# Banking crisis management: an overview of the international debate

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## Sintesi

Ogni crisi è unica per via delle differenti cause che l'hanno originata e del contesto particolare nell'ambito del quale ha luogo. Tuttavia, per quanto diverse siano tali circostanze, le crisi bancarie presentano alcune caratteristiche comuni.

Allo stesso modo, le *safety net* esistenti nei vari paesi, in particolare le procedure di insolvenza delle banche ed i sistemi di garanzia dei depositi, riflettono gli obiettivi di interesse generale che ciascun paese ha scelto ed un determinato quadro storico ed istituzionale. Ciononostante, tali sistemi condividono alcune finalità: in particolare, la protezione del sistema finanziario dai rischi di instabilità ispira la normativa in materia di crisi di molti paesi.

La globalizzazione della finanza ed il verificarsi di crisi bancarie impongono un approccio coordinato nel trattamento delle situazioni di difficoltà delle banche il cui primo passo è la definizione di un disegno generale e di un insieme di regole comuni per prevenire il rischio sistemico e accrescere l'efficienza nella soluzione delle crisi.

Frutto della collaborazione di diversi paesi, i rapporti esaminati contribuiscono a definire principi e criteri condivisi dalla comunità finanziaria internazionale, pur nella riconosciuta diversità dei sistemi giuridici ed economici cui si applicano.

Il rapporto *Supervisory Guidance on Dealing with Weak Banks* identifica le cause più frequenti all'origine delle difficoltà delle banche e propone pratiche e metodi di azione per correggere tali situazioni e ripristinare condizioni di equilibrio per giungere fino alla definizione delle strategie di uscita dal mercato per le situazioni più gravi.

Sono analizzate diverse tecniche di soluzione delle crisi e definite le condizioni necessarie per la loro applicazione. La scelta dovrebbe in ogni caso rispondere ad alcuni principi generali sui quali esiste, o è auspicabile, un consenso da parte dei vari paesi: la preferenza per le soluzioni di mercato, la ricerca di soluzioni efficienti dal punto di vista dei costi, l'uso dei fondi pubblici limitato a situazioni eccezionali.

Allo stesso modo, il rapporto sui sistemi di garanzia dei depositi (*Guidance for Developing Effective Deposit Insurance Systems*) è diretto a individuare le caratteristiche di tali sistemi compatibili con il rafforzamento della stabilità finanziaria.

I sistemi di garanzia dei depositi sono considerati una componente necessaria dei sistemi finanziari sofisticati. Ma studi recenti dimostrano che sistemi mal strutturati possono contribuire a creare condizioni di instabilità. Per questo motivo l'individuazione delle caratteristiche di tali sistemi in grado di attenuare fenomeni di *adverse selection* e di *moral hazard* rappresenta un contributo importante alla stabilità finanziaria. Fra queste, l'obbligatorietà dell'adesione ai sistemi di garanzia, la definizione di livelli di copertura compatibili con il mantenimento di un incentivo al monitoraggio della qualità delle banche, una struttura organizzativa e modalità di finanziamento coerenti con i poteri e le responsabilità dei sistemi.

Infine, il documento *Insolvency Arrangements and Contract Enforceability* analizza le procedure di risanamento e di insolvenza e la loro adeguatezza nel raggiungimento degli obiettivi di riduzione dell'incertezza, di aumento dell'efficienza e di promozione dell'equità di trattamento, alla luce di alcune tendenze di sviluppo: la rapidità dei cambiamenti dell'ambiente nel quale le insolvenze si manifestano e la crescente integrazione fra i mercati finanziari.

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La lentezza delle procedure fallimentari mal si concilia con la necessità di efficienza e certezza degli operatori e dei mercati e spiega come, nel caso delle banche, le procedure maggiormente diffuse siano quelle in cui le autorità, piuttosto che i creditori, rivestono un ruolo centrale. D'altro canto, la maggiore capacità dei mercati di valutare le attività delle banche insolventi, in particolare i crediti, facilita il ricorso a strategie di soluzione delle crisi basate sulla realizzazione di operazioni di concentrazione, piuttosto che sulla riorganizzazione su basi autonome delle banche in difficoltà.

L'altra tendenza di sviluppo è la crescente globalizzazione dei mercati e l'affermarsi di intermediari finanziari globali operanti nell'ambito di sistemi legali tuttora definiti su basi nazionali. L'operatività di tali intermediari, estesa a diverse giurisdizioni, pone il problema del coordinamento delle procedure e genera incertezza in merito alla legge che sarà applicata.

La riduzione dell'incertezza connessa alla diversità dei sistemi legali ha ispirato la recente legislazione comunitaria in materia finanziaria.

La disciplina comunitaria ha realizzato due livelli di armonizzazione. Il primo livello assicura certezza con riferimento alla legge applicabile ed alla procedura fallimentare che regola la crisi di banche con succursali in altri Stati membri. La direttiva sul risanamento e la liquidazione degli enti creditizi affida alle sole Autorità del paese di origine il potere di attuare tali misure nei confronti delle banche, le quali si estendono alle succursali operanti in altri paesi.

