in investment and other financial activities (sometimes operating in an environment of loose financial regulation) could become a source of serious financial problems for a financial institution and contribute to financial contagion, Commission of the European Communities, Communication for an EU Framework for Cross-border Crisis Management in the Banking Sector, 2009, p.11.  
10 Fonteyne et al., 2010, p.38.
The current regulatory reforms to banking sectors should be also taken into consideration when developing a more up-to-date definition on banking groups. As presented in the following section, the rules introduced under the Volcker Rule and the Vickers Report in the US and the UK respectively, as well as the draft EU regulation on structural reforms for banking groups, will require the introduction of drastic rules on banking groups. Each rule, though, relates to a different legal concept regarding the final form of a banking group. In the US, banks will be prohibited from entering into any proprietary trading activities; whereas in the UK, there will be an absolute legal and operational separation between retail and investment banking entities of the same group. Finally, according to the draft EU regulation, the deposit-taking and the trading entity will operate within the same group under a bank holding company structure. Thus, future divergences between the legal form of banks will clearly have an impact on how we interpret the notion of the banking group.

A well-designed definition may also result in better corporate governance and business management policies within banking groups. It has been suggested, for instance, that greater clarity around the concept of the banking group might encourage parent companies to undertake stronger commitments concerning the soundness of the everyday activities of the group’s constituent entities. Furthermore, the improvement and the crystallisation of such a definition under legal statutes could encourage SIBs to simplify their complex organisational structures. After all, the opacity of their structures stems principally from their efforts to take advantage of outdated legal provisions and regulatory loopholes concerning their business operations.

Such a change should first have to take place under each domestic legal order. The Cross-Border Bank Resolution Group of the Basel Committee highlighted the importance of each jurisdiction providing a national framework for coordinating the resolution of the constituent entities of a group within the limits of the jurisdiction in question. For this national

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11 Other jurisdictions contemplate also the introduction of structural rules. For instance, India and Singapore will require foreign banks to establish separately incorporated banking subsidiaries and Mexico introduced limits to group transfers and transactions between locally incorporated subsidiaries and their foreign parents, FSB, Structural Banking Reforms, 2014, p.11.


13 BCBS, 2010c, p.25.
framework to become effective a more detailed and up-to-date definition of banking groups will be essential.

Evidently, developing a straightforward international standard regarding a clear-cut definition on banking groups will be virtually impossible. Nonetheless, the international standard-setting bodies involved in the discussions around bank resolution should be able to provide guidelines on a more consolidated definition of banking groups so as to avoid growing divergence between jurisdictions. Ultimately, the existence of vague and/or conflicting definitions may further hinder cross-border coordination and cooperation.

11.2 Structural reforms for banking groups

The complexity of modern banking structures was exposed during the 2008 crisis, and it became apparent that banking structural reforms were vital in order to transform the domestic banking sectors. Consequently, numerous jurisdictions have begun to consider introducing structural reforms focused either on the restriction/prohibition of certain financial activities, the need for financial institutions to adopt specific operational structures, or the ‘ring-fencing’ or separation of banking activities between different legal entities.

The FSB has stressed that such proposals may help to: reduce the risk of cross-contamination between deposit-taking and investment banking entities; modify the appetite for risk / the risk culture prevalent in modern financial institutions; and improve the resolvability of banking entities. At the same time, there is the concern that the costs for international banks of complying with such new reforms could be significant. This might encourage regulatory arbitrage and promote a shift in financial activities to the shadow banking system, and could undermine international crisis coordination if domestic authorities ring-fence or restrict capital and liquidity in group entities operating within their jurisdictional limits.

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14 Divergence that will necessarily emerge through the different proposals on the structural reforms of banking groups.
15 FSB, Structural Banking Reforms, 2014, p.3.
16 Ibid, pp.13–16.
11.2.1 US structural banking reforms

11.2.1.1 The Volcker Rule

The Volcker Rule was introduced under Section 619 of the Dodd-Frank Act as an amendment to the Bank Holding Company Act.\(^\text{17}\)

The principal idea of the Volcker Rule is that banking entities such as credit institutions, bank holding companies, and their affiliates and subsidiaries will be banned from entering into proprietary trading or from investing in or sponsoring hedge funds or private equity funds.\(^\text{18}\) Non-banking financial companies that intend to engage in proprietary trading will have to be subject to additional capital requirements.\(^\text{19}\) The sole authorised activities will cover market making, the purchase, sale, acquisition and disposition of US state and US agencies’ bonds, risk-mitigating activities designed to reduce specific risks to the banking entity or investments in one or more small business investment companies.\(^\text{20}\)

The Rule will apply to all activities of US banks as well as the US activities of foreign banks. The regulations under the Rule are expected to have a significant impact on existing Wall Street giants like Goldman Sachs and JP Morgan, which derive 48% and 27% of their total consolidated revenues respectively from principal transactions.\(^\text{21}\)

The Rule was initially presented in just ten pages in the original Dodd-Frank document. In October 2011, however, the US authorities presented the proposed regulations for the implementation of the Rule; these amounted to 298 pages, accompanied by more than 1,300 questions on 400 different topics.\(^\text{22}\) Thus, what began as a straightforward text introduced by the former Chairman of the Federal Reserve in early 2010 has

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\(^{17}\) The Rule was named after the former Federal Reserve Chairman Paul Volcker.

\(^{18}\) Dodd-Frank Act, Title VI, § 619(a)(1).

\(^{19}\) Ibid, § 619(a)(2). Although a uniform consensus on the definition of proprietary trading remains lacking, a possible definition would be the process of “engaging as a principal for the trading account in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract”, Bergin, 2011.

\(^{20}\) Dodd-Frank Act, Title VI, Section 619(d)(1).

\(^{21}\) Touryalai, 2011.

\(^{22}\) Stewart, 2011.
evolved into a document that is too complex to understand and most likely too costly to adopt. Many of the proposed regulations are vague and leave too much room for discretion. The biggest fear is that the project will be watered down: after a period of public consultations, for example, banks managed to introduce broad exemptions.23

It was anticipated that the regulations governing the Volcker Rule would first be enacted on 21st July 2012.24 In the end, the final rules regarding the implementation of the Rule were only published in December 2013, and the financial institutions had until 21st July 2015 to modify their activities accordingly.25

11.2.1.2 Enhanced prudential standards for foreign banking organisations

In an effort to address the supervisory and regulatory challenges posed by large foreign financial institutions with a significant US presence, in February 2014 the Federal Reserve Board adopted enhanced prudential standards. These standards will have an impact on the structure, capital, liquidity and risk management of foreign banking organisations operating in the US banking market.

Foreign banking organisations with US non-branch assets of $ 50 bn or more will be obliged to form a US intermediate holding company, or to designate an existing US subsidiary as their US intermediate holding company.26 All their US subsidiaries must be held through this structure. This US intermediate holding company will be subject to the same capital, liquidity and risk management requirements as any bank holding company established in the US. The reforms will not prohibit foreign banking organisations from operating branches or other agencies in the US.

23 Touryalai, 2011.
24 However, in early 2012, the Federal Reserve Chairman Ben Bernanke acknowledged that it will be impossible to respect this deadline, as the comment period had been closed in February 2012, resulting in approximately 17,000 comments and many provisions remain too contentious, necessitating further work on them, Torres & Hopkins, 2012.
In addition, foreign banking organisations with combined US assets of $50 bn or more will need to comply with all US rules on liquidity, capital and risk management as applied in the US.\textsuperscript{27}

The implementation of the enhanced prudential standards will start in early 2016. Non-bank financial companies will not be subject to the new rules. The FSB estimates that between 15 and 20 foreign banking organisations will be required to form a US intermediate holding company.\textsuperscript{28}

\textit{11.2.2 The UK ring-fencing rules}

In the UK, the implementation of the Vickers Report could potentially radically change the UK banking sector. In September 2011, the Independent Commission on Banking, under the leadership of Sir John Vickers, released its final report on structural changes for the UK banking sector in order to promote financial stability and competition.\textsuperscript{29} Whilst this report was in keeping with the Volcker Rule, it went much further, calling for an actual separation of retail and investment banking activities of all UK banking entities.\textsuperscript{30} According to the proposed changes introduced in this report, the ring-fenced part of the bank would contain all retail and small business deposits, while the investment part of the bank would include derivatives’ transactions, debt and equity underwriting and trading in securities.\textsuperscript{31} The ring-fenced parts of a bank would be subject to higher capital requirements that could reach up to 20%, comprising equity of 10%.\textsuperscript{32} The two entities would have to remain legally and operationally separate.

The proposals have been transposed into law through the adoption of the Financial Services (Banking Reform) Act of 2013. The ring-fencing rules will be introduced in the Financial Services and Markets Act and will apply to UK incorporated entities holding more than £25 bn in core deposits. UK branches of foreign banks will not be affected.

\textsuperscript{27} \textit{Ibid}, § 252.154 – § 252.157.
\textsuperscript{28} \textit{FSB, Structural Banking Reforms}, 2014, p.6.
\textsuperscript{29} For the full text see \textit{Independent Commission on Banking}, 2011.
\textsuperscript{30} \textit{Ibid}, p.18.
\textsuperscript{31} GoFF, 2011.
\textsuperscript{32} \textit{Treanor}, 2011. The Vickers Report endorsed stricter capital requirements for the ring-fenced deposit-taking entity whereas the proposals for banking structural reforms on the EU level argue for more stringent capital rules for the trading entities, \textit{Gambacorta & van Rixtel}, 2013, p.4.
According to these provisions, the ‘ring-fenced’ body will be a UK financial institution, carrying one or more core activities (essentially deposit taking or any other regulated activity considered as such by the UK Treasury).\textsuperscript{33} Excluded activities are mainly those connected with dealing in investments as principal and market making.\textsuperscript{34} ‘Ring-fenced’ bodies will be prohibited from exercising excluded activities – and vice-versa for investment entities – or entering into contracts with other group entities other than on an arm’s length basis. Ring-fencing will be implemented by the UK Treasury once specific conditions have been fulfilled.\textsuperscript{35} The deadline for the changes is expected to coincide with the full implementation of the Basel III capital requirements in 2019.

In response to this report, UK financial institutions expressed concern that they will be subject to new regulatory requirements at a time when they are already under extreme pressure to cope with the consequences of the 2008 crisis. There are fears, for example, that these measures will have substantial impacts on consumer lending as well as on bank recovery.\textsuperscript{36}

Even UK authorities appear not entirely convinced of the appropriateness of implementing such a separation. As mentioned in the Turner Review of the FSA, such a split might not function in the modern era of globalised finance, as “the era of almost complete separation between clearing banks and merchant banks was also an era of fixed exchange rates and exchange

\textsuperscript{33} Financial Services (Banking Reform) Act, 2013, §§ 142A, 142B and 142C.
\textsuperscript{34} Ibid, § 142D.
\textsuperscript{35} One or more of the four conditions cited in section 142K of the Financial Services (Banking Reform) Act of 2013. Condition A is that the carrying on of core activities by the ring-fenced body is being adversely affected by the acts or omissions of other members of its group. Condition B is that in carrying on its business the ring-fenced body (a) is unable to take decisions independently of other members of its group, or (b) depends on resources which are provided by a member of its group and which would cease to be available in the event of the insolvency of the other member. Condition C is that in the event of the insolvency of one or more other members of its group the ring-fenced body would be unable to continue to carry on the core activities carried on by it. Condition D is that the ring-fenced body or another member of its group has engaged, or is engaged, in conduct which is having, or would be likely to have, an adverse effect on the advancement by the appropriate regulator of continuity of core services’ objectives.
\textsuperscript{36} Barclays and the RBS are likely to be those hardest hit, Goff, 2011.
controls, with far more limited capital flows and trade flows as a percentage of GDP, and much smaller role played by cross-border corporations”.

11.2.3 The EU concept of structural reforms for banks

Finally, the EU contemplates a prohibition on, and a potential legal separation of, certain significantly risky banking activities within a banking group. The principal objectives are to prevent the coverage of losses incurred in an investment banking entity by insured deposits, and to reduce the interconnectedness between credit institutions and the shadow banking system.

In February 2012, the EU Commission established a High-Level Expert Group, under the guidance of Erki Liikanen, Governor of the Central Bank of Finland, in order to examine the need for deep structural reforms of the EU banking sector. The Group published its final report in early October 2012, adopting a compromise solution that is effectively a ‘hybrid’ of the approaches proposed in the Volcker Rule in the US and the Vickers Report in the UK. This solution would not put the universal model of banking business of EU financial institutions in jeopardy. Unlike the proposals put forward in the UK and US (with the former endorsing the ring-fencing of the deposit-taking entity, and the latter the banning of banks from certain activities), the ‘Liikanen Report’ envisioned a separation of banking activities that would not necessitate the actual fragmentation or ring-fencing of certain entities within a banking group.

On the basis of the Report’s recommendations, in January 2014 the EU Commission presented the final project for a regulation on structural reforms for European banks. The principal objectives of the draft regulation are to safeguard the financial stability and resilience of the EU banking sector, as well as to introduce a Union-wide approach that will guarantee a level playing field for EU banks and mitigate the risks associated with regulatory fragmentation and lack of harmony between national legislations. In

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37 FSA, The Turner Review, 2009, p.94. For Lord Turner modern international banks, “are deeply involved in the process of lubricating a global economy…and which, in order to do that, cannot be entirely away from things that happen in trading rooms, markets that need to be made, derivative products that are legitimately offered”, House of Commons – Treasury Committee, 2009, p.96.
the absence of such reforms, the EU Commission argued, divergent national approaches might otherwise undermine efforts to achieve a single rulebook, introduce unwarranted compliance costs for cross-border banking activities, and create opportunities for regulatory arbitrage.\(^{38}\)

The draft regulation will apply to all EU credit institutions, their parent companies, and their branches and subsidiaries – including in third countries. These banking entities should be identified as G-SIBs or at least have – over a period of three consecutive years – total assets amounting at least to € 30 bn, and trading activities amounting at least to € 70 bn or 10% of the bank’s total assets.\(^{39}\) The scope of application of the regulation will also cover EU branches and subsidiaries of third country banks unless these banking entities are subject to equivalent rules at their home state or to a ‘multiple point of entry’ resolution strategy.\(^{40}\)

The principal obligation introduced by the proposed regulation is the prohibition of proprietary trading on any financial instrument or commodities.\(^{41}\) In defining proprietary trading, the definition put forward in the proposed EU regulation is much more straightforward and narrow in scope than the complex definition used in the Vocker Rule in the US.\(^{42}\)

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38 Proposal for a Regulation on Structural Measures Improving the Resilience of EU Credit Institutions, 2014, p.5. The most prominent examples have been Belgium (Loi relative au statut et au contrôle des établissements de crédit of 2014), France (Loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires) and Germany (Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen).

39 Ibid, art. 3.

40 Ibid, art. 4.

41 Ibid, art. 6(1). The prohibition will not be applied for financial instruments issued by member states central governments or when the banking entity uses its own capital as part of its cash management procedures, ibid, art. 6(2).

