

***The new European framework concerning the
recovery and resolution of credit institutions:
specific issues arising under cross border
circumstances”***



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Abbreviations

BCBS	Basel Committee on Banking Supervision
BRR	Bank Recovery and Resolution Directive
CBRG	Cross - border Bank Resolution Group
CMD	Crises Management Directive
CMGs	Cross Border Crises Management Groups
COAGs	Cross Border Cooperation Agreements
DGS	Deposit Guarantee Schemes
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EFSF	European Financial Stability Facility
ESCB	European System of Central Banks
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
FIs	Financial institutions
FMIs	Financial Market Infrastructures
FSB	Financial Stability Board
G-SIBs	Global Systemically Important Banks
G-SIFIs	Global Systemically Important Financial Institutions
IA	Impact Assessment
IAB	Impact Assessment Board
IMF	International Monetary Fund
LTROs	Longer – Term Refinancing Operations
MIS	Management Information Systems
MoU	Memorandum of Understanding
NPLs	Non – performing loans
OMT	Outright Monetary Transactions
RAP	Resolvability Assessment Process
RRP	Recovery and Resolution Plans
SBRF	Single Bank Resolution Fund
SMEs	Small Medium Enterprises
SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
UNCITRAL	United Nations Commission on International Trade Law
UNIDROIT	International Institute for the Unification of Private Law
WUD	Winding Up Directive

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ABSTRACT

Executive Summary. Failures of internationally active banks some years ago pointed to deficiencies in private and public governance for such banks as Banco Ambrosiano, BCCI, and Barings. As the European Union makes progress toward integrating the financial system within the enlarged EU, the financial safety net has again become a topic of prominent discussion.

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

Purpose. The current essay negotiates the latest developments within the European Union as response to the lessons taught from the recent financial crisis and the corresponding initiatives attempted by the EU Institutions and national regulators to preserve financial stability and foster the coordination among prudential regulators/supervisors, deposit insurance and resolution authorities between EU countries.

Regulators incentives to share information on banks financial conditions and coordinated action in a context of asymmetric information deserve special attention. The paper finally focuses on an extended presentation and analysis of the block buildings of the EU full - fledged integration (i.e. fiscal, economic, banking and political); process that despite the developments already achieved, is still ongoing and requires strong political leadership.

CHAPTER I

1.1 Preamble

The fiscal and financial crisis in the euro area has exposed critical gaps in the architecture of the stability region. In the years preceding the crisis, large capital flows within the euro area fueled the buildup of sovereign and private sector imbalances. The subsequent deterioration of balance sheets and reversal of flows has forced very sharp economic contractions and financial market fragmentation. Borrowing costs of sovereigns and national private sectors have diverged widely and persistently, cuts in monetary policy rates have had limited or no effects in several economies, and adverse sovereign – bank – real economy dynamics have been prevalent across the region.¹

Important measures for near – terms crisis management and longer – term architecture have been undertaken. Adjustment programs are being implemented and progress is being made to unwind fiscal and external imbalances that developed over years. Regional firewalls, The European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), have been created and strengthened to smooth adjustment. The framework for fiscal and economic governance has been enhanced through the “Six Pack” and the Treaty on Stability, Coordination and Governance. The European Central Bank (ECB) has provided substantial liquidity to banks, stepped in to address market strains through government bond purchases, and announced its framework for Outright Monetary Transactions (OMT). The Eurosystem has recycled part of the capital flight from the periphery to the core through the “Target 2” payments balances.²

Europe’s banking system, on the other hand, is an essential element of the “doom loop” but is also harmful in its own right, in a way that predates the sovereign debt crisis.³ Unaddressed banking system fragility, often the result of the bias of many policyholders towards supervisory forbearance⁴, results in a vicious cycle of its own in which banks keep extending credit to insolvent borrowers to avoid the pain of recognizing losses on non – performing loans (NPLs).⁵ The bank’s lending is increasingly absorbed by borrowers who will not repay, while creditworthy new borrowers are starved of credit. Whereas aggregate credit figures may show no evidence of credit contraction, in reality the allocation of credit is increasingly dysfunctional and results in an increasingly severe drag on economic growth, and on employment as a consequence. This perverse spiral has been vividly described as “zombie banks lending to zombie borrowers”, a

¹ See International Monetary Fund (2013): “A Banking Union for the Euro Area”.

² *Ibid*, p 5.

³ See Posen, Adam, and Véron (2009).

⁴ It is considered crucial at this very certain point to highlight that failure to link resolution and supervision can lead to a choice among three unappealing outcomes:

- Disruption of financial markets and the economy at large (if the ECB were not to put a bank into resolution);
- Forbearance (and possibly create an environment in which the failing bank could gamble for resurrection) or;
- Recapitalization of the failing bank through the ESM (and a very large contingent liability for European taxpayers)

Resolution should therefore be considered in the context of its intimate relationship with regulation and supervision on the one hand and emergency liquidity assistance and deposit insurance on the other.

⁵ See European Stability Risk Board (2012): “Forbearance, resolution and deposit insurance”, First Report of the European Systemic Risk Board (ESRB), Advisory Scientific Committee.

metaphor coined in the US S&L crisis⁶ and often applied to the Japanese crisis on the 1990s. Sadly, the same pattern is increasingly recognizable through Europe.⁷

The European banking system has acquired increasing life support from the ECB and national central banks, including Longer – Term Refinancing Operations (LTROs) programs with maturities increased from an initial three months to six months (March 2008), one year (June 2009) and eventually three years (December 2011). The banking fragility then was sharply worsened by doubts about the risks of euro exits or breakup and national supervisory actions that curtailed cross- border financial flows. Several coordinated initiatives, such as Europe – wide “stress tests” in September 2009, July 2010 and July 2011, and a recapitalization effort coordinated by the European Banking Authority (EBA) in 2011 – 12, may have brought marginal improvement but have generally failed to restore normal conditions in the European interbank market following the initial shock of 2007 – 08. The European Commission’s control of state aid⁸ has enabled it to act to some degree as an EU – wide coordination mechanism of Member States’ responses to banking crises, but has been generally able to intervene only at a late stage and in a reactive manner.

Europe’s banking problem has been further compounded by the general willingness of policymakers, particularly in the early years of the crisis, to guarantee all bank creditors and avoid imposing losses to any of them or at least to senior unsecured ones.⁹ However, European policymakers have gradually woken up to the political and practical unsustainability of this approach as it entails spiraling risk – taking by governments and exacerbates the “doom loop” for those countries whose fiscal sustainability becomes questionable. This realization hassled an increasing number of EU Member States (including in chronological order, Ireland, the UK, Denmark, Spain and the Netherlands with SNS Reaal) to force subordinated creditors of failing banks to incur losses.¹⁰

The experience of earlier crises in Europe and elsewhere suggests that the objective of addressing systemic banking fragility and restoring trust can only be achieved through hands – on, centralized approach of system – wide balance sheet assessment (triage), recapitalization and restructuring. The creation of the Single Supervisory Mechanism (SSM) holds the promise of a genuinely consistent triage process, something that the EBA could not achieve as it lacked direct access to bank – level information and supervisory authority of its own. The newfound emphasis on burden – sharing with bank creditors holds the promise of keeping the collective public cost of restructuring at a politically manageable (through probably still high) level, while the prospect of Banking Union should increase the stability properties of the system as a whole, thereby reducing the financial stability risk emanating from the imposition of losses on senior

⁶ See Kane (1987).

⁷ See Directorate General for Internal Policies, European Parliament: “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

⁸ According to the International Monetary Fund (IMF) estimates, crisis related losses incurred by European banks between 2007 and 2010 are close to €1 trillion or 8% of the EU GDP. Between October 2008 and October 2011, the Commission approved €4.5 trillion (equivalent to 37% of EU GDP) of state aid measures to financial institutions. The state aid rules established in response to the financial crisis are available at http://ec.europa.eu/competition/recovery/financial_sector.html.

⁹ See Goldstein, Morris, and Véron (2011).

¹⁰ See Directorate General for Internal Policies, European Parliament: “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

unsecured bondholders. Finally, the proclaimed aim to break the “doom loop” makes it possible to envisage some sharing of residual public financial burden between national budgets and the European level¹¹, with a possible role for the ESM as an instrument of financial risk – sharing.¹²

As a response, a clear and comprehensive bank resolution¹³ regime is, inter alia, crucial for ensuring long term financial stability and for reducing the potential cost of future financial crises. A number of initiatives thus are currently moving the discussion on bank resolution forward. The European Commission adopted a legislative proposal on bank recovery and resolution [the Bank Recovery and Resolution (BRR) Directive]¹⁴ on June 6th, 2012. The harmonization of the European legislation in this area should ensure that future bank failures could be managed with minimum disruption for financial stability and public finances. Given the present diversity in European resolution legislation and practice, the importance of such harmonization cannot be overestimated. The proposal aims to equip national authorities as well as banks with the necessary tools and powers to undertake preparation for future crisis and to address bank failures that cannot be avoided.¹⁵ The proposal also creates mechanisms for cross – border cooperation between authorities and banks in preventative actions as well during resolution.¹⁶

The creation of Resolution Colleges is one concrete way of addressing the coordination problem in resolution of cross – border banks. However, many aspects of the proposed cross – border cooperation arrangements are untested and give rise to a number of issues that need to be further addressed. How should responsibilities and burdens be shared between countries and how should conflicts of interest between countries be dealt with in an efficient and fair manner when they arise? On a conceptual level, the decision

¹¹ See Pisani-Ferry, Sapir, Véron, and Wolff (2012).

¹² See Directorate General for Internal Policies, European Parliament: “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

¹³ “Resolution” means the restructuring of an institution in order to ensure the continuity of its essential functions, preserve financial stability and restore the viability of all parts of the institution at question.

¹⁴ EC 2012d. European Commission (2012, June 6th). Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms COM (2012) available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

¹⁵ The European Commission’s July 2012 proposal on harmonization of national resolution regimes includes a good summary of the basic rationale for resolution mechanisms:

“Banks.....provide vital services to citizens, businesses, and the economy at large (such as deposit taking, lending and the operation of payment systems). They operate largely based on trust, and can quickly become unviable if their customers and counterparties lose confidence in their ability to meet their obligations. In case of failures, banks should be wound down in accordance to the normal insolvency procedures. However, the extent of interdependencies between institutions creates the risk of a systemic crisis when problems in one bank can cascade across the system as a whole. Because of this systemic risk and the important economic function played by institutions, the normal insolvency procedure may not be appropriate in some cases and the absence of effective tools to manage institutions in crisis has too often required the use of public funds to restore trust in even relatively small institutions so as to prevent a domino effect of failing institutions from seriously damaging the real economy.

Accordingly, an effective policy framework is needed to manage bank failures in an orderly way and to avoid contagion to other institutions. The aim of such a policy framework would be to equip the relevant authorities with common and effective tools and powers to address banking crises pre-emptively, safeguarding financial stability and minimizing taxpayers’ exposure to losses.”

¹⁶ See EBCI, Vienna Initiative (2013), “ Observations on Bank Resolution Practices and the EU Proposal”.

making process proposed in the draft directive might lead to an undesirable mismatch between the decision making competencies and responsibility for the fiscal and financial stability consequences of these decisions.¹⁷

1.2 The Status Quo

1.2.1 The Globalization of Financial Institutions¹⁸

Financial Globalization has led to the emergence of a large number of international financial groups. Cross – border banking has expanded rapidly over the last decade. Many large banks currently rely upon a global network of branches and subsidiaries, with centralized funding that is distributed within the financial group under a global strategic plan. The activities of these groups have expanded beyond traditional deposit – taking and lending to include a range of non – bank financial activities, such as securities and insurance brokerage and fund and asset management. In addition to these “universal” banks¹⁹, the international space is now dominated by several large financial institutions that operate across borders, in multiple currencies and time zones, and act as systemically – important nodes within a globalized market for capital.

The globalization of financial services could be attributed to several factors, i.e.

- a. **Financial liberalization.** In recent years many countries have eliminated barriers to the entry of foreign financial institutions;
- b. **Risk diversification.** The opportunity for financial institutions to expand abroad allows them to diversify the risk, reduce reliance on their home markets and seek new business opportunities in overseas markets;
- c. **Servicing key corporate clients.** As corporations have expanded abroad, large banks have followed them to support and profit from their expansion plans;
- d. **Brand value in emerging markets.** An internationally – recognized “brand” with a local presence in foreign markets can rapidly gain market share abroad.

The legal form of a complex financial group may not always reflect the economic substance or operational functions of that group. Several different factors may influence its structure and organization that supersede legal considerations, i.e.

- a. Commercial factors / operational efficiency²⁰

¹⁷ *Ibid*, p 2.

¹⁸ See International Monetary Fund (2010): “Resolution of Cross-Border Banks – A Proposed Framework for Enhanced Coordination”.

¹⁹ “Universal” bank in this sense refers to the wide range of financial sector activities, irrespective of the international reach of the group.

²⁰ See Herring and Carmassi (2010) that provide an exhaustive discussion and analysis of the financial structure of large complex financial institutions, the different possible motives and the implications that their complexity may have for systemic risk and safety and soundness. They present interesting tables on the operations of the 16 Large Complex Financial Institutions as of year - end 2007 that were identified by the Bank of England (2007) and other international regulators. Citigroup, for example, was shown to have over 2400 majority owned affiliates and subsidiaries including 101 bank subsidiaries, 35 insurance companies, 706 mutual and pension funds and other similar entities, 584 other subsidiaries including private equity and 1009 non- financial subsidiaries.

In terms of possible motives for organizational complexity Herring and Carmassi (2010) consider several different but important dimensions including: the need to mitigate asymmetric information between

- b. Separability / location of assets²¹
- c. Regulatory factors^{22,23}
- d. Tax treatment²⁴

Under certain circumstances, a financial group may effectively function as a single entity – in particular where a guarantee has been issued by the parent for the components of the group. As a result of the interconnectedness of the financial group’s legal entities, weaknesses in one entity can adversely affect the entire group. In group structures where liquidity is centralized, any sudden and material downgrading of the central entity’s credit ratings or the opening of insolvency proceedings against it would lead to the immediate illiquidity of the other entities of the group.²⁵ The triggering of cross default or cross guarantee arrangements for funding purposes as a result of rating downgrades or otherwise may also lead to financial distress in other parts of the group.

Moreover, the scale of activity or size of an international financial group may create systemic risks for either the home or the host jurisdiction when such groups enter into financial distress. Certain branches or subsidiaries, in economic terms, comparatively insignificant to a group, may yet be of critical importance to their host country’s financial system. In the case of a subsidiary in this position, its legal separateness may as a legal matter permit parent banks to simply “walk away”, should the subsidiary encounter difficulties, irrespective of the impact on the host country economy. However, “abandoning” a subsidiary in such a manner would involve reputational risk and could be counterproductive for the stability of a financial group.

shareholders and managers; the desire to avoid customer concerns about potential conflicts of interest; the ability to segment internal agency problems; reducing transaction costs; the consequence of legacy mergers and acquisitions etc.

²¹ For example, domestic Swedish deposits supported the expansion of Swedish banks in the Baltic region, and similarly, much of Dexia’s lending to French regional governments was funded using Belgian deposits.

²² Regulatory incentives historically have played major roles adding to the complexity of a financial firm’s structure. In the U.S. for example, restrictions on the commingling of banking and commerce and restrictions on interstate banking were major factors giving rise to the multibank holding company. For a detailed history and discussion see Fischer (1986).

²³ As per the regulatory implications, Jones (2000) also provides an interesting discussion of the methods that have been used to avoid capital adequacy constraints by banking organizations. He describes three techniques designed (a) to concentrate risk into derivative instruments that have lower measured risks and hence lower capital charges than the original assets, (b) to structure transactions that are treated by the capital standards as direct credit risks subject to an 8% capital requirement as assets sold with recourse that may have a lower dollar – for – dollar capital requirement and (c) to convert direct credit risk exposures into contractual arrangements such as standby letters of credit or other credit enhancement that may have no capital requirement at all. This latter technique gave rise to the SPVs that would purchase loans or other assets, taking them off the bank’s balance sheet, but obtain credit enhancements such as letters of credit or credit default swaps. Such techniques clearly enhance the ability of institutions to increase their effective leverage immensely.

²⁴ Tax considerations also played a major role in the formation of a bank holding company. In particular, dividends up – streamed to a parent holding company were tax deductible, which meant that debt at the parent holding company could be used to acquire banks and debt could be paid with pre-tax dividends up-streamed from subsidiary banks. This made the holding company form especially desirable for expansion- minded institutions.

²⁵ The knock – on effects on subsidiaries of Lehman Brothers, is perhaps the clearest illustration of the problem in the context of non- bank financial institutions.

1.2.2 Localized Resolution Frameworks²⁶

While international financial groups operate globally, the frameworks for addressing their distress and failure are local and apply to distinct parts of the group rather than to the group as a whole. By allowing financial institutions under supervision to establish presences in a range of jurisdictions, home authorities expose themselves to the reality that the legal frameworks for facilitating cross – border finance in stable periods are typically more effective than the cross- border resolution arrangements that are available in times of distress.

While the fragmented approach is due to a number of factors, a fundamental reason is the fact that resolution frameworks are established by national law and, absent the cooperation of the national authorities of other jurisdictions, are only enforceable vis – a – vis those institutions – or branches of institutions – operating in their territory.²⁷ In the absence of an international legal framework that empowers a supranational entity to resolve global institutions, the resolution of such institutions are subject to different national frameworks and, accordingly national authorities must proactively coordinate their actions to avoid the significant costs of an uncoordinated approach.

Moreover, the legal frameworks of many jurisdictions do not sufficiently facilitate coordination. National frameworks in certain jurisdictions do not sufficiently empower their supervisors or the relevant resolution authorities to share information with their counterparts in other jurisdictions. In the context of an ailing bank, the ring fencing of assets by host jurisdictions may undermine an effective resolution.²⁸ Home country official administrators may face difficulties in having certain recovery operations, such as “purchase and assumption” transactions, implemented in the host jurisdictions of bank branches.

Effective coordination is also hampered by the absence of a minimum level of harmonization.²⁹ National legal and regulatory frameworks often differ in key areas. In the context of bank insolvency, there is no universally – agreed approach to such questions as the triggers for the commencement of the insolvency proceedings or the powers available to the supervisors to deal with an insolvent bank.³⁰

²⁶ See International Monetary Fund (2010): “Resolution of Cross-Border Banks – A Proposed Framework for Enhanced Coordination”.

²⁷ The weakness of many countries’ bank insolvency frameworks go beyond questions of cross – border cooperation and include other areas, including the powers of the supervisors to take prompt and effective action to restructure a failing bank.

²⁸ This issue has arisen in nearly every significant failure of a large financial institution; as a result, many countries require sufficient assets to be held where they can be ring fenced in the event of a bankruptcy. See Eisenbeis (2006), and Eisenbeis and Kaufman (2005) for a discussion of this problem.

²⁹ The national legal frameworks of cooperating countries for recovery and resolution will need to have common rules on: (a) Non – discrimination against Foreign Creditors (b) Appropriate Intervention Tools (c) Appropriate Creditor Safeguards (d) Robust Rules on depositor Priority.

³⁰ The differential impacts of various insolvency regimes have concerned financial authorities and market participants for some time, and movement in conforming insolvency regimes has occurred, most notably the repeal of the “zero hour” rules unwinding payments activities in Europe and efforts sponsored by the International Institute for the Unification of Private Law (UNIDROIT), the United Nations Commission on International Trade Law (UNCITRAL) and the Hague Securities Convention to harmonize or bridge differences in insolvency arrangements.

Even where there is a minimum degree of harmonization, the multiplicity of regulatory actors may impede coordination. A financial group (whose activities might cover a range of separately regulated banking and non-banking activities) would potentially be subject to oversight from a number of different competent authorities, even at a purely domestic level. Not surprisingly, in the context of an international financial group, overlapping competencies and difficulties in discerning the scope of various national supervisors' responsibilities are amplified.

Finally, and perhaps most importantly, when the regulatory authorities are faced with the distress or failure of financial institution within the territory, they tend to give primary consideration to the potential impact on their own stakeholders: namely, creditors to branches or subsidiaries located within their jurisdiction, depositors and, in the final analysis, local taxpayers.³¹ In these circumstances, national priorities translate into a "territorial" approach³² that effectively precludes coordination: where in the event of failure of a domestic branch of a foreign bank, local assets are "ring – fenced" for the benefit of creditors to the branch. The practice of ring – fencing is geared to favoring the interests of depositors and creditors to a bank's local presence to the detriment of

³¹ See Herring (2007) in Evanoff, LaBrosse and Kaufman (eds).

Motivated and guided by such objectives, national authorities typically only take into account externalities in their own financial system while cross-border externalities are often ignored (See also Schoenmaker and Oosterloo 2005). Consequently, we conclude with globally inefficient outcomes, as several theoretical analyses illustrate (See for example Freixas, 2003 and Schoenmaker, 2011).

It is also worth mentioning that the Freixas – model of cross-border externalities provides also the theoretical foundation for the financial trilemma, i.e. the impossibility of achieving the three policy objectives in an environment with globalized financial markets: maintaining global financial stability, fostering cross-border financial integration and pursuing national financial policies, especially supervision. Any two of the three objectives could be combined with relative ease, but it is difficult to achieve all three. The financial trilemma forces policy makers to making a choice. For instance, the financial stability objective could possibly be pursued with national financial policies and supervision but only at the expense of further integration. The resulting fragmentation of the single market is however clearly at odds with the EMU framework and the requirements of the single monetary policy. Similarly, financial stability cannot be safeguarded as financial integration progresses (with an even greater degree of interconnectedness between financial institutions and markets) and financial sector policies remain a strict national competence. Pursuing financial stability and integration as joint objectives requires true European level policies. This is particularly illustrated in an ECB working paper No 245 by Holthausen and Ronde (2004) showing that with increasing financial integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare, while not taking into account externalities of their supervisory practices on other countries. This leads to an under-provision of financial stability as a public good. From a different perspective, Goodhart and Schoenmaker (2009) illustrate, both in a model and using European data, that a coordination failure emerges when ex-post coordination among different national supervisors leads to an under-provision recapitalisation of cross-border banks after a banking problem.

³² Territoriality: Many countries follow some form of "territorial" approach, under which a host country will initiate separate insolvency proceedings against a foreign debtor, instead of participating in, or deferring to, the insolvency proceeding triggered by the home country.

stakeholders in other jurisdictions.^{33, 34} In contrast universality³⁵ implies no ring fencing and instead would place all similarly ranked international creditors on an equal footing.³⁶

Although the national focus of resolution frameworks appears at odds with internationally coordinated supervisory frameworks, a thorough examination would reveal that even these supervisory frameworks are shaped by national concerns. Moreover, the implementation of such frameworks by some countries anticipates the ring fencing approach that relies on during the resolution phase.

This focus on national interest is also reflected in the mandates of many financial supervisors. With important exceptions (such as the EU ambient), these mandates

³³ To the extent that an objection to ring fencing is based on the unsettling of third party expectations, the concern is sharper where the practice of ring – fencing is ad hoc (for example where it is in response to a particular crisis situation rather than of a pre-established legal and supervisory framework).

³⁴ It should also be highlighted that even with ring – fencing, domestic agents will still have either excess savings to lend abroad or borrowing needs to finance externally. It is not clear thus how ring – fencing would affect such transfers, but it could lead to a shift in international intermediation to capital markets and shadow banks. The implications of this for risk management and appropriate regulation need to be taken into account in assessing the systemic impact of ring – fencing.

³⁵ Universality: Under a “universal” approach, the insolvency proceedings initiated against the debtor in its home country will purport to have “universal reach”. This implies that the home country trustee will seek to gain control over all the debtor’s assets and liabilities, including those located in other countries, to realize all assets and pay out the resulting proceeds to both domestic and foreign creditors according to their ranking. To be effective, universality of the home country depends on different host countries recognizing this extra-territorial effect of the home country proceedings. Such recognition is, however, far from evident.

In the EU/EEA, the European Directives on the Reorganization and Winding up of Credit Institutions of 4th April 2001 and of Insurance Undertakings of 19th March 2001, under which EU/EEA incorporated credit institutions and insurance undertakings are resolved under the law of the home EU/EEA jurisdiction, are based on the principles of unity and universality. These authorities of the home country are solely entitled to decide on the adoption of reorganization measures or the opening of winding up proceedings in application of the home country’s laws. The authorities in EU/EEA host countries (where branches or assets are located) must recognize the effects of these measures, without being able, on their part, to take reorganization measures locally or to open territorial insolvency proceedings against the branch offices set up in their territory. It is also considered that this EU approach modified the doctrine of universality, since it does not apply to non EU/EEA incorporated financial institutions or EU branches of non EU banks.

³⁶ These two specific approaches, i.e. universality vis territoriality are not absolute. Several countries have insolvency regimes with mixed features. For instance, the EU Winding Up Directive (WUD) follows an EU – wide “universal approach” for EU banks, but member states are free to maintain a “territorial” approach to branches of extra – EU banks.

In practice, the resolution of cross-border institutions is pragmatic and not based exclusively on either of the two principles. For example, in practice, many national authorities have chosen to respond to the potential collapse of EU/EEA incorporated financial institutions not by resorting to the insolvency and reorganization procedures under the framework of the European Directive on the Reorganization and Winding up of Credit Institutions but by pursuing other rescue and resolution measures. Similarly, other national authorities have applied a cooperative territorial approach by providing funding and guarantees proportionate with each authority’s national interest in order to provide time for a cross-border institution to access financing and restructure operations. Many systems combine these two approaches. Following the practice of mitigated or modified universality, embodied by the EU Insolvency Regulation of May 29th 2000 (which does not generally apply to financial institutions), the jurisdiction of the EU member state where the debtor’s domicile or center of main interests is situated, has principal competence to initiate insolvency proceedings (referred to as “main insolvency proceedings”). At the same time, the Regulation authorized other member states to open territorial proceedings (referred to as “secondary insolvency proceedings”) if the debtor has an establishment (e.g. a branch) there. A consolidated account of payments to creditors within the EU is drawn up to ensure that creditors receive equivalent payments.

typically emphasize the need to protect financial stability at the national – and not the international – level. Hence, when a group becomes distressed, the national supervisory authorities are likely to focus on domestic interests.

Corresponding with skepticism to the supra mentioned localized approach, the finance ministers of the Member States, agreed at the ECOFIN Council of June 27th 2013 on a General Approach on the draft Directive establishing a framework for the recovery and resolution of failing banks. The warmly welcomed agreement opens the way for trilogue negotiations between the Council, the Commission and the Parliament with the aim of finalizing the Directive at first reading before the end of the year³⁷.

The proposed Directive is aimed at transposing into EU law commitments made at the G20 summit in Washington DC in November 2008, when leaders called for a review of resolution regimes and bankruptcy laws “to ensure that they permit an orderly wind – down of large complex cross – border financial institutions.”