Si tratta di una scelta relativa alla giurisdizione prevalente che non richiede l'adozione di regole comuni sul trattamento dei creditori e degli altri *stakeholders* coinvolti dalla crisi; semplicemente mira ad assicurare il muto riconoscimento ed il coordinamento delle procedure per la gestione delle crisi da parte dei vari paesi.

Un secondo, maggiore livello di armonizzazione assicura un insieme di regole comuni applicate uniformemente in Europa per raggiungere lo stesso risultato economico. Separando alcune transazioni finanziarie dalla massa fallimentare, la direttiva sulla definitività dei pagamenti previene l'effetto domino nei sistemi di pagamento e di regolamento dei titoli e nei mercati regolamentati. Recentemente lo stesso approccio è stato adottato con la direttiva sulle garanzie finanziarie.

La riduzione del rischio sistemico, obiettivo condiviso dall'intera comunità finanziaria internazionale, ha consentito di superare la diversità dei sistemi legali dei vari paesi anche in presenza di differenti concetti di equità. In particolare, attraverso una forte deroga al principio storico della parità di trattamento dei creditori la disciplina comunitaria ha permesso la creazione di un ambiente più sicuro per le transazioni finanziarie in Europa.

## 1. Introduction

In the past few years the world has seen a number of banking crises both in the industrialised and in the emerging countries. These crises have shown the potential risks and the related costs of insolvencies of banks and other financial firms. As a result, increasing attention has been focused by the international financial community on defining adequate policies and on the effectiveness of the legal, institutional and regulatory framework for the treatment of bank crises.

The initiatives of the international financial institutions may be divided into two categories: the first includes guidelines and good practices addressed mainly to countries that need to strengthen their institutional frameworks for the resolution of bank crises. The second is meant to meet the major challenge for the developed countries, that is the uncertainty stemming from the cross-border dimension of financial activities. Financial institutions are frequently located in different countries and operate under different jurisdictions. As a consequence, their assets and the legal and/or economic relationships connected to them are also located in a multi-jurisdictional environment. And this may generate conflicts of law. This may also demand more efficient crisis-resolutions proceedings, which pay attention to the need for adequate coordination mechanisms of the insolvency proceedings. But even at a national level there is a need for more efficiency and legal certainty in insolvency proceedings and in the treatment of financial contracts under the insolvency arrangements.

A number of recent publications are worth to be mentioned here. I refer to the *Guidance for Developing Effective Deposit Insurance Systems*, of the Financial Stability Forum, published in September 2001 for countries wishing to adopt or reform an explicit deposit insurance system, and to the *Supervisory Guidance on Dealing with Weak Banks*, of the Basle Committee on Banking Supervision, in co-operation with its Core Principles Liaison Group, the International Monetary Fund, the World Bank, the European Commission and the BIS Financial Stability Institute, published in March 2002. This report aims at developing guidelines for dealing with problems in single banks.

As regards works in progress, I would like to mention the *Bank Insolvency Initiative*, of the World Bank, in partnership with the IMF. The project seeks to identify an appropriate legal, institutional and regulatory framework for dealing with bank insolvencies also in the context of systemic crises, and to develop the international consensus regarding that framework. The aim is to define not only guiding principles and objectives but rather an adequate set of rules for bank intervention, restructuring and resolution, liquidation and the management of distressed assets.

Moreover, the project on the *Legal and Institutional Underpinnings of the International Financial System,* of the Bank for International Settlement and the

G10, which is ongoing, seems to be extremely fruitful. This project aims at identifying deficiencies in the legal underpinnings of the financial systems of industrialised countries that may undermine a fair and efficient resolution of financial and non-financial firms. A report *Insolvency Arrangements and Contract Enforceability* was released as a consultative document in December 2002. It does not make concrete policy recommendations but recognises the need for further analysis.

I would like to summarise the findings of three reports which are particularly useful for understanding the changing environment within which the deposit guarantees schemes operate, and then focus on the regulatory framework for dealing with bank crises recently adopted in the EU.

## 2. Supervisory Guidance on Dealing with Weak Banks

The report is based on the experiences of different countries in different circumstances; so, it is not intended to be prescriptive, it just identifies good practices which have already been tried as successful. The intention is to offer practical guidance that can be adapted to specific circumstances in the areas of problems identification, corrective action, resolution techniques and exit strategies for weak banks.

A weak bank is defined as "one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management". In such cases, the supervisor should try to preserve the value of the bank's assets with minimal disruption to its operations (i.e. maintaining the *economic entity*), subject to minimising resolution costs. In certain cases, it may well be that the bank as a *legal entity* should cease to exist.[2]

The problems in a weak bank include, but are not limited to, poor management, inadequate financial resources, absence of a long-term sustainable business strategy, weak asset quality and poor systems and controls. The task of the supervisor is to identify these problems early, ensure that preventive or corrective measures are adopted, and have a resolution strategy in place should preventive action fail.

