Crisis Management Tools in the EU: What Do We Really Need?

DNB Occasional Studies

Annemarie van der Zwet
Crisis Management Tools in the EU: What Do We Really Need?
Table of contents

1. Introduction 7
2. Definitions 8
3. The US toolbox 10
4. State of Affairs in the EU 12
5. Evaluation of Intrusive Crisis Management Tools 18
   5.1 Share transfer instrument 18
   5.2 Property transfer instrument 19
   5.3 Recapitalisation 22
6. Policy Initiatives 23
   6.1 Living wills 23
   6.2 Bail-in 24
7. Conclusion 26
1 Introduction

The massive interventions of public authorities in banks and other financial institutions in recent years have resulted in increased interest from policymakers in the available crisis management tools. The crisis management framework in the US, where a special insolvency regime for banks has evolved of old, is often held up as an example in this policy debate. European countries typically lacked the US type of intrusive powers to deal with problem banks prior to the financial crisis. Since the crisis, the UK, Germany and several other European countries have introduced new crisis management instruments, while the European Commission is working on proposals for a harmonised EU crisis management framework. In this context, this article tries to answer the question: Which instruments are most useful, also in light of the experiences gained during the financial crisis?

This article first defines the core characteristics of intrusive crisis management tools (section 2) and gives a short description of the available toolbox in the US (section 3). Section 4 takes stock of the state of affairs with respect to the introduction of intrusive crisis management tools in the EU, and section 5 evaluates the merits of various intrusive crisis management tools in more detail. We continue with a discussion of recent policy initiatives (section 6), before presenting conclusions in section 7.
Before starting our evaluation, it is useful to pay attention to definitions, since many names – such as crisis management tools, special resolution regime, bank insolvency regime or proceedings – circulate for essentially the same thing. This article concentrates on powers that can be used by public authorities to intervene in financial institutions facing problems which are so serious that the institution concerned is, or will likely become, unviable. In this phase, the default scenario is liquidation. However, banks are special in the sense that their failure causes a discontinuity of financial services to depositors (public service-argument) and may affect other financial institutions (financial stability-argument). Liquidation under the general insolvency law is therefore not suitable for banks in all respects. Special instruments are needed to minimise the disruption of banking failures for the rest of the economy. The goal of these special instruments is, on the one hand, to ensure the continuation of the bank as a whole, or at least the parts which constitute a public service or are important for safeguarding financial stability. At the same time, normal failures should be mimicked in the sense that investors of the bank (shareholders but also creditors) are forced to bear the losses resulting from the risks they have taken. This last requirement limits the use of public money, and thus protects taxpayers. In addition, moral hazard - the risk appetite resulting from the expectation of bank bailouts – is discouraged, which is crucial for safeguarding the stability of the financial system in the long term.

The described dual goal of a special bank insolvency regime implies that shareholders and creditors have to accept the loss they would have accepted in case of liquidation of the bank, while (parts of) the bank continue to exist in the public interest. In order to realise this goal, it is often necessary to override shareholders and creditors’ property rights. The Basel Committee (2010a) and Hüpkes (2010) list

---

1 In the rest of this article we only refer to banks. However, it may make sense to broaden the scope of the crisis management tools to insurance companies, particularly in countries where these different types of financial institutions are intertwined in the form of financial conglomerates. More broadly, banks are often part of larger financial groups, headed by holding companies. We abstract in this article from the complexities resulting from these group structures.
Crisis Management Tools in the EU: What Do We Really Need?

various techniques to achieve this kind of resolution. Some of these instruments are not ‘new’, since they have existed for a long time in other countries, such as the US, Japan, Canada, Switzerland and Norway:

1. Share transfer instrument – the transfer of all, or specified classes, of the securities of a bank without shareholder approval in order to transfer a failing bank to a private sector purchaser, or to take the bank into temporary public ownership;

2. Property transfer instrument – the transfer of a bank’s property, rights and liabilities (including a partial transfer) without shareholder approval to a private sector purchaser or a bridge bank;

3. Recapitalisation – issuance of securities (including normal shares but also other types of capital instruments) without shareholder approval.

In the rest of this article, these instruments are referred to as intrusive crisis management tools (their merits are evaluated in section 5).

There is also a lively debate on other techniques which serve the same dual goal, but whose practical functioning is less clear, mainly because they have seldom been applied in practice. These policy initiatives (which are further explored in section 6) encompass:

4. Recovery and resolution plans. A recovery and resolution plan (or living will) implies that both the firm and the authorities consider in advance the range of actions that they might undertake to deal with a crisis at a firm, the information they need to carry out those actions, the obstacles that they may face and potential solutions. This will form the basis for considering whether further actions are required by the firm to remove obstacles to recovery or resolution. This may include the need for structural change and/or off-setting measures (FSA, 2009);

5. A so-called ‘bail-in’ by means of a debt writedown or a debt-equity conversion. Note that a debt writedown as well as debt-equity conversion are common features of normal bankruptcy procedures. However, if normal bankruptcy procedures were applied to banks, all activities of the failing bank – including important functions – would be discontinued. Therefore, these instruments can only contribute to the described dual goal of crisis management if they can be used separately from the normal bankruptcy procedure.

