BANKING RESOLUTION AS AN ECONOMIC INTERVENTION

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Abstract

The European Union financial institutions encounter serious difficulties. Above all, resolution regimes are currently being discussed, so that to ensure financial stability. The new resolution law is to replace present standard bankruptcy procedures, which are being viewed as unsuitable for banks under current crisis circumstances. On the other hand, maybe the remedy to current financial crisis is to go back to the traditional legal institutions.

Key words

bank resolution; bank bankruptcy; financial policy; financial crisis

The European Union financial institutions encounter serious difficulties. It is getting now more and more obvious, that part of the banking sector may, if not recapitalized, need in near future to be closed or broken up. In particular, the EU banking system is not ready to mitigate the systemic outcomes of excess risk-taking.

Needless to say, that over the course of the current financial crisis, the ability of governments to manage it, both domestically and, especially, in cross-border aspects, has been severely tested. What is especially important, European financial markets have become integrated to such an extent that the outcomes of problems occurring in one country usually can hardly be contained and isolated within its boundaries. In other words, internal shocks may be – and usually are – rapidly transmitted to financial institutions and markets abroad.[1] What seems to be most important, the financial crisis highlighted that public authorities (governments and EU institutions) are ill-equipped to deal with ailing banks operating in integrated financial markets.

In order to maintain essential financial services for citizens and businesses, European states had to take advantage of their public funds and inject money into private financial institutions and, on the other hand, issue guarantees on an unprecedented scale. Between

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[1] *Impact Assessment. Accompanying the document* „Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of credit Institutions and Investment Firms and Amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010", European Commission Staff Working Document, Brussels, 6 June 2012, p. 4

October 2008 and October 2011, the European Commission approved €4.5 trillion of state aid measures to financial institutions. Of course, such actions helped to avert – at least in the short term – massive banking failure and economic disruption, but at the same time, they have burdened taxpayers with still deteriorating public finances. No doubt, European governments and EU institutions as well, failed to settle the question of how to deal with the current crisis, first of all, in respect to large and cross-border banks in trouble.[2] So, now, among public interest considerations, the need to protect taxpayers and national finances has particular significance, especially in the wake of the financial crisis, where public finances were repeatedly used to bail out banks and other financial institutions, in some occasions having even detrimental effects on state budgets.[3]

1. THE NEED FOR EFFECTIVE CRISIS MANAGEMENT FRAMEWORK

First of all, bank resolution regimes are currently being discussed by international fora, so that to ensure stability in financial markets, maintain the continuity of essential functions of the banking system, protect creditors and, above all, depositors. At international level, G20 Group have called as a medium-term action for a review of resolution regimes and bankruptcy laws… to ensure that they permit an orderly wind-down…complex cross-border institutions. At the recent (September 2009) Pittsburgh summit, they committed to act together to …develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures… After that, in October 2011, the international Financial Stability Board adopted Key Attributes of Effective Resolution Regimes for Financial Institutions, that set out the essential elements considered to be highly required for an effective new resolution regime. Their implementation should allow governments to resolve financial institutions in proper manner, i.e. without taxpayer money and – at the same time – maintaining continuity of their vital economic functions. The Basel Committee on Banking Supervision also issued significant recommendation on cross border bank resolution.[4]

So, the current financial crisis has spurred renewed efforts to improve national regulatory and supervisory frameworks. All this in order to

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[2] *New crisis management measures to avoid future bank bail-outs* (European Commission press release), Brussels, 6 June 2012

[3] Babis V., *Bank Recovery and Resolution: What About Shareholder Rights?*, “Legal Studies Research Paper Series”, Paper No. 23/2012, September 2012, University of Cambridge, p. 7

[4] *Impact Assessment. Accompanying the document* “Proposal for a Directive…*”, op. cit.,* p. 4

make their financial systems less prone to excessive risk taking and better able to withstand the current crisis, above all without suffering damaging spillover effects. Since the financial crisis, governments have been developing control systems to reduce the need for bank bailouts. Robust discussions focus of course mainly on large banks, due to their systemic importance and interconnectedness. On the other hand, so far, financial authorities were looking mainly at their national ticket while ignoring international dimension.[5] Yet, the financial crisis provided clear evidence of the need for better crisis management arrangements at cross border platform.

