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QUO VADIS, EUROPE?

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QUO VADIS, EUROPE?[1]

by Dr Barbara Jeanne Attinger[2]

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Abstract

Crisis management in the financial sector is currently at the top of the reform agenda at national, European and international level. Well-designed bank resolution regimes are essential not only to meet the acute need of a credit institution in crisis but also to ensure that proper incentive structures operate in the market prior to any crisis. Existing regimes are inadequate and incentive structures have proven to be fundamentally destructive. The lack of workable crisis resolution tools has had an adverse effect on crisis prevention and imposed enormous costs on the taxpayer.

This paper summarises the main legal challenges for crisis management of ailing credit institutions and identifies the key features of an effective bank resolution regime.

Effective crisis management demands the ability to manage. In the aftermath of the financial crisis, two leading EU Member States (the United Kingdom and Germany) adopted special resolution regimes, providing for tools and powers to manage the resolution of banks. The paper assesses and compares these two approaches.

In addition, the paper analyses the emerging response at European and international level, focusing in particular on bail-ins, the suspension of netting and other rights, treatment of groups and systemically important financial institutions. At the international level, the Financial Stability Board's recently published 'Key Attributes of Effective Resolution Regimes for Financial Institutions' constitute a breakthrough in the development of a global resolution regime. At the EU level, the European Commission's proposal for an EU crisis management regime is expected to be an even more ambitious step.

The European financial sector reforms have the potential to achieve a quantum leap in the efficient cross-border management of key issues, in particular in the field of bank resolution and insolvency law. This may evolve into a whole new dimension of efficient cooperation and economic and political convergence. In the field of crisis management, the fact cannot be ignored that we need more Europe, not less.

'[F]inancial markets are not an end in themselves but a means: they are supposed to mobilize savings, allocate capital, and manage risk, transferring it from those less able to bear it to those more able.'[1]

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[1] See Stiglitz.

1. Introduction

It is within the nature of human psychology that engaging in crisis prevention is much more appealing than dealing with crisis resolution, as we tend to be overly optimistic regarding our capacity to foresee and control the future. The fact that the next financial crisis cannot be prevented but merely may be delayed is not easy to accept but nevertheless an important realisation. This facilitates preparation and – perhaps more importantly – the establishment of the proper incentives up front.

This has been understood at national, European and international level, where crisis management in the financial sector has risen to the top of the reform agenda.

The legislative action taken in the aftermath of the financial crisis builds on recent experience. The acuteness of the crisis demonstrated the serious consequences which follow from a lack of appropriate resolution tools and powers enabling the authorities to react to a credit institution under threat of failure. Emergency legislation adopted at national level[2] represents an initial reaction and serves as a starting point for reforms of a more structural nature.

Furthermore, the importance of structural and pre-defined solutions for bank[3] resolution has become clear. Such resolution regimes are capable of addressing not only the acute need of a credit institution in crisis but also the ex ante incentive structures prevailing within the market. The existing incentive structure has proven to be fundamentally destructive, as the implicit State guarantee for financial institutions creates moral hazard. Putting it more simply, crisis prevention is hindered by a lack of workable crisis resolution tools. Consequently, one benefit of the current intense debate and the creation of resolution tools and powers is that this will facilitate the establishment of the correct incentives ex ante (prior to the next crisis) and thereby benefit crisis prevention[4].

Against this background and in order to arrive at workable resolution frameworks, it is essential to be clear about what we as a society want to achieve through such frameworks. What are the primary objectives of crisis management and bank resolution regimes?

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2 See, for example, in the UK, the Banking (Special Provisions) Act 2008, adopted to nationalise Northern Rock; in Germany, the Law on financial market stabilisation (Finanzmarktstabilisierungsgesetz) triggered by the crisis of Hypo Real Estate; and in Ireland, the Credit Institutions (Stabilisation) Act 2010.

3 The word ‘bank’ is used as a synonym for ‘credit institution’, as defined in Article 4(1) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177, 30.6.2006, p. 1 (Capital Requirements Directive). According to that provision, a bank is ‘an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account’. The term ‘financial institution’ is used in a broader sense, encompassing credit institutions and thus banks, and not in the narrower sense of Article 4(5) of Directive 2006/48/EC.

4 In the financial sector, time is of the essence and any attempt to manage a crisis needs to start at a very early stage. Therefore, crisis prevention and crisis management are inseparably connected and can prove mutually beneficial.

Public debate and the emerging legislative responses identify several objectives[5], that is, protection of financial stability, depositor protection, and protection of public confidence, public funds and human rights. All of these objectives are legitimate and important, and they need to be taken into account in bank resolution.

However, they should not distract from the most important question to be clarified: Who should bear the losses[6]?

Only by resolving this question will it be possible to deal fairly with the other objectives.

The allocation of costs arising during the resolution of a bank is a difficult (policy) decision to make and involves a difficult balancing act. The current crisis has shown that without a clearly defined legal framework in place, bail-out of financial institutions is the easiest solution but brings with it a whole set of negative consequences – the most obvious being the huge cost to the taxpayer and, in addition, the distortion of competition and support for wrong incentives, thereby creating moral hazard[7]. Therefore, a carefully designed legal framework for crisis management is indispensable.

This paper establishes an overview of the main legal challenges in the crisis management of ailing credit institutions (Section 2) and how they have been addressed by individual Member States (UK and Germany) in their national legislation (Section 3.1). In Section 3.2 it describes the emerging responses at European and international level, focusing in particular on bail-ins, the suspension of netting and other rights, treatment of group structures and systemically important financial institutions. Section 4 concludes with the main findings of the paper.

2. The (legal) problems of bank resolution

Several key features of the financial crisis have their roots in legal problems, which need to be addressed and resolved in order to clear the way for smooth crisis management. Some of those key (legal) questions regarding bank resolution are outlined in this section.

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5 See, for example, the explicit list set out in Section 4 of the (UK) Banking Act 2009.
6 This question is also clearly addressed in Hüpkes (2011), p. 107.
7 Ibid., p. 104.

2.1 Why is the general law of insolvency unsuited to address the failure/resolution of a credit institution?

In order to develop crisis management solutions, the particular characteristics of banking and the financial markets need to be understood. Those characteristics render general insolvency law inappropriate and call for a special regime. Given that such a regime, if it is to be successful, needs to provide effective tools and powers that can be exercised at a very early stage of a crisis, before actual balance-sheet insolvency of the credit institution, this raises problems in relation to creditor and shareholder rights.

(a) The particular characteristics of banking

Banks and other financial institutions provide essential banking functions (e.g. provision of credit, deposit taking, and operation of payment systems[8]) on which the real economy and society as a whole depends. Consequently, these banking functions constitute a form of 'public service'[9]. This confers considerable power and influence on the financial sector and makes society highly vulnerable to its crisis.

This important role leads to a manifest public interest in preserving banking functions. However, it is important to distinguish between the functions and the institution which provides such functions. The institution should be allowed to fail while (only) the functions need to be preserved[10]. In other words, 'banking is essential; banks are not'[11].

The maxim 'borrow short, lend long' (i.e. the notion of maturity transformation) suggests that exposure to short-term lending and the underlying refinancing risk is inherent to the very business of banking. Much of the value represented within a financial institution is directly linked to its overall business model. This fact is reinforced by the complexity which characterises the financial sector. The different parts of the business are so interconnected and complex that it is difficult to break them down into manageable pieces and the whole funding concept of a bank relies on the interlinking between its products. Any attempt to resolve such a complex entity needs to deal with the risk of value deterioration should its business model break down.

8 Campbell and Lastra, pp. 34-35.
9 Hüpkes (2005), p. 3.
10 Campbell and Lastra, pp. 39 and 41 who make reference to Hüpkes (2008).
11 Parker, p. 1.

Another characteristic of the banking business is that it is almost entirely confidence-based. As is often emphasised, confidence is a bank's most valuable asset[12]. Bank runs, triggering a downwards spiral and the erosion of value, may be caused by rumours, anticipated problems or the contagious effect of other institutions' difficulties[13].

In other words, there is a psychological element in banking and just as the boom may be driven by emotions so may the bust, too. It is not sufficient to take steps to counteract market panic and a run on the bank where news of a failure spreads, as this is only one part of the story, namely, the consequence of an unsound development[14]. The other part is to avoid, in the first place, irrational and unsustainable booms, created by acquisitive investment decisions and, in many cases, too, a herd of investors following the mainstream, who build up the initial bubble. Only if these unsustainable market developments can be hindered or at least attenuated can the financial sector be considered healthy.

(b) The inappropriateness of general corporate insolvency law

General corporate insolvency law has two main drawbacks. First, it does not focus on the protection of the financial system and its stability and, second, it intervenes too late[15].

The main goal of corporate insolvency law is to ensure the satisfaction of creditors. Therefore, it focuses on their interests and often accords them a powerful and active role in the insolvency process. Given the manifest public interest in the case of bank failure in preserving financial stability and avoiding contagion, a special resolution regime for banks needs to allow the public authorities to intervene to protect this public interest. A stronger role for the resolution authority (often the supervisor) managing the process is therefore essential. In this context, it is important not to focus solely on the individual company in resolution, but to look at it from a systemic perspective, detecting contagion risks and spillover effects, and trying to preserve general confidence, in particular by ensuring the continuity of banking functions and protecting depositors[16].

In bank resolution, time is of the essence. Resolution needs to be triggered earlier than under corporate insolvency law, before balance sheet insolvency of the bank, and the resolution

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12 This predominant role accorded to confidence can be explained by the fact that the whole concept of banking is based on a maturity mismatch. Banks borrow short and lend long. Therefore they need a constant inflow of short term funds which they borrow from the market. However, market participants will only lend to a bank if they have confidence in its financial soundness and its ability to meet its liabilities. On this point, see Ballegeer, p. 161, who refers to the notion of market trust.

13 Brierley, p. 5.

14 On the need to curtail excessive balance sheet growth and how this is addressed under the new Basel III framework via a leverage ratio and countercyclical capital buffers, see e.g. Ballegeer, pp. 155 and 158.

15 See Hüpkes (2005), pp. 9 and 24; and Brierley, p. 5.

16 See Brierley, p. 5.

authority needs to be competent to trigger this process[17]. To intervene at such an early stage is clearly necessary in view of the particular characteristics of the banking business and the public interests at stake. However, this raises difficulties in relation to shareholder and creditor rights.

(c) The particular challenges regarding creditor and shareholder rights

In legal terms, the most challenging aspect of crisis management is the interference with the rights of the owners of the ailing bank (the shareholders) and of its creditors. The trickiest part is the fact that the nature of the banking business results in a manifest public interest in intervening at a pre-insolvency stage and not simply liquidating the ailing bank. Consequently, the aim of the process is not that the bank disappears but will be restructured and reorganised as a going concern. The credit institution – or at least parts of it – will thus continue to exist. In this case, the bank as debtor remains in the market and, therefore, it is more difficult to justify why: (i) creditors should be deprived of (part of) their claims; and (ii) shareholders should accept an interference in their rights.

(i) Creditor rights – the question of bail-ins and netting rights

Why should a creditor be required to relinquish its claim if its debtor continues to exist? From a neutral perspective, it is clear that this does not accord with the legal principle that contracts have to be fulfilled – *pacta sunt servanda*. If the principle of legal certainty is to retain currency within the context of financial markets, the outcome of any resolution regime has to be clear and predictable on this point.

The idea of a bail-in of creditors[18] can be understood as the opposite approach to a bail-out[19]. Instead of avoiding an immediate failure and disorderly liquidation of a credit institution through the injection of public money – thereby bailing-out the credit institution and its creditors – the creditors themselves contribute towards restoring the balance sheet stability of the bank. This contribution may consist in applying a 'haircut' to creditors' claims, that is, writing them down by a certain percentage. Or the contribution can be effected by a debt-to-equity swap, converting the creditors' claims into equity and, as a result, the creditors become shareholders of the credit institution.

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[17] See Hüpkes (2005), p. 9.

[18] European Commission (2011) Annex I contains a discussion of possible approaches to the design of debt write-down (or 'bail-in') as a resolution tool.

[19] For an interesting account of how such a bail-in could have worked in the case of Lehman Brothers, see Calello and Erwin.