---

2 The Basel Committee (2010) also mentions powers to terminate unnecessary contracts and to continue needed contracts as necessary ingredients for an effective crisis resolution regime. We regard these powers as complementary to the five main instruments, which is not to deny that powers to terminate or continue contracts can be very important for an effective crisis resolution in practice. The same reasoning holds for the powers, mentioned by Hüpkes (2010), to appoint an official to take control of the bank, and the power – not the obligation – to order a suspension of payments or stay (moratorium).
3 The US toolbox

For a proper understanding of the available toolbox in the US, it is useful to sketch a broad picture of the way in which a bank failure is handled in the US (FDIC Handbook). The bank insolvency process in the US is started when a bank’s supervisor sends a ‘failing bank letter’, advising the FDIC of the institution’s imminent failure. This is the formal start of the resolution process, in which the FDIC prepares the actual resolution. The FDIC usually organises a Purchase and Assumption (P&A) transaction, which implies the use of property transfer powers. In a P&A transaction, a healthy institution purchases some or all of the assets of a failed bank, and assumes some or all of the liabilities (including all insured deposits). The transaction is implemented when the supervisor concerned closes the institution and appoints the FDIC as a receiver. In many ways, the powers of the FDIC as a receiver of a failed institution are similar to those of a bankruptcy trustee: all powers of the board as well as the shareholders are vested in the FDIC, which is thus solely in charge of the bank concerned. A noticeable difference between the corporate and the bank insolvency regime is however, that the decisions of the FDIC as a receiver are not subject to court supervision, and its decisions are not reviewable except under very limited circumstances (Granlund (2002)) and Bliss and Kaufman (2006)). The limited role of the judiciary permits quick and decisive actions by the FDIC in bank resolutions.

Another important characteristic of the US bank insolvency regime is the existence of depositor preference. Since the adoption of the Depositor Preference Act in 1993, the following general preference scheme applies in receivership in the US:

- Administrative expenses of the receiver;
- Secured claims;
- Domestic deposits, both insured and uninsured;
- Foreign deposits and other general creditor claims;
- Subordinated creditor claims, and
- Shareholders.

While P&A transactions are a means to secure the continuation of important functions of banks, depositor preference implies the imposition of relatively large losses on unsecured creditors in liquidation (abstracting from dynamic adjustments
in the behaviour of creditors, see Marino and Bennett, 1999). In this way, the US resolution regime is suited to realise the dual goal as described in section 2.

In this set-up, the US authorities have all three intrusive crisis management tools at their disposal. As a receiver, the FDIC may use the share and property transfer instrument and can decide on the issuance of new capital as well (although the property transfer powers are used most frequently in practice). While this special resolution regime has existed for banks, savings and loans associations and credit unions for decades, it is extended to all systemically significant financial companies by the recently adopted financial reform package (Dodd-Frank Act). With the adoption of the Dodd-Frank Act, the US is also a forerunner with respect to the legal implementation of the above-mentioned policy initiatives. In particular, this Act requires large, complex financial companies to periodically submit recovery and resolution plans. Companies will be hit with higher capital requirements and restrictions on growth and activity, as well as divestment, if they fail to submit acceptable plans. These provisions suggest that it is the intention of the US legislator that large, complex groups should be restructured if necessary to safeguard financial stability. However, the extent to which this will actually happen remains to be seen, since supervisors have considerable discretion in evaluating recovery and resolution plans. The financial reform package does not contain clauses with respect to a debt writedown, but opens the possibility to require large, complex financial companies to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.

---

3 See the Conference report on the 'Dodd-Frank Wall Street Reform and Consumer Protection Act', 29 June 2010, http://banking.senate.gov/public/. Section 203 jo section 210. In particular, the Secretary of the Treasury shall decide to appoint the FDIC as a receiver, after a recommendation of the Board of the Fed and the Board of the FDIC, if the financial company is in default or in danger of default, and its failure would have serious adverse effects on financial stability in the US. If the financial company concerned does not agree with the appointment of the FDIC as a receiver, the decision of the Treasury shall be reviewed in court within 24 hours. Although this involvement of the court is a deviation from the existing special insolvency regime for banks, it means that arrangements for timely decision-making are in place.

4 Section 165 of Conference Report (see footnote 3).

5 In addition, a large, complex group will be required to take mitigatory actions if it poses a grave threat to the financial stability of the US. These mitigatory actions consist of, inter alia, restricting the ability of the company to offer financial products, requiring the company to terminate one or more activities or – if these actions are insufficient – requiring to divest its assets or off-balance-sheet items. Section 121 of Conference Report (see footnote 3).

6 Section 115 of Conference Report (see footnote 3).
4 State of Affairs in the EU

As mentioned in the introduction, various EU countries have strengthened their crisis management tools in the aftermath of the financial crisis. In order to take stock of the state of affairs in this field in the EU, we look at 12 EU countries with a significant financial sector. We define the financial sector of a particular country as significant if the size of the balance sheets of all banks, insurance companies, pension funds and mutual funds exceeds 1 trillion euro. Of the 27 EU countries, 12 countries meet this criterion, namely Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain, Sweden and the UK. Small countries like the Baltic States, and countries with a relatively small financial sector, such as Greece or Portugal, fall out of our sample. Of the 12 EU countries with a significant financial sector, six have recently introduced new legislation concerning intrusive crisis management tools. The countries concerned are Belgium, Denmark, Germany, Ireland, Spain and the UK. Other EU countries with significant financial sectors generally lack intrusive crisis management tools.7

An important distinguishing feature of banks is that they are prone to the risk of a bank run, which implies a massive withdrawal of funds by wholesale and retail depositors because they believe that the bank is, or might become, insolvent. Since this behaviour is self-fulfilling and generates negative externalities (in particular because of contagion effects), it is important for public authorities to intervene before the confidence of financial markets and the public has become so low that a bank run can be reasonably expected. Intrusive crisis management tools should therefore be used in time. The need to avoid a bank run not only requires timely decision making, but also a speedy implementation, which means in practice that authorities cannot wait for the shareholders’ permission. The importance of early intervention is often stressed in the literature on effective crisis management.