42 “Proprietary trading means using own capital or borrowed money to take positions in any type of transaction to purchase, sell or otherwise acquire or dispose of any financial instrument or commodities for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity’s risk as result of actual or anticipated client activity, through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making, including through dedicated web-based proprietary trading platforms”, ibid, art. 5(4). This narrow definition of proprietary trading underpins the principle of proportionality set out in art. 5 of the TFEU and results from the evidence that proprietary trading represents a limited part of EU banks’ balance sheets.
Furthermore, the proposed regulation grants supervisory authorities with the power to separate other high-risk trading activities (such as market-making, complex derivatives and securitisation operations) from the deposit-taking activities within the same banking group.\textsuperscript{43} The trading activities will have to be transferred to a group entity (trading entity) that will be legally, economically and operationally separate from the core credit institution.\textsuperscript{44} The principal factors to be taken into consideration with regards to the separation of the activities are: the relative size of trading assets; their leverage; the relative importance of counterparty credit risk; the relative complexity of trading derivatives; and the interconnectedness.\textsuperscript{45} Credit institutions will not be required to separate their activities if they can demonstrate to the satisfaction of their supervisor that the risks generated can be mitigated by other means.\textsuperscript{46}

All in all, each EU parent bank subject to the above requirements should create on a sub-consolidated basis two distinct sub-groups: one of which will be comprised only of core credit institutions, and the other only of trading entities.\textsuperscript{47} The group of credit institutions will be hedged in the event of an insolvency of the trading entities.

According to the timeline adopted by the Commission, the prohibition on proprietary trading should become effective in January 2017 and the provisions on separation of banking activities should enter into force in July 2018.

The main critique against the Commission’s proposal is that it is essentially backwards looking as it considers that (i) investment banking is the greatest risk for a banking group (when the balance sheets of most Eurozone credit institutions still contain a significant number of ‘bad’ loans), (ii) government support is a safety net for the deposit-taking entities of a group and (iii) an isolated resolution of the investment banking entity will have a limited impact on real economy.\textsuperscript{48}

\begin{itemize}
\item \textsuperscript{43} \textit{Ibid}, art. 9 and 10.
\item \textsuperscript{44} \textit{Ibid}, art. 13(1).
\item \textsuperscript{45} \textit{Ibid}, art. 9(2).
\item \textsuperscript{46} \textit{Ibid}, art. 11 and 12.
\item \textsuperscript{47} \textit{Ibid}, art. 13(3).
\item \textsuperscript{48} \textit{Gordon & Ringe}, 2015, p.20.
\end{itemize}
11.3 From legal formalism to economic reality: the operations of modern banking groups

Despite the clear-cut and formalistic approach under banking legislation in most jurisdictions regarding the differentiation between branches and subsidiaries, it has been a general phenomenon to view a relative substitutability between the two legal concepts under the business practices of international banking groups. This “mismatch between economic and legal reality” is the clear demonstration that the business lines of modern financial behemoths do not correspond always to the pre-determined legal patterns of group organisation. As stressed by Avgouleas, Goodhart and Schoenmaker, “banks try to have the best of both worlds: exploiting the benefits of legal structure and taking advantage of the synergies attached to operating as an integrated group”.

Although there is an important legal distinction between parent companies and subsidiaries, with subsidiaries supposedly enjoying absolute separation and complete independence from the parent company, in reality this is often not the case. Although de jure separate, subsidiaries are frequently established as matrix business entities, which might not enjoy any de facto independence. Indeed, it is common for banks to run their subsidiaries in a highly integrated manner, centralising all capital, liquidity and risk management activities to one group entity (usually the parent company). This therefore casts into doubt the principle of legal separation. By consolidating its business operations in this way the ground becomes fertile for financial contagion: the more interconnected the group’s entities, the greater the risk that to the financial stability of the whole group if one crucial entity becomes financially weak.

The way in which authorities responded to Lehman Brothers’ bankruptcy illustrates perfectly the existing gap between the consolidated

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50 Attinger, 2011, p.46.
51 Avgouleas, Goodhart & Schoenmaker, 2013, p.211.
52 IMF, 2010c, p.7.
53 It is true that the local management of a foreign subsidiary enjoys in many cases limited space for independent action due to the single treasury operation, concentrated risk management and highly integrated business operation put into place by the parent bank, Mayes, 2006, p.62.
business practices of financial institutions in the modern era and the inappropriateness of legal statutes that were in place to monitor and regulate such activities (i.e. statutes that focused at the level of each individual entity).

Lehman Brothers operated through a vast network of subsidiaries, both regulated and non-regulated entities, and had adopted a heavily consolidated organisational business model. Lehman’s subsidiaries were entirely dependent on the US holding, LBHI, and its US subsidiary, LBI, for their everyday activities. At the beginning of each business day the US parent provided liquidity to the entities across the world, which was rerouted back to the parent at the end of the day. The obvious result of the opening of a bankruptcy procedure for the parent company in the US, ignoring the interdependence of the other group entities, was a cascade of further bankruptcies of the subsidiaries around the globe. Even those entities, which appeared financially solvent, did not avoid a financial collapse by the end of the day on 15th September 2008.

The survival of a banking group can also be jeopardised not only by problems in the parent company, but history also shows that even the collapse of a subsidiary can spread contagion and eventually bring down the whole group. This was the case for the Banco Ambrosiano group, where the failure of a Luxembourg subsidiary (which was not even a banking entity) was the main catalyst for the collapse of the whole banking group.\(^{54}\)

In addition, aside the operational interconnectedness, the entities of a group might be interlinked through branding or through sharing a franchise value. This reputational connection can weigh in significantly on the decision of the parent company to intervene for financially distressed (although legally separate) foreign subsidiaries.\(^{55}\) Under the proposals


\(^{55}\) As stressed by Walter Wriston, former chairman of the Citigroup, in 1981, “it is inconceivable that any major bank would walk away from any subsidiary of its holding company”, Richard Herring & Jacopo Carmassi, The Corporate Structure of International Financial Conglomerates: Complexity and its Implications for Safety and Soundness, in Berger, Molyneux & Wilson, 2010, p.206. On the other hand, the parent can display the completely opposite reaction, as in the case of the Argentine crisis, where both European and US banks abandoned entirely not only subsidiaries but also their branches amidst the financial collapse of the state, Hüstück, Insolvency – What Is Different about Banks?, in Peter, Jeandin & Kilborn, 2006, p.5.
put forth in certain jurisdictions for the structural separation of banking groups, it will be interesting to view how such reputational links will influence the decision-making of the core or deposit-taking entity with regards to letting the trading entity fail, or vice-versa.

The determination of the parent to support other group entities is further displayed through the issuance of guarantees. These guarantee arrangements normally cover funding purposes, and describe the obligations to be fulfilled by the parent in the event of specific scenarios that might lead other parts of the group to financial distress. The overdependence of subsidiaries from the parent’s guarantees and how this practice can prove to be extremely risky for the survival of a banking group had been demonstrated in the most straightforward manner in the bankruptcy of the Icelandic Kaupthing Bank. The issue of group guarantees is linked with the controversial practice of intra-group asset transfers, which will be analysed in the following section.

Interestingly, under the ‘source-of-strength’ principle in US law “a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner”. It must be noted, however, that this principle does not apply in a cross-border context. The FDIC interpreted “a bank holding company’s failure to meet its obligation to serve as a source of strength to its subsidiary banks, including an unwillingness to provide appropriate assistance to a troubled or failing bank” as an unsound and unsafe banking practice.

Hüpkes highlights that the Swiss Federal Tribunal has also introduced the idea of a de facto obligation to the members of the group to save a failing entity from financial collapse.

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56 Schoenmaker, 2010a, p.17.
57 Code of Federal Regulation, Title 12, § 225(4).
This conflict between legal structure and operational reality concerns not only subsidiaries, but also the branches of a banking group. Theoretically, unlike subsidiaries, which are separate entities to their parent banks, branches seem to lack any element of autonomy. Yet, there is evidence that, in practice, branches enjoy significant levels of independent managerial decision-making in some cases, and that there may be a notable differentiation between their business policies and those of the parent.60

It is also common for certain jurisdictions to impose special conditions on the operations of branches of foreign banking groups within their territory. These legal provisions may disregard the integrated management within a group and the lack of any autonomy of the branch from the parent. The main objective of such conditions is to safeguard the interests of local creditors or local depositors in the event that the foreign parent company collapses, and to allow the host regulator to implement ring-fencing practices. Typical examples of such legal practices include: asset pledge or asset maintenance requirements; provisions on endowment capital; and requirements imposing the local incorporation of foreign branches.61

The above arguments highlight the ‘inability’ of the legal form to follow business functions.62 This contradiction between legal formalism and economic reality is established under insolvency law, where domestic jurisdictions apply consolidated legal procedures for branches but respect the legal separation of subsidiaries, even in the presence of integrated banking groups. Such provisions result in chaotic legal procedures, since the task of disentangling the assets of the different entities is often a daunting one. Ultimately, this can contribute to significant value destruction.

60 Mayes, 2006, p.62.
62 Hüpkes, 2009a, p.376.
The EU Winding-Up Directive provides a very illustrative example of how current bank insolvency legislation is ill suited to respond to the realities of modern banking operations and structures. The text endorses the concept of modified universality, according to which an insolvency procedure initiated in the home state of a banking group would be automatically recognised in all other EU Member States and would cover all branches of the group established in those states. Yet, bank subsidiaries are not included in the scope of this Directive, even those operating within the EU. This is concerning given that, in reality, EU banking groups organise their daily business through a vast network of subsidiaries, holding approximately € 4 tn in assets.

Jurisdictions currently in the process of reforming their banking legislation must ensure that this complex economic reality is effectively integrated into and reflected in their new bank resolution and bank insolvency regimes. Setting aside the conventional legal tradition of separating the treatment of branches and subsidiaries in favour of a more functional approach will be vital. As discussed in the previous section, the achievement of this goal will necessitate the development of a more precise definition of the concept of banking group. It is estimated that the process of developing group resolution plans will help to increase authorities’ understanding of the complexities associated with modern cross-border groups’ operational structures. This regulatory exercise will be beneficial for the reforms targeting legal provisions destined to better regulate the resolution of international banking groups.

11.4 Asset transferability

One of the most controversial issues closely linked with the operations of banking groups, is the practice of asset transfers between the different

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63 EC Winding-Up Directive, art. 9(1).
64 Sester, 2010b, p.537.
65 As stressed by the IMF, “regulators need to seek alignment between a financial group’s legal and operational organisation on the one hand and the crisis management and insolvency framework on the other”, IMF, 2010b, p.7.
group entities. These transactions might concern the transfer of collateral and capital, interbank lending, guarantees and liquidity back-up facilities. Asset transfers are tolerated in certain jurisdictions under explicit, limited requirements and have been broadly considered as a very efficient tool for liquidity, risk and crisis management. As a result, it is a practice that has become commonplace within cross-border groups, usually exercised on a case-by-case basis.

On the other hand, it should be noted that such practices can also become a major source of financial contagion, spreading financial instability even to apparently solvent, healthy group entities. It is largely because of this potential risk that asset transferability is considered controversial.

In addition, this practice may undermine the basic principle of safeguarding creditors and minority shareholders. A plethora of rules have been introduced under different domestic laws to act as legal barriers prohibiting or limiting the practice of asset transfers except on purely commercial terms and for fair consideration. These rules result either from corporate law (mainly regarding each corporate entity’s interest and creditors’ or minority shareholders’ protection) or from insolvency law (regarding transfers within a certain suspect period prior to insolvency or claw-back rules rendering intra-group transfers retroactively voidable or non-effective). Criminal sanctions can be imposed and civil actions can be filed if these rules are violated. The provision of intra-group guarantees (up-, down- or cross-stream) is also prohibited or restricted in certain jurisdictions.

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66 Intra-group asset transferability can be defined as “legally enforceable commitments for financial assistance or assurance made by one group entity upon which another group entity can call in times of stress or unexpected loss and/or commitments which regulators would regard as reliable means of support”, BCBS, 2012, p.3.
68 One of the best examples is the US, where there are mainly four conditions on transactions between depository institutions and their affiliates (the lending double limit rule, the low quality asset restriction, the full collateralisation requirement and the safe and sound banking requirements) but also certain additional qualitative restrictions (arm’s length requirement, no purchase from affiliates as a fiduciary and no acquisition of securities underwritten by the affiliate), Federal Reserve Act, §§ 23A and 23B.
70 ECB, 2010, p.3.
71 For instance in France and Belgium, ibid, p.12.
Aside from formal legal restrictions, there are also internal group procedures and guidelines that can also serve to limit – or ban entirely – asset transferability practices.\textsuperscript{72}

Even within the relatively coherent EU legal environment, the asset transferability practices of the Member States vary significantly.\textsuperscript{73} EU law is rather vague regarding the authorisation of such practices, which contributes to further confusion.\textsuperscript{74}

It has been argued that asset transferability is principally concerned with early intervention and not resolution. However, since the latter might take place once the former has failed to stabilise a financial institution, a more standardised and coherent treatment of asset transfer practices will be necessary. Resolution authorities will require legal certainty, for example, when implementing business transfers to a third party entity or a bridge bank under resolution. If the assets to be transferred to the new entity were subject to previous intra-group agreements – and thus potentially exposed to claw-back provisions – the whole resolution procedure would be significantly undermined. It is also questionable if the concept of a ‘suspect period’ – common under insolvency regimes – could apply for bank resolution. In such a case, asset transfers taking place under an early intervention stage could be made void in a subsequent resolution procedure.

\textsuperscript{72} BCBS, 2012, p.17.

\textsuperscript{73} Certain member states prohibit disadvantageous transactions or transactions at an under-value, others allow asset transfers as long as they are made at arms’ length, on standard commercial terms; others require a previous authorisation by the general assembly. In general, supervisors in all EU member states have the power to restrict intra-group asset transfers in order to avoid contagion risks, Commission of the European Communities, Staff Working Document Accompanying the Communication for an EU Framework for Cross-Border Crisis Management in the Banking Sector, 2009, p.19.

\textsuperscript{74} Recital 52 of the EU Capital Requirements Regulation stresses that “when an institution incurs an exposure to its own parent undertaking or to other subsidiaries of its parent undertaking, particular prudence is necessary. The management of such exposures incurred by institutions should be carried out in a fully autonomous manner, in accordance with the principles of sound banking management, without regard to any other considerations”. Furthermore, it allows the supervision for a banking group to be exercised on a fully consolidated basis only in cases when there is no material, practical or legal impediment to the prompt transfer of own funds from a parent to a subsidiary and vice-versa, EU Capital Requirements Regulation, 2013, art. 7(1) and (3).
One solution might be the development of a more standardised process of asset transfers, which should be based on transparent, *ex ante* requirements, and should highlight the pre-eminence of group interest. Intra-group transactions should take place within “the aggregate strategic interest of the group”.75 This concept is not new and a number of countries have introduced it under their legal framework of corporate law.76 In other countries, tribunals produced interesting case law on this issue, with the most well-known being the Rozenblum case, decided by the French *Cour de Cassation*.77

While the concept of group interest might seem quite appealing, there are concerns that a legal framework dealing with asset transfers might result in piercing the corporate veil between the different group entities and in a discriminatory treatment of the creditors of the transferor.78

As an answer to these concerns, one can highlight the formal, standardised procedure of group financial support agreements between the constituent entities of a financial group proposed by the EU Commission.79 The EU Bank Recovery and Resolution Directive will put this recommendation into practice. The Directive proposes specific conditions for the provision of intra-group financial support,80 a process of authorisation of

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75 As stressed by the IMF, “the detriment suffered by one group company as a result of a particular transfer could be compensated by the restoration of the financial soundness of the whole, which ultimately brings benefits also to the transferor”, Fonteyne et al., 2010, p.42.


77 According to the French court, transfers for the purpose of mutual support can take place between the entities of a group under strict requirements (policy for a group as a whole, financial assistance should not occur without any return for the company providing the assistance nor should it disrupt the balance of mutual obligations and should not exceed the capacity of the company that supports the burden), ibid, p.22. The Rozenblum case influenced also case law in Belgium.


