Introduction

It became clear during the global financial crisis that a country that has no bank resolution regime may have particularly acute difficulties in containing the effects of a bank crisis. The task of resolving even quite a small bank swiftly, and without allowing contagion to spread to other parts of the financial system, can be impossible if the authorities only have conventional corporate insolvency procedures at their disposal. During the global financial crisis, countries were obliged to bail out individual banks or, in some cases, their entire financial system; and in the course of doing so, they put their own sovereign creditworthiness at risk, with consequences that are still reverberating around the global economy. While a number of financial institutions may remain “Too Big To Fail” for some considerable time yet, a well functioning bank resolution regime can at least ensure that this number is reduced to the minimum.

Part 1 of this paper summarises lessons of the global financial crisis for the design of bank resolution regimes. Part 2 defines and explains the concept of “bank resolution”. Part 3 places the topic of bank resolution in its broader international policy context: as part of an integrated crisis management regime which includes planning before difficulties emerge, the implementation of recovery actions once a bank has encountered difficulties and ultimately the choice and implementation of resolution options. Part 4 then discusses the task of designing a national resolution regime: the planning, and if required structural reform, that is necessary to make resolution possible; the tools that may be made available; how the regime should be triggered; the roles of the authorities; the scope of the regime; and legal safeguards. Part 5 considers some of the cross-border aspects of resolution and the remaining problems which have yet to be solved at an international level. Part 6 concludes.

1. Lessons from the Global Financial Crisis

1.1 The Importance of Resolution Regimes

The global financial crisis revealed that where regulators lack the necessary domestic powers to resolve failing financial institutions, “Too Big To Fail” is not very big at all. This fact is most clearly illustrated by the well-publicised difficulties of Northern Rock in the United Kingdom. Northern Rock was a domestically focused UK mortgage bank with total consolidated assets of only £113.5 billion. To put this in context, the total consolidated assets of Northern Rock in 2007 were merely

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1 A fuller report of the first stage of the Northern Rock saga is available in ‘The Run on the Rock’, House of Commons Treasury Committee (House of Commons, 2008)
1/15th of those of The Royal Bank of Scotland Group plc (RBS). As wholesale funding markets dried up from August 2007 onwards, Northern Rock became unable to fund itself and had to turn to the Bank of England for emergency liquidity assistance and, shortly thereafter, to the UK Government.

The difficulty that the UK authorities faced in 2007 was that there was no legislation enabling them swiftly to resolve the position of a failing bank. A failing bank was subject to the normal insolvency legislation applying to any other company. As a result, the authorities were faced with a choice between letting Northern Rock enter normal insolvency proceedings - probably the UK administration procedure - or continuing to support the bank. The concern of the UK authorities included the fact that allowing Northern Rock to enter into insolvency proceedings might result in a "sudden stop" in the operations of Northern Rock, possibly accompanied by fire sales of assets; and would result in requests for withdrawals by depositors that neither the bank nor the UK's deposit insurance scheme (the Financial Services Compensation Scheme) could satisfy in a timely fashion, leading to a panic which could spread to other financial institutions.

Subsequent experience with the UK operations of the Lehman Brothers group has shown all too clearly that realising and distributing the assets of an insolvent financial institution can be a very lengthy, highly disputed and extremely costly process; the realisation of the assets of Lehman Brothers' UK operations and the determination of the claims and entitlements of its creditors still continues some 3 1/2 years after Lehman Brothers first entered bankruptcy.

Faced with the fact that insolvency proceedings were not a viable option for dealing with Northern Rock's difficulties, the UK authorities had a limited number of choices. The authorities might have been unable to take the bank or its business into public ownership, because this would have required the agreement of a sufficient number of Northern Rock's shareholders; it might have been impossible to reach agreement on a satisfactory price without an extended process in which shareholders, many of them by then hedge funds, could hold the Government to ransom. The Government found itself funding or guaranteeing the majority of Northern Rock's balance sheet but without a level of control that matched the burden that it had assumed. As some put it at the time, the Government had nationalised the liabilities and risks of Northern Rock but had left the assets of Northern Rock in the private sector.

The position was finally brought to an end in 2008 when the Government passed emergency legislation\(^2\) to introduce a range of resolution options for deposit-taking institutions, including empowering it to nationalise a failing bank. Using these powers, the Government nationalised Northern Rock. The period from the public emergence of Northern Rock's difficulties in mid-September 2008 to the nationalisation of the bank in mid-February 2008 was a total 5 months and during this time the troubles of Northern Rock were constantly in the headlines. By contrast, when a very similar mortgage bank, Bradford & Bingley, had to be resolved later in 2008 it was possible to use the powers that the Government now had to transfer its deposit book to a solvent bank and to take the remaining assets into public sector ownership, all in the course of a weekend.

However, the events of the autumn of 2008 made it clear that the existence of domestic bank resolution powers alone is not adequate to prevent taxpayer bailout in all circumstances. When RBS and HBOS plc faced acute financial difficulties in September 2008 following the Lehman bankruptcy,

\(^2\) The Banking (Special Provisions) Act 2008
the UK taxpayer had to step in with massive State capital injections and liquidity guarantees. The difficulty with RBS and HBOS plc was in part one of size but also one of complexity and lack of information. Neither the authorities nor the banks themselves had ready access to the information that would have been needed to implement resolution actions on a timely basis. Particularly in the case of the RBS, the difficulties were compounded by the size and complexity of its international operations. The problems of cross-border resolution of large and complex financial institutions are discussed further in Part 5 below.

1.2 The Role of Deposit Insurance

A key factor in containing the spread of contagion from the failure of a domestic bank is the existence and design of any domestic deposit insurance scheme. A well-designed deposit insurance scheme should enable depositors of the bank in difficulty to have confidence that their insured deposits are safe, and therefore discourage them from joining a bank run; it should also set a clear limit to the amount of any explicit guarantee provided by the deposit insurance scheme or by the State, rather than an implicit open-ended guarantee; and finally, and perhaps most critically, it should ensure that if the bank does fail, depositors can be paid out very swiftly, so that depositors at other institutions do not also take fright and join in a wider run on the system.3

The UK’s deposit insurance scheme at the time when Northern Rock encountered its difficulties was not fit for purpose. The amount covered by the scheme (£35,000) was relatively low and even within this coverage limit depositors were required to share in the loss.4 Moreover, the necessary practical arrangements simply did not exist to achieve a prompt payout when an institution failed – the deposit insurance scheme’s website at the time said only that it would aim to pay out within six weeks – and in the case of Northern Rock this target would not have been achievable because of the state of the bank’s systems.

1.3 How a Bank Crisis can become a Sovereign Credit Crisis

In Ireland, the authorities responded to the funding crisis that arose following the collapse of Lehman Brothers by announcing a state guarantee of all unsubordinated liabilities of the Irish banks.5 This guarantee had the effect in the short term of stabilising the outflow of funds from Irish banks but it quickly became clear that it had done so at the cost of the creditworthiness of Ireland itself. Unable to continue to fund itself in the sovereign debt markets, Ireland had to turn to the EU and the IMF for a funding package and continues to grapple with the resulting austerity programme which has been necessary to secure its lenders’ further support. Iceland also experienced a collapse of its sovereign creditworthiness as a result of the collapse of its banking system.

