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Delegations will find attached Commission document SEC(2009) 1407/09.

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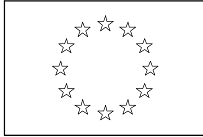

COMMISSION OF THE EUROPEAN COMMUNITIES

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0COMMISSION STAFF WORKING DOCUMENT

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

An EU Framework for Cross-border Crisis Management in the Banking Sector

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Purpose of the Commission Staff Working Paper

This Commission Staff Working Paper accompanies the Commission Communication entitled "An EU Framework for Cross-Border Crisis Management in the Banking Sector". Its purpose is to provide further clarification of specific issues raised in the Communication, and to articulate a number of question to which the Commission services are seeking answers.

1. CHAPTER 1 - SCOPE OF AN EU BANK RESOLUTION REGIME

Section 1 - The Issue

The Communication focuses on the need for, and nature of, a regime for reorganising and resolving cross-border banking groups under a coordinated or integrated resolution framework. However, this Chapter discusses whether the EU resolution framework should also include credit institutions with cross-border branches, because experience has shown that those banks can also present a real risk to financial stability in Member States where the branches carry on significant amounts of deposit-taking business. Furthermore, as banking groups often include entities that carry on investment activities and other financial services, it would make sense for a harmonised EU resolution regime extend to investment firms and possibly to insurers.

Section 2 – Which financial institutions?

Focus on deposit-taking banks

1. A specific regime for deposit-taking banks is only justified if it is accepted that banks are 'special' - that is, different from other regulated financial sector entities – and that there are particular risks associated with the failure of a bank that cannot be adequately managed in all cases by ordinary insolvency procedures that would apply to other financial institutions (or commercial enterprises generally).

2. There are strong reasons to assert that banks are indeed different. They play a unique market and economic role, performing financial services that are fundamental to the functioning of the economy: the taking of deposits, extension of credit, processing of payments and provision of financial infrastructure services more broadly. They are a direct source of credit and liquidity, through loans and guarantees, for financial and non-financial enterprises, and are the channel through which monetary policy is given effect in the real economy. While it is true that other financial institutions perform some of these functions, no entities other than credit institutions perform all of them. In particular, non-bank institutions do not offer immediately available liabilities to the public at large in the form of bank deposits, and do not provide payment services.

3. Furthermore, deposit-taking banks are peculiarly vulnerable to loss of public confidence. Retail depositors are generally not in a position to monitor and assess the financial position of a bank. However, this inequality of information and reliance on trust means that the slightest rumour that a bank's financial position is precarious is likely to trigger a bank run, as depositors seek to protect their individual interests by withdrawing their money as quickly as possible. Any reaction of this kind, whether or not it is in fact reasonable, will almost certainly precipitate rapid worsening of the bank's situation by making it more difficult and costly for the bank to obtain market funding.

4. Moreover, in highly inter-connected financial markets, the failure of one bank can be contagious. Such "negative externalities", arising from inter-bank exposures, fire sales of assets and a possible drying up of liquidity mean that bank failures carry the risk of wider systemic consequences that threaten financial stability and the integrity of the payment system.

Risks posed by failure of other financial institutions

5. Nevertheless, there are arguments that the failure of other kinds of financial institution may also pose systemic risks to the financial system that may justify conferring specific powers for authorities to manage the impact of such a failure. For example, investment firms (and in particular broker-dealers) differ from many other financial institutions in that they hold securities and cash on behalf of their clients. They may also be highly connected to other market participants through the volume of their trading and positions in derivatives. Market stability concerns also arise from the exercise of close out rights immediately insolvency is triggered. Simultaneous market activity of thousands of counterparties can cause the price of affected assets to collapse. Moreover, counterparties may be required to use the asset values determined in closing out such contracts to establish market prices for similar assets subject to contracts with third parties, so transmitting the instability of the debtor beyond its counterparties.

6. The market impact of the collapse of the Lehman group supports the view that an investment bank can be systemically important. Uncertainty about the status and location of client assets and collateral, and the status of its open trades and derivative positions caused substantial difficulties for its clients and counterparties. Moreover, the impact was much broader: several money market funds had significant exposures to Lehman and concerns about the stability of money market funds caused investors to withdraw funds, further exacerbating instability in the financial system. Similarly, the provision of financial support by the US government to AIG was motivated by the need to avert the risks to the global financial system of disorderly failure of a complex entity in a fragile market environment. The "inter-connectedness" of AIG as a result of its credit default swaps business meant that the market impact of its failure would have been too great.

7. In the US, the need for additional tools to address systemically significant financial institutions that fall outside the existing resolution regime under the FDIC has been extensively discussed in the wake of the Government funding of AIG and the bankruptcy of Lehman Brothers. The UK has also recently consulted on the development of effective resolution arrangements for investment banks.[1]

8. However, the resolution measures that are appropriate for deposit-taking banks may not necessarily be appropriate for other kinds of financial institution. For example, the power to transfer assets and liabilities to a 'bridge bank' may be suitable for deposit-taking banks because of the nature of their activities and the

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1 http://www.hm-treasury.gov.uk/consult_investment_banks.htm

objectives of the resolution, but less relevant for investment banks, where the focus of a resolution regime may be to address problems and uncertainties in respect of trading, clearing and settlement, collateral and custody of client assets.

Section 3 – What type of credit institutions?

Application to cross-border credit institutions (branches) and cross-border groups (subsidiaries)

9. Under the Credit Institutions Winding-Up and Reorganisation Directive ("CIWUD"),[2] cross-border *branches* of credit institutions are treated as part of the credit institution, and are therefore included in the insolvency proceedings for that institution under the applicable regime of the home Member State. This is an important principle underpinning the internal market. However the Directive does not harmonise substantive insolvency law provisions (including reorganisation or resolution measures). In the event of the failure of a bank, the treatment of depositors with branches in other Member States will depend on the resolution measures taken by the home Member State. If poorly-managed, the failure of a credit institution may have a negative impact on foreign depositors. Events during this crisis have shown that in extreme circumstances the financial stability of the host Member State can be affected.

10. However, CIWUD does not cover groups (with *subsidiaries* in other Member States). As a result, each subsidiary is subject to the insolvency regime of the State where it is established. If the scope of a bank resolution framework is limited to cross-border banking groups, the question remains whether the resolution of group entities should take place as coordinated national proceedings, or whether a framework for 'integrated' resolution is needed.

11. Under a framework based on coordination, resolution would take place at the level of each legal entity within a group, and be subject to the insolvency law of the country of origin under CIWUD. As banking groups often consist of both deposit taking and non-deposit taking entities, a resolution regime might need to be extended to investment firms,[3] financial institutions, and possibly even insurance companies. Integration of market and of activities means it is increasingly difficult to resolve deposit-takers in isolation. By contrast, under an integrated EU resolution framework all group entities under resolution would be dealt with under a single procedure, and would necessarily include non-deposit takers that are part of a group. This is discussed further in Chapter 8.

'Systemically important' banks/groups

12. The application of an EU resolution framework might be further restricted to 'systemically important' cross-border banks or banking groups. The potential problems associated with systemically important banks and the appropriate

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[2] Directive 2001/24/EC

[3] Currently investment firms are covered neither by the Winding-Up and Reorganisation Directive nor by the Insolvency Regulation.

policy and legislative responses are currently being discussed in the context of the G20 and the Basel Committee for Banking Supervision.

13. Any restriction of the regime to systemically important institutions or groups would require a clear definition of this concept or the identification of the institutions that fall into this category.

14. This might be done by identifying in advance the characteristics of systemically important institutions. Possible factors include:

- *size* – an institution that is "too big to fail" – measured by one or more of market capitalisation, total gross assets, total exposure (as measured by a leverage ratio), total risk weighted assets, share of EU or national insured deposits, and proportion of its EU or national market share;

- *inter-connectedness* – the likely impact that the failure would have on counterparties and other market participants – measured by one or more of proportion of capital flows, size or distribution of counterparty risk capital requirement, share of trades on clearing houses or exchanges, provision of services to other financial institutions (for example fund management, custody and reinsurance), or level of involvement in OTC markets for derivatives or credit default swaps;

- *complexity* – which may be correlated with the likely level of difficulty of managing the wind-down in the event of failure – measured by one or more of legal structure, business model, nature and level of intra-group exposures, use of unregulated entities and level of activity in complex products;

- the *role* of the institution in payment systems or other essential services.

The definition is clearly critical and potentially very complex. A more simple definition carries the risk that it would not cover all necessary cases. Specifically, experience has shown that banks which would not meet most standard definitions of systemic importance can pose real risks to financial stability in Member States where they carry on cross-border business through branches. A more complex definition would, on the other hand, offer a more comprehensive coverage of risk, but would also be harder to implement.

15. Alternatively, the identification of systemic importance could be linked to the process of preparing "wind-down plans" or "living wills" that is discussed in Chapter 2. The application of a bank resolution regime would be determined only after a thorough examination about how best to resolve the specific institution. However, if any regulatory requirement for "living wills" only applied to systemically important institutions, some kind of ex ante definition would have to be formulated and applied.

16. In any event, transparency and legal certainty would be crucial. There should be no scope for any ambiguity as to whether a resolution regime for 'systemically important' institutions applies in any particular case.

17. The existence of a resolution regime for systemically important banks could help address the widely discussed risks of 'moral hazard' associated with the perception that a bank is 'too big – or too inter-connected – to fail'. The creation of framework under which it is possible to manage the failure of a systemically important institution and to minimise its impact would clearly increase the likelihood that such a bank would be allowed to fail. This is turn should improve market discipline since debt holders would no longer consider themselves to be insulated from losses.

18. The question, therefore, is whether an EU resolution regime should be developed specifically, and exclusively, for systemically important cross-border banks, or whether this would be too restrictive. If the concept of systemic importance is useful in this context, the Commission would welcome views on how this concept should be defined and how the relevant institutions should be identified.

Implications for the design of a Resolution framework

19. If a bank is not systemically significant, executing an orderly restructuring under the normal processes of insolvency law, or a winding up process that promptly reimburses insured depositors, maximises the proceeds for creditors and quickly transfers viable operations to other banks may well be the best solution. But if a failing cross-border bank is systemically significant, the principal priority of a resolution is likely to be the maintenance of critical functions performed by that bank, which in turn will mean that different tools – such as the use of a bridge bank or transfer of business to another private sector entity - will almost certainly be more appropriate. The larger and more complex the failing bank, the more likely that a bridge bank structure may be required in cases of urgency where private sector purchasers are unable to carry out the necessary due diligence within the short timeframe available.

Section 4 –Questions

(1) Should an EU regime focus exclusively on deposit-taking banks (as opposed to any other regulated financial institution)?

(2) Should an EU regime apply exclusively to cross-border banking groups, or should it also encompass single entities which only operate cross-border (if at all) through branches?

(3) Should an EU regime apply exclusively to, 'systemically important' institutions? If so, how should this concept be defined and how should the relevant institutions be identified?

2. CHAPTER 2 - EARLY INTERVENTION – SUPERVISORY TOOLS

Section 1 - The Issue

Some elements of a framework for early intervention by supervisors already exist under Article 136 of the Capital Requirements Directive. However, significant gaps remain. There is clear evidence from recent events that the supervisory framework has not been sufficiently robust to support efficient coordination of supervisory measures aimed at restoring a cross-border group.

Section 2 – Current legal framework

EU legal framework

20. Remedial intervention by supervisors is only effective if taken at an early stage of financial difficulty when the firm, although at risk, is still a going concern. This includes the measures that can be imposed under Article 136 of the Capital Requirements Directive ('CRD'),[4] for example, a requirement to increase the institution's own funds above the minimum level specified in the Directive; a strengthening of internal organisation and governance arrangements; a requirement that the institution should apply a specific provisioning policy; a restriction on the business or operations of the credit institution; or a requirement that the institution reduce the risk inherent in its activities, products or systems. Such measures leave control of the institution in the hands of the management[5] and do not represent a significant interference with the rights of shareholders or creditors.

21. 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.[6] In addition, the Committee of European Banking Supervisors ('CEBS') (or in due course the European Banking Authority) is required to develop guidelines on the joint conduct of the Pillar 2 review (including the supervisory risk assessment[7]). However, these changes may not go far enough in ensuring that supervisors have adequate powers and tools to support an effective early intervention regime.