80 For instance, respect of the preservation or restoration of the financial stability of the group as a whole and financial support that will not jeopardise the liquidity or solvency of the entity providing the support, EU Bank Recovery and Resolution Directive, art. 19(1). These conditions are further specified by EBA standards, EBA, Consultation Paper on DRTS on the Conditions for Group Financial Support, 2014, pp.12–14.
such agreements by the competent state authorities and, if necessary, the general assembly of each group entity. With regard to creditors’ protection, it is envisaged that every agreement should be made public according to standards elaborated by EBA.

Although a very encouraging step, the procedure introduced under the EU Bank Recovery and Resolution Directive seems very cumbersome, as it demands the participation and approval of different stakeholders. Whilst EBA will play the role of mediator in case of any potential conflicts between the competent national supervisory authorities involved in the process, one can nonetheless not be certain whether its final decision will be in the best interest of the group, or rather the result of a political trade-off. Furthermore, if a general assembly rejects the agreement, the competent authorities will not be able to validate it; thus the group would reach a stalemate.

The adoption of structural reforms for banking groups – and the subsequent separation of retail and investment banking activities – would present a more radical solution. The UK ring-fencing scheme will require an absolute legal and operational separation between the deposit taking and investment banking entities of a group. The EU proposal on this issue contemplates the creation of two separate sub-groups, one including only credit institutions and the other only trading entities. The two sub-groups should remain economically, legally and operationally independent. Such measures could have significant impacts on the operations of global banks and may constrain the allocation of capital and liquidity between the entities of international banking groups.

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81 EU Bank Recovery and Resolution Directive, art. 20.
82 Ibid, art. 21.
83 Ibid, art. 26. The disclosure should be made without any delay following the conclusion of the group financial support agreement on the website of the financial institution and updated immediately following any revision of the agreement. It should contain, among others, information on the name of the entities covered by the support, the form of the support, the triggering circumstances of the support and a general description of collateral and marginal requirements, EBA, Consultation Paper on DRTS on the Conditions for Group Financial Support, 2014, pp.25–26.
84 Gambacorta & van Rixtel, 2013, p.12. One of the objectives of the EU for the introduction of its group financial support agreements under the EU Bank Recovery and Resolution Directive is to avoid exactly such counterproductive ring-fencing measures of capital and liquidity, EBA, Consultation Paper on DRTS on the Conditions for Group Financial Support, 2014, p.31.
Under such a concept of banking group, asset transfers might be theoretically and legally prohibited but in reality they cannot be eliminated. First of all, the separation concerns only retail and investment banking. Interdependencies between different credit institutions or different trading entities in the same group could still be developed through asset transfers. For instance, and with regards to the EU proposal, entities of the same sub-group would not be barred from providing legal or operational guarantees to each other. Financial contagion resulting from asset transfers might not concern the entire group, but could still impact several entities active in similar business operations.

In addition, one should not ignore the significant reputational connections that can be formed between the entities of a banking group. Even if one group entity is ring-fenced or legally and operationally hedged from the insolvency of a second group entity, the reputational risks generated by the financial troubles of the latter might force the first to intervene, either through liquidity/asset transfers or through guarantees. It would be compelled to do so in order to avoid the collapse of the second entity, which could have important repercussions on the market image of the whole group. Ultimately, however, it is still unclear how such separations would operate in practice.

Therefore, it becomes evident that the introduction of bank resolution regimes should be complimented by transparent legal practices around asset transferability. The development of a clear and efficient framework for intra-group financial transactions would allow for a more coherent treatment of asset transfers on a cross-border basis, and would limit the incentives for regulatory ring-fencing behaviours. Furthermore, if such a framework were in place, this would minimise uncoordinated state actions, which might consider such transactions null and void under resolution, undermining an optimal group solution and the safeguard of the group interest. It should also be mentioned that the development of the concept of group interest at an early intervention stage will also be beneficial under the phase of bank resolution.

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85 Gambacorta & van Rixtel, 2013, p.4.
promoting more coordinated and value maximising solutions for banking groups.\textsuperscript{88}

Whilst the solution provided by the EU in its Bank Recovery and Resolution Directive seems promising, the development of a more elaborate international standard will be necessary. In any event, such solutions should not be adopted light heartedly given the indisputable contagion and solvency risks associated with asset transfer practices can entail.

\textbf{11.5 Certain thoughts on the proposals for asset consolidation practices under insolvency}

Asset consolidation is the most radical proposal that has been put forward to date regarding the promotion of a more integrated treatment of group insolvencies. According to this concept, the different insolvency procedures that might be initiated in various jurisdictions should be combined under a single procedure, necessitating the establishment of one pool of assets from all the constituent entities of a banking group. This single pool of assets will be used for all the different group creditors across national borders. Whether or not such a consolidated insolvency concept could be legally conceivable – or indeed politically palatable – remains questionable, however, so as to also open the way for similar consolidated cross-border resolution practices for banking groups.

This idea of asset consolidation is not just a theoretical inception. The US Bankruptcy Code allows such practices, albeit only for simple corporate (i.e. non-bank and non-financial) insolvencies. The Code grants powers to the bankruptcy courts to require a substantive consolidation of the assets of the different group companies.\textsuperscript{89} Bankruptcy courts apply a two-part balancing test in order to assess whether a) \textit{“there is substantial

\textsuperscript{88} The case study of De Haas and Van Lelyveld highlighted the importance of parent funding so that group subsidiaries can continue contributing to the financial stability and growth of the host markets. They concluded that an efficient framework of capital and liquidity allocation for the most productive use within the group should be allowed under an integrated supervisory regime for multinational banks, \textit{De Haas \& De Lelyveld}, 2011, p.16.

\textsuperscript{89} U.S. Bankruptcy Code, 11 U.S.C., § 105.
identity between the entities to be consolidated” and b) “that substantive consolidation is necessary to avoid some harm or to realise some benefit”.\textsuperscript{90}

In addition, they may even decide to merge the assets of bankrupt companies of the group with those of still solvent group entities.\textsuperscript{91}

Although of particular interest, this approach to corporate group insolvencies is currently limited in application to within the US territory. And in any case, the implementation of the same scheme on a cross-border basis could prove deeply problematic.

On the one hand, asset consolidation is likely to be of much more benefit to creditors of banking groups whose structural organisation and conduct of business present a significant degree of integration. This will be the case mainly under business models, where the assets of the subsidiaries are treated as group assets.\textsuperscript{92} In the event of an insolvency, disentangling the ownership of assets and distributing liabilities could prove a daunting and time-consuming task, which might lead to unfair results for certain creditors.

On the other hand, such radical policies are subject to significant obstacles under contract and commercial regulation, insolvency and property law. The main challenge concerns creditors’ protection. Even when banking groups adopt a more integrated conduct of business, most of them normally continue to deal with creditors on an individual business basis. In this case, the safeguard of legal entity separation can be described as the basic means towards vindicating creditors’ expectations.\textsuperscript{93} The procedure of substantive consolidation by piercing the corporate veil could undermine creditors’ expectations and result in a \textit{pari passu} treatment between creditors of both financially weak and perfectly solvent group entities.\textsuperscript{94}

Furthermore, for the time being it will be inconceivable to apply such insolvency practices on a cross-border basis from a political point of view. Bankruptcy authorities remain highly reluctant to disregard the classic

\textsuperscript{90} Hirte, 2008, p.221.
\textsuperscript{91} Schoenmaker, 2010, p.18.
\textsuperscript{92} Ibid, p.17.
\textsuperscript{93} Jay Lawrence Westbrook, The Elements of Coordination in International Corporate Insolvencies: what Cross-Border Bank Insolvency Can Learn from Corporate Insolvency, Lastra, 2011, p.192.
distinction of the different entities within a banking group given the high probability of bias in favour of local creditors and depositors.

This conflict between corporate/insolvency legal theory and the efforts for the optimisation of the value of insolvency procedures renders the proposals for substantive asset consolidation under a cross-border scheme legally inconceivable and politically impossible. The same would apply for similar asset consolidation practices under bank resolution regimes.

Procedural consolidation under bank resolution\(^95\) remains the most appropriate response to the legal impediments and political concerns mentioned above. Although certain compromises will still need to be made, especially on a political level between the different national authorities, the time seems ripe for such a development. The establishment of resolution colleges as well as the proposal for a Single Resolution Mechanism at EU level, and the creation of crisis management groups for cross-border SIBs under the proposals of the FSB can be described as important steps towards achieving administrative consolidation of cross-border bank resolutions. The final chapter of the text contains an analysis on how this procedural consolidation of bank resolution practices can be put into practice.

### 11.6 Concluding remarks: towards a more integrated treatment of banking groups under bank resolution

This chapter argues for the need for a rapid transition away from the ‘one company, one insolvency, one proceeding’ principle to a more integrated approach that is more suited to dealing with the failure of complex modern international banking groups.

At the same time, one must consider that in the case of most cross-border banks, their organisational structure usually reflects the expectations of their respective clients and creditors.\(^96\) The latter choose which group entity they will conduct their business with, and enter into various contractual agreements with that entity. Their decision must therefore be

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95 Hüpkes, 2009a, p.380.
respected; the law should safeguard their rights and also clearly circumscribe their liabilities.

One may claim that the majority of institutional creditors (especially in case of financial institutions) acquired significant experience from their business practices in order to be fully informed of the activities and the opaque organisational structure of international banks. In many instances, creditors decide to conclude an agreement with a financial entity based on its brand or franchise value. The power and capacity of the parent company to intervene in the event that its subsidiaries become financially distressed also impacts significantly on the business decisions of the different creditors.

Furthermore, there have been cases where, although a creditor had entered into a contractual agreement with a specific group entity, this transaction was booked on the accounts of the parent company or of another group entity. Therefore, the treatment of the creditors should be considered under more consolidated resolution procedures, since creditors should not be regarded as the major obstacle to the latter.

Before the 2008 financial crisis, little consideration had been given to how to deal efficiently with the collapse of a cross-border banking group or the legal and practical challenges associated with regulating and managing consolidated bank resolution processes. The establishment of new bank resolution regimes in response to the crisis has provided an excellent opportunity for contemplating such legal changes more seriously. Indeed, a certain number of jurisdictions already allow more integrated approaches to the resolution of banking groups.

97 This can be usual practice mainly regarding derivative contracts, where the underlying value of the contract might be booked at another group entity than the one, with which the counterparty actually signed the agreement.

98 The Italian authorities could extend the special resolution regime for banks to domestic non-bank affiliates, if the parent company falled under the special resolution regime. In any event, such decision of the authorities did not result in piercing the corporate veil or a pooling of the assets of the different entities, BCBS, 2010c, p.25. In the UK, the Banking Act enables a UK incorporated holding company of a bank to be taken in temporary public ownership if the deposit-taking bank has been subject already to the Special Resolution Regime, UK Banking Act, §§ 82–83. In addition, former companies of a group are required to provide essential services to the transferee, which acquired part or the whole of the deposit-taking entity of the group during resolution, ibid, §§ 63–70. One should not forget, though, that the UK Special Resolution Regime applies only to UK incorporated deposit-taking banks and building societies, as well as to their overseas branches. Their foreign subsidiaries are excluded from the procedure.
Nonetheless, the Basel Committee highlighted that the “current reforms remain focused on deposit-taking banks and the resolution of single legal entities”. The majority of domestic bank resolution regimes neither cover bank holding companies, investment banks or non-bank affiliates, nor consider consolidated solutions for banking groups.

Yet, when one bears in mind that half of the modern cross-border banking groups operated at a certain point in time through a network of over 500 subsidiaries, and three of them have had more than 2,000, the need for regulatory change becomes apparent. Furthermore, not only do these subsidiaries consist of both bank and non-bank entities, but the organisational structures of these subsidiaries can take many forms; this complexity poses significant challenges to resolution authorities.

Presently, consolidated supervision, as well as the respect of capital requirements on a consolidated basis, forms part of banking legislation at both the domestic and also supranational levels. The next step for an integrated group approach will involve a consolidated treatment of bank resolution and insolvency. As mentioned in the previous section, this legal scheme will not cover asset consolidation but it should be described as procedural consolidation.

This consolidated solution cannot turn into a ‘one size fits all’ approach; after all, as stressed by the Institute of International Finance, group consolidated resolution procedures should only be implemented in situations where groups are operating on a fully integrated basis. Such centralised banking business models are often prevalent in contexts of market proximity and regional integration, such as in the EU. In such an integrated structure, when either a) the parent credit institution or the parent holding company or b) the majority of covered subsidiaries meet the conditions for

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100 Ibid, pp.10–11.
102 For instance, in Switzerland, Swiss Banking Act, art. 3d, Swiss Banking Ordinance, art. 14 and 14a and Swiss Capital Adequacy Ordinance, art. 123b.
103 Regarding the EU, there are clear rules linked to the consolidated supervision of a group and the respect of capital requirements on a consolidated basis, EU Capital Requirements Directive, 2013, art. 125–143 and 22–27.
resolution, the whole group should be able to follow down the same path.\textsuperscript{106} Conversely, such a consolidated approach would not be appropriate in situations where a banking group is organised in a decentralised manner i.e. operating through a variety of truly stand-alone subsidiaries, capable of surviving even the insolvency of the parent bank.

The drafting and implementation of efficient group resolution plans could greatly increase our understanding around these complex organisational structures. Notably, through the drafting of such plans cross-border financial institutions would be confronted with the broad spectrum of challenges that the opacity of their structures can pose. Supervisors and national regulators would also be able to acquire a more precise idea of the multifaceted nature of the business operations of international banking groups. This deeper insight would hopefully result in substantial reviews of the legal and regulatory frameworks that currently allow for the creation of such complex structures and, ultimately improved alignment between legal form and economic reality.\textsuperscript{107}

The EU Bank Recovery and Resolution Directive is interesting in this regard, since it sets forth an explicit (albeit cumbersome) framework for the establishment of group resolution plans,\textsuperscript{108} a group treatment of any obstacles to resolvability\textsuperscript{109} and defines the mandates of the different authorities involved in a group resolution.\textsuperscript{110} A lead resolution authority (in the home state) will guide the procedure, and EBA will be mandated to mediate in case of any disputes between the various national authorities involved in the process. It should be noted that the proposal for a 9\textsuperscript{th} company law directive on groups was previously abandoned after many Member States opposed it.\textsuperscript{111}

Group resolution plans could also address concerns expressed around the need to protect creditors’ rights. Paulus has proposed the formation of predetermined creditors’ groups within the group insolvency (in this case resolution) plan, which might be an interesting option to consider.\textsuperscript{112} The
task of disentangling creditors’ rights vis-à-vis the liabilities of the different constituent group entities could prove daunting for resolution authorities, and will require group resolution plans to be continually – and regularly – updated. Nonetheless, this approach may be a valuable alternative providing foreseeability to creditors and safeguarding their rankings under resolution and insolvency law.

Coherent group resolution plans will allow a more standardised treatment of certain complex resolution aspects such as bail-in. The issuance of bail-in instruments only by the parent institution within integrated banking group structures could minimise the risks of significant dilution or a probable elimination of the equity holding of the parent in the subsidiaries.\textsuperscript{113} As a result, further instabilities, caused within the group by this debt-to-equity conversion or debt write-down, might be avoided amidst a financial crisis.

To sum up, (i) the elaboration of a more precise definition of banking groups, which combines legal formalism with economic reality; (ii) a transparent and regulated approach to intra-group asset transferability; and (iii) the development of group resolution plans, will all be essential prerequisites for efficient resolution regimes dealing with cross-border banking groups. Such an approach will be beneficial as it could put the discussion around the ‘too-big-to-fail’ issue on a new basis, leading to more value-maximising and integrated, cross-border solutions.