A well-designed bank resolution regime can provide a government with options that help to avoid the issue of a blanket guarantee of the liabilities of a bank or banks and, thereby, the socialisation of all bank debt. Using the regime, the government can ensure that the burden of bank failure is shared with shareholders and creditors of the failed bank or banks.

4 Only the first £2,000 was fully covered, with depositors bearing 10% of losses within the next £33,000.
1.4 Conclusions from the Global Financial Crisis

Key lessons of the global financial crisis are that without resolution powers, even quite small banks can be Too Big To Fail and will need to be bailed out by taxpayers; that these bailouts can threaten a country’s solvency; that well-designed resolution powers may provide an alternative to bailout and enable the burden of the bank’s failure to be shared with its creditors and other stakeholders; that the relevant powers should be in place before the crisis arises; and finally that the powers must be accompanied by adequate information and planning.

In addition, the importance of well-designed deposit insurance regimes has been demonstrated. Deposit insurance needs not only to address depositors’ concerns about whether they will get their deposits back but also when the payout will happen.

2. What is Bank Resolution?

2.1 Meaning of the Term "Bank Resolution"

"Bank resolution" is not a technical or well-defined term, but is increasingly being used to describe special arrangements for the winding-up or restructuring of a failing bank by virtue of powers that go beyond the general powers conferred by the normal insolvency law applying to companies. These powers may exist within insolvency legislation or by adaptation of insolvency processes, but often they take the form of special administrative powers that can be exercised by the authorities without, or alongside, normal insolvency proceedings.

2.2 Why Normal Insolvency Proceedings are not Suitable for Banks

Normal insolvency proceedings are inherently unsuitable for banks. Payment is the very essence of banking: consumers and businesses rely on banks not only for the provision of credit and the storage of wealth but also critically for the making of prompt payments. Normal insolvency proceedings may require a freeze on payments and often require assets to be sold and their proceeds shared out among creditors in a costly procedure which may last for months or even years.

The sale of assets by an insolvency official may take place sooner than is economically optimal both for the insolvent entity and for the real economy. Although insolvency regimes differ, the insolvency official may feel obliged to wind up the assets of the insolvent entity as quickly as possible. The duty of the insolvency official is likely to be to maximise the recoveries of creditors whether or not that is the best outcome for financial stability. Even where the insolvency official has the power to continue to operate the insolvent business, he may have to sell assets to raise the funding necessary to do so. A bank’s assets may also require a degree of dynamic management, as is often the case (for example) with a derivatives book, and entering into new hedging or other transactions may require the posting of collateral even for those few counterparties which may be willing to deal with an insolvent bank. As a result, the bank’s assets may be sold in “fire sales”. These fire sales will not only diminish the proceeds recovered by the insolvent entity but may also depress prices of similar assets held by other banks. These banks in turn may then find themselves in capital or liquidity difficulties, particularly if they are required to mark their assets to market.

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6 Eva H.G. Hüpkes, 'Insolvency - Why a Special Regime for Banks?' (2003) 3 Current Developments in Monetary and Financial Law
2.3 Aims of a Bank Resolution Regime

A bank resolution regime aims to overcome some of the difficulties presented by applying normal insolvency proceedings to banks. It replaces or supplements insolvency proceedings with a speedy procedure which is very often instituted and operated by the authorities themselves rather than by any court. A bank resolution regime gives the authorities a range of tools, including the power to transfer assets and liabilities of the bank either to another bank or to a “bridge institution” which may hold the assets for long enough to optimise their eventual disposal. The range of bank resolution tools that may be considered is discussed further in Part 4 below.

Table A sets out, in simplified form, the outcomes that a resolution regime may achieve together with the outcomes to which insolvency proceedings may lead:

Table A

<table>
<thead>
<tr>
<th>Aims of resolution regimes</th>
<th>Insolvency Proceedings</th>
<th>Resolution Proceedings</th>
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<tbody>
<tr>
<td>Protect depositors</td>
<td></td>
<td></td>
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<tr>
<td>- Continuity of service</td>
<td>o</td>
<td>o</td>
</tr>
<tr>
<td>- Prompt payout of deposits</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Protect/enhance financial stability</td>
<td></td>
<td></td>
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<td>- Avoid fire sales</td>
<td>o</td>
<td>o</td>
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<tr>
<td>- Swift restructuring of activities</td>
<td>?</td>
<td>?</td>
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<tr>
<td>- Reduce “deadweight” costs</td>
<td>o</td>
<td>o</td>
</tr>
<tr>
<td>Protect public funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Viable alternative to bailout</td>
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</table>

Protection of depositors

The protection of depositors requires that essential services, and in particular payment services provided to them by their bank, continue despite the bank’s insolvency. Protection of vulnerable depositors in particular also requires that they are not made to wait for weeks or months before they can access their savings. Insolvency proceedings may fail to ensure continuity of payment services because of the “sudden stop” that is normally a feature of the taking control of the bank by the insolvency official. In addition, payment systems and other banks may not be willing to allow the insolvent bank to continue to participate in the payment process. By contrast, resolution proceedings may enable the deposits and payment operations of the bank to be swiftly transferred to a new solvent entity which can provide the former depositors of the failed bank with the continuity of service that they need.
Insolvency proceedings are not necessarily inconsistent with the prompt payout of deposits where the duties of the insolvency official are suitably integrated with the deposit insurance arrangements. However, few countries will in practice be able to achieve the period of two business days for payout that is the aim of the Federal Deposit Insurance Corporation in the United States. Resolution proceedings will not necessarily make it easier for a bank to pay out all its depositors but, where the deposit liabilities are rapidly transferred to a solvent bank, such payout is not normally necessary because depositors will have sufficient confidence in the solvent bank not to withdraw their deposits.

**Protecting and enhancing financial stability**

Ensuring the continuity of customers’ payments and other banking services, including access to their deposits, is important in protecting and enhancing financial stability. Once depositors see that the customers of one bank have lost or are unable to access their money for an extended period, they may well be likely to try to extract money from other banks, triggering a chain of bank runs across the entire system.

However, resolution proceedings can also enhance and protect financial stability in a number of other ways. By facilitating the swift restructuring of the bank’s activities between those which will be continued by a purchaser or a “good bank” and those which will enter into insolvency proceedings or be wound down in a “bad bank”, bank resolution can ensure that the loss of credit provision and other financial capacity to the real economy is minimised. By contrast, insolvency proceedings will tend to last for a longer period and the timetable for the insolvency proceedings may be driven partly by the actions of creditor groups who are interested in maximising their own recoveries rather than minimising damage to the real economy as a whole. In addition, as stated above, insolvency proceedings may lead to some “fire sales” which have the potential to transmit contagion to other banks, whereas the use of a “bridge institution” through resolution proceedings may enable assets to be held and realised over a longer period. Finally, the “deadweight” costs of insolvency, comprising not only professional costs but also the costs of the “sudden stop” termination of contracts and positions, can be very considerable; resolution proceedings may enable many of these costs to be reduced.

**Protection of public funds**

Taxpayer bailouts of banks put public funds at risk and may result in the effective nationalisation of liabilities while the assets remain in the private sector. They may also endanger the creditworthiness of the State itself. While a bank resolution regime will not necessarily be able to remove all risk of a taxpayer bailout where banks remain Too Big To Fail, it may enable the number of banks that fall into this category to be significantly reduced.

