INSOL International™

BANK RESOLUTION

Key Issues and Local Perspectives

INSOL International™

International Association of Restructuring, Insolvency & Bankruptcy Professionals

BANK RESOLUTION

Key Issues and Local Perspectives

Edited by

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President's Introduction

Banks are critical in the functioning and growth of an economy. It is especially important for regimes to be in place that allow failing banks to be dealt with in an appropriate manner. However, significant deficiencies in the treatment of failing banks were evident during the global financial crisis of 2007-08.

The leaders of the G20 met in 2009. In a statement, they recognised that "*the only sure foundation for sustainable globalisation and rising prosperity for all is an open world economy based on market principles, effective regulation, and strong global institutions*". The group pledged to take action to build a stronger, more globally consistent, supervisory and regulatory framework for the financial sector.

10 years after the G20 commitments, this book examines current approaches to dealing with failing banks. The book discusses key issues in bank resolution processes and the position in a number of specific jurisdictions, and its contributors are experts in a range of important fields. It is aimed at insolvency and restructuring professionals, other participants in bank resolution processes, lawmakers, supervisors and regulators involved in developing and operating bank resolution mechanisms.

On behalf of the Board of Directors of INSOL International, I would like to thank the contributors for committing their valuable time and writing the respective chapters. I also sincerely thank Simon Brodie, project leader and editor, for suggesting this topic to the INSOL Technical Research Committee and for his continued dedication thereafter to produce a publication that has a high level of content and practical relevance to readers. It is indeed an excellent book.

Julie Hertzberg
President
INSOL International

Preface

Simon Brodie, Editor*

Bank resolution regimes have significant implications for the financial economy and the real economy. It is therefore particularly important for such regimes to be effective. Especially given the complexities of modern financial systems, a range of perspectives is beneficial in understanding and assessing these regimes. For this reason, the contributors of the chapters of this book are drawn from the worlds of financial-sector monitoring and reform, public policymaking, legal practice, and academia. They are leaders in their respective fields, and I am delighted to have assembled such a distinguished and talented group.

It is hoped that the book will be of particular value to those who may be involved in future bank resolution processes and to those engaged in the design and operation of bank resolution regimes. While topics of special note are deliberately addressed in some detail, readers need not have any particular level of expertise in bank resolution in order to benefit from the book. It has been a pleasure collaborating with contributors of the individual chapters to craft a book that is both accessible and insightful. I am extremely grateful to all the contributors for their assiduous work to this end.

* Simon Brodie is an expert in financing, investment, and financial services. His experience includes roles with Blackstone, Freshfields Bruckhaus Deringer, Goldman Sachs, PJT Partners, and the World Bank Group. He holds an MA in Law from the University of Oxford, where he was a Demy (scholar) of Magdalen College, and an MSc in International Development from the London School of Economics and Political Science.

Introduction

Simon Brodie, Editor*

Serious problems affecting banks, and efforts to address them, have been taking place for centuries. Roman historian Tacitus describes a banking crisis of AD33 and an associated scarcity of credit, resolved by an injection into the banking system of 100 million sesterces and permission to borrow interest-free for three years.[1] Closer to today, the global financial crisis of 2007-08 and more recent bank failures have demonstrated vividly how modern banks have been imperilled by systemic as well as idiosyncratic factors. The banking-sector problems that were apparent in the global financial crisis were followed by commitments at a G20 summit in 2009 to more than USD 1 trillion of support for the world economy, including via the provision of concessional finance for the poorest countries.[2]

Banks provide credit that is vital in the growth of economies. In addition, they hold deposits and play key roles in the payment systems that are necessary for modern commerce. In light of banks' important functions, and to minimise the need for public funding in dealing with failing banks, mechanisms are required through which national or supranational authorities are able to take action to address the failure or likely failure of a bank with the benefit of public control of that bank. The legal frameworks for such mechanisms have evolved over the 10 years since 2009 and are the subject of this book. A broad global consensus has emerged on many, though not all, aspects of the topic.

Chapter I discusses the particular importance of banks and highlights the potentially very high costs of their failure if such failure is not dealt with appropriately. Describing a number of definitions of the term *bank resolution*, it notes that effective bank resolution regimes can assist in preserving continuity of essential banking functions and preclude potential financial instability. It explains that bank resolution procedures should diverge from standard corporate insolvency procedures in order to achieve these aims.

What specific legal features should a bank resolution regime have, in order to be effective? Chapter II tackles this question with detailed reference to the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, which were introduced following the global financial crisis. It notes that, while they represent international standards, they do not purport to set out a one-size-fits-all approach, and they raise specific considerations that need to be addressed in their implementation in individual domestic frameworks.

Chapter III considers a key resolution tool, *bail-in*. This tool allows the losses of a failing bank to be passed to its investors rather than taxpayers. The chapter outlines the emergence and development of the tool following the global financial crisis. It discusses the triggers for implementing a bail-in and the incentivisation of resolution authorities to intervene on a timely basis. In addition, it looks at the identities of counterparties to bail-in securities as a potential source of systemic risk, and it addresses the importance of liquidity provision in the context of bail-in.

The various approaches that have been devised to deal with failing banks have been painted on a larger canvas, that of financial regulation and supervision. Chapter IV describes trends in the evolution of the financial regulatory and supervisory architecture in different jurisdictions around the world, and highlights specific lessons from the global financial crisis for the design

* See Preface on the previous page for biography.

1 Tacitus, *Annals*, VI, 17.

2 Alongside a fiscal expansion of USD 5 trillion. G20, *London Summit – Leaders' Statement* (2009) paras 5-6.

of financial regulation and supervision. The chapter discusses different approaches to dealing with failing international banks and observes that, despite significant progress in increasing the robustness of resolution frameworks, the effective resolution of global financial institutions remains dependent on achieving cross-border cooperation.

Important aspects of bank resolution regimes in general having been examined, chapters V to XI provide local perspectives on key aspects of bank resolution regimes in particular jurisdictions.

Several of these chapters focus on the European Union, in which supranational legislation – in the form of the Bank Recovery and Resolution Directive – prescribes a level of harmonisation of bank resolution regimes across member states. Chapter V includes an overview of this Directive and of the associated Single Resolution Mechanism Regulation, the latter applying to the majority of European Union member states. The chapter also compares the banking markets and legal frameworks of certain European countries, namely Germany, Italy, Spain and the United Kingdom. In that light, it considers how the treatment of failing banks in these geographies can be expected to differ.

The position in the four individual European countries is described at length in chapters VI, VII, VIII and IX. The chapter on Spain includes an extended discussion of the resolution of Banco Popular. As of now, this is the only bank resolution to have been effected pursuant to a decision of the Single Resolution Board, the supranational resolution authority established by the Single Resolution Mechanism Regulation.

Chapter X examines the position in the Hong Kong SAR, where a new resolution regime for financial institutions (including banking-sector entities) has recently been introduced. The chapter observes that the new regime has significantly changed the landscape for the treatment of failing financial institutions that fall within its scope.

The final chapter, chapter XI, looks at the United States. It discusses the approach in the country to the resolution of global systemically important banking organisations, and highlights an emphasis in United States legislation on the use of corporate reorganisation tools within the framework of the United States Bankruptcy Code.

Considering the position around the world, recent reforms have increased the extent to which bank resolution regimes are in line with the international standards introduced following the global financial crisis. However, there are still significant gaps in the implementation of those standards, and notable variances in jurisdictions' approaches to dealing with failing banks. While it is not the case that all jurisdictions should have identical bank resolution regimes, the practical consequences of future bank failures will potentially differ meaningfully from one country to another.

We have come a long way from the banking crisis described by Tacitus, and indeed from the global financial crisis. Rapid innovation is taking place in the context of financial systems, enabled by (among other things) artificial intelligence, big data and mobile access. In addition, bank resolution regimes continue to evolve. It remains to be seen to what extent future problems affecting banks, and attempted solutions, will echo those of the past. In any case, it will be vital for those designing, assessing and participating in financial systems to remain vigilant and responsive to risks. This will allow society to reap benefits from modern banking that are both significant and robust.

London, 1 December 2019

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I. BANK RESOLUTION AND ITS IMPORTANCE

I. Bank Resolution and its Importance

Antonia Menezes and Akvile Gropper*

1. Introduction

In the last decade, we have witnessed an unprecedented number of banks fail. In the United States (the "US") alone, 528 banks have failed over the 10-year period from 2008 to 2018.[1] Banks are considered a systemic risk if the social cost of a bank failure is greater than the direct losses to the claim holders of the failing bank,[2] and we have indeed seen how a failure of one large bank can not only affect its customers, but also quickly snowball into a financial crisis with a much broader and severe economic and social impact. Between 2007 and 2010, European banks incurred almost EUR 1 trillion or 8 percent of the GDP of the European Union (the "EU") in losses related to the global financial crisis of 2007-08.[3] In 2009, the EU suffered a GDP contraction of 6 percent due to the economic recession induced by the global financial crisis.[4] During the period from 2007 to 2009, because of a retraction in global banking activities, both high-income and developing economies experienced a decline in loan flows from global banks – the volume of syndicated loans in high-income countries dropped by about 62 percent and in developing economies by about 55 percent.[5] Statistics also show that during 2008 to 2009, bank-intermediated trade finance plunged by more than 50 percent in some countries,[6] while the global trade decline was reported at USD 3.6 trillion.[7]

A number of scholars have studied the effects of bank failure on economic growth and, although it is challenging to quantify, the general consensus is that bank failures interrupt economic growth. For example, Kupiec and Ramirez (2008)[8] studied data from a period that is not coincident with recessions and found that bank failures reduce

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1 Data from the US Federal Deposit Insurance Corporation, available at: https://www.fdic.gov/bank/historical/bank.

2 Paul Kupiec and Carlos Ramirez, 'Bank Failures and the Cost of Systemic Risk: Evidence from 1900-1930' Working Paper 2008-09 (FDIC Center for Financial Research 2008), available at: https://www.fdic.gov/bank/analytical/cfr/2008/wp2008/2008-09.pdf.

3 European Commission Memo 12/416, 'Bank Recovery and Resolution Proposal: Frequently Asked Questions' (European Commission, 6 June 2012), available at: http://europa.eu/rapid/press-release_MEMO-12-416_en.htm.

4 ibid.

5 World Bank, *Global Financial Development Report* 2017/2018: *Bankers without Borders* (2018) 97.

6 These countries include Australia, Brazil, China, France, Germany, Hong Kong, India, Italy, Republic of Korea, Mexico, Spain and the US (ibid, 95).

7 ibid.

8 Kupiec and Ramirez (note 2).

subsequent economic growth. In a study of systemic banking crises, Laeven and Valencia (2018)[9] drew on 151 systemic banking crises episodes around the globe during the period from 1970 to 2017. They found that these crises were associated with permanent output losses and elevated levels of public debt (although at different levels in high-income and low- and middle-income countries).[10] They also found that sovereign debt and currency crises tend to coincide with or follow banking crises.[11]

The last global economic downturn, following the global financial crisis, was a major wakeup call to governments of both developing and developed countries. It reminded us of the importance of international banking for economic development and stability. It exposed the powerful potential of foreign banks to spread shocks from one country to another, but also, if home and host countries' institutional environments are balanced, to "compensate" for shortages in credit supply by local banks during economic downturns in host countries.

The consequences of the imbalance between home and host countries' institutional environments were evident when the global financial crisis hit the smaller economies of Central and Eastern Europe. Their banking systems were dominated by Western European bank subsidiaries – in some cases reaching 100 percent foreign bank share (for example, in Croatia) during the pre-crisis years.[12] While foreign bank subsidiaries were of systemic importance in these "small host" countries, the relevance of the "small host" operations to the parent banks was minor.[13] When the crisis hit the region, many foreign banks cut back their operations there in response to solvency and liquidity problems in the host countries or in view of their own business models and solvency issues.[14] To prevent a mass exit of foreign banks (which would have resulted in a collapse of the financial systems in the region), a series of meetings was initiated in late 2008 between the International Monetary Fund, the World Bank Group, the European Bank for Reconstruction and Development, the European Commission and others, banks, and home and host supervisors.[15] Following these meetings, a cross-national initiative, the "Vienna Initiative", was created with a goal of stabilising the financial markets and preventing a systemic crisis in the region through better regulatory coordination between home and host countries' authorities.[16]

On a global level, it became apparent that banking regulation needed to be strengthened, and that bank solvency problems had to be addressed differently. For reasons that will be discussed in this chapter, regulators have not only taken preventative measures to reduce bank failures but also changed ways of resolving failing banks.

This chapter addresses the importance of bank resolution regimes, discussing their recent history, and is organised as follows. Section 2 explains the need for resolution

9 Luc Laeven and Fabian Valencia, 'Systemic Banking Crises Revisited' Working Paper WP/18/206 (International Monetary Fund 2018), available at: https://www.imf.org/en/Publications/WP/Issues/2018/09/14/Systemic-Banking-Crises-Revisited-46232.

10 ibid.

11 ibid.

12 Ismael Ahmad Fontán, Thorsten Beck, Katia D'Hulster, Pamela Lintner, D Filiz Unsal, 'Banking Supervision and Resolution in the EU: Effects on Small Host Countries in Central, Eastern and South Eastern Europe' FinSAC Working Paper (World Bank Group 2019).

13 ibid.

14 ibid.

15 ibid.

16 Vienna Initiative, as to which see http://vienna-initiative.com.

regimes to be effective. Section 3 discusses changes to policy around the world following the global financial crisis. Section 4 concludes.

2. The importance of effective bank resolution regimes

Banks perform vital economic functions as they act as an intermediaries between savers and investors, transform short-term liabilities to longer-term assets (the *maturity transformation* function),[17] and play an important role in payment systems that are used in various sectors of economy and society,[18] holding funds and facilitating the daily settlement of payments for goods and services between participants. Moreover, in modern financial markets, banks are often interconnected, operationally and financially. While this interconnectedness brings important benefits (such as efficiency and sharing of risks), it also carries its own risks. For example, a sudden increase in deposit withdrawals in a bank can cause liquidity problems, especially given maturity transformation. Such a sudden increase in withdrawals – a run – can create a contagion effect in the financial system more broadly. The contagion effect can happen through direct channels due to contractual obligations among financial entities or indirectly through exposure to common risk factors, such as fire sales of assets or information asymmetries when depositors and other short-term creditors run on funds based on incomplete information about the banks or the financial system.[19] The global financial crisis showed very clearly how financial distress of a systemically important financial institution can spread across financial markets.

Scholars tend to agree that because banks' services are critical to customers and businesses and because of potentially far-reaching systemic risks associated with banks, bank distress should be treated differently than distress of any other business, through a resolution regime designed especially for banks.[20] Researchers generally believe that effective bank resolution requires intervention by a resolution authority with broad powers to use a range of resolution tools.[21]

There is no uniform definition of bank resolution, and it remains the case that regulatory frameworks for bank resolution are different as between countries. In a broad sense, bank resolution is statutory action by a national or supranational authority that seeks to address the failure or likely failure of a bank, involving public control. This includes wide-ranging mechanisms that have been used globally to address financial distress of banks, including the application of general corporate insolvency law by courts, and processes initiated by specially designated bank resolution authorities. The European

17 Pierluigi Bologna, 'Banks' Maturity Transformation: Risk, Reward, and Policy' Working Paper 63 (European Systemic Risk Board 2018) 5, available at: https://www.esrb.europa.eu/pub/pdf/wp/esrb.wp63.en.pdf.

18 The Core Principles for Systemically Important Payment Systems (2011) by the Committee on Payment and Settlement Systems of the Bank for International Settlements provide the following definition of a payment system: "a set of instruments, procedures and rules for the transfer of funds among system participants" (para 6.4). See https://www.bis.org/cpmi/publ/d43.pdf.

19 Laurent Clerc, Alberto Giovannini, Sam Lagfield, Tuomas Peltonen, Richard Portes, Martin Scheicher, 'Indirect Contagion: The Policy Problem' Occasional Paper 9 (European Systemic Risk Board 2016), available at: https://www.esrb.europa.eu/pub/pdf/occasional/20160126_occasional_paper_9.pdf.

20 See Eva Hüpkes, 'Insolvency – Why a Special Regime for Banks?' (International Monetary Fund 2003), available at: https://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/hupkes.pdf; also see Matej Marinč and Razvan Vlahu, 'The Economic Perspective of Bank Bankruptcy Law' Working Paper 310 (De Nederlandsche Bank 2011), available at: https://www.dnb.nl/en/binaries/working%20paper%20310_tcm47-257056.pdf.

21 See, for example, Hüpkes (note 20); Magdalena Ignatowski and Josef Korte, 'Wishful Thinking or Effective Threat? Tightening Bank Resolution Regimes and Bank Risk-Taking' Working Paper 1659 (European Central Bank 2014), available at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1659.pdf; Ana Corbacho and Shanaka J Peiris (eds), *The ASEAN Way: Sustaining Growth and Stability* (International Monetary Fund 2018) 213.

Commission uses a narrower definition of bank resolution, referring to "restructuring of an institution in order to ensure the continuity of its essential functions, preserve financial stability and restore viability of all or part of that institution".[22] The narrower definition focuses on the stabilisation of a failing bank, continuity of its functions, and financial stability as the main objectives of resolution, while liquidation is left to national insolvency laws.

The consensus that potentially systemic banks need a special resolution regime is reflected in the recent global and national reforms in this area, as discussed in section 3 below. While many of the objectives of corporate insolvency regimes and special resolution regimes for banks are similar (for example, to ensure continuity of viable firms and to provide for the efficient liquidation of non-viable ones, to provide for timely, efficient, and impartial resolution of insolvencies, and to respect the hierarchy of claims),[23] there are also notable differences. In the resolution of potentially systemic banks, the overriding objective of the resolution authority is to protect the critical economic functions provided by the bank (mainly taking of deposits, extension of credit and processing of payments) and to prevent contagion among other banks, which is key to financial stability.

Because of the differences in objectives, certain aspects of the procedure must differ, including the time of the intervention ("[r]esolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so"[24]), and the role of the stakeholders (for instance, less power to the shareholders than in a general insolvency regime).[25] Another rationale for the divergence from general insolvency law principles is the understanding of certain of banks' financial liabilities (such as deposits, money-like instruments, and risk-shifting instruments) as capital that should not be impaired – financial firms have "firm-specific liabilities, that need to be protected at [the] expense of other liabilities".[26]

In addition, to guard against systemic disruption and ensure continuity of key services, a swift process is imperative in addressing bank failure. However, ordinary insolvency procedures can be lengthy. The World Bank Group's *Doing Business* project measures time, cost and recovery value of insolvency proceedings for non-financial institutions involving domestic entities, as well as the strength of the legal framework applicable to judicial liquidation and reorganisation proceedings.[27] Based on the most recent *Doing Business* data, the average time from company default until the payment of some or all of the money owed to a bank is about 20 months in high-income countries of the Organisation for Economic Co-operation and Development, with the fastest procedures recorded in Ireland (about five months) and Japan (about seven months).[28] As such,

22 European Commission Memo (note 3).

23 World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes* (revised 2015) (2016), available at: http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf.

24 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2014) para 3.1, available at: https://www.fsb.org/2014/10/key-attributes-of-effective-resolution-regimes-for-financial-institutions-2.

25 Hüpkes (note 20) 9.

26 Bruno M Parigi, 'The Economics of Bank Resolution' (presentation for UFSP Finanzmarketregulierung, Zurich, 2-3 June 2014) 29, available at: http://www.finreg.uzh.ch/dam/jcr:ffffffff-c9a7-520d-0000-0000176649cc/PARIGIBrunoResolution.pdf.

27 World Bank, *Doing Business 2020: Comparing Business Regulation in 190 Economies* (English) (2019), available at: https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf.

28 World Bank, *Doing Business: Resolving Insolvency* (May 2019), available at: https://www.doingbusiness.org/en/data/exploretopics/resolving-insolvency.

reorganisation or liquidation of failing banks by judicial authorities can be destructive of going-concern value and interrupt vital economic functions.

In the recent past, restructuring of banks through government intervention, such as guarantees, liquidity assistance, recapitalisation or other policy intervention requiring public funds, was common. In the global financial crisis and its aftermath, it became clear that ad hoc solutions to bank failure are costly. Over the period from September 2008 to December 2011, EU member states committed a total of EUR 4.5 trillion, i.e. 37 percent of EU GDP.[29] The amount of taxpayer money effectively used (which was mainly in the form of guarantees of bank liabilities) amounted to EUR 1.7 trillion, or 13 percent of EU GDP.[30] In each of Iceland and Ireland, the cost of government intervention amounted to more than 40 percent of the country's GDP, and public debt increased by more than 70 percent of the country's GDP over a period of five years.[31]

A *bail-out* (also termed *solvency support*) is the rescue of a failing institution by means of the provision of public funds. Some of the largest bank bail-outs in history took place during the global financial crisis, after the US government passed the Emergency Economic Stabilization Act of 2008 (the "bail-out bill").[32] This created the Troubled Asset Relief Program to inject capital into distressed banks and financial institutions and prevent the collapse of the financial system. Bail-outs are not only costly, but are also associated with moral hazard, whereby – in anticipation of a bail-out in the event of distress – banks are incentivised to take excessive risks or engage in strategies to become *too big to fail* or collectively overinvest into specific classes of assets (such that in the event of systemic distress affecting those asset classes, the banks are *too many to fail*). Empirical research shows that bank resolution reforms that transfer risk from taxpayers to bank shareholders and creditors reduce the costs associated with bank failure, including the *ex ante* costs (the costs related to the risk that a solvent bank might fail in a given period).[33] This does not capture the full impact on public finances – effective bank resolution can reduce the risk of indirect effects in the real economy, as financial crises are associated with higher borrowing costs, a slowdown in GDP growth, and higher asset prices.[34]

Evidence suggests that well-structured bank resolution regimes not only help minimise public costs and economic disruption associated with failure of large banks, but also reduce the moral hazard associated with the prospect of bank bail-outs, increasing bank discipline and disincentivising risky behaviour.[35] There is also an indication that a rules-based resolution regime, which provides for a failing bank to merge with or be acquired by another institution and for orderly liquidation where necessary, has a

29 'European Union: Publication of Financial Sector Assessment Program Documentation – Technical Note on Progress with Bank Restructuring and Resolution in Europe' IMF Country Report 13/67 (International Monetary Fund 2013) 7, available at: https://www.imf.org/external/pubs/ft/scr/2013/cr1367.pdf.

30 ibid.

31 David Amaglobeli, Nicolas End, Mariusz Jarmuzek and Gerermia Palomba, 'From Systemic Crises to Fiscal Costs: Risk Factors' Working Paper WP15/166 (International Monetary Fund 2015) 2, available at: https://www.imf.org/en/Publications/WP/Issues/2016/12/31/From-Systemic-Banking-Crises-to-Fiscal-Costs-Risk-Factors-43101.

32 Pub L No 110-343, 122 Stat 3765 (2008).

33 Marianna Blix Grimaldi, Jörg Hofmeister, Sebastian Schich and Daniel Snethlage, 'Estimating the Size and Incidence of Bank Resolution Costs for Selected Banks in OECD Countries' (2016) OECD Journal: Financial Market Trends 1, available at: https://www.oecd.org/finance/Bank-resolution-costs-OECD-countries.pdf.

34 Amaglobeli and others (note 31) (citing various sources, including Claessens and others (2011); European Commission (2009); Hoggarth and others (2002); Reinhart and Rogoff (2008)).

35 Ignatowski and Korte (note 21).

positive effect on the growth of higher-quality firms (which has been termed a “catharsis effect”).[36] The effect takes place because rules-based bank resolution regimes deter banks from excessive risk-taking and promote more responsible credit allocation and monitoring. Regimes that disincentivise risky behaviour by banks result in better credit allocation to firms that “deserve credit most on grounds of economic viability and profitability”, help prevent “zombie firms”, which hamper economic performance, and help improve banks’ monitoring of firms.[37] It has been found that the effect is particularly significant in banking systems that provide access to international finance and can offset the risk of a shortage of the supply of credit associated with insolvent bank liquidation.[38]

In summary, effective bank resolution regimes can be expected to assist continuity of essential banking functions, preclude potential financial instability, minimise the use of public funds, lessen moral hazard and increase discipline in the banking sector.

3. Policy shifts in bank resolution

Proper restructuring and recapitalisation of failing banks has become a topic of intense discussions among scholars, regulators and international bodies. In 2010, the Basel Committee on Banking Supervision (the “Basel Committee”) issued recommendations to strengthen national resolution powers and their cross-border implementation.[39] One of the recommendations was for national authorities to have “appropriate tools to deal with all types of financial institutions in difficulties so that an orderly resolution can be achieved”.[40] The Basel Committee did not prescribe the method of resolution but did set out an objective – a resolution should be orderly and one that “helps maintain financial stability, minimise systemic risk, protect consumers, limit moral hazard and promote market efficiency”.[41] In 2011, the Financial Stability Board (the “FSB”) published the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the “KAs”). These defined the essential characteristics of an effective resolution regime for potentially systemic financial institutions and were expanded in 2014.[42] The regime covers resolution authority, powers and tools, operational capacity, funding, statutory safeguards, cross-border cooperation and information-sharing, and cross-border effectiveness of resolution. The KAs were endorsed by the G20 as “new international standards for resolution regimes”.[43] The biggest policy change was the relocation of the risk of bank failure from short-term creditors and taxpayers to bank shareholders and investors, and an emphasis on swift processes and value preservation.

In the years following the standards and recommendations of the FSB and the Basel Committee, a number of countries introduced new resolution regimes (e.g. Hong

36 Josef Korte, ‘Catharsis – The Real Effects of Bank Insolvency and Resolution’ Discussion Paper 21/2013 (Bundesbank 2013), available at: https://ssrn.com/abstract=2209377.

37 ibid.

38 ibid.

39 Bank for International Settlements, ‘Report and Recommendations of the Cross-border Bank Resolution Group’ (2010), available at: https://www.bis.org/publ/bcbs169.pdf.

40 ibid, 22.

41 ibid, 22.

42 FSB (note 24).

43 ibid, 1 (citing Communiqué G20 Leaders Summit, Cannes, 3-4 November 2011, section 13).

Kong),[44] additional resolution options, such as the resolution of non-bank financial institutions (e.g. Japan and the US),[45] or bail-in and bridge bank tools (e.g. Indonesia).[46] Probably the most far-reaching reforms took place within the EU with the adoption of the Bank Recovery and Resolution Directive[47] and the Single Resolution Mechanism Regulation (the "SRM Regulation"),[48] both aimed at establishing rules for the recovery and resolution of credit institutions and investment firms. The SRM Regulation created the Single Resolution Board, which is the European banking union's resolution authority and is responsible for preparing resolution plans and adopting resolution measures with respect to significant banks. Less significant banks remain under the remit of national resolution authorities. The Financial Sector Assessment Program published by the International Monetary Fund in 2018 found the resolution framework within the euro area to have been "substantially upgraded", but that fragmentation remains in practice with incentives to use national-level powers.[49]

US banking regulation, including its scheme of resolution of systemic financial institutions, also experienced important changes. Unlike the majority of European countries, the US had bank insolvency regimes in place for many years, but, following the global financial crisis, further legislative changes took place. The Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")[50] was introduced, permitting regulators to establish rules requiring banks to show how they would wind down their operations in the event of severe distress without stressing the financial system. The Dodd-Frank Act also created a backup resolution framework – the Orderly Liquidation Authority – for situations where it is determined that resolution of financial firms under the corporate insolvency regime would have serious adverse effects on US financial stability.

Notwithstanding the evolution of bank resolution tools, corporate insolvency and creditor rights regimes remain an integral part of the overall framework for bank insolvency and resolution and for facilitating financial system stability. Effective creditor rights and insolvency regimes play an essential preventative and risk management role by helping pre-empt financial distress of non-financial institutions on a systemic scale.[51] With that in mind, the World Bank Group, in collaboration with the United Nations Commission on International Trade Law ("UNCITRAL"), the International Association of Insolvency Regulators and INSOL, has set global standards for insolvency and debtor/creditor rights ("ICR"), designated by the FSB as key for sound financial systems.[52]

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44 'Key Attributes of Effective Resolution Regimes for Financial Institutions: Overview' (presentation by FSB in FinSAC Workshop 'Resolution Regimes in Europe: Implementation of Effective Resolution Regimes in the Region', Vienna, 19 April 2017), available at: http://pubdocs.worldbank.org/en/801411493605045893/S1-Eva-Hupkes-Sam-Smith-BR-Wkshop-19Apr-2017.pdf.

45 International Monetary Fund, *Global Financial Stability Report – A Decade after the Global Financial Crisis: Are We Safer?* (October 2018).

46 'Key Attributes of Effective Resolution Regimes for Financial Institutions: Overview' (note 44).

47 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

48 Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L225/1.

49 'Euro Area Policies: Financial System Stability Assessment' IMF Country Report 18/226 (International Monetary Fund 2018), available at: https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-System-Stability-Assessment-46100.

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

51 World Bank (note 23).

52 See FSB, 'Key Standards for Sound Financial Systems', available at: https://www.fsb.org/work-of-the-fsb/about-the-compendium-of-standards/key_standards.

The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes,[53] together with the UNCITRAL Legislative Guide on Insolvency,[54] are the internationally recognised benchmarks for ICR and serve as reference points for evaluating and strengthening countries' ICR systems.

4. Conclusion and considerations for the future

Resolution of distressed banks has become an important element of regulatory design to foster financial stability. The overarching goal of bank resolution regimes, as opposed to corporate insolvency regimes, is to quickly prevent damage to the financial system and broader economy by reducing the risk of systemic disruption and securing continuity of essential banking services. Researchers generally believe that effective bank resolution requires intervention by an authority with broad powers to use a range of resolution tools. While many countries still do not have effective mechanisms for resolution of failing banks, we notice significant improvements in policies over the past decade. One of the biggest improvements is the publication by the FSB of global benchmarks for resolution regimes.

The development of bank resolution strategies and tools continues to be a work in progress and there remain important gaps to address. For instance, a lot more needs to be done in the areas of resolving financial groups and cross-border bank resolutions. The reality today is that the banking sector is highly interconnected, while the regulatory systems are not. In fact, cross-border linkages are increasing and becoming more complex and, as such, pose higher global risks that might affect even countries that are generally more immune to non-systemic crises.[55] The issue of cross-border resolutions is undoubtedly important, but it is also a challenging one because it requires burden-sharing among states, and affects national budgets and legal systems, each with their own differing regulatory, supervisory and judicial powers. The FSB has been leading the way in addressing deficiencies in bank resolution regimes, and we expect to see further leadership at the national level, in the near future, in the spirit of the global standards published by the FSB.

53 World Bank (note 23).

54 UNCITRAL, 'UNCITRAL Legislative Guide on Insolvency Law' (United Nations 2005, 2012, 2013), available at: https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law.

55 Stijn Claessens, M Ayhan Kose, Luc Laeven and Fabian Valencia, *Financial Crises: Causes, Consequences, and Policy Responses* (International Monetary Fund 2014).

II. BANK RESOLUTION FRAMEWORKS: KEY LEGAL DESIGN ISSUES

II. Bank Resolution Frameworks: Key Legal Design Issues

Ross Leckow, Alessandro Gullo and Ender Emre*

1. Introduction

After the global financial crisis, new international standards on resolution regimes – the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "KAs")[1] – were adopted by the Financial Stability Board (the "FSB"). In the wake of the crisis and the KAs, most home and key host jurisdictions of global systemically important banks ("G-SIBs") have upgraded their frameworks for dealing with distressed banks, or otherwise introduced new bank resolution regimes.[2]

The KAs are premised on the recognition that public authorities must have strong and clear mandates to resolve financial institutions in an orderly manner without taxpayer exposure to loss, while preserving financial stability and maintaining the continuity of their vital economic functions. The design of resolution regimes is influenced by a number of important legal considerations, such as the balance they strike between powers under public law and property rights. Furthermore, as the concept of *resolution*, as a legal category, was not very familiar to the legal systems of many jurisdictions (and often remains to be fully tested), its effective adoption requires that resolution regimes be coherently introduced within the legal framework of a jurisdiction.

This chapter provides a critical overview of the main legal design issues that jurisdictions must address when putting in place or reforming a resolution regime for financial institutions, laying out key principles and options available, and with a focus on the banking sector. The chapter is organised as follows. Section 2 briefly discusses the status quo before the global financial crisis and examines the rationale for a special resolution regime for banks. It also presents a general overview of the features of bank resolution regimes as recommended by the KAs and the different approaches taken by jurisdictions in implementing them. Section 3 focuses on key legal features of these regimes, namely their scope, objectives, institutional setup, resolution powers and tools, legal safeguards, resolution funding, and cross-border cooperation. A conclusion is set out in section 4.

2. Bank resolution frameworks under the Key Attributes

Before the global financial crisis, bank resolution was dealt with through corporate insolvency regimes in many jurisdictions. However, it was recognised that these regimes were not well-suited to bank resolution as they do not pursue financial stability objectives, they typically provide for late triggers for intervention into problem banks,

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1 Available at: https://www.fsb.org/2014/10/key-attributes-of-effective-resolution-regimes-for-financial-institutions-2.

2 FSB, *2018 Resolution Report: 'Keeping the Pressure Up'* Seventh Report on the Implementation of Resolution Reforms (2018), available at: https://www.fsb.org/2018/11/fsb-2018-resolution-report-keeping-the-pressure-up.

and they envisage a role of the courts that, in a bank resolution context, may give rise to an inefficient and lengthy decision-making process.[3]

Furthermore, corporate insolvency regimes do not address the specific features of a bank's assets and liabilities. Bank assets are prone to rapid deterioration in their value under distressed market conditions. Another key feature of corporate insolvency regimes – a moratorium on liabilities – is not appropriate in a bank resolution as it would result, for depositors, in loss of liquidity and of access to payment services and create a risk of contagion. Requiring creditor consent for the transfer of liabilities would prove unwieldy in a bank resolution. Finally, during the global financial crisis it was recognised that the exercise of early termination rights by the counterparties of a failed financial institution, available under standard documentation for financial contracts, can hinder the continuity of critical financial services – a key objective of bank resolution – unless it is accompanied by a temporary stay on such rights.[4]

As corporate insolvency frameworks proved to be ineffective in resolving banks, especially those considered to be *too big to fail*, when confronted with the global financial crisis, many countries bailed out their failing banks instead of using their corporate insolvency frameworks. This entailed very large commitments of public funds, increased moral hazard and undermined market discipline. In the aftermath of the crisis, a consensus emerged that banks whose failure could be systemically significant or critical should be subject to a special regime that would facilitate their swift resolution by ensuring the continuity of their critical functions, while minimising costs to the public. Effective resolution frameworks to tackle the *too big to fail* problem became one of the major topics in the global reform agenda, spearheaded by the FSB. This process led to the adoption of the KAs.

The KAs establish a set of international standards for the design of the legal and institutional framework for bank resolution. In particular, the KAs: (i) require the designation of a resolution authority ("RA") with clearly defined resolution objectives; (ii) set out recovery and resolution planning requirements that call for the RA and the banks to be prepared in advance of a crisis scenario; (iii) contemplate a wide range of resolution powers and tools, to be available to the RA to deal with banks that are no longer viable; (iv) contemplate funding needs being met through privately financed (rather than public) mechanisms; (v) recommend putting in place legal safeguards to protect interested parties against interference with their property rights; and (vi) in view of the global nature of the banking business, offer an enhanced framework for cross-border cooperation in resolution.

The KAs recognise that the specific design of a bank resolution regime needs to take into account the size, structure, and complexity of a jurisdiction's financial sector, its legal system, and its institutional framework. While developed with global systemically important financial institutions in mind, the KAs acknowledge the principle of proportionality and recognise that some aspects of their standards could be more relevant than others to specific jurisdictions.[5] Domestic circumstances might, in

3 Special resolution regimes were in place for deposit-taking institutions in a number of jurisdictions, such as Canada, Italy, and the United States.

4 See KAs, Appendix I, Annex 5.

5 FSB, *The Key Attributes Assessment Methodology for the Banking Sector* (2016) (the "Assessment Methodology") 7-9.

particular, determine the extent of the resolution powers to be adopted.[6] In this respect, jurisdictions often examine the relevance of the bail-in tool based on whether the funding structure of banks allows – currently or in a foreseeable future – sufficient loss-absorbing capacity without raising any contagion concerns. Similarly, most jurisdictions employ asset management vehicles during a system-wide crisis and based on ad hoc crisis management laws, rather than as a standing tool of a resolution regime.

Jurisdictions appear to adopt different approaches both in defining the concept of resolution in their legal framework and in the implementation of a resolution. This chapter examines resolution as an overarching concept that can cover both reorganisation and liquidation.[7] The special resolution regime of the United Kingdom (the “UK”) is an example of this approach.[8] The Bank Recovery and Resolution Directive (the “BRRD”) of the European Union (the “EU”), among other regimes, equates resolution with reorganisation, and thus distinguishes it from insolvency or liquidation.[9] Under a third approach, in countries such as the United States (the “US”), the resolution of deposit-taking institutions typically takes place through the application of business reorganisation tools within an orderly receivership process. This is also known as *closed bank resolution*, as opposed to *open bank resolution*, where reorganisation measures are applied while the failed bank is open, although possibly subject to restrictions in its operations.

Open bank resolutions and closed bank resolutions entail different resolution approaches. Under a closed bank resolution, a bank’s licence is revoked, liquidation proceedings are initiated, and insured or all eligible deposit liabilities are rapidly transferred to an acquiring bank, while a moratorium is placed on other liabilities. The authorities then liquidate what remains of the failed bank through the use of typical liquidation tools.[10] This approach can be effective particularly in jurisdictions with a large number of relatively small banks. However, it may not prove feasible in jurisdictions with systemically important banks whose outright liquidation may prove difficult. In these instances, jurisdictions may opt for a framework allowing open bank resolution. Under this approach, the authorities initiate resolution proceedings and transfer deposits and certain liabilities to a third-party acquirer before the bank’s licence is revoked and

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6 For a specific discussion on tailoring KAs to the Sub-Saharan region, see World Bank, *Challenges for Resolution of Banks in Sub-Saharan Africa* (2019), available at: http://documents.worldbank.org/curated/en/831841559224344631/Challenges-for-Resolution-of-Banks-in-Sub-Saharan-Africa.

7 See Assessment Methodology. See also IMF, *Resolution of Cross-Border Banks – A Proposed Framework for Enhanced Coordination* (2010), available at: https://www.imf.org/external/np/pp/eng/2010/061110.pdf. For the purposes of this chapter, we will use the concept of resolution to refer to the placement of a non-viable bank under full public control and to the application by administrative authorities of a set of tools, policies, and processes to reorganise the bank’s business in order to continue its critical functions, or liquidate it in an orderly manner.

8 The UK’s Banking Act 2009, s 1(2), defines the special resolution regime as including the five stabilisation options plus the bank insolvency procedure and the bank administration procedure. The latter two are known as *modified insolvency proceedings*. See also the Bank of England, HM Treasury and Financial Services Authority, *Financial Stability and Depositor Protection: Strengthening the Framework* (Cm 7308, 2008) 49, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/243413/7308.pdf.

9 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190. In general, the EU has historically made limited forays into the field of insolvency law, which is not harmonised across the EU. It is perhaps a continuation of that historical trend that the BRRD does not aim at creating a harmonised insolvency regime for in-scope institutions. At the same time, the definition of “normal insolvency proceedings” under the BRRD includes insolvency proceedings that are “specific to those institutions”, which appears to contemplate that member states may establish special or modified insolvency regimes for entities within the scope of the BRRD (art 2(1)(47)).

10 For a detailed analysis of resolution through bank liquidation procedures, see David C Parker, *Closing a Failed Bank: Resolution Practices and Procedures* (IMF 2010).

the remainder of the institution is liquidated. Moreover, in an open bank resolution the authorities can use additional tools, such as share transfers and recapitalisation via new investors, that are not available in a liquidation scenario.

The choice between open bank and closed bank resolution is not a binary one, as these approaches may be complementary. The key point for jurisdictions is to have a broad range of resolution options that take account of the characteristics of their financial system and the extent to which their institutions are systemically important. The legal framework should accommodate different policy options for appropriate deployment by the authorities in a flexible manner, for instance by providing closed bank resolution as the preferred mechanism but also allowing open bank resolution when warranted by circumstances. Similar flexibility can be envisaged in the application of a *bail-in tool* on an open bank and closed bank basis (see the discussion on bail-in in section 3.6 below).

In addition to providing for a coherent conceptual understanding of *resolution* and framing it in the context of the insolvency and liquidation regime of a jurisdiction, the legal framework should establish a consistent and clear relationship between bank resolution, the supervisory framework for the financial sector, and the broader legal framework. Three main points can be noted.

First, a bank resolution framework should be viewed in the context of broader efforts towards establishing a strong financial safety net. As such, sound financial sector laws, notably the central banking law, banking law and deposit insurance law, contribute to an effective resolution regime, as recognised by the KAs. This requires a robust framework for monitoring financial stability with arrangements for effective coordination between financial safety net participants during normal and crisis times, the availability of mechanisms for effective bank supervision in line with best practices, and effective protection arrangements for depositors when the prerequisites for such arrangements are in place. Finally, where an existing financial sector authority is designated as the RA, its statutory framework law should appropriately reflect the mandate of such authority in its capacity as RA, supported by adequate resolution-related governance arrangements.

Second, while it may be part of a spectrum of actions taken by the authorities over a bank, resolution should be clearly distinguished from other supervisory actions.[11] Within this spectrum, ordinary enforcement powers (e.g. monetary fines) address violation of laws, regardless of any danger of failure. Where a bank is troubled but still viable, *early intervention* measures can strengthen its financial condition (e.g. by requiring it to raise capital) or prevent any further deterioration in its position (e.g. by requiring it not to engage in certain operations). Resolution takes place at a later stage if the bank is deemed no longer viable (or likely to cease to be viable) and without any reasonable prospect of recovery. The design of resolution triggers should reflect this distinction between early intervention and resolution.

The powers available to be exercised by the authorities under early intervention and resolution differ considerably in their nature; in particular, under resolution, the authorities have considerably more authority to take actions without the consent of

11 For a discussion on distinct aspects of enforcement, early intervention, and resolution, see Wouter Bossu and Dawn Chew, '"But We Are Different!": 12 Common Weaknesses in Banking Laws, and What to Do About Them' Working Paper WP/15/200 (IMF 2015), available at: https://www.imf.org/external/pubs/cat/longres.aspx?sk=43274.0.

other parties. For instance, in an early intervention a temporary manager may be appointed by the supervisory authority to run the bank without displacing the rights of shareholders who would typically continue to be involved in key corporate decisions (e.g. as to a merger), while creditors retain a role in the restructuring of the bank's debt. In contrast, once resolution conditions are met, resolution powers may be exercised by the authorities without the need for the consent of shareholders or creditors. Nonetheless, early intervention and resolution are closely linked: while the adoption of an early intervention measure is not typically a prerequisite to the initiation of resolution, the failure of an intervention to lead to a successful recovery may well constitute a justifiable ground to place the bank under the RA's control.

Third, the legal framework should clarify when and how resolution will derogate from any other general rules that may impede the implementation of resolution actions. For instance, a country's securities law or company law may require specific procedures that are designed to protect shareholders (e.g. rules about the convocation of a shareholders' meeting), investors or creditors (e.g. for the reduction of capital, mergers, or mandatory takeover bids). To avoid the applicability of these measures in a resolution, some countries, in the resolution law, specify that such provisions are not applicable.[12] Alternatively, jurisdictions may provide a general rule to clarify that resolution implementation will take place notwithstanding any provision in other laws. Whether and how the latter approach is conducive to legal certainty will warrant analysis in the jurisdiction undergoing a resolution reform.

3. Key legal issues in the design of bank resolution frameworks

3.1 Scope of application

The KAs recommend that any financial institution that could be systemically significant or critical if it fails should be subject to an effective resolution regime.[13]

The assessment of systemic importance for supervisory purposes (e.g. for capital surcharges) may inform but should not constrain the determination as to whether a bank is systemically important for resolution purposes. For instance, a bank that has not been designated as a domestic systemically important bank would still be systemically critical for resolution purposes if it is determined that its failure could lead to a disruption of services that are critical for the functioning of the financial system or real economy.[14]

At the same time, the KAs recognise that resolution regimes may apply more broadly than to banks deemed systemically significant or critical at the point of non-viability.[15] Designing a resolution framework that applies in general to all banks, regardless of their

12 See e.g. Denmark's Law on Restructuring and Resolution of Certain Financial Enterprises, art 47(1), and Slovakia's Law on Resolution in the Financial Markets, art 40(10).

13 Jurisdictions may have a special resolution regime that applies to different categories of financial institutions. For instance, in Singapore resolution powers apply to banks and insurers, as well as to financial market infrastructures such as operators and settlement institutions of designated payment systems and recognised market operators. Likewise, the EU's BRRD applies to credit institutions and investment firms. On the other hand, different, separate frameworks may govern the resolution of specific types of entities. For instance, in the US different laws apply to the resolution of insured depository banks and of covered financial companies, including bank holding companies and non-bank financial companies supervised by the Federal Reserve.

14 See FSB, *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Identification of Critical Functions and Critical Shared Services* (2013), note 2, available at: https://www.fsb.org/2013/07/r_130716a.

15 Assessment Methodology, Explanatory Note ("EN") 1(c).

systemic importance, has the benefit of simplicity and flexibility. Moreover, this approach is more fundamentally based on the distinctive nature of the banking business itself, which justifies the existence of a special resolution regime for all banks.[16]

The general application of resolution to all banks should not undermine the ability of the RA to exercise its powers as appropriate under the circumstances. Flexibility may be needed in calibrating recovery and resolution planning requirements based on the systemic importance of a bank, in pursuing a resolution strategy (reorganisation or liquidation), or in applying a specific resolution tool.

In defining the scope of their resolution regimes, jurisdictions should consider the complexities that may arise in the resolution of a bank that is part of a financial group. Operational interdependencies within the group can render some group entities (other than the bank itself) materially important to ensure the continuity of critical functions performed within the group. However, the RA of the bank under resolution would have no corporate control over these entities, unless they are subsidiaries. In addition, these group entities may not always coordinate their actions with the RA, particularly when they are subject to their own insolvency regimes and their administrators or liquidators may have different statutory duties. Against this background, the RA needs to have robust powers to support the continuity of critical services. These powers may be exercised through a variety of mechanisms, including through contractual arrangements that cannot be terminated by recovery or resolution events and that form part of recovery and resolution planning requirements applicable to the bank and its group.

Furthermore, the scope of a resolution regime should be extended to the holding companies of banks, if necessary in order to resolve the bank or its group as a whole. This may be the case in a *single point of entry* ("SPOE") resolution strategy, which entails the exercise of resolution powers at the level of the holding company and is generally viewed as potentially effective in resolving groups with intense interlinkages (e.g. central liquidity, trading and hedging).[17] Indeed, under this strategy losses are upstreamed to the holding company and/or capital is downstreamed from the holding company, so that banks and other group entities continue their operations without interruption. This strategy differs from another approach that has been developed to resolve a group, the *multiple point of entry* strategy, entailing the resolution of the individual parts of the group (i.e. the holding company and subsidiaries) in different, separate proceedings, possibly with a split of the group on a national or regional basis and/or along business lines.[18]

Whether the extension of the scope of the resolution regime to holding companies is needed requires careful reflection on various matters, such as the corporate structure, business model, and financing model of banking groups. The KAs acknowledge that their recommendations on such an extension are not applicable to jurisdictions that do not have bank holding companies.[19]

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16 This regime may apply also to entities that are accepting deposits and providing credit, without being legally qualified as banks (e.g. credit unions or cooperatives), although the legal form of their incorporation and their business structure may have an impact on the deployment of the resolution powers.

17 See FSB, *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies* (2013) 12ff, available at: https://www.fsb.org/2013/07/r_130716b.

18 See IMF, *Cross-Border Bank Resolution: Recent Developments* (2014) 10, available at: https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Cross-Border-Bank-Resolution-Recent-Developments-PP4872.

19 Assessment Methodology 9.

Where banks are part of foreign groups, and thus the ultimate holding companies are outside the jurisdiction of the RA, group-level resolution would require recognition or support by the home authorities of the resolution measure taken over the bank by the host authority.[20]

An additional design issue concerns the resolution triggers for holding companies. A typical approach is to apply a non-viability test to the holding company where it is a regulated company, so that this can be subject to resolution if, and only if, the entity itself is not viable.[21] However, as suggested by the KAs, some jurisdictions contemplate triggers based on the soundness of the group, such as when the subsidiary bank is not viable and its failure threatens the viability of the holding company or the group as a whole, if bank-level actions are not sufficient to achieve resolution objectives,[22] or if the orderly resolution of the bank can be more effectively achieved by resolving the holding company.[23] In designing a bank resolution framework, consideration should be given to what is the most legally sound approach that can allow a group-level resolution. In particular, given that a holding company is a separate legal entity, it should be ascertained to what extent it can be subject, as the controlling shareholder, to resolution due only to the weak financial condition of a subsidiary bank.

In relation to both holding companies and operational group entities providing critical services within a group, jurisdictions may contemplate a variety of legal mechanisms to mitigate the impacts of intragroup linkages hindering the resolvability of banks. The RA's power to require the removal of resolution impediments is particularly relevant for that purpose (see section 3.4 below). Additionally, when the holding company or the group entities are potentially subject to separate insolvency proceedings under ordinary insolvency laws, such laws could require courts and insolvency administrators to inform the RA about an insolvency filing or the commencement of insolvency processes (respectively). Insolvency administrators should also be required to coordinate their actions with the RA.

Local branches of foreign banks should also be within the scope of bank resolution regimes. The design of the resolution regime applicable to them raises specific considerations. For instance, as branches lack a separate legal personality and share capital, the RA in the host jurisdiction would not be able to exercise over them resolution powers such as merger, or recapitalisation through new share issuance or share conversion, although branches may be part of a broader resolution scheme involving the use by home authorities of these resolution powers over the branches' parent companies. On the other hand, the home resolution authority may conduct a standalone resolution through asset and liability transfers or liquidation, particularly in the absence of such a broader scheme that gives due regard to financial stability in the host jurisdiction. Furthermore, the commencement of a reorganisation or liquidation proceeding in the home country should not automatically trigger the initiation of

20 If the foreign holding companies are non-regulated entities, such group-level resolution would entail a complex interaction between the national resolution regime in the host country and the foreign jurisdiction's corporate or insolvency laws. For instance, where such a non-regulated foreign holding company issues debt for *bail-in* purposes (see section 3.6 below), the loss allocation would be determined by the home country's creditor ranking.

21 See e.g. 12 USC § 5383(c)(4).

22 See e.g. the EU's BRRD, art 33(4), and the Australian Banking Act, s 13A-1B and 1E.

23 In the Hong Kong SAR, the resolution authority may choose to resolve a holding company if: (i) the bank itself is not viable; and (ii) an orderly resolution of the bank can be more effectively achieved by resolving the holding company (see Financial Institutions (Resolution) Ordinance, s 28).

resolution over foreign branches.[24] Rather, this should be a discretionary authority given to the RA, to be exercised with a view to facilitating cross-border cooperation.

3.2 Resolution objectives

Bank resolution regimes are not designed to prevent the failure of a bank. To the contrary, they aim to provide credible options for the resolution of banks, regardless of their size and systemic importance, on the premise that banks should be allowed to fail in an orderly manner.

Resolution objectives inform the rationale and implementation of resolution regimes. They determine the RA's mandate and provide a benchmark for its accountability, set an anchor to guide resolution decisions and reflect the public-interest goals that justify the placement of a bank under the control of the RA and interference with third-party rights even if a bank is not insolvent.[25]

The objectives of bank resolution regimes differ from those of ordinary insolvency frameworks, in that they do not seek to achieve an equitable compromise among multiple classes of creditors.[26] Instead, the key objective of resolution is the "stability of the financial system", which is often spelled out through three related goals, namely the "continuity of a bank's critical functions", the "smooth functioning of payment and settlement systems", and the protection of depositors – all of which entail that resolution action must take place swiftly.[27] Resolution also seeks to avoid unnecessary value destruction and to minimise creditors' losses, where consistent with the other statutory objectives. Moreover, some jurisdictions provide for additional objectives, such as the protection of client assets, as is the case in the EU and the Hong Kong SAR.

While different resolution objectives will be complementary to each other in most cases, RAs may need to seek a tradeoff. Depending also on the objectives at hand, mechanisms to pursue such tradeoffs include: (i) prioritisation, set out in law or in a policy statement, among different resolution objectives (such as with respect to cost minimisation and losses to creditors, which as mentioned above should be pursued to the extent consistent with other objectives); (ii) a requirement to balance equally weighted objectives in each specific case;[28] and (iii) the adoption of a least-cost test (with respect to public funds) to guide the resolution strategy.

Of particular note is the tradeoff between the protection of financial stability and the minimisation of public costs. In circumstances where systemic risks threaten the soundness of the financial system, it is possible that these two objectives may not be fully reconcilable in the short term, and that public funding is needed, on a temporary and exceptional basis. In these cases, it is important that the authorities duly weigh the objectives at stake, and engage the government, as the authority responsible for fiscal

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24 See KA 7.2 and Assessment Methodology, EN 7(c).

25 Courts at national, supranational, and international levels take into account these objectives when examining the compliance of certain resolution-related restrictions with constitutional safeguards and fundamental rights.

26 Eva HG Hüpkes, *The Legal Aspects of Bank Insolvency: A Comparative Analysis of Western Europe, the United States and Canada (Studies in Comparative Corporate and Financial Law v 10)* (Kluwer Law International 2000) 20.

27 See KA 2.3. As a specific formulation of one of these objectives, in the Hong Kong SAR the RA must have regard to (among others) an objective to seek to protect depositors to no less an extent than they would be protected by the deposit protection scheme in a liquidation case (Financial Institutions (Resolution) Ordinance, s 8(1)(b)).

28 See e.g. the EU's BRRD, art 31(3).

policy and as a fiscal backstop, on possible tradeoffs. The injection of any public money should also be subject to appropriate safeguards in the legal framework.[29]

Where an agency such as the central bank or the supervisor is tasked with resolution functions, possible conflicts between its different objectives may arise. Institutional and governance arrangements within such agency can help balance the different perspectives involved in these functions while pursuing a common and coherent mandate.[30]

3.3 Institutional setup

Over the last years, there has been a growing recognition that administrative authorities (as opposed to courts) are best suited to carry out a resolution function.[31] The reasons for this are mainly related to expertise and efficiency. Administrative agencies have the required special expertise, operationally supported by consistent and daily implementation of their mandate, subject to adequate resourcing. They benefit from a significant information advantage and have a dedicated decision-making process, allowing them to act swiftly and under high confidentiality safeguards. This may be particularly helpful in jurisdictions with weak institutional frameworks such as inefficient court systems.[32] Even more fundamentally, a resolution function does not involve the resolution of a dispute or a settlement among two parties, but rather the exercise of a discretionary power as to the most appropriate course of action to serve a public interest enshrined in the law.[33] As such, an argument can be made that resolution is an executive function, rather than a judicial one.

Furthermore, a resolution regime is characterised by a number of tasks that support the deployment of resolution powers (such as recovery and resolution planning requirements and the arrangements for resolution funding) and can be best performed by an administrative agency. In addition, having an administrative agency in charge of resolution can further facilitate cooperation with other financial safety net providers (such as supervisors, central banks, deposit insurance agencies, and finance ministries).

Most jurisdictions entrust the conduct of resolution to an administrative agency. This may be the case, in particular, when resolution takes place in the context of a liquidation process (such as for deposit-taking institutions in the US). When resolution is pursued via a standalone proceeding, distinct from bank liquidation, courts remain in charge of the latter in several jurisdictions. Nonetheless, even when liquidation takes place under court supervision with the objective of winding up the residual bank after the transfer of its business, the RA should be involved in the initiation and conduct of this process, including for the appointment and the monitoring of the liquidator. This could ensure that

29 See section 3.8 below for such safeguards.

30 See Assessment Methodology, EN 7(d).

31 The KAs recommend "… [designating] administrative authority or authorities responsible for exercising the resolution powers" (KA 2.1).

32 Ross Leckow, 'The IMF/World Bank Global Insolvency Initiative – Its Purpose and Principal Features' in David S Hoelscher (ed), *Bank Restructuring and Resolution* (Palgrave Macmillan 2006) 191. A bureaucracy devoted to resolution tasks would result in expertise, economies of scale, specialised skills, and further consistency among cases. (Peter P Swire, 'Bank Insolvency Law Now That It Matters Again' (1992-1993) 42 Duke Law Journal 503).

33 Financial stability is a multidimensional notion. Thus, policy decisions about financial stability require giving consideration to these different dimensions. See Garry J Schinasi, 'Defining Financial Stability' Working Paper WP/04/187 (IMF 2004).

liquidation actions do not undermine (e.g. by way of the application of avoidance rules) the business transfer that has occurred during resolution.

Various options can be envisaged in designating an RA for banks. These include the establishment of a new RA or the assignment of this responsibility to an existing agency, which can be either the bank supervisor (and often also the central bank, such as in most eastern European and central Asian countries), or the deposit insurance agency (e.g. in Turkey and Ukraine). A hybrid model where a standalone RA and another agency (e.g. the bank supervisor, the finance ministry, or the deposit insurance agency) fulfil different resolution-related tasks is also possible. Finally, the resolution of affiliated entities within a group may fall within the statutory responsibilities of more than one RA (e.g. the bank supervisor and the securities regulator).[34] The specific institutional arrangements will be determined by various considerations, such as the size and characteristics of the financial system, the institutional arrangements in the financial sector, and the capacity and resources of the relevant authorities. Irrespective of the concrete design choice, a number of critical points should be addressed from a legal perspective:

(i) The mandate of the RA should be clearly prescribed in the law, by providing for its objectives (see section 3.2 above), with corresponding functions and powers.

(ii) To safeguard decision-making in resolution from undue political interference and industry pressure,[35] the law should preserve the functional, institutional and budgetary autonomy of the RA, and personal autonomy of the members sitting in its decision-making bodies. Since it bears the ultimate responsibility to deploy public funds, the finance ministry will be competent for any decision to apply resolution power involving the use of fiscal resources, but this should not be considered as undue interference with the RA.[36] Legal protection in favour of the RA, as an institution, and its staff, is a key aspect of autonomy. Resolution measures involve complex quantitative and qualitative assessments and carry a high risk of litigation due to their impact on shareholders and creditors. The KAs suggest that the RA and their current and former staff be protected against civil liability and related defence costs if they have discharged their duties in good faith. This reflects a balance between autonomy and accountability, in that a high bar for liability addresses possible concerns from the RA or its staff that could inhibit decisive and timely exercise of resolution powers, while incentivising the good faith exercise of these powers. This protection should also extend to the agents of the RA, including official administrator and liquidators, to the extent they act in line with the instructions of the RA.[37] Legal mechanisms to provide for legal protection and the formulation of the standard for liability vary across jurisdictions, reflecting constitutional principles and the general civil liability law system in each jurisdiction.[38]

34 In these cases, the KAs recommend that a lead authority should be identified (KAs, Essential Criterion ("EC") 2.1). The ECs can be found in the Assessment Methodology.

35 See KA 2.5 and ECs 2.3 to 2.6.

36 See Assessment Methodology, EN 2(d). This is the currently the case in the US and EU regimes. See 12 USC § 5383(b) in respect of the US, and the EU's BRRD, art 3(6).

37 An argument can be made that the managers of a *bridge bank* (see section 3.6 below) should also benefit from this form of protection, if they act under the instructions of the RA.

38 For instance, some jurisdictions use their general legal framework for this purpose, while others have a specific regime. Similarly, the threshold for liability in some jurisdictions could be "gross negligence" or "intentional wrongdoing".

(iii) With respect to the allocation of responsibilities between supervisory and resolution agencies, a balance should be struck between efficiency, continuity and operational autonomy. Supervision and resolution present different perspectives, which may conflict in certain cases. After the global financial crisis, it has been generally recognised that a resolution function requires specific and tailored institutional arrangements. Having a dedicated RA (whether in the same agency that carries out supervision or in a separate agency) can mitigate the risk of regulatory forbearance, by providing the right incentives to initiate resolution at an early stage and help preserve financial stability. The risk of such forbearance may also arise during recovery and resolution planning or in the implementation of resolution decisions, especially where supervisory approvals are needed.

At the same time, there is a clear need for coordination between supervision and resolution, to reflect the different perspectives inherent in each function. If resolution is entrusted to the agency that also conducts bank supervision, ideally a dedicated resolution team or unit should be set up, with adequate resources and separate reporting lines, while ensuring strong cooperation with the supervisory function through internal rules and confidentiality arrangements during recovery and resolution planning and implementation.[39]

(iv) The RA's governance arrangements should define the roles and responsibilities of its governing bodies and senior staff, including a clear allocation of oversight, regulatory, and daily management duties. A clear decision-making process should be established; as resolution typically entails decisions that are critical for financial stability, it is appropriate that a collegial body take these decisions.[40]

(v) Ensuring a seamless cooperation between the RA and other financial safety net participants (such as the supervisor, the central bank, the deposit insurance agency, and the finance ministry) is crucial for successfully dealing with bank failures.[41] The legal framework can contribute to this goal by providing for clear and mutually reinforcing mandates of these agencies (with no overlaps or gaps), and by requiring such cooperation, where necessary by removing any impediment such as confidentiality constraints. An increasing number of jurisdictions have also established an interagency body for the coordination of crisis preparation and management efforts by these agencies – each acting within its own respective mandate.

Finally, conferring a resolution mandate to an administrative agency does not diminish the role of the judiciary, which instead remains crucial to ensure accountability and due process. Depending on the legal system and on constitutional constraints, courts may intervene at different stages of the resolution process. In particular:

[39] See e.g. Luxembourg's Law on Establishing a Financial Sector Supervisory Commission, art 12-6, and the National Bank of Serbia's Statute, art 28(a).

[40] In a supervisory context, essential criterion 4 of Basel Core Principle 2 states that: "The supervisor has effective internal governance and communication processes that enable supervisory decisions to be taken at a level appropriate to the significance of the issue and timely decisions to be taken in the case of an emergency."

[41] See Basel Core Principle 3, KAs 2.2 and 12, and International Association of Deposit Insurers ("IADI") *Core Principles for Effective Deposit Insurance Systems* (the "IADI Core Principles"), Principle 4.

(i) In some jurisdictions, the RA is allowed or required to obtain *ex ante* court approval before placing a bank into resolution (e.g. Argentina[42] and the US[43]) or before exercising certain powers (e.g. Belgium, Japan, and the EU[44]). Courts may have this *ex ante* role in light of constitutional or administrative due process requirements, or as a protection for creditors and shareholders against the risk of undue abuse of individual property rights. The legal framework should be clear as to the circumstances in which *ex ante* judicial approval is required and should provide for appropriate safeguards to ensure that such court involvement does not hinder or delay a prompt and effective intervention by the RA.[45]

(ii) Most jurisdictions provide for the *ex post* judicial review of resolution decisions, as an expression of the constitutional principle on access to court or the protection of property rights. Three main aspects of this review are relevant under good practices to ensure the effectiveness, swiftness and certainty of the resolution actions, and each will be informed by the constitutional framework.[46]

First, the scope of judicial review should be strictly limited to legal issues: courts should defer to the discretionary powers exercised by the RA, in light of its expert judgment, and refrain from substituting their own judgment with that of the RA on the merits of the resolution decision. While discretion is not absolute, courts should apply a high threshold when assessing whether the RA has taken action that exceeded its legal authority. In particular, courts in advanced economies defer to the special expertise of the RA unless the RA's assessment contains obvious mistakes or is clearly arbitrary (e.g. Canada, Italy, the EU, the UK, and the US). Such deferential approach may be based on a long-standing tradition of judicial restraint, embedded in precedents or enshrined in the law.[47]

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42 Law on Financial Institutions, art 35B.

43 This is the case if the board of directors of a covered financial company does not consent to the appointment of the Federal Deposit Insurance Corporation (the "FDIC") as a receiver. See the Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") § 202(a)(1)(A), 12 USC § 5382(a)(1)(A).

44 In Belgium, *ex ante* court approval is needed for any disposition decision (see Law on the Legal Status and Supervision of Credit Institutions and Stockbroking Firms, art 297), but a reform proposal is underway to abolish this requirement. In Japan, *ex ante* court approval is required for implementing a number of resolution measures, including amending the articles of incorporation for the issuance of certain types of shares, the reduction of capital, or the transfer of business. See the Deposit Insurance Act of Japan, arts 87 and 126-13(1). In the EU, such court approval is needed to stay legal actions beyond the two-day suspension imposed by the RA on the enforcement of a security interest. See BRRD, art 86(3).

45 To that end, the scope of judicial review should be limited (e.g. Argentina, Japan, and the US), as examined later in this paragraph, and the court decision should be issued in a very short timeframe (e.g. 24 hours, or on an expedited basis if inviting interested parties would delay the process). See KAs, EC 5.5, and Assessment Methodology, EN 5(d), for further guidance.

46 The recent case law in various jurisdictions indicates a tendency to consider resolution-related judicial review limitations as compatible with the constitutional safeguards. See the following rulings: (i) Supreme Court of Slovenia, Case U-I-295/13, available at: http://odlocitve.us-rs.si/en/odlocitev/AN03799?q=U-I-295%2F13; (ii) Constitutional Court of Lithuania, Case No 2/2012-12/2012-9/2013, available at: http://www.lrkt.lt/en/court-acts/search/170/ta896/content; and (iii) Constitutional Court of Moldova, Case 59a/2017, available at: http://constcourt.md/libview.php?l=en&id=1094&idc=7&t=/Media/News/Mentinerea-efectelor-produse-de-actele-BNM-constitutionala, and Case 16g/2011, available at: http://www.constcourt.md/ccdocview.php?tip=hotariri&docid=16&l=en.

47 The courts in the UK and the US have historically taken a deferential position to agency discretion. As such, an RA would benefit from this deference under the general framework. In the EU, the deferential approach developed by courts was later codified in the BRRD (see art 85(3)). In contrast, Argentina presents an example where the law specifically sets a "manifest arbitrariness or unreasonableness" test for the review of RA decisions (see Law on Financial Institutions, art 35ter). For a similar case, see the Law on National Bank of Tajikistan, art 88[1].

Second, courts should not suspend or otherwise impede the implementation of resolution decisions. Some jurisdictions prohibit such types of ruling (e.g. Ukraine and the US[48]), while most civil law jurisdictions (e.g. France, Italy, Moldova, and Turkey) allow them only under narrowly defined conditions (e.g. prima facie illegality of the resolution decision and irreparable damage deriving from such decision if it is not suspended, or a rebuttable presumption that such suspension is against the public interest).

Third, the KAs recommend that where the RA acts within its powers and in good faith, judicial remedies should be limited to monetary compensation, rather than providing for a reversal of resolution decisions. Jurisdictions employ different mechanisms to pursue the legal certainty of resolution decisions. One option is an outright prohibition of reversal by courts (e.g. the US for covered financial companies[49]). In the EU, the BRRD allows courts to overturn a resolution decision (e.g. on the initiation of resolution), while preserving the legal effects of the contested action or derivative actions based on it (e.g. share acquisitions) if needed to protect financial stability and third parties acting in good faith.[50] Thus, the effects of resolution would not necessarily be unwound, even if the decision to initiate resolution were annulled. Another option involves granting to the court the discretion, after taking into account certain criteria prescribed in the law, either to overturn a resolution decision or to grant compensation.[51]

3.4 Establishing recovery and resolution planning

To ensure that advance preparations are in place for a distress scenario or a resolution case, the KAs call for recovery and resolution plans ("RRPs"). The discussion below focuses on the main aspects of RRP frameworks to be reflected in the primary law.

The legal framework should include an obligation for banks to prepare and submit recovery plans to the supervisory agency. It should ideally describe the purpose and key content of these plans. These plans serve as a guide for the recovery of a bank under a range of severe stress scenarios, including market-wide stress, and set out the measures that the bank would take to restore its financial soundness. Recovery plans should be required, at a minimum, from banks that could be systemically significant or critical if they fail. However, as other banks also stand to benefit from the timely identification of recovery measures and the inclusion of these in their risk-management frameworks, this requirement may broadly apply to all banks, or the legal framework can grant flexibility to subject other banks to such requirements.[52] Where the bank is part of a group, the supervisor should be able to require group-level plans. In all these cases, the supervisor should be able to apply these requirements proportionately, depending on predefined criteria, including the systemic importance or size of the bank. These plans should be updated annually, or more frequently either in case of material changes in conditions or as per the supervisor's request.

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48 In respect of Ukraine, the Law on National Bank of Ukraine, art 74(2), and the Code of Administrative Justice of Ukraine, art 151(3). In respect of the US, the Federal Deposit Insurance Act of 1950, § 11(j), 12 USC § 1821(j) and the Dodd-Frank Act, § 210(e), 12 USC § 5390(e).

49 The Dodd-Frank Act, § 210(e), 12 USC § 5390(e).

50 See BRRD, art 85(4). In the UK, if a court rules the RA's decision as unlawful, this will not affect a relevant transfer, special bail-in provision or powers in relation to securities, and a quashing order cannot be made in respect of the same (see the Bank Recovery and Resolution (No 2) Order 2014, SI 2014/3348, art 186).

51 Regarding the granting of compensation, see e.g. Spain's Act 11/2015, of 18 June 2015, on the Recovery and Resolution of Credit Institutions and Investment Services Firms, art 74.

