



IMF Working Paper

The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union

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European Department

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Abstract

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The global financial crisis has demonstrated weaknesses in resolution regimes for financial institutions around the globe, including in the European Union (EU). This paper considers the principles underlying resolution regimes for financial institutions, and draws out how a well-designed resolution regime can expand the toolset available for crisis management. Introducing, or in some cases expanding the scope, of these regimes is pressing to achieve more effective responses to ongoing financial sector weaknesses across the EU.

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I. INTRODUCTION

Financial stability frameworks around the world have not provided sufficiently strong safeguards against the realization of systemic disruptions and failures of major financial institutions. Robust financial stability frameworks require strong regulation and supervision and adequate deposit insurance arrangements. For the overall framework to be effective, these tools need to be complemented by dedicated resolution regimes to stabilize and control the systemic impact of a failing financial institution.² Since the onset of the crisis the absence or limited scope of such regimes has been shown up globally, including within the European Union (EU). In the absence of robust resolution regimes, the fiscal cost of supporting individual banks has surged and bail-out expectations increased, with attendant costs for the longer-term stability of the financial system.

EU countries need to be in a position to deal effectively with individual non-viable institutions, both in normal times and in crisis times, and to be able to contain the total fiscal cost of a restructuring of the banking system, should such restructuring be necessary to restore confidence and the normal functioning of the financial system. It is pressing therefore for countries across the EU to review the effectiveness of their resolution frameworks and to introduce legislation where necessary to prepare for a potential further weakening of banking systems across the region and to reduce the moral hazard from emergency action taken.

While establishing a dedicated resolution regime for cross-border institutions at the EU-level would have clear benefits, the introduction of special resolution regimes in individual countries can reduce the overall fiscal burden incurred in resolution and is likely in and of itself to be conducive to more effective management of cross-border failures. European authorities may therefore want to encourage a strengthening of regimes at the level of member states, issue guidance as to the key design features of such regimes and remove potential obstacles to the effectiveness of national regimes that might arise from existing EU level legislation.

The remainder of this paper is organized as follows. Section II reviews in detail the case for introducing special resolution regimes across the EU, referring to the crisis experience as appropriate. Section III discusses the principles sustaining a successful design of special resolution frameworks and the way such regimes can be embedded in national legislation. Section IV discusses the contribution effective national regimes can make in resolving cross-border failures.

² We refer to the need for a special resolution framework for financial institutions for brevity. The question of the appropriate scope of such regimes, e.g. the potential inclusion of non-bank financial institutions is discussed in detail in section III. B.

II. THE NEED FOR SPECIAL RESOLUTION REGIMES: CRISIS LESSONS

A. Systemic Costs of Failure and Fiscal Costs of Bailouts

There is a strong case for financial institutions to be subject to a special insolvency (resolution) regime. Banks and other financial institutions play a special role in a country's economy, performing financial services fundamental to the functioning of an economy, such as the provision of credit, the processing of payments and the provision of financial infrastructure services more broadly. They also play an important part in the transmission mechanism of monetary policy. The failure of financial institutions can cause disruption and major negative externalities, such as a liquidity crunch, the fire sale of assets, and spillovers via the interbank market.

The absence or inadequate scope of resolution tools to deal with failing financial institutions has been shown up globally, during the financial crisis that started in 2007 and intensified in the second half of 2008. Authorities were often confined to two alternatives: corporate bankruptcy—as chosen for instance by the U.S. authorities on September 15, 2008 in the case of Lehman Brothers, a global financial-services firm—and an injection of public funds—as chosen by the U.S. authorities in the case of the American International Group (AIG), a mere two days later. Events have shown that both these alternatives can be very costly. A disorderly bankruptcy can magnify the systemic impacts of the failure of a financial institution. When the authorities aim to avoid these impacts, and inject capital to support the institution, events have shown that the fiscal outlays incurred in the course of an open-ended injection of capital can also be large.

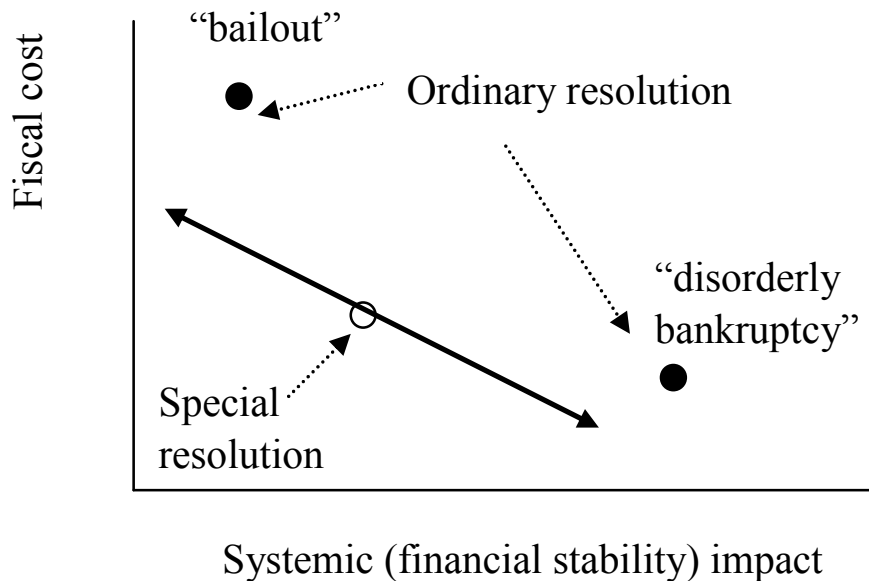
The Lehman case illustrates how a disorderly bankruptcy can lead to uncertainty and contagious disruption in financial markets. Uncertainty over the size of exposures and the eventual recovery rates on these exposures led global bank equity prices to fall sharply and interbank spreads to rise to record highs. At the same time, runs developed on U.S. money market funds that were—or were believed to be—invested in Lehman Brothers' commercial paper. Pressure on these funds soon led to fire sales of all U.S. commercial paper, reducing the flow of funds to corporate borrowers.

The Lehman case also highlights how disorderly bankruptcy can lead to a loss of access to key services, such as payment and settlement services, and may cause a disruption in these systems. Lehman Brothers did not take deposits and did not play a critical role in the U.S. large value payment system. However, since Lehman Brothers had offered prime brokerage services for a number of hedge funds, these funds lost access to credit lines they relied on to fund their positions. Moreover, hedge funds lost access to collateral that Lehman Brothers kept as their custodian, acting as the funds' intermediary in accessing the major central securities depository systems.

In the case of AIG, the systemic threat of a disorderly bankruptcy was judged too large and the U.S. authorities opted instead for an injection of public funds. On September 17, 2008, they had pledged \$20 billion, in the form of a loan granted by the Federal Reserve and backed up by the U.S. Treasury. As of March 2009, the U.S. government had lent a total of \$180 billion. This illustrates how public support can lead to an open-ended commitment, involving repeated capital injections and a large final burden on the taxpayer. Repeated injections of capital were also a feature in a number of rescue operations in Europe, including in the German cases of Hypo Real Estate (HRE) and IKB.

