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**IMPACT ASSESSMENT**

*Accompanying the*

**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN  
PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL  
COMMITTEE, THE EUROPEAN COURT OF JUSTICE AND THE EUROPEAN  
CENTRAL BANK**

**on an EU Framework for Cross-border Crisis Management in the Banking Sector**

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This report commits only the Commission's services involved in its preparation and does not prejudice the final form of any decision to be taken by the Commission

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## 1. INTRODUCTION

Over the course of this financial crisis, the ability of authorities to manage crises both domestically and in cross-border situations has been severely tested. Financial markets within the EU have become integrated to such an extent that the effects on credit institutions of problems occurring in one Member State cannot always be contained and isolated and domestic shocks may be rapidly transmitted to firms and markets in other Member States.

The lessons learned during this crisis have prompted the Commission services to examine the issue of bank resolution and to give serious consideration about how existing arrangements and cross-border cooperation can be strengthened in such a way as to more appropriately reflect the degree of integration in EU financial services market. The Commission services believe that resolving these issues will be key to restoring and further consolidating the Internal Market by providing further confidence in the home-host arrangements underpinning banking supervision, and ensuring its smooth functioning in stressed situations.

One of the most important issues concerning actions to maintain financial stability is the ability of authorities to pre-empt or manage the crisis situations of banks. The involvement of authorities may be crucial to maintaining the stability of the whole financial system, to protecting the deposits of people and companies and to maintaining the continuity of the payment systems and other basic financial services.

At international level, G20-Leaders have identified as a medium-term action the “review of resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border institutions.”<sup>1</sup> At the Pittsburgh summit on 25 September, they committed to act together to “..create more powerful tools to hold large global firms to account for the risks they take” and, more specifically, to “develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future.”

The Basel Committee is also currently dealing with this issue.<sup>2</sup> In the US, the existing crisis management system will be further improved and strengthened.<sup>3</sup> In the EU, several Member States (UK, Spain, Germany etc.) have recently reinforced their systems to enable prompt and effective crisis management of banks.

The conclusions of the October 2007 ECOFIN Council called for an enhancement of the arrangements for financial stability in the EU and a review of the tools for crisis prevention, management and resolution, including a revision of the 2001 Directive on the reorganisation and winding up of credit institutions. The report of the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière<sup>4</sup> observed: “*The lack of consistent crisis management and resolution tools across the Single Market places Europe at a*

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<sup>1</sup> G20 Leaders' declaration of the Summit on financial markets and the world economy, April 2009.

<sup>2</sup> A Basel Working Group called Cross-border Bank resolution Group (CBRG) was set up in December 2007 to study the resolution of cross-border banks. It is comparing the national policies, legal frameworks and the allocation of responsibilities for the resolution of banks with significant cross-border operations. It also promotes the use of bank specific resolution techniques for authorities. <http://www.bis.org/bcbs/index.htm>

<sup>3</sup> Financial Regulatory Reform; [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf)

<sup>4</sup> [http://ec.europa.eu/economy\\_finance/publications/publication14527\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication14527_en.pdf)

*disadvantage vis-à-vis the US and these issues should be addressed by the adoption at EU level of adequate measures.”<sup>5</sup>*

The Commission stressed in its 4 March 2009 Communication the importance of strengthening the EU's crisis management arrangements and announced its intention to publish a paper on Early intervention by June 2009. It subsequently decided, due to the complexity and importance of the issues to be addressed, to precede any policy orientations with an open consultative Communication.

While it is important that an EU approach be consistent with international developments, it is also essential and urgent – in light of the greater degree of integration and interconnectedness within the Internal Market –to carry out extensive work at EU level to complement the existing EU prudential framework.

The Communication on "A Bank Resolution Framework for the EU", that this impact assessment accompanies, presents an overview of the problems, the areas under examination related to early intervention measures and bank resolution. It focuses on cross-border banks i.e. those banks which are internationally active and of "systemic importance" but also considers whether there is a need to cover other banks which are active across borders (but not necessarily judged to be systemic)<sup>6</sup>. The Communication also considers whether there is a need to extend the scope of a possible future framework beyond deposit taking banks to other types of financial institution (e.g. investment firms and insurance companies). The Communication proposes policy objectives and an overall approach without proposing specific detailed policy solutions at this stage. This impact assessment focuses primarily on the problem definition and the need for and objectives of EU level action in this area. It also explains how EU level action in cross border crisis management would complement the other important changes (in the field of deposit insurance, capital requirements, supervisory architecture) proposed as responses to the financial crisis in order to strengthen the bank regulatory framework. In view of the consultative nature of the Communication, policy options are only considered in the broadest of terms. Any subsequent policy proposals to emerge as a result of this consultation will be subject to further and more thorough impact assessment at the appropriate stage.

#### **Key concepts used in this impact assessment:**

**Early intervention:** early remedial actions of banking **supervisors** (e.g. raising private capital, modification of business lines, divestiture of assets) which aim at correcting irregularities at banks and hence helping banks returning to normal course of business and avoiding that banks enter in a resolution stage.

**Bank resolution:** reorganisation of ailing banks (in either an administrative or judicial process) that aims at maintaining financial stability, the continuity of banking services and the revitalisation of the bank. In addition to traditional reorganisation techniques, bank resolution uses specific tools (e.g. bridge banks, forced merger, assisted acquisition, partial sale of assets) to reach the above objectives. The process is managed by a **resolution authority**, which can be different in Member States (national bank, financial supervisor, deposit

<sup>5</sup> For more details, see Annex II where the full chapter on crisis management and resolution in the De Larosière report is reproduced.

<sup>6</sup> More details on the size of the market concerned are to be found under section 3.1.

## **2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES**

### **2.1. Procedural issues**

An Inter-service Steering Committee on early intervention and bank resolution was set up in October 2008 comprising different Directorate Generals: MARKT, ECFIN, SG, SJ, ENTR, EMPL, COMP, JLS and the European Central Bank (ECB). The steering committee met in November 2008, June 2009 and September 2009.

The Impact Assessment was submitted on 10 September 2009 and discussed by the Impact Assessment Board on 23 September 2009.

The minutes of the last Steering Group meeting were attached to the Impact Assessment at the submission to the Impact Assessment Board.

The comments received from the Impact Assessment Board resulted in the following changes:

- More detailed description of the relationship between early intervention and bank resolution with other initiatives to address weaknesses highlighted by the financial crisis especially concerning the supervisory architecture;
- Clarification of the scope of the Communication in terms of banks concerned;
- More explicit reference to the problems associated with cross-border crisis management which the case studies seek to highlight ;
- Clarification of options concerning bank resolution financing;
- Addition of a table showing the impacts of major policy options on each stakeholders;
- Addition of tables methodically linking options to the full set of objectives;
- Addition of an annex on the main results of the public consultation on the review of the reorganisation and winding up of credit institutions Directive.
- Addition of an annex with a table which provides an overview of the issues covered in the Communication, including the bodies involved at different phases of a developing crisis.

### **2.2. Consultation of interested parties**

In the period until September 2009, the Commission services organised a number of consultations with experts and key stakeholders.

A working group on Early Intervention was set up in November 2008 which comprised of experts of all Member States, mostly representing Ministries of Finance. The working group met on two occasions and provided important insight and opinion to the matters under examination. Experts commented in writing on the first Issues Paper that was circulated for consultation in January 2009. Initial reactions suggest that Member State experts clearly support the Commission's work on early intervention and bank resolution, considering the

issues to be of high importance and priority. They requested the Commission to adopt an ambitious approach which at the same time sets the right balance between financial stability and the interest of stakeholders.

In the second half of 2008, the Committee of Banking Supervisors (CEBS) conducted a comprehensive survey among all banking supervisors in the EU and delivered its report to the Commission in March 2009<sup>7</sup>. The report summarises the objectives and powers, including early intervention measures and sanctioning powers of financial supervisors. The report is widely quoted in this impact assessment.

During technical meetings and continuous contacts, the issues were also discussed with the European Central Bank. Views were shared on the need for improved early intervention and bank resolution in the EU.

In July 2009, a high level Working Group of the Economic and Finance Committee published a paper entitled "Lessons from the financial crisis for European financial stability arrangements", containing 10 recommendations for improvements in the field of crisis management. The recommendations are in line with the analysis contained in this impact assessment.

An external legal consultant (DBB Law) was hired in August 2008 to support the work with key inputs, data and legal analysis. The Consultant summarised the legal frameworks of 16 Member States regarding early intervention possibilities by supervisors, insolvency legislations for banks and banking groups, and special intervention possibilities by resolution authorities. The Consultant delivered its interim report in November 2008<sup>8</sup> and its draft final report in July 2009.

The contributions of DBB Law and CEBS were important in understanding the problems that are addressed by this initiative.

In May 2007, a public consultation<sup>9</sup> was launched to seek the views of stakeholders in relation to the Directive on the reorganisation and winding up of credit institutions (2001/24/EC).<sup>10</sup> The survey respondents broadly supported the development of a legal framework tailored to the winding up and re-organisation of cross-border banking groups. The consultation's result suggested that the current directive that deals with cross border branches might need also some adjustment (e.g. investment firms are not covered by the directive, home-host responsibilities can create problems in managing cross border branches: to determine which should be the applicable law and responsible authority).

The European Banking Federation<sup>11</sup> (EBF) set up a special working group to support the work of the Commission and provided their views on early intervention and bank resolution. They delivered their draft report in April 2009. EBF expressed its support for the work of the

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<sup>7</sup> [http://www.c-ebs.org/getdoc/f7a4d0f8-5147-4aa4-bb5b-28b0e56c1910/CEBS-2009-47-Final-\(Report-on-Supervisory-Powers\)-.aspx](http://www.c-ebs.org/getdoc/f7a4d0f8-5147-4aa4-bb5b-28b0e56c1910/CEBS-2009-47-Final-(Report-on-Supervisory-Powers)-.aspx)

<sup>8</sup> [http://ec.europa.eu/internal\\_market/bank/windingup/index\\_en.htm](http://ec.europa.eu/internal_market/bank/windingup/index_en.htm)

<sup>9</sup> The summary of the main findings can be found in Annex IV. All consultations documents can be found on the following website: [http://ec.europa.eu/internal\\_market/bank/windingup/index\\_en.htm](http://ec.europa.eu/internal_market/bank/windingup/index_en.htm)

<sup>10</sup> See description of the Directive in sub-chapter: Overview of legislative framework

<sup>11</sup> Set up in 1960, the European Banking Federation is the voice of the European banking sector (EU & EFTA countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. [www.fbe.be](http://www.fbe.be)

Commission on early intervention aiming at enhancing the effectiveness of cross-border crisis management. They also supported actions regarding coordinated approaches in groups' insolvency. EBF called for a clear policy around the different stages of a crisis: who the responsible competent authorities are and what tools are at their disposal at each stage.

### **3. POLICY CONTEXT, PROBLEM DEFINITION AND SUBSIDIARITY**

#### **3.1. Background and context**

##### *3.1.1. Nature and size of the market concerned*

The Communication addresses crisis management and resolution issues in relation to internationally active banks. There are 39 large cross border banks in the EU and around 100 further banks that have subsidiaries or systemic branches in another Member State. The focus is on crisis management for individual banks under normal market conditions, as opposed to under conditions of generalised economic and systemic crisis. This is an important distinction, as policy options may differ according to the market environment. Chapter 4 presents therefore policy options that primarily applicable in the case of crisis in one individual cross-border bank. The main objective of such a crisis management framework is to put in place arrangements which are capable of handling the failure of even the largest cross-border bank without provoking wider systemic impacts. Under generalised financial crises, such as the recent crisis, there may be no alternative other than to use public funds to support the banking sector. Nevertheless, the development of effective crisis management tools should also useful in all circumstances.

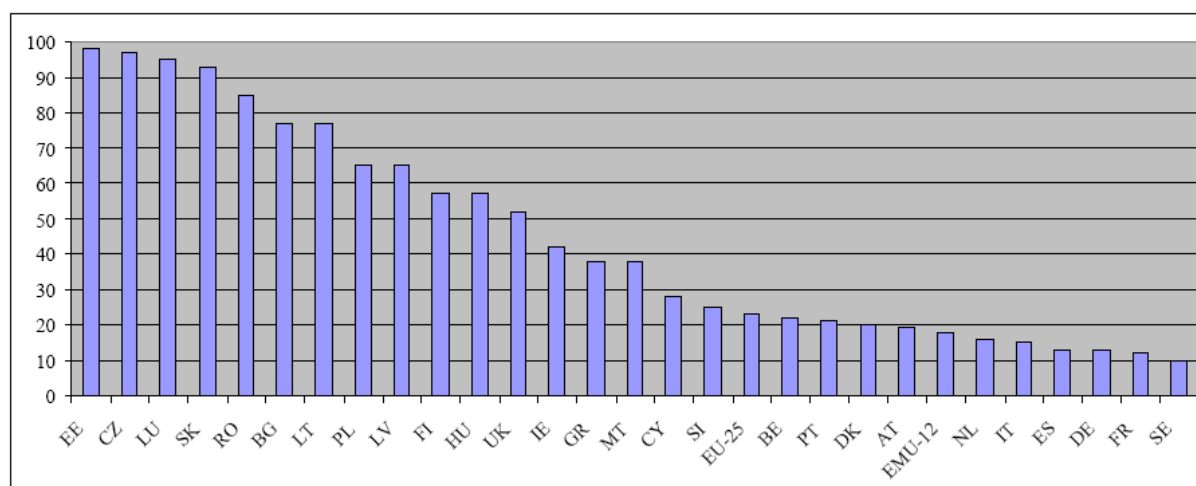
EU financial markets are increasingly integrated, especially at the wholesale level. The banking and insurance markets are dominated by pan-European groups, whose risk management functions are centralised in the group's headquarters. According to the ECB<sup>12</sup>, in 2007, total assets of approximately 8,300 credit institutions<sup>13</sup> in the EU27 were €41,072 billion with a significant share thereof owned by the 39 large cross-border groups. Their total assets represent around 68 % of the total EU banking market. Especially in the EU-12, banking markets are dominated by foreign (mostly Western European) financial groups. In these countries, on average 65% of banking assets are in foreign-owned banks. In countries like Estonia, the Czech Republic and Slovakia over 92% of banking assets are in foreign-owned banks.

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<sup>12</sup> ECB, *EU Banking Structures*, October 2008

<sup>13</sup> At a Member State level, this figure includes branches and subsidiaries of banks from other EU and third countries. Where a foreign bank has several branches in a given MS, they are counted as a single branch.

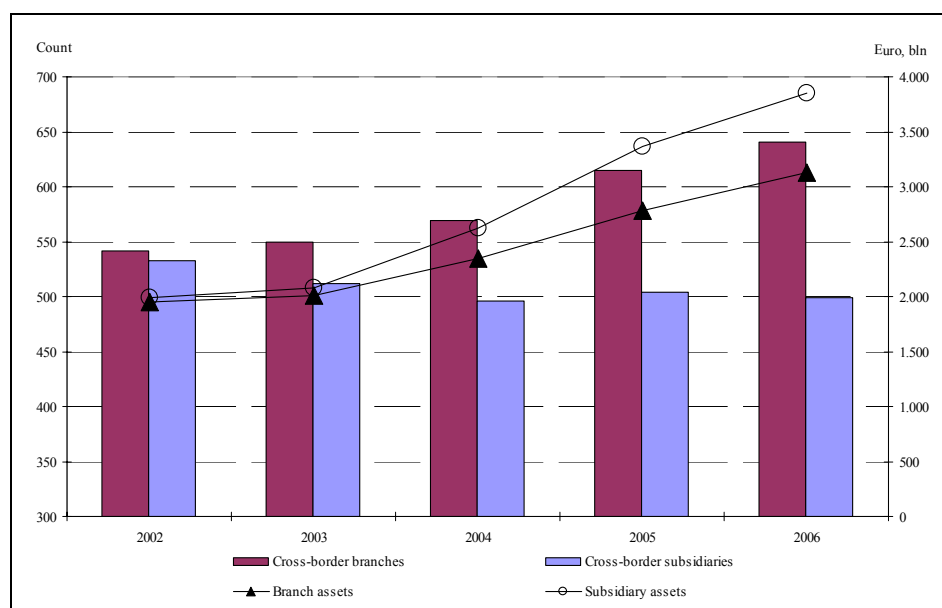
**Chart 1 Market share of foreign-owned banks (% of total assets)**



Source: European Commission, European Financial Integration Report 2008 (2009)

The assets of bank branches and subsidiaries established in another Member State has been growing over the past years. Around 500 foreign subsidiaries owned assets of almost 4000 billion euros in 2006 up from 2000 billion in 2002.

**Chart 2** Branches<sup>14</sup> and subsidiaries of credit institutions from other MS and their cross-border assets in 2002-2006



Source: ECB

### 3.1.2. Overview of legislative framework

The current EU financial stability framework is focused on ensuring banks are adequately capitalised. The Capital Requirements Directive (CRD)<sup>15</sup> contains provisions aimed at

<sup>14</sup> Where a credit institution has several branches in a given MS, they are counted as a single branch.

stabilising capital within banks, but it is not prescriptive about what to do when banks no longer meet the 8%<sup>16</sup> minimum capital threshold. The management of situations when the bank does not meet the requirements of banking laws (8% CAR) but is still not insolvent is left to national legislation.<sup>17</sup>

Presently at EU level, article 136 of the CRD deals with the early intervention powers and tools of banking supervisors in a crisis situation. This article enables the supervisors to oblige banks to implement measures that correct irregularities and restore capital requirements, e.g. by requiring them to hold additional capital, improve governance, systems and internal control arrangements, increase reserves, limit business operations and risk exposures, etc.

The CRD also establishes rules about alerting other authorities<sup>18</sup> (i.e. Central Banks and Ministries of Finance) in emergency situations, requiring coordination of supervisory activities and exchange of information in emergency situations<sup>19</sup> among Member States.

National banking legislations enable financial supervisors with different powers and tools to **intervene at an early stage** in the operation of a bank in a crisis situation. The survey of CEBS (mentioned above) summarises the main differences between national systems.

In July 2008, agreement was reached on an EU wide Memorandum of Understanding ('MoU')<sup>20</sup> setting out cross-border crisis management arrangements and involving the commitment of all signatories (e.g. EU finance ministries, Central Banks and supervisory authorities) to cooperate across borders between relevant authorities with a view to enhancing preparedness for the management of potential cross-border crisis situations. Although not legally binding in nature, the MoU defines procedures for the involvement of all relevant parties in a crisis situation, based on the existing legal responsibilities and decentralised supervisory framework, and building on existing networks of authorities (Domestic Standing Groups, colleges of supervisors, and networks of Central banks). It also defines coordination mechanisms, relying on a national coordinator in charge of actions to be taken at a national level (who may vary according to the nature, the characteristics and stages of the crisis) and Cross-Border Coordinator which, as a rule, is one of the authorities of the home country and should efficiently use internal cooperation mechanisms of the country. The MoU stipulates that sufficient cross-border procedures in normal times between all relevant authorities are to be put in place to enhance the availability of tools for crisis management; addressing the issues of burden sharing between home and host countries; and ensuring preparedness for financial crisis situations.

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<sup>15</sup> Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

<sup>16</sup> Capital Adequacy Ratio (CAR): bank's capital expressed as a percentage of its risk weighted assets.

<sup>17</sup> This approach is supplemented by the two "safety net Directives" should preventive measures fail: the DGS Directive and the Re-organisation and winding-up of credit institutions Directive (2001/24/EC). The latter Directive is limited to organising conflict of law rules (Which law is applicable in the procedure: both the host and home Member States (country of origin), or only the home Member States (universality and unity principles) but does not govern the actual insolvency laws themselves, which are left to the discretion of Member States. Furthermore it caters only for credit institutions with branches (not subsidiaries) in another Member State.

<sup>18</sup> Article 130 CRD

<sup>19</sup> Article 129(1) CRD

<sup>20</sup> Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross Border Stability (1 June 2008).

