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Special Resolution Regimes for Banking Institutions: Objectives and Limitations

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Abstract: In the present environment of weak banks and shaky state finances, the introduction of so-called Special Resolution Regimes (SRRs) for failed banking institutions has developed into a global and European policy priority. This paper responds to certain claims made in relation to the proper objectives and mode of operation of SRRs, with particular reference to a recent paper by Gustav Sjöberg. SRRs are supposed to set out effective tools for handling the failure of systemically important banks in a manner that preserves systemic stability and secures the continuous provision of the key functions of the financial system; at the same time, they incorporate elements of strict enforcement, in order to preserve market discipline and curtail moral hazard. Many policy-makers and scholars assume that an SRR with appropriate legislative objectives and strong intervention tools can of itself reconcile the aforementioned purposes.

However, any SRR which enables the continuation and restructuring of insolvent banks' operations with outside financial support, if this appears justified for systemic reasons, and/or provides protection to certain stakeholders (typically, depositors), entails by definition a relaxation of market discipline. Due to the inclusion in the statutory framework of strong elements of discretion, such a system will always be amenable ex post to negotiated enforcement and strategic behaviour on the part of bank stakeholders, who demand forbearance. Thus, a well-designed SRR can at most establish a structured and robust decisional framework, reducing the ability of the latter to game the system. But it cannot act as an effective ex ante governance tool.

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INTRODUCTION

If the global financial crisis has proven anything, it is that the financial system's image of efficiency, sophistication and strength can turn out to be highly deceptive. A great many banks, including some of the largest and most reputable global institutions, were shown to be in parlous state. In several countries, the troubles engulfed the whole banking system.

The manifest fragility of banks and banking systems impels the search for appropriate policy responses. For obvious reasons, the more conspicuous governmental decisions made at the height of the crisis were aimed at restoring normal conditions of operation in the financial markets through the provision of state guarantees or immediate financing support. However, the official reactions have also included a host of legislative and regulatory measures, seeking to establish the longer-term rules of the game for the banking industry in the post-crisis period. Amongst the flood of new institutions, rules and regulations, a range of novel arrangements for the resolution of failed banks stand out. How should the state respond, if one or several banking institutions show signs of severe financial and/or operational weakness and are on the verge of collapse? What legal and administrative tools should it have in place, so as to be ready to address adequately the situation? These issues are central to the ongoing regulatory realignment.

Before 2008, most countries lacked specialised legal frameworks and clearly defined lines of governmental-administrative responsibility for the resolution of failed banks and, in particular, of systemic banking crises (section I). Due to the recent global troubles, this has now changed. In the new environment, the introduction of so called Special Resolution Regimes (SRRs) for banking institutions, with particular objectives and attributes, has developed into a global and European policy priority (section II). In the long run, this may well prove to be the most significant and noteworthy regulatory response to the crisis.

In his contribution to a forthcoming volume,[1] Gustav Sjöberg seeks to establish at the conceptual level an SRR's proper purpose and general conditions of success (section III). In particular, Sjöberg considers that SRRs are not meant merely to provide appropriate tools for handling crises, if and when these erupt, but also to prevent them, thus playing a continuous role as 'governance tools' (section V). To meet their dual objectives, SRRs should possess, in his view, three key features, which are discussed in turn below (sections VI to VIII).

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[1] G Sjöberg, 'Banking Special Resolution Regimes as a Governance Tool', in WG Ringe and P Huber (eds), *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Oxford: Hart Publishing, forthcoming 2014), ch 12.

I. BANK FAILURES AND THEIR RESOLUTION PRIOR TO THE GLOBAL FINANCIAL CRISIS

The experiences of the period preceding the global financial crisis should have alerted policymakers to the increasing fragility of banking institutions. The apparently benign macroeconomic environment which prevailed, roughly, from the mid-1980s to the eruption of the US 'subprime mortgage' crisis in 2007—the so called 'great moderation'[2]—coincided with a rapid increase in the incidence of bank failures, small and large, sometimes isolated but often of systemic proportions. These affected, at different points in time and with variable severity, most economies in the world.[3] This trend was closely connected to the liberalisation and internationalisation of financial markets, which created new opportunities for risk taking and profit making, added to the competitive pressures that banks face and resulted in a more fluid and unpredictable economic environment.

Remarkably, up till the recent crisis, the prevalence of bank failures had failed to incentivise the search for general and internationally consistent solutions. The global and national policy debates were primarily focused on the development, implementation and cross-country convergence of prudential norms, especially of standards of capital adequacy, with a view to ensuring the viability of banking institutions and preventing crisis situations. In contrast, they either ignored or, at best, paid limited attention to the practical and legal aspects of the ex post handling of bank failures, should these occur. The same was true of most academic commentary. This 'preventative'-prudential bias of the policy debate is not surprising. After all, in a heavily regulated industry like banking, the financial or operational failure of the participating enterprises is considered to be, not a normal occurrence, but an aberration, which also counts as a failure of the legislative and regulatory authorities. Thus, in normal times it comes more naturally to the regulatory community to discuss and develop safety standards, which are supposed to prevent the materialisation of risks, than to contemplate failure as a likely scenario, requiring contingency planning. This attitude was abandoned only because of the global crisis. Its unprecedented intensity forced lawmakers and regulators to recognise that banking failures cannot be wished

[2] B Bernanke, 'The Great Moderation', remarks at the meetings of the Eastern Economic Association (Washington, DC, 20 February 2004) available at www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm.