7 We are aware of one counterexample, namely Italy. In this EU country, the Minister for the Economy and Finance, acting on a proposal from the Bank of Italy, may issue a decree revoking authorization to engage in banking and ordering the Compulsory Administrative Liquidation (CAL). A CAL generally involves the transfer of the assets and liabilities of the failed bank to a healthy bank without any interruption to business continuity. This is an application of the second intrusive crisis management instrument mentioned in the introduction, namely property transfer powers.
management.8 We can learn from the US bank insolvency regime the importance of decisive interventions, which cannot be reversed in court. This serves to calm markets as well as private depositors, who are likely to run if they perceive a material risk of the intervention being reversed. Because timely decision making, speedy implementation and decisive interventions are thus necessary to prevent bank runs, we regard these characteristics most important for an effective crisis management framework.

Table 1 evaluates the recently introduced or planned crisis management tools in Belgium, Denmark, Germany, Ireland, Spain and the UK on the basis of the above mentioned criteria. A first observation from table 1 is that there is little convergence in Europe with regard to the scope as well as the types of intrusive crisis management tools that have been introduced. In Denmark, Spain and the UK the scope of intrusive crisis management tools includes all banks, whereas the scope is confined to banks causing financial stability concerns in Belgium and Germany. In the emergency regulation of Ireland the scope of the property transfer instrument (fighting the current financial and economic crisis) and the discount of subordinated liabilities (in principle, all banks) varies. In practice, the difference between these descriptions might be smaller than it appears at first sight, since the formulation of ‘financial stability’ may offer considerable room for discretion.

With regard to the types of crisis management tools, table 1 shows that Belgium, the UK and Spain have introduced both share and property transfer instruments while Denmark apparently found a property transfer instrument sufficient. The recently adopted Restrukturierungsgesetz in Germany offers two routes for crisis management: a restructuring route and a transfer order. The restructuring route contains a wide range of instruments, but does not qualify as genuine intrusive crisis management since the meeting of shareholders can not be bypassed. In case the crisis is so severe that a lengthy procedure to reach agreement with groups of shareholders and creditors is not possible, the German supervisor can directly make use of the property transfer instrument. The emergency regulation in Ireland also encompasses a property transfer instrument, as well as the possibility to infringe upon the rights the holders of subordinated debt. Besides Ireland and Germany in the restructuring route, the other EU countries have refrained from bail-in provisions separate from the normal bankruptcy procedures. The UK is the only country in our sample that has created an explicit legal basis for its supervisor to make general rules with regard to recovery and resolution plans.9 Finally, it is

---

8 See for example Hüpkes (2004), who states that ‘As a general rule – and this has been stressed over and over again in writings on bank insolvency – prompt action is of the essence.’ The IMF (2009) also recommends allowing the banking authorities to take control of a bank at a sufficiently early stage of its difficulties.

9 Sections 139B to F of the UK Financial Services Act 2010.
generally not possible to recapitalise banks without shareholder approval in the EU, since this would interfere with the Second Company Law Directive. To sum up, in introducing intrusive crisis management tools, individual EU countries have concentrated on share and property transfer powers, whereas other intrusive crisis management tools – recapitalisation, living wills and bail-in – have received much less attention.

A second observation is that Belgium, Germany, Ireland and the UK have succeeded in formulating the triggers such that intrusive crisis management tools can be used at an early stage, particularly before the onset of actual insolvency. Thus, it appears not too complicated to allow for timely decision making in the design of intrusive crisis management tools. However, speedy implementation of intrusive crisis management tools is apparently much harder to achieve, in particular in combination with our last requirement, decisive intervention. Table 1 shows that many EU countries that have recently introduced intrusive crisis management tools are unable to implement measures fast; notable exceptions are the UK, and Germany when applying a transfer order. In the other countries analysed, either the meeting of shareholders has to agree (Denmark, Spain and Germany in the restructuring route), which clearly takes considerable time, and/or there is a lengthy legal procedure before the measures come into effect (Belgium and Germany in the restructuring route, and Ireland). This set-up renders the crisis management instruments ineffective in most cases: When far reaching restructuring measures are proposed to a shareholders’ meeting or a court, both financial markets and the public will interpret the apparent necessity of these measures as a sign that the bank concerned is in a very bad shape, and thus withdraw funding. In case of systemically relevant institutions, taxpayers will then be forced to rescue the bank, whereas the goal of intrusive crisis management tools is precisely to avoid this happening.

Against the background of the diverse national initiatives, the European Commission’s intention to come up with proposals for an EU framework for crisis management in the banking sector is most welcome. A European approach is better suited to introduce intrusive crisis management tools than national law, given the potential impact of these instruments on the funding of banks and thereby the level playing field. Actually, the large barriers that exist in Belgium, Denmark, Ireland and Spain to override rights of shareholders and creditors in the application of crisis management instruments may be attributed to a restraint to put national banks at a competitive disadvantage. In addition, harmonised crisis management tools can be expected to facilitate a coordinated resolution of cross-border institutions. This last mentioned goal is of course best served by a global approach, but a substantial European toolbox for crisis management can be regarded as a step in the right direction.
Thus far, the European Commission is still in the process of coming up with concrete proposals. It is evident from the most recent Working Document of the Commission (Commission, 2011) that it is the ambition to cover a broad spectrum of crisis management instruments, ranging from early intervention to bank resolution and the insolvency framework. In light of this broad scope, it is striking that the European Commission pays very little attention to the recapitalisation instrument and no attention at all to the desirability of introducing depositor preference. Precisely these components of an effective crisis management framework can best be realised on a European level. Incidentally, in most EU countries, depositors have the same rank as other creditors in receivership. In this context, it should be noted that the EU Directive on winding-up of credit institutions does not provide for depositor preference, whereas the EU Directive on winding-up of insurance undertakings has introduced a preference for policyholders in liquidation.

