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Bankruptcy and reorganization procedures for cross-border banks in the EU: Towards an integrated approach to the reform of the EU safety net

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Introduction

This article analyzes the complexities of reorganizing and liquidating banks that have cross-border activities within the EU in the present institutional framework that is defined by the relevant directives and national remedial supervisory, pre-insolvency and insolvency procedures. Against this background, the objectives of this article are threefold: First, the paper assesses the economic efficiency of the institutional framework that is defined by the Reorganization and Winding-Up Directive (2001/24/EC) and it identifies aspects that can hamper efficient cross-border bank resolutions. These are issues on which policy makers should focus at the time of reforming the present framework. Second, it explores areas of coordination with other EU directives that also deal with relevant aspects to bank financial crisis management. Third, it makes policy recommendations for reform.

The financial crisis that started in the summer of 2007 intensified after the collapse of Lehman Brothers, which highlighted the importance of having in place a legal framework for dealing effectively with the resolution of cross-border financial entities. Policy makers on both sides of the Atlantic have declared systemic exceptions in light of the events that unravelled after September 2008. As argued by Nieto and Schinasi (2007), under this type of circumstance the gains from policy makers´ collective action through cooperation are high.[1] Against this background, EU Ministers of Finance committed to take all necessary measures to enhance the soundness and stability of the banking system in order to restore confidence in a context where it is currently impossible to predict the duration of the current extraordinarily adverse events.[2] The recapitalization of sound "vulnerable systemically relevant financial institutions" was recognized as one means, among others, of appropriately protecting the stability of the financial system. However, in this new environment, it should still be possible for

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[1] Nieto and Schinasi, 2007 (Table 1). Cooperation among policy makers has translated into the agreement on prompt coordinated actions that encompass a common set of measures to be taken with regard to financial institutions within the EU.
[2] 2894th Economic and Financial Affairs Council Meeting, Luxemburg 7 October, 2008 (see http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/103250.pdf)

cross-border banks to be reorganized and/or wound up, although, at the time of writing, we have not seen this happen. The unwinding of the present government support measures may create conflicts among national regulators and tax payers.

Recent events have also highlighted the importance of an integrated approach to the EU financial safety net (prudential supervision, deposit insurance, reorganization and winding up, and lending of last resort). EU policy makers are adopting, for the first time since the harmonization of bank regulation that started in the EU in 1977, a comprehensive approach to its reform.[3] This article focuses on a proposal for reform of the Reorganization and Winding-Up Directive (2001/24/EC). It looks beyond the present crisis to make recommendations for the recovered financial system in order to discourage a recurrence.

The paper is divided into three sections in addition to this introduction. In section one, we present empirical evidence of the lack of convergence of prudential supervisory objectives and remedial powers in the EU, which makes the cross-border coordination of supervision more difficult. Furthermore, incentive conflicts are likely to substantially increase bank losses in case of a crisis. Section two presents some literature on bank resolution and analyses whether the 2001 Directive on Reorganization and Winding Up of Credit Institutions guarantees the objective of minimizing private and public costs. More specifically, it delves principally into the question of the consistency in the regulatory approach between the directives that govern prudential supervision and reorganization and winding up as well as between the later and deposit insurance. An annex to this section presents other EU regulations that apply to cross-border financial crises. The final section concludes and presents a proposal for reform of the Reorganization and Winding Up of Credit Institutions Directive.

1 - Is there a convergence in supervisory objectives and remedial powers in the EU? Some anecdotal evidence

In the EU, the legislative convergence process has developed around three broad principles: (1) home country control; (2) mutual recognition; and (3) minimum harmonization (with regard to requirements for chartering banks, maintaining their solvency, insuring their deposits, and other factors). The regulatory process in the EU, however, has not ensured a homogeneous transposition of these agreed principles into national regulations and supervisory practices. Consequently, different prudential regulatory and supervisory requirements still exist. The extent of these differences is not well known because, with few exceptions, there is a dearth of comparative studies of normal EU supervisory practices or emergency resolution procedures.[4] Moreover the

[3] A significant step toward the design of the EU safety net occurred in October 2007 when the Ministers of Finance in the ECOFIN agreed on a comprehensive approach that, for the first time, considered the simultaneous reform of the entire safety net including the reorganization and resolution of banks in crisis. The Council's report acknowledges the potential need for the establishment of cooperation mechanisms to promote and to foster close cooperation and information sharing, both on an ongoing basis and within the context of any crisis situation that might arise. Council of the European Union, Economic and Financial Affairs, 9 October, 2007. http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/96351.pdf. These proposals were further developed in the Report to the Informal ECOFIN meeting on actions to develop EU financial stability arrangements (Brussels, 3rd April 2008) ECOFIN/CEFCPE(2008)REP/51731, Informal ECOFIN, 10th September, 2008 ECFIN/CEFCPE (2008) REP 5454 and 2894th ECOFIN of 7th October, 2008.

4 The work of Asser (2001), Barth, Caprio and Levine. (2004), Freshfields Bruckhaus Deringer (2007), Hüpkes (2000, 2003, 2007, 2008), and Krimminger (2006) are partial exceptions. The IMF and the World

EU has not sought to harmonize practices relating to reorganization and winding up**.** In this section, we succinctly present information gathered from multiple sources on divergences in many areas that are critical for the success of normal supervisory actions and rescue operations for cross-border banks. While we were able to obtain information describing most countries' normal supervisory actions we were less successful in discovering their processes for dealing with seriously deficient banks.[5]

1-1 *Supervisory Objectives*

Table 1 shows that the objectives that countries set for their prudential supervisors are often ambitious, varied, multiple, and extend well beyond ensuring mere compliance with relevant laws and regulations.[6] It is perhaps not surprising that the supervisor is charged with promoting financial stability in the 14 EU countries where the central bank has supervisory responsibilities, but non-central bank supervisors elsewhere, including those in Sweden and the UK, also have this mandate. Moreover, supervisors in 15 countries are charged with protecting consumers and/or depositors and other creditors. If a supervisor fails to achieve financial stability, orderly functioning and confidence, or to protect consumers/depositors, it would seem likely that the government might feel obliged to bail out the banking system.[7]

Table 1. Supervisory Objectives (Number of EU Countries)

Objective	Number of Countries
Ensure Compliance with Relevant Laws and Regulations	17
Promote Financial Stability	18
Achieve the Orderly and Safe Functioning of the Financial System	13
Promote Confidence in the Banking System	6
Encourage Efficiency in the Banking System	9
Promote Banks' Ability to Compete	2
Protect Consumers and or Depositors	15
No Information	1

Sources: Freshfields Bruckhaus Deringer (2007) and IMF (2001-2007).

Bank have jointly conducted financial sector assessments of most EU countries but, except for Denmark, France, Italy, Portugal, Spain and UK, the results have been released only in summary form. In addition, the Committee of European Banking Supervisors (CEBS) displays and provides access to information regarding the laws, regulations, administrative rules and general guidance adopted by the Member States in the field of prudential regulation and supervision, although, to date, it has focused mainly on the Capital Requirement Directive. CEBS also displays aggregate statistical data on key aspects of the implementation of the prudential framework in each Member State. The supervisory practice to be disclosed includes the way in which each Member State exercises the options and national discretions available in EU banking legislation and the general criteria and methodologies used by national authorities in the Supervisory Review and Evaluation Process (SREP) of Pillar II (http://www.c-ebs.org/sd/sdtf.htm). At the time of writing, CEBS is preparing a mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers.

[5] The Basle Committee set up a group to study the Cross-Border Resolution of Banking Crises in December 2007. This group is co-chaired by Michael Krimminger and Eva Hüpkes. It is expected to publish a report which will further clarify the legal status of pre-insolvency and insolvency law of banks in the various jurisdictions consider in the study.

[6] The FSA's website says that the FSA has four statutory objectives (to maintain confidence in the financial system; promote public understanding of the financial system; secure an appropriate degree of protection for consumers; and reduce financial crime) that may potentially conflict.

[7] Here bail out means using public funds to recapitalize weak/failed banks, without necessarily removing or severely penalizing their owners.

1-2 *Information Access*[8]

If a supervisor is to conduct normal or remedial supervision successfully, it needs access to information about the financial condition and operations of each credit institution. Table 2 provides summary data on information access of EU prudential supervisors. All but one of the 27 EU supervisory bodies, including the UK, have claimed in the past that they had adequate information. Yet a House of Commons' Report (2008) concluded that the Financial Services Authority (FSA) lacked necessary information to supervise Northern Rock. Most, but not all, EU supervisors also supplement bank auditing with on-site examinations to verify banks' reported financial condition. Supervisors may not have all the timely information they need in an emergency when only 13 EU countries conduct onsite inspections annually, with the remainder inspecting less frequently—sometimes much less frequently.

Table 2. Prudential Supervisory: Access to information (Number of EU Countries)

Reports Information	**Adequate**	**Not Adequate**		
Number of Countries	*25*	*2*		
Onsite Inspections	**Annual**	**Every 2 Years**	**3 or More Years**	**No Information**
Number of Countries	*13*	*11*	*2*	*1*

Sources: Barth, Caprio and Levine (2004), Freshfields Bruckhaus Deringer (2007) and IMF (2001-2007). See http://www.imf.org/external/pubs/ft/scr/2003/cr03343.pdf.

Although in the EU, Member States have traditionally had different supervisory requirements and accounting rules, harmonization has taken place in the recent years to comply with the International Financial Reporting Standards (IFRS).[9] In addition, EU bank prudential supervisors aim at streamlining financial reporting under IFRS, focusing on harmonization of reporting formats and convergence of supervisory reporting requirements although sharing of that information on individual banks still does not take place systematically.[10]

1-3 *Approaches to Prudential Supervision*

Supervisors' approaches diverge widely among EU countries, as is shown in Table 3. The supervisor is operationally independent in only 11 EU countries, whereas the government has influence over the remaining 16 countries (including France, Germany, the Netherlands, Spain, Sweden and the UK). Government involvement may impede prompt action and could cause conflicts in the resolution of cross-border banks. No supervisor currently conducts mandatory prompt corrective action (PCA) policies (Nieto and Wall, 2006) though some regulators consider that their discretionary powers are equivalent to PCA. Following the Northern Rock episode in the United Kingdom, the Financial Services Authority (FSA) adopted a supervisory enhancement program (SEP). However, the Banking Act 2009[11] does not propose that the FSA be given additional powers or objectives or to create a separate regime of "heightened supervision".[12] According to the new Banking Act, the FSA will take the regulatory decision

[8] In the analysis of this section, we leave aside the issues related to the existing arrangements for coordination between supervisors and central banks, supervisors among countries and central banks, supervisors, ministries of finance, and deposit insurance agencies.

[9] Directive 2003/51/CE of the European Parliament and of the Council of 18 June, 2003 (Official Journal of the European Communities L 178/16).

[10] Own funds (COREP) see http://www.c-ebs.org/sd/SDReporting_COREP.htm Balance Sheet and income statement (FINREP) see http://www.c-ebs.org/sd/SDReporting_FINREP.htm.