Figure 1 illustrates this point graphically, showing the cases of “disorderly bankruptcy” and “injection of public funds” under an ordinary bankruptcy regime. A special resolution regime can lead to a net efficiency improvement in terms the tradeoff between fiscal costs and containment of systemic (financial stability) impact. It can do so by imposing on shareholders some (or all) of the losses that would otherwise be borne by taxpayers. The special resolution regime also gives the authorities more flexibility to explore the tradeoff between fiscal costs and systemic risk containment.³

Figure 1. Fiscal Cost and Systemic Impact in Resolution Regimes



Source: authors

³ The figure should not be read to imply that fiscal costs of a “disorderly bankruptcy” are necessarily low. Indeed, the fiscal cost of containing the systemic impact of disorderly bankruptcy can be large. For example, the disorderly bankruptcy of Lehman led authorities around the world to inject public funds on a massive scale, to restore confidence and stability in the financial system.

B. Lack of Control for Authorities

Both ordinary bankruptcy and capital injections may afford little control to the authorities that are charged with overseeing financial stability. In ordinary bankruptcy proceedings, authorities have limited control over actions taken by the courts. While the court or a court-appointed administrator will, in principle, seek to maximize the value of the creditors' claims, the authorities may struggle to uphold wider financial stability considerations. When the authorities seek to avoid ordinary bankruptcy, by providing public support, they may find that they have limited control over the actions taken by the firm's owners or managers.

Even when providing capital support, the authorities may have little formal powers to replace the management of a failing institution. They may use private or public calls for the management to resign—for instance, after the German Minister of Finance Steinbrück had said it "unthinkable" to keep dealing with HRE's top management, the bank's CEO was pressured enough to step down. However, such "moral suasion" may not always be effective.

To limit moral hazard, the authorities may want to have a say over bonus payments made to management and employees. However, such payments can often be made without the express approval of the authorities, even if the company is receiving public support. For instance, in the case of AIG, bonus payments were made without a prior approval by the Federal Reserve. Moreover, the Federal Reserve had no legal power to challenge these payments after they had been made.

Actions that the authorities may seek to restrict also include dividend payments to existing shareholders. The main reason is again the prevention of moral hazard. An example here is the case of Northern Rock, which had proposed a sizable dividend while receiving emergency support from the Bank of England. While Northern Rock's management could ultimately be persuaded to change the proposal, the authorities did not have formal control over the matter.⁴

More generally, when managers act in the interests of shareholders they may face incentives to shift value away from creditors and towards shareholders. An excessively large dividend payment is but one example of this. Since shareholders are protected by limited liability, another way of shifting value towards existing shareholders is to increase the risks taken by the institution, to the detriment of creditors. Research has documented that risk-shifting incentives are particularly strong when the firm is close to exhausting its capital resources and the value to shareholders of protecting the firm's franchise is low (Keeley 1990). Moreover, the incentive to increase risks may be even more pronounced when the authorities

⁴ For a detailed analysis of the Northern Rock case, see for instance Lastra (2008).

are providing credit and the firm can expect such credit to be expanded in case the risks do not pay off and the state of the firm worsens as a result.⁵

C. Efficient Solutions May Be Blocked

The efficient solution from the viewpoint of financial stability may be different from that achieved by either ordinary bankruptcy or capital injection. For example, the efficient solution may involve a sale of the institution to another financial institution as a going concern. However, existing shareholders—either large blockholders or the majority of small shareholders—may hold out and block the resolution option preferred by the authorities. This is likely to happen whenever the resolution option involves a loss of value or a loss of control for existing shareholders.

The cases of Fortis, Northern Rock, and HRE are examples of shareholder control delaying or closing off the resolution path chosen by the authorities. After Fortis was broken up, the Belgian authorities sought to sell the Belgian entity to BNP Paribas. However, a prolonged legal battle ensued over whether or not the sale to BNP Paribas required shareholder approval, in which case a number of large shareholders were likely to challenge the deal.

Similarly, while receiving emergency liquidity assistance from the Bank of England, Northern Rock was encouraged by the authorities to seek a take-over by a different banking group. Negotiations over potential deals (including a sale of the business to a consortium led by Virgin) took several months and ultimately collapsed, in part because Northern Rock's shareholders were dissatisfied with offers that were "materially below" the traded share value while the authorities demanded that emergency credit granted would have to be repaid within a set timeframe.

A third example is the take-over of HRE by the German government agency Sonderfond Finanzmarktstabilisierung (Special Fund for Financial Market Stabilization, SoFFin), the success of which was threatened by the need to seek shareholder approval. In the absence of a special legislation, the government would have been unable to force the sale to SoFFin, while its support for the company had reached €102 billion. (A special legislation was passed in March 2009, and as of May 4, 2009, the SoFFin became the holder of about 47 percent of HRE shares, and a further increase in capital, provided by SoFFin, has since brought the authorities' stake up to 90 per cent.)

D. Public Support and Moral Hazard

When ordinary bankruptcy is viewed as too costly by the authorities, bankruptcy ceases to be a credible threat. However, if in the absence of other options, public infusion of capital becomes the only alternative, this is certain to create enormous moral hazard and reduce the

⁵ See Keeley (1990) and Cordella and Yeyati (2003) for research on these effects.

force market discipline. Empirical research has documented that institutions that expect to receive public support hold smaller amounts of tangible common equity relative to total assets, on average (Nier and Baumann, 2006).

This research also shows that expectations of public support reduce the force of market discipline. While increased disclosure of information—such as envisioned under Pillar 3 of the Basel framework—can lead banks to aim for higher capital buffers, the increase in market discipline is found to be mooted for banks that expect to receive support. This means that when European financial institutions can rely on continued support, a key pillar of the Capital Requirements Directive (CRD), which introduced the new Basel framework across the EU, is unlikely to achieve its potential.

Box 1. United Kingdom: Special Resolution Regime of 2009

The failure of Northern Rock exposed the deficiencies of the U.K. regime to deal with banks in distress, which was dependent on the application of corporate insolvency law (Brierley 2009). As part of the policy response, the authorities enacted the U.K. Banking Act 2009, which strengthens the statutory framework for financial stability and depositor protection. It puts in place a special resolution regime, providing the Financial Services Authority (FSA), Bank of England (BoE), and the Treasury with stronger tools to protect financial stability by resolving banks and building societies that are failing.

The resolution options introduced by the U.K. special resolution regime (SRR) include the full or partial transfer to a private sector purchaser, transfer to a bridge bank and transfer to temporary public sector ownership. In addition, the regime provides for an enhanced bank insolvency procedure (BIP) to close a failed bank and facilitate fast and orderly payout of depositors' claims under the Financial Services Compensation Scheme or a transfer of insured deposits to a healthy private sector bank. As pointed out by Brierley (2009), these tools are broadly similar to those available to the FDIC for resolving U.S. commercial banks.

Resolution of failing banking institutions will involve intensive coordination, cooperation and information sharing among the three authorities. The Bank of England is responsible for the operation of the SRR, including the decision on which of the SRR tools to use, and its implementation. The BoE also remains responsible for the provision of liquidity support, which uses the BoE's balance sheet. The act makes the FSA responsible for determining that a banking institution is failing or is likely to fail to satisfy its threshold conditions, and that it is not reasonably likely that action will be taken by or in respect of the institution that will enable the institution to meet those conditions. It is also responsible for the authorization of a bridge bank – that is created and managed under the control of the Bank of England. The Treasury is responsible for decisions with implications for public funds, ensuring the U.K.'s ongoing compliance with its international obligations, and matters relating to the wider public interest. It is also responsible for the temporary public ownership tool, and exercises a number of the ancillary powers under the SRR.

