

THE NEED FOR SPECIAL RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS— THE CASE OF THE EUROPEAN UNION*

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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 Article 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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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. Since the onset of the crisis, the absence or limited scope of such regimes was 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 expectations of bailouts have 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 failing 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 Article is organized as follows. Part I reviews in detail the case for introducing special resolution regimes across the EU, referring to the crisis experience as appropriate. Part II discusses the principles sustaining a successful design of special resolution frameworks and the way

such regimes can be embedded in national legislation. Part III provides a sketch of the diversity of national regimes across the EU as well as recent reform initiatives. Part IV discusses the contribution effective national regimes can make in resolving cross-border failures. We then conclude.

I. 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 bankruptcy (resolution) regime. Banks and other financial institutions play a special role in a country's economy, performing financial services fundamental to the functioning of the 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, a fire sale of assets, and spillovers via the interbank market.

The absence or inadequate scope of resolution tools to deal with failing financial institutions was shown up globally during the financial crisis that started in 2007 and intensified in the second half of 2008. Authorities were often confronted with two rather unappealing options: 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—or 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.² Events have shown that both of these alternatives can be very costly. A disorderly bankruptcy can magnify the systemic impacts of the failure of a financial institution.³ When the authorities aim to avoid these impacts by injecting 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.⁴

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.⁵ At the same time, runs developed on U.S. money market

² See, e.g., Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 15, 2008, at A1; Edmond L. Andrews, *Fed's \$85 Billion Loan Rescues Insurer*, N.Y. TIMES, Sept. 17, 2008, at A1.

³ See, e.g., Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 488–90 (2010).

⁴ See *id.* at 485.

⁵ See George Matlock, *Interbank Money Markets Remain Under Pressure*, REUTERS (Sept. 24, 2008), available at <http://www.reuters.com/article/2008/09/24/markets-interbank-idUSLO27942020080924>.

funds that were—or were believed to be—invested in Lehman Brothers' commercial paper.⁶ Pressure on these funds soon led to fire sales of U.S. commercial paper, reducing the flow of funds to corporate borrowers.⁷

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.⁸ 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.⁹

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.¹⁰ On September 17, 2008, they had pledged \$85 billion, in the form of a loan granted by the Federal Reserve and backed up by the U.S. Treasury.¹¹ As of March 2009, the U.S. government had lent a total of \$182 billion.¹² 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),¹³ IKB,¹⁴ and Sachsen LB.¹⁵

Figure 1 illustrates 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 (and potentially debt holders) some or all of the losses that would otherwise be borne by taxpayers. The special

⁶ See Ayotte & Skeel, *supra* note 3, at 489.

⁷ See Christopher Condon & Bryan Keogh, *Funds' Flight from Commercial Paper Forced Fed Move*, BLOOMBERG (Oct. 7, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5hvnKFCC_pQ.

⁸ See Landon Thomas, Jr., *Funds Try to Lose Ties to Lehman*, N.Y. TIMES, Oct. 1, 2008, at C11.

⁹ See *id.*

¹⁰ See Press Release, Federal Reserve Board (Sept. 16, 2008), <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>.

¹¹ See Andrews, *supra* note 2, at A1.

¹² Colin Barr, *Geithner Calls for New Risk Watchdog*, CNN MONEY (Mar. 26, 2009), <http://money.cnn.com/2009/03/26/news/geithner.house.fortune/index.htm>.

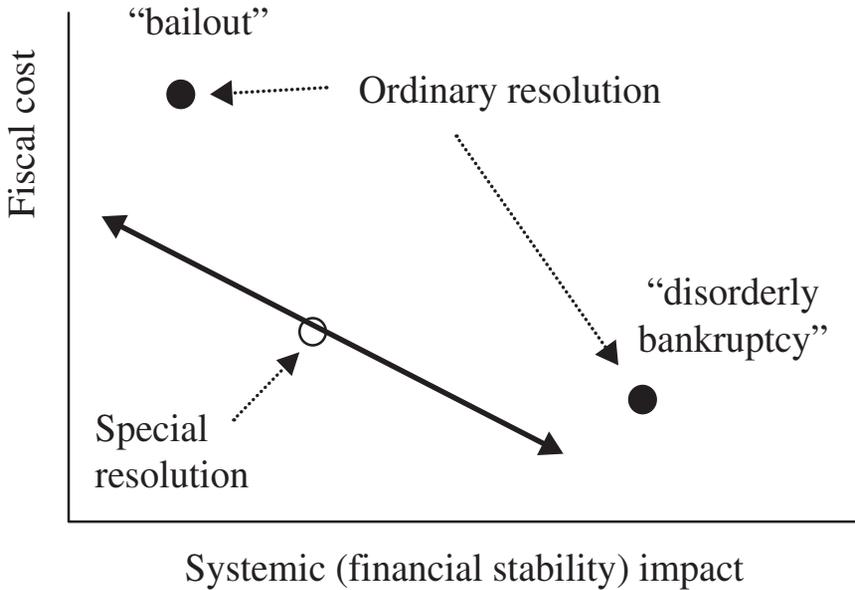
¹³ See Jann Bettinga & Brian Parkin, *Hypo Real Estate to Get EU35 Billion Bailout From State, Banks*, BLOOMBERG (Sept. 29, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&refer=germany&sid=aYrHPYX01iuQ>.

¹⁴ See Lionel Laurent, *Germany Adds to the IKB Bail-Out Fund*, FORBES (Aug. 16, 2007), http://www.forbes.com/2007/08/16/ikb-kfw-banks-markets-equity-cx_ll_0816markets17.html.

¹⁵ See Ivar Simensenin Frankfurt, *Sachsen LB is Bailed Out As Credit Crunch Fallout Widens*, FIN. TIMES (Aug. 18, 2007), <http://www.ft.com/intl/cms/s/0/9e6e71ac-4d22-11dc-a51d-0000779fd2ac.html#axzz1nVlwL1Sw>.

resolution regime also gives the country authorities more flexibility to explore the tradeoff between fiscal costs and systemic risk containment.¹⁶

FIGURE 1: FISCAL COST AND SYSTEMIC IMPACT IN RESOLUTION REGIMES



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 and have no power to expedite such proceedings when financial stability considerations imply the need for rapid action to stabilize an institution. 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 power to replace the management of a failing institution. They may

¹⁶ 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. See Ayotte & Skeel, *supra* note 3, at 497.

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.¹⁷ 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 prior approval by the Federal Reserve.¹⁸ Moreover, the Federal Reserve had no legal power to challenge these payments after they had been made.¹⁹

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.²⁰

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.²¹ Moreover, the incentive to increase risks may be even more pronounced when the authorities 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.²²

¹⁷ Madeline Winkler & Ulrike Dauer, *Near-term Hypo RE CEO Step-Down Was Condition for Rescue-Source*, DOW JONES INT’L NEWS, Oct. 6, 2008, available at Factiva, Doc. No. DJI0000020081006e4a6000jt.

¹⁸ See Edmund Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After \$170 Billion Bailout*, N.Y. TIMES (Mar. 15, 2009), <http://www.nytimes.com/2009/03/15/business/15AIG.html>.

¹⁹ See *id.*

²⁰ For a detailed analysis of the Northern Rock case, see e.g., Rosa M. Lastra, *Northern Rock, U.K. Bank Insolvency and Cross-border Bank Insolvency*, 9 J. BANKING REG. 165, 166–69 (2008).

²¹ See Michael C. Keeley, *Deposit Insurance, Risk and Market Power in Banking*, 80 AM. ECON. REV. 1183, 1184 (1990).

²² See e.g., *id.*; Tito Cordella & Eduardo Levy Yeyati, *Bank Bailouts: Moral Hazard vs. Value Effect*, 12 J. FIN. INTERMEDIATION 300, 301 (2003).

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.²³ 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.²⁴ 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.²⁵ Due to the ruling, there was significant delay before the transaction with BNP Paribas could be closed.