[11] See http://www.opsi.gov.uk/acts/acts2009/ukpga_20090001_en_1 [visited 23 February 2009]. The Banking Bill was introduced into Parliament on 7 October 2008 and received Royal Assent on 12 February 2009. The Bill is now an Act of Parliament.

[12] See Speech by Hector Sants (Chief Executive, FSA), "Dialogue on Financial Stability. How is Bank Risk to be managed", Associate Parliamentary Group on Business Finance & Accountancy Banking

that a bank is failing the test (the specified threshold conditions) to continue to be an authorized institution. Once that decision is taken, the Bank of England is the institution in charge of the Special Resolution Regime (SRR) which according to the new law, comprises three stabilization options: private sector purchase, bridge bank and temporary public ownership.[13] This early intervention system, complemented by a system of *lex specialis* (with a bank administration procedure and a bank insolvency procedure) is a significant and welcome shift in direction in the United Kingdom although there have been concerns raised about certain aspects of the legislation.[14] Once a bank is placed into the SRR, the FSA will continue to supervise the institution.

Moral suasion is popular and some supervisors (including those in France and Germany) report taking a gradual, incremental approach to corrective action, while others require a high burden of the proof, or are legislatively required to delay, before taking action.

Table 3. Supervisory Accountability (Number of EU Countries)

Independence	**Is Operationally Independent**	**Shares Responsibility with the Government**	**Consults the Government**	**Is Partly Independent**	**Is Not Independent**
Number of Countries	*11*	*5*	*5*	*3*	*3*
Style of Supervision	**Takes a Gradual Approach**	**Requires a High Burden of Proof**	**Needs to Consult Government**	**Relies on Moral Suasion**	**Required to Delay Action**
Number of Countries	*4*	*2*	*9*	*12*	*2*
Right of Appeal	**Supervisory Hearing**	**Ministerial/ Independent Review**	**To a Court**	**Court Can Compensate Not Reverse**	**3rd Party Can Contest in Court**
Number of Countries	*11*	*8*	*27**	*5*	*10***

Sources: Asser (2001), Bank of England, FSA, Treasury (2008), Barth et al. (2004), Campbell and Cartwright (2002), Decressin et al. (2007), IMF (2001 to 2007), Freshfields Bruckhaus Deringer (2007), Hüpkes (2000, 2003, 2007, 2008), House of Commons (2008).
Notes: * The court is a special administrative court in 10 of these countries.
** There was a right of appeal for 3rd parties in Germany and Luxembourg, but it is not clear that it still exists after legislative changes.

1-4 The Supervisor's Regular and Remedial Powers

Prudential supervisors need the power to deter excessive risk taking by healthy banks and to demand capital to be rebuilt at undercapitalized banks. If a bank's capital drops below minimal regulatory levels, supervisors need ways to resolve its problems before the bank becomes insolvent, but their oversight and remedial powers are very fragmented and vary widely within the EU. As Table 4 shows, not all supervisors can levy fines, remove errant managers, impose stricter capital requirements,[15] require a remedial plan, appoint a special inspector, impose conditions on the chartered bank, or restrict business activities including the prohibition of any capital expenditure. Not all supervisors can curtail owners' voting rights,[16] initiate reorganization or winding up procedures or appoint a conservator to run it.

Reform, 14 October 2008, available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/1014_hs.shtml

[13] A temporarily nationalized bank has not 'failed' and been put through an insolvency proceeding and so avoids triggering the default that voids certain contracts, such as those relating to derivatives.
[14] It is beyond the scope of this article to provide a detailed discussion of the new legislation.
[15] This power is discretionary, except in Austria, where the supervisory authority must impose additional requirements when there is a clear breach of the banking act and that situation has not been remedied by other measures (CEBS, 2009)
[16] Furthermore, in some countries the power extends only to shareholders with qualifying interests. In Spain, depending upon the triggering event, either the supervisory authority suspends voting rights or the

For example, the new banking law in the UK introduces a range of powers with regard to the new Special Resolution Regime (SSR), which encompasses pre-insolvency measures, as well as an actual bank insolvency procedure, as mentioned above. The supervisory power to prevent asset transfers also differs across the EU. Certain supervisors "are neither explicitly empowered nor required to prevent or prohibit intra-group transactions,"[17] and not all have full responsibility to prevent asset transfers.[18] Instead in many Member States, it is the judicial authorities that decide whether a transaction is detrimental to a credit institution, especially where the legal framework prohibits disadvantageous transactions during a crisis.

Table 4. Supervisor's Remedial Powers Actions as the Situation Deteriorates (Number of EU Countries)

	The Supervisor Can	Needs Government or Court Approval	The Supervisor Does Not	No Information Available
Issue Cease and Desist Orders	27			
Levy Fines and/or Penalties	24 (fines are inconsequential in 3)		3	
Remove Managers	21		6	
Demand stricter capital requirements	25		2	
Require a Remedial Plan	24		3	
Appoint a Special Inspector	20		7	
Prevent Asset Transfers	27*			
Power to Require Shareholders to Support the Institution if Needed with Cash	15	1	12	
Impose Conditions on License	22	**3**	1	
Restrict Activities/Lending	25		2	
Restrict, Place Conditions on Business	27 (4 only when a breach of legal provisions occurs)			
Restrict Voting Rights	22		5	
Initiate Reorganization /Winding Up	18	1	9	
Appoint Conservator	14	6	5	2
Revoke the License	23	8	3	

Sources: Asser (2001), Bank of England, FSA, Treasury (2008), Barth et al. (2004), Campbell and Cartwright (2002), Decressin et al. (2007), IMF (2001 to 2007), Freshfields Bruckhaus Deringer (2007), Hüpkes (2000, 2003, 2007, 2008), House of Commons (2008).

* In some countries, it is ultimately the judicial authorities who decide whether a transaction is detrimental or not to a credit institution.

The EU Commission is currently considering whether an ability to transfer assets among components (including the subsidiaries) of a weak banking group would aid its reconstruction. In sum, substantive harmonization in the EU has, so far, not removed differences in: supervisory approaches and powers, citizens' rights of appeal against supervisory decisions, the treatment of deposit insurance claims (as we further discuss below), the triggers that initiate and the procedures that govern reorganization and winding up. The lack of harmonization of the nature of the supervisory measures, the criteria of application and the moment at which measures are activated was recognized as a hindrance by the Ministers of Finance at the ECOFIN in December

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Minister of Finance or Economy suspends voting rights following a proposal from the supervisory authority. In France, the power is exercised when a provisional administrator is appointed by the authority applying to the French Court.

17 See "Summary of the public consultation on the reorganization and winding-up of credit institutions" European Commission, Internal Market and Services DG, December 2007, pp. 20-21.

18 In Austria and Bulgaria, those measures will typically be imposed by a special administrator appointed by the supervisory authority. In Italy, those measures fall under the supervisory discretion.

2007 when they committed themselves to address more of these differences and to work towards further convergence in supervisory cultures and practices.[19] Differences in supervisory approaches and powers are being addressed under the Lamfalussy architecture by the Committee of European Banking Supervisors (CEBS) and by the application of the Supervisory Review Process[20] under Pillar II of the Capital Requirement Directive (CRD) however, there is still a lack of convergence of supervisory powers and disciplinary actions.[21]

The CEBS Guidelines under the Supervisory Review Process do not remove supervisors´ discretion or establish minimum supervisory actions. They are a step in the right direction but fall short of a prompt corrective action policy based on mandatory "triggers" in the EU. Benchmarks based on predetermined, minimum capital and liquidity ratios ("triggers") would have advantages of (a) discouraging forbearance, which is particularly an issue in supervision of cross-border banks; (b) making credible the imposition of sanctions and (c) limiting losses to tax payers (Nieto and Wall, 2006). In the aftermath of Northern Rock crisis, there has been a growing support for some sort of mandatory resolution in the UK. The Special Resolution Regime (SRR) introduced by the UK Banking Act substantially expands the tool-kit available to the authorities to deal with troubled banks.[22] Nonetheless, structured early intervention based on "capital triggers" has been found wanting in the US (Eisenbeis and Wall 2002, Kaufman 2004b) and has been further tested in the present crisis in the US.[23]

2 - Reorganization and liquidation of cross border banks in crisis: What should the objectives of the policy maker be in the reform of the arrangements for financial stability in the EU?

2-1 Review of the literature on bank resolution

As explained in the previous section, differences in supervisory approaches to remedial actions are an important challenge to the efficient resolution of cross-border insolvent banks in the EU. The beginning of this section briefly reviews the financial literature that discusses the rationale for the efficient resolution of bank insolvency. That literature focuses mostly on the resolution of individual domestic banks. Despite their growing importance, less has been said about the resolution of large complex financial organizations (LCFOs) and non depository institutions

[19] Council of the European Union, Economic and Financial Affairs, 9 October, 2007. http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/96351.pdf. These proposals were further developed in the Report to the Informal ECOFIN meeting on actions to develop EU financial stability arrangements (Brussels, 3rd April 2008) ECOFIN/CEFCPE (2008)REP/51731. "INVITES the Commission, in cooperation with the Level 3 Committees, to study the differences in supervisory powers and objectives between national supervisors and, where (still) necessary and appropriate, define an adequate set of powers in the relevant Directives to ensure the proper implementation of EU Directives across Member States. In addition, the Commission, in cooperation with the Level 3 Committees, is INVITED to conduct a cross-sectoral stock taking exercise of the coherence, equivalence and actual use of powers among Member States and of the variance of sanctioning regimes. That stock-taking exercise should in particular allow to ascertain whether such sanctioning powers have sufficiently equivalent effect."

[20] See http://www.c-ebs.org/sd/Review.htm

[21] Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (the 'Recast Banking Directive'), Directive 2006/49/EC (the 'Capital Requirements Directive') - both are referred as the Capital Requirement Directive (CRD)-; Directive 94/19/EC, (the 'Deposit Guarantee-Schemes Directive') and Directive 97/9/EC (the 'Investor Compensation Scheme Directive').

[22] http://services.parliament.uk/bills/2007-08/banking.html

23 In case of Wachovia, the systemic exception foreseen in the FDICIA was applied. Citicorp appears have been rescued in accordance with the G20 agreement of November 2008 to prevent the failure of systemically important banks.

that span national borders. Outside IMF and World Bank publications less has been said out handling widespread failures.

Kaufman (2004a) argues that insolvent banks are resolved efficiently when the sum of their aggregate credit and liquidity losses is at, or close to, zero.[24] More generally, Eisenbeis and Kaufman (2006) claim that the public policy objective of resolving banks should be to reduce costs (both public and private) and permit free entry and exit of failed banks at minimal cost to society. Hüpkes (2005) argues that the objective should also be to "preserve critical functions" –in particular with respect to policies on dealing with systemically relevant institutions. Broadly speaking, there are two legal approaches for dealing with banks in crisis: *lex generalis* (the general insolvency law) and *lex specialis* (special laws designed for banks, which still may include some involvement of the courts of Justice in the actual insolvency procedures) (Hüpkes, 2003).[25] These approaches differ in terms of how effectively they achieve the above-mentioned objectives from the moment of first intervention in the problem bank to the ultimate administration of the bank in liquidation.