Any resolution regime which involves a contribution by creditors to the restructuring process, which implies that their claim will not be honoured in full or in time, constitutes an interference with their property rights[20]. Accordingly, for the regime to be lawful it must satisfy the requirements of human rights provisions, namely, the First Protocol to the European Convention on Human Rights (ECHR) and Article 17 of the Charter of Fundamental Rights of the European Union (the 'Charter')[21]. In accordance with those provisions, an interference must be

— duly justified by an overriding public interest;
— provided by law; and
— respect the principle of proportionality (i.e. the weight accorded to the public interest must be proportionate, and the measure must include fair compensation and respect the general principles of international law[22]).

According to the European Court of Human Rights (ECtHR), 'an interference with the peaceful enjoyment of possessions must strike a "fair balance" between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights'[23]. So, what does 'fair' mean? The ECtHR left considerable discretion to the legislature, giving it wide leeway to find appropriate solutions. It held that 'the legislature must have a wide margin of appreciation both with regard to the existence of a problem of public concern warranting measures of control and as to the choice of the detailed rules for the implementation of such measures. The Court will respect the legislature's judgment as to what is in the general interest unless that judgment be manifestly without reasonable foundation'[24].

Both the ECHR and the Charter provide quite sensibly that the cases in which interference with property rights is possible have to be laid down in the law ex ante. In other words, the foreseeability of the interference is a key element of justice. This is not only correct from a legal point of view, but also desirable from the financial stability perspective. Only if market participants can rely on a well-designed and stable legal regime can they calculate rationally and behave rationally. In a situation of arbitrariness and unpredictability, market runs, panics and other value-detrimental forms of behaviour are far more likely.

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20 Creditors' claims constitute possessions (property) within the meaning of and as protected by Article 1 of the First Protocol to the European Convention on Human Rights; see also Hüpkes (2011), p. 115.

21 OJ C 303, 14.12.2007, p. 1. Note that, according to Article 51 of the Charter, it has a limited field of application and is directed primarily to the institutions of the European Union. Consequently, it binds the European Commission when proposing an EU framework for bank recovery and resolution.

22 An interesting feature of customary international law is the Hull rule which demands that in the event of expropriation compensation of foreign nationals must be prompt, adequate and effective. This rule derives from a statement of the US Secretary of State Hull made in 1938 that 'under every rule of law and equity, no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate, and effective payment therefore'.

23 *Jahn and Others* v *Germany*, (Applications No 46720/99, 72203/01 and 72552/01), ECHR 2005-VI, paragraph 93.

24 *Mellacher and Others* v *Austria*, (Application No 10522/83, 11011/84 and 11070/84), 19 December 1989, Series A No 169, paragraph 45.

The requirement for fair compensation constitutes another element which is not only mandatory in legal terms but also reasonable from an economic and financial stability perspective, as without it the market would be distorted and rational behaviour made impossible[25]. The ECtHR stated that 'compensation terms under the relevant legislation are material to the assessment whether the contested measure respects the requisite fair balance and, notably, whether it imposes a disproportionate burden on the applicants. In this connection, the Court has already found that the taking of property without payment of an amount reasonably related to its value will normally constitute a disproportionate interference, and a total lack of compensation can be considered justifiable under Article 1 of Protocol No 1 only in exceptional circumstances'[26].

This opens the door in exceptional circumstances to not grant any compensation at all. Consequently, the protection against the imposition of a disproportionate and excessive burden is not particularly great[27] as the Court allows it to be balanced by a very wide notion of the public interest, which takes account of social justice elements[28]. Therefore, the legislature has a wide discretion to interfere with creditor (and shareholder) rights in bank resolution and even the total absence of compensation might be justified by exceptional circumstances[29].

One important indicator for determining fairness and whether a burden is excessive is the comparison with the expected outcome in the case of liquidation. Are the creditors likely to be worse off under the resolution scheme than they would be if the bank were to go directly into liquidation? If the answer is yes, the creditors can claim that they have to bear a greater burden than in the case of insolvency. Consequently, they should be compensated at least to the extent of what they would recover from an insolvency. Admittedly, it is difficult to determine from an ex ante perspective which losses and returns would have been realised in the case of insolvency proceedings, but any comparative valuation of future scenarios has to rely on an ex ante assessment. Therefore, the mere fact that this task is challenging does not devalue the approach.

Respecting this principle of 'no worse-off than in liquidation' is therefore an important element of every resolution regime. It has the advantage of not disturbing the economic perspective on contracting, according to which the likelihood of insolvency of a debtor constitutes a risk-factor

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25 For the same reasons as above: unpredictable outcomes, runs, panic, and no rational behaviour possible.

26 *Jahn and Others* v *Germany*, paragraph 94.

27 Ibid., paragraph 95: 'As it has already been established that the interference in question satisfied the condition of lawfulness and was not arbitrary, the lack of compensation does not of itself make the State's taking of the applicants' property unlawful [...]. Accordingly, it remains to be determined whether, in the context of a lawful deprivation of property, the applicants had to bear a disproportionate and excessive burden.'

28 Ibid., paragraph 109.

29 This was also the result in *Jahn*, where the ECtHR stated in paragraph 117 that 'having regard to all the foregoing considerations and taking account, in particular, of the uncertainty of the legal position of heirs and the grounds of social justice relied on by the German authorities, the Court concludes that in the unique context of German reunification, the lack of any compensation does not upset the "fair balance" that has to be struck between the protection of property and the requirements of the general interest. There has therefore been no violation of Article 1 of Protocol No 1.'

which has to be priced in. If a creditor can rely on the fact that any resolution regime will not treat it less favourably than the simple liquidation of the debtor in insolvency proceedings, the creditor does not need to apply a risk-premium in anticipation of such resolution measures.

Given the characteristics of the business of banking, creditors themselves may have a particular interest in seeing the bank restructured as a going concern. Liquidation under the traditional rules of company law is likely to lead to a poor return on their claims, as the assets of the banks will evaporate. Their value stands and falls with the business model of the bank as a going concern.

Another important principle of general insolvency law, whose application in resolution is a key element to avoid the imposition of an excessive burden, is the '*pari passu* principle'. Translated literally, this principle means 'with an equal step' or 'on equal footing' and, in practice, it means that the claims of equally-ranked creditors need to be satisfied without preference and proportionally. The *pari passu* principle builds to a considerable extent on the principle of non-discrimination. The notion of non-discrimination between creditors in the same situation is an important element of fair treatment and is crucial for the purposes of legal certainty. If discrimination is defined as treating two essentially identical cases differently or two essentially distinct situations alike, discriminatory treatment is per definition arbitrary, as the distinctions made are not based on objective distinguishing factors[30]. However, in relation to equally-ranked creditors, there may be objective reasons which allow for non-discriminatory distinctions to be made and such difference in treatment may achieve a better result overall in resolution and, hence, be justified in the public interest. Such non-discriminatory deviation from the *pari passu* principle should therefore be possible when implementing resolution measures and in particular bail-ins[31].

Another legal challenge in banking resolution is how to apply resolution tools without triggering close-out netting[32] and set-off[33] rights. Those rights are generally designed to mitigate risk between counterparties by setting off or netting their respective claims when a pre-defined trigger event occurs. If, for example, an event of default arises and constitutes such a trigger event, the counterparties' credit risk is reduced to the net claim outstanding between the parties. This is an

30 This definition of discrimination is used by the German Federal Constitutional Court, see its judgment of 15 July 1998 reported in BVerfGE 98, 365, at p. 385, paragraph 63, available on the Constitutional Court's website at http://www.bverfg.de/entscheidungen/rs19980715_1bvr155489.html (only in German).

31 The FSB advocates that it should be possible to deviate on proper grounds from the *pari passu* principle. See FSB (2011) *Key Attributes of Effective Resolution Regimes*, p. 11, paragraph 5.1.

32 Mengle defines close-out netting as 'a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable'. He identifies it as 'the primary means of mitigating credit risks associated with over-the-counter derivatives' and 'necessary because it enables derivatives participants to protect against adverse market changes following default of a counterparty'. See Mengle, pp. 1 and 2.

33 Set-off is essentially the same as payment netting. Unlike close-out netting it does not assume the default of one counterparty. See Mengle, p. 2.

important technique to limit the market effects of a counterparty's default and thereby helps to avoid contagion and enhance financial stability[34].

In recognition of this important risk mitigation function of set-off and netting rights, protection has been granted at EU level in several directives, notably the Settlement Finality Directive[35], the Winding-Up of Credit Institutions Directive[36] and the Financial Collateral Directive[37]. In addition, the Cross-border Bank Resolution Group (CBRG)[38] recommends that 'jurisdictions should promote the use of risk mitigation techniques that reduce systemic risk and enhance the resiliency of critical financial or market functions during a crisis or resolution of financial institutions. These risk mitigation techniques include enforceable netting agreements … '[39].

However, this positive, risk-mitigating function of netting and set-off rights may be overshadowed by other factors in a resolution scenario. The triggering of netting and set-off rights by a resolution measure can hamper its effective implementation, as large volumes of financial contracts are suddenly closed out and change the assets and liabilities basis on which the reorganisation is intended to take place. In order to allow for an effective crisis management, this adverse effect on the individual reorganisation and, thus, potentially also on the financial stability of the system needs to be avoided[40].

The CBRG proposes, therefore, that 'in these circumstances, financial stability would be better protected by transferring the debtor's financial contracts to a solvent third party, a bridge bank or another public entity. Thus, after carefully considering the circumstances that need to be addressed (i.e. defining systemic crisis), authorities need to have the requisite powers to override termination clauses and transfer financial contracts to a sound counterparty[41].' In this respect, regulation needs to allow for a temporary delay in netting and set-off rights for the purposes of effective resolution and, at the same time, must ensure continued performance of the substantive obligations, for example, payment and delivery obligations, or provision of collateral[42]. Therefore, the unconditional protection accorded to setting off and netting under the existing EU

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34 According to the European Financial Markets Lawyers Group, close-out netting is a precondition for effective financial markets. See EFMLG (2005).

35 See Article 3(1) of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166, 11.6.1998, p. 45.

36 See Article 25 of Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L 125, 5.5.2001, p. 15.

37 See Article 7 of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.6.2002, p. 43.

38 Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision.

39 CBRG, recommendation 8, p. 39.

40 The CBRG estimates that such closing out may lead to 'fire sale valuation … transmit[ing] the debtor's instability far beyond its counterparties'. Consequently, it proposes that the protection of netting and set-off should not be given absolute priority, noting that 'such risk mitigation techniques should not hamper the effective implementation of resolution measures'. See CBRG p. 39.

41 Ibid., p. 40, paragraph 115.

42 See FSB (2011) *Key Attributes of Effective Resolution Regimes*, p. 10, paragraph 4.2.

regime goes too far as this may prevent effective crisis management[43]. The different legislative approaches taken to deal with this difficult balancing act between effective netting and effective resolution are discussed below in Section 3.

(ii) Balancing shareholder rights with the need to obtain prompt resolution

Having considered the rights of creditors, another key aspect to be addressed in establishing a successful resolution regime is striking the right balance between the public interest in a quick and effective resolution and the property and voting rights of shareholders. In relation to the property rights of shareholders, the same reasoning as set out above with respect to creditors applies.

In their capacity as owners of the ailing credit institution, shareholders will generally need to bear losses before any creditors are bailed-in. Therefore, any resolution regime will interfere with their property rights first before touching upon creditors. Nonetheless, in evaluating whether this interference meets the standards required by human rights law (as described above) the critical benchmark remains the same, that is, that under the resolution scheme they are no worse-off than they would be in the case of insolvency[44]. For a resolution scheme to be effective (and at the same time encourage financial stability in the system) treatment of shareholders' rights must be fair and predictable, otherwise it may be susceptible to legal challenge.

In practice, shareholder voting rights have proven to be a substantial obstacle to prompt crisis resolution, as they can hinder any ad hoc decision to increase capital or to transfer assets and, as a consequence, may considerably slow down the restructuring process[45]. With a view to establishing a prompt resolution of banks, particular difficulties are raised by the Second Company Law Directive[46], discussed below in Section 3 in light of the special resolution regime adopted by Germany and the case-law of the European Court of Justice (ECJ)[47].

Another critical issue is to find the right balance between the need for resolution decisions to take prompt effect and ensuring the possibility for shareholders and creditors to seek review by the courts.