---

10 Garcia and Nieto (2009) mention Austria and Italy as EU countries with depositor preference.
Table 1  Overview of recently introduced intrusive crisis management tools in the EU

<table>
<thead>
<tr>
<th>Share and property transfer</th>
<th>Timely decision making</th>
<th>Speedy implementation</th>
<th>Decisive intervention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>If an insurance undertaking, credit institution or securities settlement institution is not operated in compliance with applicable law and if such non-compliance is likely to affect the stability of the Belgian or international financial system, the state may make use of a property transfer instrument or share transfer instrument. The state can take this decision after being advised by the banking supervisor (CBFA) and the Committee for systemic risks and system-relevant financial institutions (CSRSFI).</td>
<td>The decision to make use of property or share transfer powers is implemented after the court has declared that the transfer is legal and that compensatory indemnity appears to be fair. This legal procedure can take up to 27 days. In this period the planned decision to apply property or transfer powers is public.</td>
<td>After the decision is implemented, owners of transferred assets, liabilities or shares can contest the compensatory indemnity, but the transfer itself cannot be reversed.</td>
</tr>
<tr>
<td>Denmark</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>If a bank fails to meet the legal capital adequacy requirements and the bank’s capital is not restored before a deadline determined by the financial supervisor (FSA), the bank shall sign a conditional agreement providing that the bank shall transfer its assets and liabilities to a buyer designated by the Winding-Up Company (which is a public authority for crisis management). This provision does always not allow timely decision making, since capital is a lagging indicator.</td>
<td>If the shareholders’ meeting can agree on other measures that result in meeting the capital requirements, or upon liquidation, the conditional agreement shall be annulled. Thus, the shareholders’ meeting can not be bypassed, which impedes a speedy implementation.</td>
<td>The relevant law does contain provisions to challenge the transfer amount, but no provisions to reverse the agreement once it has become final. Since the agreement has to be approved by the shareholders’ meeting, the contest of this decision in court is only a theoretical option.</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>In case of a severe crisis of a credit institution, causing concern about substantial negative effects on the stability of the financial system, the financial supervisor can file a petition for the application of a reorganisation plan containing intrusive measures (such as issuance of new capital, the transfer of all or part of the business to a bridge bank, a discount on the claims of creditors and a debt-equity conversion).</td>
<td>As in the normal insolvency procedure, groups of creditors as well as shareholders have to agree to the reorganisation plan. Only after the court has confirmed this agreement, the measures will come into effect.</td>
<td>Creditors and shareholders already had the opportunity to challenge the reorganisation plan before it was implemented.</td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Bafin shall – in consultation with the Bundesbank – be authorised (from 1-1-2011) to order a bank to transfer the whole or part(s) of its assets and liabilities to an assuming entity (a bridge bank) if (i) the existence of the bank is endangered; (ii) this in turn endangers the stability of the financial system, and if (iii) there are no other, less severe means to remedy the crisis.</td>
<td>The transfer order takes effect as of the day of its notification to the bank and the assuming entity. All assets and liabilities are transferred at that date.</td>
<td>Only option available is to challenge the amount of compensation.</td>
</tr>
<tr>
<td>Country</td>
<td>Timely decision making</td>
<td>Speedy implementation</td>
<td>Decisive intervention</td>
</tr>
<tr>
<td>---------</td>
<td>------------------------</td>
<td>-----------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>The Minister of Finance may propose a (property) transfer order if he is of the opinion, having consulted the Governor of the Central Bank, that making such an order is necessary for achieving the purpose of the bill (fighting the current financial and economic crisis). He may propose a subordinated liabilities order, again after consultation of the Governor of the Central Bank, if this is necessary for preserving or restoring the financial position of the relevant institution.</td>
<td>The Minister of Finance shall apply to the High Court for a transfer order and a subordinated liabilities order. Transfer order or subordinated liabilities order is made by the High Court.</td>
<td>Stakeholders may apply to the High court, no later than 5 working days, to set the transfer order or the subordinated liabilities order aside.</td>
</tr>
<tr>
<td>Spain</td>
<td>No</td>
<td>No</td>
<td>Yes/No</td>
</tr>
<tr>
<td></td>
<td>When a credit institution (…) has weaknesses in its economic-financial situation that, depending on the development of market conditions, might jeopardize its viability (…) the institution in question will present an action plan within one month. If this action does not meet specified criteria (e.g. it is not approved by the Bank of Spain), the Bank of Spain will appoint the Fund for Orderly Bank Restructuring (FOBR) as an interim administrator. The FOBR will draw up a restructuring plan aimed at facilitating processes for merger with or absorption by other institutions or the transfer of all or part of the business to another institution.</td>
<td>With the exception of the transfer of deposits, the restructuring plan drawn up by the FOBR has to be approved by the shareholders’ meeting.</td>
<td>The relevant law does not contain any provisions to reverse the restructuring plan. If this plan is approved by shareholders, the contest of this decision in court is only a theoretical option. If the transfer of deposits is not approved by the shareholders meeting, this decision can be challenged in court and potentially be reversed.</td>
</tr>
<tr>
<td>UK</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>First, the bank is failing, or is likely to fail, to satisfy the threshold conditions (relating to the permission to carry on regulated activities). Second, having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions. The financial supervisor, FSA, judges whether a bank is meeting this criterion. The Bank of England has the right to make a recommendation to the FSA on this matter. The Bank of England is responsible for applying the stabilisation powers, which encompass share and property transfer powers.</td>
<td>Share and property transfer powers are applied without interference of the meeting of shareholders.</td>
<td>The relevant law only contains provisions to object to compensation, but no provisions to challenge the transfer itself. We understand that there is nevertheless a possibility in the UK to challenge the transfer itself in court. However, since the authorities have discretionary powers in this field, the court only judges on reasonableness, rendering a reversal of the transfer very unlikely.</td>
</tr>
</tbody>
</table>