Under special administrative rules, the prudential supervisor has broad discretion to decide when to intervene. To the extent that action is prompt and there is no supervisory forbearance, not only should there be no losses to insured depositors but the sale of a troubled domestic bank could be rapid and allow qualified borrowers to continue to use their existing credit lines. In a cross-border environment, however, incentive conflicts among a multiplicity of prudential supervisors and regulatory regimes may compromise early intervention (Bliss, 2007, Mayes, Nieto and Wall, 2008). While financial markets have grown international, regulation remains nationally based, constrained by the domain of domestic jurisdictions (Lastra, 2003 and 2007). Insolvency law defines more narrowly the specific conditions that trigger bank intervention, although in a cross-border environment, the rules of closure (and their interpretation) may be somewhat different. Moreover, insolvency law generally requires that creditors or management petition the court to intervene and this will most likely take place when the bank is deeply insolvent with little regard to the objective of minimizing credit and liquidity losses (e.g., in Luxembourg and Germany, the regulatory authorities apply to the court for the initiation of insolvency proceedings over banks).

The differential treatment of shareholders and creditors may depend more on the design of the procedure than the fact that it is administrative or judicial. For instance, under Italian law, there is a procedure for forced administrative liquidation in which shareholders have no say and are treated in the same way as in a judicial bankruptcy procedure. Differential treatment arises in the pre-insolvency stage, where jurisdictions give different weight to the protection of stakeholders' rights.

In an administrative procedure, the provisional administrator, who is appointed by the bank supervisor, exercises controlled administration over the troubled bank.[26] Provisional administration aims to make the bank financially viable and, although creditors do not have standing in the procedure (which accelerates the process) shareholders´ consent must be obtained for all actions where such is normally required by the company law that restricts the

[24] Kaufman defines credit losses as the par value of the deposits or other debts at their respective maturity dates less the recovery value of the bank as a whole or in part. He defines liquidity losses as those stemming from the depositors´ lack of immediate access to the par value of their *de jure* insured deposits or the estimated recovery value of their *de jur*e uninsured claims. Liquidity losses may also occur as a result of the lack of immediate access by qualified borrowers to their existing credit lines.
[25] The special administrative laws may also only establish exceptions to the ordinary bankruptcy law.
[26] The provisional administrator would be called the conservator in US terminology.

powers of the administrator (Hüpkes, 2003).[27] If a bank cannot be made viable under provisional administration, the alternative is liquidation, which can be handled either under a "special resolution regime" or the general bankruptcy law.

Under a "special resolution regime" (typically for banks, though it can also include other financial institutions) like the one recently adopted in the UK, the resolution authority aims primarily at maintaining depositor and creditor confidence and financial stability as well as preserving any residual value of the bank. Furthermore, in some countries such as the US, the minimization of public costs of resolution is also an explicit objective (unless the systemic exception is declared).[28] To that end, the resolution authority is vested with special powers, such as that of promptly transferring the par value of insured deposits, the estimated recovery value of uninsured deposits, and credit lines to a "bridge bank" under temporary public ownership, which, if done right, insures that the bank is resolved at a least cost.[29] This approach has influenced the recent UK legislative banking reform.

It is an approach that reduces the pressure to keep insolvent banks open with the negative consequences of diminishing the value of its franchise and thus the chances of reprivatizing the bank.[30] In the context of the recent crisis, there is some resemblance between this approach and the recapitalization by Belgium, Holland and Luxembourg of Fortis, which facilitated the later acquisition by BNP Paribas. In the absence of the adequate legal framework, Belgium and Dutch shareholders are bringing legal actions against the bank´s management and Dutch government. Under the "special resolution regime", the apportionment of losses among the shareholders and uninsured creditors can aim at minimizing moral hazard and enhancing market discipline. The prompt estimation and allocation of credit losses is of utmost importance if the bank is to be privatized. An argument in favor of the supervisors´ involvement in the bank resolution process is that supervisors that have inspected the bank since the inception of its activities until the crisis develops may be in the best position to quickly estimate the recovery value of the institution as a whole or in parts upon its legal closure. Nonetheless, the present crisis has proved how under severe market conditions banks´ financial conditions can deteriorate very fast and crisis materialize within hours, particularly if the bank is listed in the stock market.

Where there are different classes of creditors, the *pari passu* principle means that creditors within the same class are treated the same. Depositors may be in the same class as unsecured

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[27] Hüpkes (2003) argues that the Court of Justice may have limited the ability of administrative procedures to bring about effective resolution in EU Member States as a result of its 1996 opinion in *Panagis Pafitis and other v. Trapeza Kentrikis Ellados AE and others* ("Pafitis case").

28 With regard to resolving a failed bank, Article 141(a)(4)(A) of FDICIA stipulates that "the total amount of the expenditures by the Corporation…..is the least costly to the deposit insurance fund of all possible methods for meeting the Corporation's obligations under this section."

[29] Powers to allow the authorities to take control of all or part of a bank (or of its assets and liabilities) through a "bridge bank" is possible in the U.S (under the administration of the FDIC) and Canada. Also, the procedure applied by the Spanish deposit protection agency (FGD) during the Spanish banking crisis of 1977- 85 bears some resemblance to the "bridge bank." FGD gained full control of the failed bank after bad debts were written off against the remaining capital. Unless a suitable buyer for the restructured bank was found immediately, the FGD attempted to sell the bank in a limited public offering (Hüpkes, 2000). In the UK, in the aftermath of the Northern Rock crisis, the authorities are considering the "transfer of undertakings" to a bridge bank to reduce the impact of failing banks (Chapter 4 in the HMT 2008 report).

[30] The prompt estimate and allocation of credit losses is of utmost importance if the bank is to be privatized. Furthermore, requiring stakeholders to share losses is necessary to minimize moral hazard and to enhance market discipline.

creditors, or alternatively, as is the case in the US, Australia and (for a limited amount) in Switzerland they are in a higher class (depositor preference).

The general bankruptcy laws grant the receiver or liquidator exclusive control over the assets and liabilities of the failed bank. On the one hand, shareholders lose at least part of their ownership rights, which helps to speed up the process, while the procedural requirements and publicity involved in formal judicial proceedings (e.g. creditors meeting) lengthen the bankruptcy process and so may exacerbate liquidity and credit losses.[31] Moreover, Bliss (2007) argues that creditors may seek to gain control of assets prior the bankruptcy filing, thus precipitating a "rush to the exit" that bankruptcy attempts to avoid. Furthermore, creditors may demand collateral, raising the effective cost of borrowing and limiting credit access to firms that have good collateral to pledge. Finally, Bliss (2007) also refers to the possibility that creditors would price the risks they face in bankruptcy into their contracts, raising the price of credit. By the time a court-administered procedure has commenced, judicial liquidation of a bank is therefore much more likely than rehabilitation. Last but not least, court-administered procedures present multiple challenges for the cross-border resolutions of LCFIs. [32]

The conflict between the objectives for the efficient resolution of insolvent banks (as presented by Kaufman, 2004a and Eisenbeis and Kaufman, 2006) and the court administered procedures leads us to conclude with Hüpkes (2003) that shifting responsibilities to the supervisory authority increases economic efficiency as long as there are prospects for the troubled bank to continue operations. Even if the bank is to be liquidated, supervisors have an informational advantage not only about the financial condition of the bank but also about its role as a counterparty to contracts with non depository institutions (in the form of derivatives, foreign exchange contracts, repos, etc), which would justify their involvement also in the liquidation. For all of these reasons, general insolvency laws often recognize the role of banks in the economy and give preferential treatment to market participants by contemplating exceptions to the *pari passu* principle on the treatment of collateral as well as netting and close out arrangements.[33]

Campbell (2003) defends the position that the main obstacle to achieving major progress towards the international harmonization of bank insolvency laws lies in deciding whether to utilize a "special resolution regime" or a general bankruptcy law. In this regard, the Reorganization and Winding-Up Directive (2001/24/EC), which applies only to cross-border credit institutions in the EU, implicitly recognizes that difficulty, but does not resolve it as explained below. [34]

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[31] This fact is recognized in the HMT 2008 report in Chapter 4: Reducing the impact of a failing bank, paragraph 4.38 "To facilitate a prompt FSC payout, it is proposed that under the bank insolvency procedure no meeting of creditors could be held to nominate an alternative liquidator to the insolvency practitioner appointed by the Court. However, the bank liquidator would still be required to provide a report to creditors, including summary of the financial position of the bank …"

[32] There are two methods for dealing with international insolvencies: The universal or single approach and the territorial approach. The universal approach seeks to achieve a coordinated resolution of insolvency by having the courts in the relevant jurisdictions act in concert with one court taking the lead and the others conducting ancillary proceedings to support the activities of the lead court. The territorial approach, on the other hand seeks to conduct simultaneous independent proceedings in each relevant jurisdiction, with each court seeking to gain control of assets under its jurisdiction in order to satisfy claims of its own creditors.

[33] Under a contractual bank netting agreement, a bank only faces the risk that its counter party will default on payment of a net amount, not a larger gross amount. Bank collateral arrangements are protected from rules that would inhibit effective foreclosure.

[34] Official Journal of the European Communities L125, 5th May, 2001.

The recent financial crisis has emphasized that the explosion of derivatives and other complex financial contracts has left financial institutions closely intermeshed so that it has become increasingly difficult to ring-fence banks from other less regulated financial institutions.[35] This will likely have an impact on the regulation of institutions that are systemically important even if they are not banks (i.e. AIG was considered to have systemic importance). One of the relevant aspects that regulation would need to address is whether these systemically important non-bank institutions should also be subject to a *lex specialis* that would allow for the efficient management of their reorganization and winding up.[36] The collapse of Lehman Brothers has highlighted the importance of this issue.

2-2 Does the 2001 Directive on Reorganization and Winding Up of Credit Institutions guarantee the objective of minimizing private and public costs?

In spite of the fact that bank insolvency law is an important component of the EU safety net, the EU has faced hurdles and delays over the years in trying to agree on some common principles on bank insolvency. Indeed, it was only in 2001 that the Directive on Reorganization and Winding Up of Credit Institutions was finally adopted (Directive 2001/24/EC) and only recently implemented by all Member States, even though the proposed directive was initially published in 1988. The objectives of Directive 2001/24/EC are rather narrow and, in accordance with the objectives of the Treaty, mainly aimed at the elimination of "any obstacles to the freedom of establishment and the freedom to provide services within the Community." The Directive is neither particularly aimed at preserving EU financial stability nor at limiting public and private costs of bank crisis resolution.