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4 Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast).

5 Nevertheless, some countries, e.g. France have the power to replace the management of a bank by nominating a special administrator.

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

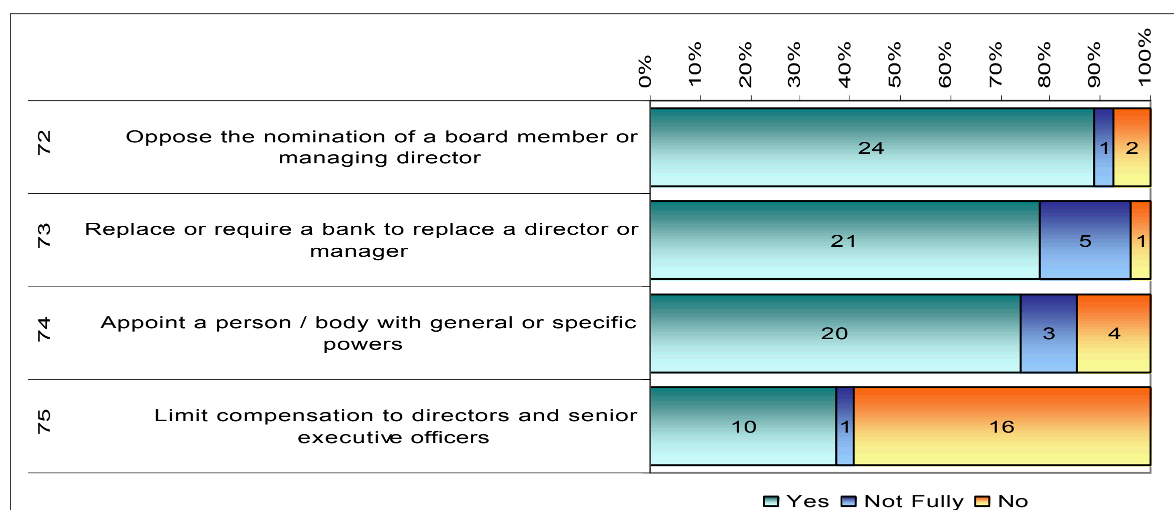
7 Article 129(3) of "CRD 2", see text of Commission proposal: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008PC0602:EN:NOT

National frameworks

22. Powers and tools available to supervisory authorities in emergency situations differ significantly across Member States. A survey conducted by CEBS[8] shows that even where limited EU harmonisation exists (Article 136 CRD), powers are not uniform. The differences are even greater with respect to powers related to the management body, to the shareholders and capital-related measures.

23. While many supervisors have powers over the composition of the bank management (to oppose nomination or require replacement), only some are empowered to appoint a special representative or administrator in an institution that is solvent and a going concern. In Italy, for example, the Minister for the Economy and Finance can appoint a provisional administrator on a proposal from the *Banca d'Italia*. In France the *Commission bancaire* has independent powers to appoint a provisional administrator to a bank. The powers of the administrator also differ. In some Member States (for example, France and Italy) the administrator can replace completely the management of the bank, while in others (for example, Austria and Luxembourg) the administrator only supervises the management and controls decisions which go beyond the ordinary course of business. Powers do not generally extend beyond that of a CEO. Reorganisation measures (such as mergers or the sale of business) cannot generally be imposed without the consent of the shareholders. In France, when a provisional administrator or a liquidator has been appointed, the *Commission bancaire*, having obtained the opinion of the deposit insurance fund, may apply to court for permission to order the transfer of the shares held by one or more executives of that institution. In Italy, special administrators operate under an oversight committee which exercises control over the measures and gives opinions.

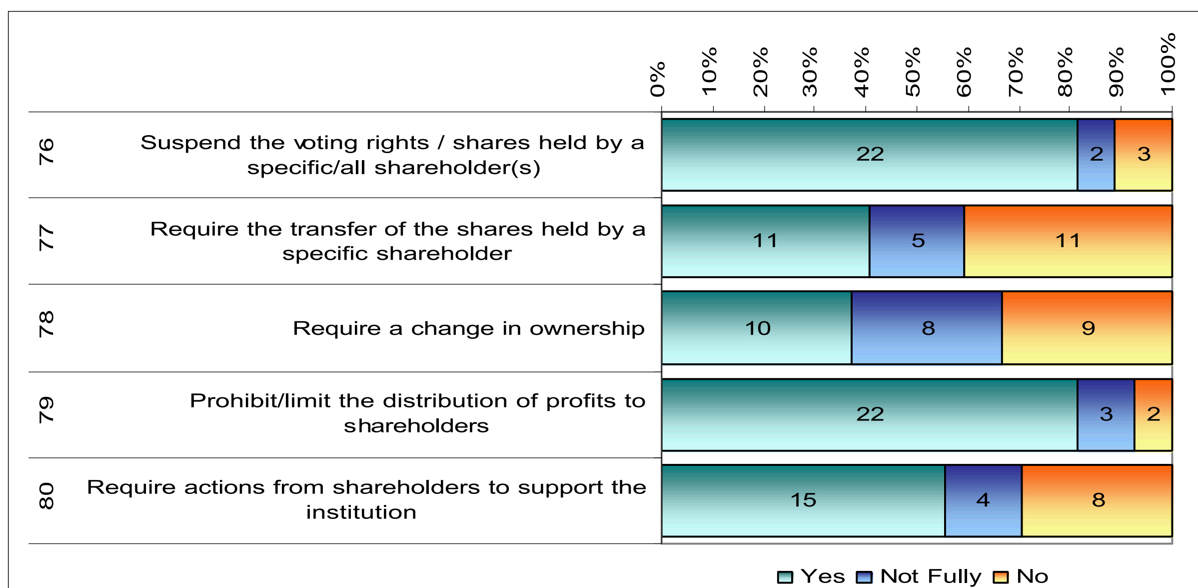
Chart 1: Competent authorities' power over the management body of a bank (source: CEBS)



8 CEBS, Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers, March 2009

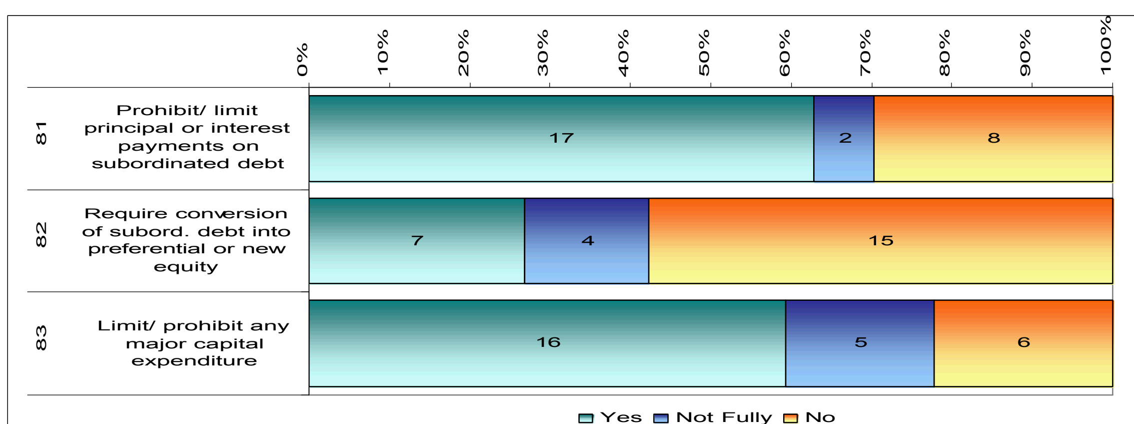
24. Measures directed at the shareholders are outlined in Chart 2 below. They can only be exercised at severely distressed institutions, and with a view to achieving wider public policy objectives, such as maintaining financial stability or protecting depositors' interests.

Chart 2: measures directed at shareholders (Source: CEBS)



25. In terms of capital related measures, only a minority of competent authorities have the power to require a bank to convert its subordinated debt into equity, whereas the majority of authorities have the power to limit or prohibit certain capital payments.

Chart 3 – Capital related measures (Source: CEBS)



26. Powers also differ in relation to 'restoration plans'. Only 16 authorities have the powers to coordinate a rescue plan before insolvency is declared. The powers to fully implement emergency measures (for example, coordination of a private sector take-over, setting up of a bridge bank) also vary from one country to another.

Section 3 – Adequacy of the current framework

Supervisory tools

27. Discrepancies between supervisors' tools and powers have the potential to compromise the effectiveness of a coordinated response to emergency situations. In particular, as indicated above, not all national supervisors have the power to require the individual entities that they supervise to submit a 'restoration plan'. Nor is there any clear framework to do this at the level of a cross-border group.

28. The effectiveness of some measures has also been called into question. In particular, CEBS emphasised that the exercise of powers directed at the shareholders may raise legal issues - as borne out by the Fortis case. As the conditions under which supervisors may exercise these powers can differ, CEBS has recommended that further clarity be sought on the ways in which these powers can be activated and how they relate to the relevant EU Company Law Directives and provisions of national company law.

Joint assessment

29. While the CRD requires joint assessment in both going concern and emergency situations, the Directive does not specify the conditions that trigger the application of specific supervisory powers, nor how joint assessment should be conducted. If national law or national supervisors interpret and apply those conditions differently, coordinated action by supervisors of different group entities might be difficult. CEBS has also noted the absence of a common set of indicators and agreed terminology between EU supervisors which would clearly define how indicators should be interpreted and applied.[9] CEBS has already identified indicators for liquidity risk and is working on other indicators to capture other risks in the context of a joint risk assessment system.

Contingency

30. The crisis has shown that some group structures may be simply too complex to manage in a crisis. In the context of contingency plans that will be required under recent changes to the CRD,[10] it may be useful to explore whether large banks should be obliged to prepare 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 the institution, the implications of legal separateness in case of resolution and the possible exercise of resolution powers. This is discussed in more detail in paragraphs 42 to 47 below.

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[9] CEBS, Mapping of supervisory objectives and powers including early intervention measures and sanctioning powers, January 2009

[10] Article 129(1)(c) of "CRD 2"

Supervision of branches

31. The supervision of the cross-border branches of a credit institution is, for most purposes, the responsibility of the regulator of the bank's home Member State. This is subject to very limited exceptions: most importantly, the regulator of the 'host' State where the branch is established shares responsibility for the supervision of liquidity in relation to the branch with the home supervisor. This principle of home State control is intended to facilitate passporting and is fundamental to the freedom of establishment under the EC Treaty.

32. It follows from this principle that the powers of the host supervisor to intervene directly in the business of a branch should be limited to those that are strictly necessary to protect depositors and investors in the host State. Currently, those powers are restricted to a power to take 'precautionary measures' in 'emergencies'.[11] The nature and scope of such precautionary measures is not specified, and there is divergent interpretation and implementation of the circumstances and way in which the power can be exercised by Member States.

33. One of the manifestations of the current financial crisis in some Member States arose from the activities of branches. For example, branches of Icelandic banks offering aggressively attractive rates of interest accepted huge numbers of retail deposits in several Member States, the total of which far exceeded the ability of the Icelandic deposit insurance scheme and the Icelandic state to meet the liability to host State depositors.

34. In the wake of these events, it is suggested by some that home State supervision of branches is fundamentally unsound as a regulatory system, that the powers of host country supervisors should be extended, or even that the right for banks to passport through a branch should be curtailed. The Commission Services take the clear view that restrictions of this kind would be inconsistent with the EC Treaty, which confers on undertakings a right to exercise the freedom of establishment. Nevertheless, the problems caused by the Icelandic banking crisis were extremely serious, and it is appropriate to examine whether the current framework is adequate to pre-empt and address problems developing in a bank that might have a seriously damaging effect on the banking sector of a host member State.

[11] The power for the host supervisor of a branch to take direct measures in 'emergency situations' is conferred by Article 33 CRD. However, as it is currently drafted it is unclear whether the powers are excercisable only in those areas where competence is specifically conferred by the CRD: that is, liquidity requirements (in cooperation with the home supervisor); conduct of business rules under MiFID; measures relating to the implementation of national monetary policy; disclosure requirements for the purposes of statistical reporting; and non-prudential requirements under, for example, national fiscal, social security and consumer protection legislation.