**Table 1 Relevant EU and national legislations and agreements**

| EU Competence                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|--------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Directive/agreement                                                                                          | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Relevance for this topic                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| <b>Capital Requirements Directive (CRD, Directive 2006/48/EC and 2006/49/EC)</b>                             | <p>CRD establishes the authorisation and pursuit of business of credit institutions along with the principle of single passport and home country control and further sets out the applicable prudential requirements: supervision and disclosure by competent authorities, consolidated supervision, capital requirements, reporting of and limits to large exposures and non-financial holdings, suitability of managers and shareholders, standards for the internal risk management and public disclosure to achieve market discipline.</p> <p>Together, the Codified banking Directive and the Capital Adequacy Directive implemented the capital requirement framework based on the Basel II accord developed by the Basel Committee on Banking Supervision (BCBS).</p>                                   | <p>Article 136 lists the minimum powers supervisors must have to correct irregularities at a bank. This list could be expanded in light of the current crisis as not all authorities had adequate tools to handle ailing banks.</p> <p>Article 129 and 130 established rules about alerting other authorities (i.e. Central Banks and Ministries of Finance) in emergency situations.</p> <p>New provisions on home/host supervision have recently been adopted (but not yet transposed into national legislation) which establish colleges of supervisors for internationally active banks.</p> |
| <b>Directive on the Reorganisation and Winding up of Credit Institutions (Directive 2001/24/EC)</b>          | <p>The Directive establishes that the home administrative or judicial authorities are the empowered authorities to decide on reorganisation measures and winding-up proceedings for credit institutions that operate branches in other Member States. The measures are governed by a single bankruptcy law, that of the home state. It prohibits the application of separate insolvency measures to branches under the law of the host State. It ensures the mutual recognition and coordination of procedures under home country control, imposes a single-entity approach by which all the assets and liabilities of the 'parent' bank and its foreign branches are reorganised or wound up as one legal entity under, subject only to exceptions specified in the Directive, the law of the home State.</p> | <p>This directive does not provide for the consolidation of insolvency proceedings for separate legal entities i.e.: subsidiaries within a banking group, and makes no attempt to harmonise national insolvency laws.</p>                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Directive on Deposit Guarantee Schemes (Directive 94/19/EC) and its amendment by Directive 2009/14/EC</b> | <p>The Directives aim at safeguarding deposits from bank customers. Each depositor is guaranteed a protection of at least € 50,000. Unless the Commission Services finds it differently, the limit will be increased to € 100,000 by 31 December 2010. Member States are obliged to ensure that one or more deposit guarantee schemes are set up. The schemes must also cover depositors at branches in other Member States.</p>                                                                                                                                                                                                                                                                                                                                                                               | <p>In certain Member States deposit guarantee schemes not only have the task to pay out deposits but also to actively take part in crisis management or even to finance a resolution.</p>                                                                                                                                                                                                                                                                                                                                                                                                        |

| EU Competence                                  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                     |
|------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Directive                                      | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Relevance for this topic                                                                                                                                                                                                            |
| <b>Memorandum of Understanding 2008</b>        | Building on the existing national and EU legislation, the objective of the Memorandum is to ensure cooperation in financial crises between <i>Financial Supervisory Authorities</i> , Central Banks and Finance Ministries through appropriate procedures for sharing of information and assessments, in order to facilitate the pursuance of their respective policy functions and to preserve stability of the financial system of individual Member States and of the EU as a whole. | Voluntary cooperation of authorities proved to be inadequate in the recent financial crisis despite the fact that the MoU was already in force.                                                                                     |
| <b>Second Company Law Directive 77/91/EEC</b>  | The Directive on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.                                                                               | Mandatory requirements on the shareholders' approval of any increase or reduction of capital as well as rules on shareholders' pre-emption rights may hinder effective resolution measures of public authorities in an ailing bank. |
| <b>Shareholder Rights Directive 2007/36/EC</b> | The Directive on the exercise of certain rights of shareholders in listed companies establishes requirements for general meetings of shareholders and in particular the convocation periods and the form of the convocation.                                                                                                                                                                                                                                                            | Long convocation periods may slow down speedy actions of authorities aiming at resolving ailing banks.                                                                                                                              |
| National Competence                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                     |
| Legislation                                    | Relevance for this topic                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                     |
| <b>Banking laws on powers of supervisors</b>   | Beyond the minimum requirements of the CRD, early intervention by supervisors is defined by national supervisory/banking laws. These laws include widespread powers which may not be compatible across Member States and may complicate cross-border supervisory cooperation.                                                                                                                                                                                                           |                                                                                                                                                                                                                                     |
| <b>Insolvency laws</b>                         | Bank resolution depends in most Member States on national insolvency provisions. Reorganisation of different entities of the same cross-border banking group will take place according to different national insolvency laws. There is no coordinated operation of these laws on a cross border level.                                                                                                                                                                                  |                                                                                                                                                                                                                                     |
| <b>Special bank resolutions laws</b>           | Special laws on bank resolution are aimed at optimising the response to a banking crisis, allowing intervention at a stage before formal insolvency has been reached. Such laws only exist in very few Member States hence the absence of special reorganisation techniques for banks can complicate cross-border coordination.                                                                                                                                                         |                                                                                                                                                                                                                                     |

### 3.1.3. Overview of ongoing developments

On 23 September 2009, the European Commission adopted a legislative proposal<sup>21</sup> to reform the architecture of European financial supervision and address critical weaknesses highlighted by the financial crisis of 2008-2009. Based on the recommendations of the de Larosière Group, the Commission proposes to create two new bodies: the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS). As for the latter, it is proposed to transform the three existing European committees of financial supervisors<sup>22</sup> into European Supervisory Authorities (ESAs), (a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA)) with commensurately increased powers to, inter alia:

- co-ordinate the work of national supervisors, in particular in case of adverse developments which potentially jeopardise the orderly functioning of the financial system in the EU;
- settle disputes between national supervisors in cases of disagreement on supervisory issues regarding a cross-border financial institution;
- take steps to harmonise national regulatory rules and move towards a common European rulebook, and
- supervise certain pan-European entities which are regulated at EU level, i.e.: Credit Rating Agencies.

The proposals of the Commission suggest that the ESAs will fulfil an active coordination role in emergency situations, while in very exceptional circumstances, the ESAs, which decision-making body consists of the Heads of the relevant national supervisory authorities, should also have the power to require national supervisors to jointly take specific action. Article 10 of the proposed regulation establishing a Banking Authority sets out the role that the new authority would play in crisis situations. It envisages that, in the case of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Community, the Commission, upon its own initiative or following a request by the Authority, the Council, or the ESRB, may adopt a decision addressed to the Authority, determining the existence of an emergency situation. In such cases, the Authority may adopt individual decisions requiring competent authorities to take the necessary action to address any risks that may jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system.

If a competent authority does not comply with the decision of the Authority, it may adopt an individual decision addressed to a financial institution requiring the necessary action to comply with its obligations under that legislation, including the cessation of any practice. Such decisions shall prevail over any previous decision adopted by the competent authorities on the same matter.

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<sup>21</sup> Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a European Banking Authority, 23 September 2009

<sup>22</sup> These are the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR).

Based on Article 23 of the Proposal, the decision making power of the EBA is however subject to a safeguard clause which makes clear that decisions by the EBA should not in any way impinge on the fiscal responsibilities of the Member States. In another initiative on crisis management, the Economic and Finance Committee has prepared a report for finance ministers in advance of the Informal ECOFIN (1 October). The report sets out a suggested way forward for an integrated framework for European financial stability arrangements, suggesting a two-strand approach:

- developing a comprehensive EU-wide framework for closer policy coordination on financial stability, in particular in a financial crisis, *without* the need for legislative proposals, and
- further enhancing the EU regulatory framework for crisis management by developing common and interoperable tools, on the basis of EU legislative proposals.

There is a clear linkage with the Commission's initiative, and a strong focus on the need to make progress on burden sharing. The Commission's Communication, on the other hand, focuses less on burden sharing (although the importance of progress in this area is clearly recognised), and concentrates more on improvement of processes in order to increase efficiency of crisis resolution and rely less on public sector financing arrangements. Both initiatives are complementary.

At international level, the G20 has been discussing crisis management and resolution among a host of other issues aimed at addressing shortcomings in the international financial regulatory system. At the Pittsburgh summit on 24-25 September 2009, the Leaders' statement called for agreement to be reached, *inter alia*, on:

*"Addressing cross-border resolutions and systemically important financial institutions by end-2010: Systemically important financial firms should develop internationally-consistent firm-specific contingency and resolution plans. Our authorities should establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention as well as improve information sharing in times of stress. We should develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future. Our prudential standards for systemically important institutions should be commensurate with the costs of their failure. The FSB should propose by the end of October 2010 possible measures including more intensive supervision and specific additional capital, liquidity, and other prudential requirements."*

## 3.2. Problem definition

### 3.2.1. General problems

While the operation of cross border banks has become highly integrated, (with the result that business lines and internal services are deeply interconnected and cannot be efficiently separated along geographical borders of Member States), crisis management of banks has remained national. As a consequence, in the event of a cross border bank failure, financial supervisors and other (resolution) authorities will only concentrate on the operations located in their respective territories. This may complicate cross border cooperation and lead to inefficient and possibly competing resolution approaches and suboptimal results at EU level.

The existing framework has proved inadequate to deal with cross-border banking failure. While the introduction of the EU Memorandum of Understanding on Cross-border Stability came too late to be effectively applied during the recent bank failures, it is questionable whether voluntary arrangements would have been sufficient to ensure smooth cooperation during the fast moving events which characterised this crisis. And while recent amendments to the CRD will result in the setting up of colleges for all cross-border groups, in the absence of a broader legal framework setting out bank resolution arrangements, there is no guarantee that cooperative solutions will be forthcoming during future crises.

A key shortcoming to effective cooperation is the misalignment of incentives between national authorities. Unless these are better aligned (both within countries and across countries), outcomes to crisis resolutions will invariably fall short of their potential. An incentive-compatible framework is thus an essential part of broader reform to the framework. In particular, trust and confidence in cooperation arrangements need to be underpinned by the assurance that the costs resulting from a cross-border resolution can be fairly shared and borne between the various stakeholders (including public funds should private sector solutions prove insufficient).

Although a number of European supervisors have tools available to **intervene in a banking crisis**, the tools which exist may be different between Member States, or in some cases may not exist at all. These differences and gaps, including legislative differences between Member States and/or a lack of a legislative/institutional basis in some countries, have the potential to complicate and even hinder the efficient cross-border handling of a banking crisis. If different authorities intervene at different points in time, pursue different objectives and use different tools and measures according to their own understanding of the problem, the results are likely to be suboptimal.

Furthermore, misalignment between the national accountability and mandate of supervisors and the cross-border nature of the banking industry complicates co-operation between supervisors of different Member States, and is an additional element leading to a suboptimal level of crisis prevention in case of cross-border banks

There is no legislation at EU level governing **bank resolution**. Beyond introducing a minimum set of powers for supervisory authorities aimed at restoring a situation in a bank<sup>23</sup>, and establishing arrangements for the winding-up and reorganisation of credit institutions with branches in other Member States, no EU framework exists which sets out how and under

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<sup>23</sup>

In Article 136 of the CRD.

which conditions authorities should act in the event of a crisis arising in a cross-border bank. The management of crises is almost entirely governed by national laws.

The diverging approaches and tools, and conflicting interests between authorities is likely to lead to inefficient crisis prevention and resolution and deliver sub optimal results at EU level. This in turn can produce more costly outcomes for EU citizens and tax-payers, as the bail-out of systemically important cross border banks can be extremely costly compared to the cost of a timely and effective resolution.<sup>24</sup> According to the latest IMF<sup>25</sup> estimates, crisis related writedowns on assets originated globally will reach \$4.1trillion by 2010, with global banking industry expected to bear about two thirds of the losses, half of which (or \$1.4 trillion, equivalent to 9% of the EU's GDP) is now attributable to European Banks.

Effective cross-border crisis resolution is also hindered by legal obstacles embedded in insolvency and company law and legal uncertainty, as well as the lack of arrangements for financing cross-border resolutions. Maintenance of continuity of banking services, which is crucial for the preservation of confidence in banks, may be jeopardised if authorities do not have tools to keep the going concern status of a bank in a resolution.

The causal links between the drivers and their consequences in the field of early intervention and resolution of banks are described in the problem tree (see section 2.2.4).

The current financial crisis has provided some clear examples of just how damaging the absence of adequate EU arrangements in the field of cross-border banking crisis resolution can be.

#### **Fortis**

In the case of Fortis, authorities from different Member States were unable to rapidly agree on a rescue plan which could have maintained the cohesion of the group structure. As a consequence the group was split up along geographical boundaries and not along a more logical and cost effective division between business lines. The situation is described in the Fortis 2008 Annual Review<sup>26</sup> as follows: *The global financial situation continued to deteriorate. Alarmist rumours affected Fortis's interbank market access, while it had to contend with an extremely substantial liquidity requirement. During the weekends of 27–28 September and 4–5 October, Fortis had to conclude a number of transactions that ultimately led to the sale of its main banking and insurance activities to strong parties. On 29 September 2008, Fortis announced that the Belgian government would invest EUR 4.7 billion in Fortis Bank SA/NV, that the Dutch government would invest EUR 4.0 billion in Fortis Bank Nederland (Holding) N.V., and that the Luxembourg government would invest EUR 2.5 billion in Fortis Banque Luxembourg SA. These investments represented 49.9 % of the common equity of the respective entities. The parties concerned expected that a solution had been found and that matters would resume their normal course. In the days that followed, the parties negotiated the implementation of these agreements with both the Luxembourg government and the Dutch government. A term sheet was signed on 30 September 2008 with the Luxembourg government. The agreement with the Dutch state, by contrast, could not be*

<sup>24</sup> Effective cross border arrangements should ensure a result that is optimal at EU level, taking into account the interests of stakeholders in all Member States, and thus minimising the overall cost all.

<sup>25</sup> IMF, Responding to the Financial Crisis and Measuring Systemic Risk (Global Financial Stability Report), April 2009

<sup>26</sup> [http://www.holding.fortis.com/shareholders/media/pdf/EN\\_AnnualReview\\_2008\\_1.pdf](http://www.holding.fortis.com/shareholders/media/pdf/EN_AnnualReview_2008_1.pdf)

implemented. Despite hopes at the beginning of the week, the situation continued to deteriorate, due to tensions in the interbank market. Fortis found it extremely difficult to regain the confidence of the market and its share continued to decline, reaching a closing price on 29 September 2008 of EUR 3.97. In terms of liquidity, the situation was extremely uncertain and it was necessary to negotiate new conditions with the Belgian central bank and to obtain an Emergency Liquidity Agreement with the Dutch central bank. Withdrawals by institutional clients and by companies had increased substantially. This situation led on 3 October to the sale of Fortis Bank Nederland (Holding) N.V., Fortis Verzekeringen Nederland N.V. and Fortis Corporate Insurance N.V. to the Dutch state for a total consideration of EUR 16.8 billion, which was allocated as follows :

- EUR 12.8 billion received for the Dutch banking activities (including ABN AMRO) remained within Fortis Bank;
- EUR 4 billion received for the Dutch insurance activities went to the Fortis holding company.

Following the transfer of the operations in the Netherlands to the Dutch state, Fortis was obliged to review its options :

- Continue on a stand-alone basis with the Belgian state as a minority shareholder in the bank;
- Find a strategic partner for Fortis Bank and for all or part of Fortis's other operations;
- Sell the remaining 50 % of the Belgian bank to the Belgian state, prior to a possible resale to a private investor"

#### **How does this example illustrate the issues highlighted in the problem definition?**

The Fortis case is a clear illustration of many of the problems which can arise during a cross border banking crisis. It shows the tendency of authorities to adopt territorial approaches in crisis resolution and how the consequent competition for assets can lead to sub-optimal results. Absence of complete information, exacerbated by the complex business structure of Fortis, compromised the early burden sharing arrangement, and ultimately resulted in the splitting of the group. The misalignment of responsibilities between authorities gave rise to tensions which further compromised cooperation. The absence of a clear legal framework under which resolution measures could be taken resulted in legal challenges from shareholders which created a protracted period of legal uncertainty.

#### **Iceland**

In the case of the Icelandic banks, the inability to deal with problems at an early stage in a cooperative manner led to the subsequent disorderly resolutions and disputes between national authorities, in particular about who should bear the costs which were incurred. "After five years of brisk expansion, the country's three main banks, representing 85% of the banking system, all collapsed during the same week in October 2008 [...] Upon their failure, the three banks were put into receivership and new banks were formed to enable the domestic payment system to continue to function smoothly. Complex negotiations between the new banks and the creditors of the old banks were needed to reach a final settlement. With hindsight, it appears that the Icelandic financial supervisory authorities had become overwhelmed by the complexity of the national banking system, and had been unable to stop their expansion. [...] An important cross-border banking issue raised by the financial crisis was that national

*deposit guarantee systems may not have enough resources to honour the minimum EU deposit guarantee obligations. The government was obliged to stand behind Iceland's Depositors' and Investors' Guarantee Fund (DIGF) to enable it to meet these obligations, thus exposing Icelandic taxpayers to a large cost."*<sup>27</sup>

**How does this example illustrate the issues highlighted in the problem definition?**

An absence of cooperation mechanisms and early intervention tools prevented an early and possibly less costly resolution to the Icelandic Banking Crisis. There was also a clear problem associated with financing the resolution, and the cross-border arrangements were limited to a Deposit Guarantee Scheme which was inadequately financed. Assets of the Icelandic banks were ring fenced in the absence of satisfactory cooperative arrangements – with counter productive effects for the Icelandic banks and their creditors.

**Lehman Brothers**

The chaotic way in which Lehman Brothers was placed into bankruptcy led to a significant loss of value for unsecured creditors, and highlighted the extreme market disruption caused by uncertainties about the location and return of client assets held by Lehman as prime broker, and about the contractual positions of Lehman's counterparties and the status of their outstanding trades. The administrators overseeing the winding down of Lehman Brothers, have described the complexity of the task they are faced with as follows<sup>28</sup>: *"Lehman Brothers was a very significant and complex global organisation, operating in multiple territories and across most areas of financial services. Its collapse also coincided with a period of unprecedented turmoil in financial markets. The US operations of Lehman Brothers, and the UK and European Lehman Brothers' entities in administration, are now being dealt with through separate legal procedures and it is as if they are no longer part of the same group. This has significant practical consequences for the Administrators in meeting their objectives. As with most global financial services organisations, on a day to day basis Lehman Brothers was previously managed and run mainly along global product lines. Following Lehman Brothers' bankruptcy in the US, and the UK and European Lehman Brothers' entities being placed into insolvency proceedings, a legal entity focus is now paramount and all information relating to the group's activities now has to be captured and assessed on a legal entity basis instead. Funding, and other interdependencies, existed between the US and various UK and European Lehman Brothers' entities and these links are now broken. These factors add further complexity to the administration. The sale of the North American investment banking and capital markets business of Lehman Brothers to Barclays also complicates the situation faced by the Administrators."*

**How does this example illustrate the issues highlighted in the problem definition?**

Lehman was an internationally active bank, with a highly complex organizational structure and was supervised by a number of different authorities. The case is a good illustration of the failure of cooperation and information sharing at a critical moment prior to and during insolvency. It also illustrates how difficult ring fencing of assets can be in practice – as liquidity was moved rapidly around the organization it was impossible for authorities to keep

<sup>27</sup> OECD Policy Brief, September 2009, Economic survey of Iceland 2009, <http://www.oecd.org/dataoecd/29/8/43455728.pdf>

<sup>28</sup> [www.pwc.co.uk/eng/issues/lehman\\_faq\\_1008.html](http://www.pwc.co.uk/eng/issues/lehman_faq_1008.html)

track of. The challenge to wind up the organization in the wake of a disorderly failure provides evidence of the inadequacies of the current territorial approach to cross-border resolution and winding up rules. Finally, the chaos caused by the collapse of Lehman is a strong illustration of the disruptive impact of the failure of a highly connected financial institution and the potential damage disorderly resolutions can have on market confidence.

The absence of adequate cross-border crisis management arrangements has almost certainly resulted in higher costs which have ultimately fallen on taxpayers. Although it is difficult to estimate with any degree of accuracy the extent of the cost savings that might result from effective cross-border arrangements, it can be expected – given the overall costs associated with banking crises – that these would be significant. Since October 2008, the European Commission has approved €3.6 trillion (equivalent to 30.5% of EU's GDP) of state aid measures to financial institutions, of which €1.5 trillion has been effectively used by June 2009.

The IMF has recently estimated the cost of banking crises as a whole since the 1970s<sup>29</sup> and concludes that on average the fiscal costs, net of recoveries, associated with crisis management average around 13.3 % of GDP, and can be as high as 55.1 % of GDP. Output losses average around 20 % of GDP during the first four years of the crisis. If this study had incorporated data from the current crisis, the costs would doubtless have been even higher<sup>30</sup>.

### 3.2.2. *Drivers and specific problems*

There are two key aspects which need to be considered in the context of a framework for bank resolution: **early intervention** (or early remedial actions) and **bank resolution** measures. Although both aim at stabilising the financial situation of a bank and thus avoiding market disruption, they can be prompted in different situations.

Early interventions or remedial actions can be prompted by financial supervisors when the bank is not threatened with immediate insolvency. In such situations supervisors can ask the banks to implement certain measures (to hold additional capital, improve governance, systems and internal control arrangements, increase reserves, limit business operations and risk exposures) to ward off the problems. Such measures leave control of the institution in the hands of the management, and do not represent a significant interference with the rights of shareholders or creditors.