E. Diversity of National Approaches within the EU

There is currently no harmonization at EU level of the national laws governing bank resolution. The regime recently introduced in the United Kingdom (Box 1) provides for special resolution powers on the part of the banking authorities that enable the authorities to take far-reaching and rapid action without the need to seek prior agreement of shareholders or creditors. Outside Europe similar powers exist in Canada, Japan and the United States, where the law provides for special rules for bank insolvency, administered by the supervisor or the deposit protection agency (Hüpkes, 2005, and Brierley, 2009). In many European countries, by contrast, the general insolvency law applies to financial institutions, with the extent of bank-specific modifications to the general law and the range of authority granted to official administrators varying across countries. In some countries, the banking authorities have the right to initiate proceedings, but the process is otherwise in the hands of the bankruptcy court. In other cases, the authorities play a stronger role in reorganization, but their powers are limited or less clearly defined. In particular, shareholders often retain the right of final approval of any reorganization measures. At the time of writing, some EU countries are in the process of reviewing the relevant legislation, or have recently revised the resolution regime. Box 2 provides more detail on cross-country differences across the EU.

Box 2. Key Legal Aspects of Current Resolution Regimes for Banks in EU Countries

Bank resolution regimes differ in many respects, including on key issues such as the ability to initiate proceedings, the powers granted to the official administrator, the specific resolution techniques available, the respective roles of the banking authorities and the courts, and the extent to which the deposit protection fund may be involved. While there seems to be a growing trend towards emerging best practices, the following brief overview highlights the different types of regimes in place in various EU member states. The overview excludes crisis response measures.

France – The Commission Bancaire takes the lead in bank resolution by appointing an official administrator, and may obtain a court order for the transfer of bank shares. Bank liquidation may only be initiated with the opinion of the Commission Bancaire and is supervised by the courts. Liquidation is a dual proceeding with separate liquidators acting with guidance by the Commission Bancaire and under the direction of the courts pursuant to the commercial code, respectively. The deposit protection scheme may assume a broader role in bank resolution.

Germany – Bank insolvency proceedings may only be initiated by the supervisory agency and are conducted under the corporate insolvency law (with certain modifications) and supervised by the courts. Prior to the initiation of insolvency proceedings, powers for the supervisory agency are limited and do not provide for restructuring techniques such as purchase-and-assumption transactions or bridge banks to facilitate prompt restructuring as shareholders' governance rights prevail. The statutory deposit protection scheme is a pay box only, though the Association of German Banks may facilitate the restructuring of member banks by drawing on resources from the private deposit protection scheme.

Hungary – The supervisory agency has limited powers in official administration and the bank resolution regime lacks a clear framework for restricting shareholders’ governance rights and for restructuring techniques such as purchase-and-assumption transactions or bridge banks. Bank liquidation proceedings are initiated by the supervisory agency and conducted under the corporate insolvency law (with certain modifications) under the supervision of the courts. The deposit protection scheme functions as a pay box only.

Ireland – Bank insolvency proceedings are generally conducted under corporate law and may be initiated by the supervisory agency or third parties. Powers for the supervisory agency in official administration are limited as shareholders’ governance rights prevail. The framework does not provide for restructuring techniques such as purchase-and-assumption transactions or bridge banks to facilitate prompt bank resolution. The deposit protection scheme functions as a pay box only.

Romania – The bank resolution regime lacks a clear framework for restricting shareholders’ governance rights in official administration and for restructuring techniques such as purchase-and-assumption transactions or bridge banks. Bank liquidation proceedings may be initiated by the supervisory agency or third parties and are conducted under the bank liquidation law drawing heavily on general corporate insolvency principles. The deposit protection scheme provides for the reimbursement of depositors, though it may take on a role in the insolvency administration.

Spain – The Bank of Spain has a broad range of powers in official administration, including the requirement for express approval of decisions taken by the shareholders’ meeting. Bank liquidation is conducted under corporate insolvency law in a court supervised proceeding that may be initiated by various parties, including creditors. The deposit protection scheme takes an active role as insolvency administrator and may provide funding to facilitate bank resolution measures. For systemically important banks, the Bank Restructuring Fund is given a key role in official administration and has the sole authority to initiate liquidation proceedings.

United Kingdom – Under the new special resolution regime, the Bank of England has strong powers in an administrative proceeding to mandate bank restructuring, including by means of purchase-and-assumption transactions or the use of a bridge bank. This includes the power to transfer bank shares. Bank resolution is initiated by the supervisory agency when certain triggers are met. The deposit protection scheme may provide funding to support bank resolution measures.

Prepared by Maike Luedersen and Alessandro Gullo (both from IMF’s Legal Department).

III. PRINCIPLES AND DESIGN OF THE FRAMEWORK

A. Principles

These considerations imply that resolution regimes are needed to expand the set of tools available to the authorities in crisis prevention and management. The ultimate goal of the special resolution regime is to safeguard financial stability. Specifically, introduction of such regimes is desirable to (i) reduce the systemic impact of a potential failure; (ii) afford control

to the authorities; (iii) shift the financial burden away from the taxpayer; (iv) let losses be borne by existing shareholders; and (v) reduce moral hazard and increase market discipline.

Reflecting these objectives, a consensus has begun to emerge as to the principal features that a resolution framework should comprise. In particular, sound practice is for the framework to

- Allow the authorities to take control of the financial institution at an early stage of its financial difficulties, through “official administration”
- Empower the authorities to use a wide range of tools to deal with a failing financial institution, without the consent of shareholders or creditors
- Establish an effective and specialized framework for liquidation of the institution that assigns a central role to the authorities
- Ensure clarity as to the objectives of the regime and define clearly the scope of judicial review
- Promote information sharing and coordination among all authorities involved in supervision and resolution

The resolution regime is a key, but not the only, part of the broader financial stability framework. Prudential supervision has particularly close links to the resolution regime: an effective resolution regime helps to make supervision more effective, and effective supervision helps to identify and prevent problems in financial institutions even before a resolution is needed. A strong resolution regime needs also to be complemented by robust deposit insurance mechanisms. These should provide for adequate coverage, a high degree of ex ante funding, to raise confidence in the ability of the scheme to honor insured claims, and a rapid payout of insured deposits. These elements can reduce systemic risk arising from the closure of an institution, by reducing the incentives of depositors to “run”, and thus help make liquidation a credible threat, especially for smaller institutions.⁶

B. Scope of Regime

Introduction of special resolution regimes requires careful reflection of the appropriate scope of the regime. For example, the regime currently operated in the United States applies only to commercial banks, and does not include bank holding companies and other financial

⁶ See Kaufmann and Seelig (2006) for further discussion of this point.

institutions, which do not take deposits, but may still warrant inclusion in a regime that aims to reduce the impact of failure of systemically important institutions and financial groups.⁷

The U.S. experience has shown up investment banks—such as Bear Stearns and Lehman—as important examples of institutions that may need to be caught by a special resolution regime even if these institutions are not taking any retail deposits. The case of Bear Stearns in particular has highlighted that wholesale funding sources can be as liable to a “run” as retail deposits. This means that swift intervention is required if liquidity pressures are not to jeopardize the solvency of the institution and cause repercussions in financial markets. The case of AIG highlighted that a financial institution can become a critical hub in the network of financial exposures. This type of institution may need to be caught by a resolution regime—as well as appropriate regulation—because the systemic impact of insolvency can be large. More generally, the U.S. experience has shown that it is not sufficient for resolution regimes to apply only at the level of a commercial bank subsidiary when the whole financial group is integrated, e.g. as regards its management of liquidity, and doubtful assets are held both inside and outside the banking subsidiary. Recent proposals by the U.S. administration are designed to address these issues, by creating the status of a Tier 1 holding company, that would be subject to a special resolution regime at the group level and irrespective of whether it contained entities that took deposits.⁸

In Europe, the prevalence of the universal banking model means that most large and complex institutions will also take deposits. However, even here, Northern Rock and HRE were examples of institutions that relied on wholesale funding to a significant extent. It may be desirable for the scope of a special resolution regime to be robust to a potential trend away from business models that involve funding through retail deposits. That said, it is clear that—at a minimum—all deposit-taking institutions (banks) need to be within the scope of the regime.