Section 4 – Possible ways forward

Supervisory tools and coordination

35. CEBS has recommended further convergence of early intervention tools available to supervisors, in particular, with respect to measures directed at the shareholders. Conditions for the exercise of those powers need to be further explored and addressed in connection with existing Company law Directives (see Chapter 7).

36. A more intrusive measure available to some supervisors is 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 some Member States the range of powers of a special representative - and in particular its impact on the powers of the general meeting – is not entirely clear. If the appointment of a special representative is considered to be an effective supervisory tool, which might be used in conjunction with a common group restoration plan, such details would need to be specified. For actions of special representatives to be coordinated in a banking group, issues such as their powers, their responsibility to shareholders and supervisors and the confidentiality of the measure would need to be addressed in a consistent way across Member States. Particular care would also be needed when assessing whether the appointment of a special representative might exacerbate the financial deterioration of the institution by causing market counterparties to withdraw credit lines.

37. The framework for joint and coordinated action by the various supervisors of a banking group could also be enhanced. For example, supervisors could be required to reach a joint decision on the basis of a common assessment and a restoration plan[12] submitted by the parent company for the group as a whole.

38. Under the new supervisory architecture that has recently been proposed by the Commission,[13] the European Banking Authority would, inter alia, have powers in the context of the CRD to ensure the consistent application of Community rules, to take specific actions in emergency situations and to settle certain disagreements between authorities including within colleges of supervisors. To ensure that decisions by the European Banking Authority, without prejudice to the application of Community law, do not impinge on the fiscal responsibilities of the Member States, a safeguard clause is also proposed, in line with the Ecofin and European Council conclusions of June 2009.[14]

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[12] That is, the basis for coordinating supervisory measures under the new Article 129(1) of 2006/48/EC.

[13] Proposal for a Regulation of the European Parliament and of the Council on a European Banking Authority, 23 September 2009.

[14] It may also be stressed that under the Commission Proposal, the powers of the European Banking Authority would not extend to bank resolution measures of the kind discussed in Chapter 4. Moreover, matters covered by Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions are outside of its statutory competence (as proposed by the Commission). However, the draft Regulation on a European Banking Authority may be amended during the process of adoption by Member States and the European Parliament.

Joint assessment and triggers

39. In support of a joint assessment framework, the Commission is currently considering further amendments to the CRD to introduce complementary prudential measures designed to capture at least the effects of leverage and liquidity risks.[15] These harmonised measures would usefully supplement the indicators that form part of an 'early warning system' to facilitate the joint assessment of emergency situations.

40. When considering the issue of a 'trigger' for supervisory actions, CEBS concluded that "*no automatic triggers exist and, consequently, early intervention measures are activated through on-going prudential supervision. Prudential supervision is based on both quantitative and qualitative analysis of the situation of credit institutions in order to determine its individual risk profile and to identify and solve any (potential problems) at an early stage*". The respective merits of 'automatic' triggers and supervisory discretion are further discussed in Chapter 5 on threshold conditions in the context of resolution measures.

Contingency planning for banks: 'Wind down plans' or 'living wills'

41. The concept of wind-down plans or 'living wills' is currently attracting considerable political and regulatory interest as a means of facilitating a more rapid resolution or winding down of large and complex financial institutions The idea is that systemically important cross-border institutions should be required to produce contingency plans to facilitate, in a period of severe financial stress or instability, the preservation of the firm as a going concern, the continuity of its financial infrastructure services, and the rapid resolution or winding down of the institution where necessary. Detailed plans may include, for example: the information that might be required by authorities to manage a crisis (such as lists of counterparties and the location of inventory assets); details of client assets, the location of custodians and arrangements for client asset protection, and relevant legal restrictions; information necessary for the settlement and netting of financial market contracts; details of information storage and IT systems, and back-up plans for record retention and data integrity; and group-wide contingency funding plans, including which business lines could be sold to raise emergency funds, and plans to reduce risks or stabilise funding.

42. In addition to the obvious advantages for supervisors, resolution authorities and insolvency officials of having this information in a comprehensive and structured form in the event of a crisis, a requirement for 'wind down plans' is attractive in that it is likely to bring about an ongoing dialogue between institutions and their supervisors which should ensure that supervisors better understand the complex structures they have to supervise. Such plans are also likely to force managers to think much more carefully about the complex financial structures that have been created within their organisation and the extent to which contractual obligations (such as default swaps) place substantial

[15] See Commission's 4 March 2009 Communication

constraints on the choices facing authorities in the event that reorganisation measures need to be undertaken.

43. However, more detailed thought needs to be given to a number of issues. For example, the discussion of wind down plans in an international context, such as the FSB and the G20, tends to be coupled with the assumption that an intended and beneficial effect of such plans would be to force a clarification and simplification of legal structures. This might include a reduction of complexity, a greater organisation of business in stand-alone subsidiaries that can be ring-fenced and reorganised separately in the event of a crisis, and stronger capitalisation and liquidity requirements on individual subsidiaries. There is no doubt that greater simplification would facilitate crisis management and resolution, and the desirability of a move towards less complex structures is an important element of the current debate on financial regulation.

44. Nevertheless, any requirement for wind down plans as a part of the EU supervisory regime would have to be properly adapted to the specific legal context of the EU and the single market. In this context, it is crucial that there is a clear understanding of the potential impacts of any such requirement on the large cross-border banking groups that are active in the EU retail market, and in particular on any possible detrimental effects on their efficiency, as well as on the effectiveness of consolidated supervision. Any measures that risked undermining the single market principles of the EU Treaty, and that might fundamentally affect that firm's business models should only be adopted after careful assessment. If one effect of 'living wills' would be to force banks to re-consider the centralisation of key management functions and their functioning across business lines, this may lead to inefficiencies and reverse the integration trend in the Internal Market.

45. On the other hand, should an EU cross-border resolution framework be developed in which allows resolution at group level, the implementation and design of 'funeral plans' need not fundamentally affect the organisation of groups and supervision, since resolution measures might be able to deal more easily with the group structure.

46. A further issue to be assessed is the extent to which such plans would be feasible in practice. For example, to what extent would cross-border banking groups be able to provide own accurate and comprehensive analysis of how different national insolvency laws would apply across the group? And given the potential detailed nature of the information contained in the plans and the dynamic nature of banking business, to what extent would it be realistic to expect that they could be kept up-to-date and relevant in a crisis situation?

Section 4 –Questions

(4) Do supervisors need additional tools and powers for early intervention, and if so, which?

(5) Should the application of early intervention measures only be the result of supervisory (joint) assessment of emergency situations, or would there be any advantage in structured or automatic triggers for early intervention?

(6) Is any modification of the current framework for the supervision of branches necessary or desirable?

(7) The Commission Services invite views on a requirement for 'wind down' plans. In particular:

- Would 'wind down' plans provide useful information to managers and supervisory authorities?
- What kinds of institution should be required to prepare them?
- What should be the content of wind down plans?
- Should the development of wind down plans be closely linked to the design of a cross-border resolution framework?

3. CHAPTER 3 - ASSET TRANSFERS

Section 1 - The Issue

The transfer of assets as a means of intra-group financial support could assist groups in managing liquidity positions and in some cases could help stabilise entities in a developing crisis. There is currently no EU authorisation regime for asset transfers, and there are significant obstacles arising from company and insolvency law.

47. The conclusions of the October 2007 ECOFIN Council requested the Commission "*to perform a feasibility study on reducing barriers for cross-border asset transferability while introducing appropriate safeguards within banking, insolvency and company law, taking into account that the reallocation of assets in a crisis affects the ability of stakeholders in different legal entities to pursue claims*".[16] The overall objective was to reinforce the primacy of private solutions, avoid counter-productive ring-fencing of assets, and facilitate a smooth management of a crisis. Intra-group asset transfers, if made at a sufficiently early stage, may help to prevent liquidity problems from developing in a group company.

48. Addressing legal obstacles to asset transfers, which arise in the context of company and insolvency law, should not be viewed as a policy objective in itself. Most barriers in fact represent legitimate protections for stakeholders, and there are sound policy reasons for restricting intra-group transfers in order to limit contagion risks.

Section 2 – Current legal framework

49. Asset transfers among entities within a group are a common and every day transaction in the normal course of business, provided that the legal entities involved meet their respective prudential requirements[17] and that transactions are carried out at arm's length.

50. There is no EU authorisation regime for asset transfers (although in some Member States authorisation by supervisory authorities is required[18]), and EU legislation does not provide a general framework of terms and conditions for transfers.[19] However, in principle, in all Member States asset transfers must be made for fair consideration, irrespective of whether they are between affiliated

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16 14 November 2008 Commission services report on asset transferability, see http://ec.europa.eu/internal_market/bank/docs/windingup/rep141108_en.pdf

17 Prior authorisation by or notification of supervisors is only required in some countries (e.g. Portugal, Italy and Poland)

18 For example, in Portugal the authorisation of a transfer by the supervisory authorities is required in crisis situations; in Italy transfers above a certain threshold must be authorised by the Bank of Italy; and in Poland authorisation is required when the transferee's own funds constitute part of the assets being transferred.

19 Recital 52 of Directive 2006/48/EC only specifies that the management of exposures should be carried out in a fully autonomous manner, in accordance with the principles of sound banking management, without regard to any other considerations.

or unconnected entities. The way that this principle is expressed and given effect varies according to the national law. Some Member States prohibit 'disadvantageous' transactions or transactions at an undervalue, while others impose the principle that transactions must be made at 'arms length', on standard commercial terms.[20] Moreover, while some requirements are set out in legislation, many have been developed through case law.

51. In many cases, there are procedural requirements such as authorisation by the General Assembly of the supervisory board. Such requirements may be triggered by the size of the transfer,[21] the fact that the transfer was not concluded in the ordinary course of business,[22] or because the transfer is made between connected parties.[23] Authorisation requirements are generally designed to ensure adequate protection for shareholders and creditors. For example, in the Czech Republic, the strict regulation of intra-group transfers of assets was adopted in reaction to a widespread practice of disadvantageous intra-group transfers in the 1990s.

52. While all supervisors have the power to restrict intra-group transfers[24] with a view to limiting contagion risks in stress situations, there is no framework permitting or facilitating the transfer of assets between affiliated entities and significant constraints under national company, insolvency and criminal law which may impose procedural obstacles even to transfers that are supposedly carried on commercial terms, and prevent transfers that are not made at arms' length.

53. Executing transfers on preferential terms runs the risk of challenges from minority shareholders or creditors, and may expose directors of the transferring company to civil or criminal liability. The difficulties and justified objections may be particularly pronounced where a transfer on preferential terms is made from a subsidiary to a parent, or between subsidiaries. While some Member States recognise and regulate the concept of a 'domination agreement' in national law,[25] this is an exception to the general rule.

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[20] In some jurisdictions, the concept of "group interest" may limit the arm's length principle.

[21] For example, in Austria, authorisation is required for an 'extraordinary transaction; in the Netherlands there is a quantitative trigger, and in the Czech Republic any transfer of assets between companies within a group of a value exceeding 10% of the share capital requires an expert valuation of the assets to be transferred and the approval of the General meeting in certain cases.

[22] For example, in the Czech Republic, a transfer must be approved by the supervisory board if the value of the assets transferred within one accounting period exceeds a third of the company's net assets. However, such authorisation is not required when the transfer is agreed in the normal course of business. There are also conditions on transfers that go beyond the ordinary course of business in Luxembourg, Poland and Estonia.

[23] In the Czech Republic, prior approval of the General meeting is required for transactions between companies that are inter-related at board level unless the transaction is made at arms length. In France, authorisation is required if a transfer is not entered into under normal terms and conditions. In Spain, the General assembly must authorise a transfer of shares from a parent to a subsidiary.

[24] CEBS, Mapping of supervisory objectives and powers including early intervention measures and sanctioning powers, January 2009.

[25] E.g. 'Control contract' in Hungary, control agreement in Germany, 'domination agreement' in the Czech Republic.