In short, although each situation is different, the report identifies important, common strands. For supervision to operate effectively, the proper regulatory, accounting and legal framework set out in Basel Core Principles for Effective Banking supervision must be in place. Supervisors must identify the causes of bank problems and tackle them at an early stage, before they become acute, with

[2] In a legal closure, the licence of the bank is withdrawn and the legal entity ceases to exist. In an economic closure, there is interruption or cessation of the operations of the bank that may often lead to severe disruption and possibly losses for the bank's customers.

the range of corrective action tools at their disposal. A combination of financial reporting and monitoring, on-site inspection and regular liaison with auditors and bank management provide a good basis for detecting problems early. If so, they can often be remedied before a bank's solvency is threatened. Supervisory measures have to be proportionate and flexible; a balance has to be struck between rigid "PCA" regimes and general less binding framework.

Coming to corrective action plans, they must be detailed and specific, showing how the bank's financial position will be restored; corrective actions should be set within a clear time frame; primary responsibility for addressing weaknesses rests with the Board and management of the bank. In case of more serious problems, when the prospect of insolvency is imminent, alternatives are necessary. They include: merger with or acquisition by a healthy bank, P&A transactions, open bank assistance and bridge bank techniques, liquidation and repayment of depositors.

Focusing on the resolution techniques and exit strategies, the Report identifies principles to guide supervisors in the resolution policy and the choice of the appropriate techniques.

The guiding objective is to minimise the disruption to the financial system and prevent difficulties at one institution from affecting other institutions and turning into systemic instability. The choice of resolution measures and between resolution and closure should be made with the aim of minimising market disruption. But also to avoid moral hazard. Supervisors should not create incentives for banks to act in a manner that involve costs that they do not bear entirely. Shareholders should not be compensated for losses when a bank gets into difficulty. Equally, supervisory action should not protect the interest of the bank's corporate officers.

These principles are:

- *Bank failures are a part of risk taking in a competitive environment.* Individual bank failures are not incompatible with maintaining the financial stability and protecting the interests of depositors. Banks can and do fail and the public should be aware of that. Well-defined criteria to determine when a bank requires reorganisation or liquidation are needed.
- *Cost-efficiency*. A least cost criterion should guide the supervisor when making choices between alternative actions consistent with achieving the supervisory objectives. It is important that the supervisor considers all costs, including exogenous costs such as instability of the financial system, in deciding on a course of action.
- *Private sector solutions are best*. A solution that does not impose costs on taxpayers and that produces minimum distortions to the banking sector is

preferable. This usually entails the take-over by a healthy institution. Private sector solutions are in line with the least cost criterion above mentioned.

- *Public funds are only for exceptional circumstances,* when potential systemic situations arise (risk of loss to a large number of customers, disruption of credit or payment services). Solvency and liquidity support should always be linked to other more permanent measures. They should be made dependent on the implementation of an action plan approved by the supervisor which would include measures to restore profitability and sound and prudent management.
- *Expedient resolution processes.* Weak banks should be reorganised or liquidated quickly in order to minimise costs to depositors, creditors and taxpayers.
- Preserving competitiveness *In case of a take-over the selection of the acquiring bank should be done on a competitive basis. An additional factor to consider is whether competition for banking services would be adversely affected.*

There may be tensions between these principles. Therefore, priorities in defining the appropriate resolution strategy should be established. Each country will decide priorities according to its public policy objectives.

Then, different resolution techniques are analysed and their implementation requirements defined.

In dealing with a weak bank it is firstly necessary to assess the possibility of addressing the problem through a private sector solution: restructuring plans or mergers and acquisitions.

*Restructuring plans*, including reorganisation measures and operational and financial restructuring, could be sufficient to overcome difficulties and recover from the crises. Such a solution should be promoted only where there is a real chance of the business being put back on a sound footing in the short term. Far-reaching restructuring may be the only solution for large and complex institutions that are unlikely to find partners with the financial resources to carry through a merger or acquisition.

Restructuring plans usually include the replacement of the bank's management and measures to restore profitability - such as the reduction of labour costs, the downsizing of some activities, the sale of branches etc. - as well as financial restructuring measures, including recapitalisation through capital injections either from the existing owners or from new investors. A temporary liquidity support may reveal necessary to reassure the market and prevent difficulties from worsening.

When a bank cannot resolve its weaknesses on its own, it should consider a merger with, or acquisition by, a healthy bank. Banks - even those that fail - are

attractive targets to investors, especially financial institutions, because of their intrinsic franchise value. [3] Arrangements for a *merger or acquisition (M&A)* should take place early, when the acquirers are still willing to take over the bank because its franchise value is higher than the reorganisation's costs. In some cases, owners and certain creditors may have to make concessions to attract acquirers. These should have sufficient capital to meet the new bank's costs and a management capable of projecting and implementing a reorganisation programme.

The advantage of an M&A type solution is that it maintains the failing bank as a going concern and preserves the value of the assets (thereby reducing the cost to the government or deposit insurer); besides, it minimises the impact on markets as there are no disruptions in banking services to customers of the failing bank, all assets are transferred and all depositors and creditors are fully protected.