For financial conglomerates, it may, more generally, be desirable for a special resolution regime to apply at the level of the parent company, rather than only at the level of each individual institution. This helps avoid the situation that financially integrated businesses are broken up in resolution; or alternatively that the cost of breaking up the integrated business is

⁷ Examining the U.S. bank insolvency code, Bliss and Kaufmann (2006) conclude that the code encourages speedy resolution at the expense of in-place management. This is in marked difference to the general U.S. bankruptcy law which favors existing management and shareholders. Differences with the general corporate bankruptcy code in the United States are further widened through an emphasis on formalized early intervention prior to insolvency, quick declaration of insolvency, prompt termination of the bank charter and shareholder control rights, ousting of senior management, strict enforcement of legal priorities of the different creditor classes, and administrative, rather than judicial, proceedings.

⁸ Department of the Treasury (2009).

gauged too large and that fiscal support for the parent company is deemed the only possible alternative.⁹

One way to approach the issue of defining the scope of the regime is for the law to enumerate the types of institutions, other than banks, that are to fall within its scope; or for the law to set out detailed criteria and quantitative thresholds that determine unequivocally whether any particular institution or financial group falls within scope. An alternative approach is for the law to set out the scope in more operational terms. This can be achieved by giving the resolution authority the power to “designate” particular non-bank institutions to fall under the scope of the regime.¹⁰ Such a designation could be made on the basis of a rigorous, but more qualitative assessment of the systemic risk posed by a given individual institutions against a suitable set of criteria. When such an assessment is conducted periodically and across all potentially relevant institutions, this permits a more dynamic framework, able to respond flexibly to developments in financial markets and changes to the business models of any particular institution.¹¹

C. Threshold Conditions

The resolution regime needs to specify a regulatory threshold, such that when the threshold is crossed, the resolution authority is entitled to take control of the firm and to commence the restructuring process. The regulatory threshold reflects the very essence of special resolution proceedings—to permit the financial stability authorities to intervene in a financial institution at an early stage of financial difficulty when, while the financial position of the firm has weakened substantially the institution may still have positive net worth.¹² This contrasts with the “balance sheet threshold” often applied in ordinary bankruptcy proceedings, that permits proceedings to be initiated only after net worth is close to exhausted. Taking control at an early stage permits the authorities to explore the most appropriate resolution option prior to a full deterioration of capital, while seeking to prevent further weakening of the institution’s condition.

⁹ United Kingdom’s special resolution regime (Box 1) contains a number of safeguards in this regard. It imposes continuity obligations on former group companies to continue to provide essential services to a transferee to which part or all of the deposit taking entity’s business is transferred. In addition, the parent company of a deposit-taking entity can be taken into temporary public ownership if the SRR is triggered in respect of the deposit-taker and this is necessary to reduce a serious threat to financial stability (Brierley, 2009).

¹⁰ The model is the power assigned to central banks to “designate” systemically important payment and settlement systems to formal oversight by the central bank. See Nier (2009) for further discussion of this point as well as the factors relevant to assess systemic importance.

¹¹ IMF and FSB were asked by G20 leaders to develop guidance for national authorities to assess systemic importance with a view to ensure that all systemically important institutions are appropriately regulated. In response guidance on an assessment of the systemic importance of particular institutions is being developed and will be presented to G20 leaders in November 2009. See also Carvajal et al (2009).

¹² See International Monetary Fund and the World Bank (2009).

There are a number of ways in which a threshold can be defined, and national authorities may need to reflect upon which is the most appropriate. In the United States, the Federal Deposit Insurance Improvement Act specifies a mandatory threshold in terms of whether a bank is “critically undercapitalized.” This in turn is defined as a leverage ratio—tangible equity to total assets—of below 2 percent. The threshold is mandatory in the sense that the authorities are not only entitled, but required by law, to take action if the threshold is breached. Other countries apply softer thresholds. The resolution regime introduced through the 2009 Banking Act in the United Kingdom (Box 1) applies a soft threshold, which amounts to a test of whether the firm in question is “likely to fail” the requirements for it to be licensed as a deposit-taker. The relevant criteria include the “adequacy of the firm’s resources”.

The choice between a soft and a hard threshold can draw on the familiar debate on “rules” versus “discretion”. A rule can increase commitment to take resolution action and therefore reduces the scope for forbearance. Indeed, a hard threshold was introduced in the United States to limit what was deemed excessive forbearance on the part of the authorities during the so-called Savings & Loans Crisis in the 1980s and early 1990s.

The case in favor of discretion rests on the argument that rules cannot capture fully all considerations that may inform a decision on what action might be appropriate at a given point in time. Introducing 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. Indeed, introducing discretion may sometimes favor more rapid action, such as when the condition of the institution is rapidly deteriorating as a result of loss of access to key funding markets, but such deterioration is not well captured by the regulatory threshold.¹³

In sum, discretion may increase ex-post efficiency, by making sure that the action taken is fully appropriate in light of the situation. A rule can increase ex-ante efficiency, by limiting forbearance and the resulting moral hazard. In practice, an appropriate solution may trade off the two. For example, in Canada the institution needs to be deemed no longer “viable”. Excessive dependence on financial assistance, lack of depositor confidence and capital deficiencies are introduced as indicative criteria of this threshold having been breached.

D. Early Remedial Action

Irrespective of the degree to which the regulatory threshold is hard or soft, it is important for actions in the resolution stage to be complemented by “early remedial action” by the relevant supervisory agency. Early remedial action is a phase of heightened supervisory involvement that is meant to reduce the chance that the resolution stage will need to be invoked. This may

¹³ The need for coordinated action in cross-border cases may also favor flexibility in the definition of the threshold. Cross-border issues are discussed in greater detail in section IV.

involve supervisory “assistance” in the design of a plan to address incipient financial weakness and the monitoring of the plan’s execution by the supervisory authority. The plan might involve the raising of private capital, modifications to particular lines of business and the divestiture of particular assets. To ensure the success of the early remedial action phase it is important for supervisory authorities to have appropriate enforcement actions at their disposal.