52 The legal framework could include transitional provisions to require recovery plans initially from the systemically important banks while the supervisory agency also builds its institutional capacity for recovery planning.

On the other hand, resolution plans, typically prepared by the RAs based on resolvability assessments, serve as a guide for the RA to achieve an orderly resolution when the resolution conditions are met. The RA should undertake a resolvability assessment in respect of a bank to evaluate the feasibility of resolution strategies and their credibility, considering the likely impact of the bank's failure on the financial system and the overall economy. The law should authorise the RA to require, and oblige the bank to undertake, the removal of any impediments to resolution, based on this resolvability assessment. In addition to requiring an increase in the bank's loss-absorbing capacity for resolution, this power should be capable of being exercised to make changes in the legal, managerial and operational structure of the bank and the banking group, to revise the existing intragroup financial arrangements or establish new ones, and to ensure the divestiture of business lines. Based on its resolvability assessment, the RA should draw up a resolution plan, with input from the bank, outlining how the RA would apply its legal powers to resolve the bank without disruption to its critical functions, and with due regard to the objective of minimising the use of public funds when protecting financial stability.

3.5 Resolution triggers

The key concept for the initiation of a resolution action is the *non-viability* of a bank. This notion is built on the concept of *regulatory insolvency* that has been developed to overcome the shortcomings of certain conventional insolvency tests.[53] While banks have access to greater funding opportunities as compared with corporate firms,[54] they are subject to liquidity runs. As a result, a balance-sheet insolvency test would only permit the initiation of resolution proceedings after it is too late (in the sense of regulatory capital already having been eroded and creditors' claims already having potentially been impaired).[55] Furthermore, in a case of financial difficulties the incentive of management and shareholders may be to continue benefiting from profits obtained from high-risk investments, rather than to help the bank recover its financial soundness.[56] A late intervention over a problem bank can also undermine the equal treatment of creditors, as some creditors may have information advantages and asset-stripping is a concrete risk.[57] In addition, experience suggests that the magnitude of a bank's financial weakness can be greater than initially assessed, due to losses that were hidden or not properly accounted for.

In view of all these factors, the KAs endorse the concept of non-viability, by recommending timely and early entry into resolution before a bank reaches the point

53 See IMF and World Bank, *An Overview of the Legal, Institutional and Regulatory Framework for Bank Insolvency* (2009) 21-22, available at: https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/An-Overview-of-the-Legal-Institutional-and-Regulatory-Framework-for-Bank-Insolvency-PP4327); Hüpkes (note 26) 13; GN Olson, 'Government Intervention: The Inadequacy of Bank Insolvency Resolution – Lessons from the American Experience' in Rosa M Lastra and Henry N Schiffman (eds), *Bank Failures and Bank Insolvency Law in Economies in Transition (International Economic Development Law v 9)* (Kluwer Law International 1999) 117.

54 Banks can access liquidity through deposit funding as an ongoing source of cash flow or from wholesale markets with their assets, which can be posted as collateral. Finally, they can also benefit from a lender of last resort facility.

55 Jack Guttentag and Richard Herring, 'The Insolvency of Financial Institutions: Assessment and Regulatory Disposition' Working Paper 17-81 (revised) (Rodney L White Center for Financial Research, Wharton School, University of Pennsylvania 1981) 13, available at: https://rodneywhitecenter.wharton.upenn.edu/wp-content/uploads/2014/03/8117.pdf.

56 ibid, 13-14.

57 Aarno Liuksila, 'The New Approach to Orderly Bank Exit: Questions and Answers' in David G Mayes and Aarno Liuksila (eds), *Who Pays for Bank Insolvency* (Palgrave Macmillan 2004) 80.

of insolvency (as assessed through the traditional tests of balance-sheet insolvency or cash-flow insolvency, or any other definition of insolvency used under the applicable insolvency regime), when a bank is no longer viable, or likely to be no longer viable, and has no reasonable prospect of becoming so.[58] The initiation of resolution before insolvency permits a bank to be resolved when it still has some positive net worth and, in principle, it is possible to preserve its critical functions with both minimum losses to depositors and creditors and minimum costs to taxpayers.

The identification of the appropriate criteria to determine whether the bank is non-viable involves a delicate balance. Triggers based on a qualitative assessment of the condition of a bank (e.g. in relation to risk management or internal governance) offer wide flexibility and allow the authorities to factor in non-quantifiable aspects of a bank's safety and soundness. However, an exclusive reliance on qualitative triggers comes with the risk of regulatory forbearance and may be more prone to legal challenges. On the other hand, triggers based on quantitative criteria (e.g. capital or liquidity ratios) may contribute to legal certainty and transparency in resolution actions, and can thus reduce forbearance risk including as a result of political pressure. However, they can incentivise banks to undertake regulatory arbitrage and disincentivise the supervisor to closely examine qualitative requirements. A design of resolution triggers that combines both types of criteria has the benefits of the two approaches.[59]

Nonetheless, there is no consensus on the specific qualitative and quantitative indicators that define the concept of non-viability.[60] In some FSB jurisdictions, an actual or likely breach of prudential requirements or banking laws is a trigger for resolution, although there is no explicit provision on the capital ratios that need to be breached or on the gravity of case that triggers resolution.[61] While such broadly defined triggers may presumably be applied in a manner that takes into account – based on proportionality considerations – the severity of the conditions that should lead to resolution, authorities could helpfully elaborate policy formulations spelling out the conditions for resolution. In contrast, other FSB jurisdictions have expressly defined capital adequacy and liquidity thresholds as a condition for entry into resolution. Furthermore, in many FSB jurisdictions the protection of financial stability, of public confidence in the stability of the national banking system, or of depositors, is a standalone resolution trigger, while in others a "public interest" test has to be met jointly with other resolution conditions[62] or as a separate trigger. One approach that jurisdictions have followed is to define the

58 See KAs, EC 3.1. The traditional cash-flow and balance-sheet insolvency tests can still be part of the triggers for resolution, in addition to the non-viability test.

59 In the EU, the European Banking Authority's Guidelines on the interpretation of "failing or likely to fail" (the "EBA Guidelines") adopt an approach based on a set of qualitative indicators which includes also the overall Supervisory Review and Evaluation Process ("SREP") score of the bank. Thus, the test indirectly takes into account also the quantitative risk assessment of the bank as reflected in its overall SREP score. See https://eba.europa.eu/regulation-and-policy/recovery-and-resolution/guidelines-on-failing-or-likely-to-fail.

60 Assessment Methodology, EN 3(c) provides some general examples of non-viability. These include: (i) regulatory capital or required liquidity falls below specified minimum levels; (ii) there is a serious impairment of the bank's access to market-based funding sources; (iii) the bank depends on official sector financial assistance to sustain operations or would be so dependent in the absence of resolution; (iv) there is a significant deterioration in the value of the bank's assets; or (v) the bank is expected in the near future to be unable to pay liabilities as they fall due.

61 For an overall assessment of the position in FSB countries, see FSB, *Second Thematic Review Report on Resolution Regimes* (FSB Peer Review Report 2016) 20ff, available at: https://www.fsb.org/2016/03/second-thematic-review-on-resolution-regimes.

62 See e.g. the EU's BRRD, art 32(1) and (5).

general conditions for resolution in the law and then to elaborate on the specific criteria, in the interest of legal certainty for financial markets and of accountability, in policy guidance documents or in regulatory standards.[63]

The legal framework should also be clear as to whether the initiation of resolution is a mandatory or a discretionary decision. This is a policy choice, where a balance between flexibility and certainty needs to be struck. Quantitative thresholds can be more suitably linked to mandatory action, by requiring the authority to take resolution action if certain, pre-defined quantitative triggers are met.[64] But arguably, even in that case, the decision taken will entail a significant degree of judgment and discretion, such as in relation to an assessment of the possibility that the problem bank may, or may not, recover.

Finally, where a bank is non-viable or likely to be non-viable, the RA should consider whether the prospect of a private-sector solution to restore the bank's financial soundness in a reasonable timeframe is available. Even when not explicitly prescribed in the law, in many jurisdictions this assessment is inherent in a broader proportionality test that the RA, as an administrative agency, observes before initiating resolution.[65]

3.6 Resolution powers and tools

Once the bank is put under public control with the initiation of resolution, the RA should be able to exercise a broad range of powers, sequentially or in combination, without shareholder or creditor consent.[66] Such consent would typically be necessary for the corporate transaction (such as merger, transfer of assets and liabilities, and write-down) through which resolution takes place. The rationale for this exemption is that, as examined in section 2 above, the objective of resolution is driven by financial stability concerns, and at a stage where the bank is no longer viable, shareholders have failed to restore the soundness of the bank (and could seek to exercise their rights under company law to delay or thwart resolution actions by the RA), and creditors' private incentives are not always aligned with the resolution objectives.[67] Any statutory or contractual requirements to obtain shareholder and creditor approvals in relation to the exercise of a resolution power or tool would therefore be at odds with the need for prompt and decisive action aimed at preserving financial stability and preventing value destruction. This unilateral deployment of resolution powers under public law should be balanced with legal safeguards. Moreover, third parties interested in the failed bank's business (such as potential acquirers) will be free to determine their possible involvement in a resolution scheme through the deployment of any relevant corporate or contractual arrangements, such as in the context of a merger or the acquisition of a bank's business or shares.

63 See e.g. EBA Guidelines.

64 This is the case under the Prompt Corrective Action framework in the US, though the appointment of the FDIC as a receiver can also be undertaken by US authorities on a discretionary basis.

65 In broad terms, the proportionality principle requires that an administrative authority's action be suitable and necessary to achieve its public goals, without imposing a disproportionate burden on private interests while pursuing these goals. As such, the authorities should not resort to more stringent measures where the relevant public objectives can be achieved with less intrusive measures. This principle is heavily relevant in civil law jurisdictions, and is widely upheld by supranational bodies (e.g. EU institutions) and international bodies (e.g. the European Court of Human Rights).

66 See Assessment Methodology, EN 3(f), which underscores that this is one of the key characteristics of resolution powers.

67 This misalignment between the creditors' interests and public interest was one of the grounds noted by the Latvian Constitutional Court when accepting the constitutionality of a provision that empowered the authorities to decide between reorganisation and liquidation. See Case No 2012-07-01, available at: http://www.satv.tiesa.gov.lv/en/cases/?search[number]=2012-07-01.

The powers of an RA can be broadly summarised under four categories. The first category of resolution powers concerns the placement of the bank under the full control of the RA. This control entails vesting all functions and responsibilities of the bank's management and shareholders with the RA so that it can take any action necessary or appropriate to run the bank. These include the removal and the replacement of senior management and directors; suspending certain operations of the bank; accessing and protecting the bank's properties, books and records; pursuing any of the bank's claims; and employing independent experts and consultants. Some jurisdictions provide for the appointment of an official administrator. Although the terminology that is used to refer to an administrator varies across jurisdictions,[68] it is generally a means of facilitating the taking of control over the bank by the RA and to exercise some resolution powers. The administrator can be an official of the RA or – subject to conflict-of-interest rules and other eligibility criteria – from the private sector. The administrator will carry out its duties within the mandate prescribed by the RA,[69] typically with approval of the latter for major transactions.[70] As a delegate, the administrator is appointed and removed by the RA, is accountable to it, and enjoys legal protection against civil actions for acts or omissions made in the discharge of its duties.

The second category of powers is aimed at containing the situation and preserving the bank's going-concern value, in the interest of a successful resolution. These powers involve some form of interference with contractual rights and their exercise is therefore subject to appropriate legal safeguards. Three areas are noteworthy:

(i) A suspension of payment obligations and a stay on creditor actions can provide the breathing space necessary to explore and implement resolution options. To address systemic risk concerns and protect the bank's going concern value, however, these measures should not be automatic, but rather discretionary, and their scope and duration should be limited (e.g. they should not extend to insured depositors, or to payment and settlement systems).[71] In some jurisdictions, such measures may only be adopted by courts either at first instance or as an extension of a previous administrative measure.

(ii) Contractual clauses may allow the counterparty of a failed bank to set off or accelerate obligations or terminate early a contract further to the occurrence of certain events such as the commencement of insolvency or resolution proceedings. In a resolution context, these clauses – included in various types of contracts such as lease, service, licence contracts, or loan agreements – could undermine the continuity of financial services and the transfer of the failed bank's business to a third-party acquirer. The legal framework should therefore clarify that rights under these clauses may not be exercised if the underlying contractual obligations continue to be performed by the bank.

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68 Terms used for this instrument include *curator*, *special manager* and *provisional administrator*. Irrespective of this labelling, this official assumes a public function exercising both management responsibilities and shareholder powers. This is different from a manager appointed by the supervisory authority by way of an early intervention measure in which case shareholder powers are not overridden as in resolution, although they may be subject to certain restrictions (e.g. not being able to change the management).

69 See KAs, EC 3.5.

70 These may include, among others, the sale of major assets or parts of the business; encumbering assets; making payment to creditors; and commencing litigation. See Assessment Methodology, EN 3(i) for other mechanisms for the oversight by the RA of such administrator.

71 IMF and World Bank (note 53) 33-34.

Likewise, the legal framework will typically allow the enforcement of set-off and early termination clauses in financial contracts, given the importance of these clauses for risk mitigation and financial stability.[72] However, the activation of these clauses upon entry into resolution or due to the exercise of resolution powers may impede a successful transfer of these contracts to an acquirer or *bridge bank* (see below) and create market volatility. The KAs seek to strike a balance by recommending that such early termination rights can be temporarily stayed (e.g. for two business days), so that the RA can determine whether to transfer such contracts. Such a stay does not preclude the exercise of early termination rights that are not related to the initiation of resolution proceedings or the exercise of resolution powers – for example, where the institution to whom the contract has been transferred defaults under the contract. Similarly, some jurisdictions permit counterparties to terminate contracts on which the bank under resolution defaults during the period of the stay, although practice among FSB jurisdictions on this specific aspect is not universal.[73]

Finally, the KAs recommend respecting the integrity of financial contracts with the same counterparty, so that these contracts are either altogether left in the residual bank to be liquidated or transferred to a new acquirer.[74] A similar constraint applies to liabilities that are secured by collateral. Where an exemption from this constraint is needed to ensure an orderly resolution, the RA should provide alternative protection, such as by substituting collateral or providing compensation.

(iii) The KAs recommend that RAs have the power to terminate contracts, as well as to claw back any bonuses or other incentive-based payments made to the bank's managers.[75] Contract termination powers can help preserve the bank's value in a successful resolution through merger, share transfer, or *purchase and assumption* (see below), particularly if the contractual terms do not entitle the successor bank to terminate loss-generating contracts. Powers to claw back bonuses can instil market discipline and serve as incentives to deter undue risk-taking by managers. As both kinds of powers are typical of insolvency proceedings, their deployment in resolution requires careful design in how they fit into a resolution proceeding, including by prescribing the procedure and criteria for their exercise.

The third category of powers allows the RA to apply resolution tools that ensure the continuity of a bank's critical functions. These powers are accompanied by the imposition of losses on shareholders and creditors – a key principle of resolution regimes, seeking to instil market discipline and to minimise the need for taxpayers' money in handling problem banks. After conducting a valuation of assets and liabilities of the bank under resolution, the RA should take action to recognise losses, allocate them to shareholders and unsecured creditors, and apply its resolution toolkit in a manner that reflects the loss allocation. The resolution tools that should be available to the RA and the underlying powers to deploy these tools are summarised below.

72 United Nations Commission on International Trade Law ("UNCITRAL"), 'UNCITRAL Legislative Guide on Insolvency Law' Parts I and II (United Nations 2005) 156-57, available at: https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law.

73 See FSB (note 61) Annex H.

74 See Assessment Methodology, EN (3)(n).

75 See KAs, ECs 3.4 and 3.5, and Assessment Methodology, EN 3(h).

- *Merger:* The RA should have the power to merge the bank under resolution with another bank, where such a private-market solution is available.[76] Where corporate law and capital markets legislation impede the prompt application of this tool, appropriate exemptions or expedited processes should be provided in order to facilitate the corporate decision-making of the healthy bank entering into the merger.[77]

- *Share transfers:* This includes the transfer of existing or newly issued shares to private-sector acquirers, or to the government as a last resort in systemic cases. Share transfers can be exercised as a standalone resolution tool or in conjunction with another tool such as a merger, recapitalisation with new investors, or *bail-in* (see below).[78]

- *Purchase and assumption (P&A):* In a P&A, a bank will purchase certain assets and assume certain liabilities (typically, deposits) of the resolved bank. To implement this tool, the RA should be given the power to transfer, in whole or in part, rights, assets and liabilities of the bank under resolution to another bank, subject to the compliance of the latter bank with supervisory requirements and with expedited formalities (e.g. on registration of transferred claims).[79] The exercise of these powers enables the RA to transfer viable parts of the bank's business, with the remainder put into liquidation, and with losses allocated to shareholders and creditors in line with creditor hierarchy rules. This tool can provide depositors – whose claims are transferred to the acquiring bank, subject to creditor hierarchy rules – with prompt access to their insured deposits, while maintaining assets of the failed bank in the private sector without disruption. Where the bank is intervened sufficiently early and the transaction is prepared in advance, good quality assets (e.g. performing loans) may be transferred against their book value – rather than at their discounted liquidation value – and the buyer may be willing to pay a premium for the franchise value of the deposit base. These features can contribute to the cost-effectiveness of the P&A as a resolution tool, thus mitigating any costs for the deposit insurance agency (when it has a role in funding the resolution transaction, as examined in section 3.8 below) or the public in general, and overall losses for creditors.

  Other important aspects relevant in the design of the legal framework for P&A include: (i) the RA's ability to make supplemental transfers or reverse transfers,[80] for instance to rectify any valuation mistakes; (ii) providing for a fair bidding process over the bank under resolution, with due regard to urgency and confidentiality requirements;[81] and (iii) provisions that ensure the succession of the acquiring bank, including its access to the payment and settlement systems, and its protection against shareholders and creditors left in the bank under resolution.[82]

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76 See KAs, EC 3.7.
77 IMF and World Bank (note 53) 39.
78 ibid, 38-39.
79 See KAs, EC 3.7, and Assessment Methodology, EN 3(m) and (n).
80 See KAs, EC 3.8, and Assessment Methodology, EN 3(s).
81 See e.g. the EU's BRRD, art 39(2) and (3).
82 By providing an assurance against any liability risk, this last point would increase the prospects of successful commercial negotiations during a P&A transaction.

- *Bridge bank:* The RA should also be able to transfer, in whole or in part, the shares, assets and liabilities of the failed bank to a bridge bank, that is, an entity under public control (e.g. under the control of the finance ministry) operating for a limited timeframe.[83] This tool allows the authorities to stabilise the failed bank's business and to ensure the continuity of its critical functions, while identifying potential private purchasers, which may not be immediately available under distressed market conditions. In contrast to placing the bank under temporary public ownership,[84] the bridge bank tool entails a clean transfer that can limit losses to the taxpayer by leaving behind bad assets, shareholders' claims and other liabilities – including contingent liabilities – in the failed bank. The legal framework should clearly set out the rules for the licensing of the bridge bank, its governance arrangements, and prudential treatment (i.e. requirements as to its safety and soundness). In the absence of compelling reasons, the bridge bank should, in principle, not enjoy any special status or preferential rights, to ensure a level playing field vis-à-vis other banks.

- *Asset management vehicle:* This tool is aimed at carving out certain assets, rights, or liabilities of the bank under resolution into a special vehicle, while the bank continues to operate (and should have a stronger capital position because, in principle, troubled assets are transferred to the special vehicle). As noted elsewhere in this chapter,[85] this tool is typically used under ad hoc crisis management laws, rather than as a standing tool under the resolution law. The risk in the use of this tool lies in an evaluation of the assets that does not fully recognise the losses of the transferring bank (with a transfer price that may, therefore, unduly benefit its shareholders and creditors). This may lead jurisdictions to provide for a requirement that transfers to an asset management vehicle be conducted in conjunction with other resolution tools, clearly prescribing loss allocation principles.[86] To appropriately manage the risk involved in the acquisition, management, and recovery of assets, the legal framework should clearly and adequately deal with the mandate, operational autonomy, and governance arrangements of the asset management vehicle.

- *Recapitalisation via new investors:* The RA should be able to reduce the nominal value of shares in a bank to reflect losses to shareholders, and then cause the bank to issue new shares for subscription by new investors within a short timeframe.

- *Bail-in (recapitalisation via debt restructuring):* After losses are imposed on shareholders, recapitalisation via bail-in entails the write down and/or conversion into equity of a broad range of eligible liabilities. Bail-in can be broadly implemented in two different ways in order to reach a recapitalisation level that ensures the viability of: (i) the bank under resolution (*open bank bail-in*); or (ii) the bridge bank (*closed bank bail-in*).[87] In an open bank bail-in, there is no liquidation of the failed bank, but instead write-down and conversion powers are applied to eligible liabilities that are not transferred to another entity. The underlying powers

83 KAs, EC 3.9, and Assessment Methodology, EN 3(p), (q) and (r).
84 See further text at notes 109 to 111 below.
85 See section 2 above on the proportionate implementation of the KAs.
86 See e.g. the EU's BRRD, art 37(5).
87 Bail-in can also be applied at the level of a holding company; however, this is not covered by the brief discussion here.

to conduct this bail-in include the authority to cancel or to reduce the nominal value of the bank's shares as well as the principal, interest or other relevant item of the liabilities of the bank, in accordance with the creditor hierarchy, and to convert liabilities into shares in the bank. On the other hand, in a closed bank bail-in, a bridge bank assumes the business to be continued. The difference between the liabilities and assets transferred to the bridge bank would create the capital for the bridge bank. The liabilities subject to bail-in would be left behind in the failed bank to absorb losses together with shareholders in a liquidation and, depending on the amount of losses incurred by the bank, may be converted into equity in the bridge bank.[88] While executed differently, both mechanisms are premised on the authority to write down and convert liabilities into equity and can create the same economic effect.[89] Certain liabilities (e.g. insured deposits or secured creditors) are typically exempted from bail-in for financial stability reasons.

- *Liquidation:* Where a P&A or bridge bank tool is implemented, liquidation can complement the reorganisation by winding down the residual bank (commonly known as the "rump") in a manner that supports the resolution actions already taken, mainly by the continuation of critical services by the entity in liquidation to the successor (e.g. a bridge bank). However, liquidation can also be used on a standalone basis without a prior reorganisation, for instance where there is no prospect of successful reorganisation or the bank is not systemically significant or critical. In these cases it should still be possible to transfer liabilities in bulk within liquidation so as to facilitate prompt access to insured deposits through such transfers, which would also reduce the costs for the deposit insurance scheme ("DIS"). To successfully fulfil all these functions, the legal framework should include additional provisions to stipulate the objectives and triggers of liquidation, to facilitate the transition from resolution to liquidation after a P&A or bridge bank tool is used, and to require the liquidator to support resolution by continuing to provide critical services and assisting the DIS.

Finally, the RA needs to have a number of additional powers to support loss allocation and restructuring measures. These include the power to change the bank's articles of association and to require registries to amend their records. Where the bank under resolution has issued listed securities, the legal framework should provide, in the context of a share transfer or bail-in, for the authority to delist such securities and clarify their subsequent treatment. Exemption from market disclosure requirements may also be necessary.[90]

3.7 Legal safeguards

Resolution involves, in the interest of financial stability, the exercise of broad discretionary powers by an administrative agency and the allocation of losses without shareholder and creditor consent before the bank becomes balance-sheet insolvent. As this interferes with third parties' rights, a set of safeguards should balance the public goal of financial stability with such rights, without hindering the swift achievement of resolution objectives.

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[88] Lucy Chennells and Venetia Wingfield, 'Bank Failure and Bail-in: An Introduction' (2015) Q3 Bank of England Quarterly Bulletin 228, 234.

[89] For further discussion on bail-in execution, and different considerations that apply to open bank bail-in and closed bank bail-in, see FSB, *Principles on Bail-in Execution* (2018), available at: https://www.fsb.org/2018/06/principles-on-bail-in-execution-2.

[90] KAs, EC 5.7.

The rule of law principles that are relevant to any administrative function are equally applicable in resolution. As part of due process requirements, the RA should respect the right to be heard where no urgent action is needed,[91] provide a statement of reasons in its decisions, and notify interested parties and the general public of such decisions, subject to confidentiality rules. Operational autonomy and robust governance arrangements of the RA would serve also as a safeguard for interested parties against resolution decisions motivated by political and industry pressure.

The involvement of independent experts provides another safeguard in this administrative process. The appointment of an independent expert is important to inform resolution decisions and to determine the amount of losses to be recognised, taking into account that evaluation criteria on the bank's assets and liabilities must conservatively reflect distressed market conditions in which resolution decisions are taken.[92] However, where such independent expert involvement is a requirement, the legal framework should still allow a preliminary valuation by the RA under urgent circumstances, provided that a final independent valuation takes place as soon as such action becomes practically possible.[93]

With respect to the imposition of losses on shareholders and creditors, bank resolution frameworks should include three main safeguards:

(i) Losses should be imposed on creditors in accordance with the ranking of claims under the insolvency regime applicable to the bank.[94] This also implies that losses should be first assumed by shareholders and unsecured creditors, not by the public.

(ii) The principle of equal (*pari passu*) treatment of creditors within the same class should be observed as a general rule, unless a departure from the *pari passu* principle is considered necessary to protect financial stability (e.g. to contain the systemic impact of the bank failure), or to maximise the value of the bank for the benefit of all creditors (e.g. the acquirer in a P&A may be willing to acquire a particular group of liabilities, but not others in the same class).[95] Therefore, the safeguard provided by the *pari passu* treatment should be subject to exceptions in the pursuance of resolution objectives. The statutory exclusion of certain liabilities from the scope of bail-in and the discretionary power to exclude other liabilities on a case-by-case basis, based on financial stability grounds, are two specific examples of such possibility of departure in the context of bail-in.

(iii) Creditors who do not receive in resolution what they would have received had the resolved bank been liquidated should have a right to compensation (the *no creditor worse off than in liquidation* ("NCWOL") safeguard).[96] This safeguard compares the treatment of creditors in resolution to what would have been the alternative scenario for the liquidation of a non-viable bank. A breach of the NCWOL

91 The European Court of Human Rights concluded in its *Capital Bank AD v Bulgaria* decision (no 49429/99 (ECtHR 24 November 2005)) that the bank should have a right to make submissions unless any delay due to such process is unduly prejudicial to the public interest. In assessing this, consideration should be given to whether the authorities have the ability to take control of the bank's management and can impose measures to prevent asset-stripping.

92 See e.g. Australian Banking Act 1959, s 13H.

93 See e.g. the EU's BRRD, art 36(2), (9) and (10).

94 KAs, EC 5.1.

95 KAs, EC 5.2. See also Assessment Methodology, EN 5(a).

96 KAs, EC 5.3. See also Assessment Methodology, EN 5(b).

safeguard does not lead to the illegality of the resolution action, but rather entitles the creditors who have been made worse off than in liquidation, as determined on the basis of an independent *ex post* valuation, to receive compensation.

To some extent, the above safeguards draw from corporate insolvency proceedings, such as with respect to the *pari passu* principle and to the treatment of dissenting creditors under a reorganisation plan.[97] However, they also present specific design features deriving from the rationale and objectives of bank resolution frameworks, driven by financial stability, need for speedy action, and protection of taxpayers' money.

Creditor hierarchy rules under insolvency regimes are an important component in the design of a resolution framework. First, the hierarchy should be clear and transparent (i.e. ideally prescribed in one specific legal instrument, such as the banking law, to reflect its aspects that are distinct from the ranking applicable to corporate entities), and not overly stratified. Second, policymakers should consider how the ranking of claims contributes to the achievement of resolution objectives.[98] In particular, a priority for deposits facilitates resolution by transferring their claims in a P&A or in a bail-in, thus preserving financial stability. Additionally, as the deposit insurance agency enjoys the same preferential treatment as insured depositors after it is subrogated to their claims, such preference helps to minimise losses to the DIS in resolution, and to the public purse in general.[99] Third, to minimise potential NCWOL risks, the insolvency hierarchy should be consistent with the specific loss allocation rules provided in resolution, including any statutory bail-in exemptions. Indeed, a NCWOL compensation risk arises if statutorily excluded liabilities are likely to suffer losses under the creditor hierarchy *pari passu* with unsecured creditors.

3.8 Funding

The consensus that emerged after the costly bail-outs (*solvency support*) of the global financial crisis is that the costs of resolution should be first borne by the shareholders and unsecured creditors of the failed bank. Yet, adequate loss-absorbing capacity may not be in place at the point of failure and the bank's assets may be illiquid or impaired.[100] Market funding, such as "private consortiums" or a "super-priority funding structure", may be unfeasible due to the amount of the funding needed or due to distressed market conditions.[101] As such, additional funding may be needed to carry out a successful resolution.

97 UNCITRAL (note 72) 226.

98 *IADI Core Principles*, Principle 14 also recommends that: "Resolution procedures [should] follow a defined creditor hierarchy in which insured deposits are protected from sharing losses and shareholders take first losses."

99 Many jurisdictions give a priority to deposit claims in the insolvency ranking. Examples include Argentina, Australia, China, the EU member states, the Hong Kong SAR, India, Indonesia, Mexico, Moldova, Russia, Singapore, Switzerland, Tajikistan, Turkey, Ukraine, and the US. However, the form of depositor preference may vary across jurisdictions. See *IADI Core Principles* for a brief explanation of different forms of depositor preference.

100 Oana M Croitoru, Marc C Dobler and Johan Molin, *Resolution Funding: Who Pays When Financial Institutions Fail?* (IMF Technical Notes and Manuals 2018) 6, available at: https://www.imf.org/en/Publications/TNM/Issues/2018/08/16/Resolution-Funding-Who-Pays-When-Financial-Institutions-Fail-46124.

101 FSB, *Guiding Principles on the Temporary Funding Needed to Support the Orderly Resolution of a Global Systemically Important Bank ("G-SIB")* (2016) 10, available at: https://www.fsb.org/2016/08/guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-g-sib. Financial sector consortiums or a group of counterparties may pool resources to provide funding to minimise their losses as creditors and to tackle externalities associated with the failure of a bank. A super-priority funding structure is similar to a debtor-in-possession financing in insolvency.

Funding may be needed in the various phases that accompany the adoption of resolution measures and may take place in different forms in the execution of these measures. These forms include:

(i) capital for the bank under resolution or a bridge bank;

(ii) liquidity, including to satisfy short-term needs;

(iii) guarantees to facilitate market funding or to cap losses incurred in the sale by the bank of certain assets;

(iv) asset acquisitions, to help separate problem assets from the bank's balance sheet;

(v) contributions to close the gap between the liabilities and the assets transferred to an acquirer in a P&A or with a bridge bank tool; and

(vi) NCWOL compensation.

International good practices point to a broad range of mechanisms to provide resolution funding.[102] These include:

(i) a deposit insurance agency with a mandate to finance resolution actions (as in e.g. the US for deposit-taking institutions);

(ii) a resolution fund, to which the industry contributes on an *ex ante* basis, and with *ex post* extraordinary contributions if resources are insufficient (as in e.g. the EU);

(iii) an *ex post* resolution fund where temporary financing is provided by the public authorities, but is later recovered from the industry (as in e.g. the US, for systemically important financial institutions, and the Hong Kong SAR); and

(iv) a combination of the above options.[103]

Resort to the above-referenced funding arrangements is activated to the extent that other private sources (i.e. the bank, creditors, and market funding) are exhausted or not available.[104] However, the specific arrangements will also depend on the purpose of the funding needed and on the mandate of the agency providing the funding. For instance, the purpose of a deposit insurance agency is to preserve depositors' interests, and the provision of capital to a bridge bank which has liabilities significantly higher than insured deposits would typically fall outside such mandate. As such, this specific funding need may be satisfied through other forms of arrangements (e.g. by a resolution fund or the finance ministry). Likewise, given the mandate of the deposit insurance agency it is not a desirable policy that DIS resources be tapped to provide open bank assistance

102 For a discussion on the policy aspects of these funding options, see Croitoru, Dobler and Molin (note 100).

103 In addition to *ex ante* resolution funding arrangements, deposit insurance funds can contribute to resolution financing in the EU. In Singapore, the conditional ability to use deposit insurance funds for resolution is supplemented with *ex post* resolution funding arrangements.

104 FSB (note 101) 9-10. See also FSB, *Funding Strategy Elements of an Implementable Resolution Plan* (2018) 12-14, available at: https://www.fsb.org/2018/06/funding-strategy-elements-of-an-implementable-resolution-plan-2. As a jurisdictional example, see the Monetary Authority of Singapore Act, s 101(3), which requires giving regard to the availability of private-sector funding before a recommendation is made to use the resolution fund.

(i.e. a direct loan, guarantees to unsecured creditors, or asset purchases).[105] Also in these instances, jurisdictions may deploy for this purpose a separate resolution fund for systemically important cases.[106]

Fundamentally, all these funding arrangements shift the burden of resolution to the banking industry, rather than relying on the public purse. However, there may be a need, on an exceptional basis, for temporary public funding. Indeed, under all of these arrangements, the public carries the residual risk of funding resolution in a systemically important situation. There are strong arguments in favour of establishing a DIS with an adequate level of *ex ante* funding and with a mandate to finance resolution, such as in a P&A[107] and on a least-cost basis.[108] But deposit insurance funds are typically calibrated to cover a proportion of insured deposits in the system and not to deal with systemically important cases, where the DIS may need a public backstop through borrowing arrangements from the Ministry of Finance. Similar considerations apply to resolution funds. Indeed, an *ex post* resolution fund relies on the provision of temporary public funds. In an *ex ante* resolution fund, a temporary public-sector backstop may be needed in case the resources of this fund are insufficient to preserve the continuity of critical functions, which is likely to be the case in the resolution of a large bank.

Additionally, public funding may include the placement of a bank under temporary public ownership, as a last resort where systemic concerns justify it.[109] This can be the case where private-market solutions are not easily available to resolve a systemically important bank, such as when distressed market conditions limit the opportunities for a merger, acquisition or P&A.[110] Legal mechanisms used for this model may differ and include options such as the transfer of shares, subscription to a new share issuance, or a merger with a state-owned bank.[111]

It is critical that resolution frameworks have strong safeguards governing the use of public funds, to preserve taxpayers' interests and address moral hazard concerns. Good practices[112] suggest that temporary public funding is:

(i) provided only if necessary to protect financial stability;

105 Nonetheless, if the DIS is also the key resolution authority, *IADI Core Principles* seems to allow a broader scope for the use of DIS funds in a resolution (see Principle 9).

106 Croitoru, Dobler and Molin (note 100) 9.

107 ibid, 9. Also, the Assessment Methodology notes that effective protection schemes for depositors are a precondition for effective bank resolution regimes under the KAs.

108 In the sense that contributions by the DIS to resolution should be "restricted to the costs the deposit insurer would otherwise have incurred in a payout of insured depositors in a liquidation net of expected recoveries" (*IADI Core Principles*, Principle 9). This is to ensure that the DIS does not incur greater losses than it would have incurred during liquidation as an insurer. However, even if the DIS' cost net of recoveries were estimated to be zero under liquidation (which may be more likely with depositor preference), the formulation of the least-cost test should not prevent an upfront disbursement to support a resolution, where needed; an upfront cash contribution from the DIS on a "gross" basis (i.e. in the amount of the insured deposits), as with a payout in liquidation, should be permitted to fund a resolution.

109 Under the KAs, the power to place a non-viable bank under temporary public ownership is not necessarily part of the resolution toolkit. See KAs, EC 6.3, and Assessment Methodology, EN 6(d).

110 Martin Čihák and Erlend Nier, 'The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union' Working Paper WP/09/200 (IMF 2009) 17.

111 Jurisdictions may provide a specific framework for the involvement of the state in resolution by way of public ownership (e.g. the UK and Ukraine).

112 Giovanni Dell'Ariccia, Maria Soledad Martinez Peria, Deniz Igan, Elsie Addo Awadzi, Marc Dobler, Damiano Sandri, *Trade-offs in Bank Resolution* (IMF Staff Discussion Note 2018) 32, available at: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2018/02/09/Trade-offs-in-Bank-Resolution-45127.

(ii) a last resort (i.e. where private funding, such as market borrowing, and the resources of the DIS – when appropriate – and of the *ex ante* resolution fund, if any, are insufficient);

(iii) subject to the imposition of losses to shareholders and subordinated creditors;[113]

(iv) based on intrusive and comprehensive restructuring plans, particularly if the support is in the form of solvency;

(v) accompanied by strict and enhanced oversight of the restructured bank;

(vi) followed by a clear exit plan (in the case of asset acquisition or equity participation); and

(vii) recouped from the banking industry, such as *ex post* levies to recover losses.[114]

Such safeguards should be provided under the legal framework.

Legal provisions on resolution funding should be complemented by operational arrangements to ensure prompt access to liquidity, where needed. It is now recognised that liquidity funding is crucial for the effectiveness of resolution measures,[115] since recapitalisation measures alone might not ensure the continuity of a bank's critical functions, to the extent that the bank needs liquidity to meet the increased payment demands by creditors under distressed market conditions.

The above liquidity issue raises a critical question about the role of central banks in resolution funding. During bank resolution, a central bank may provide liquidity (e.g. ordinary facilities, and emergency liquidity assistance ("ELA")), in strict compliance with its governing legal framework (e.g. to a solvent entity and on a collateralised basis).[116] Where the solvency of a resolved bank or bridge bank is in doubt, the framework should allow for ELA against appropriate safeguards, including an indemnity or a guarantee from the government, if such a bank is viable in the context of a realistic, time-bound recapitalisation or resolution plan (for instance, when a credible capital increase plan by new investors would bring the bank back to viability).

3.9 Cross-border cooperation[117]

As is the case in cross-border insolvency, three different approaches are, in principle, conceivable in the resolution of a cross-border bank. The first one involves a *territorial approach*, whereby the host jurisdiction liquidates or resolves the establishment located in its territory.[118] Under the *universal approach*, a cross-border bank is treated as a single entity, and its resolution is conducted under a single resolution proceeding in

113 KAs, EC 6.2.

114 See Assessment Methodology, EN 6(c). For examples of recouping mechanisms, see the Monetary Authority of Singapore Act, ss 104ff, and (in the case of the US) the Dodd-Frank Act, § 210(o), 12 USC § 5390(o).

115 For a discussion, see FSB (note 101) 6ff.

116 Croitoru, Dobler and Molin (note 100) 8.

117 See generally IMF, 'Cross-border Resolution: Progress and Challenges in Cross-border Enforcement' in *Law and Financial Stability* (IMF, forthcoming).

118 This approach applies to the liquidation of the branches of foreign banks in the US and can be adopted by the member states of the EU and the broader European Economic Area (the "EEA") in relation to the insolvency of the branches of non-EEA banks.

the home jurisdiction.[119] However, neither of these two approaches is fully adequate to tackle the challenges arising from the resolution of international banks, as these present a web of branches and subsidiaries with complex financial and operational linkages. The complexities inherent in the resolution of large international banks were illustrated during the global financial crisis, when uncoordinated actions by authorities, costly delays and large bail-outs at taxpayers' expense were evident. In response to these problems the KAs provided an enhanced cross-border cooperation framework.[120] The enhanced cooperation framework under the KAs represents a third, *middle ground approach*, whereby the home RA takes the lead in resolving the bank, and other jurisdictions are encouraged to cooperate subject to certain safeguards that preserve their national interests. This approach is premised on three pillars.

The first pillar involves the convergence of national frameworks towards the KAs. Mutual trust among relevant jurisdictions on each other's ability to effectively deal with the failure of a bank is founded on the existence of domestic frameworks aligned with best international practices.

The second pillar concerns the RA's mandate and *ex ante* operational arrangements for cooperation. The legal frameworks should empower the RA to cooperate with its foreign counterparts and eliminate any barriers to such cooperation (such as impediments to information-sharing, automatic action in a jurisdiction when a resolution decision is taken by a foreign authority, discrimination against foreign creditors, and inadequate legal protection for the RA and its staff when enforcing foreign resolution measures).[121] The KAs further recommend the establishment of "Crisis Management Groups" for global systemically important financial institutions, to be supported by institution-specific cooperation agreements that involve *ex ante* commitments from the home jurisdiction and all key jurisdictions to cooperate in recovery and resolution planning and in the implementation of resolution measures. Similar cross-border cooperation and information-sharing arrangements are also recommended between home and host authorities in the case of banks that have material cross-border operations, for instance at regional level.[122]

The third pillar contemplated by the KAs requires that jurisdictions have transparent and expedited statutory processes in place to give effect to the decisions of foreign authorities. To that end, the KAs contemplate two legal mechanisms that are complementary to each other: recognition and support. These statutory approaches can be supported by contractual mechanisms under private law.

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119 The Swiss bank liquidation or restructuring covers all the assets and liabilities of the bank wherever they are located. The automatic and mutual recognition of liquidation or reorganisation decisions of a member state under Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (the "Winding-Up Directive") implies a universal approach within the EU and the broader EEA.

120 For a brief account of the cross-border arrangements in place before the global financial crisis, see IMF (note 7).

121 See Assessment Methodology, EN 7(b). In Switzerland, the Swiss Financial Market Supervisory Authority FINMA is required to coordinate insolvency proceedings with the competent foreign authorities to the maximum extent possible (Swiss Federal Banking Act, art 37f). In Japan, the Financial Services Agency is empowered to promote international cooperation relating to its functions (Act for Establishment of the Financial Services Agency, art 4(24)).

122 See KAs, EC 11.9.

Recognition can be granted by an administrative authority[123] and/or by courts,[124] and involves "[accepting] the commencement of a foreign resolution proceeding domestically and thereby [empowering] the relevant domestic authority (either a court or an administrative agency) to enforce the foreign resolution measure or grant other forms of domestic relief, for example, a stay on domestic creditor proceedings".[125] Recognition is not provisional on the initiation of domestic resolution proceedings. Thus, it can be utilised where resolution conditions are not met for the local entity or even in the absence of any local presence (e.g. when the assets of the failed bank are located in, or its liabilities are governed by the law of, such a jurisdiction). The legal effects of recognition will be determined by the domestic law.[126]

Support, in contrast, involves action or inaction by the authorities under the domestic framework with a view to achieving outcomes in the domestic legal system that are consistent with the foreign resolution measure.[127] This mechanism can only apply in jurisdictions where the bank under resolution has a regulated presence (e.g. a branch, subsidiary, or listed securities).

Support measures can be adopted through:

(i) the exercise of domestic resolution powers, if the local establishment meets resolution conditions (for instance, the host RA may impose a stay on legal actions brought by local creditors against the foreign branch or subsidiary);[128]

(ii) supervisory powers under the domestic law (e.g. giving supervisory approval for an ownership change that arises as a result of a foreign resolution measure, or through exemptions from the application of certain regulatory requirements, such as market disclosures);[129] and

(iii) not taking domestic action (e.g. refraining from taking any action over the local establishment, to support the foreign RA's SPOE strategy).[130]

In line with the spirit of the middle ground approach, giving effect to foreign measures should be subject to certain conditions. Automatic and mutual recognition of resolution measures is rare.[131] Under the KAs, giving effect to foreign measures

123 See e.g. the EU's BRRD, arts 94 and 95, the UK's Banking Act 2009, ss 89Hff, and the Swiss Federal Banking Act, art 37g.

124 A jurisdiction's general framework for the recognition and assistance of foreign insolvency measures can be relevant also in a cross-border bank resolution context. For instance, such general framework may be broad enough to cover not only commercial insolvency decisions by a foreign court, but also the resolution and insolvency actions taken over banks by foreign administrative bodies. A separate question arises as to whether such framework would include the recommended features of the KAs (e.g. on the need for resolution measures to be implemented swiftly; see text at note 45 above).

125 Assessment Methodology, EN 7(e).

126 In the Hong Kong SAR and the UK, a recognised foreign measure has substantially the same legal effect (in the case of the Hong Kong SAR) or the same legal effect (in the case of the UK) as if made under the local laws (see the Hong Kong SAR's Financial Institutions (Resolution) Ordinance, s 188, and the UK's Banking Act 2009, s 89I) respectively. The EU's BRRD, on the other hand, does not include a provision that specifically prescribes the effect of recognition.

127 See KAs, EC 7.4.

128 FSB, *Principles for Cross-border Effectiveness of Resolution Actions* (2015) 5-6, available at: https://www.fsb.org/2015/11/principles-for-cross-border-effectiveness-of-resolution-actions.

129 ibid, 6.

130 KA 7.2 recommends that resolution or insolvency in a jurisdiction should not be triggered automatically due to resolution or insolvency action taken in another jurisdiction.

131 It is provided for by the EU's Winding-Up Directive (note 119).

should be provisional on the equitable treatment of creditors in the foreign resolution proceeding.[132] Host countries could additionally decline to enforce a foreign resolution measure if doing so would:

(i) have adverse effects on domestic financial stability;

(ii) have material fiscal implications; or

(iii) contravene their public policy.

The specific formulation and interpretation of these conditions and the domestic authorities' discretion may differ across jurisdictions. For instance, there is no universal understanding of the meaning of the *equitable treatment* of domestic creditors in foreign proceedings, or how it applies. The concept of equitable treatment may not be germane to certain civil law countries, as they would focus more on the "equal" treatment of creditors.[133] Similarly, in the absence of significant case law it is not clear whether the public policy test, mentioned above, should apply in a resolution context with a high threshold, similarly to how the *public policy* test provided under private international law and cross-border insolvency frameworks is interpreted.[134]

Where statutory recognition and support frameworks are not in place yet, interim solutions developed by jurisdictions can be useful, although they have limitations. Jurisdictions can employ a contractual approach that utilises specific clauses in relevant contracts through which the parties agree to be bound by the effect of a foreign resolution decision.[135] Important steps have been taken to implement the contractual approach – particularly by the International Swaps and Derivatives Association in cooperation with the FSB – although this approach is not a perfect substitute for statutory frameworks.[136] For instance, the effectiveness of this approach depends on the willingness of market participants to use it in all relevant cross-border contracts, including non-standard contracts.

In the same vein, an SPOE strategy may reduce the need for seeking cross-border recognition as it seeks to apply resolution powers only to the holding company at the top of the group. However, the feasibility of this strategy depends on factors such as the group structure of the resolved institution and sufficient quality of loss-absorbing capacity being issued in the right places in the group. In addition, some form of recognition, for instance to temporarily stay early termination rights against the local entity, would also still be needed under such strategy.

132 See Assessment Methodology, EN 7(g).

133 See e.g. the EU's BRRD, art 95.

134 When prescribing the grounds for the refusal of enforcement, the EU's BRRD refers (in art 95(e)) to contravention of "national law", a notion that may be broader than "public policy".

135 For instance, under the EU's BRRD, art 55, member states should impose a requirement on banks to insert such recognition clauses in the contracts that create a liability eligible for bail-in and governed by the law of a third country.

136 FSB, *Cross-border Recognition of Resolution Action* (FSB Consultative Document 2014) 11, available at: https://www.fsb.org/2014/09/c_140929.

4. Conclusion

The KAs represent the international standards for the design of bank resolution frameworks. Their goal is to resolve banks in an orderly fashion without exposing taxpayers to loss, while maintaining the continuity of their vital economic functions, and thus preserving financial stability. These standards address the inadequacies of pre-crisis resolution frameworks by entrusting the authorities with a wide range of public law powers that can be deployed at an early stage before the bank is insolvent. However, they also raise legal and policy questions that legal experts and policymakers need to answer when these standards are implemented in their domestic frameworks. These issues are complex, and solutions may be informed by the constraints under the broader institutional settings of a jurisdiction, such as with respect to the role of courts in resolution. Regardless of such constraints, jurisdictions should give due regard to the fact that financial stability is a public good, and that this public interest can be best served under a resolution framework centred on an autonomous RA with robust governance arrangements and broad powers that can be exercised promptly and flexibly.

To achieve the objective of swift resolution and pursue financial stability, bank resolution frameworks should depart from corporate insolvency frameworks to a significant degree. Resolution objectives, institutional arrangements, resolution planning, and resolution triggers provide significant examples of how resolution differs from corporate insolvency. However, bank resolution frameworks can draw from insolvency regimes in a number of critical areas, albeit with some adjustments that reflect the specific rationale and objectives of bank resolution. For instance, the distinction between reorganisation and liquidation mechanisms is also relevant to resolution, although the implementation of these mechanisms in resolution does not involve shareholder and creditor consent. Legal safeguards under a bank resolution framework may share similarities with the safeguards provided by corporate insolvency frameworks. Similar to funding arrangements in corporate insolvency, bank resolution frameworks should ultimately aim at placing the burden of resolution on the failed bank, its shareholders, creditors, and the industry. The effectiveness of a bank resolution framework lies in its ability to preserve financial stability and ensure the continuity of critical functions while creating an outcome that, like corporate insolvency, is oriented towards market discipline, as well as economic stability and growth.

III. BAIL-IN: A POST-CRISIS LEARNING PROCESS

III. Bail-in: a Post-Crisis Learning Process

Wolf-Georg Ringe*

1. Introduction

Following the recent global financial crisis, regulators and public policymakers worldwide have embraced the concept of *bail-in*, where a failing bank's losses are not passed to the taxpayer (a *bail-out*) but to the bank's investors, often through the restructuring of its balance sheet by eliminating or converting debt. First articulated by Paul Calello and Wilson Ervin in 2010,[1] the concept of bail-in is now considered the most significant regulatory achievement in the post-crisis efforts to end the problem of *too big to fail*.

Bail-in is the modern alternative to the traditional crisis-fighting tools described by 19th-century economist Walter Bagehot. In his influential book *Lombard Street*, Bagehot famously identified two alternatives: (i) providing central bank liquidity for banks that are illiquid; and (ii) winding down insolvent ones.[2] In a sense, bail-in is the modern "third way" to handle a failing financial institution by seeking to restructure and/or self-insure banks so that a rescue with public money becomes unnecessary. Over the past several years, this concept has won over many supporters around the world.

This chapter retraces the intellectual learning process over the past several years in designing and improving the regulatory framework for bail-in. As we will see, the basic idea underlying bail-in legislation is sound, but frameworks remain incomplete. For example, uncertainty remains as to the exact triggers for implementation of a bail-in by regulators. Added to this uncertainty is a question as to whether regulators will act in a timely manner in using their bail-in powers. In short, careful work is required to ensure that the bail-in tool achieves the purposes for which it is envisaged.

More conceptually speaking, it is important to stress that the financial risk that is inherent in a bank failure does not disappear. Rather it is moved to the failing bank's counterparties. The identity of these counterparties is thus paramount – where financial institutions hold securities in each other, the imposition of a bail-in operation may be a source of new systemic risk. Bail-in may even constitute an economic incentive to financial institutions to increase their mutual interconnectedness.

Finally, bail-in remains incomplete to the extent that it does not provide for liquidity of a recapitalised bank. Where no credible backstop in the form of a lender of last resort exists who may provide liquidity during and after resolution, the bail-in operation may be neither credible nor effective. Market confidence in the bank would not come back by itself.

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1 Paul Calello and Wilson Ervin, 'From Bail-out to Bail-in' *The Economist* (London, 28 January 2010).

2 Walter Bagehot, *Lombard Street: A Description of the Money Market* (Henry S King & Co 1873).

The remainder of this chapter is structured as follows. Section 2 introduces the emergence and development of the bail-in concept in post-crisis regulatory thinking. Section 3 discusses a number of questions that have not been addressed in current regulatory frameworks, including the appropriate triggers for implementation of a bail-in and the challenge of incentivising resolution authorities to intervene in a timely manner. Further, bail-in counterparties are an underexplored issue and may create new sources of systemic risk. Finally, I make the case for enhanced central bank involvement in the post-resolution phase to restore the bank's viability through greater liquidity. Section 4 concludes.

2. Resolution and bail-in: a story in four acts

2.1 Overview

To date, the post-crisis learning process on how to handle distressed systemically important financial institutions ("SIFIs") has been a play in four acts. First, the immediate post-crisis experience showed that special powers were required to wind down large financial institutions in an orderly manner because existing insolvency (also sometimes known as "bankruptcy") laws were not adequate to the task. This was the impetus for developing resolution powers for state regulators, as a de facto specific insolvency regime for banks.[3]

The second step was to equip resolution authorities with bail-in powers, enabling them to force creditors to absorb the failing institution's losses by eliminating the debts, or re-characterising them as equity. The driving force behind granting regulators these powers had little to do with the specific nature of banks or the banking business. It stemmed from the political desire to end taxpayer-funded bail-outs.

The third phase in the post-crisis agenda was the gradual emergence of a strategy for coordinated efforts among nations using bail-in powers in a global context. International consensus has been growing in support of a *single point of entry* ("SPOE") approach, meaning that the institution's home regulator should be responsible for an international banking group at the group's holding company level.

Based on this approach, the fourth phase involved the adoption of rules that guarantee the availability of sufficient "bail-in-able" debt at the holding company level. In other words, the future financial structure of these global enterprises must shift the debt to the holding company's level so that the restructuring may occur at this level and leave the more market-sensitive subsidiaries insulated from the process. To these ends, the Financial Stability Board (the "FSB") – an international institution that coordinates regulatory responses to the challenges of global financial markets – published final minimum total loss-absorbing capacity ("TLAC") standards for 30 banks identified as global systemically important banks ("G-SIBs") on 9 November 2015.[4] These standards are to be implemented from 2019 to 2022.

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3 See Robert R Bliss and George G Kaufman, 'Resolving Insolvent Large Complex Financial Institutions: A Better Way' (2011) 128 Banking Law Journal 339; Kenneth E Scott, George P Shultz and John B Taylor (eds), *Ending Government Bailouts as We Know Them* (Hoover Press 2010); Kenneth E Scott and John B Taylor (eds), *Bankruptcy Not Bailout: A Special Chapter 14* (Hoover Press 2012).

4 FSB, *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity (TLAC) Term Sheet* (2015), available at: https://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet.

2.2 Step 1: resolution instead of traditional insolvency

At the outset, it is important to consider why it is necessary to implement a resolution process instead of applying a traditional insolvency alternative for banks and other financial institutions. Traditional insolvency entails a court-supervised process that is designed to protect the substantive and procedural rights of all creditors, generally without regard for broader public interests. While it might stay collection and contract termination at the holding company level when the holding company files for insolvency, it generally will not provide the same relief to the myriad of subsidiaries, many of which are so market-sensitive that they cannot risk their own insolvency filings. Thus, the holding company's insolvency will likely trigger default provisions at the subsidiary level in various counterparty credit agreements that may permit creditors to seize collateral and may also allow non-debtor contracting parties to terminate relationships. It will also bring an abrupt halt to the trading in financial claims which are the lifeblood of a financial firm.

In contrast, resolution is an administrative process in which the goal is to protect the liquidity needs of short-term creditors, especially depositors, and to manage financial assets in a way that preserves both asset value and the franchise value of the failing institution.[5] A major objective of resolution is to avoid systemic distress in the financial sector, a social good that may not coincide with the private objective of protecting the equal treatment or absolute priority of creditor claims.[6] Along with the goal of making financial institutions more resilient is the objective of making them resolvable without taxpayer support. This two-sided approach has been dubbed a "bookends strategy".[7]

Resolution is an umbrella term that describes the process of handling a distressed bank. Under this generic term, regulators usually employ several different tools, which vary depending on the jurisdiction. Their precise availability, scope, and triggering requirements vary. Typically, resolution powers include the authority to sell or merge the bank's business with another bank, to set up a new or bridge bank to operate critical functions of the failing institution, and to separate good assets from bad ones by moving them into different institutions.

One critical element of resolution is the capacity of the administrator to offer liquidity to maintain the critical functions of the financial institution.[8] This is operationally equivalent to debtor-in-possession financing but has the advantage of assured availability in sufficient amounts at a time of systemic distress. In comparing resolution under Title II of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[9] of the United States (the "US") with the outcome of bankruptcy, the Federal Deposit Insurance Corporation (the "FDIC") projected that, in the case of Lehman Brothers, a resolution would have produced losses of only three cents on the dollar versus bankruptcy losses

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5 See John Armour, 'Making Bank Resolution Credible' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds), *Oxford Handbook of Financial Regulation* (OUP 2015) 453.

6 Randall D Guynn, 'Are Bailouts Inevitable?' (2012) 29 Yale Journal on Regulation 121, 141 (noting that the United States Bankruptcy Code, as used for corporate insolvency, does not have goals of maintaining public confidence or minimising systemic risk).

7 Paul Tucker, *Regulatory Reform, Stability, and Central Banking* (Hutchins Center on Fiscal and Monetary Policy at Brookings 2014), available at: https://www.brookings.edu/wp-content/uploads/2016/06/16-regulatory-reform-stability-central-banking-tucker.pdf.

8 See Guynn (note 6) 144.

9 Pub L No 111-203,124 Stat 1376 (2010).

of 79 cents on the dollar.[10] While a bankruptcy filing may be "fast-tracked" to move quickly, it still requires due process and the right to evidentiary hearings. While those proceedings take place, the SIFI may experience issues in the markets. In a resolution process, the administrator may move immediately to right the ship.

2.3 Step 2: bail-in as a tool in the resolution toolbox

The most important resolution power is the authority to write down the debt of a failing institution or to convert it to equity, the *bail-in* tool. The corresponding rules entitle the resolution authority to cancel or reduce liabilities to long-term creditors or to convert such liabilities partially or fully into debt or equity securities of the institution or of another entity. Such measures aim at ensuring that the shareholders and unsecured creditors of a failing financial institution bear the losses and are ultimately responsible for the costs of the failure – shifting the taxpayer's responsibility to the firm's investors.

Bail-in powers differ in two respects from the resolution mechanisms that were designed immediately after the global financial crisis. First, they seek a different allocation of the financial institution's losses, protecting the taxpayer and avoiding unpopular bail-outs.[11] Second, in conceptual terms, the bail-in tool is a type of reorganisation procedure, as opposed to liquidation.[12] That is, its primary purpose is to keep the vital parts of a large banking group alive and running; the debts of the financial institution are, however, markedly restructured.[13] Many positive side effects may flow from this double objective. For example, the allocation of losses to creditors is said to reinforce the application of market forces to a bank's success and failure (as with any business in the real economy) and to encourage greater monitoring by its creditors.[14]

Relying on this theoretical groundwork, the de facto policy starting point for bail-in was the adoption of the concept in the seminal 2011 publication *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes"), developed by the FSB.[15] The FSB has become the de facto pacemaker for international coordination in financial markets reform post-crisis, and the Key Attributes provided the blueprint for

10 FDIC, 'FDIC Report Examines How an Orderly Resolution of Lehman Brothers Could Have Been Structured under the Dodd-Frank Act' (Press Release, 18 April 2011), available at: https://www.fdic.gov/news/news/press/2011/pr11076.html. For a detailed analysis of the Lehman Brothers insolvency, see generally Michael J Fleming and Asani Sarkar, 'The Failure Resolution of Lehman Brothers' (2014) 20 Federal Reserve Bank of New York Economic Policy Review 175, available at: https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf. For a critical perspective, see Nicholas Dorn, *Democracy and Diversity in Financial Market Regulation* (Routledge 2015) 47.

11 Emilios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins' (2015) 1 Journal of Financial Regulation 3-4.

12 Armour (note 5) 471-2.

13 In the US, critics have argued that this character of bail-in appeared to conflict with the FDIC's mandate, granted under Title II of the Dodd-Frank Act, which is restricted to liquidation. See Joe Adler, 'Is the FDIC's "Single Point" Resolution Plan a Stealth Bailout?' *American Banker* (New York, 12 December 2013), available at: https://www.americanbanker.com/news/is-the-fdics-single-point-resolution-plan-a-stealth-bailout; David A Skeel, Jr, 'Who Is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-funded Bailouts?', Written Statement, Hearing before the Subcommittee on Oversight and Investigations of the Committee on Financial Services, 113th Cong (15 May 2013) 68, available at: https://www.gpo.gov/fdsys/pkg/CHRG-113hhrg81754/pdf/CHRG-113hhrg81754.pdf. More recently, see Arthur E Wilmarth, Jr, 'SPOE + TLAC = More Bailouts for Wall Street' (2016) 35(3) Banking and Financial Services Policy Report 1, 3.

14 John C Coffee, 'Systemic Risk after Dodd–Frank: Contingent Capital and the Need for Strategies beyond Oversight' (2011) 111 Columbia Law Review 795.

15 Updated in 2014 and available at: https://www.fsb.org/2014/10/key-attributes-of-effective-resolution-regimes-for-financial-institutions-2.

international best practices. In 2018, the FSB supplemented the Key Attributes with new *Principles on Bail-in Execution*, setting out more operational aspects of bail-in regimes.[16]

In the US, the Dodd-Frank Act granted sweeping powers for resolving SIFIs, effectively creating a separate bankruptcy process for institutions whose resolution under the traditional bankruptcy law would pose systemic concerns. The Orderly Liquidation Authority ("OLA") granted a broad set of powers to the FDIC, with the overarching objective of ending public bail-outs.[17] Chief among these powers are discretionary bail-in powers – the Dodd-Frank Act provides that creditors and shareholders are to bear all the losses of the financial company that has entered OLA.[18] In 2013, the FDIC elaborated on its strategy for the use of these new powers and outlined its resolution strategy.[19]

The European response appeared in the 2014 Bank Recovery and Resolution Directive (the "BRRD"),[20] an instrument seeking to harmonise resolution powers across all 28 member states of the European Union (the "EU"). This is a broad framework law, setting out a common approach for dealing with failing banks, that needs to be implemented and applied by all EU member states. It includes detailed prescriptions on bail-in authority.[21] Any public support for failing banks is virtually excluded, unless at least a substantial portion of the losses has first been absorbed by the institution's shareholders and bondholders.[22] Within the eurozone, resolution authority has been centralised in the hands of the Single Resolution Board (the "SRB"), which was given responsibility for handling large banks as part of the project to create a European Banking Union.[23]

2.4 Step 3: towards single point of entry

Despite these efforts, resolution authorities soon realised that fundamental challenges in resolving SIFIs remained. Even though resolution authorities were entrusted with wide-ranging resolution tools, the resolution of a global bank involves substantial risks. Applying resolution powers might well disrupt the financial institution's balance sheet, which might in turn lead to its expulsion from payment and clearing systems. Further, financial groups are usually commercially integrated, but their legal and geographical structures may not be. Resolution might therefore split up the banking group along

16 FSB, *Principles on Bail-in Execution* (2018), available at: https://www.fsb.org/2018/06/principles-on-bail-in-execution-2.

17 Remarks by Martin J Gruenberg, Chairman, FDIC (Peterson Institute for International Economics, 12 May 2015), available at: https://fdic.gov/news/news/speeches/spmay1215.html. For a summary, see Richard W Nelson and George G Kaufman, 'Will DFA End TBTF?' (2016) 35(4) Banking and Financial Services Policy Report 1, 6-9.

18 12 USC § 5384(a)(1).

19 The FDIC outlined the SPOE strategy in a request for public comments. See FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy* 78 Fed Reg 76,614 (18 December 2013).

20 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

21 BRRD, arts 43-58.

22 ibid, art 44(5)(a). The only exceptions are precautionary recapitalisations for solvent banks, satisfying the requirements laid down in ibid, recital 41 and art 32(4)(d), that is (a) in order to remedy a serious disturbance in the economy of an EU member state and preserve financial stability and (b) the recapitalisation taking place "at prices and on terms that do not confer an advantage upon the institution". See Stefano Micossi, Ginevra Bruzzone and Miriam Cassella, 'Fine-tuning the Use of Bail-in to Promote a Stronger EU Financial System' Special Report 136 (CEPS 2016).

23 Pursuant to Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L225/1 (the "SRM Regulation").

artificial lines, depriving it of access to vital resources (such as treasury functions, staff, operations, and central intellectual property and information technology resources that are organised globally). Finally, resolution action in one jurisdiction might not be recognised in another, mostly where resolution powers are applied to debt that is subject to foreign law. Such recognition issues might severely hamper successful resolution. In short, the resolution of a global banking group might still entail many uncertainties and legal risks.

Against this backdrop, the FSB strove to develop a common international approach. In its 2013 guidance, the FSB endorsed the SPOE approach to handle global banking groups.[24] At roughly the same time, the FDIC put forward its intellectual framework for applying the new powers granted by the Dodd-Frank Act, which also championed SPOE.[25] According to this approach, the most promising strategy is to resolve the banking group at the level of its ultimate parent, rather than the operating subsidiaries. Resolution powers (and, in particular, bail-in powers) would be applied at the level of a group's holding company by a single resolution authority.

SPOE has a number of distinct advantages.[26] First, if the bail-in-able debt is at the holding company level, the financial institution, market participants, and the regulator will be aware of the potentially bail-in-able debt, which will enhance transparency and foreseeability of resolution effects. It has the added benefit of making resources across the banking group more valuable for their specific purposes by ensuring a clear allocation of funds for their respective purposes.[27] Second, SPOE works much better in cross-border situations in facilitating an effective regulatory solution by one resolution authority and bundling the responsibility in one centre of control. This would mitigate the cross-border recognition problem. Indeed, one of the main points of critique of the alternative *multiple point of entry* approach is that it would give responsibilities to several regulators in various jurisdictions and, thus, create jurisdictional frictions and a race to grab assets for the purpose of protecting domestic creditors.[28] Finally, and most importantly, the SPOE approach ensures that the operating subsidiaries can carry on their business without fatal disruptions, destructive runs that can produce fire sale liquidations, negative asset valuation spirals, and other negative effects. Consequently, it is anticipated that a SPOE approach would lead to larger administrative savings that would lessen the overall creditor losses associated with a single resolution as compared with the independent resolution of multiple entities individually. This in turn would reduce the level of bail-in-able debt required to achieve systemic stability.

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24 FSB, *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies* (2013), available at: https://www.fsb.org/2013/07/r_130716b.

25 On the SPOE approach in detail, see John F Bovenzi, Randall D Guynn and Thomas H Jackson, 'Too Big to Fail: The Path to a Solution: A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center' (Bipartisan Policy Center 2013) 23-32, available at: https://bipartisanpolicy.org/report/too-big-fail-path-solution-525. For a general account, see Randall D Guynn, 'Framing the TBTF Problem: The Path to a Solution' in Martin Neil Baily and John B Taylor (eds), *Across the Great Divide: New Perspectives on the Financial Crisis* (Hoover Press 2014) 281, available at: http://www.hoover.org/sites/default/files/across-the-great-divide-ch13.pdf.

26 See Patrick Bolton and Martin Oehmke, 'Bank Resolution and the Structure of Global Banks' NBER Working Paper 24737 (National Bureau of Economic Research 2018), available at: http://www.nber.org/papers/w24737.

27 This may be part of the explanation as to why the credit rating of a bank holding company would normally not be much different from the credit rating of a banking entity in an integrated banking structure. See Scope Ratings, *Holding Companies: The Right Vehicle for European Bank's SPE Resolution?* (2014).

28 European Parliament, Directorate General for Internal Policies, Single Resolution Mechanism – Note (2013) 13, available at: http://www.europarl.europa.eu/document/activities/cont/201302/20130214ATT61105/20130214ATT61105EN.pdf.

Given these advantages, regulatory bodies have increasingly spoken out in favour of the SPOE approach. It received a major boost with the adoption of a joint position paper by the FDIC and the Bank of England in 2012.[29] A 2013 report by the Bipartisan Policy Center concluded that the SPOE approach is the best strategy for dealing with a failing SIFI "without resorting to taxpayer-funded bail-outs or a collapse of the financial system".[30] Since then, support has been voiced by authorities worldwide, including the FSB,[31] the European Parliament,[32] and regulators in Switzerland[33] and Germany,[34] among others.[35] The strongest endorser is the FDIC, which in 2013 released its substantial roadmap on SPOE within the operation of the Dodd-Frank Act, and in particular the Title II resolution framework.[36]

One requirement for SPOE to work is that the financial institutions are organised in such a way as to permit debt conversion without putting core members of a banking group such as individual deposit-taking entities through an insolvency proceeding.[37] This is very important to ensure the ongoing, undisrupted operation of vital financial activity that is organised in legally and contractually complex forms. Avoiding insolvency proceedings of the operating subsidiaries also facilitates resolution of banks with important cross-border activities; if the subsidiaries are not put into an insolvency proceeding, many difficult cross-border resolution issues can be avoided.

One key issue is that many banking groups outside the US are organised in a structure that does not lend itself easily to implementing an SPOE strategy. Most large US financial institutions operate in a holding company structure, largely for historical reasons.[38] In contrast, their European counterparts are typically organised as universal banks and have a complex organisational structure in which various financial services

29 FDIC and Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions* (2012), available at: https://www.fdic.gov/about/srac/2012/gsifi.pdf. For additional US support, see remarks by Martin J Gruenberg, Chairman, FDIC (Volcker Alliance Program Washington, DC, 13 October 2013), available at: https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html.

30 See Bovenzi, Guynn and Jackson (note 25).

31 See FSB (note 24).

32 See European Parliament (note 28).

33 Eidgenössische Finanzmarktaufsicht (FINMA), *Resolution of Global Systemically Important Banks: FINMA Position Paper on Resolution of G-SIBs* (2013), available at: https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/diskussionspapiere/diskussionspapier-20130807-sanierung-abwicklung-global-systemrelevante-banken.pdf?la=en.

34 See Scope Ratings (note 27).

35 For a helpful overview, see ibid.

36 See FDIC (note 10).

37 For a more detailed discussion of this argument, see Jeffrey N Gordon and Wolf-Georg Ringe, 'Bank Resolution in Europe: The Unfinished Agenda of Structural Reform' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (OUP 2015) 500, available at: http://ssrn.com/abstract=2548251 (2nd edn forthcoming 2020).