So, it is commonly considered, that what forced governments of several countries to provide extraordinary financial support to a number of so-called systemically important financial institutions (too big to fail) was the absence of an orderly resolution regime, which could ensure their smooth market exit. In the same manner, the market involvement of governments is considered to be crucial to maintaining the stability (protecting the deposits and maintaining the continuity of the payment system) of the financial system in general.[6]

Yes, banks of course provide vital services to citizens, businesses, and the economy at large. Financial and credit institutions operate largely based on trust, and can quickly become unviable, if their customers lose confidence in their ability to meet their obligations. Until now, because of this vital role played by banking system, and in the absence of effective resolution regimes, authorities have often had to put up taxpayers' money to restore trust and avoid a domino effect of failing banks from seriously damaging the real economy.[7]

The experience from the latest banking crises indicates that present insolvency laws are not quite apt to deal efficiently with the failure of financial institutions. It seems, they do not appropriately consider the need to avoid disruptions to financial stability, maintain essential services or protect depositors. In addition, traditional insolvency proceedings are rather lengthy and in the case of reorganization, require usually complex negotiations and agreements with creditors.[8] It is true, that under these standard bankruptcy procedures, for example coordination failures among a bank's creditors might essentially diminish value of troubled institution's remaining assets. Furthermore, creditors might force the bank to sell off its assets at fire sale prices. Traditional bankruptcy procedure could also interrupt a bank's ability to provide payment services to its customers, with potentially far-reaching general economic implications.

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[5] *The Bank Resolution Fund: for the EU or for the Eurozone?*, "Madariaga Report" 10 July 2012, Madariaga College of Europe Foundation, p. 1

[6] *Impact Assessment. Accompanying the document* "Proposal for a Directive…", *op. cit.*, p. 4

[7] Services of European Commission Directorate General Internal Market, *Discussion paper on the debt write-down tool – bail-in* (A working document), Brussels 2011, p. 1

[8] *Ibidem*, p. 2

In other words, the experiences gained during the financial crisis have prompted European states and EU institutions to examine the issue of bank recovery and resolution and to consider how existing arrangements and crossborder cooperation can be strengthened to better reflect the degree of integration in the EU financial market. It became commonly agreed, that resolving these issues might also be crucial to deepening the internal market.[9]

So, the first objective of the bank recovery and resolution new framework is to ensure that bank troubles are avoided as far as possible and, next, that governments and financial institutions are prepared for adverse developments.[10] In particular, emphasis has been placed on creating recovery and resolution frameworks for banks, which ensure that the costs of failure are born primarily by shareholders and not by taxpayers. As President José Manuel Barroso said in respect to European Commission project: the…proposal… will help protect our taxpayers and economies from the impact of any future bank failure […] This will contribute to stability and confidence in the EU in the future, as we work to strengthen and further integrate our interdependent economies.[11]

Recent reforms across Europe demonstrate a clear trend towards the introduction of special resolution regimes and tools aimed at "public interest" objectives, such as the maintenance of financial stability and the protection of depositors.[12] A number of jurisdictions have already adopted, or are considering adoption of legislation, to improve their resolution regimes along the lines of new common recommendations.

The first obstacle, though, is the obvious question, whether interference with shareholder rights in the context of financial crisis management is justified as a matter of policy. So, the main issue of the current discussions is how the already existing legal frameworks (protecting rather shareholder rights) can be modified to accommodate changes introduced by new recovery and resolution tools. With regard to property rights, both the draft Recovery and Resolution Directive and, for example, British Banking Act 2009, are (at least in theory) designed to comply with carve-outs under the European Convention of Human Rights. Turning to governance and procedural rights, the draft Directive introduces exemptions from other EU directives (such as the Shareholders' Rights Directive) and is to supersede any shareholder rights established in any law at national level.