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43 CBRG, recommendation 9, p. 42.

44 A detailed analysis of the legislative solutions adopted, for example, in relation to valuation methods, is provided below in Section 3.

45 This happened in relation to the restructuring of the Dutch/Belgian bank Fortis. For a detailed assessment of possible solutions and on how to achieve a fair balance between shareholder voting rights and effective crisis management, see Section 3 below.

46 See Article 25 of the Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, OJ L 26, 31.1.1977, p. 1.

47 Case C-441/93 *Pafitis and Others* [1996] ECR I-1347.

As time is of the essence in bank resolution, there is no time for lengthy judicial proceedings prior to a resolution measure taking effect (ex ante). However, this does not generally exclude the possibility of ex ante control, as is demonstrated by those legal regimes which have a court-controlled resolution/insolvency regime in place. Those regimes require prior approval by the courts before action may be taken by the resolution or insolvency authority[48]. This may stabilise the resolution measure in the sense that the ex ante court approval gives it additional legitimacy, increases legal certainty and reduces the risk of (successful) legal challenges ex post.

On the other hand, a purely administrative resolution regime, allowing (only) for an ex post control of the resolution decision taken by the resolution authority may also prove a sensible option. In that situation, any ex post review by the courts has to find the right balance between ensuring the right to a fair hearing[49] and 'not undermin[ing] the effectiveness and credibility of the banking authorities' actions in their efforts to protect the stability of the financial system'[50]. In the words of an IMF report, 'the review mechanism should only seek to determine whether the banking authorities have acted legally and should not allow the court to reassess the exercise of discretion by the banking authorities unless there is clear evidence of a manifest error of fact or an abuse or misuse of power (e.g., an "arbitrary or capricious" decision)'[51].

2.2 Why winding up cross-border credit institutions has proved so unsuccessful? Global in life – national in death

In a cross-border context, the legal and practical challenges of bank resolution become exacerbated by the fact that different legal systems apply, different authorities are involved and communication and cooperation is complex.

The difficult balancing acts needed to achieve a smooth resolution involve discretionary elements. If such discretion is exercised by the resolution authority of one State, it is far from evident that the (resolution) authorities of other States will accept this judgement without feeling the need to double-check by exercising some discretionary judgment of their own. This highlights the particular challenge in the cross-border context. Given the fact that bank resolution as such is highly complex and cannot be achieved by mechanically applying a fully anticipated and pre-defined resolution programme, it is understandable that resolution decisions coming from abroad are even harder to accept.

48 See IMF, p. 23, paragraph 37.
49 Guaranteed, inter alia, by Article 6(1) of the ECHR.
50 IMF, p. 23, paragraph 38.
51 Ibid.

This problem of mutual recognition and acceptance was raised in the English case of *Metliss*[52] which illustrates that the involvement of different legal systems can lead to difficulties. In this (very old) case, bonds were issued by the National Mortgage Bank of Greece under English law. The bank was then amalgamated with another bank by Greek decree, which also determined that the newly established National Bank of Greece and Athens[53] would become the universal successor. In the presence of a contract governed by English law, the English courts were not willing to recognise this change in contractual parties imposed by foreign statute[54].

This shows how important it is to plan ahead for a situation of cross-border resolution and to have rules in place for mutual cooperation and recognition. Smooth cross-border cooperation can be considerably facilitated by having comparable approaches in place, as well-known solutions are far easier to accept than unfamiliar approaches. Therefore, close convergence and (ideally) harmonisation of resolution tools and powers would increase the effectiveness of cross-border resolution[55].

Moreover, there is a high risk that the resolution procedure will be influenced by national interests with each State making assumptions on the particular course of action likely to best protect the (perceived) national interest. The phenomenon of ring-fencing of assets is a typical example of this behaviour, where an individual State attempts to protect its own financial interests or those of its nationals. This often hinders effective resolution and leads to a poorer result overall[56].

In the case of the resolution of the Fortis group, the Belgian and Dutch authorities failed to achieve a coordinated cross-border solution and establish a system of (mutually beneficial) burden sharing[57]. This worked out much better in the case of the Dexia group, where Belgium, France and Luxembourg managed to coordinate their action via an agreement on a joint guarantee mechanism. This avoided a break-up of the company along national lines, as happened in the case of Fortis, and the cross-border resolution process proved possible[58].

Another problem in the Fortis case related to shareholder rights and the fact that the mandatory general meeting blocked the whole rescue plan. It became apparent that the severity of this

52 *National Bank of Greece and Athens* v *Metliss* [1958] AC 509.

53 Later renamed National Bank of Greece.

54 See Clifford Chance, p. 13: 'you cannot vary English legal rights by Greek statute'.

55 CBRG observes in paragraph 69 that 'greater convergence in national laws, by promoting a common understanding, more predictability, and reliable frameworks for responsive actions, will likely improve cooperation. In particular, it should help to reduce the precipitous and perhaps unnecessary actions that could exacerbate a crisis.' See also recommendation 3.

56 The authorities and market participants may be caught in a prisoners' dilemma, setting individual incentives leading to an outcome which both in overall terms and even at an individual level is poorer than what is achievable in objective terms. See also European Bank for Reconstruction and Development (EBRD).

57 For an assessment of the Fortis resolution see CBRG, paragraph 33. The strengths and weaknesses of cross-border approaches are discussed in paragraphs 8 and 9 of the same report.

58 Ibid, paragraphs 34-37.

problem was increased exponentially by the fact that the resolution was intended to take effect on a cross-border basis.

2.3 The problem of groups – part of a whole in life, wholly apart in death?

The complexity of group structures proved to be fatal in the crisis both for supervisory authorities and the private sector itself.

This became apparent during the Lehman Brothers collapse, where nobody was able to answer the elementary question of how much exposure the financial sector had towards the approximately 3,000 Lehman Brothers legal entities operating in some 50 countries. In simple terms, nobody was able to say how much money or which institutions were at risk. This was one reason why there was a freeze in the interbank lending market[59].

The legal regimes in place were not able to reflect the complex economic reality of the group. When one looks at the structure of such groups, this does not come as much of a surprise. Their legal design, with the group split into individual legal entities, does not reflect in any way their economic functioning. The business lines do not correspond to the legal structure. Therefore, any legal system based on the single legal entity approach, which recognises only each legal entity as having legal personality and as the bearer of rights and obligations, is not able to reflect this complex group dimension.

This dilemma can be addressed in two ways. Either the legal regime can be adapted to recognise the reality of groups or groups could be required to adapt to the single legal entity approach.

In this connection, account should be given to the fact that the complexity of a group reflects a desire to increase efficiency and is intended to optimise its economic return. This is achieved by using synergies and, in particular, tax optimisation. Therefore, the complex group structure has a specific economic value.

However, as the Lehman collapse demonstrated, this comes at the cost that in a crisis an orderly resolution of the group is close to impossible and the price of its disorderly collapse is tremendous. This burden fell to a considerable extent on the public, in particular, the taxpayer. In practice, this amounts to a dual burden on the taxpayer. First, fewer taxes are paid because of the group structure and the possibility for tax optimisation. Second, in times of crisis, such group structures prove incapable of resolution and require a bail-out.

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[59] Other elements leading to the freeze in the interbank lending market were the sudden realisation that Lehman Brothers had obviously not been 'too big to fail' and that any implicit State guarantee could not be taken for granted. Furthermore, in the absence of special resolution regimes, the manifest drawbacks resulting from slow and burdensome insolvency regimes and the high level of uncertainty provoked asset fire sales. See Krimminger, p. 294, paragraphs 11.41 and 11.42.

This mismatch between economic benefit and financial burden resulting from the complexity of groups creates a considerable incentive problem and moral hazard. Consequently, complexity should entail a cost for those who create it. This could be achieved by requiring complex groups to respect higher standards and adopt special precautionary measures, such as group resolution plans and achieve higher capital standards or by subjecting them to closer supervision.

Moreover, it appears sensible to pursue a dual strategy, enhancing, on the one hand, the readiness of legal regimes to deal with an ailing group and, on the other, reducing the complexity of groups, thus increasing the stand-alone capacity of their entities. This is also suggested by the CBRG, which advocates in its second and fifth recommendations that 'each jurisdiction should establish a national framework to coordinate the resolution of the legal entities of financial groups and financial conglomerates within its jurisdiction', and that 'supervisors should work closely with relevant home and host resolution authorities in order to understand how group structures and their individual components would be resolved in a crisis'. The CBRG recommends further, 'if national authorities believe that financial institutions' group structures are too complex to permit orderly and cost-effective resolution, they should consider imposing regulatory incentives on the institutions, through capital or other prudential requirements, designed to encourage simplification of the structures in a manner that facilitates effective resolution'[60].

2.4 Systemically important financial institutions – too big, too interconnected, too unique, too complex?

What makes a credit institution systemically relevant and why is this of interest for its resolution? The problems set out above arising in the cross-border and group context become highly virulent when we are confronted with a systemically important financial institution (SIFI).

What does the descriptor 'systemically important' mean? In general terms, a credit institution can be described as systemically important if its individual crisis has a substantial (adverse) impact on the system. In this context, 'system' means not only the financial sector, but also the real economy, and, ultimately, the functioning of a state or possibly several states, if not all states. This knock-on effect from one individual market player to the system as a whole became apparent during the recent financial crisis, with the public sector forced to intervene on a massive scale in order to control the 'financial system externalities' created by ailing SIFIs[61].

Before being able to address this problem created by SIFIs, it is necessary to clearly define a SIFI. Put in simple terms, a financial institution is systemically important when its failure puts the

60 CBRG, recommendation 5, p. 31.
61 See Walter, p. 5

system at risk. But this proves difficult to determine, as 'systemic risk is an elusive concept: it can have significant economic consequences and is quantitatively important, yet there is no clear consensus on how it should be measured'[62].

In this connection, it is very important to note that simple indicators have proven good approximators for more complex measures of systemic importance[63]. In particular, the size of an institution has proven a very pertinent indicator of systemic risk and thereby of systemic importance[64]. An institution described in everyday terms as 'too big to fail' is likely to be systemically relevant. In addition to its size, also the interconnectedness, the substitutability and the complexity of a financial institution have been identified as valuable indicators of its systemic importance[65]. Furthermore, the criterion of global activity allows it to be determined whether an SIFI also constitutes a global SIFI, that is, a G-SIFI[66].

The interconnectedness of an institution with other institutions within or outside a group structure increases the risk of contagion and generally the impact of a failure on the market. Such interconnectedness reduces the stand-alone capacity of the individual legal entity and does not allow for the resolution of this individual entity without at the same time dealing with multiple interlinkages and moderating the impact on other market participants. This phenomenon is also referred to as 'too interconnected to fail'.

Substitutability is a good indicator of systemic importance, as even a small institution may be vital to the functioning of the system as a whole, if it is unique in providing crucial services which cannot be easily replaced by others.

The complexity of the business model and/or the financial products provided by an institution contributes to its systemic relevance, as it renders it very difficult for all market participants (including the institution itself) to assess the impact and the outcome of a crisis situation. This has both psychological and practical implications. It easily creates panic reactions ('runs'), as counterparties of the ailing institution are not able to assess the risk deriving from the critical situation – thereby creating a self-fulfilling prophecy of failure[67]. Furthermore, it renders crisis management extremely difficult, as it is not easily possible to separate vital business areas and to cluster the business in manageable parts.

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62 Drehmann and Tarashev, p. 26.

63 Ibid., p. 36. The authors write: 'Taken together, our results highlight that simple indicators do help to assess the degree of banks' systemic importance. Given the complexities of implementing and communicating more rigorous model-based measures of systemic importance, these results suggest that an indicator approach may be the most suitable route for practical purposes. It would also allow banks with limited system-level information to measure and manage their own systemic importance.'

64 Ibid.

65 Walter, p. 5.

66 See Financial Stability Board (2011) *Progress in the Implementation of the G20 Recommendations*, p. 2.

67 After the collapse of Lehman Brothers market participants were not able to assess precisely their own exposure and their counterparties' risk. This led to an overestimate of risk which was itself destructive of value.

As the failure of such SIFIs poses a major threat to the public purse and, ultimately, public order, there is a serious moral hazard issue, as an SIFI counts (and, hitherto, has been correct to count[68]) on being rescued.