Critically, a harmonised rulebook is established for how the costs of bank failure are allocated, starting with bank shareholders and creditors, and backed by financial support from resolution funds sourced from the banking sector and not taxpayers. The proposed Directive safeguards the integrity and unity of the Single Market, since it results to the alleviation of divergence in the fundamental concepts of the framework between Member States. Banks in all Member States will be subject to harmonised provisions governing how resolution is carried out and how the costs shall be shared. No Member State will be able to subject banks to less onerous resolution arrangements, based for example on its fiscal strength. As a result there will be no discrimination between investors in the EU and fragmentation in funding conditions for banks operating in various Member States will decrease. A degree of necessary flexibility to carve out certain categories of creditors in order to protect financial stability has been provided to national resolution authorities, but it is sufficiently framed so that the integrity of the Single Market is not undermined.³⁸

1.3 Lessons taught from the financial crisis 2007 – 2009 ³⁹

³⁷ Based on article 114 of the Treaty on the Functioning of the European Union (TFEU), the Directive requires a qualified majority for adoption by the Council, in agreement with the European Parliament.

³⁸ See Statement of Commissioner Barnier following agreement in ECOFIN on bank recovery and resolution, MEMO /13/601 (June 27th 2013).

As the Commissioner stated, “there is an inextricable link between how much capacity there is within a bank to allocate losses to shareholders and creditors, how much flexibility is given to exclude one or other creditor from having to bear losses, and how much money has to be available in resolution funds sourced from the banking sector to cover any shortfall. Fortunately, the outcome ensures an appropriate equilibrium between these variables.”

³⁹ It should be noted that the Basel Committee asked the Cross - border Bank Resolution Group (CBRG) to report on the lessons from the crisis, on recent changes and adaptations of national frameworks for cross-border resolutions, the most effective elements of current national frameworks and those features of current national frameworks that may hamper optimal response to crises. In doing so, the CBRG was requested to prepare a set of options addressing the problems with special reference to the following areas:

- The current legal and policy framework for cross – border crisis management and resolution mechanisms as applied in the current crisis;
- Analysis of the implications of the failure of a global player;

The global financial crisis which commenced in August 2007 illustrates the importance of effective cross-border crisis management. The scope, scale and complexity of international financial transactions expanded at an unprecedented pace in the years preceding the crisis, while the tools and techniques for handling cross-border bank crisis resolution have not evolved at the same pace. Some of the event during the crisis revealed gaps in intervention techniques and the absence in many countries of an appropriate set of resolution tools. Actions taken to resolve cross-border institutions during the crisis tended to be ad hoc⁴⁰, severely limited by the constraints, and to involve a significant amount of public support.⁴¹

The experience demonstrates hence the renewed urgency to the need for resolution systems for financial institutions, which both safeguard financial stability and limit moral hazard.⁴² Since many systemically important financial groups operate globally,

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- The effect of measures to protect domestic shareholders' interests and limit cross-border contagion (ring fencing) on bank crisis management and resolution in the current crisis;
 - The effect of current legal and policy approaches on cross-border financial transactions in the crisis and;
 - The potential for development of more consistent legal and policy frameworks for dealing with financial groups.

Thus, the CBRG compiled in March 2010 the Report and Recommendations of the Cross-border Bank Resolution Group as a product of its stocktaking of legal and policy frameworks for cross-border crises resolutions and its follow-up work to identify the lessons learnt from the financial crisis which began in August 2007. The report incorporates 10 explicit recommendations concerning:

- Effective national resolution powers;
- Frameworks for a coordinated resolution of financial groups;
- Convergence of national resolution measures;
- Cross-border effects of national resolution measures;
- Reduction of complexity and interconnectedness of group structures and operations;
- Planning in advance for orderly resolution;
- Cross-border cooperation and information sharing;
- Strengthening risk mitigation mechanisms;
- Transfer of contractual relationships;
- Exit strategies and market discipline.

⁴⁰ I.e. in the UK, emergency legislation enabled the resolution of several banks through nationalization, the transfer of deposits and assets to third parties and the establishment of bridge banks; the time-limited emergency legislation was subsequently replaced with a new statutory special resolution regime. In the US, emergency legislation enabled the purchase of troubled assets from financial institutions (FIs). Germany recapitalized banks with state funds and restructured them, including by transferring bad assets to assets management companies through a newly established agency that provided the necessary funding and acted as umbrella for the assets management companies. The Netherlands adopted legislation for the recapitalization or transfer of assets and liabilities of banks or insurers to another FI or a bridge institution and the intervention in a parent or holding company. The Swiss authorities reinforced the capital base of a systemic bank by subscribing to mandatory convertible notes and financing the transfer of some of the bank's illiquid assets to a special purpose vehicle; these actions were implemented through emergency legislation. France adopted legislation allowing state financial support to be provided to FIs. Russia adopted a special resolution regime for systemically important banks empowering the deposit insurer to provide capital and liquidity support. Spain adopted legislation establishing a new resolution authority with the power to recapitalize and restructure banks; several smaller banks were granted capital and liquidity support, and were sold to other banks with assistance from the resolution authority in the form of asset guarantees and capital and liquidity support. See respectively Financial Stability Board (2013): "Thematic Review on Resolution regimes".

⁴¹ See Basel Committee on Banking Supervision (2010): "Report and Recommendations of the Cross-border Bank Resolution Group".

⁴² The first generation of resolution regimes, exemplified by the US FDIC receivership and the UK's Banking Act 2009, provide an alternative to standard bankruptcy law, under which ordinary private law

an uncoordinated application of resolution systems by national authorities will render more difficult both to secure the continuity of essential functions (thereby limiting contagion), and ensure that shareholders and creditors bear the financial burden of the resolution process.

A viable and commonly understood process for resolving cross-border financial institutions may additionally support market discipline by encouraging counterparties to focus more closely on the financial risks of the institution or group and by holding to account, where appropriate, senior managers and directors. Discipline is enhanced in case that the market participants clearly perceive that authorities are willing and able to effectuate a managed resolution of a financial institution.⁴³

The assumption, and reality, on the other hand, that some institutions are “too big” or “too interconnected to fail” has introduced additional risk and a greater likelihood of cross border contagion into global finance, whereas an important consideration concerning national resolution frameworks for cross-border financial firms is to reduce reliance on (implicit or explicit) public support.⁴⁴

The absence of a multinational framework for sharing the fiscal burdens for the financial crisis is considered, along with the fact that legal systems and the fiscal responsibility was nationally orientated, inter alia, a fundamental problematic to be confronted. National authorities tend to seek to ensure that their constituents, whether taxpayers or member institutions underwriting a deposit insurance or other fund, bear only those financial burdens that are necessary to mitigate risks to their constituents. Under the circumstances of a cross-border crisis or resolution, this assessment of the comparative burdens is complicated by the various perceptions of the impact of failure of a cross-border institution and the willingness or ability of different authorities to bear a share of the burden. This assessment will also be affected by additional parameters, i.e. whether the jurisdiction is the home country of the financial institution or group, or if a host, whether the institution operates through a branch or subsidiary. As per the host countries, assessment shall be affected by asset maintenance, capital or liquidity requirements that may be imposed on branches or subsidiaries. Other considerations, such as the availability of information and the available legal and regulatory tools for

rules are suspended so as to facilitate an overnight transfer of both assets and liabilities to another institution. This type of procedure was originally conceived in order to protect depositors: the key goal was to move deposit liabilities (along with asset backing) to a solvent institution overnight and thereby avoiding triggering a bank run. However, where the channels of contagion are other than through the prospect of a depositor panic, expedited transfer powers may not be enough.

In cases though that it is desirable to keep troubled financial institution a “going concern”, transfer powers alone would not be sufficient, because any transferee institution (a) faces a very severe adverse selection problem and (b) is likely to be suffering liquidity constraints of its own. Consequently a second generation of resolution regimes has been sought. The idea is that recapitalization by writing down claims of the troubled institution’s existing creditors would facilitate continuation and consequently avoid contagion through the fire sales of assets and even greater creditor write downs that would occur otherwise.

⁴³ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

⁴⁴ *Ibid.* It is crucially important to recognize that, as vital as prudential measures may be in controlling the likelihood of relying in public support, such measures cannot limit the potential for increased moral hazard without instituting, inter alia, a viable resolution for cross-border financial institutions.

intervention, must also be evaluated and shall further complicate the assessment of burdens.⁴⁵

Under an objective – orientated overview of the crisis that erupted in August 2007, we conclude that various jurisdictions had a broad assortment of tools.⁴⁶ In many cases current powers were not fully used due to the absence of adequate time or the perceptions that the frameworks were inadequate. Indeed, the unfolding of events in a very short timeframe revealed that certain powers and tools that were not available would have been helpful in such a fast moving crisis. For example, in the United States, no one agency had the authority or the powers to resolve all the significant entities in the Bear Stearns, Lehman Brothers, or AIG groups. A special resolution regime with power to address systemic risks covered banks with deposit insurance in the United States but non- banks were subject to the general bankruptcy law, which did not provide for such special powers. Moreover, existing tools, such as bridge bank authority, were either not used because there was insufficient time or, were not available under the applicable laws for non – banking financial entities.⁴⁷

The tools and programs for national and international crisis management of markets and financial systems are far broader than those for the resolution of domestic and cross-border institutions. During the recent crisis, central banks and ministries of finance instituted a variety of liquidity support and other programs designed to promote lending in otherwise gridlocked markets, to promote recognition of asset valuations and to stabilize financial systems and foster economic recovery.⁴⁸

Under a pragmatic approach evaluation of the crisis, we realize that private sector resolutions were achievable for parts of Bear Stearns, Lehman Brothers, Fortis and the Icelandic Banks only with government support and assistance. Severe market turmoil driven in large part by significant uncertainty regarding the financial condition of, and future prospects for, many large internationally active banks propelled a significant deleveraging and a retrenchment of these and other banks from taking an additional risk. As the crisis developed, the deteriorating conditions precluded mergers or expansion by many institutions. Moreover, the Bear Stearns, Lehman Brothers, Fortis and the Icelandic Banks situations developed rapidly, leaving little or no time for shareholder approvals. The Icelandic crisis also revealed how limitations of national resources can affect the ability of national authorities to respond to a crisis involving financial institutions that had become “too big” for the home jurisdiction to provide effective consolidated supervision or to take necessary crisis management and resolution actions. Cross – border expansion can create its own risks of undamaged growth in the absence of effective supervision by home authorities.⁴⁹

In certain of these cases, the valuation of assets and liabilities proved as much of an obstacle to private resolutions as the time constraints. Banks were unable or unwilling

⁴⁵ *Ibid*, pp 8 - 9.

⁴⁶ See Claessens et al (2010) that review several major cross-border bank failures, in order to examine (i) the causes of the failures; (ii) the reasons for international cooperation, or the lack of it; (iii) the inadequacy of national resolution powers, and (iv) the impact on global financial stability.

⁴⁷ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

⁴⁸ *Ibid*, p 9.

⁴⁹ *Ibid*.

to sell problem assets due to uncertainty over market prices and, in some instances due to an unwillingness to incur the write downs likely to occur once a market price was established. Private resolutions were also thwarted by a dearth of potential buyers resulting from the industry's perceived need to preserve capital and liquidity in light of an uncertain future.⁵⁰

When banks like Fortis, Icelandic banks, Lehman Brothers, Anglo Irish Bank, Dexia, CajaSur, HBOS, RBS, Lloyds or BayernLB were hit by the financial crisis, they faced potential collapse and also posed a threat to their national financial systems and to the overall economy.

Specifically, in the case of the Icelandic Banks, the absence of early intervention prevented an early and less costly resolution, while the lack of adequate cooperation between relevant authorities resulted in banks' assets being ring-fenced. The country's deposit guarantee scheme was not adequately financed and hence could not sustain pay-outs for insured depositors.⁵¹

In the case of Fortis, on the other hand, the absence of burden – sharing arrangements between parts of the group located in various countries ultimately resulted in the group being split along national lines.⁵²

The chaotic way in which Lehman Brothers was placed into bankruptcy led to a significant loss of value for unsecured creditors and caused uncertainties about the location and return of client assets. This case highly demonstrates the failure of cooperation and information – sharing at a crucial timing, i.e. insolvency. The case also illustrates the difficulty of ring – fencing assets in practice.⁵³

The lack of effective resolution tools in the case of Anglo – Irish and Icelandic Banks highlights the possibility that the financial difficulties of a certain bank could drag the whole country into recession. Furthermore, the losses incurred by banks, such as Dexia, could have been covered by bailing in shareholders and creditors rather than employing public funds.⁵⁴

At the very specific timeline that banks like Fortis, Lehman Brothers, Dexia etc were rescued by the taxpayers, state support was the only prompt and credible solution available. However, it was clearly evidenced that bailed out / “zombie banks” do not exercise lending activities.⁵⁵

To conclude with the specific figures orientated analysis, we should mention the example of Bradford & Bingley which actually illustrates the alternative path. When in 2008 hence the FSA determined that the bank no longer met threshold conditions, the UK authorities took Bradford & Bingley into temporary ownership. Thanks to extensive prior contingency planning, the UK was enabled within limited timeframe to

⁵⁰ *Ibid.*

⁵¹ See Bank Recovery and Resolution Proposal: Frequently Asked Questions, MEMO /12/416 (June 6th 2012).

⁵² *Ibid*, p14.

⁵³ *Ibid.*

⁵⁴ *Ibid.*

⁵⁵ *Ibid*, p15.

auction off Bradford & Bingley's retail deposits, branches and associated systems. The Bradford & Bingley branches operated as usual with no interruption in services conducted.⁵⁶

Another example that should be noted is the case of Denmark's Amagerbanken. Early in 2011, the Danish Authorities demonstrated both their willingness and capacity to employ the recently instituted bank resolution framework, imposing a 41% write down of senior debt and unguaranteed deposits. Until this very certain point, the Danish Authorities had supported the unguaranteed depositors and senior creditors of failing banks via blanket guarantees, guarantees on debt issuance by the banks, and hybrid capital injections.⁵⁷

Within the spectrum of the overall consideration of the fundamental elements of the financial crisis and its aftermath, a clear conclusion to be highlighted is that the complexity of (a) large financial institutions' organizational structure, (b) the financial instruments and (c) the overlapping and occasionally dubious regulatory and tax regimes within the institutions should operate, have contributed to their opaqueness and have confounded regulators' ability to deal with them in crises situations. Moreover, a misalignment of incentives between management and firms because of the limited liability corporate form and the short horizon render financial institutions vulnerable to crisis and foster difficulty to safeguard steadiness in crisis situations.⁵⁸

The misalignment of incentives and the multidimensional complexity of financial firms also have confounded markets' ability to correctly understand and price either the assets in which they transact normal business as well as to value the institutions themselves. Measuring, monitoring and pricing risk has proved difficult for both those inside and outside the large financial institutions. The supra mentioned remarks has led to the conclusion that perhaps the simplification of the structure of the institutions would reduce complexity, better distribute risk to management and enhance regulators' and markets' ability for risk comprehension. It may also enhance the understanding of the interconnectedness among institutions, should they experience financial difficulties and may simplify and facilitate their speedy merger, recapitalization or resolution, should they no longer be going concerns.^{59, 60}

To conclude, improved resolution tools will certainly not eliminate the need for temporary governmental support, through liquidity or other funding, in order to provide for an orderly resolution of certain cross-border institutions. Such reference is highly expected in circumstance of severe market distress during which there is no ability or

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ See Federal Reserve Bank of New York Staff Report No 457 (2010).

⁵⁹ *Ibid*, pp 27 – 28.

⁶⁰ The reform of banking structures has taken high political prominence in Europe as well as in the US, where the Dodd – Frank Act of 2010 introduces the “Volcker Rule” of separation of proprietary trading, even though the implementing regulations are still being discussed by federal agencies. At the level of individual EU Member States, it has been given rise to legislative initiatives in the UK, France and Germany. At the EU level, the European Commissioner for the Internal Market and Services has commissioned a report that also recommends a form of structural separation (Liikanen, 2012). The December 2012 European Council Conclusions include the sentence “The European Council looks forward to the Commission's rapid follow up to the proposals of the high level expert group on the structure of the EU banking sector”, but not set a deadline.

willingness on behalf of the private sector to undertake additional risk along with time insufficiency to perform due diligence for the assets and liabilities evaluation. Various national authorities have been creative in developing ad hoc government assistance for large institutions during the crisis. It is also important that authorities consider the strategy or timeframe for exiting these arrangements, whereas the nature of the resolution determines the timing and the measures through which the government can withdraw such support. At the very same time, fiscal support from government, deposit insurance or other safety-nets, or alternatively temporary public ownership, may play a pivotal role in the resolution of a troubled financial institution. Continuation of such support during the critical crisis period requires a reasoned explanation and a foundation of public support. Clarity about the amount of fiscal support, its time horizon, risk sharing arrangements and the possible losses associated with it could contribute to garnering such support.⁶¹

On the other hand, it is crucial to be underlined that the establishment of an effective framework for the resolution of financial institutions is essential to any strategy that targets at securing financial stability, limiting moral hazard and protecting investors.⁶² The recent crisis demonstrates the extent to which the existing at the moment system may force national authorities to choose between two equally unattractive options: (a) a bail-out that does not fully allocate losses to shareholders and creditors; or (b) reliance on an insolvency regime that is ill-equipped to restructure financial institutions in a manner that both preserves value and safeguards financial stability. Accordingly, a key objective is the establishment of a resolution mechanism that will facilitate rapid and preemptive action by the authorities to preserve business continuity while restructuring

⁶¹ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

⁶² According to the Key Attributes of Effective Resolution Regimes for Financial Institutions published by the Financial Stability Board (FSB), the objective of an effective resolution regime is “to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation.”

An effective resolution regime should:

- Ensure continuity of systemically important financial services, and payment, clearing and settlement functions;
- Protect, where applicable and in coordination with the relevant insurance schemes and arrangements such as depositors, insurance policyholders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;
- Allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
- Not rely on public solvency support and not create an expectation that such support will be available;
- Avoid unnecessary destruction of value, and therefore seek to minimize the overall costs of resolution in home and host jurisdictions and, where consistent with the other objectives, losses for creditors;
- Provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;
- Provide a mandate in law for cooperation, information exchange and coordination domestically and with relevant foreign resolution authorities before and during resolution;
- Ensure that non-viable firms can exit the market in an orderly way; and
- Be credible, and thereby enhance market discipline and provide incentives for market-based solutions.

an institution in a manner that allocates losses to shareholders and creditors as promptly as possible, consistent with financial stability objectives.⁶³

It is finally clearly demonstrated that a resolution framework will be ineffective unless it is accompanied by a robust cross-border coordination mechanism.⁶⁴ The experience illustrated that although large, complex financial institutions operate globally; their resolution is subject to national legal frameworks. A universal orientated approach with regards to supervision⁶⁵ on the one hand combined though with a territorial approach to resolution in which all transactions and institutions are separately structured for capital, liquidity, assets and operations within each national jurisdiction on the other, would endanger the financial internal market objectives and render the financial crisis 2007 – 2009 lessons completely unconstructive.

1.4 Historic Overview

1.4.1 Historic overview preceding the EU Banking Union notion

Since the outbreak of the financial crisis, alongside the management of the crisis by national authorities, state aid scrutiny by the European Commission, and interventions by central banks, the EU and its Member States have engaged in a fundamental overhaul of bank regulation and supervision. This overhaul exercise is based to a large extent on the reforms to strengthen global financial markets agreed by global leaders at the G20 summits in London in April 2009 and thereafter, and implemented in cooperation with the FSB and the Basel Committee of Banking Supervisors (Basel Committee).⁶⁶

The underlying reform objective is to create a safer, sounder, more transparent and more responsible financial system, working for the economy, as an indispensable precondition for sustainable growth.⁶⁷ In order to achieve that objective, the EU is taking steps to increase the resilience of banks, but also of other parts of the financial system such as market infrastructures or non-bank financial institutions, and to reduce the impact of a potential bank failure. More specifically, proposed and agreed reforms aim at:

- Strengthening banks' ability to absorb bank-specific or systemic shocks arising in particular from areas which proved particularly

⁶³ See International Monetary Fund (2010): "Resolution of Cross-Border Banks – A Proposed Framework for Enhanced Coordination".

⁶⁴ Indeed, recent experience clearly demonstrates that the more interconnected and integrated international financial institutions and groups tend to be, the more disruptive and value-destroying uncoordinated local resolution actions are likely to be characterized.

⁶⁵ Internationally agreed principles on the supervision of cross-border banking groups have been in place for several decades. The Basel Committee on Banking Supervision (BCBS) issued its first statement of principles or "Concordat" regarding the supervision of banks' foreign establishments in 1975. These basic principles have been underpinned by further statements from the Committee addressing cross border supervision and home – host supervisory relationships. Since then, it has consistently called for international cooperation to ensure that no foreign bank operation evades proper supervision, including through the issuance of principles on cross border supervision and home – host supervisory relationships.

⁶⁶ See High Level Expert Group on reforming the structure of the EU banking sector, Final Liikanen Report (2012).

⁶⁷ See Commission Communication COM (2010) 301 of June 2nd 2010.

vulnerable during the financial crisis, such as trading and derivatives activities, real estate lending or short – term funding structures;

- Reducing the likelihood of asset price bubbles, among other things, by taking measures to restrain indebtedness in the system;
- Improving banks' internal risk management and staff incentive structures and supervision by public authorities, including the monitoring of systemic risk. Enhancing the resilience of market infrastructures and non-bank financial actors, and thereby reducing contagion towards and between banks;
- Preventing bank runs by more effectively protecting depositors in case of bank failures and;
- Ensuring that all banks can be wound down in an orderly manner so as to limit the effect on financial stability and depositors as well as the use of taxpayers' money, by reducing interconnectedness, increasing transparency, and creating effective procedures for the resolution of banks.⁶⁸

In this vein, the Group of Twenty Leaders in the communiqué of April 2009 reiterated the call they had made in their Summit on Financial Markets and the World Economy of 15 November 2008 for regulators and other relevant authorities as a matter of priority to strengthen cooperation on crisis prevention management and resolution and to review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly resolution of large complex cross-border financial institutions (Action Plan No. 12). In this report of March 27th 2009, the G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG2) called on the Financial Stability Forum (now reconstituted as the Financial Stability Board) and the Basel Committee to “explore the feasibility of common standards and principles as guidance for acceptable practices for cross-border resolution schemes thereby helping reduce the negative effects of uncoordinated national responses, including ring-fencing.”

On April 2nd 2009, the FSB released a set of high-level principles for Cross-border Cooperation on Crisis Management. These principles include a commitment to cooperate by the relevant authorities, including supervisory agencies, central banks and finance ministries, both in making advanced preparations for dealing with financial crises and in managing alongside core colleges to consider together the specific issues and barriers to coordinated action that may arise in handling severe stress at specific firms, to share information where necessary and possible, and to ensure that firms develop adequate contingency plans. The FSB principles cover practical and strategic ex ante preparations and set out expectations on the authorities' interrelation under a crisis circumstances. They draw upon recent and earlier experiences of dealing with cross-border firms in crisis, including the 2001 G10 Joint Taskforce Report on the Winding Down of Large and Complex Financial Institutions and the 2008 European Union Memorandum of Understanding (MoU) on Financial Stability. The FSB also issued on October 2011 the “Key Attributes of Effective Resolution Regimes for Financial Institutions” that were finally endorsed in Cannes in November 2011 by the

⁶⁸ See High Level Expert Group on reforming the structure of the EU banking sector, Final Liikanen Report (2012).

G20 Leaders, whereas in June 2012 the G20 was set to start evaluating progress in implementing these provisions across the various jurisdictions.

Additionally, The Basel Committee approved the mandate of the Cross-border Resolution Group (CBRG) in December 2007. The CBRG was requested to analyze the existing resolution policies, the allocation of responsibilities and the legal frameworks of relevant countries as a foundation to a better understanding of the potential impediments and possible improvements to cooperation in the resolution of cross-border banks. During the first half of 2008 the CBRG collected detailed descriptions of national laws and policies on the management and resolution of cross-border banks using an extensive questionnaire completed by countries represented on the Group. The CBRG used the questionnaire responses in order to identify the most significant potential impediments to the effective management and resolution of cross-border banks. The Group also engaged in dialogue with representatives of a number of significant financial institutions on cross-border experiences in the current market environment. The Interim Report of the CBRG of December 2008 summarizes the key features of existing resolution policies and identifies differences in the national approaches to crisis resolution that may give rise to conflicts in the resolution of cross-border banks.

In December 2008, the Basel Committee asked the CBRG to expand its analysis to review the developments and processes of crisis management and resolutions during the financial crisis with specific reference to case studies of significant actions by relevant authorities. In response to this direction and building on this initial stock take, the CBRG provided the Report and Recommendation to identify concrete and practical steps to improve cross-border crisis management and resolution. The Report and Recommendations have been coordinated with and seek to complement the work of the FSB by providing practicable detailed approaches to implement the FSB's Principles for Cross-border Cooperation on Crisis Management of April 2nd 2009.

In June 2010, the European Parliament adopted an own-initiative report on recommendations on cross-border crisis management in the banking sector.⁶⁹ It stressed the need for a Union wide framework to manage banks in financial distress and recommended moving towards greater integration and coherence in the resolution requirements and arrangements applicable to cross-border institutions. In December 2010, the Council (ECOFIN)⁷⁰ adopted conclusions⁷¹ calling for a Union framework for crisis prevention, management and resolution. The conclusions stress out that the framework should apply in relation to banks of all sizes, improve cross-border cooperation and consist of three pillars (preparatory and preventive measures, early intervention and resolution tools and powers). The supra mentioned pillars should “aim at preserving financial stability by protecting market and public confidence; putting prevention and preparation first; providing credible resolution tools; enabling fast and decisive action; reducing moral hazard and minimizing to the fullest possible extent the overall costs to public funds, by ensuring fair burden sharing among the financial institutions’ stakeholders; contributing to a smooth resolution of cross-border groups; ensuring legal certainty; and limiting distortions of competition.”

⁶⁹ See 2010/2006 (INI).

⁷⁰ I.e. the Economic and Financial Affairs Council.

⁷¹ 17006/1/10.

In addition, a High Level Group is due to report to the Commission in the second half of 2012 on whether, on top of ongoing regulatory reforms, structural reforms of Union banks would strengthen financial stability and improve efficiency and consumer protection.

On May 30th 2010 the Commission indicated that it will initiate a process “to map out the main steps towards a full economic and monetary union (including), inter alia, moving towards a Banking Union including an integrated financial supervision and a single deposit guarantee scheme.”

On this basis, in the period between 2008 and 2012 the Commission services organized a number of consultations and discussions with experts and key stakeholders concerning bank recovery and resolution. As the last public consultation before the adoption of the pertinent proposal, a Commission Staff Working Paper describing in detail the potential policy options under consideration by the Commission services, was published for consultation in January 2011. The consultation was terminated on the 3rd of March 2011. As per one of the resolution tools, the so called bail - in or debt write down tool, targeted discussions were organized with experts from Member States, banking industry, academic world and legal firms in April 2012. The discussions concerned the key parameters of the debt write down tool, including in particular the resolution triggers, the scope of bail - in, its potential minimum level, resolution of groups as well as grandfathering.