1 Law supplementing the recovery measures that apply to undertakings in the banking and the financial sector, June 2, 2010, and the Law providing remedies with respect to this first mentioned law, June 2, 2010.
3 Gezetsbeschluss Restrukturierungsgesetz and Clifford Chance, Discussion Draft on the Restructuring of German Credit Institutions, Newsletter, July 2010.
4 Credit Institutions (Stabilisation) Bill 2010.
5 Royal Decree-Law 9/2009, of June 26, on bank restructuring and credit institution equity reinforcement.
5 Evaluation of Intrusive Crisis Management Tools

5.1 Share transfer instrument

As mentioned above, Belgium the UK and Spain have recently introduced a share transfer instrument, while this instrument has existed for a long time in the US. The term share transfer instrument refers to the power of public authorities to expropriate shares of a failing bank from existing shareholders in favour of a private sector purchaser or a public body, without shareholder approval. The main justification of this intrusive power is that it serves to restore the normal loss absorbing function of equity and thereby the market discipline of shareholders. Banks differ fundamentally from other companies in the sense that governments will often put considerable effort into preventing their failure, e.g. by providing capital support or guarantees. However, the presence of this safety net disturbs the incentives of shareholders to agree with a solution, for example by selling their shares at a relatively low price or by accepting a dilution of their stake. In other words, if the risk of failure emerges, shareholders of banks will be more inclined to bet on the survival of the bank without fresh capital, since the potential losses of this choice are not borne by them, but by the taxpayer.\textsuperscript{11} Conversely, shareholders of ‘normal’ companies would be compelled to accept a transfer (or dilution) of their stake in comparable circumstances, since creditors would withdraw their funding otherwise. The necessity to discipline shareholders in the presence of a safety net is the main justification for a share transfer instrument.

\textsuperscript{11} Van Ewijk and Teulings (2009) describe an interesting example of this position (in Dutch) in the context of the capital support provided by the German authorities to Hypo Real Estate (HRE). The necessity to bypass shareholders in banking resolutions is also illustrated by the position of the shareholders of Northern Rock, the British bank that was nationalised in February 2008 by using the share transfer powers (that were created by the Banking (Special Provisions) Act of 2008, a temporary forerunner of the Banking Act 2009). The shareholders of this bank are still challenging in court the decision of an independent valuer that they should get no compensation. This position is misplaced, since without government support, Northern Rock would have failed, leaving the shares worthless. Shareholders who claim that their shares had market value at the time of nationalisation are effectively claiming the value of the safety net provided by taxpayers.
Whereas the main advantage of a (well-shaped) share transfer instrument is the possibility to discipline shareholders, the instrument is limited in the sense that creditors come away unscathed. This is probably justified in cases where the share transfer instrument is used to facilitate a take-over by a private party. If no interested private party can be found, the shares of the troubled bank may be transferred to the government itself or to a legal entity established by the government (nationalisation). As demonstrated in the Northern Rock case, governments are reluctant to nationalise banks, as it requires taxpayers to guarantee the obligations of the failed bank, potentially resulting in injections of new capital. Thus, the price for preserving the troubled bank as a whole - in the absence of a private sector buyer - is that the bank’s actual or potential losses are shifted from creditors to taxpayers. This failing in the market discipline of creditors is clearly a disadvantage of using the share transfer instrument to effect a nationalisation.

5.2 Property transfer instrument

The EU countries that have recently introduced a share transfer instrument, have chosen to establish a property instrument as well (Belgium, UK and Spain). However, Germany, Denmark and Ireland have introduced a property transfer instrument separate from a share transfer instrument. At face value, a share transfer instrument is superfluous on top of a property transfer instrument. After all, a take-over of a failing bank as a whole can be realised either by transferring shares (share transfer instrument) or by transferring all other assets and liabilities (property transfer instrument). Nevertheless, it makes sense to introduce both instruments, since transferring shares may be operationally much easier to realise than transferring all assets and liabilities. The value added of the property transfer instrument is that it opens the possibility to transfer not all, but only parts of the bank. These splits may occur in the following ways:

A. The most straightforward application of the property transfer instrument is for the transfer of **insured deposits**, as an alternative for payments made by the deposit insurance to individual depositors. Incidentally, this transaction by no means implies a rescue of a failing bank: If a bank is considered not to be viable anymore, its insured deposits are transferred by public authorities to another bank, that other bank receives cash from the deposit insurance to finance these additional liabilities. Subsequently, the original bank is closed. This technique is attractive since it may ensure the continuity of service to depositors. Furthermore, the bank to which the deposits are transferred is often willing to pay a price for obtaining a group of new clients (the franchise value), which lowers the cost for the deposit insurance. Finally, a single transfer of all insured deposits may be more efficient than payments to each individual depositor (provided that if the IT systems of the banks concerned are suited for executing a single transfer).
B. A more complex application is a transfer of assets such as cash, loans and mortgage loan portfolios besides insured deposits. This technique – the so-called P&A-transaction - is the most frequently used resolution method in the US, since the FDIC is obliged to choose the least cost resolution method. Assets that can be transferred together with, or at least at the same time as, the insured deposits, may yield more than the assets that are sold out of a receivership. Preserving the franchise value of the assets in addition to the franchise value of the deposits further reduces the costs for the deposit insurance. As in case A, the remaining bank will be closed, since it is even less viable after the transfer of insured deposits and assets than it was before.