54. The fact of substantive differences between national insolvency regimes may in itself be a disincentive to asset transfer. If assets are transferred between entities in different jurisdictions – either in an attempt to fortify or rescue particular group entities or in the context of a group restructuring - and the transferee is subsequently wound up, the administration of the transferred assets will be carried out under the applicable national framework. This may not provide the managers and stakeholders of the transferor with sufficient confidence that the transferor's claims to the assets will be protected, and the lack of any formal framework for the coordination of the winding up of group companies tends towards conflict and litigation between jurisdictions, as the insolvency authorities of the individual entities assert the interests of their particular creditors.

55. Insolvency law poses a further obstacle to any constructive use of intra-group asset transfer, for example to address short term liquidity problems of particular group entities, since a transfer that was carried out during the 'suspect' period preceding the commencement of winding up proceedings may be retroactively invalidated. If the transferor subsequently enters insolvency proceedings, there is a risk that the transfer may be set aside or challenged if it was made at an undervalue or was detrimental to the transferor or its creditors. Provisions conferring on administrators, liquidators or creditors the power to challenge a transaction exist in the insolvency law of most Member States, and the 'suspect' period may be as long as five years (for example, Hungary). Similarly, a preference granted by the transferee to the transferor with the objective of protecting the claim of the transferor might be subject to challenge by the insolvency officer or creditors in the event of the winding up of the transferee. Risks of this kind undermine the legal certainty of a transfer and may discourage the use of asset transfer as a means of reinforcing a group entity or stabilising a group.

Section 3 – Adequacy of the current framework

56. The fragmented framework outlined above represents a significant obstacle to a coherent and coordinated approach towards different entities of a cross-border group in crisis situations.

Company law

57. While requirements under company law have the legitimate and necessary objective of protecting shareholders and creditors, they also limit the ability to move assets rapidly around a group where that may be needed in order to avert the deterioration of a group member. However a company is a distinct legal person and, with few exceptions, Member States' laws do not contain any legal concept of a group for the purposes of establishing company law rights and obligations. In the absence of a concept of 'group interest,[26] directors of a

[26] A concept of 'group interest' exists in a number of Member States. A concept of 'group interest' exists in a number of Member States. For instance, Italian law defines the concept of banking group and lays down the parent company's responsibility for the sound and prudent management of the group as a whole. Germany and Portugal have introduced formal group law in their companies legislation, and the

company are neither responsible to other group entities, nor to the group as a whole, and should they act to promote the interests of the group in a way that is detrimental to their own company, they could be in breach of their duties and at risk of liability under national company law. Where a transfer may be deemed detrimental to shareholders or creditors, directors are at risk of civil or criminal liability under national law. This severely restricts any potential for using intra-group asset transfer as a tool for averting or managing a developing liquidity crisis in a group entity.

Insolvency law

58. The core of the problem for cross-border resolution arrangements and intra-group asset transfers to support entities with liquidity problems is the concern that creditors will be worse off as a result of the arrangements or transfer than they would have been if the arrangements or transfer had not taken place and insolvent entities had simply been wound up under the applicable national law. The powers to set aside transfers made during the 'suspect' period is, of course, designed to protect creditors against precisely this kind of concern, but can create uncertainty for group entities wishing to engage in asset transfer.

Section 4 – Possible ways forward

Company law

59. Introducing a concept of 'group interest' for banking groups might be one way of underpinning transfers and addressing the risks of liability for directors. Such a concept is currently developed in the national law of only a small minority of Member States[27] and varies between those States where it exists. However, this concept raises a number of challenges. For very good reasons, both company law and insolvency law remain focussed on the individual legal entity and the protection of its shareholders and creditors. Moreover, directors of individual companies may not be able or willing to assess the group interest, and the benefits of modifying company law to change the duties of directors to permit this are questionable.

60. A more limited concept of the interdependence and mutual interest of group companies has been developed in the 'Rozenblum' case law,[28] and may provide an alternative set of framing principles for financial support for a group entity prior to insolvency and outside resolution measures. Described as constituting " the clearest common denominator found in group law",[29] the Rozenblum

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concept has been developed in case law in other jurisdictions. For example, the 'Rozenblum' doctrine developed by the French *Cour de Cassation* sets clear criteria about the circumstances in which assets may be transferred between group companies for the purposes of mutual support. That case law has been followed in Belgium. However, the development of a law on groups of companies in the 'Ninth Directive' was abandoned owing to strong opposition from a number of Member States

27 This is provided in case law in e.g. BE and FR, or as part of national frameworks for groups of company (e.g. DE, CZ,HU)

28 French Cass. Crim, 4 February 1985. Similar case law exists in Belgium.

29 Eddy Wymeersch, "*Conflicts of interest in financial services groups*" (see CESR web site).

judgment ruled that transfers may take place between legal entities of the same group at agreed conditions (without considerations on transfer pricing) provided that the following conditions are met:

- there must be a policy with regard to the group as a whole;
- financial assistance should not occur without any return for the company providing the assistance nor should it disrupt the balance of mutual obligations;
- the financial assistance should not exceed the capacity of the company that supports the burden.

61. The judgment permits mutual support provided that "it does not take place on a unilateral basis, but that there is a sufficient quid pro quo to avoid one of the partners to be always on the losing side", and "that support does not exceed what can reasonably be expected from the supporting partner".[30] Significantly, "this rule would forbid support being given in the light of insolvency or without necessary guarantees if the support could exceed the capacity of the creditor".[31] Any framework based on the conditions developed in this case law could only facilitate transfers made while the company receiving support was still solvent.

62. The Rozenblum judgment also specifies that financial support should be provided in accordance with conditions agreed by shareholders on a case-by-case basis. Alternatively, it may be sufficient to require that financial support may take place only in accordance with a general agreement whose terms, policies and procedures would be agreed *ex ante* by shareholders of all legal entities within a banking group.

63. If pursued, the concept of 'banking group' would have to be developed in conjunction with a framework for coordinated or integrated treatment of banking groups under insolvency, as outlined in Chapter 8.

Insolvency law

64. If a facilitating regime for financial support were to be based on these or similar principles, further thought would need to be given to protections for creditors of the company providing the support. This might entail, for example, a priority ranking for that company under the applicable national insolvency law in the event of the insolvency of the transferee.

65. This Chapter has focussed on the transfer of assets between solvent group entities. Financial support to an entity under resolution or 'intra-group' financing to support the reorganisation of a group as a whole, would need to be addressed in the context of insolvency law. Intra-group financing is recognised by UNCITRAL as a key component of group insolvency law, and raises fundamental questions about whether, in the circumstances of a resolution, authorities should be able to override stakeholders' rights on financial stability

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30 Eddy Wymeersch, ibid., p.5.
31 Eddy Wymeersch, ibid., p.6.

grounds, or whether any decision on intra-group financing should always be subject to the consent of the creditors of the transferor.

Section 5 –Questions

(8) The Commission Services invite views on the advantages, if any, of designing a framework for asset transfers along the lines outlined above.

(9) What are the appropriate safeguards for creditors?

(10) Is the concept of 'banking group' worth exploring further?

4. CHAPTER 4 - RESOLUTION TOOLS

Section 1 - The Issue

National approaches to bank resolution fall broadly into two categories: those that operate under general corporate insolvency law, including administration and those that have a special regime for banks. In both cases, the rules are limited to national banking operations. They do not, and cannot, apply on a cross-border basis. An effective range of tools must give authorities options other than public financial support and liquidation to address problems in an ailing bank.

Section 2 – The current legal framework

Member States' legal frameworks to deal with bank crisis differ

66. There is no harmonisation at EU level of the national laws governing bank resolution. Beyond introducing a minimum set of powers for supervisory authorities aimed at restoring the situation of a bank,[32] and establishing arrangements for the winding-up and reorganisation of credit institutions with branches in other Member States,[33] no EU framework exists which sets out how and under which conditions authorities should act in the event of a crisis arising in a bank.

67. The management of crises is almost entirely governed by national laws. A study carried out on behalf of the Commission services[34] provides evidence about 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 wider legal system of each country (for example, provisions governing commercial and contract law, ownership law, labour law, netting and set-off, tax law). 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. Finally the extent of powers and the conditions governing their use also differ according to each national system.

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[32] These powers are described in Chapter 2.

[33] The EU Directive on reorganisation and winding up of credit institutions (CIWUD) sets out how credit institutions with cross-border branches may be reorganised or wound up (under the home state insolvency proceedings). However the Directive does not extend to cross-border subsidiaries and was never intended to harmonise insolvency proceedings, as national laws were at the time believed to be sufficient.

[34] In 2008, the Commission engaged consultants DBB Law to carry out a survey in the context of the study on "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". The survey covered the following EU Member States: Austria, Belgium, Czech Republic, Denmark, Estonia, France, Germany, Hungary, Italy, Luxembourg, Poland, Portugal, Romania, Spain, Sweden, the Netherlands and the United Kingdom.

Bank-specific regimes vs. corporate insolvency law

68. The first major difference is in the basic design adopted by Member States for their bank resolution frameworks. The International Monetary Fund has identified two possible broad approaches:[35]

- *Bank specific* regimes, which treat banks which are insolvent or likely to become insolvent differently from other commercial entities (including other kinds of financial institution);

- *General corporate insolvency* regimes, where no specific framework applicable to banks exists.

69. However in practice the situation in EU Member States is more nuanced: certain bank specific regimes are in fact largely based on or refer to corporate insolvency law for all aspects not regulated by the specific regime,[36] while most corporate insolvency laws contain provisions which are adapted to the particular problems of a bank insolvency.[37]

70. The distinction is nonetheless significant in one important respect. The choice of regime under which to carry out a reorganisation of a bank may affect the outcome if the *objectives* pursued are not the same:

- Bank specific regimes generally seek to achieve broader social objectives including the preservation of financial stability, continuity of key banking services, protection of insured depositors and the minimisation of costs to the public;

- In the case of corporate insolvency law, by contrast, objectives pursued are aimed at achieving fair and predictable treatment of creditors and maximisation of asset value in the interest of creditors.

Judicial vs. administrative proceedings

71. A further important distinction between systems is whether they are managed as part of court-based procedures (*"judicial")*, or whether they are initiated and conducted by administrative authorities without judicial involvement (*"administrative"*).

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35 See "Overview of the Legal, Institutional, and Regulatory Frameworks for Bank Insolvency", 2009, International Monetary Fund.

36 For instance, Article 80 (6) of the Italian Banking Law, governing the proceedings of 'compulsory administrative liquidation' for banks, refers to the Italian bankruptcy law as regards all the aspects not covered by these specific proceedings.

37 for instance banking supervisors may play a role in insolvency proceedings e.g. the supervisor may be the initiator of proceedings, to the exclusion of debtors and creditors (e.g. in the case of German law), or the supervisor may make a proposal to the Court concerning the appointment of an administrator (e.g. HU), or the supervisor's approval may be required for certain decisions in order to ensure compliance with banking regulations (e.g. in Sweden the only exception to corporate insolvency law is that the financial supervisory authority appoints a general representative in the proceeding to participate in the management of the bankruptcy estate together with the receiver appointed under the bankruptcy code)..

- General corporate insolvency proceedings are invariably initiated and overseen by the courts and carried out by court-appointed officials;

- Bank-specific regimes can on the other hand be either court based or administrative. In certain cases the administration is conducted by administrative authorities, although this may be subject to judicial oversight, and the liquidation proceedings remain under the control of the judicial authorities.[38]

72. As bank resolution may require authorities to be in a position to act quickly and decisively in order to safeguard financial stability, a system which relies on court procedures may, unless special procedures exist, be insufficiently responsive in urgent situations and may not be able to take account of the particular characteristics of banks and of bank insolvency. On the other hand, a system which relies on the powers of administrative authorities may be less well adapted to ensuring legal certainty and adequate protection of stakeholders.

73. Given the different national approaches, any new EU framework will need to carefully consider the correct balance between the potentially conflicting outcomes delivered by different systems.

A graduated approach to reorganisation, resolution and liquidation

74. Regardless of whether the regime is bank specific or based on general corporate insolvency, most national systems offer the options of re-organisation or, where there is no reasonable prospect of restoring the business, an orderly liquidation. In some Member States, an institution may be placed under "special administration"[39] where an official authority takes control of the bank and decides on the extent to which it can be re-structured or liquidated. The extent of this control varies: in some Member States (for example, France and Italy) the administrator can replace the management of the bank entirely, while in others (for example, Austria and Luxembourg) the administrator only supervises the management and controls decisions which go beyond the ordinary course of business.