When banks are close to insolvency, actions and measures need to be more severe in order to pre-empt potential instabilities in the banking and the whole financial system resulting from bankruptcy. In such situations, public authorities (central banks, finance ministries, deposit guarantee schemes, judicial and supervisory authorities) might need to take over certain decisions on the business operation of a bank and implement far reaching restructuring, reorganisation measures.

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<sup>29</sup> Systemic Banking Crises: A New Database Luc Laeven and Fabian Valencia, IMF, November 2008

<sup>30</sup> For more detailed quantification of the costs of the financial crisis, see also the European Commission's report "Public Finances in EMU 2009", [http://ec.europa.eu/economy\\_finance/publications/publication\\_summary15289\\_en.htm](http://ec.europa.eu/economy_finance/publications/publication_summary15289_en.htm)

### 3.2.2.1. Early intervention

Driver: Lack of effective early warning indicators and early-intervention triggers

Problems: Sub-optimal effectiveness in prevention of crisis situations in cross-border banks

Effective prevention of crisis situations is conditional on **accurate and early detection** of stress situations. Early intervention measures are activated by different triggers developed by each Member State. Results of a recent CEBS survey<sup>31</sup> shows that only a few Member States' domestic legal frameworks specify the triggers that lead to automatic corrective action. Supervisors are obliged to act if an indicator hits a threshold<sup>32</sup>. However, CEBS acknowledges that such threshold levels for above indicators are too low for remedial measures to be considered true early intervention measures and supervisory action will need to be taken long before the situation of an individual institution deteriorates to such a level.

More commonly, early intervention measures are activated by ongoing prudential supervision whereby analysis is performed on the basis of financial and prudential information collected either during on-site inspections or via regular off-site communication. In this regard, in order to detect potential problems most EU supervisory authorities have developed Risk Assessment Systems<sup>33</sup> (RAS) that play an important role in the Supervisory Review and Evaluation Process (SREP)<sup>34</sup> (part of Pillar 2<sup>35</sup> of the CRD). RAS are typically geared towards assessing a broad range of risk factors based on a set of quantitative,<sup>36</sup> qualitative and supervisory indicators.

The events of 2008 have demonstrated that effectiveness of current early warning systems employed by the supervisory community is sub-optimal. Certain risks were underestimated because smaller-than-warranted importance had been assigned to them while the signalling capacity of some risk indicators has been erroneously overlooked. This may have interfered with a timely undertaking of appropriate actions and in turn necessitated more intrusive and costly – for many stakeholders involved - intervention measures. *"Once problems escalated*

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<sup>31</sup> [http://www.c-ebs.org/getdoc/f7a4d0f8-5147-4aa4-bb5b-28b0e56c1910/CEBS-2009-47-Final-\(Report-on-Supervisory-Powers\)-.aspx](http://www.c-ebs.org/getdoc/f7a4d0f8-5147-4aa4-bb5b-28b0e56c1910/CEBS-2009-47-Final-(Report-on-Supervisory-Powers)-.aspx)

<sup>32</sup> For instance, in Czech Republic, the supervisory authority must impose remedial measures (e.g. capital increase, acquisition of assets having a risk weighting of less than 100%, prohibition to acquire any interest in any other legal entity, prohibition to grant a loan to a person having a special relation with the institution) if it becomes aware that an institution's capital is lower than two thirds of the minimum required capital; in Hungary, the supervisory authority shall use corrective measures if the own funds are less than 75% or less than 50% of the capital requirements; while in Slovakia, the supervisory authority shall place a credit institution under forced administration if the own funds of the institution concerned fall below 50% of the minimum requirement.

<sup>33</sup> For more on features of Risk Assessment Systems please see <http://www.c-ebs.org/Supervisory-Disclosure/Supervisory-review.aspx>

<sup>34</sup> See Glossary

<sup>35</sup> See Glossary

<sup>36</sup> Quantitative indicators (e.g., capital ratios, composition of own funds) are often analysed by comparing them against those of peer institutions. This allows authorities to identify worst performers or a relative strength of an institution vis-à-vis a peer group average. In some Member States, statistical models (For instance, *Système d'Aide à l'Analyse Bancaire (SAABA)* used by the French Commission Bancaire, forecasts likely evolution of an institution's solvency and quality of its credit portfolio.) are used to conduct a more-in-depth quantitative analysis of the soundness of credit institutions. Such quantitative analysis is then complemented with a qualitative review of risk management and internal control systems.

*into specific crises, there were real problems of information exchange and collective decision making involving central banks, supervisors and finance ministries...Regulators and supervisors focused on the micro-prudential supervision of individual financial institutions and not sufficiently on the macro-systemic risks of a contagion of correlated horizontal shocks.*<sup>37</sup>

More specifically, the crisis has demonstrated that current approaches focus too narrowly on capital ratios while underestimating the effects of leverage and liquidity on the 'soundness' of an institution as perceived by market participants. In this regard, the predictive power of certain market-based indicators has not been given due attention. Tier 1 capital ratio<sup>38</sup> at Fortis, Dexia and Hypo Real Estate Holding were at 9.1%, 11.3% and 8.6%, respectively, at the time when their share price<sup>39</sup> was experiencing a precipitous decline, eventually prompting national governments to take action in late September 2008. This raises a question about the risk capture of capital requirements under the Basel II framework and, in retrospect, underscores the merit of certain forward-looking market-based indicators that might be used to supplement the more traditional warning tools that are based on the past data.

Empirical studies provide some support for the above observations. A recent study (Poghosyan, Čihák, 2009)<sup>40</sup> on bank distress events in the EU from 1997 until 2008 looked at a range of potential indicators and possible threshold levels that could be used to identify weak banks. The analysis found that indicators linked to bank leverage and liquidity (defined as the share of wholesale financing of liabilities<sup>41</sup>) have a significant predictive power. Indicators based on asset quality, bank profitability, market discipline, contagion effect and stock price were found to be relevant as well. With regard to 19 distress events that took place in 2008, the study showed that while some mechanics identified over the entire observation period remained in place, certain differences existed. More specifically, a managerial quality-based indicator was found to have a significant predictive potential for the most recent bank distress events.

Driver: Divergence in national early warning indicators and early-intervention tools

Problems: Sub-optimal level of supervisory cooperation and effectiveness in prevention of crisis situations at cross-border banks

It is evident, that all Member States operate some form of pre-intervention mechanism in order to handle a crisis in an ailing bank. But the nature of the measures, the criteria

<sup>37</sup> De Larosiére report – CH I Causes of the financial crisis, pp 10-11.

<sup>38</sup> Tier 1 capital ratio - definition. Average Tier 1 ratio for 35 large diversified and internationally active EU banks was equal to 7.6% at the end of June 2008 (source: ECB, CEBS).

<sup>39</sup> Dexia's stock came under pressure following a series of financial commitments aiming at maintaining the AAA credit rating at its bond insurance unit Financial Security Assurance Inc. Fortis' problems were linked mainly with the financing (€24 billion) of its commitment to buy Dutch operations of the ABN AMRO bank. Difficulties of Hypo Real Estate Holding were predominantly linked to its exposure to collateralised debt obligations (CDOs) and short-term liquidity shortage.

<sup>40</sup> Poghosyan, T., and Čihák, M., *Distress in European Banks: An Analysis Based on a New Data Set*, IMF Working Paper, January 2009

<sup>41</sup> Banks' dependence on wholesale funding was acknowledged by the FSA as one of the main culprits for distress events at the UK banks during the current crisis (speech by Hector Sants, Chief Executive of the FSA, to the Associate Parliamentary Group on Business Finance & Accountancy Banking Reform, October 14, 2008).

conditioning their application and the moment at which measures are activated are not harmonised and consequently differ across Member States.

Divergence in national approaches to early intervention arises in all phases of the process. Early warning indicators and their threshold levels that prompt supervisors to take appropriate measures vary across Member States as they are embedded in the Pillar 2 process. In this regard, CEBS<sup>42</sup> has observed that currently there is no minimal common set of early warning indicators and no commonly agreed definition for each of them.

With regard to the toolkit of measures and powers available to supervisors, Article 136 of the CRD already specifies some of these. It stipulates that in order to address a distress situation at an early stage, supervisory authorities should be able to require banks to hold additional capital, improve governance, systems and internal control arrangements, increase reserves, limit business operations and risk exposures stemming therefrom. The stocktaking of supervisory objectives and powers conducted by CEBS<sup>43</sup> revealed that several Member States implemented this Article differently, hence supervisory authorities have slightly different tools, and that a number of authorities lacked certain powers. Further convergence might be needed in this respect if such differences have the potential to complicate cross-border cooperation between authorities.

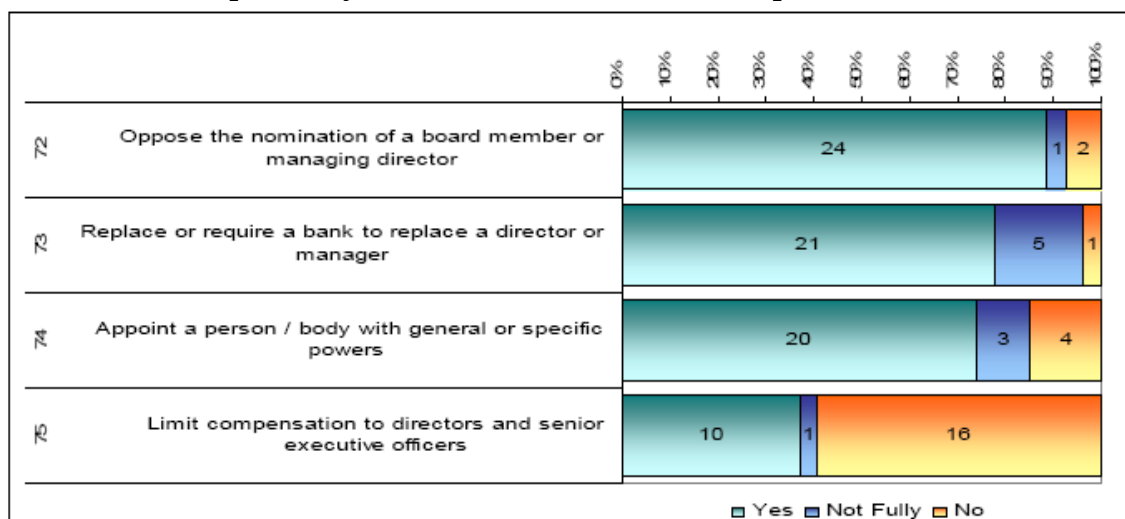
In order to intervene effectively and promptly to restore the soundness of a bank, supervisors might also need to resort to additional domestic measures that go beyond the legal requirements of the EU legislation. In fact, some supervisors are entrusted with regulatory powers in the field of prudential supervision which enable them to issue mandatory secondary legislation and non-mandatory rules and principles. All authorities have a "general power" to ensure compliance with the laws and regulations governing the activities of a bank. However, a number of supervisors either cannot achieve certain measures through general powers or do not have access to the same specific powers that are available to the supervisory authorities in other Member States (see Chart 1). Specific circumstances that trigger application of a given power may also differ, therefore, contributing to the divergence of practices.

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<sup>42</sup> CEBS, Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers, January 2009

<sup>43</sup> CEBS, Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers, January 2009

**Chart 3 Supervisory authorities' access to selected powers and measures**



Source: CEBS

Certain supervisory powers (e.g. suspending voting rights, transfer of shares, changing ownership, prohibiting dividends) impacting on shareholder rights can be also exercised with a view to achieving wider public policy objectives, such as maintaining financial stability and protecting depositors' interests. Most of these powers are not prevented by EU rules and are used – to a varying degree – by national supervisors or other authorities.

Some of these powers can be viewed as alternative means to arrive to the same end. For instance, authorities who do not have powers to require a transfer of shares or change in ownership may use the suspension of rights to indirectly incite a change in ownership (AT), or, by limiting distribution of profits may indirectly achieve an increase in capital (MT). Nevertheless, a number of authorities lack access to some of these powers and, as a result, cannot attain – directly or indirectly – the same outcomes as their counterparts in other Member States<sup>44</sup>.

Given that a speedy action is often critically important to the survival of an institution and to the ability for supervisors to minimise costs associated with its failure<sup>45</sup>, differences in national pre-intervention approaches have the potential to complicate or impair efficient and coordinated cross-border crisis handling.

**Driver:** Misalignment between national accountability and mandate of supervisors and cross-border nature of the industry

**Problems:** Sub-optimal level of supervisory cooperation impairing the effectiveness of cross-border crisis prevention and counterproductive ring fencing of assets

As a result of industry consolidation over the recent years, large cross-border banks now dominate the European banking landscape (see section 2.1).

<sup>44</sup> For example, NL and DK have neither a power to limit profit distributions nor a power to require shareholders to provide financial support to an institution (Authority in LU may limit, but not prohibit distribution of profits).

<sup>45</sup> This was particularly evident during the resolution of Fortis (see section 2.2.1).

Given the degree of banking market integration, it has been argued for some time that the key hurdle in developing a functional and effective EU financial stability framework is rooted in the fact that fiduciary responsibilities of national authorities are towards national governments limiting their incentives to work towards a common EU stability framework<sup>46</sup>. Before the current crisis, national authorities were reluctant to develop commonly binding EU principles and procedures for cross-border financial crisis prevention and resolution and often resorted to introducing their own national legislation to achieve home Member State-oriented objectives. As a result behaviour during a financial crisis has tended to be nationally focused. According to the IMF : "the dominant strategy for supervisors in an LCFI<sup>47</sup> crisis will likely be to look out for the national treasury, using informational advantages to that effect, notwithstanding MoUs on information sharing and cooperation. A scramble for assets in an LCFI crisis is thus likely and would have significant cross-border spill over, preventing efficient and effective crisis management and resolution. In this set-up, it is natural for national prudential authorities to fear loss of control over domestically-active financial players"<sup>48</sup>.

This conflict, whereby host Member States have an incentive to ring-fence assets (i.e. keep them within their jurisdiction) whereas home Member States have an incentive to seek the centralisation of assets while keeping liabilities decentralised, is of most relevance for 'significant' subsidiaries.

Currently, while supervisory authorities in all Member States have a power to limit or prohibit intra-group transfers and transactions<sup>49</sup>, no framework currently exists to facilitate cross-border intra-group asset transfers. This is especially problematic for intra-group financing across borders. Company law requirements (directors' liability) and different insolvency measures (intra-group transfers in suspect period) can severely restrict any potential for using intra-group asset transfer as a tool for averting or managing a developing liquidity crisis in a group entity. There is currently no EU authorisation regime for asset transfers (although in some Member States authorisation by supervisory authorities is required), and EU legislation does not provide a general framework of terms and conditions for transfers. In some cases Member States prohibit 'disadvantageous' transactions or transactions at undervalue, while others impose the principle that transactions must be made at 'arms length', on standard commercial terms. In many cases, procedural requirements, such as authorisation by the General Assembly of the supervisory board may be triggered by the size of the transfer, the fact that the transfer was not concluded in the ordinary course of business, or because the transfer is made between connected parties. As there is no concept of 'group interest' at EU level, directors of a company are neither responsible to other group entities, nor to the group as a whole. Indeed, should they act to promote the interests of the group in a way that is detrimental to their own company, they would likely be in breach of their duties and at risk of liability under national company law or even civil or criminal liability under national law. Under national insolvency laws, transfers carried out during the 'suspect' period preceding the commencement of winding up proceedings may be retroactively invalidated, or else the transfer may be set aside or challenged if it was made at an undervalue or was detrimental to the transferor or its creditors. As a consequence, cross-border banking groups are unable to

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<sup>46</sup> IMF Country Reports No. 07/260, July 2007, and No.08/262, August 2008

<sup>47</sup> LCFI - large and complex financial institutions

<sup>48</sup> IMF Country Report No. 07/260, paragraph 26

<sup>49</sup> CEBS, Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers, January 2009

mobilise available assets in one part of the group in support of another part of the group which may be encountering liquidity shortfalls.

Disincentives to cooperate have implications not only for shareholders, but also creditors and employees of cross-border banks, as an uncooperative crisis management process between national authorities may undermine the effectiveness of pre-intervention measures and banks' private crisis resolution solutions, with the ultimate financial burden falling on taxpayers.

Recent changes to the legislative framework have resulted in some important progress to put in place cooperation arrangements aimed at enhancing EU-wide financial stability. The CRD<sup>50</sup> already requires that supervisory authorities coordinate in gathering and dissemination of relevant information and, more generally, coordinate their supervisory activities in both going concern and emergency situations. However, the Directive does not specify the conditions that trigger the application of such measures, and how joint assessment should be conducted. If national law or national supervisors interpret those conditions differently, coordinated action by supervisors of different group entities might be difficult.

A number of revisions to the existing CRD provisions, designed to i) enhance work organisation and information sharing in supervisory colleges, including obligation to alert peer supervisory authorities if financial stability in their respective Member State is jeopardised and ii) clarify rights and responsibilities of home and host supervisors, including host supervisors of significant branches, have recently been adopted<sup>51</sup> (they will come into effect in 2010). The establishment of colleges of supervisors will improve cooperation and coordination of national supervisors in the cases of cross border banks, including situation when early intervention might be needed. Cooperation may however not grant always a common conclusion and joint actions in a crisis situation when national interests confront with each other.

To facilitate more effective supervisory cooperation on these and other issues in a cross-border context, CEBS has developed a Template Multilateral Cooperation and Coordination Agreement<sup>52</sup> that was field-tested by eight supervisory colleges in 2008. The guidelines, however, are not legally binding and supervisors are supposed to implement them on a best efforts basis only, thereby impeding effectiveness of the initiative. To date, currently only six supervisory authorities (CZ, FI, LU, SI, SK, and UK) have been explicitly mandated with promoting convergence of supervisory practices<sup>53</sup>.

The new European Banking Authority (EBA) will further foster the cooperation among supervisors and ensure the consistent application of Community rules including technical standards developed by the Authority. The EBA will contribute to promoting the efficient and

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<sup>50</sup> Article 129 (1)

<sup>51</sup> [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/crd\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/crd_proposal_en.pdf)

<sup>52</sup> This agreement lays out the basis for the cooperation between the competent authorities and the practical organization of the supervisory activities on a specific group in going-concern as well as in emergency situations. These activities include, but are not necessarily limited to, the role of the college of supervisors, the role and responsibilities of the competent authorities, information exchange among supervisors, communication with a specific group, sharing and delegation of tasks, Basel 2 validation procedures concerning internal models for credit, market and operational risks, Supervisory Review and Evaluation Process (SREP), and crisis management. <http://www.c-ebs.org/getdoc/aaafdb97-f131-4af6-96b5-34720c1bd2ad/CEBS-2007-177-rev-4-template-for-written-agreemen.aspx>

<sup>53</sup> CEBS, Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers, January 2009

consistent functioning of colleges of supervisors and monitor the coherence of the work across colleges. In adverse developments which potentially jeopardise the functioning of the financial system in the EU, the EBA will fulfil an active coordination role between national supervisors. In exceptional situations EBA will have the power to require national supervisors to jointly take specific actions.

#### 3.2.2.2. Bank resolution

There is currently no EU framework which deals with problems in a bank once it approaches insolvency as this stretches beyond the sphere of supervisory competence. Consequently Member States have adopted very different approaches to bank resolution, both with respect to the tools available and the conditions determining their application. The diversity of national crisis intervention arrangements and gaps in the tools provided under Member States' legal frameworks makes cross-border management of intervention measures particularly challenging in an increasingly integrated Internal Market. Any inadequacies in cooperation arrangements, different crisis management toolkits and conditions under which tools may be applied, lacking financing arrangements have the potential to complicate or even compromise effective crisis management.

Driver: Lack of effective tools and powers and diverging national resolution tools & powers

Problems: Inefficient cross-border bank crisis resolution process and suboptimal outcomes

A study carried out on behalf of the Commission services<sup>54</sup> describes the extent to which Member States' arrangements differ: they are based on **different approaches**, pursue **different goals** and have been designed to fit with the **different wider legal systems** of each country (e.g. provisions governing areas such as commercial and contract law, ownership law, labour law, netting and set-off,<sup>55</sup> tax law, etc.). The powers to manage bank crises are split between **different domestic authorities**, ranging from supervisory authorities, to central banks, to government ministries, judicial authorities and in some cases deposit guarantee schemes, and the extent of powers and the conditions governing their use also differ according to each national system.

As regards reorganisation tools, general insolvency frameworks enable the use of certain tools to be applied to banks. These include:

- mergers or acquisitions (transfer of all shares to the third party on an ongoing basis)
- agreements with creditors, concerning reduction of debt, debt restructuring, debt-equity conversion
- assets sales
- closure of non viable part of the business

In certain Member States, more specific techniques for *bank* restructuring may also be available:

- purchase-and-assumption transactions (transfer of assets and liabilities to a purchaser; the transfer may include all the assets and liabilities or part of the assets with certain liabilities)
- “Good-Bank/Bad-Bank” separation and bridge banks<sup>56</sup> (selling of non-performing loans and other substandard assets for collection or transferring viable assets to a newly set up bank)
- nationalisation.