\textsuperscript{113} DG Internal Market and Services, 2011, p.91.
Chapter 12
THE IMPORTANCE AND CHALLENGES OF CROSS-BORDER COOPERATION AND COORDINATION

12.1 The need for innovative solutions to an old problem

The need for effective cross-border cooperation and coordination during bank resolution lies at the heart of this work. However, there is little doubt that this represents a real challenge for the jurisdictions undergoing legislative reforms. As argued in the previous chapter, the internationalisation of banking groups also necessitates a much more integrated legal approach. The previous chapter focused on the need for alignment between the legal and business/operational realities of international banking groups. This chapter examines the requirements for efficient cooperation and coordination between state authorities in the field of bank resolution. Obviously, a transition away from the ‘united we stand, divided we fall’ approach to international bank insolvency towards more consolidated and supranational approaches to bank resolution is not expected to be straightforward.

The business of banking has become largely international. As the networks between the cross-border banking groups have become increasingly interconnected and far-reaching, this has contributed to financial growth. Yet, at the same time increased internationalisation is also a major contributing factor to crisis contagion.

Prior to the 2008 crisis, information sharing practices and coordination between state authorities in relation to both supervision and resolution was based on the principles of minimal harmonisation, mutual recognition, comity and reciprocity. For the most part, soft law instruments such as MoUs and informal bilateral or multilateral crisis management agreements supported supervisory cooperation in normal times. However, such MoUs failed to secure cooperation during the global financial crisis. Since MoUs were non-binding and relied on the political willingness of the parties to the agreement, many of the commitments contained within
them – such as the sharing of information in a timely manner – were not respected during the crisis: faced with serious domestic financial stability concerns, authorities resorted instead to ad hoc, unilateral actions.

Even within the relatively harmonised EU legal environment, any cooperation efforts between state authorities resulted from bilateral, informal and *ad hoc* agreements; host states were rarely informed about the actions of the home authorities, and in most cases when they were it was at a very late stage.¹ The majority of the EU Member States neglected their commitments under the 2008 EU MoU entirely, and resorted instead to pre-existing state arrangements already in force prior to 2008. This resulted for example, in highly uncoordinated responses to the collapse of Fortis as well as to the Icelandic crisis.²

Since the onset of the financial meltdown, there has been a significant decline in financial integration, even in the consolidated EU banking market.³ Notwithstanding this fact, cross-border activities still represent the most crucial business practices for the majority of big banks.

Within the EU, the growth of European banks prior to the crisis was accompanied by cross-border penetration of EU banking markets;⁴ a significant percentage of the total assets of banks in some EU Member States are located outside the home state of incorporation.⁵ Conducting research on this topic, Schoenmaker and Oosterloo identified that, within the EU context, the number of groups with the potential to pose significant cross-border externalities is substantial and increasing.⁶

Conversely, US banking groups – with the exception of Citigroup – maintain a more domestic orientation.⁷ All the same, the US bank holding companies with $ 50 bn or more in consolidated assets own more than 6,000 foreign entities.⁸

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¹ Fonteyne *et al.*, 2010, p.72.
² The use by the UK authorities of anti-terrorist legislation in order to freeze the assets of the UK branches of Icelandic banks is a clear indicator of poor cross-border crisis management between European states, Dewatripont & Freixas, 2012, p.135.
³ ECB, 2011, p.31.
⁵ *Ibid*, p.53.
⁶ Schoenmaker & Oosterloo, 2005, p.23.
Furthermore, the two biggest Swiss G-SIBs remain major players in the international banking markets and, as it became obvious in 2008, their international business can spread global turbulences rapidly in Switzerland.

One of the key lessons from the 2008 crisis was that “the more interconnected and integrated international financial institutions become the more disruptive and value-destroying uncoordinated local resolution actions are likely to be”. Therefore, this crisis brought to light the urgent need for reforms focusing on cross-border bank resolution in order to prevent and/or enable authorities to more effectively deal with future cross-border banking failures.

It is important to stress that an important prerequisite to cross-border cooperation and coordination is the establishment of certain global standards by the relevant international bodies in favour of a more consolidated, global approach to bank resolution. Indeed, the harmonisation of national / domestic bank resolution standards should be viewed as the first step in efforts to encourage a level-playing field and avoid regulatory arbitrage and ‘forum-shopping’ opportunities for financial institutions. Ultimately, the harmonisation of rules can contribute to the creation of functional cross-border mechanisms capable of dealing with systemic bank failures. Nevertheless, ultimately these reports are not quite successful in fostering harmonisation.

The role of international bodies such as the BCBS or the FSB is to present – in an impartial manner – the most suitable practices regarding bank resolution. However, whilst the plain enumeration of a broad variety of possible solutions to the challenge of cross-border bank failures can safeguard impartiality, at the same time the development of such ‘soft-law’ proposals can be counter-productive: broadly formulated standards that attempt to cover a wide spectrum of bank resolution practices may ultimately become subject to discretionary interpretation by domestic authorities, thus resulting in regulatory discrepancies rather than promoting divergence.

Undoubtedly, in order to encourage cooperation between jurisdictions during a financial crisis, one of the key concerns of international regulatory

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9 IMF, 2010c, p.12.
10 The BCBS considers the convergence of domestic resolution measures as a very important element of cross-border coordination, BCBS, 2011, p.26.
bodies is to develop minimum standards that the majority of jurisdictions are likely to be willing to adopt in order to improve their bank resolution policies.\textsuperscript{11} Yet, there are limitations to developing standards that are overly broad. Therefore, it is vital that these standard-setting bodies develop more prescriptive standards regarding optimal bank resolution policies. Only then will effective harmonisation become achievable.

Thus, encouraging harmonisation of domestic bank resolution practices as well as cross-border cooperation and coordination entails more than simply developing a list of different standards. While factors such as mutual trust, precedents, or commonality of interests will play a significant part in cross-border bank resolution, the approximation of laws and legal concepts among the various jurisdictions remains of utmost importance.\textsuperscript{12}

Nowhere is this continuous struggle for harmonisation more apparent than in the context of the EU, where strenuous efforts and compromises to transform the environment from one of minimal harmonisation of banking regulation between Member States have paid off, resulting in the current relatively homogeneous practices implemented through secondary legislation. Under the leadership of the EBA, the coordination of EU regulatory practices through recommendations and technical standards,\textsuperscript{13} has led to the establishment of a common regulatory culture.\textsuperscript{14}

To sum up, given the significant coordination issues associated with resolution efforts for cross-border banking groups, it will be difficult to imagine the development of cross-border cooperation and coordination policies in the field of crisis management without any prior efforts to achieve substantial harmonisation of standards. One should stress, however, that harmonisation does not necessarily imply absolute convergence.

This chapter first describes the classic approaches to international bank insolvency that are important to consider in relation to cross-border bank resolution. It then touches upon the discussions with regards to the point of entry of bank resolution practices. It finally outlines the fundamental elements of cross-border coordination and cooperation in relation

\textsuperscript{11} IMF, 2010c, p.19.
\textsuperscript{13} EU Regulation 1093/2010 Establishing a European Banking Authority, 2010, art. 8.
\textsuperscript{14} \textit{Ibid}, art. 29.
to bank resolution; namely, cross-border cooperation agreements and crisis management groups for G-SIBs.

12.2 Traditional approaches to cross-border bank insolvency

12.2.1 Territoriality

In the absence of pre-existing standards for sharing the losses from a cross-border insolvency, jurisdictions have traditionally developed territorial approaches to dealing with the failure of an international banking group, driven by national interests. Such territorial approaches have frequently devolved into ring-fencing practices in a cross-border banking crisis. The need to address such issues continues to hamper efforts at establishing an international approach to resolution.

In the context of bank insolvency under the principle of territoriality, each host authority will initiate a separate insolvency procedure, irrespective of the initial proceedings already open by the home authorities of a banking group.\(^{15}\) State authorities will formally separate the assets of the local entities of a banking group within their jurisdiction. These assets become subject to the exclusive decision-making powers of each host authority, which applies ring-fencing policies.\(^{16}\) Consequently, no foreign court or foreign insolvency authorities can include such assets in their respective insolvency procedures.

Essentially, there is a separate insolvency procedure for each jurisdiction in which distinct entities of a banking group operate. While foreign creditors can normally participate in the insolvency proceedings of another jurisdiction, they are usually confronted with complex legislation; as such, they are effectively discriminated against, as preference rules for local creditors of the banking entity under insolvency are established. Profit

\(^{15}\) IMF, 2010c, p.10.

\(^{16}\) One of the most common examples regarding ring-fencing practices is that of the US bank insolvency regime, which covers, not only the foreign branches of US banks, but also the US branches of foreign banks, *Coleton*, 2012, p.74.
maximisation for domestic creditors is one of the cornerstones of the arguments rationalising territorial approaches to insolvency proceedings.

The treatment of depositors is also not straightforward in the majority of these jurisdictions. In certain cases, the legislation provides for depositor preference, resulting in severe discrimination between local and foreign depositors.\(^{17}\)

Within this legal environment, efforts to cooperate and the sharing of information across borders is severely impeded. A case in point is the collapse of Lehman Brothers, and the subsequent litigations regarding the location of the bank’s assets. The so-called ‘hotchpot’ rule – which prevents claimants who have already participated in a proceeding from full participation in another action in a different jurisdiction – is the only concrete example of where a minimum level of cross-border cooperation is endorsed in the context of territoriality.\(^{18}\)

It has been argued that an important benefit of territorial insolvency proceedings is the maximisation of the estate value, as well as the predictability of the legal procedure. Nonetheless, these two potential advantages are outweighed by the fact that the initiation of numerous uncoordinated insolvency proceedings under territorial insolvency regimes often results in chaotic – and sometimes prolonged – legal battles, which can contribute to value destruction. Thus, profit maximisation cannot always be guaranteed.

Furthermore, territoriality can potentially contribute to ex ante ‘forum-shopping’ practices, i.e. when creditors decide to book their debt with entities operating in jurisdictions capable of safeguarding their rights in the event of bank insolvency.\(^{19}\) Debtors might be also involved in cases of fraud, concealing assets or transferring them to foreign jurisdictions in order to avoid the consequences of the insolvency policies of a certain state.

In addition, differential rules under DGS that allow for discrimination between local and foreign depositors could become a potential source of contagion risk. If a host state denies the protection of and compensation to foreign depositors, the spillover effects of the crisis for the home state

\(^{17}\) Among the examples Austria, Italy, Norway, the UK, Australia, Hong Kong and the USA, \textit{Garcia & Nieto}, 2005, p.214.

\(^{18}\) \textit{Baxter, Hansen & Sommer}, 2004, p.60.

\(^{19}\) \textit{Ibid}, p.87.
of these depositors will be substantial.\textsuperscript{20} There have been recent initiatives asking for the elimination of such depositor preference rules, which are now considered outdated and inefficient in the context of today’s international banking market.\textsuperscript{21}

The 2008 financial crisis brought to the fore the limitations of such insolvency policies. Thus, the reform of territorial insolvency policies will be a necessary step towards the endorsement of more coordinated cross-border bank resolution practices.

\textit{12.2.2 Universality}

An alternative process to a territorial approach is a universal approach to bank insolvency. In this case, the insolvency proceedings initiated by the home authority of the cross-border banking group would have universal reach and cover all assets and liabilities of the group, irrespective of their location.\textsuperscript{22} A significant element of extra-territoriality is present in such type of proceedings. Host jurisdictions would be required to automatically recognise the initiation of such proceedings by the home state and cooperate with home authorities in the process of asset collection. Foreign creditors and depositors would receive equal treatment to their local peers. More importantly, they would be reimbursed solely on the basis of their ranking: nationality considerations would be irrelevant.

Such a legal regime would guarantee the speed and efficiency of an insolvency procedure in order to avoid any unnecessary value destruction of the assets of the different banking group entities. Predictability for creditors and depositors could be also enhanced, as their rights would be effectively safeguarded according to precise, \textit{ex ante} rules. The costs of the proceedings under universality would also be significantly lower for the

\textsuperscript{20} The example of Iceland denying compensation to UK and Dutch depositors, following the collapse of its banking system, and the subsequent political and legal conflicts can demonstrate the complexities of the issue. As mentioned by the Governor of the Central Bank of Iceland, “the response to Iceland’s crisis was characterised by ring-fencing and hostility, yet it is well known that such an approach creates a worse outcome in the aggregate”, Gudmundsson, Rebuilding after the Financial Crisis, in Coleton, 2012, p.70.

\textsuperscript{21} Institute of International Finance, 2011, p.30.

\textsuperscript{22} IMF, 2010c, p.10.
participants, since they would not be required to file multiple claims in multiple fora.\textsuperscript{23}

Whilst such a regime regulating cross-border insolvencies might seem promising, it is unlikely to be politically palatable: given that the rules regulating insolvency have significant impacts on domestic financial stability, most states would be unwilling to hand over part of their sovereignty.

In addition, the proposal to create a supranational authority invested with universal powers in case of the collapse of an international bank is also likely to be met with significant resistance. Whilst one could envisage such a development within the EU, such a regulatory evolution on an international scale is inconceivable. Along with states’ unwillingness to establish such a concept, there is another additional obstacle: supranational authorities tend to become overly political and, ultimately, excessively bureaucratic;\textsuperscript{24} thus compromising their efficiency.

With regards to cross-border crisis management, then, coordination will be the key element, and not centralisation. On this basis, international bodies have increasingly promoted a ‘middle approach’ between territoriality and universality. A modified universality approach recognises the strong possibility of ring-fencing in crisis situations and aims to empower the home authorities to initiate insolvency proceedings. Furthermore, they will be able to require the recognition of their insolvency proceedings in host jurisdictions. Host jurisdictions can always decide to initiate either plenary or ancillary proceedings with regard to the group entities operating within their territory. Should they decide on the latter, they should seek cooperation and coordination with the home state.

UNCITRAL’s Model Law on Cross-Border Insolvency illustrates how such a modified universality framework might be established. The Model Law covers the cases of: (i) an inward-bound request for recognition of a foreign proceeding; (ii) an outward-bound request from a court or administrator in the enacting state for recognition abroad of an insolvency proceeding commenced under the laws of the enacting state; and (iii) coordination of proceedings taking place concurrently in two or more states.\textsuperscript{25}

\textsuperscript{23} Baxter, Hansen & Sommer, 2004, p.84


\textsuperscript{25} UNCITRAL, 1997, art. 1(1).
recognition of a foreign proceeding by the courts of the enacting state allows foreign representatives as well as foreign creditors automatic access to the proceedings. These stakeholders should be notified of any developments relating to the proceedings. The Model Law describes the procedure relating to the request for the recognition of a foreign proceeding and the requirements for granting such recognition. The recognition of a foreign proceeding as the main proceeding results in an automatic stay on any further individual actions or proceedings against the debtor and execution against the debtor’s assets.

The core of the Model Law lies with the requirements for cooperation and direct communication between the authorities of the enacting state and the foreign courts or representatives. This commitment to cooperate and communicate directly becomes of vital importance mainly with regards to concurrent proceedings, which might be initiated in more than two states. The sole grounds for refusing to recognise foreign proceedings or to cooperation with foreign representatives is if this would be contrary to the public policy of this state.