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.²⁶ 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.²⁷

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.²⁸ In the absence of special legislation, the government would have been unable to force the sale to SoFFin, while its

²³ See David Jolly, *BNP Paribas Suspends Takeover of Fortis of Belgium*, N.Y. TIMES (Dec. 8, 2008), <http://www.nytimes.com/2008/12/18/business/worldbusiness/18iht-fortis.4.18796550.html>.

²⁴ See *id.*

²⁵ *Id.*

²⁶ See Peter Thal Larson, *Northern Rock Plunges on Cut-Price Bids*, FIN. TIMES (Nov. 19, 2007), available at <http://www.ft.com/intl/cms/s/0/e0c0e3ba-9678-11dc-b2da-0000779fd2ac.html#axzz1lwUtxztC>.

²⁷ See *id.*

²⁸ See James Wilson, *Berlin Paves Way for HRE Takeover*, FIN. TIMES (Mar. 20, 2009), available at <http://www.ft.com/intl/cms/s/0/6c9ed798-153f-11de-b9a9-0000779fd2ac.html#axzz1lwUtxztC>.

support for the company had reached €102 billion.²⁹ Eventually, however, 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, subsequently brought the authorities' stake up to 90 per cent.³⁰

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 force of 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, increasing the likelihood of failure.³¹ This research also shows that expectations of public support reduce the force of market discipline that may go along with enhanced disclosure of information. 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 mooted for banks that expect to receive support.

More recent evidence has unearthed a strong correlation between the weaknesses of supervisory and resolution powers at the national level and the build-up of financial imbalances across the OECD ahead of the global financial crisis. Using an index of supervisory and resolution powers that was constructed from information contained in a World Bank database, Merrouche and Nier show that the build-up of financial imbalances, as measured by increases in the size of banking sector balance sheets relative to core deposits, was stronger where national early remedial and resolution powers were relatively weak.³²

²⁹ *Id.* See also Chris V. Nicholson, *Germany Prepares New Rescue Methods for Banks*, DEALBOOK (Aug. 6, 2009, 7:19 AM), <http://dealbook.nytimes.com/2009/08/06/germany-prepares-new-rescue-methods-for-banks>.

³⁰ Andrew Sorkin, *Hypo Real Estate May Need More Capital, Report Says*, DEALBOOK (Sept. 14, 2009, 5:23 AM), <http://dealbook.nytimes.com/2009/09/14/hypo-real-estate-may-need-more-capital-report-says>.

³¹ See, e.g., Erlend Nier & Ursel Baumann, *Market Discipline, Disclosure and Moral Hazard in Banking*, 15 J. FIN. INTERMEDIATION 332, 335 (2006).

³² See Ouarda Merrouche & Erlend Nier, *What Caused the Global Financial Crisis? – Evidence on the Drivers of Financial Imbalances 1999–2007*, (Int'l Monetary Fund, Working Paper No. WP/10/265, 2010), available at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=24370.0>.

II. 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 also needs to be complemented by robust deposit insurance mechanisms. These mechanisms should provide for adequate coverage, a high degree of *ex ante* funding, and a rapid payout of insured deposits that should increase confidence in the ability of the scheme to honor insured claims. 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.³³

³³ For further discussion of this point, *see generally* George G. Kaufmann & Steven A. Seelig, *Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity*

B. Scope of Regime

Introduction of special resolution regimes requires careful reflection of the appropriate scope of the regime. For example, the regime operated in the United States during the financial crisis applied only to commercial banks, and did not include bank holding companies and other financial 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.³⁴

The U.S. experience has shown investment banks—such as Bear Stearns and Lehman—to be 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.³⁵ 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 highlights that a financial institution can become a critical hub in the network of financial exposures.³⁶ 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., in its management of liquidity) and doubtful assets are held both inside and outside the banking subsidiary.

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

of Banking Crises, Systemic Risk and Too-Big-to Fail, in BANK RESTRUCTURING AND RESOLUTION (David Hoelscher ed., 2006).

³⁴ Examining the U.S. bank insolvency code, Bliss and Kaufmann 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. See ROBERT R. BLISS & GEORGE G. KAUFMAN, FED. RES. BANK OF CHI., A COMPARISON OF U.S. CORPORATE AND BANK INSOLVENCY RESOLUTION 44 (2006).

³⁵ See Landon Thomas, *Run on Big Wall St. Bank Spurs U.S.-Backed Rescue*, N.Y. TIMES, Mar. 15, 2008, at A1.

³⁶ See Gretchen Morgenson, *Behind Biggest Insurer's Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

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 gauged too large and that fiscal support for the parent company is deemed the only possible alternative.³⁷

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.³⁸ 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 institution 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 that is able to respond flexibly to developments in financial markets and changes to the business models of any particular institution.³⁹

One example is the approach taken in the United States. The Dodd-Frank Wall Street Reform and Consumer Protection Act enables the authorities to designate financial companies, including bank holding companies and their non-bank subsidiaries, as well as systemically important non-bank companies, such as insurance companies and securities brokers, as covered

³⁷ The United Kingdom’s special resolution regime, discussed earlier, 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. See PETER BRIERLEY, BANK OF ENGLAND, *THE UK SPECIAL RESOLUTION REGIME FOR FAILING BANKS IN AN INTERNATIONAL CONTEXT* 12 (2009).

³⁸ 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 generally Erlend Nier, *Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis* (IMF Working Paper No. 09/70, 2009) [hereinafter *Financial Stability Frameworks*] for further discussion of this point as well as the factors relevant to assess systemic importance.

³⁹ The IMF, FSB and the Bank for International Settlements (BIS) 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 was presented to the G20 in November 2009. See INT’L MONETARY FUND, FINANCIAL STABILITY BOARD AND BANK FOR INTERNATIONAL SETTLEMENT, *GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS, REPORT TO THE G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS* (2009).

by an expanded special resolution regime operated by the Federal Deposit Insurance Corporation (FDIC).⁴⁰

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.⁴¹ This contrasts with the “balance sheet threshold” often applied in ordinary bankruptcy proceedings, which 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.

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 Act specifies a mandatory threshold in terms of whether a bank is “critically undercapitalized.”⁴² 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 (discussed earlier) 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.”⁴³

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 reduce the scope for forbearance. Indeed, a hard threshold was introduced in the United States to limit what was

⁴⁰ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴¹ See INT’L MONETARY FUND & WORLD BANK, AN OVERVIEW OF THE LEGAL, INSTITUTIONAL, AND REGULATORY FRAMEWORK FOR BANK INSOLVENCY (2009), www.imf.org/external/np/pp/eng/2009/041709.pdf.

⁴² Federal Deposit Insurance Act § 38, 12 U.S.C. § 18310 (2006).

⁴³ U.K. Financial Services and Markets Act, 2000, c. 8, § 296.

deemed excessive forbearance on the part of the authorities during the so-called Savings & Loans Crisis in the 1980s and early 1990s.⁴⁴

The case in favor of discretion rests on the argument that rules cannot fully capture 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.⁴⁵

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.”⁴⁶ 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 involve supervisory “assistance” in the design of a “recovery plan” to address incipient financial weakness and the monitoring of the plan’s execution by the supervisory authority. The plan might involve raising 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 resolu-

⁴⁴ See David G. Mayes, *Banking Crisis Resolution Policy – Lessons from Recent Experience* 10 (CESifo, Working Paper No. 2823, 2009), available at www.cesifo-economic-studies.de/DocDL/cesifo1_wp2823.pdf.

⁴⁵ 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 Part III.

⁴⁶ Canada Deposit Insurance Act, R.S.C. 1985, c. C-3.

tion of such institutions are assigned to the same agency.⁴⁷ 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 reach 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 report 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.⁴⁸

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. Most of these are available under the existing regimes in the United States, the United Kingdom, Mexico, South Korea, Canada, and Japan.⁴⁹

1. 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, protect the public purse and at the same time protect 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 able to reach 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.⁵⁰

⁴⁷ This agency then acts as a single “systemic risk regulator.” See *Financial Stability Frameworks*, *supra* note 38, at 43.