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[9] *Impact Assessment. Accompanying the document* "Proposal for a Directive…*", op. cit.,* p. 4

[10] *Ibidem, p. 4*

[11] *New crisis management, op. cit.*

[12] Basel Committee on Banking Supervision, *Resolution policies and frameworks – progress so far*, July 2011, p. 1

The arguments in favor of new regime appear quite compelling. Namely, there is a "public interest" need to protect financial stability. On the other hand, there are bank's shareholders, who have voluntarily undertaken a business risk when investing in banks. Of course, there should be no doubts, that shareholders relying on the implicit government guarantee on banks can demonstrate moral hazard and have incentives to increase risk-taking. So, the exercise of shareholder rights is likely to delay or block an effective bank resolution. Consequently, it appears that some degree of interference with shareholder rights, especially when a crisis occurs, is unavoidable.[13]

The second problem concerns the fact, that, still though, the banking sector is highly integrated within the EU, systems to deal with bank crises remain nationally based. At the same time, they seem to be insufficient to deal with cross-border institutions in difficulty. Coordination in such circumstances is likely to be very complicated. If governments have limited options available to resolve banks, this increases the moral hazard and generates an expectation that large and interconnected banks will again turn to public funds in the event of problems. Therefore, it seems, only EU as an organization can ensure that, in times of trouble, credit institutions are subject to coherent intervention.[14]

2. BANK RESOLUTION – A BIG PICTURE PERSPECTIVE

In case of a bank failure, at least in the case of large systemic banks, the public costs are significantly bigger than the shareholders burden. This alone means that shareholders' perverse incentives can have severe and wide-ranging implications on whole economy. Second, shareholders of large banks are prone to moral hazard, because of the expectation that big (too big to fail) banks will not be allowed to collapse.[15] The intended consequences of new bank resolution regimes, therefore, are to reduce the ex post social costs of financial institutions becoming insolvent.[16]

The new resolution regimes are to replace present standard bankruptcy procedures, which are now being viewed as unsuitable for banks under current crisis circumstances. First of all, it includes an assumption, that potential banking collapse should be addressed with great speed and effectiveness, mainly to preserve an institution's asset

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[13] Babis V., *op. cit*, p. 33
[14] *Impact Assessment. Accompanying the document* "Proposal for a Directive…*", op. cit.*, p. 18
[15]Babis V., *op. cit*, p. 8
[16] Gimber A. R., *Bank resolution, bailouts and the time consistency problem*, European University Institute, March 2012, p. 1

value. Although originally designed as a tool of last resort, bank resolution regime allow also supervisors to address the failing financial institutions pre-emptively. Current insolvency laws, involving the judiciary decisions, do not permit effective action until an institution is balance-sheet. Resolving a bank at a late stage can increase depositor and creditor losses.

In general, the proposed tools are divided into powers of "prevention", "early intervention" and "resolution". In other words, interventions by the authorities become more intrusive as the situation of financial institution deteriorates, but now shareholder protection is an important issue in company law.

As the owners of the company, shareholders are entitled to participate in decision-making process, in particular for significant decisions which can affect their investment.[17] Given the importance of shareholder protection, the case for interfering with shareholder rights in the context of new recovery and resolution is not straightforward.[18]

But now financial institutions, as well as national supervisory authorities will be required to draw up recovery and resolution plans on how to deal with crucial financial problems. If a bank is in financial trouble, a set of tools should be in place in order to deal with the crisis at an early stage. Such supervisory intervention is to ensure that financial stress are addressed as soon as it arise. Financial authorities will have greater powers to intervene, especially when a bank is about to breach regulatory capital requirements. They could require the institution to implement any measures set out in the recovery plan, draw up an action programme and a timetable for its implementation, require the convening of a meeting of shareholders to adopt urgent decisions, and require the institution to draw up a plan for restructuring of debt with its creditors. In addition, in some circumstances authorities will be able even to appoint a special manager at a bank for a limited period, when the tools described above are not sufficient to reverse the situation. The primary duty of a special manager will be to restore the financial situation of the bank and the sound and prudent management of its business.[19]