The so-called EU Winding-Up Directive is another instrument introducing elements of modified universality for cross-border bank insolvency. The home authorities of a credit institution are solely responsible for the initiation of winding-up proceedings; these proceedings shall be automatically recognised – and with no further formality – within the territory of all Member States in which branches of the insolvent credit institution operate. The law of the home Member State shall determine all the necessary elements relating to the winding-up procedure. Upon initiation of the proceedings, the competent authority of the home Member State shall inform all known creditors having their domicile within a Member State individually and without delay, so that they can lodge their claims or submit written observations.

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26 Ibid, art. 12–14.
27 Ibid, art. 15 and 17.
28 Ibid, art. 20. In general, even in the case of a non-main proceeding, the court recognising a foreign proceeding may grant any appropriate relief in order to protect the assets of the debtor or the interests of the creditors, ibid, art. 21.
29 Ibid, art. 25–27.
31 Ibid, art. 6.
32 EC WINDING-UP DIRECTIVE, art. 9.
33 Ibid, art. 14 and 16.
Both instruments mentioned above confront significant challenges, however. The UNCITRAL Model Law is a soft-law instrument introducing standards on the harmonisation of insolvency practices. Thus, when incorporating the Model Law into domestic legislation, a state may modify or leave out certain provisions. In addition, banks and insurance companies are exempt from its scope of application.\(^{34}\)

Meanwhile, the scope of application of the EU Winding-Up Directive is also very limited, applying only to credit institutions and not to investment entities. Moreover, whilst it allows universal insolvency proceedings covering the branches of a credit institution, the subsidiaries of this institution are excluded from the procedure. Yet, as frequently emphasised throughout this contribution, European banks conduct their cross-border business through a vast network of subsidiaries. Finally, there are no provisions under the Directive regarding the coordination of proceedings that are initiated by the home state with those potentially taking place in third, non-EU Member States.

It is clear that whilst modified universality – as currently applied in specific cases – could prove valuable as a starting point, on its own it is unlikely to be sufficient to deal with the complexities of cross-border bank resolution proceedings.

### 12.3 The point of entry of cross-border bank resolution

Contemporary resolution strategies for cross-border groups are broadly centred on two approaches: ‘single point of entry’ or ‘multiple point of entry’.

In the case of a single point of entry resolution strategy, the cross-border resolution of a banking group will actually take place through measures implemented exclusively at the level of the parent or holding company of the group. Cooperation and the sharing of information with regards to the timely cross-border recognition and enforcement of assets’ and liabilities’ transfers or of stays on various contractual arrangements between the home and involved host authorities, as well as liquidity access

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\(^{34}\) UNCITRAL, 1997, art. 1(2).
for all group entities are essential aspects of such policies. The core of the single point of entry approach is that the different group entities (foreign branches and subsidiaries) can remain fully operational while resolution measures are implemented at the level of the parent/holding company.

Alternatively, a multiple point of entry resolution approach involves two or more resolution authorities applying resolution tools to multiple parts of a group rather than limiting these actions to the parent level. This requires separate resolution strategies to be articulated for each part of the group that may be separately resolved, according to the specific circumstances in each jurisdiction. Under this approach, effective cooperation between home and host authorities becomes even more important, in order to safeguard value maximisation and avoid hazardous financial repercussions. The success of such resolution policies rests on the thorough resolution planning and the drafting of efficient cross-border cooperation agreements.

The FDIC and the BoE have taken a pragmatic approach to the single point of entry approach in their jointly-produced document regarding the coordination of resolution practices for G-SIBs operating within their territories. In the event of a cross-border collapse of a US or UK global banking group, both authorities have decided that they will implement a ‘top-down’ resolution strategy, applying their respective resolution powers at the level of the parent company.\textsuperscript{35} Such an intervention would entail the removal of senior management; the wiping out of shareholders; and writing down of unsecured creditors’ claims.

In such an arrangement, the FDIC will impose a receivership on the holding company. It will then create a bridge financial holding company, into which it will transfer the assets from the receivership estate. Shareholders will remain under receivership, and unsecured creditors will have their claims written down or converted into equity in order to recapitalise this new entity. The bridge company will be eventually be sold to interested third parties. Broadly speaking, the FDIC, as a receiver, will provide assurances for the ongoing operations of all other group entities.

Meanwhile, the BoE will provide for an administration of the holding company by a trustee implementing a recapitalisation. The trustee can impose losses on shareholders and decide which of the debt securities will

\textsuperscript{35} FDIC & BoE, 2012, p.i.
be cancelled or written down in order to achieve this recapitalisation. In case the holding company does not dispose of adequate debt, recapitalisation will be implemented through a contribution of the DGS. Following a successful recapitalisation, broader restructuring measures will be implemented.

Both authorities expect that liquidity will continue to be downstreamed as normal from the parent to branches and subsidiaries, which will be largely unaffected and able to continue their business almost as usual.¹³⁶

In the same spirit, in August 2013 FINMA published a position paper on the resolution of Switzerland’s G-SIBs. In this paper, the Swiss regulator also states a preference for a single point of entry resolution approach for the two Swiss G-SIBs, focused on the top-level holding or parent company. In this paper, FINMA suggests that – given the structure/nature of the largest Swiss banks – a bail-in at the parent bank (i.e. turning creditors into shareholders or imposing losses on their claims) would be the most suitable strategy in order to achieve the goals of: covering the anticipated recapitalisation needs of the group; restoring market confidence; and safeguarding the stability of the troubled bank.¹³⁷ According to FINMA, group subsidiaries should be able to continue their operations on a going-concern basis, since their access to liquidity would be guaranteed following the recapitalisation of the parent or the holding company.

These initiatives open a window to the potential regulatory responses of big financial centres to the resolution of cross-border banks. Despite minor procedural divergences, all three authorities identified the need to resort first and foremost to bail-in practices, with heavy losses imposed on shareholders and creditors. They demonstrate, thus, the need to harmonise practices on such a crucial but still controversial resolution tool.

The joint document of the FDIC and the BoE is an important step towards cross-border coordination of resolution practices. Similar policy agreements between other jurisdictions could be also beneficial for the drafting of efficient cross-border cooperation agreements and for resolution planning purposes. It should be stressed, though, that such position documents should remain a first step towards international coordination;

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¹³⁶ Ibid, p.11.
¹³⁷ FINMA, 2013, pp.6 and 13.
under no circumstances should they outweigh cross-border cooperation agreements drafted with the participation of all concerned authorities (both home and host).

Additionally, the participating authorities must not rely too heavily on such plans, given that the reality of a financial crisis can rapidly overcome their expectations. Limiting resolution approaches entirely to the level of the holding or parent company may not be the most appropriate or effective strategy in the case of banking groups that are highly integrated, if various group entities are entirely dependent on the holding company for liquidity, investments and other guarantees (as was the case for Lehman Brothers, for example). In this case, it would be erroneous to expect that foreign branches and subsidiaries will continue to operate entirely unaffected. Rather, an intervention at the level of the holding company could lead to significant operational disruptions.

None of the above documents describe in detail how the recapitalisation of the parent or the holding company through bail-in would help to restore order if the financial troubles are located at the level of the subsidiary. In such a scenario, the home resolution authority must be able to grant permission to the parent to inject equity to the troubled subsidiary, either in kind, in cash or through the write-down or conversion of the parent’s holdings in the subsidiary’s non-equity instruments. Further complications could arise if the parent’s holdings need to be written down or converted in order to recapitalise the subsidiary but the parent does not own 100% of the common equity of the subsidiary (i.e. there are numerous other third party shareholders.) In this case, the creditors of the parent whose claims are written down or converted might suffer significant losses, and the ‘no creditor worse off’ principle could be violated.

The introduction of TLAC requirements for G-SIBs by the FSB may help to address the financing challenges of a single point of entry resolution approaches. TLAC should be available not only in sufficient amounts, but also at the right locations of a group in order to adequately serve the purpose of the single point of entry approach. According to these requirements, the material foreign subsidiaries in host jurisdictions as well as the parent/holding company of the group should hold internal TLAC buffers.

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commensurate with their size and risk exposure.\textsuperscript{40} Internal TLAC will be part of the consolidate balance sheet of the banking group.

Thus, if the home authority opens a resolution procedure at the level of the parent / holding company, any losses or recapitalisation needs of these subsidiaries should be covered by their internal TLAC requirements. In this case, the home authority should not be required to downstream equity to the material subsidiaries; the latter should, instead, be in a position to cover its own recapitalisation needs through the conversion or write-down of internal TLAC located at their level. However, as TLAC will be pre-positioned at specific subsidiaries, it cannot be shifted by the parent entity if the financial problems will unfold in subsidiaries that do not own any TLAC.\textsuperscript{41}

Of course, there are big question marks over how single point of entry resolution approaches will operate in the interim, before G-SIBs have been able to build up the TLAC requirements.\textsuperscript{42} One must also not forget that TLAC requirements will only apply to those G-SIBs that appear on the list published by the FSB. That said, single point of entry resolution approaches may also be chosen for cross-border banking groups that are not defined as G-SIBs. Yet for these types of banking groups, questions remain regarding the recapitalisation needs of foreign subsidiaries when resolution applies only to the parent/holding company. Finally, TLAC does not address the challenges posed by liquidity financing of the subsidiaries during a single point of entry resolution approach.

In any case, the enforcement of bail-in powers (conversion or write-down of debt instruments) remains a contentious and complex issue. For instance, FINMA highlighted that a significant amount of bail-inable liabilities of the two Swiss G-SIBs is issued out of foreign branches and is governed by non-Swiss law.\textsuperscript{43} Execution risks and the likelihood of challenges by foreign authorities remain quite substantial and might jeopardise regulator’s attempts to implement its single point of entry resolution. The same concern could be expressed regarding the execution of stays on contractual agreements.\textsuperscript{44}

\textsuperscript{40} FSB, \textit{Adequacy of loss-absorbing capacity of G-SIBs}, 2014, pp.7–8.
\textsuperscript{41} Kupiec & Wallison, 2014, p.38.
\textsuperscript{42} Not earlier than 2019 for G-SIBs operating in developed markets. Emerging markets are currently excluded from the scope of application of TLAC.
\textsuperscript{43} FINMA, 2013, p.11.
\textsuperscript{44} For instance, numerous financial contracts of US SIBs are always entered at the level of a foreign subsidiary. Consequently, there could be issues with the stay imposed by
On the other hand, a multiple point of entry resolution procedure presents equal challenges. Whilst such an approach allows each resolution authority considerable discretion in the choice of which measures to implement, according to the specificities of each entity, the requirements of cross-border coordination will be more onerous. As a result, multiple point of entry approaches pose a much higher risk to the future success of the joint effort, and potential ring-fencing practices may result in a stalemate.

Evidently, there cannot be a ‘one size fits all’ solution regarding the point of entry of a resolution procedure. The final decision will ultimately be heavily dependent on the business structure of the group (i.e. integrated or decentralised).\(^{45}\) Considerations such as the root causes of the failure; the size and operations of the specific group entities causing the failure; as well as macro-economic conditions will all need to be taken into account when deciding on the resolution approach to be taken.\(^{46}\) However, the single point of entry approach might not be feasible from a practical point-of-view. Resolution planning will certainly be helpful in revealing some of the potential advantages and drawbacks of either approach for each individual G-SIB; this provides resolution authorities with some indication of the most suitable choice. The implementation of TLAC requirements at the level of both the parent and the material subsidiaries of the group may also improve the feasibility of single point of entry resolution approaches but will not address all challenges. In any event, it will be important that national resolution authorities adopt a transparent approach with regards to their resolution strategies rather than developing contracative ambiguity or conflicting approaches according to each financial institution in question.\(^{47}\)

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\(^{45}\) Institute of International Finance, 2012, p.4.


\(^{47}\) As highlighted by Huertas, this will be the case when “the home country wishes to have the option to implement a Single Point of Entry approach when the losses have occurred at the domestic subsidiary, but reserve the right to resort to a Multiple Point of Entry approach when the losses are at a foreign subsidiary”, Huertas, 2015, p.26.
12.4 Implementing resolution on a cross-border level

12.4.1 Essential components of cross-border cooperation agreements

The FSB has identified the completion of institution-specific, cross-border cooperation agreements (COAGs) as one of the core instruments to help ensure the effective implementation of its ‘Key Attributes’. The negotiation of such agreements between the home and relevant host authorities that need to be involved in the preparation and management of a crisis affecting a G-SIB is intended to provide a framework facilitating cross-border cooperation and information sharing between these parties for resolution purposes. Since introducing the concept of a COAG in its ‘Key Attributes’ document, the FSB has continued to work on the elaboration of adequate standards that will make COAGs fully operational.

The failure of non-binding bi- and multilateral MoUs to secure cooperation during the 2008 financial meltdown demonstrated the need for reforms in international crisis management agreements, and, specifically, the need for national authorities to have at their disposal effective legal tools and cooperative arrangements for the resolution of cross-border financial groups. Soft-law instruments, when implemented within a framework and complemented by frequent peer reviews and ‘name and shame’ schemes, can result in positive developments. Nevertheless, in the most critical moments, their non-binding nature hampers effective cooperation, due to the fact that considerable discretion is left to state authorities in deciding whether or not to comply. One should also stress that the legitimacy of soft-law standards has been repeatedly questioned, due to their elaboration by international bodies that have a limited membership and

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48 Even within the EU legal framework, the concept of MoUs did not play any significant role in the decision-making process of the different state authorities or their subsequent actions to safeguard the stability of the banking sector, Fonteyne et al., 2010, p.74. According to the EU MoU on cooperation between the various member states’ authorities on cross-border financial stability, signed in 2008, the parties had committed themselves to open, full, constructive and timely cooperation and had been encouraged to develop Voluntary Specific Cooperation Agreements and establish Cross-border Stability Groups, EU MoU, 2008, pp.3 and 6.
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a mono-dimensional character, and which are normally biased towards richer, more powerful and more sophisticated states.\(^49\)

It is important to note that the overly broad nature of pre-crisis MoUs was also unconducive to cross-border cooperation. By covering a broad spectrum of crisis events without elaborating further on the details of each specific crisis management situation on an institution-specific basis, these MoUs lacked clarity and were unable to address the precise organisational and business challenges of each international bank.\(^50\) Based mainly on the recognition of general principles and the formulation of broad policy declarations, MoUs cannot address the special informational needs created during a financial crisis.\(^51\)

Hence, the new bank resolution regimes must not be reliant on cross-border crisis management schemes based on MoUs. Whilst the latter might remain an initial step preparing the ground for further international action,\(^52\) the tasks of developing and implementing cross-border resolution policies will instead become part of enhanced COAGs.

COAGs should be drafted on an institution-specific basis in order to efficiently address the organisational specificities of each SIB, as well as the particular impediments resulting from its business operations. Notwithstanding this fact, individual COAGs should not be viewed in isolation; they could eventually enrich international dialogue and promote macro-economic considerations, thereby contributing to the safeguard of global financial stability.

As maintained by the FSB, COAGs should group home and material host authorities, involved in the planning and crisis resolution stages.\(^53\) To help support resolution authorities during the drafting of COAGs, the FSB has prepared a list of standards.

First of all, they should lay down the nature and the objectives of cross-border cooperation and define the role and responsibilities of each authority, both before a crisis (especially with regards to recovery and resolution

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\(^{50}\) BCBS, 2011, p.4.
\(^{51}\) Krimminger, 2005, p.9.
\(^{52}\) David G. Mayes, Early Intervention and Prompt Corrective Action in Europe, in Green, Pentecost & Weyman-Jones, 2011, p.165.
\(^{53}\) FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2011, p.14.
planning) and during a crisis.\textsuperscript{54} On the basis of such precise arrangements, crisis management will be more efficient and rapid and any potential overlap of responsibilities minimised.