It is equally important for the early remedial action and resolution phases to be well-integrated operationally. Operational integration of the early remedial action and resolution phases can be facilitated when both the prudential regulation of systemically important institutions and the resolution of such institutions is assigned to the same agency.¹⁴ Where more than one agency is involved in supervision and resolution, this integration requires rules governing the exchange of information between agencies. It also requires a high degree of coordination between all authorities involved. Such coordination should involve clear and detailed processes to effect the appropriate degree of consultation and to achieve the aggregation of views held by different authorities. An example are the rules that govern cooperation between the Canadian banking regulator (OSFI) and the Canadian deposit insurance agency (CDIC), along four stages of an integrated early remedial action and resolution process. A recently updated “Guide to Intervention” describes the four stages of intensifying intervention, the actions that may be taken by both authorities in each stage and the means of coordination between both authorities.¹⁵

E. Specific Tools Required

Effective resolution needs to expand the set of tools available to authorities in the resolution phase beyond the “default options” of liquidation and capital support. The following tools have been found particularly useful and should be considered when existing regimes are reviewed.¹⁶ They are available under the existing regimes in the United States, the United Kingdom, Canada, and Japan.¹⁷

Acquisition by a private sector purchaser. Acquisition of the failing institution as a whole is often the most desirable outcome when a financial institution is in distress. This solution can provide continuity of services, protects the public purse and at the same time protects the interests of creditors and counterparties, whose exposures to the failing institution are replaced by claims on a stronger institution. Importantly, the resolution authority needs to be

¹⁴ This agency then acts as a single “systemic risk regulator”. This point is further explored in Nier (2009).

¹⁵ Available from the OFSI website at http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=522

¹⁶ Seelig (2006) provides a detailed discussion of the relative advantages and disadvantages of each of these tools.

¹⁷ See Brierley (2009), Box 4. Japan has historically shown a preference for capital injections and temporary nationalization, rather than bridge bank tools. Canada introduced a bridge bank tool in January 2009.

able to effect a private sector sale, even if the terms of the sale impose losses on existing shareholders. This can be achieved by assigning the power to effect the transfer of the institution on terms that do not require the consent of existing shareholders.¹⁸

Bridge bank tool. Bridge banks are temporary institutions created by the resolution authority to take over the operation of the failing institution and preserve its going concern value, while the resolution authority seeks to arrange a permanent resolution of the failure. The bridge bank tool allows the resolution authority to “bridge” the gap between an institution’s failure and the time when a suitable purchaser has been found. This tool may be attractive in particular for large and complex organizations, where due diligence examinations of assets and liabilities by a potential purchaser can take time and where it is important to keep up critical services, such as payment and infrastructure services provided the firm.¹⁹ Importantly, under the bridge bank tool, the incumbent management is replaced and new management services contracted by the resolution authority.

Partial transfer of deposits and assets to a “good bank”. In instances where some of the institution’s assets are doubtful, nonperforming or difficult to value, it may not be possible to find an acquirer who is willing to take over the institution as a whole, since such a takeover exposes the acquirer to the uncertainty associated with the valuation of the bad assets. In these cases the resolution authority needs to have the powers to effect a partial sale of assets and liabilities. In a “good bank” solution only easy-to-value or “clean” assets are transferred in addition to deposits and (a fraction of) the bank’s other liabilities.²⁰ The residual institution will be left with the difficult-to-value or “toxic” assets as well as the cash raised by the transfer. Having effectively been turned into a “bad bank” the residual institution continues to be owned by existing shareholders, whose capital therefore continues to be at risk from a loss in value of the toxic assets.

Assisted sale to a private sector purchaser. In cases where some of the assets are difficult to value, an alternative is for the authorities to sell the institution as a whole, but to provide some form of financing or a guarantee to the acquirer. Importantly, such a guarantee is

¹⁸ An example of a successful use of such powers is the resolution of the Washington Mutual, the 6th largest bank by assets in the United States. The FDIC, as the receiver, sold Washington Mutual's assets, including the branch network, all of its deposit liabilities, and secured debts to JPMorgan Chase for \$1.9 billion. This transaction did not require any FDIC funds or other fiscal support.

¹⁹ See Hüpkes (2000)

²⁰ This solution opens up the possibility that some creditors (e.g. junior debt holders) are 'left' in the bad bank while others (e.g. depositors) have their claim transferred to a good bank. This may conflict with the principle, important in general bankruptcy law, that creditors of the same class are treated equally. On the other hand, the solution may be appropriate to safeguard financial stability while protecting the public purse. In order to mitigate the resulting trade-off, appropriate safeguards can be introduced. For example, under the UK regime, creditors left behind in a partial sale are compensated so that they are no worse off than they would have been in a liquidation in which the whole bank might have been placed had the partial sale not been used.

provided to the acquiring firm, rather than to the existing firm and its shareholders, reducing moral hazard and preserving incentives for private risk management.²¹

Temporary public control. As a last resort, the government needs to be able to take temporary public ownership of the failing institution. This tool may be most appropriate where a significant amount of public funds needs to be made available to stabilize the failing institution. Temporary public control (nationalization) was the main tool used under the Swedish “triage” approach for those banking institutions that were deemed neither “clearly non-viable” nor “clearly viable”.²² Temporary public control may be particularly useful if the banking system is highly concentrated and there are limited options for a sale to private bidders.

What is common across all of these tools is the absence of a subsidy to existing shareholders. Instead, each of the resolution paths will typically impose losses on shareholders, relative to a situation where the firm is bailed out. As argued above, this is useful both to reduce public outlays in bank resolution and to increase longer-run financial stability by strengthening private incentives for risk-management. Moreover, as long as shares in the failing institution are widely held, imposing losses on shareholders should not be a greater concern from the point of view of the stability of the system than when losses are imposed on the sovereign. Finally, relative to ordinary liquidation—the tool commonly used in corporate insolvency of non-financial firms—shareholders would not tend to be worse off under the resolution tools described. In liquidation, shareholders hold the most junior claim and typically lose their entire investment. Under the resolution tools described here the losses to shareholders are likewise capped by the amount of their investment. The liquidation value is also a relevant yardstick to compare the shareholder’s position under the use of special resolution tools. This is because if these tools were not used—and in the absence of public support—liquidation of the firm is the most likely eventual outcome.

Relative to ordinary bankruptcy and liquidation all resolution tools will tend to reduce losses borne by creditors, including both senior and junior classes. This is because in a liquidation of financial institutions the recovery on assets is typically low and because low recovery will be felt most acutely by creditors, while shareholders’ losses are capped by limited liability.

²¹ This tool was used by the FDIC in the course of the resolution of Wachovia, the 4th largest U.S bank holding company by assets. Under the terms of the proposed sale to Citigroup, the FDIC capped Citigroup’s potential losses, by guaranteeing losses above \$42 billion. The resolution of Wachovia took a surprising turn when Wells Fargo emerged as a rival bidder after Citigroup believed to have secured the deal.

²² At the time, the powers necessary to nationalize banking institutions were brought in by emergency legislation. The Swedish authorities have, in 2009 once again brought in emergency legislation that enables the use of nationalization. The Swedish banking authorities otherwise lacks the tools and powers associated with a special resolution framework, needing to rely instead on the provisions of the general corporate insolvency law in bank resolution.

Since the resolution paths opened up through reorganization are more efficient, such resolution will therefore in the normal course tend to protect the interests of creditors.

Losses for creditors may be most likely under the “good bank approach,” where there is a partial sale of “clean” assets to a good bank and this bank also assumes the liabilities—up to the value of the clean assets—from the residual bank. In this case, whenever the book value of the difficult-to-value assets exceeds shareholder funds, some (classes of) creditors will, by a simple balance sheet identity, need to remain exposed to the valuation risk associated with the remaining assets. From the point of view of market discipline and longer term financial stability, letting losses be borne by junior debtholders is useful. However, when other financial institutions hold sizable exposures, by virtue of holding some of the junior debt or through derivatives exposures, uncertainty about future losses will increase the vulnerability of these institutions. The resolution authority can avoid such knock-on effects on other financial institutions by buying out financial institutions with sizable exposures.²³ Such an approach can shift valuation risk away from the financial sector in a well-targeted way and may strike a reasonable balance between protecting financial stability on the one hand and taxpayers’ interests on the other.