Directive 2001/24/EC does not seek to harmonize national legislation concerning re-organization measures and winding-up proceedings (including a common rule of bank closure), rather it ensures mutual recognition and co-ordination of these procedures by the Member States of the EU, based upon the principle of home-country control, as well as the necessary cooperation between authorities.[37] It embraces the principles of unity and universality, single entity approach to liquidation, and the equal treatment of creditors.[38] In spite of the far reaching effects, the

[35] Financial regulators were concerned that the collapse of Bear Stearns would create serious fears about "counterparty risk" because the institution was a crucial participant in the credit derivative market. Bear Stearns was also an important participant in the so-called tri-party repo market, the sector where banks and brokers lend securities to each other overnight in exchange for cash. This source of financing is important for banks in the US. Some analysts refer to the term "too interconnected to fail," particularly in times of crisis when interconnections among different financial institutions typically rise. (FT, Thursday, April, 24, 2008).

[36] This has become a major issue in the U.S. The FDIC's *lex specialis* applies only to insured banks, not to their holding companies or other financial institutions such as investment banks.

[37] For an analysis of the Directive, see Campbell (2003), Hadjiemmanuil (2005) and Nierop and Stenström (2002). Campbell, Andrew, 'Issues in Cross-Border Bank Insolvency: The European Community Directive on the Reorganization and Winding Up of Credit Institutions' in Current Developments in Monetary and Financial Law, Vol. 3, International Monetary Fund, Washington DC, 2003; Hadjiemmanuil, Christos, 'Europe's Universalist Approach to Cross-Border Bank Resolution Issues', Chapter 15 in D. Evanoff & G. Kaufman, Systemic Financial Crises: Resolving Large Bank Insolvencies, World Publishing, 2005; Nierop, Erwin and Mikael Stenström. 'Cross-Border Aspects of Insolvency Proceedings for Credit Institutions: a Legal Perspective', paper presented at the International Seminar on Legal and Regulatory Aspects of Financial Stability in Basel in January 2002.

[38] Under Directive 2001/24/EC, where a credit institution with branches in other Member States is wound up or reorganised, the winding up or reorganisation is initiated and carried out under a single procedure by the authorities of the Member State where the credit institution has been authorised (known as the home Member State). This approach is consistent with the principle of home Member State supervision pursuant to the EU Banking Directives. The Directive covers only the insolvency of branches of credit

Directive is subject to interpretation as the definition of reorganization measures and the definition of winding-up proceedings contained in the Directive are open definitions. As a result, the range of measures foreseen by national law and falling under the Directive's definition of reorganisation measures and winding up procedures is rather varied. In addition the responsible authority (administrative or judicial) and the grounds that trigger the reorganization and winding up procedures vary within the EU countries.

The Reorganization and Winding-Up Directive becomes applicable when a credit institution is acknowledged to be insolvent. However, no common threshold for the initiation of bank insolvency proceedings exists in the EU. Although it has not been possible to determine the nature of the laws governing bank bankruptcy in many EU countries, what information is available suggests that EU countries vary widely on the range of reorganization measures and winding-up proceedings foreseen by the national laws and who takes charge of the proceedings. Greece appears to use a law designed specifically to deal with failed credit institutions and to resolve them using administrative proceedings. Belgium has special law governing bank failures but utilizes judicial receivership proceedings. Finland and Sweden apply their general bankruptcy laws and judicial receivership. France, Germany, Italy, Spain and the Netherlands have enacted special provisions for insolvent banks that adjust the general bankruptcy laws that make possible administrative receivership proceedings in France, Italy and Spain. The introduction of an SRR in the UK reinforces our case for *lex specialis.* As stated above, the UK Government introduced the Banking Bill 2007-2008 into parliament on 7 October 2008 and received Royal Assent on 12 February 2009. The new Banking Act 2009 establishes for the first time a permanent statutory regime for dealing with failing banks, including a new bank insolvency procedure. [39]

When reorganization measures are specific to credit institutions, it is generally the supervisory authority that it is entitled to initiate and oversee them. The arrangement in the UK however divides the responsibility between the FSA as supervisor and the Bank of England as resolution agency. In countries where the same bankruptcy procedures are applicable to all companies, the supervisory authority is but one of the entities that can initiate reorganization and it is usually the creditors, the entity concerned, or its directors that do so. In some countries (including Germany and the Netherlands) however only the supervisor can file for bankruptcy. In most EU countries' winding up occurs under the jurisdiction of the court, although in one such country, the court has to obtain the supervisory authority's opinion before the credit institution can be wound up. Winding up is controlled by the administrative authorities (supervisors and the Minister of Finance) in the other countries (including Italy and Spain).

Table 5 shows that six European prudential supervisors (including those in Germany, Italy and the Netherlands), have direct power to impose a moratorium on legal actions to, for example, enforce the debts of a troubled credit institution, while others need approval from the government or the court to do so. Not all supervisors have this power: For example, bank supervisors in France and Spain have to apply to the courts for a moratorium on legal action.[40]

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institutions in other Member States, but does not cover subsidiaries of banking groups in other Member States.

[39] It also extends the powers of the Bank of England with regard to financial stability and oversight of inter-bank payment systems, and introduces modest changes to the Financial Services Compensation Scheme. See http://www.opsi.gov.uk/acts/acts2009/ukpga_20090001_en_1, supra note 11.

[40] In Spain, the board of directors is obliged to ask for the opening of insolvency proceedings within two months once they become aware of the insolvency (voluntary insolvency). Creditors are also entitled to ask

As described in Nieto and Wall (2006), such measures are typically accompanied with some form of direct or indirect control by a provisional administrator on bank's management.[41] In many EU countries (including France, Germany and Spain) the supervisor can suspend payments by the troubled bank, although approval from the government is needed in two countries and from the court is needed in another two.

Table 5. Responsibilities in Bankruptcy (Number of EU Countries)

Topic	Supervisor	Government	Court	Creditors	Not Known
Can Impose a Moratorium	11 (6 directly, 1 with government approval[1], and 4 with court approval)	5 (3 on the recommendation of the supervisor)	5	0	6
Can Suspend Payments	15 (11 directly, 2 with government approval[1] and 2 with court approval)		1	0	11
Revokes the License	19 (7 need approval from the government and 5 need approval from the court)	5 (3 as recommended by the supervisor**)**	3	0	0
Can File for CI Bankruptcy[2]	15 (1 needs government approval[1]	0	3	4	11
Can Close the CI	7 (1 needs government approval[1])	0	19	0	1
Can Appoint Liquidator	12 (2 need government approval[1])	1 (supervisor recommends)	22	0	0

Sources: Asser (2001), Bank of England, FSA, Treasury (2008), Barth et al. (2004), Campbell and Cartwright (2002), Decressin et al. (2007), IMF (2001 to 2007), Freshfields Bruckhaus Deringer (2007), Hüpkes (2000, 2003, 2007, 2008), House of Commons (2008).
Notes: [1]Government approval comes usually from the ministry of finance or the ministry of the economy.
[2]May sum to more than 27 because some countries give two bodies the authority to act.

EU Countries vary on the range of measures foreseen by national law and in their perception of what falls under the Directive's definition of reorganization measures and winding up proceedings. They differ also on the grounds that trigger the measures/proceedings on which parties are entitled to initiate proceedings, and on which authority (administrative or judicial) is in charge. The supervisor can revoke the banking license in most of the EU (including France, Germany, the Netherlands, Sweden, and the UK), although he/she may need government approval elsewhere. The government formally revokes the license on the recommendation of the supervisor in Italy and Spain, while the Court does so in three other EU countries. The Court legally closes the bank in the majority of EU countries (including France, Germany, Italy, the Netherlands, Spain, and Sweden). Otherwise, the supervisor legally closes the failed bank. Needing approval is likely to encourage supervisory forbearance and delay the speedy action needed in a crisis. It may be that court determination of bank insolvency is a trivial exercise that merely uses available data to verify the supervisors' arithmetic; otherwise it may be substantive but and may require the court to undertake actions that lie beyond its competence (Nieto and Wall, 2006). The supervisor can sometimes appoint the receiver/liquidator, while the Court mostly does so. In a number of countries both the supervisor and the Court have this power. All

for the opening of insolvency proceedings (compulsory insolvency) if they can demonstrate that the company has ceased to pay its debts on a general basis, its assets have been seized or some specific obligations have not been met (such as the payment of taxes, salaries or debts to the Social Security System during the last three months). The initiation of insolvency proceedings is decided by the competent judge after informing the Banco de España.

[41] Hüpkes (2003) describes the suspension and appointment of a provisional administrator as a "quasi-insolvency" procedure, which gives the provisional administrator wide ranging powers to bring about a resolution, including the sale of new stock and the transfer of ownership.

of the above hinder the possibility of establishing a common closure rule for banks in the EU. Furthermore, the possibility of establishing a closure rule at a positive level of capital under a special resolution regime (as the one under discussion in the United Kingdom) in order to protect depositors and tax payers raises some issues under the European Convention on Human Rights. [42]

Regarding communication between resolution authorities, Directive 2001/24/EC (art. 4) refers to the obligation of the administrative and judicial authorities of the home Member State to inform "without delay" the competent authorities of the host country (generally prudential supervisors) of their decision to adopt any reorganization measure. In this regard, it is even more surprising that the 2008 MoU on cross border financial stability does not encompass the national resolution authorities. Furthermore, the 2001 Directive does not specify the means or the time frame for communicating that information. The Directive is also evasive regarding the obligation to send for publication the information about the decision to open reorganization measures or winding up proceedings to the Official Journal of the European Union.[43] Moreover, the principle of professional secrecy limits the possibility of more structured exchange of information before the initiation of the reorganization and winding up process.

Very few countries provide specific rules for reorganization measures and winding up proceedings concerning banking groups. Directive 2001/24/EC is limited to procedural aspects concerning each legal entity within a cross-border banking group. This limited scope does not allow taking into account synergies within such a group, which may benefit all creditors in case of reorganisation. This lack of group-wide approach to winding up and reorganisation could lead to the failure of subsidiaries or even the group, which could otherwise have been reorganised and remained solvent in whole or part.

Finally, the 2001 Directive contains a number of conflict-of-law rules applicable to certain matters affected by a reorganization measure or the opening of winding up procedures. This is particularly the case for the provisions that deal with set-offs, property rights and netting and repurchase agreements.[44] These conflicts cannot be resolved only by means of reforming the 2001 Directive but may require a more full-fledged review of the Community legislation.

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[42] This hurdle can be overcome, though. According to Hüpkes, E., *Special Resolution and Shareholders Rights* (paper presented at the workshop organized by Cass Business School on the new UK Regime for Resolution of Banking Problems on 7 April 2008), 'Shareholders have legitimate rights that need to be respected in a special resolution regime. (…) [I]t is necessary to provide a clear legal framework with adequate intervention powers that make the restriction or elimination of shareholders rights predictable as does the corporate insolvency regime'.

[43] This also raises the issue of the standardization of the information.