Then, if introduced, the debt write-down tool would give resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity. This special tool would be at the disposal of the authorities, together with the other resolution tools, at the moment when a troubled institution meets the conditions for entry into resolution. The conditions for exercising the bail- in power could be the same as the ones for the

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[17]Babis V., *op. cit*, p. 2
[18]*Ibidem*, p. 6

[19]*New crisis management measures to avoid future bank bail-outs* (European Commission press release), Brussels, 6 June 2012

other resolution tools. The point of entry into resolution would be when the institution is failing or likely to fail (which could be a point close to insolvency, but earlier than the criteria for commencement of traditional insolvency proceedings).[20]

In the event of incipient insolvency and when no alternative action would help prevent collapse of the bank, and – above all – that the public interest is at stake, authorities should take control of the institution and initiate decisive resolution action. Authorities would have a number of new powers and instruments to deploy. These include selling a bank in whole or in parts to third party buyers, who may also assume the bank's liabilities, an asset separation tool to remove so-called 'toxic' assets prior to putting the bank up for sale, a bridge bank option for the creation of a temporary bank for eventual sale, a debt-write down tool for potentially systemically important banks requiring forced capital injections by subordinated creditors, and, finally, a public ownership option to seek to prevent systemic disruptions. The resolution authority may also sell assets by securitization to a wider range of buyers.

In other words, bank resolution proposal has three objectives: first, maintaining financial stability by ensuring the continuity of vital banking functions, which are in the public interest; second, minimizing the costs for taxpayers; and third, avoiding disorderly insolvency. What seems to be most important, imposing bank losses on shareholders can contribute to reducing shareholders' excessive risk-taking incentives, and can incentivize shareholders to exercise discipline on bank directors.[21]

In order to deal with cross-border financial groups, a network of national resolution funds and resolution authorities will be set up. Besides, national authorities are to cooperate in a new regime. Joint resolution actions are to be facilitated by the European Banking Authority. This institution will facilitate joint actions and act, if necessary, as a binding mediator, what seem to lay the foundations for an increasingly integrated EU-level oversight of cross-border entities.[22] Thus, the use of bank resolution regimes is a substitute for forms of direct and indirect public assistance such as capital injections, special liquidity facilities, asset purchase schemes and liability guarantees.[23]

The idea itself is not new. In the aftermath of the late-2000s financial crisis, new bank resolution regimes have already been enacted or proposed in several countries across the globe.

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[20]Services of European Commission Directorate General Internal Market, *op. cit*, p. 5
[21]Babis V., *op. cit*, p. 8
[22]*New crisis management, op. cit.*

[23]Gimber A. R., *Bank resolution, op. cit*, p. 2

The U.S. has the longest established bank resolution regime. The Federal Deposit Insurance Corporation, in administrating the regime, is granted a number of special powers under the federal law, ranging from the power to repudiate a contract of a troubled bank, request a stay on any litigation against the bank under its receivership, and rights of "special defenses" such as preventing any improperly documented claims against the bank under its receivership and prohibiting courts from issuing injunctions to impede the resolution and liquidation activities. There are three main roles played by FDIC in relation to the bank resolution. Namely – acting as an insurer of bank depositors; acting as a statutory receiver for failing banks and administering the resolution regime and, finally, acting as a prudential supervisor and regulator of banks generally, including triggering the so-called prompt corrective action. Under the current legislation, the FDIC is able to impose losses on unsecured creditors in the process of resolving failing banks.

The UK Special Resolution Regime, established under the Banking Act (2009), also provides the authorities such as the HM Treasury, Bank of England and Financial Services Authority, with a set of tools to carry out stabilization and orderly resolution. The set of tools available for stabilization includes power to enable the Bank of England to either sell a failing bank's business to a third party; transfer the bank to a bridge bank (controlled by the BOE) or put the bank into temporary public ownership (i.e. nationalization). The tools available for orderly resolution of financial institution include modification of procedures to expedite depositors' claims payment and facilitate transfer of deposits to a different bank. The resolution tools under these special regimes are also supplemented by the bail-in powers, which would enable the resolution authority to impose losses on all unsecured debt of a failing institution.