38 Jeffrey N Gordon and Wolf-Georg Ringe, 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take' (2015) 115 Columbia Law Review 1297, 1330ff.

are provided by divisions of the bank or through subsidiaries of the bank.[39]

There is an ongoing debate regarding if and how European banks should be required to adopt a holding company structure to facilitate SPOE.[40] Several European regulators have begun to set incentives for this structural conversion. For example, Swiss rules on banking capital requirements lower those requirements for banks that adjust their organisational structure to make the bank more easily resolvable. This move has prompted Swiss SIFIs to change their structure to one very similar to the holding company structure common in the US.[41] Following new regulation in the United Kingdom (the "UK"), British banks are beginning to issue debt at the holding company level.[42] And more recently, banks elsewhere in Europe have announced plans to reorganise their operations in a holding structure more amenable to resolution.[43] At least in one case, this move was apparently required by the SRB.[44]

2.5 Step 4: providing sufficient bail-in-able debt

Logically, the concept of a bail-in requires that banks and other financial institutions have something to be bailed in. In other words, there must be debts owed by the financial institution that may be cancelled or converted. In the most recent initiatives, regulators have begun to specify an array of standards requiring financial institutions to hold a certain minimum amount of debt that would be subject to bail-in powers and be available to recapitalise the institutions.[45]

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39 On the European universal banking model, see Jordi Canals, *Universal Banking: International Comparisons and Theoretical Perspectives* (OUP 1997) 6-11. The typical US "holding company" group model is not popular in Europe, see High-Level Expert Group on Reforming the Structure of the EU Banking Sector, *Final Report* (2012) 137, (the "Liikanen Report"), available at: https://ec.europa.eu/info/sites/info/files/efsir-2012-25042013_en.pdf. See also Institute of International Finance, *Making Resolution Robust – Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions* (2012) 52; Bob Penn, 'Single Point of Entry Resolution: A Milestone for Regulators: A Millstone for Banks?' (Allen & Overy nd), available at: http://www.allenovery.com/publications/en-gb/lrrfs/uk/Pages/Single-point-of-entry-resolution.aspx; James R Barth, Daniel E Nolle and Apanard Prabha, 'Banking Structure, Regulation, and Supervision in 1993 and 2013: Comparisons across Countries and over Time' (2014) 13 Journal of International Business and Law 231, 251-4, Table 4; James R Barth, Daniel E Nolle and Tara N Rice, 'Commercial Banking Structure, Regulation, and Performance: An International Comparison' OCC Working Paper 97-6 (Office of the Comptroller of the Currency 1997) Tables 5, 6a, 6b, available at: https://www.occ.gov/publications-and-resources/publications/economics-working-papers/files/1990-1999/economic-working-paper-1997-6.html; Richard J Herring and Anthony M Santomero, 'The Corporate Structure of Financial Conglomerates' (1990) 4 Journal of Financial Services Research 471, 481-9; Richard Herring and Jacopo Carmassi, 'The Corporate Structure of International Financial Conglomerates: Complexity and its Implications for Safety and Soundness' in Allen N Berger, Philip Molyneux and John OS Wilson (eds), *The Oxford Handbook of Banking* (OUP 2010) 195, 217-21.

40 See Gordon and Ringe (note 37); Gordon and Ringe (note 38) 1365.

41 James Shotter, 'Credit Suisse to Overhaul Structure' *Financial Times* (London, 21 November 2013), available at: http://www.ft.com/intl/cms/s/0/45d5a706-527d-11e3-8586-00144feabdc0.html; James Shotter, 'Swiss Bank Creditors Face Bail-in Risk' *Financial Times* (London, 8 August 2013), available at: http://www.ft.com/intl/cms/s/0/48ab28a0-ff6e-11e2-919a-00144feab7de.html. According to rating agency Fitch Ratings, it is likely that other European banks are under pressure to follow this example. Shotter, 'Credit Suisse' (this note); see also James Shotter, 'UBS Plans Dividend as Part of Overhaul to Ease a Crisis Break-up' *Financial Times* (London, 6 May 2014), available at: http://www.ft.com/intl/cms/s/0/7c5ffa50-d4d8-11e3-8f77-00144feabdc0.html.

42 Sam Fleming, 'Banks Address "Too Big to Fail" Question with Debt Shift' *Financial Times* (London, 26 December 2013), available at: http://www.ft.com/cms/s/0/df877896-6c7e-11e3-ad36-00144feabdc0.html.

43 Fitch Ratings, 'New UniCredit Structure Would Simplify a Resolution' (20 November 2015), available at: https://www.fitchratings.com/site/pr/994472; Joe Brennan, 'Banks Advance Bond "Bail-in" Plans under New European Rules' *Irish Times* (Dublin, 3 February 2017), available at: http://www.irishtimes.com/business/financial-services/banks-advance-bond-bail-in-plans-under-new-european-rules-1.2962210.

44 Ciarán Hancock, 'Bank of Ireland Gets Court Approval to Set up New Holding Company' *Irish Times* (Dublin, 23 June 2017), available at: https://www.irishtimes.com/business/financial-services/bank-of-ireland-gets-court-approval-to-set-up-new-holding-company-1.3131510.

45 For an in-depth examination, see James McAndrews, Donald P Morgan, João AC Santos and Tanju Yorulmazer, 'What Makes Large Bank Failures so Messy and What Should Be Done about It?' (2014) 20 Federal Reserve Bank of New York Economic Policy Review 229.

In 2015, the FSB published its final *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* and a related term sheet, setting out internationally agreed standards on TLAC for G-SIBs.[46] According to these standards, G-SIBs will be required to meet TLAC requirements alongside the minimum regulatory requirements set out in the Basel III framework.[47] More specifically, they will be required to meet a minimum TLAC requirement of at least 16 percent of the resolution group's risk-weighted assets starting in 2019 and at least 18 percent in 2022. The firm-specific required level of TLAC will vary, depending on the particular institution, from at least 16 percent up to 25 percent of risk-weighted assets.[48] The European approach to this issue is the *minimum requirement for own funds and eligible liabilities* ("MREL") for all EU banks in line with the BRRD requirements, further specified by Regulatory Technical Standards.[49] The TLAC principles only apply to G-SIBs, whereas MREL covers all EU banks and investment firms.[50] For European G-SIBs, MREL will need to be set consistently with TLAC, and an adjustment of MREL has recently been approved.[51] For US financial institutions, the Federal Reserve recently adopted its own version of TLAC, which is broadly consistent with the FSB variant and will come into force in 2019.[52] Although some differences remain, these three approaches complement one other.[53]

3. Unresolved questions

3.1 Introduction

Even though the four steps outlined above evidence a significant intellectual development in the effort to achieve a credible resolution strategy, many issues remain unresolved. This chapter now proceeds to discuss some of these open issues surrounding bail-in, which inform the present-day policy discussion. I shall discuss the credibility of the tool (in section 3.2 below), the issue of counterparty risk and contagion between financial institutions (in section 3.3 below), and finally the unresolved issue of liquidity during resolution (in section 3.4 below).

46 FSB (note 4).

47 As to which, see Bank for International Settlements ("BIS"), 'Basel III: International Regulatory Framework for Banks', available at: https://www.bis.org/bcbs/basel3.htm.

48 FSB (note 4) 13. The limits were based on a calculation of losses during the global financial crisis in an earlier consultation document. See FSB, 'Issues for Consideration in the Development of a Proposal on Adequacy of Loss Absorbing Capacity in Resolution' (SC/2013/45, 18 December 2013) Annex, 26-31.

49 Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities [2016] OJ L237/1.

50 MREL also allows for broader discretion and may go significantly beyond TLAC requirements. See Fernando Restoy, Chairman, Financial Stability Institute, BIS, 'Bail-in in the New Bank Resolution Framework: Is There an Issue with the Middle Class?' (Speech at IADI-ERC International Conference: Resolution and Deposit Guarantee Schemes in Europe: Incomplete Processes and Uncertain Outcomes, Naples, Italy, 23 March 2018), available at: https://www.bis.org/speeches/sp180323.pdf.

51 In the recently adopted Banking Package, which includes, inter alia, Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms [2019] OJ L150/226, and Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC [2019] OJ L150/296.

52 Federal Reserve, *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important US Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations*, 82 Fed Reg 8,266 (24 January 2017).

53 Andrew Gracie, 'TLAC and MREL: From Design to Implementation' (Speech at BBA Loss Absorbing Capacity Forum, London, 17 July 2015), available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/tlac-and-mrel-from-design-to-implementation; see also Restoy (note 50).

3.2 Credibility of the bail-in tool

While the theoretical and intellectual underpinnings of the bail-in concept have great merit, its success depends on its practical implementation and the specific design of the bail-in powers. Just as Mario Draghi reassured markets with a few words on the approach of the European Central Bank (the "ECB"),[54] the installation of bail-in tools must first and foremost send a robust signal to the markets. The credibility of the bail-in strategy is paramount if it is to fulfil its purpose.

The main question is whether a bail-in resolution will be triggered by regulators when it is most needed. Answering this question brings into play two separate, but related, matters. First, do the legal requirements for the application of bail-in powers adequately respond to the policy objectives we seek to achieve? Second, even if the answer to the first question is yes, will regulators act on a timely basis to make use of their bail-in powers, or will other influences work against timely intervention? This and the following subsections explore these issues in more detail.

3.2.1 The trigger for bail-in

Some commentators have suggested that the appropriate trigger for bail-in should be balance-sheet insolvency, arguing that bail-in powers should be initiated at a stage when a financial institution is close to being either balance-sheet or cash-flow insolvent.[55] The principal argument in support of this approach is that bail-in implies such a substantial interference with the rights of stakeholders that it should only be allowed when the bank is insolvent and in danger of liquidation. However, a key disadvantage to this triggering event is that it may be too late to restore the bank to viability.

For this reason, others advocate for earlier triggers, such as the initiation of official administration or other early intervention. This is generally engaged by either qualitative triggers such as a repeated breach of regulatory standards, or quantitative triggers such as capital adequacy ratios falling below a certain level (e.g. below 50 percent or 75 percent of the norm). In some jurisdictions, a *public interest* finding may also be required. Pre-insolvency triggers would generally allow for a more prompt and effective response to a bank's difficulties, but they suffer from disadvantages as well. In some legal systems, the pre-insolvency triggers could raise legal questions as to the position of senior creditors relative to other stakeholders (including shareholders), official interference with contractual rights, and non-discrimination, which may require compensation to debt holders that are adversely affected.

The academic debate that accompanied early regulatory attempts has weighed more heavily in favour of early trigger dates. A staff team of the International Monetary Fund (the "IMF"), led by Jianping Zhou, made the case for applying bail-in before balance-sheet insolvency. They argued that the optimal trigger should be "close to

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54 On 26 July 2012, Draghi single-handedly resolved the eurozone sovereign debt crisis by announcing that, "[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." Mario Draghi, President of the European Central Bank (Speech at Global Investment Conference in London, 26 July 2012), available at: https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.

55 See e.g. John Crawford, 'Resolution Triggers for Systemically Important Financial Institutions' (2018) 97 Nebraska Law Review 65.

but before balance-sheet insolvency".[56] The trigger could be based on a combination of quantitative and qualitative assessments, such as a combination of a breach of regulatory minima (e.g. a minimum capital adequacy ratio) and concerns about the distressed institution's liquidity problems. The triggers, although discretionary, should not be seen as arbitrary, which means that the resolution authority should be able to decide to initiate the process of bail-in only when the trigger criteria are met. Since 2012, there has been a growing consensus that bail-in powers must be applied earlier than the point of insolvency. This reflects the trend toward viewing a bail-in as a potent tool to stymie investor panics and run risks, rather than merely shifting the financial responsibility for bank failures to bondholders. The working group on bail-in at the International Capital Markets Association summarised the state-of-the-art thinking in 2014, the group's chairman explaining that "[r]egulators will want to be able to conduct an orderly bail-in or resolution *well before investors start the panic*".[57] In a similar vein, Larry Wall, Executive Director at the Federal Reserve, stated that timely intervention is paramount to achieve a successful bail-in operation.[58]

The growing consensus in favour of earlier intervention recognises that bail-in can only work if sufficient bail-in-able debt is available to cover the losses. If the triggering moment is set too late, losses may have reached the point where the bail-in-able debt is inadequate, jeopardising the prospect of a credible resolution. To the extent that bail-in-able debt is long-term and not runnable, financial liabilities will remain that are runnable. Typically, these are the non-insured financial liabilities.[59] This, in turn, may lead to the acceleration of a downward spiral as creditors and other stakeholders lose faith in the institution and seek to withdraw their exposure, causing further liquidity problems.[60] In contrast, if an institution is resolved earlier, then other investors (who are not at risk of being bailed in) would be fully protected. In fact, this is the precise goal of the SPOE strategy: intervene at the holding company only, and let critical subsidiaries be unaffected and continue to operate normally.[61] Most of these regular creditors and other stakeholders should continue normal operations with their subsidiary even if they anticipate that the banking group may soon be put into resolution. The willingness of these parties to continue their business would greatly facilitate the reorganisation of the failing banking group into a new, viable operation.

Thus, there is a strong case for early intervention to make maximum use of the potential of the bail-in tool. Legislation should reflect this strategy. And the requirements for intervention should be made more concrete, while leaving the regulators with plenty of flexibility to initiate resolution sooner.

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56 Jianping Zhou, Virginia Rutledge, Wouter Bossu, Marc Dobler, Nadege Jassaud and Michael Moore, *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions* (IMF Staff Discussion Note 2012) 11, available at: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/From-Bail-out-to-Bail-in-Mandatory-Debt-Restructuring-of-Systemic-Financial-Institutions-25858.

57 Tim Skeet, 'Europe's Bank Bail-in Rules Change Game' *Financial Times* (London, 10 September 2014) 30 (emphasis added), available at: https://www.ft.com/content/63b6de76-31c9-11e4-b377-00144feabdc0.

58 Larry D Wall, 'Bail-in Debt: Will the Supervisors Pull the Trigger in Time?' (Federal Reserve Bank of Atlanta, CenFIS publication, August 2014), available at: https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1408.aspx.

59 This point is emphasised by McAndrews and others (note 45).

60 ibid, 243.

61 Gordon and Ringe (notes 37 and 38).

3.2.2 *Would regulators intervene on a timely basis?*

Even if the standards are revised along these lines, the question remains as to whether regulators would take timely actions to initiate resolution, owing to incentives to delay intervention. Seminal work by Anat Admati and Martin Hellwig asserts that regulators are likely to be reluctant to do so in the case of complex international banking groups.[62] Thomas Hoenig, former Vice Chairman of the FDIC, stated in 2011:

> "[T]here are important weaknesses with this framework. In particular, the final decision on solvency is not market driven but rests with different regulatory agencies and finally with the Secretary of the Treasury, which will bring political considerations into what should be a financial determination."[63]

While this comment was made regarding the system in the US, it could also be used to describe the more complicated decision-making process in Europe, which is not completely transparent.[64]

Behavioural research indicates that civil servants, faced with complex decisions and unknown risks, are typically risk averse and tend to underestimate the risks.[65] Following the global financial crisis, the threats and risks of banking failure are still very much present, but institutional memories are beginning to fade. The longer the time lag between the actual need to deal with a failing global SIFI and the last banking crisis, the more difficult it will be for the relevant authority to estimate accurately the potential costs of the SIFI's failure.[66]

Other powerful considerations may encourage slow action or inaction by regulators.[67] In a complex world with many uncertainties and imponderable risks, nobody wants to be the one "pulling the plug" on a large banking group. If the decision later turns out to have been premature, the authority may face significant public criticism (or even liability) with the benefit of hindsight. Moreover, links between banks and governments are widely acknowledged: preserving banks can preserve jobs and facilitate the

62 Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It* (Princeton University Press 2013) 77.

63 Deniz Anginer, 'Written Testimony of Deniz Anginer for the hearing "Examining the GAO Report on Government Support for Bank Holding Companies" before the Senate Subcommittee on Financial Institutions and Consumer Protection' (United States Senate, 31 July 2014), available at: https://www.banking.senate.gov/imo/media/doc/AnginerTestimonyFICP73114.pdf; see also Editorial Comment, 'Still Too Big, Still Can't Fail' *Wall Street Journal* (New York, 5 March 2011) 11, available at: https://www.wsj.com/articles/SB10001424052748703530504576164880968752682. At the time, Mr Hoenig was chief executive of the Tenth District Federal Reserve Bank in Kansas City, Missouri.

64 See e.g. Martin Hellwig, 'Yes Virginia, There is a European Banking Union! But It May Not Make Your Wishes Come True' (MPI Collective Goods Preprints No 2014/12, Max Planck Institute, August 2014) 23, available at: http://homepage.coll.mpg.de/pdf_dat/2014_12online.pdf: "[G]iven the uncertainties about how systemically important functions are to be maintained and funded, I expect that, in a clutch, most governments will decide that it is better to avoid a resolution procedure altogether."

65 Eldar Shafir (ed), *The Behavioral Foundations of Public Policy* (Princeton University Press 2012). The possibility of regulatory capture and cognitive biases may also exist, in theory.

66 David A Skeel, Jr, 'Single Point of Entry and the Bankruptcy Alternative' in Baily and Taylor (note 25) 311, 323; see also Kenneth Ayotte and David A Skeel, Jr, 'Bankruptcy or Bailouts?' (2010) 35 Journal of Corporation Law 469, 497.

67 McAndrews and others (note 45) 230, "plausibly" assume that a resolution authority "is 'slow' in the sense that it will shut down and resolve a firm only once its (book) equity capital is exhausted".

provision of local finance.[68] Where retail investors would be affected by bail-in, politicians can be expected to fear public anger.[69]

All of this may account for the fact that, in the past, states have invariably resorted to bail-outs rather than bail-ins, not interfering with creditor rights.[70] Looking at previous banking crises, David Skeel has observed that "regulators have rarely if ever intervened in a timely fashion".[71] In fact, he points out that an absence of timely public authority action exhibited itself as far back as the savings and loan crisis in the US in the 1980s.[72] Consequently, lawmakers enacted the Prompt Corrective Action rules, requiring early regulatory intervention. Despite these rules, there was a great deal of room left for regulatory discretion and, therefore, the added rules did not produce a satisfactory regulatory response.[73]

In the case of bail-ins, much has been done to address these issues. The Dodd-Frank Act and the SPOE approach provide for a much more credible and realistic prospect of timely intervention than before, and international agreements on coordinated approaches are currently being developed.[74] In Europe, the emergence of the European Banking Union and its centralised Single Resolution Mechanism (the "SRM") has taken the decision to resolve the largest banks out of the hands of the eurozone member states, hopefully overcoming most national biases and any potential for undue delay on the part of national banking authorities.

Nevertheless, one way that lawmakers could contribute to ensure that resolution authorities intervene on a timely basis would be to clarify the bail-in triggering conditions, to make them mandatory at a certain point (while maintaining flexibility to utilise them even earlier), and to restrict any potential loopholes that remain. At present, the conditions for bail-in are typically relatively vague and discretionary. Specific detail is required to limit regulatory discretion.[75] Another avenue for improvement would be to reduce the number of regulatory agencies or bodies that are involved in the process. These steps are currently underway.[76]

68 This issue has been nicely summarised by Mike Mayo in his book, *Exile on Wall Street – One Analyst's Fight to Save the Big Banks from Themselves* (John Wiley 2012) 148: "The pain of letting one of these institutions go under is almost always too much for politicians and our government to bear."

69 See e.g. Banca D'Italia, *Annual Report 2015 – The Governor's Concluding Remarks* (31 May 2016) 14, available at: https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2016/en-cf-2015.pdf?language_id=1.

70 Ayotte and Skeel (note 66).

71 Skeel (note 66) 323.

72 ibid.

73 See comments of William Lang, Office of the Comptroller of the Currency, 'Research Roundtable: What Can an Examination of Savings and Loans Reveal about Financial Institutions, Markets and Regulation' in James R Barth, Susanne Trimbath and Glenn Yago (eds), *The Savings and Loan Crisis: Lessons from a Regulatory Failure* (Kluwer Academic Publishers and Milken Institute 2004) 340.

74 See, for example, the accord between the FDIC and the Bank of England (note 29). The FDIC is currently negotiating with other regulators worldwide. See Bloomberg Business, 'FDIC's Gruenberg on Resolution Strategy for Banks' (21 November 2013).

75 This is currently being implemented in Europe by way of delegated lawmaking. See e.g. Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 specifying further the circumstances where exclusion from the application of write-down or conversion powers is necessary under article 44(3) of Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms [2016] OJ L144/11.

76 See, for example, the recent Banking Package (note 51).

3.3 Counterparty risk and contagion

A matter related to the issue of credibility is the degree of interconnectedness between financial institutions and its implications for the operation of bail-in. Traditionally, banks tend to hold a significant portion of each other's debt. While this would not be a particular concern in the case of industrial firms, the special character of financial services and the high degree of (other) interconnectedness in the financial sector mean that such cross-participations could be a new source of systemic risk.

3.3.1 Bail-in and systemic risk

To begin with, it is important to note that a bail-in decision may be frustrated by any systemic risk it creates. Bail-out had been implicitly signalled as the last resort for bank rescue during the global financial crisis and remains the only tool available to address systemic risk that cannot be stemmed by bail-in.[77] The more interconnected banks become, the more likely it is that the authorities will resort to a bail-out rather than a bail-in resolution, if bail-in creates further systemic risk. Therefore, banks' appraisals of bank interconnections will likely incorporate the benefits of the same types of moral hazard that apply to a bail-out. The higher the degree of bank interconnectedness, the more likely that the purpose of bail-in may be frustrated, since states are forced to resort to more traditional bank rescue operations, namely bail-outs.

There is, in addition, a more benign interpretation of bank interconnections. Banks are *positively* incentivised to become interconnected to respond to the possible realisation of *small* financial risks, as opposed to systemic risk events. Research has demonstrated that, for coping with small external shocks, a network of interbank links is said to be more robust than a circular chain of interbank links,[78] and larger degrees of interconnections increase the potential of the network to absorb small shocks.[79] Moreover, smaller degrees of financial institution interconnections (a single (central) counterparty – a "star" – in the extreme) increase the amplification of small shocks.[80]

Taking into account these two effects, it appears that banks may retain relative advantages in investing in other banks' capital. Moreover, due to the additional systemic risk induced by interconnectedness, bail-in has separated the market for holding banking liabilities, and counterproductively developed an equilibrium where banking capital liabilities are more attractive to other banks than to non-banks. Banks would be expected to be more likely than non-banks to purchase other banks' securities issuances because they would estimate higher implicit premiums than non-bank investors, from increasing the likelihood of being bailed out; they would, in other words, likely become more interconnected with each other.

77 Reint Gropp, Christian Gruendl and Andre Guettler, 'The Impact of Public Guarantees on Bank Risk-taking: Evidence from a Natural Experiment' (2013) 18 Review of Finance 457.

78 Xavier Freixas, Bruno M Parigi and Jean-Charles Rochet, 'Systemic Risk, Interbank Relations, and Liquidity Provision by the Central Bank' (2000) 32 Journal of Money, Credit and Banking 611.

79 Daron Acemoglu, Asuman Ozdaglar and Alireza Tahbaz-Salehi, 'Systemic Risk and Stability in Financial Networks' (2015) 105 American Economic Review 564.

80 Franklin Allen and Anna Babus, 'Networks in Finance' in Paul Kleindorfer and Jerry Wind (eds), *Network-Based Strategies and Competencies* (Wharton School Publishing 2009) 367.

3.3.2 Evidence

In a separate study, which can only be sketched here, the present author analyses this issue and finds evidence on increased interconnectedness between banks following the introduction of bail-in legislation in the EU.[81] Using data from the Securities Holdings Statistics database of the ECB, the study documents a significant and robust increase of banks' holdings of other banks' securities, relative to non-banks' holdings, following the entry into force of both the bail-in tool under the BRRD and the SRM, which both entered into force on 1 January 2016.

This growing interconnectedness confirms that the regulatory framework must take into account the identity of the counterparties to banking capital. There are relative advantages for banks that invest in other banks, because the bail-in framework does not internalise the systemic risk costs that arise out of counterparty selection. The ensuing incentives create a moral hazard in the selection of banking capital counterparties; banks' best response is to choose to invest in other banks and thereby select more systemic risk than is socially preferred.

Regulators have realised that interconnectedness can potentially undermine the effectiveness of bail-in. The FSB identified this issue early on, and its standards now require resolution authorities to use their prudential tools to restrict large banks' holdings of instruments issued by G-SIBs that are eligible to meet the TLAC requirements.[82] The Basel Committee on Banking Supervision is currently developing a regime that restricts a financial institution's ability to invest in the loss-absorbing capacity of another institution, precisely so that a shock experienced by one firm is not automatically transmitted to the other.[83]

3.4 Liquidity during resolution

Following the experiences of the global financial crisis, it is now generally accepted that during and after any recapitalisation a financial institution will typically experience increased liquidity needs generated by market volatility, uncertainty surrounding asset valuations, and an asymmetry of information regarding the firm's viability.[84]

It is clear that the primary source of liquidity for a bank in resolution should be the institution's own resources and its access to private-sector sources of funding. Growing consensus has emerged, however, that firms in resolution may need to have access, if necessary, to a public backstop for liquidity purposes that would provide temporary funding, promote market confidence and encourage private-sector counterparties to provide funding.[85]

81 Wolf-Georg Ringe and Jatine Patel, 'The Dark Side of Bank Resolution: Counterparty Risk through Bail-in' Working Paper 31/2019 (European Banking Institute 2019), available at: https://ssrn.com/abstract=3314103.

82 FSB (note 4) xii.

83 Lucy Chennells and Venetia Wingfield, 'Bank Failure and Bail-in: An Introduction' (2015) Q3 Bank of England Quarterly Bulletin 228, 237.

84 FSB, *Guiding Principles on the Temporary Funding Needed to Support the Orderly Resolution of a Global Systemically Important Bank ("G-SIB")* (2016), available at: https://www.fsb.org/2016/08/guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-g-sib.

85 ibid.

3.4.1 Existing sources of funding for liquidity purposes

At the outset, it is important to understand that liquidity was initially not a key priority for bail-in. This is because bail-in was originally conceived mainly as a redistribution tool that would shift the loss allocation to the bank's creditors in order to avoid taxpayer rescues.[86] It was only later that bail-in was understood also as a tool that would address investor confidence and stem market panics. The bail-in operation is a technical process. It accomplishes, technically, the writing-down of the firm's losses, and the conversion of long-term unsecured claims of the failed SIFI into equity in the new institution, via administrative action under law.[87] The basic philosophy of bail-in is thus that the financial institution is being *recapitalised*, but importantly it is not given *liquidity*. A sufficiently recapitalised firm, so the theory goes, will then be able to access funding on the market. This is very much the thinking of the FDIC, which noted in its 2013 concept release on SPOE that:

> "It is anticipated that funding the bridge financial company [to which critical subsidiaries would be transferred] would initially be the top priority for its new management. In raising new funds the bridge would have some substantial advantages over its predecessor. The bridge financial company would have a strong balance sheet with assets significantly greater than liabilities since unsecured debt obligations would be left as claims in the receivership while all assets will be transferred. As a result, the FDIC expects the bridge financial company and its subsidiaries to be in a position to borrow from customary sources in the private markets in order to meet liquidity needs."[88]

Still, the FDIC acknowledges that a limited amount of funding would be available through the Orderly Liquidation Fund (the "OLF"), if necessary, for the brief transitional period of reorganisation. The FDIC can supply this temporary liquidity through: (1) a direct cash infusion from the OLF; (2) a drawdown on a Treasury line of credit; or (3) the guarantee of new debt obligations issued by the bank.[89] The FDIC has repeatedly stressed that such funding would not be loss-absorbing. In other words, it may not be used to provide capital support to the institution, but only used for liquidity purposes.[90] Driven by the desire to reduce public support for banks viewed as profligate, the Dodd-Frank Act severely curtailed the ability of the Federal Reserve to provide liquidity assistance to non-bank institutions. It imposed new restrictions in section 13(3) of the Federal Reserve Act. Moreover, the identity of a lender of last resort for financial institutions that have been recapitalised under Title I of the Dodd-Frank Act is unclear.

Over time, liquidity provision during resolution has been focused on by other regulators too. For example, the Bank of England has developed a Resolution Liquidity

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86 Wolf-Georg Ringe, 'Bank Bail-in between Liquidity and Solvency' (2018) 92 American Bankruptcy Law Journal 299, 326-28.

87 See FDIC (note 19) 76,616: "[Long-term] debt in the failed company would be converted into equity that would serve to ensure that the new operations would be well-capitalized."

88 ibid, 76,617.

89 See the Dodd-Frank Act, 12 USC §§ 5384(d), 5390(n)(8)(B), identifying how the FDIC may supply "funds for the orderly liquidation of a covered financial company" and noting that the FDIC may issue contingent liabilities during receivership. As the bridge financial company is incorporated and operated by the FDIC, these obligations are full faith and credit obligations of the US government.

90 Henry Engler, 'FDIC Adds More Flesh to "Single Point of Entry" Resolution Plans, but Questions Remain' (*Reuters Financial Regulatory Forum*, 18 December 2013), available at: http://blogs.reuters.com/financial-regulatory-forum/2013/12/18/fdic-adds-more-flesh-to-single-point-of-entry-resolution-plans-but-questions-remain.

Framework,[91] which would allow a firm that is in resolution to obtain liquidity to smooth the transition to market-based funding, albeit subject to appropriately punitive conditions to minimise moral hazard. This has been explained in further detail in a Memorandum of Understanding that was presented to the UK Parliament.[92]

Within the eurozone, however, the issue of liquidity through a lender of last resort has not been sufficiently addressed. In a recent review of the bank resolution framework, the European Commission stated that the eurozone's facilities such as the Single Resolution Fund (the "SRF") may not be sufficient for their purpose and that further work on this issue would be essential.[93]

Any liquidity provided by an EU member state's public authorities would need to comply with the EU state aid framework, to minimise any distortion of the EU internal market. In addition, an EU financial institution would be expected to make a gradual return to using private-sector sources of funding, as soon as market confidence returns.

3.4.2 The case for lender of last resort funding

Let us revisit the theoretical starting point. Theoretically, after a successful reorganisation via resolution, the bank should be fully capitalised and, thus, solvent. However, there is a difference between capital and liquidity. Assets need to have real and measurable value to provide capital, but they do not necessarily have to be liquid. In other words, both liquid and illiquid assets may count as capital. Consequently, a recapitalisation operation does not necessarily ensure that the institution has access to liquid assets. In order to ensure continuity of business, a recapitalised bank needs to announce a credible liquidity programme before markets open in relevant geographies following the resolution. Where resolution occurs over a weekend – to provide as much time as possible for it to be carried out before any public disclosure is required – such a programme must ultimately be announced before relevant markets open on the Monday morning.

Theoretically, if third parties on the market have sufficient trust in the newly capitalised bank, the solvent institution should be able to convert any illiquid assets into cash and, thus, continue its business unaffected. However, the global financial crisis proved that this was not a realistic expectation in the face of general market panic. Where markets become dysfunctional, even healthy and solid banks may not have sufficient liquidity from private-sector sources.[94] Moreover, empirical research shows that an institution that has recently undergone resolution will still suffer from a lack of investors' short-term confidence in the bank.[95] This would likely lead to significant outflows of deposits. Thus,

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91 Bank of England, *The Bank of England's Approach to Resolution* (October 2017) 22, available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2017/october/the-bank-of-england-approach-to-resolution.

92 HM Treasury, 'Memorandum of Understanding on Resolution Planning and Financial Crisis Management' (October 2017), available at: https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/resolution-planning-and-financial-crisis-management.pdf.

93 European Commission, *Report on the Application and Review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation)* (2019) 7-8, available at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190430-report-bank-recovery-resolution_en.pdf.

94 See Chennells and Wingfield (note 83) 236: "[I]t may be the case that, in the short term, a firm requires liquidity as a temporary backstop if market participants are not immediately willing to lend to it." In fact, the need for lender of last resort functions during normal times and bank financing via the discount window (Federal Reserve) or Emergency Liquidity Assistance (ECB) is proof of the validity of this proposition.

95 Martin Brown, Ioanna S Evangelou and Helmut Stix, 'Banking Crises, Bail-ins and Money Holdings' Working Paper 2017-2 (Central Bank of Cyprus 2017), available at: https://ssrn.com/abstract=3102815.

there is a strong need for a robust lender of last resort to provide emergency liquidity both during and after a bank resolution process.[96] This is a matter that should be entrusted to the central bank, which should be empowered to provide liquidity to a bank both during and after resolution. Liquidity could come from the central bank's public schemes, or be provided on a bilateral, individually tailored basis.

In the US, it is appropriate for flexibility for central bank funding to be permitted. Former Federal Reserve Chairman Ben Bernanke maintains that flexibility in addressing liquidity needs was a crucial component in the successful restoration of market confidence during the crisis.[97] The issue should be addressed in legislation, to make the framework for failing financial institutions more robust in the US.

In the European context, it is appropriate for the ECB to provide liquidity with the objective of ensuring a smooth transition of the recovered bank.[98] The ECB is the only player in the European context with access to unlimited resources and, thus, the only credible provider of a liquidity backstop. At the same time, the ECB should be prohibited from absorbing losses; what is required is quick access to liquidity without any loss-bearing obligations. The ECB should demand that an institution pledge all unencumbered assets it may have.[99]

4. Conclusion

This chapter has sketched the emergence of bail-in as a powerful tool for resolution authorities. As we have seen, the basic idea is sound: to address the implicit rescue guarantee of large banks by their governments, regulators are now equipped with much better and stronger powers that would allocate losses to the private sector. This reintroduces market discipline to large banks, reduces moral hazard and creates stronger incentives for creditors to engage in monitoring. The goals of bail-in have evolved over the few years since it was implemented, moving from only a *redistribution* purpose of sparing taxpayers the need to rescue banks, to include a *market-stabilising* function of stemming panics and avoiding run risks.

However, bail-in frameworks remain incomplete on a number of fronts. The issues to be addressed include, inter alia, formulating appropriate criteria to trigger bail-in measures and to overcome a natural reluctance of resolution authorities to intervene and apply their bail-in powers. There is a strong case for early intervention triggers. Further, liquidity provision during and after resolution is crucial for bail-in to be credible and should be provided by a robust lender of last resort. Finally, the identities of holders of bail-in securities may be a source of systemic risk. After all, bail-in does not remove the risk of bank failure – it simply places such risk on other players in the financial system.

96 ibid.

97 Ben S Bernanke, 'Warren-Vitter and the Lender of Last Resort' (*Brookings Institution Blog*, 15 May 2015), available at: http://www.brookings.edu/blogs/ben-bernanke/posts/2015/05/15-warren-vitter-proposal. See also remarks by Donald Kohn, Brookings Institution, 'The Fed's Role in International Crises' (Speech at Federal Reserve Bank of Dallas Conference: The Federal Reserve's Role in the Global Economy, Dallas, 18 September 2014), available at: https://www.brookings.edu/on-the-record/the-feds-role-in-international-crises.

98 For a discussion of this argument in a different context, see Gordon and Ringe (note 38) 1354. There is nothing in the BRRD or the SRM Regulation that would rule out provision of liquidity by the ECB in the event of resolution.

99 Further, to ensure that the ECB does not incur any losses, the eurozone's SRF could be redesigned to provide additional collateral to the ECB, if needed. See Thomas Huertas and María J Nieto, 'How Much Is Enough? The Case of the Resolution Fund in Europe' (*Vox CEPR Policy Portal*, 18 March 2014), available at: http://www.voxeu.org/article/ensuring-european-resolution-fund-large-enough. The SRF might also guarantee privately sourced liquidity.

IV. INSTITUTIONAL STRUCTURE FOR FINANCIAL REGULATION AND SUPERVISION: WHERE DOES BANK RESOLUTION FIT?

IV. Institutional Structure for Financial Regulation and Supervision: Where does Bank Resolution Fit?

Alexandra Lai and Patrícia Mora*

1. Introduction

The global financial crisis (the "GFC") provided a number of significant insights into how financial regulatory frameworks can be improved.[1] In sections 2 and 3 of this chapter, we examine the evolution of the financial regulatory architecture globally and draw lessons from the GFC for the design of regulatory structure, namely (1) an understanding of the interactions between price stability and financial stability, (2) the need for regulatory structures to incorporate an explicit macroprudential mandate, separate from the objective of safety and soundness of individual financial institutions, and (3) the need for enhanced crisis management frameworks, notably through special resolution regimes for banks and other systemically important financial institutions. An essential ingredient for effective resolution of global financial institutions is cross-border cooperation. Section 4 of this chapter draws insights from economic literature on cooperation and discusses two main strategies for resolving international banks, the single point of entry and multiple point of entry approaches. Section 5 concludes.

2. The structure of financial regulation

Prior to the 1980s, financial regulation tended to be organised along sectoral lines, with separate regulators for banking, insurance and markets (covering securities firms and asset managers, and responsible for preserving market integrity). Prudential and conduct of business regulation[2] were typically assigned to the regulator of each individual sector. This *sectoral* approach to financial regulatory structure reflected financial systems in which banking, insurance and securities business were substantially carried out by separate firms.

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The views expressed in this chapter are solely those of the authors and do not necessarily reflect the views of the Bank of Canada or Banco de Portugal. These views greatly benefited from the authors' participation in the development of regulatory initiatives aimed at increasing the resilience of the bank resolution framework, internationally and in Canada.

1 In this chapter, the term "regulation" covers both regulation (setting rules and guidelines) and supervision (examining institutions and evaluating their compliance with laws and regulations).

2 Prudential regulation focuses on the safety and soundness of individual financial institutions, by requiring these financial institutions to maintain minimum capital and liquidity levels and have adequate risk controls in place, and through restrictions on the activities they may undertake.

Through the 1990s, consolidation in the financial services industry led to financial conglomerates, which combine banking, insurance and securities business under a financial group.[3] Developments, such as the Gramm-Leach-Bliley Act (1999)[4] in the United States (the "US") which repealed the Glass-Steagall legislation[5] and the creation of the euro in 1999, continued to stimulate the wave of consolidation in the financial services industry.

Financial innovation also blurred the sectoral lines, with firms providing complex financial products that incorporated insurance, banking and securities offerings. For example, the securitisation process (in which loans are structured into securities typically underwritten and distributed by investment banks) resulted in non-bank financial firms becoming an integral part of the credit intermediation process. Efforts to capture scale also led to globalisation of banking and increased interconnections, resulting in financial institutions that were large, relative to domestic financial systems and even economies, and which were systemic by virtue of these interconnections. Today, innovation and scale economies continue to be key driving forces in the financial services landscape.

Through the 1980s and beyond, the structure of regulation correspondingly moved towards greater integration. Scandinavian countries (Denmark, Norway and Sweden) and Singapore adopted the integrated model in the 1980s and the adoption of this model around the world increased when the United Kingdom (the "UK") moved to an integrated model in 1997.[6] This model is characterised by a single supervisory agency responsible for the regulation of banks, insurance companies, and securities markets, as well as the conduct of pension and mutual funds. In the majority of integrated regulatory models, the central bank has separate responsibilities for price stability, liquidity insurance for the financial sector, and oversight of payments, clearing and settlement systems. Some jurisdictions (Singapore, for example) have included the integrated supervisory agency within the central bank.

An integrated regulatory model has several advantages. It can promote a comprehensive view of the financial system and reduces the need for interagency coordination. It reduces the regulatory burden for regulated institutions by providing a single point of contact and more consistent regulation, resulting in a level playing field for financial institutions operating across sectors. However, some of its strengths can also be framed as disadvantages. For example, this model is subject to the criticism that a single regulator operating without challenges that may be provided in a model with multiple regulators could become complacent or, in theory, subject to regulatory capture.[7] Also, a level regulatory playing field may not be appropriate

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3 Group of Ten, *Report on the Consolidation of the Financial Sector* (2001). The most important forces encouraging consolidation were (and still are) improvements in information technology, financial deregulation, globalisation of financial and real markets, and increased shareholder pressure for financial performance.

4 See Fred Furlong, 'The Gramm-Leach-Bliley Act and Financial Integration' 10 FRBSF Economic Letters (Federal Reserve Bank of San Francisco, 2000), available at: https://www.frbsf.org/economic-research/publications/economic-letter/2000/march/the-gramm-leach-bliley-act-and-financial-integration.

5 See Julia Maues, 'Banking Act of 1933 (Glass-Steagall)' (*Federal Reserve History*, 2013), available at: https://www.federalreservehistory.org/essays/glass_steagall_act.

6 Korea (1999), Japan (2000), Hungary (2000), Latvia (2001), Austria (2002), Germany (2002), Finland (2003), United Arab Emirates (2003), Belgium (2004), and Poland (2008) adopted the integrated regulatory model. Canada (1987) adopted a variant where one agency is the integrated regulator for federal banks and insurance companies, with a separate securities regulator. Mexico (1999) has an integrated regulator for banks and securities markets, with a separate insurance regulator. Erlend Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' Working Paper WP/09/70 (International Monetary Fund 2009).

7 These disadvantages may be mitigated through internal checks and balances so that various departments within the agency challenge each other. Accountability to government can also reduce the risk of complacency.

if there are a few large and systemic institutions in the financial system that warrant more stringent regulation. Other weaknesses of the integrated model became apparent from some countries' experiences in the GFC. The UK's experience highlighted the fact that conduct of business regulation and prudential regulation may not be a good combination in the remit of a single regulator.[8] The Turner Review acknowledged that the preoccupation of the Financial Services Authority (the then financial services regulator) with conduct regulation led to some failings in its prudential regulation due to insufficient attention and resources being allocated to this mandate.[9] One reason for such bias towards conduct regulation is that conduct of business issues tend to be more publicly visible during normal times.

Today, although many emerging economies with smaller financial sectors continue to have sectoral or integrated financial regulatory structures, most advanced economies have adopted partially integrated models for their financial regulatory structure. Following Bank for International Settlements ("BIS") (2018),[10] we can characterise the main partially integrated, or hybrid, models as the *Twin Peaks* model (Australia, Netherlands, UK) or the *Two Agency* model (China, France, Italy). The Twin Peaks model, first suggested by Taylor (1995), is based on establishing two separate financial supervisory authorities, one specialising in the prudential monitoring of regulated institutions and another on the oversight of business conduct.[11] This model confers independence to the supervisory functions and takes advantage of potential synergies arising from cross-sectoral prudential or business conduct supervision. The Two Agency model is another partially integrated model with two supervisors, but in this case the division of mandates is by type of institutions instead of function. One agency deals with prudential and conduct supervision of the banking and insurance sectors, while the other is responsible for securities firms and markets.

The optimal choice of framework for financial sector oversight hinges on how well these frameworks achieve the objectives of financial stability,[12] safety and soundness of financial institutions, fairness and efficiency of markets, and fair treatment of consumers and investors, by leveraging synergies across regulatory functions, and mitigating conflicts of interest across functions. These are influenced by several factors which include the structure of the financial sector, past experience with financial crises, and legal, historical, cultural and political-economy factors.[13]

3. Lessons from the global financial crisis for regulatory structure

Before the GFC, the main debate on regulatory structure was as to whether prudential supervision should be combined with conduct regulation. Until recently, the prevailing view was that the soundness of the system would be achieved mainly through the

8 Eilís Ferran, 'The Break-up of the Financial Services Authority in the UK' in Robin H Huang and Dirk Schoenmaker (eds), *Institutional Structure of Financial Regulation: Theories and International Experiences* (Routledge 2015).

9 Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (2009).

10 BIS, *Financial Supervisory Architecture: What Has Changed after the Crisis?* (2018) FSI Insights No 8.

11 Michael Taylor, '"Twin Peaks": A Regulatory Structure for the New Century' CSFI No 20 (Centre for the Study of Financial Innovation December 1995).

12 Financial stability is most often defined in relation to the absence of system-wide malfunction in which the financial system fails to perform its basic functions of providing a means of payment and credit intermediation to the economy. The concept also refers to the resilience of a financial system to stress, having self-corrective mechanisms to limit, contain, and deal with the emergence of imbalances before they constitute a threat to the system. For more detail, see World Bank, 'Key Terms Explained: Financial Stability', available at: http://www.worldbank.org/en/publication/gfdr/gfdr-2016/background/financial-stability.

13 BIS (note 10); BIS, *Structural Changes in Banking after the Crisis* CGFS Papers No 60 (2018).

soundness and safety of its individual components, hence, the safety and soundness objective was synonymous with the financial stability objective. The GFC revealed the fallacy of those assumptions, leading to some lessons, namely, (1) the need for a system-wide *(macroprudential)* perspective, (2) the importance of crisis management, not just to deal with fallout from a failure, especially of systemically important financial institutions, but also to ensure the right incentives for market discipline of these institutions, and (3) nations ignore the interactions between price and financial stability at their own peril!

Actions taken to safeguard the soundness of individual financial institutions can undermine the financial system as a whole. In response to funding runs, banks might sell their assets. If many banks do this, it can create a fire sale. Banks may also hoard liquidity as a precautionary measure in times of uncertainty, causing interbank markets to seize up. And when banks curtail lending in order to replenish capital levels, this can create economic losses that can affect the balance-sheet health of other banks, exacerbating their distress and leading, at the extreme, to a broad credit contraction. Hence, it is essential to have a systemic view of banks and how their actions can impact the system. That said, it is just as important to bear in mind that financial institutions other than banks can affect the financial system. Regulatory reforms aimed at enhancing the resilience of regulated institutions can result in some financial activity being driven out of the regulated sector and towards shadow banks, or credit intermediation involving entities and activities being driven outside the regular banking system.[14] This, combined with ongoing product innovation commonly referred to as fintech, can bestow on non-bank institutions increasingly material roles in the credit intermediation process.[15] Hence, regulatory authorities need continuously to assess the appropriateness of the regulatory perimeter.

Although an integrated regulatory model can lead to one agency having a comprehensive view of the financial system, in the past integrated regulators tended not to be assigned explicit macroprudential mandates. While central banks had started to get into the business of systemic risk surveillance starting in the late 1990s (following the Asian financial crisis of 1997-98), they were not assigned policy tools for mitigating systemic risk. Indeed, the prevailing view at that time was that central banks should focus on "mopping up" after a crisis through interest rate policy, rather than on "leaning against the wind" by mitigating a buildup in financial imbalances.

Financial intermediation is an inherently risky business, requiring maturity and liquidity transformation (that is, the provision of long-term illiquid loans funded by short-term liquid liabilities such as redeemable retail deposits or wholesale funding of short duration) by the providers of leverage. Regulators require that banks hold risk-absorbing capital in the form of equity or retained earnings, as well as cash or other highly liquid assets such as government bonds and highly rated debt securities, against the risk that losses to loan books or funding runs materialise.[16] However, regardless of how well-capitalised an institution may be, large losses to the loan portfolio can materialise, for example in the

[14] Financial Stability Board ("FSB"), *Global Monitoring Report on Non-bank Financial Intermediation 2018* (2019).

[15] The FSB defines fintech as technologically enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services. See FSB, *Financial Stability Implications from FinTech: Supervisory and Regulatory Issues that Merit Authorities' Attention* (2017).

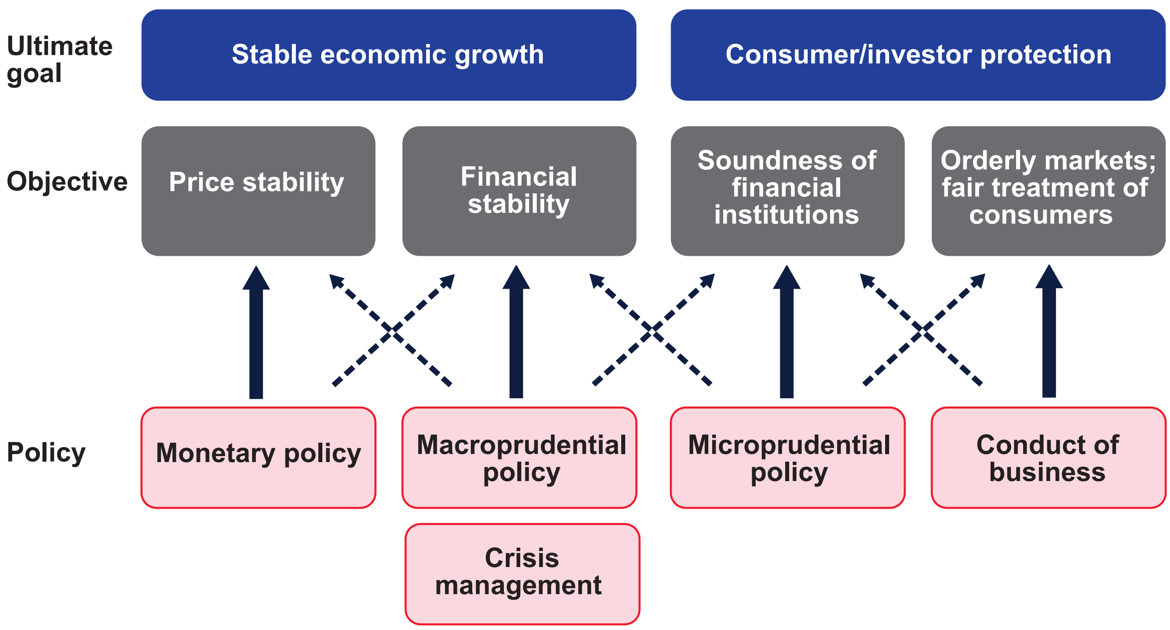
[16] The Basel III framework establishes international standards for minimum capital and liquidity requirements. For details of Basel III, see BIS, 'Basel III: International Regulatory Framework for Banks', available at: https://www.bis.org/bcbs/basel3.htm.

face of an asset price correction ("bursting" of an asset price bubble), underscoring the importance of crisis management (including effective bank resolution).

There are many ways in which price stability and financial stability may interact.[17] Central banks' interest-rate decisions affect both price stability and financial stability, by influencing the cost of financing and hence credit flows. For example, monetary easing in response to deflationary pressures stimulates the economy by encouraging households and businesses to spend or invest more through increased borrowing. This drives up leverage and asset prices in the economy and can lead to a buildup of systemic risk. High levels of indebtedness, on the other hand, reduce the willingness of households to spend out of their disposable income and can constrain the effectiveness of monetary loosening designed to stimulate the economy. On the other hand, macroprudential measures to reduce leverage in the economy, such as stricter mortgage underwriting rules that lenders are required to apply, likely reduces demand for housing, which can have a negative effect on inflation and economic growth.[18]

Drawing on these lessons, there is a different way in which we should view the overall policy framework for the monetary and financial systems. See Figure 1, adapted from Kremers and Schoenmaker (2010),[19] for an illustration of this policy framework. At the bottom, we list various policies, each of which has a primary impact on an objective of financial regulation (solid arrow), as well as secondary impacts on other objectives (dotted arrows). For example, macroprudential policies primarily target financial stability but also affect price stability and soundness of individual financial institutions. To the policies considered in Kremers and Schoenmaker (2010), we add crisis management, within which the resolution of financial institutions is situated.

Figure 1: Policy framework and objectives



17 See remarks by Timothy Lane, Deputy Governor of the Bank of Canada, 'Monetary Policy and Financial Stability – Looking for the Right Tools' (HEC Montréal, 8 February 2016), available at: https://www.bankofcanada.ca/2016/02/monetary-policy-financial-stability-looking-right-tools.

18 Björn Richter, Moritz Schularick and Ilhyock Shim, 'The Macroeconomic Effects of Macroprudential Policies' Working Paper 740 (BIS 2018).

19 Jeroen Kremers and Dirk Schoenmaker, 'Twin Peaks: Experience in the Netherlands' Special Paper 196 (LSE Financial Markets Group 2010).

Monetary policy and macroprudential policy both aim to preserve economic stability in the interest of sustained long-term growth, and both operate by affecting financial conditions primarily through changes in the price and availability of credit. However, each has a different intermediate goal. Monetary policy focuses on achieving economic stability by promoting price stability, while microprudential and macroprudential policies aim to promote financial stability by strengthening and maintaining the resilience of the financial system and reducing the buildup of imbalances.[20] Microprudential policy, by limiting distress of and enhancing the soundness of individual financial institutions, has the ultimate goal of protecting depositors and policy holders. Similarly, conduct of business policy protects consumers of financial services and products through regulation that governs the conduct of financial institutions in the provision of these services and products.

As circumstances can arise where these objectives may be in conflict with each other, it is also necessary to determine a hierarchy among these objectives. The overriding objectives should be price and financial stability, as they are most directly linked to economic welfare. Price stability (or low and stable inflation) has contributed to improving the welfare of households by making economic output less volatile, reducing the severity of employment shocks, protecting the value of household wealth, and encouraging business investment.[21] Research has shown that financial crises tend to have lasting negative effects on economic output.[22] Objectives aimed at individual institutions or consumers should generally be secondary to the system-wide objectives, although one must be cognisant that policies aimed at individual institutions' soundness can also have implications for financial stability, in particular where these regulations are directed at systemically important financial institutions. Safety and soundness of financial institutions, market functioning, and consumer protection can be seen as equally ranked objectives subservient to price and financial stability.

Recognising that financial stability may not be achieved simply by ensuring the soundness of individual financial institutions and that failures of these institutions are possible, regardless of the quality of supervision, reforms in many countries have focused on integrating an explicit macroprudential objective, establishing a policy toolkit aimed at mitigating systemic risk, and introducing a special resolution regime for financial institutions as part of an effective crisis management framework. An important question is then whether central banks, given their roles in systemic risk surveillance and the provision of last resort liquidity, should be given the mandate for the mitigation of systemic risk (along with the policy toolkit for achieving this) and for bank resolution.

Mitigation of systemic risks (or macroprudential regulation) is generally seen as the natural remit of central banks. This is the view taken by most jurisdictions, which have formalised a systemic risk mandate for central banks (with varying powers

[20] Patrícia Palhau Mora and Michael Januska, 'On the Nexus of Monetary Policy and Financial Stability: Is the Financial System More Resilient?' Staff Discussion Paper 2016-12 (Bank of Canada 2016).

[21] Then Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke linked price stability with lower output volatility in 2004 remarks (Meetings of the Eastern Economic Association, Washington DC, 20 February 2004), available at: https://www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm and also articulated the benefits of price stability in a 2006 speech (The Center for Economic Policy Studies, Princeton University, 24 February 2006), available at: https://www.federalreserve.gov/newsevents/speech/bernanke20060224a.htm.

[22] Valerie Cerra and Sweta Chaman Saxena, 'Growth Dynamics: The Myth of Economic Recovery' (2008) 98(1) American Economic Review 439; Stephen Cecchetti, Marion Kohler and Christian Upper, 'Financial Crises and Economic Activity' Working Paper 15379 (National Bureau of Economic Research 2009); Christina Romer and David Romer, 'New Evidence on the Aftermath of Financial Crises in Advanced Countries' (2017) 107(10) American Economic Review 3072.

or tools for achieving that mandate), though a few countries have allotted this responsibility to either their Treasury or a separate supervisory agency. Placing macroprudential regulation within the central bank leverages the central bank's expertise in macrofinancial analysis and its knowledge of financial markets gleaned from the conduct of monetary policy. Given the interactions between monetary and macroprudential policies, a central bank that is also a macroprudential authority may be better able to make effective tradeoffs between price and financial stability. For example, in circumstances where deflationary pressures require a looser monetary policy stance, but low interest rates can incentivise households or corporates to take on debt, increasing systemic risk, it is useful for a central bank to have in its control different policy instruments in the pursuit of both objectives. Finally, operational independence for monetary policy has generally been established for central banks, and one might argue that it would be beneficial to place the authority for macroprudential policy in the hands of a central bank that has established credibility for independent policy decisions. The importance of having an independent monetary authority, authorised to take politically unpopular tightening measures against inflation, has long been recognised, and such independence has been shown to lead to positive outcomes for price stability. Theoretical arguments for central bank independence in the conduct of monetary policy have been articulated by Kydland and Prescott (1977) and Barro and Gordon (1983).[23] Alesina and Summers (1993) and various other authors have established an empirical correlation between central bank independence and price stability.[24] Arguably, a macroprudential authority also requires such independence in order to take countercyclical policy measures, particularly during the upswing of the financial cycle (when the "going is good") when financial vulnerabilities are building up.

The GFC highlighted a dire need for special resolution regimes for financial institutions, particularly those that are systemically important. Questions were raised as to the appropriate placement of resolution mandates within the organisational structure of regulation. Economic literature discusses the potential for bank regulators to exercise regulatory forbearance for various reasons, including time inconsistency (where the incentives to intervene once a financial institution is in distress differ from those in place from an *ex ante* perspective) and reputational considerations.[25] Regulatory forbearance refers to situations where bank regulators allow banks to continue operating with lower capital levels even when it may be socially efficient to close them. This delay in closure typically results in the destruction of the banks' asset values, leading to greater losses for a resolution authority and for private stakeholders in the event of a failure. Even where failure is ultimately avoided, for example by bailing out a bank, social costs may have been incurred due to banks' having taken on excessive risk in anticipation of regulatory forbearance and the resultant socially inefficient allocation of resources. Therein lies a fundamental misalignment of interests between the prudential regulator and resolution authority for banks. The potential cost of regulatory forbearance has

23 Finn E Kydland and Edward C Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans' (1977) 85(3) Journal of Political Economy 473; Robert J Barro and David B Gordon, 'Rules, Discretion and Reputation in a Model of Monetary Policy' (1983) 12(1) Journal of Monetary Economics 101.

24 Alberto Alesina and Lawrence H Summers, 'Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence' (1993) 25(2) Journal of Money, Credit and Banking 151. The issue is also discussed by Stanley Fischer in a 2015 speech, 'Central Bank Independence' (National Economists Club, Washington DC, 9 November 2015), available at: https://www.bis.org/review/r151109c.htm.

25 Mailath and Mester (1994) model how regulatory forbearance can result when a regulator cannot credibly commit to an action (*time inconsistency*). Morrison and White (2010) discuss a case where regulatory forbearance can arise due to reputational considerations to avoid contagious bank failures. George J Mailath and Loretta J Mester, 'A Positive Analysis of Bank Closure' (1994) 3 Journal of Financial Intermediation 272; Alan D Morrison and Lucy White, 'Reputational Contagion and Optimal Regulatory Forbearance' Working Paper 1196 (European Central Bank 2010).

to be balanced against the benefit of leveraging the expertise and knowledge of bank supervisors to carry out resolution. In practice, most jurisdictions mitigate the incentives towards regulatory forbearance by giving deposit insurers the right to withdraw insurance and adopting Prompt Corrective Action ("PCA") frameworks to reduce the bank regulator's discretion in closing banks.[26]

With respect to bank resolution regimes, some jurisdictions have placed resolution powers with a separate resolution authority (e.g. Austria, Canada, the European Union (the "EU"),[27] Finland, Sweden and the US) and allowed either the prudential regulator or the resolution authority to initiate resolution. On the other hand, the majority of EU member countries (regardless of jurisdiction size, suggesting that capacity constraints, including of human capital, may not be first-order) have opted to leverage economies of scale by placing resolution powers within the central bank (which is often also the supervisory agency). The latter institutional model could, in principle, better allow resolution processes to benefit from timely access to supervisory information, but such access may be achieved through appropriate information-sharing mechanisms (e.g. Memoranda of Understanding) between the different authorities. In fact, for countries which have established the resolution authority within central banks that have supervisory functions, it is important to mitigate the risk that the lack of independence of the resolution authority leads to an outcome where resolution considerations become second-order.[28] In such cases, the resolution function should be run independently from supervisory or monetary policy functions, and the authority should have sole decision-making responsibility for the implementation of resolution measures.

To conclude, no one regulatory structure or model has proven superior in terms of avoiding or managing financial crises. Instead some things are important, regardless of how regulation is organised. To be effective, the financial regulatory architecture should provide for:

- *Clarity of roles and mandates,* with each agency given *sufficient powers and resources* to discharge its respective mandate(s). In cases where an agency has multiple mandates, a hierarchy should be established across the mandates. This will aid the agency in resolving any conflicts between its objectives, should such conflicts arise.

- *Comprehensive view of the financial system.* There should be an agency explicitly charged with a macroprudential mandate and a requirement for coordination and information-sharing between regulatory agencies to support a comprehensive view of risks and vulnerabilities to the financial system. The underlying principle is also relevant to regulatory structures featuring an integrated regulator, as the internal organisation of the single regulator (for example, with responsibilities split across sectoral lines across different departments in the agency) can also create silos that

26 PCA frameworks outline transparently the thresholds for bank performance, asset quality, and capital and liquidity levels that can lead to mandatory and discretionary regulatory actions aimed at arresting deterioration in a bank's financial health and resolving the underlying problems that have led to a breach of these thresholds. The primary aim of PCA frameworks is to help supervisors enforce corrective measures in a rule-based manner and reduce the risk of regulatory forbearance.

27 The European Central Bank (the "ECB") is responsible for the supervision of significant institutions, while the Single Resolution Board (the "SRB") has responsibilities in respect of resolution. The ECB is expected to provide all relevant information about a bank to the SRB to help inform its assessment process. The ECB, after consulting the SRB, is responsible for the determination that a bank is failing or likely to fail. However, the SRB can also make such an assessment (upon giving prior notice of such intention to the ECB).

28 FSB, *Peer Review of the Netherlands* (2014).

may impede the development of a comprehensive view without the appropriate coordination and information-sharing across departments.

- *Continuous review of the perimeter of regulation,* to ensure that the structure and scope of regulation remains appropriate given developments in the financial sector.

- *Political independence for regulatory agencies.* As discussed earlier, it is important for monetary authorities to have some degree of independence to take politically unpopular tightening measures, and arguably macroprudential authorities also require independence. Microprudential supervision of large financial institutions should also be insulated from efforts of these institutions to lobby politicians. The existence of operational independence would not detract from the necessity of holding regulatory authorities accountable to sustain their legitimacy in the long run, particularly with regards to the exercise of policy instruments with such far-reaching economic effects as monetary and macroprudential policies. In almost all countries, central banks' accountability is enforced through requirements for regular reporting to the legislative and executive arms of government. Accountability is also enhanced by transparency of regulatory actions through public communications.[29]

- *Cooperation and information-sharing across borders* among home and key host authorities of systemically important financial institutions with global footprints. This is the subject of the next section of this chapter.

4. Cross-border dimensions of resolution

The 29 global banks that have been identified by the Basel Committee on Banking Supervision ("BCBS") in 2018 as systemically important for the global financial system ("G-SIBs") continue to pose the greatest systemic risks due to their complex legal structures, interconnectedness and importance to the home, and some host, countries' economies. This is in part due to the lingering nexus between the stability of a bank or banking system and that of its sovereign. This nexus involves the financial health of banks and sovereigns being tightly intertwined, as vulnerabilities in one of them can spill over to the other via direct exposures to the sovereign, guarantees to the banks, and the macroeconomic channel.[30] In general, there does not seem to be clear evidence of a systemic retrenchment from core credit provision by G-SIBs over the past decade, and in fact some of these banks are now larger in size than they were pre-crisis. According to the Financial Stability Board (the "FSB"), G-SIBs' share in global banking assets has increased from 34 percent in 2017 to 38 percent a decade later, with assets increasing from USD 1.3 trillion to about USD 1.8 trillion.[31] The International Monetary Fund also notes that cross-border claims of domestic banks have increased

[29] Fischer (note 24) and Aikman and others discuss the use of transparency (through regular public reporting) to enhance accountability of monetary and macroprudential authorities respectively: David Aikman, Jonathan Bridges, Anil Kashyap and Caspar Siegert, 'Would Macroprudential Regulation Have Prevented the Last Crisis?' (2019) 33(1) Journal of Economic Perspectives 107.

[30] Increases in sovereign risk result in higher funding costs and uncertainty and may require fiscal consolidation (involving a reduction in government deficits *ex post*), contributing to the weakening of economic activity. The negative impact on the credit quality of loan portfolios in turn has a negative impact on the domestic banking system's stability, creating a feedback loop to the sovereign as well. Giovanni Dell'Ariccia, Caio Ferreira, Nigel Jenkinson, Luc Laeven, Alberto Martin, Camelia Minoiu and Alexander Popov, 'Managing the Sovereign–Bank Nexus' Working Paper 2177 (European Central Bank 2018).

[31] FSB, *Implementation and Effects of the G20 Financial Regulatory Reforms* (2018).

from USD 7 trillion to USD 12 trillion between 2013 and 2017 (while those of foreign banking offices – branches and subsidiaries – remained relatively flat at close to USD 10 trillion).[32]

Cooperation with foreign authorities is necessary to ensure effective resolution of global financial institutions. Despite significant progress having been made in the form of an international standard for resolution regimes[33] – namely, the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes") – and by countries that are home or host to G-SIBs by the introduction of bank resolution regimes aligned with the Key Attributes, less progress has been made to secure international cooperation when it comes to resolving a G-SIB.[34] While we focus our discussion of cross-border cooperation on G-SIBs, the same arguments are applicable in respect of other large international banks.

Existing resolution frameworks are established by national law and, without international cooperation, are enforceable only for the legal entities operating within their own jurisdiction. Actions taken by one jurisdiction can impose costs on others by damaging the critical functions of other entities in the group through the loss of liquidity or of access to important infrastructure. For example, a national regulator may *ring-fence* assets in its jurisdiction, in the sense of preventing cash that materialises in that jurisdiction from being transferred out of the jurisdiction. The lack of coordination can increase overall resolution costs, as we observed in the failure of Lehman Brothers due, partly, to the US and the UK authorities adopting territorial approaches.[35] Cooperative outcomes are almost certain to be superior. Any cooperative framework that mitigates the potential for ring-fencing, and promotes the mutual recognition of actions among authorities, supports financial stability and economic growth. In theory, the existence of an internationally binding statutory framework for bank resolution, with a supranational or global resolution authority that initiates resolution proceedings and manages the process, best achieves this. We admit, however, that this outcome, which entails a loss of sovereignty, is politically challenging in most jurisdictions.

In general, international work has focused on advancing an intermediate approach to cooperation, which acknowledges that individual jurisdictions will act in their own self-interest but still aims to create an environment in which the benefits of cooperating outweigh the benefits of acting unilaterally. Two sets of preconditions are needed to engender a broad move by home and host jurisdictions of G-SIBs towards cooperative outcomes. The first relates to the capacity to cooperate and the second the provision of incentives to cooperate.

Addressing countries' capacity to cooperate is a necessary condition for cooperation. In the first instance, any legal impediments must be removed so that each participating jurisdiction has the ability to share information, recognise resolution proceedings and

32 See International Monetary Fund, *Global Financial Stability Report: A Decade after the Global Financial Crisis: Are We Safer?* (October 2018) ch 1.

33 FSB, *2018 Resolution Report: 'Keeping the Pressure Up'* Seventh Report on the Implementation of Resolution Reforms (2018), available at: https://www.fsb.org/2018/11/fsb-2018-resolution-report-keeping-the-pressure-up.

34 Cross-border supervisory cooperation is generally better established, through supervisory colleges that focus on information-sharing to ensure better supervision and assessment of risks to cross-border banking groups. A report by the BCBS found progress towards enhanced information-sharing and coordinated risk assessment activities in supervisory colleges. BCBS, *Progress Report on the Implementation of Principles for Effective Supervisory Colleges* (2017).

35 For a more in-depth discussion, see Alexandra Lai and Adi Mordel, 'The Resolution of Systemically Important Financial Institutions' (2012) Bank of Canada Financial System Review 37.

measures undertaken by G-SIB's home authorities, and treat all creditors equally, regardless of their location. At a minimum, as required by the Key Attributes, national resolution regimes should not contain automatic triggers leading to actions that could hamper cooperative measures aimed at stabilising or resolving a cross-border financial institution. Full implementation of the Key Attributes – that is, the establishment of credible national resolution regimes in which authorities have adequate powers and resources to resolve a G-SIB, the legal framework to support collective cross-border actions, and an international forum for relevant authorities for the exchange of information and coordination of recovery and resolution measures related to each G-SIB – would largely address this precondition. Of the 11 countries home to G-SIBs as of November 2018,[36] 10 are in almost full compliance with the Key Attributes. China, home to four G-SIBs as of November 2018, is less advanced in this respect, and its resolution regime lacks a number of powers prescribed in the Key Attributes (e.g. to establish a temporary bridge institution, to write down and convert liabilities, to impose a temporary stay on early termination rights, and to resolve bank holding companies).[37]

Absent statutory means for recognising resolution actions across borders, contractual approaches can be helpful. A significant step to improve countries' capacity to cooperate was taken in November 2014, when the International Swaps and Derivatives Association ("ISDA") Resolution Stay Protocol was adopted by the 18 G-SIBs that agreed to be signatories at launch. The protocol, which was later replaced by the ISDA 2015 Universal Resolution Stay Protocol (the "Protocol"), provides for cross-border recognition of stays on financial claims by foreign institutions, regardless of the governing law in the agreement. This gives authorities in the applicable jurisdictions more time to organise an orderly resolution of a troubled bank and can limit the potential for a destabilising funding run.[38] Since its inception, the Protocol has been expanded to cover a broader range of transactions, more countries have been recognised as eligible, and adoption of the Protocol by internationally active derivatives counterparties has become more widespread.[39]

Notwithstanding the capacity to cooperate, authorities in home and host jurisdictions also need to be willing to cooperate. This will be driven by whether incentives are in place to sustain cooperation (the assumption is that economic agents are rational and cooperate only if it is in their best interest to do so). Drawing on the economic literature

36 G-SIB home countries are Canada, China, France, Germany, Italy, Japan, Netherlands, Spain, Switzerland, the UK and the US.