Besides, a key part of COAGs will be the development of mechanisms to facilitate the sharing of information between resolution authorities; these mechanisms should place priority on confidentiality. This process should involve not only the authorities participating in the agreements but should also lay down the principles for sharing of information with every host authority, material or not. Even non-material host jurisdictions should be kept informed of the resolution strategies elaborated between the home and material host jurisdictions of a G-SIB. The same policies should apply with regards to public disclosure.

The authorities responsible for drafting a COAG will also be responsible for the development and implementation of recovery and resolution plans, and for resolvability assessments for each G-SIB. COAGs will set out the procedure for coordination between the authorities during the aforementioned exercises. They should also specify how often they should be reviewed, and allow for the organisation of periodic crisis simulation scenarios in order to examine in practice the viability and efficiency of the plans.

It is crucial that, under COAGs, states will commit to address any legal and operational impediment to the implementation of cross-border resolution actions. Consequently, procedural requirements should be put into place for: the recognition and implementation of transfers of assets, liabilities and any contractual arrangements; the recognition of stays regarding close-out netting and set-off agreements; and the execution of bail-in schemes.\textsuperscript{55}

Another crucial element of COAGs should be the identification of domestic funding arrangements for the entities of a failing bank, to facilitate the measures implemented under resolution. The participating authorities should examine the existence and operations of resolution funds under domestic banking regimes in order to get a clear picture with regards to the establishment of potential burden-sharing mechanisms.

Finally, COAGs will also set the rules to ensure the efficient operations of CMGs, established for each G-SIB. On the one hand, home authorities

\textsuperscript{54} Ibid, p.14.
\textsuperscript{55} Ibid, p.25.
should commit to coordinating and facilitating CMGs’ meetings, and coordinating the resolution of a bank as a whole by taking into account the interdependencies between the group entities and avoiding any action that could trigger financial instability in host jurisdictions.\textsuperscript{56} Meanwhile, host authorities should undertake to cooperate with home authorities, in case of a resolution procedure implemented at the level of the parent company, and also alert their counterparties to any deterioration of the financial condition of the group entities operating within their territory.

The process of drafting fully operational COAGs for all G-SIBs is still ongoing. Certain requirements, though, should already become subject to revision and improvement in order to avoid critical weaknesses in the future, which might put their efficacy at stake amidst a crisis.

The FSB established standards and guidelines regarding the main characteristics of COAGs. According to these standards, COAGs will be considered soft-law instruments, allowing the participating authorities – and especially to the home jurisdiction, which will coordinate the procedure – certain discretionary powers in implementing these standards. Unfortunately, this might lead to crisis management actions that are no less fragmented than those in responses to the 2008 crisis, based on the MoUs. It is true that the members participating in a COAG can decide on the legal nature of the agreement.\textsuperscript{57} It is expected, though, that the majority – if not all – of the participating jurisdictions will avoid entering into a binding agreement. Therefore, their commitments will be made on a voluntary basis.

Confronted with this reality, the FSB is currently preparing an assessment exercise to measure adherence to the ‘Key Attributes’ under COAGs. Sufficient monitoring practices could guarantee the early identification of deficiencies/deviations and safeguard the proper enforcement of standards among the various states.\textsuperscript{58}

A harmonisation of legal regimes regulating resolution across the globe will also facilitate the preparation and implementation of COAGs.\textsuperscript{59} The

\textsuperscript{56} Ibid, p.24.
\textsuperscript{57} Ibid, p.22.
\textsuperscript{58} Avgouleas, 2012, p.231.
\textsuperscript{59} As stressed by the Institute of International Finance, “cross-border agreements need to be effective on the legal and not simply the operational level”, Institute of International Finance, 2011, p.29.
development of standardised mechanisms for recognising and enforcing resolution decisions on a cross-border basis is still deeply problematic. Non-standardised mechanisms or informal procedures are currently in place between jurisdictions, for example, to facilitate the rapid transfer of assets and liabilities in a cross-border context. The mutual recognition of stays on specific contractual arrangements is also of absolute necessity for the operation of COAGs. Most jurisdictions have not still reached the point of establishing transparent and expedited procedures giving effect to foreign resolution measures. Coordination of legal reforms will therefore be essential, otherwise COAGs may prove to be nothing more than rhetoric.

In any event, under a soft-law instrument one cannot exclude the possibility that the resolution authorities of a state might resort to discretionary actions. However, in order to minimise any negative repercussions of these actions, they should take place under explicit, *ex ante* conditions. Public policy reasons or the inaction of the other participating authorities may provide sufficient grounds for such discretionary decisions. Still, resolution authorities should make use of any available communication channel to consult with their peers beforehand and minimise the risk that of their decision having significant spillover effects on other states.

Finally, the FSB did not fully consider the potential obstacles relating to information-sharing through COAGs. According to the FSB, such policies should take place with clear reference to the legal basis for information-sharing in the respective national laws. As a result, each jurisdiction will be able to share information based on differing terms and conditions established under domestic legislation. Such an approach cannot facilitate cross-border cooperation. In addition, each state is free to designate its competent resolution authority. Therefore, under a COAG the group of signatories might comprise of supervisory authorities, central banks, ministries of finance and even DGSs. There could be significant hurdles, for example, impeding information-sharing between a bank supervisor and an authority not acting in a supervisory capacity.

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60 FSB, Resolution of SIFIs, Progress Report, 2012, p.11.
Furthermore, the issue of confidentiality of such cross-border agreements remains poorly addressed. The divergent requirements established under each domestic resolution regime to address such a crucial issue cannot be relied upon.

One solution would be to include explicit common terms and conditions regulating information sharing and confidentiality across the participating jurisdictions. For instance, specific conditions requiring the recipient authority to seek prior consent for any onward disclosure of information, with effective sanctions in case of breach, could become integral part of COAGs.64

All in all, COAGs have clearly helped to address some of the inadequacies of the non-legally binding cooperative arrangements that were in place between the competent authorities in key jurisdictions prior to the 2008 crisis. They maintain an institution-specific focus, provide for an international mandate of cooperation, and cover a broad variety of issues such as: non-discrimination; optimal resolution outcomes for creditors; joint recovery and resolution planning; information sharing; early warning; and efficient crisis management.65 Nonetheless, institution-specific COAGs are at different stages of development, and the task of combining the particularities of these various objectives in one single instrument is rather challenging.

It is obvious that bank resolution reforms on a domestic level, and legal harmonisation on a global scale will influence the evolution of COAGs. In their current form, however, COAGs are unlikely to be sufficient to safeguard the negative impacts of the next cross-border financial crisis. Since they kept the form of soft-law instruments, the extent to which national authorities will adhere to these agreements and thus these agreements are able to make effective cross-border cooperation a reality in the context of a real life crisis event remains to be seen. Thus, it would be more appropriate to describe these agreements as statements of intent concerning cross-border information-sharing and the recognition and enforcement of foreign decisions. Whilst the FSB considers such issues constituent elements of COAGs, it fails to analyse how these elements will be put into practice.

65 Institute of International Finance, 2011, p.29.
On such a contentious issue such as the failure of an international bank, soft-law instruments seem the only politically acceptable solution. Clearly, simple MoUs are inadequate for addressing the particular complexities of cross-border resolution, since they are not institution-specific in focus and do not take into consideration the variety of crisis scenarios and the informational requirements inherent in the global coordination of a G-SIB’s resolution. More deliberations will be necessary with regards to the optimal characteristics of an effective cross-border crisis management agreement. COAGs, in their current form, should not be viewed as the end result of this legal and political exercise.

It is worth re-iterating here that, for the time being, COAGs are only established for G-SIBs. Similar cross-border cooperation agreements could, however, have a beneficial impact on the resolution of all banks that have cross-border activities. This exercise should be much more straightforward and less time-consuming for cross-border SIBs since fewer states will need to be involved in the drafting of such instruments for SIBs than for G-SIBs.

### 12.4.2 Crisis Management Groups

According to the FSB’s ‘Key Attributes’ principles, all G-SIBs must participate in crisis management groups (CMGs). These CMGs will effectively be the mechanisms by which the guidelines established under COAGs with regards to the resolution of G-SIBs will be put into practice. They will operate on an institution-specific basis, focusing on crisis preparedness, as well as on the management of the cross-border resolution of a global banking group and they will bring together every home and material host authority involved in crisis management proceedings. The range of authorities participating in these groups will cover bank supervisors, central banks, national treasuries, ministries of finance and DGSs. CMGs will be responsible for reporting back to the FSB on issues relating to progress in coordination and information-sharing, recovery and resolution planning, as well as resolvability assessments.\(^6\)

For the time being, CMGs have been established for all of the G-SIBs identified by the FSB in November 2011, with a broad membership including bank supervisory authorities, central banks and the resolution authorities of both home and material host jurisdictions (where these are separate).  

CMGs will set the ground for a new era of interactions between home and host authorities. In order to safeguard confidentiality when sharing institution-specific and ensure the swiftness of decision-making procedures, only material host authorities will be present at a CMG. Outside of the CMGs, home authorities must consult with all host authorities on a frequent basis and the latter should forward any information that could be of a material impact to the financial condition of the group without delay. The members participating in a CMG should bear in mind the interests of such non-participating host authorities and the potential repercussions of any decision on their economies.

Such considerations could help to end the ‘too big to fail’ phenomenon, by putting in place decision-making procedures that more efficiently integrate the concerns of non-material host authorities with regards to financial stability. It has been upheld that the final decision regarding the survival of a non-material entity of a banking group should ultimately rest solely with the home authority. However, if the non-material entity presents elements of systemic importance for a host jurisdiction, this arrangement could have disastrous results for a host economy. Substantial information sharing and coordination of actions between national authorities through the CMGs could minimise risks relating to arbitrary decision-making, with significant spillover effects for third economies.

Whilst the principle responsibility for crisis management will usually overlap with the principal responsibility for supervision – and as a result

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68 Home authorities should provide to host jurisdictions not represented in the CMG information on the applicable resolution regime, the firm’s structure, the resolution strategies and operational plans, the findings of a resolvability assessment etc., FSB, Guidance on Cooperation and Information Sharing with Non-CMG Host Authorities, 2014, pp.6–8.
69 Such information may concern specificities of the local resolution regime, the results of local resolvability assessments (if undertaken), legal and practical provisions related to confidentiality and the cases where local authorities may decide to take independent national action, ibid, pp.8–9.
belong to home authorities – the operation of CMGs requires an advanced role for material host authorities. Host authorities will facilitate the dissemination of information, and alert the other members of a CMG the financial situation of a local branch or subsidiary deteriorates. Discretionary, standalone actions should be kept to a minimum according to *ex ante* conditions; for example, in cases where the home authority is unwilling or unable to act promptly.

The role of the home authority remains fundamental to the operations of CMGs. Home authorities have been identified as the lead authorities of a cross-border resolution procedure. The home authority will chair each meeting of the CMG, and will coordinate recovery and resolution planning exercises and resolvability assessments, with the active participation of the other present authorities. It will also be responsible for the coordination of the actual resolution strategy of the G-SIB. Even if the home authority will eventually be forced into resorting to discretionary actions, it should notify the host authorities without undue delay, and always consider the impacts of its actions on their domestic financial stability.70 Clearly, home authorities should not use their leadership role, as a pretext for dominating the CMG, imposing their decisions to the other participants or eventually ‘highjacking’ a bank resolution procedure.

The success of CMGs will depend heavily on the principles established under COAGs. The role and responsibilities of each participating authority should be precisely circumscribed in order to avoid regulatory duplication or omissions/inactions. The lack of dispute mediation mechanisms within CMGs, however, could jeopardise the achievement of efficient decision-making.

Moreover, within interconnected banking markets, CMGs should be able to interact with each other, sharing information that will be crucial for avoiding systemic risk hazards. However, once again, national authorities may be reluctant to share information if they have legitimate concerns around confidentiality; thus highlighting the urgent need for the FSB to introduce standards ensuring the safeguard of confidentiality.

CMGs remain, however, in their nascent stage; as such, it is still too early to come to any firm conclusions regarding the likely effectiveness of

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their current form and operations. That said, they appear to suffer from similar deficiencies as the COAGs (as described in the previous section). Namely, explicit working standards on decision-making and information-sharing for CMGs are lacking, as are dispute mediation mechanisms. More importantly, CMGs alone cannot prevent resolution procedures being subject to discretionary state actions, vindicated on the basis of *ordre public* and financial stability arguments.

Finally, there is the risk that participating authorities will view CMGs as a static exercise, requiring just one or two meetings per year. On the contrary, CMGs should become a forum bringing resolution authorities and their crisis management traditions closer and enhancing exchanges based on frequent crisis management simulation tests and scenarios. As part of continuous monitoring of the activities of CMGs, the FSB should review their structure and operations closely in order to identify – and correct – any potential deficiencies that might jeopardise the future efficiency of these groups.

### 12.5 Concluding remarks: transition from fragmented to coordinated cross-border resolution policies

The above sections described some of the elements necessary for the successful implementation of cross-border resolution schemes. At the heart of these developments is an increasing recognition of the need for more effective cooperation and coordination between the various national resolution authorities involved in a cross-border resolution procedure. Such considerations have become the cornerstone of further future work. Efficient mechanisms for cross-border crisis management should focus mainly on bank resolution without neglecting the importance of bank supervision.

Nonetheless, all necessary objectives are far from being fulfilled. A great number of domestic legislations on bank resolution maintain a
domestic focus concerning international banks. Most developing economies, which remained largely unaffected by the 2008 crisis, have adopted softer regulatory reforms and tend to downplay the importance of international coordination on crisis management. As a result, numerous state authorities still lack a formal legal mandate to cooperate with their foreign counterparts and any foreign decisions relating to bank resolution and insolvency are recognised on a case-by-case basis, provided that specific conditions are met.

Whilst the international standard-setting bodies have contributed significantly to the international dialogue, these efforts fall short of substantially enhancing cross-border cooperation and coordination on crisis management. The BCBS and the FSB identified as their main policy the removal of obstacles to international cooperation. However, they avoid prioritising the proposed resolution standards and they offer no clear approach regarding the obligation of the different state authorities to cooperate with one another. Regarding resolution planning, a common cross-jurisdictional approach – outlining the scope, form and requirements of these plans – has yet to be established. Despite the introduction of significant reforms, the EU has adopted a very broad approach to cross-border cooperation and it remains to be seen if and how the commitments associated with this will be upheld.

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71 Like the UK Special Resolution Regime, which lacks any reference to the issue of cross-border bank resolution policies, despite the international activities of UK banks and the importance of London as a financial centre, David G. Mayes, Resolution Methods for Cross-border Banks in the Present Crisis, in LaBrosse, Raymond, Olivares-Caminal & Singh, 2009, p.322. In addition, the US system currently maintains its traditional approaches to cross-border insolvency, as the introduction of the Dodd-Frank Act failed to establish new rules on cross-border information exchange and coordination of resolution procedures. Finally, the Swiss Banking Act did not reform its rules on cooperation with foreign authorities during a banking crisis and the newly enacted FINMA Bank Insolvency Ordinance, although it presents elements of universality, it remains quite vague with regard to the conditions of cross-border cooperation.

72 Jenkins, Rabinovitch & Leahy, 2011.
73 BCBS, 2011, pp.26 and 31.
74 Institute of International Finance, 2012, p.II.
75 EU Bank Recovery and Resolution Directive, art. 93–98. EBA will play an important role in elaborating administrative framework agreements with the authorities of third states.
“Developments in the banking system have outgrown the traditional country based system of regulation and concern”, as financial services have become increasingly concentrated and interconnected. While foreign banks may add depth and expertise to a local banking market – and in doing so improve competition – they can also expose a host economy to unprecedented risks of financial contagion. Thus, highly interconnected global banks can exacerbate the transmission of risks as well as the impact of the failure of one financial institution on the whole system.