In general, the commonly agreed bank resolution principles seek to ensure that no financial institution, whether a bank or another financial actor, should be too big to fail.[24] Resolution is an essential complement to other measures designed to make financial system safer and less prone to fail, such as requirements for more and better-quality capital[25], additional loss-absorbency requirements for the largest banks, and the examination into possible structural steps to address banks' business models weaknesses.[26] The introduction of a minimum set of special bank resolution tools in European states are to significantly increase the governments and special authorities chances of achieving really effective resolution and hence of maintaining the

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[24]European Commission Directorate General Internal Market and Services, *Consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks*, Brussels 2011, p. 3

[25] The proposed Capital Requirements Directive IV implementing the Basel III accord

[26]Services of European Commission Directorate General Internal Market, *op. cit.*, pp. 1-2

continuity of key financial services and the stability of the financial system as a whole. In contrast to traditional insolvency laws, a special resolution procedure for banks would give governments the ability to use tools which are more suited to the needs of the banking system and allow a more appropriate balance of priorities to be struck with regard to stakeholders (namely favoring depositors and continuity of vital services).

Of course, although bank resolution regimes may reduce the workload of normal bankruptcy courts, they place additional burdens on the authorities responsible for implementing them. Such regimes may call for additional monitoring of financial institutions by regulators, and for more extensive cooperation between different government agencies, and this means additional cost.[27]

Nevertheless, the proposed crisis management framework at EU level is, first of all, intended to further enable financial stability and reduce moral hazard and save public funds. In addition it aims to protect and further develop the internal market for financial services.[28]

So, in the future, bail in instead of bailing out, says an European Commission proposal on the recovery and resolution of credit institutions and investment firms, presented to the finance ministers at the Ecofin Council on 10 July 2012. Rather than relying on public funds, a mechanism is creates to diminish or even stop the contagion to other markets and cut the possible formidable domino effect.[29] A supplementary mechanism would enable banks' debt to be written down or partially converted into equity ('bail-in'). This can be beneficial in cases where other tools may not be sufficient to resolve a complex and interdependent financial institution in a way that protects overall stability and public funds.[30]

3. FINANCIAL CRISIS - FREE MARKET OF GOVERNMENTS TO BLAME?

Although the new regime – as an element of also planned European Banking Union – is in the making yet, the European public institutions already have shifted its stance in respect to functioning of the financial market. For example, the already taken European Central Bank's decisions seem to be radically transforming the monetary union. In

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[27]Gimber A. R., *Bank resolution, op. cit.*, p. 2

[28]*Impact Assessment. Accompanying the document* "Proposal for a Directive…*"*, *op. cit.*, p. 9

[29]Services of European Commission Directorate General Internal Market, *op. cit*., p. 1

[30]*Impact Assessment. Accompanying the document* "Proposal for a Directive…*"*, *op. cit.*, p. 43

particular, the ECB's authorities have recently indicated, that it would be appropriate to share bank-failure burdens more widely, which is quite logical against the background of forthcoming legislation on an EU-wide bank resolution regime. On the other hand, the regulatory agencies use extraordinarily detailed rulebooks in order to seek – as British economist Philip Booth writes – the needle of abuse in the great haystack of financial transactions.

Anyway, there is a growing distrust in free markets today. The European politicians stress even quite commonly, that we need more financial regulation to save us from the failures of capitalism. But are they right? Maybe something obvious is missed here. Ludwig von Mises, stated in his fundamental Human Action: [Free market opponents…] blame the market economy for the consequences of the very anticapitalistic policies which they themselves advocate as necessary and beneficial reforms.[31]

When governments spend, sometimes recklessly, more than they receive in taxes, they issue bonds to finance their increased debt. Banks are the main creditors of such governments, even such as that of Greece. In any event banks buy the bonds, because they know the ECB will accept them in a reverse transaction such as a collateralized loan. In other words, the ECB generates capital gains for the banks of the Euro zone and transforms risky sovereign debt into a sound product, simply by removing the risk, which – of course – in the long run create seeds of banking own downfall.