37 FSB (note 33).

38 The aim is to ensure cross-border derivatives trades are captured by statutory stays on cross-default and early termination rights within qualified financial contracts such as swaps and repurchase agreements, in the event a bank counterparty enters into resolution, giving effect to national regulations in some countries. The protocol overrides derivatives market participants' usual contractual rights to exercise default rights in the aforementioned cases.

39 The original 2014 Resolution Stay Protocol recognises the resolution regimes in France, Germany, Japan, Switzerland, the UK and the US as *Identified Regimes*, which allows counterparties to contractually recognise cross-border application of provisions of the resolution regimes in those jurisdictions. The subsequent 2015 Universal Resolution Stay Protocol has been built out with "country annexes", allowing for contractual recognition of cross-border application of provisions of other resolution regimes (those in *Protocol-eligible Jurisdictions*). As of 1 September 2019, country annexes have been established for Hong Kong, Italy, the Netherlands, Spain and Sweden. To extend the applicable treatment under the Protocol (which was intended for G-SIBs), the ISDA Resolution Stay Jurisdictional Modular Protocol has been developed and is intended to be adhered to by most market participants, including buy-side counterparties (i.e. to have adherence that is much broader than just by G-SIBs). As of 1 September 2019, jurisdictional modules have been developed for France, Germany, Italy, Japan, Switzerland, the UK and the US. For more information, see the ISDA website: https://www.isda.org/protocol/isda-2015-universal-resolution-stay-protocol and https://www.isda.org/protocol/isda-resolution-stay-jurisdictional-modular-protocol.

on cooperative games, there are several factors that can incentivise cooperation.[40] Insights from this literature are based on studying repeated versions of the "prisoner's dilemma" game which is a classic example of a situation where two rational players could receive important benefits from cooperating or suffer from the failure to do so, but find it difficult or expensive to coordinate their activities. This is reflected in constructing the game such that each player has a high payoff from both cooperating and the worst payoff when both choose to defect. However, a player gains the most if it chooses to defect while the other player cooperates. Rationality would tend to drive each player to choose defection when the game is played only once. However, theory shows that cooperation may be sustained if the game is repeated under certain circumstances. In particular, cooperative outcomes can emerge if the game is repeated infinitely, or if the number of repetitions is uncertain but is sufficiently large, players' identity is not anonymous and there is a large likelihood that one will interact with the same player in future rounds of the game. In more concrete terms, the incentive to cooperate in the resolution of a G-SIB is higher if home and key host jurisdictions are more integrated (say through trade or the use of a common currency) and where information on past behaviour in relation to resolutions is available. In addition, we would expect cooperation to be more likely when the cost of an uncoordinated resolution is large relative to the cost incurred in a coordinated resolution and the gains to cooperation can be equitably shared among participating jurisdictions.

The legal structure and business model of a G-SIB can affect the gains to cooperation in its resolution. The more integrated is a financial group, due to centralisation of capital, liquidity and risk management or IT services, the more disruptive or value-destroying are uncoordinated resolution actions, and hence the greater the benefit from a coordinated resolution.[41] It would also be important for these benefits to be accrued equitably and in line with the costs incurred by participating jurisdictions in funding the resolution.

The cost of resolution arises in the form of (temporary) financing required to sustain the operations of the bank in resolution and financing required by the resolution authority to undertake various aspects of the resolution itself (e.g. valuation of assets, and compensation to creditors affected by the resolution). In a coordinated resolution led by the home jurisdiction, much of this cost will fall on the home jurisdiction. The fiscal capacity of the home jurisdiction is therefore a factor to consider, despite mechanisms that have been put in place to ensure that private stakeholders participate in the costs of bank resolution. Given the size of G-SIBs relative to their home jurisdictions, host countries may need to contribute to financing a coordinated group-wide resolution. Ideally, an agreement between home and key host jurisdictions should be negotiated for each G-SIB before a crisis, but we recognise this is hard to do. At the minimum, setting out principles for burden-sharing in advance of a crisis will support the adoption of cooperative resolution actions.[42] While such principles would not necessarily constitute legally binding agreements, they would help national authorities to compare the potential costs of undertaking a coordinated approach to resolution versus taking unilateral actions.

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[40] Robert J Aumann, 'Acceptable Points in General Cooperative N-person Games' in RD Luce and AW Tucker (eds), *Contributions to the Theory of Games IV: Annals of Mathematics Studies 40* (Princeton University Press 1959) 287.

[41] Dirk Schoenmaker, 'The Impact of the Legal and Operational Structures of Euro-area Banks on their Resolvability' Policy Contribution No 23 (Bruegel 2016); Patrick Bolton and Martin Oehmke, 'Bank Resolution and the Structure of Global Banks' Working Paper (Columbia University 2016).

[42] Goodhart and Schoenmaker outline several of the forms that burden-sharing agreements can take. Charles Goodhart and Dirk Schoenmaker, 'Fiscal Burden Sharing in Cross-Border Banking Crises' (2009) 5(1) International Journal of Central Banking 141.

Finally, transparency is also needed to sustain cooperation.[43] Adequate preparation and information exchange before and during crises yields benefits by lowering the cost of resolution and building trust. Indeed, the FSB requires crisis management groups ("CMGs") to be established for G-SIBs, as well institution-specific cooperation agreements. CMGs are designed to be the primary forum for information-sharing on crisis preparedness and resolution. Cooperation agreements, if they include sufficient detail regarding the information to be provided in a crisis to other country authorities, and are able to establish, *ex ante*, a mechanism to assess and guide burden-sharing across jurisdictions, could be important tools to foster cooperation. The FSB also requires for each G-SIB a resolution plan that details how critical services provided by a firm and its subsidiaries would be maintained during resolution and how the necessary resolution strategies would be financed.[44] To increase clarity over how the resolution of a G-SIB may play out, two resolution approaches have been articulated by standard-setters and resolution authorities: the *single point of entry* ("SPOE") and the *multiple point of entry* ("MPOE") resolution approaches.

- In SPOE, the banking group is resolved at the ultimate parent holding or operating entity, rather than the local or foreign operating companies facing stress, under the helm of the home resolution authority.[45] The parent company's resources can be used to recapitalise its material operating subsidiaries as needed, through one or both of the downstreaming of capital and the upstreaming of losses. To support an SPOE resolution, internal loss-absorbing capacity should be held at each significant subsidiary or group in key host jurisdictions at levels that would be adequate to absorb severe losses and sustain the operations of these subsidiaries. The FSB has published requirements for the amount of Total Loss-Absorbing Capacity ("TLAC") at each significant subsidiary (*internal TLAC*), in addition to the amount to be held at the overall group level (*external TLAC*).[46]

- In MPOE, there is an *ex ante* recognition that international legal frameworks differ and resolution is a task for multiple national authorities. Outcomes are less materially influenced by the existence, or not, of a coordinated approach across borders, with each authority choosing to apply the most appropriate resolution strategy to the entities in its jurisdiction. Each significant subsidiary or group in key host jurisdictions is required to hold loss-absorbing capacity equal to the FSB's external TLAC requirement.

The SPOE approach to resolution of a G-SIB is more coordinated relative to the MPOE approach. Its success will depend on whether the preconditions exist to support the level of cooperation needed to undertake the SPOE resolution process. Recognising the benefits of a coordinated group-wide approach to resolving a G-SIB, the SPOE approach has been adopted by authorities for all but two G-SIBs. Given the predominance of G-SIBs that are based in the US and the EU (19 out of 29),

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43 In theory, players in the repeated game need to be able to identify who has defected in order to punish the defection (either by imposing a levy or by refusing to cooperate with the defector in future rounds of the game).

44 FSB, *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies* (2013), available at: https://www.fsb.org/2013/07/r_130716b; FSB, *Funding Strategy Elements of an Implementable Resolution Plan* (2018), available at: https://www.fsb.org/2018/06/funding-strategy-elements-of-an-implementable-resolution-plan-2.

45 The SPOE strategy derives primarily from the resolution frameworks adopted in the US and the UK.

46 FSB, *Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs* (2017). Material subsidiaries of G-SIBs which follow an SPOE resolution strategy will be required to hold internal TLAC equivalent to 75 percent to 90 percent of the external TLAC requirements that would apply to the material sub-group if it were itself a resolution group.

we discuss the extent to which these jurisdictions meet the preconditions for cooperation with respect to their capacity and the incentives in place to support an SPOE resolution approach.

Although the US resolution regime is in full compliance with the principles and recommendations of the Key Attributes, national regulators are required to abide by legislation requiring national interests to be given priority.[47] These constraints create important limitations that severely limit the ability of US authorities to support any action that would negatively impact the US operations of a global bank and domestic financial stability, even if that might lead to smaller overall losses. A commitment (preferably binding and negotiated before a crisis) to redistribute the benefits (or costs) of a coordinated resolution in such a way as to ensure a benefit to US interests could be a way forward. However, we are not aware of work in the official sector towards establishing principles for the international sharing of benefits and burdens, or an agreement between states on this.

In the EU, the movement is towards a banking union, in which EU-level authorities are responsible for the supervision and resolution of significant banks headquartered in the EU. The EU framework establishes a regionally binding statutory framework for bank resolution, and as such we expect more cooperative outcomes for banks that operate mainly within the EU. Such framework supports adopting an SPOE approach to resolution for the banks in the EU. However, the banking union is not yet complete, as a common deposit insurance scheme and a common credible backstop to provide funding in resolution are still lacking, so some challenges remain.[48] In the meantime, there is still a significant role for national competent authorities and coordination is needed to ensure a consistent application of rules and equitable outcomes.

Despite the adoption of the SPOE approach for most US- and EU-based G-SIBs, the US and the EU now require that material subsidiaries of foreign banks (with assets above USD 50 billion in the US, and EUR 40 billion in the EU) create intermediate holding companies in the US and the EU respectively, which are subject to more stringent capital, liquidity, leverage, and loss-absorbency requirements. Further, host regulators have been tightening branches' financial, operating and governance requirements to converge with the stricter rules for subsidiaries. Such actions for foreign banking offices may result in incentives leaning towards the adoption of a more MPOE-like resolution strategy for the group. Although there may be benefits from these approaches from a host regulator's perspective, particularly in periods of stress, these actions can lead to higher overall resolution costs across a banking group, and to

47 Saule T Omarova, 'One Step Forward, Two Steps Back?' in Huang and Schoenmaker (note 8).

48 In the EU, liquidity provision, through Emergency Liquidity Assistance, is still the remit of national central banks. Funding for resolution may also be provided by the Single Resolution Fund, but its pre-funded resources are limited and would be insufficient in case of a severe banking crisis, in which case the national governments of EU member states can be expected to assume the main burden (see European Commission, *Report on the Application and Review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation)* (2019) 7, available at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190430-report-bank-recovery-resolution_en.pdf). We have observed some deviations between outcomes in crisis management situations under the EU-wide bank recovery and resolution framework (e.g. in the cases of Banco Popular, and Banca Popolare di Vicenza and Veneto Banca).

fragmented, standalone banking units that do not benefit from cross-border economies of scale and scope in a business as usual context.[49]

5. Conclusion

Post-GFC, financial regulatory structures have evolved to incorporate an explicit macroprudential authority and an emphasis on crisis management, with the latter leading to the establishment of bank resolution regimes in many countries. Most countries have placed the macroprudential mandate with their central banks. In theory, the resolution mandate should be assigned to an authority separate from the supervisory authority, either in a separate authority or within central banks without supervisory functions. In practice, most European jurisdictions have opted to locate their resolution authority in central banks with supervisory functions, relying on internal governance to provide separation between supervisory and resolution functions.

No one regulatory structure or model has proven superior in terms of avoiding or managing financial crises. To be effective, the financial regulatory architecture should provide for clarity of roles and mandates, with sufficient powers, resources and political independence provided to agencies for the discharge of their mandates. In addition, there needs to be an explicit macroprudential authority charged with developing a comprehensive view of the financial system, and supported in this role by appropriate coordination and information-sharing across agencies. Regulatory agencies should continuously review the perimeter of regulation, to take account of developments in the financial sector. Crisis management is crucial and cross-border cooperation is key to effectively resolving internationally active banks, particularly G-SIBs.

Important progress has been made towards promoting the resolvability of banks (at least at the individual jurisdiction level) and fostering the cross-border cooperation needed for the resolution of G-SIBs. The establishment of resolution regimes that broadly align with the Key Attributes, and contractual solutions such as the resolution protocol (including jurisdictional modules and country annexes) developed by ISDA, are key initiatives in this area. However, more progress is needed to increase the likelihood of cooperative outcomes, in line with an SPOE resolution approach, supporting the time consistency of regulatory actions and fostering efficiencies in global banking. One area of particular importance is the quality and depth of cooperation agreements, which, to be effective, should be sufficiently detailed with regards to the level of information to be shared and articulate the principles for burden-sharing across participating jurisdictions to ensure that the gains to cooperation are equitably allocated across parties. Last, and recognising that burden-sharing with private stakeholders is the new normal in bank resolution, it is important that the framework for resolution funding adequately supports authorities' capacity to undertake a bank resolution.

[49] As noted in Patrícia Palhau Mora, 'The "Too Big to Fail" Subsidy in Canada: Some Estimates' Staff Working Paper 2018-19 (Bank of Canada 2018), optimal bank size is uncertain and a matter of debate. Early literature suggests economies of scale are exhausted at USD 50 billion in assets, the current threshold for enhanced prudential oversight in the US under the Dodd-Frank Act (Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376 (2010)), but recent studies suggest that this asset threshold may be higher due to the growing cost of technology and corporate-level costs such as management compensation. For a review of the literature on economies of scale and scope in banking, see Luc Laeven, Lev Ratnovski and Hui Tong, 'Bank Size and Systemic Risk' Staff Discussion Note 14/04 (International Monetary Fund 2014).

V. EUROPEAN UNION: OVERVIEW AND COMPARATIVE PERSPECTIVE

V. European Union: Overview and Comparative Perspective

Lars Westpfahl and Patrick Cichy*

1. Introduction

This chapter provides an overview of the laws of the European Union (the "EU") concerning the resolution of banks. The focus is on the Bank Recovery and Resolution Directive (the "BRRD")[1] and the Single Resolution Mechanism Regulation (the "SRM Regulation").[2] These two legal acts harmonise large parts of the laws concerning the recovery and resolution of banks in the EU and have recently been revised by the Banking Package of May 2019.[3] In addition, the EU laws concerning state aid will be discussed, as these laws can also be of relevance to the resolution of banks. Notwithstanding the harmonisation at the European level, there remains room for differences in the laws of the EU member states (the "Member States").

The chapter is organised as follows: section 2 introduces the regulatory background of the laws of the EU concerning bank resolution. Section 3 describes the BRRD in detail and section 4 covers the SRM Regulation. The EU state aid rules are laid out in section 5. Section 6 examines differences in the way failing banks can be expected to be handled in European countries. Section 7 concludes.

2. Regulatory background

2.1 Lessons from the global financial crisis

The EU laws concerning the recovery and resolution of banks were designed against the backdrop of the global financial crisis.[4] In the course of the financial crisis, it had become clear that the application of regular national insolvency law did not take sufficient account of the specific role and relevance that banks have in the financial sector:

- On the one hand, banks provide essential services for the overall economy (*critical functions*), which – among other things – include the extension of loans to companies and participation in payment systems. If these services had to be discontinued in the event of a bank's failure, this would lead to considerable negative implications for the overall economy.

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

2 Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L225/1.

3 Which includes, inter alia, Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms [2019] OJ L150/226, and Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC [2019] OJ L150/296.

4 See BRRD, recitals 1 to 4.

- On the other hand, banks are typically interconnected, which means that the failure of one bank may threaten financial stability as a whole (*contagion*). In order to avoid this, taxpayers' money had been used widely in the financial crisis to stabilise banks (*bail-out*).

In the EU, the stabilisation of banks with taxpayers' money has adverse consequences, as the economic consequences of failure are no longer borne by the relevant market entity but by government and taxpayers instead.[5] This effect led to undesirable incentives for excessive risk-taking in the financial sector (*moral hazard*), as banks could anticipate being stabilised by the government in the event of their failure.

Moreover, there is a risk of distortion of competition, as individual Member States may have different approaches to bail-outs. While one Member State may be ready to use taxpayers' money to stabilise banks, another Member State may not. As a result, the funding cost of a bank varies with its location, thus contradicting the principle of one *Single European Market*.[6]

2.2 European resolution regime for banks

The main objective of the EU laws is to prevent these negative implications. Taxpayers' money is no longer to be used to stabilise banks; instead investors are to carry the risk of failure (*bail-in* instead of bail-out). That is, the economic consequences of failure are to remain with the relevant market entity which also receives the benefits from operating the business.[7]

At the level of the EU, the most significant legal act concerning the recovery and resolution of banks is the BRRD. The BRRD was adopted in 2014 and applies to all Member States. In addition, the Joint Committee of the European Economic Area (the "EEA") has decided to incorporate the BRRD into the EEA Agreement. However, entry into force of the decision is still pending. Therefore, the three non-EU member states of the EEA (Iceland, Norway and Liechtenstein) are not required to implement the BRRD but may be required to do so in the future. The main goal of the Directive is to provide the Member States with a reliable set of instruments which can be used to intervene where a bank is failing or likely to fail. Through these instruments, threats to financial stability are to be countered without the involvement of taxpayers' money. The BRRD is based on international groundwork and implements central ideas of the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes"), which were adopted by the Financial Stability Board (the "FSB") in 2011 and updated in 2014.

The BRRD is supplemented by the SRM Regulation, which was also adopted in 2014 and applies to the majority, though not to all, of the Member States.[8] The main goal of the SRM Regulation is to harmonise the application, across participating Member States, of the resolution instruments provided for in the BRRD. To this end, the Single Resolution Board (the "SRB") was established and this serves as the competent resolution authority at a supranational level, with overall responsibility for the resolution of banks in participating Member States.[9]

5 See ibid, recital 45.
6 See ibid, recital 9.
7 See ibid, recital 67.
8 See SRM Regulation, art 4.
9 ibid, art 7.

The process of regulation and reform at the European level remains unbroken. This can, for example, be seen by the recent revision of the BRRD and the SRM Regulation. The Banking Package of May 2019 introduces a number of additions and changes to the existing resolution regime.

3. Bank Recovery and Resolution Directive

3.1 General information

3.1.1 Minimum harmonisation

As a Directive, the BRRD was required to be transposed into national law by the Member States. It only has the effect of minimum harmonisation. The Member States were (and remain) entitled to adopt additional or stricter provisions. However, these must not conflict with the BRRD.[10]

3.1.2 Scope of application

The provisions of the BRRD essentially apply to all financial institutions established in the EU. These include investment firms with initial capital exceeding EUR 730,000 and credit institutions. In addition, the BRRD includes provisions in respect of certain financial institutions, financial holding companies, mixed holding companies and branches of institutions established in third countries.[11]

3.2 Core content

The BRRD deals with four main topics. These are: (i) the preparation of recovery and resolution plans; (ii) early intervention; (iii) the definition of resolution tools and powers; and (iv) guidelines for the coordination and cooperation of national authorities.

For these purposes, the Member States were required to establish national resolution authorities.[12] These may be identical to the supervisory authorities. However, supervisory and resolution functions have to be kept separate in terms of organisation and personnel.

3.2.1 Recovery and resolution planning

The BRRD introduces requirements for recovery and resolution plans. The requirements for both plans are part of the *living will* laws. They aim to prevent financial imbalances from an *ex ante* perspective and also form a key component of the Key Attributes.[13]

i. Recovery plan

Pursuant to article 5 of the BRRD, every bank is to be individually responsible for constructing its own recovery plan. The plan should describe measures that can be taken to restore financial stability in the event of a significant worsening in the bank's financial situation.[14] In the plan, various stress scenarios including system-

10 BRRD, art 1(2).
11 ibid, art 1(1).
12 ibid, art 3(1).
13 See Key Attribute 11.
14 BRRD, art 5(1).

wide events have to be taken into account.[15] In order to guarantee the timely application of the envisaged restructuring measures, the plans should contain indicators that can be easily monitored relating to the financial situation. Under article 9 of the BRRD, thresholds have to be set above which the execution of measures defined in the recovery plan has to be considered. However, there is no obligation to actually carry out the recovery measures. The necessary content of the plan is further specified in section A of the Annex to the BRRD.

The bank's recovery plan is then reviewed by the competent supervisor in accordance with article 6 of the BRRD. The competent supervisor is in principle determined by the national legislator. However, supervision for certain Member States is harmonised under the Single Supervisory Mechanism (the "SSM") under the Single Supervisory Mechanism Regulation (the "SSM Regulation")[16] as supplemented by the Single Supervisory Mechanism Framework Regulation[17] (see section 4.1 below). In the review, the supervisor will assess whether the measures are likely to restore or maintain the bank's viability and financial situation.[18] It will also be examined whether the recovery measures can be implemented quickly and effectively while avoiding negative effects on financial stability.[19]

In the event that the supervisory authority detects any material deficiencies or impediments during the assessment, it will request that these be addressed.[20] If no sufficiently revised recovery plan is submitted after the request, the supervisory authority may itself determine the necessary changes to the plan. If these are insufficient in themselves, the supervisory authority may require the bank to indicate changes it may make to its business in order to remedy the deficiencies or impediments to the implementation of the recovery plan.[21] As a final step, the authority itself may determine the nature of the measures to be undertaken.

The recovery plans must be updated at least once a year.[22] For smaller banks, the preparation of the recovery plan is simplified pursuant to article 4 of the BRRD. In the case of banks belonging to a group that is subject to consolidated supervision, a group recovery plan must be drawn up in accordance with article 7 of the BRRD, which is then reviewed by the competent supervisor in accordance with article 8 of the BRRD.

ii. Resolution plan

In addition to a recovery plan, a resolution plan must be drawn up for each bank. Requirements in respect of resolution plans can be found in articles 10 to 14 of the BRRD and articles 8 to 12 of the SRM Regulation. Unlike a recovery plan, a resolution plan will not be drawn up by a bank itself, but by the resolution

15 ibid, art 5(6).

16 Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63.

17 Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141/1.

18 BRRD, art 6(2)(a).

19 ibid, art 6(2)(b).

20 ibid, art 6(5), first subpara.

21 ibid, art 6(6), first subpara.

22 ibid, art 5(2).

authority.[23] However, the bank has to cooperate as much as necessary in its construction.[24] The resolution plan is to be understood as an instruction to the resolution authorities on how to act in a resolution case and is intended to enable them to intervene swiftly in cases where time is of the essence.

During the process of planning, the resolution authority determines the resolution measures that have to be taken if the conditions for resolution are met (see section 3.2.3.ii below).[25] This forward-looking planning is intended to enable timely intervention in the event that the bank is failing or likely to fail. It is particularly important, however, that no extraordinary support from public funds can be implied. The same applies to Emergency Liquidity Assistance ("ELA") or other liquidity assistance provided by the central bank on the basis of non-standardised conditions.[26] The paradigm shift towards the minimisation of the use of public funds is therefore already effected during the process of resolution planning.[27] We will further examine this paradigm shift during the discussion of resolution actions in section 3.2.3 below.

Moreover, the BRRD intends to address the *too big to fail* problem as early as possible.[28] The resolution planning entails an examination of whether the bank is resolvable.[29] Resolvability exists if liquidation is possible within the framework of normal insolvency proceedings or if resolution using resolution measures is possible, without significant negative effects on the financial stability of a Member State.[30]

If the resolution authority determines that the bank is not resolvable, it must notify the bank accordingly.[31] Within four months of receipt of the notification, the bank must then propose measures that enable it to be resolvable.[32] The resolution authority examines whether the proposed measures are suitable in removing the impediments to an orderly resolution.[33] If this is not the case, alternative measures may be required. This may include the limitation of risk positions.[34] Ultimately, the resolution authority has a wide range of powers to intervene in the business of the bank in order to enable it to be resolvable.

Again, special provisions apply to groups. In particular, a group resolution plan must be drawn up which includes the various group entities.[35] The group resolution plan may entail intragroup financial support. Pursuant to article 19 of the BRRD, members of a group may enter into an agreement to provide financial support to any other party to the agreement that meets the conditions for early intervention pursuant to article 27 of the BRRD. The agreement as well as any actual payment are dependent on certain conditions including, inter alia, the authorisation of the

23 ibid, art 10.
24 ibid, art 11.
25 ibid, art 10(1).
26 ibid, art 10(3). See further text at note 48 below.
27 See ibid, recital 31.
28 See ibid, recital 29.
29 ibid, art 15(1).
30 ibid, art 15(1), second subpara.
31 ibid, art 17(1).
32 ibid, art 17(3).
33 ibid, art 17(4).
34 See ibid, art 17(5).
35 ibid, arts 12 and 13.

competent supervisor. However, article 27 of the BRRD does not supersede other grounds for intragroup financial support pursuant to national law.

3.2.2 Early intervention

Articles 27 to 30 of the BRRD provide for *early intervention* powers of the supervisory authorities. Early intervention is intended to prevent the risk of failure at the earliest stage possible. The powers include the possibility of removing the senior management and management bodies[36] and – as a fallback measure – appointing a temporary administrator of the bank.[37] In addition, a supervisory authority has the power to request the implementation of measures laid down in the recovery plan.[38]

These powers may only be applied when the financial situation of the bank has deteriorated considerably, and there is an infringement of certain supervisory requirements or a threat of such an infringement in the near future.[39] The early intervention powers supplement the other abilities of the supervisory authorities to intervene. These include, in particular, supervisory powers provided in the SSM Regulation[40] and national laws transposing the Capital Requirements Directive (the "CRD").[41]

3.2.3 Resolution actions

The main focus of the BRRD is on resolution actions. In the event of a crisis of a bank, the resolution authorities enjoy a wide range of resolution tools and powers in order to preserve the stability of the financial markets. When the conditions for resolution are met (see section 3.2.3.ii below), normal insolvency proceedings may not be commenced without the consent of the relevant resolution authority.[42] When applying the resolution tools and exercising the resolution powers, not only relevant specific provisions but also general principles and resolution objectives have to be taken into consideration.

i. General principles and resolution objectives

The competent resolution authorities are given a relatively wide margin of discretion in the application of resolution actions. However, the discretion granted must be exercised in accordance with, and is limited by, the resolution principles and objectives.

According to article 31(2) of the BRRD, the general resolution objectives are to:

- ensure the continuity of critical functions;
- avoid a significant adverse effect on the financial system (preventing contagion);

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36 ibid, art 28.
37 ibid, art 29.
38 ibid, art 27(1)(a).
39 ibid, art 27(1).
40 SSM Regulation, art 16; see section 4.1 below.
41 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [2013] OJ L176/338. See in particular CRD, art 104.
42 BRRD, art 86.

- protect public funds by minimising reliance on extraordinary public financial support; and

- protect covered deposits[43] as well as client funds and client assets.

It is therefore not in itself an objective to eliminate threats to the survival of the bank. The resolution authorities have to prevent systemic threats, even if this means the liquidation of the bank. Similarly, the objective of obtaining the best possible recovery for creditors – an objective which can be found in numerous national insolvency laws – is not directly reflected in the BRRD.

The objectives have to be met while complying with the following general principles:[44]

- shareholders of the bank under resolution shall bear losses first;

- creditors of the bank under resolution shall bear losses after the shareholders and in accordance with the ranking of their claims under normal insolvency proceedings;

- the management body and senior management of the bank under resolution shall be replaced;

- the management body and senior management of the bank under resolution shall provide all necessary assistance for the achievement of the resolution objectives;

- natural and legal persons shall be held liable, subject to Member State law, under civil or criminal law for their responsibility for the failure of the bank;

- except where otherwise provided, creditors of the same class shall be treated equally;

- no creditor shall incur higher losses than would have been incurred if the bank had been wound up under normal insolvency law (*no creditor worse off than in liquidation* ("NCWOL")); and

- covered deposits shall be fully protected.

The principles and objectives must be observed when implementing the resolution actions. The NCWOL principle is significant[45] and may often be expected to give rise to legal disputes, as in the resolution of the Spanish bank Banco Popular.

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43 This includes depositors covered by the Deposit Guarantee Scheme Directive (Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) [2014] OJ L173/149) and investors covered by the Investor-Compensation Scheme Directive (Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes [1997] OJ L84/22).

44 BRRD, art 34.

45 It can be found in ibid, art 34(1)(g). Its significance is stressed in ibid, recital 5.

ii. Conditions for resolution

The objectives of resolution are also reflected in the conditions for applying resolution actions. In order for the resolution actions to be used, the conditions pursuant to article 32 of the BRRD must first be met.[46] These are specifically:

- Failing or likely to fail.[47]

  A failure exists if the bank is or will, in the near future, be unable to pay its debts or other liabilities as they fall due. Additionally, the bank is failing if the assets of the bank are, or will in the near future be, less than its liabilities. The bank is also failing if it infringes or will, in the near future, infringe the requirements for continuing licensing in a way that would justify the withdrawal of its banking licence by the competent authority. Finally, the use of extraordinary financial support from public funds is regarded as a failure. In this respect, however, there are some conditions under which public support does not lead to the bank being considered failing or likely to fail: the bank must be solvent and state aid must not be used to offset losses that the bank has incurred or is likely to incur in the near future. It also must be compatible with the state aid framework by taking the form of one of the following:

  - A guarantee to back liquidity facilities provided by central banks according to the central banks' conditions. For the eurozone, the European Central Bank (the "ECB") has laid down strict requirements for the provision of ELA to banks. After approval by the ECB, ELA can be granted in exceptional circumstances and on a case-by-case basis by eurozone national central banks. It can only be provided to illiquid but solvent banks and is dependent on adequate collateral.[48]

  - A guarantee of newly issued liabilities.

  - An injection of own funds or purchase of capital instruments (a *precautionary recapitalisation*) at prices and on terms that do not confer an advantage upon the bank, and only to the extent necessary to address a capital shortfall established in the national, EU or SSM-wide stress tests, asset quality reviews or equivalent exercises.[49] The ECB carries out *comprehensive assessments* of banks which it supervises directly under the SSM Regulation (see section 4.1 below) together with the national supervisors, to ensure that banks are adequately capitalised and can withstand possible financial shocks. There are regular as well as ad hoc comprehensive assessments. In each case, the assessment comprises an asset quality review and a stress test performed in close cooperation with the European Banking Authority. The asset quality review is a point-in-time assessment of the accuracy of the carrying value of banks' assets. The stress tests, on the other hand, provide

46 It is, inter alia, possible to take resolution actions vis-à-vis a holding company when one or more subsidiaries meet the conditions for resolution and their assets and liabilities are such that their failure threatens a bank or the group as whole (ibid, art 33(4)).

47 ibid, art 32(1)(a).

48 See ECB, *Agreement on Emergency Liquidity Assistance* dated 17 May 2017, available at: https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf?.

49 BRRD, art 32(4)(d).

a forward-looking examination of the resilience of banks' solvency to two hypothetical scenarios (a baseline and an adverse scenario).

- No reasonable prospect that any alternative private-sector measures including early intervention measures would prevent the failure of the institution in a reasonable timeframe.[50]

- Resolution action is necessary in the public interest.[51] Whether a resolution action is in the public interest depends in particular on whether the objectives of resolution can or cannot be achieved to the same extent by way of normal insolvency proceedings.

While the resolution authority determines whether the latter two conditions are met, in principle the competent supervisor assesses whether a bank is failing or likely to fail. Nevertheless, the national legislator may opt to transfer this determination to the resolution authority provided that it has the necessary tools for making such a determination. Where the conditions for resolution are met, the resolution authority may apply resolution actions at its discretion

The practical application of resolution actions is preceded by a valuation of the assets and liabilities of the bank. This should be carried out fairly, realistically and prudently by a person who is independent of both the bank and the supervisory authority.[52] However, a preliminary assessment by the resolution authority is possible in urgent cases.[53] An *ex post* definitive valuation then has to be conducted as soon as practicable.[54] The valuation serves as a basis for further decisions of the resolution authority in the procedure,[55] including "whether the conditions for resolution or the conditions for the write down or conversion" are met (see section 3.2.3.iii.d below).[56] It also contains information on the subdivision of creditors into classes according to their ranking under the applicable insolvency law, as well as an estimation of the treatment of the individual classes of shareholders and creditors under national insolvency law.[57] This is relevant with regard to the NCWOL principle described in section 3.2.3.i above. Legal action against the valuation cannot be taken in isolation; the valuation can only be challenged together with the resolution tool.[58]

iii. Resolution tools

The BRRD provides for four different resolution tools: (i) the sale of business tool; (ii) the bridge institution tool; (iii) the asset separation tool; and (iv) the bail-in tool. Member States may also introduce further resolution tools, provided that such additional powers do not prevent effective group resolution when applied to a

50 ibid, art 32(1)(b).
51 ibid, art 32(1)(c).
52 ibid, art 36(1).
53 ibid, art 36(9).
54 ibid, art 36(10) and (11).
55 ibid, art 36(4).
56 ibid, art 36(4)(a).
57 ibid, art 36(8). SRM Regulation, art 20(16), requires a valuation to be carried out as soon as possible after resolution for the specific purposes of assessing whether shareholders and creditors would have received better treatment under normal insolvency proceedings. See further section 6.2 below.
58 BRRD, art 36(13).

cross-border group and are consistent with the resolution objectives and general principles (see section 3.2.3.i above).[59]

The tools involving a transfer of business, i.e. the sale of business tool, the bridge institution tool, and the asset separation tool, are remarkable in that the consent of the shareholders to the transaction is not required. Nor is it necessary to comply with the provisions of company and securities law. The instruments differ according to the nature of the legal person of the purchaser. While the sale of business tool is for a transfer to a private purchaser, a bridge institution or the acquiring company in case of an asset separation is to be controlled by the resolution authorities.[60]
In the case of the private-sector solution, the purchaser must agree to the transaction.

a. Sale of business[61]

When applying the sale of business tool, the resolution authorities have the power to transfer shares or other instruments of ownership as well as all or any assets, rights or liabilities.[62] Both an asset deal and a share deal are therefore possible. The transfer takes place on a commercial basis, taking into account the valuation of the institution's assets.[63] There are detailed requirements for marketing.[64] Fair marketing must be carried out by the resolution authority, with no conflicts of interest. There must be neither undue preferential treatment nor discrimination against potential purchasers. The purchase price must be as high as possible and marketing must be carried out quickly.[65] In exceptional cases, however, the resolution authority may refrain from complying with these procedural requirements. The purchaser is solely liable for the transferred liabilities. There are facilitations and accelerated procedures whenever a banking licence is required.[66] Even if the necessary assessments have not yet been carried out, the sale of business may take immediate legal effect. In this case, some caveats exist including, but not limited to, a suspension of the acquirer's voting rights during the assessment.

b. Bridge institution[67]

Additionally or alternatively, a bridge institution may be used. The bridge institution is supposed to maintain access to critical functions and also prepare a sale to one or more private purchasers.[68] The possibility of a transfer to a bridge institution has to be considered, particularly where no willing purchaser can be found in the market. In principle, a resale by the bridge institution should then take place within a period of two years.[69] The bridge institution must be established specifically for this purpose. With regard to what may be

59 ibid, art 37(9).
60 ibid, arts 40(2) and 42(2).
61 ibid, arts 38 and 39.
62 ibid, art 38(1).
63 ibid, art 38(2)
64 ibid, art 39.
65 ibid, art 39(2).
66 ibid, art 38(7) to (9).
67 ibid, arts 40 and 41.
68 ibid, art 40(2).
69 ibid, art 41(5).

transferred, the same possibilities exist as in the context of the sale of business tool.[70] Pursuant to article 40(3) of the BRRD, the total value of liabilities transferred to the bridge institution cannot exceed the total value of the rights and assets transferred to it. As such, it cannot be used as a *bad bank* (in the sense of a vehicle undertaking only non-viable activities). The management body or senior management of a bridge institution have no liability to shareholders and creditors of the institution under resolution in the discharge of their duties, other than in cases of gross negligence or serious misconduct, and Member States may further limit such liability.[71]

c. Asset separation[72]

The bridge institution tool must be distinguished from the asset separation tool. The latter is not used to enable the continuation of critical functions but for the preparation of a sale or the liquidation of the bank, by the transfer to one or more asset management vehicles.[73] The consideration for such transfer can be nominal or negative.[74] This facilitates the establishment of a bad bank, which may increase the attractiveness to potential purchasers of a corporate transaction with the institution under resolution. The separation of assets may only take place in conjunction with another resolution tool.[75] Otherwise, the bank could be financially restructured without investors' participating in the losses. This would be contrary to the principles of the BRRD. The management body or senior management of an asset management vehicle have no liability to shareholders and creditors of the institution under resolution in the discharge of their duties, other than in cases of gross negligence or serious misconduct, and Member States may further limit such liability.[76]

d. Bail-in[77]

- Principles

The bail-in tool plays a central role in the structure of the BRRD.[78] It is supposed to ensure that creditors participate in the bank's losses and the costs of resolution. In this way, a bail-in can be used to recapitalise the bank. The conversion of debt into equity may strengthen the capital base and result in adherence to supervisory requirements relating to own funds which include Tier 1 capital and Tier 2 capital.[79] In connection with a transfer of the bank, bail-in can also capitalise the purchaser. Closely linked to the bail-in tool, but to be distinguished from it, is the power to write down or convert shares or other instruments of ownership.[80] This power is regulated separately and applies under different conditions.[81] The resolution authorities

70 ibid, art 40(1).
71 ibid, art 40(12).
72 ibid, art 42.
73 ibid, art 42(3).
74 ibid, art 42(6).
75 ibid, art 37(5). Other resolution tools may be applied individually or in any combination (ibid, art 37(4)).
76 ibid, art 42(13).
77 ibid, arts 43ff.
78 See ibid, recital 67. It may be used in conjunction with the bridge institution tool (ibid, art 43(2)(b)(i)) or the sale of business or asset separation tool (ibid, art 43(2)(b)(ii)).
79 CRD, art 104.
80 BRRD, art 63.
81 ibid, arts 59 to 62.

may already use this power if the bank is failing or likely to fail, and it is mandatory to exercise it under certain conditions.

- Application in practice

It is possible to convert debt instruments or claims into Tier 1 capital. This is comparable to a debt-to-equity swap, but without the approval of shareholders or creditors being required. On the other hand, the principal amount of a debt instrument or a claim may be written down in whole or in part.

In principle, bail-in is possible for all liabilities. However, some liabilities are excluded from bail-in by law under article 44(2) of the BRRD, including:

- covered deposits;
- secured liabilities;
- liabilities that arise from the holding of client assets or client money, provided that the client is protected under applicable insolvency law, as well as liabilities from certain fiduciary relationships;
- liabilities to banks, excluding entities that are part of the same group, with an original maturity of less than seven days;
- liabilities with a remaining maturity of less than seven days owed to payment and securities settlement systems or their participants arising from participation in such a system;
- certain liabilities to employees, commercial or trade creditors arising from the provision of goods or services that are critical to the daily functioning of their operations;
- liabilities to tax and social security authorities, provided that those liabilities are preferred under the applicable law; and
- liabilities to deposit guarantee schemes arising from contributions due.

In addition, the resolution authority may determine further exceptions in individual cases.[82] Insofar as an exception is applied, this may lead to unequal treatment of creditors who would be otherwise treated equally in normal insolvency proceedings. This violation of the NCWOL principle allows a claim for compensation against the resolution financing arrangement (see section 3.2.3.iv.b below).[83] The resolution financing arrangement may, however, pay the amount due directly to the bank if a total contribution of at least eight percent of the institution's total liabilities has been made as part of the bail-in, and provided the contribution of the resolution financing arrangement does not exceed five percent of the total liabilities.[84]

82 ibid, art 44(3).
83 ibid, art 75.
84 ibid, art 44(4) and (5).

The resolution authority must first calculate the total amount of claims to be included. The amount required to compensate for any existing balance-sheet insolvency, to meet the requirements for Common Equity Tier 1 capital[85] and to meet any additional market expectations with regard to the provision of Common Equity Tier 1 ("CET1") capital, must be assessed.[86] The amount calculated in this way must then be allocated among the creditors. There is a liability cascade in the application of the bail-in; the following order for write-down and conversion applies:[87]

- CET1 instruments;
- Additional Tier 1 instruments;
- Tier 2 instruments;
- other eligible liabilities in accordance with the hierarchy of claims in normal insolvency proceedings.

In order to implement this ranking structure, different conversion ratios will be applied to the different categories of capital instruments and liabilities respectively. A higher conversion ratio will be applied to senior liabilities under national insolvency law. Creditors of equal ranking will, in principle, be treated equally.[88] Own funds are to be cancelled. Only to the extent that the institution has a positive net asset value the instruments of ownership remain, but they will be considerably diluted as a result of the conversion.

▪ Minimum requirement for own funds and eligible liabilities

In order to ensure the effectiveness of a bail-in, the BRRD sets out a *minimum requirement for own funds and eligible liabilities* ("MREL").[89] In the event of a resolution, sufficient eligible liabilities have to be available. In addition to the institution-specific MREL, the parent undertaking of a group has to comply with MREL on a consolidated basis. In this context, third-country subsidiaries of the group must be included. MREL supplements banks' capital requirements.[90]

MREL will be determined by the resolution authority on a case-by-case basis. The resolution authority considers the ratio of own funds and eligible liabilities to total liabilities. A liability is considered eligible if:[91]

- it is issued and fully paid up;

85 See, inter alia, CRD, art 92. The CRD and the Capital Requirements Regulation (the "CRR") (Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms [2013] OJ L176/1) transpose the standards laid down by the Basel III framework. For details of Basel III, see BIS, 'Basel III: International Regulatory Framework for Banks', available at: https://www.bis.org/bcbs/basel3.htm.

86 BRRD, art 46(1) and (2).

87 ibid, art 48.

88 ibid, art 48(2), first subparagraph.

89 vibid, art 45.

90 Under the CRD and the CRR.

91 BRRD, art 45(4).

- it is not owed to, secured by or guaranteed by the bank itself;

- the purchase of the instrument was not funded directly or indirectly by the bank;

- it has a remaining maturity of at least one year;

- it does not arise from a derivative; and

- it does not arise from a preferred deposit in the national insolvency ranking in accordance with article 108 of the BRRD; pursuant to this provision, certain deposits and claims of deposit guarantee schemes must rank higher than the claims of ordinary unsecured creditors in national insolvency law.

It is the responsibility of the institution to ensure that liabilities governed by the law of a third country are effectively eligible. For capital instruments and liabilities issued after 1 January 2015, contractual recognition of potential bail-in must be agreed.[92] The resolution authority may require the bank to demonstrate that a bail-in would be effective under the laws of the third country. If this cannot be demonstrated to the satisfaction of the resolution authority, the liability is not counted towards MREL.

- Business reorganisation plan

  If the bail-in is used to recapitalise the bank, it has to be accompanied by a business reorganisation plan.[93] Financial restructuring should go hand in hand with operational restructuring. The plan must set out how the long-term viability of the institution can be restored within an appropriate timeframe.[94] The plan is subject to approval of the resolution authority. After approval, the plan will be implemented by the management body of the bank.

- Revision of the BRRD

  The revision of the BRRD mentioned in sections 1 and 2.2 above brings about some structural changes in the field of MREL. The core concern of the reform is to harmonise MREL with *total loss-absorbing capacity* ("TLAC") requirements. The TLAC requirements were published by the FSB[95] and have the same objective as MREL. In the event of a bank's failure, sufficient capital should be available to continue its critical functions without the use of public funds and to prevent a threat to financial stability in general. However, the TLAC requirements only apply to global systemically important institutions.

92 ibid, art 55.
93 ibid, arts 51 and 52.
94 ibid, art 52(4).
95 See FSB, *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity (TLAC) Term Sheet* (2015).

iv. Supplementary powers and other measures; financing

Further actions may be required to implement and complement the resolution tools. In this regard, the resolution authorities may use resolution powers. Financing through a resolution financing arrangement is available as a fallback. As a last resort, the BRRD also provides for governmental financial stabilisation tools.

a. Resolution powers

The resolution authorities are granted additional resolution powers to accompany the application of a resolution tool. The resolution powers have to be exercised in compliance with the resolution objectives and general resolution principles (see section 3.2.3.i above).

The BRRD states generally that the resolution authority must have all the powers necessary to apply the resolution tools.[96] A number of powers are specifically emphasised in the BRRD. These include rights to request information, the power to take control of the bank and the possibility to influence the legal relations of the bank with third parties.

In addition, some temporary powers of the resolution authorities are explicitly mentioned. These are:

- a power to suspend certain payment or delivery obligations;[97]
- a power to restrict the enforcement of security interests;[98] and
- a power to temporarily suspend termination rights.[99]

These powers take effect from the moment notice is given until midnight at the end of the following business day. They may be used to ensure financial stability in the short term. Moreover, a resolution authority may provide for continuity arrangements in respect of the bank's business (such as in relation to contracts) to ensure that a resolution is effective and that, where relevant, the business may be operated by a party to whom it has been transferred.[100]

After the revision of the BRRD, article 33a of the BRRD explicitly provides for the possibility of a moratorium, bringing the BRRD in line with the requirements of the Key Attributes.[101] The bank's payment and delivery obligations may be suspended. In contrast to the other powers, the moratorium power may be used even if there is no sufficient public interest for a resolution (see section 3.2.3.ii above) and only the other resolution conditions are met.

[96] BRRD, art 63(1).
[97] ibid, art 69.
[98] ibid, art 70.
[99] ibid, art 71.
[100] ibid, art 64(3).
[101] See Key Attribute 3.2(xi).

b. Financing arrangements

In principle, investors and creditors should bear the costs of the resolution (through bail-in). However, this may lead to claims for compensation by creditors for breach of the NCWOL principle described in section 3.2.3.i above. At the same time, the supply of external liquidity may also become necessary. Article 100 of the BRRD therefore requires each Member State to set up a national resolution financing arrangement.

The permissible use is limited by article 101(1) of the BRRD. It can only be used to:

- guarantee the assets or the liabilities of the bank under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- make loans to the bank under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- purchase assets of the bank under resolution;
- make contributions to a bridge institution or an asset management vehicle;
- pay compensation to shareholders or creditors or directly to the bank in cases where certain creditors are excluded from a bail-in and this would lead to a violation of the NCWOL principle (see section 3.2.3.iii.d above); or
- lend to other financing arrangements on a voluntary basis (see below).

The target level of the financing arrangement of a Member State is at least one percent of the covered deposits of all institutions authorised in its territory. The target level has to be met by 31 December 2024. In order to attain the target level, contributions are required at least annually from the banks (including branches) licensed in the respective territory.[102] The starting point for determining the amount of contributions from a bank is the amount of its liabilities (excluding own funds) less covered deposits compared with the aggregate liabilities (excluding own funds) less covered deposits of all banks licensed in the territory of the Member State. The risk structure of the bank must also be taken into account.[103]

If these *ex ante* contributions are insufficient, there must be extraordinary contributions retrospectively (*ex post* contributions) from the banks authorised in the Member State's territory. The allocation of such *ex post* contributions among banks is on the same basis as the allocation of *ex ante* contributions.[104] As a fallback, alternative funding means must be available. This may include borrowings or other forms of support from banks or other third parties.[105] If

[102] BRRD, art 103(1).
[103] ibid, art 103(2).
[104] ibid, art 104(1).
[105] ibid, art 105.

such alternative funding means are not immediately accessible on reasonable terms, a request to borrow may be made to other financing arrangements within the EU.[106]

c. Government financial stabilisation tools

Although the BRRD's objective is to avoid the use of public funds, such use is not completely excluded. *Government financial stabilisation tools* may be used in accordance with articles 56 to 58 of the BRRD. These include public equity support and temporary public ownership.[107] Each instrument can only be used as a last resort. Accordingly, narrow conditions are laid down for the use of such tools: a contribution to loss absorption and recapitalisation must have been made in the amount of at least eight percent of the total liabilities of the bank by way of a bail-in and/or write-down and conversion of capital instruments,[108] and the use is conditional on prior and final approval under the EU state aid framework (see section 5 below).[109] There is no obligation on Member States to use these tools.

3.2.4 Coordination and cooperation between national authorities

Finally, the provisions of the BRRD concerning the coordination and cooperation between national authorities are important. These are particularly relevant in the case of cross-border groups. For such cases, preserving financial stability requires a coordinated approach to resolution. For this reason, resolution colleges are established.[110] They provide an institutional framework for cooperation between national resolution authorities. Among other things, information is exchanged within the resolution colleges for the purposes of drawing up a group resolution plan and early intervention measures.[111] Close coordination when applying resolution tools may be facilitated through the preparation of a group resolution scheme.[112] If entities of a group are based in different Member States and certain other conditions are met, it is possible to develop a group resolution scheme within the college. However, the national resolution authorities may object to the implementation of the group resolution scheme and determine their own actions. Even then, at least a comprehensive information exchange and coordination of resolution actions must take place.[113]

Under the Credit Institutions Winding-up Directive,[114] which was extended to the EEA, reorganisation measures (and winding up proceedings) of a Member State have to be recognised in the other Member States. This includes actions of a national resolution authority. However, there are some exemptions which concern, inter alia, third parties' rights in rem.[115] For this reason, the BRRD introduces additional provisions regarding cross-border resolutions. In cases where a transfer of business is effected the Member

[106] ibid, art 106.
[107] ibid, arts 57 and 58 respectively. See also the provision for precautionary recapitalisation in ibid, art 32(4), described in the text at note 49 above.
[108] ibid, art 37(10)(a).
[109] ibid, art 37(10)(b).
[110] ibid, arts 88 and 89.
[111] ibid, art 88(1).
[112] ibid, art 91.
[113] ibid, art 91(12).
[114] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions [2001] OJ L125/15.
[115] See ibid, art 21.

State of the resolution authority must ensure that the transfer has effect in or under the law of other Member States in which affected assets are located.[116] However, Member States in which affected assets are located have to cooperate with the resolution authority.[117] The legal rules concerning write-down and conversion powers (including the bail-in) are designed in another way. Here, it is not the resolution authority but the Member State whose laws govern the affected liabilities or capital instruments that must ensure that the principal amount is reduced or that the liabilities or capital instruments are converted.[118] Pursuant to article 93 of the BRRD, the European Council (the "Council") must conclude agreements with third countries that provide for legal recognition. Until then, recognition of resolution actions in third countries is governed by the applicable law of the respective third country. Conversely, there are provisions regarding the recognition of resolution proceedings of a third country and their enforcement in Member States. Recognition or enforcement of third-country resolution proceedings may be refused if:[119]

- recognition would have adverse effects on financial stability;
- independent resolution action, in relation to a branch of the third-country institution in the Member State, is necessary to achieve one or more of the resolution objectives;
- creditors would not receive the same treatment as third-country creditors with similar legal rights under the resolution proceedings;
- recognition or enforcement would have material fiscal implications for the Member State; or
- the effects of such recognition or enforcement would be contrary to national law.

4. Single Resolution Mechanism

4.1 General; regulatory background

The Single Resolution Mechanism (the "SRM") further harmonises the resolution of banks within the EU with regard to certain Member States. Considerable discretion is granted to the competent resolution authority by the BRRD. In the case of cross-border groups, coordination and cooperation takes place, but the national resolution authorities do not necessarily have to agree on a uniform resolution scheme. The purpose of the SRM is to ensure the uniform exercise of discretionary powers and the uniform application of resolution tools.[120] To this end, the SRB is established by means of a directly applicable Regulation. It is a European agency based in Brussels. The SRB is granted far-reaching powers of resolution and acts as a resolution authority at a supranational level. In addition, a supranational resolution fund (the Single Resolution Fund or "SRF") has been set up. In terms of content, the SRB makes use of the instruments laid down in the BRRD. Since the BRRD is not directly applicable and needs to be transposed into national law, and to spare the SRB from having to apply national law, the corresponding powers are again explicitly set out in

116 BRRD, art 66(1).
117 ibid, art 66(2).
118 ibid, art 66(4).
119 ibid, arts 94 and 95.
120 SRM Regulation, recital 11.

the SRM Regulation for application by the SRB. In this respect, the SRM Regulation often mirrors the provisions of the BRRD: these are often repeated with the same wording or reference is made to them. Pursuant to the Banking Package of May 2019, the revisions with regard to MREL – as referred to in section 3.2.3.iii.d above – are implemented in the SRM Regulation.

The SRM is the second pillar of the European Banking Union alongside the SSM.[121] The SSM places *significant* banks in participating countries under the direct supervision of the ECB.[122] The national supervisory authorities remain responsible for supervising the other (*less significant*) institutions in participating countries, except that the ECB may (i) issue general requirements in this regard and receive regular reports (*indirect supervision*) and (ii) exercise direct supervision in respect of banks in participating countries when necessary to ensure consistent application of high supervisory standards. The SSM comprises the ECB and the national supervisory authorities of the eurozone countries. Non-eurozone Member States may participate in the SSM on a voluntary basis (*opt-in*).

The scope of application of the SRM is harmonised with that of the SSM.[123] This means that the SRM does not apply in all Member States. The standards apply to banks in Member States whose currency is the euro and in Member States that have decided to participate voluntarily in the SSM. There are currently no Member States in the latter category. The limited scope of application also follows the consideration that access to the SRF should only exist where the ECB has (direct or indirect) supervisory powers.[124]

The system for the allocation of responsibilities is also based on the SSM model. The SRB has direct responsibility for systemically important banks and groups supervised directly by the ECB. It also covers cross-border groups.[125] Within this framework, the SRB itself makes resolution decisions and adopts resolution schemes. The decisions are then implemented by the national resolution authorities.[126] The national resolution authorities apply the national law transposing the BRRD.[127] For other banks and groups, the national resolution authorities make resolution decisions and draw up resolution schemes.[128] The situation is different where the use of funds from the SRF is planned. The resolution scheme must then be approved by the SRB.

4.2 Single Resolution Board decision-making process

The SRB's decision-making process is complex given that the rules are based on political compromise. In detail, the path to a resolution scheme is as follows:[129]

- Assessment of the resolution conditions: The ECB is responsible for assessing whether a bank is failing or likely to fail (see section 3.2.3.ii above). If the ECB does not make a decision within three days after a request by the SRB, the SRB may itself determine whether this condition has been met. The other requirements

121 See SSM Regulation and SRM Regulation, recital 7.
122 SSM Regulation, art 6(4).
123 SRM Regulation, art 4(1).
124 See ibid, recital 17.
125 ibid, art 7(2).
126 ibid, art 18(9).
127 ibid, art 29(1).
128 ibid, art 7(3).
129 See ibid, art 18.

((i) no prospect that private-sector measures would avert the failure and (ii) public interest; see section 3.2.3.ii above) are assessed by the SRB.

- Adoption of a resolution scheme by the SRB and transmission to the European Commission (the "Commission").
- Assessment by the Commission: The Commission evaluates the discretionary aspects of the resolution scheme. The Commission must transmit the scheme within 12 hours to the Council if it wants to object to it on the ground that the resolution scheme does not pass the public interest test (see section 3.2.3.ii above). The Council must also be involved if the Commission proposes a material modification of the amount of the SRF's contribution provided for in the resolution scheme. The Council then has 12 hours to object to or approve the resolution scheme. With regard to other discretionary aspects of the resolution scheme, the Commission may object or propose modifications on its own. The resolution scheme enters into force if no objection has been raised within 24 hours.
- Instruction of the national resolution authority by the SRB to implement the resolution scheme.
- Implementation of the resolution scheme by the national resolution authority exercising powers under the national law transposing the BRRD.

Special provisions apply if the resolution scheme includes support from the SRF or state aid within the meaning of article 107 of the Treaty on the Functioning of the European Union (the "TFEU"). In accordance with article 19 of the SRM Regulation, the Commission then has to examine the compatibility of the support or aid with the European Single Market.

The decisions of the Commission and the Council are subject to tight deadlines. Resolution can be completed over the course of a weekend.

4.3 Single Resolution Fund

For all participating Member States, the SRF is set up as a resolution financing arrangement.[130] The SRF essentially implements the requirement in article 100(1) of the BRRD that participating Member States establish resolution financing arrangements. The target level amounts to one percent of the covered deposits of all banks licensed in participating Member States, and it is estimated that it will have a total amount of around EUR 55 billion.[131] The fund is managed by the SRB,[132] and its use follows the general principles outlined in section 3.2.3.iv.b above.

The collection and use of contributions, however, is not based solely on the SRM Regulation, but also on an intergovernmental agreement.[133]

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130 ibid, art 67.

131 See https://www.consilium.europa.eu/en/policies/banking-union/single-resolution-mechanism.

132 SRM Regulation, art 75(1).

133 Council of the European Union, *Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund* dated 14 May 2014, available at: http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2010088%202014%20INIT.

The SRF at the outset consists of national chambers, with funds transferred to these chambers from the participating Member States' national resolution funds. The national chambers will be merged in the course of the initial phase. At the end of the initial phase by 31 December 2023, the chambers are dissolved. The financing of the resolution actions is staggered in the following manner:

- Utilisation of the chamber of the Member State in which the bank in resolution was active. There is an upper percentage limit for the utilisation. This will decrease continuously in the course of the initial phase.
- Recourse to the chambers of the other Member States. The recourse is limited on a percentage basis, i.e. the other chambers can only be accessed up to a certain amount. The proportion to which recourse can be made increases during the initial phase.
- Unlimited recourse to the chamber of the Member State in which the bank has operated.
- Collection of (extraordinary) *ex post* contributions from credit institutions in participating Member States.
- Borrowing by the SRB for the account of the SRF.

5. European Union state aid rules

In order to obtain a full picture of the EU law framework for bank resolution, the EU state aid rules have to be taken into account, too. While the state aid rules played an important role during the global financial crisis, they also continue to govern the handling of struggling banks after the adoption of the BRRD and the SRM Regulation. However, their scope of application has changed since the adoption of the BRRD and the SRM Regulation.

During the financial crisis, no formal EU law framework for the recovery and resolution of banks was in place. As such, it was up to national legislators to put in place rules governing resolution. Nevertheless, Member States had to comply with the European state aid rules when they wanted to rely on bail-outs, which was, as noted in section 2.1 above, often the case.

This in turn led to the Commission taking an important role in the handling of failing banks, bringing it into the position of a de facto resolution authority. Pursuant to article 108 of the TFEU, any state aid within the meaning of article 107 of the TFEU may not be put into effect until the Commission – through its Directorate-General for Competition – has taken, or is deemed to have taken, a decision authorising the aid. State aid broadly means an advantage conferred on a selective basis to an enterprise by a national authority. The Commission has to decide whether or not the aid is compatible with the single market.[134] This is the case if, inter alia, the aid is necessary to remedy a serious disturbance in the economy of a Member State.[135] The Commission is granted a wide margin of discretion. During the financial crisis and thereafter, the Commission specified the requirements for state aid to be considered compatible with the single

[134] TFEU, art 107(2) and (3).
[135] ibid, art 107(3)(b).

market by issuing a series of Communications.[136] The Communications laid down comprehensive requirements for the granting of state aid.

The Communications were revised in 2013 by the Commission (in Banking Communication II[137]) which anticipated the adoption of the BRRD and the SRM Regulation. The state aid rules as laid down in Banking Communication II and the BRRD and SRM Regulation follow similar guiding principles, and state aid is seen as a last resort.[138] It has to be limited to the minimum necessary. Moreover, adequate contributions by the beneficiary of aid to the restructuring costs have to be provided; this is known as the principle of *burden-sharing*.[139] Such contributions are to be obtained from holders of equity and subordinated debt, via *bail-in* (not to be mistaken for bail-in under the BRRD and SRM Regulation). Unlike in the case of the BRRD, however, the Commission does not consider a contribution from senior debt holders as a mandatory component of the principle of burden-sharing.[140] Before any capital injection may be effected, a restructuring plan has to be submitted.[141] Distortions of competition must be limited.[142] As a general matter, ways by which the bank can restore long-term viability must be shown,[143] but state aid might also be approved for an orderly wind-down of the bank.

In general, whenever a bank requires public financial support, it is considered failing or likely to fail (see section 3.2.3.ii above).[144] Therefore, the resolution of the bank may be triggered when state aid is granted outside of an existing resolution context. This reflects the paradigm shift from bail-out to bail-in pursued in the BRRD. However, there are (narrow) conditions under which the provision of state aid does not lead to the bank being considered failing or likely to fail (see section 3.2.3.ii above).

In an existing resolution context, the use of state aid is limited as well. Here, the government financial stabilisation tools (see section 3.2.3.iv.c above) may be used. Additionally, recourse to the national resolution funds is possible to provide liquidity for the bank, including as state aid in the context of liquidation (*liquidation aid*). On the other hand, the use of a deposit guarantee scheme to assist in restructuring a bank may constitute state aid.[145] Finally, even though use of the SRF does not constitute

136 See *Banking Communication* (Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C270/8); *Recapitalisation Communication* (Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2); *Impaired Assets Communication* (Communication from the Commission on the treatment of impaired assets in the Community banking sector [2009] OJ C72/1); *Restructuring Communication* (Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules [2009] OJ C195/9); *Prolongation Communication* (Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis [2010] OJ C329/7); Prolongation Communication II (Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis [2011] OJ C356/7).

137 Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis [2013] OJ C216/1.

138 Banking Communication II, para 19.

139 ibid, para 15.

140 ibid, para 42.

141 ibid, para 23.

142 See ibid, para 7.

143 See ibid, para 8.

144 BRRD, art 32(4)(d).

145 Banking Communication II, para 63.

state aid, since it is executed on a supranational level, the state aid rules as laid out in article 107 of the TFEU nevertheless apply pursuant to article 19(3) of the SRM Regulation.

6. Differences between European countries

The BRRD leads to a significant level of harmonisation of bank resolution law in the Member States. The authorities are provided with a comprehensive set of instruments to prevent banks from getting into difficulties and, in the event of a crisis, to carry out a resolution in compliance with the resolution objectives. Still, there remains room for differences in the way failing banks are addressed. The differences are of a factual nature to some extent, resulting from differences in the banking markets of individual Member States. They are also of a legal nature, resulting from continuing differences in the various national bank insolvency laws. It should be noted that the BRRD only has the effect of minimum harmonisation. There is room for additional provisions by the Member States. Furthermore, the national laws on bank insolvency are relevant within the framework of the BRRD.

6.1 Differences in European countries' banking markets

The handling of the resolution law is significantly influenced by the structure of the national banking system. This will be illustrated by reference to four European jurisdictions – Germany, Italy, Spain and the United Kingdom (the "UK") – with a discussion of the general structure of the banking sector, the level of centralisation, and holding structures.

6.1.1 General structure of the banking markets and centralisation

The banking sector can be examined with respect to the share of the public sector. It can also be assessed how centralised the banking market is.

When applying these criteria, the German banking market stands out in particular. It is characterised by a three-pillar system. The banking market is divided into private banks, public savings banks and cooperative banks. This structure is linked to a high degree of decentralisation.[146]

In contrast, the banking sector in the UK is highly concentrated. The banking market is dominated by a few large banks. Three global systemically important banks are located in the UK as of November 2018.[147] Many other international credit institutions are also active there.

The Spanish banking market is divided into Spanish and foreign universal banks, savings banks, and credit cooperatives (rural savings banks). Consolidation has taken place as a result of the financial crisis. Numerous regional savings banks had to close or merge. The three largest banking groups now account for 60 percent of all deposits.[148]

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[146] See Bain & Company, *Deutschlands Banken 2016: Die Stunde der Entscheider* (2016), available at: https://www.bain.com/contentassets/7857d773569343949df3f77e7e6ba86d/bain-studie_deutschlands_banken_2016_ds_final.pdf (in German).

[147] Barclays, HSBC and Standard Chartered; see FSB, *2018 List of Global Systemically Important Banks* (G-SIBs) (2018), available at: https://www.fsb.org/2018/11/2018-list-of-global-systemically-important-banks-g-sibs.

[148] 'Spain – Banking Systems' (*Export.gov*, 21 June 2019), available at: https://www.export.gov/article?id=Spain-banking-systems.

The Italian banking sector is comparable to the German one in some respects. There are numerous regionally active small and medium-sized banks.[149] Although consolidation has taken place since the 1990s, it has not progressed very far. Italy also has a large number of holding companies. A special feature of the banking sector is associated with the relatively limited depth of the domestic capital market: financing is mostly provided by banks. At the same time, Italian banks hold a particularly high percentage of non-performing loans.[150]

The comparison reveals some considerable differences in the banking markets of the individual countries. These differences influence not only the banks' susceptibility to crises, but also the way in which resolution should be carried out, for instance with regard to risks of contagion. Banks with a regional focus might not be as interconnected as large banks dominating the national banking market. In practice, bank resolution will thus vary considerably from one European country to another.

6.1.2 Differences in holding structures

There are also differences in holding structures that have an impact on bank resolution. In countries in continental Europe, both bank holding companies and subsidiaries typically have operational activities. In each unit, at least some of the bank's funding is raised independently. In contrast, in the UK, typically only bank subsidiaries have operational business. Bank funding is generally undertaken at the level of the parent company. The parent company typically holds shares and subordinated capital instruments in the subsidiary.

The latter structure enables a *single point of entry* approach to be adopted in group resolution cases. The shares or capital instruments of the parent company in the subsidiary can be written down or converted. In other respects, there is no effect on the liabilities of the operating subsidiary. The restructuring of external liabilities then takes place at the level of the parent company. If, on the other hand, external capital is raised by each unit, a *multiple point of entry* approach is generally required. A bail-in would need to be applied in each unit.

6.2 Differences in European countries' legal frameworks[151]

Considerable room for national law exists in cases where there is no public interest in the application of a resolution tool (see section 3.2.3.ii above). Here, the national (bank) insolvency law, which is not harmonised by the BRRD nor by the SRM Regulation, applies. The decision whether the insolvency of a bank is governed by general insolvency law or by a regime specific to the insolvency of banks is also taken by the Member States.[152] Individual countries have pursued very different paths in this respect. In Germany, the Insolvency Code, which also governs the insolvency of non-financial companies, applies. The law is only partially modified for banks. For example, the necessary application for insolvency can only be filed by the German supervisory authority. The Italian legislator has gone the other way. In principle, the

149 'Italy – Banking Systems' (*Export.gov*, 15 August 2019), available at: https://www.export.gov/article?id=Italy-Banking-Systems.

150 Corrado Macchiarelli, Renato Giacon, Andromachi Georgosouli and Mara Monti, 'Why Non-performing Loans are Still Putting the European Banking Union at Risk' (*LSE Comment*, 27 March 2019), available at: https://blogs.lse.ac.uk/europpblog/2019/03/27/why-non-performing-loans-are-still-putting-the-european-banking-union-at-risk.

151 This subsection draws on chapters VI, VII, VIII and IX of this book.

152 See BRRD, art 2(1)(47).

national insolvency code does not apply to banks, but a special liquidation procedure (*liquidazione coatta amministrativa*) exists for banks. Its aim is the liquidation of all assets of the bank. However, the continuation of the bank can be permitted in individual cases for the purposes of improving recoveries. There are also special insolvency procedures in the UK for banks. They focus on the protection of deposits and client assets. The national law determines whether and under what conditions these proceedings may be opened.

Apart from the BRRD or before resolution tools are available under the BRRD in a particular case, there may also be room for the application of national procedures. The national law may provide for further (pre-insolvency) restructuring procedures. In Germany, a rehabilitation procedure (*Sanierungsverfahren*) and a reorganisation procedure (*Reorganisationverfahren*) are in place. In the context of a rehabilitation procedure rights of third parties cannot be impaired, but within the framework of a rehabilitation plan new financing can be provided, which would have priority over other insolvency claims in a subsequent insolvency. The reorganisation procedure is comparable to an English scheme of arrangement procedure. However, it is only applicable to avert a threat to financial stability. Neither procedure has gained relevance in practice. In contrast, the Italian pre-insolvency procedure for banks, known as the extraordinary administration procedure (*amministrazione straordinaria*), has played a more important role. The Bank of Italy appoints one or more extraordinary commissioners (*commissari straordinari*) to exercise the functions of the bank's managing body (unless otherwise provided). The commissioners have far-reaching powers, including the possibility of imposing a moratorium.

Finally, national law plays an important role within the framework of the NCWOL principle described in section 3.2.3.i above. No creditor should be worse off than would be the case in hypothetical national insolvency proceedings. This makes the ranking of claims under national law relevant to the resolution of banks. In this respect, there are considerable differences in the laws of individual countries. These relate, for example, to the treatment of employee claims, tax claims and other public-sector claims. The priority of shareholder loans is also handled differently.

However, the priority of claims is at least partly modified by the BRRD. As noted in section 3.2.3.iii.d above, according to article 108 of the BRRD, certain deposits and claims of deposit guarantee schemes must rank higher than the claims of ordinary unsecured creditors. Additionally, a new class (non-preferred senior debt) has been created which ranks lower than other insolvency claims. Apart from this harmonisation, however, the ranking of claims depends on provisions of national law.

6.3 Comparison between the cases of Banco Popular and Veneto Banca and Banca Popolare di Vicenza

A comparison between the resolution of Banco Popular[153] and the cases of Veneto Banca and Banca Popolare di Vicenza[154] illustrates the main points of this section: the way in which a resolution is handled depends on the peculiarities of the individual case and national bank insolvency law as a backdrop.