In the EU, only the UK Banking Act 2009<sup>57</sup> explicitly lists specific bank restructuring techniques which can be applied by the authorities without the consent of the shareholders under the Special Resolution Regime. In other Member States, although specific tools may not be explicitly prescribed in the legislation, specific restructuring techniques may also be available either under administrative or judicial proceedings applied to banks.

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<sup>54</sup> DBB Law "Study on the feasibility of reducing obstacles to the transfer of assets within a cross border banking group during a financial crisis and of establishing a legal framework for the reorganisation and winding-up of cross border banking groups", 2009.

<sup>55</sup> See Glossary

<sup>56</sup> See Glossary

<sup>57</sup> [http://www.opsi.gov.uk/acts/acts2009/pdf/ukpga\\_20090001\\_en.pdf](http://www.opsi.gov.uk/acts/acts2009/pdf/ukpga_20090001_en.pdf)

- In Italy, for example, the law does not specify which techniques the appointed special administrator may use, but the powers are set more broadly with the law stipulating that the administrator must *promote helpful solutions in the interest of depositors*. Possible wide interpretations may include a merger, acquisition or partial sales of assets. However an important difference compared to the UK system is that shareholders retain the right for final approval of any reorganisation measure.
- In France, the provisional administrator nominated by the banking supervisor may conclude transactions in the ordinary course of business. However a more intrusive intervention entailing a transfer of shares without the shareholders' authorisation, requires the administrator to obtain a court order. Settlements with creditors may be achieved through various types of proceedings at the initiative of the debtor<sup>58</sup>. Specific bank re-structuring techniques may only be used under an insolvency proceeding.
- In Germany, the legal framework does not provide a bank specific administrative reorganisation, however under the corporate insolvency law certain techniques (e.g. asset sales) are possible subject to the approval of creditors.
- In Sweden, no formal reorganisation proceedings are possible for banks – they can only be reorganised on a voluntary basis through negotiations with shareholders and creditors. Under a judicial insolvency, only liquidation is possible.

In certain Member States however, reorganisation of banks is not an option at all, as only liquidation is possible under insolvency proceedings.

Differences in the availability of tools, the extent of powers held by authorities and the conditions under which they can be exercised is likely to give rise to tensions in a cross-border resolution and hamper efficient cooperation:

- If national authorities are equipped with **different tools and powers**, certain measures can be impossible to implement. As a basic example, if one national authority has the power to transfer part of the business to a third party purchaser by executive order, while another cannot do so, a rapid and coordinated intervention by those two authorities to deal with affiliated banks in their respective jurisdictions might be difficult. If cross border reorganisation measures are impossible to implement, national authorities are left with limited choices, among which the very expensive bail-out is the most likely outcome.
- **Different types of procedure** can slow down the overall crisis resolution process for a group. Where the necessary measures require judicial approval, or have to be taken within the framework of court-directed insolvency proceedings, they may not necessarily lend themselves to a quick handling of a crisis situation (e.g. in France). In other countries, administrative processes, managed by the supervisor or central bank can implement measures more rapidly. The interaction of judicial and administrative processes implemented in different countries can thus harm efficiency and risk losing value during a prolonged resolution process.

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<sup>58</sup> For instance, France has three types of proceedings provided by the commercial code and applicable to banks, aimed at a settlement with creditors: the "ad hoc mandate", the composition procedure and safeguard procedure.

- **Diverging threshold conditions** – which when reached (in different points in time in different Member States) permit a national resolution authority to intervene and take control of a troubled institution in specified ways – may also prevent coordinated action at cross border level. Not all Member State authorities have the power to intervene to stabilise and reorganise an ailing bank at an early stage before the formal point of insolvency (as defined in national law) is reached. The diverging conditions for prompting resolutions may reduce the chances of immediate actions at group level.

Until recently, cross-border banking failures were extremely rare events, and consequently many Member States' crisis resolution arrangements have never been tested. However experiences during the crisis have exposed a number of serious shortcomings in certain Member States and demonstrate how damaging the absence of adequate EU arrangements can be.

The examples (Fortis, Lehman, Icelandic banks) listed in the general problem description chapter also show how diverging tools can undermine optimal results. Most recently, in Germany, there has been an intense debate about how to improve the existing bank resolution framework, in light of subprime-related losses faced by the banking sector (e.g., at Landesbanken, such as Sachsen LB and WestLB, as well as at IKB and Hypo Real)<sup>59</sup>.

Driver: Misalignment between national responsibility, accountability of authorities and cross-border nature of the industry

Problems: Suboptimal level of cooperation between authorities

Despite the agreement of July 2008 on an EU wide Memorandum of Understanding ('MoU')<sup>60</sup> setting out cross-border crisis management arrangements, as mentioned above, recent events have highlighted the limits of a framework based on **voluntary cooperation** between national authorities. There has been inadequate transmission of information to other interested parties in other Member States and the agreement to open, full, constructive and timely cooperation is weakened by a legal framework that militates towards national approaches. In times of crisis, national interest has proved much stronger than the broader general interest. The limitations of the MoU have been recognised recently in a report to the Economic and Finance Committee<sup>61</sup>, *"The MoU framework has not played a key operational role in the management of the crisis. Its limited relevance in the financial crisis is partly explained by the fact that it was designed as a tool primarily aimed at dealing with crises limited to individual cross-border financial institutions and not with a global systemic crisis in mind. In addition, the implementation of the MoU is still ongoing, particularly regarding the voluntary establishment of Cross-Border Stability Groups (CBSGs) and Voluntary Specific Cooperation Agreements (VSCAs).*

National interest is reinforced by the EU legal framework for company and insolvency law, which is based around individual legal entities and the rights of the stakeholders – shareholders and creditors – of those individual entities.

<sup>59</sup> See IMF working paper "Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis", P. 21, author: Walter Neir

<sup>60</sup> Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross Border Stability (1 June 2008).

<sup>61</sup> Report from the EFC's High level Working Group: Lessons from the financial crisis for European financial stability arrangements

**Different insolvency procedures** are also a significant obstacle to the ability of, or the incentives for, Member States to adopt resolution measures in respect of a cross-border banking group. Any reorganisation or liquidation will necessarily be carried out in accordance with national insolvency procedures, and any coordination must be based on the voluntary cooperation between different national insolvency authorities and officers.<sup>62</sup> Under current arrangements insolvency proceedings are only effective in the country where they are initiated, and will administer only those assets that are located within that jurisdiction.<sup>63</sup> However, in practice cooperation between national insolvency authorities is often uneasy and imperfect, and cannot deal effectively with financial conglomerates, international holding structures and the organisation of financial groups according to business lines.

Reorganisation measures that concentrate only on one entity without taking into account the interests of the broader group risk the possibility of value loss for certain parts of the group. The value of synergy, goodwill and certain immaterial assets could decrease leaving creditors and shareholders with lower collateral against their claims.

At EU level and in most of the Member States' **company laws**, there is no concept of 'group interest' which might otherwise facilitate the resolution of cross-border banking groups. Directors of a company are neither responsible to other group entities, nor to the group as a whole. Indeed, should they act to promote the interests of the group in a way that is detrimental to their own company, they would likely be in breach of their duties and at risk of liability under national company law or even civil or criminal liability under national law. As the legal basis of group treatment is missing, it is very problematic to handle banking groups as a single economic entity during a resolution. Such limitations might undermine a universal approach which has the potential to reach a more optimal result at EU level.

The Fortis case provided a good example how the lack of cooperation structures can result in a suboptimal solution for both Member States. The failure of joint reorganisation resulted in separation of the group along geographical borders (ignoring coherence of business lines) and costly bailout by the governments involved.

Driver: Lack of adequate arrangements for financing a cross border resolution

Problems: Suboptimal level of cooperation between authorities and Inefficient cross border bank resolutions process and suboptimal outcomes.

The current financial crisis is of such severity that Member States have needed to take exceptional measures, such as capital injections and guarantees of banks' debt, to protect financial stability and to combat the economic downturn.<sup>64</sup> Such measures fall outside the scope of the Commission's Communication, and are already the subject of Commission

<sup>62</sup> Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions prohibits the application of separate insolvency measures to branches under the law of the host State. It ensures the mutual recognition and coordination of procedures under home country control, imposes a single-entity approach by which all the assets and liabilities of the 'parent' bank and its foreign branches are reorganised or wound up as one legal entity under, subject only to exceptions specified in the Directive, the law of the home State. However, this directive does not provide for the consolidation of insolvency proceedings for separate legal entities within a banking group, and makes no attempt to harmonise national insolvency law.

<sup>63</sup> This is subject to the exception under Directive 2001/24/EC of branch assets that are located in another Member State.

<sup>64</sup> Such bank re-structuring measures are considered in the context of EU rules on state aid.

communications on measures taken in relation to financial institutions, on recapitalisation, on the treatment of impaired assets and on rescue and restructuring aid. The Communication on bank resolution explores the contours of a resolution regime that would ensure that authorities have the appropriate tools for intervening quickly to stabilise and restructure a failing cross-border bank, with the objective of minimising the need for States to resort to the kind of exceptional measures that have been used in this crisis.

The provision of funding in a resolution may come from intra-group, external or public sources. Financing a resolution for a cross-border bank raises particular challenges compared with domestic banks, and the first real experiences of cross-border bank failures have confirmed serious shortcomings in this area.

Cross-border **intra-group financing** may be an alternative to public funding, but its potential is currently limited by the obstacles to intra-group asset transfer. As insolvency legislations and procedures are national, domestic authorities have a legitimate interest, and are likely to be motivated by a political imperative, to ring-fence the national assets of an ailing bank in order to protect national deposits and maximise the assets available to the creditors of the national entity. At the same time however, it also limits feasibility of asset transfer between group entities as a means of addressing liquidity problems within other parts of the group, even if such action would be in the interests of the group as a whole.

Most Member States' legislations do not provide incentives for **private investors to finance** an ailing bank under resolution. Private financing sources may not have adequate incentives and guarantees in insolvency proceedings (no priority in the ranking of claims in many Member States, or possibility for collateral), which may consequently discourage risk-taking. Consideration could be given whether and how incentives should be in place for private financing during such proceedings.

In certain Member States, funds of the **deposit guarantee scheme** can be used not only to pay out depositors when a bank fails but also to finance reorganisation of an ailing bank. Such transactions may be rational if the cost of financing - taking into account the probability of successful reorganisation - is smaller for the DGS than the total payout to all depositors of the same bank in the event of bankruptcy. Only a few Member States (e.g. Spain, Italy and more recently UK) currently allow this possibility. Lack of coherence between national DGS roles may further impede coordinated actions on a cross border basis.

In terms of **public funding**, while the general interest may entail maintaining different parts of a financial group together as a coherent whole, action by national authorities, who are accountable to their own national taxpayers, may be dictated by narrower domestic considerations. In the absence of burden sharing arrangements and aligned incentives to cooperate, the likely outcome to a cross-border intervention will be a series of uncoordinated and potentially competitive actions taken by authorities with a view to minimising losses for their own taxpayers, but with no – or at best limited – regard to the consequences for citizens outside their jurisdiction. This may raise the overall cost of a resolution, and limit the possible spectrum of stabilisation measures involving public financing as a result of ring fencing and national solutions.

Driver: Legal obstacles to effective and efficient bank resolution

Problems: Lack of legal certainty and Inefficient cross border bank resolutions process and suboptimal outcomes.

The current crisis has shown that legislation does not always strike the right balance between achieving objectives such as financial stability and adequate safeguarding of different stakeholders' rights. This issue has given rise to substantial legal uncertainty for many stakeholders in the recent crisis and has the potential to cause further uncertainties in the future.

There are 2 major conflicts of interest:

1. Shareholders' *versus* authorities' (public) interest
2. Legal entity's *versus* banking group's interest

#### 1. Shareholders' *versus* authorities' (public) interest

Banks are subject to general company law rules and in particular certain rules aimed at the protection of the company's shareholders. At European level, there are mandatory requirements on the shareholders' approval of any increase or reduction of capital as well as rules on shareholders' pre-emption rights in the Second Company Law Directive<sup>65</sup>. Furthermore, the Shareholder Rights Directive<sup>66</sup> - which had to be transposed by Member States by 3 August 2009 - establishes requirements for general meetings of shareholders and in particular the convocation periods and the form of the convocation. As regards re-organisation measures, the general meeting of shareholders has a decision making role according to the Third<sup>67</sup> and the Tenth<sup>68</sup> Company Law Directives if mergers are concerned, and in the Sixth<sup>69</sup> Company law Directive in the case of divisions. These rules on mergers and divisions need not however apply in cases where the company or companies are the subject of bankruptcy proceedings, proceedings relating to the winding-up of insolvent companies, judicial arrangements, compositions and *analogous proceedings*. Finally, there are also requirements at national level in a number of Member States, such as the requirement to have any material transaction approved by the general meeting.

The present crisis has shown that interventions by public authorities to ailing banks need to be implemented in a very short period of time (within 24-72 hours). If interventions need to be delayed due to constraints in the legislation (e.g. need to obtain shareholders' approval at a general meeting) there is a risk that banks might already fail before the necessary procedures have been complied with<sup>70</sup>. Banks, and especially large systematically important banks, are susceptible to bank-runs, and the in view of the degree of interconnectedness of financial markets, the knock-on effects could lead to the collapse of other institutions and hence to a

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<sup>65</sup> Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent

<sup>66</sup> Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies

<sup>67</sup> [Third Council Directive 78/855/EEC](#) of 9 October 1978 based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies

<sup>68</sup> Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies

<sup>69</sup> [Sixth Council Directive 82/891/EEC](#) of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies

<sup>70</sup> Convocation of the general meeting of a company shall be issued not later than on the 21st day before the day of the meeting

general banking crisis. Public authorities and many analysts<sup>71</sup> argue that due to the special nature and high importance of the banking sector in the broader economy, financial stability must take precedence over shareholders' rights in such situations<sup>72</sup>. There needs to be a balance found between shareholders' right and the common interest of financial stability.

The Fortis case has demonstrated that resolution-measures of authorities can be attacked by shareholders through the courts and in the absence of a clear legal framework they can be ruled retroactively void.

## 2. Legal entity's versus banking group's interest

In a crisis situation, all members of a banking group might not have identical interests. While certain subsidiaries might be financially strong, the parent may be faced with difficulties or vice-versa. Although the economic rationale could justify a group-wide solution for the problems, legal provisions can block such outcomes.

**Reorganisation measures under insolvency law** only cater for national legal entities. This means that the national conditions for reorganisation would have to be met for each relevant group entity, separate proceedings would need to be opened and managed and that the relevant authorities in Member States where legal entities of the group are incorporated would concentrate solely on that respective entity.

The Winding-up and Reorganisation Directive introduces the universality principle<sup>73</sup> in insolvency for the EU but it only governs credit institutions with branches in other Member States, and not subsidiaries. Furthermore, the Directive never intended to harmonise insolvency proceedings, as national laws were at the time believed to be sufficient. However the lack of insolvency legislation dealing with groups with subsidiaries limits the possibilities to reorganise a cross-border banking group, in a market which has since become increasingly integrated and consolidated.

|                                                                |
|----------------------------------------------------------------|
| Driver: Barriers to maintaining continuity of banking services |
|----------------------------------------------------------------|

|                                                       |
|-------------------------------------------------------|
| Problems: Interruption of continuous banking services |
|-------------------------------------------------------|

To maintain confidence in the banking and financial system, customers of banks, especially depositors need to be assured that they can have uninterrupted access to banking services, especially to their deposits. Although Deposit Guarantee Schemes, which guarantee reimbursement of deposits up to a certain limit, are in place in all Member States, basic banking services, such as bill payments, credit cards, transfers are equally important for (especially retail) customers. Similarly a reorganisation or liquidation of a bank may cause disruption of services to other market participants, provoking loss of confidence, bank runs and hence instability in the financial system. The new Banking Act in the UK, which introduced a

<sup>71</sup> E.g.: An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency, Staff of IMF and World Bank, April 17, 2009.

<sup>72</sup> If the bank fails and undergo an insolvency proceeding, shareholders would immediately loose their rights in any case. In a situation when banks need public intervention, they are technically insolvent (imminent insolvency).

<sup>73</sup> See Glossary

Special Resolution Regime, has explicitly addressed this issue by setting the continuity of banking services as an objective<sup>74</sup> in a bank resolution process.

Present arrangements, legislations, and resolution systems do not necessarily enable authorities to maintain basic banking services when a bank reaches the point of insolvency<sup>75</sup>. Banks may be forced to stop providing services and make deposits unavailable if insolvency proceedings are initiated against them. The moratorium, while an important tool at the initial stages of a bank insolvency (by providing the re-organising authority sufficient time and opportunities to take necessary measures), may explicitly prohibit customers to access their deposits, or make payments. Consequently not only deposits will be blocked for private and corporate customers but also other services like direct debit, standing orders, payments, credit cards would stop. This may incur further problems for customers e.g. utilities may be switched off.

In addition to the above problems, certain bank resolution tools (e.g. bridge banks) would need to be supplemented by other measures to ensure the continuity of banking services. In the event of the transfer of business to a bridge bank or a partial sale to a private sector entity, the residual company would need to provide support necessary to ensure the continuity of banking services offered by the bridge bank or purchaser. Such support might be necessary, for example, where certain systems, contracts or services necessary to the operation of a bridge bank have not been transferred from the residual company. This however may not be possible in all Member States if the residual company is placed under an insolvency procedure.

Continuity of banking services may also be jeopardised by the actions of third parties should they decide to terminate contracts under certain circumstances, for example where the contracts are transferred to a bridge bank, before the actions of the resolution authority have been completed.

### 3.2.3. *Baseline scenario*

The baseline scenario would be one in which the EU would continue to rely on the existing narrow (or non existing) EU legislation and widespread national legislations and arrangement in crisis situation of cross border banks.

In the case of **early intervention** by supervisors, this would mean that supervisors in different Member States would continue to have different powers and intervention tools against different members of the same cross border banks that breach certain regulation or become financially weaker. They would intervene at different times, under different conditions and trigger mechanisms and implement different measures. This would probably not ensure that problems of cross border banks could be effectively stopped before they became more serious and started affecting other members of the group located in different Member States.

When cross border banks approach insolvency, different national authorities would continue to focus their **resolution** activities only on the respective subsidiary or mother of the banking

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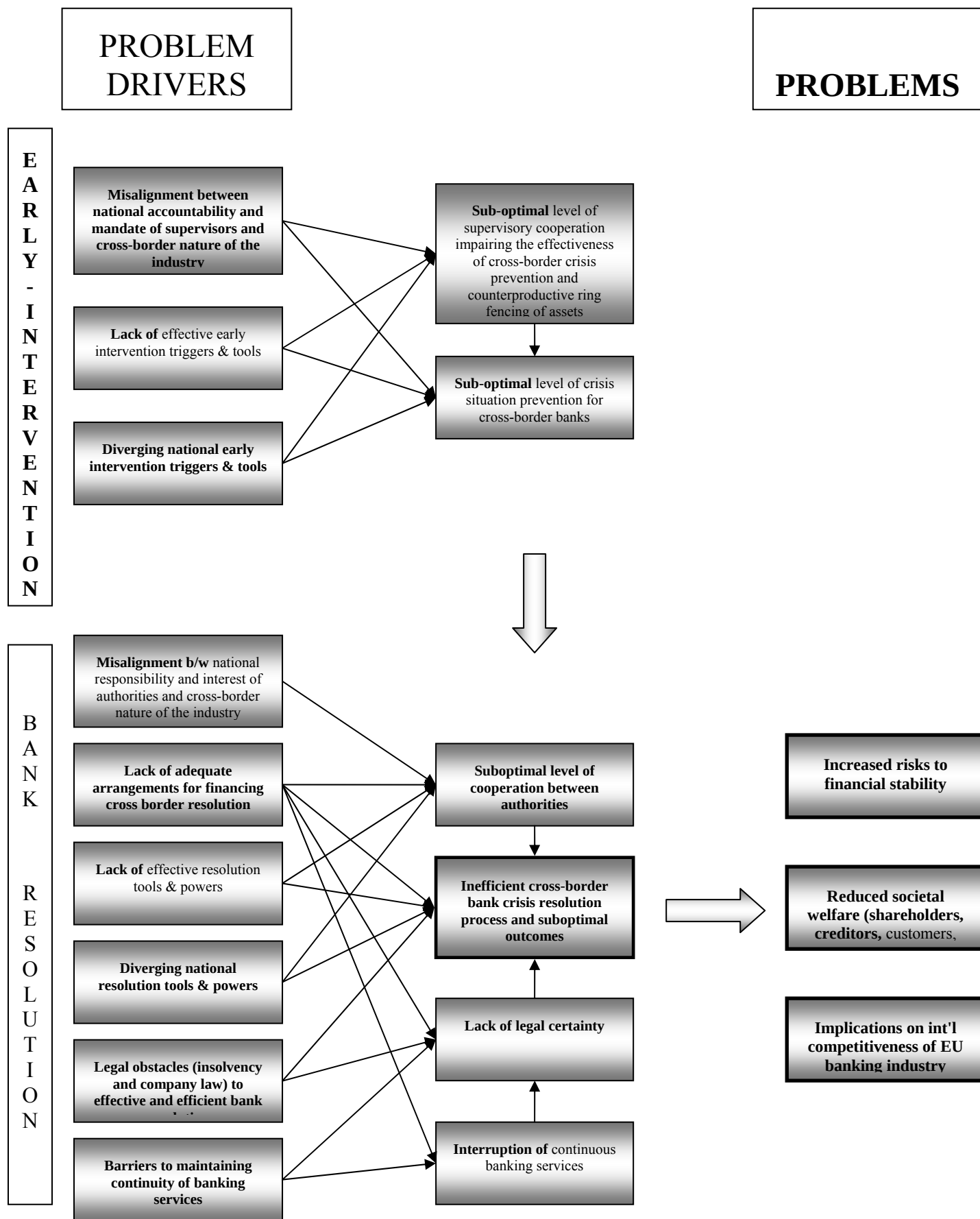
<sup>74</sup> Article 4 (9) of Banking Act 2009

<sup>75</sup> A recent study by the IMF on bank insolvency (“An overview of the legal, institutional, and regulatory framework for bank insolvency”, April 2009) argues that the aim of a bank restructuring should be to secure the continuation of the bank’s business in a way that minimizes disruptions to the financial system and limits costs to depositors, other creditors, and taxpayers.

group that are located in their territory. Conflicting interests would be likely to impede a more optimal reorganisation solutions, optimised at the group level, taking into consideration the interest of all Member States. National solutions would probably be more costly for the citizens and taxpayers of the EU than if the group were reorganised at EU level.