[44] Title IV of the Banks Winding-up Directive contains a number of conflict-of-law rules applicable to certain matters affected by a reorganization measure or the opening of winding-up proceedings. Of particular relevance in the context of crisis management issues are the following provisions. Under Article 10(2)(c) of the Directive the law of the home Member State shall determine in particular the conditions under which set-offs may be invoked. Under Article 23 of the Directive the adoption of reorganization measures or the opening of winding-up proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the credit institution, where such a set-off is permitted by the law applicable to the credit institution's claim. This shall not preclude the actions for voidness, voidability or unenforceability of legal acts detrimental to all creditors. Under Article 24 of the Directive the enforcement of proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralized deposit system held or located in a Member State shall be governed by the law of the Member State where the register, account or centralized deposit system in which those rights are recorded is held or located.

Against this background, the October 2007 ECOFIN conclusions called for an enhancement of the arrangements for financial stability in the EU and a review of the tools for crisis prevention, management and resolution, including a revision of the Directive reorganization and winding up of credit institutions and a clarification of the Deposit Guarantee Directive. For this purpose, the Commission carried out a public consultation, to seek clarification on: (a) whether Directive 2001/24/EC on the reorganisation and winding up of credit institutions leaves gaps and ambiguities which need to be removed, and (b) issues related to the treatment of cross-border banking groups (i.e. parent credit institutions with subsidiaries in other Member States) in a crisis situation or under reorganisation.[45] These issues are being subject to further study/investigation. However, in the light of the ongoing financial crisis, priority has been given to the reform of other rules, notably the amendment of the Capital Requirements Directive, the Deposit Guarantee Schemes Directive and the Solvency II (re insurance companies) Directive, as well as the introduction of rules on credit rating agencies. The concern remains of having a patchwork of rules with regard to cross-border banks' crisis management in the EU, as we further elaborate in the ensuing section.

2-3 A comprehensive approach to the reform of bank insolvency in Europe

The strong national orientation of the EU safety net suggests that in the face of a cross border crisis, national authorities would have a strong tendency to put their own national interest first since the present structure of supervision, deposit insurance coverage and bank resolution largely follows the national legal structure of banking groups.[46] The lack of incentives to cooperate (including sharing information) has been highlighted by a number of authors (Garcia and Nieto, 2007; Nieto and Schinasi, 2007; Mayes, Nieto and Wall, 2008) who share the view that the existing institutional framework encourages delayed solutions likely to substantially increase taxpayer losses. It can be argued that a breakthrough toward architectural design of the EU safety net occurred in October 2007 when Ministers of Finance in the ECOFIN agreed on a comprehensive approach that, for the first time, considered the simultaneous reform of the entire EU safety net including a revision of the

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Under Article 25 of the Directive netting agreements shall be governed solely by the law of the contract which governs such agreements. Under Article 26 of the Directive repurchase agreements shall be governed solely by the law of the contract which governs such agreements. This is without prejudice to the above-referenced Article 24. Under Article 27 of the Directive transactions carried out in the context of a regulated market shall be governed solely by the law of the contract which governs such transactions. This is without prejudice to the above-referenced Article 24. The above-referenced provisions of the Directive regarding set-off and netting should be read in conjunction with Articles 1, 2 and 7 of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (the Financial Collateral Directive), which requires Member States to ensure that a close-out netting provision of a financial collateral arrangement (or an arrangement of which a financial collateral arrangement forms part) to which, inter alia, a credit institution is party can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganization measures in respect of the credit institution.

[45] The purpose of the public consultation was to take stock of legal frameworks in the different Member States relating to the reorganization and winding up of banking groups. The consultation also aimed at identifying problems preventing a smooth crisis management and a smooth resolution process. See Consultation on the Reorganization and Winding Up Directive (12-6-2007) http://ec.europa.eu/internal_market/bank/windingup/index_en.htm

[46] This is explained by the fact that regulation is generally addressed to single entities rather than groups including a foreign parent undertaking and other companies belonging to the same group that find lesser consideration than the domestic entity.

Directive on reorganization and winding up of credit institutions (LOLR was not considered since it is not regulated by a Directive).

The authors of this article identify a number of areas were coordination is most needed, particularly but not exclusively, regarding the Directives that deal with the other two safety net regulators: prudential supervision, and deposit guarantees.[47] In addition, there is a patchwork of rules (mostly Directives) that applies to cross-border banking crises that needs to be taken into consideration at the time of dealing with a cross-border banking crisis (the Appendix contains a summary of some of these rules dispersed in various legislative instruments).[48] EU Member States also resort to other types of rules, often in the form of a Memorandum of Understanding, to establish some principles of co-operation in the regulation of cross-border establishments.[49] None of the existing MoUs do encompass either the deposit insurance or the reorganization and resolution authorities other than the prudential supervisors.

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[47] Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (the 'Recast Banking Directive'), Directive 2006/49/EC (the 'Capital Requirements Directive') -both are referred as the Capital Requirement Directive, CRD-; Directive 94/19/EC, (the 'Deposit Guarantee-Schemes Directive') and Directive 97/9/EC (the 'Investor Compensation Scheme Directive').

[48] The EU insolvency regime consists of one regulation on insolvency proceedings (Council Regulation (EC) No. 1346/2000 of 29 May 2000) and of two directives: a Directive on the reorganisation and winding up of credit institutions (Directive 2001/24/EC of 4 April 2001), and a Directive concerning the reorganisation and winding-up of insurance undertakings (Directive 2001/17/EC of 19 March 2001). Furthermore, other Directives also contain provisions that apply to crisis situations (e.g. with regard to exchange of information), most notably: Directive 2002/87/EC, (the 'Financial Conglomerates Directive'), Directive 94/19/EC, (the 'Deposit Guarantee-Schemes Directive') as well as Directive 2003/6/EC (the 'Market Abuse Directive' or MAD), Directive 2004/39/EC (the 'Market in Financial Instruments Directive' or MIFID) and Directive 97/9/EC (the 'Investor Compensation Scheme Directive'), Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (the Financial Collateral Directive; Community state aid rules laid down in Articles 87-89 of the Treaty and secondary legislation thereunder; Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and securities settlement systems (the Settlement Finality Directive; Directive 2002/47/EC of the European Parliament and of the Council on financial collateral agreements (Collateral Directive).

[49] However, MoUs are voluntary arrangements, and are not legally binding. Moreover, in the case of the first three multilateral MoUs (the MoU on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations, 18 May 2005;the MoU on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations, 10 March 2003; and the MoU on cooperation between payment systems overseers and banking supervisors in Stage Three of Economic and Monetary Union,1 Jan 2001) only a press release was published. A new MoU on Co-operation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on cross-border financial stability was signed on 1st June 2008. This new MOU considers the implications of market turmoil for financial institutions with cross-border operations, with the aim to provide general principles and guidelines for crisis management and an analytical framework for preparing responses. (The fact that this 2008 MOU has been published is a commendable step toward greater transparency).

Not only there is a patchwork of rules, but there are also gaps in those rules.[50] The problems of having a patchwork of rules, with gaps and loopholes, are further compounded by complexity on the one hand (for instance, with regard to the European financial architecture, with a plethora of committees, while responsibility for supervision and fiscal policy remains at the national level) and to the need of consistency with related areas of law, on the other hand. For example, the need for consistency with EU state aid rules and competition law must also be considered in the reform of the Winding Up Directive. This is a thorny issue as shown in the case of Northern Rock, because the law in this area is somewhat unclear,[51] and because the demands of competition and the demands of regulation, supervision and crisis management are not always aligned (See Appendix for the brief description of the Community state aid rules laid down in Articles 87-89 of the Treaty and secondary legislation).

Prudential Supervision and Reorganization and Winding Up

Consistency in the regulatory approach between supervisors and resolution authorities requires “implicit” coordination since no "explicit" coordination mechanisms between them exist as yet (e.g. existing MoUs do not include the reorganization and resolution authorities). Directive 2001/24/EC covers only the insolvency of branches of credit institutions in other Member States and establishes the principle of the home Member State responsibility in line with the same principle of supervision pursuant to the EU Banking Directives. The 2001 Directive does not cover subsidiaries of banking groups in other Member States. This exclusion raises a question whether it is feasible to resolve separately parent and subsidiary in a fair and efficient manner (Hadjiemmanuil, 2004).[52] The analogy with the Lehman Brothers insolvency (even though Lehman Brothers was an investment bank not a commercial bank) is illustrative to show the problems of institutions that are global in name and aspirations, but when it comes to the point of insolvency, they become as many legal entities as countries in which they are operating through subsidiaries (and some times even through branches, in the event of ring-fencing).

The present structure of supervision, as it is the case of reorganization and resolution, follows the legal structure of banking groups, the principal exceptions are that the home country supervisor of a bank parent will exercise supervisory authority over a bank subsidiary incorporated in another country through its supervision of the consolidated group and the home country supervisory may be the sole prudential supervisor if the host country

[50] For instance, the Consultation document published by the Commission in December 2007 (Summary of the Public Consultation on the Reorganisation and Winding Up of Credit Institutions) identifies some of the gaps in the scope of the Directive, such as:
“No Community legislation currently allows cross-border treatment of investment firms (that hold client money or assets).
As credit institutions, electronic money institutions are already covered by the Winding Up Directive, but this many not be the case for e-money institutions under a waiver.
It has been noted that some insurance companies (e.g. reinsurance) are not covered by the Directive on the reorganisation and winding up of insurance companies.
Payment Institutions as defined in the Payment Services Directive should also be addressed”.

[51] Banks (whether publicly or privately owned) are subject to EC competition rules (articles 81-89 EC Treaty), including state aid rules (Articles 87-89) as confirmed by the European Court of Justice in Zuchner v Bayerische Vereinsbank (Case 172/80 [1981] ECR 2021) and other cases.

[52] This author points out, the failure of Banco Ambrosiano´s unregulated holding-company subsidiary in Luxembourg effectively brought down the Italian banking group.

supervisor of the subsidiary delegates its responsibility. [53] [54] This apportionment of responsibilities is not mirrored in the Directive 2001/24/EC (nor in the deposit insurance and investor protection Directives), which does not include bank (and, in general, financial institutions) subsidiaries in its scope. For this reason, the "colleges of supervisors" and the "consolidating supervisor" envisaged in the CRD[55] and the Commission Proposal (2008) are not matched by similar structures in the 2001 Directive.[56]

This seemingly lack of consistency in the approaches of prudential supervision and reorganization and resolution of cross border banks raises the question of whether a common decision-making structure to deal with cross-border banks and, more in general, financial conglomerates in crisis is needed (see Mayes, Nieto and Wall, 2008 for a proposal of a collegial approach to bank resolution). In the absence of special bankruptcy provisions for cross-border banks in the EU, such common decision-making structure would facilitate coordination among the existing different grounds for their application as well as among the different authorities that can initiate and manage the reorganization and winding up procedures. Consistent with the exclusion of subsidiaries in its scope, the 2001 Directive does not foresee the delegation of responsibilities of the resolution authority of host country in the home country authority. The possible inclusion of subsidiaries in the scope of the Directive could make the consideration of "delegation" conceptually attractive for the winding up of cross border banks.