75. Official administration only lasts for a limited period (Italy, Romania, Austria: one year, Estonia: six months) after which, if not successful, the bank is wound up. In certain countries the official administration must necessarily precede liquidation, while in others (for example, Italy) it is not a pre-requisite. In some Member States, the official administration also involves a "moratorium" or suspension of payments. Depending on the system, the moratorium may simply entail a stay of the enforcement actions by creditors, a partial suspension of the payment of debts, or a total suspension of all the payment and collection

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[38] For example, Estonia has 2 types of proceedings: one administrative (moratorium) aimed at the recovery of the bank and one judicial (ordinary bankruptcy proceedings adapted to banks).

[39] This general form of proceedings has been identified by the IMF in its ""Overview of the Legal, Institutional, and Regulatory Frameworks for Bank Insolvency", 2009 (see p. 26 and following), on the basis of certain common characteristics. However, the IMF notes that the terminology varies widely from country to country. In the EU panorama, examples of this form of proceedings are the special administration (*amministrazione straordinaria*) in Italy, rehabilitation proceedings (*postępowanie naprawcze)* in Poland, receivership (*Geschäftsaufsich*) in Austria.

activities of the bank. In some countries (for example, Luxembourg, Estonia), the moratorium is automatic, while in others it is at the discretion of the authorities (for example, Italy).

76. In certain systems (for example, Italy) liquidation proceedings may also be used to sell the business as a going concern, and leaving only a residual non viable part of the bank with the original legal entity for liquidation.

77. The common trait of such frameworks is that they provide for a graduated approach to intervention, first seeking a resolution with the agreement of stakeholders, and involving more intrusive powers to authorities only in the context of a liquidation. The Italian approach to resolution is presented in more detail below. Importantly, a 'graduated approach' does not mean that resolution always needs to follow pre-determined stages, but, in appropriate circumstances, the consent of shareholders may help the restructuration process.

The Italian approach to resolution

In Italy, banks can be reorganised under a "special administration" system which can be ordered by the Minister for the Economy and Finance, acting on a proposal from the *Banca d'Italia*. The procedure can last up to one year. Conditions for special administration include:

i) there must be serious administrative irregularities or serious violations of laws governing the bank's activities;

ii) serious capital losses or illiquidity which can affect the stability of the whole financial system are expected.

The *Banca d'Italia* appoints one or more special administrators and an oversight committee. The special administrator exercises the administrative powers of the bank and is entrusted with eliminating irregularities and promoting solutions that protect the interests of the depositors. This may include proposing a restructuring plan for the bank which may entail a merger, acquisition, or partial sale of assets. Under the special administration the shareholders are deprived of certain rights, although they maintain the right to decide on any restructuring operation that is normally subject to their approval.

Subject to the authorisation of the *Banca d'Italia*, the administrator(s) may suspend payment of the bank's liabilities of whatever kind and the restitution to customers of financial instruments connected with the provision of investment services for a period of up to one month. The suspension does not constitute insolvency.

The Ministry of Economy and Finance, on a proposal from the Bank of Italy, can withdraw the licence of a bank and commence its liquidation (Compulsory Administrative Liquidation) if the administrative irregularities or violations of laws, regulations or bylaws or the losses are exceptionally serious. Liquidators can take any decision concerning the restructuring of the bank without the need for the shareholder approval. The law allows the liquidator to sell all or part of the assets. The Deposit Guarantee Scheme may decide on the basis of the "least cost solution" whether to pay out the depositors or finance the sale of the business.

78. Spain has recently reformed its legal framework for dealing with stressed banks[40] and has introduced a graduated approach. Restructuring of banks takes

[40] Royal Decree of 27 June relating to the Fund for Orderly Bank Restructuring

place in three stages. Under the first stage, a purely private sector solution is sought without the intervention of the Deposit Guarantee Scheme ('DGS'). The second stage entails the adoption of restructuring measures with the participation of the DGS. The third stage entails the restructuring process with the intervention of the Fund for Orderly Bank Restructuring. When a bank is in the third stage, the Bank of Spain will replace its managers by those appointed by the Fund. The Fund will report on the financial institution and will submit a restructuring plan to the Bank of Spain.

Immediate pre-emptive resolution

79. A significantly different approach is adopted in the context of the recently adopted UK special resolution regime.[41]

80. The UK special resolution regime prioritises the objectives of the protection and enhancement of the stability of the financial system and of public confidence in the banking system, the protection of depositors and of public funds, and facilitates rapid and intrusive action by the administrative authorities. The relevant UK authorities may sell all or part of the business or of the shares of the bank to a private purchaser, or to transfer all or part of the business to a publicly owned 'bridge bank', or to take the bank into temporary public ownership. Importantly, these actions can be taken by the authorities without the consent of the shareholders and the creditors. These arrangements allow for a splitting of the viable part of the business which is transferred to a private purchaser or to a new legal entity from the non-viable part of the business which is left with the original legal entity. The original legal entity may be kept functioning for some time under administration if it needs to provide essential services to the transferred business. Eventually, the original legal entity is put into liquidation.

Tools for dealing with bank crisis

81. National crisis management frameworks also differ as regards the tools that authorities may employ to take control of a bank and to remedy the situation, or at least to manage its failure.

82. In most Member States, general insolvency frameworks include reorganisation tools which can also be applied to banks. These include:

– the arrangement of mergers or acquisitions (by transfer of shares to a third party);

– agreements with creditors concerning reduction of debt, debt restructuring, debt-equity conversion;

– asset sales;

– closure of non-viable parts of the business.

[41] See: http://www.bankofengland.co.uk/financialstability/role/risk_reduction/srr/index.htm

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

- purchase-and-assumption transactions (transfer of some or all of the bank's assets and liabilities to a purchaser);
- the creation of "good" and "bad" banks and bridge banks (that is, the sale of non-performing loans and other substandard assets for collection to an asset management vehicle, or the transfer of viable assets to a bank established for that purpose and generally owned, at least in part, by the State);
- nationalisation.

84. In the EU, only the UK Banking Act 2009 confers dedicated bank restructuring tools which can be applied by the authorities without the consent of the stakeholders. However, in other Member States, specific restructuring techniques, although not detailed in a special regime for bank resolution, may be available under either administrative or judicial proceedings applied to banks.

- 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*. Wide interpreted, such 'solutions' 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 of approval for 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.[42] 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.

85. There are significant differences and gaps in the tools provided under the current legal framework in Member States. Voluntary reorganisation, involving the consent of shareholders or creditors, may not always produce the desired results: indeed, there have been several cases during the recent crisis where shareholders have obstructed or challenged action proposed or taken by national authorities.[43] Furthermore, while generally framed laws may offer greater

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42 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.

43 For example in the cases of restructuring Northern Rock, Fortis and HRE.

flexibility to take the requisite measures, a legal framework that confers specific measures and sets out clearly the conditions for their use would minimise problems of legal uncertainty and the risk of challenge. Finally, the lack of adequate re-structuring tools may mean that authorities resort more quickly and more frequently to financial support with public funds, and may result in more costly crisis resolution.

Section 3 – Adequacy of the current framework

How national regimes meet the objectives of a resolution framework

86. Recent experience has highlighted a number of gaps and deficiencies in national systems for bank resolution. Certain types of procedure are not well-adapted to the specific nature of the banking sector and the imperatives of preserving financial stability and confidence in the banking system. The crisis has shown that fast, effective, and legally sound stabilisation or resolution is essential. However, under some systems emergency measures can be frustrated by shareholder protections, while other systems quite simply lack the possibility to re-organise a bank on a non-voluntary basis.

87. Ordinary insolvency proceedings may be too slow or too costly to fulfil financial stability objectives. There are compelling reasons for enhancing national regimes to adapt them better to the specific problems and objectives of bank resolution:

- Unless authorities are equipped with adequate stabilisation tools, they may be forced into bailing out banks;
- With appropriate tools, losses can be more easily directed onto shareholders and creditors rather than tax-payers;
- When ordinary bankruptcy is viewed as too costly or to pose too great a risk to financial stability, bankruptcy ceases to be a credible threat. This undermines market discipline and creates moral hazard;
- Continuity of services is key to financial stability.

The inconsistency of national tools for effective coordination

88. The scope for effective cross-border resolution is severely limited where national authorities do not share a common set of tools. As a basic example, if one national authority has the power to transfer assets to a third party purchaser by executive order, while another cannot do so other than by judicial proceedings, a rapid and coordinated intervention by those two authorities to deal with affiliated banks in their respective jurisdictions might be difficult. The problem is, of course, exacerbated if one of the national authorities involved does not have the necessary power at all. This would prevent national authorities from acting rapidly in a coordinated way to stabilise a cross-border group and to ensure business continuity.

89. The reorganisation of a banking group is likely to be more difficult if a one member is subject to a moratorium or suspension of payments and stops functioning as a going concern while other entities continue their business. While the suspension of certain creditors' claims may be appropriate for an ordered resolution, an automatic and complete moratorium for an inflexible period specified by law would result in a loss of value of the bank, prevent the continuity of services and undermine depositor confidence. Only a discretionary moratorium, limited to the time and scope strictly necessary, would be compatible with the objectives of continuity of services, financial stability and cost minimization.

Speed of intervention

90. The point at which resolution measures can be imposed is also crucial. 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 lack of harmonised threshold conditions – which when crossed permit a national authority to intervene and take control of a troubled institution in specified ways – may prevent coordinated action in relation to a cross-border group. This is further discussed in Chapter 5.

91. Procedural differences can also have an impact on the timing of coordinated measures. Where the necessary measures require judicial approval or have to be taken with in the framework of court-directed insolvency proceedings, they may not necessarily lend themselves to a timely and fast crisis intervention. While a graduated approach may be preferable where developing problems are identified at a sufficiently early stage, a legal regime that is based on a graduated intervention may not deal effectively with cases where serious problems emerge quickly and decline is rapid.

Reorganisation measures cannot be applied at group level

92. Reorganisation measures under insolvency law only cater for national entities. This means that the national conditions for reorganisation would have to be met for each relevant group entity and that the relevant authorities in Member States where legal entities of the group are incorporated will have to cooperate in applying such measures to each legal entity.

Section 4 – Possible ways forward

93. While it may be appropriate to preserve a wide range of possibilities in Member States' national toolkits, the following resolution tools may be necessary to deliver the objectives of an EU bank resolution framework:[44]

– The power to arrange acquisition by a private sector purchaser: this will frequently be the best way to achieve the objectives of business continuity,

[44] See IMF working paper "The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union", Martin Čihák and Erlend Nier, http://www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf

financial stability and minimising the cost to the public purse. It also effectively protects the interests of creditors and counterparties, whose exposures to the failing institution are replaced by claims on a stronger institution. National authorities need to have the power to transfer the institution to a private sector purchaser without seeking or obtaining the consent of the existing shareholders.

– The power to transfer assets and liabilities to a 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. The residual failing institution can then be wound up, once its services are no longer required, in an orderly manner.

– The power to partially transfer assets to a 'bad bank': authorities should also have the power to 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.

94. The resolution tools prescribed under an EU regime could be exercised either by national resolution authorities or by special administrators appointed under national law. That is, a bank resolution regime could be combined with a national system of "special administration" provided the special administrators have the power to take the necessary measures quickly and without procedural hurdles that would impede their effectiveness. In this respect, the IMF recommends that "the law should make clear that the official administrator is authorised not merely to take normal managerial decisions, but also to decide on and implement far-reaching corporate actions of the type that, in a normal situation, would require shareholders' approval (for example, the sale of all or parts of the bank's business), provided that for some decisions the approval of the court or the relevant banking authorities may be required."[45]

Section 5 – Questions

(11) Which objectives should bank resolution tools seek to pursue? Which objectives should be prioritised?

(12) What resolution measures are necessary? In particular, would the resolution tools outlined in paragraph 92 be appropriate and sufficient for an EU regime?

(13) Would administrative reorganisation (as described) be a viable option for financial institutions – or might there be a risk that the appointment of an administrator could exacerbate liquidity problems due to loss of confidence?