In this vein, the EU Commission on the June 6th 2012 adopted the proposal for a Directive of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms. The Commission services have also prepared an Impact Assessment (IA) for the proposal. The comments by the Impact Assessment Board (IAB) expressed in their first and second opinion in May and June 2011 have been taken into account. In addition, the text of the IA has been updated reflecting latest developments in international fora as well as incorporation of the results of the discussions on the bail – in tool that took place in April 2012.

Concretely, the revised IA improves the presentation of the legal and institutional context by describing the responsibilities of the national supervisors and resolution authorities and the relationships between the proposal for bail – in and the planned CRD IV requirements. The text of the IA better explains the content of options, in particular the one related to the bail – in / debt write down tool. Also the impacts of the bail – in tool on the costs of funding for banks and non financial firms (SMEs) have been added. A section related to the coherence of the proposal with other regulatory proposals has been completed. Monitoring and evaluation arrangements were further clarified by singling out the most relevant indicators to be monitored.

Moreover, in June 2012, the Presidents of the European Council, European Commission, Eurogroup and ECB, issued a joint report “Towards a Genuine Economic and Monetary Union” that sets out the four essential building blocks for the future EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability. In order to address the negative feedback loops between the sovereign crisis and banking sector, EU financial fragmentation, and macroeconomic imbalances,

the European Council of June 2012⁷² particularly asked for a road map for the achievement of such a genuine Economic and Monetary Union (in accordance with the relevant report tabled on June 26th of the same year by the President of the European Council).⁷³ As a first step, following a specific call from the Euro Area Summit⁷⁴, the European Commission presented on September 12th 2012 legislative proposal for the establishment of a single supervisory mechanism (SSM) in Europe, with a view of achieving a Banking Union going forward.⁷⁵

The European Council meeting of December 14th 2012 has outlined a policy sequence that should be interpreted as three successive steps including the Single Supervisory Mechanism (SSM) with the European Central Bank (ECB) at its core; the Bank Recovery and Resolution (BRR) Directive and the operational framework for direct recapitalizations by the European Stability Mechanism (ESM); and the Single Resolution Mechanism (SRM). An implicit fourth step of completing a sustainable Banking Union should finally be identified, which unlike the first three will require treaty changes and deeper fiscal and political integration, and may include a European insolvency regime, a European resolution regime and a more integrated fiscal and deposit insurance framework supported by enhanced democratic accountability.⁷⁶

Implementing the supra mentioned sequence would by corollary involve a complex balancing of short-term, medium term and long-term objectives. Nevertheless, certain of these objectives should be addressed as early as possible, as indicatively mentioning the Single Resolution Mechanism (SRM), whereas others could not be met until a later stage. In the very short-term though (2013 – early 2014), the proactive initiatives (involving system – wide bank balance sheet assessments, state aid control, imposition of losses on creditors of failed banks and proportionate involvement of the ESM in bank recapitalizations) should be undoubtedly deployed to reserve the gradual “zombification” of Europe’ banking system.

1.4.2 Historic overview related to the EU Banking Union notion

⁷² See European Council Conclusion, 28/29 June 2012, EUCO 76/12, paragraph 4 (b).

⁷³ See Van Rompuy Report (2012): Towards a Genuine Economic and Monetary Union, EUCO 120/12.

⁷⁴ More particularly, the Statement of the Summit reads as follows: “We affirm that it is imperative to break the vicious cycle between banks and sovereigns.” See respectively Euro Area Summit Statement June 29th 2012, first paragraph, first sentence.

⁷⁵ Specifically, in response to this demand, the Commission issued on September 12th 2012:

- An announcement regarding “A roadmap for a Banking Union” [see COM(2012) 510];
- A proposal for a Council Regulation “conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions” [see COM(2012) 511]; and
- A proposal for a Regulation of the European Parliament and of the Council “amending Regulation (EU) No 1093/2010 establishing the European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation conferring specific tasks on the ECB concerning policies related to the prudential supervision of credit institutions” [COM(2012) 512].

⁷⁶ The need for steps beyond the SRM has been obliquely acknowledged by European policymakers, including the acknowledgement by the ECB executive board members that further integration of deposit insurance beyond the Deposit Guarantee Schemes Directive (DGS Directive) will be needed but not urgently. See indicatively Constâncio Vitor (2012), Hearing before the Select Committee on EU Economic and Financial Affairs of the House of Lords and also Constâncio Vitor (2013): “Establishment of the Single Supervisory Mechanism: The first Pillar of the Banking Union”. The European Commission has also referred to the desirability of future treaty changes to perfect the design of the SSM (2012).

Uncoordinated national responses to the failure of banks have reinforced the link between banks and sovereigns and led to a worrying fragmentation of the Single Market in lending and funding. This fragmentation is particularly damaging within the euro area zone, where monetary policy transmission is impaired and the ring-fencing of funding impedes efficient lending to the real economy and thus growth.⁷⁷

Swift progress towards a Banking Union, comprising single centralized mechanisms for the supervision and restructuring of banks, is indispensable to ensure financial stability and growth in the euro area.⁷⁸ Building on the strong regulatory framework common on the 28 members of the Single Market, i.e. single rulebook⁷⁹, the European Commission proposed on September 12th 2012 a Single Banking Supervision Mechanism (SSM) in the euro area that is expected to be fully operation in late 2014.

In order to present a structural analysis of the Banking Union regime, the comprising complementary building blocks, of which the SSM⁸⁰ forms an integral part, should be descriptively underlined.

⁷⁷ Between 1999 and 2007 private debt levels were able to increase so significantly because the integration of national markets allowed for a higher borrowing from abroad and increased leverage. Banks were at the centre of this process both in lending and borrowing countries. It is also well known that these flows were not perfectly optimised by rational private agents, whereas the minimalist institutional construction of the euro area lacked the tools to discourage such developments. The official bodies that could have intervened to prevent such developments were national supervisors both in lending and borrowing countries. Yet they lacked the perspective to do so and also the instruments to contain private capital flows that were considered to result from optimizing self-equilibrating markets. Only macro-prudential measures agreed through a consensus at the European level could have confronted the situation. In other words, there was a mismatch between the degree of integration and the scope of governance. In retrospect, the euro area was not prepared at the moment to deal with the build-up of systemic risks.

⁷⁸ For arguments in favor or against setting up a European Banking Union, see (in chronological order) Carmassi, Di Noia and Micossi (2012), Pisany – Ferry, Sapir, Vèron and Wolff (2012) and Constâncio (2012).

⁷⁹ See European Commission: “A comprehensive EU response to the financial crisis: a strong financial framework for Europe and a Banking Union for the euro zone”, MEMO/13/679. The backbone of the single rulebook comprises of rules on stronger prudential requirements, on strengthening deposit guarantee schemes and on common recovery and resolution tools. In order to complement the key pillars of the single rulebook, the Commission has tabled legislation on other aspects so as to make the financial sector overall more robust. Therefore, the following rules are already in force:

- Stricter rules on hedge funds (see MEMO/10/572);
- Stricter rules on short selling and credit default swaps (see MEMO/11/713);
- A comprehensive set of rule for derivatives (see MEMO/12/232);
- A framework for reliable high quality credit ratings (see MEMO/13/571)

Proposals have also been made and are still negotiated on:

- Reform of the audit sector (see IP/11/1480);
- Reform on the framework for market abuse (see IP/11/1217 and IP/12/846);
- Revision of current rules on markets in financial instruments (see IP/11/1219) and investment funds (see IP/10/869)

Further proposal will finally be made shortly in order to finalize the framework as follows:

- Review of the reform of the structure of the banking sector through the work of the high-level expert group headed by Erkki Liikanen (see IP/12/1048);
- Shadow banking including Money Market funds and Securities Law (see IP/12/253);
- Revision of the governance of market benchmarks such as Libor (see IP/12/939).

⁸⁰ The SSM shall be incorporated in the European System of Financial Supervisors (ESFS) that is in operation since January 2011. In this respect:

- The SSM shall be responsible for the micro-prudential supervision of credit institutions;
- The European Stability Risk Board (ESRB) shall continue to be responsible for the macro-prudential oversight of the European financial system, including the ECB; and

The first block is the establishment of the single rulebook.⁸¹ In addition to the CRD IV⁸², the Resolution framework and Deposit Guarantee ambient harmonization shall lead to the creation of a single rulebook that will significantly contribute towards the creation of a level playing field. The reinforcement of the single rulebook shall be attributed to the SSM, as a European dimension to be provided to the way that supervision is conducted, whereas the EBA will be equipped with the legal competence to monitor the implementation phase.

The establishment of an EU framework for single supervision forms the second element of the Banking Union.⁸³ In this vein, the SSM shall consist a mechanism, composed of

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- The EBA shall continue to be responsible for contributing to the evolution of European banking law, as well as discharging the specific supervisory tasks conferred on it, in accordance with the provisions of its statutory Regulation.

⁸¹ The form “single rulebook” is commonly used, from a stricto sensu perspective, to refer to the total harmonization of the rules pertaining to the micro – and macro – prudential regulation of credit institutions, adopted at three levels:

- At “Level 1” by the European Parliament and the (ECOFIN) Council in the form of Regulations and Directives;
- At “Level 2” by the European Commission in the form of regulatory and implementing technical standards; and
- At “level 3” by the European Banking Authority in the form of recommendations and guidelines [see respectively Gortsos (2011)].

From a lato sensu perspective, however, the single rulebook should also refer to the full harmonization of rules pertaining to the resolution of credit institutions and the operation of the single deposit guarantee scheme.

⁸² I.e. the proposal for a Directive of the European Parliament and the Council “on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/ EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate” (CRD IV).

⁸³ For a summary of the different proposals with regard to the creation of one or more supranational financial supervisory authorities in the EU, see Lastra (2006) and Hadjiemmanuil (2006) in Chalmers, Hadjiemmanuil, Monti and Tomkins (eds).

national competent authorities and the ECB⁸⁴, with the possibility of non –euro area Member States to participate.⁸⁵

Main features of the SSM shall be summarized on the following points:

- Conferring new supervision powers on the ECB for the banks of the euro area, i.e. the coherent and consistent application of the single rulebook in the euro area zone, the direct supervision of banks having assets of more than €30 billion or constituting at least 20% of their home country's GDP, the monitoring of the supervision exerted by national supervisors on less significant banks.⁸⁶ That

⁸⁴ It should be highlighted that although within the euro area more than 6000 banks are currently operating (a similar order of magnitude as in the United States), the 150 largest banks cover roughly 80% of banking system assets. Therefore, certain degree of delegation is unquestionably considered necessary. Full centralization is thus neither practical nor desirable, as supervisory knowledge and recourses remain at national level. Full decentralization on the other hand, in which the center merely validates decisions is not desirable either, particularly when common recourses are at stake (for example given, the ESM direct recapitalization of banks or future common backstops). The goal should be the creation of a coherent and consistent supervisory mechanism with adequate information flow and final significant decision taken at the center. In order to ensure that incentives are compatible, the degree of delegation should be clarified. It would depend on the ECB's supervisory classification of risks for each bank, and factors such as the importance of local knowledge and know – how, the systemic dimension of banks and tasks and the amount of discretion required in decision making. For example, institutions with systemic implications should be subject to more intrusive supervision from the center, as should functions that are more subject to discretion, capture by the industry, or influence by politics. Consolidated supervision of financial groups would involve inter-agency to oversee non-bank financial institutions as well. See respectively the IMF Staff Discussion Note (2013): “A Banking Union for the Euro Area”.

As a result, the Council Regulation proposal includes a “vertical” transfer, from the Member States to the European Union, of specific tasks concerning policies relating to the micro-prudential supervision of credit institutions, “with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the EU and each Member State, with full regard and duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage.” The Commission's proposal was to submit, on a gradual basis, all credit institutions incorporated in participating Member States under the regime of the ECB's specific tasks. Nevertheless, certain Member States, including Germany, the Netherlands and Finland, voiced their opposition to all credit institutions incorporated within their jurisdiction being subjected to the ECB's micro-prudential supervision, pointing out that the micro-prudential supervision of smaller credit institutions, mainly those without cross-border activity doing business exclusively at local level (e.g. Sparkassen in Germany), should remain with national authorities.

In this vein, it was finally concluded that these tasks shall be carried out based on the “decentralization principle”, according to which national competent authorities will be the ECB's “executive arm”, exactly as is the case of euro area Member State Central Banks in the context of the implementation of the single monetary policy. The national competent authorities will carry out day-to-day inspections, while all tasks not conferred on the ECB will remain with them. See respectively Gortsos (2013): “The single supervisory mechanism: a major building block towards a European Banking Union (the full Europeanisation of the bank safety net)”.

⁸⁵ According to the IMF, Staff Discussion Note (2013), as prerequisite for the establishment of a sound basis for the SSM should be classified: (i) operational independence of the SSM (ii) clear objectives and mandates (iii) legal protection of supervisors (iv) transparent processes, sound governance and adequate recourses and last but not least (v) accountability.

⁸⁶ The proposed specific tasks conferred on the ECB with regard to credit institutions established in participating Member States are, in principal, the following:

- Granting of authorization and withdrawal of authorization of credit institutions;
- For credit institutions established in a participating Member State, which are willing to establish a branch or provide cross-border services in a non-participating Member State, the performance of tasks which would fall upon the competent authority of the home Member State under existing EU banking law;

said, the ECB may at any moment decide to directly supervise one or more of these credit institutions to ensure consistent application of high supervisory standards;⁸⁷

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- Assessment of application for the acquisition and disposal of qualifying holdings in a credit institution, except in the event of bank resolution;
 - Ensuring compliance on the part of credit institutions with EU banking law provisions with regard to (i) own funds requirements including securitization (ii) limits on large credit exposures (iii) liquidity (iv) leverage and (v) public disclosure of information on these matters ('Pillar 3' of the current regulatory framework);
 - Ensuring compliance by credit institutions with the provision of EU banking law provisions, as to the existence of (i) robust corporate governance arrangements, including fit-and-proper requirements as regards persons responsible for the management processes, internal control mechanisms, remuneration policies and practices as well as (ii) effective internal capital adequacy assessment processes, including Internal Ratings Based models.
 - Conduct of supervisory reviews of credit institutions, including, where appropriate, in coordination with EBA, stress tests and their possible publication, in order to determine whether the arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held by these institutions ensure a sound management and coverage of their risks;
 - Ad hoc imposition, on the basis of relevant findings and in accordance with EU banking law provisions ('Pillar 2' of the current regulatory framework) of (i) specific additional own funds requirements, disclosure obligations and liquidity requirements, as well as (ii) the measures in the cases specifically made available to competent authorities by European banking law;
 - As regards the micro-prudential supervision of banking groups on a consolidated basis: (i) supervision on a consolidated basis over credit institutions' parent companies incorporated in a participating Member State (including over financial holding companies and mixed financial holding companies) and (ii) participation in the supervision on a consolidated basis, including in colleges of supervisors without prejudice to the participation of national competent authorities of participating Member States in these colleges as observers, in relation to parent companies not established in one of the participating Member State;
 - In the area of supplementary supervision of financial conglomerates (i) participation in supplementary supervision in relation to the credit institutions included in such financial conglomerates and (ii) assuming the tasks of a coordinator where the ECB is appointed as the coordinator for a financial conglomerate in accordance with the criteria set out in relevant European financial law;
 - Finally, carrying out supervisory tasks in relation to recovery plans and early intervention, where a credit institution or group in relation to which the ECB is the consolidating supervisor does not meet or is likely to breach the applicable micro-prudential supervision requirements, and, only in the cases explicitly stipulated by European banking law for competent authorities, structural changes required from credit institutions to prevent financial stress or failure, excluding any resolution powers. It is also worth mentioning, however, that the early intervention powers are vast in what concerns the governance and scope of activity of institutions that start confronting problems that could lead to the point of non-viability. Consequently, such powers are related to what is usually called "prompt corrective action" regarding problematic banks and can be applied before the bank is delivered to the Resolution Authority.

⁸⁷ Contrary to the definition and implementation of the single monetary and foreign exchange policy, for which competencies became supranational, the ECB has not shifted into a supranational supervisory authority for the financial system, or even at least one of its sectors, given that relevant competences have remained with Member States. Article 105, paragraph 5 of the Treaty establishing the European Community (TEC), as carried over verbatim in Article 3.3 of the Statute of the European System of Central Banks (ESCB) and the ECB, stipulated that: "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". The relevant competence of the ECB was mainly to submit opinions, in accordance with Article 105, paragraph 4 of the TEC, within the limits and under the conditions set out in Decision 98/415/EC of the Council, issued on the basis of Article 105, paragraph 5. The Treaty of Lisbon did not amend these provisions. They are repeated verbatim in Article 127, paragraph 5 and 127, paragraph 4 respectively of the Treaty on the Functioning of the European Union (TFEU) and continue to be in force.

- Possibility for participation / opt – in for all non euro area Member States;⁸⁸
- As per the cross-border banks actively operating both within and outside the participating in the SSM Member States, existing home / host supervisor coordination procedures shall continue existing as per se;
- Finally EBA shall retain its role as key player for the Single Market, ensuring consistency in the application of the single rulebook to all banks within the EU by the SSM and all national supervisors outside the latter regime.

The third element of the Banking Union is the establishment of a Single Resolution Mechanism (SRM). An important pre-condition is the swift adoption of the Bank Recovery and Resolution Directive, as the latter lays out a harmonized toolbox of resolution powers. The Single Resolution Mechanism would build on the measures and tools laid down in the Directive, particularly by providing a robust framework that allows for prompt and coordinated resolution action, specifically where cross-border banks, whose orderly resolution is the Achilles heel needed to be addressed, are concerned.

Taking into account the thematic of the thesis at question, it is worth elaborating on the operational frame and specificities of the particular element. In concrete, on July 10th 2013 the European Commission proposed a Single Resolution Mechanism (SRM) for the Banking Union that would ensure that, notwithstanding the more sound supervision, should a bank subject to the SSM confront financial difficulties, its resolution could be managed efficiently with minimum costs to taxpayers and the real economy, ensuring in parallel “that supervision and resolution are aligned at a central level, whilst involving all relevant national players, and backed by an appropriate resolution funding arrangement”.⁸⁹

As per the historic overview, the SRM was announced by the Commission in the “Communication on A Roadmap Towards a Banking Union” (September 2012) and in the “Blueprint for a Deep and Genuine Economic and Monetary Union” (November

Nevertheless, the TEC also contained an enabling clause (known as “sleeping beauty clause”), currently Article 127, paragraph 6 of the TFEU, according to which: “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.” It is also worth mentioning that:

- Any regulation adopted on the basis of this Article has to be issued by the Economic and Financial Affairs Council (ECOFIN) in accordance with a special legislative procedure (Article 289, paragraph 2 TFEU), in which the European Parliament’s contribution, along with that of the ECB, is limited to an advisory role, and
- Such a Regulation must be unanimously approved by the ECOFIN Council.

See respectively Gortsos (2013).

⁸⁸ In concrete, non euro area Member States could participate through establishing a close cooperation agreement with the ECB. By giving non euro area Member States full membership and voting rights in the Supervisory Body, i.e. the body responsible for the preparation of decisions on supervisory matters, they are placed on an equal footing with euro area Members States. However, as the ECB Governing Council is the ultimate decision – making body of the ECB, its role in the SSM is reduced to the possibility of accepting or rejecting the decisions of the Supervisory Board. At the same time, a system integrating a mediation panel is foreseen in the Regulation in case of divergences that may involve a non euro area Member State. All these mechanisms were accepted at the level of the Council by all governments, which seem to indicate an expectation for an extension of the SSM well beyond the euro area zone.

⁸⁹ See Michael Barnier, Internal Market and Services Commissioner, pertinent statement (IP/13/674).

2012). The European Council in December 2012 recognized the necessity to set up a SRM to accompany the SSM in the Banking Union so that supervision and resolution be exercised by the same level of authority⁹⁰ and therefore in March 2013, it committed to complete the Banking Union via a series of steps, confirming, inter alia, that the proposal for a SRM should be classified as a matter of priority with the intention of adopting it in advance of the termination of the current European Parliament term in 2014. As a result, at the 27 – 28 June European Council, EU leaders set themselves the target of reaching an agreement on the mechanism⁹¹ by the end of 2013, so that it could be adopted before the end of the EU Parliament term and application would be enabled from January 2015, together with the BRR Directive.⁹²

The European Parliament, on the other hand, has also consistently called for greater integration in the arrangements for resolving banks and thus in a Resolution adopted on June 13th 2013 urged the Commission to adopt as quickly as possible the proposal establishing the SRM.

As per the operation specificities, the SRM shall apply to all 6.000 banks established in the Member States participating in the SSM. The Commission proposes the creation of a Single Resolution Board (SRB), comprising the ECB, the European Commission, and the national authorities of Member States participating in the Banking Union. The ECB, in its role in the SSM, would then signal when a bank established in a Member State participating in the Banking Union is in “severe financial difficulties and thus needs to be resolved”. The SRB would “prepare” the resolution of a bank, with “broad

⁹⁰ Indeed, it is considered impossible to have a single European mechanism for the supervision of banks but to leave the resolution to national authorities, as tensions between the supervisor (ECB) and national resolution authorities could emerge over the manner that ailing banks should be dealt with. At the same time, market expectations about Member States’ ability to deal with bank failure nationally could persist, reinforcing negative feedback loops between sovereigns and banks and maintaining fragmentation and competitive distortions across the Single Market.

The need for swift and decisive action backed by EU level funding arrangements was also highlighted by the recent financial crisis in Cyprus. In order to avoid a situation in which bank resolution was conducted at national level with a disproportionate impact on the real economy and to curd uncertainty and prevent bank runs and contagion of other parts of the euro area and the Single Market, a supranational regime is essentially indispensable. A network of national authorities, even if coordinated at intergovernmental level, is not sufficiently operational. See respectively European Commission (2013) MEMO / 13/ 675.

⁹¹ It is worth mentioning that initially there were developed two practical possibilities as per the central body of the SRM, each of which merits extensive argumentation. On the one hand, the European Commission would host the central body of the SRM, for which adequate relationships should be defined both with the College of Commissioners and with the DG COMP. Crucially, a sufficient degree of independence in the resolution tasks should be ensured. As an alternative option, a new body would be created, on either temporary or permanent basis. Such a choice within the EU institutional framework would undoubtedly raise concerns as per the Treaty basis and the decision making autonomy that such a new body would guarantee (Meroni jurisprudence). Finally, establishment by a specific treaty, as was the case with the ESM, would raise even more complex questions as per the relationship with the existing EU institutions, including in terms of accountability and judicial review.

⁹² Before the proposed rules enter into force, any bank crises would continue to be managed on the basis of national regimes. However, these regimes are set to converge increasingly towards agreed principles of resolution, namely the allocation of bank losses to shareholders and creditors instead of taxpayers. This is achieved on the one hand by the revised guidelines on state aid to banks as adopted on the July 10th 2013 (see IP/13/672) and on the other, the possibility of direct recapitalization of banks by the ESM. Both require appropriate “burden-sharing” by private investors in a bank as a condition of public support by national and ESM resources.

preparatory powers”, and would be “responsible for the key decisions on how a bank would be resolved”, with national resolution authorities “closely involved”.

It would then fall to the Commission to make the decision on whether to enter the bank at stake into resolution, since such decision could not rest with the SRB on the basis of “legal grounds”. In concrete, under the existing EU Treaty, at European level, only an EU institution (i.e. European Commission, ECB, Council of the EU, European Parliament or Court of Justice of the European Union) could take the final decision on when to trigger the resolution of a certain credit institution.⁹³ The Commission would, however, take recommendations from the SRB and therefore clearly states that its role will be “limited to the decision to trigger the resolution following a proposal” by the SRB. National resolution authorities would retain though responsibility for executing the resolution actions, with the SRB exercising an oversight role, monitoring the implementation by national authorities. In the case that national authorities would not comply with SRB decisions, the latter would have the power to directly address the executive orders to the troubled institutions.

A Single Bank Resolution Fund (SBRF) would also be set up under the control of the SRB “to back its decisions and ensure the availability of medium – term funding support while the bank is restructured”. It is envisaged that the fund would be created from contributions by the banking industry, through the pooling of the resources of national funds of participating countries. During and up to the building up of such funds, though, the Commission intends to enable borrowing arrangements from the markets. It is crucial though for a credible European Resolution Mechanism to ensure credible funding arrangements, financed ex ante. Otherwise the existing coordination problems in providing assistance for restructuring would persist, and the link between states and banks would not be over ceded.

Compared to a mere network of national resolution authorities, a SRM with strong decision making body and accompanied by a SBRF would unquestionably provide key benefits for Member States, taxpayers, banks and at an enlarged scale financial and economic stability within the EU, such as⁹⁴:

- Strong centralized decision making process that would obviously ensure the effectiveness and speediness of resolution decisions across participating Member States, avoiding uncoordinated actions, minimizing negative impacts on financial stability and limiting the need for financial support;

⁹³ It should be highlighted that the Commission enjoys the necessary experience on bank restructuring due to previous involvement as a condition for approving state aids to banks, its unquestionably successful contribution to the management of the recent international financial crisis and to addressing the current fiscal crisis in the euro zone. As guardian of the Treaties, the Commission could be considered as the best placed amongst the EU institutions to ensure that final decisions fully respect the principles underpinning the functioning of the EU and are consistent and equal across The Single Market. Its role would also ensure that the overall mechanism remains fully accountable vis-a – vis the European Parliament and Member States.

Adding resolution powers, on the other hand, to the ECB’s monetary and supervisory roles would raise conflict of interest concerns. Furthermore, the politically charged nature of bank resolution strikes as difficult to square with the ECB’s independence. Nevertheless, under its capacity as supervisor under the SSM and in view of their in-depth knowledge of the banking sector, the ECB is set to play a fundamental role, not least as per the proposal for the resolution trigger.

⁹⁴ See European Commission (2013) MEMO / 13/ 675.

- A central body with expertise and experience on bank resolution would enable effective bank resolution, with limited adverse effects for taxpayers compared to individual national authorities with limited recourses and expertise;
- A Single resolution fund would enable pooling significant resources from bank contributions and therefore guarantee taxpayers' protection in a clearly more effective manner compared to national funds, whereas at the same time a level playing field for banks across participating Member States would be safeguarded.