Safety net regulators need to have accurate and timely information on the overall financial condition of a banking group if they are to effectively anticipate problems and efficiently resolve banks in crisis. This has been recognized in the CRD (Art. 132) by requiring supervisors to provide one another with any information which is *essential* or *relevant* for the exercise of the other authorities' supervisory tasks, which includes information on deposit

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[53] Consolidated supervision is based on the assumption that financial groups form a single economic entity. However, when one comes to the question of the resolution of a failed multinational bank, or of a complex financial group with activities and business units with different legal entities incorporated in various jurisdictions, the assumption that financial groups form a single economic entity appears to be not always valid in a bankruptcy scenario where the group is split up into its many legal entities.
The powers of the consolidating supervisor have been strengthened in the CRD and the Commission proposal (2008). The consolidating supervisor chairs the colleges of supervisors and leads the process of model validation. Delegation is contemplated in Article 131 of the Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Official Journal of the European Union L177/201 30 June, 2006). In addition, according to Article 44, the home country authorities are responsible for the prudential supervision of consolidated banking groups including bank subsidiaries and affiliates in other Member States.

[54] The Commission proposed changes to the CRD. In spite of recognizing the principle of home Member State control, it proposes to include the host country supervisors of systemically important branches in the colleges of supervisors. EU Commission (DG Internal Markets and Services, Brussels, 16 April, 2008).

[55] Similar structures can be found in the supplementary supervision of financial conglomerates under the name of "coordinator" of the "relevant competent authorities." Directive 2002/87/EC of the European Parliament and of the Council of 16 December, 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (Official Journal of the European Union L35 11 February, 2003) (Conglomerates´ Directive). This Directive is not particularly aimed at cross border financial conglomerates.

[56] Similar provisions regarding the exchange of information do exist in the Conglomerates Directive (art.12).

guarantees. This legal provision has been further specified in the Commission Proposal (2008) with the need to reach agreements within the "colleges" on the disclosure requirements for "significant" subsidiaries, on reporting for the calculation of minimum regulatory requirements, on the treatment of intra-group exposures for large exposures and on own funds requirements in excess of the minimum level (European Commission, 2008). The Directive 2001/24/EC (Art. 4) establishes the obligation to inform "without delay" to the competent authorities of the host Member State (prudential supervisors) of their decision to adopt any reorganization measure (similar information requirements to the home country supervisor are established for host country authorities).[57] However, this precept is not specific about the time and the means, including the format, for communication. Furthermore, it is silent about the need of information exchange among authorities "before" the reorganization measures are adopted. The existence of a common decision-making structure to deal with cross border banks and financial conglomerates in crisis would facilitate the exchange of information before and after the adoption of the reorganization measures. The fact that a bank had to be put into resolution suggests that a quick sale of the entire group is unlikely. The group is likely to have arranged such a sale before resolution, if that were possible. Mayes, Nieto and Wall (2008) argue that the resolution of almost all large cross-border groups is likely to involve their being operated as some equivalent of a bridge bank (or bridge banking group) pending the return of its assets to the private sector.[58] Someone will have to have managerial authority over the bank and in almost all cases the home country supervisor will be the logical party to appoint the new management. The bank's management should be overseen by a board with representatives from all of the affected countries. In these authors´ views, this function can be performed by the resolution college.

Deposit Insurance and Reorganization and Winding Up

The Deposit Insurance Directive [59] imposed minimal conformity and Member States chose a diverse set of responses when implementing it. Table 6 shows differences in: the extent of and exclusions from coverage, the practice of coinsurance, the timing of repayment, the sources and adequacy of funding, the authority of the insurer, its ownership and governance.[60]

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[57] Moreover, the 2001 Directive does not have common provisions on the publication of the reorganization measures and winding up proceedings and the non-compliance consequences in the Official Journal of the European Union.

[58] The shareholders would lose their claim in the sense that their control rights over the bank would be permanently terminated. If the proceeds from selling the group back to the private sector exceed all of the creditors' claims on the bank, the excessive would be returned to the shareholders. On the other hand, any losses in excess of equity would be allocated to the bank's creditors, the governments that provided assistance, and the deposit insurers. In the US, a bridge bank has gone through receivership. This is different from government recapitalization, which aims at avoiding the declaration of insolvency and its consequences for voiding certain contracts

[59] Directive 94/19/EC of the European Parliament and of the Council of 30th May, 1994 on deposit-guarantee schemes. (OJ L 135, 32st May). Some countries have separate schemes for savings and cooperative institutions, but the data here refer only to schemes for commercial and universal banks, except for Germany, which has two schemes for banks, one public and one private. Hence the numbers sometimes sum to 28 rather than 27.

[60] Until the 2008 financial crisis, the majority of schemes offered coverage at €20,000 per person per bank, the minimum set in the Deposit Insurance Directive, but France, Italy, Sweden and the UK offered significantly higher compensation. Responding to the international financial crisis and fearing runs, Austria, Denmark, Greece**,** Germany, Hungary, Ireland, Portugal, Slovakia and Slovenia offered full

Table 6. Diversity in EU Deposit Insurance Schemes (Number of Countries)[1]

Coverage Before September 2008	**€20,000 or less[2]**	**To €50,000**	**€50,000 to €100,000**		**Over €100,000**	**Has Coinsurance**
Countries	*14*	*11*	*1*		*1*	*12[3]*
Excludes[4]	**Deposits in Non-Member Currencies**	**High-Rate or Prejudicial Deposits**	**Govt. Deposits**	**Insider Deposits**	**Offsets Loans against Deposits**	
Countries	*7*	*18*	*22*	*24*	*22*	
Payout	**Depositors File Claim**	**1-3 Months**	**3 Months + Extensions**		**One year or More**	
Countries	*9*	*4*	*21*		*2*	
Funding	**Ex Ante/Mixed**	**Ex Post**	**State Back-up**		**Depositors Have Priority**	
Countries	*16/5*	*6*	*13*		*9*	
Finances	**Has Target**	**Eligible-Deposit Base**	**Covered-Deposit Base**		**Risk-Bases Premiums**	
Countries	*11*	*17*	*6*		*8*	
Regular Premiums	**<=0.1**	**<=0.2**	**<=0.5**		**>0.5**	
Countries	*11*	*3*	*2*		*1*	
Additional Funds	**Extra Levies Permitted**	**Levies Not Permitted**	**Unlimited Borrowing**		**Limited Borrowing**	**No Borrowing**
Countries	*18*	*3*	*18*		*5*	*5*
% Coverage Ratio[5]	**>=1.0%**	**0.5 <=1.0%**	**0.25<=0.5%**		**0<=0.25%**	**<0**
Countries	*5*	*5*	*5*		*5*	*1*
Robustness Indicator[6]	**>=80%**	**>=60%**	**>=40%**		**<40%**	**Don't Know**
Countries	*6*	*2*	*1*		*3*	*15*
Investments	**EU Securities**	**Central Bank**	**Bank Securities**		**Other**	**Don't Know**
Countries	*15*	*4*	*4*		*5*	*2*
Authority	**Narrow: Pay-Box**	**Can Intervene**	**Can Cancel Insurance**			
Countries	*19*	*10[1]*	*4*			
DGS Actions since 1994	**Has Made Payouts**	**Has Made No Payouts**	**Has Intervened**		**Has Not Intervened**	**Don't Know**
Countries	*17*	*8*	*3*		*22*	*2*
Administration	**Government**	**Joint**	**Private**		**Separate Legal Entity**	**Not Separate Legal Entity**
Countries	*10*	*9*	*8*		*23*	*4*
Board Composition	**All public**	**Mixed**	**All Private**			**Don't Know**
Countries	*9*	*14*	*5[1]*			

Sources : Cariboni et al. (2008), EU Commission (2007, 2008c), and Garcia (2000).
Notes: [1] Some countries have separate schemes for savings and cooperative institutions, but the data here refer only to schemes for commercial and universal banks. Germany has two schemes for banks, one public and one private. Hence the numbers sometimes sum to 28 rather than 27.
[2]Some central and eastern European countries have been allowed a grace period before meeting the €20,000 minimum coverage. [3] Nine countries apply a haircut to all insured deposits; three apply it only above the minimum coverage level. [4]The EU deposit insurance directive requires excluding from coverage deposits from credit institutions and those arising from money laundering. [5] Percentage ratio of the size of the DGS fund to the total value of deposits eligible for insurance.[6] Percentage ratio of the number of member banks whose deposits the fund could pay out (with limited borrowing) to the total number of banks.

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guarantees in September and October 2008 (Barber 2008, Labrosse 2008). Belgium, Finland, France, Italy, the Netherlands, Poland, Spain, Sweden, and the UK extended coverage. The Irish guarantee applied only to Irish banks and their branches abroad and an Icelandic bank hesitated to compensate Dutch and British depositors, both of which ran counter to the spirit of a unified European banking market and highlighted concerns over the right to protection for depositors in cross-border banks. Iceland is not a member of the EU, but it is a member of the European Economic Area, which subscribes to the EU rules.

The EU Commission (2006) acknowledged that the Directive needed revision to fit the new era of cross-border banking,[61] but recommended deferring to Members to make improvements without amending the Directive.[62] In the context of the present financial crisis, Member States' finance ministers agreed abruptly on October 7, 2008, to increase minimum coverage to €50,000 (Commission 2008c). On October 15, 2008, the Commission proposed to increase coverage again to €100,000, to end coinsurance,[63] and to speed repayment after "the competent authorities have determined that the credit institution appears to be unable to repay the deposit or a judicial authority has ruled that the claims of depositors are suspended" (Commission 2008c, p.3). These proposals were agreed by the ECOFIN meeting on 2 December 2008.[64] Also a shorter payout deadline of 20 working days (with a possible extension to 30 working days) was agreed, compared with the previous deadline of three months extendable to nine months. In our view, this extension is completely inadequate to prevent bank runs, the Commission had originally proposed three days, the European Parliament suggested fourteen calendar days (in the USA, the FDIC pays out the next business day. [65]

These proposals leave several deficiencies unaddressed. First, the differences of deposit guarantee configurations allow the cross-border banks to position their membership to gain advantage over competitors and exercise regulatory arbitrage particularly in times of crisis. Moreover, this lack of "implicit" coordination via full harmonization of deposit guarantee schemes hinders coordination with the resolution authorities since no "explicit" coordination mechanisms between them exist as yet (e.g. existing MoUs do not include both resolution and deposit insurance regulators). Moreover, those differences also reduce consumers' understanding of the nature and extent of their deposit guarantees, especially for deposits held in the branches or subsidiaries of cross-border banks. Ignorance over the terms of the

[61] The Commission was concerned about substantial differences in (1) the level of guarantees; and (2) methods of payout including their financing. At the end of 2007 the EU Parliament called for inquiries into: the amount covered, the scope of the guarantee, different funding mechanisms, cooperation and cost-sharing in a cross-border crisis, establishing an early warning system, risk-basing contributions, and shortening the deadlines for paying compensation. In response, the Commission canvassed its members and found that most preferred the status quo to incurring the potentially high cost of implementing a revised directive.