All of the “good bank,” the “assisted sale,” and the “temporary public control” offer alternative approaches to dealing with bad or “toxic” assets. These approaches differ in the degree to which the public sector assumes valuation risks. Risks assumed by the public sector are lowest under the good bank approach and highest under the “temporary public control” approach. However, they each avoid the difficulties inherent in solutions that envisage a voluntary sale of difficult-to-value assets by the troubled firm to a private bidder.²⁴ As set out above, moreover, none of these tools involve a subsidy to the existing shareholders of the failing institution and each therefore preserves incentives for private risk management. This is contrast to some of the asset resolution schemes that have since Oct 2008 been devised to cleanse the financial system of its legacy assets.

F. Judicial Review²⁵

When control over the resolution proceedings rests with the banking authorities in “official administration” or in liquidation, rather than with the courts, judicial review needs to be provided for. Judicial review is not part of the resolution proceedings themselves but a separate proceeding in which the court reviews, *ex post*, actions taken by the banking

²³ A similar approach was taken by the U.S. authorities in relation to losses that global counterparties stood to suffer from the failure of AIG. Existing derivatives contract on CDOs were honored or closed out in a manner that avoided losses for financial institutions.

²⁴ A voluntary sale is difficult because the troubled institution may have better information on its portfolio or because a complex portfolio can be worth more at the margin to the troubled institution than to a potential buyer.

²⁵ This section draws heavily on International Monetary Fund and the World Bank (2009).

authorities. In the context of bank resolution the scope for judicial review should be clearly circumscribed so as not to undermine the effectiveness and credibility of the banking authorities' actions in their efforts to protect the stability of the financial system. This requires first that the courts should not be able to stop a resolution action that is sought by the authorities and should only be able to review whether proper procedures were followed *ex post*. In addition, the review mechanism should only seek to determine whether the banking authorities have acted legally and should not allow the court to reassess their exercise of discretion unless there is clear evidence of a manifest error of fact or an abuse of power.

The onus is instead on the legal framework to clearly set out the public policy objectives that the resolution framework seeks to achieve, such as the preservation of financial stability, and to define clearly the extent of discretion afforded to the banking authorities in pursuit of these objectives.²⁶ This is important in particular since actions taken by the banking authorities, such as a forced transfer of assets, will typically have a bearing on the property rights afforded to the owners of the institution. In this respect, moreover, the resolution framework needs to be consistent with the general considerations—often set out in constitutional law—that govern the conditions under which personal property rights can be constrained by the authorities.

Where the relevant actions of the banking authorities inflict damage on a bank's owners without proper justification, the remedy can be in the form of monetary compensation (damages). However, the legal framework should establish clear limits on the circumstances in which such damages may be awarded. To this end many jurisdictions have limited the liability of the authorities to gross negligence or bad faith. In any case, there should be statutory immunity for banking authority officials from civil liability for actions they have taken in good faith.

G. EU-wide Legal Issues

The European Convention on Human Rights also enshrines property rights (Protocol 1, Art. 1). It states the right to “peaceful enjoyment of possessions,” but also recognizes that this right can be constrained. No one should be deprived of property “except in the public interest and subject to the conditions provided for by law.” The European Court of Human Rights has ruled that it will “respect the legislature’s judgment as to what is in the general interest, unless this judgment is manifestly without reasonable foundation.”²⁷ This suggests that a special resolution framework whose objective was firmly grounded in the interest of

²⁶ In the UK the following objectives are set out in statute: maintaining financial stability, protecting confidence in the banking sector; protecting depositors; protecting public funds; and avoiding interference with property rights in contravention of the relevant articles of the European Convention of Human Rights.

²⁷ *Mellacher vs Austria* (1089) 12 EHRR 391

preserving financial stability would not conflict with the European Convention on Human Rights and would be upheld by the courts.

There are a number of provisions in several EU company law directives that set out the rights of the general meeting in relation to major corporate decisions, such as increases in capital, mergers and divisions. These directives are meant to provide a minimum level of influence on the part of shareholders and constrain the discretion of the management of publicly held corporations. When the scope of these directives is unrestricted, these provisions may be viewed as conflicting with the powers required in national bank resolution frameworks, in particular the need on the part of the authorities to take action without prior consent of stakeholders.²⁸ To provide the necessary legal clarity, their application in bank resolution may therefore need to be restricted explicitly, through further European legislation.

H. The Interest of National and European Authorities

A revision of the national frameworks for the resolution of financial institutions can be in the interest of each member state of the EU, as well as in the interest of the EU as a whole. As argued above, appropriate resolution regimes can contribute to financial stability both in crisis times and in normal times, by reducing moral hazard and increasing market discipline. Introduction of strong resolution regimes is likely therefore to benefit financial stability across the region.

In view of the stresses on the European financial system brought on by the financial crisis, the absence of effective resolution regimes also has an important fiscal dimension. When special resolution tools are missing this is likely to increase the fiscal outlays needed to restructure a national banking system, on average. A larger outlay than what is strictly necessary should be avoided at a time when shrinking tax revenues reduce fiscal room for maneuver. Moreover, importantly, fiscal outlays to restructure the banking system can compete with alternative uses of funds, such as a broader fiscal stimulus, which may be desirable to replace reduced private demand.

From a monetary policy point of view, national central banks and the ECB have an interest that, where national banking systems are weakened, effective and speedy action can be taken to restructure the banking system, since otherwise the effectiveness of monetary policy is likely to be reduced. During Japan's so-called "lost decade" (in the 1990s), it is widely believed that the effectiveness of monetary policy was hampered by insufficiently rigorous restructuring of the banking system. Introduction of a sound legal frameworks for the resolution of financial institutions across the Euro area is likely to increase the speed and

²⁸ Pafitis vs Ellados, European Court Reports 1996, pages I-01347

decisiveness of efforts to restructure national banking systems. This may come to increase effectiveness of monetary policy as well as the speed of recovery of the economy.

Finally, the absence of robust resolution frameworks also affects competition in the provision of financial services across the EU. The absence of robust resolution frameworks will make it more likely that national authorities resort to propping up failing financial institutions. Such support may conflict with the general principle underlying Articles 92–94 of the Treaty of Rome, that State Aid distorts competition and runs counter to a common market.²⁹ More specifically, an unfair competitive advantage is conferred upon non-viable firms who benefit from state support in the absence of a strong resolution framework, but could have been successfully resolved had a stronger legal framework been put in place.

These considerations imply that European authorities may want to encourage national authorities to adopt legislation, where necessary, to introduce (or increase the effectiveness of) appropriate resolution frameworks, both within the Euro area and across the European Union as a whole.

IV. CROSS-BORDER ISSUES

The financial crisis has illustrated that handling the failure of a cross-border financial group involves an additional layer of complexity. It can cause significant tensions between home and host countries that may stand in the way of cost-minimizing solutions. Particularly complicated have been cases when problems in financial institutions exceeded their home country's capacity to offer support (the Icelandic banks) and the resolution of truly multinational banks, such as Fortis. In those cases, holding up the letter and spirit of existing arrangements has proven hard.