153 See chapter VIII of this book, section 3.
154 See chapter VII of this book, section 3.

As the Italian bank insolvency law already proved to be effective in handling difficult bank resolutions, the resolution authorities were able to rely on the national procedures. There was found to be no public interest in putting the banks into resolution pursuant to the BRRD. Assets and liabilities – excluding non-performing loans – were transferred to a purchaser under national law. Non-performing loans were transferred to a state-participated company, while the shareholders' rights remained with the liquidated entity. It is noteworthy that prior to and during the liquidation there were questions as to the willingness of the Italian resolution authority to apply the bail-in rules to the two banks. It has been suggested that a bail-in of ordinary creditors might have triggered a systemic crisis and was thus avoided by the resolution authorities.[155]

There was no comparable experience with the Spanish legal framework for bank resolution when Banco Popular was put into resolution. Resolution instruments of the BRRD and SRM Regulation were used to handle the case. The case was special in that there was already a potential purchaser for Banco Popular on the market – Banco Santander. The SRB therefore made use of the sale of business tool: prior to the transfer, the SRB exercised the power of write-down and conversion of capital instruments to address the shortfall in the value of the bank. In particular, all the existing shares (CET1) and the Additional Tier 1 instruments were written down, while the Tier 2 instruments were converted into a new share, which was transferred to Banco Santander for the price of one euro.

7. Conclusion and outlook

The comparison of the underlying conditions for bank resolution in European countries shows that there are a number of differences, both legal and practical. The treatment of a struggling bank will, to some extent, always depend on the particularities of both the local banking sector and national bank insolvency law. However, large parts of bank resolution law have now been harmonised at a supranational level within the EU, particularly in the BRRD and SRM Regulation. This legislation provides a flexible set of instruments to the competent resolution authorities of the EU as well as at the national level. It remains to be seen in which direction the resolution law develops in the future. While certain reluctance to use the bail-in tool has so far been observed, this could change once MREL has been fully implemented in its new form by the revision of the BRRD and SRM Regulation. In this new form, MREL will set out enhanced minimum requirements for own funds and liabilities that can be used for a bail-in and thereby strengthen the effectiveness of the bail-in tool.

[155] Tyler Davies, 'Who's Afraid of the Big Bad Bail-in?' (*GlobalCapital*, 10 May 2016), available at: http://www.globalcapital.com/article/xqrdfvpw1jv9/who-is-afraid-of-the-big-bad-bail-in.

VI. GERMANY

VI. Germany

Sacha Lürken*

1. Introduction

Prior to the 2007-08 global financial crisis (the "GFC"), Germany had no specific law governing the resolution or insolvency of financial institutions, just rules spread among various laws dealing with bank regulation and company insolvency generally; these laws included the transposition of the Credit Institutions Winding-Up Directive.[1]

Between 2008 and 2010, concurrently with many other European nations, Germany enacted several laws aimed at containing the financial crisis and maintaining the stability of the financial system, in particular allowing for a separation of systemically important parts of a bank from its "toxic assets". As a result of that legislation, the Federal Republic incorporated the Financial Markets Stabilisation Agency (Finanzmarktstabilisierungsagentur, the "FMSA"), which in turn incorporated two public law institutions (*Anstalten des öffentlichen Rechts*) as bad banks to acquire the "toxic assets" of German lenders Hypo Real Estate AG (acquired by FMS Wertmanagement AöR) and WestLB AG (acquired by Erste Abwicklungsanstalt AöR).[2]

The Bank Recovery and Resolution Directive (the "BRRD")[3] was transposed into German law under the Act on Restructuring and Resolution (*Sanierungs- und Abwicklungsgesetz*, "SAG"). Following this, the prior laws are generally no longer applicable. One notable exception is the Credit Institution Reorganisation Act (*Gesetz zur Reorganisation von Kreditinstituten*, "KredReorgG"), which provides for proceedings (as yet untested) akin to an English law scheme of arrangement to reorganise a bank's liabilities through votes of creditors and shareholders. Another piece that remained is the option for German Federal states to incorporate bad banks as public law institutions under state law; this option was used to facilitate the sale of the state-owned *Landesbank* HSH Nordbank AG.[4]

In this chapter, the most relevant German laws for bank restructurings are described in further detail. The chapter is organised as follows. Section 2 contains an overview of the legal framework in Germany for bank resolutions. Section 3 describes the deposit guarantee schemes and institutional protection schemes in Germany. Section 4 contains selected case studies of bank resolutions in Germany during the GFC and prior to the coming into force of the BRRD regime.

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1 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions [2001] OJ L125/15.

2 See case studies in section 4 below.

3 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

4 See section 4.1 below.

2. The German legal framework for bank resolution

2.1 Act on Recovery and Resolution (*Sanierungs- und Abwicklungsgesetz*)

SAG is the primary German law on bank resolution, and came into force on 1 January 2015. In line with the BRRD, SAG governs recovery and resolution planning, early intervention powers, and resolution.

2.1.1 Interdependencies with other laws

i. Relationship between the Single Resolution Mechanism Regulation and *Sanierungs- und Abwicklungsgesetz*

Given that the Single Resolution Mechanism Regulation ("SRMR")[5] is directly applicable in Germany and supersedes national law, SAG only applies to bank resolutions where the SRMR is not applicable (see § 1 SAG). The interrelationship between the SRMR and SAG has two elements:

- **Resolution authority:** The national resolution authority, the Federal Financial Services Supervision Agency (Bundesanstalt für Finanzdienstleistungsaufsicht, "BaFin"),[6] is competent for the resolution of *less significant* banks.[7] It also has to enforce the SRB's resolution decisions using its powers under SAG.

- **Applicable law:** As the SRMR supersedes national law, even in cases where BaFin is the competent resolution authority, it will primarily apply the provisions of the SRMR where they are applicable. However, the relevant powers in exercising resolution tools (e.g. to issue an order requiring a failing bank to separate certain assets) are laid out in SAG.

ii. Relationship between the Bank Recovery and Resolution Directive and the *Sanierungs- und Abwicklungsgesetz*

The process to transpose a European Directive into national laws with stricter requirements is colloquially referred to as "gold-plating". Most of the provisions of the BRRD have been transposed into German law via SAG without modification and therefore are not discussed specifically in this chapter. Reference is made to chapter V of this book in relation to the BRRD in general. However, Germany has expressly gold-plated the BRRD as regards the automatic recognition of asset transfers and stay provisions.

- **Recognition of transfers of assets and liabilities (BRRD, art 66; § 153 SAG)**

  Article 66(2) of the BRRD requires European Union member states ("Member States") to provide "reasonable assistance" to ensure that transfers of assets located in Germany or liabilities governed by German law referred to in article 66(1) of the BRRD, if so ordered by a resolution authority of another Member

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5 Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L 225/1.

6 With effect from 1 January 2018, the competence of the FMSA as national resolution authority passed to BaFin.

7 SRMR, art 7(3).

State, are given effect in accordance with national law. This would only have required that German authorities provide assistance with the registration of such transfers. § 153 SAG goes beyond that requirement and provides for automatic recognition of such transfers in Germany, without the need for *exequatur* or other similar act by a German authority.[8]

- **Stay of pending proceedings (BRRD, art 86(3); § 151 SAG)**

  Article 86(3) of the BRRD requires Member States to give resolution authorities the right to request a court to apply a stay of proceedings to which an institution is a party. Germany has gold-plated this provision by applying an automatic stay (§ 151 SAG).

  The Munich Court of Appeal, in a judgment that has been criticised, held in the *HETA Asset Resolution* case that the automatic stay also applies to resolution measures taken by other Member States' resolution authorities.[9]

2.1.2 Recovery and resolution planning

i. Recovery planning

§§ 12-20 SAG[10] transpose articles 5 to 9 of the BRRD into German law. An institution has to draw up and maintain recovery plans ("Recovery Plans") providing for measures to be taken to restore their financial position following a significant deterioration, unless BaFin (with the consent of the Deutsche Bundesbank, the German central bank) has exempted the institution. Institutions that are members of an institutional protection scheme[11] may apply to be exempted, unless they:

- are systematically relevant;
- are supervised by the European Central Bank;
- have assets of more than EUR 30 billion; or
- the value of their assets exceeds 20 percent of Germany's GDP.

An institution has to produce a Recovery Plan within a deadline set by BaFin, which can be extended to up to 12 months. The Recovery Plan needs to be renewed annually, and after any change in the institution's legal or organisational structure, its business activities or its financial situation, or any other change in the general risk situation that may materially impact the Recovery Plan.

[8] § 153 SAG therefore avoids a situation such as that in the case of *Goldman Sachs International v Novo Banco SA* [2018] UKSC 34, where the United Kingdom Supreme Court was asked to consider whether to enforce a (re-)transfer of liabilities made under Portuguese law (though the court in that case ultimately decided that it did not have jurisdiction to hear the claim).

[9] *Oberlandesgericht München, Urt. v.* 25.06.2018 – 17 U 2168/15, BeckRS 2018, 19664.

[10] §§ 12-20 SAG, transposing BRRD, arts 5 to 9, replaced prior national provisions on recovery planning introduced on 7 August 2013.

[11] This applies in particular to savings banks (*Sparkassen*), cooperative banks (*Genossenschaftsbanken*), and *Landesbanken* (see section 3 below).

§ 21a SAG authorises BaFin to issue a regulation on the content of Recovery Plans.[12] BaFin and the Deutsche Bundesbank undertook a consultation on a draft regulation on the minimum requirements for Recovery Plans (*Verordnung über die Mindestanforderungen an Sanierungspläne*, "MaSanV").[13] The consultation period ended on 25 April 2019; so far, no final form of MaSanV has been issued.
§ 19 SAG allows a reduction of the standards for Recovery Plans and the deadlines within which they have to be produced and renewed in consideration of the impact which a failure of an institution would have in relation to its size and the size and complexity of its business activities, its ownership, its legal form, its risk profile and its interconnectedness and membership of an institutional protection scheme.

ii. Resolution planning

§§ 40 to 48 SAG transpose articles 10 to 14 of the BRRD into German law. Articles 8 to 12 of the SRMR apply in addition. BaFin has issued a bulletin with respect to the information to be submitted by institutions for resolution plans[14] A resolution plan must contain, inter alia, a detailed statement on the resolvability of the institution. It must not assume:

- any extraordinary public financial support besides the use of the Single Resolution Fund;
- any central bank emergency liquidity assistance; or
- any central bank liquidity assistance provided on non-standard collateralisation, tenor and interest rate terms.

2.1.3 Restructuring fund

In 2011, Germany introduced the Restructuring Fund Act (*Restrukturierungs-fondsgesetz*) according to which BaFin established the Restructuring Fund for Institutions (*Restrukturierungsfonds für Institute*) to raise contributions from banks for future financial support of failing banks. The contributions raised by the Restructuring Fund are now (and funds raised in prior years were) transferred to the Single Resolution Fund.[15]

2.2 Credit Institution Reorganisation Act (*Gesetz zur Reorganisation von Kreditinstituten*)

In response to the GFC, KredReorgG was passed on 9 December 2010 and became

[12] BaFin had issued a bulletin (*Rundschreiben*) dated 25 April 2014 on recovery plans under the pre-SAG legislation on Recovery Plans, available at: https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Rundschreiben/rs_1403_masan_ba.html (in German).

[13] The draft regulation and guidance on its relation with applicable European regulatory technical standards is available at: https://www.bundesbank.de/de/aufgaben/bankenaufsicht/einzelaspekte/sanierung-und-abwicklung/verordnung-zu-den-mindestanforderungen-an-sanierungsplaene-fuer-institute-und-wertpapierfirmen-masanv--598748 (in German).

[14] BaFin bulletin (*Rundschreiben*) 09/2019, available at: https://www.bafin.de/SharedDocs/Downloads/DE/Rundschreiben/dl_rs_092019_Rundschreiben.pdf?__blob=publicationFile&v=3 (in German).

[15] The German Federal Constitutional Court dismissed a complaint against the Single Resolution Fund and the transfer (*Bundesverfassungsgericht*, judgment of 30 July 2019, cases 2 1685/2014 and 2 BvR 2631/2014).

effective on 1 January 2011. It is coexistent with the resolution tools under the SRMR and SAG. The key difference is that KredReorgG is a bank- and stakeholder-driven process, whereas resolution under the SRMR and SAG is driven by the resolution authorities.

KredReorgG establishes two in-court procedures:

- a "Recovery Procedure" (*Sanierungsverfahren*), which cannot impair creditors' rights directly; and
- a "Reorganisation Procedure" (*Reorganisationverfahren*), which can impair creditors' and shareholders' rights.

Both procedures can be initiated either by the bank itself or by BaFin. Proceedings take place before the Frankfurt Higher Regional Court (Oberlandesgericht Frankfurt). In both procedures, a restructuring adviser (the "Restructuring Adviser") is appointed, who, with court approval, can exercise fairly extensive powers. To date, neither of these procedures has been applied.

2.2.1 Recovery Procedure (Sanierungsverfahren)

The Recovery Procedure is a non-public "self-cure" procedure at the bank's initiative. It requires:

- a notice from the bank to BaFin that it is reasonably likely to fail to comply with its regulatory capital requirements (as set out in § 45 German Banking Act (*Kreditwesengesetz,* "KWG"));[16]
- delivery of a Recovery Plan; and
- a proposal for the appointment of a Restructuring Adviser, who can be a director, employee or adviser of the bank.

The Recovery Plan has to set out the steps by which the bank intends to restructure the bank *without impairing the rights of any third person*. However, a Recovery Plan can provide for "super senior" new money financing in an amount of up to 10 percent of the bank's own funds, which, if approved by the court, has priority over all other unsecured senior creditors in a subsequent insolvency of the bank.

BaFin has to exercise reasonable discretion whether to submit the Recovery Plan to the Higher Regional Court for approval and can also propose a different restructuring adviser. If BaFin submits the Recovery Plan, the court will review it and, unless it finds it *evidently inappropriate*, order the commencement of the Recovery Procedure. The Restructuring Adviser then has the power to supervise the implementation of the Recovery Procedure, which includes the power to inspect books and records and attend management and supervisory board meetings.

[16] The notice may trigger *early intervention* measures by the European Central Bank (under article 16 of the Single Supervisory Mechanism Regulation, Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63) or BaFin (§ 45 KWG; § 36 SAG).

The Recovery Procedure can terminate in three ways:

- by order of the court upon notice by the Restructuring Adviser that the Recovery Plan has been implemented;
- by BaFin exercising its powers under § 45c, 46 or 46b KWG or a resolution authority applying a resolution tool; or
- by petition of the Restructuring Adviser (with the bank's consent) to BaFin to commence a Reorganisation Procedure.

2.2.2 Reorganisation Procedure (Reorganisationsverfahren)

i. General scope

The Reorganisation Procedure is modelled on the German insolvency plan procedure (see section 2.5.3.iii below), which in turn is modelled on the Chapter 11 process of the United States (the "US"). Different from an insolvency plan or Chapter 11 process, it does not extend to all liabilities of the bank (i.e. it is not a universal process affecting all creditors similarly), but can be limited to certain liabilities and/or the bank's shareholders; it is therefore more similar to an English law scheme of arrangement.

It is only available to avert instability of the financial system (§ 1(1) KredReorgG), i.e. it cannot be used for the restructuring of systemically non-relevant banks. Its stakeholder-driven nature is generally considered an impediment to its practical use, as a systemically relevant bank will typically have so many counterparties that organising the relevant stakeholder groups may be so time-consuming that the bank's daily business may be severely affected.

It requires that the bank is *failing or likely to fail* within the same meaning under which resolution tools can be applied. The Reorganisation Procedure could therefore be considered as an alternative to application of a resolution tool, or (given the stakeholder voting) a "private-sector" solution.[17]

The Reorganisation Procedure is semi-public. Notices of the convening of creditors' and shareholders' meetings will be published in the online Federal Gazette (*Bundesanzeiger*), which is accessible to everybody; meetings and documents are open only to affected stakeholders. It is evident that there is a risk of a bank run when these notices are made public. § 13 KredReorgG therefore imposes a standstill of one banking day on the termination of contracts between the bank and its counterparties (including a closeout of derivative contracts, but excluding deposits protected by a mandatory or voluntary deposit protection scheme, as to which see section 3 below). However, one day will practically be insufficient to negotiate a deal with all critical counterparties. In theory, BaFin could impose a moratorium (§ 46g KWG) on the bank's payment obligations to avoid a payment run. Practically though, the moratorium would result in a disruption of the bank's operations that would likely dramatically exacerbate the bank's difficulties. It is therefore a common view in the German market that the Reorganisation

[17] For the purposes of BRRD, art 32(1)(b).

Procedure is unlikely to have any substantial practical scope. It can only be useful in cases where a deal has been pre-agreed with critical counterparties before the bank enters the Reorganisation Procedure, a course of events that seems unlikely to be achievable in a bank that is systemically important.

ii. Procedure

Only BaFin has standing to file the required petition for a Reorganisation Procedure with the Higher Regional Court. BaFin will make a filing:

- if a Recovery Procedure has previously been initiated, at the Restructuring Adviser's request (with the consent of the bank); or
- upon the bank's request, if the bank deems a prior Recovery Procedure not to be successful (i.e. effectively because an impairment of third parties' rights is necessary to resolve its issues).

The bank has to submit a "Reorganisation Plan" (the "Plan") together with the petition. The plan has to provide for classes, but only with respect to those stakeholders that are to be impaired. Classes are determined according to the stakeholders' legal position. This means that (if they are to be impaired) a Plan must at least separate out the following classes:

- secured creditors;
- unsecured preferred senior creditors;
- unsecured *non-preferred senior* creditors;
- unsecured creditors subordinated by law (with one class for each category of subordinated liability);
- contractually subordinated creditors; and
- equity.[18]

The Plan may provide for additional classes of creditors classes if necessary to distinguish between creditors with the same legal rights but different economic interests, e.g. unsecured financial and trade creditors.

Deposits secured by a deposit protection scheme, employee liabilities and pension liabilities cannot be impaired.

Creditors vote in a creditors' meeting. The Plan is accepted if, in each class, a majority (50 percent) by amount and by number of creditors present in the meeting votes in favour.

Shareholders vote in an extraordinary general meeting ("EGM"), where a majority of 50 percent of shares is generally sufficient. However, 66⅔ percent are

[18] See generally section 2.5.3 below regarding the ranking of claims, and specifically Figure 3, 'Liabilities Subordinated by Law (§ 39(1) InsO)', for the five categories of subordinated liabilities referred to here.

required if new shares are to be issued and existing shareholders are excluded from subscription rights; that requirement falls back to 50 percent if a quorum of shareholders representing 50 percent of share capital has been reached.

If those majorities are not reached, the court can still confirm the Plan (and enforce a cramdown) if:

- a majority of classes has voted in favour;
- the Plan does not put non-consenting classes into a worse position than they would be without the Plan;
- no creditor receives any value in excess of its par claim;
- no creditor ranking equally with a creditor in a non-consenting class receives more value; and
- if the class of shareholders has not accepted the Plan, the Plan provides for reasonable and appropriate measures to avoid instability in the financial system.

The court will confirm the Plan if:

- the Plan substantially complies with all legal requirements, in particular with regard to class formation;
- the Plan has been accepted in the creditors' meeting with the majorities required, as set out above;
- the accepting vote was not subject to undue influence (e.g. through financial inducement to vote); and
- no creditor has objected, or, if a creditor has objected:
  - the objecting creditor has not provided prima facie evidence that it would likely receive less value under the Plan than without the Plan (*best interests* test); and
  - collateral is provided to compensate the creditor for the difference between what it receives under the Plan and what it would recover without the Plan.

Creditors have no rights of appeal against confirmation of a Plan by the court. Shareholders can appeal the EGM resolution, but even if the EGM resolution is revoked, the court can still cram down the shareholders.

2.3 Financial Market Stability Law Package 2008-09 (*Finanzmarktstabilisierungsgesetze*)

In an effort to contain the effects of the GFC on German systemically relevant banks, Germany passed several laws between October 2008 and October 2009. The most relevant of the provisions for present purposes were:

- the amendment of the balance-sheet insolvency test;[19] and
- the establishment of the FMSA, a government agency, to manage the Financial Market Stability Fund (*Finanzmarktstabilisierungsfonds*, "SoFFin"), a trust (*Sondervermögen*).

SoFFin had the authority to grant *stabilisation measures*, which included:

- granting of guarantees;
- subscription of Common Equity Tier 1 ("CET1") and Additional Tier 1 ("AT1") capital instruments;
- acquisition of risk positions;
- carve-out of risk positions into bad banks held by SoFFin; and
- expropriation of capital instruments.

Most stabilisation measures have become inapplicable effective as of 31 December 2014 after transposition of the BRRD. One notable exception is that bad banks can still be established (and their privileges[20] used) by a German Federal state (§ 8b Financial Markets Stabilisation Fund Act (*Finanzmarktstabilisierungsfondsgesetz*, "FMStFG")). This has been used, for example, to carve out a portfolio of non-performing shipping loans from HSH Nordbank AG ("HSH Nordbank") to HSH Portfoliomanagement AöR, a bad bank owned by the states of Hamburg and Schleswig-Holstein (see section 4.1 below).

2.4 Regulatory powers for banks in *special situations* under *Kreditwesengesetz*

KWG is the main German legislation regulating the financial sector. It provides for certain regulatory powers in *special situations.* These powers are co-existent with the resolution authority's *early intervention* powers, so both authorities can exercise their powers at the same time. The governmental authorities for enforcing KWG and certain other regulatory provisions are BaFin and the Deutsche Bundesbank.

Figure 1 sets out some of the more relevant powers of BaFin and other authorities, for present purposes, under KWG.

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19 The balance-sheet insolvency test (under § 19 Insolvency Code (*Insolvenzordnung*) has always been and still is a two-tier test of liabilities versus assets and the company's going-concern status. Under the old test, if the value of a company's liabilities exceeded the value of its assets, it was insolvent; the question whether it was a going concern was only relevant for the valuation of the assets. Under the amended test, even if liabilities exceed assets, the company is still solvent as long as it has a positive going-concern forecast (i.e. is forecast to remain solvent). The amended test is still in effect (see section 2.5.2 below).

20 § 8a(5) FMStFG exempts bad banks from the requirement to hold a banking licence. § 8a(8) FMStFG exempts *bad banks* from various provisions of German law protecting shareholders' or creditors' rights in a corporate reorganisation, for instance (i) the requirement to have the demerger agreement audited and (ii) the joint liability of the transferor (*good bank*) in respect of liabilities transferred to the bad bank. It also reduces the required majority of shareholder votes for approval of the demerger agreement from 75 percent to 66⅔ percent (and to 50 percent if a quorum of 50 percent of shareholders is present).

Figure 1: Powers of BaFin and other authorities

Legal provision	Short description	Requirements	Actions
§ 45 KWG	Actions to increase own funds or liquidity	If it can be expected that due to the assets, financial condition, profit situation or other circumstances of a bank, the bank will not sustainably comply with capital requirements under the Capital Requirements Regulation (the "CRR")[21] or KWG	BaFin can instruct the bank to take all necessary actions, in particular: - to deliver a business plan covering three or more years; - to review, and report on, risk positions; - to report on actions to strengthen CET1, own funds and liquidity: - to submit a Recovery Plan; and - if the above are not sufficient to address sustainable compliance with capital requirements, any of the actions below
		Bank does not comply with capital requirements	Inter alia: - a ban on dividends or AT1 instruments; - a ban on dissolution of capital reserves; and - restrictions on bonuses
§ 45 c KWG	Appointment of a special commissioner	Deficiencies in management or other corporate bodies	Special commissioner assumes role of managing director or other corporate body
		Repeated regulatory breaches	Special commissioner can take all appropriate risk management measures
		Breach of regulatory capital requirements	Special commissioner can draft restructuring plan or supervise its implementation
		BaFin has issued regulatory orders against bank	Special commissioner can supervise implementation of orders issued by BaFin
§ 46 KWG	Actions in case of risks for creditors	Impairment of bank's ability to honour its liabilities	BaFin can take all appropriate actions, including: - restrictions on payments, transfers, credits or acceptance of payments and deposits; - a ban on directors from acting on behalf of bank; and - instructions regarding bank's operations
§ 46 g KWG	Moratorium	Financial difficulties threatening to impair economic stability	The Federal Government can: - order a moratorium, i.e. grant the bank a deadline to meet its obligations and block creditors' process or insolvency proceedings; - close the bank or parts of its business; and - suspend stock-exchange trading

[21] Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms [2013] OJ L176/1.

2.5 Insolvency Code

2.5.1 Introduction

Germany has no special laws for insolvencies of banks. As with any other corporate or personal insolvency, insolvency proceedings for banks are governed by the Insolvency Code (*Insolvenzordnung*, "InsO"). However, certain provisions of InsO are only applicable to banks (such as § 104 InsO (exempting closeout netting provisions in derivatives contracts from the general rules on rejection of executory contracts) and § 166(3) InsO (exempting financial collateral from the administrator's collection powers). A bank will be subject to insolvency proceedings if the resolution authorities do not avoid an insolvency through resolution action (i.e. if they do not find there to be a public interest in maintaining the bank as a going concern) and if the bank cannot in another way avoid an insolvency.

2.5.2 Petition for insolvency proceedings

A German bank's directors must, within three weeks, notify BaFin (§ 46b(1)2 KWG) if the bank is:

- cash-flow insolvent (*zahlungsunfähig*);
- balance-sheet insolvent (*überschuldet*); or
- imminently cash-flow insolvent (*drohend zahlungsunfähig*) (§ 18 InsO).

Cash-flow insolvency (*Zahlungsunfähigkeit*) (§ 17 InsO) means that the bank cannot pay its liabilities then due. The amount of liabilities due is determined based on the liabilities due on the testing date and falling due within the next three weeks as compared to the cash and cash equivalents generated within the three-week period. At the end of the period, the coverage ratio of cash and cash equivalents to liabilities due must be at least 90 percent, otherwise the bank is cash-flow insolvent.

Balance-sheet insolvency (*Überschuldung*) (§ 19 InsO) means that the bank's liabilities exceed the fair value of its assets, unless it is more likely than not that the bank can continue as a going concern (the latter test being known as the *going-concern prognosis*). A positive going-concern prognosis requires that the bank will more likely than not be able to pay all its liabilities as and when they fall due within the forecast period. The forecast period is generally assumed to cover at least the current and the next financial year. If it can already be anticipated that material liabilities will become due after that period (e.g. with the maturity of substantial financial indebtedness), the forecast period needs to extend until the date they are anticipated to become due. Given uncertainty around estimating likelihoods of future cash flows, directors have to carefully document the factual bases for their assessments.

Imminent cash-flow insolvency (*drohende Zahlungsunfähigkeit*) (§ 18 InsO) is broadly similar to a negative going-concern prognosis (see above), i.e. is given if a bank will more likely than not be unable to pay all its liabilities as and when they fall due within the forecast period of generally at least the current and the next financial year.

Unlike in the case of non-bank businesses, BaFin has the exclusive standing to make a filing with the insolvency court for the opening of insolvency proceedings over a bank; neither the bank itself nor creditors have standing to make a filing with the insolvency court.

2.5.3 *Insolvency process*

i. Overview

The insolvency process is divided into two stages:

- From filing until opening of the insolvency proceedings – the provisional insolvency proceedings (*Insolvenzeröffnungsverfahren*)
- Opened insolvency proceedings (*Insolvenzverfahren*)

Typically, the provisional insolvency proceedings last for three months from the filing date to take advantage of the state-funding of wages and salaries (*Insolvenzgeld*) for any unpaid salaries dating back three months prior to opening of the insolvency proceedings. During that period, the court will:

- appoint a provisional administrator (*vorläufiger Insolvenzverwalter*)[22] and a provisional creditors' committee (*vorläufiger Gläubigerausschuss*); and
- issue certain orders to protect the bank's assets, such as restrictions on asset disposals, collection of receipts and a moratorium on creditors' process.

After that period, the court will open insolvency proceedings. The court and creditors' meeting usually confirm the provisional administrator (*vorläufiger Insolvenzverwalter*) and the provisional creditors' committee (*vorläufiger Gläubigerausschuss*) as administrator (*Insolvenzverwalter*) and creditors' committee (*Gläubigerausschuss*) respectively. No later than three months after the opening of proceedings, a report hearing among creditors has to be convened to resolve on a liquidation, sale or continuation of the business. The creditors' meeting can also resolve on a plan of reorganisation. The plan can be presented exclusively by the administrator or by the bank.

ii. Regular insolvency procedure (*Regelinsolvenzverfahren*)

Unless the creditors' meeting approves an insolvency plan procedure,[23] the administrator will liquidate the business by either selling all or parts of the bank's business in an asset deal (leaving liabilities behind), or by a winding-down of the bank's assets.

The administrator has the power to dispose of the bank's unencumbered assets. Collateral can be realised as a matter of law by the secured creditor without the administrator, except for collateral that is (i) a moveable asset in the administrator's possession[24] or (ii) a receivable which has been assigned as collateral. In respect of these two categories of collateral, the administrator has an exclusive right to realisation (but has to turn over the proceeds, minus a fee, to the secured creditor),

[22] A motion for debtor-in-possession (*Eigenverwaltung*) is available, but would likely be rejected by the insolvency court based on concerns regarding creditors' interests.

[23] See section 2.5.3.iii below.

[24] A share certificate held in a securities deposit account is a moveable asset for this purpose if the certificate represents more than 20 percent of the shares in the relevant company (see *Bundesgerichtshof, Urt. v.* 24.09.2015 – IX ZR 272/13).

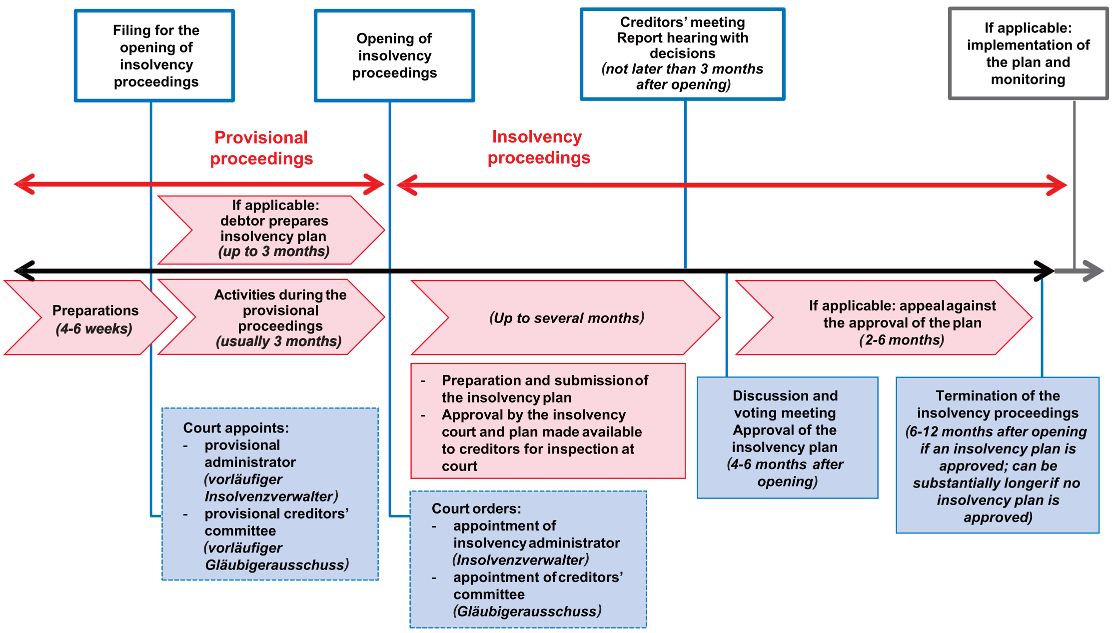
save that receivables or other assets that constitute financial collateral within the meaning of the Financial Collateral Directive[25] can be realised by the secured creditor (§ 166(3) InsO).

The sale of material assets requires consent of the creditors' committee (§ 160 InsO). Sales to certain interested parties (including, inter alia, (i) persons affiliated with the bank and (ii) creditors with claims exceeding 20 percent of all claims) require consent from the creditors' meeting (not only the creditors' committee) (§ 162 InsO).

iii. Insolvency plan procedure (*Insolvenzplan*)

Instead of selling or liquidating the bank's business and striking the company off the companies register, the bank can be reorganised through an insolvency plan (*Insolvenzplan*). The insolvency plan procedure is closely modelled on the Chapter 11 process under the US Bankruptcy Code. In addition to the earlier parts of the process, the insolvency plan procedure is depicted in Figure 2.

Figure 2: Timeline of insolvency plan procedure



(i) Right to propose insolvency plan

Only the bank's management or the administrator (upon instruction by the creditors' meeting) has the right to propose a plan. Creditors or shareholders have no plan proposal right. However, creditors whose consent is crucial for plan approval will typically be consulted during the plan-drafting process. Once drafted, the plan is submitted to the insolvency court for approval. If it is approved, it is made available at court for inspection by creditors.

[25] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements [2002] OJ L168/43.

(ii) Content of insolvency plan

The insolvency plan consists of two parts: (1) a declaratory part containing a description of the factual background; and (2) a constructive part setting out how the legal position of the respective creditor class will be affected under the plan. The factual part describes all information relevant for creditors to make an informed voting decision on the bank's business, including actions taken prior to and during the insolvency proceedings. The constructive part sets out (a) the different classes of creditors (see below) and (b) how the plan will affect creditors' rights and (if applicable) corporate actions, such as share capital reductions and increases or a change to articles of association.

(iii) Class formation

The insolvency plan can impair the rights of: (a) secured creditors; (b) general unsecured, unsubordinated creditors; (c) subordinated creditors; and (d) shareholders. It cannot affect the rights of administrative creditors (i.e. creditors whose claims have administrative expense status). The plan must provide for separate classes for at least secured and unsecured creditors. Generally, no class is required for subordinated creditors; their claims are deemed to be waived unless otherwise provided for in the plan. A separate class for shareholders is required if the plan impairs shareholders' rights. The plan can provide for additional classes if necessary to distinguish between creditors with the same legal rights but different economic interests, e.g. unsecured financial and trade creditors. It should provide for separate classes for employees and the pension protection fund if their claims are to be impaired under the plan. In practice, separate classes are created for trade creditors, financial creditors, small creditors, and other unsecured creditors.

(iv) Plan voting

Creditors and shareholders vote in a meeting. The plan is accepted if, in each class, a majority (50 percent) by amount and by number of creditors present in the meeting votes in favour. In the class of shareholders, a majority of 50 percent of shares is sufficient. If those majorities are not reached, the court can still confirm the plan (and enforce a cramdown) if:

- a majority of classes has voted in favour;
- the plan does not put non-consenting classes into a worse position than they would be without the plan;
- no creditor receives any value in excess of its par claim;
- no creditor ranking equally with a creditor in a non-consenting class receives more value; and
- no subordinated creditor or shareholder receives any value.

(v) Plan confirmation

The court will (after consultation with the creditors' committee, the administrator and the bank's management) confirm the plan if:

- the plan substantially complies with all legal requirements, in particular with regard to class formation;
- the plan has been accepted by each class with the majorities required, as set out above;
- the accepting vote was not subject to undue influence (e.g. through financial inducement to vote); and
- no creditor or shareholder has objected, or, if a creditor or shareholder has objected:
    - the objecting party has not provided prima facie evidence that it would likely receive less value under the plan than without the plan (*best interests* test); and
    - collateral is provided to compensate the objecting party for the difference between what it receives under the plan and what it would recover without the plan.

(vi) Appeal

After plan confirmation by the court, creditors or shareholders who voted against the plan and filed an objection in the plan voting meeting can, within two weeks, file an appeal. The appeal is successful if the appellant can provide prima facie evidence that it would receive *materially* less value under the plan than without the plan. As long as the appeal is pending, the plan confirmation does not become effective. The plan proponent can, however, file a motion with the court of appeal to grant summary confirmation of the plan. The court of appeal will grant the motion if it considers that its benefits outweigh the potential damage to the appellant.

(vii) Effect of plan

Once the court order confirming the plan has become effective, the plan will be binding on all creditors and shareholders, regardless of whether they were present in the creditors' meeting or have filed a proof of debt. The insolvency proceedings are later terminated.

iv. Priority of claims in bank insolvency (§ 46f(6) to (9) KWG; §§ 38 to 39 InsO)

- **Overview**

Like the laws of many other jurisdictions, German insolvency law generally distinguishes between the following classes of claims:

1) Administrative expenses

2) Secured creditors

3) General unsecured, unsubordinated (or “senior”) creditors

4) Subordinated creditors

5) Shareholders

However, for insolvencies of banks under German insolvency law, certain subcategories within the category of senior creditors have been created. The reason for the creation of these subcategories is the protection of depositors and the *no creditor worse off than in liquidation* (“NCWOL”) principle under the BRRD and SRMR, which provides that following a bail-in or other resolution action, no creditor shall be worse off than it would be in a liquidation of the bank.

Figure 3 shows the different categories of capital and their ranking in an insolvency of a bank. These categories will now be discussed.

Figure 3: Categories of bank capital

<table>
<tr><td colspan="2">Deposits of private individuals and small- and medium-sized enterprises (“SMEs”)
≤ EUR 100,000</td></tr>
<tr><td colspan="2">Deposits of private individuals and SMEs > EUR 100,000</td></tr>
<tr><td colspan="2">“New” Preferred Senior</td></tr>
<tr><td>Deposits of non-SME companies</td><td>All liabilities that are not non- preferred senior liabilities and do not fall within any other category in this table</td></tr>
<tr><td>“Old” Non-Preferred Senior
(Subordination by Law)</td><td>“New” Non-Preferred Senior
(Contractual Subordination)</td></tr>
<tr><td colspan="2">Liabilities Subordinated by Law (§ 39(1) InsO)
(1) Interest accruing after commencement of insolvency proceedings
(2) Legal expenses
(3) Penalties and fines
(4) Liabilities for which bank receives no consideration
(5) Liabilities from shareholder loans and equivalent transactions</td></tr>
<tr><td colspan="2">Contractually Subordinated Liabilities according to § 39(2) InsO</td></tr>
<tr><td colspan="2">Tier 2 – Supplementary Capital</td></tr>
<tr><td colspan="2">AT1 – Additional Tier 1 Capital</td></tr>
<tr><td colspan="2">CET1 – Common Equity Tier 1</td></tr>
</table>

- **General rule: *pari passu* ranking of all general unsecured, unsubordinated claims ahead of subordinated claims and equity**

  As noted in section 2.5.1 above, InsO applies to banks. This includes the state-owned *Landesbanken*, which may be incorporated as public law institutions (*Anstalten des öffentlichen Rechts*). It also includes savings banks (*Sparkassen*) and building societies (*Landesbausparkassen*), which are incorporated as public law institutions.[26]

  InsO does not know preferred pre-petition claims,[27] such as taxes or employees. § 38 InsO treats all general unsecured, unsubordinated (or "senior") creditors who have a monetary claim against the debtor at the time of the opening of insolvency proceedings as *pari passu* (the *par condicio creditorum* rule). In a bank insolvency, where typically very limited secured claims exist, senior creditors could expect to participate in the bank's entire estate less the administrative expenses incurred during the insolvency proceedings, on a *pari passu* basis.

- **First exception: deposits**

  Until 1 January 2017, the only modification to the par *condicio creditorum* rule for claims in bank insolvencies was that the following claims ranked ahead of senior claims (see § 46f(4) KWG):

  - in first priority, deposits covered by a mandatory deposit guarantee scheme (see section 3 below) up to the maximum amount covered, and such claims to which a deposit guarantee scheme is subrogated; and

  - in second priority, and *pari passu* among themselves, *eligible deposits* (as defined in the Deposit Guarantee Scheme Directive (the "DGSD")[28]) held by individuals or SMEs, and deposits with a bank in the European Union that were accepted by a branch of that bank outside the European Union.

- **Second exception: *non-preferred senior* claims issued before 21 July 2018**

  Effective as of 1 January 2017, the priority of senior claims against banks was further differentiated. The following unsecured debt instruments were subordinated to all other senior claims, but would still rank ahead of subordinated claims:

  - bearer bonds (*Inhaberschuldverschreibungen*);

  - negotiable bonds (*Orderschuldverschreibungen*);

[26] § 14(1) InsO allows each German Federal state to determine in its laws whether public law institutions can be subject to insolvency proceedings. The laws of the German Federal states typically exclude such institutions, with the exception of *Landesbanken* and savings banks, from insolvency proceedings.

[27] Some liabilities (in particular taxes due to business transactions in provisional proceedings, under § 55(4) InsO) are elevated to administrative expense status by operation of law.

[28] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) [2014] OJ L173/149.

- rights comparable to those under the above instruments which are tradeable on a market;

- promissory note loans (*Schuldschein-Darlehen*); and

- non-negotiable registered bonds (*Namensschuldverschreibungen*),

in each case with the exception of the following (i.e. the instruments below still rank senior to the above):

- instruments that qualify as deposits (as described above under the heading 'First exception: deposits');

- instruments issued by public institutions that cannot become subject to insolvency proceedings;[29]

- instruments with a maturity of less than one year;

- instruments exempted from a bail-in under § 91(2) SAG / article 44(2) of the BRRD; or

- *structured financial products*, defined as instruments where:

  - repayment, or the amount of repayment, depends on the occurrence or non-occurrence of an event which is uncertain at the point in time when the debt instruments are issued, or settlement is made other than by monetary payment; or

  - payment of interest or the amount of interest payments depends on the occurrence or non-occurrence of an event which is uncertain at the point in time when the debt instruments are issued, unless the payment of interest or the amount of interest payments solely depends on a fixed or customary floating reference interest rate[30] and is settled by monetary payment.

BaFin has issued guidance on what features make a debt obligation a *structured financial product*.[31] According to the BaFin guidance, the following features will result in a debt instrument *not* being considered a *structured financial product* (i.e. will make it a non-preferred senior claim):

29 See note 26 above.

30 The requirement for the floating interest rate to be customary was introduced through an amendment on 21 July 2018.

31 BaFin, *Joint interpretation guide on the classification of certain liabilities of CRR institutions under insolvency law pursuant to section 46f(5) to (7) of the German Banking Act (Kreditwesengesetz) as amended* (2016), available at: https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Merkblatt/mb_160805_Auslegungshilfe_46f_en.html, replaced as of 3 May 2019 by BaFin, *Merkblatt zur insolvenzrechtlichen Behandlung bestimmter Verbindlichkeiten von CRR-Instituten* (2019), available at: https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Meldung/2019/meldung_190503_Merkblatt_46f_KWG.html (in German). The main text reflects this 2019 guidance.

- the interest rate is either: (i) fixed; or (ii) floating but defined by reference to EURIBOR, LIBOR or EONIA,[32] unless the reference rate is for a significantly longer period than the instrument's interest periods;[33]

- (solely) a contractual acceleration right or a right of early repayment is granted (because such a right does not create uncertainty as to the repayment amount);

- the debt instrument is a zero-coupon instrument (because the compounding of interest – paid in a lump sum at maturity – is fixed, there is no uncertainty as to the amount of interest payable); or

- the principal has to be repaid in a foreign currency (because this does not create uncertainty as to the repayment amount, as an exchange rate can be straightforwardly determined).

This new priority applies to all claims that meet the criteria described above, regardless of whether they were issued before or after 1 January 2017; see below for claims under instruments issued after 21 July 2018. There is no grandfathering protection for instruments issued before 1 January 2017.

This new priority was introduced against the background of the NCWOL principle. The German lawmaker facilitated application of this principle by subordinating certain claims against banks, the repayment value of which is easy to determine, thereby laying the basis for an easier bail-in of such claims.[34]

- **Third exception: non-preferred senior claims issued after 21 July 2018**

The above rule was again modified effective as of 21 July 2018. As a result of an amendment of article 108 of the BRRD, § 46f KWG was amended and introduced a new hierarchy of instruments:

- If the instrument's terms and conditions expressly state it to be "non-preferred senior", it ranks (a) *pari passu* with non-preferred senior claims issued before 21 July 2018 and (b) senior to general unsecured, unsubordinated claims.

- If the instrument's terms do not contain such a provision, it ranks (a) senior to non-preferred senior claims issued before 21 July 2018, (b) *pari passu* with preferred senior claims issued before 21 July 2018, and (c) senior to general unsecured, unsubordinated claims.

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32 Reference rates such as ESTER, SONIA and SOFR will also be covered, because the amount of interest payable at a customary reference rate can in principle be straightforwardly determined.

33 For example, if the reference rate is a 10-year interest rate whilst the instrument's interest payment dates are annual.

34 This was achieved through general subordination by law. Other means discussed were requiring banks to expressly include subordination language (in newly issued instruments), which is the solution required by the amendment of BRRD, art 108 (see the text), or issuing loss-absorbing capacity instruments at the level of the holding company (thereby structurally subordinating these claims).

All other features described above under the heading ‘Second exception: *non-preferred senior* claims issued before 21 July 2018’ that differentiate non-preferred senior and preferred senior claims continue to do so.

- **Liabilities subordinated by law**

The following categories of claims are subordinated in the following priority to general unsecured, unsubordinated claims that (pursuant to § 38 InsO) rank *pari passu* (see above). Numbers represent subsections of § 39 InsO.

1. Interest accruing since the opening of insolvency proceedings

2. Costs and expenses incurred in connection with the collection of claims (e.g. legal expenses)

3. Fines and penalties

4. Liabilities from transactions for which the bank receives no consideration (e.g. donations)

5. Liabilities from shareholder loans and equivalent transactions

The last is a highly relevant, yet complex category of subordinated liabilities, abundant with case law,[35] in particular on what is considered an *equivalent transaction* to a shareholder loan. An *equivalent transaction* can result from:

- the creditor being a person equivalent to a shareholder;

- the transaction being equivalent to a loan; or

- both together (e.g. where a trading counterparty controlled by a direct or indirect shareholder defers a receivable from a trading transaction).

Creditor equivalent to a shareholder

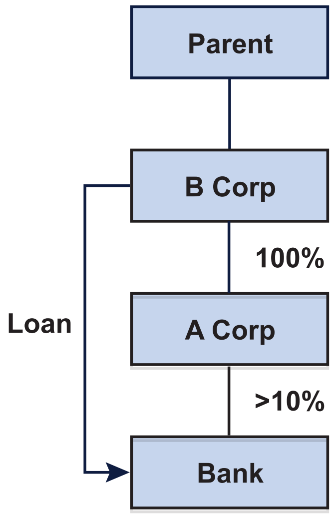
This basically captures structures where the borrower (bank) and the creditor have a joint ultimate parent.

Generally, all loans from a shareholder holding more than 10 percent of a corporation’s shares or partnership’s interests are subordinated.

This also extends to indirect shareholdings of 10 percent or more as long as the ultimate shareholder has indirect *control* over 10 percent or more of the shares in the bank. See Figure 4 for an example.

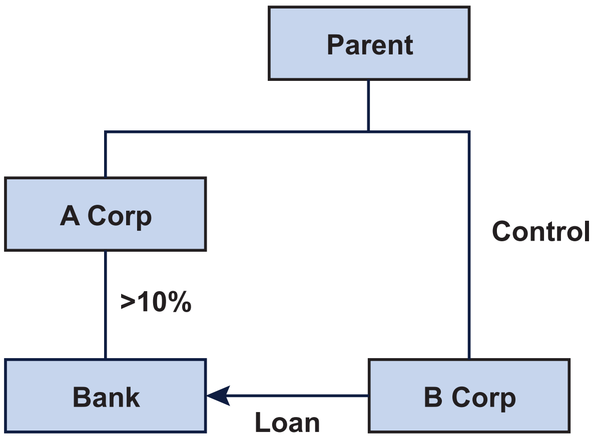
[35] For example, *Bundesgerichtshof, Urt. v.* 27.06.2019 – IX ZR 167/18, and *Bundesgerichtshof, Urt. v.* 15.11.2018 – IX ZR 39/18.

Figure 4: Illustration of a scenario in which a creditor is equivalent to a shareholder



It also extends to loans made by a third party under the *control* of (or under common *control* with) a shareholder holding more than 10 percent. See Figure 5 for an example.

Figure 5: Illustration of another scenario in which a creditor is equivalent to a shareholder



Control generally means that the shareholder can instruct the lender's management. In many jurisdictions, this will apply in the case of a shareholding of more than 50 percent, but also at lower levels, e.g. if the shareholder is also a managing director of the lender. Control does not exist if the lender is an entity that by virtue of applicable corporate law does not have to follow instructions from the shareholder. This is the case if the lender is incorporated as a German stock corporation (*Aktiengesellschaft*) without a domination agreement, as the management of an *Aktiengesellschaft* has to operate the company solely in its own dutiful discretion.[36]

[36] *Bundesgerichtshof, Urt. v.* 05.05.2008 – II ZR 108/07.

Transaction equivalent to a loan

Equivalent transaction can also refer to the type of transaction if it is equivalent to a loan. While affiliated entities can enter into arm's length transactions with a German debtor, receivables from such a transaction can be re-characterised as a loan if they remain outstanding for a period longer than usual. Basically, every transaction the effect of which is to finance the debtor (as opposed to a contemporaneous exchange of goods or services) can be re-characterised as a loan.

The § 39(1)5 InsO priority of claims becomes relevant when parent entities provide financial support to a German subsidiary, as was the case in the insolvency of Lehman Brothers Bankhaus AG ("LBB"). LBB's parent, Lehman Brothers Holdings Inc ("LBHI"), had guaranteed all of LBB's indebtedness to its external creditors. LBHI was itself in Chapter 11 proceedings in the US, and LBB's creditors filed their claims also in LBHI's Chapter 11 case. LBHI's recourse claim against LBB was subordinated pursuant to § 39(1)5 InsO.

- **Contractually subordinated liabilities (§ 39(2) InsO)**

  Liabilities, the terms of which contain provisions subordinating them in the bank's insolvency, rank junior to claims subordinated by law unless agreed otherwise. Subordinated liabilities are, depending on their features, treated as Tier 2 instruments or AT1 instruments, under the CRR. They are therefore commonly issued by banks, typically in note form.

- **Equity and equity-like instruments (§ 199 InsO)**

  Only if a surplus remains, after settlement of subordinated liabilities, can distributions be made to holders of shares or equity-like instruments. Most AT1 instruments, such as profit participation rights (*Genussrechte*) or silent partnership rights (*stille Gesellschaften*), will fall into this category.

3. Deposit guarantee schemes and institutional protection schemes

3.1 Overview

The German banking sector has historically been divided between privately held banks (*Privatbanken*),[37] publicly held banks (*Öffentliche Banken*), savings banks (*Sparkassen*), cooperative banks (*Genossenschaftsbanken*, consisting of *Volksbanken* and *Raiffeisenbanken*) and building societies *Landesbausparkassen*). The diversity of the German banking sector, in particular the relevance of savings banks, has often been held to be a cause of the relative insignificance of German privately held banks compared to privately held banks in jurisdictions with a less diversified banking market, such as the US or the United Kingdom.

Savings banks and building societies are incorporated as public law institutions (*Anstalten des öffentlichen Rechts*). Their only member(s) typically are local and regional municipalities, such as the towns or cities in which they are incorporated.

[37] *Privately held* in this context means that the bank's shareholders are not part of a public body. It does not mean that the bank is not listed; in fact, most of the large German privately held banks are publicly listed.

Cooperative banks are incorporated as registered cooperatives (*eingetragene Genossenschaft*), a form of limited company that is subject to the supervision of an authority.

The savings banks and cooperative banks are typically also members or shareholders of larger institutions, in the case of savings banks a regional state-owned *Landesbank*, and in the case of cooperative banks DZ Bank AG.

3.2 Private banks' deposit guarantee schemes

3.2.1 Mandatory Deposit Guarantee Scheme (Entschädigungseinrichtung deutscher Banken GmbH)

The *Entschädigungseinrichtung deutscher Banken GmbH* (German Banks' Compensation Scheme, known as the "EdB") is a *deposit guarantee scheme* within the meaning of the DGSD.

3.2.2 Voluntary Deposit Guarantee Scheme (Einlagensicherungsfonds)

Given the limitations as to the amount of compensation available under the mandatory deposit guarantee scheme regime, the association of German private banks (*Bundesverband deutscher Banken e.V.*, "BdB") as early as 1976 established a voluntary fund, the ESF (*Einlagensicherungsfonds*).[38] Only banks that are members of the BdB need to pay contributions to the ESF. However, given the high amount insured, membership in the BdB and the accompanying coverage through the ESF have become a marketing tool for German privately held banks. The terms and conditions under which deposits are guaranteed are set out in the ESF's articles of association.[39] The articles have undergone amendments in 2015 and 2017 which limit the coverage provided, with further amendments becoming effective as of 2020.

The deposit protection by the ESF is fully discretionary. Bank customers do not have a legal claim against the ESF for compensation, and it is not a *deposit guarantee scheme* within the meaning of the DGSD. As a result, the ESF will likely not step in if a major German bank becomes troubled. However, the ESF was deployed in the insolvency of LBB (the German Lehman Brothers subsidiary) in 2008 by reimbursing *c.* EUR 5.5 billion of insured deposits, and in that of Maple Bank in 2016 by reimbursing *c.* EUR 2.6 billion of insured deposits.

3.2.3 Savings Banks' Institutional Protection Scheme (Sicherungssystem der Sparkassen-Finanzgruppe)

The Deutsche Sparkassen- und Giroverband e.V. ("DSGV") operates the Savings Banks Finance Group's Institutional Protection Scheme (*Sicherungssystem der Sparkassen-Finanzgruppe*, the "DSGV-IPS").[40] It is an *institutional protection scheme* for the purposes of article 113(7) of the CRR and article 4(2) of the DGSD. This means it not only protects deposits as required under the DGSD, but in addition can provide financial support to sustain a distressed bank as a going concern. If such support is provided, this can have the effect that creditors of the distressed bank whose claims would not be considered *deposits* and thus not protected under the DGSD remain unimpaired.

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38 See https://einlagensicherungsfonds.de (in German).

39 Available at: https://bankenverband.de/media/publikationen/11-2017_Statut_ELS_A5_.pdf (in German).

40 The statutes of the DSGV-IPS are available at: https://www.dsgv.de/sparkassen-finanzgruppe/sicherungssystem.html (in German).

All *Landesbanken*, savings banks and building societies are members of the DSGV-IPS. The DSGV-IPS consists of three institutions – one covering the *Landesbanken*, one covering the savings banks (with regional subunions), and one covering the building societies. These three institutions are jointly liable vis-à-vis depositors in the case of default by one of them.

3.2.4 Cooperative Banks' Deposit Protection Scheme

The German cooperative banks (*Volksbanken* and *Raiffeisenbanken*) operate an *institutional protection scheme* for the purposes of article 113(7) of the CRR and article 4(2) of the DGSD (see section 3.2.3 above), through BVR Institutssicherungs GmbH ("BVR-IPS").[41]

BVR-IPS can support a member through guarantees, capital injections, loans or share subscriptions. The decision is made by BVR-IPS's management board with the consent of its shareholder, BVR Institutssicherungs GmbH. It is fully discretionary; members have no legal right to support measures.

4. Case studies

4.1 Bank resolutions

The two case studies referred to here are bank resolutions arising from the GFC.[42] These were undertaken under the Financial Market Stability Law Package, most of which is no longer relevant (see section 2.3 above). They therefore cannot be seen as precedents for the treatment of future German bank failures – which will all be governed by the SRMR regime, or result in insolvency proceedings in the absence of public interest (see section 2.5.1 above), except that the HSH Nordbank carve-out model could be used to demerge "toxic assets", such as non-performing loans, from another *Landesbank* to a state-owned bad bank under § 8b FMStFG.

- **WestLB (now known as Portigon)**[43]

  The predecessor of WestLB AG ("WestLB"), Westdeutsche Landesbank Girozentrale, existed since 1832. As a result of a state aid review by the European Commission which found the owners' unlimited liability for its obligations to be illegal state aid, Westdeutsche Landesbank Girozentrale was split in 2002 into Landesbank NRW (now known as NRW.Bank) and WestLB.

  WestLB was owned by the state of North Rhine-Westphalia (partly directly and partly through NRW.Bank) (*c.* 37.74 percent), the Union of Savings Banks Rhineland (Rheinischer Sparkassen- und Giroverband) (*c.* 25.03 percent), the Union of Savings Banks Westphalia-Lippe (Sparkassen- und Giroverband Westfalen-Lippe) (*c.* 25.03 percent), the Regional Association of Rhineland

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41 The statutes of the BVR-IPS are available at: https://www.bvr-institutssicherung.de (in German).

42 The case studies listed here are neither a complete list of all bank resolutions in Germany, nor do they comprehensively list all events around the relevant resolutions. Further cases, and further details on the cases referred to here, can be found on the state aid database of the European Commission Directorate-General for Competition, available at: http://ec.europa.eu/competition/elojade/isef.

43 Information obtained from Commission Decision of 12 May 2009 on the State aid C 43/2008 (ex N 390/2008) implemented by Germany for the restructuring of WestLB AG, and Commission Decision of 20 December 2011 on the State aid C 40/2009 and C 43/2008 for the restructuring of WestLB AG, OJ L148/1.

(Landschaftsverband Rheinland) (*c.* 6.09 percent) and the Regional Association of Westphalia-Lippe (Landschaftsverband Westfalen-Lippe) (*c.* 6.09 percent).

As a result of heavy losses caused by the failure of investments (speculation in shares, and investments in the US subprime mortgage market) during the GFC, WestLB was subject to the actions described below. It was renamed Portigon AG.

Date	Measure	Amount	Comment
8 Feb 2008		EUR 23bn	WestLB transfers a portfolio of financial instruments to an off-balance sheet special purpose vehicle called Phoenix Light Limited
	Guarantee facility	EUR 5bn	A "risk shield" for the Phoenix portfolio, consisting of two guarantees by WestLB's owners for Phoenix's liabilities
23 Sep 2009	Guarantee facility	EUR 6.4bn	For certain tranches of the Phoenix portfolio
23 Dec 2009 / 30 Apr 2010	Bad bank – first asset transfer	EUR 77.5bn	WestLB carves out a portfolio of securities and loans to Germany's first bad bank under § 8 FMStFG, called Erste Abwicklungsanstalt AöR ("EAA") The Phoenix "risk shield" is transferred to EAA WestLB's owners provide a EUR 1 bn loss guarantee to EAA Liability of Savings Banks Unions for further losses is capped at EUR 4.5bn; excess losses are to be borne by the state of North Rhine-Westphalia and SoFFin
	Capital injection	EUR 3bn	Capital reserve for EAA
23 Dec 2009 / 4 Jan 2010 / 30 Apr 2010	Recapitalisation	EUR 3bn	WestLB issues loss-participating silent partnership interests with 10 percent interest p.a. to SoFFin
	Guarantee facility	EUR 1bn	Granted by NRW.Bank (EUR 482m), savings banks (EUR 501m), and Landschaftsverband Rheinland, Landschaftsverband Westfalen Lippe and other shareholders (EUR 17m); further losses for Savings Banks Unions are capped at EUR 4bn; potential losses exceeding the capital of EAA as well as the guarantee facilities are to be compensated by the FMSA and NRW.Bank

Date	Measure	Amount	Comment
23 Jun 2011 / 13 Dec 2011 / 30 Jun 2012	Breaking up of WestLB by way of a tripartite demerger: - The "Verbundbank" business is acquired by Landesbank Hessen-Thüringen Girozentrale (Helaba) - All other assets and liabilities are transferred to EAA - WestLB is renamed Portigon AG and continues to operate as a provider of services for financial portfolios	*c.* EUR 40bn to 45bn[44] EUR 120bn to 150bn[45]	The transfers are effected under § 8 FMStFG, i.e. excluding joint liability of transferor and transferee for the transferred liabilities[46]

- **HSH Nordbank**[47]

HSH Nordbank was created in 2003 through a merger of the former *Landesbanken* of the German Federal states of Hamburg and Schleswig-Holstein. It was owned by the state of Hamburg (30.41 percent), the state of Schleswig-Holstein (29.10 percent), WestLB (25.67 percent), the Union of Savings Banks in Schleswig-Holstein (Sparkassen- und Giroverband für Schleswig-Holstein) (13.20 percent) and the Union of Savings Banks in Bavaria (Sparkassenverband Bayern) (1.62 percent). In 2006, financial investor J.C. Flowers acquired WestLB's stake. As a result of heavy losses caused by the failure of investments (especially shipping loans) during the GFC, HSH Nordbank was subject to the actions described below.

Date	Measure	Amount	Comment
1 Apr 2009	Guarantee facility by SoFFin	EUR 17bn	HSH Nordbank had applied for EUR 30bn
29 Apr 2009			BaFin notifies HSH Nordbank of its intent to impose a moratorium
30 Apr 2009	CET1 increase	EUR 3bn	The states of Hamburg and Schleswig-Holstein (through HSH Finanzfonds AöR) increase their shareholding to 85.5 percent (financed through bonds issued by HSH Finanzfonds AöR)
20 Sep 2011	Guarantee facility	EUR 10bn (reduced to EUR 7bn in September 2011)	Provided by HSH Finanzfonds AöR

44 Reported amount of total assets and liabilities.
45 Book value of assets transferred to EAA.
46 See note 20 above.
47 Information obtained from Commission Decision (EU) of 2 May 2016 on the State aid and measures SA.29338 (2013/C-30) and SA.44910 (2016/N) in favour of HSH Nordbank AG [2016] OJ L319/13.

Date	Measure	Amount	Comment
22 May 2013	Guarantee facility	EUR 3bn	The HSH Finanzfonds AöR guarantee facility is increased to EUR 10bn again
2 May 2016			The European Commission Directorate-General for Competition approves the guarantee increase conditional on, inter alia, the sale of at least 75 percent of HSH Nordbank to a private investor by 28 February 2018
1 Jul 2016	Bad bank	EUR 4.1bn	The states of Hamburg and Schleswig-Holstein (through HSH Portfoliomanagement AöR) acquire a portfolio of non-performing shipping loans from HSH Nordbank, causing a loss of EUR 1.7bn, which was absorbed by the HSH Finanzfonds AöR guarantee facility The transfer of the portfolio is effected through a demerger in reliance on § 8b FMStFG,[48] allowing HSH Nordbank to carve out the portfolio without having to grant security to creditors or holders of hybrid instruments
28 Feb 2018		*c.* EUR 1bn	HSH Nordbank is sold to a consortium of investors, including J.C. Flowers, Cerberus and Goldentree

4.2 Deposit protection

- **Lehman Brothers Bankhaus**[49]

The first real test case for the German privately held banks' voluntary deposit guarantee scheme, the ESF, was the insolvency of LBB, the German Lehman Brothers subsidiary. LBB's total liabilities were in excess of EUR 10 billion, of which *c.* EUR 5.5 billion consisted of eligible deposits under the statutes of the ESF in force at the time. ESF did not have cash of EUR 5.5 billion, but instead of refusing compensation (which it legally could have done), ESF issued notes[50] guaranteed by SoFFin and subscribed by its member banks in an equal amount, the proceeds of which were used to compensate LBB's depositors. ESF was subrogated to these depositors' rights. As the recoveries in the LBB insolvency were 100 percent of principal, ESF was eventually able to repay the notes.

[48] See section 2.3 above.

[49] Information obtained from the European Commission's State aid decision of 21 January 2009 (Case N 17/2009).

[50] Through a newly incorporated company, Sicherungseinrichtungsgesellschaft deutscher Banken GmbH.

VII. ITALY

VII. Italy

Gabriella Covino, Nadia Cuppini and Rita Gismondi*

1. Introduction

The Bank Recovery and Resolution Directive (the "BRRD")[1] was transposed into the Italian legal and regulatory framework by means of two different pieces of legislation:

(i) The Italian Legislative Decree 16 November 2015, No 180 ("Decree 180"), establishing, among others, the regime regarding the powers and functions of the national resolution authority, the preparation of resolution plans, the opening and closing of resolution proceedings, the adoption of resolution measures, and the national resolution fund.

(ii) The Italian Legislative Decree 16 November 2015, No 181 ("Decree 181"), containing the necessary amendments to national legislation, and, in particular, to the Italian Legislative Decree 1 September 1993, No 385 (the Italian Consolidated Law on Banking, the "CLB") and to the Italian Legislative Decree 24 February 1998, No 58 (the Italian Consolidated Law on Finance, the "CLF").

From a structural perspective, it is possible to state that the choice of the Italian legislator was, in brief, to adopt a separate set of rules for the provisions primarily related to the exercise of resolution functions (Decree 180) and to maintain the provisions primarily related to the exercise of supervisory functions mainly in the CLB and the CLF (as modified by Decree 181).

It is worth noting that not all instruments introduced by the BRRD were previously unknown in Italy. Indeed, prior to the new legislation of the European Union (the "EU"), the Italian legal and regulatory framework for banking crises was based on two pre-insolvency and insolvency procedures contemplated by the CLB, i.e. extraordinary administration (*amministrazione straordinaria*) and compulsory administrative liquidation (*liquidazione coatta amministrativa*). As stated by some authors, it can be argued to a certain extent that, under the previous regime, together with the

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[1] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

abovementioned procedures, the Italian supervisory practices already envisaged "unwritten resolution tools" (such as asset separation, the creation of bad banks and the use of special purpose vehicles), which were often combined with bail-out solutions and operated by the Italian authorities with the aim of avoiding "value disruption" and ensuring "business continuity" of the financial institution concerned.[2]

Under the legal and regulatory framework resulting from the implementation of the BRRD, such goals have been developed and are now pursued through a broader range of measures and procedures, which include the new (and more powerful) instruments alongside the two traditional pre-insolvency and insolvency procedures (i.e. extraordinary administration and compulsory administrative liquidation) amended in light of the principles provided by the BRRD.

Under the new approach, the timing of intervention has also been improved. Indeed, while the procedures and tools contemplated by the previous regime were mainly focused on a phase where the financial institution was already unsound or failing, the BRRD implementing measures require that, in business as usual, a bank take steps to prepare for the management of possible crises. During normal operations, financial institutions and competent authorities are expected to carry out preparatory activities to prevent crises and, when crises occur, to intervene sufficiently early and quickly as to ensure the continuity of the institution's critical financial and economic functions, while minimising the impact of a possible failure on the economy and financial system.

This chapter is organised as follows. Section 2 discusses the BRRD implementing measures. In particular, it illustrates the scope of application of Decree 180, the role of the Banca d'Italia (the Bank of Italy, the Italian central bank) as a national resolution authority and the preparatory activities that financial institutions and authorities are required to carry out in order to deal with situations of crisis in respect of the institutions. Moreover, in order to better understand how such crises are managed from a practical point of view, this section analyses crisis management procedures and the conditions necessary to make use of them. The section discusses the objectives and principles of resolution, as well as the valuation necessary to carry out any resolution action and the role of the national resolution fund. Finally, the section provides an overview of relevant pre-insolvency and insolvency procedures, being extraordinary administration (*amministrazione straordinaria*) and compulsory administrative liquidation (*liquidazione coatta amministrativa*). Section 3 discusses recent cases in which crisis management procedures have been used in Italy. In particular, it examines the case of Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara, and Cassa di Risparmio della Provincia di Chieti, as well as the cases of Monte dei Paschi di Siena and Banca Popolare di Vicenza and Veneto Banca. We refer to chapter V of this book for an extended discussion of the BRRD.

2 See Professor Raffaele Lener, *Bank Resolution in Practice: The Banking Crisis in Italy* (Freshfields Bruckhaus Deringer 2017) 5. In this regard, see also Paolo Carriere, 'Crisi bancaria e bail in: prime noterelle sui decreti di recepimento della direttiva BRRD' (2016) Rivista di diritto bancario 1, where the author states that "it is not that compulsory administrative liquidation […] which until now has governed […] situations of serious crises and banking insolvency did not already have access to crisis management tools for many aspects comparable [to those introduced by the BRRD]" (translation). Original Italian text: "non è che la procedura di liquidazione coatta amministrativa […] che fino ad oggi ha disciplinato […] le situazioni di crisi e di insolvenza bancaria non avesse già accesso a strumenti di gestione della crisi per molti versi equiparabili [a quelli introdotti dalla BRRD]".

2. The legal and regulatory framework for the management of banking crises

2.1 Bank Recovery and Resolution Directive implementing measures

2.1.1 Scope of application of Decree 180

Decree 180 contains the Italian BRRD implementing measures applicable to banks having their legal office in Italy, companies belonging to Italian banking groups, companies included in the consolidated perimeter of supervision of Italian banking groups,[3] and companies having their legal office in Italy that are included in the consolidated perimeter of supervision in other EU member states ("Member States"). The aim of these measures is to ensure the continuity of an institution's critical financial and economic functions, while minimising the impact of a possible failure on the economy and financial system. The following subsections provide an overview of the Italian regime.

2.1.2 National resolution authority

Decree 180 identifies the Bank of Italy as the national resolution authority ("NRA"), specifying its powers and functions, as well as the forms of cooperation with the other NRAs in relation to the management of banking crises under the EU legislation.[4] Consistent with the requirements of the BRRD[5] Decree 180 requires the Bank of Italy – which performs both supervisory and resolution functions – to adopt suitable organisational measures in order to ensure operational independence between supervisory and resolution functions carried out by it, the separation of internal structures (through the establishment of separate organisational units), and the prevention of possible conflicts of interest.[6]

With respect to the entities and groups in relation to which the Bank of Italy acts as NRA, these are identified in accordance with the Single Resolution Mechanism Regulation (the "SRMR"),[7] establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of the Single Resolution Mechanism (the "SRM") and Single Resolution Fund (the "SRF").

According to the SRMR, the management of crises at entities or groups that are classified as systemically important or which operate across borders within the eurozone is carried out directly at the level of the SRM and, in particular, by the Single Resolution Board ("SRB").