[62] The Commission said it would seek "pragmatic and achievable approaches to identified problems which do not require changes to the existing regulatory framework." (p.2). These changes were to encompass the definition of deposits, the scope of coverage, coinsurance, topping-up arrangements, information exchange, risk basing contributions, transferring or refunding DGS contributions, consumer information and advertising, speed to repayment, and data availability.

[63] Facing a haircut, depositors ran at Northern Rock.

[64] As reported in Bloomberg (December 8, 2008) the European Parliament's economic committee backed the doubling of deposit insurance to 100,000 Euros to boost confidence after a bank run last year heralded the spread of the financial crisis. The measure endorsed by the lawmakers in Brussels (December 8) would raise the coverage by the end of next year, if the full Parliament votes along the same lines. National governments are pushing to delay the increase by two years. Both sides must agree for the bill to become law. The initiative aims to ease consumers' fears of losing their savings in the banking crisis, after depositors lined up at Northern Rock Plc branches last year to pull money out of the U.K. lender, since taken over by the government. Bringing national rules into line also eases competitive pressures after an Irish guarantee helped attract deposits from U.K. banks.

[65] Kaufman (2004) and Garcia (2000) argue that depositors need to be paid promptly to discourage runs. Garcia (2000), the EU Commission (2008c) and Ayadi and Lastra (2008) demonstrate that EU countries repay deposits only slowly, due to data, staff and funding inadequacies. Nine countries require depositors to lodge a claim for compensation when their bank fails. This, plus the deficiency in deposit data—particularly for cross-border deposits—and the fact that many countries offset outstanding loans against deposits when calculating the amount insured, make it difficult calculate and quickly repay insured deposits and complicate the resolution of cross-border banks, especially when conflicts arise among countries' interests.

guarantee can increase depositors' propensity to run, reduce the authorities' options for strengthening a troubled bank, raise its resolution costs, decrease financial stability, and encourage the authorities to bail out rather than efficiently resolve failing banks.[66]

The proposals raise the minimum level of coverage but impose no maximum. Hardy and Nieto (2008) argue that such an agreement would be beneficial especially in the absence of full coordination in prudential supervision because each country may tend to provide excessively generous deposit guarantees. Capping deposit guarantees will induce countries to tighten supervision.

Second, the deposit insurance Directive is compatible with the Winding up Directive in that the home country both resolves and insures the deposits of the main bank and its branches (including those in other Member States) while the host country bears these responsibilities for the bank's subsidiaries. However, it impedes the conversion of cross-border subsidiaries into branches because the Directive makes no provision for transferring contributions already paid from the host fund to the home-country deposit insurer.

Third, the host country is responsible for the additional coverage provided to branches of Member banks that top up their coverage to its higher levels. Topping-up branches are then insured by two deposit insurers and pay premiums to both (see Article 4.3 and Annex II). This arrangement complicates and delays the payout process while calculating which insurer is responsible for which part of a topped-up-deposit (Commission 2007). It could confuse depositors and reduce their confidence in the deposit guarantee.

Fourth, the topping-up provision may exacerbate the information deficiency and cause additional problems when resolving certain cross-border banks.[67] Information sharing is also discouraged because, while the government runs insurance schemes in over half of the countries, elsewhere they are either privately or jointly run (this fact partly explains the different initial government behavior regarding their support to their deposit insurance schemes in fall of 2008). It is more difficult to share information across borders where private bodies provide, or are involved in providing, deposit insurance.

Fifth, the proposals make no attempt to ensure adequate funding in a crisis.

Sixth, the proposals make no attempt to harmonize the different roles of the deposit guarantee schemes. Two-thirds of EU deposit insurance schemes have very limited roles—serving mainly as pay-boxes to ferry compensation to insured depositors of the failed bank—and they lack the authority, structure and resources to resolve banks in crisis. Almost a third of EU deposit insurers, however, can intervene in weak banks and/or resolve failed institutions. The experiences surrounding the run at Northern Rock raise questions whether a special resolution regime with an extent receiver would be beneficial in resolving troubled and failed financial institutions in the EU and, if so, which body—the central bank, supervisor, or deposit insurer—should shoulder this responsibility.

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[66] This is especially so because the Directive does not define a deposit and imposes conflicting obligations with respect to providing information to depositors. Article 9(1) requires the insurer to make information available to depositors in a "readily comprehensible manner," but it makes no provision to ensure compliance and Article 9(3) discourages banks from advertising their coverage to prevent them from bidding competitively for deposits.

[67] While Annex II of the Directive requires that the home and topping up host authorities "cooperate fully" to ensure that appropriate compensation is paid, the Directive neither says nor implies anything about sharing information in other circumstances.

Last but not least, since the Winding Up Directive lacks an agreed definition of insolvency, so there is a lack of clarity as to what would trigger the deposit guarantee. Article 1(3) of the deposit insurance Directive obliges the insurer to pay compensation when a deposit becomes "unavailable," that is, when the deposit has become due but has not been paid. The deposit guarantee Directive was enacted before the Winding Up Directive, but one might presume that placing an institution into reorganization or winding up would trigger the guarantee. Moreover, Table 5 above indicates that authorities in several countries have the ability to freeze deposits at banks that have not been declared to be insolvent and it is unclear whether this would trigger the deposit guarantee. Deciding when the guarantee becomes operative when a cross-border bank fails is likely to hamper prompt action in a crisis, and so increase the costs of the actions that are ultimately taken. Moreover, the 1994 Directive (Article 3.3) allows the insurer to exclude banks from a guarantee scheme after giving 12 months notice—until then deposits are to be fully covered—a requirement that could reduce resolution options. Title 3.5 requires the license issuer to revoke the authorization if the troubled bank has not found alternative guarantee arrangements by the end of the notice period. Article 4.4 requires the consent of the licensing body and a similar notice period if host-country authorities wish to exclude a topping-up branch from their deposit insurance scheme.

Table 7 summarizes how the coordination issues have been or not have been dealt with in the context of the Directives that regulate the safety net regulators (prudential supervision, deposit insurance and reorganization and resolution).

Table 7. Coordination between supervision, deposit insurance and crisis resolution

Issue	Capital Requirement Directive	Reorganization and Winding Up Directive	Deposit Insurance Directive
Scope	Branches and subsidiries	Branches	Branches
Coordination of regulators	"Colleges" (home and host country supervisors)	No "colleges". Resolution authorities act independently from each other and from supervisors. Implicit via principles of unity, universality and single entity (applies only to branches).	No "colleges". Deposit insurers act independently from each other and from resolution authorities.
Information sharing	Information sharing within colleges is subject to minimum requirements, including formats.	Bilateral obligation to inform to Member States' prudential supervisors of branches, but is not specific about the time, format and means.	No obligation to share information, but there is a need to inform depositors.
Time of Intervention	Defines minimum regulatory capital. (But Pillar 2 lacks a definition of "triggers".)	There is no threshold for the initiation of bank insolvency proceedings.	Compensation is to be paid when a deposit becomes "unavailable."
Coordination of regulatory action	Lack of convergence of supervisory powers and disciplinary actions.	Differences on the definitions; which authority is responsible and the grounds for initiation.	Minimal convergence. There is no requirement for coordination.

Source: Authors´ analysis

5- Conclusions: A proposal for reform

The financial crisis is highlighting the importance of an integrated approach to the EU safety net: prudential supervision, deposit insurance, reorganization and winding up and lender of last resort. For the first time since the harmonization of bank regulation started in 1977, a significant step toward architectural redesign occurred in October 2007 when Ministers of Finance in the ECOFIN agreed on a comprehensive approach that, for the first time, considered the simultaneous reform of the entire EU safety net. This article focuses on a proposal for reform of the Reorganization and Winding-Up Directive (2001/24/EC) and it explores areas of coordination with other EU Directives that also deal with relevant aspects in the bank financial crisis management. Our main recommendations focus on the following aspects:

- In the absence of centralized prudential supervision for cross-border institutions, policy makers should give priority to ensuring the convergence of supervisory powers and disciplinary actions if the revision of the Reorganization and Winding Up Directive is to be effective. Moreover, such convergence should ideally encompass a framework for early intervention by colleges of supervisors based on common triggers while acknowledging that this approach has limitations in the case of a systemic crisis.

- Greater harmonization of depositor protection schemes is also warranted and, among other aspects, in relation to their role as resolution agencies. Consideration should be given to establishing not only a minimum level of deposit insurance coverage, but also to cap deposit guarantees, and to ensuring the adequacy of funding.

The reform of the Reorganization and Winding Up Directive should focus, <u>in the short term</u>, on:

a) A broad and clear definition of reorganization and winding up that encompasses the various existing procedures;
b) A common definition of bank insolvency. It is important that the triggers for commencement of proceedings are equivalent across EU Member States. The placing of an institution into reorganization or winding up should unequivocally trigger the deposit guarantee;
c) The inclusion of subsidiaries and, possibly, of systemically important investment firms, under the scope of the Directive;
d) The creation of a coordinating structure among resolution authorities and deposit guarantee schemes that would facilitate coordinated action (parallel to the colleges of supervisors). Ideally, reorganization and winding up authorities when different from supervisors should be included in the 2008 MoU*;*
e) The development of common and precise requirements for information to be given to host Member States at the time of the intervention or even before it has taken place. In this regard, the desirability of common formats should be considered. This exchange of information should ideally take place in the context of the coordinating structure of resolution authorities.

The reform of the Reorganization and Winding Up Directive should focus, <u>in the medium term</u>, on:

a) Establishing a "special resolution regime" for cross-border EU banks in which prudential supervisors of the home and hosts countries would be heavily involved in order to benefit from their wealth of information and their existing coordinating structures (colleges). Such regime should confer upon the competent authorities a wide range of tools that can be applied with flexibility and regulatory discretion, such as bridge banks, assisted or unassisted mergers (transfer of the whole business or part of its business), sale of assets to a third party, deposit transfers to a third party, liquidation (including pay-off to insured depositors), government infusion of equity, other government guarantees, nationalization and others. The laws should foresee that some times the authorities need to use several tools, including the combination of government assistance and private assistance. The laws can also include tools that can remain 'dormant' in the legislation for a long time.[68] A residual clause (or

[68] Section 13.3 of the Federal Reserve Act, which was invoked in the rescue of Bear Stearns, was a useful provision to provide a legal basis for the rescue of an investment bank, Bear Stearns (March 2008) marks the first time since the 1960s that the Fed authorized the provision of emergency funds to any financial institution other than a regulated bank. See *Financial* Times, 15 March 2008.

clauses) empowering the competent authorities to act in circumstances not foreseen in the new law – but which threaten the goals of the special insolvency laws– ought to be considered.

b) Contemplating the possibility of delegation of the host country's resolution authority (if the scope of the Directive is widened to include subsidiaries) to the home country resolution authority.

Finally, in parallel with the developments on the potential centralization of supervision in the EU, consideration should be made to create an EU wide deposit guarantee fund with capabilities to reorganize and resolve cross-border banks licensed in the EU.[69]

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[69] Deposit insurance seems relevant at present only to banks that are deemed not to be systemically important. Hence this recommendation would not deal with systemically important banks that have been nationalized / recapitalized.