At the same time we assume that proposals of the Commission aiming at improving the macro warning systems would create an improved environment. The proposed *European System of Financial Supervisors (ESFS)*, and the new European Supervisory Authorities (ESAs), would help cooperation of supervisors and better functioning of Colleges. The ESAs should fulfil an active coordination role between national supervisory authorities, in particular in case of adverse developments which potentially jeopardise the orderly functioning and integrity of the financial system in the EU. However, in some emergency situations, coordination may not be sufficient, notably when national supervisors alone lack the tools to respond rapidly to an emerging cross-border crisis. The ESAs should therefore, in such exceptional circumstances, have the power to require national supervisors to jointly take specific action. The determination of a cross-border emergency situation involves a degree of appreciation, and should therefore be left to the European Commission. Moreover, given the fact that no decision by the Authorities should impinge on the fiscal responsibilities of the Member states, the Authorities cannot make any decisions related to resolution processes, as this will almost always entail the possibility that public funds are used.

### 3.2.4. Problem tree



### 3.3. The EU's right to act and justification

Action at European level is required in this field due to the high integration of the banking market within the EU (see section 2.1). However, systems to deal with crises within banks remain nationally based and ill adapted to deal with cross-border situations. Coordination in such circumstances is likely to be complicated and the objectives pursued by each authority may differ. As a consequence, Member State authorities cannot be sure that critical problems arising in a cross-border banking group can be solved fairly, effectively and expediently through robust cooperation arrangements. Unless these flaws in the framework are adequately addressed, national authorities will be left in practice with only two alternatives: they can either take the politically unpopular option of using public money to bail out banks or they can decide to ring fence assets in a cross-border bank and apply national resolution tools at each entity level – which may drive up the overall cost of the resolution. Limited options available to authorities would increase the risk of moral hazard and generate an expectation that large banks would be bailed out in the event of problems.

The financial crisis has underlined the importance of strengthening cross-border crisis management arrangements. It is a matter of priority to address these shortcomings which undermine the Internal Market, by considering the introduction of new crisis management arrangements and tools at EU level, as well as the changes that may be needed to the broader legal framework in order to underpin cross-border cooperative solutions. Underpinning a new framework with the introduction of incentives necessary to induce cross-border cooperation is a task which can most effectively be undertaken at European level (this is particularly true with respect to addressing differences between national resolution and insolvency frameworks as well as arrangements for burden sharing).

### 3.4. Objectives

Viewed from an EU perspective, it would seem that the **general objectives** could be to

- Maintain financial stability and confidence in banks, avoid contagion of problems;
- Minimise losses for society as a whole and especially for taxpayers;
- Strengthen the internal market for banking services while maintaining a level playing field.

Within the context of **early intervention**, the following **specific objectives** could be:

- Develop tools and triggers to detect problems in banks and intervene at an early stage ;
- Ensure efficient cooperation between national financial supervisors responsible for cross border banks in crisis situations.

The table below links the problem drivers for early intervention with a possible set of operational and specific objectives in this area.

**Table 2 Problem drivers and possible objectives for early intervention:**

| Problem drivers                                                                                                 | Specific objectives                                                              |                                      |
|-----------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------|--------------------------------------|
|                                                                                                                 | Develop tools and triggers to detect problems in banks and intervene at an early | Efficient cooperation of supervisors |
| Misalignment between national accountability and mandate of supervisors and cross-border nature of the industry | v                                                                                | v                                    |
| Lack of effective early intervention triggers & tools                                                           | v                                                                                | v                                    |
| Diverging national early intervention triggers & tools                                                          | v                                                                                | v                                    |

For **bank resolution specific objectives** could be:

- Develop tools and triggers to ensure reorganisation and resolution of cross border banks in a timely and robust manner;
- Improve cooperation of national resolution authorities to deliver optimal solutions at EU level;
- Create certainty and predictability around bank resolutions for all stakeholders;
- Ensure continuity of basic banking services during resolution.

The table below links the problem drivers for bank resolution with a possible set of operational and specific objectives in this area.

**Table 3 Problem drivers and possible objectives for bank resolution:**

| Problem drivers                                                                                 | Specific objectives                                                                                                    |                                                 |                 |                                |
|-------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------|-----------------|--------------------------------|
|                                                                                                 | Develop tools and triggers to ensure reorganisation and resolution of cross border banks in a timely and robust manner | Efficient cooperation of resolution authorities | Legal certainty | Continuity of banking services |
| Misalignment b/w national responsibility of authorities and cross-border nature of the industry | v                                                                                                                      | v                                               |                 |                                |
| Lack of adequate arrangements for financing cross border resolution                             | v                                                                                                                      | v                                               | v               | v                              |
| Lack of effective resolution tools & powers                                                     | v                                                                                                                      | v                                               |                 |                                |
| Diverging national resolution tools & powers                                                    | v                                                                                                                      | v                                               |                 |                                |
| Legal obstacles to effective and efficient bank resolution                                      | v                                                                                                                      |                                                 | v               |                                |
| Barriers to maintaining continuity of banking services                                          | v                                                                                                                      |                                                 | v               | v                              |

## **4. POLICY OPTIONS AND ANALYSIS OF IMPACTS**

For the purposes of this impact assessment, the analysis of options is restricted at this stage to a general assessment about the introduction of a new framework and the alternatives. Some areas which could be dealt with under a new framework are also assessed - but without favouring or proposing any concrete measures. Indeed policy options which are considered should not be interpreted as a closed list of options, and should further options come to light as a result of the stakeholder consultation, these may be assessed at a later stage when the Commission makes firm proposals.

### **4.1. General Considerations about the need for a new bank resolution framework**

#### **4.1.1. *Baseline Scenario (no changes to current bank resolution arrangements)***

Under this scenario, no new framework for bank resolution is introduced at EU level. Crisis management remains a national competence, combined with a limited set of arrangements at EU level – in particular as agreed in the 2008 Memorandum of Understanding on Cross-border Stability, and supplemented by recent changes to the Capital Requirements Directive which establish colleges for cross-border banking groups, new alert and information exchange obligations and provisions on joint decision-taking.

The fundamental problems resulting from misalignment of responsibilities and accountability between different authorities, differences between national tools and powers and conditions determining their use, absence of cross-border financing arrangements and the broader legal obstacles which hamper cross-border cooperation are not addressed. Recent experiences during the crisis have provided clear evidence that such a situation is not sustainable, and have resulted in very considerable additional costs for the economy (see section 2.2.3 for a quantitative indication of costs).

#### **4.1.2. *Introduction of an EU bank resolution framework***

Under this scenario, an EU bank resolution framework is introduced which seeks to achieve the objectives set out in Section 3. The details of what such a framework might contain are explained in the Communication and the specific options are assessed in more detail in the following sections. The framework would need to be designed to address the problems identified in section 2, and to fulfil the key objectives for a bank resolution process. However putting in place of such a framework would entail considerable challenges – especially in those areas where there is currently no harmonisation at EU level.

As to the feasibility of such an approach, it needs to be recognised that certain aspects of such a framework may entail fundamental changes to existing approaches to bank resolution at national level. On the other hand, changes to national systems would be kept to the minimum absolutely necessary to ensure coherent application at EU level, and the introduction of new tools need not necessarily require the phasing out of existing tools. National approaches to resolution could be retained to deal with purely domestic banking crises. The framework could be designed in such a way as to ensure complementarity between existing rules and the new tools, although some changes may be necessary in order to eliminate potential areas where conflicts would be likely to occur. Furthermore the depth and seriousness of the current crisis has already prompted a number of Member States to embark on significant reforms of their current systems, and early consultations with Member States have suggested there would be strong support to develop common approaches at EU level.

With regard to the level of ambition achievable for such a framework, much will depend on the outcome of consultations with Member States – which is the reason that the Commission's position remains open at this stage. This is especially the case with respect to options to address differences between bank insolvency laws, and the choice of tools for bank resolution.

Introduction of a bank resolution framework would affect the rights of certain stakeholders – in particular those of creditors and shareholders. In this respect, there is an important debate which needs to be held about striking the correct balance between those rights and the broader societal interest. The Communication recognises this and considers the need for the introduction of appropriate safeguards whenever bank resolution measures impact on stakeholders' rights.

#### *4.1.3. Scaling back cross-border banking groups in order to manage crises more efficiently on a national basis*

An alternative and opposite possibility to the introduction of an EU bank resolution framework would be to recognise the limitations of the existing arrangements (as described in the baseline scenario) and to require changes to cross-border banking structures in such a way that they no longer posed any threat to an efficient resolution process. Such an approach would have the advantage of resolving any uncertainties about crisis resolution which would remain a purely national competence without the need for new cross-border cooperation arrangements. During a crisis resolution process, assets would be ring fenced, banks would be re-organised along national lines and winding up would take place in accordance with national insolvency law.

However, for the resolution process to remain truly national, it would be necessary to require banking structures which ensured that all legal entities within a cross-border banking group could continue to operate on a stand-alone basis – in the event of failure of other parts of the group. This approach would ignore the fact that cross-border banking groups, for reasons of efficiency, tend to centralise certain functions (liquidity management, IT, etc.) in specific parts of the group. In a modern global banking environment, many of the assets may be located in different jurisdictions and thus subject to different insolvency proceedings – some form of cooperation between insolvency/resolution authorities could not be avoided. Furthermore, applying restrictions to cross-border provision of services or establishment would run counter to the basic principles in the EU Treaty which guarantee such freedoms. Any such approach would necessarily entail a modification of the Treaty – in a way which would fundamentally undermine the Internal Market. Finally, insistence on autonomous national banking structures would obviate economies of scale, drive up costs of banking services and place EU banks at a competitive disadvantage in a global market.

**Table 4:** Summary of impacts on stakeholder groups of the introduction of a new crisis management framework

| Key Stakeholders<br>Policy options                     | Banking Industry                                                                                                                                           | Supervisors/Crisis management authorities                                                                                                                            | Creditors                                                                                                                                         | Shareholders                                                                                                                                                                                               | Bank Employees                                                                                                                                                                                              | Depositors                                                                                                                                                     | Bank customers                                                                                    | Taxpayers                                                                                                                                                                                                             |
|--------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Baseline</b>                                        | +/-<br>Expectation that in the absence of alternatives, banks will be saved, but risks to financial stability                                              | -<br>Absence of clear incentives to fully cooperate and coordinate combined with lack of harmonised tools                                                            | -<br>Legal uncertainty                                                                                                                            | +/-<br>Continued protection of rights under EU and national legislation, but uncertainty about how resolution measures will be applied                                                                     | -<br>Uncertainty about how a banking group would be resolved and how it might impact employees                                                                                                              | -<br>Uncertainty about how cross-border deposits would be treated in event of bank failure                                                                     | -<br>Uncertainty around the continuity of the banking operation in a crisis situation.            | -<br>Absence of clear framework tailored for ailing banks will result in increased fiscal burdens                                                                                                                     |
| <b>Introduction of an EU bank resolution framework</b> | +/-<br>Improved financial stability, but no bank would be too big to fail and resolution outcomes could entail radical changes in operation and structure. | +<br>Improved incentives and ability to cooperate. Better chances for optimal solutions (all interests taken into consideration and solutions optimised at EU level) | +<br>Clearer framework would improve prospects of equal treatment across the group, with better prospects for maintenance of continuous operation | +/-<br>Potential loss of protection under EU and national laws, but greater certainty about when and how authorities are allowed to act, backed, when necessary, by safeguards and compensation mechanisms | +/-<br>Ability of authorities to cooperate and manage problems in a group would increase chances of effective early intervention but enhancing the option to allow a bank to fail may result in job losses. | +<br>More certainty about effective cross-border handling and focus on continuity of services should allow depositors to benefit from cross-border competition | +<br>Maintenance of continuous banking services.                                                  | +<br>A new framework to enable effective crisis management should reduce fiscal burdens                                                                                                                               |
| <b>Scaling back of cross border groups</b>             | -<br>Damage to cross-border bank business models and to international competitiveness, higher cost, lower synergies, lower profitability.                  | +<br>Less need to cooperate, reduced risk of conflicts, clearer responsibilities.                                                                                    | +/-<br>More certainty about treatment, but possible unequal treatment across the group                                                            | -/+<br>Less profitable firms as a result of less efficient business models, but greater certainty about how resolution would apply at national level, more adapted to national circumstances               | +/-<br>More clarity that resolution will take place at national level – but possible negative impacts on cross-border business models and competitiveness                                                   | +/-<br>More clarity about deposit protection, but fewer cross-border opportunities and higher prices for services due to reduced competition                   | -<br>Limited choices for banking products and potentially higher pricing due to lower competition | +/-<br>National solutions maybe suboptimal at EU level, certain countries may bear higher fiscal cost. More certainty would reduce risk that national taxpayers might contribute to resolution in other Member States |

Legend: + overall positive effect, - overall negative effect, +/- overall mixed effect

## 4.2. Early Intervention

In the following section, options addressing problems at early intervention are analysed. They are separated according to the following areas: policies to address the problem of differences in triggers, policies to address the problem of differences in tools and policies to address misalignment.

### 4.2.1. *Possible policies to address early intervention conditions, triggers*

#### 4.2.1.1. Baseline scenario (no changes)

Recent events have shown that the soundness of individual firms has been too often supervised in isolation with little focus on the degree of interdependence within the financial system. In order to ensure a more timely detection and prevention of risks to financial stability, the Commission recently adopted a regulation on establishing a European Systemic Risk Board (ESRB)<sup>76</sup>. The ESRB will enhance the effectiveness of early warning mechanisms by improving interaction between micro- and macro-level prudential analyses. The participation of the European Banking Authority and national supervisors in the work of the ESRB will ensure that assessment of macro-prudential risks is based on complete and accurate information about developments in the financial system. At the same time, based on its analysis, the ESRB will be able to issue risk warnings and recommendations which will have a specified timeline for a policy response and could be addressed to, among others, the EBA and national supervisors. Were the addressees of such warnings and recommendations to choose not to act, reasons for inaction would have to be explained to the ESRB. Such mechanism should partially contribute to a more effective identification of potential problems at individual institutions.

However at micro level, national supervisors of the same banking group would continue to use different indicators for detecting problems in banks. They would continue to assess these indicators with diverging methodology and assessment process. Different understanding of the problem would prompt diverging actions at different times, which could weaken the effectiveness of measures against a bank with liquidity or solvency problems. The proposed European Banking Authority may help in developing common indicators and understanding.

#### 4.2.1.2. Common assessment of common early warning indicators

Under this option, a harmonised minimum set of early warning indicators could be developed in the EU taking into account the existing methodologies of national supervisors. However, not only the indicators but also their assessment could be harmonised. Common assessment of the situations could be developed to ensure coordinated actions that are optimal for the cross border group as a whole.<sup>77</sup> The decision on which would be the necessary measures to correct

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<sup>76</sup> Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, COM (2009) 499

<sup>77</sup> In support of a joint assessment framework, the Commission is planning to include new changes into the CRD which would introduce new complementary prudential measures designed to capture at least

the situation at a bank would be however left to the discretion of the national supervisors concerned.

#### *Impacts:*

Compared to the baseline scenario this option would ensure that different supervisors of the same cross border banking group would use the same methodology when analysing problems in the operation. This would facilitate cooperation among them as the common indicators and their common understanding would substantially ease the communication and the joint conclusion making. Common practices would also help banks as they would face the same (or at least very similar) of indicators that different supervisors in different countries would follow. This would contribute to the stability of the system and could help towards ensuring more optimal solutions at EU (or group) level for all stakeholders if banking groups need corrective actions from supervisors.

#### 4.2.1.3. Automatic, hard triggers

It is possible not only to harmonise indicators and assessments but also to oblige authorities to act if certain thresholds of indicators are hit (hard triggers). Mostly quantitative indicators can be applied for implementing such hard triggers based on solvency (such as a capital adequacy or leverage) or liquidity indicators. It is also possible to tie supervisory actions to thresholds i.e. obliging supervisors to implement predefined measures without any discretion regarding the concrete situation and specificity of the banking group. In the US under the Prompt Corrective Action (PCA) framework, critically undercapitalised banks (having a tangible equity to total assets ratio equal to or less than 2 percent and those banks that do not have an adequate plan to restore capital to the required levels) are prohibited from continuing activities, and banks must be placed under receivership within 90 days.

#### *Impacts:*

Compared to the baseline scenario the use of hard triggers would bring all the benefits as the previous option and would create an even clearer situation for all stakeholders. The same hard triggers applied in all Member States would be an effective means of synchronising actions of supervisors and facilitate cooperation. Conditions and possible actions of supervisors would be known ex-ante to the whole industry, greatly decreasing the uncertainties around intervention of supervisors and thus compliance cost.

At the same time, advance knowledge of the basis for supervisory intervention could provide opportunities for regulatory arbitrage on the part of banks. Knowledge that the supervisor focuses on certain indicators, might lead to banks manipulating their balance sheets to hide deviations. Moreover, hard indicators / benchmark ratios could reduce supervisors' incentives to maintain comprehensive oversight of financial institutions, thereby allowing potential problems elsewhere to escape detection.

Moreover, it is very difficult to identify single indicators that would be adequate to detect every possible technical problem and/or incorporate all the possible relevant data and information for a proper supervisory assessment. As each case is different, indicators that

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the effects of leverage and liquidity risks. These harmonised measures would usefully supplement the indicators that form part of the 'early warning system' that will facilitate the joint assessment of emergency situations.

efficiently detect problems in a specific case can be also different<sup>78</sup>. A single set of hard triggers could thus prove to be a blunt instrument for use in complex and developing situations.

If not only the need for actions is tied to quantitative levels, but also the measures/tools to be applied by supervisors are pre-defined, the certainty of intervention is even higher.

While this would protect supervisors from possible litigation by stakeholders who are negatively affected by the interventions (where that is possible under national law) and also bring certainty for ailing banks that can be fully aware of the consequences of their incorrect operation, supervisors would on the other hand lose the flexibility for their interventions, increasing the risk that problems are inappropriately handled and hence resulting in suboptimal outcomes.

#### *4.2.2. Possible policies to address early intervention tools*

##### *4.2.2.1. Baseline scenario (no changes)*

If no action is taken, national authorities will continue to have diverging tools and powers to correct irregularities at different members of the same cross border banking group. This could lead to situations where certain parts of the same banking group could not participate in a coordinated stabilisation because banking supervisors of those Member States do not have the powers to implement measures. This would risk suboptimal outcomes for certain stakeholders in the EU.

The continued uncertainty around the possibility to transfer assets within a cross border banking group would continue to impede optimal allocation of liquidity in a crisis situation.

##### *4.2.2.2. Expanded minimum set of early intervention tools*

The list of minimum supervisory tools and powers to correct the operation of a banking group provided for by Article 136 of the CRD could be further expanded. Based on existing practices of national supervisors, it is possible to expand the minimum set of supervisory tools. It is important for an effective intervention at group level that all European supervisors have appropriate enforcement actions at their disposal. The aim would not be to equip supervisors with exactly the same tools, but rather that tools available for supervisors should deliver the same result. In addition to the minimum set of harmonised tools and powers, national supervisors may have additional tools not necessarily available for everybody.