The experiences of international bank failures have long illustrated the difficulties that exist in the context of banks operating in numerous jurisdictions. A well-known case is the failure of the BCCI bank in 1990, in which the interaction of different liquidation regimes and other relevant laws introduced many complexities and uncertainties concerning the disposition of a failed multinational bank's assets and payments of claims against it (e.g., Herring, 2004).

A. State of Play and Issues Raised by the Crisis

In the European Union a particular tension arises since cross-border activity is encouraged as a way of achieving a common market for financial services, while there is no pan-European legal and administrative framework with respect to bank insolvency. Moreover, in the

²⁹ Hüpkes (2000) discusses the conditions the European Commission uses in specific cases to determine (i) whether State Aid has been granted and (ii) whether such aid is consistent with a common market.

absence of a strong EU-level fiscal authority, the resolution of failing institutions remains the domain of national authorities.

A number of past and present initiatives aim to resolve this basic tension for the European Union. The Directive on the Reorganization and Winding-Up of Credit Institutions, introduced in 2001, represents a particularly important advance.³⁰ The Directive stipulates that the competent authorities of the home country that granted the banking license has sole power to initiate and implement all reorganization measures provided for in the law of the home country and that these measures have full effect throughout the European Union. This adopts the “single-entity” and “universality” principles for all European banking institutions and ensures that resolution measures taken by the home authority apply equally to all cross-border branches. These principles do not however apply to the case where a banking institution entertains (wholly-owned) subsidiaries in a different country within the EU. Such a subsidiary is viewed instead as a legally separate entity with a separate license. For subsidiaries, therefore, it still holds that insolvency proceedings can be brought in every jurisdiction where a failed bank maintains an establishment. This is an important constraint, because much of the recent cross-border expansion in European banking markets has been through subsidiaries. Matters become very complex for an LCFI with numerous branches and operationally-integrated subsidiaries.

Recent EU initiatives to address these difficulties include the ECOFIN crisis management principles, adopted in October 2007, and the June 2008 crisis management MoU.³¹ These agreements encourage voluntary cooperation and the sharing of the fiscal burdens involved in the resolution of specific cross-border groups. However, country authorities have found it difficult to live up to these commitments in the heat of a crisis. In particular, while principles for the sharing of fiscal burdens are agreed, the crisis experience has shown that these agreements do not always stick in a crisis. More generally, the current EU rules³² do not seek to harmonize national legislation concerning bank insolvency proceedings, which remain different across the EU.

These weaknesses have been illustrated in the case of Fortis Group (Box 3). A burden-sharing agreement was reached between the three governments involved (Belgium, the Netherlands, and Luxembourg), but this agreement fell apart within days. Markets and depositors continued to lose confidence and Fortis could not be saved as a going concern, resulting in a further loss of value as the operational integration of the group was undone in a split along national lines. For small countries with banking sectors dominated by foreign-

³⁰ Directive 2001/24, known as the “Winding-Up Directive”

³¹ The October 2007 ECOFIN conclusions called for an enhancement of the arrangements for financial stability in the EU and a review of the tools for crisis prevention, management and resolution, including a revision of the Winding-Up Directive and a clarification of the Deposit Guarantee Directive.

³² In addition to the Winding-Up Directive, mentioned above, the EU insolvency regime consists of a regulation on insolvency proceedings (No. 1346/2000) and a directive concerning the reorganization and winding up of insurance undertakings (2001/17).

owned financial institutions, the main challenge has been determining the extent to which foreign financial institutions active within their borders could benefit from support put in place by their home countries.

Box 3. Fortis: A Case Study in Resolving Cross-Border Financial Institutions

Fortis has been a financial institution with major market presence in the Benelux countries. Up to September 28, 2008, it had a complex bi-national holding structure, with ownership resting ultimately with Fortis SA/NV and Fortis N.V. The corporate structure included a bank holding company (Fortis Bank SA/NV) incorporated in Belgium, banking subsidiaries incorporated in the Netherlands (Fortis Bank Nederland (Holding) N.V.) and Luxembourg (Fortis Banque Luxembourg SA), and an investment management subsidiary (Fortis Investment Management SA/NV) incorporated in Belgium. The Group's insurance business was located in Fortis Insurance N.V., which also had three subsidiaries, Fortis Insurance Netherlands N.V. (in the Netherlands), Fortis Insurance International SA/NV, and Fortis Insurance Belgium SA/NV (in Belgium). In addition to its Benelux operations, the group also had subsidiaries in a range of other countries, including the United Kingdom, France, Germany, Turkey, Russia, and Ukraine.^{1/}

In late September 2008, Fortis became subject to bankruptcy rumors, leading to large withdrawals (EUR 50 billion in two working days), mainly by business customers. According to subsequent court proceedings, the institution was solvent at the time, but the withdrawals led to liquidity problems.

Fortis was partially nationalized on September 28, 2008, with the three Benelux countries injecting a total of €11.2 billion (US\$16.3 billion). The initial press releases reported that the governments of Belgium, the Netherlands, and Luxembourg would invest €4.7 billion, €4 billion, and €2.5 billion in the Belgian, Dutch, and Luxembourg Fortis Banks, respectively. In actuality, Belgium invested its stake into Fortis Bank SA/NV in return for newly issued shares, making up 49 percent of total outstanding shares in that company, with the Netherlands doing the same for Fortis Bank Nederland. Luxembourg has agreed to a loan convertible into a 49 percent share of Fortis Banque Luxembourg.

Markets and depositors continued to lose confidence, however, with continuing withdrawals by business customers causing further liquidity problems. Ultimately, Fortis could not be saved as a going concern, resulting in a further loss of value as the operational integration of the group was undone in a split along national lines. On October 3, the Dutch authorities announced that they would purchase the Dutch banking and insurance subsidiaries of Fortis for €16.8 billion (\$23.3 billion). At the same time, the Luxembourg government increased its control of its part to 52 percent. In Belgium, the state has acquired the other banking activities, and it was announced that a majority stake would be sold off to the French bank BNP Paribas (the deal did not include the main holding company, but it included the insurance and banking subsidiaries, except for Fortis Insurance International). However, Dutch and Belgian shareholders' associations have requested a review of the takeover.

The case of Fortis provides an illustration of shareholder control delaying or closing off the resolution path chosen by the authorities. The Belgian government had to revise and renegotiate its rescue strategy for the Belgian activities of Fortis because it needed to obtain shareholder approval. A prolonged legal battle ensued over whether or not the deal agreed with BNP Paribas required shareholder approval, in which case a number of large shareholders were likely to challenge the deal.

The legality of the sale to BNP Paribas was at first confirmed by the Belgian Commercial Court, but on December 12, 2008, this decision was reversed by a ruling of the Court of Appeal in Brussels. Due to the ruling, the closing of the transaction with BNP Paribas has been postponed.

Sources: www.fortis.com, www.holding.fortis.com/general/history.asp, *Fortis Annual Review 2008*.

B. National Resolution Regimes and Cross-Border Issues

The current state of play on the resolution of cross-border issues raises the question whether the introduction of special resolution regimes at the national level could be a useful element to help achieve a more effective resolution of financial institutions that operate across European borders.

By virtue of the Winding-Up Directive, resolution actions taken by authorities in accordance with their national (special) resolution framework have full legal force across the EU, including in cases where the failing institutions has branches in other member states. Importantly, the legal effect with respect to branches does not depend on the approval of the (host) authorities of the countries where branches are located. This means that the benefits of special resolution regimes will extend to the resolution of cross-border branches.