If a private sector M&A is not forthcoming or cannot be arranged, a *purchase and assumption (P&A) transaction* may be considered. A P&A transaction is one where a healthy institution or private investor(s) purchases some or all of the assets and assumes some or all of the liabilities of a failed bank. P&A transactions in most countries require withdrawal of the bank licence and the commencement of resolution proceedings by the liquidator.

This type of transaction can be attractive to an acquirer, because of the intangibles, even when the bank is insolvent. However, such situations are rare. Usually, a financial inducement is necessary to compensate for a shortfall and/or the costs of the reorganisation exceeding the franchise value and to make the bank attractive for potential acquirers. Incentives may take the form of cash injections by the deposit insurer, or in exceptional cases, by the government. This form of assistance must be justified as the least cost alternative.

A P&A transaction may be structured in many different ways, depending on the objectives and requirements of the deposit insurer or the government, as well as of the acquirer. The transaction may be structured so that the acquirer purchases all assets and assumes all deposits or purchases only a portion of assets and assumes a portion of the deposits. A clean bank P&A transaction occurs when the acquiring institution assumes the deposit liabilities and purchases the cash and cash equivalent assets, the "good" loans and other high quality assets of the bank. Assets not sold to the acquirer at resolution are passed on to the liquidator for disposal.

The P&A type solution has significant benefits as it saves the value of the assets of the failed bank, thereby reducing the resolution cost. It minimises the impact on the market by returning assets and deposits to normal banking operations with the acquiring bank quickly; it can typically be completed over a

[3] The franchise value may include instant access to a particular market segment, acquisition of a desirable deposits pool, and a vast financial distribution system with a minimum investment.

weekend and customers with insured deposits suffer no loss in service and have immediate access to their funds. This approach minimises moral hazard as long as closing the bank as a legal entity implies that the shareholders lose their investment and the management is removed.

A *bridge bank* is a resolution technique aimed at bridging the gap between the failure and the final solution. The weak bank is closed and placed under liquidation. A new bank, referred to as a bridge bank, is licensed and controlled by the liquidator who can evaluate and market the bank in such a manner that allows for a satisfactory acquisition by a third party. It also allows potential purchasers the time necessary to assess the bank's condition in order to submit their offers while at the same time permitting uninterrupted service to bank customers.

This transaction is most commonly used when the failed institution is unusually large or complex or when the deposit insurer or the government believes there is value to be realised or costs minimised, but does not have a ready solution. It has the advantage of gaining time to find another bank willing to step in and prepare the terms of the operation. However, it should not be used to postpone a permanent solution, nor should the arrangement be allowed to remain in place for any significant length of time as the bank will lose value if customers withdraw.

If no investor is willing to step in to rescue the bank, the repayment of depositors and the liquidation of the bank's assets are unavoidable. In countries with a deposit insurance scheme, closure of the bank and depositor pay-off is also the right decision where a depositor pay-off is less costly than other resolution measures. The costs of a depositor pay-off will fall in the first instance on the other banks, if the insurance scheme is privately funded, on the government otherwise.

The liquidators will proceed with the direct realisation of the assets in order to pay creditors under the rules governing general insolvency proceedings or bank-specific insolvency proceedings, depending on the institutional framework in place. Where depositors are protected by deposit guarantee schemes, the schemes usually acquire creditor status after making payment and participate in the liquidation allotments in place of the depositors. A specific section of the report is devoted to the management of impaired assets.

To conclude, when dealing with failing or failed banks, alternatives to simply liquidating the institution's assets and paying creditors should be evaluated as often this does not result in the most efficient use of resources. In fact, most financial institutions have less value if liquidated in a "fire sale" fashion than when they are sold "as a whole".

Not only closing a bank and liquidating it could be the least convenient solution, but it may generate other negative effects due to the disruption of the relationship with borrowers and depositors, possible delays in the reimbursement of depositor etc. In any case, the choice of the resolution technique should be guided by the principles identified in the report.

## 3. Guidance for Developing Effective Deposit Insurance Systems

The report, mainly addressed to countries considering the adoption or the reform of an explicit limited-coverage deposit insurance system (DIS), was developed through a consultative process that involved over 100 countries. It can therefore be adapted to a broad range of countries, circumstances and settings.

It begins with the two goals for any DIS: to contribute to the stability of the financial system and to protect less financially-sophisticated depositors from losses when banks fail.

Explicit, limited coverage deposit insurance is preferable to implicit protection but, to avoid moral hazard, a DIS needs to be well designed, well implemented and understood by the public. It also needs to be backed by strong prudential regulation and supervision, sound accounting and disclosure regimes and enforcement by effective laws.

We will shortly look at five aspects of the specific design features of a DIS: mandates and powers, structure, membership, coverage issues and funding.

The choice of how a DIS is to be operated depends on many factors that are unique to each country and its financial system. There is not a single *mandate* suitable for all deposit insurers. They range from the so called “pay-box systems” (confined to paying the claims of depositors after a bank has been closed) to those with broader powers and responsibilities (risk-minimiser which may also provide financial assistance to resolve failing banks, minimising the losses for the DIS). But there must be consistency between the stated objectives and the *powers and responsibilities* given to the deposit insurers. And the mandate must be clear: clarifying the role of the DIS within the financial safety net reinforces the stability of the financial system.