In this modern banking environment, traditional bilateral banking resolution arrangements will no longer suffice. The 2008 crisis brought to the fore the inadequacy of the cross-border MoU approach – popular prior to the 2008 crisis although functional only in rare cases – in promoting a coordinated resolution response. Indeed, many hold these non-binding soft-law instruments partly to blame for the fragmented crisis management responses to the crisis. As such, these instruments are now considered outdated. Based on the considerations presented above, home and host authorities should focus on the elaboration of operational COAGs.

Institution-specific CMGs will commit to the implementation of these agreements by establishing a forum promoting information-sharing, in which the divergent – and potentially conflicting – interests of the participating authorities will be considered. Regarding CMGs, coordination, and not centralisation, of powers will be of key importance. The aspects of disclosure and confidentiality around COAGs and resolution plans should be considered in detail and a certain degree of interaction between the various CMGs should be achieved for reasons of macro-economic financial stability. Finally, detailed burden-sharing schemes should be put in place to facilitate the intervention of authorities during a crisis. International bodies such as the BCBS and the FSB will play an essential role


78 An exceptional case of a formal MoU on joint supervisory policies and the treatment of financial institutions in distress is the one signed among the Nordic states. In practice, one should distinguish between a general MoU on supervisory policies, institution specific MoUs regarding the groups of Nordea and Sampo, as well as a separate MoU on crisis management among the respective central banks, Cihaľ & Decressin, 2007, p.23.
in identifying non-cooperative jurisdictions through peer reviews, and assisting these jurisdictions to adhere.

All in all, outside of the limited environment of the EU, legally-binding agreements on cross-border resolution are not expected to be developed – at least in the near future. At the same time, the creation of global standards regulating cross-border cooperation and coordination remains a vital ongoing process. Still, one should not forget the importance of incentives for state authorities regarding the coordination of their actions.

It has been argued that national interests are most likely to drive the decisions of national resolution authorities, who seek to protect national sovereignty and authority, and that, as a consequence, cross-border agreements can only be operational between jurisdictions that share relatively similar legal, regulatory and financial traditions.\textsuperscript{79} This argument, though – that the objectives of cross-border financial stability and of domestic financial policies are necessarily incompatible – does not seem convincing. Following the 2008 financial collapse, the majority of jurisdictions realised that more closely aligned and consistent approaches to crisis management are in each nation’s best interests.\textsuperscript{80}

Cross-border coordination on the basis of soft-law instruments may resemble a ‘prisoners’ dilemma’; in other words, “\textit{cooperation action could be beneficial but cannot be guaranteed, so authorities may seek to take pre-emptive and non-cooperative action}”.\textsuperscript{81} It will be hard for each jurisdiction to hand over part of its sovereignty with regard to crisis management decision-making. Ideally, the benefits for global banking and financial stability should outweigh such concerns and limitations; yet in reality, similar concerns have a significant bearing on the final decisions of state authorities, especially when the latter operate under the broad instructions of soft-law instruments. Hence, COAGs and CMGs have to be considered in their current form not only as an important development but also as the basis for future efforts towards more optimal cross-border resolution management.

\textsuperscript{79} Krimminger, 2005, p.24.

\textsuperscript{80} Acharya, 2011, p.49. At the end of the day, as stressed by Freixas, “\textit{financial stability is a goal that every individual country is interested in achieving, so there are good grounds for cooperation}”, Freixas, 2003, p.113.

\textsuperscript{81} Charles Randell, \textit{Group Resolution under the EU Resolution Directive}, in Dombret & Kenadjian, 2013, p.44.
CONCLUSION

“We think everything should be allowed to fail but we need a resolution mechanism so that the system is not destroyed. To dismantle a bank in a way that does not damage the system should be doable. It is better than being too big to fail”

Jamie Dimon, CEO of JP Morgan Chase

The overall cost and consequences of the 2008 financial crisis and its aftermath were unprecedented. Financial institutions and regulators realised the dangers of the ‘too big to fail’ doctrine that had existed for decades – i.e. the belief that some banks are simply too big to be allowed to fail and must, therefore, be rescued by the government – for financial stability. Without question, one of the factors that made this crisis so deep and widespread was its international dimension: the extent and nature of international banking integration increased countries’ vulnerability to financial contagion. Ultimately, only a handful of markets remained relatively unscathed from the financial shock.

The 2008 crisis brought to light the inadequacy of pre-existing non-binding bilateral and multilateral cooperation agreements and ‘soft law’ instruments in dealing with the failure of complex, cross-border banking groups; the ‘united we stand, divided we fall’ dogma was once more vindicated. The first three case studies described in chapter 1 illustrate the far-reaching impact that the failure of some cross-border banks had on the stability of the wider economy, as well as the potentially disastrous consequences of uncoordinated and ad hoc responses implemented by multiple domestic authorities in response to such failures in the absence of efficient cross-border resolution mechanisms.

Confronted with the dilemma of either allowing international banks to collapse or stepping in and rescuing them, most national governments – in the absence of comprehensive bank insolvency regimes – had little choice but to respond with institutional bailouts in order to prevent the

2. As the former Governor of the BoE, Mervyn King, pointed out, “banks are global in life but national in death”, in McCormick, 2010, p.145.
total collapse of systemic institutions. However, significant controversy has accompanied these unprecedented injections of liquidity and capital designed to preserve a few irresponsible and overly large institutions, which came at the expense of the taxpayer. As resentment among the public at funding bailouts grew, regulators became determined to never allow a crisis on a similar scale to happen again and proposed numerous legislative reforms to prevent a reoccurrence.\(^3\)

Bank resolution – a purely administrative crisis management procedure that allows the safeguard of the critical functions of a failing bank at a pre-insolvency stage while its residual parts are subject to traditional liquidation proceedings – has been proposed as the antidote to the ‘too big to fail’ problem.\(^4\) Bank resolution, it is argued, should safeguard market financial stability and minimise the risks of financial contagion and unnecessary value destruction. A regulatory concept that has already been tested (mainly in the US), implemented principally for small- and medium-sized banks, has been transformed into the most preferable alternative to the insolvency of financial institutions.

Much has been achieved in the last years: from the vague proposals of the Cross-Border Bank Resolution Group of the Basel Committee, to the first global bank resolution standards developed by the FSB in 2011 (the ‘Key Attributes’); and from the elaborate (albeit complex) rules of the Dodd-Frank Act, to the EU Regulation for the first consolidated Single Resolution Mechanism. As highlighted in chapter 2, legislative developments in the field of bank resolution have been considerable, swift and – often – very dynamic. One should also mention that these developments form an integral part of broader crisis management frameworks, designed to harmonise and improve the tools for dealing with future bank crises, and which focus on – among other things – bank recovery, capital

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\(^3\) Paul Tucker, the former Deputy Governor of the BoE highlighted that “in the circumstances in which we found ourselves, where on a Monday night a major bank, integral to our financial system, said that it could not get to the end of the day, I think it would have been an act of economic vandalism not to have stepped in and rescued it. But I think we need to design a framework, which makes that very, very much less likely in the future”, Evidence to the Treasury Select Committee (26/01/2010), cited in \textit{ibid}, p.85.

\(^4\) As eloquently put by Sommer, “megabanks are more than big banks. They are more complex; they are more interlocked; they are more global. They also have a peculiar corporate structure and – most importantly – peculiar liabilities. They are atypical firms. They need atypical insolvency law”, \textit{Sommer}, 2014, p.3.
requirements, liquidity oversight and a potential segmentation of banking activities.

On the other hand, the selective presentation of noteworthy domestic and supranational rules and international standards has illustrated the proliferation of legal incoherence and the increasing uncertainty around the practical aspects of the implementation of bank resolution. Even where jurisdictions have undertaken initiatives to address the ‘too big to fail’ problem and have put resolution regimes in place, often these developments are not well coordinated between the major financial centres. Such legal divergences between jurisdictions could eventually lead to issues around level-playing field distortion, and therefore jeopardise future progress in bank resolution practices. It seems as if many of the rules proposed to help prevent a future financial crisis are implemented without any common understanding of the nature and causes of the previous financial crisis; especially in terms of the interconnectedness and global character of the financial markets.6

First of all, resolution authorities will need to navigate through a vast array of resolution objectives in order to complete a resolution procedure successfully. Although the existence of multiple resolution goals is not essentially problematic in itself, a failure to prioritise these goals could result in the development of different policies that are incompatible. Conflicts are bound to arise around the need to safeguard public interest but also the private rights of various stakeholders. Prioritisation aside, as outlined in chapter 3, greater emphasis must also be placed on the overall objective of cross-border cooperation and coordination; in many cases, this is notably absent. Additionally, the development of precise global standards with regards to the nature of ambiguous concepts such as financial stability or public interest will be necessary in order to minimise the challenges associated with a divergence in interpretations.

On another note, resolution authorities have argued heatedly over the optimal design of resolution triggers. For the time being, there is a widespread tendency for resolution authorities to adopt ‘soft’ triggers that afford them greater flexibility; yet such discretionary triggers may encourage

5 “Only a few jurisdictions report having resolution regimes in place that are fully or almost fully aligned with the Key Attributes”, FSB, Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability, 2014, p.9.
regulatory forbearance (i.e. the potential for a fully briefed regulator to decide not to intervene) and lead to market confusion. Chapter 4 argued for a progressive financial viability test; a test that is based on market-based models and forward-looking quantitative, as well as qualitative, crisis indicators – such as liquidity ratios, CDS spreads, and evaluations of crisis simulation scenarios. Whilst regulatory discretion is a ‘necessary evil’ in order to safeguard flexibility, specific elements of ‘hard’ triggers (for instance those related to regulatory capital or liquidity) could limit the risks associated with ‘soft’ triggers. Such ‘hard’ elements could enhance cross-border harmonisation of resolution triggers. However, the violation of such ‘hard’ thresholds should not lead to automatic actions; rather, authorities should be obliged to examine the situation in hand and decide which solution should ideally be implemented. In addition, the creation of a series of trigger levels should be endorsed, leading to the progressive implementation of increasingly stringent measures according to the specific circumstances of each crisis management stage.

Chapter 5 examined the role of resolution authorities and argued that the functions exercised by each authority should be explicitly circumscribed under statute: By contrast, overly vague mandates risk creating confusion among different regulators and this can ultimately lead to regulatory overlaps and conflicts – or even inaction. Bank supervisors are best placed to initiate resolution triggers and implement bank resolution given their close proximity to financial institutions. Central banks also have a crucial role to play in bank resolution, namely in ensuring liquidity in times of financial turmoil. In the event that the role of central banks in financial regulation is expanded (i.e. where prudential supervision is combined with central banking), central banks should not adopt an additional resolution mandate but rather a separate resolution authority should be established in the jurisdiction in question.

Finally, despite the distinct role of each resolution authority, a lead resolution authority should be designated for each jurisdiction. Clearly, it is unrealistic to develop a ‘one-size-fits-all’ solution. Nonetheless, some degree of cross-border harmonisation will be essential in order to overcome problems associated with lack of cooperation between lead resolution authorities with different domestic institutional statuses.

Chapter 6 presented the four principal resolution tools available to resolution authorities during a resolution procedure (bridge bank, sale of business, asset separation and bail-in mechanisms) and outlined the main
characteristics of each of these. Whilst these tools may look good on paper, the reality of implementing them on a cross-border basis, in practice, may be much more challenging. Most notably, resolution authorities are likely to encounter challenges regarding the valuation of transferred assets; the recognition and enforcement of foreign decisions; the timeframes for the completion of such tools established under legislation; the treatment of creditors; or the issue of how such tools will be funded.

An important part of Chapter 6 is dedicated to the analysis of bail-in. Whilst bail-in is expected to become the most important instrument for a rapid recapitalisation and stabilisation of a failing bank, there are significant weaknesses to this tool in its current form. Specifically, the implementation of this tool may give rise to market panic and market contagion; thus, further consideration needs to be given to this. Additionally, the effectiveness of this tool could be jeopardised by the fact that most banks hold inadequate debt buffers. The inclusion of uninsured depositors in bail-inable creditors’ classes may further contribute to such panic phenomena, especially in troubled economies. This calls for the introduction of depositor preference rules as a minimum protection standard. Finally, the enforcement of domestic bail-in powers for contracts governed by foreign law remains a contentious issue.

Chapter 7 illustrated that bank resolution tools can allow the authorities to take actions that may interfere with individual private property rights. This has been a natural result of increased state intervention in the daily operations of the financial system following the 2008 financial collapse, and of the change of mentality with regards to traditional principles of corporate law. In accordance with the existing rules under bank

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7 As stressed by the Economist, “the biggest casualty of the crisis has been the idea that financial markets are inherently self-correcting and best left to their own devices”, The Economist, 2011, p.3. The President of the United States, Barack Obama, eloquently encapsulated the need to strike a balance between the powers of the market and the guidance of the government: “There has always been a tension between those who place their faith in the invisible hand of the marketplace and those who place more trust in the guiding hand of the government. In the aggregate of countless independent decisions, we see the potential for creativity – and the potential for abuse. We are called upon to put in place those reforms that allow our best qualities to flourish – while keeping those worst traits in check. We are called upon to recognise that the free market is the most powerful generative force for our prosperity – but it is not a free license to ignore the consequences of our actions”, Remarks by the US President on the 21st Century Financial Regulatory Reform, The White House (17/06/2009), cited in McNeil & O’Brien, 2010, p.12.
resolution, a resolution authority is obliged to determine compensation according to legally accorded ranks. Shareholders will be the first to suffer losses and will be subject to important limitations regarding the exercise of their governance rights within a financial institution. While the influence of resolution measures on better corporate governance is still disputed, it is estimated that bank resolution rules could make a significant contribution to improved corporate governance practices; specifically, it is reasonable to expect more shareholder activism with regards to issues such as executives’ remuneration and business strategies deemed controversial. Obviously, one should not expect the same of institutional and individual shareholders. Yet the role of the latter should not be underrated.

In the context of modern bank resolution tools, creditors are the next in line after the shareholders to bear notable infringements on their property rights. Their claims may be (partially or entirely) written off; they may experience a transformation of their status into shareholders; or see their contractual arrangements become subject to temporary stays. Resolution authorities are right to comply with these rules-based conditions, since they are designed to ensure the smooth completion of bank resolution with minimum disruption to the financial system. Thus the safeguard of creditors’ rankings – as well as of the *pari passu* principle – is of fundamental importance and must be safeguarded in order to give bank creditors and investors legal certainty. Yet this is not currently guaranteed in all jurisdictions.

Similarly, it is assumed that since resolution authorities are officially forbidden to ‘cherry-pick’ between contractual agreements with a specific counterparty – and must, instead, transfer all of a specific creditor’s covered contracts – this will guarantee the fair treatment of each creditor. Yet, in most jurisdictions the criteria surrounding the implementation of this prohibition are vague – or altogether absent. Thus, in practice resolution authorities are likely to be able to use considerable discretion in making the final choice of which assets or contracts to be transferred.

Specific limits to the discretionary powers of resolution authorities when intervening in a financial crisis should be clearly defined under resolution statutes. Courts will make the final decisions regarding the legitimacy of resolution actions that restrict shareholders’ and creditors’ rights. This fact notwithstanding, the lack of precise standards facilitating the mandate of the courts might render the accomplishment of their tasks
problematic. Deciding exactly where to fix the interpretational yardstick of authorities’ actions will be extremely challenging.