⁴⁸ See OFF. OF THE SUPERINTENDENT OF FIN. INSTS. CAN., GUIDE TO INTERVENTION FOR FEDERALLY REGULATED DEPOSIT-TAKING INSTITUTIONS 5–11 (2010), available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/practices/supervisory/Guide_Int_e.pdf.

⁴⁹ See BRIERLEY, *supra* note 37, at 6. 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.

⁵⁰ 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. See Press Release, Federal Deposit Insurance Corporation,

2. *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.⁵¹ 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, provided by the firm.⁵² Importantly, under the bridge bank tool, the incumbent management is replaced and new management services are contracted for by the resolution authority.⁵³

3. *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 risks from a further deterioration of the value 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.⁵⁴ 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

JPMorgan Chase Acquires Banking Operations of Washington Mutual (Sept. 25, 2008), <http://www.fdic.gov/news/news/press/2008/pr08085.html>.

⁵¹ Bridge banks were used in Japan in 1998 to “take over the business of failed institutions so that creditworthy borrowers would not be left in the lurch if their main bank goes under.” Sheryl WuDunn, *The Markets; The Japanese Stock Market Extends Its Rally to 7 Days*, N.Y. TIMES, July 2, 1998, at D5. The tool has also been used in the United States by the FDIC for Meriden Trust in 1994. *See Connecticut Bank Shut*, N.Y. TIMES, July 8, 1994, at D12.

⁵² *See* EVA H. G. HÜPKES, *THE LEGAL ASPECTS OF BANK INSOLVENCY: A COMPARATIVE ANALYSIS OF WESTERN EUROPE, THE UNITED STATES, AND CANADA* 90–91 (2000).

⁵³ The Federal Deposit Insurance Corporation provides that a bridge depository institution shall have an interim board directors appointed by the Corporation. *See* Federal Deposit Insurance Act § 11, 12 U.S.C. § 1821(n)(1)(D) (2006).

⁵⁴ 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. *See generally*, Douglas Faucette et al., *Good Bank/Bad Bank*, 126 BANKING L.J. 291 (2009). For example, under the U.K. 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. *See* GEOFFREY DAVIES & MARC DOBLER, *BANK OF ENGLAND, BANK RESOLUTION AND SAFEGUARDING THE CREDITORS LEFT BEHIND* 216–18 (2011).

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.

4. *Forced transfer of doubtful assets to a “bad bank”*

The resolution authority may alternatively want to be in a position to set up a new entity, such as an asset management company under government control, and force the transfer of doubtful or toxic assets to that company, which may be in a position to hold on to the doubtful assets or have special skills in collecting on or selling these assets into the market.⁵⁵ In using this tool, care needs to be taken to ensure that the transfer occurs at a fair price, which may be difficult to determine in stressed market conditions. It is important also to ensure that, while the original entity can participate in any upside, it is not left with any residual uncertainty on the downside, which could weigh on its cost of funding and compromise the success of resolution.

5. *Assisted sale to a private sector purchaser*

In cases where some of the assets are difficult to value, a further alternative is for authorities to sell the institution as a whole, but provide some form of financing or a guarantee to the acquirer. Importantly, such a guarantee is provided to the acquiring firm, rather than to the existing firm and its shareholders, reducing moral hazard and preserving incentives for private risk management.⁵⁶

6. *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 need 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 bank-

⁵⁵ This tool was used when the Swedish government established Securum, a bank founded to take on bad assets during the Swedish Banking Rescue of 1991–92. See Erik Ipsen, *A Swedish Bank Born to Be Bad*, N.Y. TIMES (Oct. 29, 1993), <http://www.nytimes.com/1993/10/29/business/worldbusiness/29iht-bao.html>. More recently, in 2009, the Irish government established the National Asset Management Agency, a bad bank. See *Highlights—Key Points of Ireland’s Bank Rescue*, REUTERS (Mar. 30, 2010), available at <http://blogs.reuters.com/financial-regulatory-forum/2010/03/30/highlights-key-points-of-irelands-bank-rescue>.

⁵⁶ 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. See generally Frank A. Hirsch Jr. & Joseph S. Dowdy, *Whither Wachovia? Wells Fargo Wins the Battle for the Storied North Carolina Banking Institution*, 13 N.C. BANKING INST. 167 (2009).

ing institutions deemed neither “clearly non-viable” nor “clearly viable” during the 1990s.⁵⁷ 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. However, it is important to ensure that former shareholders take the first loss and do not benefit from the assistance provided by the public, that new management is contracted, and that the institution is restructured in a way that can restore viability.

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. In a liquidation of financial institutions, the recovery on assets is typically low and low recovery is felt most acutely by creditors, while shareholders’ losses are capped by limited liability. 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

⁵⁷ At the time, the powers necessary to nationalize banking institutions were brought in by emergency legislation. The Swedish authorities have, in October 2008, once again brought in emergency legislation, the “Government Support to Credit Institutions Act,” that enables the use of nationalization. See *The 2008 Financial Crisis—a Summary of Government Measures*, MINISTRY OF FIN. SWED. (NOV. 15, 2009), <http://www.sweden.gov.se/sb/d/15390/a/180397>. For example, the Swedish government seized D. Carnegie & Co. AB, Sweden’s largest publicly traded investment bank, in 2008. See Press Release, Finansinspektionen, FI’s Decision on Carnegie’s License (Nov. 10, 2008), <http://www.fi.se/Folder-EN/Startpage/Press/Press-releases/Listan/FIs-decision-on-Carnegies-licence>. The Swedish banking authorities otherwise lack 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.

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 debt holders is useful. However, when other financial institutions hold sizable exposures, uncertainty about future losses will increase the vulnerability of these institutions, potentially contributing to systemic risk. One approach to resolving this dilemma is for the resolution authority to buy out financial institutions with sizable exposures as part of the resolution process.⁵⁸ Another is for the law to prohibit banks from holding each other's subordinated or senior debt, or otherwise to discourage such exposures, through higher capital requirements on exposures to other financial institutions and regulations imposing limits on the size of individual exposures, so as to keep knock-on effects at a manageable level.

All of the "good bank," "bad bank," "assisted sale," and "temporary public control" tools 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.⁵⁹ 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 in contrast to some of the asset resolution schemes that have, since October 2008, been devised to cleanse the financial system of its legacy assets, which often envisaged voluntary sales and sought to incentivize such sales through attractive pricing.⁶⁰

⁵⁸ 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 contracts on CDOs were honored or closed out in a manner that avoided losses for financial institutions. See Thomas C. Baxter Jr., Executive Vice President and General Counsel, Federal Reserve Bank of New York, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, FED. RESERVE BANK OF N.Y. (Jan. 27, 2010), available at <http://www.newyorkfed.org/newsevents/speeches/2010/bax100127.html>; see also Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, at A1.

⁵⁹ A voluntary sale is difficult to achieve because the troubled institution may have better information on its portfolio, leading it to place a higher value on the assets than an outside bidder, or because a complex portfolio can be worth more at the margin to the troubled institution than to a potential buyer. A voluntary sale at fair value may also be impeded by accounting losses that arise when the assets are held at accounting values above their fair value.

⁶⁰ Examples are the U.S. Troubled Asset Relief Program (TARP) that was originally conceived to relieve banks of their toxic assets through voluntary sales, as well as the German asset relief scheme, approved by the European Commission in July 2009 (<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1216>). In practice, neither scheme was taken up, illustrating the difficulties of cleansing bank balance sheets through voluntary sales.