C. It is also possible to use the property transfer instrument to transfer underperforming or toxic assets to separate vehicle (a bad bank) in order to cleanse the balance sheet of the troubled bank. It is questionable whether this operation requires an intrusive power, since the bank concerned (as well as its shareholders and creditors) will normally be interested in divesting its bad assets. However, the European Commission rightly points to the possible value added of this type of split in conjunction with other resolution tools (Commission, 2011). For example, it may be easier to find a buyer for the shares of a problem bank, if the bank concerned is forced to divest its bad assets first.

In principle, it is advantageous to save only the sound parts of a troubled bank. Firstly, leaving the bad assets behind in the original bank will increase the attractiveness of the sound parts for a private sector purchaser (see Bank of England et al, 2008). The preferred option of a private sector solution thus becomes feasible more often. In cases where a private sector solution can still not be realised in time, the technique of splitting allows the government to save only the essential functions - from a public service or a financial stability viewpoint – of the troubled bank. In this case, it is worth considering the establishment of a temporary legal entity to which the essential parts of the bank are transferred (a bridge bank). Naturally, a targeted instead of a full rescue limits the amount of public funds involved. In addition, the liquidation of the remaining bank probably means that not only shareholders, but also creditors are confronted with the losses resulting from the risks taken by the bank.

12 It is also possible that all deposits, thus both the insured and uninsured deposits, are transferred to another bank. However, providing 100 percent protection causes moral hazard among depositors.
13 Please note that establishing a bridge bank is operationally complex. These complexities relate to questions such as: Which institution is responsible for establishing the bridge bank?; Who will manage it; How will the bridge bank be financed? etc. Answering these questions requires thorough preparations, since there will not be enough time to create a bridge bank from scratch in crisis situations.
Although the increased market discipline of creditors besides shareholders is an important argument in favour of the property transfer instrument, it should be noted that the amount of losses ultimately borne by creditors also depend on their rank in liquidation. In the UK, the Banking Act stipulates that creditors will need to be compensated to the extent that they suffer no greater loss than in liquidation to respect property rights. In the absence of depositor preference, this means that the liquidation value of the transferred assets has to be reimbursed to the creditors of the original bank, which severely undermines the attractiveness of splitting banks in crisis situations. In countries with depositor preference this will not be necessary at all, or to a lesser extent, since the depositors are entitled to value of the transferred assets before other creditors.

Applying the property transfer instrument also has disadvantages. The main problem is that splitting a bank is complex and therefore time consuming, which is at odds with the time pressure of crisis management. Usually, banks try to realise synergies by centralising key functions (such as risk management, IT and Treasury) and an organization along ‘business lines’ (such as retail banking, corporate banking and investment banking). This results in interrelations between different legal entities, or in other words a mismatch between the legal and operational structure. These interrelations are probably intensified by tax and regulatory arbitrage (Avgouleas et.al., 2010). When different legal entities of a bank are interconnected, it is very difficult to produce precise, legal definitions of the activities to be transferred and the activities staying behind in the original bank. Thus, the mismatch between the legal and operational structure of banks effectively impede an effective split. Incidentally, it appears reasonable to expect that this mismatch or opaqueness is particularly manifest in large banks: the larger the bank, the more opportunities for interrelations exist. Smaller banks will often have simpler organizations, in which the operational and legal structures will often correspond more closely. It is therefore no coincidence that the technique of splitting bank is primarily applied to small banks in practice. During the financial crisis, usually small banks were split to save the sound parts, particularly in the US.

14 Art. 60 Banking Act 2009.
15 Within Europe, the following (small) banks were split during the financial crisis to save the essential parts: the Danish bank Roskilde in 2007, and in the UK the British subsidiaries of Icelandic banks (2008), Bradford and Bingley (2008) and the Dunfermline Building Society (2009). In the US, numerous small banks have been split during and in the aftermath of the financial crisis. We are aware of one large bank where the P&A-technique was applied as a resolution method, namely Washington Mutual (WaMu) in September 2008. At the time of its collapse it was the sixth-largest bank in the US (asset value $ 327.9 billion). All of its deposits and most of its assets were sold to JP Morgan Chase by the FDIC.
Recapitalisation

As noted in section 4, EU countries generally have no recapitalisation instrument at their disposal, since this would conflict with the Second Company Law Directive. However, there is a convincing argument to formulate an exception for banks from the provision in the Second Directive that any increase of subscribed capital must be decided upon by the meeting of shareholders. This argument is essentially the same as the reasoning in favour of a share transfer instrument, namely that the normal loss absorbing function of equity is disturbed by the existence of the safety net for banks. In other words, the fact that shareholders of a failing bank know that there is a high probability of the government rescuing the bank, undermines their willingness to cooperate with a resolution.

In cases where the preferred solution is a take-over of the failing bank as a whole, both the share transfer instrument and the recapitalisation instrument can be used. By means of the recapitalisation instrument so many new shares can be emitted that the new owner gets a majority stake. A difference between the two techniques is that shares can be transferred without any compensation, whereas in case of recapitalisation, existing shareholders always preserve some value. However, existing shareholders can also be expropriated fully by means of recapitalisation, if it is combined with the power to write down existing shares. This power was successfully used in Norway to fight the banking crisis that occurred in the early 1990s in this country (Moe et.al., 2004 and Gulbrandsen, 2005).