[45] IMF and World Bank, April 2009, An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency

5. CHAPTER 5 – THRESHOLD CONDITIONS FOR RESOLUTION

Section 1 - The Issue

Clear "threshold conditions" that must be met before the powers of intervention are triggered are central to an EU resolution regime. They facilitate coordinated action by national authorities, reduce the risk of challenge, and provide legal certainty for shareholders and creditors as to the circumstances in which action might be taken. The threshold conditions for an EU regime should allow intervention at the appropriate stage, while being sufficiently rigorous to ensure that intervention which interferes with the rights of stakeholders is justified by clear public interest in, for example, financial stability and the continuity of banking services.

Section 2 – Current legal framework

95. Conditions which determine how and when authorities may intervene are a crucial component of a bank resolution regime. Depending on how conditions are set, they can either enhance or restrain the ability of authorities to take preventative or remedial action. The ability to take measures to intervene in a timely manner, which may be before the bank is technically insolvent, may be crucial for the objectives of ensuring continuity of services, preserving financial stability and minimising public costs.

- *Conditions for entering insolvency*

96. Although the terminology may be different the relevant thresholds under insolvency law are generally based on one or both of two concepts:

  - the "illiquidity threshold", i.e. the debtor is unable to meets its obligations as they fall due;[46] and
  - the "balance sheet threshold", i.e. the entity's balance shows a negative net worth (the liabilities exceed the assets).

97. Austrian law, for example, provides that when *over-indebtedness* or *illiquidity* can be remedied, the credit institution or the supervisor may request an order for receivership from the court.[47] The threshold for the commencement of winding up is only reached where the over-indebtedness or liquidity cannot be remedied.

98. In some Member States the threshold for intervention is the "imminent insolvency" of the debtor, that is, where the debtor is likely to be unable to pay future obligations when they fall due. For example, as a modification to ordinary French corporate insolvency law, credit institutions are deemed to be insolvent if they are actually unable to meet their current liabilities or will be unable to do so in the near future.

[46] This threshold is defined as "general cessation of payments" in certain systems.

[47] Section 83, subsection 1 BWG.

- *Conditions for pre-insolvent intervention*

99. Member States which permit bank intervention at an early stage of financial distress also set the conditions for the exercise of powers. These thresholds are generally what the International Monetary Fund has termed "regulatory thresholds",[48] that is, they are based on the breach of banking regulatory requirements rather than the threshold conditions for general corporate insolvency. The conditions differ between systems: they may refer to the breach of either specific rules or of banking regulations generally, and they may be of a qualitative or a quantitative nature (that is, focussed on capital requirements). Their aim is to allow authorities to intervene before insolvency - while the bank still has a positive net worth.

100. In UK for example, under the new Banking Act, one of the threshold conditions for intervention is that the bank is failing, or is likely to fail, to satisfy the conditions to permit it to carry on regulated activities. In Poland, “rehabilitation” proceedings should be applied if the bank incurs a balance sheet loss, or if there appears to be a threat of a balance sheet loss or risk of insolvency. In Hungary, a list of detailed regulatory conditions is set out by law, and these include both qualitative conditions and the failure to meet capital requirements.

- *Threat to financial stability as a condition*

101. In many Member States a necessary condition for more intrusive forms of crisis intervention is the risk to the financial stability.

    - In the UK, the Treasury or the Bank of England may exercise the "private sector purchaser" and "bridge bank" options only on condition that the stability of the financial systems of the UK, or the maintenance of public confidence in the stability of the banking system is jeopardized or in order to protect depositors.

    - The Italian law also refers to the risk to the stability of the financial system as one of the possible conditions for the special administration.

    - In the Czech Republic, a bank may be put into administration if its continued operation endangers the stability of the banking system.

Section 3 – Adequacy of Threshold Conditions

102. Any measures to stabilise a bank which limit the rights of stakeholders would need to be based on a clear demonstration that the action is proportionate to the seriousness of the problems in the institution in question and driven by the clear public interest in, for example, financial stability and the continuity of banking services.

103. However, the public interest in ensuring the continuity of banking services and in an orderly resolution also means that intervention should be possible at a

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[48] See "Overview of the Legal, Institutional, and Regulatory Frameworks for Bank Insolvency", 2009, International Monetary Fund.

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. If authorities cannot intervene before the bank is technically insolvent, this is likely to limit the choice of effective options for stabilisation and resolution, or increase the amount of public funds that will need to be committed in support of such an option.

104. Broadly speaking, there are two approaches to defining the appropriate conditions to trigger stabilisation and resolution measures. The first is based on hard solvency triggers which define when a bank is critically undercapitalised. If a bank falls below the solvency threshold, authorities can be entitled, or even required, to take action. The US, for example, applies a mandatory threshold based on leverage ratio.

105. While providing an effective means of ensuring common and predictable supervisory responses, triggers based on the *solvency* of an institution have proved irrelevant during the current crisis, in so far as the most relevant weakness facing institutions has been absence of liquidity. Because a bank is at risk of a run, an illiquidity problem can turn very rapidly into insolvency. The current crisis has clearly shown that capital ratios cannot capture all the possible material information which is necessary to detect problems in a bank at an early stage.

106. The second approach uses a soft regulatory threshold which involves a more nuanced supervisory judgment and may allow the relevant authority greater discretion as to whether to intervene. The UK Special Resolution Regime, for example, is triggered by such a soft threshold based on the regulator's assessment of whether the bank is failing, or is likely to fail, to meet the conditions of authorisation (which include an assessment of its capital and more generally the 'adequacy of the firms' resources')[49] and unlikely (without intervention) to be able to remedy that failure, coupled with a public interest condition. Under an EU regime, a 'public interest' test might include a European dimension, requiring national authorities to take into account the impact of national measures on the financial stability in other Member States.

107. A clear framework for intervention will reduce the risk of challenge to actions taken by national authorities, and provide legal certainty for shareholders and creditors about the circumstances in which action might be taken and the protections conferred upon them. In order to increase the legal certainty of resolution measures, it may be appropriate to limit the grounds for judicial review. For example, legal challenges to measures taken under a statutory framework might be restricted to the review of the legality of an authority's action. That is, a review would determine whether the authority acted within its powers and whether measures were proportionate to the public interest at stake, but would not allow judicial authorities to reassess any exercise of discretion unless there was clear evidence of a manifest error of fact, an abuse of power or bad faith. This would not, or course, preclude challenge under the European Convention on Human Rights (see Chapter 7).

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[49] Conditions for licensing a bank are harmonised under Directive 2006/48/EC.

Section 4 – Possible ways forward

108. A regime which gives authorities the power to take exceptional action or to intervene in the management, structure or activities of an undertaking needs to set clear conditions defining when that action can be taken. The conditions will reflect the nature of the intervention in question, the stage at which it is most useful or appropriate, and the degree of interference with stakeholders' rights that the intervention entails.

Section 5 – Questions

(14) What threshold conditions would be appropriate for the use of resolution tools?

(15) Should different conditions be defined for the use of different tools, and in particular in the case of a graduated approach to resolution?

6. CHAPTER 6 - ANCILLARY MEASURES TO SUPPORT RESOLUTION

Section 1 – The Issue

Reorganisation measures that split a financial group, or transfer parts of the business to another institution may disrupt operations and contractual arrangements or affect market counterparties. Safeguards may be necessary to ensure continuity of services and financing as well as appropriate protection of the rights of shareholders and creditors.

Section 2 – Continuity of services

109. Reorganisation measures need to be effected in such a way that they do not cause critical disruption to business operations. A resolution framework would need to ensure that 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 other group entities, could be required to provide the support needed to ensure the continuity of banking services 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, or where essential support services were formerly provided to former bank by another group entity. That requirement should apply irrespective of whether the entity providing the support is located in the same Member State as the bridge bank or purchaser.

110. It may also be necessary to restrict the rights of third parties to terminate contracts in certain circumstances, for example where the contracts are transferred to a bridge bank, so that the continuity of banking services is not jeopardised.

Section 3 - Partial property transfers

111. Bank resolution measures may involve a partial property transfer, whereby national authorities transfer some of the assets of an ailing bank to another entity, leaving the remainder in the residual company. The ability to make partial transfers is likely to increase the chances of smooth continuity for the viable parts of the business, and a successful resolution using a bridge bank or a private sector purchaser. However, a partial property transfer also risks disadvantaging creditors of the residual company, and may also seriously disrupt commercial contracts.

112. First, if the splitting into two entities results in an insolvent residual company, the creditors that remain in the residual company may be worse off than creditors of the same ranking that are transferred to the bridge bank. This might be resolved if the residual company is given a certain and enforceable economic interest in the net proceeds of the resolution, for example the proceeds of any subsequent sale of the bridge bank to a private sector entity. However, there remains a risk that compensation determined in this way might not be sufficient to ensure that creditors that remain with the insolvent residual bank are left no worse off than they would have been in the event of a whole bank insolvency.

113. Second, a partial property transfer can interfere with widely used commercial structures such as set-off and netting arrangements, security interests and structured finance. This could have serious consequences. For example, any undermining of legal certainty that financial contracts will be subject to set-off and netting could lead to increased regulatory capital requirements for banks' counterparties, since they might be required to account for their credit exposure to an EU bank on a gross rather than a net basis. Similarly, if security interests could be disrupted by a partial transfer, counterparties that have lent to banks on a secured basis will not have legal certainty that they can enforce against the collateral on which the loan is secured. This could have a negative effect on the cost of finance for EU banks that are potentially subject to resolution measures involving partial transfers, and could lead to counterparties withdrawing credit at an earlier stage, precipitating the deterioration of an institution that is perceived to be at risk. This could also have very serious effects on the operation of clearing and settlement systems (which are of systemic importance) and put strains on the conduct of monetary policy operations by Central Banks to the extent that partial property transfers might affect collateral arrangements entered into in relation to the operation of such systems and to the policy of Central Banks.

114. Safeguards would need to address these issues. The legal and commercial problems connected with partial property transfers, and appropriate safeguards, have been explored extensively by the UK government, respondents to the various public consultations, and the expert advisors it appointed for this purposes, in the course of the preparation of the UK special resolution regime under the Banking Act 2009.[50] That work provides a valuable resource for understanding the problems. However, any solutions developed at EU level would have to be compatible with the different legal systems of the EU. Further detailed consideration therefore needs to be given both to appropriate compensation for creditors[51] and safeguards for financial contracts and commercial arrangements that may be affected by partial property transfers.

Section 4 – Changes required under insolvency law

115. Modifications to insolvency law in support of re-organisation measures applied to cross-border groups may also be necessary. As a minimum, a moratorium should be possible to prevent the opening of other proceedings once a resolution measure has been applied. This would be necessary to maintain the continuity of services and to ensure an orderly resolution process.

116. Work on an EU resolution regime might also consider how to facilitate the continuous operation of the business under reorganisation by securing access to funds. For example, finance after the commencement of an insolvency procedure ("post-commencement finance") may be obtained from other members of the group operating as a going concern. This raises the question of

[50] http://www.hm-treasury.gov.uk/consult_special_resolution_regimes.htm

[51] Including mechanisms for ensuring that creditors whose claims remain with the residual bank are no worse off in the winding up of that residual bank than they would have been in the hypothetical event of a whole bank insolvency.

whether the entity financing the insolvent group member should have a priority ranking. In the absence of enabling or clarifying treatment in insolvency law, the provision of finance in the period before commencement of the insolvency proceedings may also be subject to avoidance and carry the risk of liability for both the lender and the debtor.[52]

117. UNCITRAL[53] supports the development of a system for "post commencement finance" between affiliated entities. In order to enable group members to finance the affiliate under reorganisation, techniques need to be found to secure repayment of their claim. These might include a priority in a subsequent liquidation of the affiliate, a security interest on unencumbered assets, or a junior security interest on already encumbered assets. Authorisation of post commencement finance and securing assets for repayment of the financing affiliate might also require the approval of creditors of the entity providing the funding or of the court to secure the protection of all affected parties.

Section 5 – Questions

(16) What kind of specific protection and support measures are needed in the context of partial transfers or the splitting of a group, including measures for the protection of creditors?

(17) What changes to insolvency law would be necessary to support bank resolution measures (e.g. moratorium, post commencement financing, etc.)?