3. **The International Policy Context of Bank Resolution**

3.1 **Background to the FSB’s Key Attributes**

One of the key lessons of the financial crisis was that bank resolution powers alone are not always sufficient to address the damage that a failing bank may do. The United States has had bank resolution powers since the "New Deal" legislation of the 1930s, but even in the United States it was not possible to deal with the difficulties of some of the largest financial institutions during the global
financial crisis without providing massive taxpayer support. The size and complexity of the bank’s activities, together with a lack of information about their operations, meant that bailouts had to be given.

Therefore, international policymakers have stressed that bank resolution powers must be part of an integrated approach to crisis management in respect of a bank, which should start with recovery planning and resolution planning when the bank is still healthy, proceeding through implementation of corrective measures identified in the bank’s own recovery plan as difficulties emerge, with resolution being the final resort once it has become apparent that the bank is unlikely to be able to stabilise its own situation.

At the centre of this integrated crisis management approach is the concept of the “Living Will”: strictly, this comprises two separate plans, one for recovery and the other for resolution of the bank. Recovery plans are required to be prepared by the bank itself and should focus on the measures that the bank may take to stabilise its situation, normally without assuming official help. These measures may include accessing additional sources of liquidity, raising new capital from shareholders, discontinuing business lines or disposing of assets. The resolution plan is generally conceived of as a plan owned and operated by the authorities, prepared using information provided by the bank. The authorities may (or may not) share the resolution plan with the bank. In the course of preparing the resolution plan, the authorities will gather the necessary information to understand the structure and business of the bank, its key dependencies, and the critical barriers to efficient resolution. They can then take the opportunity to require the bank to address barriers to resolution including, possibly, simplifying its structure.

Armed with this information, the authorities will be able to choose and trigger a resolution option once they are satisfied that it is necessary. The implementation of resolution is likely to require the authorities to have a range of additional knowledge and skills which typically they do not possess as a result of their prudential supervision activities. They may have to hire professional advisers to provide the necessary expertise at short notice and they may also need to make extensive use of the bank’s own personnel. Finally, a key aspect of any resolution option is the question of how the operations of the bank, or of the new entities to which its assets are transferred on resolution, will be funded, and whether this will result in additional central bank or taxpayer exposure.

3.2 The Key Attributes

Background

The current “gold standard” of guidelines for the resolution of failing banks is provided by the Financial Stability Board’s November 2011 publication, “Key Attributes of Effective Resolution Regimes for Financial Institutions” (the Key Attributes). This document was endorsed by G20 leaders at the Cannes Summit and, taken together with the proposals of the Basel Committee on

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8 Slaughter and May, 'Unfinished Testaments: The Blueprints for Recovery and Resolution' (Slaughter and May October 2011)
9 ‘Key Attributes of Effective Resolution Regimes for Financial Institutions' (Financial Stability Board October 2011)
Banking Supervision (BCBS) for additional capital for systemically important financial institutions (SIFIs), represents some of the most important components of the regime to address the Too Big to Fail problem that the supranational authorities are aiming to implement internationally.

The Key Attributes have woven together three strands of work to produce an important package of proposals for the resolution of financial institutions. The first strand concerns resolution tools, resolution planning and cooperation. This strand is the continuation of the work of the Cross-border Bank Resolution Group of the BCBS, which produced its key Report and Recommendations in March 2010. This report highlighted (among other things) the importance of:

- National authorities having appropriate tools to deal with all types of financial institutions in difficulties
- Convergence of those tools internationally, to facilitate the co-ordinated resolution of financial institutions that are active in multiple jurisdictions, coupled with mutual recognition of resolution proceedings and measures
- Coordination in the resolution of groups and conglomerates
- Resolution planning
- Cross-border cooperation and information sharing
- The ability of authorities to transfer contractual relationships of failing firms without closeout, so as to reduce contagion.

The second strand concerns "bail-in". This has been a key development in the international discussion of the resolution of global SIFIs (G-SIFIs). Regulators have become increasingly interested in the potential to revolutionise the way that the balance sheets of financial firms respond to financial crises through contractual or statutory mechanisms to convert unsecured debt to equity or to require unsecured debt to be written down. This bail-in of debt, once a defined trigger point is reached, mirrors the debt-equity swaps that traditionally take place in insolvency but without the necessity to impose such debt-equity swaps through normal insolvency processes, which (as explained above) are inherently unsuitable for financial firms.

The final key strand that has enabled the FSB to bring forward a consensus package of measures on the resolution of financial institutions has been the increasing recognition that a comprehensive solution to the problem of cross-border resolution – that is to say, a solution to which national governments and authorities of different countries bind themselves ahead of an institution’s failure – is unlikely to be achieved in the medium-term. The FSB has therefore concentrated its short-term efforts on ensuring that national authorities have appropriate and convergent resolution tools, and on facilitating rather than mandating cross-border cooperation and recognition of resolution measures, in the hope that the conditions will exist for national authorities to find it in their interests to cooperate.

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Key provisions

The Key Attributes set out the 12 essential features that should be part of resolution regimes in all jurisdictions and whose implementation "should allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions." The Appendix to this paper sets out a summary of the Key Attributes document. So far as banks are concerned, it envisages that each jurisdiction will have a designated resolution authority with appropriate resolution powers, including powers to terminate contracts, continue or assign contracts, purchase or sell assets, write down debt and take any other action necessary to restructure or wind down the firm’s operations. In exercising these powers, the resolution authority should be able to override the rights of shareholders and other third-party rights that would otherwise prevent the exercise of these powers. The Key Attributes document specifically envisages that exercise of resolution powers should not trigger statutory or contractual set-off rights or constitute an event that entitles a counterparty to exercise contractual termination rights, provided that the substantive obligations under the contract continue to be performed. In addition, the resolution authority should have the power to stay termination rights temporarily. These powers should be counterbalanced by appropriate safeguards, including a requirement to respect the hierarchy of claims that would apply in liquidation. Creditors should have a right to compensation where they do not receive at a minimum what they would have received in the liquidation of the firm (the "no creditor worse off than in liquidation" safeguard).

The Key Attributes document emphasises the importance of cross-border cooperation and envisages that domestic resolution authorities will be required to have regard to the impact of their actions on other jurisdictions and empowered to grant recognition of measures taken by other jurisdictions. The coordination of actions in respect of cross-border firms should be conducted through a crisis management group and for all G-SIFIs, at a minimum, there should be institution-specific cooperation agreements between the home and relevant host authorities addressing the procedures for cooperation.

Recovery and resolution planning in relation to firms should be complemented by resolvability assessments which should, where necessary, lead to the adoption of appropriate measures including changes to a firm’s structure to improve resolvability.

The FSB is due to produce a progress report by April 2012 on the extension of the Key Attributes from G-SIFIs to nationally systemic institutions.

3.3 EU Commission Crisis Management Directive

At the same time, the EU Commission has been working on a Crisis Management Directive which is likely to implement many of the concepts in the Key Attributes document. Following initial consultations on the proposal, progress on the Crisis Management Directive has been delayed due to the Eurozone crisis, but publication of a draft is expected shortly.

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12 Key Attributes, Foreword, p1
Countries which are aiming for accession to the European Union in the future may wish to consider whether to design their bank resolution regime so as to be consistent, so far as possible, with the EU Crisis Management Directive and other relevant aspects of EU law. The EU State Aids regime is also significant in this context.