The legal problems of bank resolution set out above proved to have fatal effect during the financial crisis, as there was no plan or tools to deal with them. Legal systems and public authorities were not prepared for the task of resolving ailing financial institutions and, hence, crisis management was very difficult and achieved, ultimately, at the taxpayers' expense.

Effective crisis management calls for the ability to manage. In other words, authorities need to have the tools and powers to influence the destiny and the running (down) of the credit institution concerned. These tools and powers necessary are reflected in legislative reforms at a national level and in the new crisis management framework discussed on the European and international level.

3. The (legislative) attempts to achieve solutions

In Section 2 of this paper, four main legal issues were identified as having crucial relevance for an effective bank resolution regime: (a) the particular characteristics of banking triggering the need to make special provision for creditor and shareholder rights during resolution; (b) cross-border aspects to the banking business; (c) the group dimension; and (d) the leveraged problems arising in the case of SIFIs.

Section 3 will focus on: (a) how these problems have been addressed at national level; and (b) proposals to address them at European and international level.

3.1 National law: responses to the crisis in the UK and Germany

The deficiencies in the legal systems set out above became all too apparent in the recent financial crisis, prompting public authorities to take action. Within the EU, legislation was adopted at Member State level, reflecting the continued national responsibility for the viability of domestic financial institutions. Two leading Member States (the United Kingdom and Germany), adopted special resolution regimes in the aftermath of the financial crisis. In both cases, these new

[68] The only exception was the case of Lehman Brothers. Its profound market impact now stands symbolically for the major harm which can be caused to the financial market and the real economy as a whole. Therefore, this example tends to increase the moral hazard problem, as other market participants feel reassured that in all cases the public authorities will want to avoid the repetition of such a catastrophic failure.

regimes were triggered by the financial turmoil directly arising from credit institutions incorporated in those states, that is, Northern Rock (UK) and Hypo Real Estate (Germany).

An analysis and comparison of the two special resolution regimes is of particular interest from two different perspectives. First, it allows a comparison of the solutions adopted by two very different jurisdictions facing very similar problems. Second, the solutions adopted offer a specific example of how crisis management can be addressed and, consequently, provide a very useful precedent for future legislation at the EU level, discussed further below.

(a) The UK Banking Act 2009

The UK experienced how difficult it is to react to a crisis of a bank when Northern Rock experienced a bank run in 2007. The British authorities could not find any other solution than to nationalise the bank and, thus, to socialise its credit risk[69]. Against that background, the need for a special resolution regime (SRR) for banks became apparent. The Banking Act 2009 addresses this need and creates such a SRR[70].

(i) A special regime with clearly defined triggers and objectives

The concept of a SRR is defined by the Banking Act in a broad way, comprising stabilisation options, an insolvency procedure (in a narrow sense) and an administration procedure[71].

Section 1 of the Banking Act 2009 defines the purpose of the SRR as being 'to address the situation where all or part of the business of a bank has encountered, or is likely to encounter, financial difficulties'. Accordingly, it opens the door for anticipatory action[72], as it allows the resolution authority already to intervene at the point where, in its assessment, from an ex ante perspective, the bank will probably ('likely') encounter difficulties. This allows for intervention at a very early stage. This addresses the special need within the financial sector to intervene before the crisis manifests itself and confidence in a credit institution is starting to erode.

The SRR builds on the current 'tripartite' model of financial regulation in the UK, subject to revision at present[73], and provides for all three authorities, namely the Bank of England (BoE),

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69 For a comprehensive analysis of the Northern Rock case see SUERF – The European Money and Finance Forum.

70 Further clarification is provided by the Code of Practice issued by HM Treasury (the UK's Ministry of Finance). According to point 1.3 of the Code, the Code of Practice 'supports the legal framework of the SRR, and provides guidance as to how and in what circumstances the authorities will use the special resolution tools'.

71 Section 1(2) of the Banking Act 2009 provides that 'the special resolution regime consists of (a) the three stabilisation options; (b) the bank insolvency procedure (provided by Part 2); and (c) the bank administration procedure (provided by Part 3)'.

72 Campbell and Lastra, p. 53.

73 The UK Government plans to reform the domestic regulatory framework. These plans include the creation of an independent Financial Policy Committee at the Bank of England and a new prudential regulator as a subsidiary of the Bank. For detail, see HM Treasury.

the Treasury (the UK's Ministry of Finance) and the Financial Services Authority (FSA), 'the tripartite authorities', to have a role in bank resolution.

It is the FSA which decides if the general conditions are satisfied in order to place a credit institution under the SRR and, in addition, if one of the stabilisation options may apply. Consequently, it is responsible for triggering the SRR as such[74]. The general conditions for exercising a stabilisation power are laid down in section 7 of the Act. This provides that the FSA needs to be satisfied that (Condition 1) the bank is failing or is likely to fail to satisfy the threshold conditions (which allow it to carry on banking business), and (Condition 2) it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions. According to section 7(4), if prior public financial assistance was provided by the BoE or the Treasury, the FSA must treat Conditions 1 and 2 as met if it is satisfied that they would have been met without such assistance.

Thus, it lies within the powers and discretion of the supervisory authority to determine the commencement of the SRR.

The three stabilisation options available to address a situation of financial difficulties are: (a) the transfer to a private sector purchaser; (b) the transfer to a bridge bank; and (c) the transfer to temporary public ownership[75].

The Bank of England is responsible for option (a), the selling of all or parts of the business to a private sector purchaser. It can do so by using one of the two stabilisation powers, that is, the share transfer power and the property transfer power[76]. Consequently, the BoE can effect a transfer to a private sector purchaser via a share transfer instrument or a property transfer instrument[77]. Moreover, it can transfer all or part of the business to a bridge bank (stabilisation option (b)) by using a property transfer instrument[78].

The Treasury is the responsible authority regarding the transfer into temporary public ownership, which it can effect via a share transfer order[79].

In addition to the general conditions which must be satisfied for the SRR to be triggered, the Banking Act 2009 provides for specific conditions which need to be fulfilled in relation to the different stabilisation powers. The BoE and the Treasury are competent to decide whether these specific conditions are met[80].

74 Section 7 of the Banking Act 2009.
75 Section 1(3) of the Banking Act 2009.
76 See sections 1(4), 11, 15 and 33 of the Banking Act 2009.
77 See sections 11, 15 and 33 of the Banking Act 2009.
78 Section 12 of the Banking Act 2009.
79 Section 13 of the Banking Act 2009.
80 See sections 8 and 9 of the Banking Act 2009.

Before the BoE can sell all or parts of the business to a private sector purchaser or transfer them to a bridge bank, it needs to be satisfied[81] that this 'is necessary, having regard to the public interest in (a) the stability of the financial systems of the United Kingdom; (b) the maintenance of public confidence in the stability of the banking systems of the United Kingdom; or (c) the protection of depositors'[82]. If the ailing bank has received financial assistance from the Treasury, these (alternative) conditions are replaced by the (cumulative) conditions that '(a) the Treasury have recommended the Bank of England to exercise the stabilisation power on the grounds that it is necessary to protect the public interest; and (b) in the Bank [of England]'s opinion, exercise of the stabilisation power is an appropriate way to provide that protection'[83]. This demonstrates that in all cases transfer to a private sector purchaser or use of the bridge bank tool must be justified in the public interest.

Before the Treasury is allowed to take a bank into temporary public ownership, it has to be satisfied that this is necessary either 'to resolve or reduce a serious threat to the stability of the financial systems of the United Kingdom' or 'to protect the public interest, where the Treasury have provided financial assistance in respect of the bank for the purpose of resolving or reducing a serious threat to the stability of the financial systems of the United Kingdom'[84]. This demonstrates once again that the legislature seeks to ensure that any interference in creditor and shareholder rights is justified in the public interest.

A particular feature of the UK scheme is that it establishes special resolution objectives which must be considered by the tripartite authorities when using the stabilisation powers, the bank insolvency procedure, or the bank administration procedure[85]. The five special resolution objectives are:

(1) to protect and enhance the stability of the financial systems of the UK;

(2) to protect and enhance public confidence in the stability of the banking systems of the UK;

(3) to protect depositors;

(4) to protect public funds; and

(5) to avoid interfering with property rights in contravention of a right granted by the European Convention of Human Rights.

The articulation of these explicit resolution objectives illustrates that the legislature has taken account of the particular characteristics of banking and recognises the need to protect the banking

81 It must first consult the Treasury and the FSA, see section 8(3) of the Banking Act 2009.
82 Section 8(2) of the Banking Act 2009.
83 Section 8(5) of the Banking Act 2009.
84 Section 9 of the Banking Act 2009.
85 Section 4 of the Banking Act 2009.

function as such and, in addition, public confidence in its continuity. This is the very essence of the special treatment afforded to credit institutions in comparison to other companies and thus provides the legal justification for the special resolution regime as such.

(ii) Balancing public and private interests

In identifying the five special resolution objectives to which the authorities must have regard, the UK scheme transparently addresses the delicate balance to be achieved between the public interest (objectives 1, 2, and 4) and the private interest (objectives 3 and 5). This contributes to the clarity of the SRR and to legal certainty, as the potential conflict between these interests can be dealt with openly and up front. The legislation explicitly states that the objectives are not ranked and that 'they are to be balanced as appropriate in each case'[86]. However, use of the wording 'to protect' in objectives 1 to 4 is stronger than 'to avoid interfering with property rights' in objective 5. The latter wording suggests that such interference is unwanted but nonetheless acceptable if unavoidable in order to reach the appropriate balance.

The Act dedicates a whole part (sections 49 to 62) to compensation. It envisages 'three methods of protecting the financial interests of transferors and others'[87]. The system of compensation is based on orders issued in connection with a share transfer or a property transfer effected in relation to an ailing bank (the transferor) with a view to protecting the financial interests of the transferor (in particular, its shareholders) and third parties (in particular, creditors)[88]. A compensation scheme order will determine whether and, if so, under what conditions compensation is to be paid to the transferor[89] and may include an order for third party compensation[90].

The terms of these orders may provide for the appointment of an independent valuer, whose role is to determine the amount of any compensation payable. According to the legislation, 'independent valuers (and their staff) are neither servants nor agents of the Crown'[91], in other words, they act independently in a personal capacity. Furthermore, the compensation scheme order may specify valuation principles to be applied[92].

86 Section 4(10) of the Banking Act 2009.
87 Section 49 of the Banking Act 2009.
88 Section 49 of the Banking Act 2009 envisages three types of orders, the 'compensation scheme order', the 'resolution fund order' and the 'third party compensation order'.
89 Section 49(2) of the Banking Act 2009.
90 Section 59(2) of the Banking Act 2009. In addition, section 60(1) of the Banking Act 2009 authorises the Treasury to 'make regulations about third party compensation arrangements in the case of partial property transfer'. On the basis of this power, the Treasury has issued the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 which lay down in more detail how the independent valuer will conduct the valuation.
91 Section 55(7) of the Banking Act 2009.
92 Such valuation principles may in particular establish specified methods, specified dates or periods relevant for the valuation, or specified matters to be taken into account or to be disregarded. See section 57(2) of the Banking Act 2009.

A very important element intended to avoid a bail-out of shareholders is the fact that the 'independent valuer must disregard actual or potential financial assistance provided by the Bank of England or the Treasury (disregarding ordinary market assistance offered by the Bank on its usual terms)'[93]. This means that any implicit state guarantee perceived by the market as ensuring a bail-out and thus inflating the market price of the shares has to be deducted by the independent valuer.

Furthermore, the legislation provides explicitly that 'there is nothing to prevent the application of the valuation principles in an order from resulting in no compensation being payable to a transferor'[94]. In other words, it may well be that the valuation results in nil compensation. This is in line with the case-law of the ECtHR[95].

The Banking Act 2009 explicitly refers to the principle of 'no worse-off than in liquidation', stating that in establishing compensation arrangements in the case of a partial property transfer, regard should be had to the desirability of ensuring that creditors left behind in the transferring bank do not receive less favourable treatment in the case of insolvency after the transfer than they would have received had the bank entered into insolvency immediately before the transfer[96].

These provisions make clear that the SRR takes account of the legitimate interests of the transferors and thus their shareholders and respects their property rights, but at the same time leaves no room for a bail-out. This is a good example of how to 'strike a fair balance between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights' as called for by the European Court of Human Rights[97].