Under the newly proposed resolution structure, achieving high degree of centralization is desirable for various reasons⁹⁵:

- Bank resolution crucially requires the ability to make high-risk decisions very quickly and under intense pressure. The decisions may in particular include the liquidation of a bank, the assumption of risky assets on a public-sector balance sheet, and mandating the immediate sale of assets or activities to third parties. Such requirement thus implies a high degree of centralization of authority. In the case of large banks operating across borders within Europe, the current distribution of decision making power in bank restructuring between the national and supranational level has sometimes caused considerable delays. In certain instances (as Fortis and Dexia) the break-up of multinational banks along national borders could not be avoided, resulting to great harm to the Single Market;
- A system where supervision is centralized but resolution is not may damage the effectiveness and credibility of the supervisor. While the new SSM could in principle force a resolution by withdrawing a banking license, national resolution authorities may refuse to proceed with required actions. Such knowledge could lead the ECB to delay the supervisory decision in order to avoid a disorderly scenario. In principle, the SSM Regulation as amended by the Council is designed to prevent a deadlock in such circumstances, but how the case might work in practice remains to be tested. Through its current liquidity policy the ECB may lend to banks that could be insolvent, but it does not have the institutional responsibility for the pertinent assessment. Such liquidity provisioning terms forms part of the monetary policy and the supervisory responsibility is squarely with the national authorities. Once the ECB has been assigned with the supervisory responsibility, it would breach its mandate by providing liquidity to banks it deems insolvent;
- The incentive structure of a decentralized resolution system cannot be easily aligned with a system that involves burden-sharing among Member States. If resolution remains primarily a responsibility of Member States while the fiscal cost or resolution is already partially mutualised, national resolution authorities will not have the appropriate incentives to minimize the overall public costs of bank resolution.

However, it is crucial to highlight that a fully centralized system could not be achieved at this building block without a respective significant revision of the European Treaties and taking into account the absence of a dramatically more integrated fiscal framework.

⁹⁵ See Directorate General For Internal Policies (2013): "Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context".

By corollary, the SRM could not be strictly in parallel to the SSM as per its design and establishment for at least two major grounds.⁹⁶

Initially, bank resolution regimes are considered to be established in parallel and as an alternative to insolvency regimes. Nevertheless, a European bank insolvency regime is out of reach, at least as concerns the specific Banking Union building block. Additionally, failure to identify in the current Treaties an adequate and sufficiently robust legal basis for a European insolvency regime is unquestionable. Even assuming such a proper basis, the creation of an effective supranational insolvency regime is bound to feasibly require long preparation and planning period.⁹⁷

Secondly, bank resolution regimes are linked to fiscal or quasi-fiscal resources. Unlike insolvency processes, they could result in the public assumption of significant financial risk and liabilities. Experience illustrates that certain bank resolution processes eventually lead to a financial gain to public authorities, whereas others result in a financial loss. It is often impossible to predict *ab initio* the eventual financial outcome. An increased willingness to impose losses on bank creditors could help reduce the public cost of future bank resolution, but not to the extent that such cost could be assumed entirely alleviated.⁹⁸

Finally, it is considered essential to stress out that the legal basis for the proposal is Article 114 of the Treaty on the Functioning of the EU that allows the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the Single Market. Uniform application of a single set of resolution rules, along with access to a single European resolution fund by a central authority, would thus restore the orderly functioning of the EU banking markets, would remove potential obstacles to the exercise of the free movement of capital, freedom to provide services and freedom of establishment and last but not least would avoid significant distortion of competition, at least in those Member States which share the supervision of credit institutions at European level.

The existence of financial backstop could be considered as the fourth element of a complete Banking Union, especially due to the possibility of direct capitalization of banks by European funds, i.e. the ESM.⁹⁹ Such element would unquestionably be of great importance for the achievement of the goal of the Banking Union project, namely to mitigate the negative feedback loop between banks and sovereigns.

As such, at the euro area Summit, on June 29th 2012, it was proposed that once an effective supervisory mechanism involving the ECB was established for credit institutions in the euro area, the (future) ESM could have the possibility to directly recapitalize banks, in order to contribute to the breaking of the vicious circle between banks and sovereigns, since the ESM loans would not add to the debt burden of

⁹⁶ *Ibid*, pp 16 - 17.

⁹⁷ *Ibid*.

⁹⁸ *Ibid*.

⁹⁹ It is crucial at this very specific point to underline that the Finance Ministers of certain Member States (in particular, Germany, the Netherlands and Finland) argued that “direct bank recapitalization by the ESM should take place based on an approach that adheres to the basic order of first using private capital, then national public capital and only as a last resort the ESM” (Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, September 25th 2012).

countries facing intense market pressure.¹⁰⁰ The Eurogroup, on June 20th 2013, agreed thus on the main features of ESM direct bank recapitalization, which shall be reflected in the operational framework of the instrument. Particularly, in order to reflect the close correlation between two important parts of the new EU financial framework (most importantly the BRR Directive and the DGS Directive), on which the Banking Union shall be based, the Eurogroup agreed that the operational framework shall be finalized as soon as the supra mentioned proposals are adopted by the European Parliament.

Finally, the fifth element of the Banking Union shall be the establishment of a common system of deposit protection. The first step would be the adoption of the legislative proposal on the deposit guarantee schemes, providing thus for a harmonized framework. Such framework would therefore ensure depositor confidence and enable the national deposit guarantee schemes, built on common EU standards, to interact with the SRM. By corollary, the establishment of a European deposit guarantee scheme is not essential in the short term. Nevertheless, a common system, built on common EU standards, would be fundamental in the future to ensure enhanced depositor confidence in the robustness of all European banks. The supra mentioned element would also contribute to reduce the risk of financial fragmentation that results from contagion fears and is detrimental to the smoothing functioning of the single monetary policy.

1.5 Concluding Remarks

It is essential to underline that a bank resolution regime should not be seen as a magic bullet that would as of itself put an end to moral hazard and systemic risk. There are cases of fairly effective resolution of a systemic banking crisis without a prior resolution regime in place for crisis, such as in Sweden in the early 1990s. Conversely, a country may have introduced a special resolution regime in its legislation but fail to use it when appropriate, or use it in manner that does not avoid systemic contagion. Even with well-designed processes to impose losses on creditors, a resolution regime cannot guarantee that no use of public money will ever be necessary, especially in very severe crisis scenarios. A number of EU Member States have passed legislation that creates special bank resolution regimes since 2007, but most of these remain essentially untested yet. International coordination is recent in this area of banking policy, and has met a significant milestone with the first-time publication by the FSB of “key attributes of effective resolution regimes for financial institutions” (FSB, 2011). Crucial factors of effectiveness include the speed of the process, which requires carefully designed decision making processes and very professional management, and its ability to intervene early. As noted by an experienced observer, “Whatever the mechanism for resolving a bank, the sooner that is done, the less the likely burden that will have to be subsequently met”.¹⁰¹

¹⁰⁰ It was actually estimated by the Commission that once a robust financial framework is operational, including stronger prudential requirements and the ability to resolve banks in an orderly manner, the bail – in tool inclusive, the needs for further recapitalization would be essentially rare. Based on previous experience, it could be concluded indeed that no bank, beyond a very specific example, which faced financial problems since 2008 in the EU, would have needed extra recapitalization (from public funding), should CRD IV levels of capital have been held and the bail-in tool exercised.

¹⁰¹ See Goodhart (2012); See also Directorate General For Internal Policies (2013): “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

The exercise of resolution powers and the measures adopted should also particularly take into account the circumstances under which the failure occurs. In case that the problem arises in terms of an individual credit institution and the rest of the financial system is therefore not affected, authorities should be able to exercise their resolution powers without much concern for contagion effects. In a fragile environment, though, greater care should be exercised to avoid destabilizing financial markets. For example, it may not be possible to exercise the resolution tools on several systemically important credit institutions at the same time without jeopardizing financial stability. Similarly, the broader the crisis and the greater the concern over possible contagion effects, the more important it is that credit institutions could be maintained as going concerns.¹⁰²

There is a fundamental difference between an individual credit institution in a crisis and a crisis which strikes the banking or financial system as a whole as regards, inter alia, the character of the crisis, asset price developments and consequences for the overall economy. Hence, the treatment of an individual credit institution in a crisis should be different from the treatment of a crisis which hits the financial system as a whole, and this applies in particular to the resolution of the crisis. Therefore, resolution tools should be designed and suitable to counter a broad set of largely unpredictable scenarios.¹⁰³

Resolution of credit institutions which maintains them as a going concern may, as a last resort, involve government stabilization tools, including temporary public ownership. It is crucial therefore that the resolution powers and the financing arrangements are structured in such a way that taxpayers are the beneficiaries of any surplus that may result from the restructuring of a credit institution that is put back on a safe footing by the authorities. Responsibility and assumption of risk should be accompanied by reward. Where, following resolution, restructured credit institutions are simply handed to private owners, such as bondholders whose claims have been converted to equity, such requirement is not met.¹⁰⁴

In light of the consequences that the failure of a credit institution may have on the financial system and the economy of a Member State as well as the possible need to use public funds to resolve a crisis, Ministries of Finance or other relevant ministries in the Member States should be closely involved, at an early stage, in the process of crisis management and resolution.¹⁰⁵

In Europe, the difficulty of introducing an effective framework for bank resolution is compounded by a number of specific factors, i.e. the EU is in a state of systemic banking fragility and of unusual institutional uncertainty; its financial system is dominated by banks, with a high degree of banking sector concentration in many of its Member States; its insolvency framework is fragmented along national lines, and so is its fiscal framework for most purposes in spite of recent tentative steps towards fiscal integration in the euro area zone; its policymakers and investors have almost no experience of orderly bank resolution, as most past cases of bank failures have been handled through public bail-outs and / or nationalizations.¹⁰⁶

¹⁰² See European Parliament, Plenary Sitting, Report on the BRR Directive (2013).

¹⁰³ *Ibid*, p18.

¹⁰⁴ *Ibid*, p 8.

¹⁰⁵ *Ibid*.

¹⁰⁶ See Goldstein and Vèron (2011); See also Directorate General For Internal Policies (2013): “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

Conversely, a powerful motivation to create or strengthen effective resolution regimes in Europe is provided by the “doom loop” that has developed in the euro area between credit conditions that apply to vulnerable countries as sovereign issuers on the one hand, and to banks included in these countries on the other . The reality of this “doom loop” or vicious circle is illustrated by the high correlation between credit ratings and credit market indicators between these sovereign and banks¹⁰⁷, and its acknowledgement has prominently driven policy initiative since at least early 2012. Well – designed resolution regimes hold the promise of both limiting banking sector instability, and minimizing the fiscal cost of future bank failures.¹⁰⁸

In this vein, the EU bank resolution agenda combines short-term and long-term challenges. In a nutshell, resolving the current banking crisis (including the objective of breaking the “doom loop” which was classified by the European Council as a short-term “imperative”) is framed in the short term, whereas building a sustainable EU banking policy framework or Banking Union is allocated in the longer term. The combination of short- and long-term aims is well known though to be both unavoidable and exceedingly difficult in a context of systemic financial crisis. Too much focus on the short-term challenges could sow the seeds of future disruption. Conversely, excessive focus on the long-term challenges carries the risk of ignoring the urgency of the situation at hand, and the usually high cost of delaying decisive action.¹⁰⁹

An additional source of complexity is the long-term uncertainty about the geographical perimeter of the EU, reinforced by the possibility of an in-or-out referendum in the UK by 2017¹¹⁰, and about whether the boundaries of the four “unions”, i.e. the banking, the fiscal, the economic and the political ones, will ultimately coincide with those of the EU or the euro area.

Considered in this light, the eventual completion of the Banking Union is affected by multiple linkages with other components of the fourfold agenda¹¹¹, amongst others:

- Linkage between Banking Union and Fiscal Union: even assuming extensive burden-sharing by creditors, there will always remain cases or scenarios in which systemic risk crisis resolution shall require extended access to public money, and the aim to break the “doom loop” means that at least some of the required money must unquestionably be raised from the European level;¹¹²
- Linkage between Banking Union and Economic Union: certain economic policies, including housing policy, aspects of tax policy, and personal and corporate insolvency legislation, could have significant impact on the accumulation and distribution of risk in the banking system and justify adequate “macro-prudential” oversight;¹¹³

¹⁰⁷ See Angeloni and Wolff (2012).

¹⁰⁸ See also Directorate General For Internal Policies (2013): “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

¹⁰⁹ *Ibid*, p 9.

¹¹⁰ See Cameron (2013).

¹¹¹ See Directorate General For Internal Policies (2013): “Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context”.

¹¹² See Pisani-Ferry and Wolff (2012); See also Wolff (2012).

¹¹³ See Wolff (2011).

- Linkage between Banking Union and Political Union: bank crisis management and resolution can have widespread economic and social consequences and therefore must be subjected to appropriate mechanism of political accountability;¹¹⁴

Finally, transitional consideration would also be crucial.¹¹⁵ Given the sensitivity of banking issues to matters of trust, reputation and expectations, all new arrangements might be necessary to be fully effective from their very first day of operation. This is undoubtedly inevitably challenging as there is no direct precedent or working model of a supranational banking policy framework. The smooth introduction of the euro in 1999 – 2002 attests that large – scale unprecedented policy projects can be successful if carefully designed and planned, but the necessities of the crisis impose a compression of the planning and preparation phases that creates important risks as regards both the design and execution. The concerns focus inter alia on¹¹⁶:

- The credibility of the ECB during the likely phase when the SSM is up and running and has to operate without the SRM may be endangered, in case that a situation arises in which the ECB may have to delay supervisory decisions due to the unwillingness or inadequacy of the national resolution system to take appropriate actions;
- Additional risk is related to the possibility of wide cross-country differences in resolution practices. Following a supervisory decision of the ECB and in the absence of a clear SRM framework, the concern is that national resolution authorities might undertake action in a way that is considered harmful for the single financial market.

There is no doubt that we are at the forefront of a new era. Once the ECB is assigned with its new supervisory tasks, governmental influence on credit institutions within the euro area zone shall be significantly diminished.¹¹⁷ Mergers and acquisitions will be subject to the ECB approval rather than under the national competent authorities' capacity. By corollary, the European banking system is expected to be shaped at supranational level within the next few decades, leading to a greater degree of concentration in the European banking landscape and to a very essential decline in the number of credit institutions operating across the euro area Member States.¹¹⁸

To conclude, despite the fact that few could have foreseen such momentous developments, it is worth presenting the words of a man of vision and a great European, Tommaso Padoa-Schioppa, ex member of the ECB's Board responsible for financial stability that wrote back in 1999, a few weeks after the inception of the euro: "I am convinced, however, that in the future the needs will change and the multilateral mode

¹¹⁴ See Vèron (2012).

¹¹⁵ See Goyal, Rishi, Petya Koeva Brooks, Pradhan, Tressel, Dell' Ariccia, Leckow, Ceyla Pazarbasioglu, and IMF Staff Team (2013).

¹¹⁶ See Directorate General For Internal Policies (2013): "Next Steps on the Road to a European Banking Union: The Single Resolution Mechanism in Context".

¹¹⁷ "The conditions under which credit institutions will invest in sovereign bonds will substantially change in future, since banks' dependence on Member States (where applicable) will be kept under bounds. Weaning national banking systems from government influence could thus become an important spring board for creating institutional conditions that could lead to an EU fiscal union, provided the necessary political will exists".

¹¹⁸ See Gortsos (2013).

will have to deepen substantially. Over time such a mode will have to be structured to the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the euro area to be as prompt and effective as it is within a single nation”.¹¹⁹

At that time such words might have sounded premature but another man of great vision was also verified, writing in his Memories: “These are no premature ideas, there are only opportune moments that it is necessary to wait for....Everything is possible in exceptional moments provided we would be ready....”

*“Financial services are like fire; hugely beneficial to us, but can be very dangerous as well. Because fire is so contagious and damaging, everyone have an interest in our neighbour’s fire safety arrangements. Like fire, **damage can best be contained when it is detected and extinguished early**”*¹²⁰



¹¹⁹ See Padoa-Schioppa (1999).

¹²⁰ Strauss-Kahn (2010): “Crisis management arrangements for a European Banking System: Building a Crisis Management Framework for the Single Market”, Keynote speech, European Commission conference on Cross-border crisis management, Brussels, March 19th 2011.

CHAPTER II

2. The European framework for the recovery and resolution of credit institutions and investment firms as addressed by the June 2012 proposal Directive

2.1 Background

On June 6th 2012 the European Commission (EC) published its long awaited Draft Directive on recovery and resolution of credit institutions and investment firms, including extensive powers for resolution authorities to bail – in a wide range of liabilities. The Directive is the output of the work that the EC has been conducting on crisis management since 2008 which has included a number of discussions and consultations with relevant stakeholders. The introduction of the Directive, and the scale of the EBA involvement in both the implementation and ongoing management of all aspects of the recovery and resolution regime in Europe consists a clear indication that a more pan – European approach to crisis management in the financial services sector is intended.

The Directive is required to be transposed into national law by December 31st 2014, with the exception of the requirements relating to bail – in that are required to be implemented by January 1st 2018, and contains approximately 28 instances where the EBA is expected to produce technical standards or guidelines.

It is crucial at this very specific point to underline the fundamentality of the EBA role, through the preparation of the technical standards, its role as a non- voting attendee of all Resolution colleges, as a mediator between resolution authorities and through relations with third country resolution authorities.

The implementation of the proposals incorporated in the Directive will unquestionably be complicated and require amendments to a number of aspects of national law. Such fact was also acknowledged by the EC and that was the reason therefore that the legal instrument considered as the most appropriate and adopted was the Directive, introducing the pertinent requirements over a Regulation.

The main requirements of the Directive are summarized under the following highlights:

- All Member States will be required to designate **a resolution authority** with sufficient expertise and resources to manage bank resolutions;
- All in – scope entities will be required to produce **recovery plans** and provide information and analysis to the resolution authorities to allow them to produce **resolution plans**;
- Arrangements may be put in place for the provision of **intra – group financial support** in a recovery situation;
- Competent authorities will have **early intervention** powers available in a crisis situation to require institutions to take a wide variety of actions. The authorities

will also be able to appoint a special manager to temporarily run the institution in the place of management;

- **Resolution triggers** are harmonized and, for reasons of financial stability, will allow authorities to place an institution in resolution before it is balance sheet insolvent;
- The resolution authority will be provided with a set of **specific resolution tools and powers**. These include tools to: allow elements of the business to be sold without normal approvals (sale of business tool); allow assets and liabilities to be transferred to a newly established bank owned by the authorities (bridge institution tool); place certain assets and liabilities into an asset management vehicle to be managed in an orderly manner (asset separation tool); and the power to write down the claims of unsecured creditors or convert them to equity (bail – in tool);
- **A temporary stay** on the rights of creditors and counterparties to close out, accelerate or otherwise terminate contracts with the failing institution until 5 pm the following business day;
- **Safeguards** to protect counterparties by preventing partial transfers that would involve the splitting of linked liabilities or other linked arrangements;
- **Resolution Colleges** will be required for each institution led by the home resolution authority and including the EBA. Depending on the status of cooperation agreements, this will also possible apply to those foreign headquartered firms with two or more subsidiaries within the EU;
- A framework for cooperation with resolution authorities **outside the EU**, including powers in relation to branches in the EU. The EBA will be able to recognize third country resolution proceedings or refuse to recognize them (for example where they disadvantage depositors in the EU).
- Member States will be required to build up a **resolution fund** equivalent to 1% of covered deposits over 10 years;

2.2 Proposed regime overview

2.2.1 Scope of application (Article 1)

The scope of the proposed resolution regime is extremely broad. It not only applies to all credit institutions, but also to:

(a) investment firms, defined as those firms subject to an initial capital requirement of EUR730.000,00 (a 730k firm), under Article 9 of Directive 2006/49/EC (the Recast CAD);

(b) any financial institution (as defined in Directive 2006/48/EC (the Recast BCD) and encompassing undertakings, other than credit institutions, engaged in a wide range of financial services activities) which is a subsidiary of a credit institution, 730k firm or company within the scope of (c) or (d) and is subject to consolidated supervision at the level of the parent;

(c) financial holding companies, mixed financial holding companies and mixed activity holding companies in the EEA (Relevant Holding Companies); and

(d) subject to certain conditions, EU branches of third country firms.

It should be pointed out that each of the resolution tools are designed to be available in respect of each of the categories of in-scope entity, but there are differing conditions for use of the resolution tools.

2.2.2 The resolution authority (Article 3)

Member States will be required to appoint a resolution authority, which may be the same body as the Member State's supervisory authority, provided that there is functional separation and that appropriate arrangements to avoid conflicts of interest are in place.

Member States will additionally be required to inform the European EBA of the national authority (or authorities) appointed as resolution authorities. The EBA will publish a list of those resolution authorities.

2.2.3 Recovery Plans (Articles 5 – 8)

Institutions will be required to prepare and maintain recovery plans which will constitute a 'governance arrangement' within the meaning of Article 22 of the Recast BCD. In effect, therefore, a recovery plan will be a condition of authorization. Article 4 of the Draft Directive specifies certain information which must be included in the recovery plan, but the Draft Directive also empowers the EBA and Commission to, respectively, develop and adopt draft regulatory technical standards on the minimum content of the recovery plans.¹²¹

Institutions will be required to submit their recovery plans to the resolution authority, which will review those plans to ensure compliance with Article 5 of the Draft Directive as well as the plan's ability to restore the viability and financial soundness of the institution without causing any significant adverse effect on the financial system. Authorities are given the power to require the institution to take any measure it considers necessary to ensure that potential impediments to or deficiencies in the implementation of a recovery plan are removed, including inter alia changes to the business strategy, funding strategy and governance structure of the institution.

Parent undertakings and institutions subject to consolidated supervision will be required to prepare and maintain group recovery plans, as well as a recovery plan for each institution that is part of the group, each of which must cover the elements and arrangements set out in Article 5 of the Draft Directive, and giving details of any arrangements for intra-group financial support adopted in accordance with Article 16 of the Draft Directive. The group recovery plan must be submitted for review by the consolidating supervisor and all relevant competent authorities.

¹²¹ The EBA has pre-emptively commenced work in relation to this power and on May 15th 2012 released a discussion paper on a template for recovery plans.

A recovery plan must be approved by the board (or equivalent managing body) of the institution or, in the case of group recovery plans, by the board of the parent undertaking or institution subject to consolidated supervision and the board of each institution that is part of the group prior to submission to the authorities.

2.2.4 Resolution plans (Articles 9 – 12)

Resolution authorities will be required to develop resolution plans for each institution that is not part of a group subject to consolidated supervision and for each group. Group plans shall include resolution plans for the parent undertaking or institution that is subject to consolidated supervision and each institution within the group. Group resolution plans are to be prepared by group level resolution authorities jointly with the resolution authorities of the subsidiaries in resolution colleges.

The authorities will be required to update a resolution plan annually or after any event or occurrence which could have a material effect on the plan. Institutions will be required to provide the authorities with the information necessary to write the resolution plan.

The Commission intends that resolution plans respond to a range of idiosyncratic and market-wide stress scenarios. The EBA will issue guidelines aimed at the convergence of supervisory practice for the preparation of the scenarios for group resolution plans.

The content of the resolution plan is to include:

- a demonstration of how critical functions and core business lines could be legally and economically separated from other functions, so as to ensure continuity, and a description of critical interdependencies;
- a description of options for preserving access to payments and clearing services and other infrastructures;
- a detailed description of the assessment of the institution's resolvability and details of any measures required to address or remove identified impediments to resolvability;
- a detailed description of the different resolution strategies that could be applied, and how they could be financed without the assumption of any extraordinary public financial support;
- an analysis of the impact of the plan on other institutions within the group; and
- a communication plan.

2.2.5 Assessments of resolvability and preventative powers (Articles 13 – 15)

Pursuant to the Draft Directive, resolution authorities, in consultation with competent authorities, will be required to assess the extent to which institutions and groups are resolvable without the assumption of extraordinary financial support. To this end, Article 13(1) states that an institution or group shall be deemed resolvable if “it is feasible and credible for the resolution authority either to liquidate it under normal

insolvency proceedings or to resolve it by applying the different resolution tools and powers to the institution or group without giving rise to significant adverse consequences for the financial systems... of the Member State in which the institution is situated, having regard to the economy or financial stability in that same or other Member State or the Union and with a view to ensuring the continuity of critical functions carried out by the institution or group...”.

Where it is considered that there are potential substantive impediments to the resolvability of an institution, the institution will be required (upon receipt of notice from the resolution authority) to propose measures to address or remove the impediment in this regard. Article 14 of the Draft Directive does not provide institutions with the option to challenge the resolution authority’s determination of an impediment, nor does the Draft Directive provide for judicial review of such assessments, following which, resolution authorities may require the institution or group to take actions to reduce or remove the impediment.

The authorities’ powers in this regard are extremely broad and include powers *inter alia* to require service level agreements, divestiture of specific assets, changes to the legal or operational structures of the institution, limitation or cessation of activities, requiring establishment of a new parent financial holding company, capital raising and minimum levels of ‘eligible liabilities’ for the purposes of bail-in.

The EBA has been tasked with providing technical standards to specify the remedial actions which resolution authorities may require of an institution and the circumstances in which each may be used. These standards will be critical in order to ensure that institutions and groups have clarity and comfort that the authorities’ preventative powers will be used in proportionate, forensic and appropriate ways, so as to ensure that ‘least-cost’ measures are adopted and that the going concern viability of the institution or group is not threatened.

2.2.6 Intra-group financial support (Articles 16 – 19)

Recognizing that many jurisdictions do not allow for a concept of ‘group interest’ (i.e. the idea that each member of a group has an indirect interest in the prosperity of the group as a whole) and that the provision of intra-group financial support can thus be hampered, the Draft Directive seeks to provide some relief from national law restrictions on intra-group support. The Draft Directive requires Member States to permit groups to enter into agreements which provide for financial support in the form of loans, guarantees and provision of collateral to support transactions with third parties or any combination of these.

The agreements are intended to provide that such financial support will be given where the following conditions are met:

- there is a reasonable prospect that the recipient’s financial difficulties will be remedied as a result of the financial support;
- the financial support has the objective of preserving or restoring the financial stability of the group as a whole;

- the financial support is provided for consideration and the consideration is appropriate; and
- the liquidity or solvency of the provider is not threatened by the provision of the financial support, and the provider will not breach its own funds requirements as a result.

Such agreements will only be permitted where the supervisory authority (logically, each supervisory authority of each party to the agreement, which is not clear though on the face of the Draft Directive) is of the opinion that the parties are not in breach of their capital or liquidity requirements and are not at risk of insolvency. Groups are also required to submit any proposed agreement to the group's consolidating supervisor for authorization to be granted, should the agreement be consistent with the conditions for the provision of financial support.

Taking particularly into consideration that the new regime provides for a minimum level of harmonization, the Draft Directive does not prohibit the provision of intra-group financial support outside of such authorised agreements. However, despite the limited stated purpose of this Chapter of the Draft Directive, the requirement to obtain authorisation suggests that the Commission may intend for such authorised agreements to be the only means by which intra-group financial support is to be available. If this is the case, further clarity is required on how the requirements for authorised agreements will dove-tail with firms' current group financing arrangements and the extent to which any transitional period is to be put in place.