An advantage of recapitalisation vis-à-vis the share transfer instrument is that it is more flexible because it can also be used to give a capital injection by a private investor or the government without shareholder approval. In cases where no private party is willing to rescue the bank concerned and a failure is deemed to be unacceptable (e.g. because of financial stability concerns) governments will often prefer an early capital injection instead of a full-fledged nationalisation, primarily because the exit may be easier. However, it should be noted that the fundamental disadvantage of providing government support is independent of the precise technique. As in the case of a nationalisation (by means of the share transfer power), an early capital injection by the government (using the recapitalisation technique) also creates moral hazard among creditors and potentially undermines public finances. Huertas (2010) rightly remarks that under an early capital injection, the taxpayer effectively takes the risk that the bank will not recover, not the private providers of non-equity capital to the bank. Thus, as the share transfer instrument, recapitalisation can be used effectively to discipline shareholders, but protects creditors.
6 Policy Initiatives

6.1 Living wills

Figure 1 gives an impression of the functioning of living wills, or recovery and resolution plans. Living wills ask banks to make preparations that allow them to provide information at short notice to the authorities enabling them to make a choice among the resolution methods, should intervention be necessary. Theoretically, the resolution tools encompass all intrusive crisis management tools (share transfer instrument, property transfer instrument and recapitalisation) as well as liquidation. As is pointed out by advocates of living wills, the overriding objective is to avoid a rescue of the bank as a whole, even if it is considered to be systemically relevant (Avgouleas et al., 2010). Supervisors must therefore ensure that all systemically important activities have been identified and properly insulated, so that they could be spun off to another firm in the event of insolvency (Claessens, et. al., 2010). As explained above, only the property transfer instrument allows a split, and thus a targeted rescue of the key parts of the bank concerned. A living will can therefore be interpreted as an instrument to restructure a bank in such a way that splitting also becomes technically feasible in case of large, systemically relevant banks. This policy initiative is expected to reduce moral hazard by making it clear to shareholders, creditors and other counterparties that systemically relevant institutions can be resolved in such a way that losses are imposed on them.

Slightly amended version of figure presented by Huertas (2010).
Apart from the loss of efficiency resulting from a forced disintegration of large, systemically relevant banks, the fundamental question is to what extent ‘living wills’ will really help to resolve the well-known ‘too important to fail’ problem. The essence of ‘too important to fail’ is that market participants expect that governments will bail out institutions which perform a very important function in the financial system; this expectation has probably become stronger as a result of the wave of bailouts during the financial crisis. The problem is that the expectation of a bailout weakens the normal, upward effect of risky behaviour on the costs of funding, and thereby encourages risk taking by the financial institutions concerned. According to a joint methodology developed by the FSB, the IMF and the BIS (FSB et al. 2009), the systemic importance of markets and institutions depends on:

- **Size**: the volume of financial services provided by the individual component of the financial system;
- **Substitutability**: the extent to which other components of the system can provide the same services in the event of failure;
- **Interconnectedness**: linkages with other components of the financial system.

These characteristics can be regarded as the main dimensions of ‘too important to fail’. Splitting a systemically important bank, prepared by a living will, helps to solve the second dimension, namely the lack of substitutes for the services provided by the systemically relevant bank; these key parts can be transferred to a private sector purchaser or a bridge bank by means of the property transfer instrument. However, a living will does not affect the other dimensions of ‘too important to fail’. This implies that for banks which are ‘too important to fail’ in all three dimensions - which is not unthinkable at all - a targeted rescue of the key parts will in principle not suffice to prevent financial instability. After all, the remaining bank will be closed in such a scenario, which implies that claims of unsecured creditors (such as bondholders, other financial institutions, counterparties in derivatives contracts) will not be repaid at all, or will be repaid partially after a substantial delay. This is exactly the situation governments will try to avoid if a bank is considered ‘too important to fail’ because of the size or interconnectedness of its claims. A living will, facilitating a split of ‘too important to fail’ banks, is thus suited for saving the key parts of these banks in case of crises, but does not diminish the size of the bank nor its interconnectedness. In this sense, a living will helps to reduce the ‘too important to fail’ problem, but does not solve it.

### 6.2 Bail-in

Another strand to address the ‘too big to fail’ problem is to design a mechanism which allows the authorities to write down debt or to convert debt into equity. This power would enable a bank that has reached the point of non-viability, to absorb big losses and continue to operate as a going concern at the same time (see for
example Huertas (2010), Commission (2011)). Incidentally, a bail-in mechanism is related to recent proposals of the Basel Committee that all debt instruments which qualify as regulatory capital should be subject to writedown or be convertible into common equity in the event that a bank is unable to support itself in the private market (Basel Committee, 2010b). These last proposals try to improve the loss absorbency of debt instruments by means of a mandatory change in the contractual terms of the debt instruments concerned (contractual approach), whereas a bail-in mechanism would in principle also encompass ‘normal’ debt instruments without these special provisions (statutory approach). In the rest of this article, we abstract from the contractual approach, since if the debt instrument concerned – so called convertible bonds - have early and credible triggers, they can be regarded as an effective way to increase the financial buffers of banks. This is important, but analytically different from the discussion about intrusive crisis management tools.

It is clear that particularly the statutory approach will be very complicated to put into practice. This is for example due to the required consistency with the seniority of claims: a bail-in mechanism would need to write-down equity first, before debt holders can be confronted with losses. It is probably more complex to introduce depositor preference, which would be necessary if deposits were not subject to bail-in. As highlighted in section 4, depositors have the same rank as other creditors in most EU countries. This can of course be changed, but it probably requires time to build consensus on the desirability of depositor preference, given the potential impact on the cost of funding for banks. The fact that many banks – not only cross-border but also national banks - have contracts governed by foreign law also complicates a bail-in mechanism. In the presence of foreign contracts, an effective bail-in mechanism requires recognition of any write down or conversion by foreign courts. Thus, implementing a bail-in mechanism demands far-reaching reforms at international level.