F. Additional Measures to Address “Too Important to Fail”

Even where the authorities dispose of the core set of special resolution powers set out above, large and complex financial institutions may prove difficult to resolve in an orderly manner without exposing taxpayers to loss from solvency support, while maintaining continuity of their vital functions. This concern has sparked intensive debate among academics and regulators on additional measures that can be taken to address the risk of failure of institutions that are “too important to fail.”⁶¹ There is an emerging consensus that a multipronged and integrated set of policies is required.⁶²

1. Capital requirements

One important element is regulatory requirements for systemically important institutions to hold additional capital that can ensure a greater capacity to absorb losses and reduce the likelihood of failure of such firms. For globally systemically important firms the size of these additional requirements have recently been agreed to by the Financial Stability Board (FSB) and will amount to up to 2.5% of risk weighted assets, to be met with common equity.⁶³

2. Contingent capital

A number of studies have called for additional capital requirements that firms could meet with debt instruments that convert into equity when the firm is under stress, known as contingent convertible capital (CoCos). A benefit of CoCos is that they may be less burdensome than common equity, since interest payments on debt instruments are usually treated as an expense and are therefore tax deductible. Moreover, a number of studies argue that CoCo requirements can have beneficial incentive effects. For example, Calomiris and Herring argue that when conversion is triggered by falls in the market value of equity relative to assets, shareholders have incentives to issue new equity so as to avoid conversion of convertible debt, since conversion is designed to result in a substantial dilution of shareholders.⁶⁴ Properly

⁶¹ See, e.g., İnci Ötoker-Robe et al., *The Too-Important-to-Fail Conundrum: Impossible to Ignore and Difficult to Resolve (Int’l Monetary Fund Staff Discussion Note No. SDN/11/12, 2011)*, www.imf.org/external/pubs/ft/sdn/2011/sdn1112.pdf.

⁶² See *id.*

⁶³ See Agustino Fontevicchia, *The 29 Global Banks That Are Too Big To Fail*, FORBES (Nov. 4, 2011, 1:04 PM), <http://www.forbes.com/sites/afontevicchia/2011/11/04/the-worlds-29-most-systemically-important-banks>.

⁶⁴ See e.g., CHARLES W. CALOMIRIS & RICHARD J. HERRING, WHY AND HOW TO DESIGN A CONTINGENT CONVERTIBLE DEBT REQUIREMENT 18 (2011), available at <http://ssrn.com/abstract=1815406>; CHARLES W. CALOMIRIS & RICHARD J. HERRING, A CONTINGENT CAPITAL REQUIREMENT FOR BANKS (2011), available at http://economics21.org/files/pdfs/commentary/04_21_2011_ContingentCapital.pdf.

constructed, a contingent capital requirement can thus complement early remedial action imposed by supervisors.

3. *Measures to improve resolvability.*

The Financial Stability Board has recommended that supervisors regularly assess the feasibility of resolution strategies and be given the power to require appropriate measures to remove obstacles to resolvability.⁶⁵ This could include powers to require changes to the firm's business structure, systems, and organization to reduce the complexity and costliness of resolution. For example, to enable the continued operations of systemically important functions, authorities may need to be in a position to require that these functions be segregated in legally and operationally independent entities, so that they can be easily separated from and shielded from problems of the group. However, while in the United States, the Dodd-Frank Act has given the Federal Reserve fairly broad powers to improve resolvability, very few supervisory authorities in Europe (or elsewhere) currently dispose of these powers.⁶⁶

4. *Resolution funds*

A number of countries, including Germany and Sweden, have recently established dedicated resolution funds that can contribute to the funding of costs incurred in resolving financial institutions.⁶⁷ The International Monetary Fund (IMF) has proposed for such resolution funds to be pre-funded by a levy on the non-deposit (wholesale) liabilities of financial institutions.⁶⁸ These liabilities are not covered by traditional deposit insurance schemes, but have proven to be vulnerable to runs. The proposed levies can therefore reduce incentives for financial institutions to over-rely on such volatile funding. A further advantage of industry-funded schemes is that they reduce the need for taxpayer support of resolution actions. However, a disadvantage of resolution funds is that, unlike capital requirements, they do not by themselves reduce the likelihood of failure of individual institutions, and may increase the likelihood of failure in a pro-cyclical fashion when contributions are increased at a time of systemic stress. Care needs also be taken that resolution funds are used only to support resolution action that wipes out shareholders and replaces management, since the availability of a dedicated

⁶⁵ See FIN. STABILITY BD., KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS 15–16 (2011), http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

⁶⁶ See BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, RESOLUTION POLICIES AND FRAMEWORKS—PROGRESS SO FAR (2011), available at <http://www.bis.org/publ/bcbs200.pdf>.

⁶⁷ See Nikki Tait et al., *Europe Faces Bank Resolution Fund Debate*, FIN. TIMES (May 26, 2010, 10:34 PM), available at <http://www.ft.com/intl/cms/s/0/03f66b8e-6908-11df-910b-00144feab49a.html#axzz1qqDxbVRG>.

⁶⁸ See INT'L MONETARY FUND, A FAIR AND SUBSTANTIAL CONTRIBUTION BY THE FINANCIAL SECTOR 13 (2010), available at <http://www.imf.org/external/np/g20/pdf/062710b.pdf>.

fund may otherwise contribute to bailout expectations, creating moral hazard.

5. *Bail-in powers*

There is continuing debate on the merits of expanding the resolution toolbox beyond the tools discussed in the previous section to include bail-in powers, that is, the power to write down the claims of senior unsecured creditors, or to force a conversion to equity of such claims. Such powers were established in Denmark in October 2010 and used in the resolution of Amagerbanken in February 2011.⁶⁹ The benefit of these powers is that the write-down of claims can help re-establish the firm as a going concern, by boosting the bank's equity capital, while shielding taxpayer from losses. These powers also address an anomaly where holders of senior corporate debt are at risk in insolvency proceedings, while the early resolution of banks often largely preserves the value of senior debt (as argued above). However, the use of bail-in powers can put strains on both the stricken bank's funding and other banks' funding, increasing the cost of replacing maturing debt, in particular in stress times when investor confidence is fragile.⁷⁰ A separate issue arises when senior debt instruments are held by other leveraged financial institutions, such as other banks or money-market mutual funds. In this case a write-down of senior debt can trigger the very systemic repercussions that the introduction of special resolution powers are meant to avoid. To address this issue, it is possible to exempt certain classes of claims, such as short-term debt and interbank liabilities. However, such exemptions may then lead banks to increase the share of exempt liabilities in their funding structure, requiring mandatory levels of issuance of bail-in debt.

G. *Judicial Review*

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.⁷¹ 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 authorities.⁷² 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 fi-

⁶⁹ See Frances Shwartzkopff, *Denmark Tells Banks Facing Insolvency to Prepare Auction Plans*, BLOOMBERG BUSINESSWEEK (Oct. 12, 2011, 4:58 AM), <http://www.businessweek.com/news/2011-10-12/denmark-tells-banks-facing-insolvency-to-prepare-auction-plans.html>.

⁷⁰ See Tracy Alloway, *Concerns Grow Over Denmark's Bail-in Rules*, FIN. TIMES (May 23, 2011), available at <http://www.ft.com/intl/cms/s/0/281c7f70-855f-11e0-ae32-00144fea8dc0.html#axzz1m2fa9zjd>.

⁷¹ See INT'L MONETARY FUND & WORLD BANK, *supra* note 41, at 5.

⁷² See *id.* at 23.

nancial system.⁷³ 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.⁷⁴

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.⁷⁵ 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.⁷⁶

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.⁷⁷ 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.⁷⁸

H. EU-wide Legal Issues

The European Convention on Human Rights also enshrines property rights.⁷⁹ It states the right to “peaceful enjoyment of . . . possessions,” but also recognizes that this right can be constrained.⁸⁰ No one should be deprived of property “except in the public interest and subject to the conditions provided for by law. . . .”⁸¹ The European Court of Human Rights has ruled

⁷³ *Id.* See also INT'L MONETARY FUND, INTEGRATING EUROPE'S FINANCIAL MARKETS 223 (Jörg Decressin et al. eds., 2007).

⁷⁴ See INT'L MONETARY FUND & WORLD BANK, *supra* note 41, at 5, 23.

⁷⁵ In the U.K. 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.

⁷⁶ See INT'L MONETARY FUND & WORLD BANK, *supra* note 41, at 19 n.13.

⁷⁷ *Id.* at 24.

⁷⁸ *Id.*

⁷⁹ The Convention for the Protection of Human Rights and Fundamental Freedoms, Protocol 1, Art. 1 (1952).