2.2.7 Early Intervention (Articles 20 – 22)

An area of significant concern is the Draft Directive's proposed early intervention powers, which are to be available to the competent authorities in circumstances where a credit institution or 730k firm does not meet or is likely to breach its capital requirements under the BCD.

The early intervention powers, which are designed to apply in addition to the powers granted to supervisory authorities under the BCD, include the power to require the institution to implement one or more of the measures set out in its recovery plan, the ability to directly convene shareholder meetings, the power to require management to make changes to the composition of the board of the credit institution or investment firm and the power to contact potential purchasers in preparation for the resolution of the institution, subject to certain restrictions, including confidentiality concerns. Furthermore, in cases that the early intervention measures are considered insufficient to rectify a serious deterioration in the institution's financial position, competent authorities may appoint a 'special manager' to the institution.

The special manager will take on the overall management functions of the institution, and will be burdened with a statutory duty, overriding all other managerial responsibilities, to rectify the institution's financial situation and restore "sound and prudent management". It will also be answerable to the authorities, who may set limits on the special manager's powers and take steps to remove the special manager at any time. The Commission have ducked difficult questions raised in responses to the consultation with respect to the inherent conflicts of interest faced by a special manager

having responsibilities to both the shareholders of the institution and to the relevant competent authorities and thus, indirectly, to the market as a whole.

The possibility of pre-emptive approaches to potential purchasers is a recent addition to the Draft Directive, the codification of which seems likely to prove controversial.

Preparation of technical standards designed to ensure consistent application of the early intervention powers (though, interestingly, not the appointment of a special manager or conduct of a special management), has been delegated to the EBA.

2.2.8 Pre – resolution requirements & valuation and write down of capital (Articles 30 and 51 – 55)

Prior to applying the resolution tools, resolution authorities will be required to arrange for an independent person, or the authority itself, to undertake a preliminary valuation of the assets and liabilities of the institution, together with an assessment of the likely returns to each class of creditors in the event of an insolvency of the institution, with a view to ensuring that any losses which will arise on resolution are recognized at the moment the resolution tools are exercised. Notwithstanding such aim, under circumstances where the market for a specific asset or liability “is not functioning properly”, the Draft Directive permits the valuation to reflect the long term economic value of that asset or liability.

Arguably, this requirement for a mandatory valuation exercise required prior to resolution will have little practical utility for any large institution. Even in the case of an idiosyncratic scenario, markets are likely to be turbulent in the period surrounding the resolution or failure of an institution and the values of an institution’s assets and liabilities are likely to be extremely volatile.

However, it is likely that this requirement will drive regulatory authorities to focus on the ability of firms, and groups, to provide comprehensive and accurate financial data promptly on request as part of their resolution planning.

In addition, implementing the Basel Committee recommendation on write down at the point of non-viability, the Draft Directive proposes a mandatory write down of capital before any resolution such that:

- (A) Common Equity Tier 1 capital is written down, in proportion to the losses and up to their capacity, i.e. Common Equity Tier 1 is to be written off before other classes of capital are affected; and
- (B) the principal amount of Additional Tier 1 and Tier 2 instruments, defined as ‘relevant capital instruments’, is permanently reduced to zero, presumably only if the losses exceed the total value of the relevant class of capital. The holders of the relevant capital instruments will not be entitled to compensation, other than the receipt of Common Equity Tier 1 capital instruments.

The mandatory write down is not required in respect of relevant capital instruments which are subject to contractual write down or conversion to Common Equity Tier 1 upon certain events, including that a resolution authority has made a determination that the institution meets the conditions for resolution or that the institution will no longer

be viable unless the write down occurs. Although the drafting of this section is unclear, the intention is that conversion to Common Equity Tier 1 should occur immediately prior to the exercise of resolution powers, thereby enabling write down of such instruments consistent with other Common Equity Tier 1 instruments.

Institutions may be required by resolution authorities to maintain the necessary prior authorisation to issue the required number of Common Equity Tier 1 instruments on a write-down; there is no express reference to any need to issue replacement Additional Tier 1 or Tier 2 capital instruments.

2.2.9 Objectives, conditions and general principles of resolution (Articles 26 – 29 and 87)

The Draft Directive provides for six resolution objectives, each of equal significance, as follows:

- to ensure the continuity of critical functions;
- to avoid significant adverse effects on financial stability, including by preventing contagion, and maintaining market discipline;
- to protect public funds by minimizing reliance on extraordinary public financial support;
- to avoid unnecessary destruction of value and to seek to minimize the cost of resolution;
- to protect depositors and investors covered by national guarantee schemes; and
- to protect client funds and client assets.

In addition to the objectives, Article 29 provides for a number of principles, with which any resolution action should comply. The Draft Directive is concerned to ensure that shareholders of an institution bear first losses, that creditors of a failing institution bear losses in accordance with the order of priority of their claims (i.e. following shareholders) , that senior management is replaced and, as individuals, bear losses in accordance with their civil and criminal liability, that all creditors of an insolvent institution of the same class are treated in an equitable manner subject to the provisions of the Draft Directive, whereas no creditor is left worse off than he or she would have been in an insolvency of the institution. In relation to groups, the Draft Directive also requires that resolution of an institution within a group occurs in a manner which minimises the impact on the remaining members of that group as well as the impact on the financial stability of the EU and the Member States in which the group operates.

The conditions for resolution of a credit institution or 730k firm are that:

- the competent authority or resolution authority determines that the institution is failing or likely to fail;
- there is no reasonable prospect that any alternative action would prevent failure of the institution in a reasonable timeframe; and
- resolution action is in the public interest.

Article 27(2) goes on to provide that an institution will be “failing or likely to fail” if the institution:

- is in breach, or there are objective elements to support a determination that the institution will be in breach in the near future, of the capital requirements necessary for its authorization;
- has assets which are, or there are objective elements to support a determination that the institution’s assets will be in the near future, less than its liabilities;
- is, or there are objective elements to support a determination that the institution will be in the near future, unable to pay its obligations as they fall due; and
- subject to certain exceptions, receives extraordinary public support.

Additional detail on the circumstances in which sub-paragraphs (a) to (d) will apply is to be the subject of delegated legislation by the Commission on the basis of EBA recommendations.

For a financial institution, other than a credit institution or a 730k firm, to be placed into resolution, the resolution conditions must be satisfied both in respect of that entity and in respect of the parent institution which is subject to consolidated supervision. In relation to Relevant Holding Companies, the conditions must be met in respect of both the Relevant Holding Company and at least one subsidiary which is an institution.

In respect of branches of third country institutions, the relevant resolution conditions are that one or more of the following has been met:

- the branch no longer meets, or is likely not to meet, the Member State’s conditions for its authorization and operation and there is no prospect of restoration in a reasonable timeframe;
- the third country institution is unable, or is unlikely to be unable, to pay its obligations to domestic creditors, or obligations that have been created or booked through the branch, as they fall due and the resolution authority is satisfied that no third country resolution proceeding or insolvency proceeding has been or will be initiated in relation to that institution;
- the relevant third country authority has initiated a resolution proceeding in relation to the third country institution, or has notified to the resolution authority its intention to initiate such a proceeding, and either (i) the third country resolution proceeding would have an adverse effect on the financial stability of the Member State, (ii) independent resolution of the branch is necessary in order to achieve one or more of the resolution objectives or (iii) creditors would not receive equal treatment with third country creditors under the third country resolution proceedings.

2.2.10 Resolution tools (Articles 31 – 50)

Member States will be required to have in place resolution tools, which may be applied to a credit institution, 730k firm, financial institution or a Relevant Holding Company, which include:

- **the sale of business tool** : power to transfer instruments of ownership, assets, and rights or liabilities of the failing institution to another institution (which is not a bridge institution);
- **the bridge institution tool** : power to transfer assets and rights or liabilities of the failing institution to a bridge institution, being an entity which is wholly or partially owned by a public authority (which may be the resolution authority);
- **the asset separation tool** : in conjunction with another resolution tool only, power to transfer assets and rights of an institution under resolution to a publicly-owned asset management vehicle with a view to maximizing their value through eventual sale; and
- **the bail in tool** – power to write down the institution’s ‘eligible liabilities’ in order to resolve the failing institution as a going concern and where systemically important services are transferred to a bridge institution and the failing bank ceases to operate.

As explicitly stated under the scope of the current thesis, the Draft Directive provides for a minimum harmonisation framework, whereas Recital 26 explicitly confirms that Member States should be able to utilise resolution tools which are in addition to those noted above.

2.2.11 Bail – in (Articles 37 – 50)

As anticipated, the Commission have moved forward with their intention to include a bail-in tool in the Draft Directive, despite the lack of clear direction evidenced by their Spring 2012 consultation paper.

It had previously been suggested that bail-in might operate as some sort of pre-resolution tool, subject to different requirements and triggers. The Commission have chosen an alternative route and thus the Draft Directive proposes that the bail-in tool shall apply to all of an institution’s ‘eligible liabilities’, defined as all of the institution’s liabilities excluding the following:

- guaranteed deposits (‘guaranteed’ refers to the deposit guarantee scheme under Directive 94/19/EC);
- secured liabilities;
- any liability that arises by virtue of the holding by the institution of client assets or client money, or a fiduciary relationship between the institution (as fiduciary) and another person (as beneficiary);
- liabilities with an original maturity of less than one month; and
- any liability to an employee or a trade creditor in connection with the provision of goods or services that are essential to the daily functioning of the institution’s operations, including IT services, utilities and the rental, servicing and upkeep

of premises, or any liabilities to tax and social security authorities, where such liabilities are preferred under national insolvency law.

The Draft Directive confirms that the value of any secured liability which is in excess of the collateral against which it is secured should be included in the institution's 'eligible liabilities'. However, Member States are given the option to exclude any covered bond as defined in Article 22(4) of Council Directive 85/611/EEC, i.e. the UCITS Directive. This express provision for full protection for covered bonds, including any residual unsecured claim against the institution issuer, is helpful.

Many respondents to the Commission's Spring 2012 consultation paper, including ISDA, had argued that derivatives contracts should also be excluded on the basis that derivatives positions are inherently difficult to value in a short period of time, particularly in a volatile market. The Commission have clearly been swayed by concerns that a blanket exclusion of derivatives liabilities might lead to market distortions, in that transactions could be structured as derivatives so as to avoid liabilities thereunder being bail-inable, and have chosen to leave the inclusion of derivatives liabilities to the discretion of Member States on a case-by-case basis, in particular considering the systemic impact of closing out derivatives positions in order to apply the bail-in tool.

It is worth noting that similar concerns about the ability to value a liability in a short period of time exist in connection with the 'excess' portion of any secured liability, which will necessarily involve a valuation of the relevant collateral. This is particularly so where the collateral is highly illiquid.

The Draft Directive requires that institutions hold a sufficient aggregate amount of own funds and "eligible liabilities", so as to ensure that liabilities are not structured in such a way as to avoid bail-in. However, in contrast to earlier proposals, the Commission have left the determination of the appropriate amount of 'eligible liabilities' to the discretion of Member States, which must determine the minimum amount on the basis of the institution's resolvability, size, business model and risk profile, as well as its potential impact on financial stability. The requirements for a minimum amount of eligible liabilities may, subject to certain conditions, apply to groups on a consolidated basis.

It is required that, upon application of the bail-in tool, existing shares be either cancelled or severely diluted. In light of the Commission's requirements for write down of capital instruments, an institution's shareholders at the point of bail-in will be individuals who had, prior to the write down, held Additional Tier 1 or Tier 2 capital instruments. Further, it is to be expected that the institution no longer retains any Additional Tier 1 or Tier 2 capital instruments.

Accordingly, it is not clear how the proposed hierarchy of write down set out in Article 43 and Articles 51 to 55 operates. A logical hierarchy would require that shareholdings be written down to zero before Additional Tier 1 or Tier 2 capital instruments are written down, that Additional Tier 1 instruments that are liabilities and Tier 2 instruments be written down to zero before other subordinated debt is written down, and that such subordinated debt be written down to zero before other 'eligible liabilities'

are bailed in. At each level, the write down, if not to zero, is to be in proportion to the institution's losses.

There are also questions as to what compensation for equity holders, who were previously holders of Additional Tier 1 or Tier 2 capital instruments, might be, i.e. is the value that would have received in a normal insolvency to be assessed by reference to their position before or after the write down of Relevant Capital Instruments?

The bail-in tool is designed to be used for one of the two following purposes:

- to recapitalize an institution so as to enable it to continue as a going concern; or
- to write-down liabilities that have been transferred to a bridge institution with a view to providing capital for that bridge institution.

Bail-in may be used for the first purpose only where there is a realistic prospect that the bail-in, accompanied by the implementation of a business reorganization plan, will restore the institution to financial soundness and long-term viability, in addition to meeting the resolution objectives.

The Draft Directive requires that any use of a bail-in tool be accompanied by the appointment of an administrator to the resolved institution or bridge institution, as the case may be, and that the administrator present a business reorganization plan to the resolution authority, the Commission and the EBA within one month of being appointed. The business reorganization plan will be subject to the approval of the resolution authority and the administrator must report on progress on a monthly basis.

2.2.12 Resolution powers (Articles 56 – 64)

In order to be able to apply the resolution tools, the Draft Directive provides that resolution authorities should have the power to transfer an institution's shares, debt instruments, rights, assets and liabilities, power to write off or cancel shares, power to write down or convert debt, power to replace senior management, power to impose a temporary moratorium on payments under debt instruments issued by the institution and power to require the institution to issue new shares or other capital instruments.

A range of ancillary powers, applicable in the context of a transfer and available where use is appropriate to ensure achievement of the resolution objectives, are also included. Such powers would enable the resolution authority to:

- provide for the relevant transfer to take effect free from any liability or encumbrance affecting the financial instruments, rights, assets or liabilities transferred;
- de-list shares;
- provide for the recipient to be treated as if it were the institution under resolution for the purposes of any obligations, contracts or arrangements made by, or actions taken by, the institution under resolution;
- require the institution under resolution or the recipient to provide the other with information and assistance;

- cancel or modify the terms of a contract to which the credit institution under resolution is a party or to substitute a transferee as a party;
- enforce contracts entered into by a subsidiary, the obligations under which are guaranteed or otherwise supported by the parent undertaking, notwithstanding the absence of any relevant contractual right, in certain circumstances.

In particular, the power to cancel or modify contractual terms, which would impact on third parties' private law rights, is dangerously wide. In the context of use of a transfer power or the power to write down debt, Member States must also ensure that resolution authorities have the power to make continuity arrangements so as to ensure that the resolution action is effective and the business transferred may be operated by the recipient. This may include powers in respect of the continuity of contracts, the assumption of liabilities by the recipient and the substitution of the recipient for the institution in any legal proceedings concerning the transferred property, rights and liabilities.

Draft Article 58 will require Member States to ensure that resolution authorities may compel any institution under resolution, or any entity in the same group as that institution, to provide those operational services and facilities to the recipient under a transfer order which are required to enable it to operate the business transferred to it effectively. This provision is drafted such that this power must also be available where the institution under resolution is in fact subject to normal insolvency proceedings. Such requirement may therefore necessitate some amendment to national insolvency laws.

Resolution authorities are also to be given the power to suspend:

- the contractual payment and delivery obligations of the institution under resolution, other than obligations under insured deposits;
- the enforcement of security interests secured over property of the institution in resolution, except in respect of security interests held by a central counterparty over margin or collateral pledged to it by the institution; and
- termination rights of any party under a financial contract arising by reason of resolution action, until 5pm on the business day following notice of application of the resolution tools.

In respect of (iii), 'termination right' has been defined to mean "a right to terminate a contract on an event of default as defined in or for the purposes of the contract, and includes any related right to accelerate, close out, set-off or net obligations or any related provision that suspends, modifies or extinguishes an obligation of a party to the contract to make a payment". As currently defined, this provision would affect all financial contracts, including netting arrangements, entered into with institutions or other entities within the scope of the Draft Directive, particularly as the Draft Directive also provides that the exercise of this suspension power and, indeed, application of any resolution tool, will trump the provisions of the Collateral Directive, which requires recognition of close-out netting provisions. Further, the effect of this provision as currently drafted could be that counterparties will be required to continue to make payments and deliveries to the institution, even where the institution's obligations to make reciprocal deliveries or payments have been suspended. While well-intentioned,

it is an open question whether a suspension power is likely to improve the likelihood of successful resolution given the messaging it provides to the market and the likely precautionary non-payment it would trigger by counterparties.

Finally, the Draft Directive includes override powers which require that where a resolution authority has decided that the conditions for resolution are met, or has taken a resolution action, that action shall itself not make it possible for anyone to:

- exercise a termination or acceleration right, or declare an event of default, under any agreement to which the institution under resolution is a party;
- obtain possession or exercise control over any property of the institution under resolution; or
- affect any contractual rights of the institution under resolution.

2.2.13 Safeguards (Articles 65 – 73)

The Draft Directive provides for certain protections of creditor's rights, or safeguards. Where the resolution authority has transferred only part of the property of the institution to another entity or from a bridge institution or asset separation vehicle to another entity, a partial property transfer, or has applied the bail-in tool, the 'no creditor worse off' principle will apply, such that creditors will receive compensation to be paid by the resolution authority, to ensure that they receive at least as much in payment of their claims as they would have done in an insolvency.

Further, in respect of a partial property transfer or the use of the general contractual modification power, Member States are to ensure "appropriate protection" for security arrangements, title transfer collateral arrangements, set-off arrangements, netting agreements and structured finance arrangements. Appropriate protection is further described in Articles 69 – 71 of the Draft Directive and is intended to include assurance that a transfer of some but not all of the rights and liabilities under a title transfer collateral arrangement, set-off arrangement, netting agreement or structured finance arrangement, is prevented. Assets over which security has been granted, the related liability and the benefit of the security must all be kept together, i.e. all transferred or all not transferred, and termination or modification of the property rights or liabilities under a structured finance arrangement by use of the ancillary resolution powers must be prevented.

The Draft Directive also provides for safeguards for the operation of trading, clearing and settlement systems, in effect to ensure that the default rules of such systems shall take precedence over the exercise of a resolution tool which purports (i) to transfer property, rights or liabilities of the institution in resolution, (ii) to use of ancillary powers to cancel or amend the terms of a contract to which the institution in resolution is a party, or (iii) to substitute a recipient, i.e. a transferee, as a party.

Rather unsatisfactorily, the Draft Directive does not provide for any comprehensive consequence of a breach of a safeguard by the resolution authorities. Article 73 seeks to deal with the uncertainty surrounding effectiveness of transfers of non-EEA contracts or property. The Article requires that any transfer or purported transfer of all of an institution's property, rights or liabilities to another entity which is ineffective in relation to certain property located outside of the EU or property governed by the law

of a third country shall be void. No express provision is made for the consequence of a partial property transfer which has a similar nexus to foreign law and is thus not effective in relation to all of the property transferred or purported to be transferred. Perhaps more concerning is that no express provision is made for the consequences of a partial property transfer which purports to transfer some, but not all, of the rights and liabilities under a title transfer collateral arrangement, set-off arrangement, netting agreement or structured finance arrangement. Without provision for such consequences, the safeguards as drafted may be insufficient to ensure that clean netting or set-off opinions can be given in respect of such arrangements.

2.2.14 Exclusion of termination rights (Article 77)

The Draft Directive requires that third parties be restricted from exercising termination rights under financial contracts with institutions under resolution unless that resolution action is the sale of business tool or bridge institution tool and the relevant financial contract has been left with the residual institution. This requirement differs from the default override provided for in Article 57(5) in that the restriction applies in respect of a termination right, howsoever arising, i.e. not just a termination right arising as a result of the resolution action.

The same restriction applies in respect of:

- rights under provisions in financial contracts that suspend, modify or extinguish an obligation of the institution under resolution to make a payment (the Draft Directive unhelpfully describes such provisions as ‘walk away clauses’); and
- statutory rights of set-off.

As presently drafted, this provision is worryingly broad and could operate to exclude antecedent rights unrelated to resolution. This could be considered as a significant infringement of the private law rights of third parties.

2.2.15 Rights to challenge resolution and restrictions on other judicial proceedings (Articles 78 – 79)

Persons affected by a decision of a resolution authority to take a resolution action will have the right to apply for a judicial review of that decision, and the remedy for any wrongful decision taken is to be limited to compensation for the loss suffered by the applicant as a result of that decision. Any annulment of the decision by the courts is not to affect any subsequent acts based on that decision, including any transfers of property. While there are circumstances in which damages are unlikely to be an appropriate remedy for the losses suffered, this would appear to be an appropriate balancing of the need for some means of redress with the need for legal certainty.

The commencement of normal insolvency proceedings in respect of an institution under resolution is to be restricted. Moreover, the resolution authorities shall be permitted to approach the courts for a stay on any other judicial actions or proceedings to which the institution under resolution is or becomes a party.

2.2.16 Procedural obligations (Articles 74 – 76 and 89)

Institutions will be required to notify their supervisory authority in the event that it is failing or likely to fail. If the supervisory authority decides that the conditions for resolution are met, it will be required to notify the resolution authority for that institution, the central bank, the group level resolution authority (if applicable) and the consolidating supervisor (if applicable).

The Directive also imposes notification obligations on the resolution authority, which are engaged once resolution action has been taken, including a requirement to make public the fact that a resolution action has been taken.

2.2.17 Third countries (Articles 84 – 88)

In addition to requiring that resolution authorities have the power to resolve branches of third country firms, in accordance with the Financial Stability Board's Key Attributes, the Draft Directive also envisages that Member States and competent authorities will enter into co-operation agreements with third country resolution authorities regarding the means of cooperation between all relevant resolution authorities in respect of an international group. Until such time as these cooperation agreements are in place:

- framework cooperation agreements, to be concluded by the EBA, will apply. Such framework agreements will not be binding on the EBA, but Member States will be expected to conclude agreements with third countries in line with the relevant EBA framework agreement; and
- the EBA shall recognize third country resolution proceedings, as appropriate, in which case Member States' resolution authorities will be required to implement the EBA's recognition.

For the purposes of a resolution authority's implementation of the EBA's recognition of third country proceedings, resolution authorities shall be empowered to (i) exercise the transfer powers in relation to assets, rights and liabilities of the third country institution that are located in their Member State, or governed by the laws of their Member State or, in the case of claims in relation to such rights or liabilities, are enforceable in their Member State and (ii) perfect a transfer of ownership of any institution established in their Member State which is a subsidiary of the third country institution.

2.2.18 Confidentiality (Article 89)

The authorities will be subject to confidentiality obligations, albeit with significant carve outs, including the provision of information to third country regulators where such third country regulators are also subject to obligations of professional secrecy and the information is necessary for them to perform their functions as a resolution authority.

2.2.19 Financing Arrangements (Articles 90 – 99)

Member States will be required to establish financing arrangements in order to ensure the efficient implementation of the resolution tools and powers. Member States will therefore be required to collect ex ante contributions from the industry in order to provide a pre-funded resolution fund to pay for the cost of resolution and they will have the powers to require ex post contributions where the value of the fund has been depleted.

The total value of the fund is required, within 10 years of the entry into force of the Directive, to be at least 1% of the amount of all guaranteed deposits held by institutions authorized in the particular Member State. It is stated that the fund shall benefit from any amounts received from the institution under resolution or bridge institution, including any earnings on investments or other earnings.

The Draft Directive also requires that Member States' resolution funds have the right to borrow from other Member States' resolution funds and be obliged to lend to other Member States' resolution funds. While this is clearly not a pan-European resolution fund of the kind that has been mooted in recent proposals for a Banking Union, it is a significant step towards such a European fund. It is expected that this requirement will be hotly negotiated by the Member States as the Draft Directive makes its way through the European parliamentary process.

It will be open to Member States whether they wish to operate the resolution fund as part of their deposit guarantee scheme or separately. The Draft Directive requires that any deposit guarantee scheme be liable in a resolution scenario for the amount of losses that it would have borne in a "normal" insolvency proceeding, up to the amount of guaranteed deposits. To ensure that such schemes do in fact contribute to the costs of a resolution, the Draft Directive goes on to require that national insolvency laws ensure that such schemes rank *pari passu* with unsecured creditors in any normal insolvency proceeding.

2.2.20 Sanctions (Articles 100 – 102)

The Draft Directive provides for Member States to have the power to impose a wide range of sanctions on institutions, or members of the institutions management or other responsible individuals, for any breach of the requirements of the Draft Directive.

2.2.21 Amendments to the winding up Directive and other European legislation (Articles 104 – 112)

The Draft Directive proposes the amendment of the Credit Institutions Winding Up Directive (the WUD) so as to bring investment firms within the scope of that directive. Under current law, there is no European framework for the cross-border recognition of insolvency or reorganization measures in respect of investment firms, as many investment firms are carved out of the scope of the European Insolvency Regulation 1346/2000. Following implementation of this amendment, insolvency or reorganization proceedings in respect of an EU investment firm will only be permitted to be opened in the jurisdiction in which it is established; Furthermore, all other Member States will be subject to mandatory recognition of such home state proceedings.

In addition, the WUD is to be amended to provide that a resolution action, in respect of any entity falling within the scope of Article 1 of the Draft Directive, i.e. credit institutions, 730k firms, certain other financial institutions and Relevant Holding Companies, is recognized as a reorganization procedure for the purposes of the WUD. Accordingly, resolution of such entities will be subject to mandatory mutual recognition across the EU.

The definition of an investment firm given in the proposed amendment to Article 3 of the WUD is broad enough to capture third country investment firms, including their EU branches.¹²²

The Draft Directive also envisages derogations from EU company law and amendments to the Collateral Directive in order to ensure that the requirement that close-out netting provisions be recognized in accordance with their terms does not impede the exercise of a resolution power, or the temporary suspension of termination rights.

2.3 Areas of Concern

2.3.1 Application to investment firms

As noted above, use of the Term ‘institution’ or ‘institution under resolution’ throughout the Draft Directive, raises questions as to the extent to which the resolution powers in particular are intended to be available in respect of financial institutions which are not credit institutions or 730k firms, or in respect of Relevant Holding Companies. For example, as it is currently drafted, Chapter IV of Title IV, dealing with the write down of capital instruments, would apply only in respect of capital instruments issued by a credit institution or an EUR 730k firm. Given the Commission’s clear intention to provide for group resolution, including on a cross-border basis, this is a manifest error in the drafting of the Draft Directive, but one with important ramifications.

2.3.2 The EBA role

The EBA is given a broad range of tasks and roles under the Draft Directive. At the macro level, Articles 4(3) and 39(6) require the EBA to report to the Commission by January 1st 2018 on the need for amendments to minimize divergence at the Member State level in relation to the application of Recovery and Resolution Plans (RRP) requirements to small or non-systemic firms and the minimum level of eligible liabilities.