When European Monetary Union was established, financial markets were expected to act as an additional corrective measure against unsound fiscal policies. But are big banks today really free-market institutions? Evidently they live in a some sort of symbiosis, not with standard market participants, but – to some at least extent – with governments that they are financing. Of course, all this against the clear legal intent at the establishment of the monetary union, that was to avoid monetary financing of member state budgets by EBC.

As P. Booth states, the European governments have accumulated sufficient debt that it does not even require a failing banking system to call into question their credit rating. At the same time, all sorts of mechanisms are being designed to try to hide away these bad debts. Governments are lending to banks; banks are lending to governments; the European Union creates all sorts of new-fangled schemes to lend to both. Such operations can take place because the EBC can freely create and lend money against the collateral of public and private sector assets of any eurozone member nation.[32]

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[31] Mises L., *Human Action. A Treatise on Economics*, Ludwig von Mises Institute 1998, p. 829

[32]Booth P., *We must write off bad debt*, Institute of Economic Affairs blog, www.iea.org.uk, 18 November 2012

So, rather than looking for free market inherent instabilities, maybe we should rather look at the instabilities caused by government-driven shift from the traditional institutions of law. These institutions, not administrative decisions, should have primary responsibility in monitoring relationships in financial sector.

4. CONCLUSIONS

In respect to comparison between traditional bankruptcy laws and new resolution regimes one special aspect should be emphasized. Namely, both these set of tools broadly adopt the same principle with regard to shareholders in resolution: shareholders should be the first to absorb financial losses. It other words, shareholders rights can be modified without their approval (but potentially subject to appropriate compensations). Of course there is no doubt, that judiciary complex procedures compared to administrative resolution are slow, but – what doesn't seem to be commonly noticed – shifting from traditional law and economic institutions can if fact be very dangerous.

First of all[33], the factor-market flexibility shouldn't be inhibited. Bankruptcies are an institution that can speed up the process of relative price adjustments, transferring savings and factors of production. They favor a rapid sale of malinvestments, setting free savings and factors of production. We can't forget, that the market economy is a profit and loss system, so bankruptcies are thus essential for a fast recovery.

The conditions for the use of resolution tools and powers need to ensure that authorities are able to take action before a bank is economically insolvent in order to increase the realistic chances of successful and effective resolution. Managed failure, where the management and shareholders bear the losses first, will also reduce moral hazard. At the same time though, resolution measures could limit the fundamental rights of shareholders and debt holders. Therefore they would only be applied in exceptional situations and in the interest of the general public.[34] Currently though, faced with an imminent failure of a significant financial institution, existing tools available to public authorities may not always be sufficient to enable this new recovery or resolution of the situation. In such cases, authorities may have no choice but to come back to provide public support to prop up the ailing institution – once again at taxpayer

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[33] Corrigan S., *The Road to a New Serfdom*, The Cobden Centre, www.cobdencentre.org, 21 November 2011

[34] *Impact Assessment. Accompanying the document* "Proposal for a Directive…*", op. cit.,* p. 23

expense. What is really needed now is to start writing-off bad debt in banking system and, at the same time, ensure, that those who have underwritten that lending take losses. In other words, financial markets need to recognize bad debt for what it is and business failure for what it is.[35] Besides, bank crisis resolution, together with a deposit guarantee scheme and the capital requirements legislation, are the foundations of the banking union, which in fact is still far-away project.

There are markets – here and now, which accompanied by stable law, can help to best discipline financial market participants – banks and governments as well. So, the remedy to current crisis is rather to stick to the traditional legal institutions and European financial rules established in the Treaty on the Functioning of the European Union. Proposals to let banks fail under new planned resolution regime and protect taxpayers money in such a manner are maybe the right, but surely somewhat dangerous direction.

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[35] Booth P., *op. cit.*

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