⁸⁰ *Id.*

⁸¹ *Id.*

that it will “respect the legislature’s judgment as to what is in the general interest, unless this judgment is manifestly without reasonable foundation.”⁸² This suggests that a special resolution framework whose objective was firmly grounded in the interest of 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.⁸³ 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.⁸⁴ To provide the necessary legal clarity, their application in bank resolution may therefore need to be restricted explicitly, through further European legislation.

III. DIVERSITY OF APPROACHES AND RECENT REFORM INITIATIVES

A. *Diversity of National Approaches within the EU*

There is currently no harmonization at the EU level of the national laws governing bank resolution, although there is clearly a recent trend toward introducing specialized bank resolution regimes. A prominent example in this regard is the regime introduced in the United Kingdom in 2009, which 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.⁸⁵

Outside Europe, similar powers exist in Canada, Mexico, Japan, South Korea and the United States, where the law provides for special rules for bank insolvency, administered by the supervisor or the deposit protection agency.⁸⁶ In many European countries, by contrast, the general insolvency

⁸² Mellacher v. Austria, 169 Eur. Ct. H.R. (1989).

⁸³ See e.g., Directive 2007/36, of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies, 2007 O.J. (L 184); Directive 2009/109, of the European Parliament and of the Council of 16 September 2009 amending Council Directives 77/91/EEC and 82/891/EEC, and Directive 2005/56/EC as Regards Reporting and Documentation Requirements in the Case of Mergers and Divisions, 2009 O.J. (L 259); Directive 2006/68, of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC, 1977 O.J. (L 26) as Regards the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, 2006 O.J. (L 264).

⁸⁴ See e.g., Pafitis v. Ellados, 1996 E.C.R. I-01363, 1383.

⁸⁵ See generally BRIERLEY, *supra* note 37.

⁸⁶ See e.g., Hüpkes, *supra* note 52, at 88–90.

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.⁸⁷ For example, in some European countries, the banking authorities have the right to initiate proceedings, but the process is otherwise in the hands of the bankruptcy court.⁸⁸ In other cases, the authorities play a stronger role in reorganization, but their powers are limited or less clearly defined.⁸⁹ In particular, shareholders often retain the right of final approval of any reorganization measures.

At the time of writing, several EU countries recently introduced a special resolution regime or substantially strengthened an existing regime. In addition to the United Kingdom, the countries that recently introduced special resolution regimes include Denmark, Germany and Ireland.⁹⁰ Austria recently strengthened its resolution regime, as did several other countries, and virtually all the other EU member countries are considering changes or are in the process of revising the relevant legislation.⁹¹ On a global scale, our calculations based on a recently updated Banking Regulation and Supervision Survey carried out by the World Bank reveals a very similar picture (Figure 2).

The following brief and selective overview highlights some of the different types of regimes in place in various EU member states, as well as the recent trend towards special resolution regimes.

1. United Kingdom

The failure of Northern Rock exposed the deficiencies of the United Kingdom (U.K.) regime to deal with banks in distress, which was dependent on the application of corporate insolvency law.⁹² As part of the policy response, the authorities enacted the U.K. Banking Act 2009, which strengthened the statutory framework for financial stability and depositor protection.⁹³ It put in place a special resolution regime, providing the Bank of England (BoE), and the Treasury with stronger tools to protect financial stability by resolving banks and building societies that are failing.⁹⁴

⁸⁷ See *id.*

⁸⁸ See MATEJ MARINĚ & RAZVAN VLAHU, *THE ECONOMICS OF BANK BANKRUPTCY LAW* 103–109 (2011).

⁸⁹ See *id.*

⁹⁰ See the country-by-country discussion below.

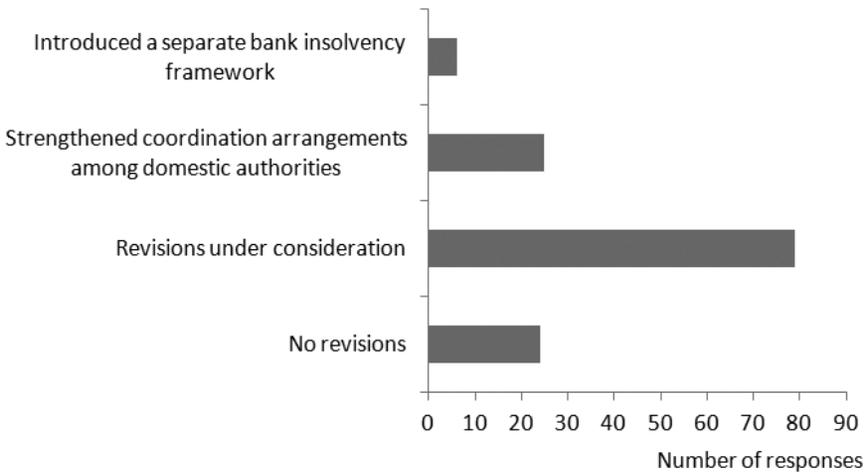
⁹¹ Katharina Overhofer & Usula Rath, *Austria: Financial Market Authority Tightens Insider Rules In New Compliance Regulation*, SCHONHERR (Jan. 31, 2012), <http://www.schoenherr.eu/news-publications/legal-insights/austria-financial-market-authority-tightens-insider-rules-in-new-compliance-regulation>.

⁹² See BRIERLEY, *supra* note 37 at 4.

⁹³ Banking Act 2009, c. 1 (U.K.).

⁹⁴ In 2010, the U.K. authorities announced plans to abolish the FSA and divide its responsibilities between the Bank of England and two newly created authorities: the Prudential Regulatory Authority (focusing on prudential regulation) and the Financial Conduct Authority (focusing on regulation of market conduct). The transition is to be completed by 2012. For an in-depth discussion of the coordination mechanism among the three agencies in the new

FIGURE 2: REVISIONS IN COUNTRIES' BANK RESOLUTION FRAMEWORKS, 2008–11



Source: Authors, based on information from the World Bank's 2011 Banking Regulation and Supervision Survey (<http://go.worldbank.org/SNUSW978P0> and <http://www.worldbank.org/fianancialdevelopment>).

Note: The survey is based on responses from senior banking supervisors in 142 countries. This figure is based on survey question 11.12, which asked: "Have you introduced significant changes to the bank resolution framework in your country as a result of the global financial crisis?"

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.⁹⁵ In addition, the regime provides for an enhanced bank insolvency procedure 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.⁹⁶ As pointed out by Brierley, these tools are broadly similar to those available to the FDIC for resolving U.S. commercial banks.⁹⁷

The 2009 Act makes the BoE responsible for the operation of the SRR, including the decision on which of the SRR tools to use, and its implementation.⁹⁸ The BoE also remains responsible for the provision of liquidity support, which uses the BoE's balance sheet.⁹⁹ The act makes the Financial Services Authority (FSA) responsible for determining that a banking institu-

framework, *see* INT'L MONETARY FUND, UNITED KINGDOM: THE FUTURE OF REGULATION AND SUPERVISION TECHNICAL NOTE (2011).

⁹⁵ *See* Banking Act 2009, *supra* note 93.

⁹⁶ *See id.*

⁹⁷ *See* BRIERLEY, *supra* note 37 at 9.

⁹⁸ *See* Banking Act 2009, *supra* note 93.

⁹⁹ *See id.*

tion 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.¹⁰⁰ The Treasury is responsible for decisions with implications for public funds, including the use of the temporary public ownership tool, and exercises a number of the ancillary powers under the SRR.¹⁰¹

2. Denmark

In October 2008, Denmark introduced a temporary special resolution regime for its banking system.¹⁰² It operated under a joint agreement between the Danish government and the Danish Bankers Association, representing most of the country's banks.¹⁰³ The association members were in the first instance responsible for themselves resolving a problem bank or banks through reorganization, takeover or break-up as appropriate.¹⁰⁴ Where this failed and a bank was insolvent, the association was to transfer the failed institution to a state-owned winding-up company.¹⁰⁵ The cost of the liquidation, which may include break-up and sale of viable elements, is borne (up to a ceiling) by the association. At the same time, a guarantee scheme was established under which the government provides an unlimited guarantee for all deposits and inter-bank lending in the banks joining the scheme. The scheme provides for losses on subordinated debt and senior unsecured debt.