With *structure*, a choice has to be made between assigning the function to an existing entity or establishing a new, separate one. In both cases, governance should ensure that the DIS is transparent, free from conflicts of interest and subject to clear oversight and responsibilities. The report underlines the importance of the availability of qualified people to meet the objectives of the DIS.

Information sharing and co-ordination among financial safety-net participants is crucial, especially when the safety-net functions are assigned to

different organisations. Deposit insurer's information needs vary significantly according to the mandate. The collection and sharing of information on banks should be co-ordinated with the supervisory authority, which is the primary source of information, to minimise the reporting burdens on banks. Clearly specified agreements are desirable because of the sensitivity of bank-specific information and the need for maintaining confidentiality.

The second design feature is *membership.* This implies a decision about which banks are eligible for membership. Explicit eligibility rules are necessary. It is critical to verify whether the bank is subject to strong prudential regulation and supervision.

In general, membership should be compulsory to avoid adverse selection. The stronger banks may opt out if depositors are unaware and not sensitive to the existence of a DIS. Different approaches may be applied for granting membership: will eligible banks be given membership automatically or should they be required to apply for entry? By establishing entry criteria, the DIS can better control the risks it assumes.

The third feature is *coverage*, including scope and level issues. What an insurable deposit is should be clearly defined, depending on the relative importance of different deposit instruments. Once the relevant deposits are selected, exclusions of specific instruments or depositors can be decided; deposits held by depositors who are deemed capable of assessing the financial condition of a bank should be excluded to foster market discipline.

To assess the adequacy of a certain level of coverage, the size distribution of deposits held in banks has to be considered. Whatever level is selected, it must be credible and internally consistent with other design features and meet the public-policy objectives of the DIS.

How do we apply coverage limits? There are different options: on a per deposit or per depositor basis, per bank or across all member banks. Deposit insurance on a per depositor and per bank basis is preferable in order to strike a balance between effectively limiting coverage and contributing to financial stability and keeping the information requirements reasonable.

Coinsurance (a pre-specified proportion of deposits is insured) should be applied above a certain amount. In this way, individuals holding small account balances are fully protected and individuals holding larger account balances maintain an incentive to monitor banks. The reason for limiting coinsurance above a certain amount is that individuals who have small account balances may bear a cost for bank failure without increasing market discipline if they are not able to monitor the bank or if the costs of doing so exceed the benefits.

Another important design feature is *funding.* Sound funding arrangements are critical for the effectiveness of a DIS and the maintenance of public

confidence. A DIS should have available all funding mechanisms necessary to ensure prompt reimbursement of depositors' claims.

Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective DIS. Policymakers should consider the effect of premium levels on the financial health of banks.

There are two funding mechanisms: funding on an ex ante and funding on an ex post basis. There are advantages and disadvantages. Ex ante systems allow for distributing the premiums paid over the course of a business cycle but they remove capital from the banking system because premiums paid in cannot be used for other purposes.

Ex post systems require banks to pay premiums only after failures occur. Therefore, premiums are most likely to be collected during an economic downturn: and this can create pressure for forbearance as the banks' ability to pay is weakened. Failed banks will not have contributed to the cost of their own failure. Depositors' reimbursement may be more problematic. Banks may be required to provide substantial sums in a short span of time. This may be difficult for banks that have not created an appropriate reserve funds in previous years. On the other hand, ex post systems may improve interbank monitoring because each bank will have an incentive to avoid costs associated with the failure of another bank participating in the fund.

In practice, DIS are often funded on a combined ex ante and ex post basis. For instance, many ex-ante schemes allow for asking banks to top up the fund in case of need. This would keep premiums at an acceptable level. Other systems envisage partial reductions of premiums in exchange for a commitment to pay in case of need.

In establishing a deposit insurance fund, there are two alternatives, each with advantages and disadvantages, namely to set steady premiums over a long period or to maintain a target fund ratio or range, with premiums adjusted over time. In the first case the disadvantage is that the fund could fluctuate in response to insurance losses and may be inadequate to meet obligations to depositors. The second alternative could result in banks paying low premiums in good times and high premiums in an economic downturn. And a target fund ratio should be able to reduce the probability of the fund's insolvency but estimating the probabilities of losses is very difficult in practice.

There is another choice for the design of a DIS: flat-rate premium systems and risk-adjusted premiums systems. With a flat-rate system, low risk banks pay for part of the deposit insurance benefit received by high-risk banks. Banks may increase their risk profile without incurring additional deposit insurance costs. And this may encourage excessive risk taking by banks.

Premiums differentiated on the basis of individual banks' risk profile are preferable when the information required to implement the system is available. We know that evaluating risk is difficult and costly. Moreover, imposing high premiums on already troubled banks may have destabilising effects which, in turn, should be assessed.

The debate on Deposit guarantee schemes in Europe may be summed up in two questions. Is there a need to further harmonise the deposit insurance schemes in Europe? Is there a best practice design for a DIS? In other words, is there any feature of the European deposit insurance schemes that is of high importance for the schemes' viability but which at present is outside the scope of EU Directive 94/19/EC?