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Appendix : An indicative list of other rules that apply to cross-border banking crises[70]

Community state aid rules laid down in Articles 87-89 of the Treaty and secondary legislation thereof, which have been the subject of controversy lately, in the light of numerous rescue packages in several EU Member States. The Commission has approved many of them, but the rules require further clarification and consistency. Article 87(1) of the Treaty provides that, save as otherwise provided in the Treaty, any aid granted by a Member State or though State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market. Under Article 87(3) certain aid is considered to be compatible with the common market, including in particular aid "to remedy a serious disturbance in the economy of a Member State". The main criteria used to assess whether an aid granted from a Member State´s resources could fall within the Article 87(3) exemption might be found in Community Guidelines on state aid for rescuing and restructuring firms in difficulty. Further guidance in terms of conditions under which the state aid could be deemed as compatible with the common market provides numerous Commission decisions. For example, in the Crédit Lyonnais case the Commission has, inter alia, indicated, that, to be permitted, the State aid granted to a bank must comply with following four principles: (1) aid should restore the viability of the firm within a reasonable timescale, (2) should be in proportion to the restructuring costs and benefits and should not exceed what is strictly necessary, (3) measures should have the least distorting effect on competition possible and the firm should make significant financial contribution to the restructuring costs, (4) measures should be taken to compensate competitors as far as possible for the adverse effects of aid.

On 8 December 2008, the European Commission published detailed guidance on how Member States can recapitalize banks in the current financial crisis to ensure adequate levels of lending to the rest of the economy and stabilize financial markets whilst avoiding excessive distortions of competition, in line with EU state aid rules. The Communication complements and refines the broader guidance document adopted on 13 October 2008 (see IP/08/1495), to ensure Member States had rapid guidance on the adequate pricing of state capital injections into sound “vulnerable systemically relevant financial institutions.” The present guidance further addresses the necessity of appropriate safeguards to ensure that the public capital is used to sustain lending to the real economy and not to finance aggressive commercial conduct to the detriment of competitors who manage without state aid. Such safeguards also need to provide incentives for maintaining state intervention in the financial sector only as long as the crisis in the financial markets so requires. The Communication establishes principles for the pricing of state capital injections into fundamentally sound banks based on base rates set by central banks to which a risk premium is added that has to reflect the risk profile of each beneficiary bank, the type of capital used and the level of safeguards accompanying the recapitalisation to avoid abuse of the public funding. Riskier banks will have to pay a higher rate of remuneration. The pricing mechanism needs to carry a

[70] The authors would like to thank Niall Lenihan, Assistant General Counsel in the Legal Services of the European Central Bank, for pointing out relevant EU rules with regard to cross-border bank resolution.

sufficient incentive to keep the duration of state involvement to a minimum, for example through a remuneration rate that increases over time.[71]

Banks in distress that face a risk of insolvency should in principle be required to pay more for state support and to observe stricter safeguards. The use of state capital for such banks can be accepted only on the condition of a far-reaching restructuring restoring their long-term viability, including where appropriate a change in management and in corporate governance.

Member States have the possibility of creating schemes for recapitalisation that are open to all banks if the rate of remuneration is set at a predetermined level which ensures an appropriate overall return over time.

The Commission will monitor and review the recapitalisation measures taken by Member States. Six months after an individual measure or after the introduction of a recapitalisation scheme, the Member State concerned will report to the Commission on how the state capital has been used. The report must also include an exit strategy for fundamentally sound banks and a restructuring plan for distressed banks.

Under Article 3(1) of the Settlement Finality Directive, transfer orders and netting shall be legally enforceable and, even in the event of insolvency proceedings against a participant, shall be binding on third parties, provided that transfer orders were entered into a system before the moment of opening of such insolvency proceedings. Where, exceptionally, transfer orders are entered into a system after the moment of opening of insolvency proceedings and are carried out on the day of opening of such proceedings, they shall be legally enforceable and binding on third parties only if, after the time of settlement, the settlement agent, the central counterparty or the clearing house can prove that they were not aware, nor should have been aware, of the opening of such proceedings. Article 3(2) of the Directive provides that no law, regulation, rule or practice on the setting aside of contracts and transactions concluded before the moment of opening of insolvency proceedings shall lead to the unwinding of a netting. Article 5 of the Directive provides that a transfer order may not be revoked by a participant in a system, nor by a third party, from the moment defined by the rules of that system. Article 7 of the Directive provides that insolvency proceedings shall not have retroactive effects on the rights and obligations of a participant arising from, or in connection with, its participation in a system earlier than the moment of opening of such proceedings (i.e., the moment when the relevant judicial or administrative authority handed down its decision). Article 9(1) of the Directive provides that the rights of a participant to collateral security provided to it in connection with a system shall not be affected by insolvency proceedings against the participant. Such collateral security may be realized for the satisfaction of these rights.

Directive 2002/47/EC of the European Parliament and of the Council on financial collateral agreements (Collateral Directive) lays down a Community regime applicable to financial collateral arrangements which greatly simplifies the ease with which certain specified categories of persons (including public authorities, central banks, credit institutions, investment firms, insurance undertakings, UCITS, clearing houses and, unless Member States provide otherwise, corporates) may enter into financial collateral

[71] Communication available at
<http://ec.europa.eu/comm/competition/state_aid/legislation/specific_rules.html

arrangements (meaning title transfer financial collateral arrangements including repurchase agreements and security financial collateral arrangements) under which the financial collateral to be provided consists of cash or financial instruments, including shares and debt securities negotiable on the capital markets.

Under Article 4(5) of the Collateral Directive Member States shall ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider or collateral taker. Under Article 7(1) of the Directive Member States shall ensure that a close-out netting provision of a financial collateral arrangement (e.g., a master repurchase or securities lending agreement), or of an arrangement of which a financial collateral arrangement form part (e.g., an ISDA master agreement of which a credit support annex forms part), can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker. Under Article 8 of the Directive certain insolvency provisions are disapplied. In particular, under Article 8(1) of the Directive, Member States shall ensure that a financial collateral arrangement, as well as the provision of financial collateral under such arrangement, may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided (a) on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement; or (b) in a prescribed period prior to, and defined by reference to, the commencement of such proceedings or measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures. Under Article 8(2) of the Directive Member States shall ensure that where a financial collateral arrangement or a relevant financial obligation has come into existence, or financial collateral has been provided on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures, it shall be legally enforceable and binding on third parties if the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures. Article 8(3) of the Directive provides that where a financial collateral arrangement contains (a) an obligation to provide financial collateral or additional financial collateral in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations, or (b) a right to withdraw financial collateral on providing, by way of substitution or exchange, financial collateral of substantially the same value, Member States shall ensure that the provision of financial collateral, additional financial collateral or substitute or replacement financial collateral under such an obligation or right shall not be treated as invalid or reversed or declared void on the sole basis that such provision was made on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement or in a prescribed period prior to, and defined by reference to, the commencement of winding-up proceedings or reorganisation measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures.

Without prejudice to the foregoing, Article 8(4) of the Directive clarifies that the Directive leaves unaffected the general rules of national insolvency law in relation to

the voidance of transactions entered into during the above-referenced prescribed period prior to the commencement of winding-up proceedings or reorganization measures.

With regard to the Market Abuse Directive, Directive 2003/6/EC, the Governor of the Bank of England, Mervyn King, in his testimony in front of the Treasury Select Committee (20 September 2007) cited it as a legal obstacle that had prevented the Bank from acting as lender of last resort in the way the Bank would have preferred.[72] The governor said that he would have preferred to give covert aid to Northern Rock, without the public being aware of the Bank's intervention, but that would have been illegal, according to the City Code on Takeovers and Mergers and the 2004 Market Abuse Directive (as implemented under section 118 of the FSMA). He pointed to Article 6 of MAD, which states that "an issuer [such as Northern Rock] may under his own responsibility delay the public disclosure of inside information [such as support from the Bank of England] . . . such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information". Legitimate interests include "the event that the financial viability of the issuer is in grave and imminent danger". 'In any event, and whatever the merits of the competing views on the Directive, it is singularly unfortunate that a measure designed to promote investor confidence has apparently helped to precipitate blind panic and the first run on a UK bank for over a century'. (Charles Proctor).[73]

Under Article 13(7) of the Market in Financial Instruments Directive (MIFID), Directive 2004/39/EC, an investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients´ ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent. Recital 26 of the MiFID states that in order to protect an investor's ownership and other similar rights in respect of securities those rights should in particular be kept distinct from those of the firm. This principle should not, however, prevent a firm from doing business in

[72] Lastra (2008). See The Times, 21 September 2007 pages 6-7. See George Walker (2008). The claim that the assistance could not be covert is questionable. A different interpretation of the Market Abuse Directive (in particular Article 6) and a dispensation of its more stringent implementation in the UK would have rendered the covert assistance possible in the opinion of some commentators, such as Charles Proctor. As Proctor (mimeo, 2008) points out: "The core provisions of the Directive have been transposed into UK law by the Disclosure Rules and Transparency Rules ("DTR") of the FSA's Handbook. (…)It should be emphasized that the disclosure requirements do not directly apply to the Bank of England; they only apply to publicly listed entities – such as Northern Rock-- and those responsible for arranging the issue of such securities. They do not therefore directly inhibit the Bank of England in the conduct of its "lender of last resort" function. Nevertheless, the point would clearly have been a concern to the Board of Northern Rock. The difficulty here is that, whilst the FSA's guidance allows an issuer to delay release of information about negotiations to restructure its debt, it does not allow it to defer disclosure of the fact that it is in financial difficulties. If this distinction appears curious, it must be recalled that the spirit of the rules is to promote early disclosure. The FSA has power to modify the disclosure rules in particular cases, and it may well be that a short-term dispensation could have been granted on the basis that a run on Northern Rock might have wider consequences for the financial system. It is not clear whether this option was considered or could have been used in this particular situation'. As Walker (2008) points out, 'The Northern Rock board and the FSA had both received legal advice that any assistance would have to be overt. Once a company had received emergency liquidity support, an announcement would have to be made to the market despite the concessions permitted under Article 6(2) of the Market Abuse Directive. The UK implemented requirements set out in Rule 2.5.1, 2.5.2 and 2.5.3 of the FSA's Disclosure and Transparency Rules which provided that disclosure could only be withheld where this would not mislead the markets and the confidentiality of the information could be ensured.

[73] See Charles Proctor (mimeo, 2008).

its name but on behalf of the investor, where that is required by the very nature of the transaction and the investor is in agreement, for example stock lending. These provisions are further specified by Articles 16-19 of the Commission Directive implementing the MiFID.

Finally, there are also other relevant Directives with regard to cross-border crisis management: Directive 97/9/EC, 'Investor Compensation Schemes Directive', Directive 2002/87/EC, 'Financial Conglomerates Directive', and, as mentioned earlier, Directive 2006/49/EC, 'Capital Requirements Directive' as well as Directive 2006/48/EC of 14 June 2006, the 'Recast Banking Directive'.