(18) What safeguards are needed for financial contracts and commercial arrangements that may be affected by partial property transfers?

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[52] Some insolvency laws provide that where a lender advances funds to an insolvent debtor in that period, it may be responsible for any increase in the liabilities of other creditors or the advance will be subject to avoidance in any ensuing insolvency proceedings. In other examples, the insolvency representative who borrows money may face personal liability for repayment.

[53] Working Group V of UNCITRAL is considering recommendations on easing intra-group financing for entities under insolvency in relation to the treatment of corporate groups in insolvency. See: http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html

7. CHAPTER 7 - COMPANY LAW AND SHAREHOLDERS' RIGHTS

Section 1 – The Issue

While a robust framework of shareholders' rights is essential for good corporate governance and for the free movement of capital, those rights must be balanced with the public interest in the ability of resolution authorities to intervene quickly and decisively to restructure a failing institution or group to minimise contagion and ensure the stability of the banking system in affected Member States. The question is how to recognise shareholders' rights and avoid challenges to cross-border resolution measures by shareholders whose rights under national company law or rights to property have been affected?

Section 2 – Current legal framework

Company law framework

118. EU law contains a number of mandatory requirements that confer rights on shareholders of public limited liability companies. The capital maintenance regime under the Second Company Law Directive[54] requires the approval of the shareholders' general meeting for any increase in capital and any reduction (except under a court order) in the subscribed capital, and confers pre-emption rights on existing shareholders. The Shareholders' Rights Directive[55] - which had to be transposed by Member States by August 2009 – 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. As regards re-organisation measures applied to certain limited liability companies, rules in the Third Company Law Directive[56] and the Directive on cross border mergers[57] contain provisions on the role of the general meeting in the case of national mergers and cross-border mergers respectively, and the Sixth Company law Directive[58] in the case of divisions.[59]

119. The Second Company Law Directive applies to those types of public limited liability companies that are listed in Article 1 of the Directive. The Directive does not make special provision for the situation where a company enters

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

[55] Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p.17.

[56] 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, OJ L 378, 31.12.1982, p.47

[57] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies

[58] 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

[59] Where the company to be acquired has entered insolvency or comparable proceedings, the Third and the Sixth Directives allow Member States to derogate from their requirements, see Article 1(3) Directive 78/855/EEC and Article 1(4) Directive 82/891/EEC.

insolvency. It can therefore be concluded that the rules of the Directive - including the requirement of a general meeting resolution for any capital increase and decrease - apply as long as a bank operates in one of the forms of a public limited liability company specified in Article 1. Furthermore, the Directive does not provide for any exemptions in crisis situations where a company undergoes serious financial difficulties or a credit institution is reorganised.[60]

120. The Third and the Sixth Company law Directives and the Cross-border mergers Directive do not contain specific rules in cases where a company gets into difficulties. However, according to the rules of the directives, the requirement for the approval of the general meeting can be waived by Member States under specific circumstances.[61] In all cases, however, a one month publication period has to be respected for the publication of the draft terms of merger or division.

121. Furthermore, Member States are not required to apply the Third or the Sixth Company Law Directives *"where the company or companies which are being acquired or will cease to exist are the subject of bankruptcy proceedings, proceedings relating to the winding-up of insolvent companies, judicial arrangements, compositions and analogous proceedings".*[62] The Directive on cross-border mergers does not contain any similar derogation.

122. In addition to these mandatory requirements in EU law, national company law, listing rules and the articles of association of banks may contain further rules on the right of shareholders in the context of restructuring measures. In particular the requirement that all material transactions have to be approved by the general meeting applies in a number of Member States.[63]

European Convention on Human Rights

123. The European Convention on Human Rights ("ECHR") and its First Protocol have been signed by all EU Member States. Its rules have been recognised by the European Court of Justice as general principles of EU law and have been reflected in the Treaty of Amsterdam which calls for respect for the fundamental rights guaranteed by the Convention.

124. Under Article 1, Protocol 1 ("A1P1") to the ECHR, any transfer of ownership or assets of an ailing bank must comply with the shareholders' right to property. This guarantees the peaceful enjoyment of possessions, including shares.[64]

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[60] Joint Cases C-19/90 and C-20/90 Karella and Karellas v. Minister of Industry, Energy and Technology and organisations AE [1991] E.C.R I-2691, and C-441/93 Panagis Pafitis and Others v. Trapeza ellados A.E. and Others [1996] ECR I-1347

[61] Article 8 Directive 78/855/EEC, Article 6 Directive 82/891 EEC; Art. 9(3) Directive 2005/56/EC.

[62] Article 1(3) Directive 78/855/EEC; Article 1(4) Directive 82/891/EEC

[63] A similar rule in the Corporate Governance Statement of the bank formed the basis of the Court decision in the case "Fortis".

[64] Article 1 of Protocol 1 of the European Convention on Human rights states:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

Shareholders have the right not to be deprived of their shares, or to suffer a diminution in their value, unless the interference is justified in the public interest and in accordance with conditions provided in law, and in accordance with international law.

125. Any interference with the peaceful enjoyment of possessions must strike 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”.[65] A deprivation of property without payment of an amount that is reasonably related to its value will normally constitute a disproportionate interference that is unjustified. However, there is no right to full compensation since “legitimate objectives of public interest, such as [are] pursued in measures of economic reform or measures designed to ensure greater social justice, may call for less than reimbursement of the full market value”.[66]

126. Furthermore, Articles 6 and 13 ECHR provide for the shareholders' right to due process ("fair and public hearing") and to a legal remedy against unlawful interference with their rights.

National frameworks for bank resolution

127. As far as creditors' rights are concerned, where national frameworks for bank resolution are based on insolvency law they include the principle of the equal treatment of creditors who enjoy the same ranking. As a consequence, creditors are involved in various ways in the proceedings and their consent is usually required for any decisions which may affect their rights and entitlements, such as sale of assets outside the ordinary course of business, the continuation of the business, consideration and approval of a reorganisation plan. However, the current national frameworks for bank resolution differ in the way they deal with the rights of stakeholders, and there are in particular differences with regard to the rights of the shareholders.

128. In most systems, placing a bank into provisional official administration implies only a partial reduction of shareholders rights. For instance, shareholders may be deprived of the right to call the general meeting and draft the agenda or the right to take certain decisions which would normally be reserved for the general meeting (such as the appointment of the management or liability actions against previous managers). However, in general shareholders retain their right to approve the more far reaching bank restructuring measures which affect their ownership rights (for instance this is the case in Italy, Romania, Poland and Austria). Only in certain Member States can these decisions be taken without the shareholders’ consent. For instance, in France, the administrator may be authorised by the court to sell the shares of a bank without the agreement of the shareholders. In the Czech Republic, the administrator must seek the approval of the central bank instead of the general meeting of the shareholders. The

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The preceding provisions shall not, however, in any way impair the right of the State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure payment of taxes or other contributions or penalties."

65 *Sporring and Lonnroth v Sweden* (1982) 5 EHRR 35

66 *Lithgow v United Kingdom (*(1986) 8 EHRR 329. paragraph 121.

extent to which such a national rule is consistent with the current legislative framework at EU level remains to be examined.

129. Under the UK Special Resolution Regime, the authorities may take certain decisions affecting the rights of shareholders and creditors without their prior consent (to the extent that such consent is not required under EU law). However, the system does provide for certain safeguards for the protection of their interests. In the case of a partial transfer of assets and liabilities, creditors that are left in the residual company are entitled to compensation based on the principle that they should be no worse off than they would have been had the bank been fully liquidated. The calculation of the proceeds of a hypothetical whole-bank liquidation and the dividends that would be paid to each creditors is determined by an independent valuer. Secured creditors may be transferred with the relevant collateral to the new company. The same principle applies to shareholders when shares are transferred to a private purchaser or to a bridge bank: they are entitled to compensation which cannot be inferior to what they would have received in the event of the liquidation of the whole bank. The stakeholders are entitled to judicial review of the decision of the authorities affecting their rights. However, this review cannot reverse the operations decided by the authorities but only affect the amount of the compensation.

Section 3 – Adequacy of the current framework

130. The procedural requirements contained in EU law do not necessarily interfere with bank resolution where measures may be taken or required by supervisors exercising powers under Article 136 of the CRD since the necessary time to comply with such requirements is likely to be available. Furthermore, the harmonisation of the requirements through the EU directives ensures a level playing field within the EU. However, it cannot be excluded that, under exceptional circumstances, certain of these requirements (for example, the minimum convocation period under the Shareholder Rights Directive) may pose hurdles to effective crisis resolution. In extreme situations, the requirement for prior consent of stakeholders for restructuring decisions, while ensuring a degree of legal certainty and high stakeholder protection, may undermine attempts by authorities to handle a bank crisis quickly - for example by orchestrating a private sector purchase. Lack of approval by affected shareholders may hamper the adoption of appropriate solutions that involve, for example, the transfer of assets or shares.

131. The latter problem was demonstrated by the case of Fortis where, under Belgian law, shareholder control delayed the implementation of the sale of a majority stake in the Belgian bank to BNP Paribas. The rescue plan had to be revised and renegotiated because shareholder approval was required, and resolution was delayed by a prolonged legal challenge with resulting uncertainty for creditors, employees and other stakeholders in Fortis.

Section 4 – Possible ways forward

132. Adjustments to the Company law Directives and to national company laws may be needed to guarantee the ability of national authorities to intervene rapidly

without having to seek shareholder approval and thus to ensure continuity of essential services that have been provided by the bank and to minimise the systemic impact of its failure.

133. Such adjustments have three potential objectives: (1) they could be aimed at clarifying the scope of the Company Law Directives, and in particular the question to what extent the Second Company law Directive applies to companies that have reached insolvency; (2) they could provide for specific exemptions from certain of the rules of the Company law Directives in the context of bank resolution schemes; and/or (3) they could provide for exemptions in the context of such resolution procedures from requirements imposed by national company laws (or allowed by these laws and laid down in listing rules or articles of association).

134. However, reflecting the protection conferred by Article 1, Protocol 1, any restriction of shareholder rights would need to be justified by an overriding public interest and made subject to the appropriate safeguards to ensure that the rights of shareholders are given proper weight. Those safeguards should entail conditions for intervention that reflect the considerations of public interest recognised in the jurisprudence of ECHR, and adequate arrangements for the compensation of shareholders. Furthermore, a stabilization and resolution framework would have to respect constitutional limitations of Member States' laws – as guaranteed under the EU Treaty.

135. Finally, 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 can 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.

Section 5 – Questions

(19) Is it necessary to derogate from certain of the requirements imposed by the EU Company Law Directives and, if so, what conditions should apply to any such derogation? If the scope of an EU special resolution framework extended beyond deposit-taking banks to cover other financial institutions (see Chapter 1), should such derogations from the EU Company law rules apply to all financial institutions covered?

(20) The Fortis case has shown that requirements imposed only at the level of the national law, or allowed by it, can also impair effective measures to save an ailing bank. Is it therefore necessary to regulate at EU level to ensure that such national rules do not apply in where measures are taken under a bank resolution framework? If so, what conditions should apply to any such derogation from national rules?

(21) What kind of triggers or conditions are likely to best deliver the objectives set out in paragraphs 132-133, and to ensure that intervention in the field of shareholder rights is proportionate and justified? In particular, should these triggers or conditions be the

same as those discussed in Chapter 5, or should the conditions for interference be stricter where shareholders' rights are at stake.

(22) Should mechanisms for compensation be set out at EU level, and if so how should this be done?

8. CHAPTER 8 - COORDINATION V/INTEGRATION OF RESOLUTION AND INSOLVENCY

Section 1 – The Issue

This Chapter focuses on the changes, if any, that may be needed to insolvency law to support an EU resolution regime for banking groups.

The resolution of a cross-border banking group would entail the application of resolution measures to group entities in different jurisdictions. This requires, as a minimum, a framework for coordinated action by the relevant national resolution authorities. However, it may be necessary to go further and provide for an integrated resolution orchestrated by a lead authority.

Any resolution will almost certainly be accompanied by the application of insolvency measures to elements of the group. The effectiveness of that resolution, and the willingness of national authorities to apply resolution at group level, may depend to a large extent on the ability of the applicable insolvency regimes to support the resolution measures.