The Draft Directive calls for the EBA to develop technical standards in connection with no less than 23 of the proposed provisions. Such technical standards are required to be

¹²² As regards branches of third country firms, the WUD does not impose any restrictions on the ability to commence insolvency proceedings in a Member State or require any foreign proceedings to be recognised in the Member State; rather, it contains provisions requiring notifications of the commencement of an insolvency proceeding or reorganisation measure in respect of a branch to be given to the competent authorities in any other Member State in which that third country firm has a branch. Further, the respective insolvency practitioners would be required to “endeavour to coordinate” their actions.

in place 12 months after the date of entry into force of the Draft Directive; on the timeframe posed in explanatory memorandum accompanying the Draft Directive, this would see such standards in place on or about January 1st 2015, i.e. coinciding with implementation by the Member States.

The EBA also has been tasked with the development of non-binding framework co-operation agreements with third countries, in advance of resolution authorities and/or Colleges developing firm-specific co-operation agreements.

Finally, the EBA is expected to establish its own resolution authority, to participate in resolution Colleges and to act as binding mediator in a range of potential disputes between the resolution authorities of individual Member States. As regards this mediation role, the Draft Directive lacks clarity as to what it is that the EBA is empowered to decide upon in the event of a dispute in a number of areas, giving rise to concerns about the transfer of supervisory power to Europe.

Interestingly, despite the enormity of the task facing the EBA and the fact that they have clearly started to develop technical standards in certain areas, the Legislative Financial Statement accompanying the Draft Directive suggests that the EBA will not commence work under the Draft Directive until 2014.

In circumstances where the scope of the Draft Directive includes investment firms, it is questionable whether some of these tasks should in fact be shared with the European Securities and Markets Authority that, has an obligation under the Regulation¹²³ by which it was constituted, “to contribute to the consistent and coherent functioning of colleges of supervisors, the monitoring, assessment and measurement of systemic risk, and the development and coordination of recovery and resolution plans”.

2.4 The June 26th 2013 EU Finance Ministers agreement¹²⁴

European Union finance ministers on the night of June 26th 2013 agreed the parameters for the draft of the Directive on bank recovery and resolution. Such agreement is considered of crucial importance, taking into account that as recently as a week before, they were unable to reach a consensus, but it was tensely hoped that this deal would unquestionably pave the way for implementation of the EU’s Banking Union.

The ministers have agreed in principle the means by which a failing bank would be resolved. These included asset separation and disposals, the establishment of a bridge institution for “good bank assets” and the imposition of losses on shareholders and unsecured creditors, who stand to lose a minimum of 8% of total liabilities in the event of a bank failure, rising to 20% of risk-weighted assets “under special circumstances”.

Taking into serious consideration the significance of the bail – in tool, the ministers have additionally agreed that unsecured bondholders and large corporate depositors would be first in line after shareholders to bear losses. Unguaranteed deposits by individuals and those from smaller business could be bailed in but would have

¹²³ See Regulation (EU) 1095/2010.

¹²⁴ See Council of the European Union, Press Release 11228 / 27th June 2013.

preferential treatment, as would any liabilities to the European Investment Bank.¹²⁵ Deposits below €100,000, which are covered by the EU deposit guarantee scheme, secured instruments such as covered bonds, short-term inter-bank loans and staff salaries and pensions would not finally be bailed in.

The draft also establishes that the EU's bailout fund, the European Stability Mechanism, can be employed to bail out banks directly, but only after unsecured creditors have taken losses. Member states will also have to raise a new fund for use in a banking crisis, although there are certain national exemptions.

Certain Member States voted for more flexibility on national implementation, with Britain objecting to plans for a single EU resolution fund on the grounds that it already operates a bank levy for this purpose. Compromises in this latest draft include allowing individual States to make their own arrangements, but at a minimum these would have to match funds raised by Member States contributing to the common fund.

It should finally be noted that the finance ministers' agreement provoked controversial reactions. Certain debt capital markets bankers contended that the increased stock of capital required by Basel III would act as a cushion and would limit a repricing of the market, whereas others pointed out that the removal of seniors' status at the top of the capital structure would reduce it to the credit quality of more costly subordinated debt. Certain analysts finally characterized the agreement as negative for senior, especially for weakly capitalized banks, and viewed that it was not reflected in the prices at the then existing levels. Higher differentiation among stronger and weaker banks was certainly expected.

2.5 Cross – border dimension

2.5.1 Introductory remarks

So far, solutions to the financial trilemma have been sought through international coordination of regulation and supervision. This could, however, be considered as starting from the wrong side. It assumes that what is needed is to make sure that supervisors can cooperate (by harmonizing rules and agreeing on protocols), but there is nothing to assure that they will cooperate. Cooperation requires incentives, which in turn depend on who picks up the pieces if supervision fails to prevent failures. Without an understanding of the possible endgame, resolution, it is impossible to make a rationale choice about what needs to be supervised and who is in charge.¹²⁶ Only by having clarity on cross-border resolution, which includes not just the procedures to be followed, but importantly who will be providing financing and shouldering losses, will there be proper incentives for supervisory cooperation. The FSB report on Effective Resolution Regimes propose “commitments” for cooperation between home and host

¹²⁵ Clarity on the bail-in hierarchy is certainly welcomed, as is the fact that the ministers have finally been able to agree a deal in principle. But with the ultimate aim being a European standard on bank resolution, Societe Generale analysts at the very same morning noted some deficiencies. They actually wrote: “This for now isn’t going to address financial fragmentation in the euro area. It highlights a limited loss of national sovereignty and a minimal move towards risk mutualisation.”

¹²⁶ See Claessens et al (2010).

countries, but fails to provide incentives for cooperation or to impose sanctions on lack of cooperation. More generally, Goodhart (2011) discusses the problem of enforcing standards, including imposing sanctions, by international regulatory committees.¹²⁷

The orderly resolution of a cross-border financial institution, on the other hand, requires effective and compatible national resolution frameworks. Back on 2010, the Basel Committee CBRG identified significant differences across countries in the frameworks for resolving banks. Differences also exist within countries between the approaches for resolving different types of financial institutions. Some of these differences have their source in differences in the substantive company laws and legal frameworks for supervision. Some of these differences reflect the specific oversight imperatives for different financial institutions that may in turn require certain variations in crisis management and resolution tools with different protections for different types of claimants. For example, certain laws governing securities firms impose special protections for customer securities while other laws governing insurance contracts impose specific protections for policyholders.¹²⁸

2.5.2 Cross-border resolution under the auspices of the EU Draft Proposal Directive

The Commission proposes a framework for enhancing cooperation between national authorities in relation to recovery and resolution matters. **“Resolution Colleges”** shall be established under the leadership of the Group Resolution Authority (with the EBA participation), with the objective of coordinating preparatory and resolution measures among national authorities to try to ensure optimal resolution at EU level. In particular, Resolution Colleges will provide a framework for the Group Resolution Authority, the other relevant Resolution Authorities and, where appropriate, Consolidating Supervisors and other relevant Competent Authorities to perform the following tasks:

- Exchanging information relevant to the development of group resolution plans, for the application to groups of preparatory and preventative powers and for group resolution;
- Developing group resolution plans;
- Assessing the resolvability of groups;
- Exercising powers to address or remove impediments to the resolvability of groups;
- Deciding on the need to establish a Group Resolution Scheme;
- Securing agreement on Group Resolution Schemes;
- Coordinating public communication of group resolution strategies and Group Resolution Schemes;
- Coordinating the use of “resolution funds”.

¹²⁷ See Goodhart (2011).

¹²⁸ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

The EBA shall develop draft regulatory standards in order to specify the operational functioning of Resolution Colleges for the performance of these tasks.

The College for a particular group will comprise the Group Resolution Authority, the Resolution Authorities in each Member State in which a group member subject to consolidated supervision is established, and the EBA.

Finance Ministries of relevant Member States will also be members of the Resolution College. Such membership shall be of particular importance in case that issues discussed by the Resolution College may have an impact on a Member State's public funds.

If the Group has subsidiary Institutions in non - EU countries, the Resolution Authorities in those countries may also be invited to participate, as observers, in the Resolution College at the request of the Group Resolution Authority, provided that the non-EU Resolution Authorities are subject to confidentiality requirements that are equivalent to those established by the Crises Management Directive (CMD).

The Group Resolution Authority will chair the Resolution College and it will be responsible for, among other things, the coordination of all activities of the Resolution College, for the organization of meetings and to ensure all members and the EBA are fully informed of relevant information regarding resolution matters. The Group Resolution Authority will decide which members should participate in particular meetings depending on specific needs.

The EBA's principal role in the Resolution College will be to promote and monitor the efficient, effective and consistent functioning of the Resolution College. If resolution College members cannot agree on a certain subject, such as the required resolution action for an Entity under Resolution, the EBA will act as a mediator. The EBA may attend meetings of the Resolution College, but will not have voting rights at those meetings.

If an Institution within a group is failing or likely to fail, the relevant Resolution Authority must inform the Resolution College. The relevant Resolution Authority will also propose the resolution measures or other insolvency measures that it considers appropriate for the institution.

After receiving such notification, the members of the Resolution College will assess the likely impact of the failure of the institution in question and the proposed resolution measures or other insolvency measures on the group or on affiliated institutions in other Member States. The Group Resolution Authority, after consultation with the other Resolution Authorities, could reach one of the following conclusions:

- The failure of the institution (or taking the proposed resolution measures or other insolvency measures to resolve the institution) would not have a detrimental effect on the group or on affiliated institutions in other Member States, in which case the Resolution Authority responsible for the institution in question may take the proposed measures; or

- The failure of the institution (or taking the proposed resolution measures or other insolvency measures to resolve the institution) would have a detrimental effect on the group or on affiliated institutions in other Member States, in which case the Group Resolution Authority will propose and submit to the Resolution College a Group resolution Scheme within 24 hours of the notification to the Resolution College that the Institution is failing or likely to fail.

A Group Resolution Scheme must:

- Outline the resolution actions that should be taken by the relevant Resolution Authorities in relation to the EU parent undertaking or particular group entities, with the objective of preserving the value of the group as a whole, minimizing the impact on financial stability in the Member States in which the group operates and minimizing the use of extraordinary public financial support;
- Specify how those resolution actions should be coordinated; and
- Establish a plan for funding resolution actions. Such plan must take into account the principles that would have been agreed as part of the group resolution plan regarding the sharing of responsibility for the financing of resolution actions between the relevant Member States.

Any member of the Resolution College that disagrees with the Group Resolution Scheme and believes that independent resolution actions or measures must be taken for reasons of financial stability may refer the matter to the EBA for a decision. The EBA will be required to take a decision within 24 hours.

A Resolution Authority may also support resolution actions taken by non – EU authorities in respect of assets or liabilities located in, or governed by the law of, the Resolution Authority’s jurisdiction and which belong to a non – EU institution (including EU branches of that institution) pursuant to:

- A cooperation agreement between the relevant non – EU resolution proceedings;
- The EBA recognizing the relevant non – EU resolution proceedings.

If the EBA decides that non – EU resolution proceedings should be recognized in the EU, Member States must enable their Resolution Authorities to:

- Exercise the transfer powers in relation to assets of a non – EU institution that are located in their Member State or governed by the law of their Member State;
- Exercise the transfer powers in relation to rights and liabilities of a non – EU Institution that are booked by the branch in their Member State or governed by the law of their Member State, or where claims in relation to such rights and liabilities are enforceable in their Member State; and
- Perfect a transfer of shares or instruments of ownership in a domestic subsidiary institution established in the relevant Member State.

However the EBA, after consultation with the relevant Resolution Authorities, will refuse to recognize non – EU resolution proceedings, if it considers that:

- These proceedings would have an adverse effect on financial stability in any Member State; or
- An independent resolution action in relation to the branch is necessary to achieve one or more of the Resolution Objectives; or
- Creditors would not receive equal treatment with non – EU creditors under non – EU resolution proceedings.

Resolution Authorities will be permitted to take resolution actions in relation to a branch of non – EU Institution that are independent of any non – EU resolution procedure if such action is necessary in the public interest and one or more of the following conditions are met:

- The branch no longer meets, or is likely not to meet, the conditions imposed by the Member State's law for its authorization and operation within that Member State and there is no prospect that any private sector, supervisory or relevant non – EU action or procedure would restore the branch to compliance or prevent failure in reasonable timeframe;
- The non – EU Institution is unable, or is likely to be unable, to pay its obligations to domestic creditors, or obligations that have been created or booked through the branch, as they fall due and the relevant Resolution Authority is satisfied that non – EU resolution proceedings or insolvency proceeding has been or will be initiated in relation to that institution; or
- The relevant non – EU Authority has initiated resolution proceedings in relation to the non – EU institution, or has notified to the Resolution Authority its intention to initiate such a proceeding, and one of the circumstances that would lead to a decision by the EBA to refuse recognition on the non – EU resolution proceedings applies.

2.6 Legal issues of cross-border resolution within the EU context: the desirability and feasibility of achieving an EU cross – border resolution framework

2.6.1 National incentives and crisis resolution within the cross-border dimension framework: territorial vs. universal resolution approaches¹²⁹

The concepts of universality and territoriality strictly only describe the way in which national authorities will apply their insolvency and related resolution processes to individual institutions (a financial institution with branches and assets located in other jurisdictions). These concepts are not determinative in the situation of financial groups consisting of multiple legal entities. Accordingly whether a jurisdiction follows the universal approach or territorial approach in relation to branches does not govern the resolution of subsidiaries of foreign institutions. In both cases, the subsidiary is subject

¹²⁹ *Ibid*, pp 18- 22.

to separate, local insolvency proceedings. There are however differences among jurisdictions with respect to the treatment of intra-group claims in insolvency. National insolvency law in most countries surveyed allows intra-group transactions to be retroactively ruled void or ineffective if they were carried out during a "suspect period" preceding the insolvency proceedings and/or on preferential terms ("avoidance provisions"). Although such provisions are not necessarily specific to intra-group transactions and frequently target transactions with any third parties that are detrimental to other creditors, more stringent rules frequently apply to transactions with affiliates.

There is no framework for the resolution of cross-border financial groups or financial conglomerates. At the national level, few jurisdictions have a framework for the resolution of domestic financial groups or financial conglomerates. Such frameworks consist of a regime for the coordination of the proceedings governing the individual components of the group ("procedural consolidation"). In certain jurisdictions judicial practice has led to the development of the concept of a pooling of the assets of the individual entities making up the group (referred to as "substantive consolidation" or "piercing of the corporate veil"). It is generally applied very exceptionally and under narrowly defined circumstances.

Some members of the Basel Committee CBRG are of the view that the presence of effective supervisory ring fencing measures and the territorial approach encourage early intervention by authorities. Host authorities in a jurisdiction that uses ring fencing have a strong incentive to ensure the assets of the local branch exceed local liabilities. In this context, ring fencing can have the effect of more closely aligning the supervisory authority of the host country with the assets available to pay stakeholders of the local branch or other office. The threat of ring fencing by foreign host authorities is also likely to place pressure on the home jurisdiction to resolve the problem besetting the institution. A ring fencing approach also can contribute to the resiliency of the separate operations within host countries by promoting the separate functionality of the local operating branch or other office. Finally, some members have argued that ring fencing can be carried out without significant damage to the group depending on early action, liquidity contingency planning by the parent and the relative size of the home/host firms.

Other members stressed the potential problems arising from the restrictions on capital flows resulting from ring fencing which are likely to cause problems for legal entities of the financial group in other jurisdictions and the group as a whole. Ring fencing can thus exacerbate the problems and increase the probability of default of the parent bank and its subsidiaries. From the perspective of cross-border financial institutions, ring fencing may create inefficiencies in the allocation of capital and liquidity. From the perspective of host jurisdictions, ring fencing may allow greater controls on capital, liquidity and risk management to ensure protection of host country creditors. Some members emphasized that this control can also impose costs on the host jurisdiction if cross-border institutions limit or reduce their operations in those host countries. Finally, ring fencing by host authorities may undermine an orderly resolution brought by the home country authorities, who will be seeking to apply the resolution to the bank and all its foreign branches, by reducing the pool of assets that is capable of being transferred at a premium to a bridge bank or private sector purchaser in the home country.

The fact that ring fencing has occurred between national jurisdictions with pre-existing cross-border rules providing for allocation of responsibility for deposit insurance and similar types of public commitments and with long histories of close supervisory cooperation, demonstrates the strong likelihood of ring fencing in crisis management or insolvency resolution. This is particularly so where host supervisors are faced with the prospect of the failure of the home office to whom liquidity has been upstreamed. The crisis has also demonstrated that in a period of market instability there is rarely time to carefully weigh cooperative cross-border management of crises.

In most cases, national authorities seek to ensure that their constituents, whether taxpayers or member institutions underwriting a deposit insurance or other fund, bear only those financial burdens that are necessary to prevent the risks to their constituents of a disorderly collapse and attendant contagion effects without expending those funds. In a cross-border crisis or resolution, this comparative assessment is complicated by the potential effect of foreign operations, foreign regulators, and their willingness and ability to bear a share of the burden.

In the absence of ex ante agreement between home and the major host jurisdictions on the sharing of financial burdens for the resolution of cross-border financial institutions designed to maintain the cross-border functionality of the financial institution, most jurisdictions are likely to opt for separate resolution of a failing financial institution operating within their jurisdiction. At this stage, reaching such broad international agreement appears significantly challenging as the practical implications of burden sharing give rise to considerable reservations. However, some further progress in this respect should not be ruled out in a regional or bank-specific context. In the current environment, if no burden-sharing agreement can be reached, the most practical steps may be to recognize the strong possibility of ring fencing and implement appropriate crisis management arrangements and supervisory requirements that promote clarity and protect stakeholders. Clear rules that allocate responsibilities will allow stakeholders in multiple jurisdictions to plan more efficiently for the potential consequences of insolvency.

The CBRG recommends a “middle ground” approach that recognizes the strong possibility of ring fencing in a crisis and helps ensure that home and host countries as well as financial institutions focus on needed resiliency within national borders. Such an approach may require certain discrete changes to national laws and resolution frameworks to create a more complementary legal framework that facilitates financial stability and continuity of key financial functions across borders. While not denying the legitimacy of ring fencing in the current context, this approach aims at improving, inter alia, the ability of different national authorities to facilitate continuity in critical cross-border operations that, absent such efforts, may contribute to contagion effects in multiple countries, while minimizing moral hazard. This middle approach merely protects systemically significant functions, performed by the failing financial institution, but not the financial institution itself, at least in its current ownership and corporate structure. It would limit moral hazard and promote market discipline by imposing losses on shareholders and other creditors wherever appropriate.

Encouraging greater cross-border cooperation within such a middle ground approach requires improved understanding of the parameters for action by different authorities and greater convergence in national laws. The working group additionally prepared an

extensive database on the national bank resolution and insolvency laws of Member States that could lay the foundation for greater understanding, though it will require regular updating.

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. For example, establishing more consistent approaches to early intervention and triggering conditions for intervention will provide a more predictable framework for planning and, based upon such pre-planning, for cooperation in a crisis. Similarly, the option of a bridge financial institution will allow authorities to have greater confidence that there is a viable resolution option that facilitates continuity in key linkages. These and other steps should improve confidence in national processes and facilitate coordination on any necessary assurances to other authorities and exchanges of essential information.

An alternative approach would be to take the steps necessary to establish a comprehensive, universal framework for the resolution of cross-border financial groups. This framework would accord primacy to the resolution of all domestic and cross-border activities of a failing financial group by the jurisdiction in which the institution is headquartered or possibly by a supranational entity. The implementation of a universal framework will require national authorities to address a number of difficult issues.¹³⁰

Such a framework would need to be set out in a binding legal instrument or international treaty¹³¹ and provide, inter alia, for the following:

- Terms and conditions for the sharing of the financial burdens of the resolution, which would need to include crisis management and resolution expenditures, such as public funding and deposit insurance or other guarantee coverage;
- Determination of the competent authority for the resolution proceedings of all component parts of the group and for the coordination of these proceedings, including the exchange of information between the authorities of different proceedings;
- Determination of the applicable rules governing the crisis management and resolution stage;
- A process to ensure coordination for the administration and supervision of the affairs of the group entities, including day-to-day operations where the business is to be continued, for instance, through a temporary structure using public financing, post-commencement finance or intra-group assets transfers;

¹³⁰ See Schoenmaker (2012); See also Lastra (2012) that argues in favour of a convention or treaty of limited scope, covering the actual conduct of a cross-border resolution and leaving aside the more controversial aspects, notably burden sharing (in the case of bail – out).

¹³¹ Such type of binding instrument could potentially be concluded between a selected group of countries that retain advanced sufficiency in this area or at a larger scale, confidence in the legal infrastructure including the laws, judicial systems and regulatory institutions in those countries or within the relevant regional authority.

- A commitment of national jurisdictions to undertake the necessary legal reforms, which may require a harmonization of national rules governing cross-border crisis management and resolutions, including rules on core issues such as a common definition for bank insolvency, avoidance powers, minimum rights and obligations of creditors including depositors, treatment of intra-group claims, ranking of claims, rights to set-off and netting, and the treatment of certain financial contracts, submission and admission of claims, and distributions to creditors;
- A process to ensure the equitable treatment of the creditors, depositors, counterparties and shareholders of group entities, regardless of the jurisdiction in which they are located, which would require careful assessment of the provision of intra-group financing;
- Harmonized and mutually compatible deposit insurance level to ensure the equal treatment of all depositors of the entities; and
- An agreement, supported by conforming statutory changes, to give full force and effect to decisions and actions across borders.

The implementation of such a framework would require major changes to national legal frameworks and also raise conceptual problems related to corporate separateness and the different legal approaches to the treatment of group interest. It would also need to address the many practical problems that typically arise in a complex cross-border resolution because of the inherent complexity of groups, the difficulty of obtaining information if record keeping and risk management systems are not well-maintained, the necessity of identifying assets, liabilities, and counterparties on a legal entity basis, sorting out inter-company transactions, and obtaining control over assets. Addressing these challenges would require additional supervisory and regulatory measures, as well as coordination among national authorities, to promote improvement in the information technology systems and processes of cross border financial institutions.

The work undertaken by the United Nations Commission on International Trade Law (UNCITRAL) on the insolvency and on the treatment of domestic enterprise groups may provide further guidance on how such a framework could be established. The work of UNCITRAL confronts many challenges. One of the problems is that the concept of “center of main interests”, which determines in which jurisdictions proceedings may be initiated, is not uniformly and universally applied. Its application would require binding agreements. National authorities and policymakers should examine whether the recommendations, which UNCITRAL is developing for judicial bankruptcy proceedings governing groups of enterprises, could inform the work underway to improve the coordination of resolution proceedings of financial groups and conglomerates.¹³² While valuable, the UNCITRAL work alone will not likely address the many unique issues implicated in the resolution of specifically enterprise groups and conglomerates.

¹³² On July 17th 2009, UNCITRAL adopted a Practice Guide on Cross-Border Insolvency Cooperation. The purpose of the Practice Guide is to provide readily accessible information on current practice in insolvency proceedings with respect to cross-border coordination and cooperation for reference and use by judges, practitioners and other stakeholders. However, the Practice Guide does not contain any actual recommendations, the elaboration of which is still to be decided.

2.6.2 Frameworks for coordinated resolution of financial groups¹³³

As demonstrated by the financial crisis, the absence of a process for the coordinated resolution of the legal entities in a financial group or financial conglomerate limits the options available to national or regional authorities for crisis management and further limits the possible coordinated resolution of such cross-border groups or conglomerates. While other challenges, such as the lack of time or inadequate information, may render any process difficult, the absence of a coordinated resolution mechanism for the legal entities in financial groups and financial conglomerates means that the only alternatives often are either a disorderly collapse or a bail-out.

Most systemically important financial functions or services¹³⁴ are provided by companies that are part of a financial group. Regulation is based on the type of businesses conducted by a company and financial groups are typically subject to separate rules, and perhaps separate regulators, for the banking, insurance and securities businesses conducted by companies in the group. These separate rules also often impose different accounting standards, liquidity requirements, and regulatory objectives for such businesses.¹³⁵ The differences create potentially complicating factors that affect the resolution of domestic or cross-border financial groups. These complications become more difficult for cross-border financial groups because of the different regulatory, supervisory, and legal rules that apply to the legal entities that comprise the group. For example, providing liquidity lines may be possible for holders of banking licenses within one group, and/or within one jurisdiction, but the rules may not allow groups to provide the same support to their insurance subsidiaries or to non-bank entities within the same group, or to subsidiaries in other jurisdictions. As a different example, there is no uniform framework for determining which Member State has jurisdiction and which law applies to resolve the insolvency of different types of financial institutions within the EU. Deposit-taking institutions are subject to the Winding Up Directive on credit institutions. Insurance undertakings are subject to the Winding Up Directive on insurance undertakings. Other entities are subject to the EU Insolvency Regulation except that EU investment firms that hold client assets fall outside the scope of the Banks Winding Up Directive, the Insurance Companies Winding Up Directive and the Insolvency Regulation. The absence of a uniform framework necessarily becomes a significant complicating factor during crisis management and resolution for a cross-border financial group.

Existing national legal and regulatory arrangements are not designed to coordinate the resolution of problems in all of the significant legal entities of a financial group operating through a multiplicity of separate legal entities. Insolvency rules apply on a legal entity basis and may differ depending on the types of businesses within the financial group. Most jurisdictions do not have a framework for the resolution of financial groups located within their borders. There are some limited exceptions. In Italy, for example, the authorities have the power to extend the special resolution regime

¹³³ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

¹³⁴ See FSB, IMF and BIS Report to the G-20 Finance Ministers and Central Bank Governors (2009): “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” that sets out criteria and indicators for identifying systemic relevance.

¹³⁵ See Bank for International Settlements (2001): “Joint Forum, Risk Management Practices and Regulatory Capital, Cross-Sector Comparison”.

for banks to domestic non-bank affiliates so long as the parent company falls under the special regime. Under the Italian procedures, the supervisor can initiate a proceeding at the same time for several group entities and appoint the same receiver, but it does not remove corporate separateness and does not lead to a pooling of the assets.

Disparate crisis management and resolution processes for the different business lines of the financial group, particularly where the group may be systemically significant to the national financial system, are likely to impair the ability of national authorities to respond coherently and prevent a disorderly collapse. If the crisis management and resolution framework does not provide a viable resolution process for such groups, then the only alternative will continue to be ad hoc actions by national authorities. Such responses, while often effective in avoiding a disorderly collapse as shown during the crisis, limit the discretion and flexibility of national authorities, render cooperation with other authorities more difficult and often increase moral hazard. A regime to allow for the compatible and coordinated resolution of a financial group operating in multiple legal entities is an essential feature of a national resolution process. However, it is not a sufficient condition. To be capable of responding to a crisis involving, multinational financial groups it is necessary to achieve an improved coordination of the national resolution processes.