[3] Examining the period 1970–2011, Laeven and Valencia identify 147 'systemic' banking crises; their definition of a 'systemic' crisis combines significant signs of distress in the banking system with significant public intervention measures in response to the losses suffered by banks; L Laeven and F Valencia, 'Systemic Banking Crises Database: An Update', IMF Working Paper No WP/12/163 (June 2012) available at www.imf.org/external/pubs/ft/wp/2012/wp12163.pdf. Interestingly, of all the systemic banking crises identified by Laeven and Valencia, only four occurred before 1980 (specifically, in 1976 and 1977), while from that point onwards crises become common, with clusters observed in the early 1980s, at three points in the 1990s (affecting, consecutively, the transition economies, Latin America and East Asia) and finally in 2008 (with the eruption of the largest ever number of incidents, namely, 22).

away, nor assumed to be fully preventable, no matter how robust the applicable prudential regime.

This does not mean that in the past there was complete lack of concern for the treatment of bank failures, but simply that this took place in the form of ad hoc, improvised crisis management, once a failure had already occurred. Common global or European standards for bank resolution were lacking, and even at the domestic level most countries had not developed sufficient permanent arrangements for dealing with this eventuality.

More precisely, at the domestic level, the public authorities with responsibility for the banking sector did not stand idly by when bank failures occurred. However, their responses were frequently based, not on preordained policies and stable rules, but on a combination of administrative actions taking place without the benefit of clear and precise legislative guidance and of discretionary financial interventions. In addressing banks' distress, a variety of official actors—governments, central banks, banking regulators, deposit insurers, courts or other insolvency officials—could apply in makeshift ways, and possibly with little co-ordination, a diverse range of tools and powers: financial support measures, extended by the government or the central bank either on the basis of special legislation or by utilising the general provisions of fiscal, central banking, contract or company law; supervisory and enforcement decisions made under the standing administrative mandate of the regulatory authorities; or restructuring or liquidation decisions made by the courts or the relevant insolvency officials after the opening of formal insolvency proceedings.[4] The overall approach to bank crisis management thus lacked a clear legal and administrative structure, and the outcome of the official interventions was almost always up for grabs.

Of course, the level of actors and the type of response would typically depend on the nature and systemic impact of each case. Thus, in financial crises of systemic proportions the key official decisions have almost always been made or, at least, approved by the political leadership. The handling of such crises was—and continues to be—treated essentially as a matter of discretionary macroeconomic policy, rather than as a microeconomic question of market ordering, which could be regulated in advance by way of standing legal norms. The official interventions usually take the form of financial support operations in favour of part or the whole of the banking industry (for instance, extension by the central bank of emergency liquidity assistance or, to use the traditional term, lending of last resort, or provision by the state of blanket guarantees over banks' assets or liabilities), possibly in conjunction with the nationalisation of institutions which are no longer able to operate independently.

[4] See C Hadjiemmanuil, 'Bank Resolution Policy and the Organization of Bank Insolvency Proceedings: Critical Dilemmas', in DG Mayes and A Liuksila (eds), *Who Pays for Bank Insolvency?* (Basingstoke and New York: Palgrave Macmillan, 2004) 276–80.

In the past, an essentially similar approach was followed whenever the imminent failure of a large banking institution raised the fear of contagion. When institutions of this type (formerly called 'too big to fail', but lately going by the more neutral appellation of 'systemically important financial institutions', or 'SIFIs') fell in distress, their fate was invariably decided, not by strict application of the applicable regulatory or insolvency rules, which might mandate the revocation of their licence or their placing in liquidation, but through hastily arranged mergers, refinancing packages or restructuring schemes, initiated by the ministry of finance or the central bank. Interventions of this type frequently involved the participation of the failed institutions' private competitors; thus, from a legal viewpoint, they could often be carried out by using the tools of negotiation, implicit pressure and private contracting, without need for formal acts of public law.

In contrast, the isolated failures of less significant financial institutions were occasionally allowed to run their course. In other words, from time to time a bank might go into insolvent liquidation. In this case, the standing legislation on bank insolvency (together with the administrative norms on the withdrawal of a bank's licence) would come into operation. Some jurisdictions had in place special insolvency rules for banking institutions. Other countries applied to the failed banks the norms of general corporate insolvency law. Even in the latter case, however, the insolvency law was frequently supplemented by a deposit guarantee system, covering the claims of retail depositors. All in all, the standing legislation applicable to failed banks suffered from two fundamental shortcomings: first, it only regulated bank insolvency proceedings as such, but did not cover the financial participation of the state in the rescue and/or restructuring of failed banks; and secondly, it was usually fragmentary or underdeveloped and did not fully articulate bank regulation as an administrative activity, on the one hand, with bank insolvency proceedings (winding up and, possibly, rehabilitation through restructuring), on the other. This was a recipe for inconsistency and confusion.