In particular, the list of supervisory tools in Article 136 does not include the power to require the submission of a restoration plan for a group. A number of national supervisors already have the power to require the individual entities that they supervise to develop such a plan, but there is no clear framework to do this at the level of a cross-border group.

It may also be useful to explore whether large banks should be obliged to prepare in advance and submit to authorities plans which detail the arrangements for winding down the institution should it fail. Such plans could in particular look at cross-border dependencies of

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<sup>78</sup> The current crisis drew attention to the importance of liquidity indicators since capital ratios were not informative this time. In the future, it is not evident which indicators will have larger importance.

the institution, the implications of legal separateness in case of resolution and the possible exercise of resolution powers.

Consideration could also be given as to whether the power to change the management of the bank by nominating a special representative (an 'administrator' or 'manager') with the objective of restoring the financial situation of the institution in the context of common group restoration plan should be granted.

#### *Impacts:*

An expanded harmonised set of early intervention tools that can achieve the same results to pre-empt or correct problems at supervisory level could greatly increase the overall effectiveness of crisis management in the EU. It could improve cooperative actions of different supervisors and enable important actions/measures that are presently not available in all Member States where a cross border banking group may operate. Joint restoration plan for a group (for example) would ensure that resources available at different subsidiaries in different Member States may be optimally reallocated at EU level by using the synergies of the group.

Coordinated early remedial actions would contribute to the stability of the banking and financial system in all Member States concerned and could help prevent problems evolving and resulting in bank-resolution. If done at the appropriate moment, early supervisory actions can result in substantial cost savings for society and taxpayers and avoid the need for bail-outs (of systematically important cross border banks)<sup>79</sup>.

#### 4.2.2.3. Single set of early intervention tools

An alternative approach to ensuring that all national authorities have tools that achieve similar results would be to agree on a fully harmonised list of supervisory tools and powers that need to be made available for all European banking supervisors. This could also include any additional tools presently not available for any national supervisor. Such new tools would mainly relate to early remedial actions for cross border banking groups.

Compared to the baseline scenario, a single set of supervisory early intervention tools would deliver all the benefits which are outlined in the previous option. Having exactly the same tools and powers in all Member States would reinforce further chances of developing cooperative early remedial actions for the same banking group. This could also enable effective solutions to prevent escalation of problems and hence assure stability for all stakeholders.

Legal implementation of such a solution might however pose problems for certain Member States. Due to differences in legal systems (e.g. constitutional limitations) and arrangements for banking supervision (single supervisor or shared competences among supervisor and national bank and DGS), setting exactly the same tools and powers (and not tools that achieve the same results) in all Member States could be difficult to reach.

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<sup>79</sup> See the cost of the current in Chapter 2.2.1.General problems

#### 4.2.3. Possible policies to address misalignment between responsibility of national supervision and international business

##### 4.2.3.1. Baseline scenario (no changes)

The voluntary cooperation between supervisors in crisis situations has proved to be inadequate in ensuring a co-ordinated reaction which led to suboptimal results and high costs for Member States. As national authorities are accountable only to their national Parliaments, and as no clear ex ante burden sharing arrangements have yet been developed, host authorities can only hope that home authorities will take their situation into account in the event of a crisis. The imbalance between home and host countries may be further deepened by differences in size between countries.

If no adjustments to the existing arrangements are made, there will be no improvement in the prospects that that cooperation will work better in a future crisis when there are once again likely to be competing interests between Member States. Prudential supervision, as well as the capacity to manage the stability of the financial system, is highly dependent on the quality of co-operation and information exchange between supervisors. Problems of communication, or a lack of trust between supervisors, can severely endanger the effective control of the institutions or financial systems concerned.

The Commission has recently proposed to create a European Banking Authority by transforming the Committee of European Banking Supervisors (CEBS)<sup>80</sup>. It is proposed that the Authority<sup>81</sup> should be able to require national supervisory authorities to take specific actions to remedy an emergency situation. As the determination of an emergency situation involves a significant degree of discretion, this power is therefore left to the Commission<sup>82</sup>.

The power of the Authority to make decision in crisis situation would ensure timely decision-making and coordinated actions. As a crisis-situation can evolve in days (evidenced by the recent crisis) prompt supervisory actions could be more effectively implemented at the EU level.

From the point of view of effectively protecting depositors, the prime objective is to respond to crisis situations with highly coordinated and harmonised measures. The fact that the responsibility for crisis management over locally incorporated and supervised entities of cross-border groups is predominantly national-based heightens the need for close EU coordination and action.

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<sup>80</sup> See more details above in Chapter 3.2.2.1.

<sup>81</sup> Recital 21 of Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a European Banking Authority, adopted on 23 September 2009.

<sup>82</sup> The explanatory memorandum of the Commission's proposed regulation establishing an European Banking Authority states that "the ESAs shall fulfil an active coordination role between national supervisory authorities, in particular in case of adverse developments which potentially jeopardise the orderly functioning and integrity of the financial system in the EU. However, in some emergency situations, coordination may not be sufficient, notably when national supervisors alone lack the tools to respond rapidly to an emerging cross-border crisis. The ESAs should therefore, in such exceptional circumstances, have the power to require national supervisors to jointly take specific action. The determination of a cross-border emergency situation involves a degree of appreciation, and should therefore be left to the European Commission. This is subject to the safeguard clause (see 6.2.11). In parallel, work should be accelerated to build a comprehensive cross-border framework to strengthen the European Union's financial crisis management/resolution systems, including guarantee schemes and burden sharing".

#### 4.2.3.2. Improved cooperation between supervisors in crisis situation

In addition to the proposed changes in the architecture of supervision and the proposed set up of the European Banking Authority, certain elements of supervisory cooperation in crisis situations could be further improved.

Consideration could be given as to whether, when a crisis begins to develop in a cross-border group, supervisors should be required to come to a joint decision, on the basis of a common assessment and a restoration plan submitted by the parent company for the group as a whole. A joint decision would only make sense where different legal entities of a group are facing similar stress events, and require similar restoration measures. Recently agreed changes to the Capital Requirements Directive will require consolidating supervisors to plan and coordinate joint assessments in emergency situations, exceptional measures, the implementation of contingency plans and communication to the public<sup>83</sup>. However, the Directive does not specify the conditions that trigger the application of such measures, and how joint assessment should be conducted. If national law or national supervisors interpret those conditions differently, coordinated action by supervisors of different group entities might be difficult.

It would also be possible to increase the role and power of home supervisors in crisis situations where the problems affected more than one Member State and a joint prompt action were needed to prevent escalation.

#### *Impacts:*

Joint decision might ensure that measures taken by different national supervisors reach an optimal outcome for the group as a whole. This would provide a more advantageous outcome for all stakeholders. Concerned banks could face a more efficient procedure.

At the same time, voluntary cooperation has its limits when interests and important issues are at stake. Even with an improved cooperation framework, agreement on actions is not assured which can still result in suboptimal results at EU level.

The increased role of home supervisors in a crisis situation would however limit the powers of host supervisors and would result in a misalignment between the accountability of host authorities to their taxpayers and their (decreasing) competences in terms of prudential requirements. In this respect, this option could have a particularly negative impact on the Member States in Central Europe.

### **4.3. Bank resolution**

#### *4.3.1. Possible policies to address bank resolution tools and triggers*

##### *4.3.1.1. Baseline scenario (no changes)*

Under the baseline scenario bank resolution would be left to the competence of national resolution authorities (national banks, supervisors, judges, DGS etc.) which have different procedures for ailing or insolvent banks. Resolution of a cross border banking group would remain fragmented by national borders where authorities would follow diverging goals and

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<sup>83</sup> Article 129(1)(c) of Directive 2006/48/EC as re-casted in 2009 (Publication in the Official Journal is still pending).

apply diverging measures. Certain authorities could reorganise banks in a special bank resolution framework (e.g. UK), others could prompt a special administration (e.g. Italy); many would need to initiate a judicial insolvency proceeding (e.g. Germany). In several countries, reorganisation would remain as a missing option (e.g. in SE only liquidation is possible). This would not deliver an optimal outcome for all stakeholders in the EU.

#### 4.3.1.2. Minimum set of harmonised bank resolution tools and clear triggers

While it may be appropriate to preserve a wide range of possibilities in Member States' national toolkits, consideration should be given to equipping all resolution authorities with a minimum set of core tools with a view to meeting the common objectives of an EU bank resolution framework. Effective tools could enable authorities to implement measures other than public financial support and liquidation to address problems in an ailing bank. In order to preserve financial stability, they could enable authorities to intervene rapidly, ensure the continuity of essential banking services, and give authorities the time to organise an orderly resolution. Such tools<sup>84</sup> could include:

- The power to arrange acquisition by a private sector purchaser;
- The power to transfer assets and liabilities to a bridge bank;
- The power to partially transfer assets to a 'Bad bank' or 'Good bank';
- Assisted sale of part of the business to a private sector purchaser;
- Nationalisation.

The goal would not be that each authority should have exactly the same tool, but rather that measures implemented by different authorities should deliver the same or equivalent results. In addition to the minimum set of resolution tools, national authorities could keep their specific tools and powers in relation to bank resolution.

#### *Impacts:*

The introduction of special bank resolution tools in all Member States would significantly increase the chances of authorities to achieve a successful resolution. By introducing a special resolution procedure for cross border banks, authorities could pre-empt initiating reorganisation under insolvency laws. This would save time (in terms of fulfilment of more lengthy procedures under insolvency laws) enable techniques which are more suited to the needs of a bank resolution (e.g. bridge bank<sup>85</sup>) to be used and allow for a more appropriate balance of priorities to be exercised with regard to stakeholders (depositors, continuity of services for all customers) as opposed to only creditors as under an insolvency procedure.

If banks can be reorganised in a timely and effective manner, financial stability would be substantially strengthened and the probability of fiscal consequences of a bank failure would

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<sup>84</sup> In case public resources are involved, such tools would need to be undertaken in compliance with State Aid rules.

<sup>85</sup> A bridge bank can keep the going concern status of the viable part of the banking business, and help avoiding formal insolvency.

diminish. It would also mean less need to support weakened financial institutions, more competition and consequently the internal market would be strengthened.

Since the aim of resolution is to as far as possible avoid that costs are borne by taxpayers, losses are imposed in the first instance on shareholders. However the above techniques, if applied at a point before the bank is technically balance sheet insolvent, may constitute a limitation to their rights. If public interest were best served by ensuring the continuity of banking services and an orderly resolution, this may be justified and intervention should be possible at a stage before the bank is “balance sheet” insolvent: that is, before the bank has reached the relevant threshold for the purposes of ordinary insolvency proceedings. The use of resolution tools would thus need to be fully justified, on the basis of commonly agreed and legally sound conditions set out in a bank resolution framework. In particular, a clear demonstration would be needed that an action which limited the rights of stakeholders was proportionate to the seriousness of the problems in the institution and driven by clear public interest.

#### 4.3.1.3. Single set of bank resolution tools

Under this option a closed list of tools and powers could be defined for all resolution authorities dealing with cross border banks. Under an EU framework tools and powers could be harmonised to a maximum extent.

##### *Impacts:*

Maximum harmonisation could bring all the benefits of the previous option compared to the baseline scenario. This would create an even clearer system for bank resolution. Practical implementation of such a maximum harmonisation would however most likely cause problems in many Member States because of differences between legal systems (e.g. constitutional limitations) and differences in responsibilities of authorities (banking supervisor, national bank, ministry of finance, deposit guarantee scheme).

#### 4.3.2. *Possible policies to address misalignment between responsibility of national authorities and international business*

##### 4.3.2.1. Baseline scenario (no changes)

Under this option, national authorities would keep their focus on banking entities located on their respective territory. The geographical separation of resolution measures implemented by national authorities would probably continue to be misaligned with the highly integrated operation of a cross border banking groups. Reorganisation procedures and actions would differ in all Member States concerned which would result in different outcomes. Separate procedures would probably not take into account the positive, synergic effects of possible resolution at group level. The lack of agreement (or binding decision) would risk that national authorities implement uncoordinated measures resulting in suboptimal outcomes (e.g. Fortis case).

The 2008 Memorandum of Understanding that created a cooperation framework between different authorities (Ministries of Finance, Central Banks, supervisors) in crisis situations did not prove to be effective in practice. On the basis of recent experience, the Commission believes it unlikely that in the future when Cross Border Stability Groups have been created in

accordance with the MoU, the *voluntary* cooperation under this framework will manage to reach the objectives of coordinated cross-border resolution.

The proposal of the Commission to establish the European System of Financial Supervisors (ESFS), does not foresee any role for these Authorities in a resolution process. Hence apart from their coordinating and decision-making role in supervisory actions in case of emergency situations, these Authorities will not have any power in a resolution. The safeguard clause of the proposal makes clear that decisions by the ESAs in no way impinge on the fiscal responsibilities of the Member States. This also constrains the Authorities from making any decisions related to resolution processes, as this will almost always entail the possibility that public funds are used.

#### 4.3.2.2. Improved cooperation between resolution and other authorities

##### *Cooperation between resolution authorities*

Cooperation could be further improved if there were more binding obligations. For example, supervisors could be legally obliged to alert *resolution authorities* where they consider that a cross border bank is failing or is likely to get into difficulties and that it is reasonably unlikely that the bank will be able to turn itself around, while resolution authorities of different legal entities within a group could be legally obliged to consult each other before taking measures on a legal entity of the group. It could be a precondition before the taking of any resolution measures at cross-border level that a discussion takes place between the resolution authorities on the situation of the bank (e.g. taking into account its ability to meet threshold conditions assessed by supervisors), while acknowledging that specific circumstances may require rapid decisions. Consideration could also be given as to whether resolution authorities should be obliged to consider (but not necessarily apply) joint resolution measures which would be to the benefit of the group as a whole.

Voluntary cooperation could be further improved if decisions made by certain authorities were to be made binding. Home resolution authorities might also nominate a "lead administrator" for the banking group who would be responsible for coordinated resolution. More radically, this approach could provide for the nomination of the same administrator to all group members concerned. Those proceedings would be conducted in accordance with the applicable national legal regime.

Finally, cooperation would be significantly enhanced if it were clear in advance that if public money needed to be spent, the costs would be shared fairly across countries. This would create the correct incentives and ensure that it was in everyone's interest to cooperate fully towards the minimisation of the total social cost.

##### *Cooperation of judicial authorities*

Not only *resolution authorities* but also *courts and insolvency practitioners* could be required to exchange information and coordinate actions on a cross border basis in respect of different group entities under resolution. Proposals to facilitate cooperation between administrators and

courts located in different jurisdictions have been or are being developed by UNCITRAL<sup>86</sup> and could provide useful models for an EU cooperation framework for the resolution and liquidation of cross border banking groups. Two principle approaches might be explored:

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<sup>86</sup> United Nations Commission on International Trade Law, [www.uncitral.org](http://www.uncitral.org)

- *Coordination framework for cooperation and exchange of information*

This would entail the conduct of territorial proceedings, in relation to separate legal entities, in accordance with the applicable national insolvency regime. New EU rules would establish requirements for courts, insolvency practitioners and (where applicable) resolution authorities to exchange information in respect of the different group entities under resolution.

Going further, a new EU instrument could also provide a framework for coordinated stabilisation or reorganisation plans and facilitate the coordination of the use and disposition of assets, use of avoidance powers<sup>87</sup> and distributions to creditors. Such measures might address some of the problems experienced in the liquidation of affiliated entities where there has been significant co-mingling of assets<sup>88</sup>.

- *Coordination of national proceedings by a “lead administrator”*

This approach would facilitate a more directed coordination of national proceedings in relation to group entities by a 'lead' administrator or liquidator (possibly that of the parent company, although some flexibility might be appropriate), or by a lead national authority for the purposes of stabilisation measures. EU rules would, among other things, set out procedures for the adoption of a coordinated stabilisation or reorganisation plan and for decision-taking within agreed objectives.

Increased coordination for bank resolution would improve chances for an optimal outcome at EU level. Measures that take into account other parts of a cross border bank group could be more efficient (e.g. lower cost by using collaterals available internally) and more effective in reaching better outcomes for all stakeholders (e.g. ensuring continuity of banking services for customers by maintaining uninterrupted intra-group support).

*Impacts:*

Binding decisions taken by certain (home) authorities instead of the lack of agreement in case of voluntary cooperation would improve the effectiveness of resolution measures at EU level. They could increase promptness of actions instead of enduring and non conclusive decision-making. At the same time, Member States would probably be reluctant to shift their powers over their banks in a resolution process to other Member States. One of the most crucial questions here is who should finance the resolution, if public funds are needed. Would the country that makes the final binding decision also assume the (financial) consequences for its decisions?

#### 4.3.2.3. Increased powers to EU institutions in bank resolution

Under a new European framework, EU bodies could be given decision-making roles in a cross border bank resolution. Consideration should be given as to whether any EU institution (the new European Banking Authority or any other existing authorities) should be empowered to coordinate and/or lead a resolution of banking groups. If national resolution authorities were

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<sup>87</sup> Transactions executed in the suspect period e.g. 6 months before insolvency may be ruled void or null.

<sup>88</sup> Assets are intermingled if it is impossible or too costly to separate assets of two legal entities.

unable to reach agreement, an EU body might be best placed to make the final binding decision.

#### *Impacts:*

This option would bring all the benefits (i.e.: effectiveness and efficiency) of the previous option for all stakeholders. The European Council, in its conclusions of 19 June 2009, recommended that a European System of Financial Supervisors (ESFS), comprising three, new European Supervisory Authorities (ESA), be established, while stressing that decisions taken by the latter should not impinge on the fiscal responsibilities of Member States. Against this background, it is unlikely that Member States would currently be in the position to shift their powers on bank resolution to any EU body. To come to a situation where an EU body could decide on these issues, further steps are needed to come to robust burden-sharing arrangements between Member States.

#### *4.3.3. Possible options to address legal obstacles (company, insolvency law) to bank resolution*

##### *4.3.3.1. Baseline scenario (no changes)*

Under the baseline scenario, Member States' diverging national legislations would continue to govern cross-border bank resolutions. Company law provisions would continue to hinder authorities from implementing prompt actions without consulting shareholders. National insolvency laws would continue to focus only on maximizing value for creditors without taking into account financial stability and other stakeholders such as taxpayers. Different national resolution or insolvency systems would probably have encounter difficulties to cooperate. Any reorganisation or liquidation would necessarily be carried out in accordance with national insolvency procedures, and any coordination would be based on the voluntary cooperation between different national insolvency authorities and officers. Under current arrangements insolvency proceedings are only effective in the country where they are initiated, and will administer only those assets that are located within that jurisdiction.<sup>89</sup>

##### *4.3.3.2. Adjustments in company and insolvency laws to support bank resolution*

**Company law** at EU<sup>90</sup> and national level<sup>91</sup> could be amended in such a way as to enable authorities to take rapid and decisive actions. This might entail limiting certain rights (to decision and property) of bank shareholders. Such measures and thus limitations to rights could be implemented only in the public interest of financial stability.

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<sup>89</sup> This is subject to the exception under Directive 2001/24/EC of branch assets that are located in another Member State.

<sup>90</sup> The capital maintenance regime under the Second Company Law Directive requires the approval of the shareholders' general meeting for any increase or reduction of issued share capital and confers pre-emption rights for existing shareholders. The Shareholder Rights Directive sets out requirements relating to the general meeting of shareholders of listed companies, and in particular specifies the convocation periods and the form of the convocation.

<sup>91</sup> There are domestic requirements in the company law or listing rules in a number of Member States, such as the requirement that material transactions be approved by the general meeting.

Convocation periods for the general meeting of shareholders that could prolong key resolution decisions could be decreased or in exceptional cases shareholders' approval could be totally abolished.<sup>92</sup>

Measures (like transfer of ownership or assets of an ailing bank) must comply with shareholders' right to property under Article 1, Protocol 1 ('A1P1') of the European Convention of Human Rights ('ECHR'). A1P1 does not prevent the use by national resolution authorities of intrusive measures that interfere with shareholders' property rights in a bank, if it strikes a "fair balance" between "the demands of the general interest of the community and the requirement of the protection of the individual's fundamental rights".<sup>93</sup> However, a stabilization and resolution framework would need to respect constitutional limitations of Member States' laws – as guaranteed under the EU Treaty – and would need to contain appropriate safeguards to ensure that the rights of shareholders are given proper weight.

For losses suffered as a result of resolution measures, bank shareholders should be entitled to compensation. Where rights granted by EU law are affected, appropriate mechanisms for redress and compensation would need to be agreed and set out at EU level. The question for further consideration is whether for all other cases, appropriate mechanisms could be left to the discretion of Member States. If resolution measures are applied at a cross-border level, involving entities in more than one Member State, it seems logical that redress possibilities and compensation for shareholders of the affected entities should be determined in the same way.