The role of courts in resolution remains subject to debate. In order to ensure flexibility, speed and the safeguarding of market stability, courts should not become an integral part of a resolution procedure. If courts are granted with resolution powers that are too broad, they might overstep their mandate and end up exercising legislative or (even worse) political functions. Moreover, they remain deeply associated with traditional rigid insolvency regimes. On the other hand, they should be able to review, ex post, actions taken by the resolution authorities in order to determine whether the authorities have acted legally in restricting shareholders’ and creditors’ rights, ensure the transparency and legitimacy of the process and decide on compensation for any stakeholder who has been wrongfully affected. Such actions will become an effective backstop to resolution authorities’ discretion or eventual arbitrary actions. A certain degree of judicial activism cannot be avoided and might even be welcome in shaping better future resolution practices. In the case of the EU, the prospective interventions of the ECJ, as well as of the ECtHR are anticipated with great interest.

The no creditor worse off than under liquidation (NCWL) principle is indeed a stimulating theoretical concept. However, valuating compensation entitlements in practice will be very challenging: the extent to which an independent valuer is able to accurately determine ‘actual treatment’ versus ‘hypothetical treatment’ under insolvency in such circumstances remains uncertain. It could be impossible to guarantee fairness when it comes to compensation, and instead over- or under-valuation will become the norm. Even if the stakeholders affected by the resolution are satisfied with the amount of the adjudicated compensation, ambiguity exists with regards to what form the compensation will take. Will the offer of shares or debt instruments with a high yield (for instance CoCos) in a new financial institution be considered equivalent to direct monetary compensation? How quickly should state mechanisms execute their judgment on compensation? And how should the case evolve if the competent mechanism declares itself unable to compensate the prejudiced creditors? These are just some of the fundamental questions that remained unanswered under the existing resolution rules.

Resolution planning and resolution funding may hold the keys to the overall success of bank resolution schemes. Chapter 8 illustrated that
the exercise of drafting and updating resolution plans – albeit a daunting one – will provide authorities with a valuable insider view of the corporate structure and business lines of modern banks. And for the financial institutions themselves, such plans will allow them to confront the credible scenario of their financial demise.

The resolution planning process, however, will not be a straightforward one. There are many potential challenges associated with the drafting of resolution plans, including: the amount of information to be collected will require an open, frank and constant dialogue between resolution authorities and the financial industry, and this cannot be taken for granted; resolution planning is currently subject to complex requirements varying across jurisdictions and contributing to confusion for global financial institutions; concerns around confidentiality have not yet been sufficiently addressed; it is questionable whether the annual updates will adequately reflect the current financial condition of a bank; and, finally, most resolution authorities lack the powers to intervene when financial institutions are unable to address the challenges brought to light by resolution plans and resolvability assessments. All of these challenges risk resolution planning becoming merely an exercise in compliance. One should also bear in mind that resolution plans are merely roadmaps towards resolution; resolution authorities and banks must not be lulled into a false sense of security.

Chapter 9 highlighted that resolution funding should be based on domestic funds, financed by the financial sector through *ex ante* fixed levies. This chapter stressed the need for clear regional or international standards to regulate the valuation of these levies. Such standards should reflect the size and potential contribution to systemic risk/negative externalities of each financial institution. Deposit guarantee schemes (DGSs) could contribute to resolution financing according to specific conditions, and the amount of these funds should not exceed the amount that would have been necessary to repay depositors if the bank had been wound up under normal insolvency proceedings. A fusion between resolution funds and DGSs should not be endorsed, since their objectives – while similar – are not identical.

Bail-in schemes and other private sector arrangements should be limited to a complementary role in resolution financing. Central banks should provide liquidity to a bridge bank or a new banking entity resulting from resolution. The role of state treasuries should not be underestimated in periods of financial distress; due to the lengthy phase-in periods for the
creation of resolution funds, state treasuries’ contributions are not to be excluded in the interim period before independent and efficient resolution funding mechanisms have been put into place. The participation of treasuries, however, should follow explicit *ex ante* conditions and clear mechanisms for the recovery of public funds must be developed.

Last but not least, the introduction of a burden-sharing formula will be a fundamental prerequisite of resolution funding schemes during a cross-border crisis. Indeed, cross-border bank resolution cannot become a credible crisis management mechanism without this crucial aspect being resolved.

Part III, the final part of this contribution, focused on the institutional challenges for cross-border resolution regimes. The complexities of such challenges could jeopardise the development and efficient implementation of resolution practices. Hence, these issues require also particular attention.

Chapter 10 outlined that the first of many significant challenges to consider is how to define whether a financial institution is systemic or not, and how to standardise this definition. Although certain criteria for defining systemic importance are universally accepted (size / interconnectedness / complexity / substitutability / cross-jurisdictional activities), ‘measuring’ such concepts will be extremely challenging. Fixing such ‘hard’ parameters will be necessary to guard against cross-border regulatory heterogeneity, yet this exercise will not come without its own risks: certain financial institutions may decide to stay just below these limits in order to avoid the additional requirements imposed on systemic banks. They may, thus, not be considered systemic even though their negative externalities and the threat they pose for the system remain significant.

Supplementary qualitative indicators relating to systemic importance should therefore be proposed to complement the quantitative indicators. One should acknowledge that the special market characteristics of each jurisdiction will have an impact on how one judges whether a bank is systemic or not. These market needs and considerations must not be ignored: differences in interpretation between home and host jurisdictions could become the source of conflict.

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8 "A system that does not allow for state support in one form or another is not realistic", Sjöberg, 2014, p.204.
Chapter 10 touched upon the scope of application of bank resolution regimes. Resolution practices need to be implemented more broadly, covering both SIBs and small- or medium-sized banks. This point notwithstanding, certain requirements that will inevitably be particularly time-consuming, complex and expensive to put into practice – such as resolvability assessments, resolution plans or additional capital to Basel III rules – should only apply to SIBs, since smaller domestic banks are unlikely to have the resources (financial and organisational) required to comply with these regulatory demands. One remains sceptical regarding the existing form of the proposal for a separation between global and domestic SIBs due to the level-playing field drawbacks for the latter, the risk of rules’ overlap and the potential impact of over-regulation on financial activities.

Chapter 10 highlighted that bank resolution has shifted our focus from systemic institutions to systemic functions. All institutions should be allowed to fail, but specific critical functions should be safeguarded and should not be subject to traditional insolvency proceedings. Still, with only few standards available, there is no clear agreement on the most important factors of criticality.

Chapter 11 examined how in practice the business lines of international banks do not always correspond to the pre-determined legal patterns of group organisation. A procedural consolidation of bank resolution schemes should be applied for banking groups. The analysis demonstrates that, regrettably, the single entity legal theory is still very much alive and robust. So far no group notion has been elaborated in most jurisdictions and the need for a clear definition on banking groups is vital. The first position papers on crisis management policies focus on ‘single point of entry’ resolution practices, ignoring or downplaying the potential repercussions of such decisions on group entities and host states. The proposals for the segmentation of banking activities aim to limit interconnectedness, but in an era of globalised finance the implementation of these proposals might prove quite onerous. Reflections on the treatment of asset transferability schemes under resolution are notably absent. Hence, there is still the risk that national resolution authorities will resort to ‘ring-fencing’ practices and the implementation of piecemeal individual solutions for failing banking groups.

By and large, the core of this contribution focuses on cross-border considerations and complexities during the implementation of bank resolution. Chapter 12 illustrated that much work remains to be done in order
to guarantee efficient cross-border cooperation and coordination in future resolution proceedings. Harmonisation – but not necessarily absolute uniformity – of resolution rules is a first critical prerequisite, and this should be followed by standardisation of cross-border resolution practices.

For the most part, MoUs and other informal bilateral or multilateral crisis management agreements supported supervisory cooperation in normal times prior to the 2008 financial crisis. However, such ‘soft law’ instruments failed to secure cooperation between authorities during the crisis. To help address the inadequacies of such ‘soft law’ instruments, institution-specific cross-border cooperation agreements (COAGs) have been proposed, along with crisis management groups (CMGs) to help promote cross-border cooperation and coordination and ensure the effective implementation of the FSB’s ‘Key Attributes’. Nonetheless, there is growing concern that these novel instruments share the same weakness as the MoUs – namely, they are non-binding. In addition, they are anticipatory in nature, i.e. they seem to simply assume what will be necessary in order to have resolution authorities cooperate, but they do not stipulate any material policies so as to ensure that they will actually cooperate.9 Consequently, these instruments should not be viewed as the end result of the efforts towards securing greater cooperation between national authorities.

One should also note that the balance of power in cross-border crisis management relations remains rather unaltered: while host authorities will certainly enjoy a more advanced role in the new institutional fora, home authorities will continue to exercise a dominant position. Home regulators will still make the ‘life and death’ decisions, free to apply their viewpoint regarding the systemic importance of a group entity. Meanwhile, dispute mediation mechanisms are absent from the new cross-border cooperation arrangements; there is therefore the risk that any conflicts between authorities could end in a stalemate.

On the basis of the aforementioned arguments, it becomes obvious that reforms to the cross-border bank resolution framework remain incomplete. Despite the initial determination and the impressive legislative progress, the discussions around the ‘too big to fail’ problem – with the exception of the EU – might have lost momentum. While the majority of international banks have complied with a great number of the new rules,

they have demonstrated a growing appetite for risk.\textsuperscript{10} The banking sectors of the emerging economies, which were less affected by the 2008 financial crisis, have been subject to relatively soft regulatory reforms.\textsuperscript{11} Developing economies did little to improve their bank supervision and bank resolution practices. In addition, as the large banks complained that profits were slumping and clients were deserting them, some regulators have been poised to review their rules.\textsuperscript{12}

The ‘too big to fail’ problem has not been resolved. It is estimated that many large international banking groups remain extremely interconnected and they also maintain important links with a substantial number of smaller banks across the world.\textsuperscript{13} Higher capital adequacy requirements are expected to boost the resilience of banks and allow them to address sudden shocks. On the other hand, there are concerns that higher capital cushions and liquidity buffers might eventually intensify banks’ appetite for risk and result in increased risk-taking practices.\textsuperscript{14} Consequently, the global banking system remains vulnerable to the possibility of a rapid onset of a systemic crisis.\textsuperscript{15}

Furthermore, numerous states are currently confronted with unsustainable sovereign debt burdens. For instance, the Eurozone banking sector is still very fragile\textsuperscript{16}: numerous cross-border banking groups in

\textsuperscript{10} Jenkins, 2011.
\textsuperscript{11} Jenkins, Masters & Braithwaite, 2011.
\textsuperscript{12} Particularly with regard to capital adequacy requirements, Masters & Murphy, 2011. According to Admati and Hellwig, “Basel III requirements are still considered low and reflect the political impact that the banks had on the policy debate and the flawed and misleading claims that are made in discussions about banking legislation”, Admati & Hellwig, 2013, p.180.
\textsuperscript{13} The Economist, 2011, p.12.
\textsuperscript{14} Herring, 2009b, p.5.
\textsuperscript{15} As highlighted by Admati and Hellwig, “banks may be more robust today than they were in 2008, but this statement does not say much about where they really are and where they should be”, Admati & Hellwig, 2013, p.226.
\textsuperscript{16} Most Eurozone banking sectors have been severely under-capitalised since the last financial crisis. The ECB recently completed an Asset Quality Review for 130 Eurozone banks in 19 countries. The ECB stressed that in case of materialisation of the adverse scenario under the exercise the aggregate available capital of the Eurozone banks is expected to be depleted by € 215.5 bn (22% of the capital of the participating banks), leading to a decrease of the CET1 ratio for the median participating bank by 4.0 percentage points from 12.4% to 8.3%. 25 Eurozone banks are already subject to
Conclusion

Peripheral economies are struggling to overcome financial troubles, and the biggest banks became simply ‘too big to bail’. Not everyone is optimistic about the future, given that there are doubts regarding the efficiency of the first consolidated supranational resolution mechanism.\footnote{Sommer, 2014, p.15.}

Finalising cross-border bank resolution mechanisms in the near future will be a daunting task.\footnote{Huertas, 2014, p.6.} It will be a lengthy legal and political process and it will require substantial compromises by all actors involved (politicians, financial institutions and regulators). In the words of Ingves, it is expected that “landing the reforms will take at least as much effort and commitment as launching them in the first place.”\footnote{Ingves, 2014, p.5.} Even if the legal challenges will be overcome, political will for the completion of the project – which is vital – is currently lacking. Ending the ‘too fail to fail’ problem does not only require modifying insolvency law but also convincing the markets that state governments will not continue bailing out troubled banks.\footnote{Huertas, 2014, p.6.} Cross-border cooperation during a financial crisis should “involve ceding sovereignty, rather than extending comity”.\footnote{Sommer, 2014, p.15.}

This contribution concludes on an optimistic note. It has become a common belief that all legal orders share common principles and common interests that can be at stake during a financial crisis. These principles and interests should be transformed into incentives and standards, and, finally, into concrete rules paving the way for credible cross-border crisis
management policies. The author hopes that the reflections of this work will nourish the arguments of the existing dialogue towards this goal.

Charles Goodhart summarised this difficult but necessary choice: “if one could assume that we were in a closed economy and all with just one legal regulatory system and one fiscal system, operating or changing the laws could be a great deal easier. The difficulty is that we are not. The great problem is that if you try to make a change in one country, it affects the competitive position of all the financial intermediaries, which are cross-border and you always get the problem about the level playing field, which means that it is quite difficult to move ahead without international agreement”, Evidence to the Treasury Select Committee (26/01/2010), cited in McCormick, 2010, p.33.
LIST OF ABBREVIATIONS

BCBS  Basel Committee on Banking Supervision
BIS   Bank of International Settlements
BoE  Bank of England
CDS  Credit Default Swap
CET1  Common Equity Tier 1
CMG  Crisis Management Group
COAG  Cross-border Cooperation Agreement
CoCo  Contingent Convertible Bond
DGS  Deposit Guarantee Scheme
EBA  European Banking Authority
EC  European Communities
ECB  European Central Bank
ECHR  European Convention on Human Rights
ECJ  European Court of Justice
ECOFIN  Economic and Financial Affairs Council
ECtHR  European Court of Human Rights
EMU  European Monetary Union
ESFS  European System of Financial Supervision
ESRB  European Systemic Risk Board
EU  European Union
FDIC  Federal Deposit Insurance Corporation
FDIA  Federal Deposit Insurance Act
FINMA  Swiss Financial Markets Supervisory Authority
FRBNY  Federal Reserve Bank of New York
FSA  Financial Services Authority
FSB  Financial Stability Board
IMF  International Monetary Fund
LCR  Liquidity Coverage Ratio
LOLR  Lender of Last Resort
M&A  Mergers & Acquisitions
MoU  Memorandum of Understanding
NCWL  No Creditor Worse Off under Liquidation
NSFR  Net Stable Funding Ratio
OECD  Organisation for Economic Cooperation and Development
OLF  Orderly Liquidation Fund
RBC  Risk Bearing Capital
RWA  Risk-weighted Assets
SEC  Securities and Exchange Commission
SFBC  Swiss Federal Banking Commission
SIB  Systemically Important Bank
SIFI  Systemically Important Financial Institution
SIPC  Securities Investor Protection Corporation
SNB  Swiss National Bank
SRM  Single Resolution Mechanism
SRR  Special Resolution Regime
SSM  Single Supervisory Mechanism
TC  Target Capital
TFEU  Treaty of the Functioning of the European Union
TLAC  Total Loss Absorbing Capacity
UNCITRAL  United Nations Commission on International Trade Law


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