It would appear, therefore, that the UK has introduced an exemplary, clear and transparent valuation and compensation regime.

No ex ante involvement of the court is envisaged when resolution measures are adopted. The procedure established by the SRR is purely administrative. This absence of ex ante judicial control has the benefit of saving time in a situation where prompt action is of the essence. A possible disadvantage can be seen in the fact that without ex ante approval by the courts the measure lacks an element of stability, as a court will take an independent view and its approval confers additional legitimacy and hence legal certainty. The chances of an ex post challenge[98] may therefore be increased.

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93 Section 57(3) of the Banking Act 2009, emphasis added.
94 Section 57(5) of the Banking Act 2009.
95 See *Jahn and Others* v *Germany*, paragraph 117.
96 Section 60(2) of the Banking Act 2009.
97 See *Jahn and Others* v *Germany*, paragraph 93.
98 The right of shareholders and creditors to be heard in court is sufficiently safeguarded by this ex post judicial control.

In relation to ex post judicial control of decisions made under the SRR, section 73 of the Act envisages that a share transfer order or instrument or property transfer instrument 'may include provision for disputes to be determined in a specified manner', in particular by conferring jurisdiction on a court or tribunal, or by conferring discretion on a specified person. This demonstrates that even in relation to review by the courts, measures taken under the SRR remain special. In particular, the element of discretion demonstrates that decisions taken can only be successfully challenged if they lack any reasonable foundation (on the basis of the information available ex ante at the time the decision was taken). These hurdles are quite high and make a successful challenge unlikely and, as a consequence, help ensure an effective and stable decision-making process during resolution.

The Banking Act 2009 contains several provisions addressing the problem of (close-out) netting and set-off rights during resolution. Section 22 establishes that a share transfer instrument or order may make provision to the effect that no aspect of such a share transfer may be regarded as a trigger event (default event) with respect to netting, set-off and early termination rights. The same rule applies for property transfer instruments[99]. With respect to partial property transfers, the legislation takes account of creditors' special need for protection given that such a partial transfer can prove disruptive in relation to their set-off and netting rights. It therefore confers a power on the Treasury to restrict such partial transfers and to protect certain interests (e.g. in set-off and netting) by order[100].

(iii) Protecting banking functions

The Banking Act 2009 has two interesting features to protect banking functions (not the institution itself) and thereby to protect the functioning of the financial markets.

The first is the concept of bank administration, defined in section 136. The Banking Act 2009 builds on and extends the scope of this procedure. Under the new regime, the primary objective of the bank administrator, appointed for the purposes of bank administration, is to support the commercial purchaser or the bridge bank, by supplying such services and facilities as are necessary for that party to operate effectively[101]. Only as a secondary objective will the administrator pursue the objectives of 'normal' administration, aiming at the rescue or liquidation of the bank depending on what is more favourable for its creditors. This new support function is clearly designed to enable the smooth transition from the transferor to the private sector purchaser or the bridge bank and therefore to avoid disruptions in banking functions as such.

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99 Section 38 of the Banking Act 2009.

100 Sections 47 and 48 of the Banking Act 2009. The Treasury made use of this power in adopting the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, which is available on the UK legislation website at www.legislation.gov.uk/uksi/2009/322/pdfs/uksi_20090322_en.pdf.

101 Sections 137 and 138 of the Banking Act 2009.

The second feature is the 'continuity obligation', which addresses the need to preserve banking functions and, at the same time, the special situation within a group[102]. It consists of an extensive set of powers conferred on the BoE and the Treasury to interfere in the contractual relationship between the group companies, the (former) member of the group in resolution[103] and the private sector purchaser or bridge bank (both known as transferees). These powers are sufficiently extensive that existing contracts and arrangements can be modified, the transferee can be added as a party to a contract, and rights and obligations can be imposed on group companies and the transferee as if created by contract[104]. It would appear that with such wide-ranging tools in place it will be possible to manage the resolution of the individual bank taking account of its position within the group. As these powers interfere considerably with the rights of other group entities, especially their freedom of contract, they may only be exercised if this is necessary for business continuity and have to be exercised by way of order.

Another element of the Banking Act 2009 addressing the complexity raised by group structures is the power conferred on the Treasury to 'take a parent undertaking of a bank (the "holding company") into temporary public ownership'[105] under certain conditions.

With the introduction of the Banking Act 2009, the legislature has delivered a comprehensive response to the problems arising in bank resolution, addressing many of the critical issues with exemplary clarity. It therefore provides a model for other jurisdictions and for current discussions at the European level. However, certain aspects were not (and in part could not be) addressed at national level, most importantly the problems of cross-border (group) resolution.

Finally, it should be noted that the UK approach to financial regulation – with implications also for the SRR created by the Banking Act 2009 – remains a 'moving target' as it is currently under review and awaiting reform[106].

(b) The special resolution regime in Germany

Following steps taken in the UK, Germany, too, has adopted comprehensive legislation to resolve difficulties in the banking sector.

In the case of Germany, the difficulties encountered by the bank Hypo Real Estate (HRE) and the uncomfortable rescue by the state clearly demonstrated the need for a structural change to legislation. During the HRE crisis it became obvious how paralysed the authorities are in the

[102] Sections 63 to 70 of the Banking Act 2009.
[103] This (former) member of the group is the bank subject to a property transfer or share transfer.
[104] Sections 64 and 67 of the Banking Act 2009.
[105] Section 82 of the Banking Act 2009.
[106] See HM Treasury.

absence of effective resolution tools and powers. The emergency laws adopted in this context[107] did not provide for long-term solutions, but paved the way for a more ambitious structural reform. The Law on bank restructuring was adopted in autumn 2010 and entered into force on 1 January 2011. This law is a piece of omnibus legislation which introduces a new Law on the reorganisation of credit institutions (Kreditinstitute-Reorganisationsgesetz), a new Law establishing a restructuring fund (Restrukturierungsfondsgesetz) and which amends several other laws, most importantly the Law on banking (Kreditwesengesetz).

(i) Voluntary recovery and reorganisation procedures, subject to judicial supervision

The newly introduced Law on reorganisation establishes two voluntary proceedings, one for recovery (Sanierungsverfahren) and one for reorganisation (Reorganisationsverfahren), with only the latter having the potential to interference with creditor or shareholder rights.

In relation to both procedures, the roles of the credit institution itself, the supervisory authority (BaFin)[108] and the Higher Regional Court (Oberlandesgericht) may be summarised as follows:

— The credit institution needs to be proactive as it has to initiate and file for the procedure to be opened by notifying BaFin and, in that regard, it must present a recovery or reorganisation plan and propose a recovery or reorganisation adviser[109].

— BaFin has the authority to evaluate the appropriateness of the procedure and the plan suggested and will – if convinced of its appropriateness – file an application with the court to open the procedure. It can propose a different adviser, if it considers the adviser proposed by the credit institution inappropriate.

— The Higher Regional Court has the authority to take the final decision on whether to open the procedure and approve the plan, which will only enter into force thereafter[110].

As the reorganisation plan underlying the reorganisation procedure may interfere with shareholder and creditor rights, BaFin will only file an application to open this procedure if two conditions are fulfilled. First, the credit institution must face a going-concern risk, and, second,

[107] Law on the Implementation of a Package of Measures to Stabilise the Financial Market (Finanzmarktstabilisierungsgesetz), adopted on 17 October 2008. An English translation of the law prepared by the Federal Ministry of Finance is available on its website at http://www.bundesfinanzministerium.de/nn_128734/DE/BMF__Startseite/Aktuelles/Aktuelle__Gesetze/Gesetze__Verordnungen/Finanzmarktstabi__engl__anl,templateId=raw,property=publicationFile.pdf.

[108] The authority's full title is Bundesanstalt für Finanzdienstleistungsaufsicht, known in English as the Federal Financial Supervisory Authority.

[109] Section 2(2) of the Law on reorganisation makes provision for the proposal of a recovery adviser (Sanierungsberater) and by analogy (see section 7(5)) this applies also to the proposal of a reorganisation adviser (Reorganisationsberater) specified in section 19(5).

[110] Sections 20 and 21 of the Law on reorganisation.

this must result in a risk to the system (systemic risk)[111]. The second condition reflects the fact that the reorganisation procedure is effected in the public interest with a view to protecting financial stability[112]. This is the inherent justification for any potential interference with creditor or shareholder rights necessary in the course of this procedure.

For instance, reorganisation procedures may provide for a debt-to-equity swap, converting creditors' claims into equity and thus diluting existing shareholdings. To ensure that shareholders' property rights are respected, the reorganisation provisions require the credit institution concerned to pay to those shareholders appropriate compensation to be determined by one or more authorised expert proposed by the reorganisation adviser and appointed by the court[113].

The reorganisation plan may also provide for a (full or partial) transfer of assets or liabilities[114] and establish a 'haircut' or moratorium on creditors' claims[115].

The reorganisation plan needs to be approved by the creditors and – to the extent that they are concerned – also by the shareholders. In this connection, the legislative rules allow under certain circumstances for individual groups of creditors and also shareholders to be overruled in any opposition they may have to the plan[116]. Consequently, the consent of an individual group of creditors is deemed to be given if: (a) they are expected not to be worse off as a result of the plan than they would be in its absence; (b) they receive an appropriate share of the proceeds available for distribution under the plan; and (c) the majority of the other groups of creditors have consented. Shareholders' consent is deemed to be given if: (a) the majority of creditors have consented; (b) the measures set out in the reorganisation plan are intended to avoid major negative knock-on effects on other financial sector institutions resulting from the going-concern risk to the credit institution and to avoid any instability in the financial system; and (c) these measures are appropriate, necessary and reasonable.

However, in light of the protection accorded to shareholder rights by the Second Company Law Directive as interpreted by the ECJ, it is uncertain whether this possibility to override shareholder dissent is consistent with EU law. In *Pafitis and Others*, the ECJ held it essential to observe the shareholder rights established under the directive, noting that the directive does not provide for any exception in favour of the public interest in the situation of an urgent need for prompt bank

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[111] See section 7(2) of the Law on reorganisation which refers to the notions of going-concern risk (Bestandsgefährdung) and systemic risk (Systemgefährdung) as defined in the newly inserted section 48b of the Law on banking. An English translation of this provision and excerpts from the Law on reorganisation can be found in Deutsche Bundesbank, p. 65.

[112] This was also highlighted in the explanatory memorandum to the draft law.

[113] Section 9(2) of the Law on reorganisation.

[114] Section 11 of the Law on reorganisation provides for this transfer to be effected to an existing or newly established entity in exchange for shares of this latter entity.

[115] Section 12 of the Law on reorganisation.

[116] Section 19(2) and (4) of the Law on reorganisation.

restructuring which is blocked or at least delayed by shareholders[117]. Such literal interpretation of the directive leads to shareholder rights having priority over the public interest in financial stability. This does not seem appropriate given the manifest public interest at stake.

It is unclear whether the ECJ would maintain the position it took in *Pafitis and Others* in view of the financial crisis. A phrase in the judgment suggests that – even in the absence of an amendment to the directive – there is room for an emergency derogation from shareholder voting rights. The judgment in *Pafitis and Others* rests on the finding that 'the [public] interests at issue can […] be given equal and appropriate protection by other means'[118]. If, however, other means are not available or not sufficient to address the situation of an ailing bank in view of a deep financial crisis and high contagion risk, it would appear that the ECJ is willing to accept the overriding of shareholder rights in order to protect the public interest[119].

As regards close-out netting, set-off, early termination and comparable contractual rights which could be triggered by the reorganisation procedure, the new scheme envisages a temporary stay of such rights[120]. This stay starts with the credit institution filing for the opening of the procedure and lasts until the end of the next business day.

It is not very likely that the new voluntary procedures in the Law on reorganisation will ever be used. The nature of the incentive structure facing an ailing bank does not encourage it to deliberately initiate the procedure. If, in fact, such procedures are initiated, the financial problems become apparent and the risk of a run very real. In addition, the current crisis has shown that the management of banks tends to ignore the gravity of the situation for as long as possible – presumably because it is not appealing to admit failure and more attractive to maintain the hope of recovery.