Section 2 – The current legal framework

136. In the resolution of a cross-border banking group, measures must be applied to legal entities in different jurisdictions. This requires either coordination between the national resolution authorities involved or an integrated resolution orchestrated by a lead authority. Under a simple cooperation and coordination framework, the resolution of a banking group will necessarily be carried out at the level of each legal entity in accordance with the applicable national regime. For example, relevant resolution authorities could be subject to a duty to consult each other before taking measures in relation to a member of a banking group. Going further, they might be required to consider (but not necessarily apply) joint resolution measures if that would be likely to represent the best outcome for the group as a whole.

137. However, while the simplest option legally, this may not reflect commercial reality. Banking groups are increasingly operationally and commercially interdependent, frequently centralise liquidity management in a way that entails the intermingling of assets, and are organised and operated in a way that reflects business lines rather than legal structure. Even where coordinated, separate entity resolution will not necessarily allow the most efficient reorganisation. These concerns can only be fully addressed by greater structural integration of a resolution framework, possibly by designating a single authority to be responsible for the resolution of a particular group. The Commission Communication on an EU Framework for Cross-border Crisis Management in the Banking Sector outlines these alternative approaches.

138. However, any resolution will almost certainly be carried out in conjunction with national insolvency procedures.[67] The separate entity approach to resolution

[67] 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

means that insolvency proceedings are only effective in the country where they are initiated, and will administer only those assets that are located within that jurisdiction.[68] This territorial approach to cross border insolvencies has not kept pace with the increasing irrelevance of national frontiers in a global financial market. 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.

139. These difficulties are aggravated by procedural and substantive differences in national insolvency laws for credit institutions. Some Member States use the same general corporate insolvency law for the reorganisation and winding up of banks, while others have special proceedings for credit institutions. Special banking insolvency regimes may entail a system of depositor preference, so that depositors' claims are paid before those of general creditors, while this will not be the case where banks are subject to a general corporate insolvency regime.

Section 3 – Adequacy of the current framework

140. The territorial nature of insolvency law and the substantive differences between national regimes may represent a disincentive to coordinated or integrated group resolution. If insolvency is necessarily 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. It also limits the 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.

Section 4 – Possible ways forward

141. It may therefore be necessary to develop EU measures for the insolvency of banking groups to complement and support bank resolution measures. Of course, the nature of any adaptation of insolvency law that may be needed will depend on the nature of any EU resolution regime and the way in which multi-jurisdictional application is managed: whether by coordination of separate national actions or by a more integrated approach. The need for modification of insolvency law arises to the extent that measures adopted at EU level facilitate or are likely to result in the reorganisation of business or the transfer of assets between group entities in different jurisdictions. A coordinated approach to resolution may require fewer changes (if any) to insolvency law than an integrated regime. An enabling regime for asset transfer would almost certainly

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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.

[68] This is subject to the exception under Directive 2001/24/EC of branch assets that are located in another Member State.

require adjustments to national insolvency law to ensure adequate protection for creditors of the transferor, but might be most consistent with more structural coordination or integration of insolvency proceedings for banking groups.

142. There are two basic approaches for the design of an EU resolution framework. Under a *coordinated* framework, each legal entity of a cross-border group would be resolved under the insolvency law of its country of incorporation, but formal framework would permit or require those proceedings to be coordinated where appropriate. Under an *integrated* framework, the insolvency of the group as a whole would be conducted under a single process, possibly in accordance with a single applicable regime.

Coordination

143. Coordination may be in particular efficient where banking groups are not integrated, or where ring-fencing of a legal entity is needed to e.g. avoid contagion of risks. Two principal approaches might be explored.

144. The first – a framework for cooperation and exchange of information – would entail_EU rules requiring courts and insolvency officials to exchange information in respect of the different group entities under resolution. However, the insolvency of the individual group entities would continue to be conducted in accordance with the applicable national insolvency regime. Going further, a new EU instrument might also provide a framework for coordinated stabilisation or reorganisation plans and, in the context of reorganisation or liquidation, facilitate the coordination of the use and disposition of assets, use of avoidance powers 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.

145. The second approach would facilitate a more directed coordination of national proceedings in relation to group entities by a 'lead' administrator or liquidator. EU rules would determine the identity of that lead practitioner in a way that was consistent with the principal focus of its business activities. . Such rules might also include procedures for the adoption of a coordinated stabilisation or reorganisation plan and for decision-taking in accordance with agreed objectives. More radically, this approach could provide for the nomination of the same insolvency administrator to all the group members concerned. Those proceedings would be conducted in accordance with the applicable national insolvency regime.

146. An initiative of this kind would not be unprecedented and might be able to draw upon other international work.. In an EU context, Council Regulation (EC) No 1346/2000 on insolvency proceedings[69] requires liquidators to cooperate

[69] Council Regulation (EC) No 1346/2000 applies to the reorganisation or winding up of a single legal entity with establishments in multiple jurisdictions, and does not deal with the insolvency of groups. Banks, investment firms and collective investment undertakings are excluded from its scope. Its central principle is that the main insolvency proceedings with universal scope are conducted in the Member State where the debtor has the centre of its main interests ('COMI'), while retaining the possibility that secondary local proceedings may be opened in other Member States whether the debtor has an

closely, in particular by exchanging information. In order to ensure the dominant role of the main insolvency proceedings, the liquidator has the power to intervene in concurrent secondary proceedings, for example, by proposing a restructuring plan or composition or applying for a suspension of the realisation of the assets in the secondary insolvency proceedings.

147. Proposals by UNCITRAL[70] to facilitate cooperation between insolvency officials and courts located in different jurisdictions could also provide a useful model for an EU cooperation framework for the resolution and liquidation of cross border banking groups. This work focussed on the expansion of the Model Law on coordination and cooperation for enterprise groups (but not financial institutions).[71] Under the draft recommendations, courts and administrators would be required to cooperate and communicate with foreign courts and administrators responsible for other members of the group. The recommended measures include:

– the use of bilateral and multilateral agreements and the exchange of information between administrators of enterprise group members located in different jurisdictions;

– agreement between insolvency representatives on the division of powers and allocation of responsibilities, with one insolvency representative taking a coordinating or leading role;

– the agreement of coordinated reorganisation plans;

– coordination with respect to administration and supervision of the affairs of the group members subject to insolvency proceedings, including day-to-day operations where the business is to be continued, post-commencement finance, safeguarding of assets, use and disposal of assets, use of avoidance powers; submission and admission of claims, and distributions to creditors.

148. UNCITRAL also considers that coordination may be achieved by appointing the same insolvency representative in multiple proceedings affecting members of the same group in different States where that person meets applicable local requirements.

establishment. It provides specific rules of jurisdiction, applicable law and recognition of judgements, while enhancing co-ordination of measures in relation to an insolvent debtor's assets.

[70] UNCITRAL Working Group V, Treatment of enterprise groups in insolvency.(See www.uncitral.org)

[71] The UNCITRAL Model Law on Cross-Border Insolvency, adopted in 1997, offers an effective framework for cross-border insolvency where an insolvent entity has assets in more than one State or where creditors are established in a jurisdiction other than the one where the insolvency proceeding is taking place. It applies to the insolvency of a single entity with establishments and assets in multiple jurisdictions, and does not address groups. The Model Law does not attempt a substantive harmonisation of insolvency law; rather, it develops mechanisms for cooperation and coordination, including foreign assistance for an insolvency proceeding taking place in the enacting State; access for foreign representatives to courts of the enacting State; recognition of foreign proceedings; cross-border cooperation; and coordination of concurrent proceedings.

Integration

149. Because of the nature of groups and the way in which they operate, there may be a complex web of financial transactions between group members. Centralisation of liquidity is a common feature in EU banking groups. Because of the intermingling of assets that centralised liquidity risk management may entail, creditors may have to deal with different members in insolvency proceedings or even with the group as a single economic entity. The coordination of separate national insolvency proceedings may not achieve an equitable treatment for creditors in such cases. In more general terms, where subsidiaries are 'branch-like' in practice, it may be appropriate to allow creditors to file claims not only against the subsidiary that is their counterparty, but also against the parent, as the 'dominant' company.

150. Some national regimes contain remedies for overcoming the perceived inefficiency and unfairness of the traditional single entity approach where the disentangling of operations or assets is excessively complex, or other reasons justify treating the group as a single enterprise. Such remedies include: extending liability for debts of an affiliate to other solvent group members, as well as to corporate office holders and shareholders; contribution orders; and asset pooling or substantive consolidation orders.

Extension of liability to affiliated entities

151. Certain laws recognize circumstances in which exceptions to the limited liability of corporate entities can be made, so that another group member and its office holders may be made liable for the debts and actions of an affiliate. Extending liability for external debts and, in some cases, the actions of the group members subject to insolvency proceedings to solvent group members and relevant office holders is a remedy available to individual creditors on a case-by-case basis and is generally subject to rigorous conditions. The following conditions are typical:

– A subsidiary has been operated as the parent company’s agent, trustee or partner;

– A group member has exploited or abused its control over another group member, including operating a subsidiary continually at a loss in its own interests;

– Creditors have been misled to believe that they are dealing with a single enterprise, rather than with a member of a group.

Contribution orders

152. A contribution order is an order by which a court can require a solvent group member to contribute funds to cover all or some of the debts of other group members subject to insolvency proceedings. Considerations relevant to the granting of such an order may include:

– the extent to which a related group member took part in the management of the group member;

– the extent to which the reasons for liquidation are attributable to the actions of the related group member, for example, failure to perform a contract or the fact that the parent had permitted the subsidiary to continue trading whilst insolvent.

Substantive consolidation

153. Substantive consolidation, in insolvency proceedings involving two or more group members, generally permits authorities to disregard the separate identity of each group member in appropriate circumstances and consolidate their assets and liabilities, treating them as though held and incurred by a single entity. This has the effect of creating a single estate for the general benefit of all creditors of the consolidated group members.

154. Consolidation might be appropriate where it leads to greater return of value for creditors, either because of the structural relationship between the group members and their conduct of business and financial relationships or because of the value of assets common to the whole group, such as intellectual property.

155. However this technique pierces the corporate veil and the claims of creditors of a more solvent entity are treated *pari passu* with creditors of a financially weaker affiliate. Because this undermines a fundamental principle of company law, consolidation is generally restricted to situations when the assets or liabilities of the enterprise group members are intermingled to such an extent that the ownership of assets and responsibility for liabilities cannot be identified without disproportionate expense or delay; or where the enterprise group members are engaged in a fraudulent scheme or activity and substantive consolidation is essential to rectify that scheme or activity.

156. Where these techniques are available under national law, their application is necessarily restricted to entities within the same jurisdiction, and subject to the same insolvency regime. If similar measures were to be developed for use in insolvency proceedings for cross-border banking groups, the new dimension of different insolvency regimes - with different substantive rules on, for example, priority and avoidance powers – would need to be addressed.

157. In the EU, a single set of harmonised insolvency rules, covering procedural and substantive elements, might be developed for cross-border banking groups. They could ensure, as a minimum, that core powers such as repudiation and the avoidance of security interests were exercisable in the same way; harmonised rules on priority; and in particular that unsecured claims of depositors (or, if applicable, any subrogated claim by a Deposit Guarantee Scheme).

158. One possible approach might be to introduce changes via a "28th regime": 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.

159. Clearly, the difficulty of such work 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. Moreover, like commercial law generally, national insolvency law enhances the commercial attractiveness of a jurisdiction, and harmonisation could remove competitive advantages that States currently perceive to be conferred by their national systems. 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. A single set of harmonised insolvency rules is likely to change the contractual terms of bilateral agreements between firms and counterparts, which may be disruptive on specific market segments.

Section 4 –Questions

(23) Are mechanisms for cooperation and communication between authorities and administrators responsible for the resolution and insolvency of a cross border banking group desirable? The Commission services would also welcome views on the form that such mechanisms might take.

(24) Is a more integrated resolution and insolvency framework for banking groups feasible and desirable?

– In particular, should the Commission explore mechanisms at EU level for the extension of liability, contribution orders and pooling or substantive consolidation in relation to cross border banking groups.

(25) Would a "28th regime" be useful and feasible? If so, what would be the appropriate scope of its application, and the difficulties of applying it to existing entities?