The Directive harmonises the main elements of the European deposit guarantee schemes (compulsory membership, home country responsibility, coverage on a per depositor basis, etc.) leaving some items to the autonomy of the individual countries. This is the case with the mandate, the organisation and the governance of the schemes, which are wholly left to the Member States. In other cases, such as coverage, the Directive establishes a minimum, leaving the Member States free to choose a higher level. Sometimes the Directive establishes a principle and leaves the details to the Member States. This is the case of the funding and the financing mechanisms of the schemes.

Leaving a certain degree of autonomy, some flexibility to Member States was appropriate especially at the initial stage of the harmonisation but is it still necessary now? or a best practice mechanism should be identified? The debate is ongoing.

## 4. Legal and Institutional Underpinnings of the International Financial System

I would like now to turn to problems that mainly affect countries with well-developed economic, financial and legal infrastructures. Let me mention the most significant issues explored by the consultative document "Insolvency arrangements and contracts enforceability".

It addresses both financial institutions and financially active non-financial firms. Financial activities of non-financial firms for the management of their capital, funding and risks are increasing and may pose significant risks to the financial system.

It is based on two comparative surveys: the first, on the insolvency arrangements for financial institutions and financially active non-financial firms; the second, on the treatment of financial contracts under these insolvency

arrangements (close-out netting and offset provisions, finality rules in the payment systems and collateral agreements to support financial transactions).

It considers that, notwithstanding the diversity of the insolvency laws, all of them have the same problem: to resolve the claims of stakeholders when the debtor's firm does not have sufficient resources to satisfy all claims on time and in full.

There are two traditional solutions to this problem*: liquidation*, that transforms the firm's assets into cash and distributes the proceeds to the claimants in accordance with priority rules, and *reorganisation*, that seeks to preserve the entity and to redefine the claims of stakeholders so that they better correspond to the firm's value and expected cash flows.

Liquidation often disrupts the going-concern value of the firm (piecemeal liquidation) but the whole firm may be liquidated as a unit, preserving its economic value, perhaps at distressed prices. Reorganisations rely on negotiation between debtors and creditors. They may fail because of holdout problems, that is a minority of creditors may hold out. Chapter 11-style reorganisations seek to avoid this problem through provisions that bind dissenting stakeholders ("cram down").

Then there are *liability transfers*, such as purchase-and-assumption transactions, leading to a restructured balance sheet without the need for negotiations. An insolvency official assigns the liabilities and part or all of the assets to another institution. It is especially useful when liabilities have a going concern value such as bank deposits.

A distinction is made between *official-centred* insolvency processes and *stakeholder-centred* insolvency processes, depending on the role of creditors and the person charged with the liquidation or reorganisation (a liquidator, a receiver, a trustee or a court).

Official-centred models tend to be dominant in liquidations and liabilities transfer, including bank insolvency proceedings. Traditional reorganisations tend to be stakeholder-centred. In many of them the creditors act collectively through creditors' committees, and the official role is less central.

These alternative insolvency proceedings are evaluated from the point of view of three main criteria from the goals of any insolvency arrangements. These goals are:

- the reduction of legal and financial uncertainty. If the uncertainty is too great, market participants will not be able to assess the risks in making contracts; the reduction of uncertainty helps market participants make choices based on their willingness to bear risks;

- the promotion of efficiency, by maximising the value of the insolvency estate, reducing the transaction costs and preserving the value of firm-specific assets;
- the provision of fair and equitable treatment, expressed in the rules which define the rights of debtors and the rights and relative priorities of creditors and other stakeholders. These rules express value judgements made by each national insolvency law.

Legal certainty and efficiency reduce the potential for market disruption and therefore liquidity and systemic risk. Yet, as underlined by the report, there may be conflicts between these goals. For example, legal certainty about close-out netting may make phases of the insolvency processes quicker and more efficient. But it may also change the effective priority of claimants and the equity among creditors in an insolvency. Each national legal framework tries to strike a balance between them on the basis of local preferences and traditions.

One outcome, which is consistent with reducing tensions among the three objectives, is to maximise the value of the insolvency estate. Fully realising the value of the firm's assets is compatible with efficiency and does not affect equity: as creditors are paid according to an established set of priorities, no creditor is worse off and some are better off.

Using this framework for analysis the Group has identified two salient issues. The first is the gap developing between the rapidly changing environment in which insolvencies occur and the slower evolution of national insolvency regimes. Even though these regimes have evolved over time, they have not kept pace with changes in capital markets, globalisation, corporate governance and markets for corporate control. The gap increases the demand for legal certainty and efficiency by market participants.

The most important source of uncertainty and inefficiency is the slowness of traditional insolvency processes. These processes tend to be initiated later than they should and tend to move very slowly after their commencement. Earlier initiation and faster resolution would be more efficient.

Late initiation is a problem of incentives. Creditors have strong incentives to initiate insolvency but they have little information on the debtor's financial situation. Also, creditor initiation is made difficult by many insolvency regimes. Debtors' initiation is easier but they seldom want to declare early insolvency.