Nonetheless, one situation in which an application might be made is where BaFin – which itself is not entitled to initiate the proceeding without the consent of the credit institution concerned – exercises pressure and influences the management decision by announcing that it is taking measures under the Law on banking in the absence of the initiation of the voluntary procedure.

However, even where the whole procedure is initiated by a credit institution itself, it does not seem likely that it will lead to effective results, as it is probably too slow. If the whole procedure leading to the adoption of a reorganisation plan is pursued and that plan is approved by a vote of the parties concerned, in order to take effect, it still requires approval by the court[121]. The Higher Regional Court competent to issue judicial approval has up to three months in which to reach a

[117] *Pafitis and Others*, paragraphs 42 and 49 to 51.
[118] Ibid., paragraph 51.
[119] Ibid., paragraphs 50 and 51.
[120] Section 13 of the Law on reorganisation.
[121] Section 20(1) of the Law on reorganisation.

decision – a timeframe which seems unrealistically long in light of the systemic risk created by the ailing bank. Having regard to the fact that time is of the essence in bank resolution, the procedure established by the new Law on the reorganisation of credit institutions appears too burdensome.

(ii) New compulsory resolution powers conferred on the supervisory authority (BaFin)

The new powers inserted into the Law on banking as a result of the reform provide for two different sets of measures. First, they extend the power to order measures in special cases[122] and, second, they provide for a new set of measures concerning credit institutions in the case of dangers to the stability of the financial system (transfer orders)[123].

BaFin may impose measures in special cases if it considers that developments in the credit institution's assets and liabilities, its financial situation or its earnings justify the presumption that it will on a permanent basis not fulfil capital or liquidity requirements. The possible actions it may take in light of this negative assessment are strengthened and include a prohibition on the use of certain accounting devices and on the distribution of dividends, and an order to reduce risk related to certain activities or kinds of business[124]. If capital or liquidity requirements are currently not met, BaFin may request, in addition, the submission of a detailed restructuring plan.

Moreover, BaFin can nominate a 'special administrator', who can take over the management (or parts thereof) of the credit institution by replacing its board[125]. This special administrator may also establish a restructuring plan and prepare a transfer order.

A transfer order is a resolution tool by which BaFin can transfer all or part of the assets and liabilities of a failing bank to a healthy private sector purchaser or to a (publicly-owned) bridge bank which will temporarily take on these assets and liabilities in order to buy time for a private sector solution[126].

BaFin may make such a transfer order provided that two triggers are satisfied. First, the credit institution must be endangered as a going concern (going concern risk) such as to put the stability of the financial system at risk (systemic risk)[127]. Going concern risk is defined as the risk that in the event of failure to take corrective measures the credit institution will collapse as a result of insolvency. Such risk will be presumed if capital or available means of payment fall below a

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122 Sections 45 to 48 of the Law on banking.
123 Sections 48a to 48s of the Law on banking.
124 Section 45(2) of the Law on banking. As a general rule, prior to taking such measures BaFin must give the credit institution an opportunity to correct the deficiencies itself, see section 45(5) of the Law on banking.
125 Section 45c of the Law on banking.
126 Section 48a of the Law on banking.
127 On the definitions of going concern risk and systemic risk established in section 48b of the Law on banking, see Deutsche Bundesbank, p. 65.

certain threshold or such shortfall is expected[128]. Systemic risk is said to arise if the going concern risk of a credit institution could have severe adverse effects on other players in the financial sector, on the financial markets or on the general confidence of depositors and other market players in the operational capability of the financial system[129]. Following consultation with the Bundesbank, it is for BaFin to determine whether such risks are present[130].

Second, the transfer order must be necessary in the sense that no alternative equally secure means are available to respond to the systemic risk[131].

As is the case in the UK under the Banking Act 2009, the Law on bank restructuring provides for the operation of a compensation scheme in the case of a (partial or full) transfer order made by BaFin.

The ailing institution from which the assets and liabilities are transferred (the transferor) will receive compensation if the value of the property transferred is positive. Such compensation will consist in the shares of the acquiring entity, unless this is unacceptable to the acquiring entity or threatens to frustrate the purpose of the transfer order. In that situation, compensation will be made in cash[132]. Any supporting payments from the restructuring fund or government bodies made or proposed to be made with a view to avoiding or overcoming the going concern risk may not be taken into account to the benefit of the transferor[133]. As with the UK regime, this deduction for proposed support appears to ensure that account is taken of potential price distortions resulting from the implicit State guarantee.

Comparable to the independent valuer provided for under UK law, an expert auditor will be appointed to conduct the valuation. If this cannot be achieved in the time available before the transfer order is issued, a preliminary valuation may be made with the final valuation to follow within four months of the issue of the order[134].

The transfer order must specify the methods and assumptions used in determining the valuation. This indicates that a very careful and detailed approach may be adopted to include assumptions concerning influences on pricing and, as a result, can avoid any form of over-compensation and bail-out.

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[128] Section 48b(1) of the Law on banking.
[129] Section 48b(2) of the Law on banking.
[130] Section 48b(3) of the Law on banking.
[131] Section 48a(2)(2) of the Law on banking.
[132] Section 48d(1) of the Law on banking.
[133] Section 48d(2) of the Law on banking.
[134] Section 48d(4) of the Law on banking.

Interestingly, the German legislation also envisages a situation in which the value of the assets and liabilities transferred is negative. In such a case, the transferor has to pay the acquiring entity cash compensation[135].

Legal protection for the transferor is ensured by a right to obtain ex post judicial scrutiny by which it may seek, in particular, an adjustment to the compensation scheme[136].

In the case of a transfer order made by BaFin, the legislation recognises the potential problem that assets (or liabilities) might be governed by foreign law which does not recognise the legal effect of the order. In that case, the legislation imposes an obligation on the credit institution (transferor) to work towards the transfer of those assets by means accepted under the relevant foreign law[137].

A transfer as such may not constitute a trigger event for early termination rights and close-out netting. However, in the case of a partial transfer order, to protect the legitimate interests of counterparties, the legislation provides that the transfer will not constitute a trigger event only where the assets transferred are transferred together with their respective securities and also where all assets covered by netting agreements are transferred en bloc. This is comparable to the position under the UK regime. Both regimes protect creditors against the disruption of their contractual relationships via a partial transfer affecting their set-off and netting rights.

The German SRR inserts certain new provisions into the Law on banking to address the situation within a group and allow a transfer order (designed as resolution tool for individual credit institutions) to be imposed on parent companies, financial holding companies and financial conglomerate holding companies[138].

In that connection, it provides for two situations in which a transfer order may be applied to a parent undertaking or holding within the group. The first situation is where the available capital of the banking group, financial holding group or financial conglomerate covers less than 90 percent of the capital requirements or where such deficiency in cover must be expected in the absence of corrective action. The second situation is where the parent, holding or a subsidiary is endangered as a going concern and, as a result, other group companies are at risk, which, in turn, endangers the system[139].

The legislation also takes account of the cross-border element of groups, providing that foreign subsidiaries, too, are capable of triggering these measures vis-à-vis the parent. Where subsidiaries are registered in another state, it will be presumed that they are endangered as a going concern if capital or liquidity requirements of that other state are not met or insolvency (or comparable)

[135] Section 48d(6) of the Law on banking. This cash claim of the transferee against the transferor has the same insolvency ranking as the liabilities covered by the transfer order.
[136] Section 48r of the Law on banking.
[137] Section 48i of the Law on banking.
[138] Sections 48o, 48p and 48q of the Law on banking.
[139] Section 48o of the Law on banking.

proceedings are imminent and cannot be averted by intra-group asset transfers without endangering other group companies.

These provisions acknowledge that consideration needs to be given to the particular situation within a group. However, no provision is made for effective group resolution. Moreover, the German scheme does not go as far as the UK's regime which allows interference with contractual relationships within the group, forcing group entities to modify, maintain or even create new contractual relationships (see the discussion of the 'continuity obligation' above). In this respect, further reflection appears necessary and is currently underway at European level[140].

An interesting feature of the German bank restructuring legislation is that it addresses potential funding needs in resolution by establishes a restructuring fund which is intended to stabilise financial markets by overcoming going concern and systemic risks[141]. This fund may set up a bridge bank, to which assets and liabilities of an ailing credit institution may be transferred; it may acquire shares in this bridge bank; it may provide guarantees[142] for claims against the transferee (private sector purchaser or bridge bank); and it may recapitalise the transferee, in order to pursue an important objective of the German State which cannot be attained otherwise in a better and more economical manner[143]. The restructuring fund is financed via an ex ante levy from the financial sector, which may be complemented by special ex post contributions where necessary[144].

(c) Comparative summary of the UK and the German approach

The special resolution regimes adopted by the UK and Germany offer helpful tools both to intervene efficiently at an early stage of a banking crisis and to resolve the ailing institution concerned.

A key feature of both regimes is the transparency and hence predictability with which they manage to address the difficult task of balancing the public interest in swift resolution against the private rights, in particular property rights, of creditors and shareholders.

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[140] See Section 3.2 of this paper below.

[141] Section 3 of the Law establishing a restructuring fund. The fund is established with the German Federal Agency for Financial Market Stabilisation (FMSA), a Federal agency which reports to the Federal Ministry of Finance. It manages the restructuring fund and collects the bank levy. For further details see the website of FMSA at www.fmsa.de/en.

[142] Guarantees may be issued to a total of EUR 100bn for which fees must be charged. See section 6 of the Law establishing a restructuring fund.

[143] Section 3(2) of the Law establishing a restructuring fund.

[144] Section 12 of the Law establishing a restructuring fund and the ordinance of 20 July 2011 on the levy for the restructuring fund (Restrukturierungsfonds-Verordnung), BGBl. I, p. 1406. In addition, a loan may be granted by the Ministry of Finance to a maximum of EUR 20bn.

Under both the UK and the German regime, following an ex ante assessment, the resolution authorities may take anticipatory action where this is deemed necessary to protect the public interest.

As regards the tools available, the UK legislation establishes a more comprehensive toolbox, contained in the clear structure of the Banking Act 2009. Although the German regime is more scattered, with provisions located in different laws, in substance, it provides for clear resolution powers. Both regimes offer the possibility to transfer assets and liabilities to a private sector purchaser or to a publicly owned bridge bank (transferee), whilst only the UK legislation provides explicitly for a temporary public ownership option. A considerable advantage of the German legislation is that it offers a solution to the financing of resolution measures, establishing a restructuring fund financed by ex ante levies on the private sector which may recapitalise the transferee or grant guarantees in its favour.

Both regimes contain provisions on compensation, comprising a fair valuation of assets and liabilities by independent experts. An important element of this valuation exercise is the deduction of any state support even where such support is only potential. A key element of fairness is the fact that the principle of 'no worse-off than in liquidation' is respected. The regimes allow for the award of nil compensation, provided that this results from a fair and objective valuation. The German law goes even further and provides explicitly for compensation to be paid by the transferor to the transferee where the total value of the assets and liabilities transferred is negative.

The German law provides for ex ante judicial involvement only in the case of voluntary recovery and reorganisation procedures. In relation to compulsory resolution measures taken by the resolution authority, the court is involved only ex post, as is the case under the UK regime.

Both regimes are unable to adequately address the cross-border and group dimensions of any banking crisis. This runs the risk that these national regimes will be ineffective in relation to SIFIs, as these generally act cross-border and are structured as a group. Therefore, those problems can only be convincingly addressed at the European or international level.

3.2 The responses at the European and international level

(a) European level

Within the EU, insolvency law has been firmly in the clutches of national sovereignty and no harmonisation of the substantive law in this area has taken place. Only procedural aspects of insolvency law have been harmonised at the EU level[145].

The financial crisis has brought the issue of crisis management and insolvency law to the very top of the legislative agenda both at a national and at the European and international level. We are witnessing a crucial phase of legislative action which may prove a valuable window of opportunity.

Given this particular momentum, the European Commission plans to progress in three steps[146]. First, it intends to adopt a legislative proposal for a harmonised EU regime for crisis prevention and bank recovery and resolution. Second, by the end of 2012 it 'will examine the need for further harmonisation of bank insolvency regimes, with the aim of resolving and liquidating them under the same substantive and procedural rules, and will publish a report, accompanied if appropriate by a legislative proposal'. And finally, it will consider 'a third step [which] should include the creation of an integrated resolution regime, possibly based on a single European Resolution Authority, by 2014'[147].