The scheme was amended several times, and in August 2011, the country authorities announced measures to (i) strengthening the compensation scheme to make it more attractive to take over banks in distress; (ii) remove barriers to mergers between banks by offering a state guarantee with increased premiums; (iii) financing through contributions to the Guarantee Fund for Depositors and Investors (and the winding-up department) to even-out sector payments to the scheme, as well as establishing a possible consolidation fund; and (iv) preparing future regulation on Systemically Important Financial Institutions in Denmark.¹⁰⁶

¹⁰⁰ *See id.*

¹⁰¹ *See id.*

¹⁰² *See* Press Release, Ministry of Finance of Denmark, *The Danish Government and Danish Bankers Association Have Agreed on Measures to Safeguard Financial Stability* (Sept. 6, 2008), <http://uk.fm.dk/News/Press%20releases/2008/10/081006%20Measures%20to%20safe%20guard%20financial%20stability.aspx>; *see also* Act on Financial Stability, Lov om finansiel stabilitet – Lov nr. 1003 af 10 (Oct. 2008), <http://www.finansielstabilitet.dk/Images/PDFer/Engelsk/2008.10.10%20Act%20on%20Financial%20Stability.pdf>.

¹⁰³ *Id.*

¹⁰⁴ *See e.g.* FEARGUS O RAGHALLAIGH & MARK KENNEDY, MAZARS, BANKING CRISES AND SPECIAL RESOLUTION REGIMES, 50 (2011).

¹⁰⁵ *See id.*

¹⁰⁶ *See* MINISTRY OF BUSINESS AND GROWTH DENMARK, THE AGREEMENT WILL STRENGTHEN CONFIDENCE IN THE DANISH BANKING SECTOR, <http://www.evm.dk/english/news/2011/25-08-11-the-agreement-will-strengthen> and <http://www.evm.dk/~media/oem/pdf/2011/pressemeddelelser-2011/25-08-11-bankpakke-4/25-08-11-agreement-eng.ashx>.

3. *Germany*

Up to 2011, bank insolvency proceedings were conducted under the corporate insolvency law (with certain modifications) and supervised by the courts.¹⁰⁷ Prior to the initiation of insolvency proceedings, powers for the supervisory agency were limited and did not provide for restructuring techniques such as purchase-and-assumption transactions or bridge banks to facilitate prompt restructuring as shareholders' rights prevailed.¹⁰⁸ The statutory deposit protection scheme was a pay box only, though the Association of German Banks could facilitate the restructuring of member banks by drawing on resources from the private deposit protection scheme.¹⁰⁹

In early 2011, Germany introduced a new Bank Restructuring Act, which strengthens the early intervention powers of the supervisory authority, and gives supervisors a broader range of resolution powers.¹¹⁰ If necessary and under special circumstances, supervisors will be empowered to transfer the assets of a failing bank, wholly or partly, to a private bank or bridge bank.¹¹¹ Furthermore, a bank levy was introduced to provide funding for resolution measures.¹¹²

4. *Ireland*

Before the crisis, bank insolvency proceedings were conducted under corporate law and could be initiated by the supervisory agency or third parties.¹¹³ Powers for the supervisory agency in official administration were limited as shareholders' governance rights prevailed.¹¹⁴ The framework did not provide for restructuring techniques such as purchase-and-assumption transactions or bridge banks to facilitate prompt bank resolution.¹¹⁵

In 2011, Ireland enacted the Central Bank and Credit Institutions (Resolution) Act, which provided the Central Bank with specific resolution powers to address failing credit institutions.¹¹⁶ These powers include the creation of a resolution fund, the creation of bridge banks, the making of transfer orders and additional powers in the liquidation of credit institutions.¹¹⁷

¹⁰⁷ See, e.g., Hüpkes, *supra* note 52.

¹⁰⁸ See *id.*

¹⁰⁹ See *id.*

¹¹⁰ See, e.g., BINGHAM: GERMAN BANK RESTRUCTURING ACT IMPACT ON INVESTORS IN DEBT, HYBRID AND EQUITY SECURITIES ISSUED BY GERMAN BANKS (2011), <http://www.bingham.com/Alerts/2011/02/German-Bank-Restructuring-Act>.

¹¹¹ See *id.*

¹¹² See *id.*

¹¹³ See, e.g., Hüpkes, *supra* note 52.

¹¹⁴ See *id.*

¹¹⁵ See *id.*

¹¹⁶ See IRELAND: CENTRAL BANK AND CREDIT INSTITUTIONS (RESOLUTION) ACT 2011 (<http://www.irishstatutebook.ie/pdf/2011/en.act.2011.0027.PDF>).

¹¹⁷ *Id.*

5. Austria

In October 2008, Austria enacted a legislative package to enhance the supervisory powers of the Financial Market Authority (FMA) to protect depositors and to stabilize and strengthen credit institutions.¹¹⁸ The most important change with regard to the FMA's activity in the area of banking supervision was the tightening up of its powers to limit the risks arising from banking transactions and banking operations. If a credit institution or group of credit institutions fails to limit its risks appropriately, the FMA may impose a higher minimum capital requirement on the bank concerned with immediate effect (Article 70 para. 4a BWG). Moreover, a "Clearing Bank", was established under the auspices of the Ministry of Finance to lend to credit institutions and insurance companies, with the Ministry providing guarantees for bond issues of the Clearing Bank. The Minister of Finance is also authorized, in case of a considerable economic disruption, to recapitalize credit institutions or insurance companies and to guarantee their liabilities. Recapitalization measures may involve the granting of loans and supply of own funds (especially participation capital), acquisition of shares, or even, if the above measures fail, nationalization.¹¹⁹

In 2012, the country authorities started consultations on a new early intervention and bank resolution framework.¹²⁰ According to an IMF staff team, the objective of the new framework should be to provide Austrian supervisors with a better basis — and clearer responsibility — to impose early and forceful corrective measures.¹²¹

6. France

The Autorité de Contrôle Prudentiel (ACP), attached to the Banque de France, takes the lead in bank resolution, and has available a broad set of powers to initiate or execute resolution with the aim either to restructure the institution or to ensure its orderly liquidation, although no specific resolution framework for financial institutions is in place.¹²² The ACP may appoint an official administrator, and may obtain a court order for the transfer of bank

¹¹⁸ The package was announced in Federal Law Gazette I no. 2008/136 and entered into force on October 27, 2008. In addition to the adoption of the Interbankenmarktstärkungsgesetz (IBSG; Interbank Market Support Act) and the Finanzmarktstabilitätsgesetz (FinStaG, Financial Market Stability Act), this package also encompassed amendments to existing laws, among them the Banking Act (BWG).

¹¹⁹ See AUSTRIAN FINANCIAL MARKET AUTHORITY, ANNUAL REPORT 2008 (http://www.fma.gv.at/IBInteraktiv/2008/EN/CH0188_detail.htm).

¹²⁰ INT'L MONETARY FUND, AUSTRIA — 2012 ARTICLE IV CONSULTATION PRELIMINARY CONCLUSIONS, JULY 2, 2012 (<http://www.imf.org/external/np/ms/2012/070212.htm>).