4. Designing a National Resolution Regime

4.1 Introduction

In addition to reviewing these international standards for resolution, policymakers designing a new national bank resolution regime for a country are likely to turn to existing bank resolution regimes as possible models. The United States model is often mentioned, because the United States has a well-established regime for the resolution of depository institutions, as currently contained in the Federal Deposit Insurance Act of 1950 and administered by the Federal Deposit Insurance Corporation (FDIC). Many thousands of United States banks have been successfully resolved under this regime. The United States resolution model has also been recently overhauled by Title II of the Dodd-Frank Act, which provides the FDIC with an “Orderly Liquidation Authority” for a range of covered financial companies that go beyond the depository institutions to which the Federal Deposit Insurance Act of 1950 applies.

In addition, the UK Banking Act 2009 is also sometimes mentioned as a model, because the United Kingdom has very recently designed and implemented a new resolution framework for banks.

However, when designing a new bank resolution regime it is also important to take into account the particular features of the country where the regime will need to be operated. National banking systems differ very significantly. Few resemble the banking system in the United States, with its large number of relatively small regional banks. Similarly, many national banking systems may not resemble the United Kingdom system, with a small number of very large and globally active institutions holding a major share of the domestic market.

Differences between national banking systems include the number and concentration of banks; the deposit insurance arrangements, if any; the extent to which state ownership plays an important part in the banking system; the cross-border activities, diversification and complexity of individual banks; the role that foreign banks play in the domestic banking system; the extent to which foreign currency assets and liabilities are significant for domestic banking institutions; and the role of other savings institutions, such as credit unions. The United States and United Kingdom models may be useful precedents but they should not be adopted without analysis and, where appropriate, adaptation.

4.2 Planning and structuring for resolution

A key point that policymakers should think about in conjunction with their choice of resolution powers is whether the key banks in their jurisdiction are likely to be resolvable at all. Practical resolution of banks requires not just the correct legal powers but also the information, skills and structures to make resolution a reality.

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14 Wall Street Reform and Consumer Protection Act of 2010, HR 4173
The requirement for information should be addressed in the authorities’ resolution planning. These plans should be based on packages of detailed information provided by the relevant bank, including information about its structure, assets and liabilities, focussing on the key barriers to its prompt resolution, such as dependencies on third parties.

The requirement for skills may need to be addressed partly by having a specialist unit which is dedicated to planning for resolution activities but also partly by ensuring that external advisers with appropriate skills are available at short notice.

The question of legal structure of banks is one of the most important for policymakers to consider. It may be impossible to resolve some of the key banks in the relevant jurisdiction if their legal structures are either too opaque and complicated or unsuited for the prompt separation of essential from non-essential activities. In the United Kingdom, the Independent Commission on Banking has recommended that the essential activities of UK banks be structurally separated from their other activities by establishment of separate subsidiaries. This separation will, it is hoped, make it easier to implement resolution of the essential activities in the future. Policymakers should consider whether requiring their banks to restructure, so that essential activities and other activities are located in separate subsidiaries under a common holding company, would facilitate the resolution of the essential activities.

4.3 Resolution tools

Policymakers should consider at least five possible tools as part of their possible resolution toolkit.

Prompt payout

The first tool which should be considered is the prompt payout of depositors, i.e. paying out depositors (in respect of their insured deposits) immediately, normally with the bank being closed at the same time or shortly thereafter.

Where deposits are subject to deposit insurance it is critical that depositors receive their money within a short period of time, both to avoid hardship and to ensure that contagion is not transmitted through the banking system by fear as depositors become concerned about their deposits in other institutions.

Prompt payout is likely to need to be accompanied by modifications to the normal corporate insolvency regime. In both the United States and the United Kingdom adjustments have been made to the regime that would otherwise apply. In the United States, the FDIC is appointed as receiver of the bank, pays out the insured deposits and then recovers the (preferred) claim for the deposits in the bank’s receivership. In the United Kingdom, in the case of liquidation of a bank, additional duties are imposed on the liquidator to work with the FSCS in the prompt payout of depositors.16

15 ‘Final Report and Recommendations of the Independent Commission on Banking’ (Independent Commission on Banking September 2011). The UK Government is currently considering to what extent it will implement the Commission’s recommendations.
16 Banking Act 2009, section 99(2)
**Purchase-and-assumption**

The second tool involves the transfer of assets and liabilities to another bank in what is referred to in the United States system as a "purchase-and-assumption" transaction. Under a purchase-and-assumption transaction, the authorities hold an accelerated auction of the deposit-taking business of the failed or failing bank. They select the offer that is most attractive. In the United States, this offer must normally be the offer which results in the least cost to the deposit insurance scheme. In the United Kingdom, the authorities have a greater margin of discretion in choosing between different possible purchasers in a purchase-and-assumption transaction.

Once the successful purchaser has been selected, specified liabilities and, possibly, assets of the failed bank are transferred to it. Table B gives a schematic overview of a typical purchase-and-assumption transaction.

**Table B**

<table>
<thead>
<tr>
<th>Description</th>
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<tbody>
<tr>
<td>Banking Industry</td>
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<tr>
<td>Pays levy</td>
</tr>
<tr>
<td>Pays $48 balancing payment</td>
</tr>
<tr>
<td>Deposit Insurer</td>
</tr>
<tr>
<td>Claims $48 in insolvency</td>
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<tr>
<td>Failed Bank</td>
</tr>
<tr>
<td>Transfer of $50 of assets</td>
</tr>
<tr>
<td>Purchaser</td>
</tr>
<tr>
<td>Assumption of $100 of deposits</td>
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<tr>
<td>Depositors</td>
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<tr>
<td>$100</td>
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<td>Depositors</td>
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In the example, $100 of deposit liabilities are transferred to the purchaser and $50 of "good" assets of the bank are also transferred. On top of that, the deposit insurer pays the purchaser $48. As a result of these elements of the transaction, the purchaser will have assumed $100 of deposit liabilities and acquired $98 of assets ($50 of "good" assets from the failed bank and $48 from the deposit insurance scheme). The "premium" that the successful purchaser has paid for the deposit business of the failed bank in this example is therefore $2.

The deposit insurer steps into the shoes of the depositors whose claims have now been assumed by the purchaser and pursues those claims in the insolvency proceedings of the failed bank on behalf of the deposit insurance scheme. In the United States, deposits of a bank receive preference over other unsecured debts in its insolvency. In other jurisdictions, deposits may or may not be preferred. If the deposit insurance scheme is unable to replenish its assets by pursuing these claims in the
insolvency of the failed bank, then it will be able to top up the scheme by levying the banking industry.

**Bridge institution**

The third tool which policymakers will wish to consider is the creation of a "bridge bank" or, more accurately, a "bridge institution". The bridge institution is an entity owned by the official sector to which assets and liabilities of a failed bank are transferred. A bridge institution may be used as a means of transferring the operational business of a bank out of the entity which is going to fall into insolvency, so that the operating business can be stabilised and then disposed of in a purchase-and-assumption transaction or sale. Alternatively, a bridge institution may be used to take assets of the failed bank out of the insolvent entity so that they may be wound down in a more stable manner, and over a longer time period, than might be the case in insolvency (sometimes referred to as a "bad bank"). In the latter case, the institution may not require a banking licence since it will be managing assets rather than taking deposits and giving new credit.