The European Commission is currently working on the first step, the EU framework for bank recovery and resolution. It is expected to present its proposal in December 2011[148]. The details of this framework are already reflected in the Commission's Communication on a new EU framework for crisis management in the financial sector[149] and its consultation document: 'Technical details of a possible EU framework for bank recovery and resolution'[150].

In order to reflect the scope of this paper and in light of the national resolution regimes described above, this chapter will: (i) briefly describe the main elements of the emerging framework before turning to focus on three aspects; (ii) bail-ins of creditors; (iii) temporary suspension of close-out netting and other rights; and (iv) the treatment of groups.

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[145] Of particular importance to the banking sector is the Winding-Up of Credit Institutions Directive (Directive 2001/24/EC) which seeks to establish a single winding-up procedure for a credit institution and its branches (located in other Member States), applying the insolvency law of the Member State where the credit institution has its registered office. This is known as the principle of home country control. For more detail, see Peters, p. 134 et seq.

[146] See European Commission (2011), p. 7.

[147] Ibid.

[148] This was the latest information available when finalising this article.

[149] European Commission (2010).

[150] European Commission (2011).

(i) Outline of the emerging EU resolution framework

The Commission has defined the overriding objective of the EU resolution framework to be the notion that 'ailing institutions of any type and size, and in particular systemically important institutions, can be allowed to fail without risk to financial stability whilst avoiding costs to taxpayers'[151].

In that regard, the Commission envisages that the new framework will be based on seven principles: put prevention and preparation first; provide credible resolution tools; enable fast and decisive action; reduce moral hazard; contribute to a smooth resolution of cross-border groups; ensure legal certainty; and limit distortions of competition[152].

These principles are emphasised in the Commission's consultation document in the context of three phases of crisis management identified. First, the prevention phase, comprising preventative powers such as stress tests, enhanced supervision, resolution and recovery planning and intra-group financial support. Second, the early intervention phase, comprising extended powers under Article 136(1) of the Capital Requirements Directive (CRD)[153] such as recapitalisation, limitation of business, change in management, or enhanced reporting. And third, the resolution phase, comprising the resolution tools and powers such as a sale of business tool, bridge bank tool, an asset separation tool, or a debt conversion or debt write down tool.

A robust and efficient crisis management framework in every Member State, which builds on prevention, early intervention and resolution tools and powers ensuring certain minimum standards and compatibility across Europe, is rightly considered to be of the utmost importance to find a sustainable way out of the crisis. This paper will focus on the third stage covering bank resolution. The effectiveness of the special resolution regimes for financial institutions within the EU Member States will be enhanced the better those regimes interact and, thus, the more harmonised they are[154].

This follows from several factors, the most obvious of which is the cross-border dimension to crisis management especially in the group context. However, inherently national interests also point in favour of strong convergence and harmonisation.

Substantial differences in national bank resolution regimes, in particular in relation to the protection of shareholder and creditor rights, lead to market distortions, forum shopping and an unclear and non-transparent situation across Europe, resulting in uncertainty in the market. This augments the risk of nervousness, volatility and runs, which runs contrary to the (national and

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151 European Commission (2010), p. 3.
152 Ibid., p. 4.
153 Directive 2006/48/EC.
154 The ESCB contribution to the Commission's public consultation also advocates closer harmonisation at the European level, see ESCB, p. 1.

supranational) interest in financial stability. Therefore, an identical (or at least comparable) toolbox of measures and powers, as well as minimum standards for the protection of shareholders and creditors – and thus investors – is to the benefit of the whole system and its stability.

It became apparent during the recent crisis that (financial) problems arising in some jurisdictions, which derive from structural problems in the banking sector, a lack of supervision or insufficient tools and powers to react to a failure of a bank without a bail-out, spread easily across the euro area and Europe as a whole and develop contagious effects. The public interest does not stop at national borders but can only be convincingly protected within the system as a whole. Therefore, the issue of crisis management within the financial sector is a European issue and no Member State will be able to address it comprehensively on its own.

(ii) The bail-in proposal of the Commission

In its consultation document of January 2011[155], the Commission proposes bail-ins as an additional last-resort resolution tool, if the other resolution tools (private sector purchaser or bridge bank; good bank/bad bank split) are not considered sufficient. In order not to distort the market, a very careful phasing-in is proposed, according to which none of the debt existing today may be subject to a bail-in, but only such debt as arises (whether newly issued or rolled over) after the implementation of the regime.

The Commission envisages two alternative approaches – a contractual one and a statutory one. The contractual approach, also described as a targeted approach, proposes that credit institutions be required to issue a fixed amount of debt which can as a matter of contract be bailed-in, i.e. written down or converted into equity if a pre-defined trigger is reached. Consequently, creditors would be required to consent ex ante to the possibility of their claim being written down or converted.

Under the statutory or comprehensive approach, a statutory power would be conferred on the resolution authority 'to write down by a discretionary amount or convert to an equity claim, all senior debt deemed necessary to ensure the credit institution is returned to solvency'[156].

Current developments witnessed in the financial markets demonstrate the need for a transparent and predictable basis of calculation for investors. Consequently, it is crucial not to agitate markets by employing a different regime and approach in each Member State but to develop a single European approach to bail-ins.

One very important element to understand in the context of the bail-in discussion is that it simply addresses balance sheet stability. Using this tool will not release new money nor will liquidity be enhanced. This emphasises what can be achieved and what cannot be achieved through bail-ins.

[155] European Commission (2011).
[156] European Commission (2011), p. 87.

They simply allow for the recapitalisation of the balance sheet without any injection of external capital.

The assumption is that after brushing up the balance sheet, new investors will be found more easily, as the bank looks far healthier, and, in fact, is healthier, as its liabilities will have been considerably reduced. However, it is far from guaranteed that the market will react positively and that investors will be willing to inject fresh money into the credit institution concerned.

Key factors in determining the success of such a bail-in regime will include its compliance with the principles of human rights law governing peaceful enjoyment of property and the predictability of its outcome and, hence, its alignment with the expectations of market participants[157]. However, it would appear that the Commission is considering the possibility to accord resolution authorities the power to discriminate[158].

Discrimination between equally ranked creditors is highly problematic both from the perspective of human rights and predictability. Discriminatory treatment defined as treating essentially identical cases differently or essentially different cases the same is per se not justified by objective differences and, therefore, unduly infringes property rights.

However, the situation could arise where a differentiated treatment of creditors of the same class may be necessary to achieve an optimal result during reorganisation[159]. In such a scenario, the overall outcome in resolution is optimised by not respecting the *pari passu* principle within a class of creditors. In order to achieve the intended positive consequences of such differentiated treatment, it is important that it follows transparent principles and safeguards[160] and that the differentiation is justified by objective criteria. In those circumstances, it will not be discriminatory. In other words, any exceptional deviation from the *pari passu* principle cannot be allowed to build on discriminatory treatment and, in any case, it must be ensured that the principle that creditors cannot be worse off than they would be in immediate liquidation is respected[161]. This differentiated approach shows that the principle of no worse-off than in liquidation functions as a bottom line in the system of creditor safeguards and has to be respected in all cases, while the *pari passu* principle allows for exceptions, provided these are objectively justified and, therefore, non-discriminatory.

(iii) Temporary suspension of close-out netting and other rights

The Commission's consultation document contains a whole part on the temporary suspension of rights to 'enforce obligations against a credit institution under resolution and rights to close out

157 See above Section 2.1(c)(i) and Hüpkes (2011), p. 127.
158 See Question 62b in European Commission (2011), p. 88.
159 Hüpkes (2011), p. 121.
160 See also FSB (2011), *Effective Resolution*, p. 6.
161 See above Section 2.1(c)(i) and Hüpkes (2011), p. 122.

netting, in order to give resolution authorities time to decide which assets or liabilities should be transferred and to effect the transfers'[162].

This encompasses a suspension of any payment or delivery obligations for 48 hours starting at the time when the credit institution enters into resolution[163], or – if this leaves more time – until 5 pm on the business day following the decision to put the credit institution under resolution.

For the same timeframe, the consultation document envisages a power for the resolution authorities to 'impose a temporary suspension of all close out rights of any party under a netting arrangement with a failing credit institution that arise solely by reason of an action or anticipated action by the resolution authority (that is, use of resolution tools or resolution powers)'[164].

When defining which rights may be exercised upon expiry of this temporary suspension, the consultation document differentiates between those 'counterparties whose covered rights and liabilities have been transferred …, and those whose covered rights and liabilities remain with the residual, failed bank'. For the first category, it proposes that 'the transfer and any related action by the resolution authority shall not be treated as a default event (and any term to that effect under a netting arrangement shall be void)'. This would not apply to the second category, as 'if the rights and liabilities covered by a netting arrangement remain with the relevant credit institution, a person may exercise all rights under that arrangement' after expiry of the temporary suspension.

The consultation document envisages also the provision of safeguards in the case of a partial transfer which are intended to prevent 'the transfer of some, but not all, of the rights and liabilities that are protected under a title transfer financial collateral arrangement, a set-off arrangement or a netting arrangement between the credit institution and another person'[165].

These proposals are in line with the recommendations made by the Basel Committee on Bank Supervision's Cross-border Bank Resolution Group (CBRG)[166]. The proposed regime entails considerable change to the current framework of unconditional protection of close-out netting and set off rights and strikes an adequate balance between the interference with these rights necessary for the purposes of effective bank resolution and the necessity of protecting those rights as such.

(iv) The treatment of groups

The issue of groups has not been comprehensively addressed by the SRRs of individual Member States. This is due to a considerable extent to the cross-border dimension of most groups and also to the fact that any national solo attempt risks to distort the market and bring competitive

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[162] European Commission (2011), sections G12 and G13, pp. 64-66.

[163] Meaning the point in time when the suspension 'is notified, and for this purpose it would be treated as notified when the resolution authority makes public its decision'. See European Commission (2011), p. 65.

[164] European Commission (2011), p. 64.

[165] European Commission (2011) p. 69 et seq. This avoids any cherry picking.

[166] See CBRG, recommendation 9 and p. 40 et seq.

disadvantages. Therefore, if solutions are to be found it seems that they will need to be achieved at the European level.

One of the key elements missing at the European level is a clear definition of the notion of a group and of the group interest[167]. The Commission's consultation document and previous communications do not address this problem. Although the Commission acknowledges the lack of a European definition of what constitutes a group and recognises the resulting lack of legal certainty[168], it takes the view that transfers of assets within a group may be a helpful tool to overcome the situation where group entities experience liquidity stress. It proposes that this could be achieved through group financial support agreements, concluded ex ante between the single legal entities of the group.

This idea of intra-group asset transfers where one or more members of the group are experiencing financial difficulties appears appealing, as it looks as if the single legal entity which benefits from the economic synergies and structure of the group will also take responsibility should the situation become difficult. It therefore appears as if the economic benefits enjoyed during normal conditions are counterbalanced by an (economic) responsibility to the rest of the group at a time of crisis. This sounds like a very equitable solution.

However, intra-group financial support agreements do not change the fundamental principle that only the single legal entity (and not the group itself) has legal personality and is able to bear rights and obligations. Therefore, the Commission's proposal goes against the fundamental expectation of market participants when entering into contractual relationships with individual legal entities, namely, that their counterparties only enter into transfer agreements at arm's-length and on commercial terms. The deviation from this fundamental legal principle is likely to cause legal uncertainty for all parties concerned, including market participants doing business with individual entities of the group.

Without a clear concept of group and group interest, this piercing of the corporate veil of the individual legal entities forming the group and the intermingling of their assets lacks an adequate legal foundation. Therefore, the concept of intra-group asset transfers can only be implemented convincingly if, first, there is a clearly defined and legally enforceable concept of a group at the European level and, second, this encompasses a clear definition of group interest, thus providing the legitimacy for such transfers in an individual case.

Even if these conceptual concerns are overcome, doubts may be raised whether in times of crisis, having regard to the financial difficulties facing a group, the transfers envisaged under the current

167 The definition in Article 4(45) of the Capital Requirements Directive (Directive 2006/48/EC) does not provide for a sufficiently clear notion of a group.