When the failing institution entertains (wholly-owned) subsidiaries, by contrast, this does not hold necessarily, by virtue of the law. Nonetheless, even in these cases, special resolution regimes are likely to affect the negotiations and the eventual outcome of the cross-border resolution.³³

First, as set out in detail above, an effective regime will tend to reduce the fiscal burden involved in resolution. When the overall fiscal burden is reduced, an agreement among national authorities on sharing the burden is likely to be easier. As a result, an agreement on the appropriate resolution path for a financial group is more likely to be reached.

Second, special resolution regimes are likely to reduce the difficulties associated with asymmetric situations where the subsidiary is systemic in a small (host) country, but failure of the parent institution is not considered to have major systemic impacts in the home country. In the absence of a special resolution regime in the home country, the host authorities must be concerned that the home authorities decide to let go the institution, since from the point of view of the home authority, the fiscal cost of saving the institution may not be justified. On the other hand, when a special resolution regime is in place that provides the home authority with the power to effect a forced sale of the institution to a different banking

³³ In principle, in these cases, the host authority can threaten to revoke the license it issued to the subsidiary and to take unilateral action with respect to the subsidiary, including actions that result in the liquidation of the subsidiary. The host authority will therefore in practice often be able to force an agreement on the resolution path to be chosen.

group, the home country authorities may well judge that the cost of using this option is small relative to the cost of letting the institution fail, with obvious benefits to the host economy.

Third, the “bridge bank” tool may be particularly helpful as an interim solution in complicated cross-border cases. As set out above, in a national context, a bridge bank tool is useful when time is needed to resolve a complex group, for instance to prepare a sale to a private bidder. In complex cross-border cases, likewise, negotiation of a permanent solution involving different national authorities may be difficult for lack of adequate time. When agreement between national authorities needs to be reached under extreme time pressure, often “by the end of the weekend,” it may be difficult to find the best solution and more likely that any agreement reached may subsequently fall apart. Where a special resolution regime is in place in the home country of a complex cross-border group, the authorities can initially transfer the holding company, including its ownership stakes in cross-border subsidiaries, to a bridge bank institution.³⁴ This leaves intact the rights of the host authority with respect to potential action relative to the subsidiary and is unlikely therefore to meet opposition from the host authorities. The bridge bank approach then takes away some of the extreme time pressure that can make a negotiation of a cross-border resolution quite challenging.

C. European Resolution Regime for Cross-Border Financial Institutions

These considerations imply that the introduction of effective special resolution regimes across the EU has the potential to make an important contribution towards more effective resolution of cross-border groups. However national special resolution regimes may not be sufficient to fully address all cross-border issues. For example, since the existing Winding-Up Directive only applies to “credit institutions”, if individual countries’ resolution regimes were to have an expanded scope—taking in systemically important non-bank institutions as well as banks—cross-border issues are likely to reemerge even in the context of branches. A potential solution is for a revised Winding-Up Directive to cover banks (credit institutions in the EU terminology), with a provision that, in exceptional circumstances, systemically important financial institutions could be covered.³⁵ Introduction of special resolution regimes are also not able to resolve all conflicts that might arise between the interests of different national authorities in resolution. For example, when losses are distributed unevenly across subsidiaries, the authorities in those countries where losses are relatively small have an incentive to bring resolution action at the level of the subsidiary, for example, by effecting a

³⁴ This can be achieved by transferring all assets and liabilities of the holding company to the bridge bank. Importantly, such a transfer does not involve the transfer of assets and liabilities held at the level of cross-border subsidiaries, which may not be in the gift of the home authorities. Likewise, while an intra-group transfer of assets or liabilities poses difficulties in a cross-border context, it is not required to set up the bridge bank.

³⁵ The definition of what is ‘systemically important’ should be left at the national level, but could involve cross-border consultation and guidance by international authorities.

transfer of shares from the parent company to a new local entity. However, such action can reduce the chance of a successful resolution of the group as a whole.

One way of resolving these issues is a revision of the Winding-Up directive that extends the resolution power of the home authorities (or a collective of decision makers involving also the host authorities and European authorities) to all EU subsidiaries. Conceptually, universality across both branches and subsidiaries would reflect better the reality of an integrated business—indeed, many cross-border financial institutions in Europe have both. Such a solution would also reduce legal complexities, uncertainty and transactions costs in general.

A resolution regime that applies at the fully consolidated level may come to be an element in a dedicated European regime for cross-border financial institutions, such as the one discussed in Cihak and Decressin (2007). The regime might in addition include: (i) a European banking license; (ii) a European deposit insurance scheme, covering deposits issued by branches and subsidiaries; and (iii) strong supervision and information sharing among relevant authorities, as effected, for example by colleges of supervisors that involve both home and host country authorities.

There is a legitimate question whether a dedicated resolution authority for cross-border financial institutions is acceptable to host countries who may be concerned over a loss of resolution powers over subsidiaries. However, dedicated resolution regimes reduce the chance of a systemic impact on the host country economy, shifting the burden on existing shareholders, who may or may not be residents of the host country. This might make delegation of resolution powers to a dedicated authority politically acceptable for both the home and the host country.

For example, a resolution authority could be set up in such a way that the interests of both home and host country authorities, as well as the appropriate European authorities (such as a European deposit insurance corporation) are reflected in the resolution path chosen. This is not trivial to do, since it may require setting up a dedicated resolution authority for each cross-border institution.

It is worth bearing in mind finally, that even a European solution to these issues would only be partial and could not solve the broader problem that there is currently no agreed international framework for the resolution of financial institutions that operate across national borders. The possibility of such agreements is currently a subject of active international debate. However, the complexity of the task means that such agreements are difficult to put in place at a fully international level. If so, stricter regulation of cross-border institutions will need to be considered as part of the answer.

V. CONCLUSION

There is a strong conceptual case for banks and other systemically important institutions to be subject to a special insolvency regime. Standard judicial insolvency regimes do not necessarily take into account financial stability considerations and are typically cumbersome and slow, while in financial crises speedy and decisive action is necessary.

Special resolution regimes can contribute to overall financial stability, and improve the trade-off between the need to stabilize the financial system and to minimize fiscal costs and longer run-costs of moral hazard. More specifically, by expanding the toolset at the disposal of authorities, a special regime may come to facilitate a decisive restructuring of weakened financial institutions, should such an effort be needed as part of an overall strategy to restore confidence in the financial system. At the same time, additional tools open up a number of alternative ways of dealing with legacy assets that can avoid the granting of a subsidy to existing shareholders.

Special resolution regimes are critical to increasing the effectiveness of resolution within member countries. In addition, they can contribute to more effective resolution of cross-border institutions. This holds by virtue of the Winding-Up Directive for all cases that involve cross-border branches only. Even outside of the scope of this directive, special resolution regimes may facilitate a more efficient resolution of complex cross-border entities, by reducing the fiscal burden and buying time for agreements to be reached between affected member countries.

An alternative solution for major cross-border groups would be an EU-level resolution framework at a fully consolidated level. However, since effective national regimes are needed in any case, a more realistic approach at this stage is for the European authorities to encourage individual EU countries to assess the scope for a review of national frameworks. The EU authorities can also provide important guidance as to the principles for the design of special resolution frameworks in a European context and provide clarity over the scope of existing EU company law that might otherwise constrain the effectiveness of special resolution frameworks.

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