Some of the issues that arise in determining how a bridge institution should fit into the resolution regime include:

- Will the bridge institution need a banking licence?
- Who should establish and own the bridge institution?
- What liability will its directors or other managers be exposed to?
- Will it be subject to rules applying to other public sector institutions, such as procurement rules?
- How will the bridge institution be funded?
- How will it appear in the country's national accounts?

**Bail-in**

A fourth resolution tool which policymakers should consider is "bail-in". As explained above, bail-in involves the conversion or writing down of debt claims against the failed bank. There are two basic types of bail-in:

- **Going concern bail-in**: this requires triggering of the conversion or write-down prior to the collapse of the bank, so that it may continue in its current form as a going concern. Going concern bail-in has been designed using contingent convertible debt instruments, or "CoCos", which are bonds which are either convertible into equity or can be written down once a bank's capital ratio reduces to a certain trigger point. This trigger point is set some way above the level at which the bank's licence would be withdrawn for failure to meet its capital requirements. The idea is that once the bank's capital position deteriorates to the trigger point, conversion of the instruments or their writing down can be activated and the capital position of the bank restored to a healthy level. This process enables the bank to continue to trade, but dilutes or wipes out the interests of the previous shareholders.

- **Gone concern bail-in**: under this model, unsecured debts of the failed bank are liable to be written down or converted into equity at the point when the bank has failed. The purpose of the bail-in in this case is not to enable the bank to continue without intervention by the
authorities, but rather to provide a means of sharing the burden between the public and the private sector following official intervention by - in effect - subordinating the claims of the bailed-in creditors to the claims of the creditors (such as depositors or the authorities as lenders of emergency assistance) who are intended to be preferred, and to wipe out the interests of the existing shareholders. This type of "gone concern" bail-in may require the write-down or conversion of a larger mass of debt than would be the case under "going concern" bail-in, since the position of the bank may have deteriorated further by the time it is implemented and market confidence will be more difficult to regain. Since gone concern bail-in is an official action and targets a greater mass of debt than the debt with contractual bail-in terms that the bank has raised, it must be achieved using statutory powers.

The development of bail-in is at an early stage and there are a number of issues to which satisfactory answers have not yet been fully developed. The first issue is whether the market capacity exists to allow bail-in to be implemented. With the high-trigger contractual bail-in method there have been some successful issues of Cocos\textsuperscript{17} but they remain very much the exception rather than the rule; many institutions are currently experiencing significant difficulty in raising normal senior unsecured debt from the markets, let alone convertible instruments. The effect that these Cocos may have on market behaviour is also controversial: some commentators say that they provide an incentive for the holders of the CoCos to take short positions in the equity of the bank as it deteriorates in order to hedge their conversion risk and that this may result in a "death spiral" of the share price which will, in turn, transmit contagion to the bank's funding activities.

As regards low-trigger statutory bail-in, some commentators doubt that senior debt investors will be willing to fund the banks in the future if their debt claim is subject to this type of bail-in. There are also difficult questions as to whether the introduction of a statutory bail-in regime should be retrospective, applying to debt issued prior to the point at which the bail-in powers come into force, or only applied to debt raised in the future. Quite apart from the legal difficulties that may apply in some jurisdictions to the imposition of retrospective legislation, questions of market confidence and market capacity also arise.

If bail-in powers are to be given to the authorities, it will be important to make clear which categories of senior debt are liable to be "bailed-in". Most commentators agree that secured debt should not be interfered with by bail-in powers and many also agree that derivatives claims and other claims of a normal interbank nature should be exempt from bail-in. This is because, unless carefully implemented, bail-in has the potential to be a means of transmission of losses, and therefore contagion, from a failed bank to other banks in the financial system.

Bail-in is also a difficult process to implement with large, complex and internationally active groups. These groups may consist of multiple entities with unsecured liabilities at different levels of the group structure; the policy and business judgements as to which entities in the group should be subject to bail-in, and in respect of which claims, are highly complex. In addition, some of these entities may be incorporated in foreign jurisdictions and even some of the liabilities of the entities incorporated in the home jurisdiction may be governed by foreign law. The ability of the home authorities to impose bail-in on the group as a whole may, therefore, be limited.

\textsuperscript{17} Notably, by Credit Suisse
Nationalisation

A final tool which policymakers may wish to consider is nationalisation of the troubled bank. Nationalisation is not a feature of the Federal Deposit Insurance Act regime in the United States. Where a country has a relatively unconcentrated banking sector it may be possible to avoid a systemic bank crisis without nationalising any banks. However, where the bank sector is heavily concentrated and there are a small number of banks which may individually represent a systemic risk for the country, it may be necessary to have provision to take a troubled bank into temporary public ownership if other forms of bank resolution are not possible. The United Kingdom has such a very concentrated banking sector, and power to take a bank into temporary public ownership has been included in the Banking Act 2009.¹⁸

Nationalisation is of course a very politically and legally sensitive topic and may be particularly sensitive in countries with a recent history of expropriation of property and state interference in private sector activity. The design of any powers to nationalise a bank will need to take into account legal restrictions in the relevant country, such as constitutional guarantees of property and limits on the ability of the state to expropriate assets, as well as restrictions contained in other instruments such as bilateral investment treaties. It may be necessary to pay compensation if nationalisation powers are used. The question of legal safeguards is further discussed in paragraph 4.7 below.

Ancillary provisions

The resolution tools described above will need to be supplemented by ancillary provisions in the relevant legislation. These provisions may need, for example, to give power to override the provisions of contracts, including default and termination rights; the act of nationalising a bank or transferring its assets to a bridge institution or private sector purchaser may give rise to change-in-control issues under contracts to which the bank is a party, including the terms of its debt instruments. The use of such powers also raises questions of the Rule of Law, and it is important that the powers are well-defined and subject to appropriate legal safeguards.

However, although it may be possible for the legislation to deal with domestic legal issues that arise under either private or public instruments, it may not be possible to deal with foreign law issues. As a result, the resolution of a bank with any international operations or international funding will need careful consideration and planning and may need to be coordinated with the host authorities in the foreign jurisdictions where it has operations.

Once policymakers have decided on the menu of resolution powers and ancillary provisions that they believe should be introduced in their jurisdiction, they will also need to consider a number of other key questions:

- How should the use of these powers be triggered?
- Which institutions should play which roles in relation to the resolution powers?
- Which types of financial institution should the powers apply to?
- What legal safeguards should be afforded to shareholders and creditors?

¹⁸ Banking Act 2009, section 13
4.4 Triggering resolution powers

A number of issues need to be borne in mind when policymakers consider how resolution powers should be triggered.

Prompt corrective action

The first key point is that the experience in other countries, and in particular in the United States, would suggest that delaying the closure or resolution of a troubled bank tends to increase the costs of its failure, not only to its own shareholders and creditors but also to the real economy. The most compelling evidence supporting this proposition comes from the United States experience of the Savings & Loan (S&L) crisis of the 1980s. Regulators of thrifts, as S&L institutions were known, generally exercised “forbearance” (i.e. permitted thrifts to continue operating despite significant issues about their compliance with capital and other prudential requirements). In the wake of the S&L crisis in the United States, Congress amended the Federal Deposit Insurance Act of 1950 through the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) so as to introduce the principle of “prompt corrective action”. Under prompt corrective action, the FDIC is mandated to take certain actions when a regulated institution breaches various capital ratios. The aim of the legislation is to ensure that, to a large extent, the discretion of the regulator is taken away.