2.6.3 Convergence of national resolution measures¹³⁶

The effective coordination of cross-border solutions may be problematic if countries apply different crisis management approaches. Certain countries place greater emphasis in their national laws on protection of the institution and others on the protection of creditors. Furthermore, the insolvency regimes of different jurisdictions may have different objectives (some may have a pro-debtor bias, while others may be pro-creditor); they may apply different ranking of priorities or different treatment of claims. Few resolution frameworks place emphasis on the protection of systemically significant financial functions independent of the institution itself. These differences are reflected in the different statutory tools, grounds for intervention, and scope of authority for restructuring troubled financial institutions provided to national authorities. While there is no necessity for all countries to adopt a common approach to crisis management and resolutions, it is essential for improved cross-border cooperation that countries agree that the process should facilitate the continuity of key financial functions, such as clearing and settlement, and an orderly resolution.

The consequences of these differences in approach are further aggravated by procedural and substantive differences in national insolvency laws. Some countries use general corporate insolvency law for the reorganization and winding up of financial institutions, while others have special proceedings for banks and other financial institutions which provide for tailor-made resolution measures. Certain countries also retain special resolution regimes for banks, but not for other types of financial institutions. There are important public policy and legal differences between corporate bankruptcy proceedings and special resolution regimes for financial institutions.

¹³⁶ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

Differences in resolution regimes also affect the ex ante behavior of financial market participants. For instance, if one jurisdiction treats unsecured bond holders more favorably than other jurisdictions in the event of a resolution, bond holders will likely be more willing to offer such financing during periods of financial distress in the most lenient jurisdiction.

2.6.4 Cross-border effects of national resolution measures¹³⁷

Crisis intervention takes place within national legal frameworks, and crisis management tools have been designed to work mainly in a national context. However, national competence does not extend to assets situated in other countries, and any extraterritorially orientated measures require cooperation with other relevant jurisdictions. Recognition of the legal status of, or actions by, foreign courts or authorities (subject to national policy or other limitations) has long been a feature of judicial and supervisory cooperation.

Certain national resolution mechanisms (for example provisions that allow the transfer of assets and liabilities to a bridge bank or to other institutions) may be important tools for facilitating the continuity of essential business operations. However, their effectiveness in a cross-border context may be hampered because the actions of the home jurisdiction will not necessarily be recognized and promptly implemented by host countries. The absence of coordination in the implementation of such mechanisms may make it difficult to coordinate a cross-border solution.

Notwithstanding the differences among national laws and approaches, it may nevertheless be beneficial in certain circumstances to be able to coordinate national proceedings. Certain but definitely not all national jurisdictions have the authority to recognize a foreign bank resolution measures. For instance, the Swiss FINMA has the power to recognize foreign bank resolution measures, including protective measures and bankruptcy decrees, in order to give a foreign administrator or liquidator control over assets located in Switzerland. Recognition is subject to the condition that the decree is enforceable, that Swiss creditors are treated equitably with non-Swiss creditors, that recognition does not result in violation of Swiss *ordre public*, and that there is reciprocity. In the event of recognition, FINMA will appoint a liquidator or administrator to carry out ancillary proceedings which are limited to the branch assets located in Switzerland. In the context of these proceedings, the secured and privileged (domestic and foreign) creditors of the bank will be paid. The remainder of the liquidation proceeds will be turned over to the foreign proceedings. The UK insolvency law provides a similar approach for non-EEA institutions. In the United States, the Bankruptcy Code provides procedures for recognizing foreign proceedings. However, these provisions are expressly not applied to banks. Notwithstanding that exception, the relevant State or federal branch liquidator is empowered to transfer remaining assets of the branch to the home country liquidator after all recognized claims of US branch creditors have been paid. In Europe, the WUD established the principle of recognition of other Member States' proceedings for branches. There are important public policy distinctions between insolvency proceedings involving commercial enterprises and those involving large, interconnected financial institutions. The public interest in financial system stability may be affected by the insolvency of large, interconnected

¹³⁷ *Ibid*, pp 27 – 29.

cross-border financial institutions and will therefore need to be considered in applying these principles for mutual recognition.

The development of similar procedures for the national authorities responsible for crisis management and bank resolution would improve coordination and cooperation by defining the terms and conditions governing the initiation of early intervention and resolution measures.¹³⁸

According to the CBRG, further work toward more effective recognition of foreign crisis management and resolution proceedings should be undertaken at the bilateral, regional or even international level. National authorities, or multinational groupings, may wish to consider putting in place bilateral or multilateral procedures to allow for recognition of foreign representatives and foreign crisis management and resolution proceedings and/or measures, subject to defined legal, public policy or other limitations. Specification of the grounds for such recognition, its scope (whether purely procedural or extending to any substantive issues), and the effect of such recognition in the recognizing jurisdiction will clarify the terms for official cooperation and coordination. Institution-specific procedures designed to facilitate recognition of foreign crisis management and resolution proceedings are also considerable parameters.

These procedures could define the criteria for recognition of the representative capacity of a foreign national authority or for the effectiveness of resolution measures across borders. They could define the public policy limitations for such recognition, and if consistent with law and policy leave appropriate discretion for recognition of substantive steps taken by such authorities. One example is the cross-border recognition of a temporary delay on immediate close-out. Another important procedural example would be to adopt steps specifying the grounds under which one jurisdiction would recognise the transfer of ownership or property from a failing financial institution directly to a private firm, to a national insolvency authority, or to a bridge financial institution or another public entity. Mutual recognition could also extend to substantive decisions on claims and other resolution decisions. The scope of recognition of crisis management and resolution proceedings in other countries is governed by national law, but consideration of enhancements of such recognition will promote improvements in coordination among national authorities.

2.6.5 Complexity and interconnectedness of group structures and operations¹³⁹

¹³⁸ The Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency notes that even where banks and insurance companies are generally excluded from the model law as enacted by a particular country, the enacting country might wish to treat, for recognition purposes, a foreign insolvency proceeding relating to a bank or an insurance company as an ordinary insolvency proceeding in certain circumstances. The guide notes that in enacting the exclusion for banks and insurance companies, a country may wish to make sure that it would not inadvertently and undesirably limit the right of the insolvency administrator or court to seek assistance or recognition abroad of an insolvency proceeding conducted in the territory of the enacting country, merely because that insolvency is subject to a special regulatory regime. See respectively the Guide to Enactment at paragraphs 63-64.

¹³⁹ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

Although large international group corporate structures operating in multiple jurisdictions generate significant efficiencies for the group, they tend to increase complexity and may create contagion by intertwining the financial health of one company with others within the group. Moreover, they can be used to take advantage of differences between regulatory regimes and can be used as a conduit for placing funds and products in unregulated entities (for example SPEs, SIVs). In a crisis, this can be beneficial or detrimental to different groups of customers. Events during the crisis have raised the issue of the value, whether implicit or explicit, that can be ascribed to parental guarantees, or even general assumptions that parental support will be forthcoming. Such arrangements can serve a useful purpose for supervisors when an individual subsidiary encounters financial difficulties, but their value in a situation where the group as a whole is in a distressed condition is clearly more questionable. Conversely, the group's (or parent company's) potential liability for actions taken to preserve the reputation of another part of the group needs to be more explicitly built into both the supervisor's and the group's own analysis and stress testing. For example, some investment management firms (or the banks which owned them) provided financial support to money market funds to mitigate potential reputational risk from losses.

Responding to the differing regulatory infrastructures within different countries, the legal structures used may, or may not, correspond to significant direct capital, liquidity or supervisory responsibilities by the host countries. In effect, in certain jurisdictions branches or offices may have to meet many of the requirements normally imposed on locally-incorporated subsidiaries, while in other jurisdictions subsidiaries may function much more like branches integrated into the parent institutions' business and management.

Supervisors should thus seek to better understand the extent to which an entity within the group, rather than the group itself, can remain a going concern or experience an orderly resolution that protects its customers in the event of problems at, or a collapse of, the other companies in the group. Such enhanced supervisory planning will enable authorities to better assess the extent to which changes are needed to the way in which financial groups or conglomerates manage and structure themselves and to which local operations of international groups should be separately and strongly capitalized. For instance, the authorities may require that institutions establish clear lines between deposit-taking and other banking operations, so that the depositor book can be easily transferred to another institution in times of failure with minimum disturbance to the confidence of depositors. The resolution of troubled deposit-taking entities may also be facilitated through the imposition of requirements on other former group companies to continue, if possible, to provide essential services to any healthy institution (including a bridge bank) to which some or all of the business of the deposit-taking entity has been transferred.

Most supervision of liquidity management within groups has been predicated predominantly on consideration of the group as a going concern. But it seems clear that the supervisor also needs to take account of the "gone concern" scenario and the resulting position of the legal entities. Doubts about an institution's ability to effectively manage liquidity centrally during a liquidity crisis can lead jurisdictions to compensate by requiring additional liquidity buffers or by ring fencing liquidity or assets.

If groups are therefore allowed to operate in a more integrated manner and manage their liquidity, at least in part, on a group-wide basis, there needs to be good cooperation between home and host supervisors and thorough and more coordinated licensing and supervision of entities. This includes regular sharing of relevant supervisory information as well as a clear understanding of the effects of the operating model on crisis management and resolution.¹⁴⁰

2.6.6 Planning in advance for orderly resolution¹⁴¹

The crisis that began in August 2007 demonstrated the many challenges to achieving orderly resolution of multiple complex cross-border financial institutions in a global financial crisis. The crisis has underlined that thorough crisis prevention must pay attention to corporate form and the operation of nationally based insolvency procedures. Although certain large financial institutions provide functions that are systemically important, similar in some sense to infrastructures or public utilities, their business continuity and contingency planning arrangements have not typically been required to include resolution contingencies. While no successful business operates in a wind-down mode, resolution contingency planning should therefore become a part of the supervisory process for large and complex cross-border institutions.

Local supervisors may also believe that entities under their jurisdiction have ample funding resources in a crisis until they become aware that other jurisdictions are also relying on the same liquidity pool. For that reason among others, supervisors from different countries need to cooperate closely in order to ensure the consistency of group-wide as well as local contingency funding plans. In addition, home and host supervisors should inform each other of regulatory or legal restrictions that affect the transfer of assets between entities and across borders or otherwise affect the group operations as a whole.

Actions taken in a crisis are influenced by expectations of how weak or failing institutions will be handled in a crisis. Sometimes ring fencing measures are driven by a lack of information about how the resolution process functions in the jurisdictions where the financial institution operates. As a consequence, supervisors may make conservative assumptions and ring fence as a precaution.

Expectations about the availability of assets or liquidity by cross-border institutions, as well as national authorities may be upset by the complex practical and legal issues involved in defining where specific assets, particularly securities and other financial claims, are legally booked or held. The uncertainty surrounding the defining of available assets in a particular jurisdiction will complicate decision-making both by institutions and national authorities in any crisis or resolution.

¹⁴⁰ Note should be taken to the fact that in the EU, by virtue of the freedom of establishment and free movement of services under the EC Treaty, supervisors would not be legally able to require that operations by EU-chartered banking or financial groups be conducted through subsidiaries instead of branches.

¹⁴¹ See Basel Committee on Banking Supervision (2010): “Report and Recommendations of the Cross-border Bank Resolution Group”.

The contingency plans of all systemically important cross-border financial institutions and groups should address as a contingency a period of severe financial distress or financial instability and provide a plan, proportionate to the size and complexity of the institution's and/or group's structure and business, to preserve the firm as a going concern, promote the resiliency of key functions and facilitate the rapid resolution or wind-down should that prove necessary. Such resiliency and wind down contingency planning should be a regular component of supervisory oversight and take into account cross-border dependencies, implications of legal separateness of entities for resolution and the possible exercise of intervention and resolution powers.

In terms of practicality, such pre – planning would unquestionably enhance risk management within the banking industry itself, whereby institutions might be acting in a more prudent way in respect to risk taking, driven by the desire to retain and present a reliable and credible plan. Being well aware that the idea behind the contingency plan is to allow for an orderly exit for the bank, we might conclude with incentives for institutions to de – risk its operations, by shedding off positions, businesses or operations that are highly risky. Such a tendency would not only improve banks' accountability, but would also essentially contribute to the gradual enhancement of market discipline as the aim is to reduce the bail out expectations.¹⁴²

A regular exchange among the relevant national authorities should ensure the mutual understanding of all aspects of the legal and regulatory framework that are critical for both contingency planning and management and resolution of a crisis.¹⁴³ Critical

¹⁴² As observed by the Squam Lake Report, Chapter 8, Improving Resolution Options, contingency plans might be able to prevent the catastrophic nature and scale of disaster of the financial crisis which occurred with very limited warning and under tight deadlines, as such planning would allow the relevant authorities to better anticipate the steps necessary during distress periods. Nevertheless, it should not be underestimated that incorporated scenarios might be very theoretic, as certain processes could not be possibly documented let alone quantified, calculated and thus included within the plan and may therefore lead to inefficient corporate structures that might create trapped pools of capital. See respectively Ackermann (2009a).

¹⁴³ Among the issues for such information exchanges may be the following:

- The legal and policy framework, including the resolution process for failing financial institutions, corporate disclosure and reporting requirements, competition requirements, including limits on market share and bank asset size, deposit insurance schemes, including coverage and the existence and type of depositor preference rules;
- The framework for providing liquidity, including the collateral accepted by the central bank (the terms and conditions for accepting collateral) for normal operations and for facilities that provide liquidity under stress;
- The terms of and restrictions imposed on any support provided by the government;
- The operational and technical specificities of payment and settlement systems, i.e. whether membership in a payment, clearing and settlement system is discontinued or suspended, or whether the default event that triggers discontinuation of membership will be automatic or subject to a specific decision by the system; and
- Critical assumptions on the potential measures that may be taken by national authorities in a crisis, such as ring fencing or territorial resolution measures, the treatment of depositors and other creditors, the treatment of financial market contracts. Where practicable, the potential responses of national authorities in a crisis should be discussed with those authorities.

Furthermore, according to FSB Consultative Document (2011): "Effective Resolution of Systemically Important Financial Institutions", jurisdictions should require firms to have in place Management Information Systems (MIS) able to produce on a timely basis, in normal times for recovery and resolution planning as well as in resolution and under a separation scenario, information required at both the group and legal entities levels. Firms should be required to maintain a detailed inventory, including description

assumptions on measures that may be taken by domestic and foreign authorities in a crisis, such as ring fencing, the treatment of depositors and other creditors and the treatment of financial contracts, should be verified with relevant foreign authorities.

2.6.7 Cross-border cooperation and information sharing¹⁴⁴

The supervisory responsibility of the home country of the parent of a banking group and the host country of that parent's subsidiary is governed by the Basel Concordat. While the intent of the Concordat is that no bank's (foreign) establishment be left without effective supervision, the complexity of financial group structures has obscured the precise roles and responsibilities of the various home and host supervisors, and their responsibilities for supervision at the consolidated or subordinate entity level. The Concordat provides that the home-country supervisor (of the parent) is responsible for the supervision of the group on a consolidated basis (along with that of the individual institutions authorized in its jurisdiction), and the host-country supervisor (of any foreign subsidiary) is responsible for the subsidiaries authorized in the host country.¹⁴⁵ The Concordat further states that the responsibility for the supervision of a branch with respect to solvency resides primarily with the home supervisor. The responsibility with respect to the supervision of liquidity usually resides with the host supervisor.

However, this division of supervisory responsibilities either within a single jurisdiction or between different countries may not necessarily be consistent with the division of responsibilities relating to crisis management and resolution, including the provision of central bank liquidity both in domestic and foreign currencies.¹⁴⁶ These complexities and the potential confusion regarding responsibilities may affect the effectiveness and even willingness of authorities to cooperate and share information in accordance with the Basel Committee's 1996 Paper on the Supervision of Cross-Border Banking (reiterated in its Core Principles Methodology, Principle 25). The principles require that the home regulator inform the host of any significant problems that arise in the head office.

In a crisis, the authorities responsible for the resolution of an internationally active bank need to obtain firm-specific information that may not be regularly exchanged in the course of normal supervisory cooperation, as for example, specific information with respect to clearing or netting exposures, operational details, and more detailed or higher frequency information regarding liquidity. In addition, the exchange of cross-sectorial information, for instance, between a central bank and a supervisor may also be necessary.

Certain countries address information sharing only in the context of normal supervision. They do not clearly differentiate what provisions or arrangements will apply in crisis situations. In a crisis, there could be a need to exchange information across different

and location of the key MIS used in their material legal entities, mapped to their essential and systemically important functions.

¹⁴⁴ See the Basel Committee on Banking Supervision (2010): "Report and Recommendations of the Cross-border Bank Resolution Group".

¹⁴⁵ See Basel Committee on Banking Supervision (1983): "Principles for the Supervision of Banks' Foreign Establishments".

¹⁴⁶ Due to the need for central banks to provide for liquidity in a currency other than the currency of issue, central banks have entered into swap arrangements with each other.

authorities such as between the home supervisor and a foreign central bank or among different sectorial supervisors. Certain supervisory authorities do not, however, have a clear authority for, or are prevented by law from, sharing information directly with a foreign authority other than a supervisor (“diagonal information sharing”). The onward disclosure of information obtained from another authority (“L-shape information sharing”) is frequently restricted, or requires the approval of the authority that produced it. This restriction allows the owner of the information to ensure reciprocity and check that the domestic conditions for information sharing are verified. This restriction can, however, delay information sharing in a crisis. Restrictions on L-shape information sharing are likely to restrict transmission by a home supervisor to a host supervisor of information obtained from another host, or the transmission of information obtained from, or prepared jointly with, another domestic authority.¹⁴⁷

Supervisors have entered into various arrangements to share information, including exchanges of letters and Memoranda of Understanding (MoUs).¹⁴⁸ Such arrangements set out expectations for supervisory cooperation and exchanges of information during normal supervisory activities. Nevertheless, they are not legally enforceable and generally do not indicate how supervisors might cooperate in a crisis. Certain MoUs on crisis management cooperation have already been established, such as those among EU countries, though, given recent experience there are reasonable concerns that such MoUs will not be followed in times of crisis.

In certain cases, on the other hand, intervention actions such as ring fencing may be taken by national authorities without comprehensive information about a foreign institution’s operations or a foreign authority’s probable willingness or ability to respond. During the current crisis, some supervisors have detected shortcomings in the sharing of information and in the timely communication of problems affecting specific institutions due to several reasons. Sometimes supervisors have difficulties in obtaining, processing and analyzing information and thus are unable to share information in a timely manner with other supervisors. Home country authorities may be reluctant to provide complete information that they perceive as negative to host authorities, because they fear it would spread distress or prompt the host authorities to take measures considered adverse to the national interests of the reluctant authorities. However, host supervisors that are unable to obtain that information from the reluctant authorities may be more, not less, inclined to take action to protect local depositors and creditors and ring fence assets. In certain cases, better information sharing could reduce

¹⁴⁷ The *Key Attributes* stipulate that sharing of information within Crises Management Groups (CMGs) with other authorities with a role in the resolution of a particular firm should be possible under the legal frameworks of all jurisdictions, subject to specific conditions being met to protect the confidentiality of the information. The recipient authority should be subject to confidentiality requirements that are equivalent to those that apply to the disclosing authority, with effective sanctions for breach; and should commit not to disclose the information to third parties or the public, to seek prior consent for any onward disclosure of information, and to undertake best efforts to resist disclosure where compelled by statute or legal process, including by employing legal means to challenge an order to disclose. Professional secrecy obligations should generally prohibit officers and employees of authorities from disclosing information acquired in the course of discharging their mandates. In jurisdictions with ‘Freedom of Information’ legislation, exemptions from disclosure requirements should be possible for resolution related information received from foreign authorities. See respectively FSB Progress Report (2012): “Resolution of Systematically Important Financial Institutions”.

¹⁴⁸ See Basel Committee on Banking Supervision (2001): “Essential Elements of a Statement of Cooperation between Banking Supervisors”.

the need for ring fencing (although it may on the contrary reinforce ring fencing responses unless alternative cooperative solutions are available).

Supervisory Colleges are a significant era for enhancing supervisory cooperation. However, due to overriding national mandates supervisory colleges are not decision-making bodies. They are a useful tool to facilitate the multilateral exchange of supervisory information and views and assessments not only between home and individual host supervisors, but also among host supervisors. They help establish an organizational and personal network among supervisors so as to facilitate on-going communication and a coordinated and effective supervisory effort in a crisis.

Responsibilities in supervision and regulation and the associated information needs should finally be reviewed in light of the responsibilities that fall on a jurisdiction in case of the failure of an institution. The College of supervisors may be an appropriate forum to discuss such responsibilities. Key home and host supervisors should agree on a common process that defines what information needs to be exchanged, and when and how this should best be done, with particular regard to confidentiality, security, relevance and accessibility. There is a need for information to be exchanged before and during a crisis to assist in dealing with a crisis. Authorities should exchange information on the relevant aspects of their legal and regulatory frameworks and the different national authorities' powers and responsibilities for regulation, supervision, liquidity provision, crisis management and resolution.¹⁴⁹

2.6.8 Peer Review of Resolution Regimes

At their February 2013 meeting, the G20 Finance Ministers and Central Bank Governors reiterated their commitment to ensure that all global systemically important financial institutions (G-SIFIs) are resolvable, and requested a report on progress.

Authorities have made continued efforts to develop resolution strategies and operational plans for all G-SIFIs and to introduce resolution powers and tools consistent with the Key Attributes of Effective Resolution Regimes for Financial Institutions endorsed by the G20 at Cannes. As shown by the FSB's recent peer review, substantial headway was made in the US with the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) and there have been refinements to resolution regimes in other FSB jurisdictions, including in Australia, Germany, France, Netherlands, Spain, Switzerland and the UK.¹⁵⁰ Further legislative measures are

¹⁴⁹ The negotiation of institution-specific cross-border cooperation agreements (COAGs) amongst relevant home and host authorities, as required for each G-SIFI under the *Key Attributes*, is intended to put in place a more predictable and explicit framework for sharing information for resolution and resolution planning purposes. It will also require authorities to determine whether their legal framework provides the appropriate gateways for information sharing, or whether they need to be revised to allow the sharing information for resolution purposes with the full range of authorities involved in resolution. Many jurisdictions' legal regimes already have appropriate scope for authorities to improve cross-border and domestic information-sharing for resolution purposes. However, important work remains to be done to address the practical and policy concerns involved in sharing recovery and resolution information. The FSB is examining how to address remaining obstacles and improve the on-going work, including institution-specific COAGs currently being developed, to facilitate information sharing for resolution purposes. See respectively FSB Progress Report (2012): "Resolution of Systematically Important Financial Institutions".

¹⁵⁰ See FSB (2013): "Thematic Review on Resolution Regimes", Peer Review Report, Annex A.

necessary to implement the Key Attributes fully and to put in place the powers and arrangements for cross-border cooperation and recognition of resolution measures needed to make resolution strategies and plans operational. The adoption and implementation of the EU's Recovery and Resolution Directive will be a significant step in this direction since the EU is home to a number of G-SIFIs. It is important that both home and host countries to G-SIFIs have the necessary resolution tools and the capacity to cooperate across borders to resolve these institutions without systemic disruption and without exposing taxpayers to loss.¹⁵¹

In November 2010, FSB Members undertook to develop resolution strategies, operational resolution plans and firm-specific cross-border co-operation agreements (COAGs) that set out a process for cooperation and information sharing for all G-SIFIs.¹⁵² Some progress has been made with respect to the institutions that were designated as G-SIFIs in November 2011.¹⁵³ However, progress has been relatively slow both because the issue is complex and because in many jurisdictions the powers necessary for implementing a preferred resolution strategy have not yet been provided.¹⁵⁴

Cross-border Crisis Management Groups (CMGs) have been established for all G-SIFIs¹⁵⁵, though two of them are still 'domestic', i.e., none of the members are host authorities. Most home authorities of G-SIFIs report that they have developed high-level resolution strategies and discussed and shared these with host authorities participating in the CMGs. They are also developing operational resolution plans that build on these high-level strategies. However, completion of these plans hinges on the finalization of legal and regulatory reforms and on the agreement of a cooperation

¹⁵¹ See FSB (2013): "Implementing the FSB Key Attributes of Effective Resolution Regimes – how far can we come?", Report to the G20 Finance Ministers and Central Bank Governors on progress in reforming resolution regimes and resolution planning for globally systemically important financial institutions (G-SIFIs).

¹⁵² Cross-border cooperation agreements (COAGs) should help facilitate institution-specific crisis management planning and cooperation amongst relevant authorities, with a presumption in favor of cooperation in the event of the institution's resolution and build upon the FSF's *Principles for cross-border cooperation in crisis management* as endorsed by the G20 Leaders Summit in London in April 2009. They should support the preparation of Recovery and Resolution Plans (RRPs) and the effective implementation of resolution measures in a crisis by providing a framework for possible solutions to legal or other impediments that may exist. This will require firm-specific agreements among all members of a firm's Cross-border Crisis Management Group (CMG), including the relevant authorities from the home and all key host jurisdictions. Bi-national agreements, i.e., agreement between the relevant authorities of the home and a host jurisdiction that set out how national legal and resolution regimes would interact given a firm's business, and firm-specific multinational agreements among home and all key host jurisdictions, may complement each other.

The effectiveness of institution-specific cooperation agreements hinges on the home and host authorities having the necessary resolution powers in relation to the firm's operations, including the branch operation of a foreign financial institution.

The institution-specific cooperation agreement establishes additionally a framework for the development of RRP, based on the conduct of pre-crisis resolvability assessments, and for cooperation and coordination in crisis in line with the agreed RRP. Both RRP and cooperation agreements are expected to be regularly updated and evolve over time.

¹⁵³ See FSB (2011): "Policy Measures to Address Systemically Important Financial Institutions".

¹⁵⁴ See FSB (2013): "Implementing the FSB Key Attributes of Effective Resolution Regimes – how far can we come?", Report to the G20 Finance Ministers and Central Bank Governors on progress in reforming resolution regimes and resolution planning for globally systemically important financial institutions (G-SIFIs).

¹⁵⁵ See FSB (2012): "Update of group of global systemically important banks (G-SIBs)".

framework set out in COAGs that supports their cross-border implementation. While work on COAGs is progressing, none has yet been agreed and, in some cases, the institution-specific contents of the agreements are not yet being negotiated.¹⁵⁶

Resolution planning by CMGs has coalesced around two stylized approaches:¹⁵⁷

- a **“single point of entry” (SPE) strategy**, which involves the application of resolution powers at the top holding or parent company level by a single resolution authority, with the assets and operations of subsidiaries being preserved on a going concern basis and the restructured parent or successor to the parent serving as “source of strength” by recapitalizing subsidiaries and down-streaming liquidity, as necessary; and
- a **“multiple point of entry” (MPE) strategy**, which involves the application of resolution powers by two or more resolution authorities to multiple parts of the group, and break-up of the group into two or more separate parts along national, regional or functional lines, or some combination of each.