¹²¹ *Id.*

¹²² See, e.g., JACOPO CARMASSI, ELISABETTA LUCHETTI, AND STEFANO MICOSI, OVERCOMING TOO-BIG-TO-FAIL: A REGULATORY FRAMEWORK TO LIMIT MORAL HAZARD AND FREE RIDING IN THE FINANCIAL SECTOR, CENTRE FOR EUROPEAN POLICY STUDIES, BRUSSELS (2010) (www.ceps.eu/ceps/download/3025).

shares.¹²³ Bank liquidation may only be initiated with the opinion of the ACP and is supervised by the courts.¹²⁴ Liquidation is a dual proceeding with separate liquidators acting with guidance by the ACP and under the direction of the courts pursuant to the commercial code, respectively.¹²⁵ The deposit protection scheme may assume a broader role in bank resolution.¹²⁶

7. *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.¹²⁷ Bank liquidation is conducted under corporate insolvency law in a court-supervised proceeding that may be initiated by various parties, including creditors.¹²⁸ The deposit protection scheme takes an active role as insolvency administrator and may provide funding to facilitate bank resolution measures.¹²⁹ 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.¹³⁰

8. *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. The deposit protection scheme functions as a pay box only. 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 authorities recently adopted legislation for enhancing the provisions on special administration, legal protection, and the initiation of bank liquidation proceedings.¹³¹ However, the planned introduction of a comprehensive bank resolution regime ran into legal issues involving shareholders' rights and the protection of property rights under the constitution. Although the authorities

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ See, e.g., EVA H.G. HÜPKES "INSOLVENCY: WHY A SPECIAL REGIME FOR BANKS?" CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW, VOLUME 3. WASHINGTON DC: INT'L MONETARY FUND (2005).

¹²⁷ See, e.g., Int'l Monetary Fund: Spain: Safety Net, Bank Resolution, and Crisis Management Framework—Technical Note, IMF Country Report No. 12/145 (2012) (<http://www.imf.org/external/pubs/ft/scr/2012/cr12145.pdf>).

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ See INT'L MONETARY FUND, HUNGARY: EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2008 STAND-BY ARRANGEMENT (2011) (<http://www.imf.org/external/pubs/ft/scr/2011/cr11145.pdf>) and LETTER OF INTEREST, March 2009, paragraph 20.

submitted the draft law to Parliament, it was never voted on and has subsequently been withdrawn.¹³²

9. Romania

Romania entered the crisis with a bank resolution regime lacking 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. In response to the crisis, the bank resolution framework has been amended to enhance the special administrator's ability to implement an extended range of measures, and legal amendments were enacted to broaden the grounds for the activation of deposit insurance and accelerate payouts.¹³³

B. *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.¹³⁴ 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 European Central Bank 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

¹³² *Id.*

¹³³ See INT'L MONETARY FUND, "ROMANIA: EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2009 STAND-BY ARRANGEMENT, IMF COUNTRY REPORT No. 12/64 (2012) (<http://www.imf.org/external/pubs/ft/scr/2012/cr1264.pdf>).

¹³⁴ See *Financial Stability Frameworks*, *supra* note 38, at 28.

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.¹³⁵ Introduction of a sound legal framework for the resolution of financial institutions across the Euro area is likely to increase the speed and decisiveness of efforts to restructure national banking systems.¹³⁶ 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 European Union. 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.¹³⁷ 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 have a strong interest in encouraging 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.

C. *Recent EU Reform Proposals*

In January 2011, the European Commission issued for public consultation a working document entitled "Technical details of a possible EU framework for bank recovery and resolution", which follows an earlier Communication on "An EU Framework for Crisis Management in the Financial Sector."¹³⁸ Following this consultation, the EU Commission issued a proposal for a directive, establishing a framework for recovery and resolution of credit institutions and investment firms in June 2012.¹³⁹

¹³⁵ See INT'L MONETARY FUND, WORLD ECONOMIC AND FINANCIAL SURVEYS, REGIONAL ECONOMIC OUTLOOK, ASIA AND PACIFIC, GLOBAL CRISIS: THE ASIAN CONTEXT 59–63 (2009).

¹³⁶ Cf. Lucas Papademos, Vice President, European Cent. Bank, Address at the 37th Economics Conference in Vienna: Monetary Policy and the 'Great Crisis': Lessons and Challenges (May 14, 2009).

¹³⁷ Hüpkes, *supra* note 52, 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.

¹³⁸ DG Internal Market and Services, Technical Details of a Possible EU Framework for Bank Recovery and Resolution (DG Internal Market and Services Working Paper, 2009); EUR. COMM'N, AN EU FRAMEWORK FOR CRISIS MANAGEMENT IN THE FINANCIAL SECTOR (2010).

¹³⁹ EUR. COMM'N, PROPOSAL FOR A DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ESTABLISHING A FRAMEWORK FOR THE RECOVERY AND RESOLUTION OF CREDIT INSTITUTIONS AND INVESTMENT FIRMS (2012).

Together these documents set out the European Commission's proposals for a legislative framework introducing stronger and harmonized national bank recovery and resolution regimes across the EU. The objective of the new EU-wide framework is for ailing financial institutions, and in particular systemically important institutions, to be allowed to fail without risks to financial stability whilst avoiding costs to taxpayers.¹⁴⁰ The regime is meant to apply to all banks, as well as systemically important investment firms and parent companies of such firms. It combines significantly strengthened early intervention powers for national supervisory authorities with a harmonized set of special resolution powers that will be administered by national resolution authorities, rather than the courts.

Expanded early intervention powers will be available where a credit institution is deemed "likely to breach" the requirements of the Capital Requirements Directive (CRD) and are suggested to include: requiring the institution to raise capital, restricting or prohibiting dividend distributions, restricting or limiting risky businesses and exposures, and requiring the institution to draw up and implement a specific recovery plan.¹⁴¹ In addition to these expanded supervisory powers, supervisors will be given the power to appoint a "special manager" to take over the management of the struggling institution.¹⁴²

The Commission proposes for all EU jurisdictions to have a minimum set of resolution powers, including (i) "a sale of business" tool which will enable the authorities to effect the full or partial sale of the institution without the consent of shareholders; (ii) a "bridge bank tool," which enables authorities to transfer the business to a temporary bridge bank; and (iii) an "asset separation tool," which is meant to enable authorities to transfer underperforming or toxic assets to a separate vehicle.¹⁴³ Alongside these more traditional resolution tools, the Commission proposes options that would enable the authorities to bail in senior creditors, by writing down the value of their claims, or forcing their conversion to equity when the resolution threshold is met, so as to help restore viability of the firm as a going concern.¹⁴⁴ In addition, the European Commission has proposed the setting up of resolution funds in each member state, which would be pre-funded by levies on non-deposit liabilities of financial institutions and designed to contribute to the cost of resolving individual failing institutions.¹⁴⁵

The European Commission is considering a range of "trigger conditions" that would have to be met for a firm to enter the resolution phase. These include a quantitative trigger—that the bank fails to meet the regulatory minimum (tier 1) capital ratio—as well as more qualitative triggers that

¹⁴⁰ *See id.* at 3.

¹⁴¹ *Id.* at 5–8.

¹⁴² *Id.* at 8.

¹⁴³ *Id.* at 9–10.

¹⁴⁴ *Id.* at 11.

¹⁴⁵ *Id.* at 15.

involve supervisory assessments of the likelihood of the bank becoming balance sheet insolvent or unable to pay its obligations.¹⁴⁶ In addition, since resolution actions may involve intrusive interventions that interfere with the rights of shareholders and creditors under conventional law, the Commission proposes that resolution needs to be in the “public interest” based on the objectives of maintaining financial stability and protecting public funds as well as insured depositors.¹⁴⁷ The idea is that if the public interest test is not met, the firm should be wound down in an orderly liquidation procedure.¹⁴⁸

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.¹⁴⁹ 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.¹⁵⁰ In those cases, holding up the letter and spirit of existing cooperation and “burden sharing” arrangements has proven hard. Moreover, the crisis illustrated an important challenge for small countries with banking sectors that are dominated by foreign-owned financial institutions, where it may be difficult to determine the extent to which foreign financial institutions will benefit from support put in place by their home countries.

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

¹⁴⁶ *Id.* at 7–8.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 7.

¹⁴⁹ Indeed, 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. *See e.g.*, Richard J. Herring, *BCCI & Barings: Bank Resolutions Complicated by Fraud and Global Corporate Structure*, in *SYSTEMIC FINANCIAL CRISES: RESOLVING LARGE BANK INSOLVENCIES* 321–45 (Douglas D. Evanoff & George G. Kaufman eds., 2005).