**Insolvency laws** could be amended to support coordination of resolution measures and reorganisation at group level. Reorganisation might be carried out under an administrative process or under a judicial insolvency procedure. In the first case insolvency laws would need to be adjusted to allow resolution of an ailing bank under a special procedure. In the second case, insolvency procedures would need to be amended to cater for the group as a whole.

#### 4.3.3.3. Developing new EU legislation for resolution of cross border banks

Instead of amending existing EU and national legislations governing company and insolvency law provisions to facilitate coordinated cross border bank resolution, a new EU legislative framework could be developed. The administrative special framework would deal only with the resolution of cross border banking groups and regulate commencement and management of procedures; resolution tools and powers of EU and national authorities; shareholders' rights; compensations; ranking of creditors; group interest, intragroup transactions. Certain contracts (e.g. employment, set off, netting, etc.) would however continue to be settled according to national laws. Similarly, employees' information and consultation rights would continue to be ruled by national laws (which in many instances implement Community law).

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<sup>92</sup> With a view to the requirement established by the Second Company law Directive, the European Court of Justice has clarified that neither the Treaty nor the Second Directive itself provide for a possibility for Member States to derogate from this rule in crisis situations and where the company undergoes serious financial difficulties, judgment of the ECJ in the joined cases C-19/90 and C-20/90, "Karella and Karellas".

<sup>93</sup> Spörting and Lonnroth v Sweden (1982) 5 EHRR 35

### *Impacts:*

The introduction of such a legislative framework would create a clear and transparent system for the resolution of cross border banking groups; all stakeholders would have an overview about their rights and obligations. The new system would be effective as the tools of the new procedure would enable reaching the specific goals of a bank resolution. It would also be efficient as a speedy administrative process could replace a number of diverging national processes.

The difficulty of developing such a 'quasi' harmonised insolvency system for cross border banks cannot be underestimated. Insolvency law is closely related to other areas of national law such as the law of property, contract and commercial law, and rules on aspects such as priority reflect social policy. Accommodating distinct national concepts, such as trusts or floating charges, in a unified code would be complex. Furthermore, it is recognised that if convergence is desirable it should ideally be global. However, work in the EU could allow it to shape any subsequent global initiatives.

Such a project might take the form of a separate and self-contained insolvency regime that would be available, and would replace the otherwise applicable national regimes, for the reorganisation and winding up of cross-border banking groups in the EU. Such a regime would only fully address the problems associated with the separate entity approach under national insolvency law if it permitted an integrated treatment of the group entities. Careful thought would need to be given to the application of such a regime and the extent – if at all – to which it should be optional for systemically important cross-border banking groups. It is recognised that any imposition of a new EU insolvency regime on existing entities would raise transitional problems, including the impact on creditors and counterparties.

#### *4.3.4. Possible policies to support financing of cross border resolution*

The policies listed below are not necessarily mutually exclusive solutions. Financing from private sources does not mean that the involvement of public sources can not become unavoidable at a certain point of the resolution. However one of the main objectives for a bank resolution framework is to minimize losses for society as a whole and especially for taxpayers. This implies that finding solutions to facilitate resolution measures for a cross-border bank should be considered a last – and not first – resort. As a consequence the focus in the first instance is on how to increase the chances of a resolution without recourse to public funds. Public financing solutions – in particular making progress on burden sharing – are considered, in particular because clarifications in advance on how costs may be shared between Member States should instil additional confidence into a resolution process which can in turn enhance the prospects for a successful resolution at minimal cost to the taxpayer.

##### *4.3.4.1. Baseline scenario (no changes)*

Under current rules, financing of a cross border resolution is not assured from either private or public sources. The absence of funding arrangements underpinning intervention measures in a cross-border context limits the range of resolution tools that authorities may use, potentially to the detriment of the cost minimisation objective.

Most Member States' legislations do not provide incentives for private investors to finance an ailing bank under resolution. Intra-group financing would continue to generate legal uncertainty due to the risk of retroactive invalidity. Financing from other private sources

would continue not to have adequate incentives and guarantees in insolvency proceedings (no priority in the ranking of claims in many Member States, collateral provision).

The use of public funds in a cross border case would continue to be possible on a national basis, which entails that resolution measures would also be divided along geographical borders. This would maintain the risk for suboptimal reorganisation results at banking group level.

#### 4.3.4.2. Adjustments in company law and insolvency laws to support private sector financing of resolution

Private sector funding should be the most favoured of solutions in terms of bank resolution as it avoids the use of public sources. Legal certainty surrounding the actions taken by bank resolution authorities can be key in reinforcing opportunities for private sector solutions. Any risk that restructuring measures might be subsequently unwound through court appeal processes may seriously restrict the readiness of private sector parties to invest in asset purchases or to take over all or part of a rescued credit institution (the Fortis resolution and eventual sale to a private sector purchaser was plagued by legal uncertainty). Legal uncertainty that discourages private sector financing solutions of ailing banks due to the high risk and lack of assurance for repayment should be addressed.

##### *Impacts:*

Adjustments to company and insolvency laws would facilitate private sector solutions which carry the financial cost of a bank resolution. Compared to the baseline scenario, preferential treatment of private funds financing a resolution could be cost efficient, especially for taxpayers. If incentives and guarantees could be provided in order to encourage private investment, increase legal certainty and reduce the risks for investors associated with a bank insolvency procedure, the use of public funds would be more likely to be minimised or avoided. Introducing changes to insolvency and company laws so as to give preferential treatment to private sector financing provided in the context of a bank resolution would however negatively impact existing unsecured creditors of the ailing bank in a possible subsequent liquidation.

#### 4.3.4.3. Intra-group asset transferability framework

Added impetus could be given to work on the feasibility of introducing a framework to allow intra-group cross-border asset transferability after the commencement of an insolvency procedure.

A clear framework regulating the transfer of assets as a means of intra-group financial support and a measure for stabilising entities in a banking group, could assist groups in liquidity management and in some cases could help in the management of a developing crisis. However if transfers are executed on preferential terms, there is a risk of challenges from minority shareholders, creditors or insolvency administrators.<sup>94</sup> Directors bearing liability for their own company may be exposed to civil or criminal liability.

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<sup>94</sup> Intragroup transactions taking place prior to insolvency (in the suspect period e.g. in 6 months) could be retroactively ruled null and void.

According to the UNCITRAL, the following guarantees could be granted for such "post commencement financing"<sup>95</sup> in an insolvency procedure (or in a special bank resolution framework):

- A priority in the order of creditors may be established in a subsequent liquidation (e.g. ahead of ordinary unsecured creditors, including those unsecured creditors with administrative priority)
- A security interest may also be granted for the lender on unencumbered assets<sup>96</sup> or as a junior or lower security interest on already encumbered assets
- The group member subject to insolvency proceedings may also guarantee or provide other assurance of repayment for post-commencement finance.

#### *Impacts:*

The synergies generated by reallocated funds within a group could contribute significantly to the reorganisation of a group without the need for public funds, and allow continuous operation of the group while a solution was being found for the business. This would help to preserve value in the ailing bank. The cross border transfer of funds between entities after commencement of insolvency proceedings however could be contrary to the interests of the Member State and creditors from where the transfer is executed. Consideration could be given to constructing a framework that allows such a transfer and at the same time grants sufficient (above listed) guarantees for certain stakeholders.

#### 4.3.4.4. Financing through Deposit Guarantee Schemes

The feasibility of using Deposit Guarantee Schemes beyond their traditional paybox function could be explored. In some Member States (e.g. Spain), the deposit insurance fund may assess whether it is more cost efficient to finance a resolution of an ailing bank or to let the bank fail and pay out to depositors. The Commission is currently preparing a report<sup>97</sup> on further amending the Directive 94/19/EEC on Deposit Guarantee Schemes (DGS). One of the issues under examination is whether the scope of the DGS should be extended beyond the paybox function.

#### *Impacts:*

Financing through DGS would have the advantage that the banking sector would contribute more directly to ensuring its own stability, and lessen the potential burden on taxpayers. In order to play a meaningful role in crisis intervention, substantial additional funding resources would be necessary, compared to what is currently available.<sup>98</sup> Reliance solely on ex ante funds (which currently amount to an estimated €13 billion in all DGS combined<sup>99</sup>) would be quite simply inadequate. However, DGS are not solely reliant on ex ante funds, and by

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<sup>95</sup> Financing provided after the insolvency procedure begins.

<sup>96</sup> Not used as a collateral to secure payments of the debtor.

<sup>97</sup> More information, including the public consultation results on the DGS review can be found on the following website: [http://ec.europa.eu/internal\\_market/bank/guarantee/index\\_en.htm](http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm)

<sup>98</sup> Even more so in the case of large, complex cross-border financial groups

<sup>99</sup> See Commission Communication on the review of Directive 94/19/EC on Deposit Guarantee Schemes: [http://ec.europa.eu/internal\\_market/bank/docs/guarantee/comm9419\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/guarantee/comm9419_en.pdf)

pooling the financing capacities of all DGS and sufficiently strengthening the funding base, it might be feasible to address the problems in a large cross-border banking group. Use of DGS funds to rescue ailing banks would need to comply with State Aid rules in order to ensure a level playing field across banks and Member States.

#### 4.3.4.5. Developing public funding arrangements

Although one of the major motivations for developing a cross-border bank resolution framework would be avoidance of the use of public funds, it needs nevertheless to be recognised that bank resolution measures may ultimately require public funding - in compliance with State Aid rules - should private sector solutions prove insufficient. This implies further development of arrangements which set out how financial burdens should be shared if resolution measures need to be applied to a cross-border group. A recent report to the Economic and Finance Committee<sup>100</sup> has recommended that the EU framework for financial stability should include voluntary ex ante arrangements for burden sharing regarding cross-border financial groups, supported by an EU-wide terms of reference, with newly established cross-border stability groups playing a key role in monitoring their implementation. In light of experiences during the recent crisis, more clarity about cost sharing would be an essential part of any new framework, and would assist in building a robust framework for cooperation and provide further incentives to converge national systems. Conversely, the putting in place of coherent sets of tools should provide the necessary assurance about the capacity of other national authorities to act in an appropriate manner and at an appropriate time. Finally, the existence of clear burden sharing arrangements would be an important enhancement to the Internal Market, especially with respect to addressing particular concerns about the current structure of the Internal Market (e.g. the issue of smaller countries and the relative size of their banking sector, and the predominance of foreign owned banks in some host countries).

#### *Impacts:*

An agreement on burden sharing - in compliance with EU State Aid rules - would substantially increase the effectiveness of cross border resolution measures. Establishing clarity about the financing arrangements would provide the right incentives so that Member States would be more likely to cooperate in a cross border bank resolution and to implement measures that bring optimal solutions at EU level. The mere existence of burden sharing arrangements could also serve to reinforce the viability of private sector solutions. Greater clarity would also contribute to the efficiency of the resolution, as speedy decisions and actions have higher chances for successful early reorganisation where the involvement of public funds can be avoided. On the other hand, advance commitment between Member States on precise modalities would be particularly challenging given that each crisis situation differs. Burden sharing arrangements would need to be tailored to each institution and agreed in the appropriate forum. Safeguards would also be needed to ensure that Member States did not walk away from non-binding arrangements.

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<sup>100</sup> Lessons from the financial crisis for European financial stability arrangements, EFC High-Level Working Group on Cross-Border Financial Stability Arrangements, July 2008.

#### 4.3.5. *Possible policies to support continuity of banking services*

##### 4.3.5.1. Baseline scenario (no changes)

If no changes in EU or national legislations are implemented, continuity of banking services in a crisis situation or in an insolvency of a cross border bank would not be assured in all Member States. Formal reorganisation or liquidation of banks could freeze assets of certain customers or impede any payment transactions in one part of the banking group, while allowing it in an other. The lack of regulation about the bridge bank's contractual relationships with the residual company (in particular with regard to the need to provide continuous mutual support of operations) would render such a resolution technique obsolete, limiting the choices of authorities and resulting in higher costs.

##### 4.3.5.2. Adjustments in company laws and insolvency laws to support continuity of services

Amendments might need to be implemented to company and insolvency laws in certain situations to ensure continuity of basic banking services:

###### 1. Bridge bank solution and partial sales of assets (operation)

For an effective implementation of a bridge bank solution, certain adjustments in legislation would need to be implemented. Both the residual company (in the event of the transfer of business to a bridge bank or a partial sale to a private sector entity) and the transferred part needed to provide support<sup>101</sup> to each other, which are necessary to ensure the continuity of banking services. General insolvency law and company law does not necessarily allow such service provision in an insolvency proceeding, which is special for bridge banks or partial sales under bank resolution. Both insolvency laws and company laws could be amended to support such resolution techniques. This should apply irrespective of whether the entity providing the support is located in the same Member State as the bridge bank or purchaser.

###### 2. Termination of contracts by third parties

In order that continuity of banking services is not jeopardised by the sudden termination of contracts by third parties, it might be also necessary to restrict termination rights under certain circumstances, for example where the contracts are transferred to a bridge bank.

###### 3. Insolvency proceedings prompted by resolution measures

In order to avoid that additional insolvency proceedings are not opened once the relevant national authorities have decided to apply a resolution measure, modifications to national insolvency laws might be needed. Considerations should be given whether to introduce the possibility of simultaneously applying a moratorium<sup>102</sup> to a cross-border banking group undergoing resolution for the purpose

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<sup>101</sup> Such support might be necessary, for example, where certain systems, contracts or services necessary to the operation of a bridge bank have not been transferred from the residual company, or where essential support services were formerly provided to former bank by another group entity.

<sup>102</sup> A legal official (usually a judge) can order a delay of payment due to extenuating circumstances that make one party unable to give payment to another.

of ensuring continuity of services and ensuring an orderly resolution process. This would need to be very short in duration, if the intention was to re-structure the group as a going concern.

*Impacts:*

The above options could help to achieve continuity of services, which could be one of the main objectives of a special bank resolution framework. Customers, mostly private persons and SMEs are often dependent on services of one particular bank. In case of failure, many could suffer further financial losses in addition to the risk to their deposits. If payment services are blocked, private persons may face difficulties keeping up their mortgage or other loan payments, or face being cut off by public utility services (gas, water, electricity). SMEs' business can seriously suffer if they can not pay their suppliers on time. Thus policies above would have positive effects on the stability of the financial sector as a whole and benefit especially households and smaller companies.

If the relation between a bridge bank and the residual company is clearly established by legislation, authorities can apply this technique in a bank resolution. A "Bridge bank" solution (putting the viable part of the business in a new bank) can give time for authorities for finding the best reorganisation solution hence increases the efficiency of the procedure.

Such changes would however require Member States to change general insolvency legislations and/or introduce special administrative bank resolution frameworks.

#### 4.3.5.3. Linkage between objectives and options

##### Early intervention

| <i>Objectives</i>                                                                                                          |                                                                                        |                                                                                                                              |
|----------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|
|                                                                                                                            | Develop tools and triggers to detect problems in banks and intervene at an early stage | Ensure efficient cooperation between national financial supervisors responsible for cross border banks in crisis situations. |
| <i>Policy options</i>                                                                                                      |                                                                                        |                                                                                                                              |
| <b>Possible policies to address early intervention conditions, triggers</b>                                                |                                                                                        |                                                                                                                              |
| Common assessment of common early warning indicators                                                                       | •                                                                                      | ○                                                                                                                            |
| Automatic, hard triggers                                                                                                   | •                                                                                      | ○                                                                                                                            |
| <b>Possible policies to address early intervention tools</b>                                                               |                                                                                        |                                                                                                                              |
| Expanded minimum set of early intervention tools                                                                           | •                                                                                      |                                                                                                                              |
| Single set of early intervention tools                                                                                     | •                                                                                      |                                                                                                                              |
| <b>Possible policies to address misalignment between responsibility of national supervision and international business</b> |                                                                                        |                                                                                                                              |
| Baseline scenario with setting up European Banking Authority                                                               |                                                                                        | •                                                                                                                            |
| Improved cooperation between supervisors in crisis situation                                                               |                                                                                        | •                                                                                                                            |

• Direct link    ○ Indirect link

## Bank resolution

| <i>Objectives</i>                                                                                                          | Develop tools and triggers to ensure reorganisation and resolution of cross border banks in a timely and robust manner | Improve cooperation of national resolution authorities to deliver optimal solutions at EU level | Create certainty and predictability around bank resolutions for all stakeholders | Ensure continuity of basic banking services during resolution |
|----------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------|---------------------------------------------------------------|
| <i>Policy options</i>                                                                                                      |                                                                                                                        |                                                                                                 |                                                                                  |                                                               |
| <b>Possible policies to address bank resolution tools and triggers</b>                                                     |                                                                                                                        |                                                                                                 |                                                                                  |                                                               |
| Minimum set of harmonised bank resolution tools and clear triggers                                                         | •                                                                                                                      | ○                                                                                               | •                                                                                | •                                                             |
| Single set of bank resolution tools                                                                                        | •                                                                                                                      | ○                                                                                               | •                                                                                | •                                                             |
| <b>Possible policies to address misalignment between responsibility of national authorities and international business</b> |                                                                                                                        |                                                                                                 |                                                                                  |                                                               |
| Improved cooperation between resolution and other authorities                                                              |                                                                                                                        | •                                                                                               | ○                                                                                |                                                               |
| Increased powers to EU institutions in bank resolution                                                                     |                                                                                                                        | •                                                                                               | ○                                                                                |                                                               |
| <b>Possible options to address legal obstacles (company, insolvency law) to bank resolution</b>                            |                                                                                                                        |                                                                                                 |                                                                                  |                                                               |
| Adjustments in company and insolvency laws to support bank resolution                                                      | ○                                                                                                                      |                                                                                                 | •                                                                                |                                                               |
| Developing new EU legislation for resolution of cross border banks                                                         | ○                                                                                                                      |                                                                                                 | •                                                                                |                                                               |
| <b>Possible policies to support financing of cross border resolution</b>                                                   |                                                                                                                        |                                                                                                 |                                                                                  |                                                               |
| Adjustments in company law and insolvency laws to support private sector financing of resolution                           | •                                                                                                                      | ○                                                                                               | ○                                                                                |                                                               |
| Intra-group asset transferability framework                                                                                | •                                                                                                                      | ○                                                                                               | ○                                                                                |                                                               |
| Financing through Deposit Guarantee Schemes                                                                                | •                                                                                                                      | ○                                                                                               | ○                                                                                |                                                               |
| Developing public funding arrangements                                                                                     | •                                                                                                                      | ○                                                                                               | ○                                                                                |                                                               |
| <b>Possible policies to support continuity of banking services</b>                                                         |                                                                                                                        |                                                                                                 |                                                                                  |                                                               |
| Adjustments in company and insolvency laws to support continuity of services                                               |                                                                                                                        |                                                                                                 | ○                                                                                | •                                                             |

• Direct link    ○ Indirect link

#### **4.4. Impact on EU budget**

The above policy options do not have any implications for the budget of the European Union. Early intervention and bank resolutions would be primarily managed by national authorities.

#### **4.5. Package and cumulative effects**

The issues listed above comprise wide legislative areas and touch upon substantial responsibilities of authorities. Many policies address problems that have emerged over recent times and have never been analysed and attempted to be solved before. Early intervention and bank resolution are however so interconnected with all the issues described in this impact assessment that policies could not be introduced in isolation. If special bank resolution tools are provided for authorities, cross border cooperation, financing, company law, insolvency law areas need to be adjusted accordingly.

To reach the general and specific objectives defined above, amendments in EU and national laws would be substantial. Granted rights and interests could be sacrificed for financial stability and cooperation structures need to be reshaped to reach optimal results.

## 5. ANNEX I: GLOSSARY

**Bad bank – Good Bank** Bad or Good bank is created when authorities separate good from bad assets by selling non-performing loans and 'toxic' or difficult-to-value assets to a separate asset management vehicle (often referred to as a 'bad bank'). The aim is to sanitise the balance sheet of the failing bank in order to restore it to viability or with a view to facilitating a private sector solution

**Bank resolution** Bank resolution: reorganisation of ailing banks (in either an administrative or judicial process) that aims at maintaining financial stability, the continuity of banking services and the revitalisation of the bank. In addition to traditional reorganisation techniques, bank resolution uses specific tools (e.g. bridge banks, forced merger, assisted acquisition, partial sale of assets) to reach the above objectives. The process is managed by a resolution authority, which can be different in Member States (national bank, financial supervisor, deposit guarantee scheme, ministry of finance, special authority).

|                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|-----------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Basel II</b> | Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. The Basel II framework has 3 pillars: Pillar I Minimum Capital Requirement, Pillar II Supervisory Review Process, Pillar III Market discipline. |
|-----------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

**Bridge bank** A 'bridge bank' is a temporary licensed banking institution created, and generally owned by or on behalf of, the national authority to take over the viable business of the failing institution and preserve it as a going concern while the authority seeks to arrange a permanent resolution, such as to a suitable private sector purchaser.