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3 In particular, those indicated in CLB, art 65(1)(c)(h) (i.e. banking, financial and *instrumental companies* not included in a banking group but supervised by a natural or legal person that controls a bank or a banking group, and companies that control at least one bank). Under CLB, art 59, *instrumental companies* are companies that exercise, exclusively or predominantly, activities that are auxiliary to the activities of the companies of a group, including those connected to the ownership and the administration of real estate and the management of information technology services.

4 Besides the powers and functions of the Bank of Italy, Decree 180 also provides for the role played by the Ministry of Economy and Finance in relation to the crisis management procedures contemplated therein. See further section 2.1.4.2 below.

5 BRRD, art 3.

6 In this regard, it is worth noting that the Bank of Italy has established a specific Resolution and Crisis Management Unit, which is structurally separated from its Banking and Financial Supervision Unit.

7 Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L225/1.

Under the abovementioned framework, the Bank of Italy – acting as the Italian NRA – remains responsible for managing crises at entities and groups that are *less significant*.[8] In the performance of these activities, the Bank of Italy acts, in any case, in accordance with the guidelines established by the SRB, in order to ensure that it pursues the objectives of the EU legal and regulatory framework.

Both the SRB and the Bank of Italy have available to them a rich toolbox introduced pursuant to the BRRD, for early intervention, crisis management and resolution.

2.1.3 Recovery and resolution planning

During business as usual, financial institutions and competent authorities are required to carry out preparatory activities to deal effectively with crisis situations in respect of the institutions. In this regard, the CLB provides for:

(i) Individual or group recovery plans that must be prepared by the relevant institutions and submitted for the approval to the Bank of Italy or the European Central Bank (the "ECB") (depending on which of these is the competent supervisory authority under the Single Supervisory Mechanism[9]). The recovery plans concern the measures that must be adopted by the institutions to rebalance their economic and financial situation in case of significant deterioration, but not yet involving a situation of failure.

(ii) Individual or group resolution plans that must be prepared by the Bank of Italy or the SRB (depending on which of these is the competent resolution authority under the SRM). The resolution plans define the strategies for crisis management to be adopted in cases of actual failure.

When drafting and updating the resolution plans referred to above, the Bank of Italy or the SRB (as the case may be) must conduct an assessment of the extent to which financial institutions and groups are resolvable and, where necessary, take measures to address or remove impediments to resolvability in coordination with the institutions and the competent supervisory authorities, pursuant to the procedures established by the SRMR. Among the measures that may be taken, there is the possibility to request the institution to limit its maximum individual and aggregate exposures, to divest specific assets, to limit or cease specific existing or proposed activities, and to set up a parent financial holding company in a Member State.

2.1.4 Crisis management procedures

2.1.4.1 Overview

The crisis management procedures that may be employed under Italian law in relation to a situation of failure or risk of failure are:

8 SRMR, art 7(3).

9 Under the Single Supervisory Mechanism Regulation (Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63) as supplemented by the Single Supervisory Mechanism Framework Regulation (Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141/1).

(i) the write-down or conversion of relevant capital instruments into shares or other ownership instruments of the institution concerned;

(ii) resolution, which may include, in brief, the sale of the business of the institution, the setting up of a bridge institution, the separation of the performing assets from the impaired or underperforming assets of the failing institution (i.e. the setting-up of a bad bank) and the bail-in of shareholders and creditors; or

(iii) compulsory administrative liquidation, as described in section 2.2.3 below.

The above crisis management procedures are subject to a series of common principles contemplated by Decree 180, including the conditions for commencing a crisis management procedure, the objectives and principles of resolution, and the valuation of assets and liabilities. We now turn to such common principles.

2.1.4.2 The conditions for commencing a crisis management procedure

Decree 180 provides that a crisis management procedure may be commenced only if the institution is *failing or likely to fail* and there are no alternative solutions that could allow the institution to overcome the situation within a reasonable timeframe (for example, the involvement of private parties, the adoption of supervisory measures such as *early intervention* – for instance, replacing one or both of the managing body and the board of statutory auditors of the bank – or extraordinary administration as described in section 2.2.2 below).

In accordance with the BRRD, Decree 180 establishes specific cases in which an institution is deemed to be *failing or likely to fail*, which include, among other things, the following circumstances:

(i) infringement by the institution of the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation;

(ii) the assets of the institution being less than its liabilities; and

(iii) the institution being unable to pay its debts and other liabilities as they fall due.

When the above conditions are satisfied, the institution is subject to one of the following crisis management procedures:

(i) write-down or conversion of capital instruments;

(ii) compulsory administrative liquidation (see section 2.2.3 below); and

(iii) resolution.

According to Decree 180, resolution may be undertaken when:

(i) the write-down or conversion of relevant capital instruments (alone or in combination with the intervention of third parties) would not be sufficient to overcome the failure or likelihood of failure of the bank;[10]

10 When the write-down or conversion of capital instruments is sufficient to recapitalise the institution, it may be applied alone; otherwise, it may be applied within resolution, before any other resolution action takes place.

(ii) it is necessary and proportionate in the public interest; and

(iii) compulsory administrative liquidation would not achieve the objectives indicated in section 2.1.4.3 below to the same extent.

Pursuant to Decree 180, the Ministry of Economy and Finance approves the decision on the basis of which the Bank of Italy commences resolution and which includes the resolution terms.

2.1.4.3 The objectives and principles of resolution

Decree 180 provides that resolution must pursue a number of specific objectives, which include, among other things, the continuity of the essential functions of the institution concerned, financial stability, the limitation of public expenditure, the protection of depositors and other creditors, and the protection of client assets.

Among the principles underlying the resolution regime as a whole, those concerning burden-sharing between shareholders and creditors are particularly important. On the basis of such principles:

(i) losses are borne by shareholders and creditors in accordance with the order of priority of their claims in normal insolvency proceedings;

(ii) unless expressly provided otherwise, shareholders and creditors with the same priority must be treated in an equitable manner (exceptional differences should be only as justified in the public interest);

(iii) no shareholder or creditor should incur greater losses than it would have incurred if the institution had been wound up under compulsory administrative liquidation as described in section 2.2.3 below (the *no creditor worse off than in liquidation* (“NCWOL”) principle); and

(iv) covered deposits are fully protected.

2.1.4.4 Valuation of assets and liabilities

Before any write-down or conversion of relevant capital instruments or any resolution action takes place, Decree 180 requires a fair and realistic valuation of the assets and liabilities of the institution to be carried out by an independent expert.

The valuation must include among other things:

(i) an indication of whether the conditions required to carry out a write-down or conversion of relevant capital instruments or for resolution are met;

(ii) a quantification of the losses of the institution or the group and the amount of financial support necessary to recapitalise it; and

(iii) the estimated market value of the institution and an analysis of the treatment that each class of shareholders and creditors would be expected to receive if the institution were wound up under compulsory administrative liquidation (as described in section 2.2.3 below), in order to verify compliance with the NCWOL principle.

When due to reasons of urgency it is not possible to carry out a valuation complying with all the abovementioned requirements, a provisional valuation can be made directly by the Bank of Italy (or by extraordinary commissioners appointed in accordance with article 71 of the CLB – see section 2.2.2 below). The provisional valuation must subsequently be confirmed by an independent expert by means of an *ex post* definitive valuation, aimed at (i) ensuring that possible losses are fully recognised in the books of accounts of the institution and (ii) informing any decision to write back creditors' claims or to increase the value of consideration paid to the institution.[11]

2.1.5 *Resolution fund*

Via Resolution 18 November 2015, No 1226609/15, implementing article 78ff of Decree 180, the Bank of Italy established the national resolution fund (the "NRF"), which collects from banks (*ex ante* and, where necessary, *ex post*) the contributions needed in order to finance resolution procedures. Pursuant to the SRMR, the NRF is included in the SRF during the initial phase of the SRF.

The resources of the NRF are distinct from the assets of the Bank of Italy as well as from those of the entities that contribute to the NRF. The Bank of Italy, as NRA, deploys the NRF in compliance with the objectives and principles of resolution referred to articles 21 and 22 of Decree 180. According to article 79 of Decree 180, the use of the NRF may be ordered by the Bank of Italy, for, inter alia, one or more of the following purposes:

(i) to guarantee the assets or liabilities of entities in resolution;

(ii) to grant financing to entities in resolution;

(iii) to purchase assets of entities in resolution;

(iv) to subscribe for capital in, and make contributions to the assets of, a bridge institution or asset management vehicle;

(v) to pay compensation to shareholders and creditors of entities in resolution; and

(vi) to subscribe for capital in, and make contributions to the assets of, entities in resolution, when bail-in is applied and certain liabilities are excluded from the bail-in.

2.2 Pre-insolvency and insolvency procedures: extraordinary administration and compulsory administrative liquidation

2.2.1 *Overview*

As mentioned in section 1 above, extraordinary administration (*amministrazione straordinaria*) and compulsory administrative liquidation (*liquidazione coatta amministrativa*) were already contemplated in the Italian legal and regulatory framework as pre-insolvency and insolvency procedures governed by the CLB. Such procedures have been amended by Decree 180 and Decree 181, so as to be in compliance with the principles and rules set forth by the BRRD.

11 In accordance with the provisions of Decree 180 implementing BRRD, art 36(10) and (11).

2.2.2 *Extraordinary administration (amministrazione straordinaria)*

Extraordinary administration is opened through an act of the Bank of Italy that provides for the dissolution of the managing and controlling bodies of a bank in the case of: (i) serious irregularities in the governance of the bank, or serious legal, administrative or regulatory breaches by the bank, or significant failure (i.e. significant distress or a crisis situation) of the bank; or (ii) serious equity losses; or (iii) a reasoned request by the managing body or by an extraordinary shareholders' meeting of the bank for the dissolution of its managing and controlling bodies.

Extraordinary administration does not imply that the bank is insolvent under Article 5 of the Royal Decree 16 March 1942, No 267 (the Italian Bankruptcy Law), according to which a company is deemed to be insolvent when it is no longer able on a regular basis to meet its obligations as they become due. Extraordinary administration lasts no more than one year, unless the Bank of Italy provides an extension by further periods of one year.

With the dissolution of the managing and controlling bodies of the bank, in accordance with article 71 of the CLB the Bank of Italy appoints one or more extraordinary commissioners (*commissari straordinari*) and a surveillance committee (*comitato di sorveglianza*) consisting of three or five members, having professional and integrity requirements and needing to be free from any conflict of interest.

Unless otherwise provided by the appointment order issued by the Bank of Italy, the extraordinary commissioners exercise all the functions of the managing body of the bank and have powers according to the Italian Civil Code, applicable legislation and the bylaws of the bank. Certain limitations on the functions and powers of the extraordinary commissioners, or further specific roles, could be imposed by the Bank of Italy. Furthermore, certain acts of the extraordinary commissioners may be subject to authorisation by the Bank of Italy.

The extraordinary commissioners are required to:

(i) ascertain the economic and financial situation of the bank;

(ii) as applicable, remove the irregularities in the governance, or remedy the legal, administrative or regulatory breaches or the equity losses; and

(iii) identify solutions in the interests of depositors and for the purposes of correct and prudent management of the bank.

The extraordinary commissioners are entitled to bring liability actions against the managing body, the statutory auditors and the external auditors of the bank, upon prior authorisation by the Bank of Italy and an opinion of the surveillance committee.

The surveillance committee is an advisory and control body consisting of three or five members.

Subject to certain conditions, the extraordinary commissioners may suspend any payments of debts or financial instruments for one month (with a possible extension by a further two months) in order to protect creditors' interests, upon prior authorisation by the Bank of Italy and an opinion of the surveillance committee. The suspension of payments also means an automatic stay of any precautionary or enforcement proceedings[12] over the bank's assets and financial instruments of its clients, as well as in respect of any liens or mortgages on the bank's assets (unless already in effect before the suspension).

2.2.3 Compulsory administrative liquidation (liquidazione coatta amministrativa)

Compulsory administrative liquidation is opened, either during extraordinary administration or voluntarily by the bank, through a decree issued by the Ministry of Economy and Finance upon a recommendation of the Bank of Italy, if the requirements set forth by Decree 180 for a crisis management procedure are met (see section 2.1.4.2 above) and provided that resolution could not be commenced pursuant to Decree 180.

In compulsory administrative liquidation, the Bank of Italy appoints one or more liquidator commissioners (*commissari liquidatori*) and a surveillance committee (*comitato di sorveglianza*). As in the case of extraordinary administration, the surveillance committee consists of three or five members, has professional and integrity requirements, and must be free from any conflict of interest. It has the same powers and functions as in extraordinary administration (see section 2.2.2 above).

Compulsory administrative liquidation is aimed at the liquidation of all the assets of the bank, although the continuation of business activities may be authorised by the Bank of Italy for the purposes of a better outcome of the liquidation. Upon the opening of compulsory administrative liquidation, an automatic stay applies in respect of any precautionary or enforcement proceedings[13] over the bank's assets and financial instruments of its clients, as well as in respect of any liens or mortgages on the bank's assets (unless already in effect before the suspension).

Special rules apply to the process of verification of claims in the framework of compulsory administrative liquidation. A proposal for a composition with creditors may be filed with the court by the liquidator commissioners (upon a favourable opinion of the surveillance committee), or the bank (upon a favourable opinion of both the liquidator commissioners and the surveillance committee), but such proposal is subject to authorisation of the Bank of Italy. The proposal must include, at a minimum, the recovery percentage offered to creditors, the timeframe for the relevant payment, and the securities offered to creditors, if any. The proposal for a composition with creditors is subject to approval by the court, which will take into account any objections filed by creditors or other interested parties and the opinion of the Bank of Italy on such objections.

3. Recent cases in which crisis management procedures have been used in Italy[14]

3.1 Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara, and Cassa di Risparmio della Provincia di Chieti

One of the most relevant and commented on cases in Italy in which the resolution tools provided by the BRRD were used is the resolution of Banca delle Marche,

12 Precautionary proceedings include, for example, interim injunctions.

13 See note 12 above.

14 Where not otherwise stated, the sources of information for this section are primarily the website of the Bank of Italy (https://www.bancaditalia.it/homepage/index.html) and contributions published in specialised periodicals.

Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara, and Cassa di Risparmio della Provincia di Chieti, four small banks whose total market share at the time of resolution was equal to one percent of the system-wide deposit (the "Four Banks"). As clarified by the Bank of Italy in a number of communications, the Four Banks were – despite several previous recovery attempts, including extraordinary administration[15] – in a significant and irreversible situation of instability and distress, involving unsustainable liquidity positions.

In order to understand the context that led to the resolution of the Four Banks, it is worth emphasising the following. Before the BRRD was implemented in Italy, the Italian competent authorities (the Ministry of Economy and Finance and the Bank of Italy) assessed the possibility of using the Interbank Deposit Protection Fund (Fondo Interbancario di Tutela dei Depositi, the "FITD"), a deposit guarantee scheme established to protect deposits and to which all Italian banks contribute.[16]

However, especially taking into account Banking Communication II of the European Commission's Directorate-General for Competition, issued in 2013,[17] the involvement of the FITD to assist in restructuring a bank was considered as potentially constituting state aid under EU rules, notwithstanding that it was privately financed by the banking sector.[18] [19] In particular, Banking Communication II made involvement of the FITD to assist in restructuring a bank conditional on *burden-sharing*, according to which, in the case of a bank's failure, shares and subordinated bonds must be written down or (in the case of the latter) converted into equity before any form of state aid is permissible.

Shortly after the enactment of the Italian rules implementing the BRRD in mid-November 2015 enabling the use of burden-sharing measures in Italy, the Bank of Italy decided to resolve the Four Banks. The timing of the resolution decision allowed access to the NRF solely on the basis of the burden-sharing principle, without the need for prior application of bail-in (which would have affected not only shareholders and bondholders, but also other creditors and a substantial part of the deposits not protected by the FITD). This was possible because, at the time of the resolution decision, the rules of Decree 180 concerning the write-down and conversion of capital instruments were already in force, but its provisions regarding bail-in were not.

15 The Four Banks entered extraordinary administration on 15 October 2013 (Banca delle Marche), 10 February 2015 (Banca Popolare dell'Etruria e del Lazio), 27 May 2013 (Cassa di Risparmio di Ferrara), and 5 September 2014 (Cassa di Risparmio della Provincia di Chieti).

16 With the exception of cooperative credit banks, which participate in another protection scheme, the Fondo di Garanzia dei Depositanti del Credito Cooperativo. Both schemes are *deposit guarantee schemes* within the meaning of the Deposit Guarantee Scheme Directive (Directive (EU) 2014/49 of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) [2014] OJ L173/149). Branches of non-EU banks authorised in Italy also contribute to the FITD, unless they participate in an equivalent foreign guarantee system.

17 Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis [2013] OJ C216/1.

18 Such involvement of the FITD was found by the European Commission to be state aid in Commission Decision (EU) 2016/1208 of 23 December 2015 on State aid granted by Italy to the bank Tercas (Case SA 39451 (2015/C) (ex 2015/NN)) [2016] OJ L203/1). This decision was subsequently annulled by the General Court of the EU, on the grounds that the European Commission inappropriately concluded that the measures granted to Tercas entailed the use of Italian state resources and were imputable to the Italian state (Judgment in Joined Cases T-98/16, *Italy v Commission*, T-196/16, *Banca Popolare di Bari SCpA v Commission*, and T-198/16, *Fondo interbancario di tutela dei depositi v Commission*). The decision to annul is currently under appeal.

19 Ignazio Visco, *Hearing regarding Proposed Appointment of the Governor of the Bank of Italy, Senate Enquiry into the Conditions of the Italian Banking and Financial System and the Protection of Savings, including with regard to Supervision, Crisis Resolution and the Guarantee of European Deposits*, 19 April 2016.

Those provisions would become mandatory only in January 2016.[20] The timing of the resolution of the Four Banks also allowed avoidance of compulsory administrative liquidation, which would have been inevitable before the implementation of the BRRD. According to the Ministry of Economy and Finance and the Bank of Italy (as competent authorities), compulsory administrative liquidation would have led to the interruption of business continuity, with disruptive effects not only on a broader range of liabilities (such as deposits, ordinary bonds and current accounts) but also on the employment of the Four Banks' personnel.

On 21 November 2015, with effect as from 22 November 2015, the Bank of Italy, with the approval of the Ministry of Economy and Finance, adopted a plan for the resolution of each of the Four Banks, which provided for the continuity of the credit and financial services provided by them in their local markets.[21]

The implementation of the resolution plans, in consideration of significant losses,[22] consisted of the write-off of reserves, share capital and the nominal value of the subordinated liabilities included in equity, with the consequent extinction of related administrative rights.[23]

The resolution plans provided for splitting the "good" part of the balance sheet of each of the Four Banks from the "bad" part and establishing four "good banks" (the "Bridge Banks"). All assets, except non-performing loans, and all liabilities (i.e. current accounts, deposits and ordinary bonds) were transferred to the Bridge Banks.

At the same time, the "bad" parts of the Four Banks' balance sheets (i.e. the non-performing loans) were transferred to a bad bank, namely Rev Gestione Crediti ("Rev"), an entity specialised in the recovery of non-performing loans whose share capital was fully owned by the Bank of Italy.

In this context, the intervention of the NRF – totalling EUR 3.6 billion[24] – was allocated as follows: EUR 1.7 billion to cover the losses of the Four Banks, EUR 1.8 billion to recapitalise the Bridge Banks, and EUR 140 million to endow Rev with the minimum capital needed for operations.

At the end of a complex process, on 10 May 2017 three Bridge Banks, namely Nuova Banca Marche, Nuova Banca Popolare dell'Etruria e del Lazio and Nuova Cassa di Risparmio di Chieti, were sold to Unione di Banche Italiane, while the fourth

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20 Carmelo Barbagallo, *Cassa di Risparmio di Ferrara, Banca delle Marche, Cassa di Risparmio della Provincia di Chieti, Banca Popolare dell'Etruria e del Lazio, Parliamentary committee of enquiry on the financial and banking system*, 12 December 2017.

21 Bank of Italy, *The Resolution to the Crisis at Four Banks under Special Administration* (2015), available at: https://www.bancaditalia.it/media/notizia/resolution-to-the-crisis-at-four-banks-under-special-administration.

22 The Bank of Italy decided to adopt the resolution decisions of the Four Banks at a time when their financial situation did not allow the continuation of the extraordinary administration, nor the acquisition of the Four Banks by other banking groups.

23 Bank of Italy, *Measures of the National Resolution Authorities* (2015) Annex, available at: https://www.bancaditalia.it/media/notizia/resolution-to-the-crisis-at-four-banks-under-special-administration. The administrative rights of a shareholder consist, inter alia, of: (i) the right to intervene in shareholders' meetings; (ii) the right to vote at shareholders' meetings; and (iii) the right to challenge the resolutions of shareholders' meetings. The losses imposed on shareholders and subordinated creditors amounted to approximately EUR 870 million; see https://www.bancaditalia.it/media/approfondimenti/2016/d-e-r-quattro-banche/index.html?com.dotmarketing.htmlpage.language=1.

24 European Parliament, *'Bail-ins' in Recent Banking Resolution and State Aid Cases* (2016), available at: http://www.Europarl.Europa.eu/RegData/etudes/IDAN/2016/574395/IPOL_IDA(2016)574395_EN.pdf.

Bridge Bank, Nuova Cassa di Risparmio di Ferrara, was sold on 30 June 2017 to BPER Banca. The sales of the Bridge Banks were executed following the fulfilment of all the conditions precedent established in the sale agreements, which included recapitalisation of the Bridge Banks by the NRF and the transfer to securitisation vehicles of their non-performing loans (accrued after the start of resolution) and unlikely-to-pay loans (not included in the initial transfer to Rev).

In accordance with the provisions of the abovementioned sale agreements, and in the days immediately following the sales, the former Bridge Banks transferred "detachable coupons" (complex financial instruments) to the NRF. These instruments, issued in the context of the transfer by the Bridge Banks of non-performing loans and unlikely-to-pay loans, assigned to the NRF the right to participate in possible additional returns on the transferred portfolios.[25]

3.2 Monte dei Paschi di Siena

In 2016, Banca Monte dei Paschi di Siena ("MPS") was subject to a stress test by the European Banking Authority in cooperation with the ECB and the national supervisory authority (the Bank of Italy). As the stress test showed an equity gap in the case of an adverse scenario, the ECB requested MPS to take the necessary measures to overcome the situation.

As a first measure, MPS decided to carry out a capital increase of EUR 5 billion, to be subscribed by private-sector investors. However, this did not have a successful outcome.[26] In that context, on 23 December 2016 the Italian Government adopted Law Decree No 237 of 23 December 2016 ("Law Decree 237")[27] on measures to support the financial stability of banks, as an executive measure under article 18 of Decree 180 (which relates to extraordinary public financial support). In particular, Law Decree 237 (which remains in force) empowers the Italian competent authority (the Ministry of Economy and Finance), taking into account assessments and evaluations carried out by the Bank of Italy, to grant public support to Italian banks in difficulty within the state aid framework. On 30 December 2016, MPS filed a request, pursuant to Law Decree 237, for precautionary recapitalisation.[28]

On 1 June 2017 the European Commission, after confirmation by the ECB that MPS was solvent, authorised the release of state aid and the precautionary recapitalisation of MPS by the Italian Government. In this light, MPS obtained extraordinary public support to carry out a restructuring process, the cost of which was allocated to the Italian Government and to the shareholders and junior creditors of MPS, in compliance with the burden-sharing principle. The precautionary recapitalisation was in a total amount of EUR 8.1 billion, including the conversion of junior bonds in a principal amount of EUR 4.3 billion and a capital injection by the Italian Government of EUR 3.9 billion.[29]

25 Bank of Italy, *Report on the National Resolution Fund* (2017).

26 The investment orders collected were not sufficient to reach the required amount of EUR 5 billion.

27 Converted into law, with amendments, by Law 17 February 2017, No 15.

28 Bank of Italy, *The Precautionary Recapitalisation of MPS: Questions and Answers* (2017).

29 Although the capital shortfall calculated by the ECB was equal to EUR 8.8 billion, the total amount of the precautionary recapitalisation was limited to EUR 8.1 billion due to additional capital measures taken by MPS, namely asset sales.

3.3 Banca Popolare di Vicenza and Veneto Banca

Banca Popolare di Vicenza and Veneto Banca (the "Two Banks") had been monitored by the ECB since 2014, because of capital shortfalls shown in comprehensive assessments. High levels of non-performing loans and critical issues with the business models of the Two Banks meant that, notwithstanding the investment of Fondo Atlante (a bank-funded investment fund) of about EUR 3.5 billion in 2016, the financial situation of the Two Banks became even worse. The ECB required the filing of plans for recapitalisation to meet capital requirements.

In March 2017 the Two Banks failed to find private sources for recapitalisation and, pursuant to Law Decree 237,[30] filed a request for precautionary recapitalisation. However, the European authorities stated that the conditions for preliminary recapitalisation were not met. On 23 June 2017 the ECB declared the Two Banks failing or likely to fail under article 18(1)(a) and (4)(a) of the SRMR, and the SRB excluded the existence of a public interest justifying resolution of the Two Banks (see further the last paragraph of this subsection).

In that light, the plan was to transfer parts of the Two Banks, excluding non-performing loans, to Intesa SanPaolo. On 24 June 2017, the Italian state notified the European Commission of its intention to provide state aid for the liquidation of the Two Banks, in order to avoid the effects of economic disruption in the Veneto region because of the exit from the market of the Two Banks.

On 25 June 2017 the European Commission approved such state aid. It noted that shareholders and the holders of subordinate obligations were fully contributing to the costs, so as to reduce the burden on the Italian state. It also noted that the Two Banks would be liquidated in an orderly way and exit the market, while the transferred assets and activities would be significantly restructured and reduced by Intesa SanPaolo, and that in combination this would limit distortions of competition arising from the state aid. In addition, the European Commission determined that Intesa SanPaolo was not a beneficiary of state aid under the transaction, on the basis that it was selected through an open, fair and transparent procedure fully managed by the Italian authorities, ensuring that assets and activities were transferred at the best available price.

The Two Banks were put into compulsory administrative liquidation via Law Decree No 99 of 25 June 2017 ("Law Decree 99"). On 26 June 2017 the Bank of Italy announced the transfer to Intesa SanPaolo of parts of the Two Banks, for an overall symbolic value of one euro. The liquidator commissioners of the Two Banks arranged for the transfer of assets and liabilities, including the transfer of employees, to Intesa SanPaolo, which replaced the assignor banks in contractual relationships with clients. The non-performing loans of the Two Banks were excluded from the transfer of assets and liabilities and would be transferred to a state-participated company, while the shareholders' rights and the subordinated liabilities would remain with the liquidation. The transaction was aimed at ensuring the protection of all depositors and senior creditors, as well as compensation for owners of subordinated financial instruments retail in cases of mis-selling.

[30] See section 3.2 above.

The case of the Two Banks shows that the approach and view adopted by the SRB can be different from those adopted by national authorities. Indeed, the SRB determined that liquidation of the Two Banks would not have a systemic impact at either the national level or the local level (more specifically, that (i) the functions performed by the Two Banks were not critical, and (ii) the failure of the Two Banks was not likely to result in significant adverse effects on financial stability),[31] while the Italian Law Decree 99 (i) noted that, in the absence of public financial support, there would be an interruption in the provision of credit to businesses and families, with a negative economic and social impact and negative effects on employment, and (ii) stated that public financial support was necessary to avoid a serious disturbance to the local economy.[32]

31 SRB, 'The SRB Will Not Take Resolution Action in Relation to Banca Popolare di Vicenza and Veneto Banca' (Press Release, 23 June 2017), available at: https://srb.europa.eu/en/node/341.

32 See https://www.gazzettaufficiale.it/eli/id/2017/06/25/17G00115/sg (in Italian).

VIII. SPAIN

VIII. Spain

Adrián Thery and Rafael González-Gallarza Granizo*

1. Introduction

Spain has been one of the main testing grounds for the Single Resolution Mechanism (the "SRM") with the resolution in 2017 of one of the largest Spanish banks, Banco Popular, a case we will closely examine in this chapter.

The chapter is organised as follows. Section 2 contains a general description of the applicable legal framework with a discussion of the aspects where it differs from the Bank Recovery and Resolution Directive ("BRRD").[1] Section 3 addresses the Banco Popular case, with a detailed review of the events and decisions that led to the placing of the bank into resolution on 7 June 2017 and the terms and conditions of the resolution scheme. We also attempt to extract some relevant lessons from this case. Section 4 is concerned with the ordinary insolvency procedure which applies to failing banks in Spain where the public interest ground for resolution does not exist. The section presents the case of Banco Madrid, a smaller bank that was liquidated in normal insolvency proceedings in 2015 following the demise of its parent based in Andorra, Banca Privada d'Andorra.

2. The legal framework

Spain is a euro area country and is therefore a participating state in the Single Supervisory Mechanism (the "SSM") under the Single Supervisory Mechanism Regulation[2] as supplemented by the Single Supervisory Mechanism Framework Regulation,[3] and in the SRM under the Single Resolution Mechanism Regulation (the "SRMR").[4]

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

2 Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63.

3 Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141/1.

4 Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L225/1.

Spain implemented the BRRD through Act 11/2015, of 18 June 2015, on the Recovery and Resolution of Credit Institutions and Investment Services Firms ("Act 11/2015"). The fourth additional provision of Act 11/2015 specifies that it will operate in conformity with the SRMR. Act 11/2015 is an Act of Parliament and it gave the Government powers to issue secondary legislation in the form of Royal Decree 1012/2015 of 6 November 2015.

The Spanish executive resolution authority tasked with implementing the resolution decisions of the Single Resolution Board (the "SRB") under the SRMR is the Fondo de Resolución Ordenada Bancaria ("FROB").[5] FROB is a public entity with its own legal personality.

The bank resolution framework in Spain is, overall, the same as for the other euro area countries. We refer to chapter V of this book for the general analysis. Act 11/2015 implemented the BRRD faithfully and we will simply note the following:

- Article 37(9) of the BRRD provides that member states of the European Union ("Member States") may confer upon resolution authorities additional resolution tools and powers, but Spain has not made use of this discretion except, possibly, for article 68.a) of Act 11/2015. This article provides that FROB may, in cases of urgency and if necessary to meet the resolution objectives, use the sale of business and bridge institution tools prior to approving a resolution scheme.

- Articles 40(12) and 42(13) of the BRRD provide that the management body or senior management of a bridge institution or asset management vehicle shall have no liability to shareholders and creditors of the institution under resolution in the discharge of their duties, other than in cases of gross negligence or serious misconduct, and that Member States may further limit such liability. Articles 27.9 and 28.4 of Act 11/2015 exclude liability for "serious faults and infractions", which seems a more protective standard for the management body or senior management of the bridge institution or asset management vehicle.

- Spain has not made use of the possibility to provide for *ex ante* judicial approval of resolution actions under article 85(1) of the BRRD.

- Spain has included two particular provisions among the so-called "procedural rules" in Act 11/2015:

    - First, article 74.1 of Act 11/2015 provides that court judgments cannot be enforced according to their own terms if they declare unlawful certain types of resolutions or decisions by the authorities that are rendered either within early intervention and resolution processes or through the corporate-law powers of banks' corporate bodies (when decisions from the board or the general shareholders' meeting are needed for formal reasons in order to validly implement such processes). In these cases of impossible enforcement, a limit is placed on the damages that the injured parties are able to seek: at the most, the difference between the damage actually sustained by the appellant and the loss it would have sustained if, when the relevant decision or resolution was adopted, the entity had been liquidated in an insolvency proceeding.

[5] FROB also has the early intervention and resolution functions set out in SRMR, art 7(3), in respect of the Spanish credit institutions that are not subject to the direct authority of the SRB.

- Second, article 72.2 of Act 11/2015 contains a provision regarding judicial review of acts and decisions that are rendered in early intervention and resolution processes. This provision stipulates that any valuation accompanying the supervisor's and the resolution authority's acts and decisions cannot be the subject of a separate appeal and is only challengeable in appeals lodged against those acts and decisions; if the valuation is not challenged, it must then be used by the court as a basis for its own assessment of any appealed acts or decisions. This provision is in line with article 36(13) of the BRRD, yet may slightly differ from its article 85(3), according to which Member States must ensure that: (i) any *ex ante* court review of acts and decisions rendered in early intervention and resolution processes is expeditious; and (ii) national courts make their own assessment based on the complex economic assessments of the facts carried out by the resolution authority.

A similar issue to the last one noted above was examined in the only bank resolution precedent in Spain before the Banco Popular case in 2017. That precedent was the resolution of Caja Rural de Mota del Cuervo, which was declared non-viable by the Banco de España (the Bank of Spain, the Spanish central bank) as supervisor on 14 January 2014, and FROB was appointed as its provisional administrator according to Act 9/2012 (the forerunner of Act 11/2015 and with very similar provisions for our purposes).

The resolution of Caja Rural de Mota del Cuervo was carried out through an accelerated sale of its ownership instruments to the best bidder. FROB expressly upheld that the obtained price enabled a better result for shareholders and creditors than they would have obtained in liquidation.

The Caja's cooperative members lost part of their investment and took legal action seeking compensation. However, although the cooperative members pleaded an undervaluation of the institution in the resolution process, they did not appeal against all of FROB's acts, but just two of them (the provisional substitution of the Caja's managing body, and the transfer to the successful bidder of the funds they had contributed to the Caja's capital).

The National Appellate Court (Judicial Review Chamber) set aside both appeals. The first appeal was dismissed on the basis that they should have appealed against the decision approving the resolution plan as the final act in the procedure. The second appeal was also dismissed, in essence on the basis, from one angle, that the valuation was not necessary because the procedure was urgent (article 68.b); and, from another, that the failure to value the Caja's endowment should have been challenged in the civil courts as an issue relating to management of the foundation by its board of trustees. In short, the court did not enter into the challengers' main argument (as to the level of the valuation). Although both judgments applied Act 9/2012, when they were rendered[6] Act 11/2015 was already in force and, in particular, the provision in article 72.2 discussed above, the logic of which is very similar to the reasoning used by the National Appellate Court in the Caja Rural de Mota del Cuervo case.

6 Judgments by the National Appellate Court (Judicial Review Chamber) no 555 and no 556 of 13 October 2016 (ROJ nos SAN 3919/2016 and SAN 3920/2016 respectively).

We will now focus on what is the most important bank resolution in the Spanish jurisdiction as at the date of writing: the Banco Popular case. Section 4 below discusses certain relevant aspects of the Spanish legal framework applicable to normal insolvency proceedings.

3. The Banco Popular case

3.1 Introduction

Banco Popular underwent resolution under a scheme adopted by the SRB on 7 June 2017 and its share capital was sold for one euro on the same date to Banco Santander, by applying the sale of business tool. The case is interesting for many reasons, including the large size of the bank, the extremely quick resolution process, and the fact that it did not require the injection of resolution or other public funds. The burden of resolution was borne entirely by shareholders and the holders of the bank's capital instruments, which lost their investment down to the last euro while all the senior debt holders and depositors remained unscathed.

From a more technical perspective, the case is also interesting in our view regarding two more specific elements in particular. The first is how and why resolution departed from the way it was depicted in the bank's resolution plan adopted by the SRB in December 2016 (the "Plan"). The other element is how use of the sale of business tool followed on from, and took advantage of, a private sale process attempted by the bank shortly before resolution. Generally, the structure of the process is very interesting because it bears some resemblance, with all the proper safeguards, to a pre-packaged sale ("pre-pack") transaction.

The Banco Popular case is not over, in that the resolution procedure is still in progress, especially the *right to be heard* phase. The numerous lawsuits it has engendered are also continuing.

We will concentrate on the events leading up to resolution and the resolution decision itself in the period between February and June 2017 without examining subsequent events. The period we will discuss is at the centre of the case and is sufficiently complex and illustrative to warrant our fullest attention.[7]

3.2 Banco Popular and its difficulties

Banco Popular was the sixth largest bank in Spain as at the start of 2017, with EUR 147,114 million in assets, 1,644 branches in Spain, and 10,600 employees. It was a *significant* bank directly supervised by the European Central Bank ("the ECB") under the SSM.[8] The bank specialised in retail and commercial banking with a certain focus on small and medium-sized enterprises ("SMEs"). It had a simple group structure comprising a parent undertaking, Banco Popular Español, SA (with shares traded on the Spanish stock exchange and containing most of the business in terms of earnings),

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7 The information we have used is available on the websites of the SRB and FROB at: https://srb.europa.eu and http://www.frob.es respectively. We have found particularly useful and informative the speech made by Elke König, SRB Chair, on 11 December 2017, to the Spanish Parliament's lower house as part of the parliamentary inquiry on the financial crisis in Spain, in which she provided a detailed account of the rationale for the decisions taken by the SRB in respect of Banco Popular.

8 The Banco Popular group was a *significant* group in accordance with SSM Regulation, art 6(4), and was therefore under the direct authority of the SRB under SRMR, art 7(2).

and three main wholly owned subsidiaries: Banco Pastor, SA (Spain); Popular Banca Privada, SA (Spain); and Banco Popular Portugal, SA (Portugal). The group was present mainly in Spain and to a lesser extent in Portugal;[9] it had a small overseas presence, with a wholly owned subsidiary in Florida (United States), and a minority stake in a Mexican bank.

As a result of a high level of non-performing assets and other weaknesses, Banco Popular had to strengthen its regulatory capital position through a EUR 2,500 million capital increase in 2016 with shares issued at a 45 percent discount. Its situation nevertheless worsened even further in the first months of 2017.

In February 2017, the bank announced losses of EUR 3,485 million as of year-end 2016, and in April, new adverse changes to its financial position were revealed. The first quarterly results announced in May were worse than expected. Its ratings were downgraded between February and June. The bank publicly recognised in April 2017 that it needed a capital increase or a major corporate transaction.

The declining situation and repeated adverse press resulted in a drastic fall in its share price and, importantly, a growing level of deposit outflows causing an alarming deterioration in the bank's liquidity position.

3.3 The Plan compared with the actual resolution scheme

Before we describe the private solution attempted by Banco Popular, it is interesting to take a look at the main content of the Plan (which was adopted in December 2016) and compare this with the actual terms on which resolution occurred a few months later.

The Plan discarded liquidation in a normal insolvency procedure because of the disruption it would bring to the bank's critical functions, which were identified as deposit-taking, lending to SMEs, and payment and cash management services. The Plan also acknowledged a high risk of direct or indirect contagion to other institutions. The Plan was implemented in this respect, in that Banco Popular was put into resolution and not a *concurso de acreedores* which is the regular insolvency procedure in Spain as explained in section 4 below.

The Plan also stated that the centralised business model of the group called for a *single point of entry* resolution strategy at the level of the parent undertaking. It was also implemented in this respect, in that the whole group was disposed of by selling the shares in the parent undertaking.

Bail-in was also recommended in the Plan as the preferred resolution tool. The Plan further contemplated a resolution strategy in two phases: first, a stabilisation phase where the bail-in tool was to be used, followed by a restructuring phase in which a business reorganisation plan would be presented and implemented by management of the bank.

9 It seems that Banco Popular had no *significant* branches in other Member States (within the meaning of the Capital Requirements Directive (Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [2013] OJ L176/338). Moreover, the public information does not refer to any consultation or contact between the SRB and any national resolution authority other than FROB and the Bank of Portugal (on account of the Portuguese subsidiary).

This last part of the Plan was not put into practice, in that the SRB elected the sale of business tool. The SRB's decision on 7 June 2017 adopting the resolution scheme[10] justified this departure from the Plan on the ground that the Plan was based on the assumption that the bank's failure would be due to the deterioration of its capital position and what actually caused the failure was its critical liquidity position. The SRB further argued that, because of the liquidity problem, the bail-in tool under article 43 of the BRRD (and article 27 of the SRMR) would not put the bank back on its feet. Interestingly, the SRB added that: "[T]his is, in particular, the case due to the already large number of encumbered assets of the [i]nstitution when entering resolution." The decision did not dwell further on this aspect and the specific nature of such encumbrances. It may refer to the secured financing facilities obtained by the bank from the ECB and the assets used as collateral for these facilities.

3.4 The private sale process paved the way for the sale of business in resolution

We will return now to the actual course of events and to April 2017 when the bank commenced a private sale process of its own shares with a view to attracting a strong purchaser that would restore its strength. Within that private sale process, a virtual data room ("VDR") with due diligence materials was organised, and a number of other national and international banks were contacted, including Banco Santander. Five institutions expressed their interest and were invited to submit bids. The deadline for receiving bids was originally set at 10 June 2017 and subsequently postponed to the end of June.

The private process had not been completed before the first week of June, when the collapse was so likely in the eyes of the bank itself, the ECB and the SRB, that resolution became inevitable.

The existence of a very advanced private sale process immediately before the resolution procedure is one of the main characteristics of the Banco Popular case. The final sale of the shares to Banco Santander immediately upon placing the bank into resolution and writing down all capital instruments would hardly have been conceivable if Banco Santander had not participated in that private sale process.

In fact, as we will see below, the available public information contains elements showing that the measures adopted by the ECB and the SRB ran in parallel and contemplated the private sale process at least during May and June. It appears that the authorities hoped for the best (the success, in time, of the private sale process) but prepared for the worst (taking steps in preparation for a potential resolution). At some point, probably between 3 June and 6 June 2017, the authorities came to the conclusion that deposit outflows were such that the resolution procedure could not wait and should take over from the private sale process.

In a way, the private sale process continued as the marketing procedure adopted by the SRB as part of the sale of business tool. That marketing procedure followed on from, and took advantage of, all the steps and developments that had already taken place in the private process, such as the VDR and the interest already raised among potential buyers, especially Banco Santander, which ultimately made the only binding bid.

10 *Decision of the Single Resolution Board in its Executive Session of 7 June 2017 concerning the Adoption of a Resolution Scheme in respect of Banco Popular Español, SA* (non-confidential version), SRB/EES/2017/08.

The authorities may also have had a sense of urgency when they turned their sights to potential buyers. Depositors were running on the bank and at some point, sooner rather than later, prospective buyers could also lose interest in a crumbling franchise.[11] Therefore, the SRB probably came to the conclusion that the only way to secure a binding bid from a buyer, which would presumably recognise little or no value in the bank's existing capital instruments, was to write them down in the framework of resolution. Write-down and conversion of capital instruments was impossible to achieve within a purely private process.

From this perspective, we can regard the Banco Popular case as a form of "pre-pack" where public and private actions converged to sell the bank on the best possible terms, free from pre-existing capital instruments, and with the sanction of the authorities. It looks as if, in our case, resolution occurred just in time as only one buyer put in a bid and it was for one euro. Had the authorities waited too long the bank could possibly have ceased to be able to operate, and the only interested buyer would have withdrawn.

3.5 The first preparatory steps for resolution

The sequence of events we will now look at shows how the private sale process and the steps taken by the authorities first ran in parallel and were somehow coordinated until the point where they merged into resolution and use of the sale of business tool.

- **ECB and SRB on the alert**

  On 2 May 2017, the Banco Popular crisis management group at the ECB met to discuss the situation. On 18 May 2017, the SRB asked the ECB to provide it with specific and updated information on the bank.

- **SRB requests an independent valuation**

  On 23 May 2017, the SRB went a step further and hired Deloitte to perform a valuation under article 36 of the BRRD (and article 20 of the SRMR); a day later, the SRB requested Banco Popular to provide the necessary information for the valuation to be prepared. The valuation was requested under article 36(9) of the BRRD (and article 20(10) of the SRMR) as a provisional process for urgency reasons.

  Until that point, culmination of the private sale process may have continued to be plan A in the mind of the authorities. The economic valuation report was requested in preparation for resolution (which would have been plan B).

[11] Spain implemented the Deposit Guarantee Scheme Directive (now Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) [2014] OJ L173/149) by means of Royal Law Decree 16/2011 of 14 October 2011, which created the Fondo de Garantía de Depósitos en Entidades de Crédito (the "FGD"), and Royal Decree 2606/1996 of 20 December 1996. Unlike in other bank failure cases, which saw the FGD deploying funds either in a preventative fashion (to avoid having to cover deposits) or to directly cover deposits, in the Banco Popular case it was not deployed in any manner.

- **ECB gives the bank five days of life**

  On 2 June 2017, the ECB sounded the alarm: it informed the SRB that the situation of the bank was deteriorating rapidly as a result of the fast deposit outflow, and that it might become unable to pay its debts as they fell due within the following week. Although the public information is not entirely clear on this point, it seems that the ECB's assessment that the bank was likely to collapse in a matter of days was also related to the fact that Banco Popular had exhausted its capacity to borrow money from the ECB under the Emergency Liquidity Assistance mechanism.

  On the day it received this warning from the ECB, the SRB prepared for use of the sale of business tool. The SRB knew from the ECB that there was a private sale process going on, so it made a direct request to the bank to supply information on this. We know that the binding bids were only due by the end of June so we are able to infer that the SRB lost faith that the private sale would materialise before lack of liquidity would bring the bank to a grinding halt in the second week of June.

  This is probably when plan B became plan A.

3.6 The marketing decision

Consistent with its intention to build on the private sale process, the SRB also asked Banco Popular on 2 June 2017 to stand ready to provide potential purchasers participating in a possible marketing procedure adopted by the resolution authorities (under article 39 of the BRRD (and article 24 of the SRMR)) with access to the VDR set up as part of the private sale process.

The information the SRB received from the bank on the private sale process must have supported the SRB's determination that use of the sale of business tool was the preferred resolution strategy. A day later, on 3 June 2017, the SRB adopted a decisive course: it decided to commence the marketing procedure in relation to the bank and provided FROB (as the Spanish executive resolution authority) with the marketing requirements under article 39 of the BRRD (and article 24 of the SRMR).

Under the 3 June 2017 decision, the SRB mandated FROB to organise the sale of Banco Popular and seek binding and irrevocable bids. Importantly, the decision invoked reasons of urgency to direct FROB to contact the five other banks that expressed their interest within the private sale process (and which, as we know, had not yet come to submit any binding bids). Reasons of urgency and confidentiality justified restricting the circle of invited parties to those five entities and no more. The SRB further expressed a position that, based on the information it had received from Banco Popular, it seemed very unlikely that any potential bidder other than those five banks would now be interested in the process.

We can see clearly how the SRB designed the sale process as a continuation of the private attempt to the point where it took up exactly where Banco Popular had left off.

The marketing decision of 3 June 2017 also set out the criteria that would determine the selection of the best bid. The main criterion was to be the offered sale price, but FROB received instructions from the SRB to consider the following factors: the bidder's ability to obtain the necessary regulatory approvals and the likelihood that it would address the liquidity problems of Banco Popular.

The decision is not entirely clear as to which authority (the SRB or FROB) would ultimately select the best bid. With the main criterion being the offered price, this determination would admittedly be straightforward for either authority to make. However, the wording of the decision is ambiguous as to satisfaction of the other two qualitative criteria. It read: “FROB, following the approval of the SRB in its Extended Executive Session, may decide”, followed by a description of the qualitative criteria.

Another important feature of the SRB’s decision of 3 June 2017 to put in motion the marketing process is that it was just a preparatory step: it did not constitute the decision to place Banco Popular into resolution nor the decision to adopt the sale of business tool as the resolution strategy. This was explicit in article 4 of the decision, entitled “Relationship with a potential resolution scheme” and reading as follows: “This decision is without prejudice to any potential resolution scheme to be adopted by the SRB in its Executive Session taking into account the circumstances of the case at that point in time.”

The five potential bidders were immediately requested to sign a non-disclosure agreement (“NDA”) but only two of them signed the NDA and returned it to FROB on 4 June 2017; these two parties were then given access to the VDR. It may be presumed that they were given fresh access to substantially the same VDR that had been organised and that the two parties had already examined within the private sale process. The proposed sale documents were also provided by FROB to the two parties.

3.7 A sale conditional on resolution

A letter was sent by FROB on 6 June 2017 to the two parties that had signed the NDA, which set out the terms of the sale process consistently with those of the SRB’s decision of 3 June 2017. FROB’s letter warrants a few comments.

Notably, it made clear that the bank had not yet been placed into resolution and that no resolution scheme had been approved. The letter referred to a “possible resolution”. Parties were invited to submit a binding purchase bid for all the shares in the bank not later than 6 June 2017 at 23:59 “for a price that must be an exact figure (not a range) equal to or greater than one euro”.

The letter also specified that acceptance of the bid and performance of the sale and purchase agreement would be conditional on the simultaneous adoption by the SRB of the resolution scheme and the measures to be taken by FROB to implement that resolution scheme. All these steps were scheduled for 7 June 2017.

This part of the letter had the “pre-pack” hue we have already mentioned. The process was not designed as commencing with the decision by the SRB to put Banco Popular into resolution and to approve a resolution scheme consisting of application of the sale of business tool, followed by the sale process, the selection of the buyer, and the completion of the sale. The process worked in reverse order. The sale was organised as a preparatory step conducive to the receipt of a unilateral purchase bid and a possible subsequent declaration of resolution with the adoption of a specific resolution scheme (in the form of the sale of business tool); resolution was to coincide with acceptance of the best bid and was to be the final step. Clearly, the SRB wanted to take the key step only after receiving bids.

The SRB was thus free, if no bids were received or if no bids were acceptable, to leave aside the sale of business tool and adopt another resolution scheme. Such an alternative scheme could possibly have followed the lines set out in the Plan except for the resolution funds that the authorities would have had to inject to cover the pressing liquidity needs of the failed bank.

3.8 Bidders not to rely on public financial support

This process, in which a “negative price” was not admissible, was probably aimed at preventing potential bidders from assuming that public resolution funds would facilitate the transaction. They were not permitted to compete on the basis of asking for the lowest public financial support; if a party wanted Banco Popular, it would not be paid for it.

However, the minimum price was set at one euro and no more. The authorities were ready to contemplate a situation where all the bank’s capital instruments would be written down. FROB’s letter left no doubt as to the fact that there was a chance that all holders of existing Tier 1 and Tier 2 capital could lose their entire investments. It expressly stated that the offered price could actually be one euro after successively writing down in full the bank’s convertible perpetual bonds (Additional Tier 1) in addition to its ordinary shares (Common Equity Tier 1 (“CET1”)), and, if need be, its subordinated bonds as well (Tier 2).

The letter, however, implicitly excluded the conversion or write-down of any senior debt issued by the bank because the only liabilities expressed to be capable of being extinguished within the offer were the Tier 1 and Tier 2 layers.[12] It should be noted that at that time, senior non-preferred bonds as a permissible part of the *minimum requirement for own funds and eligible liabilities* (“MREL”)[13] did not exist in the market.

On 5 June 2017, the SRB concluded the valuation under article 36(4)(a) of the BRRD (and article 20(5)(a) of the SRMR) reporting the determination of “whether the conditions for resolution or the conditions for the write down or conversion” are met. This report is silent as to any write-down or conversion of capital instruments and any quantitative indicator.

On 6 June 2017, Deloitte concluded the economic valuation commissioned from this firm on 23 May 2017 as we have seen (see section 3.5 above). The report provided an assessment of the value of the bank in liquidation and the recoveries expected by each class of creditors as required by article 36(8) of the BRRD. The report concluded that “subordinated creditors would achieve no recoveries”. This statement was surely in the SRB’s mind when purchase bids were requested from the two potential buyers.

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[12] The resolution scheme ultimately adopted by the SRB on 7 June 2017 (see section 3.9 below) did not use the bail-in tool provided for in BRRD, art 43 (and SRMR, art 27). The resolution scheme used the sale of business tool as provided for in BRRD, art 38 (and SRMR, art 24), and exercised the power to write down and convert the shares and the “relevant capital instruments” (Additional Tier 1 and Tier 2 instruments) as provided for in BRRD, art 59 (and SRMR, art 21). The bail-in tool allows for the write-down or conversion not only of ordinary shares and “relevant capital instruments”; it also allows for the write-down and conversion of the *eligible liabilities* of an institution – a term that includes its unsecured debt instruments. The sale of business tool does not allow per se for any write-down or conversion of any instruments; such write-down and conversion is only possible if the sale of business tool is used in combination with the power provided for in BRRD, art 59 (and SRMR, art 21) (which does not cover unsecured debt instruments) or the bail-in tool (see BRRD, art 37(4) (and SRMR, art 22(4)) and BRRD, art 43(2)(b)(ii) (and SRMR, art 27(1)(b)(ii))).

[13] Under BRRD, art 45 (and SRMR, art 12).

3.9 Resolution

The resolution process continued its accelerated pace.

- **Banco Popular declares itself likely to fail**

  On 6 June 2017, the bank communicated to the ECB that its board of directors had assessed that the bank was likely to fail. This recognition by the bank itself was another decisive factor that sealed the fate of the bank.

- **ECB declaration that failing or likely to fail**

  On the same day, the ECB determined that the bank was failing or likely to fail in accordance with article 32(1)(a) of the BRRD (and article 18(1) of the SRMR) and informed the SRB of this.

- **Banco Santander submits the only bid**

  On 7 June 2017, FROB received only one binding bid. Banco Santander offered to pay one euro subject to a full write-down of all capital instruments without exception from CET1 to Tier 2. The other institution that had signed the NDA declined to submit a bid. It is safe to presume that Banco Santander would hardly have been able to submit its bid within such an extremely tight timeframe had it not participated in the private sale process and thereby acquainted itself with the target.

- **Resolution and sale of the business**

  On the same day, 7 June 2017, the bid was accepted and the SRB issued its decision to place Banco Popular into resolution and adopt the resolution scheme in the form of use of the sale of business tool. The European Commission endorsed the resolution scheme without objections and FROB issued an order for the write-down of capital instruments. Technically, FROB's decision provided for a domino-like succession of write-down, conversion, further write-down and further conversion of each of the capital instruments, culminating in the conversion of the most senior instruments into one share newly issued to FROB.[14] FROB sold that share to Banco Santander for one euro on 7 June 2017, subject to all regulatory approvals.

  On the day of the acquisition, Banco Santander injected several billions of euros of liquidity, enabling Banco Popular to continue its operations the day after and

[14] FROB acted in accordance with the priority of claims. Unlike in the case of Caja Rural de Mota del Cuervo (see section 2 above), FROB referred to the future final valuation under article 20(16) of the SRMR. See end of Principle Of Law #2 of 7 June 2017 (as stated in the Resolution of the FROB Governing Committee adopting the measures required to implement the Decision of the Single Resolution Board in its Extended Executive Session of 7 June 2017 concerning the adoption of the resolution scheme in respect of Banco Popular Español, SA): "Vis-à-vis the second principle, it should be noted that based on the information of the economic valuation of the entity, the shareholders and creditors whose capital instruments will be written down and/or converted will not incur greater losses than they would have incurred under normal insolvency proceedings. In this respect, according to article 20(16) of the SRMR, the SRB must confirm the treatment referred to in the previous paragraph by obtaining a valuation from an independent expert to assess whether shareholders and creditors would have received better treatment if the entity had entered into normal insolvency proceedings. This valuation, to be carried out after the resolution measures in this decision are implemented, must determine whether shareholders and creditors should be compensated for any difference between the losses borne and those that would have been incurred in a winding up under normal insolvency proceedings, and would be entitled to payment of the difference."

comply with the regulatory liquidity ratios. Subsequently, Banco Santander increased the capital of the bank to meet the applicable solvency requirements.

The regulatory approvals for the acquisition were obtained very quickly and the transfer was fully completed.

3.10 Subsequent events

The resolution procedure continued its course, in particular with the *right to be heard* phase offered to the shareholders and holders of capital instruments that had been converted and written down.[15] The procedure is ongoing at the time of writing.

Many of the capital instrument holders that lost their investment have instituted legal proceedings against the resolution decisions. Lawsuits have been filed with the Spanish courts and the Court of Justice of the European Union, against FROB and the SRB. The terms and outcome of this litigation are outside the scope of this chapter.

3.11 Lessons for resolution planning

If we take a broader view and ask ourselves what lessons may be learned from the Banco Popular case for resolution planning in general the following reflections may be offered.

We know that the SRB concluded that the sale of business was the best tool to meet the resolution objectives. It appears that the SRB elected the sale of business tool out of pragmatism rather than theoretical reasoning. A private sale was ongoing at the time the SRB felt it needed to step in. The SRB saw fit to give a chance to its conclusion with the decisive assistance of a compulsory write-down of existing capital instruments. This played out well because one of the participants in the private sale process submitted a bid that did not require public bail-out money and did not impose any bailing-in of senior creditors. In the absence of such a bid, it is unclear whether the SRB would or could have used the sale of business tool. In this sense, the use of the sale of business tool was to a certain extent determined by the particular circumstances.

It is not necessarily the case that the circumstances of the fall of Banco Popular will never be repeated. Indeed, banks with a gradually weakening capital position may end up being prone to collapse because of liquidity problems. In such a situation, the bail-in tool by itself may not be a solution.

In the case of Banco Popular, the sale of business tool worked because a private sale process had led to interest on the part of one solid party that was willing and able to restore the distressed bank's liquidity position and confidence among its depositors. It is this head start and the time gained thanks to the advancements achieved in the private sale that probably made the difference.

15 On 14 June 2018 the SRB received from Deloitte the valuation report issued in accordance with SRMR, art 20(16), to determine the treatment that shareholders and capital instrument holders would have received had Banco Popular been liquidated under normal insolvency proceedings. The report concluded that shareholders and creditors would have received no recoveries at all. Based on this, on 2 August 2018 the SRB issued a preliminary decision not to pay any compensation to the shareholders and capital instrument holders under BRRD, art 101(1) (and SRMR, art 76(1)). The SRB also invited the affected parties to express their views in the framework of the *right to be heard* under article 41(2)(a) of the Charter of Fundamental Rights of the European Union before making its final decision.

With a view to ensuring that such a solution is available in other cases, resolution planners should look at this precedent and give consideration to requiring a bank – at least as a backstop position – to be ready to launch a sale process at any time. The bank would prepare and regularly update all the necessary elements of the process (especially a VDR and all other sale and due diligence materials) and stand ready to send invitations to prospective purchasers at the first sign of distress. For banks, like Banco Popular, centrally operated and funded and, therefore, suited to a *single point of entr*y resolution strategy, at the level of the parent undertaking, the advantage in terms of improved resolvability of this sale preparedness (which may translate into reduced MREL) may justify its costs.

4. Insolvency proceedings as the other route

The Spanish collective insolvency proceeding for corporates is a *concurso de acreedores*, also known simply as *concurso*. It can be opened at the request of the debtor or creditors. After an initial observation period, the common phase (*fase común*), it follows one of two paths, as a reorganisation procedure (*fase de convenio*) or a liquidation procedure (*fase de liquidación*). When an insolvency proceeding is commenced, the commercial court appoints an insolvency practitioner, who generally only supervises the debtor, unless the insolvency proceeding turns towards the liquidation phase (which implies the winding-up and dissolution of the debtor legal entity). Should the liquidation phase be opened, the insolvency practitioner will step into the shoes of the managing body for all purposes (except for liaising with and representing the shareholders in the insolvency proceeding). The liquidation phase may involve a sale of the business, a piecemeal sale of assets, or a combination of both.

Under Act 11/2015, if the Bank of Spain or FROB so decides on the ground of public interest, resolution takes precedence over an insolvency proceeding. This does not mean, however, that the bank cannot later enter into an insolvency proceeding, so as to be liquidated in the event that it undergoes resolution and has its business or assets transferred. Even if in these cases the insolvency proceeding has been expressly excluded in the resolution plan, the procedure for assessing the directors' liability will nevertheless be commenced, under article 174.1 of the Insolvency Act.[16]

The ranking for payment in liquidation was adopted by the Spanish bank resolution legislation. Additional provision 14 of Act 11/2015 addresses the ranking for payment in insolvency proceedings of rights in respect of most exposed deposits and of the

[16] Act 6/2005, of 22 April 2005, on the Restructuring and Liquidation of Credit Institutions. Translation of art 174.1: "1. In the event of adoption of administrative measures involving the winding up and liquidation of an institution and excluding the option of an insolvency order, the supervisory authority that adopted those measures shall immediately give notice of the resolution to the judge with jurisdiction for an insolvency order in respect of that entity. 2. After the notice has been received, and even if the administrative decision is not final, the judge, on its own motion or on the motion of the Public Prosecutor's Office or of the public authority, shall render a decision ordering the formation of an independent assessment procedure, without a prior insolvency order. The decision shall be made public as required in this law for the court decision on commencement of liquidation." Original Spanish text: "1. En los casos de adopción de medidas administrativas que comporten la disolución y liquidación de una entidad y excluyan la posibilidad de declarar el concurso, la autoridad supervisora que las hubiera acordado comunicará inmediatamente la resolución al juez que fuera competente para la declaración de concurso de esa entidad. 2. Recibida la comunicación y, aunque la resolución administrativa no sea firme, el juez, de oficio o a solicitud del Ministerio Fiscal o de la autoridad administrativa, dictará auto acordando la formación de una sección autónoma de calificación, sin previa declaración de concurso. Se dará al auto la publicidad prevista en esta ley para la resolución judicial de apertura de la liquidación."

relevant guarantee fund post-subrogation (as generally preferred claims), non-preferred debt instruments (as ordinary unsecured claims), and equity and subordinated debt instruments (as subordinated claims).

Similarly, as the only insolvency proceeding that may be initiated on a mandatory basis by creditors, the *concurso* is also the Spanish mechanism included by reference in Act 11/2015 (additional provision 15) to transpose the restrictions on the commencement of insolvency proceedings established in article 86 of the BRRD. In essence, for a voluntary insolvency proceeding in respect of a credit institution to be commenced, notice of that intention must first have been given to the Bank of Spain and to FROB, and these two institutions must not have elected an early intervention or resolution process. Any judicial proceeding contrary to this is deemed null and void as a matter of law. The same rule applies in the event of a *concurso* initiated by a creditor. Indeed, this rule was applied by Madrid Commercial Court No 9[17] to reject the petition for *concurso* made in October 2017 by an investor against Banco Popular, after FROB adopted the decision on its resolution on 7 June 2017 to execute the SRB resolution mechanism (see section 3.9 above).

If neither the Bank of Spain nor FROB considers that an early intervention or resolution process is preferable, the commercial court is free to commence an insolvency proceeding in respect of the insolvent institution. In that case, the judge will appoint the insolvency practitioner from among those proposed by FROB (article 27.6 of the Insolvency Act), in addition to applying the relevant special legislation in the insolvency proceeding.[18]

This is what happened in the case of Banco Madrid, the first Spanish credit institution not to undergo resolution under the new European legislation, but instead to be liquidated in formal insolvency proceedings. On 10 March 2015, the Bank of Spain decided to effect intervention of Banco Madrid, wholly owned by Banca Privada d'Andorra ("BPA"). Intervention of BPA had been effected by the Andorran supervisory authority for prudential reasons following BPA's naming by the US Treasury as a financial institution of money-laundering concern.

On 13 March 2015, the Spanish anti-money laundering supervisor, the Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias, reported Banco Madrid's management team to the Fiscalía Especial contra la Corrupción y la Criminalidad Organizada (the Spanish anti-corruption prosecution service) for alleged money laundering and other suspicious activities.

On 16 March 2015, new directors of Banco Madrid appointed by the Bank of Spain (as supervisor) decided to file a voluntary petition for *concurso* in respect of the financial institution. On 17 March 2015, Madrid Commercial Court No 1 suspended the insolvency proceeding until such time as FROB decided whether to commence a resolution process or restructure the bank. FROB submitted that it would not undertake a restructuring or resolution of Banco Madrid "because the requirements in the law were not satisfied".

[17] Decision of 13 November 2017 by Madrid Commercial Court No 9.
[18] Special legislation included in additional provision 2 of the Insolvency Act.

On 25 March 2015, Madrid Commercial Court No 1 opened a voluntary *concurso* in respect of Banco Madrid. It was decided that the liquidation phase of the insolvency proceeding should be commenced immediately. Insolvency practitioners (Francisco Vera and Pedro Martín) replaced the directors that had previously been appointed by the Bank of Spain.

On 22 September 2015, the insolvency practitioners filed a liquidation plan for Banco Madrid. On 22 April 2016, the insolvency practitioners sold the bank's asset management arm to Trea Asset Management for EUR 16.5 million. The insolvency practitioners could not sell its banking and brokerage businesses because the regulatory authorisations for them had been withdrawn. However, the liquidation of Banco Madrid is widely seen as a success in that, putting to the test the insolvency system for liquidating a credit institution, it achieved in a reasonable period of time repayment of all preferred claims (post-petition and privileged claims) and of more than 80 percent of ordinary unsecured claims.

IX. UNITED KINGDOM

IX. United Kingdom

Hodge Malek QC, James Potts and Sophia Dzwig*

1. Introduction

This chapter addresses the bank resolution regime of the United Kingdom (the "UK"). In particular, it provides an overview of the UK regime and its key features (section 2) before considering a number of issues in more detail, including resolution planning (section 3), stabilisation options (section 4), and modified insolvency procedures (section 5). The chapter then includes a number of case studies (section 6). It concludes by summarising the current planning that is being undertaken by the UK for its resolution regime after Brexit (section 7). The chapter is not intended to provide a summary of the resolution regime of the European Union (the "EU") overall, which can be found in chapter V of this book.

2. The bank resolution regime

2.1 Overview

The UK has a highly developed bank resolution regime which has yet to be tested by a major bank failure. It possesses special resolution tools under the Banking Act 2009 (the "Act"), which have only been used twice: once in relation to Dunfermline Building Society in March 2009; and once in relation to Southsea Mortgage and Investment Company Limited in June 2011. The UK's special administration regime, which includes a form of insolvency proceeding, has also been used on a small number of occasions. See the case studies in section 6 below.

The UK has primarily implemented the Bank Recovery and Resolution Directive (the "BRRD")[1] via the Act,[2] as amended by the Financial Services Act 2012 and the Bank Recovery and Resolution Order 2016. It applies to banks, building societies and certain investment firms incorporated in the UK, including the UK subsidiaries of foreign firms. The BRRD is fully implemented in UK law, but it has not been transposed word for word. There are therefore a number of differences between the general EU approach and the UK's approach. These include differences in the resolution objectives (the UK has seven resolution objectives rather than five) and differences in terminology (for example, the UK refers to the "private sector purchaser" tool rather than the "sale of business" tool, and the "bridge bank" tool rather than the "bridge institution" tool). It has also been suggested that there are substantive differences between the BRRD and the UK's mechanisms for ensuring that no shareholder or creditor is worse off in a bank resolution than they would be in ordinary insolvency proceedings (an issue discussed in section 4.8 below).

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

2 The Act itself builds on the foundation of the Banking (Special Provisions) Act 2008.

The UK's resolution authority is its central bank, the Bank of England (the "Bank").[3] The Bank has been at the forefront of international cooperation on bank resolution and recovery. As the Independent Evaluation Office (the "IEO") of the Bank said in its June 2018 report, *Evaluation of the Bank of England's Resolution Arrangements* (the "IEO Report"):

> "The Bank has been instrumental in spearheading international efforts on developing policy on resolvability, where it is widely acknowledged as an intellectual leader. It is also among the forefront of its international peers in terms of implementing the domestic resolution framework, and has been praised for the external communication of its approach."[4]

HM Treasury (the "Treasury") has published a statutory code of practice which sets out its policy on the use of the special resolution regime.[5] Further detailed guidance is contained the Bank's October 2017 publication titled *The Bank of England's Approach to Resolution*, which is known as the Purple Book.[6] The Purple Book is seen by many in the industry as "setting the benchmark internationally".[7]

The Bank has made a commitment to Parliament to achieve a fully operational resolution framework in respect of major UK banks by 2022.[8] The last major step in completing that project is the implementation of the Resolvability Assessment Framework package, which was published on 30 July 2019 following a consultation that closed on 5 April 2019; see further section 3 below.

2.2 Special resolution objectives

The Act implements the BRRD's strategy of ending *too big to fail* and providing mechanisms for orderly bank failure. It does so via the following seven *special resolution objectives*, which expand on the five objectives in article 31(2) of the BRRD.

Objective 1 is to ensure the continuity of banking services in the UK and of critical functions.

Objective 2 is to protect and enhance the stability of the financial system of the UK, including in particular by:

(a) preventing contagion (including contagion to market infrastructures such as investment exchanges, clearing houses, recognised central securities depositories and central counterparties); and

(b) maintaining market discipline.

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3 See https://www.bankofengland.co.uk/financial-stability/resolution.
4 IEO Report, 3.
5 Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/602948/Special-Resolution-Regime-Code-of-Practice.pdf.
6 Available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2017/october/the-bank-of-england-approach-to-resolution.
7 See IEO Report, 13, box 2.
8 Bank of England, *The Bank of England's Response to the Treasury Committee's Enquiry into Capital* (2017), available at: http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/capital-andresolution/written/69208.html.

Objective 3 is to protect and enhance public confidence in the stability of the financial system of the UK.

Objective 4 is to protect public funds, including by minimising reliance on extraordinary public financial support.

Objective 5 is to protect:

(a) investors to the extent that they have investments covered by an investor compensation scheme; and

(b) depositors to the extent that they have deposits covered by the Financial Services Compensation Scheme (the "FSCS") or another deposit guarantee scheme.[9]

Objective 6, which applies in any case in which client assets may be affected, is to protect those assets.

Objective 7 is to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1998).[10]

The UK's objectives 3 and 7 are not found in article 31 of the BRRD, but they do reflect the recitals to the BRRD.[11] There is no hierarchy among the special resolution measures, which must be balanced as appropriate.[12]

2.3 The structure of the bank resolution regime

The Treasury, the Bank, the Prudential Regulation Authority (the "PRA"), the Financial Conduct Authority (the "FCA") and the FSCS each play a role in the UK's resolution regime.