Certain strategies draw on elements of both the SPE and MPE strategies. The FSB is undertaking further work on the preconditions for the effective implementation of these strategies, including in particular:¹⁵⁸

- adequate loss absorbing capacity at the right location and effective mechanisms through which losses can be absorbed;
- the enforceability of the write down or conversion of debt by the resolution authority when the debt is issued in a foreign jurisdiction;
- the sources of funding for resolution in a cross-border context;
- appropriate legal, operational and financial structures that support effective resolution and are aligned with the resolution strategy; and
- the treatment of financial contracts in a manner that supports the effective implementation of the resolution strategy and avoids contagion through large-scale early termination of financial contracts when an entity enters into resolution.

A successful implementation of both strategies will require the effective coordination of the different resolution actions undertaken by home and host authorities. Firm specific cooperation agreements therefore need to set out general expectations as regards action by home and host authorities participating in a CMG in implementing the resolution strategies.¹⁵⁹

¹⁵⁶ See FSB (2013): “Implementing the FSB Key Attributes of Effective Resolution Regimes – how far can we come?”, Report to the G20 Finance Ministers and Central Bank Governors on progress in reforming resolution regimes and resolution planning for globally systemically important financial institutions (G-SIFIs).

¹⁵⁷ *Ibid*, p 4.

¹⁵⁸ *Ibid*.

¹⁵⁹ *Ibid*.

To support the recovery and resolution planning work, the FSB issued a consultative document in November 2012.¹⁶⁰ It provides (i) guidance on triggers for recovery actions and stress scenarios that should be used in G-SIFI recovery plans; (ii) guidance to help identify the functions that make a firm systemically relevant and assist the CMG resolution planning process; and (iii) guidance on the development of resolution strategies and plans. The guidance will be finalized in the course of 2013.¹⁶¹

Effective information sharing is essential for planning and carrying out resolution. Further supporting guidance is planned therefore during 2013 on information sharing, both between authorities that participate in CMGs and as regards procedures for cooperation and information sharing with host authorities for which a G-SIFI's operations are locally systemic but that are not represented on its CMG.¹⁶²

CMGs are expected to undertake a first review of the feasibility and credibility of putting the G-SIFI resolution plans into operation in the second half of 2013. Thereafter, the FSB will launch its Resolvability Assessment Process (RAP) which will assess the resolvability of each G-SIFI by a group of high-level policymakers from home and key host authorities of the G-SIFI.¹⁶³

Furthermore, in its most recent publication 'Recommendation on the development of recovery plans' published on January 23rd 2013, the EBA recommends major EU cross-border banking groups to develop recovery plans by the end of 2013. The recommendation follows its previously published discussion paper on recovery plans in May 2012 and is pending the completion of the EU's Crisis Management Directive that will set out a consistent framework across the EU for recovery and resolution of credit institutions and investment firms.

The purpose of the recommendation is to make sure that at least the major EU cross-border banks, develop group recovery plans by the end of this year. The plans are required to be submitted to the respective competent authorities and discussed within Colleges of Supervisors. The recommendation is intended to fill the interim period before the EU adopts a legislative framework based on its proposal for the CMD.

The EBA has provided a template for the preparation of the recovery plans which covers the following aspects:

- General but comprehensive information on the institution and its governance structure;
- The list and description of options available in a crisis situation and an assessment of their execution and impact; and

¹⁶⁰ See FSB (2012): "Recovery and Resolution Planning: Making the Key Attributes Requirements Operational".

¹⁶¹ See FSB (2013): "Implementing the FSB Key Attributes of Effective Resolution Regimes – how far can we come?", Report to the G20 Finance Ministers and Central Bank Governors on progress in reforming resolution regimes and resolution planning for globally systemically important financial institutions (G-SIFIs).

¹⁶² *Ibid*, p 4.

¹⁶³ *Ibid*, p 5.

- The measures which the institution plans to implement to facilitate, in the future, the update of the recovery plan or its implementation in crisis times.

The EBA has also introduced a requirement for institutions to complete an Operational Contingency Plan which sets out the contingency details of how a firm's operations and its access to market infrastructure will be preserved at the implementation of a firm's recovery option.

To the author's view, it should be pointed out that timely and consistent implementation of the Key Attributes is additionally an essential part of the reforms needed to end "too big to fail". As noted, legislative action to reform resolution regimes is required in many jurisdictions before identified resolution strategies and plans for G-SIFIs can be implemented effectively. Reforms to resolution regimes are therefore a priority area under the FSB Coordination Framework for Implementation Monitoring,¹⁶⁴ under which the implementation of the Key Attributes by FSB member jurisdictions will undergo intensive monitoring and detailed reporting. A first thematic peer review of national resolution regimes using the Key Attributes as a benchmark was completed during 2013.

Whereas legislative reforms have been undertaken by certain FSB jurisdictions, implementation of the Key Attributes is still at an early stage. The key findings suggest that despite considerable progress much work remains to be done, i.e.:¹⁶⁵

- In many countries, resolution authorities currently lack important powers needed to resolve systemic institutions, such as powers to write down and convert liabilities of a failing institution to equity ("bail – in") or to impose a temporary stay on the exercise of financial contracts;
- In terms of regime scope, most jurisdictions lack the powers to take control of the parent company or affiliates of a failed financial institution, and do not have the authorities or powers to resolve systemic non-bank institutions, such as central counterparties and other financial market infrastructures (FMIs);
- Many jurisdictions currently have neither expedited procedures for giving effect to foreign resolution actions nor clear and dedicated statutory provisions for domestic authorities to share confidential information and cooperate for resolution purposes with foreign authorities. These limitations on cross-border cooperation and information sharing are significant impediments to resolution planning for Global Systemically Important Banks (G-SIBs);
- Finally, many jurisdictions lack a statutory resolution planning requirement or the power to require firms to make changes to their organizational and financial structures in order to improve their resolvability.

There are unquestionably further steps being taken at EU level to harmonise the resolution rules for complex cross-border banking and investment services groups. Exploring how bank insolvency regimes can be further harmonised is one such

¹⁶⁴ See FSB (2011): "A Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms".

¹⁶⁵ See FSB To G20 Ministers and Central Bank Governors (2013): "Progress of Financial Reforms".

initiative which would enable banks to resolve and liquidate under the same substantive and procedural rules.

2.6.9 Cost benefit Analysis of an EU cross-border bank resolution framework.

It should be considered unquestionable and evidently established by worldwide experience that cross-border banking services and activities results to manifold benefits not only for the economies, but also for individuals, as it provides a wider spectrum of options within the financial market and therefore enhances competition terms. Conversely, along with the benefits that are produced, there have arisen significant risks and challenges to be confronted. Cross-border banking within Europe in particular is evaluated as highly more prevalent than its counterparties across the world. Yet, despite the high level cross-border banking integration in Europe, the overall banking regulation, supervision and resolution framework should still be considered “decentralized” and adherence is achieved to minimum harmonization concept vis – a – vis Banking Directives that allow great flexibility and freedom to Member States.

The current fragmented resolution framework across Europe causes disparities and creates an uneven playing field for market participants and players. Therefore, legal uncertainties are raised for all quarters and in particular the shareholder and bank investors.

Due to the legal uncertainties, the key stakeholders are led to realize the high risk of potentially losing their investments vis – a – vis haircut implementations and shall be thus reasonably discouraged to continue overtaking such risks under the cross-border dimension. By corollary, strong disincentives for further banking integrations are established within the single market.

In turn, a reversal in the internal market process for banking is provoked and subsequently citizens and businesses enjoy lesser choices and limited competition terms. Since banks, nevertheless, should be considered driving forces for real economy, such a reduction in the scale of integration will be followed by a slow-down economic growth.

To conclude, cooperation and trust among resolution authorities should be built up. The mandates of resolution authorities should be framed so that they have to duly consider the potential impact of their resolution actions on financial stability in other jurisdictions. In applying resolution powers to individual components of a financial group, the resolution authority should have to take into account the overall impact on the group as a whole and the impact on financial stability in other jurisdictions concerned and undertake best efforts to avoid taking actions that could reasonably be expected to trigger instability elsewhere in the group or in the financial system.¹⁶⁶

There should be, finally, a strong encouragement of cross-border cooperation supported by robust abilities to cooperate. However, the statutory framework for cross-border

¹⁶⁶ See FSB Consultative Document (2011): “Effective Resolution of Systemically Important Financial Institutions”.

cooperation should not be so prescriptive as to deprive jurisdictions of the flexibility to act when necessary to achieve domestic stability in the absence of effective cross-border cooperation and information sharing,¹⁶⁷ or in the event of inaction or inappropriate action by the home authority. Provisions that hamper fair cross-border resolution need to be removed. More specifically, jurisdictions should ensure that no legal, regulatory or policy impediments exist that hinder the appropriate exchange of information, including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for insurance guarantee schemes.¹⁶⁸

A detailed treatment of the technical challenges to cross-border resolution is beyond the scope of the specific essay. However, possibly the most significant challenge is a non-technical one, which is whether, despite any amount of forward planning, the behavior expected of resolution authorities in multiple jurisdictions will in fact materialize during a crisis period. On analysis, this rapidly becomes far more a political challenge than a legal one.¹⁶⁹ However, it seems that the more work that is done to achieve transparency about how groups would be resolved on a cross-border basis in a range of realistic scenarios, the more likely it is that consequent market expectations would make it politically difficult for a resolution authority to deviate from the expected course of action.

2.7 Concluding Remarks

“Circumstances are beyond human control, but our conduct is in our power|”
Benjamin Disraeli

Quo Vadis Europe? Political Leadership and Intra – Europe Communication as key parameters for a full – fledged EU regime

Guy Verhofstadt, Member of the European Parliament stated that “the crisis is not over because we have only been addressing the symptoms and only with half measures. EU leaders may well repeat to each other that the worst of the crisis is over but they should take a reality check. Most of the measures taken so far are showing once again their short term nature, including the fake firewall”.

¹⁶⁷ This should not apply though where jurisdictions are subject to a binding obligation to respect resolution of financial institutions under the authority of the home jurisdiction (as for example the EU Winding up and Reorganization Directives).

¹⁶⁸ See FSB Consultative Document (2011): “Effective Resolution of Systemically Important Financial Institutions”.

¹⁶⁹ Senator Mark Warner, the Virginia Democrat who leads the National Security and International Trade and Finance Subcommittee, said regulators were given “enormous power” to demand banks be safer to dismantle in a crisis., though he stated that he is “personally hopeful that they will use those tools somewhat aggressive”.

The worst period of crisis might be considered to be over, but such consideration would not mean that the financial market and real economy has, not even partially, recovered. The crisis evidenced that the presence of systemically important financial institutions cannot be overlooked, whereas at the same time we have witnessed that cross-border institutions have developed complex and intertwined structures that result to high degree of integration within the Eurozone. By corollary, a leeway, in order to achieve counterbalance and prevent the domino effect that might be caused by the potential failure of one bank contaminating and affecting an entire nation or even reaching a global spectrum, is established as necessity.

Schoenmaker declares that following the financial crisis, certain cross-border banks have come back to where it originally came from,¹⁷⁰ i.e. banks are acting more cautiously and nationalistic than ever. Such reaction would definitely not be classified as the right response to the crisis. Instead, it leads to the disintegration of the internal market and the weakening of the financial institutions, whereas in parallel, it deteriorates Europe's market competition terms compared to the Asia region. Policymakers are now at the frontline of deciding the way ahead for Europe and thus, they must now pave the way to ensure the appropriate distance of the industry from nationalistic measures, dividing the EU. Any decisions taken and approaches adopted will have a significant bearing on the manner that banks, investors, market players, depositors and consumers will behave in the future. A solid and consistent cross-border resolution framework is therefore evaluated as indispensable.

Cross-border resolution is impeded by major differences in national resolution regimes, absence of mutual recognition to give effect to resolution measures across borders, and lack of planning for handling stress and resolution. The complexity and integrated nature of many firms' group structures and operations, with multiple legal entities spanning national borders and business lines, make rapid and orderly resolutions of these institutions under current regimes virtually impossible. Legislative changes are likely to be needed in many jurisdictions to ensure that resolution authorities have resolution powers with regard to all financial institutions operating in their jurisdictions, including the local branch operations of foreign institutions. Cross-border cooperation and effective pre-planning of resolution will be difficult if not impossible if the authority over failed institutions, including foreign bank branches, resides with the courts. As part of its statutory objectives, the resolution authority should duly consider the potential impact of its resolution actions on financial stability in other jurisdictions. It should have the legal capacity to cooperate and coordinate effectively with foreign resolution authorities, to exchange information in normal times and in crisis, and to draw up and implement RRP and cooperation agreements on an institution-specific basis.

Incomplete architecture. Europe needs to take a bold step forward and fundamentally overhaul its financial stability architecture, in order to allow the EU to reap from the benefits of financial integration and to protect the market via an equally integrated EU crisis management and resolution framework. Having identified the potential pros and cons of the desirability as well as the feasibility of such a target regime, we are in the position to realize the necessity for having **'more and not less of Europe'**.

¹⁷⁰ For example, following the demise of Fortis, cross-border penetration from EU countries fell back from 16 percent to 7 percent in the Netherlands. See respectively Schoenmaker (2011): "The European Banking Landscape After the Crisis", DSF Policy Paper No. 12.

On the other hand, although finance spans the euro area in a dense network of cross-border banks and obligations, the current architecture of stability is based largely on national supervision, national resolution, and national safety nets. Such architecture causes several implications, including:¹⁷¹

- **Bank-sovereign-real economy links.** Absent the ability to control local interest rate conditions, the existing architecture strengthens the link between a country's banking industry and real sectors and therefore health of its public finances. During periods of prosperity and growth, banks may grow to overwhelm national supervisory capacities. Nevertheless, during stress periods, they may overwhelm national fiscal resources. Similarly, in case that a sovereign's finances are sound, then its backstop for its banks is credible. But if they are weak, then its banks are more vulnerable and will face higher funding costs. As a result, private borrowing costs rise with the sovereign's, imparting procyclicality (costs rise as conditions deteriorate and capital flows out), impairing the transmission of monetary policy (as rate cuts have limited or no effect), and amplifying fragmentation of financial markets and volatility.
- **Skewed incentives.** National authorities may unduly favor the national banking system and economy, regardless of outward spillovers, which lie beyond their mandates. During good times, they may not be stringent or capable enough to limit the buildup of excesses. In bad times though, they may encourage reducing cross-border activities of their banks, exacerbating financial fragmentation. Delays in resolving stresses would only exacerbate the eventual cost. Since therefore a bank's distress may have adverse cross-border externalities, other countries may have no choice but to support those whose banking systems run into trouble.

At the end of the day, the answer of the very essence of the problematic may lie only in a quantum leap towards a comprehensive effort at pan - European level, spectrum of reform that unquestionably demands high political leadership.

The challenge for policymakers is to stem the crisis while ensuring that actions dovetail seamlessly into the future steady state. Hence, agreeing at the outset on the elements, modalities, and resources for a Banking Union can help avoid the pitfalls of a piecemeal approach and an outcome that is worse than at the start. The December 2012 European Council agreement on an SSM centered at the European Central Bank is an important step, but raises challenges that should not be underestimated. Meanwhile, to delink weak sovereigns from future residual banking sector risks, it will be important to undertake as soon as possible direct recapitalization of frail domestically systemic banks by the ESM. Failing, non-systemic banks should be wound down at least cost, and frail, domestically systemic banks should be resuscitated by shareholders, creditors, the sovereign, and the ESM.¹⁷²

The case for a Banking Union for the euro area is both immediate and longer term wise. Moving responsibility for potential financial support and bank supervision to a shared

¹⁷¹ See IMF Staff Discussion Note (2013): "A Banking Union for the Euro Area".

¹⁷² *Ibid*, p 4.

level can reduce fragmentation of financial markets, stem deposit flight, and weaken the vicious loop of rising sovereign and bank borrowing costs. In steady state, a single framework should bring a uniformly high standard of confidence and oversight, reduce national distortions, and mitigate the buildup of concentrated risk that compromises systemic stability. **Time is of the essence.**¹⁷³

The final political end-game should consequently remain focused not merely on safeguarding the Internal Market on Financial Services, but on deepening the integration level further. Efforts should be channelled towards enabling the financial system to continue supporting the real economy and thus foster economic growth,¹⁷⁴ which in turn shall provoke better level of prosperity for the European citizens. By contrast, a different treatment of the euro-area financial services would force a split of the EU financial system and may thus end up with the establishment of an internationally competitive financial centre outside the “European” zone confronting a more traditional financial system operating within the “European” framework.¹⁷⁵ Such would be definitely not a win – win situation, whereby London and its “City” business centre may lose significant business against its European neighbours, and the continental European countries would face a less dynamic financial system.¹⁷⁶

Incentivizing opt-in. Over time, certain EU countries may want to be part of the Banking Union even if they do not join the euro area. A strong Banking Union that offers risk sharing (while avoiding the mutualization of legacy issues) and ensures least-cost bank resolution could be an attractive proposition. Moving supervision to the ECB could improve supervisory quality in certain countries, reduce compliance costs for cross-border banks, limit scope for regulatory arbitrage, eliminate host-home coordination issues, and increase the congruence between the market for financial services and the underlying prudential framework. A single resolution authority and common safety nets, with backstops, would provide further benefits in terms of risk sharing, when these are in place. But there are also drawbacks and complications, including the interaction of multiple central banks (with implications for the lender of last resort function and the conduct of macro-prudential policies), difficulties in ensuring adequate participation of the “opt-ins” in SSM decisions, a loss of sovereignty, and potentially less flexibility to deal with country specificities. These costs are likely to be less, especially for those whose currencies are pegged to the euro, have high levels of foreign currency liabilities, or have a sizable presence of euro-area banks in their financial systems. If these members adopt the euro at the same time as they join the Banking Union, the benefit would likely outweigh the cost, just as it does for euro area members currently.¹⁷⁷

The current climate in the political scene: the two - speed Europe. In view of the above, much greater fiscal integration, at least within the euro-zone, is seen by certain people of vision, as either the reasonable next step in the “European dream” development or as the necessity following the European sovereign debt crisis.

¹⁷³ *Ibid.*

¹⁷⁴ See Goodhart and Schoenmaker (2011).

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*

¹⁷⁷ See IMF Staff Discussion Note (2013): “A Banking Union for the Euro Area”.

Note should be taken, according to the author's view, to the fact that even though the majority of the EU Member States participate in the EMU, based on the common euro currency, fiscal-related issues such as taxation still remain at the national level. Decision-making relating to tax and fiscal issues are traditionally thought to be central to national prerogative and thus, any decisions within the EU relating to such policies should be unanimously approved by the Member States. Therefore, when the UK and the Czech Republic exercised its veto not to join the fiscal compact at the European Summit in Brussels, the 25 remaining Member States carried on with "enhanced-cooperation", a new concept of the Lisbon Treaty. Under the framework of an "enhanced cooperation",¹⁷⁸ only the participating Member States would assume the obligations of putting in place strict limits to the respective Member State's powers with regard to spending and borrowing, which in turn shall be enforced by the Commission and the Court. However, it has finally been evidenced following the financial crisis that a monetary union without a fiscal union would lead to an incomplete economic integration.¹⁷⁹

As a quick recap of the supra analysis, we cannot continue with the current model of the internal banking market, where the current regime and financial and business reality allow cross-border banking activities at European level, whereas supervision and resolution remain primarily as national responsibility with minimum harmonization, or as termed by Schoenmaker, '**loose coordination**'. Besides, the home – host country principle division of responsibility is not sustainable in order to shoulder such large cross-border banks in Europe, should a crisis of extended nature unfolds. The crisis clearly demonstrated that authorities of Member States were driven more by its nationalistic agenda rather than a European spectrum agenda. In this line of thought, the only way to settle is to align banking supervision and resolution and frame European cross-border banks on a **level playing field**.

The Banking Union is obviously not a panacea, but it can be pivotal in fighting the current crisis by breaking the vicious loop between sovereign and bank costs and by fixing the broken transmission mechanism from ECB policy rates to final borrowing and lending rates across the full span of the euro area. While speed is important, reformers will need to be mindful of wrong sequencing and a piecemeal approach, which could actually worsen outcomes.

"Finally, history teaches us that financial crises are often repeated, though no two crises are alike. They are also difficult to predict and, thus, to avoid. Hence, both crisis prevention and crisis resolution are crucial for ensuring the resilience of the

¹⁷⁸ In other words, enhanced cooperation allows those countries of the Union that wish to continue to cooperate more closely with each other, to continue acting as such, while respecting at the same time the Union legal framework. The Member States concerned can thus move forward at different speeds and/or towards different goals.

¹⁷⁹ It is worth mentioning that for the time being, the UK may wish to remain 'opted-out', but this has essential impact on the banking industry and results to a divided internal market for financial services with potential damage and disintegration effects for the cross-border banking arena. In order to achieve a high level financial services provision within the euro-zone, the UK collaborates should participate in the new economic and political venture of integration, since notice should be given to the fact that there is a huge presence of cross-border banks in the UK (through branches or subsidiaries).

financial system. The key is to ‘be well prepared’.....to always expect the unexpected....”¹⁸⁰



TIMELINE

¹⁸⁰ See Batunanggar, “Comparison of Problem Bank Identification, Intervention and Resolution in the SEACEN Countries”.

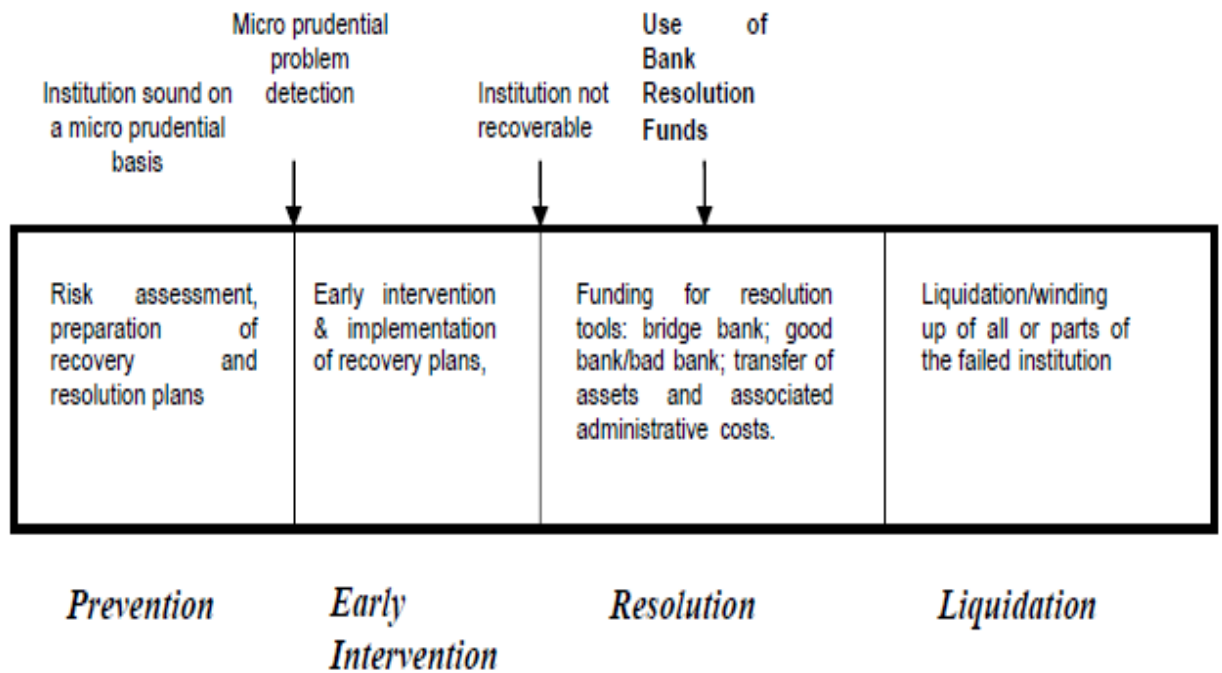
1951	Treaty of Paris creates the European Coal and Steel Community (ECSC) with six members.
1957	Treaty of Rome transforms ECSC into European Economic Community (EEC)
1967	Merger of EEC and Euratom into European Communities (EC)
1973	Denmark, Ireland and the United Kingdom join the EC
1981	Greece joins the EC
1986	Portugal and Spain join the EC
1992	Maastricht Treaty broadens the EC into the European Union (EU), with a commitment to Economic and Monetary Union (EMU), including the creation of the Euro
1995	Austria, Finland and Sweden join the EU
1998	Creation of the European Central Bank (ECB)
1999	Introduction of the euro as a unit of account
2002	Euro banknotes and coins enter circulation
2004	Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia join the EU
2004	A European Convention presents a draft Constitutional Treaty that is later rejected in referenda in France and the Netherlands
2007	Bulgaria and Romania join the EU
2008	Global financial crisis begins to hit European banks and markets in a serious way
2009	Lisbon Treaty reforms EU institutions and gives greater voice to the European Parliament
2009	De Larosiere report calls for reform of European banking regulatory system
2010	April - Greek government requests an initial loan from European partners
2010	May - EU leaders announce €70 billion plan to protect the euro
2010	May - EU ministers agree €500 billion fund to save the euro from disaster
2010	November - Irish government seeks assistance from the EU and IMF
2011	January - The European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority begin operations
2011	April - Portugal requests a rescue package
2011	September - Europe's debt crisis prompts central banks to provide dollar liquidity
2011	October - Final country to approve the expansion of the eurozone's rescue fund
2011	October - Banks agree 50 percent reduction on Greece's debt: private investors take 'haircut' on Greek bonds in €100 billion package of measures that also strengthens European rescue fund
2011	December - Confidential paper from Council President Herman Van Rompuy proposes empowering the commission to impose austerity
2011	December - ECB institutes LTRO program to provide three-year liquidity for banks
2011	December - EU agrees "Fiscal Compact", coordinating economic policies and debt ceiling
2012	February - Second batch of three-year LTRO loans takes total lent to more than €1 trillion
2012	March - Eurozone ministers agree €500 billion in new bailout funds

2012	May • G8 leaders end summit with pledge to keep Greece in eurozone
2012	May • Germany rules out common Eurobonds
2012	June • Spain seeks a European rescue package for its banks
2012	June • G7 finance ministers back greater fiscal and financial union in eurozone
2012	June • Cyprus seeks eurozone bailout
2012	June • Euro Summit calls for quick movement to European Banking Union
2012	July • ECB will do 'whatever it takes' to preserve the currency declares Mario Draghi
2012	September • European Commission proposes plan for European banking supervision
2012	September • Draghi secures agreement for 'outright monetary transactions' scheme
2012	October • European Stability Mechanism becomes legally effective
2012	October • European Summit agree on a broad outline of European Banking Union
2012	November • Catalan referendum on independence
2013	January • European leaders to reach full political agreement on supervision
2013	January • ECB to begin taking on overall supervisory role for Eurozone banks
2014	January • ECB to be fully effective as bank supervisor

Source of timeline: IMF

ANNEX

Depiction of the resolution frameworks within the overall institution's cycle



Source of illustration: EU Commission

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