**Capital adequacy ratio** Capital adequacy ratios ("CAR") are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. A bank's capital is the "cushion" for potential losses, which protect the bank's depositors or other lenders.

|                                 |                                                                                                                                                                                              |
|---------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Consolidating supervisor</b> | The supervisor responsible for the supervision on a consolidated basis of a banking group. As a rule, this is the supervisor of the Member State where the parent bank of the group is based |
|---------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

**Early intervention** Early intervention: early remedial actions of banking supervisors (e.g. raising private capital, modification of business lines, divestiture of assets) which aim at correcting irregularities at banks and hence helping banks returning to normal course of business and avoiding that banks enter in a resolution stage.

**European Banking Authority (EBA)** The objective of the Authority shall be to contribute to: (i) improving the functioning of the internal market, including in particular a high, effective and consistent level of prudential regulation and supervision, (ii) protecting depositors and investors, (iii) protecting the integrity, efficiency and orderly functioning of financial markets, (iv) maintaining the stability of the financial system, and (v) strengthening international supervisory coordination.

**European Supervisory authorities (ESA)** ESA is created by transforming the European supervisory Committees<sup>103</sup> in a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA) and a European Insurance and Occupational Pension Authority (EIOPA)

**European System of Financial supervisors** A network of national supervisors working in tandem with the new European Supervisory Authorities (ESA) thereby combining the advantages of an overarching European framework for financial supervision with the expertise of local micro-prudential supervisory bodies that are

<sup>103</sup> These are the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR).

**(ESFS)** closest to the institutions operating in their jurisdictions.

|                      |                                                                                                                                                                     |
|----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Going concern</b> | A going concern is a business that functions with the intention or threat of liquidation for the foreseeable future, usually regarded as at least within 12 months. |
|----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|

**Leverage ratio** A ratio that compares capital with assets without risk adjustment. The Commission is working on a proposal to supplement the capital adequacy ratio with a simple leverage ratio.

**Memorandum of Understanding (MoU)** A set of principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance by participating authorities of their respective policy functions

**Pillar II** The second pillar of the Basel Framework that deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It gives banks a power to review their risk management system.

**Set-off / Netting** An agreement between two parties to balance one debt against another or a loss against a gain.

**Supervisory Review and Evaluation Process (SREP)** The Supervisory Review and Evaluation Process (SREP) is part of the larger Supervisory Review Process. The competent authority conducts the SREP. It is a comprehensive process which supervisors use to review and evaluate the institution's exposure to risks. It is also used to review and evaluate the adequacy and reliability of the institution's Internal Capital Adequacy Assessment Process (ICAAP), and the adequacy of the institution's own funds and internal capital in relation to the assessment of its overall risk profile. It is done to monitor ongoing compliance with standards laid down in the CRD and to identify any weakness or inadequacies and necessary prudential measures

**6. ANNEX II: EXTRACT FROM THE DE LAROSIÈRE REPORT DEALING WITH CRISIS MANAGEMENT AND RESOLUTION**

**VI. CRISIS MANAGEMENT AND RESOLUTION**

125. As a general observation, it has been clearly demonstrated that the stakes in a banking crisis are high for Governments and society at large because such a situation has the potential to jeopardise financial stability and the real economy. The crisis has also shown that crisis prevention, crisis management and crisis resolution tools should all be handled in a consistent regulatory framework.
126. Of course, crisis prevention should be the first preoccupation of national and EU authorities (see chapter on supervision). Supervisors should act as early as possible in order to address the vulnerabilities identified in a given institution, and use all means available to them to this effect (e.g. calling on contributions from shareholders, fostering the acquisition of the institution concerned by a stronger one). In this respect, the role of central banks which are by essence well placed to observe the first signs of vulnerability of a bank is of crucial importance. Therefore in countries where supervision is not in the hands of the central bank, a close collaboration must be ensured between supervisors and central banks. But crises will always occur and recent experiences in managing crises have shown that many improvements to the present system are called for.

**a) Dealing with the moral hazard issue**

127. “Constructive ambiguity” regarding decisions whether or not public sector support will be made available can be useful to contain moral hazard. However, the cure for moral hazard is not to be ambiguous on the issue of public sector involvement as such in crisis management. Two aspects need to be distinguished and require different treatment. On the one hand, a clear and consistent framework for crisis management is required with full transparency and certainty that the authorities have developed concrete crisis management plans to be used in cases where absence of such public sector support is likely to create uncertainty and threaten financial stability. On the other hand, constructive ambiguity and uncertainty is appropriate in the application of these arrangements in future individual cases of distressed banks<sup>104</sup>.

**b) Framework for dealing with distressed banks**

128. In the management of a crisis, priority should always be given to private-sector solutions (e.g. restructuring). When these solutions appear insufficient, then public authorities have to play a more prominent role and the injection of public money becomes often inevitable.
129. As far as domestic national banks are concerned, crisis management should be kept at the national level. National supervisors know the banks well, the political

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<sup>104</sup> This approach is recommended by Charles Goodhart and Dirk Schoenmaker, “Fiscal Burden Sharing in Cross Border Banking Crises”, in International Journal of Central Banking, to be published early 2009.

authorities have at their disposal a consistent legal framework and taxpayers' concerns can be dealt with in the democratic framework of an elected government. For cross-border institutions at EU level, because of different supervisory, crisis management and resolution tools as well as different company and insolvency laws, the situation is much more complex to handle. There are inconsistencies between national legislation preventing an orderly and efficient handling of an institution in difficulty.

130. For example, company law provisions in some countries prevent in times of crisis the transfer of assets from one legal entity to another within the same group. This makes it impossible to transfer assets where they are needed, even though this may be crucial to safeguard the viability of the group as a whole. Another problem is that some countries place, in their national laws, emphasis on the protection of the institution while other countries attach a greater priority to the protection of creditors. In the crisis resolution phase, other problems appear: for example, the ranks of creditors are different from one Member State to the other.
131. The lack of consistent crisis management and resolution tools across the Single Market places Europe at a disadvantage vis-à-vis the US and these issues should be addressed by the adoption at EU level of adequate measures.

### **c) Deposit Guarantee Schemes (DGS)**

132. The crisis has demonstrated that the current organisation of DGSs in the Member States was a major weakness in the EU banking regulatory framework<sup>105</sup>. The Commission recent proposal is an important step to improve the current regime, as it will improve the protection of depositors.
133. A critical element of this proposal is the requirement that all Member States apply the same amount of DGS protection for each depositor. The EU cannot indeed continue to rely on the principle of a minimum coverage level, which can be topped-up at national level. This principle presents two major flaws: first, in a situation

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The Commission's recent proposal is an important step to improve the current DGS-regime, as it strengthens harmonisation and improves the protection of depositors. However, the directive still leaves a large degree of discretion to member states, particularly in relation to funding arrangements, administrative responsibility and the role of DGS in the overall crisis management framework. Leaving these issues unresolved at EU-level implies that significant weaknesses remain in the DGS framework, including inter alia:

- Unsustainable funding – the current lack of sophisticated and risk sensitive funding arrangements involves a significant risk that governments will have to carry the financial burden intended for the banks, or worse, that the DGS fails on their commitments (both of which illustrated by the Icelandic case). In particular, in relation to the any of the 43 European LFCIs identified earlier in the chapter, no current scheme can be expected to have the capacity to make reimbursements without involving public funds.
- Limited use in crisis management – Even if DGS' had that capacity, the pay box nature of most schemes makes it unlikely that they ever will be utilised for LFCIs, because of the large externalities associated with letting such institutions fail.
- Negative effects on financial stability – reliance on ex-post funding and lack of risk sensitive premiums weakens market discipline (moral hazard), distort the efficient allocation of deposits, as well as it may be a source of pro-cyclicality.
- Obstacle to efficient crisis management – due to incompatible schemes (trigger points, early intervention powers etc.) and diverging incentives among member states.

where a national banking sector is perceived as becoming fragile, there is the risk that deposits would be moved to the countries with the most protective regime (thus weakening banks in the first country even further); second, it would mean that in the same Member State the customers of a local bank and those using the services of a third country branch could enjoy different coverage levels. As the crisis has shown, this cannot be reconciled with the notion of a well-functioning Single Market.

134. Another important element to be taken into account is the way in which the DGSs are funded. In this respect, the Group is of the view that preference should be given to schemes which are pre-funded by the financial sector. Such schemes are better to foster confidence and help avoiding pro-cyclical effects resulting from banks having to pay into the schemes at a time where they are already in difficulty.
135. Normally, pre-funded DGSs should take care in the future of losses incurred by depositors. Nonetheless, it is probable that for very large and cross border institutions, pre-funded mechanisms might not be sufficient to cover these guarantees. In order to preserve trust in the system, it should be made clear that in those cases pre-funded schemes would have to be topped-up by the State.
136. The idea of a pooled EU fund, composed of the national deposit guarantee funds, has been discussed by the Group, but has not been supported. The setting-up and management of such a fund would raise numerous political and practical problems. Furthermore, one fails to see the added-value that such a fund would have in comparison to national funds operating under well-harmonised rules (notably for coverage levels and the triggering of the scheme).

EU harmonization should not go as far either as laying down rules on the possible use of DGSs in the management of a crisis. It should not prohibit additional roles beyond the base task for a DGS to act ex post, in the crisis resolution phase, as a pay box by reimbursing the guaranteed amount to depositors in a defaulted bank. Most member countries limit their national DGS to this pay box function. Some countries, however, extend the activities by giving their DGS also a rescue function. The Group did not see any need for EU harmonization in this respect.

137. There is a specific case (of the Icelandic type) when a supervisory authority allows some of its banks to mushroom large branches in other EU countries, whilst the home Member State is not able to honour the deposit guarantee schemes which are inadequate for such exposures. The guarantee responsibilities then de facto fall into the jurisdiction of the host country. This is not acceptable and should at least be addressed, for example, in the following way: the host Member State should have the right to inquire whether the funds available in the DGS of the home Member State are indeed sufficient to protect fully the depositors in the host Member State. Should the host Member State not have sufficient guarantees that this is indeed the case, the only way to address this kind of problem is to give sufficient powers to the host supervisory authorities to take measures that would at the very beginning curtail the expansive trends observed.
138. The Group has not entered into the specifics of the protection of policy-holders and investors. It nevertheless considers that the above general principles, and in particular the equal protection of all customers in the Single Market, should also be implemented in the insurance and investment sectors.

#### **d) Burden sharing**

139. The issue of burden sharing in cases of crisis resolution is extremely complicated for two reasons. First, cases where financial support from both public sector and private sector is needed to reach an acceptable solution are more complex than rescues where either private or public money is involved. Second, agreement on burden sharing on an ex post basis, at the moment of the rescue operation, is more difficult to reach than when one can rely on predetermined, ex ante arrangements.
140. As noted above, the current lack of pan-EU mechanism to resolve a crisis affecting a cross-border group implies that there is no choice but to resolve this crisis at national entity-level or to agree on improvised, ad hoc cross-border solutions. The lack of a financing mechanism to support the resolution of a cross-border group further complicates the situation.
141. On the basis of the experiences learnt from the crisis, the Group believes that the Member States should become able to manage a crisis in a more adequate way than is feasible today. There would be merit, in order to achieve this, in developing more detailed criteria on burden sharing than the principles established in the current Memorandum of Understanding (MoU), which limits the sharing of a fiscal burden to two main principles: the economic impact of the crisis on the Member States concerned (equity principle) and the allocation of home/host supervisory powers (accountability principle).
142. Burden sharing arrangements could, in addition, include one of the following criteria, or a combination thereof:
- the deposits of the institution;
  - the assets (either in terms of accounting values, market values or risk-weighted values) of the institution;
  - the revenue flows of the institution;
  - the share of payment system flows of the institution;
  - the division of supervisory responsibility; the party responsible for supervisory work, analysis and decision being also responsible for an appropriately larger share of the costs.
143. These criteria would preferably be implemented by amending the 2008 MoU. Where needed, additional criteria could be agreed.

***Recommendation 13: The Group calls for a coherent and workable regulatory framework for crisis management in the EU:***

- *without pre-judging the intervention in future individual cases of distressed financial institutions, a transparent and clear framework for managing crises should be developed;*
- *all relevant authorities in the EU should be equipped with appropriate and equivalent crisis prevention and crisis intervention tools;*

- *legal obstacles which stand in the way of using these tools in a cross-border context should be removed, with adequate measures to be adopted at EU level.*
- *Recommendation 14: Deposit Guarantee Schemes (DGS) in the EU should be harmonised and preferably be pre-funded by the private sector (in exceptional cases topped up by the State) and provide high, equal protection to all bank customers throughout the EU.*

*The principle of high, equal protection of all customers should also be implemented in the insurance and investment sectors.*

*The Group recognises that the present arrangements for safeguarding the interests of depositors in host countries have not proved robust in all cases, and recommends that the existing powers of host countries in respect of branches be reviewed to deal with the problems which have occurred in this context.*

*Recommendation 15: In view of the absence of an EU-level mechanisms for financing cross-border crisis resolution efforts, Member States should agree on more detailed criteria for burden sharing than those contained in the existing Memorandum of Understanding (MoU) and amend the MoU accordingly.*

## 7. ANNEX III: MAIN ELEMENTS OF A POSSIBLE FUTURE FRAMEWORK (EXTRACT FROM THE COMMISSION COMMUNICATION)

The issues that need to be addressed in order to construct an EU crisis management framework to deal with cross-border banks are described in greater detail in the Communication and accompanying staff working document. The table below provides an overview of what those issues are and when they are likely to be relevant. Measures aimed at strengthening crisis prevention fall outside the scope of the Communication, and are the subject of separate Commission initiatives.

The Communication covers three areas that, for the purposes of discussion, are presented as conceptually distinct. These are:

1. **Early intervention** (section 3), covering actions by supervisors with the aim of restoring the stability and financial soundness of an institution when problems are developing, together with intra-group asset transfer between solvent entities for the purposes of financial support. These actions would be taken before the thresholds conditions for resolution are met, and before it is or likely to become insolvent (within the meaning of the applicable law). The new European Banking Authority could play a role in coordinating supervisory early intervention in a cross-border group;
2. **Resolution** (section 4), covering measures taken by national resolution authorities to manage a crisis in a banking institution, to contain its impact on financial stability and, where appropriate, to facilitate an orderly winding up of the whole or parts of the institution. These measures take place outside of the framework of banking supervision, and may be taken by authorities other than supervisors, although it is by no means precluded that supervisors might be involved.
3. **Insolvency** (Section 5), covering reorganisation and winding up that takes place under the applicable insolvency regime.

Although these measures are presented as conceptually distinct, they do not necessarily constitute separate and sequential 'phases' of a crisis. In practice, there may be considerable overlap between resolution and insolvency, in particular, and supervisory early intervention may move rapidly into resolution measures.

|                                    | Going concern supervision/Crisis prevention                                                                                                                                                                                                                                             | ↔ Scope of the Crisis Management Communication ↔                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                |
|------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                    |                                                                                                                                                                                                                                                                                         | Early intervention                                                                                                                                                                                                                                           | Bank resolution                                                                                                                                                                                                                                                    | Insolvency framework                                                                                                                                                                                                                           |
| Current situation                  | Capital Requirements Directive 3 pillar approach (CRD)<br>Colleges<br>National authorities<br>Committee of European Banking Supervisors (CEBS)<br>Stress testing                                                                                                                        | CRD (Art. 130 + 136)<br>Colleges<br>Emergency Liquidity Assistance by National Central Banks (NCBs)<br>2008 MoU                                                                                                                                              | 2008 MoU – determines who (e.g. finance ministries, NCBs) coordinates actions with other competent authorities (coordination via cross-border stability groups)                                                                                                    | Winding up Directive:<br>Winding-up of a cross-border branches takes place under insolvency procedures of country of parent bank.<br>Winding up of cross-border subsidiaries takes place according to procedures where subsidiary is licensed. |
| Possible changes for consideration | Establish European Systemic Risk Board (ESRB) and European Banking Authority (EBA)<br>Leverage ratio<br>Management of risks (remuneration structures)<br>Quantity and Quality of capital<br>Enhanced capital requirements<br>Supervision of liquidity<br>Preparation of Wind-down plans | European Banking Authority<br>New powers towards bank management<br>Joint assessment framework<br>Restoration plans<br>Asset transferability framework<br>Expanded common tools for supervisors (CEBS)<br>Clarify home/host branch supervision (Art. 33 CRD) | New bank resolution tools<br>New framework for cooperation<br>Broader changes to the legal framework in support of new bank resolution tools<br>Mechanisms to finance cross-border resolutions (including possible role for DGS)<br>Application of wind-down plans | Facilitate integrated winding up of a group:<br>– Coordination framework for insolvency proceedings<br>– Lead insolvency administrator<br>– Integrated resolution by a single authority<br>– Asset transfers under post commencement financing |

**8. ANNEX IV. SUMMARY OF THE PUBLIC CONSULTATION CONCERNING DIRECTIVE ON THE REORGANISATION AND WINDING UP OF CREDIT INSTITUTIONS (2001/24/EC).**

**Main results of the consultation<sup>106</sup>**

In May 2007, the Commission launched a public consultation on: (i) whether Directive 2001/24/EC on the reorganisation and winding up of credit institutions leaves gaps or ambiguities that need to be removed; and (ii) issues arising in the context of crisis management and resolution for banking groups (i.e. parent credit institutions with subsidiaries in other Member States). The purpose of the public consultation was to take stock of Member States' legal frameworks relating to the reorganisation of banking groups, and to identify possible problems preventing smooth crisis management, which may involve asset transfers within banking groups.

In response to its consultation, the Commission received 51 answers to the consultation; 39 were from Member States' national authorities and 12 from industry. The Commission's report on the public consultation summarised the responses and presented an overview of the policy issues raised by respondents (Ministries of Finance, Justice, Economic Affairs, financial supervisors, national and international industry associations, deposit guarantee schemes, central banks).

**Problems, ambiguities in the current text**

Even though the Directive's rules have never been applied in practice, respondents expressed their views on a number of provisions that might need clarification or amendment. Respondents asked for more clarity on issues related to the role of host authorities, equivalence of claims, form of publication, deadlines, and provisions on information exchange.

Respondents also called for new legislation catering for the insolvency of cross-border branches of investment firms and payment institutions, which are at present not covered by any directives. A more precise reference to e-money institutions in this context would also be welcomed by some respondents.

**Extension of the Directive — winding-up of cross-border banking groups**

Member States and the industry broadly supported a legal framework tailored to the winding-up and reorganisation of cross-border banking groups. This would contribute to further enhancing the financial stability arrangements given the increased activity of cross-border financial groups.

Respondents proposed a set of possible solutions regarding both the winding-up and reorganisation of cross-border banking groups and the reduction of obstacles to asset

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<sup>106</sup> All consultation documents are available on the following website:  
[http://ec.europa.eu/internal\\_market/bank/windingup/index\\_en.htm](http://ec.europa.eu/internal_market/bank/windingup/index_en.htm)

transferability. Some of these solutions might be mutually exclusive, while others might be applied cumulatively.

Possible options/solutions suggested by respondents could include:

- (i) Full harmonisation across Member States;
- (ii) Harmonisation limited to specific circumstances (e.g. in case of intermingled assets, confusion of proceedings, cases of mismanagement);
- (iii) Coordination of multiple insolvency proceedings by a “lead” insolvency administrator governed by the law of each Member State;
- (iv) Possibility for all creditors to file claims against any insolvent entities of the group;
- (v) Mere cooperation (requirement for administrators to cooperate and for the judicial/administrative authorities to consult the authorities of the home country of the parent company).

### **Asset transferability within a cross-border banking group**

The following solutions might be considered to address legal obstacles to asset transferability:

- (i) Full harmonisation to overcome obstacles in terms of company law, banking law and insolvency law;
- (ii) Harmonisation with respect to some key issues (e.g. group’s interest in company law);
- (iii) Supervisory arrangements for asset transferability (e.g. agreement of home and host banking supervisory authorities) and conditions to allow asset transferability;
- (iv) Mutual intra-group agreement (i.e. intra-group guarantees).

However, in the interest of financial stability, such asset transfer should not be detrimental to entities from which assets have been transferred. The overall benefit of stakeholders (shareholders, creditors, governments, and employees) needs to be assured. Adequate safeguards could include:

- guarantees provided by the parent or another entity of the group;
- access to all proceedings for creditors with a priority right;
- cooperation and agreement of national authorities to transfer of assets;
- protection of minority shareholders, creditors and the entity transferring assets as part of a group’s winding-up or reorganisation process.

### **Powers of supervisors**

Any EU-wide approach to winding-up and asset transferability may require similar specific powers for authorities to fully and effectively cooperate. In this respect, the consultation has demonstrated that the EU legal framework is fragmented. The extent of banking supervisory authorities’ involvement in crisis resolution and management varies from one country to another. Future work needs to address this situation in order to enable banking supervisory authorities (hereinafter “competent authorities”) and other authorities to work together effectively.