Under the BRRD, the resolution function of the relevant authority must be kept operationally separate from its supervisory and other functions.[13] Unlike some jurisdictions which have chosen to entrust those functions to separate institutions, the UK has kept both within the Bank. The supervisory body is the PRA. The resolution function is performed by the UK's Resolution Directorate (the "Directorate"), which is part of the Bank's Deputy Governorship for Financial Stability.[14] The Directorate employed only 50 staff in June 2018. Its small size is to prevent it assuming a secondary supervisory function, and to give it a single voice.[15] On the other hand, the IEO Report suggested in June 2018 that the Bank may need to be able to expand the Directorate using other Bank employees in times of crisis.[16]

9 The FSCS is the UK's deposit guarantee scheme, which meets the requirements of the Deposit Guarantee Scheme Directive (Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) [2014] OJ L173/149).

10 Banking Act 2009, s 4(3) to (9).

11 See in particular recitals 50 and 53.

12 Banking Act 2009, s 4(10).

13 BRRD, art 3.

14 IEO Report, 7.

15 ibid, 7.

16 ibid, 22.

The tools potentially available for use in a resolution can be broken down as follows:

(1) the stabilisation options (Part 1 of the Act);

(2) the Bank (or Building Society) Insolvency Procedure (Part 2 of the Act); and

(3) the Bank (or Building Society) Administration Procedure (Part 3 of the Act).

The Treasury, the Bank, the PRA and the FCA are each required to have regard to the special resolution objectives in using or considering the use of any of the above tools.[17]

3. Resolution planning and the resolvability assessment framework

The Bank develops a resolution plan for each UK firm and group, based on a preferred resolution strategy which follows one of three broad resolution strategies: *bail-in, partial transfer* or *insolvency*.[18] See further sections 4 and 5 below. Banks are required to undertake contingency planning for resolution. In order to ensure that resolution plans can be effective, the Bank undertakes an annual resolvability assessment (in consultation with the PRA or FCA) for each firm to identify any barriers to resolvability, such as loss-absorbing capacity and cross-border cooperation issues.[19]

The PRA undertakes continual and bespoke supervision of firms' health.[20] Since 2014 the Bank has also run concurrent stress tests (to inform wider policy). These are now annual for the UK's largest banks and building societies. Other firms must carry out their own stress testing according to annual PRA guidance.[21] Firms under stress may be put on a FCA/PRA watchlist.[22] The PRA will assess a firm's proximity to failure using the PRA's Proactive Intervention Framework (the "PIF"), which assesses firms in five categories, called *stages*, ranging from *low risk to viability of firm* to *firm in resolution or being actively wound up*.[23] A higher PIF stage will usually mean the Bank intensifies its contingency planning for resolution, informed by its own watchlist.[24]

As noted in section 2.1 above, the Resolvability Assessment Framework was published on 30 July 2019. It is designed to increase transparency over the resolvability of firms where the preferred resolution strategy is bail-in or partial transfer. The Resolvability Assessment Framework has three main elements:

(1) The Bank will assess resolvability in accordance with a Policy Statement, which sets out the outcomes the Bank considers necessary to support resolution.[25] The key requirements are as follows:[26]

17 Banking Act 2009, s 4(2).
18 Purple Book, 27, para 3.2.
19 ibid, 27, para 3.7.
20 See PRA, *The Prudential Regulation Authority's Approach to Banking Supervision* (2018) 28-40, available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf.
21 See https://www.bankofengland.co.uk/stress-testing.
22 Purple Book, 31, para 3.27.
23 ibid, 31, para 3.28 and fig 7.
24 ibid, 31, para 3.30.
25 Bank of England, *The Bank of England's Approach to Assessing Resolvability* (2019). The Bank has also published the following Policy Statements (each in 2019): (a) *Funding in Resolution*, (b) *Continuity of Access to Financial Market Infrastructure*, (c) *Restructuring Planning*, and (d) *Management, Governance and Communication*.
26 Bank of England, *Approach to Assessing Resolvability* (note 25) 5, para 1.14.

(a) Firms must have adequate financial resources in the context of resolution. They must therefore:

(i) meet the minimum requirement for own funds and eligible liabilities, appropriately distributed across their business;

(ii) be able to support a timely assessment of their capital position and recapitalisation needs; and

(iii) be able to analyse and mobilise liquidity in resolution.

(b) Firms must be able to continue to do business through resolution and restructuring.

(c) Firms must be able to coordinate and communicate effectively within the firm and with the authorities and markets so that resolution and subsequent restructuring are orderly.

(2) Firms are required to produce an assessment of their preparations for resolution, identifying any barriers to successful resolution and putting in place plans to address them. A report of the assessment must be submitted to the PRA and the firm must publicly publish a summary of its most recent report.[27] This is intended to provide more transparency to investors and the public.

(3) The Bank intends to make a public statement concerning the resolvability of each major UK firm. These will not be simple "pass" or "fail" judgments but will identify any shortcomings. The Bank envisages publishing a series of public statements as follows:

(a) a first statement in 2021 following firms' completion of their first assessments in 2020, focusing on the progress made by firms and their plans for becoming fully resolvable by 2022;

(b) a second statement following firms' reports in 2022, assessing firms' progress against their plans and what work remains to achieve the resolvability outcomes; and

(c) in subsequent years, from 2024, public statements are expected to focus on how far firms maintain their resolvability in light of their evolving business models and their progress in addressing any issues they or the Bank have identified.

4. Stabilisation options

4.1 Overview

The Act implements each of the resolution tools set out in the BRRD, which it refers to as stabilisation "options" that can be exercised by use of specified statutory "powers". The stabilisation options are: private-sector purchaser (called "sale of business" in the

[27] PRA Policy Statement PS15/19: *Resolution Assessment and Public Disclosure by Firms* and Supervisory Statement 4/19: *Resolution Assessment and Public Disclosure by Firms*.

BRRD[28]); bridge bank (called "bridge institution" in the BRRD[29]); asset management vehicle (called "asset separation" in the BRRD[30]); bail-in;[31] and temporary public ownership (one of the "government financial stabilisation tools" in the BRRD[32]).

4.2 Pre-conditions for the use of stabilisation options

There are four general conditions for a stabilisation option to be used, and the Act designates the decision-making responsibilities in relation to each:[33]

(1) First, the PRA (or the FCA if the entity is solely regulated by the FCA[34]) must decide that the firm is *failing or likely to fail*.[35] In making such a decision, the PRA must consult with the Bank.[36] The criterion would be satisfied in the following circumstances:[37]

   (a) there has been a failure to meet asset or management requirements that would justify the PRA cancelling the bank's permission to carry out regulated activities;

   (b) the firm's assets are less than its liabilities;

   (c) the bank is unable to pay its liabilities; or

   (d) extraordinary public financial support is required but other than to remedy a serious disturbance in the economy of the UK.

(2) Second, the Bank must decide that it is not reasonably likely that action other than resolution will prevent the failure of the firm.[38] In making this decision, the Bank must consult with the PRA, the FCA and the Treasury.[39] Possible alternative actions include supervisory measures such as suspending dividends or management bonuses, financial restructuring or partial sale.[40] This condition is deemed met if, but for financial assistance from the Treasury or the Bank, it would be met.[41] Insolvency is not required.[42] Any mandatory write-down of capital instruments will be taken into account.[43]

(3) Third, the Bank must decide that using a stabilisation option is in the public interest in the advancement of a special resolution objective.[44] In making that decision, the Bank must consult with the PRA, the FCA and the Treasury.[45]

28 BRRD, arts 38 and 39.
29 ibid, arts 40 and 41.
30 ibid, art 42.
31 ibid, arts 43ff.
32 ibid, arts 56 to 58.
33 For a graphical representation, see Purple Book, 15, fig 3.
34 Banking Act 2009, s 83A.
35 ibid, s 7(2).
36 ibid, s 7(5F).
37 ibid, s 7(5C).
38 ibid, s 7(3).
39 ibid, s 7(5G).
40 Purple Book, 14, para 1.22.
41 Banking Act 2009, s 7(5B).
42 Purple Book, 14, para 1.23.
43 ibid, 14, para 1.21.
44 Banking Act 2009, s 7(4).
45 ibid, s 7(5H).

(4) Fourth, the Bank must decide that the special resolution objectives will not be met to the same extent by a winding-up of the bank.[46] In making that decision, the Bank must consult with the PRA, the FCA and the Treasury.[47]

4.3 Private-sector purchaser[48]

This involves the transfer of all or part (in a *partial transfer*[49]) of a firm's shares or property to an authorised private purchaser. It does not require the consent of the firm, nor its shareholders, customers or counterparties.[50] The transfer process will usually follow an auction.[51] The marketing process must be transparent, without conflicts of interest, must take account of the need to act quickly and must maximise the sale price as far as possible.[52]

Firms for which partial transfer is appropriate tend to have a single critical function, relating to accounts customers use for everyday payments and cash withdrawals.[53] The tool will be used for firms with between 40,000 and 80,000 transactional accounts, below the threshold for bail-in (see section 4.6 below).[54] A transactional account is one used at least nine times in the three months prior to an annual monitoring date.[55] As a minimum, this tool should mean high-ranking deposits (including FSCS-protected deposits) are transferred with high-quality assets to a private-sector purchaser or bridge bank. The rest of the firm is likely to be put into insolvency.[56]

4.4 Bridge bank[57]

A bridge bank may be used where there is no immediate private-sector purchaser.[58] The Act implements the BRRD requirements that the bridge bank must be wholly or partly owned by the Bank, controlled by the Bank and created to receive the transfer with a view to maintaining access to critical functions and later selling the business.[59]

The Bank will not consider resolution complete, where a bridge bank has been used, until there is a more permanent arrangement.[60] If, within two years of the initial transfer to the bridge bank, there has been no onward transfer, the Bank must without delay take steps to wind up the bridge bank (subject to exceptions and extensions).[61]

46 ibid, s 7(5).
47 ibid, s 7(5H).
48 See ibid, s 11.
49 Purple Book, 8 and 16, box 1.
50 ibid, 15, para 1.27.
51 ibid, 25, para 2.19.
52 Banking Act 2009, s 11A(2).
53 Purple Book, 16, box 1.
54 ibid, 8.
55 ibid, 16, box 1.
56 ibid.
57 See Banking Act 2009, s 12 (banks) and s 84D(A1) (building societies).
58 Purple Book, 25, para 2.20.
59 Banking Act 2009, s 12(1A); BRRD, art 40(2).
60 Purple Book, 26, para 2.35.
61 Banking Act 2009, s 12(3A) to (3D).

4.5 Asset management vehicle[62]

This tool can only be used with another resolution tool.[63] An asset management vehicle is wholly or partly owned by the Bank, controlled by the Bank and created for the purpose of receiving assets from a firm or bridge bank.[64] It can also only be used if a normal liquidation of the assets would adversely affect financial markets, the transfer is necessary to ensure the proper functioning of the transferring bank or bridge bank or it would maximise recoveries.[65]

The asset management vehicle must manage the assets transferred to it with a view to maximising their value by sale or winding down.[66]

4.6 Bail-in[67]

The Purple Book states that the Bank considers this tool appropriate for the largest firms, with balance sheets of not less than GBP 15 billion to GBP 25 billion, which are too large to split up or sell to a private purchaser.[68] These include all global systemically important banks and domestic systemically important banks,[69] but not central counterparties.[70]

The Bank's preferred strategy for the majority of global systemically important banks is *single point of entry* ("SPOE") bail-in. Under the SPOE strategy, the bail-in tool is applied to a single entity in the group, normally the top financial holding company of the group which has issued shares and debt instruments to the market. This ensures that the subsidiary operating companies remain fully operational and can be recapitalised in the case of significant losses by triggering the internal instruments they have issued to the parent company.[71] By contrast, a *multiple point of entry* strategy may be appropriate for a few global systemically important banks that operate in key jurisdictions through intermediate holding companies that are managed and funded in local markets.[72]

4.7 Temporary public ownership[73]

This is the last resort.[74] In addition to the usual conditions for resolution,[75] the Treasury may only take a bank into temporary public ownership if satisfied that it is necessary to resolve or reduce a serious threat to the UK financial systems, or to protect the public interest where the Treasury has provided financial assistance.[76] The Treasury must consult the PRA, the FCA and the Bank before making that decision.[77]

62 See ibid, s 12ZA.
63 ibid, s 8ZA(2).
64 ibid, s 12ZA(2).
65 ibid, s 8ZA(3); Purple Book, 25-6, para 2.25.
66 Banking Act 2009, s 12ZA(4).
67 See ibid, s 12A (banks), s 81BA (banking group companies), and s 84A (building societies).
68 Purple Book, 16, box 1.
69 ibid, 24, box 3.
70 ibid, 19, para 1.48.
71 ibid, 22, para 2.8, and 24, box 3.
72 ibid, 22, para 2.9.
73 See Banking Act 2009, ss 9 and 13.
74 Purple Book, 17, para 1.38; BRRD, art 56(3).
75 Banking Act 2009, s 9(5).
76 ibid, s 9(1) to (3).
77 ibid, s 9(4).

4.8 The procedure for bank resolution

The resolution of a firm usually takes place outside normal market hours over a weekend – as in the case of Dunfermline Building Society (see section 6.2 below) – commonly termed a "resolution weekend", although an actual weekend may not be required for smaller firms, or where there has been extensive advance planning or the firm is not failing especially quickly.[78]

Many of the Bank's resolution powers do not require the sanction of the courts. Much can be done by statutory instrument.[79]

The Bank considers there to be the following three phases, once an institution has entered into resolution:

(1) stabilisation, in which the Bank decides how best to use the resolution tools to preserve critical structures by restoring solvency;[80]

(2) restructuring, to address the causes of the institution's failure and restore viability;[81] and

(3) exit from resolution, in which the Bank's role ceases.

The UK has implemented a number of safeguards (broadly aimed at protecting members of the public) required by the BRRD, such as:

(1) *Continuity obligations* to preserve facilities and services that the use of resolution tools might otherwise disrupt.[82]

(2) No shareholder or creditor should be worse off than they would be in an insolvency (and any that are will be compensated by the Treasury, which in turn will recover from industry).[83]

It has been suggested[84] that the *no creditor worse off than in liquidation* ("NCWOL") approach under the Act is difficult to reconcile with the BRRD. The Act does not appear to limit the freedom of the resolution authority to take resolution actions so long as adequate after-the-event compensation is paid, whereas the BRRD can be interpreted as imposing the NCWOL safeguard as an express limitation on the resolution authority's freedom of action.[85] It remains an open

78 Purple Book, 21, para 2.6.

79 A list of powers to make statutory instruments in the resolution context (for instance to effect share transfers) is at section 259 of the Act. Those that do not require the scrutiny of Parliament are at section 259(5) of the Act.

80 Purple Book, 21, paras 2.2 and 2.4.

81 ibid, para 2.2.

82 Banking Act 2009, ss 63 to 70; BRRD, art 64(3).

83 Purple Book, 17, para 1.35; BRRD, art 34(1)(g).

84 Simon Gleeson and Randall Guynn, *Bank Resolution and Crisis Management: Law and Practice* (OUP 2016) paras 13.49 to 13.55.

85 This interpretation arises from the difference between the language of article 73(a) of the BRRD (which provides that in a partial transfer of property the shareholders and those creditors whose claims have not been transferred must receive in satisfaction of their claims "at least as much as what they would have received" in a normal winding-up) and article 73(b) in relation to bail-in (which provides that shareholders and creditors whose claims have been written down or converted to equity must "not incur greater losses than they would have incurred" in a normal winding-up). One view is that no distinction was intended between article 73(a) and (b) and the difference merely reflects that it is inappropriate to use the language of "satisfaction of claims" when talking about claims that have been converted to equity.

question whether the UK approach potentially allows for "over-bailing-in" creditors with compensation after the event, and whether this is compatible with the BRRD. In practice, this issue is unlikely to arise because, in deciding whether to use the bail-in tool, the Bank and PRA are bound to have regard to the NCWOL safeguard as well as the need to balance the burdens on the taxpayer and the industry as a whole under special resolution objectives 2, 3, 4 and 7.

(3) Eight percent of liabilities must be met by shareholders and creditors before use of public funds will be considered.[86] Further, Treasury consent is required if use a resolution tool is likely to have implications for public funds.[87]

(4) Contractual counterparties cannot terminate agreements purely because a firm is in resolution, so long as the firm continues to perform its substantive obligations.[88]

(5) Netting and set-off provisions and collateral arrangements will be respected.[89]

(6) The Bank can suspend contractual payment and delivery obligations,[90] and termination rights,[91] for two days.[92]

(7) If the Treasury notifies the Bank that the use of a resolution tool would contravene an international-law obligation of the UK, then the Bank cannot exercise that tool.[93]

4.9 Schemes of arrangement and company voluntary arrangements

A financial institution may avail itself of a statutory procedure other than a resolution procedure to reorganise its capital structure. Two key procedures in this regard, which are not specific to financial institutions, are *schemes of arrangement* and *company voluntary arrangements* ("CVAs"). A scheme of arrangement involves a compromise between a solvent or insolvent company and one or more classes of its shareholders or creditors, which is sanctioned by the court. A company voluntary arrangement is an insolvency proceeding involving a compromise between a company and its creditors, which is capable of binding unsecured creditors.

5. Modified insolvency

5.1 Overview

The statutory modified insolvency regimes for banks,[94] building societies,[95] credit unions,[96] and investment firms[97] are applied either alongside the stabilisation options or when using a stabilisation option is not appropriate.[98] The special insolvency

86 Purple Book, 17, para 1.38; BRRD, art 37(10)(a) (government financial stabilisation tools) and art 44(4) and (5) (bail-in tool).
87 Banking Act 2009, ss 78 to 79.
88 ibid, s 48Z.
89 ibid, s 48P.
90 ibid, s 70A.
91 ibid, s 70C.
92 ibid, ss 70A(3) and 70C(6); BRRD, art 71.
93 Banking Act 2009, ss 76 and 77.
94 ibid, s 91.
95 ibid, s 130.
96 ibid, s 131.
97 Investment Bank Special Administration Regulations 2011.
98 Purple Book, 12-13, para 1.12.

procedures will only be used for firms holding protected deposits or client assets. Otherwise normal insolvency procedures apply.[99]

5.2 The Bank (or Building Society) Insolvency Procedure

The Bank (or Building Society) Insolvency Procedure ("BIP"),[100] part of the special resolution regime, is designed to ensure rapid payout of deposits protected by the FSCS or the transfer of FSCS-protected deposits to a viable firm.[101]

An application for BIP may be made by the Bank, Secretary of State or PRA[102] (or the FCA if the entity is solely regulated by the FCA[103]) on the grounds that:[104]

(i) the firm is unable or likely to become unable to pay its debts;

(ii) winding-up would be fair; or

(iii) (in the case of an application by the Secretary of State) winding-up would be in the public interest.

In the case of an application by the Bank, PRA or FCA, conditions (1) and (2) as set out in section 4.2 above apply.[105]

A liquidator will be appointed,[106] along with a liquidation committee to supervise and advise on how the liquidator should deal with deposits.[107]

The liquidator's statutory priority is to work with the FSCS to pay out protected deposits[108] within seven days if possible.[109] The secondary statutory aim is to wind up the firm. In insolvency, FSCS deposits are super-preferred.[110]

5.3 The Bank (or Building Society) Administration Procedure

The Bank (or Building Society) Administration Procedure ("BAP"),[111] part of the special resolution regime, is used where part of a firm has been sold to a private purchaser.[112] The court appoints an administrator[113] on the application of the Bank. The grounds for an application are that the Bank intends to use the private-sector purchaser tool, and the firm is unable to pay its debts or likely to become unable to pay its debts as a result of the use of that tool.[114]

99 ibid, 18, para 1.40.
100 See Banking Act 2009, pt 2.
101 Purple Book, 18, para 1.41.
102 Banking Act 2009, s 95.
103 ibid, s 129A.
104 ibid, s 96.
105 ibid.
106 ibid, s 105.
107 ibid, ss 100 to 102.
108 ibid, ss 99, 123 and 124.
109 Purple Book, 18, para 1.42.
110 The order of priority since January 2015 is at Purple Book, 18, fig 4.
111 See Banking Act 2009, pt 3.
112 ibid, s 136(2)(a).
113 ibid, s 144.
114 ibid, s 143.

The administrator has two statutory objectives: (i) supporting the commercial purchaser and (ii) normal administration, that is, to rescue the firm as a going concern or achieve a better result than winding up the firm without prior administration. The first has priority.[115]

5.4 The Special Administration Regime

Investment firms are potentially subject to the Special Administration Regime (the "SAR"), governed by the Investment Bank Special Administration Regulations 2011 (the "Regulations") and other statutory instruments. The SAR is distinct from the special resolution regime, and its application has resulted in several reported cases in the UK.

The main features of the Regulations are:[116]

(1) An investment bank enters SAR by a court order (*special administration order*) appointing an administrator.[117]

(2) The administrator must, in accordance with proposals from the creditors, clients, and FCA or PRA, pursue the three special administration objectives which are:

  (i) ensuring the return of client assets as soon as reasonably practicable;

  (ii) ensuring timely engagement with market infrastructure bodies and authorities; and

  (iii) rescuing the investment bank as a going concern or winding it up in the best interests of creditors.[118]

There is no prescribed hierarchy among the special administration objectives.[119]

If an investment bank is deposit-taking but without eligible depositors, then the SAR rather than BIP must be used.[120]

The application for the special administration order may be made by the investment bank, its directors, a creditor or contributory, a designated magistrates' court officer exercising powers in relation to fines, the Secretary of State, the FCA and/or the PRA.[121]

The grounds for applying are that the investment bank is or is likely to be unable to pay its debts, it would be fair to put the investment bank into SAR, or it would be expedient to do so.[122] The regulator may direct the administrator to prioritise one or more of the special administration objectives described above.[123]

115 ibid, ss 137, 138 and 140.
116 Investment Bank Special Administration Regulations 2011, reg 3(2).
117 ibid, regs 4 and 7.
118 ibid, reg 10.
119 ibid, reg 10(3). However, see text at note 123 below regarding prioritisation.
120 Investment Bank Special Administration Regulations 2011, reg 3(4).
121 ibid, reg 5.
122 ibid, reg 6.
123 ibid, regs 16-19.

In respect of the first special administration objective, the administrator has: reporting obligations to the FSCS;[124] restricted rights to transfer property;[125] obligations to reconcile client money and make up any shortfall from the investment bank's own accounts;[126] the right to set a bar date or apply to the court for a "hard" bar date for claims to ownership of or security over an asset, or to client money;[127] and the obligation to pro-rate shortfalls in omnibus accounts.[128]

A supplier may not terminate a supply to an investment bank in SAR unless charges remain unpaid for 28 days, the administrator consents, or the court gives the supplier permission. The supplier cannot make supply conditional on payment of outstanding charges.[129]

If the administrator thinks it has achieved the rescue of the investment bank as a going concern, it must apply to the court to end the administration.[130] It may propose a CVA if it pursues winding-up.[131]

6. Case studies

6.1 Introduction

As noted in section 2.1 above, there has been no major bank failure in the UK since the making of the Act. Nonetheless, the private-sector purchaser tool was used in relation to Dunfermline Building Society ("DBS") in March 2009 and the modified insolvency procedures have been used since. The IEO stated in its June 2018 report that, "although it has been [some time] since the Bank has carried out a resolution of a PRA-regulated firm, the requisite expertise and know-how is available."[132]

6.2 Dunfermline Building Society – resolution: the private-sector purchaser tool

DBS was established in 1869. It was Scotland's largest independent building society in March 2009 with 350,000 customers, 550 staff and 34 branches.[133]

By February 2008 DBS was one of two UK lenders offering mortgages with loan-to-value ratios over 100 percent.[134] DBS diversified into commercial lending to be more competitive.[135] Doing so had added GBP 25 million to member value and had not come close to breaching any statutory limits,[136] but from 2005 the Financial Services Authority (the "FSA"), as regulator, had raised commercial lending at DBS as a concern.[137] DBS had also set up a subsidiary, Dunfermline Solutions, to provide software solutions and

124 ibid, reg 10A.
125 ibid, regs 10B-G.
126 ibid, reg 10H.
127 ibid, regs 11 and 12A-E.
128 ibid, reg 12.
129 ibid, reg 14.
130 ibid, reg 20.
131 ibid, reg 21.
132 IEO Report, 20.
133 House of Commons Scottish Affairs Committee Fifth Report of Session 2008-2009, para 11.
134 ibid, para 13.
135 ibid, para 18.
136 ibid, para 21.
137 ibid, para 31.

back-office services, and had undertaken an information technology project whose poor management led to losses of GBP 9.5 million that were not clearly communicated to members.[138]

Worsening economic conditions meant the FSA increased stress testing from August 2007 and raised capital requirements in 2008. Although there was no immediate cash-flow issue,[139] this meant DBS was lacking GBP 20 million of Tier 1 regulatory capital.[140] By March 2009 an injection of GBP 60 million was needed to stabilise DBS for two years.[141] The UK authorities decided not to risk public money (on the basis that they would not get the GBP 60 million back, DBS never having made an annual profit over GBP 6 million) and a consortium of building societies refused to invest in DBS unless there was matching public investment. That triggered the use of the recently introduced resolution regime.[142]

Over the weekend of 28 and 29 March 2009, the Bank used the private-sector purchaser tool in respect of DBS. The FSA determined on Saturday 28 March that DBS met the criteria for resolution. Nationwide Building Society ("Nationwide") acquired retail and wholesale deposits, branches and residential mortgages (other than social-housing loans and related deposits). Social-housing loans and related deposits were transferred to a bridge bank. The remainder of DBS's business was put into BIP by a court order on 30 March 2009. There was no disruption to customers.[143] The main disruption for employees was that the head office was disbanded.[144]

Nationwide then bought the social-housing loans and related deposits at auction.[145] The transfer from the bridge bank to Nationwide was completed on 1 July 2009.[146]

There was widespread criticism in Scotland of the UK authorities' failure to keep DBS independent. Some likened the resolution to using a sledgehammer to crack a nut on the basis that a small amount of money could have been injected to preserve DBS's independence, and because the long-term prospects of DBS – rather than short-term non-viability – were the rationale for the resolution.[147] That said, the subsequent report by the House of Commons Scottish Affairs Committee found that: "the ultimate responsibility for the plight that Dunfermline found itself in lay with the Board of the Society. The poor project management of Dunfermline Solutions made a significant contribution to the failure of the Society."[148]

138 ibid, paras 24-8.
139 ibid, para 2.
140 ibid, paras 32-3.
141 ibid, para 36.
142 ibid, paras 37-40.
143 Bank of England, 'Dunfermline Building Society' (News Release, 30 March 2009), available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2009/march/dunfermline-building-society.pdf.
144 House of Commons (note 133) para 85.
145 Bank of England, 'Dunfermline Resolution: Announcement of the Preferred Bidder for the Social Housing Lending Business' (News Release, 17 June 2009), available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2009/june/dunfermline-resolution-announcement-of-the-preferred-bidder-for-social-housing-lending-business.pdf.
146 Bank of England, 'Dunfermline Resolution: Completion of the Sale of the Social Housing Lending Business to Nationwide Building Society' (News Release, 1 July 2009), available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2009/july/dunfermline-resolution-completion-of-the-sale-of-the-social-housing-lending-business.pdf.
147 Derek Arnott, 'Dunfermline Building Society – The FSA's Supervisory Approach' [2009] JIBFL 509.
148 House of Commons (note 133) para 87.

The FSCS contributed to the costs of the resolution,[149] as did the taxpayer. The total public funds required were GBP 1.6 billion, most of which (apparently between GBP 1 billion and GBP 1.5 billion) was funded by the industry-funded FSCS.[150]

6.3 Southsea Mortgage and Investment Company Limited – resolution: the Bank Insolvency Procedure

On 16 June 2011 the Bank announced it had applied to the court for, and the court had made, an order putting Southsea Mortgage and Investment Company Limited ("Southsea") into BIP, with partners from BDO LLP as liquidators. Southsea was much smaller than DBS. It had approximately 250 depositors and retail deposits of GBP 7.4 million. The resolution followed "a deterioration in its financial position as a result of management decisions and the firm's specific business model". The FSCS would cover deposits of up to GBP 85,000 and there appears to have been no disruption for customers.[151]

Southsea is an example of a building society in respect of which the conditions for initiating resolution were found to be met but which was deemed too small for the bail-in or private-sector purchaser tools to be appropriate.

6.4 Worldspreads Limited – the Special Administration Regime

Worldspreads Limited ("Worldspreads") was an investment bank with 15,000 clients spread-betting and trading in contracts for difference. At an urgent Sunday hearing on 18 March 2012, the court (Hildyard J) made a special administration order,[152] after a new management team had found that its predecessors deliberately falsified client money reconciliations and inappropriately used client money, and mixed client money with company money. The gross amount owed to clients was approximately GBP 30 million. The investment bank had less than GBP 6 million in client accounts, and it had GBP 16.6 million in company accounts.[153] If clients could transact with Worldspreads on the opening of the Asian and Australasian markets (at 22:30 on the Sunday, London time), they would withdraw their money and render the operation of the business and the distribution of client assets impossible.[154]

The judge recorded that the relevant criteria were: (a) whether the subject company was an investment bank; and (b) either that the bank was or was likely to become unable to pay its debts, or it would be fair to put the bank into special administration. Factors indicating that a special administration order was fair in this case were that it should assist orderly resolution of client money claims, should mitigate the ongoing risks to clients, might allow a sale of part or all of the business, would permit an investigation by the administrators, and would facilitate structured liaison with market infrastructure bodies and the FSA as regulator.[155] The special administration order granted by the judge included recitals indicating the status of the special administration

149 Purple Book, 25, para 2.24.
150 House of Commons (note 133) para 66.
151 Bank of England, 'Southsea Mortgage and Investment Company Limited' (News Release, 16 June 2011), available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2011/june/southsea-mortgage-and-investment-company-limited.pdf.
152 *Re Worldspreads Limited* [2012] EWHC 1263 (Ch).
153 ibid, [5]-[7].
154 ibid, [10]-[11].
155 ibid, [21]-[24].

order under the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency to assist with overseas recognition.[156]

The case returned to court in 2015, when Birss J approved a procedure for distribution of client money, setting out a bar date for clients to contact Worldspreads' administrators, provisions dealing with costs and expenses, and methods for dealing with disputed claims and final distributions.[157] These were not covered by the Client Assets Sourcebook ("CASS") rules, which covered client assets but not client money.[158] The FSCS had been assigned 95.8 percent of claims, but there were about 1,000 clients with claims totalling GBP 1.2 million who had not assigned claims.[159] A further 10,662 clients, 9,230 of whom had a nil balance, had not responded.[160] There was an impasse not envisioned by the legislation.[161] The FCA had agreed a temporary modification to the CASS rules for Worldspreads specifically, but this did not prevent the need to come to court for directions.[162]

Birss J exercised the court's inherent jurisdiction to supervise and intervene in the administration of trust assets and made the order. In particular, the court was satisfied that the administrators had taken all reasonable steps to identify or notify potential client-money claimants and the solution balanced the interests of all clients and was in the best interests of the administration. Further, there was to be an additional round of communications.[163]

6.5 Co-operative Bank plc

Although the Co-operative Bank (the "Co-op") has never been the subject of resolution, the court has twice approved restructurings designed to avoid triggering the resolution mechanisms.

In 2013, the Co-op needed GBP 1.5 billion of regulatory capital to avoid resolution.[164] It had seven series of subordinated loan notes with aggregate principal values of *c.* GBP 907 million and *c.* EUR 35 million, two series of perpetual subordinated bonds with an aggregate principal value of GBP 310 million, and one series of preference shares with a nominal value of GBP 60 million.[165] It was proposed that the perpetual bonds and preference shares be replaced with new bonds. These proposals were approved at meetings of the holders.[166] Pursuant to a proposed scheme of arrangement, the holders of the loan notes would receive new debt instruments and equity, and would be entitled to participate in an offer of new equity.[167] The judge noted the overwhelming majority approval of holders and sanctioned the scheme.[168]

156 ibid, [35]-[39].
157 *Re Worldspreads Limited* [2015] EWHC 1719 (Ch), [2016] 1 BCLC 162.
158 ibid, [7]-[8].
159 ibid, [10].
160 ibid, [11].
161 ibid, [16].
162 ibid, [17] and [19].
163 ibid, [22]-[33].
164 *Re The Co-operative Bank plc* [2013] EWHC 4397 (Ch) [3].
165 ibid, [4].
166 ibid, [5].
167 ibid, [6].
168 ibid, [10] and [14].

In 2017, the Co-op needed to increase its regulatory capital because of a combination of losses suffered and the maturity of GBP 400 million of senior notes.[169] The court sanctioned schemes of arrangement as part of a restructuring and recapitalisation of the bank, in the absence of which the likely alternative would have been a mandatory write-down of the ordinary shares and subordinated notes, either as a preliminary step to, or in the course of, special resolution.[170] Before making the order, the court noted the evidence was that, in the event of resolution, it was anticipated that shareholders and subordinated noteholders would not recover anything.[171]

6.6 Hume Capital Securities plc – the Special Administration Regime

Hume Capital Securities plc ("Hume"), an investment bank, had client assets of over GBP 35.7 million in aggregate,[172] but incurred substantial losses and in March 2015 requested suspension of trading in its shares. It was suspended from membership of the Stock Exchange and agreed with the FCA to stop carrying out regulated activities save in respect of existing business. Hume was placed into the SAR by the court on 16 March 2015.

In *Re Hume Capital Securities plc*,[173] the court (HHJ Keyser QC) approved a distribution plan. The judge indicated that there was no specific guidance in the applicable statutory instrument for the court in deciding whether to approve a plan, but necessarily the court would wish to be satisfied that it furthered the objective of returning client assets as soon as reasonably practicable and that it was just and appropriate.[174] The acceptance of the plan by the creditors' committee was particularly material for the court and the FCA's stance was relevant, and due weight was also given to the administrators' judgment, although none of that was conclusive.[175]

Rather than partitioning assets in order to return them to clients, the administrators had devised a solution the judge described as "more elegant and simple but equally effective for the purpose of distribution of and return of assets".[176] The custodian role in the administration would be transferred to a third party that had formerly been interested in buying the assets. Each client would choose whether to have a relationship with the third party, have the assets transferred directly back to it (the client) or to have their assets kept by the custodian on trust for the administrators.[177] Fixed costs would be reimbursed by the FSCS.[178] The judge was satisfied that this was a "highly convenient method of achieving objective 1" which would work "fairly, equitably and reasonably", and that the alternatives would be "far more likely to impose unnecessary delay and costs upon the claimants".[179]

169 *Re The Co-operative Bank plc* [2017] EWHC 2269 (Ch) [4].
170 ibid, [10].
171 ibid, [11].
172 *Re Hume Capital Securities plc* [2015] EWHC 3717 (Ch) [12].
173 *Hume* (note 172).
174 ibid, [9].
175 ibid, [10]-[11].
176 ibid, [14].
177 ibid, [13]-[14].
178 ibid, [16]-[18].
179 ibid, [22].

6.7 Strand Capital Limited – the Special Administration Regime

Strand Capital Limited ("Strand Capital") collapsed and was placed into special administration by an order on 17 May 2017 with Smith & Williamson and LA Business Recovery Limited as the administrators.[180] Strand Capital had approximately 3,000 customers and investments and cash deposits of approximately GBP 12.5 million.[181] However, its directors were unable to reconcile client assets or give access to trading platforms. The FSCS has started paying client money balances up to GBP 50,000 per customer. For customers who had invested through a self-invested personal pension ("SIPP"), compensation is being paid directly to the SIPP.[182] By November 2018, the FSCS had paid GBP 5.8 million in compensation.[183]

On 2 April 2019 Henry Carr J approved a distribution plan for the return of client assets, which had been unanimously approved by Strand Capital's creditors' committee.[184] The administrators anticipated no shortfall in client assets. Only a limited number of mostly corporate clients would have to bear costs associated with the distribution; FSCS compensation would cover such costs for the vast majority of clients.[185] The creditors' committee and the FSCS had approved an approach to costs whereby each account held by a client with an accepted client-asset claim paid a fixed amount.[186] The judge therefore considered that the distribution plan facilitated a "fair, reasonable and efficient means of returning client assets […] in a manner which will result in their return as soon as is reasonably practicable" and was in accordance with the Regulations.[187]

7. Brexit and bank resolution

There continues to be uncertainty surrounding the UK's resolution and recovery regime after Brexit, just as for many other areas of banking regulation.

The Bank issued two consultation papers specifically dealing with the challenges of Brexit in October 2018[188] and December 2018.[189] These relate to the EU Binding Technical Standards for bank resolution.

Technical Standards have historically been implemented in UK legislation by reference to numerous EU legal concepts and pieces of legislation. The Bank proposed a suite of changes to replace cross-references to EU law with purely domestic legislative wording.

180 *Re Strand Capital Limited* [2017] EWHC 3561 (Ch); FCA, 'Strand Capital Limited Enters Administration' (Press Release, 17 May 2017), available at: https://www.fca.org.uk/news/press-releases/strand-capital-limited-enters-administration.
181 Administrators' report (June 2018) 26.
182 See https://www.fscs.org.uk/what-we-cover/investments/strand-capital-limited.
183 Administrators' report (December 2018) para 3.2.
184 *Re Strand Capital Limited* [2019] EWHC 1449 (Ch).
185 ibid, [8].
186 ibid, [11].
187 ibid, [16].
188 *UK Withdrawal from the EU: The Bank of England's Approach to Resolution Statements of Policy and Onshored Binding Technical Standards* ("Consultation 1"), part of the consultation package *The Bank of England's Approach to Amending Financial Services Legislation under the European Union (Withdrawal) Act 2018* (PRA CP25/18).
189 *UK Withdrawal from the EU: Further Changes to PRA Rulebook and Binding Technical Standards – Resolution Binding Technical Standards* (PRA CP32/18).

Key features of the proposed changes, as explained in the consultation papers, were the following:

(1) The BRRD does not have any legal effect after Brexit. The applicable legislation is domestic legislation as amended by the Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018.[190]

(2) Aspects of the BRRD which are clearly not appropriate to the UK post-Brexit, such as joint decisions with the resolution authorities of the European Economic Area ('EEA'), should be interpreted as no longer applying.[191]

(3) After Brexit, only onshored Technical Standards apply.[192]

(4) Any references to the EU resolution colleges no longer apply.[193]

(5) Any references to the European Banking Authority no longer apply.[194]

(6) Any references to the EEA are references to the UK.[195]

(7) Any references to third countries include the EEA.[196]

(8) Specific references to non-EEA law (in particular the PRA rules on terms in third-country contracts that recognise that a liability may be written down, and the terms preventing termination purely because of resolution) are to be interpreted as set out in a related PRA Consultation paper.[197] [198]

(9) There are no amendments where the existing legislation deals with the relevant Technical Standard sufficiently.[199]

On 28 February 2019, the Bank and PRA issued near-final policy following these consultations. On 18 April 2019, the Bank and PRA published a Policy Statement[200] setting out their final policy, including Supervisory Statements and a Policy Statement, which will almost all have effect from "exit day" (then assumed to be 31 October 2019 at 23:00). In relation to the BRRD, the Bank and PRA have each issued an EU exit instrument.[201] On 25 July 2019, the Bank and PRA published a consultation paper[202] to consult among other things on temporary transitional provisions and changes to the EU exit instruments. The consultation closed on 18 September 2019.

190 Consultation 1, para 2.5.
191 ibid, para 2.6.
192 ibid, para 2.7.
193 ibid, para 2.9.
194 ibid, para 2.11.
195 ibid, para 2.12.
196 ibid, para 2.13.
197 ibid, para 2.14.
198 *UK Withdrawal from the EU: Changes to PRA Rulebook and Onshored Binding Technical Standards* (CP26/18).
199 Consultation 1, para 3.5.
200 PRA Policy Statement 5/19.
201 The EU Exit Instrument: The Technical Standards (Bank Recovery and Resolution Directive) (Amendment Etc) (EU Exit) (No 1) Instrument 2019 issued by the Bank, and the EU Exit Instrument: The Technical Standards (Bank Recovery and Resolution Directive) (EU Exit) (No 2) Instrument 2019 issued by the PRA.
202 *UK Withdrawal from the EU: Changes Following Extension of Article 50* (CP18/19).

The Bank and PRA have stated that they expect firms, after exit day, to continue to comply with guidelines complied with pre-Brexit on the application of the BRRD.[203] Ultimately, the Bank and PRA are keen to ensure that there is a smooth transition with as few substantive changes to the resolution regime as possible. Of course, after Brexit the UK is no longer bound in law to follow the EU's approach to resolution (which was in any event shaped to a significant degree by the contributions of UK regulatory bodies). However, the EU will no doubt insist on equivalence of the UK to the EU regime as a condition for a continued close relationship between the UK's and the EU's financial services sectors.

[203] Policy Statement: *Interpretation of EU Guidelines and Recommendations: Bank of England and PRA Approach after the UK's Withdrawal from the EU* (2019), para 2.2. A non-exhaustive list of the guidelines that continue to apply is set out in Appendix 2 to the Policy Statement.

X. HONG KONG SAR

X. Hong Kong SAR

Hannah Cassidy and Jennifer Fong*

1. Introduction

The global financial crisis of 2007-08 exposed serious flaws in the powers of governments and regulators to deal with the resolution and recovery of failing financial institutions ("FIs"). In 2009 the Financial Stability Board (the "FSB") was tasked by the G20 with, among other things, identifying and overseeing action needed to address vulnerabilities affecting the financial system. The FSB aimed to facilitate improved financial sector policies such that critical or systemically significant FIs could fail safely.

The features that each resolution regime should have to support this outcome are set out in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes"). These standards were published in November 2011 after being endorsed by the G20 at the Cannes Summit and were expanded in October 2014. The international aspects of the Key Attributes are significant to the Hong Kong SAR ("Hong Kong"), as 29 global systemically important FIs ("G-SIFIs") are hosted in Hong Kong. The Key Attributes focus on ensuring that no FI is regarded as *too big to fail* and seek to avoid a need for FIs to receive government funding in the event they become non-viable.

While the existing Hong Kong regulators (the Hong Kong Monetary Authority (the "HKMA"), the Securities and Futures Commission (the "SFC") and the Insurance Authority (the "IA") (together, the "Authorities")) were previously empowered with supervisory intervention tools in their respective sectors, there was a lack of clarity on the resolution process for a systemically important FI.

To address these gaps, on 7 July 2017 the HKMA Resolution Office issued the Financial Institutions (Resolution) Ordinance (the "FIRO"), which aims to establish a resolution regime for Hong Kong FIs that is in line with the resolution standards published by the FSB. The Financial Institutions (Resolution) (Protected Arrangements) Regulation (the "Protected Arrangements Regulation") also became effective on the same date.

The Hong Kong resolution regime arrangements target two types of crisis-related planning:

- **Recovery planning** – to restore the strength and viability of FIs, by taking steps to identify and document available options for recovery. Such options may include asset and portfolio sales, liability management exercises, capital raising and obtaining access to liquidity.

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- **Resolution planning** – to plan for the scenario where the FI has no reasonable prospect of recovery. This will usually involve identifying the FI's critical services and critical economic functions, and preparing stabilisation options to deal with the FI's business and functions in an orderly fashion.

The amendments are also designed to comply with the latest international standards set by the Basel Committee on Banking Supervision and to modernise some existing large exposure provisions to bring them more closely into line with latest market developments and risk management practices.

The FIRO has significantly changed the landscape in Hong Kong for the recovery and resolution of FIs within its scope ("within-scope FIs"). It is aimed at strengthening the resilience of Hong Kong's financial system and enhancing Hong Kong's position as an international financial centre. In the event that it becomes necessary, the hope is that the Hong Kong regulators will be better placed to carry out an orderly resolution of failing FIs in a manner that protects financial stability as well as public funds in Hong Kong.

To ensure the effectiveness of resolution arrangements, the Authorities will need to work with FIs and other entities to prepare and plan for resolution. FIs are required to make changes to their legal, financial and operational structures to remove any impediments to resolution.

This chapter is organised as follows. Section 2 describes supervisory intervention powers prior to the introduction of the FIRO. Section 3 outlines the lead-up to the implementation of the FIRO. Section 4 describes the FIRO regime. Section 5 describes resolution powers under the FIRO and associated matters. Section 6 discusses market-critical contracts in the context of resolution. Section 7 discusses loss-absorbing capacity. Section 8 discusses recovery of costs. Section 9 addresses cross-border resolution arrangements. Section 10 focuses on the resolution of deposit-taking institutions. Section 11 discusses stress testing. Section 12 concludes.

2. The pre-FIRO regime

2.1 Supervisory powers

Prior to the introduction of the FIRO, the HKMA, SFC and IA already possessed a range of supervisory intervention powers. Although these are not as extensive as under the FIRO, we set out the powers to illustrate the limited powers under the previous regime. Such powers remain in place.

2.2 The HKMA's powers under the Banking Ordinance

Authorised institutions ("AIs") are institutions which are authorised under the Banking Ordinance (the "BO") to carry on the business of taking deposits.[1] Under section 52 of the BO,[2] an AI is required to inform the HKMA that it is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payments. If the HKMA is of the opinion that the AI is carrying on its business in a manner detrimental to the

[1] Hong Kong maintains a three-tier banking system of AIs, comprising banks, restricted-licence banks, and deposit-taking companies. AIs are regulated by the HKMA.

[2] Based on the latest (March 2014) version of the BO.

interests of stakeholders, that the AI is insolvent or is likely to become unable to meet its obligations or is about to suspend payments, or if other thresholds are met, the HKMA may, after consultation with the Financial Secretary, exercise one or more of the following powers as necessary:

- to require the institution, by notice in writing served on it, to take any action in relation to its affairs, business and property;
- to give a direction that, during a specified period, the institution shall seek advice on the management of its affairs, business and property from an appointed adviser as defined under the BO;
- to give a direction that, for a specified period, the affairs, business and property of the institution shall be managed by an appointed manager as defined under the BO; and
- to report the circumstances to the Chief Executive in Council.

2.3 The SFC's powers under the Securities and Futures Ordinance

The SFC has powers of intervention under part X of the Securities and Futures Ordinance (the "SFO"),[3] whereby it may by notice in writing:

- prohibit a licensed corporation ("LC") from entering into transactions of a specified description, soliciting business, or carrying on business in a specified manner; or
- require an LC to carry on business in, and only in, a specified manner.

Such a prohibition or requirement imposed on an LC may relate to transactions entered into in connection with the entity's business that constitutes a regulated activity, or transactions connected to its business that constitutes a regulated activity.

The SFC may also by notice in writing prohibit an LC from disposing or dealing, or assisting another person to dispose or deal, in relevant property.[4] In addition, the SFC may, by notice in writing, require an LC to maintain property in Hong Kong and in any specified place outside Hong Kong such that the property maintained is of the value and of the description that appears to the SFC to be desirable with a view to ensuring it can meet its liabilities, and in such a manner that will enable the LC at any time freely to transfer or otherwise dispose of the property. The SFC may, for the purposes of this requirement, require that property of a specified description shall or shall not be taken into account.

2.4 The IA's powers under the Insurance Ordinance

The IA has powers of intervention under part V of the Insurance Ordinance (the "IO"),[5] whereby it can exercise certain powers in sections 27 to 35 of the IO if it considers the exercise of the powers to be desirable for protecting policyholders or potential

[3] Based on the latest (March 2014) version of the SFO.

[4] SFO, s 205. Relevant property is defined to mean, in relation to an LC, any property held by the LC, acting within the capacity for which the LC is licensed, on behalf of any of the clients of the LC or on its behalf, or any other property which the SFC reasonably believes to be owned or controlled by the LC.

[5] Based on the latest (March 2014) version of the IO.

policyholders of the insurer against the risk that the insurer may be unable to meet its liabilities or to fulfil the reasonable expectations of policyholders or potential policyholders.

The restrictions and requirements on the insurer include but are not limited to:

- not to effect or vary any contracts of insurance;
- not to make or realise investments of a specified class or description;
- to require that assets be maintained in Hong Kong, having regard to the insurer's arrangements for the reinsurance of risks;
- to require that assets of the entity be held by a trustee;
- to require the taking of all such steps as are requisite to secure that the aggregate of premiums to be received by the insurer in consideration of liabilities incurred during a specified period shall not exceed a specified amount;
- to require the carrying out of an actuarial investigation into the financial condition of that business, or any specified business, at a specified date;
- to require any documents to be deposited with the IA to be deposited before a specified date;
- to furnish information about specified matters, including the production of any specified books or records; and
- to take such action in respect of its affairs, business or property as the IA considers appropriate.

3. The timeline for introduction of the FIRO

The FIRO was introduced after a consultation by the Financial Services and the Treasury Bureau of the Hong Kong Government (the "FSTB") in conjunction with the Authorities.

The consultation process started in January 2014, when the FSTB in conjunction with the other Hong Kong regulators issued an initial consultation paper ("CP1")[6] on an effective resolution regime in Hong Kong.

In January 2015, the Authorities issued a second consultation paper ("CP2")[7] which set forth the Authorities' conclusions with respect to several of the questions that were raised in CP1 as well as further proposals on how the Hong Kong resolution regime should be structured. CP2 also took into account international developments on key resolution issues since CP1.

6 CP1 is available at: http://www.fstb.gov.hk/fsb/ppr/consult/resolution_e.pdf.

7 CP2 is available at: http://www.gov.hk/en/residents/government/publication/consultation/docs/2015/RR.pdf.

The consultations were followed up in October 2015 by a response by the Authorities in the form of a paper entitled *An Effective Resolution Regime for Financial Institutions in Hong Kong: Consultation Response and Certain Further Issues* ("CP3").[8]

The FIRO was enacted by the Legislative Council on 22 June 2016. The Secretary for Financial Services and the Treasury appointed 7 July 2017 as the commencement date of the FIRO, with the exception of certain provisions which will commence operation pending the making of the relevant rules.

In addition, three chapters of a Code of Practice were published by the HKMA on the same day to provide guidance on the approach to resolution planning for AIs, core information requirements, and operational independence of the HKMA as a resolution authority ("RA"). Further details are provided in section 10 below.

At the time of implementation of the FIRO regime, Hong Kong was one of the first few jurisdictions in Asia to put into place a resolution regime that is fully compliant with international standards.

4. The FIRO regime

4.1 Objectives

As codified in section 8 of the FIRO, the RA focuses on four resolution objectives:

- to promote and seek to maintain the general stability and effective working of the financial system in Hong Kong, including by securing continued provision of critical financial services, including payment, clearing and settlement functions;
- to seek to protect depositors, investors and policyholders to no less an extent than they would be protected (for instance, by deposit insurance) on a winding-up;
- to protect client assets[9] of within-scope FIs to no less an extent than they would be protected on a winding-up;[10] and
- subject to pursuing the above resolution objectives, to seek to contain the costs of resolution and, in so doing, to protect public funds.

In CP2, the Authorities noted that some of the respondents to CP1 had suggested that an additional objective should be added requiring the RA duly to consider the impact of its actions on financial stability in other jurisdictions. However, they had concerns that a formal objective of the RA duly to consider the impact of its actions on financial stability

8 CP3 is available at: http://www.fstb.gov.hk/fsb/ppr/consult/doc/resolutionregime_conclu_e.pdf.

9 The definition of *client assets* follows the definition as set out in the SFO and has been expanded to cover assets held by an in-scope FI or a holding company or affiliated operational entity in the course of conducting the business of acting as a trustee or custodian. The intention of this extended definition is to protect the existing common law position that trust and custody assets are protected from the insolvency of trustees and custodians (respectively) and so should continue to be protected despite the introduction of the resolution regime.

10 The Authorities included this objective in CP3, noting that including this specific objective would be in line with the approach adopted in the European Union's Bank Recovery and Resolution Directive (Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190) (in art 31), the United Kingdom's Banking Act 2009 (in s 4(8)), and the Key Attributes (preamble, and Appendix II, Annex 3, s 2).

in overseas jurisdictions might conflict with other resolution objectives (for example the objective to protect financial stability locally).

This could also restrict the local RA's ability to take independent action in respect of a within-scope FI in Hong Kong, even where the resolution strategy proposed by an overseas authority did not meet the local conditions for supporting cross-border resolution action.

Hence, rather than establish an additional formal resolution objective, the Authorities preferred that the RA be required duly to consider the potential impact of its actions on financial stability in other jurisdictions in the context of deciding how to apply its powers in respect of a cross-border resolution.

Before issuing a notice relating to a resolvability measure, the RA must have regard to:[11]

- how difficult it would be to carry out an orderly resolution of the financial institution or holding company, in accordance with a resolution plan, if the contemplated measures were not taken;
- the likely impact of complying with the notice, including on the future viability and capacity of the financial institution to continue to perform critical financial functions; and
- if applicable, the advisability of taking measures to remove impediments in Hong Kong to facilitate the orderly resolution of the financial institution or holding company in accordance with a non-Hong Kong resolution plan.

4.2 Within-scope financial institutions

The Hong Kong resolution regime under the FIRO is a single cross-sectoral regime covering within-scope FIs, which are divided into three categories by sector, namely, the banking, insurance, and securities and futures sectors:

- ***Banking sector entities***
  - AIs incorporated in Hong Kong and outside Hong Kong;
  - settlement institutions of a designated clearing and settlement system (not an AI and not wholly owned or operated by the Government);
  - system operators of a designated clearing and settlement system (not an AI and not wholly owned or operated by the Government);
  - FIs designated by the HKMA;
  - holding companies; and
  - affiliated operational entities.

[11] FIRO, s 14(3).

- ***Insurance sector entities***
  - global systemically important insurers ("G-SIIs");
  - FIs designated by the IA;
  - holding companies; and
  - affiliated operational entities.
- ***Securities and futures sector entities***
  - LCs which are designated as non-bank non-insurer G-SIFIs;
  - LCs that are a branch or subsidiary of, or a subsidiary of a holding company of, a global systemically important bank or a G-SII;
  - recognised clearing houses;
  - recognised exchange companies designated as within the scope of the FIRO;
  - FIs designated by the SFC;
  - holding companies; and
  - affiliated operational entities.

Some of an RA's powers may also cover the holding companies of within-scope FIs. For example, under section 14 of the FIRO, an RA can require a holding company of a within-scope FI to make changes to improve its resolvability.[12] Moreover, under section 28 of the FIRO, an RA may resolve a holding company of a within-scope FI as if it were itself a within-scope FI if resolving the holding company can more effectively achieve resolution objectives. The rationale for including holding companies is that in some cases, an orderly resolution of a within-scope FI may only be feasibly achieved, or may be more effectively achieved, by initiating a resolution at the holding company level due to the way in which a group is structured or operates.[13]

Further, the Financial Secretary is empowered to designate systemically important recognised exchange companies to be within the scope of the regime, on the recommendation of the SFC.

The Financial Secretary's designation power also extends to both regulated and unregulated entities, such that it will be able to bring FIs which are initially not covered by the regime within the scope of the FIRO in the future if it should become apparent that systemic disruption could result were they ever to become non-viable and in particular, at a time when their condition is deteriorating rapidly. This was a key point noted in CP3,[14] where it was observed that in the aftermath of the global financial crisis, there has been an increased focus on shadow banking and the identification of significant shadow-banking activities and entities.

12 Regarding resolvability of AIs, see further section 10.2 below.

13 Under section 29 of the FIRO, an RA may resolve an affiliated operational entity of a within-scope FI as if it were itself a within-scope FI, subject to certain conditions.

14 See CP3, para 9.

It is not practical for an individual resolution strategy to be devised for every bank in Hong Kong. Hence, the HKMA has confirmed that it is only where the non-viability of a bank would likely pose a risk to the stability and effective working of the financial system in Hong Kong that a resolution strategy will be devised. The HKMA has proposed that a framework based on a simple measure of the size of a bank should be the threshold for developing a resolution strategy.

The framework should also allow for deviations with reference to institution-specific factors, which may include metrics relating to the relevant AI's deposit-taking activities such as number of depositors, volume of depositors, number of transactional accounts and number of depositors who have deposits at that AI (with balances in excess of the compensation limit under the deposit protection scheme provided for under the Deposit Protection Scheme Ordinance). Any locally incorporated bank with total consolidated assets above HKD 150 billion (approximately USD 19 billion) should expect a resolution strategy to be devised.

Where the resolution strategy envisages the application of a stabilisation option to an entity incorporated in Hong Kong, the HKMA can classify such entity as a *resolution entity* under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements—Banking Sector) Rules (the "LAC Rules"). Further details are provided in section 7 below.

4.3 Resolution authorities

The HKMA, SFC and IA are the designated RAs for FIs operating in the banking, securities and futures, and insurance sectors, respectively.

Under section 7 of the FIRO, the Financial Secretary is empowered to designate one of the three RAs as a lead RA for each cross-sector financial group (i.e. a group containing within-scope FIs under the purview of different RAs and hence requiring the oversight of more than one RA) in circumstances where the interconnection between the within-scope FIs within the group structure renders a group resolution more appropriate.

The selection of the lead RA is likely to be based on the relative systemic importance of the within-scope FIs, with the RA of the FI that poses the greatest systemic risk to lead. The Authorities stated in CP3 that they intend to develop an assessment methodology drawing upon elements of the processes established internationally to assess the systemic importance of banks, insurers and other entities. The lead RA will be responsible for consulting and coordinating with the other RAs to plan for and execute an orderly resolution and to assume an ultimate decision-making role in the event that a consensus cannot be reached among all the relevant RAs.

The lead RA's power includes both an ability to direct another RA to take (or not to take) a specified action, and where necessary, to take an action itself (in both cases in accordance with the powers provided in the legislation establishing the resolution regime) in respect of a within-scope FI that would not usually be under its purview. However, it was noted that it would be relatively rare for a lead RA to act unilaterally in taking action in place of another RA.[15]

[15] See FSTB, HKMA, SFC and IA, *An Effective Resolution Regime for Financial Institutions in Hong Kong: Consultation Response and Certain Further Issues* (2015) para 12.

The requirements for the role of the lead RA are set out in section 9 of the FIRO, which explicitly empowers the lead RA to give written directions to other RAs or to perform functions under the FIRO in respect of an FI as if it were the RA of the sector to which the FI belongs. RAs not appointed as the lead RA in such situations are obliged to comply with the lead RA's written directions. However, if the lead RA does not provide any written directions, the non-lead RAs can perform their respective functions under the FIRO as empowered thereunder (other than the powers that are exclusively exercisable by the lead RA).[16]

As of 27 April 2018, pursuant to section 7 of the FIRO, the HKMA has been designated as the lead RA of 25 existing cross-sectoral groups that involve banking sector entities, and the IA has been designated as the lead RA of six cross-sectoral groups.

5. Resolution powers and associated matters

5.1 Initiation of resolution

To initiate resolution of a within-scope FI, an RA must be satisfied that all of the following conditions are met:

- the FI has ceased, or is likely to cease, to be viable;
- there is no reasonable prospect that private-sector action (outside of resolution) would result in the FI becoming viable again within a reasonable period;
- the non-viability of the FI poses risks to the stability and effective working of the financial system of Hong Kong, including the continued performance of critical financial functions; and
- resolution will avoid or mitigate the risks mentioned above.

If any of the applicable conditions is not satisfied, an insolvent FI (or its holding company or affiliated operational entity) will not be subject to resolution and it may be left with the possibility of being wound up in accordance with the usual insolvency regime (see section 5.4 below).

Further, before initiating resolution the RA must:

- consult the Financial Secretary;
- where appropriate, liaise with the HKMA, the IA or the SFC for the purpose of securing coordination in relation to the exercise of their respective regulatory powers; and
- issue to the FI a letter in writing stating (among other things) its intention to initiate resolution, the reasons for the intended resolution and that the FI has an opportunity to make representations on the intended resolution within a reasonable period of time.

16 Pursuant to FIRO, s 9(6), only the lead RA may make a resolution instrument (under FIRO, pt 5), or make a recognition instrument relating to a non-Hong Kong resolution action taken in relation to an FI or one of its group companies.

There is no mechanism provided in the FIRO for appealing against RAs' decisions to initiate resolution. However, RAs' exercise of powers is subject to challenge by way of judicial review.

5.2 Stabilisation options

Five stabilisation options are provided in the FIRO. The RA can apply them individually, in combination or sequentially.[17]

The options are:

- ***Transfer of a failing financial institution or some or all of its business to a commercial purchaser***
  - The RA has the power to determine which parts of the business are to be transferred (i.e. there can be a partial transfer) and how to effect a transfer without obtaining consent from the shareholders of the FI.
- ***Transfer of a failing financial institution or some or all of its business to a bridge institution, as a temporary arrangement***
  - This will offer the RA the additional flexibility to secure the onward sale of the entire FI in the short to medium term, once a third-party purchaser has been afforded sufficient opportunity to conduct due diligence, whilst maintaining the provision of critical financial services in the interim.
  - An RA will be required to wind up a bridge institution within two years following the last transfer made to the bridge institution. Where a sale is pending or extension is otherwise necessary to meet the resolution objectives, the FIRO provides for the possibility to extend this two-year period, after consultation with the Financial Secretary.
  - The manner in which a bridge institution is capitalised will depend to some extent upon the resolution strategy deployed in any given case. If a bridge institution is used in conjunction with a *bail-in* (see below), then all or part of the capitalisation might be achieved through debt write-off or the conversion of the FI's debt instruments into equity in the bridge institution.
  - Given that the philosophy underlying resolution is to minimise the use of public funds, approaches involving capitalisation by write-off or conversion of the FI's debt would obviously be preferred to the use of public funds. However, where necessary to achieve a swift and orderly resolution, some public funds might be deployed temporarily to capitalise a bridge institution. This would be on the basis that such funds would be recouped from sales of shares in, or assets from, the bridge institution or, failing which, from other sources such as an *ex post* levy, as provided for in part 12 of the FIRO.

17 FIRO, s 34.

- ***Transfer of a failing financial institution's assets, rights and liabilities to an asset management vehicle***

  - Pursuant to this option, the asset management vehicle will manage the assets transferred to it with a view to maximising their value through eventual sale or orderly wind-down.

- ***Write-off or conversion into equity of certain liabilities of a failing authorised institution, in order to absorb losses and restore its capital position (bail-in)***

  - This option allows an RA to write down interests of shareholders and creditors but not *excluded liabilities*.

  - *Excluded liabilities* are among others (i) secured liabilities, (ii) liabilities arising from participation in designated clearing and settlement systems and owed to such systems or to operators of or participants in such systems, and (iii) liabilities arising from participation in the services provided by a recognised clearing house and owed to the clearing house or to its clearing participants.[18]

- ***Transfer of a failing financial institution to a temporary public ownership company by the use of public funds, as a last resort***

5.3 Temporary stays

The ability of the RA to carry out an orderly resolution may be compromised if counterparts to the failing FI have an unfettered contractual right to trigger early termination, acceleration or other closeout rights.

To prevent this from happening, the FIRO provides that:

- entry into a resolution and use of a stabilisation option does not trigger contractual set-off rights or constitute an event that triggers contractual acceleration or early termination; and

- the RA has the power to stay temporarily early termination rights of counterparts.

The power to implement temporary stays provides the RA with a maximum of one business day to determine what form resolution should take, although it only applies to early termination rights.

In CP3, the Authorities were of the view that, in order to avoid precipitating any disorderly termination of contracts that could undermine resolution action, the scope of the temporary stay should be extended to all contracts whose early termination could hinder the ability of the RA to achieve the resolution objectives.[19] Accordingly, both financial and non-financial contracts will be within the scope of the temporary stay (and will be equally subject to the relevant safeguards).

It is expected that FIs, in the course of resolution planning, will identify the contracts that are critical to its business, and that therefore must be continued in resolution, and

[18] FIRO, sch 5.
[19] See CP3, para 23.

will further identify the extent to which they contain early termination rights that could pose a threat to continuity of business on resolution.

5.4 Winding-up, reorganisation, and the relationship between resolution and winding-up

Hong Kong does not have a liquidation regime specific to financial institutions, or (outside the resolution context) a reorganisation regime specific to financial institutions. Procedures applicable to non-financial companies apply to financial institutions.

- ***Winding-up***

  There are several types of winding-up procedure in Hong Kong for a company that is insolvent (i.e. a director of the company has not certified its solvency). These include *creditors' voluntary liquidation* and *compulsory liquidation*. A creditors' voluntary liquidation is initiated by the directors or shareholders of a company. A compulsory liquidation is initiated by the presentation of a winding-up petition to the court by a creditor or another party; the court may make a winding-up order on one of a number of grounds, including that the company is unable to pay its debts. In each type of procedure, a liquidator realises the company's assets and distributes the proceeds to creditors, and the company is dissolved.

- ***Reorganisation***

  Leaving aside the FIRO, Hong Kong does not have a formal procedure specifically designed for reorganisations. A *scheme of arrangement* may be used to achieve a reorganisation. It involves a compromise between a company (which may be solvent or insolvent) and one or more classes of shareholders or creditors, which is sanctioned by the court.

If a resolution could be pre-empted and avoided by a single creditor petitioning for the winding-up of a within-scope FI, this could frustrate the underlying objective of maintaining financial stability. As such, notice of an intention to present a petition for the winding-up of a within-scope FI will be required (this provision in the FIRO is not yet in operation), and the RA will be afforded a period of seven days to consider whether to initiate a resolution before the winding-up petition can be presented to the court.

In the context of bail-in, whilst an FI remains in resolution in the sense that the RA is continuing to take steps to achieve the effective application of the bail-in stabilisation option (including primarily valuation for the purpose of determining final bail-in terms), there remains a need to prevent any competing winding-up action being taken. Under certain circumstances, for instance where a bail-in stabilisation option has been applied but a bail-in provision contained in a bail-in instrument has not yet been fully implemented, winding-up proceedings may not be commenced in relation to the FI or any holding company except with the consent in writing of the RA notwithstanding any other provisions contained in any other ordinances.[20]

However, where the application of a stabilisation option results in critical financial services being transferred out of a residual FI, it is envisaged that any such residual FI may enter winding-up proceedings.

20 FIRO, s 193.

5.5 Supporting the transferred business

There may be links between a residual FI and any business transferred by application of a stabilisation option. In such cases, the RA is empowered to direct the residual FI to continue to provide, on reasonable commercial terms, any services (such as information technology, human resources and compliance functions) which (i) are essential to the continuity of any critical financial services that have been transferred out of the residual FI, but (ii) for any reason have not been transferred alongside them.[21]

The Authorities also noted in CP3 (though it is not specified in the FIRO) that it is intended that a liquidator of a residual FI should be obliged to support the RA if it should be necessary – following the application of a stabilisation option – to undertake any supplemental or reverse transfer of assets, rights or liabilities out of, or into, the residual entity in order to ensure the effectiveness of resolution.[22]

5.6 Suspension of obligations

The RA will also be able to effect a temporary suspension of obligations to make payment or delivery under a contract to which an FI (or a holding company or subsidiary) is a party.

During the suspension period, no creditor may enforce any security given by the relevant FI. However, this is not applicable to *excluded obligations*,[23] such as an obligation of an FI in relation to its participation (directly or indirectly) in financial market infrastructure. Certain obligations, such as payment and delivery obligations by central clearing parties to clearing members, are also excluded from scope.

5.7 Remuneration clawback

The RA will be able to apply for clawback of both fixed and variable remuneration, and the application will be determined by the court. It is intended that such applications may be made at any time by the RA once the resolution of an FI has been initiated.

This is a specific Hong Kong feature added to the FIRO. In Hong Kong, the RA will be able to apply for a remuneration clawback order against senior management of an FI (including those who may have a material impact on its risk profile). What this means is that, if the senior management staff carried out actions intentionally, recklessly or negligently that materially contributed to the FI's non-viability, then such staff's remuneration may be clawed back, up to a maximum value of the remuneration paid within three years prior to resolution (extended to six years in cases of dishonesty).

5.8 Compensation

Creditors have a right to compensation where they do not receive as a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime (also known as the *no creditor worse off than in liquidation principle*).

21 FIRO, s 79.
22 CP3, para 28.
23 As defined in FIRO, s 84.

In such cases, an independent valuer will be appointed to assess whether the resolution treatment is less favourable to a pre-resolution creditor or pre-resolution shareholder than the winding-up treatment and therefore determine whether compensation is payable based on assumptions and principles set out in part 6 of the FIRO, which relate to: (i) adherence to the creditor hierarchy in the hypothetical liquidation valuation; (ii) not taking into account any public financial support; and (iii) not taking into account the effect of any stabilisation option.

The determination is subject to review by the Resolution Compensation Tribunal.

5.9 Resolvability measures

The Resolvability Review Tribunal has been established to provide an avenue of appeal in relation to decisions made by an RA requiring a within-scope FI or its holding company (or both) to make changes – for example, in relation to structure and operations – for the purpose of improving its resolvability.[24]

6. Protected arrangements

The purpose of the Protected Arrangements Regulation is to seek to ensure that resolution does not impact the way certain types of market-critical contracts work, one example being the netting provisions in certain Master Agreements.

Under the Protected Arrangements Regulation, certain financial arrangements will be protected from the application of stabilisation options. These *protected arrangements* consist of secured arrangements, set-off and netting arrangements, title-transfer arrangements, structured finance arrangements, and clearing and settlement systems arrangements.

Under these arrangements, significant numbers of market participants rely on the interaction of the arrangements' constituent parts to limit their exposures to loss and so there are merits, from the perspective of preserving broader financial stability, in endeavouring to limit the effects of resolution powers that could separate, modify or terminate the constituent parts of such arrangements or avoid and override the effect of set-off or netting.