Apart from these far-reaching institutional changes, the fundamental question is: will it really help? As in the case of living wills, the problem with a bail-in mechanism is that does not change anything with regard to the size or interconnectedness of financial institutions. Indeed, key functions of the bank concerned are continued, which offers a solution for the lack of substitutes. However, this will not alter the expectation of financial markets and the public that large and interconnected financial institutions will not fail. If the institutions concerned would nevertheless defaulted on their obligations as a result of the application of a bail-in mechanism, this would come as a shock and likely result in financial instability. Like a living will, establishing a bail-in mechanism therefore offers a partial, but probably not a sufficient solution for the ‘too important to fail’ problem.
The central question of this article is what priorities Europe should set in introducing an effective crisis management framework. We can learn from the American experience that whichever instruments are chosen for introduction on a European level, they should always allow timely decision making, speedy implementation and decisive intervention in order to avoid or counteract panic in financial markets. National initiatives in Europe to strengthen the crisis management framework often do not meet these requirements.

Recapitalisation and transferring shares are both useful techniques in fighting moral hazard among shareholders. This is particularly an advantage in cases when there is a private sector party interested in buying the troubled bank as a whole or taking a stake in it. In these circumstances, recapitalisation – in combination with the power to write down shares - is more flexible, since it facilitates a partial as well as a full take-over. Thus, the EU should remove the existing barrier for recapitalisation, and create an exception for financial companies in the Second Directive. As long as recapitalisation is not compatible with European law, individual EU countries should strive to introduce share transfer powers to facilitate at least a full take-over of a troubled bank.

The property transfer instrument opens the possibility to discipline not only shareholders, but also creditors by splitting the troubled bank. This is particularly important if there is no interested private sector party, and the government is forced to rescue the bank to safeguard financial stability and/or public services. The extent to which losses can be imposed on creditors, however, also depends on their rank in liquidation. In the vast majority of EU countries, it is impossible to force other creditors to bear more losses than retail depositors, which undermines the attractiveness of splitting banks in crisis situations. The EU should therefore start a discussion on the desirability of introducing depositor preference, as part of the EU framework for crisis management. However, even if depositor preference were introduced in Europe, splitting large banks would hardly be conceivable in crisis situations because of the mismatch between the legal and operational structures.

Living wills can be interpreted as an instrument to restructure a bank in such a way that splitting also becomes feasible in case of large, systemically relevant banks. This
policy initiative, as well as a bail-in mechanism, are specifically meant to counteract the ‘too important to fail’ problem. An important characteristic of ‘too important to fail’ is that the expectation of a bailout, results in unacceptable risks for financial stability if this expectation proves wrong. It is questionable whether living wills and bail-in will really change ‘too important to fail’ expectations. In the context of intrusive crisis management tools, the EU should therefore focus its attention on changing the Second Directive, open the debate on the desirability of introducing depositor preference, and introducing harmonised property transfer powers.
Literature


Basel Committee on Banking Supervision (2010b), ‘Consultative Document; Proposal to ensure the Loss Absorbency of Regulatory Capital at the Point of Non-viability’.


Publications in this series as from January 2003

Robert-Paul Berben, Jan Marc Berk, Ekniti Nitibanprapas, Kanit Sangsupsan, Pisit Puapan and Piyaporn Sodsriwiboon

Vol.1/No.2 (2003) The blurring of distinctions between financial sectors: fact or fiction?
Annemarie van der Zwaet

Vol.1/No.3 (2003) Intermediation, integration and internationalisation: a survey on banking in Europe
Jaap Bikker and Sandra Wesseling

Sander Oosterloo and Jakob de Haan

Aerdt Houben, Jan Kakes and Garry Schinasi

Gillian Garcia and Henriëtte Prast

Micro-financial incentives and policy considerations
W. Allard Bruinsboof and Sybille G. Grob

Vol.3/No.2 (2005) Payments are no free lunch
Hans Brits and Carlo Winder

Maria Demertzis, Peter van Els, Sybille Grob and Marga Peeters

J.W.B. Bos, J. Draulans, D. van den Kommer and B.A. Verhoef

Vol.4/No.3 (2006) How fair are fair values?
A comparison for cross-listed financial companies
Marian Berden and Franka Liedorp
<table>
<thead>
<tr>
<th>Volume/Number (Year)</th>
<th>Title</th>
<th>Authors/Contributors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vol.5/No.1 (2007)</td>
<td>Microfinanciering, deposito’s en toezicht: de wereld is groot, denk klein!</td>
<td>Ronald Bosman en Iskander Schrijvers</td>
</tr>
<tr>
<td>Vol.5/No.2 (2007)</td>
<td>Public feedback for better banknote design 2</td>
<td>Hans de Heij</td>
</tr>
<tr>
<td>Vol.7/No.1 (2009)</td>
<td>How does cross-border collateral affect a country’s central bank and prudential supervisor?</td>
<td>Jeanette Capel</td>
</tr>
<tr>
<td>Vol.7/No.2 (2009)</td>
<td>Banknote design for the visually impaired</td>
<td>Hans de Heij</td>
</tr>
</tbody>
</table>
Vol.7/No.3 (2009) Distortionary effects of crisis measures and how to limit them
Jan Willem van den End, Silvie Verkaart and Arjen van Dijkhuizen

Piet Buitelaar and Henk van Kerkhoff

John Lewis

Vol.8/No.3 (2010) Macro-effects of higher capital and liquidity requirements for Banks - Empirical evidence for the Netherlands
Robert-Paul Berben, Beata Bierut, Jan Willem van den End and Jan Kakes

Vol.8/No.4 (2010) Banknote design for retailers and public
Hans de Heij

Vol.9/No.1 (2011) DELFI: DNB’s Macroeconomic Policy Model of the Netherlands

Vol.9/No.2 (2011) Crisis Management Tools in the EU: What Do We Really Need?
Annemarie van der Zwaet
Crisis Management

Tools in the EU:

What Do We Really

Need?

DNB

Occasional Studies

Annemarie van der Zwet

DNB Occasional Studies

Vol.9/No.2 (2011)