168 European Commission (2011), p. 23.

proposals can be executed swiftly enough. The approach proposed relies on a mixture of voluntary (contractual and discretion-based) and compulsory (supervision-based) elements and it remains unclear whether those entities which are still sufficiently healthy to provide assets would commit quickly enough to the role of transferor, as they will still need to take the specific decision to provide support[169]. In overall terms, the multiplicity of procedural steps necessary does not make the transfer easy to implement.

However, even if all of these hurdles can be overcome, the concept of intra-group asset transfers remains unconvincing, as it tries to cure the symptoms of the problems arising in bank resolution in a group context instead of addressing their cause. That cause is to be found in the complexity and interconnectedness of the economic reality of groups and the fact that their economic functioning is not reflected in their legal structure[170]. In light of this reality, intra-group asset transfers could possibly even increase the contagion risk within a group, further reduce the independent capacity of its individual entities and thereby aggravate the problem of entities which are too big, too interconnected and too complex to fail[171]. A more convincing approach, therefore, is not to pave the way for more group but for less[172].

A more promising approach put forward in the Commission's consultation paper is to enhance the burden of supervision and the preparedness for resolution at group level. This serves a dual purpose. First, it ensures that groups are better prepared for a crisis. Second, it incentivises the simplification of group structures, as it will be easier to develop group recovery and resolution plans and, hence, less burdensome within a less complex structure. In this respect, the consolidated supervisory and resolution colleges, modelled on the existing supervisory colleges, will play a major role. In conjunction with the harmonised toolbox of resolution measures in each Member State, this is likely to facilitate crisis management of groups.

(b) The need to address the problems created by systemically important financial institutions at an international level

How can we overcome the paralysis deriving from the systemic relevance of some financial institutions? The problem of SIFIs has been acknowledged at an international level and it is also

169 See European Commission (2011), p. 27. One important criterion missing from the current list (which it is proposed that the transferor should consider when taking this decision) is an assessment of the creditworthiness of the transferee. However, inclusion of this criterion would make it very difficult to predict whether support from the rest of the group would, in fact, be granted, as by definition the transferee is in a situation of financial difficulty and thus under normal market conditions most likely not the most creditworthy counterparty.

170 See Section 2.3 above and CBRG, recommendation 5.

171 Ibid. See also ESCB, p. 3.

172 See Section 2.3 above and CBRG, recommendation 5.

at this level that comprehensive and convincing solutions may be found. This follows primarily from the fact that SIFIs are predominantly characterised by their large size, which generally goes hand in hand with their global activity[173]. Therefore, problems arising for and from SIFIs can only be addressed by a common effort.

A very important step in addressing the risks for the global financial system deriving from SIFIs was taken by the G20 at the Cannes Summit, endorsing a comprehensive policy framework prepared by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) and committing to its implementation[174]. The detailed reports which outline the policy measures endorsed are: (a) the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions[175]; (b) the BCBS's Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement[176]; and (c) the FSB's progress report on Intensity and Effectiveness of SIFI Supervision[177].

With their focus on resolution, the FSB's Key Attributes, in particular, constitute a breakthrough as they set a new international standard for resolution regimes and 'represent a very significant step towards achieving this international policy goal of making too-big-to-fail a thing of the past'[178]. Twelve essential features of resolution regimes are identified, establishing a form of minimum standard to be satisfied by resolution regimes in all jurisdictions[179]. The FSB seeks to encourage the convergence of national resolution regimes through the incorporation of the tools and powers set out in the Key Attributes, and, as a consequence, facilitate the coordinated resolution of firms active in multiple countries.

An important element in achieving such convergence, that is, a level playing field across jurisdictions and sectors, and thus avoiding regulatory arbitrage is to be found in the broad scope of the measures envisaged by the FSB, covering all financial institutions. Resolution is triggered at the point of non-viability or when the firm is likely to be no longer viable, and has no reasonable prospect of becoming so. This aims at a point before balance sheet insolvency and the disappearance of all equity and, thus, also allows for anticipatory action building on an ex ante prognosis. The FSB opts for a broad toolbox of resolution measures, including the replacement/takeover of management, the transfer of assets and liabilities, the setting up of a

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173 See above, Section 2.4.

174 See G20, paragraphs 27 and 28. For a summary of the policy measures see FSB (2011), *Policy Measures*.

175 FSB (2011) *Key Attributes*.

176 BCBS (2011).

177 FSB (2011) *Intensity and Effectiveness*.

178 Statement of Mario Draghi (speaking in his former capacity as chairman of the FSB), see FSB (2011) *FSB issues International Standard*.

179 These twelve features are (1) scope; (2) resolution authority; (3) resolution powers; (4) set-off, netting, collateralisation, segregation of client assets; (5) safeguards; (6) funding of firms in resolution; (7) legal framework conditions for cross-border cooperation; (8) Crisis Management Groups (CMGs); (9) institution-specific cross-border cooperation agreements; (10) resolvability assessments; (11) recovery and resolution planning; and (12) access to information and information sharing.

bridge bank or an asset management vehicle, and a bail-in. The bail-in tool it encourages is intended to facilitate the write down of equity or other instruments of ownership of the firm and unsecured and uninsured creditor claims, a debt-to-equity swap of all or parts of unsecured and uninsured creditor claims, and the conversion or write-down of any contingent convertible or contractual bail-in instruments[180].

The framework envisages that powers will be exercised in a manner which respects the hierarchy of claims 'while providing flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole'[181]. It explicitly commits to the 'no creditor worse off than in liquidation' safeguard and envisages a right to compensation up to this minimum level. Accordingly, the FSB adopts the same differentiated approach advocated above, that is, that the 'no creditor worse off than in liquidation' principle constitutes the bottom line in the system of creditor safeguards and has to be satisfied in all cases, while the *pari passu* principle allows for exceptions, if they are objectively justified and, therefore, non-discriminatory[182].

Moreover, the framework calls on national resolution authorities to undertake resolvability assessments and recovery and resolution planning for G-SIFIs and to develop institution-specific cross-border cooperation agreements. According to the FSB, G-SIFIs should be required to have a higher loss absorbency capacity 'tailored to the impact of their default, rising from 1% to 2.5% of risk-weighted assets (with an empty bucket of 3.5% to discourage further 'systemicness'), to be met with common equity'[183]. In addition, it proposes that all SIFIs will be subject to more intensive and effective supervision.

In establishing its policy framework, the FSB rightly associates the risk created by (G-)SIFIs with higher costs, which follow from higher standards to be satisfied in supervision and resolution, the requirement to take preventive action, such as recovery and resolution planning and additional capital requirements. These costs are part of the solution. Getting the incentives right also means ensuring that market players pay for the risk they create and, thus, have an incentive to become more risk-averse.

All these FSB proposals point in the right direction. They begin to address the problems caused by SIFIs at the international level and seek to ensure that the risks generated by SIFIs are met by the imposition of costs. This should considerably attenuate both the willingness to engage in risky behaviour and the moral hazard problem.

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180 FSB (2011) *Key Features*, p. 9.
181 Ibid., p. 11.
182 See above Section 3.2(a)(ii).
183 FSB (2011) *Policy Measures for SIFIs*, p. 1.

4. Conclusions

The particular characteristics of banking call for special resolution regimes.

The aim of SRR must be to protect the banking function not to protect the banks. Society has a manifest public interest in the banking function but credit institutions as such must be allowed to fail in order to avoid moral hazard and market inefficiencies. In that connection, the complexity in the financial sector calls for special resolution regimes which provide clear resolution tools and powers for the resolution authority to intervene promptly before balance sheet insolvency and to restructure the credit institution concerned in light of its overall funding concept and business plan. Such clear and predictable resolution tools establish up front the right incentives for the financial sector and help preserve market confidence during a crisis as market participants will be able to rely on effective crisis management. This in turn helps avoiding contagion, erosion of value and bank runs. In order to avoid any obligation to bail out an institution at the taxpayer's expense, which might otherwise be the only option to preserve financial stability, the legal certainty that credit institutions can be effectively resolved is essential. The losses incurred in the failure of credit institutions should be borne by its owners (the shareholders) and its creditors.

Property rights do not constitute an obstacle to prompt and efficient bank resolution.

Neither creditors' nor shareholders' property rights hinder the use of crisis management tools provided these are properly designed and applied.

This is subject to three conditions:

— the special resolution regime needs to be clear and predictable in its provision for the possibility to interfere with shareholder and creditor rights;

— there has to be an overriding public interest justifying the interference;

— the interference with property rights has to be proportionate. This entails: (a) that no alternative exists which constitutes a lesser interference and is equally effective in safeguarding the public interest; and (b) that adequate compensation is paid. Where the situation justifies this, shareholders and creditors may be awarded nil compensation. Moreover, creditors and shareholders should have the possibility to obtain judicial review to safeguard their right to due process. This review may operate on an ex post basis.

These conditions need to be reflected in the special resolution regimes for credit institutions. Both Member States and the EU institutions should take this into account when addressing the issue of creditor bail-ins, expropriation and other interferences with property rights in special resolution regimes. This will increase legal certainty for market participants who, as a result, are not obliged to apply risk premiums to cover this uncertainty and avoid market distortion, as it is clear from the outset that credit institutions can be wound down and that no implicit State guarantees are given.

National special resolution regimes are capable of addressing the characteristics of credit institutions at national level.

The UK regime is exemplary in this respect, as it provides an effective toolbox for bank resolution, sets out clearly the objectives of special resolution, and explicitly addresses the protection of property rights. The legislation explicitly lays down the 'no creditor worse-off than in liquidation' principle and includes a whole chapter on compensation. Also the German regime contains prompt and effective resolution tools and arguably provides adequate protection of creditor and shareholder rights. Its major legal disadvantage, in comparison with the UK regime is the fact that it is not contained in one comprehensive statute but dispersed across various laws. Its main advantage is the fact that it addresses the funding of resolution measures through the establishment of a restructuring fund.

National special resolution regimes are unable to convincingly address cross-border and group issues.

Neither the UK nor the German regime offers a convincing solution to cross-border issues and the resolution of credit institutions in a (cross-border) group context. This highlights the very essence of cross-border problems, which can only be comprehensively addressed at a cross-border level, that is, at the European or international level.

The issues posed by groups and cross-border arrangements are often closely connected. In relation to groups, there is an additional dimension, the mismatch between economic and legal reality. This mismatch makes it extremely difficult to address the failure of credit institutions within a group structure, as the group dimension is difficult to reflect in special resolution regimes and insolvency laws. This is because the business lines of the group may not (and, in fact, often do not) match its legal structure. The only legal persons capable of bearing rights and obligations are the individual legal entities. Therefore, they are addressed as the debtors when it comes to a financial crisis.

To overcome this mismatch the most convincing strategy is to pursue a dual approach, combining a better adaptation of legal systems to the reality of groups with a reduction in group complexity. It is of the utmost importance to ensure that the risks that complex groups generate are met with the imposition of costs. This will considerably attenuate the willingness to take unsustainable risk and the moral hazard problem.

SIFIs leverage problems generally faced in bank resolution and, hence, call for bigger solutions.
In this context, 'bigger' refers in particular to geographical scope. What is required is to provide convincing solutions for global players (G-SIFIs) on a global scale. Policymakers seem to have understood that it is crucial that the risks generated by SIFIs are met with the imposition of costs which result, for example, from the imposition of higher capital requirements and stricter protective measures (for example, the preparation of detailed resolution plans). The solutions need to be found at the European and international levels. It appears that these solutions are emerging in real time. Interesting developments took place only very recently (for example, adoption of the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions) and more lie ahead (for example, the Commission's forthcoming proposal for an EU crisis management framework).

Developments at a European level concerning crisis management in the financial sector are of crucial interest as they may constitute a precedent for the development of economic law and policy more generally.
The extreme pressure put on policymakers by the financial crisis and the resulting urgency have triggered policy developments of unprecedented and unimagined speed and size. As substantial issues regarding bank resolution cannot be overcome at national level by Member States, solutions must be found at the European (or even international) level. Not finding such solutions will be incredibly expensive for the EU as a whole and to the disadvantage of each individual Member State.
Therefore, the reforms to the financial sector have the potential to constitute a quantum leap in efficient cross-border management of key issues, in particular in the field of bank resolution and insolvency law. This may evolve into a whole new dimension of efficient cooperation and economic and political convergence. In the field of crisis management, the fact cannot be ignored that we need more Europe, not less.

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