After the initiation, stakeholder-centred reorganisations tend to be slow as they usually involve a great deal of negotiation. Liquidations are slow as well because, even if the assets are sold quickly, they may involve a lot of litigation that delay the distribution of the proceeds.

But more certain and efficient insolvency processes have also expanded. Some innovative processes may better deal with the new context. Market-based

insolvency mechanisms, such as auctions and expedited asset sales, may increase efficiency and the bankruptcy estate available.

These mechanisms are based on the increased capacity to price and sell in markets many components that were previously firm specific, that is specialised to the insolvent firm's activities and sold with difficulty to others. Liabilities transfers, mergers and liquidations are easier within markets that can provide adequate capital and management to distressed firms or absorb these. The case for reorganisations that only rely on the firm's internal resources weakens.

We will now turn the attention more specifically to banks. Bank insolvency law has two approaches: some jurisdictions treat bank insolvency like ordinary insolvency, others have a distinct legal regime governing bank insolvency. But in any of these jurisdictions the bank regulator can initiate the insolvency proceeding. And supervisors have usually the appropriate combination of information and incentives for timely insolvency initiation. Therefore, the problem of late initiation is reduced.

The slower kind of proceedings - the stakeholder-centred ones - are discouraged in bank insolvency law and the faster techniques - such as liquidations, mergers and liabilities transfers - are widespread. Bank reorganisations often take the form of banks supervisory-led workouts, outside of any formal insolvency process.

These differences are mainly due to the nature of liquidity and systemic risk. This creates a need for rapid insolvency processes that are best conducted by an official. Secondly, effective supervision leading to interventions before the appearance of the financial distress is a good substitute for reorganisation. Thirdly, firm-specific assets are less common in modern banks. The loan book of a bank is becoming more and more transparent thanks to the development of markets for credit information. This greater transparency helps sell rapidly particular components of the balance sheet and makes the liquidation of the bank as a whole easier. Lastly, bank creditors are disperse and weak. The governance problem of creditors' committee would be particularly difficult. This creates a tendency to supervisory-led proceedings.

As there is an increasing overlap among different types of firms, in the sense that the financial activities of large non-financial firms are increasing, the expedited procedures being developed for banks may be relevant.

The second survey conducted within the report, concerning financial contracts enforceability, shows that the different pace of change between financial markets and insolvency practices also regards settlement risks of payments and financial instruments used for liquidity and risk management. These risks have been mitigated through special legal exceptions to general principles of insolvency law, the so-called "carve outs". These exceptions

include those enforcing close-out netting of derivative and foreign exchange contracts, multilateral netting of payment systems, collateral arrangements securing these contracts, etc. For example, collateral used for financial contracts is protected from the effects of insolvency arrangements through laws permitting rapid liquidation, close-out and netting of obligations.

These exceptions increase legal certainty and efficiency, as they reduce settlement risk. But they also change priorities within the insolvency regimes. The private benefits and the market benefits of limiting market disruption and sustaining liquidity seem to outweigh any loss to the other creditors.

Each jurisdiction has its own list of carve outs and this may create conflicts among jurisdictions. And hence the second issue identified by the Group. It stems from the increasing globalisation of financial activities and the global scope of financial institutions in a legal environment still defined by national jurisdictions.

Global financial conglomerates operate across legal jurisdictions. Therefore, many jurisdictions can claim to be the insolvency jurisdiction. Moreover, key decision-making and risk control activities are centralised in one or a few financial centres. The business within a single jurisdiction could not be reorganised on a stand-alone basis.

The financial markets are global as well. Financial products are traded throughout the world among counterparties who may be anywhere, while settlement is often located in a single centre. Collateral may be located in jurisdictions different from the location of the debt it secures, creating complex cross border relations which place stress on cross border insolvency laws.

In an international context legal uncertainty can increase dramatically. Which law will govern the insolvency proceeding? Which law will determine whether a netting contract is valid? The problem has two dimensions: the choice of the insolvency regime and the potential for forum shopping and the frictions between different regimes even after a forum has been selected.

Focusing on the coordination of insolvency proceedings, some cross border models are possible: the first is a *full universal* insolvency model, where the main jurisdiction insolvency law will govern the insolvency of the entire firm, irrespective of its assets being located in the same country or in a number of different jurisdictions. The other jurisdictions play an ancillary role. This model implies a surrender of sovereignty and predefined rules that determine the role of jurisdictions. Secondly, we have *modified universal* model; in this environment each jurisdiction maintains sovereignty but a cooperative approach is encouraged. Lastly, in the *territorial* insolvency model each jurisdiction acts independently of the others. The insolvent firm is simply liquidated or reorganised along jurisdictional lines.

The territorial insolvency model is inefficient as it involves several proceedings and races for assets both by officials and creditors. Some assets may not be subject to insolvency proceeding at all if they are located in jurisdictions where the requirements for insolvency are not met. Reorganisations may be very difficult in the territorial model. Different countries may have different types of reorganisation measures as well as different rules and criteria for deciding whether a reorganisation may be attempted.