However, there is also evidence that suggests that significant forbearance has continued since the enactment of FDICIA. Forbearance is still possible because often the balance sheet and stated capital position of an institution lags some way behind the true state of its business, as a result of failure to take adequate provisions for non-recovery of loans and other assets. Regulators may be slow to recognise that banks’ assets are overvalued. In addition, there may be significant scope for an institution to “game” its capital position through manipulation of risk weightings and other techniques.

Therefore, if a bank recovery and resolution regime is to include an effective prompt corrective action feature, consideration needs to be given to adding triggers for prompt corrective action other than capital triggers and appropriate safeguards in the governance of the regulatory authorities to try to reduce the extent to which forbearance is given.

The United Kingdom does not have a similar prompt corrective action regime but it is envisaged that a “proactive intervention framework”, under which intervention by the authorities is presumed to be necessary at various trigger points, will be introduced. However, the authorities will still retain some discretion not to take the specified intervention if they consider that there are compelling reasons.

Inadequacy of insolvency triggers

A second issue that needs to be borne in mind in defining the trigger point for use of resolution powers is the fact that the traditional definitions of insolvency for the purpose of insolvency proceedings are likely to take effect too late for the benefits of resolution to be obtained. Insolvency triggers are normally defined by reference to the presence or absence of positive net assets (balance...
sheet insolvency) or inability to pay debts as they fall due (cash flow insolvency). However, by the point that a bank is insolvent within the meaning of normal insolvency law, it is likely to have long since passed the point at which bank regulators should have stopped it from operating.

Legal concerns arise, however, if the trigger point for the use of resolution powers – many of which may seem quite draconian – is both early and contains a significant measure of discretion for the authorities. This point is discussed further in paragraph 4.7 below.

4.5 Allocation of Roles to the Authorities

Another key issue which policymakers need to bear in mind in the design of resolution regimes is the allocation of powers and functions between the various authorities in the official sector. In most jurisdictions there will be at least two, and possibly four, authorities who may play a role:

- the finance ministry, which is responsible (among other things) for decisions involving the use of taxpayer funds;
- the central bank, which plays a role as lender of last resort to banks with liquidity problems;
- the bank regulator (in those jurisdictions where the central bank is not also the regulator), which is responsible for the prudential regulation of the bank; and
- the deposit insurance fund, which may play different roles according to the model of deposit insurance scheme operating in the country concerned.

Each of these authorities may have a significant role to play in the resolution process. The key question is which of the authorities should be involved, firstly, in the triggering of resolution and, secondly, in the choice of resolution option to be pursued.

Generally, it is considered that the triggering of resolution is best initiated by the authority responsible for the supervision of the bank, i.e. the bank regulator or, in those jurisdictions where the central bank also plays the role of regulator, the central bank. This is because the bank regulator will have the best knowledge of the state of the bank’s affairs and is also normally responsible for judging when an institution has ceased to meet regulatory requirements. However, when it comes to choosing which of the various resolution options should be pursued, it may be necessary to give an explicit role to the central bank and the finance ministry, since the choice of resolution option may require both funding from the central bank and some element of taxpayer support. The role of the deposit insurance scheme may differ significantly according to whether it is established on a pure "paybox" model (i.e. with responsibilities limited to collecting in levies from the industry and paying out sums to depositors, such as the FSCS in the UK) or whether it is a "risk minimiser" (such as the FDIC in the US) which is actively involved in the bank resolution process with a view to minimising the payout by the deposit insurance scheme.

4.6 Scope of the Resolution Regime

A final key design issue is which of the various financial institutions in the financial system should be subject to resolution arrangements. Generally speaking, countries have started by applying resolution regimes to their depository institutions only, but during the course of the global financial crisis a consensus has begun to emerge that a case exists to subject other institutions to resolution
procedures. Title II of the Dodd-Frank Act in the US aims to ensure that non-bank SIFIs may be designated as “covered financial companies” and made subject to the Orderly Liquidation Authority.

Even where only depository institutions are involved, it may be necessary to take powers that can operate on not only the specific legal entity within the group that is the deposit-taker but also on holding companies and affiliates providing essential services, such as information technology or administrative services on which the deposit-taking entity relies.

In countries where a significant part of the banking system is represented by the domestic subsidiaries or branches of foreign banks or financial conglomerates, specific consideration may need to be given to whether and how the resolution tools could be used.

The possible extension of the resolution regime to other key financial sector players such as broking firms (investment banks), insurance companies, payment systems, exchanges, clearing houses and central counterparties also needs to be considered, but should not delay the design and implementation of a regime for banks.

4.7 Legal Safeguards

Bank resolution powers may represent a major incursion into the private property and rights of banks and their shareholders and creditors. Accordingly, care needs to be taken to ensure that they are drafted with clarity and that there are suitable legal safeguards to protect the persons who may be affected by their exercise. 20

These safeguards need to be applied both to the triggering of resolution and to the way in which the chosen resolution option is applied to the bank and its shareholders and creditors.

Objectives

In order to reduce the scope for the authorities to misuse the wide powers that they may be given by a resolution regime, it may be appropriate to ensure that the legislation sets out clearly the objectives for which the authorities may use the powers. This statement of objectives then provides a reference point for a court to judge whether the powers have been used for the right purposes. The UK Banking Act 2009 follows this approach: section 4 of the Act sets out the key objectives as follows:

- to protect and enhance the stability of the UK financial systems (including continuity of banking services);
- to protect and enhance public confidence in the stability of UK banking systems;
- to protect depositors;
- to protect public funds; and
- to avoid interfering with property rights in contravention of the European Convention on Human Rights.

Triggering resolution

It seems inevitable that the trigger point for a well-designed resolution regime will be set prior to the formal onset of insolvency and some measure of regulatory discretion may be necessary in the determination of whether the trigger point has been reached. For example, in the United Kingdom, the trigger point for the use of the resolution powers under the Banking Act 2009 is that the regulator forms the opinion that the bank has ceased or is likely to cease to satisfy its "threshold conditions" for authorisation under the Financial Services and Markets Act 2000. These threshold conditions include some relatively objective capital requirements but also include some quite subjective requirements such as suitability of management.

Consideration therefore needs to be given to the safeguards and procedures which will apply to prevent resolution powers being triggered, to the detriment of shareholders and creditors in the failed bank, when they should not be used. It should be considered whether the triggering of resolution powers should be a purely administrative action, which can be taken by the authorities without any application to court, or whether it should be judicially supervised. In the United Kingdom, the resolution regime is a largely administrative regime although aggrieved parties retain the right to seek judicial review of the authorities' actions ex post facto. Other regimes have varying degrees of judicial involvement in the process. Whether or not the courts are to be directly involved in the process itself, it is clear that the principle of the Rule of Law requires that aggrieved parties should have the ability to challenge the process, if only after the event and, possibly, to seek compensation where resolution powers have been triggered without any reasonable justification.

In order to allow the authorities who are operating the resolution regime to act with confidence, however, it may be necessary to make specific provision in the resolution legislation to the effect that individual officials of the resolution authority, or possibly the resolution authority itself, enjoy immunity from liability.