7. Loss-absorbing Capacity Rules

While the FIRO provides the necessary legal framework for resolution, it is only the first step in ensuring that the failure of within-scope FIs can be managed in an orderly way.

A pre-requisite identified by the HKMA is to ensure that Hong Kong banks have enough financial resources to absorb losses so that it is the shareholders and creditors that will be first in line to meet any losses, to minimise the risk to public funds.

Where a bail-in stabilisation option is adopted, certain liabilities issued by the failing FI may need to be written down or converted into equity to reduce debt with a view to absorbing losses and recapitalising the failing FI. Loss-absorbing capacity ("LAC") is required to ensure that a stock of liabilities to which this option can be applied is available.

24 Regarding resolvability of AIs, see further section 10.2 below.

The Loss-absorbing Capacity Rules (the "LAC Rules") have been introduced by the HKMA as RA, pursuant to section 19(1) of the FIRO, to ensure that Hong Kong banks have sufficient financial resources to bear losses ahead of other liabilities and to provide recapitalisation resources for use in the event of a resolution.

The LAC Rules were gazetted on 19 October 2018 and came into operation on 14 December 2018. In general, the LAC Rules closely align with the development of international guidelines on LAC, in particular, the FSB's *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity (TLAC) Term Sheet* (the "TLAC Term Sheet"). The LAC Rules prescribe LAC requirements for AIs and their group companies, under which they will be required to maintain minimum levels of internal and external LAC as applicable based on factors such as the circumstances of each AI and the preferred resolution strategy (if any) developed or adopted by the HKMA for that AI.

There are a few areas in relation to LAC requirements where adjustments have been made to the international standards to ensure that the relevant requirements in Hong Kong are properly suited to local circumstances. In particular, the criteria for classifying material subsidiaries are not identical to those set out in the TLAC Term Sheet in that the classification criteria in Hong Kong are based on the resolution group rather than the wider banking group. Further, external LAC that counts towards meeting a resolution entity's external LAC requirement must be issued directly by the resolution entity unless it is a Common Equity Tier 1 capital instrument.

Under the current HKMA timetable in respect of the timing of implementation of the LAC requirements, to avoid requiring the issuance of a large amount of LAC in the Hong Kong market in a short period of time, the HKMA (as RA) has expressed an intention that, apart from any entities to which rule 32 of the LAC Rules applies,[25] no domestic systemically important bank (or group company thereof) should be required to meet any LAC requirement any earlier than 1 January 2022, and no other AI (or group company thereof) will be required to meet any LAC requirement any earlier than 1 January 2023. Where the HKMA (as RA) determines that a particular entity may not be able to meet the LAC requirements with reference to this timetable, it has the flexibility to consider extending the implementation period on a case-by-case basis.

Where an entity that is subject to a requirement under the LAC Rules fails or becomes aware that it is likely to fail to comply with that requirement, the RA must be notified. The RA then has the authority to require the entity to take remedial action.[26]

8. Recovery of costs

The FIRO sets out a mechanism for an *ex post* recovery of the relevant costs by an RA and the Financial Secretary from an FI incurred in the resolution of the FI.

Where a stabilisation option is applied to an FI or to a holding company or affiliated operational entity following the satisfaction of all the conditions for initiating a resolution (see section 5.1 above), the RA or the Financial Secretary is empowered to charge for all the reasonable costs properly incurred in connection with: (i) the preparation and making of a resolution instrument through which any of the stabilisation options

25 LAC Rules, r 32 stipulates further LAC ratio requirements for certain global systemically important banks.
26 LAC Rules, rr 61 and 62.

described in section 5.2 above is applied; and (ii) compensation and valuation under part 6 of the FIRO.[27] Any money received in respect of the costs charged must be paid into a resolution-funding account which deals with inflows and outflows of resolution-related items such as resolution funds, proceeds of resolution, costs recovered following the application of stabilisation options and any reasonable costs of an RA.[28]

Costs charged by the RA or the Financial Secretary can be recovered from the FI as a civil debt.[29]

However, the RA and the Financial Secretary are not allowed to charge the costs where the charging of the costs might undermine the meeting of the resolution objectives referred to in section 4.1 above.[30]

9. Cross-border resolution arrangements

In CP3, the Authorities noted that, in principle, a coordinated and cooperative approach to the resolution of a cross-border FI has the potential to protect financial stability better across both home and host jurisdictions.[31] An RA could be expected to recognise and act in support of a cross-border resolution action if it will deliver a satisfactory outcome for stability in Hong Kong and will not disadvantage local creditors relative to foreign creditors.

As Hong Kong plays host to a significant number of FIs operating as subsidiaries or branches of foreign firms, the Authorities emphasised that it is important that the local resolution regime balances the need to promote financial stability and fair treatment locally with measures to recognise resolution actions being taken by a foreign RA to resolve an overseas-incorporated FI. As such, there is a need for a recognition mechanism, whereby the foreign resolution action may be recognised irrespective of whether the trigger conditions for initiation of resolution locally are met, and for such recognition to have effect with respect not only to within-scope FIs but to all FIs.

The FIRO provides for a statutory framework and a contractual approach to give cross-border effect to resolution actions. The statutory framework consists of the following elements:

- **Recognition process** – gives effect to measures adopted by the foreign home authority in accordance with Hong Kong law.

- **Supportive measures** – involves the taking of resolution measures by the relevant RAs in Hong Kong to support the resolution action taken by the foreign RA. Recognition is not an automatic process, and the RA has to consult the Financial Secretary before making a recognition instrument.

- **Contractual approach** – requirements for contractual recognition of stays on early termination rights and the exercise of bail-in powers. This can be useful as an interim recognition measure.

27 FIRO, s 177.
28 FIRO, s 177(5).
29 FIRO, s 177(4).
30 FIRO, s 177(3).
31 CP3, para 50.

With regard to LAC, the HKMA has noted that, when using powers (as RA) under the LAC Rules, the HKMA will act in close coordination with relevant authorities in other jurisdictions. Cross-border cooperation between RAs is a prerequisite for effective resolution planning for international banking groups, whether through crisis management groups or resolution colleges for G-SIFIs, or on a bilateral basis for smaller banks.

However, it is the HKMA's view that it is not appropriate that the legislation in Hong Kong should constrain the HKMA by requiring consensus among the RAs of other jurisdictions before the HKMA can exercise powers under the LAC Rules.

10. Deposit-taking institutions

10.1 The HKMA'S FIRO Code of Practice

We now turn to deposit-taking institutions specifically. Most within-scope FIs will be deposit-taking institutions, i.e. AIs.[32] These are regulated by the HKMA. Pursuant to section 196 of the FIRO, the HKMA, as an RA, has issued a Code of Practice in relation to its functions given by the FIRO. To date, the HKMA has issued in total four chapters (with the latest chapter issued on 20 March 2019) covering its functions as an RA and resolution standards for FIs.

10.2 The HKMA's approach to resolution planning; core information requirements

In relation to AIs, the approach to resolution can be divided into three broad stages:

- Contingency planning stage: taking action to establish a state of readiness so that a failing AI may be resolved in an orderly manner if the need arises.
- Stabilisation stage: initiating resolution and applying stabilisation options (see section 5.2 above).
- Restructuring and exit stage: restructuring and changing business model of the whole of an AI as necessary to address the cause of failure and ensure that the resolved entity is viable with a view to bringing the resolution to a close.

To prepare for the effective use of the resolution powers in the event of a failing AI's resolution, advance resolution planning needs to be undertaken by the HKMA. The HKMA is also responsible for determining which AIs should be prioritised for resolution planning.[33] The planning must be conducted well in advance of an AI experiencing stress and regardless of the AI's current likelihood of, or proximity to, failure. In this regard, the HKMA has provided guidance for AIs on its approach to resolution planning by a chapter of its Code of Practice.

The HKMA's approach to resolution planning, which aligns with the Key Attributes and international best practice, generally involves four key activities:

- gathering information from the AI;[34]

32 See note 1 above.
33 See HKMA, *Resolution Regime – Code of Practice*, ch LAC-1 (2019).
34 See FIRO, s 158.

- setting a preferred resolution strategy and developing a resolution plan that operationalises the preferred strategy;[35]
- assessing the AI's resolvability;[36] and
- addressing impediments to resolvability.[37]

In gathering information from the AI, the HKMA will first require the AI to submit core information, which is intended to assist the HKMA with developing the preferred resolution strategy and a resolution plan. Guidance in respect of what constitutes the core information that AIs will be expected to provide is set out in another chapter of the HKMA's Code of Practice. In general, in requesting the core information, the HKMA will start with information which is considered to have more significant potential impact on financial stability in Hong Kong. AIs are expected to submit core information within six months following receipt of a notice from the HKMA and the submissions should be made in the format specified by the HKMA.

Under certain circumstances, the AI may be required to furnish the HKMA with supplementary information to support further development of the preferred resolution strategy, inform the HKMA's resolvability assessments and identify actions for the AI to take to remove any identified impediments to resolvability.

In setting a preferred resolution strategy and developing a resolution plan, the HKMA will have regard to a number of factors specific to a particular AI, which may include the AI's legal entity structure, its nature of business, the scale of its business, the nature of any operational dependencies on intragroup entities and third parties and the nature of its funding arrangements. The HKMA will then identify entities that are within the scope of the resolution regime and determine which stabilisation options should be applied.

Broadly speaking, the HKMA's preferred resolution strategy will reflect an optimal approach to the resolution that achieves the resolution objectives. The strategy will then form the basis for subsequent resolution-planning work for the AI and underpin any measures that the AI may need to take to remove or mitigate the effect of any significant impediments to an orderly resolution and in order to be considered resolvable by the HKMA.

After setting the preferred resolution strategy and developing a resolution plan, the HKMA will conduct a resolvability assessment to consider both the feasibility and the credibility of the preferred strategy with reference to relevant standards. In doing so, the HKMA will take into account various circumstances of the AI, which may include its external and internal loss-absorbing and recapitalisation capacity, operational services continuity in resolution, early termination risk in financial contracts in resolution, capability to support timely and robust valuations required for the execution of a stabilisation option, continuity of access to payment, settlement and clearing services in resolution, liquidity and collateral reporting capability and post-stabilisation restructuring capability. As these all concern the AI's own attributes, the AI's input is critical to the assessment.

35 See ibid, s 13(1).
36 See ibid, s 12(1).
37 See ibid, s 14.

Following the resolvability assessment, where there is an AI-specific impediment to the resolvability, the HKMA will require the AI to propose measures to address the impediment within a set timeframe. If the measures proposed by the AI are agreed by the HKMA, such measures will be formalised and the HKMA will oversee the remediation. However, if the remediation measures are not agreed, the HKMA will serve a notice of directions to direct the AI to take measures in relation to its structure, operation, assets, rights or liabilities that are considered reasonably required to remove or mitigate the effect of the impediment.[38] After that, the HKMA will oversee the AI's remediation.

10.3 Operational independence of the HKMA as resolution authority

One of the key attributes established in the Key Attributes is that an RA should have operational independence consistent with its statutory responsibilities, transparent processes, sound governance and adequate resources.[39] It is further elaborated that an RA may have functions other than resolution.

Indeed, an authority that carries out resolution functions may also carry out other functions such as supervision provided that adequate governance arrangements are in place to manage any perceived or actual conflicts of interest that may arise from combining those functions within a single authority.[40]

The chapter on operational independence in the HKMA's Code of Practice focuses on the following:

- **Structural independence** – the HKMA established, in April 2017, a Resolution Office (a separate office within the HKMA) which is responsible for supporting the HKMA in discharging its functions as an RA under the FIRO.

- **Internal coordination and decision-making mechanism within the HKMA** – there are appropriate gateways in different ordinances such as the BO and the FIRO for sharing information.

- **External coordination with AIs** – there are information-gathering powers under the FIRO that can be exercised (see section 10.2 above).

- **Accountability and transparency** – rigorous evaluation and accountability mechanisms must be in place to assess the effectiveness of any resolution measures[41] (a number of reporting requirements are already in place and further rules, regulations and standards are envisaged).

11. Stress testing

Stress testing involves the use of financial techniques to assess a financial institution's vulnerabilities if market conditions become adverse. AIs are expected to have internal stress-testing programmes that match the standards set out in the HKMA's supervisory policy manual on stress testing.[42] The HKMA, however, adopts a proportionate approach to assessing AIs' stress-testing programmes; smaller AIs will not be expected

[38] See ibid, s 14.
[39] Key Attributes, para 2.5.
[40] FSB, *Key Attributes Assessment Methodology for the Banking Sector* (2016) Explanatory Note 2(d).
[41] Key Attributes, para 2.5.
[42] See HKMA, *Supervisory Policy Manual* (2012) module IC-5.

to undergo overly onerous stress-testing programmes. Whilst AIs will generally have different risk profiles and appetites and therefore possess differing levels of tolerance to different stress impact factors, the development and implementation of a stress-testing programme generally entails the following:

1. defining the main objectives of the stress testing – it should be clear as to what is being covered;

2. reviewing the nature of the AI's exposures and the environment it operates in;

3. designing stress tests that are appropriate to the AI, particularly in light of risk assessments – in doing so, AIs should pay particular attention to the inter-relationship between different factors such as price shocks for specific asset categories or an increase in liquidity needs as a result of the drawdown of liquidity commitments;

4. acquiring the relevant corporate approvals, if necessary, and implementing the stress tests; and

5. regular re-assessment and updating on the appropriateness of the stress tests and the documentation of them.

Stress tests should be carefully documented, with their objective, structure, methodology and assumptions all clearly set out. The HKMA has emphasised that stress testing should form an integral part of an AI's overall governance and risk management framework.[43]

12. Conclusion

The increased global focus on effective recovery and resolution has become a central focus for FIs in preparing for stress situations and planning for the steps that can be taken should an FI reach the point of non-viability.

With the implementation of the FIRO, Hong Kong has taken a big step forward to build a more resilient financial system that supports strong and sustainable economic growth. It is even more encouraging to note that the steps taken to consider recovery and resolution planning are designed to comply with the latest international standards, in particular those published by the FSB.

43 See ibid, para 2.3.

XI. UNITED STATES: GLOBAL SYSTEMICALLY IMPORTANT BANKING ORGANISATIONS

XI. United States: Global Systemically Important Banking Organisations

Donald S Bernstein*

1. Introduction

The failure of Lehman Brothers in September 2008 demonstrated the dangers of a disorderly liquidation of a global systemically important financial institution ("G-SIFI"). A complex financial services firm with global operations functions as an integrated enterprise while each constituent part continues as a going concern. However, its parts collapse haphazardly into multiple conflicting liquidation procedures upon its demise. In Lehman's case, the liquidation process resulted in the deconsolidation of control of the firm among various supervisors, courts and liquidators. It also resulted in wholesale closeouts of its financial contracts, frantic selling of the seized collateral (depressing asset prices throughout financial markets), and the sale of whatever was left of the firm's businesses and remaining assets for a fraction of their value prior to the commencement of insolvency proceedings (known in the US as *bankruptcy* proceedings). This chaotic sequence of events sparked fear in financial markets that other financial firms might suffer the same fate and threatened to cascade into contagious panic that could only be halted by government intervention, placing taxpayer funds at risk.

In the harsh light of these events and their aftermath, the inadequacy of the tools to resolve a G-SIFI available in 2008 and the need for better tools to avoid the abrupt unravelling of such firms became quite clear. Tools were needed that would permit a distressed financial firm's systemically important operations to be recapitalised and stabilised as going concerns, to be continued or wound down without destabilising markets, with losses allocated fairly among private-sector stakeholders and with no need for or expectation of putting taxpayer funds at risk. As a result, a recapitalisation or "bail-in" approach to resolution became the global standard – endorsed in the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, and adopted as resolution regimes in a number of countries and regions, including in the European Union's Bank Recovery and Resolution Directive.[1]

This chapter is devoted to the version of the recapitalisation approach to resolution adopted in the United States (the "US"): the *single point of entry* ("SPOE") resolution model.

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

2. The special resolution regimes before the financial crisis

2.1 Overview

A number of jurisdictions did not establish resolution regimes for financial firms until after the global financial crisis of 2007-08. In the US, however, a framework for the reorganisation of most failing non-financial enterprises – namely, Chapter 11 of the US Bankruptcy Code (the "Bankruptcy Code") – has long coexisted with separate frameworks for bank failures (the Federal Deposit Insurance Act of 1950 or "FDIA") and failures of broker-dealers (the Securities Investor Protection Act of 1970 or "SIPA"), each with deep historical roots and decades of development. Section 2.2 below briefly summarises the FDIA, which was originally conceived in 1933 as a response to the failure of banks en masse during the Great Depression. The following section summarises the SIPA.

2.2 Bank resolution – the Federal Deposit Insurance Act

The Federal Deposit Insurance Corporation (the "FDIC") is the resolution authority for insured depository institutions ("IDIs") in the US.[2] Its primary mission is to maintain public confidence and stability in the US financial system by protecting insured deposits and promoting sound banking practices.[3] The FDIA establishes the FDIC's powers and obligations for resolving failed IDIs, which consist primarily in arranging the value-maximising disposition of a failed IDI's assets and the satisfaction of its liabilities in accordance with the priority of creditors' claims.

If recovery options for an IDI no longer remain viable, the resolution process for the failing IDI would proceed with the appointment of the FDIC as the IDI's receiver.[4] Insolvency is the most common ground for appointing a receiver, but the statutory grounds for receivership are broadly defined and would generally arise long before a distressed IDI becomes balance-sheet insolvent,[5] leaving its supervisors and the FDIC with some discretion as to when the IDI's charter is revoked and receivership is initiated. Upon appointment as receiver, the FDIC "steps into the shoes" of the failed IDI to arrange a smooth and orderly resolution transaction.[6]

The FDIC has several options for structuring resolution transactions and is required by statute to select the one projected to be least costly to the deposit insurance fund.[7] The most commonly used transaction structure is a purchase and assumption

[2] IDI is the US term for what in European parlance would be known as a credit institution with authorisation to take deposits and membership of a deposit guarantee scheme.

[3] See, e.g. FDIC, *2017 Annual Report* (2018) 5, available at: https://www.fdic.gov/about/strategic/report/2017annualreport/contents.html; FDIC, *Resolutions Handbook* (2014) 1, available at: https://www.fdic.gov/bank/historical/reshandbook (the "FDIC Resolutions Handbook").

[4] Actions taken by the FDIC in its capacity as the receiver, or liquidating agent, of a failed IDI are legally and conceptually distinct from actions taken in its capacity as deposit insurer.

[5] 12 USC § 1821(c)(5) (setting forth the grounds for receivership, which include not only that the IDI is "likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business" but also an "unsafe or unsound condition to transact business", or "any violation of any law or regulation […] that is likely to […] weaken the institution's condition", among others).

[6] FDIC Resolutions Handbook, 6.

[7] 12 USC § 1823. The deposit insurance fund (often called the "DIF") is the pool of assets maintained by the FDIC to support its guarantee of insured deposits and bear the costs of IDI failures. It is the American equivalent of what in Europe are called deposit guarantee schemes. As of 30 September 2018, the DIF's total fund balance was approximately USD 100.2 billion. The DIF is funded primarily through quarterly assessments paid by IDIs, as well as interest income on its investments in securities. See FDIC, Quarterly Banking Profile: Third Quarter 2018 (2018), available at: https://www.fdic.gov/bank/analytical/qbp/2018sep.

("P&A"), in which another IDI purchases the failed IDI's assets and assumes certain of its liabilities, including its insured deposits, following the conclusion of a confidential bidding process.[8] The FDIC can also resolve an IDI through a depositor payoff, in which payments are made to depositors up to the amount of their insured deposits, but would generally use this method only if a P&A cannot be arranged on cost-effective terms.[9]

The FDIC may also establish a bridge bank to facilitate an orderly resolution.[10] As the name implies, a bridge bank is not a permanent solution; it is a temporary vehicle into which the FDIC can transfer parts of a failed IDI's business and assets so it can stabilise those operations as a going concern and continue paying insured depositors while arranging a value-maximising resolution transaction. The rest of the failed IDI's assets and liabilities, typically including all of its unsecured, non-deposit liabilities, would be left behind in receivership and administered through the FDIC's claims process. By leaving these liabilities behind in the receivership, the FDIC in effect recapitalises the bank, and it may also provide financial support from the deposit insurance fund as needed for the bridge bank to maintain sufficient liquidity to meet its obligations. A larger, more complex IDI is more likely to be resolved through a bridge bank because it would have fewer potential acquirers and because more time and resources are needed to plan and execute the disposition of its business through one or more P&As or strategic sales. The central concept of a bridge bank resolution – separating a failed IDI into a good entity and a bad entity, to stabilise and maximise the value realised from the former and to implement an orderly claim resolution process for the latter – is also fundamental to the SPOE approach to resolution of a G-SIFI, as we shall see in section 3 below.

2.3 The Securities Investor Protection Act

In the US, broker-dealers must register with the Securities and Exchange Commission ("SEC"), and their permitted activities primarily consist of underwriting, dealing and making markets in securities, and the provision of investment management and advisory services. Prior to the enactment of the Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[11] a broker-dealer would be resolved under the SIPA. Unlike proceedings under Chapter 11 of the US federal Bankruptcy Code ("Chapter 11 Proceedings") or a bank resolution under the FDIA, in which parts of an entity's business are expected to be preserved as going concerns, entry into SIPA proceedings requires a broker-dealer to be liquidated.

Under SIPA, the Securities Investor Protection Corporation (the "SIPC") would act in coordination with a bankruptcy court-appointed trustee to administer the claims of the broker-dealer's customers and creditors. To protect the customers and creditors, the failing broker-dealer would generally be required to cease conducting any business upon the commencement of a SIPA proceeding, and the trustee would seek to sell or transfer the broker-dealer's customer accounts to another, solvent broker-dealer as soon as practicable so that customers could regain access to the their accounts and resume trading activity.

8 FDIC Resolutions Handbook, 16-19. The European analogue to a P&A resolution would be a partial transfer resolution effected through use of the asset transfer tool.
9 FDIC Resolutions Handbook, 19-20.
10 ibid, 18.
11 Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376 (2010).

For any customer accounts or property not transferred, the SIPC would administer a claims process in which each customer would receive a pro rata share of the customer property available for distribution. Deficiency claims may be satisfied by advances from the SIPC of up to USD 500,000 per customer, and, to the extent of any remaining deficiency, a customer may receive a share of the broker-dealer's non-customer property on a *pari passu* basis with general unsecured creditors.

3. Single point of entry resolution

The US special resolution regimes for banks and broker-dealers described in section 2 above work very well for a bank or broker-dealer that operates independently,[12] but not for one that operates as part of an integrated global banking organisation. In the US today, the top-tier corporate parent of each of the largest US global systemically important banking organisations ("G-SIBs") is a bank holding company ("BHC"), regulated by the Federal Reserve. The firm's banking and other critical operations are not conducted by its holding company, but by its numerous subsidiaries, which may include US IDIs, non-US branches and banks, US and non-US broker-dealers and various other non-bank operating subsidiaries in various countries around the world.

The SPOE approach to resolution involves commencing resolution proceedings only with respect to the financial firm's BHC, with all losses of the distressed financial firm being borne by shareholders and creditors of that entity, and not by creditors of the firm's operating subsidiaries or by taxpayers. The G-SIB's operating entities, such as its banking or broker-dealer subsidiaries, would never enter into bankruptcy or resolution proceedings of their own. Instead, they would be recapitalised before reaching the point of non-viability ("PONV") and, upon commencement of resolution proceedings for the parent holding company, they would be transferred to a newly created, debt-free "bridge" holding company, where they would continue to operate. The old holding company's creditors and shareholders would be left behind, either in bankruptcy proceedings or in a receivership under the US special resolution regime, Orderly Liquidation Authority ("OLA"), enacted as Title II of the Dodd-Frank Act.[13] Thus, a viable recapitalised firm would be created, the value of which would be preserved without the need for any of the firm's operating subsidiaries to enter into separate and potentially prolonged and systemically disruptive resolution processes of their own.

The objective of the SPOE approach to resolution is to preserve the continuity and value of the firm's operating businesses and promote financial stability while the holding company's shareholders and creditors absorb the firm's losses. The holding company's stakeholders nevertheless benefit because liquidation of the firm's valuable operating businesses and assets at fire-sale prices is avoided and the going concern value of the firm's operating subsidiaries is preserved. This value ultimately becomes available for distribution to stakeholders of the old holding company at the end of the resolution process.

The FDIC and the Bank of England have worked jointly on the development of SPOE strategies to resolve a G-SIB,[14] and the FDIC has stated its intent to use an SPOE

[12] FDIC Chair Jelena McWilliams, as her predecessors in every generation have also done, proudly proclaims that "no depositor has ever lost a penny of insured deposits". See e.g. keynote remarks by Jelena McWilliams, Chairman, FDIC (2018 Annual Conference of The Clearing House and Bank Policy Institute, New York, 28 November 2018), available at: https://www.fdic.gov/news/news/speeches/spnov2818.html.

[13] See further section 4.2 below.

[14] See FDIC and Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions* (2012), available at: https://www.fdic.gov/about/srac/2012/gsifi.pdf.

strategy for the resolution of a G-SIB under OLA.[15] As discussed in the following sections, an SPOE resolution could be executed successfully under either OLA or through Chapter 11 Proceedings.

US financial firms, together with their primary regulators, have taken steps to enhance the ability to resolve financial firms using the SPOE model. The largest US firms have undergone substantial changes since 2008 that improve their resilience, including a substantial increase in capital and balance-sheet liquidity to meet regulatory requirements and risk management needs, the derisking of the balance sheets, and capital restructuring to address regulatory requirements for sufficient amounts of loss-absorbing debt and assets in their holding companies. In addition, the largest firms have implemented secured support agreements providing for the recapitalisation of their subsidiaries should it become necessary, and they are implementing amendments to financial contracts to reduce the risk of termination of such contracts in the event the holding company in the group commences bankruptcy proceedings.

The measures to improve US financial stability and to prepare for implementation of the SPOE approach to resolution as part of the post-financial crisis reforms under the Dodd-Frank Act are summarised in the next section.

4. Overview of post-crisis reforms under the Dodd-Frank Act

4.1 The Dodd-Frank Act

In 2010, the US Congress passed the Dodd-Frank Act to address the vulnerabilities in the US financial system that led to the global financial crisis of 2007-08 and exacerbated its damaging effects. The Dodd-Frank Act was the most extensive reform of US financial regulation since the Great Depression. With respect to the resilience and resolution of systemically important financial firms, its most important provisions are set forth in Title I, which establishes enhanced prudential standards and resolution planning requirements, and Title II, which establishes a new special resolution regime, OLA, each as described in sections 4.2 and 4.3 below.

By requiring the largest BHCs and foreign banking organisations operating in the US to meet enhanced prudential standards, Title I of the Dodd-Frank Act is designed to reduce both the likelihood of any large financial firm's failure and the negative systemic impact if one were to fail. The enhanced prudential standards include capital planning, requirements for total loss-absorbing capacity ("TLAC"), leverage and liquidity requirements, risk management requirements, concentration limits, and resolution planning.[16] Several of these can be summarised as follows:

- **Capital planning and stress testing:** each year, the Federal Reserve conducts the Comprehensive Capital Analysis and Review ("CCAR")[17] of the largest BHCs, to assess the adequacy of their capital levels and capital planning processes and their ability to withstand a prolonged period of severe macroeconomic stress. The CCAR process is supplemented by Dodd-Frank Act stress testing, a

[15] See FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed Reg 76,614 (18 December 2013) (the "FDIC SPOE Statement").

[16] 12 USC § 5365.

[17] See 12 CFR § 225.8.

forward-looking exercise that applies to a larger group of financial institutions and assesses whether institutions have sufficient capital to absorb losses and continue operations during adverse economic conditions.[18]

- **Total loss-absorbing capacity and long-term debt requirements:**[19] US G-SIBs must maintain a minimum level of TLAC, that is structurally subordinate to, and thus exposed to losses before, any liability owed to the depositors or other creditors of the firm's operating subsidiaries. This TLAC includes the BHC's equity and other capital instruments, which can absorb losses while the firm remains a going concern, and a certain portion that must consist of unsecured long-term debt issued by the BHC that is structurally subordinated to the liabilities of operating subsidiaries and can be converted into equity (or left behind in the former BHC when a bridge holding company is created) in resolution to recapitalise the firm. These requirements help ensure that an important prerequisite for executing an SPOE resolution will be satisfied.[20]

- **Minimum liquidity coverage ratio:** the largest BHCs must hold a minimum amount of high-quality, liquid assets sufficient to cover their projected net cash outflows during a 30-day period of stress. A firm's ratio of liquid assets to its projected net cash outflows is its liquidity coverage ratio ("LCR").[21]

- **Resolution planning:**[22] every large BHC must periodically submit to the Federal Reserve and FDIC a resolution plan, commonly known as a "living will", setting out a plan for the rapid and orderly resolution of its operations *under federal bankruptcy law* without serious adverse effects on US financial stability in the event of its material financial distress or failure. These plans, which focus on resolution *in bankruptcy proceedings*, rather than under OLA, are discussed in detail in section 4.3 below.

The existing supervisory framework for Prompt Corrective Action, which imposes heightened regulatory scrutiny and requires corrective actions to be taken if a financial firm's capital ratios decline to specified levels, has also been enhanced since the enactment of the Dodd-Frank Act.[23]

4.2 Orderly Liquidation Authority under Title II of the Dodd-Frank Act

The resolution tools available in 2008 were poorly adapted to the integrated, global operating structures of the largest financial firms and were inadequate to enable their resolution without adverse systemic consequences. In response, the US adopted Title II of the Dodd-Frank Act, which created a new special resolution regime designed to ensure that financial firms could fail without destabilising the US financial system and without risk to taxpayer funds.[24] OLA provides an alternative to bankruptcy that addresses specific challenges presented by the failure of a financial firm engaged in maturity transformation, which is modelled on the FDIA resolution regime for banks, with changes to align it more closely with the Bankruptcy Code.

18 See ibid, pt 252.
19 ibid §§ 252.62, 252.63.
20 82 Fed Reg 8,266-67.
21 12 CFR Part 249.
22 12 USC § 5365(d).
23 For a summary of the Prompt Corrective Action framework, see FDIC, *Risk Management Manual of Examination Policies*, section 2.1-8, available at: https://www.fdic.gov/regulations/safety/manual/section2-1.pdf.
24 12 USC §§ 5381-94.

OLA could potentially be invoked for any *financial company*[25] through a process commonly referred to as "turning the three keys". Upon the written recommendation of (1) two-thirds of the Board of Governors of the Federal Reserve System and (2) two-thirds of the Board of Directors of the FDIC, (3) the Secretary of the Treasury (the "Secretary"), in consultation with the President, may appoint the FDIC as the receiver of a financial company upon making a determination that certain systemic risk criteria are met.[26] The statutory criteria set forth under Title II require the Secretary to make the following determinations with respect to the financial company in question:

- it is "in default or in danger of default";[27]
- its failure and resolution under otherwise applicable insolvency law would have serious adverse effects on US financial stability;[28]
- no viable private-sector alternative is available to prevent its default;[29]
- any effect on the claims or interests of its creditors, counterparties and shareholders, and on other market participants, is appropriate given the impact that any action taken under OLA would have on US financial stability;[30]
- invoking OLA would avoid or mitigate the adverse effects of its resolution under other applicable insolvency law, taking into consideration the effectiveness of actions under OLA, the cost to taxpayers, and the potential to increase moral hazard;[31]
- a federal regulatory agency has ordered the conversion of all of its convertible debt instruments that are subject to conversion by regulatory order;[32] and
- the company is a *financial company* as defined under Title II.[33]

If, after the Secretary determines that the requirements for invoking OLA have been met, the board of directors of the covered financial company acquiesces or consents to the appointment of the FDIC as receiver, the Secretary is required to appoint the FDIC as receiver. If, however, the board of directors does not acquiesce or consent, the Secretary is required to petition the United States District Court for the District of Columbia for an order authorising the Secretary to appoint the FDIC as receiver.[34]

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25 ibid § 5381(a)(11). A *financial company* is any company organised under US law that is a BHC, a non-bank financial company supervised by the Federal Reserve, or a company predominantly engaged in activities that are financial in nature, other than an IDI or insurance company.

26 ibid §§ 5383(a)-(b).

27 ibid §§ 5383(b)(1), (c)(4). A financial company is in default or in danger of default if: (i) a case with respect to the financial company has been, or likely will be, promptly commenced under the Bankruptcy Code; (ii) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital; (iii) the assets of the financial company are, or are likely to be, less than its obligations to creditors; or (iv) the financial company is, or is likely to be, unable to pay its obligations in the normal course of business.

28 ibid § 5383(b)(2).

29 ibid § 5383(b)(3).

30 ibid § 5383(b)(4).

31 ibid § 5383(b)(5).

32 ibid § 5383(b)(6).

33 ibid § 5383(b)(7).

34 ibid § 5382(a)(1)(A).

In light of the fact that resolution plans under Title I of the Dodd-Frank Act must address resolution under the Bankruptcy Code (not OLA) and are reviewed for credibility by US regulators,[35] the fact that, to invoke OLA, the Secretary must determine that the financial company's failure and resolution under otherwise applicable insolvency law would have adverse systemic effects is notable. Taken together, these two requirements indicate that proceedings under the Bankruptcy Code, and not under OLA, are the preferred path for resolution of financial firms under the Dodd-Frank Act.[36]

If, however, OLA is invoked, once appointed as receiver under OLA, the FDIC has powers modelled largely on its powers to resolve IDIs under the FDIA. These powers include the ability to: (i) transfer all or any portion of the failed company's assets or liabilities at fair value to a third party;[37] (ii) establish a bridge financial company to which parts of the failed company's business may be transferred, so they can be stabilised pending an ultimate disposition through one or more sales, initial public offerings or wind-downs;[38] (iii) administer the claims of the failed company's creditors in accordance with their priority, subject to certain requirements but with the flexibility to treat similarly situated creditors differently, provided that every creditor is no worse off than would have been the case if the failed company had been liquidated in bankruptcy proceedings;[39] and (iv) provide financial support to the bridge financial company, including in the form of loans or guarantees, subject to certain conditions as discussed below.[40] The FDIC may also prevent the enforcement of default and termination clauses conditioned on the insolvency or bankruptcy of the failed company (*ipso facto* clauses), except in the case of qualified financial contracts ("QFCs") such as derivatives that are not transferred to and assumed by the bridge financial company,[41] and it may repudiate most other types of contracts, other than secured debts, subject to certain conditions.[42] Generally speaking, the FDIC has broad discretion to exercise its powers as receiver, with judicial review expressly limited by law.[43]

The FDIC's objective is to minimise the use of public-sector funding in an OLA resolution. Among other things, it can facilitate private-sector funding by providing guarantees to the bridge financial company and its subsidiaries.[44] If sufficient private-

35 ibid § 5365(d).

36 See e.g. FDIC SPOE Statement, 78 Fed Reg at 76,615: "Although the statute makes clear that bankruptcy is the preferred resolution framework in the event of the failure of a [systemically important financial institution], Congress recognised that a [systemically important financial institution] might not be resolvable under bankruptcy without posing a systemic risk to the US economy. Title II, therefore, provides a back-up authority […]".

37 12 USC § 5390(a)(1).

38 ibid § 5390(a)(1)(F).

39 ibid § 5390(b).

40 ibid § 5390(h).

41 OLA's prohibition on enforcement of *ipso facto* clauses does not apply to QFCs. However, OLA does provide a stay of one business day on QFC creditors' exercise of any default rights, during which the FDIC may transfer the failed company's QFCs, and its obligations as guarantor or credit support provider on operating subsidiaries' QFCs, to the bridge financial company. So long as the transfer is consummated within the stay period, the effect of the transfer would be to nullify any default rights that the failed company's QFC counterparties might otherwise have been able to exercise as a result of the failed company's entry into OLA receivership, including direct default rights on QFCs to which the failed company is a counterparty or cross-defaults on QFCs to which its operating subsidiaries are counterparties.

42 12 USC § 5390(c). Generally, the FDIC as receiver may repudiate other contracts to which the financial company is a party if the FDIC determines, in its discretion, that performance would be burdensome and that repudiation would promote the orderly resolution of the financial company.

43 ibid § 5390(e) (prohibiting a court, unless expressly provided to the contrary in the statute, from taking any action to restrain or affect the exercise of powers or functions of the receiver, and limiting any remedy against the FDIC or receiver to money damages).

44 78 Fed Reg 76,614-15.

sector funding cannot be obtained, however, the FDIC can provide funding directly to the bridge financial company using the Orderly Liquidation Fund ("OLF") as necessary to meet the bridge financial company's short-term liquidity needs.[45] The FDIC can obtain OLF funding by issuing debt securities to the US Treasury, in an amount limited for 30 days to 10 percent of the failed company's total consolidated assets, based on its most recent financial statements, and, after completing an initial valuation, up to 90 percent of the fair value of the failed company's total consolidated assets available for repayment, as calculated by the FDIC.[46] In addition, Title II includes an express prohibition on taxpayers' bearing losses, and any use of OLF funding is subject to provision for repayment with priority over all other unsecured claims and, if necessary, through assessments imposed on other financial firms.[47]

4.3 Resolution planning under the Bankruptcy Code

As noted in section 4.2 above, while OLA provides a number of important tools to implement an SPOE resolution strategy, the Dodd-Frank Act makes it clear that the Bankruptcy Code remains the preferred resolution regime for a large financial company, and that OLA is a backup resolution procedure for use only in circumstances in which resolution in bankruptcy is not viable.[48] Accordingly, the resolution planning provisions of section 165(d) of Title I require that BHCs prepare for an orderly resolution under the Bankruptcy Code,[49] notwithstanding that critical resolution tools available under OLA either are not available (such as the OLF and the ability to stay QFC closeouts) or not expressly provided for under the Bankruptcy Code.

The US takes a different approach to resolution planning from most other jurisdictions. Responsibility for the development of resolution plans for each financial firm in most jurisdictions rests with its resolution authority, typically in coordination with supervisory and other authorities. In the US, on the other hand, a large BHC must prepare and periodically submit its own resolution plan to the FDIC and the Federal Reserve.

Although BHCs prepare their Title I resolution plans in contemplation of resolution in bankruptcy proceedings, the Title I plans have the same objective as resolution under Title II – to maintain US financial stability without risk to taxpayers – and Title I resolution planning and Title II reinforce one another. A BHC's resolution plan must describe a detailed strategy for rapid and orderly resolution, with descriptions of strategies to address the company's core business lines, material entities, critical operations and critical services.[50] These plans must also adopt stringent assumptions, which include the unavailability of extraordinary financial support from the US or any other government.[51] In practical terms, it would be impossible for the FDIC to execute a successful resolution under OLA without the planning and preparation done by BHCs as part of the resolution planning process under Title I.

The process of developing resolution plans and their detailed contents has been iterative and has had to address the gaps in resolution tools under the Bankruptcy Code with contractual or other workarounds. Over the years, the Federal Reserve

45 12 USC § 5390.
46 ibid § 5390(n).
47 ibid § 5394 (prohibition on taxpayer funding) and § 5390(o) (assessments).
48 See ibid § 5383(a)(2)(F).
49 ibid § 5365(d).
50 12 CFR, pt 243.
51 ibid § 243.4(a)(4)(ii).

and the FDIC have issued guidance or regulations addressing a range of topics, including operational continuity, access to critical financial market infrastructures, liquidity pre-positioning (see section 5.4 below), meeting resolution capital and liquidity execution needs and amendments to QFCs.[52] The refinement of resolution plans and the imposition of contractual workarounds on market participants has enabled each successive submission to advance beyond the basic building blocks to more sophisticated capabilities and detailed contingency planning.

To ensure the effectiveness of resolution plans, the Federal Reserve and the FDIC review the plans and may jointly determine that a plan is not credible or would not facilitate rapid and orderly resolution.[53] If a company fails to remedy deficiencies identified by the Federal Reserve and the FDIC, the agencies may jointly take action by imposing "more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations of the company, or any subsidiary thereof".[54] If a company subject to these restrictions nonetheless fails to correct any deficiencies within two years, the FDIC and the Federal Reserve may jointly, in consultation with the Financial Stability Oversight Council (the "FSOC"), force it to divest certain assets or operations – in effect, to break it up by regulatory order.[55]

5. Resolution readiness requirements adopted in the US since 2008

5.1 Introduction

US G-SIBs today are subject to a number of resolution readiness requirements designed to improve both their resilience and resolvability.

5.2 Capital and liquidity

As described in section 4.1 above, US G-SIBs have undergone substantial changes since 2008 to improve their resilience, including holding significantly greater levels of regulatory capital and liquidity during business-as-usual. Through the CCAR process, large BHCs must submit annual capital plans demonstrating their ability to maintain capital above minimum regulatory capital ratios on a *pro forma* basis after taking planned capital actions under baselines, adverse and severely adverse economic conditions throughout the stipulated nine-quarter planning horizon.[56] These minimum capital ratios have been significantly increased and bolstered in connection with the US implementation of the Basel Committee's Basel III capital standards ("US Basel III").[57] US Basel III includes new minimum risk-based capital ratios, capital buffers, eligibility

52 For a non-exhaustive list, see e.g. 76 Fed Reg 67,323 (final rule implementing Federal Reserve and FDIC resolution plan regulations); Federal Reserve and FDIC, *Resolution Planning Guidance for Eight Large, Complex US Banking Organizations* (2018); Federal Reserve and FDIC, *FAQs for Guidance for 2017 165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015* (2017); Federal Reserve and FDIC, *Guidance for 2018 § I 65(d) Annual Resolution Plan Submission by Foreign-Based Covered Companies that Submitted Initial Resolution Plans in 2015* (2017); and Federal Reserve and FDIC, *Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Initial Resolution Plans in 2015* (2016).

53 12 USC § 5365(d)(4).

54 ibid § 5365(d)(5)(A).

55 ibid § 5365(d)(5)(B). The FSOC is chaired by the Secretary of the Treasury and its members include the heads of the federal financial regulatory agencies. Its purpose, in broad terms, is to identify risks to US financial stability, promote market discipline and respond to emerging threats.

56 Federal Reserve, *Capital Plans*, 76 Fed Reg 74,631 (1 December 2011).

57 For details of Basel III, see BIS, 'Basel III: International Regulatory Framework for Banks', available at: https://www.bis.org/bcbs/basel3.htm.

criteria for common equity Tier 1, additional Tier 1 and Tier 2 capital instruments, deductions from and adjustments to regulatory capital and recognition of minority interests. US Basel III also subjects US systemically important financial institutions ("SIFIs") to a risk-based capital surcharge in addition to otherwise applicable risk-based capital ratios. As a result of these reforms, US G-SIBs should be able to sustain significantly greater losses without nearing the PONV than they would have been able to in 2008.

In addition to the minimum LCR described in section 4.1 above, which requires BHCs to maintain a sufficient quantity of high-quality liquid assets to survive a 30-day liquidity stress event, US SIFIs are required under the above enhanced prudential standards rules to conduct regular internal liquidity stress tests and implement liquidity risk-management requirements, including periodic reviews of business lines for liquidity risks. The net result of these business-as-usual liquidity requirements is that US G-SIBs today hold significantly greater quantities of liquid assets and are less reliant on short-term funding than they were in 2008, substantially reducing the risk of experiencing a liquidity crisis that would cause one of them to reach the PONV.

5.3 Total loss-absorbing capacity and clean holding company requirements

US G-SIBs are also subject to TLAC, long-term debt and clean holding company requirements designed to ensure that if the firm were to reach the PONV, its BHC would have sufficient loss-absorbing capacity to absorb losses incurred by the firm's operating subsidiaries to execute an SPOE resolution strategy. US G-SIBs are required to issue TLAC instruments generally in the form of high-quality equity capital and unsecured long-term debt issued by the BHC. In addition, US G-SIBs are subject to clean holding company requirements pursuant to which their BHCs generally are prohibited from bearing material amounts of third-party liabilities other than unsecured long-term debt. As a result, the BHCs of the US G-SIBs hold assets that consist of little more than equity interests in and debt obligations of their subsidiaries, and their external liabilities are structurally subordinated to the liabilities of their operating subsidiaries, such as deposits, commercial paper, and third-party derivatives and other financial contracts. These restrictions are designed to ensure that if the firm fails, the top-tier parent's liabilities can be written down or converted into equity in an SPOE resolution without causing or spreading destabilising contagion.

5.4 Pre-positioning

While US G-SIBs generally raise money in the capital markets for subsidiaries' operations through their BHCs, for resolution planning resources, they generally divide their consolidated capital and liquidity resources between "contributable resources" that are held at the BHC or another affiliate, such as an intermediate holding company ("IHC") (described in greater depth in section 6.3 below), and pre-positioned resources that are held at operating subsidiaries. US regulators have required each US G-SIB to develop methodologies to determine the optimal balance between contributable and pre-positioned resources as part of their resolution capital adequacy and positioning ("RCAP") and resolution liquidity adequacy and positioning ("RLAP") frameworks. Holding more pre-positioned resources mitigates uncertainty at the operating subsidiary level that intercompany frictions might impede an operating subsidiary's ability to obtain additional capital or liquidity support in a time of stress. Holding more contributable resources at the BHC level helps ensure that recapitalisation resources can be available where needed in the corporate group to meet unanticipated losses and liquidity outflows, no matter where such losses or outflows occur. Excess pre-positioning in advance of identifying needs in an actual distress scenario reduces a firm's flexibility to direct capital and liquidity where and when needed. In part to address this tradeoff, US G-SIBs have entered into secured support agreements, which provide assurance to subsidiaries that contributed resources maintained at the BHC or at an IHC will be made available to operating subsidiaries when needed. Secured support agreements are described in greater detail in section 6.3 below.

5.5 Legal entity rationalisation and separability

US G-SIBs are required as part of the resolution planning process to maintain a legal entity structure that facilitates orderly resolution. Firms must develop legal entity rationalisation criteria that are embedded into business-as-usual decision making, which must, among other things, address alignment of business activities with legal entities, clean lines of ownership, clean funding pathways and minimisation of complexity. Relatedly, US G-SIBs are required to identify business units that could be divested, individually or in groups, in a resolution scenario (*objects of sale*).[58]

6. Resolution of global systemically important banking organisations under the Bankruptcy Code

6.1 Introduction

The first resolution plans were submitted by US G-SIBs in 2012 and since then substantial progress has been made towards making orderly resolution under the Bankruptcy Code operationally feasible. This has included the development of SPOE strategies for use under the Bankruptcy Code, as well as implementing the legal and operational infrastructure necessary for the execution of such strategies. This section highlights some of the most important milestones in this process.

6.2 Assuring the sufficiency of resolution resources

For an SPOE resolution under the Bankruptcy Code to be successful, a firm's BHC must file for bankruptcy at a time when the firm has sufficient capital and liquidity resources to sustain it through the resolution process. In addition to the business-as-usual capital and liquidity, external TLAC and RCAP and RLAP requirements described in section 5 above, US regulators also require US G-SIBs to develop governance triggers designed to assure timely support of subsidiaries and commencement of resolution proceedings. US G-SIBs must have, at a minimum, triggers that result in: (i) the escalation of information to senior management and board(s); (ii) the provision of support to operating subsidiaries; and (iii) the filing of the BHC for bankruptcy.[59] Depending on the firm, there may be triggers that result in other actions, related to financial, operational, legal and regulatory vulnerabilities that have been identified as part of the resolution planning process.

Triggers that result in the provision of support to operating subsidiaries are generally based on specified capital and/or liquidity metrics, including the *resolution capital execution need* ("RCEN") and *resolution liquidity execution need* ("RLEN"). RCEN and

58 See Federal Reserve and FDIC, *Resolution Planning Guidance for Eight Large, Complex US Banking Organizations* (note 52).

59 See ibid (note 52).

RLEN metrics are designed to project the actual needs of operating subsidiaries during an imminent SPOE resolution. RCEN metrics project the capital resources needed at each operating subsidiary following the BHC's bankruptcy filing, to cover projected losses experienced by the operating subsidiaries while the SPOE resolution is being executed. RLEN metrics project the liquidity resources needed at each operating subsidiary to cover net liquidity outflows after the BHC's bankruptcy filing and until liquidity levels of the recapitalised firm stabilise. During a period of financial stress (identified based on parameters such as the level of sustained losses, liquidity outflows or other financial parameters), US G-SIBs are required to estimate and update regularly their RCEN and RLEN projections. If a US G-SIB's capital or liquidity resources were to decline to a point where they are approaching the RCEN or RLEN projected to be required for successful resolution of the firm, the BHC would be required to commence bankruptcy proceedings and dedicate the firm's remaining capital and liquidity resources to the continuation or orderly wind-down of the firm's operating subsidiaries. This trigger has been incorporated into the firms' secured support agreements, as described in section 6.3 below.

6.3 Protecting pre-bankruptcy support of operating subsidiaries

6.3.1 Overview

Under an SPOE resolution strategy, during a stress period and prior to the BHC's filing for Chapter 11 Proceedings, contributable resources of the BHC are used to support stressed operating subsidiaries. To prevent any legal or other challenges to the provision of such support, each US G-SIB has, as part of the resolution planning process, adopted a contractually binding support mechanism known as a *support agreement*, and has granted security interests in contributable assets held by its BHC or by a prefunded intermediate holding or special purpose funding subsidiary (IHC) to secure the support obligations under the agreement.

6.3.2 Secured support agreements

A support agreement creates a secured contractually binding commitment on the part of the BHC to transfer available contributable resources to a G-SIB's operating subsidiaries, or a solvent IHC, also party to and obligated under the support agreement, for the purpose of assuring that capital and liquidity support are provided in a timely manner to the firm's operating subsidiaries during the resolution process. All of the US G-SIBs have entered into support agreements, and the obligations to operating subsidiaries under the support agreements generally are secured by a security interest in substantially all of the contributable resources available to provide support under the support agreement, whether held by the BHC or by an IHC. The US G-SIBs have taken steps to perfect these security interests under the applicable Uniform Commercial Code in the US and under applicable non-US law. The obligations to provide contributable resources under secured support agreements are generally based on the various capital and/or liquidity triggers, including the RCEN and RLEN triggers referred to in section 6.2 above, creating a contractual obligation to provide support so available resources will be sufficient to carry the operating subsidiaries through a resolution period.

Secured support agreements are designed to assure that any transfer of support would be enforceable against third-party creditors. The US G-SIBs entered into their secured support agreements when they were unambiguously solvent, and the firms publicly disclose the support agreements and related security agreements during business-as-usual in the public sections of their resolution plans, in periodic disclosures required under the Securities Exchange Act of 1934 and in debt offering documents. These actions are intended to protect support transfers from legal challenges, for example under the Bankruptcy Code's avoidance powers, and to put creditors on notice of the existence of the support obligations and the liens securing them. The secured claims that would arise for breach of the support agreement if it were not performed help to assure that it is in the interest of the BHC and its stakeholders for the BHC to perform its support obligations on a timely basis, and that providing such support is consistent with BHC directors' fiduciary duties.

6.3.3 Intermediate holding companies

For both legal and practical reasons, a number of US G-SIBs make use of pre-funded IHCs. Concurrently with or soon after the execution of a secured support agreement, the BHC transfers all or a substantial portion of the contributable resources available to provide support under the support agreement to an IHC that is also party to the secured support agreement and is obligated to provide support to the operating subsidiaries in resolution. The IHC generally has no operations or material liabilities to unaffiliated third parties and thus does not have external creditors who could impede the contribution of resources to operating subsidiaries in resolution. The use of an IHC removes the need to contribute all available resources directly to operating subsidiaries based on long-range RCEN and RLEN projections prior to commencement of the BHC's bankruptcy, at a time when the actual resolution needs of individual subsidiaries are not yet known. The IHC can instead contribute resources to operating subsidiaries as and when needed after the BHC's bankruptcy. This reduces the possibility that resources will be erroneously pre-positioned in operating subsidiaries whose needs in resolution turn out to be lower than expected and as a result are unavailable to operating subsidiaries whose needs in resolution turn out to be higher than expected.

6.4 Limitations on closeouts by financial contract counterparties

US regulators finalised in 2017 rules designed to mitigate the risk of destabilising closeouts of derivatives and other QFCs when a US G-SIB's BHC commences bankruptcy proceedings (the "QFC Stay Rules").[60] The Bankruptcy Code imposes an automatic stay that prevents creditors of a bankrupt entity from exercising their default rights against a debtor in bankruptcy in order to give the company time to reorganise or to propose a plan of liquidation. QFCs, however, are generally exempt from this stay, meaning that a QFC counterparty can exercise its direct default rights against a company in bankruptcy, including cross-defaults to the bankruptcy of an affiliate (in this case, the BHC). The closeout of Lehman Brothers' QFC book had disastrous consequences in 2008, when the failure of Lehman triggered the closeout of vast volumes of derivatives, repos and other QFCs.[61] Initially, only Lehman's parent holding company filed for bankruptcy while its US subsidiaries remained open and operating.

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60 82 Fed Reg 42,882.

61 Lehman was party to more than 900,000 derivatives contracts, with a global derivatives position estimated at USD 35 trillion at the time of its bankruptcy. See Michael Fleming and Asani Sarkar, 'The Failure of Lehman Brothers' (2014) Federal Reserve Bank of New York Economic Policy Review 10. The Report of the Examiner in the Chapter 11 Proceedings of Lehman's holding company states that: "Alvarez and Marsal[, a restructuring advisory firm retained by Lehman,] asserted that as much as USD 75 billion in value was destroyed by the form of Lehman's bankruptcy. For example, Bryan P. Marsal told the Examiner that the bankruptcy resulted in the loss of 70% of USD 48 billion of receivables from derivatives that could otherwise have been unwound." Anton R Valukas, *Examiner's Report: Bankruptcy of Lehman Brothers Holdings Inc.*, Vol 2, 725 (11 March 2010).

However, Lehman's entry into bankruptcy proceedings triggered cross-default rights with respect to its subsidiaries' QFCs, which, when exercised, led to massive liquidity outflows and destruction of value as massive volumes of collateral for such transactions were dumped on the market, depressing market prices. Once Lehman's subsidiaries filed for bankruptcy, its QFC counterparties, even those with QFCs that did not contain cross-defaults to the holding company's bankruptcy, were also able to close out their transactions.

One of the goals of the SPOE approach to resolution, as described in section 3 above, is to keep the operating subsidiaries of a US G-SIB solvent, open and operating. While the BHCs of US G-SIBs are themselves prohibited from entering into third-party QFCs,[62] they still may guarantee their subsidiaries' third-party QFCs. In order to prevent the closeout by QFC counterparties of QFCs with operating subsidiaries based on cross-default rights from the parent's entry into bankruptcy, pushing those operating subsidiaries into bankruptcy themselves, US regulators worked with regulatory authorities from France, Germany, Japan, Switzerland and the United Kingdom, as well as with the International Swaps and Derivatives Association ("ISDA") and G-SIBs around the world, to launch the ISDA Resolution Stay Protocol in 2014, which was later expanded to become the ISDA 2015 Universal Resolution Stay Protocol (the "ISDA Protocol").[63] Adherence to the ISDA Protocol provides for the contractual recognition of statutory stays under certain special resolution regimes, including OLA, and, of particular importance for US G-SIBs, contractual limitations on early termination rights due to cross-defaults, including in the event of bankruptcy proceedings of a US BHC in connection with implementation of an SPOE resolution. Because adherence to the ISDA Protocol limits the closeout rights of G-SIBs as counterparties to other G-SIBs, initially local regulators required the G-SIBs in their countries to adhere to the Protocol. In the US, these limitations are being extended to other types of counterparties pursuant to the QFC Stay Rules.

The QFC Stay Rules are designed to implement the ISDA Protocol's contractual solutions on a market-wide basis in the US by prohibiting US G-SIBs and their subsidiaries from continuing to trade in new QFCs with a given counterparty unless both new QFCs and all existing QFCs with that counterparty are remediated in a manner similar to that provided in the ISDA Protocol. For QFCs under non-US law or with non-US counterparties, this includes express recognition of the FDIC's stay-and-transfer powers under OLA (see section 4.2 above), addressing the risk that these powers may not be recognised outside of the US. In addition, for all QFCs, cross-default rights in QFCs and transfer restrictions in guarantees that are based directly or indirectly on the parent or another affiliate becoming subject to bankruptcy proceedings must be limited in a manner similar to that set forth in the ISDA Protocol, and there is a safe harbour for compliance with the QFC Stay Rules by adherence to the ISDA Protocol.

6.5 Expedited bankruptcy court motion to implement single point of entry resolution

For an SPOE resolution under the Bankruptcy Code to be executed successfully, the period immediately following the BHC's bankruptcy filing will be critical. Swift action must be taken to implement the firm's SPOE recapitalisation so the firm's operations can be stabilised. Among other things, it will be necessary to restore the confidence of customers and counterparties, stem any outflow of deposits and other runnable liabilities, and reduce the risk of ring-fencing by local authorities. This requires communicating quickly, clearly and credibly to financial markets that, notwithstanding

62 12 CFR § 252.64(a)(3).

63 ISDA, *ISDA 2015 Universal Resolution Stay Protocol*.

the bankruptcy of the BHC, the firm's operating subsidiaries are continuing in business as fully capitalised going concerns or are being wound down in an orderly manner, as solvent, non-bankrupt entities. If confusion exists, there is a serious risk that misperception of the operating subsidiaries as insolvent or close to insolvency (although unjustified) could lead to a run on these entities and ring-fencing by local authorities, undermining the firm's ability to obtain credit and continue in business.

Gaining bankruptcy court authorisation to transfer the firm's operating subsidiaries to a new debt-free holding company ("New HoldCo") as promptly as possible after commencement of the BHC's Chapter 11 Proceedings, if they are not being wound down, is of paramount importance. To accomplish this, the BHC would, together with its bankruptcy petition, file a motion with the bankruptcy court to obtain expedited authorisation, among other things, to transfer all of the shares of its operating subsidiaries to New HoldCo (an "Expedited Transfer Motion").[64] More specifically, the Expedited Transfer Motion would seek a bankruptcy court order approving: (i) the transfer pursuant to section 363 of the Bankruptcy Code of the stock of the operating subsidiaries (including the firm's IHC, if any) to New HoldCo, which would be owned by an independent private trust whose sole beneficiary would be the former BHC, as Chapter 11 debtor; and (ii) the assumption by New HoldCo of any guarantees or other contingent credit support obligations of the BHC in respect of its operating subsidiaries' QFCs (as required under the QFC Stay Rules). The court would be requested to shorten the notice period for the motion so the Expedited Transfer Motion could be decided very quickly (within only a couple of days at most) after commencement of the Chapter 11 Proceedings.

The Expedited Transfer Motion's objectives would be to preserve the value of the operating subsidiaries and minimise adverse effects on systemic stability by halting the flight of customers and counterparties, reducing the need for fire sales of assets, discouraging ring-fencing and meeting the requirements for contractual waivers of QFC cross-default rights. In order to avoid QFC cross-default terminations, the order granting the motion must be granted and the transfer consummated within the deadline imposed by the ISDA Protocol, as implemented in regulation through the QFC Stay Rules. The deadline is the later of 48 hours and one full business day after the BHC's bankruptcy filing, a period often referred to as the "resolution weekend".[65] Upon consummation of the transfer, any guarantees or other credit support for the operating subsidiaries' QFCs that had previously been furnished by the bankrupt BHC would be assumed by New HoldCo. QFC counterparties' cross-default rights would not be enforceable so long as the operating subsidiaries continue to perform their contractual obligations and certain other basic conditions remain satisfied.[66]

64 The BHC may meet the requirements for contractual waivers of QFC cross-default rights by filing an expedited Guarantee Elevation Motion (rather than an Expedited Transfer Motion) as described in more detail at note 66 below.

65 The expectation is that the BHC would commence its Chapter 11 Proceedings either on a Friday after the close of business or over the weekend, and the operating subsidiaries would be recapitalised and open for business on the following Monday, after being transferred to New HoldCo.

66 A Guarantee Elevation Motion provides an alternative way to meet the contractual requirements for waivers of QFC cross-default rights in an SPOE resolution where a BHC's operating subsidiaries, though solvent after their recapitalisation and implementation of the firm's secured support agreement, are not expected to continue as going concerns under a New HoldCo but rather are expected to be wound down in an orderly manner as subsidiaries of the debtor BHC. A Guarantee Elevation Motion seeks to provide QFC counterparties the same assurance of the operating subsidiaries' continued creditworthiness as if their guarantees had been transferred to a New HoldCo, by elevating the priority of the debtor BHC's guarantees above the priority of unsecured claims in the BHC's Chapter 11 Proceedings. Granting of the Guarantee Elevation Motion thereby facilitates an orderly, value-maximising wind-down of the solvent, recapitalised subsidiaries. The expectation is that all counterparty obligations would be satisfied by the operating subsidiaries in their solvent wind-down and the "elevated" guarantees would never be called upon.

The Expedited Transfer Motion would include a detailed description of the facts underlying the BHC's failure and lay out for the court the factual and legal justifications for granting the requested order. It would, among other things, explain why consummation of the contemplated transactions is the best way to preserve the value of the BHC's assets for the benefit of the BHC's creditors, mitigate systemic risk, and preserve a viable financial institution in the interest of all of the BHC's stakeholders, customers and the public. At the court hearing on the motion, evidence would be presented regarding these issues and also to show why New HoldCo, as a fully capitalised, open and functioning financial institution, will have the ability to continue to operate as a going concern, preventing losses to counterparties and customers and maximising the value of the operating subsidiaries for the benefit of the BHC and its creditors in the Chapter 11 Proceedings. In addition, evidence would be presented regarding the qualifications of the proposed trustee of the trust that will act as the shareholder of New HoldCo and the proposed management of New HoldCo, as well as the adequacy of reporting and other safeguards of the rights of the debtor BHC's creditors included in agreements among New HoldCo, the shareholder trust and the debtor BHC. Finally, evidence would be presented to demonstrate that, by preserving the ability of the firm to provide uninterrupted service to its many depositors, customers and counterparties, approval of the motion will protect the public interest by avoiding systemic risk and the financial contagion that might otherwise result from the disorderly resolution of the BHC and its subsidiary operations. Since US regulators are the supervisors of the debtor BHC and would become the supervisors of New HoldCo, they would have an opportunity to be heard at the court hearing regarding all of the above issues, and it is highly likely that the bankruptcy court would give substantial weight to their views.[67]

To assure timely approval of the Expedited Transfer Motion, US regulators and practitioners have devoted considerable effort to *ex ante* preparation, and the SPOE approach to resolution and the expected timing and required proof for approval of an Expedited Transfer Motion have been the subject of presentations to bankruptcy judges from jurisdictions across the US.[68] US G-SIBs have developed playbooks and documentation templates as part of their Title I resolution plans, and engagement on these issues among the judiciary, leading bankruptcy and regulatory practitioners, legal scholars and regulators is expected to continue.[69]

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67 It is expected that US regulators will have assessed the suitability of the qualifications of the proposed trustee and the proposed management of New HoldCo, including any appropriate replacements for existing management, prior to commencement of the BHC's Chapter 11 Proceedings.

68 For example, a broad group of judges, practitioners, academics and regulators discussed best practices for use of the SPOE approach for the orderly resolution of a G-SIFI under the Bankruptcy Code at a conference hosted in December 2016 by the Wharton Financial Institutions Center at the University of Pennsylvania. For more information, please see Wharton Financial Institutions Center, *Resolution of Global Systemically Important Financial Institutions Under the Bankruptcy Code* (7 December 2016), available at: https://fic.wharton.upenn.edu/resolution-under-bankruptcy. Widely attended subsequent sessions with judges in attendance have occurred under the auspices of the American Bankruptcy Institute, the Federal Judicial Center, the International Insolvency Institute, New York University School of Law, and the University of Pennsylvania Law School, among others.

69 Meetings of the FDIC's Systemic Resolution Advisory Committee provide another forum for representatives of the regulatory agencies and from practice, academia and the judiciary to discuss a broad range of issues regarding the resolution of SIFIs under the Bankruptcy Code and OLA.

7. The Bankruptcy Code and Orderly Liquidation Authority – complementary laws and proposed reforms

Comparisons of the Bankruptcy Code and OLA as tools for resolution have generated vigorous debate and a growing body of literature. Some of the commentary reflects ill-informed, reflexive viewpoints, but sometimes it reflects more constructive, thoughtful critiques. Critics of OLA have argued that the sweeping, discretionary authority conferred on the FDIC – in particular, the flexibility to depart from strict *pari passu* treatment of similarly situated creditors, and the availability of OLF funding – may weaken market discipline and may be inconsistent with the rule of law. Others assert that the Bankruptcy Code does not contain sufficient tools or funding to permit orderly resolution of the largest firms.

The same recognition of the need for better resolution tools that led to creation of OLA has also led to academic and legislative proposals for amending the Bankruptcy Code to address the specific challenges of resolving large financial firms. These proposals build on work sponsored by the Hoover Institution and are often called "Chapter 14" proposals, following the suggestion that a proposed new chapter "14" be added to the Bankruptcy Code to address the resolution of systemically important financial firms.[70]

Some of OLA's most vocal critics have argued that it should be repealed and replaced entirely with Chapter 14. Nonetheless, consensus has largely settled around the view that OLA and Chapter 14 frameworks are mutually reinforcing, rather than exclusive, of one another. A report published in February 2018 by the US Department of the Treasury[71] explicitly adopts this position, with recommendations and detailed supporting analyses for making bankruptcy more effective for the resolution of large financial firms and thereby making invocation of OLA less likely. FDIC Chair Jelena McWilliams stated in a November 2018 speech that, while "any failure should be dealt with through bankruptcy, we should also acknowledge that the Bankruptcy Code was not written with large, complex financial institutions in mind".[72] She went on to express support for Chapter 14 proposals that would "establish a more tailored, transparent process for large financial firms".[73]

Legislative proposals based on Chapter 14 have drawn strong support from across the political spectrum; indeed, a bill that would have added a new subchapter to Chapter 11 based on the Chapter 14 proposal passed the US House of Representatives with a bipartisan vote.[74] Hearings have been held before the Senate Judiciary Committee on a companion Senate bill.[75]

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70 See Financial Institution Bankruptcy Act of 2017, HR 1667, 115th Cong (2017); Financial CHOICE Act of 2017, HR 10, 115th Cong §§ 121-23 (2017); Taxpayer Protection and Responsible Resolution Act, S 1840, 114th Cong §§ 2-4 (2015); Taxpayer Protection and Responsible Resolution Act, S 1861, 113th Cong §§ 3-5 (2013); Kenneth E Scott, Thomas H Jackson and John B Taylor (eds), *Making Failure Feasible: How Bankruptcy Reform Can End 'Too Big to Fail'* (Hoover Institution Press 2015) (providing the most recent version of the Hoover Institution proposal); and Bipartisan Policy Center, *Too Big to Fail: The Path to a Solution* (2013).

71 See US Department Of The Treasury, *Orderly Liquidation Authority and Bankruptcy Reform* (2018).

72 Keynote remarks by McWilliams (note 12).

73 ibid.

74 See Financial Institution Bankruptcy Act of 2017, HR 1667, 115th Cong (2017). See also Financial CHOICE Act of 2017, HR 10, 115th Cong §§ 121-23 (2017); Taxpayer Protection and Responsible Resolution Act, S 1840, 114th Cong §§ 2-4 (2015); and Taxpayer Protection and Responsible Resolution Act, S 1861, 113th Cong §§ 3-5 (2013).

75 *Big Bank Bankruptcy: 10 Years after Lehman Brothers and the Taxpayer Protection and Responsible Resolution Act*, Hearing Before the Senate Committee on the Judiciary, 115th Cong (13 November 2018).

The Chapter 14 framework would amend the Bankruptcy Code in a number of ways that obviate the need for workarounds that have been adopted in the US G-SIB Title I resolution plans.[76] For example, to provide a roadmap for timely bankruptcy court approval to transfer ownership of a failed BHC's operating subsidiaries to a bridge holding company, Chapter 14 would create an expedited process for notice and hearing, explicitly specifying the criteria for approval of a transfer motion. It would also establish a designated panel of bankruptcy court judges with the requisite background to act with appropriate speed. To facilitate continuity of the failed BHC's operating subsidiaries, the Chapter 14 framework would expressly provide for the appointment of a special trustee to become shareholder of the newly created bridge holding company for the benefit of the bankruptcy estate, subject to limited bankruptcy court oversight. It would create a safe harbour for pre-bankruptcy support transfers made by the BHC to its operating subsidiaries to assure that such transfers, whether pursuant to a secured support agreement or otherwise, are protected from legal challenges. To avoid potential destabilisation from the early termination of QFCs, the Chapter 14 framework would eliminate applicability of the Bankruptcy Code safe harbours for QFC closeout rights in the event of a qualifying transfer, even in the absence of contractual waivers of the kind described in section 6.4 above. QFCs would be subject to the same 48-hour stay and override of *ipso facto* default and cross-default rights provided in the ISDA Protocol, which would then become permanent if certain conditions are met. Finally, the Chapter 14 framework would explicitly confirm US regulators' standing to raise and be heard on any issue in the bankruptcy case, which will be as important in connection with a transfer under Chapter 14 as it is under current law as described in section 6.5 above.

Whether these reforms will be enacted remains to be seen, but they highlight how far thinking has progressed regarding how the Bankruptcy Code and regulatory requirements can work together to assure the orderly resolution of a US G-SIB. This thinking is already reflected in the US G-SIBs' Title I resolution plans and the detailed playbooks for implementation of those plans under the Bankruptcy Code as currently in force.

[76] See ibid, testimony of Donald S Bernstein, Davis Polk & Wardwell LLP.

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