Banks' reorganisations are conducted by the supervisors, without the formal insolvency processes. Therefore they are not hindered by the territorial model but require a strong supervisory cooperation. On the other hand, banks strongly rely on netting and collateralisation in their risk management, which could frequently be cross border. This may be incompatible with the territorial model (why should an official recognise the netting of a foreign debt against a domestic debt if he is committed to ignoring foreign assets and liabilities?).

The European Union has recently adopted a number of important acts for coordinating cross-border insolvencies.

I wish to mention the Directives on Winding Up of Credit Institutions and on Winding Up of Insurance Companies and the Insolvency Regulation for non financial firms, the Settlement Finality Directive and the Directive on Financial Collateral Arrangements.

The Insurance and Credit Institution Directives do not seek to harmonise national insolvency proceedings but rather to ensure mutual recognition and coordination of the procedures by the Member States.

A form of full universality is prescribed. The authorities of the home Member States (the State where the firm has its head office) shall be the only ones empowered to implement reorganisation measures or winding-up procedures concerning a firm, including branches established in other Member States. The laws of the home Member State shall in particular govern the conditions for invoking set-off, the effects of insolvency on contracts, the treatment of claims and rules for assessing admission and priorities of claims, etc. No secondary proceedings shall be started by the other Member States.

As for financial contracts, the Settlement Finality Directive, now implemented in national legislation by all Member States, is aimed at reducing settlement risk through the provision of the finality of settlement of transfers of funds and securities through payment and securities settlement systems even in the case of insolvency, as well as provisions on the enforceability of collateral securities. Insolvency proceedings must not have any impact on the enforceability of orders validly entered into payment or securities settlement systems or on collateral provided for a system.

The Collateral Directive is intended to address legal uncertainty stemming from cross border use of collateral between Member States, providing a clear and predictable regime for banks and financial institutions with regard to the taking of financial collateral consisting of transferable securities and cash.

## 5. Conclusions

Each crisis is unique because of the different circumstances under which it occurs. Yet, however different the circumstances may be, bank crises do have certain features in common.

Likewise, each country has its own safety net and bank insolvency proceedings which reflect their respective public policy objectives. Nevertheless, financial stability inspires the design of the legal framework for dealing with bank crises throughout the world.

Financial globalisation and the frequency of banking crises make a co-ordinated approach to dealing with them necessary. The first step is to have in place a general framework and a set of common rules to prevent systemic risk and improve the efficiency in the resolution of banking crises.

The reports explored in this presentation, based on the contributions of many countries, aim at identifying principles and criteria shared by the international financial community, without prejudice to legal and economic singularities in their respective environments.

This is not an easy task. We know that crisis resolution proceedings reflect public policy choices and objectives rooted in each country's history and traditions and they jealously wish to guard their sovereignty (debtor-friendly and creditor-friendly proceedings; priority ranking more favourable to certain kinds of creditors, etc.). Countries may be willing to agree on a few general principles but when trying to define specific rules it is far more difficult to reach a consensus, especially on the ground of equity.

At EU level a number of significant provisions adopted in the last few years contribute to the clarification of the framework governing cross-border bank crises and offer adequate grounds for the solution of the co-ordination and efficiency problems.

We can identify two different levels of harmonisation in the European statutory approach. The first level ensures certainty regarding the applicable law and the insolvency proceedings that shall regulate crises in banks with branches in other Member States. The authorities of the home Member States shall be the only ones empowered to implement reorganisation measures or winding-up procedures concerning a bank, including branches established in other Member States.

This choice-of-law jurisdiction does not require the adoption of a common set of rules for the treatment of creditors and other stakeholders involved in the proceedings. It simply aims at ensuring mutual recognition and co-ordination of the banking crises proceedings by the Member States.

A second and deeper level of harmonisation ensures a common set of rules to be strictly implemented in all the European countries in order to achieve the same result.

In the second half of the nineties, a basic requirement for ensuring the soundness of the financial system was identified in the reduction of systemic risk, an objective shared by the entire financial community. By carving financial transactions out of the insolvency estate, EU law prevents a domino effect in securities settlement systems and regulated markets. More recently the same approach was adopted for financial collateral. By setting aside the historical principle of equal treatment of creditors, the statutory instruments of the Community allow a safer environment for the financial transactions in all the Member States.

Let me leave you with two problems identified by the latter document that was examined.

The universality and the cooperative approach implicit in the EU insolvency regulation are useful and effective developments in dealing with cross border insolvency. Can they be extended outside the EU?

The full universal model, which implies a surrender of sovereignty, may be difficult to implement outside in the short term. Even within the regulatory framework of the EU a very long time was necessary to reach a consensus.

A second set of problems is outstanding even in a full universal proceeding, including the EU insolvency directives: namely, corporate groups. In general insolvency law each corporation is normally liquidated separately, often subject to a separate insolvency proceeding.

Financial groups are subject to the same de-consolidated insolvency proceedings as non-financial business groups. The consolidated approach, where a central supervisor is responsible for the entire financial group, is not yet applied in financial insolvency law. Subsidiaries remain subject to the insolvency law of the host country. Any insolvency process of a financial group with subsidiaries in other countries still needs a cooperative approach among the safety net players of the different Member States.

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