Safeguards for resolution

Exercise of particular resolution powers may involve a significant interference with private property or other rights. For example, the transfer of assets of a failed bank by use of the purchase-and-assumption tool or the bridge institution tool deprives the bank of its property; and the overriding of contractual default or termination provisions deprives the contractual counterparty of those rights. The deprivation of property becomes most acute when the state exercises a nationalisation tool to deprive shareholders of the bank of the ownership of those shares.

Protection of property rights

Property rights may be protected by the constitution of the relevant jurisdiction or by international commitments, such as those contained in bilateral investment treaties.

In the case of the United Kingdom, the European Convention on Human Rights has been implemented into national law through the Human Rights Act 1998.

Article 1 of the First Protocol to the Convention concerns the right to property and the cases decided by the Strasbourg court suggest that, normally, the State should pay compensation for any taking of private property. However, although the Banking Act 2009 makes provision for compensation to be
paid where resolution powers are used, but provides that the compensation is to be calculated on the basis of a valuation of the shares that disregards financial support given to the bank by the State. Whether provisions such as these are compatible with Article 1 of the First Protocol to the Convention is the subject of an appeal to the court in Strasbourg by certain former shareholders of Northern Rock.

While it may be impossible to resolve a bank successfully without some interference with property rights, it is important to ensure that the exercise of the powers is subject to review by the courts. In the case of the United Kingdom, Article 6 of the European Convention on Human Rights provides that everyone has a right to a fair hearing by an impartial and independent tribunal in the determination of his civil rights and obligations. The requirement of Article 6 is satisfied by the availability of the judicial review procedure in the United Kingdom.

"No creditor worse off"

The use of resolution tools, including in particular bail-in, may result in the position of a creditor being worse than would have been the case if the bank had undergone normal insolvency proceedings. The FSB’s Key Attributes acknowledge the principle that no creditor should be worse off than in a liquidation. Although this concept is relatively easy to express, it is less clear what it will mean in a particular case.

In the United Kingdom, the "no creditor worse off than in liquidation" concept is implemented by regulations made under the Banking Act 2009. These provide that where part of the property of a bank is transferred using resolution powers, provision will be made to assess the compensation for pre-transfer creditors (or some of them) on the basis of the treatment which they would have received in insolvency if no further public assistance had been given to the bank after the first resolution action took effect.

Safeguards for particular types of counterparty

The FSB’s Key Attributes also acknowledge the special status that should be afforded by a bank resolution regime to certain types of creditor and counterparty.

Derivatives counterparties enjoy a privileged status under the Federal Deposit Insurance Act of 1950. The legislation provides that "qualified financial contracts" (a definition which encompasses most types of derivatives contract) may be subject to a short moratorium on the exercise of rights of termination or close-out but that the FDIC, in exercising its rights to transfer assets and liabilities of the bank, must either transfer all qualified financial contracts with a particular party or none of them. "Cherry picking" of only selected qualified financial contracts with a particular counterparty is not permitted.

The Banking Act 2009 provides for the Treasury to make regulations to protect security interests, title transfer collateral arrangements, set-off arrangements and netting arrangements. The

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21 Banking Act 2009, sections 49 to 62
23 Banking Act 2009, section 60
24 Banking Act 2009, sections 47 and 48
regulations\(^{25}\) (among other things) prohibit cherry-picking of the rights and liabilities under title transfer collateral, set-off or netting arrangements or the transfer of liabilities without the associated security. These safeguards reflect, to a certain extent, the special status afforded to counterparties and to certain types of market contract by the Financial Collateral Arrangements Directive and the Settlement Finality Directive in the EU.

The FSB’s Key Attributes envisage that a moratorium on the exercise of termination and close-out rights should be a feature of all resolution regimes.

5. **Cross-border Aspects**

The major item of unfinished business in the design of effective bank resolution regimes for internationally active financial institutions is the cross-border effectiveness of resolution procedures.

Where an internationally active financial institution conducts business in foreign countries through branches, the authorities of that country may seek to take jurisdiction over its assets in that country notwithstanding that the resolution or insolvency laws of the bank’s home country may take a "universal" approach and seek to gather in all worldwide assets for distribution to all worldwide creditors. This problem is generally referred to as “ring-fencing”.

The issue of universality and ring fencing is, however, often less significant than the fact that the financial institution may have chosen to structure its operations through a series of affiliates incorporated under the laws of the jurisdictions where it does business or, in some cases, incorporated under the laws of tax havens or other jurisdictions where it can gain a regulatory or fiscal advantage. Each of these affiliates is likely to collapse when the principal bank in the group collapses and, when the affiliates collapse, they will normally be subject to the resolution or insolvency laws of the jurisdictions where they have been incorporated.

The result may be that the operations of the financial institution in the various different countries in which it operates are subject to different resolution and insolvency laws which may make it impossible for the group to be resolved in an efficient and co-ordinated way. Regardless of the legal regimes applying in each of these countries to the operations of the financial institution, the relevant authorities in each of those jurisdictions may not co-operate because it is concerned to protect its own depositors or other stakeholders.

Even where the financial institution has no presence in other countries, it may have assets or liabilities that are governed by foreign laws. Those foreign laws may not recognise the effect of resolution actions taken under the domestic laws of the financial institution’s jurisdiction.

The Key Attributes aim to ensure that countries have convergent and consistent bank resolution powers and that those powers include the power to recognise resolution actions taken by other jurisdictions and to co-operate with the authorities in those jurisdictions. This cooperation should be further developed through Crisis Management Groups for the relevant financial institution which conduct resolvability assessments for that institution on the basis of Recovery and Resolution Plans, and by institution-specific cooperation agreements.

Although these features of the FSB’s Key Attributes represent significant steps forward towards the eventual goal of a workable system of cross-border cooperation in the resolution of global financial institutions, for the time being no system of binding international commitments to co-operate is on the agenda. Policymakers in a jurisdiction that is introducing a resolution regime should therefore be alive to the risk, or perhaps probability, that they may not find that other key jurisdictions choose to co-operate with them in a particular case.

6. Conclusion

The global financial crisis has revealed the importance of a bank resolution regime in enabling a country to contain the effect of a crisis affecting one of its banks. In the absence of a bank resolution regime, bailouts may be inevitable and the creditworthiness of the country itself may be put at risk.

However, bank resolution powers are not enough: they need to be accompanied by appropriate deposit insurance schemes and by appropriate resolution planning, which may require the structures of banks to be re-examined and reorganised.

Normal insolvency proceedings are inherently unsuitable for banks. They may result in a “sudden stop” in the bank’s operations and a significant delay in payments to depositors and other creditors, as well as fire sales. Moreover, insolvency as defined by normal insolvency laws will often come at a much later point than the point when a bank’s licence should be suspended. The resolution regime for banks needs, therefore, to come into operation at a suitably early trigger point and to provide a special set of powers that can support the rapid payout of bank deposits and, where appropriate, the transfer and restructuring of the bank’s assets and liabilities. These powers need to be operated with the wider public interest in financial stability in mind, rather than in the interests of the bank’s creditors and it may therefore be appropriate to provide for a regime which is initiated and operated by the authorities, subject to appropriate judicial review.