¹⁵⁰ See Wim Fonteyne et al., *Crisis Management and Resolution for a European Banking System* 60 (Int’l Monetary Fund, Working Paper No. 10/70, 2010)

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.¹⁵¹ 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.¹⁵² 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.¹⁵³

Importantly, however, these principles do not apply to the case where a banking institution entertains (wholly-owned) subsidiaries in a different country within the EU. A subsidiary has a separate banking license granted by the host country and is viewed as a legally separate entity.¹⁵⁴ For subsidiaries, therefore, resolution and insolvency proceedings can be initiated in every jurisdiction where a failed bank maintains an establishment. Moreover, resolution action taken by the home authorities cannot be enforced against potentially important subsidiaries, whose resolution instead requires the cooperation of the host country authorities.¹⁵⁵ This is an important constraint, because much of the recent cross-border expansion in European banking markets has been through subsidiaries, often occurring through takeovers of existing entities. Matters become very complex for an LCFI with numerous branches and operationally-integrated subsidiaries when resolution needs to be conducted on a separate entity basis and is in the hands of several national authorities or the courts of several countries with potentially competing interests.

Existing EU initiatives to address these difficulties include the ECOFIN crisis management principles, adopted in October 2007,¹⁵⁶ and the June 2008

¹⁵¹ Directive 2001/24, of the European Parliament and of the Council of 4 April 2001 on the Reorganisation and Winding Up of Credit Institutions, 2001 O.J. (L 125) 15.

¹⁵² *See id.*

¹⁵³ In addition to the Winding-Up Directive, the EU insolvency regime consists of a regulation on insolvency proceedings (Council Regulation 1346/2000, 2000 O.J. (L 160)) and a directive concerning the reorganization and winding up of insurance undertakings (Directive 2001/17, of the European Parliament and of the Council of 19 March 2001 on the Reorganisation and Winding-up of Insurance Undertakings, 2001 O.J. (L 110)).

¹⁵⁴ *See* Directive 2001/24, *supra* note 151.

¹⁵⁵ *See id.*

¹⁵⁶ 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. *See* Press Release, Council of the European Union, Economic and Financial Affairs (Oct. 9, 2007), http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/96375.pdf.

crisis management Memorandum of Understanding.¹⁵⁷ 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.

These difficulties have been illustrated by the case of Fortis Group. Fortis has been a financial institution with major market presence in the Benelux countries.¹⁵⁸ 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.¹⁵⁹ 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.¹⁶⁰

In late September 2008, Fortis became subject to bankruptcy rumors, leading to large withdrawals (€50 billion in two working days), mainly by business customers.¹⁶¹ According to subsequent court proceedings, the institution was solvent at the time, but the withdrawals led to liquidity problems.¹⁶² Fortis was partially nationalized on September 28, 2008, with the three Benelux countries injecting a total of €11.2 billion (US\$16.3 billion).¹⁶³ 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.¹⁶⁴ 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

¹⁵⁷ Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Financial Ministries of the European Union on Cross-Border Financial Stability (June 1, 2008).

¹⁵⁸ See FORTIS, ANNUAL REPORT 2008.

¹⁵⁹ See *id.*

¹⁶⁰ 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 See *id.*

¹⁶¹ Zdenek Kudrna, *Cross-border Resolution of Failed Banks in the EU: A Search for the Second-best Policies* 12 (Institute for European Integration Research Working Paper No. 08/2010, 2010), available at <http://www.eif.oeaw.ac.at/downloads/workingpapers/wp2010-08.pdf>.

¹⁶² *Id.*

¹⁶³ Tina Wang, *Fortis Pulled Back From the Brink*, FORBES (Sept. 28, 2008, 11:40 PM), http://www.forbes.com/2008/09/28/fortis-bailout-pingan-markets-equity-cx_tw_0928markets01.html.

¹⁶⁴ *Id.*

Fortis Bank Nederland. Luxembourg has agreed to a loan convertible into a 49 percent share of Fortis Banque Luxembourg.¹⁶⁵

Despite these joint measures, markets and depositors continued to lose confidence, with continuing withdrawals by business customers causing further liquidity problems.¹⁶⁶ Under this pressure, the burden-sharing agreement reached between the three governments fell apart, in a matter of days.¹⁶⁷ 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.¹⁶⁸ On October 3, 2008, the Dutch authorities announced that they would purchase the Dutch banking and insurance subsidiaries of Fortis for €16.8 billion (\$23.3 billion).¹⁶⁹ At the same time, the Luxembourg government increased its control of its part to 52 percent.¹⁷⁰ 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).¹⁷¹ However, Dutch and Belgian shareholders' associations requested a review of the takeover and a prolonged legal battle ensued.¹⁷²

B. National Resolution Regimes and Cross-Border Issues

The difficulty 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.¹⁷³ 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.

¹⁶⁵ *Id.*

¹⁶⁶ *See* Kudrna, *supra* note 161, at 13.

¹⁶⁷ *See id.*

¹⁶⁸ *See id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ Michael Steen & Scheherazade Daneshkhu, *Fortis Shareholders Reject BNP Deal*, FIN. TIMES (Feb. 11, 2009), available at <http://www.ft.com/intl/cms/s/0/68065628-f84f-11dd-aae8-000077b07658.html#axzz1qRDXng00>.

¹⁷² *See id.*

¹⁷³ *See EU Directive on Reorganization and Winding-Up of Banks Implemented*, INTERNATIONAL LAW OFFICE (Feb. 25, 2005), <http://www.internationallawoffice.com/newsletters/detail.aspx?g=E8081442-77c2-48d3-8dde-62c7056f3b5a>.

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.¹⁷⁴

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 potential remaining fiscal burden is likely to be easier than in the absence of special resolution regimes, when the provision of substantial state support is often the only viable option. As a result, with special resolution regimes in place, 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 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.¹⁷⁵ This leaves intact the rights of

¹⁷⁴ 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.

¹⁷⁵ 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

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.¹⁷⁶ In particular, introduction of special resolution regimes are 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, so as to maximize the value of assets and minimize the losses incurred locally. However, such action can reduce the chance of a successful resolution of the group as a whole.

Recent European Commission proposals for a Directive envisage two interlinked pieces of reform to address these issues, which involve requirements to consult and cooperate when resolving affiliated entities.¹⁷⁷ First, resolution colleges would be set up for each cross-border group which would be chaired by the home (group-level) resolution authority and also involve the host authorities and the European Banking Authority (EBA). Second, group level resolution authorities are to be given the power to decide, in consultation with European and host country authorities, whether a group-level resolution is appropriate. A group resolution scheme would then be implemented through coordinated action by national authorities. If a national resolution authority disagrees with the proposed group resolution plan and considers that it needs to take independent resolution action, it needs to refer the matter to the EBA, who will take a binding decision within 24 hours.

Another way of resolving these issues is by extending 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.

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.

¹⁷⁶ See Martin Čihák & Jörg Decressin, *The Case for a European Banking Charter* (Int'l Monetary Fund, Working Paper No. 07/173, 2007), available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07173.pdf>.

¹⁷⁷ See EUR. COMM'N, *supra* note 140, Articles 80-83 of the draft legislative text.

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.¹⁷⁸ The regime might in addition include: (i) a European banking license; (ii) a European resolution authority and European resolution fund (iii) a European deposit insurance scheme, covering deposits issued by branches and subsidiaries; and (iii) strong supervision under the auspices of the new European Banking Authority, also involving colleges of supervisors that include both home and host country authorities.

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.

CONCLUSION

There is a strong conceptual case for banks and other systemically important institutions to be subject to a special resolution 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.

¹⁷⁸ See Čihák & Decressin, *supra* note 176, at 8–9; Wim Fonteyne et al., *Crisis Management and Resolution for a European Banking System* 60 (Int'l Monetary Fund, Working Paper No. 10/70, 2010).

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 introduce European legislation that will establish strong and harmonized national resolution frameworks across the European Union and to complement these regimes by articulating processes for cooperation between authorities in cross-border cases.