A consensus is emerging as to the features that a bank resolution regime should have, with the publication of the FSB’s “Key Attributes of Effective Resolution Regimes for Financial Institutions”. Policymakers in a particular jurisdiction who are considering the design of a bank resolution regime may also turn to some of the regimes elsewhere in the world, such as those in the United States and the United Kingdom, but should keep in mind the fact that their own banking system may be very different from the systems in those countries.

In the design of a resolution regime, the key resolution tools which policymakers should consider are prompt payout; purchase-and-assumption; a bridge institution; bail-in; and nationalisation. Exercise of each of these powers may represent a significant intrusion into the private property rights of shareholders, creditors and other stakeholders. Care should, therefore, be taken in the design of the trigger point for the exercise of the powers as well as the appropriate legal safeguards to protect against the misuse of the powers. The legal safeguards should also provide protections to certain types of creditor.

Consideration also needs to be given to the allocation of functions within the resolution regime to the particular authorities in the country. The resolution authority needs access to the right skills and may need this access on short notice.
Finally, the difficulties of operating national powers in the case of financial institutions which operate internationally needs to be borne in mind. The domestic resolution powers may not be legally effective and authorities in other jurisdictions may not wish to co-operate. Resolution plans should be designed with due regard to this issue.
Appendix

Summary of the FSB's Key Attributes Document

(i) **Scope**

The regime should extend to “any financial institution that could be systemically significant or critical if it fails”, and should extend to holding companies, non-regulated operational entities that are significant to the business of the group and branches of foreign firms. The regime should require a recovery and resolution plan, regular resolvability assessments and institution-specific cross-border cooperation agreements.

(ii) **Resolution authority**

The resolution authority or authorities designated in each jurisdiction should have appropriate statutory objectives and functions, including pursuing financial stability, protecting depositors and other insured investors and (subject to those objectives) seeking to minimise the costs of resolution. Significantly, it is proposed that the resolution authority should have a statutory objective to “duly consider the potential impact of its resolution actions on financial stability in other jurisdictions”.

(iii) **Resolution powers**

Resolution should be initiated when a firm is no longer viable or likely to be no longer viable and has no reasonable prospect of becoming viable. Resolution authorities should have a broad range of powers, including:

- overriding shareholder rights of the firm in resolution, including requirements for shareholder approval;

- transferring or selling assets and liabilities including deposits and shares, without such transactions requiring consent or constituting a default; establishing a bridge institution to take over critical functions and viable operations (including reversing transfers to such an institution, subject to appropriate safeguards);

- establishing a separate asset management vehicle for non-performing loans or difficult-to-value assets;

- "bail-in within resolution" to help achieve continuity of essential functions by converting unsecured and uninsured creditor claims into equity or other instruments of ownership so as to (a) recapitalise the entity or (b) capitalise a newly established entity to which functions have been transferred, respecting the hierarchy of claims in a liquidation, applying to equity,

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26 Key Attributes, para 1.1

27 However, this recommendation is not applicable in Europe to the extent that the Credit Institutions Winding-up Directive 2001/24/EC (the Winding-up Directive) confers universal resolution authority on the home state.

28 Key Attributes, para 2.3(iv)
other ownership instruments, unsecured and uninsured creditor claims and enabling conversion or write-down of any contractual bail-in instruments not already triggered; and - temporarily staying termination rights that would otherwise be triggered by resolution; imposing a moratorium with suspension of payments to unsecured creditors and a stay on creditor actions, subject to protections for central counterparties, payment, clearing and settlement systems and netting and collateral agreements.

The Key Attributes recognise the importance of a cross-border view of resolution: "in applying resolution powers to individual components of a financial group located in its jurisdiction, the resolution authority should take into account the impact on the group as a whole and on financial stability in other affected jurisdictions, and undertake best efforts to avoid taking actions that could reasonably be expected to trigger instability elsewhere in the group or in the financial system."^29

(iv) Set-off, netting, collateralisation, segregation of client assets

The legal framework governing these issues should be transparent and enforceable during a crisis. Subject to adequate safeguards, entry into resolution should not trigger set-off, acceleration or termination rights, provided that the substantive obligations under the contract continue to be performed. However, should acceleration or termination rights nevertheless be exercisable, the resolution authority should have the power to stay such rights temporarily, for a limited period such as 2 business days, where they arise by reason only of entry into resolution or in connection with the exercise of resolution powers.

(v) Safeguards

Resolution powers should respect the hierarchy of claims "while providing flexibility to depart from the general principle of equal (pari passu) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole". 30 Creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime (the "no creditor worse off than in liquidation" safeguard). 31

(vi) Funding of firms in resolution

The Key Attributes document states that jurisdictions should have policies in place so that authorities are not constrained to rely on public ownership or bail-out funds as a means of resolving firms. Losses incurred from the provision of temporary funding should be recovered from

^29 Key Attributes, para 3.9
^30 Key Attributes, para 5.1
^31 The FSB does not seek to define how "no creditor worse off than in liquidation" should operate. A key question is whether the (hypothetical) liquidation against which the creditor's position is compared is a liquidation of the firm without the benefit of any public support, even if such support has in fact already been given at the point of resolution; in practice, the resolution of a large firm may involve such support, including through the use of lender of last resort facilities. Section 57(4) of the UK Banking Act 2009 addresses this issue by providing that the valuation of the firm against which compensation should be assessed should ignore actual or potential financial assistance provided by the Bank of England or the Treasury (disregarding ordinary market assistance provided by the Bank of England on its usual terms)
shareholders and creditors (subject to the "no creditor worse off than in liquidation" safeguard) or, if necessary, from the financial system more widely.

(vii) **Legal framework conditions for cross-border cooperation**

The mandate of a resolution authority should empower and strongly encourage the authority wherever possible to act to achieve a cooperative solution with foreign resolution authorities. The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority or, in exceptional circumstances, to take measures on its own initiative. National laws should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. Jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures.

(viii) **Crisis management groups**

Home and key host authorities of all G-SIFIs should maintain Crisis Management Groups (CMGs) with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm. CMGs should report as appropriate to the FSB and the FSB Peer Review Council on progress, the recovery and resolution planning for G-SIFIs and their resolvability.

(ix) **Institution-specific cross-border cooperation agreements**

The Key Attributes document contains an Annex setting out the minimum essential elements of an institution-specific cooperation agreement for a G-SIFI.

(x) **Resolvability assessments**

The Key Attributes document states that "to improve a firm's resolvability, supervisory authorities or resolution authorities should have powers to require, where necessary, the adoption of appropriate measures, such as changes to a firm's business practices, structure or organisation, to reduce the complexity and costliness of resolution, duly taking into account the effect on the soundness and stability of ongoing business. To enable the continued operations of systemically important functions, authorities should evaluate whether to require that these functions be segregated in legally or operationally independent entities that are shielded from group problems."³²

(xi) **Recovery and resolution planning**

The Key Attributes document contains an Annex setting out the essential elements of Recovery and Resolution Plans, which should be put in place for all G-SIFIs and for any other firm that its home authority assesses could have an impact on financial stability in the event of its failure. The Recovery and Resolution Plan should be informed by the resolvability assessments. For G-SIFIs, the home resolution authority should lead the development of the group resolution plan in coordination with all members of the firm’s CMG.

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³² Key Attributes, para 10.5
(xii) **Access to information and information-sharing**

There should be no impediments to hinder the appropriate exchange of information and the arrangements for information sharing should be set out in the institution-specific cooperation agreements.