A major exception has been the United States. There, in the aftermath of the 'savings-and-loan' (or 'S&L') financial crisis of the late 1980s, the Congress adopted the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),[5] which introduced a novel, robust and quite rational resolution system for American depository institutions. Operated by the Federal Deposit Insurance Corporation (FDIC), the FDICIA system integrated into a single regulatory (as distinct from judicial) process the provision of protection to the eligible depositors of failed banks (a policy applicable in the US since the 1930s) with the orderly resolution of the latter through expedited quasi-insolvency proceedings, guided by explicit legal policies and criteria. Nonetheless, despite the precedent set by FDICIA, until the eruption of the global financial crisis, the domestic and international policy pronouncements on bank crisis management and, in particular, bank insolvency law were few and far between.

[5] PL 102-242, 105 Stat 2236.

Naturally, the international financial institutions and regulatory fora had not failed to notice the global surge in bank failures. Thus, from around 2000 onwards, they introduced in their agendas the issue of bank insolvency law and engaged in some exploratory work on the subject. The main initiatives of this period included: a technical paper issued in September 2001 by the Financial Stability Forum (the precursor of the Financial Stability Board, or FSB), which provided guidance to countries seeking to set up a deposit insurance system;[6] the 'Weak Banks' report issued in March 2002 by the Basel Committee on Banking Supervision (BCBS), setting out a structured approach to the management of bank distress and failure;[7] and a report prepared jointly by the International Monetary Fund (IMF) and the World Bank in 2002–03, comprising a detailed checklist of the institutional options and technical solutions that a national framework for the treatment of bank insolvency should address.[8] Significantly, the BCBS's 'Weak Banks' report covered both the pre- and post-insolvency phases of bank distress. However, it failed to address the complex institutional issues involved in the post-insolvency phase or in situations of systemic crisis, when the banking supervisory authority may either lack jurisdiction or be restricted to specific actions, while other authorities—the judiciary, the government, the central bank, or the deposit insurer—assume distinct and critical roles. This shortcoming was inherent in the fact that this was a BCBS report: written by and for regulators, the 'Weak Banks' report could not speak to or guide the actions of non-regulatory decision makers. As for the IMF/World Bank paper, its drafting was effectively completed by early 2004, but it was not formally endorsed and published until after the global financial crisis, in April 2009.[9] Thus, it was unavailable to influence the development of the legal and institutional situation while there was still time. All in all, by 2008 the various international efforts had not yet yielded concrete results, and the regulatory community still had a long way to go in order to arrive to globally consistent solutions.

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[6] Financial Stability Forum, 'Guidance for Developing Effective Deposit Insurance Systems' (September 2001) available at www.financialstabilityboard.org/publications/r_0109b.htm.

[7] BCBS, 'Supervisory Guidance on Dealing with Weak Banks: Report of the Task Force on Dealing with Weak Banks' (March 2002) (the 'Weak Banks' report) available at www.bis.org/publ/bcbs88.pdf.

[8] See RB Leckow, 'The IMF/World Bank Global Insolvency Initiative—Its Purpose and Principal Features' in DS Hoelscher (ed), *Bank Restructuring and Resolution* (Basingstoke and New York: Palgrave Macmillan, 2006) 184–98.

[9] IMF and World Bank, 'An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency' (17 April 2009) available at www.imf.org/external/np/pp/eng/2009/041709.pdf.

II. SPECIAL RESOLUTION REGIMES FOR BANKS AS A NEW POLICY PRIORITY

Evidently, the crisis has changed all that. Especially after the collapse of Lehman Brothers, states on both sides of the Atlantic sought to prevent the collapse of large banks and to reverse the freezing of interbank lending markets by putting together emergency bank-support (or bail-out) programmes of various descriptions and huge proportions, whose fiscal implications were profound and quite disturbing. Most bail-out packages were introduced in the final months of 2008. They relied on a variety of tools, such as blanket deposit guarantees, guarantees in favour of wholesale bank creditors, capital injections, special lending assistance by states, emergency liquidity assistance by central banks, asset guarantees and direct asset-purchase programmes, which operated in parallel with general macroeconomic measures of monetary and fiscal easing.

As the market environment becomes more stable, the financial burden becomes a key incentive for governments and central banks to seek a rapid exit from the bail-out packages.[10] By the same token, the fiscal nexus exercises a strong influence on the longer-term official policy stance, since it induces states to make bail-outs less likely in the future, by endorsing novel legal and regulatory tools for the treatment of bank failures, with the specific aim of discouraging and constraining the application of public monies in bank rescue operations. This has turned out to be a top priority at all policy-making levels—the global, the European and the national.[11]

The UK was one of the first countries to adopt a special resolution regime (SRR) for banks in the wake of the crisis.[12] The basic elements of its new statute, which was enacted in February 2009, have been a source of inspiration (or rather, a usable legislative model) for other jurisdictions. Germany has adopted its own version of SSR in December 2010.[13]

Globally, the BCBS has acted by promulgating, in co-operation with the International Association of Deposit Insurers (IADI), revamped standards for deposit insurance systems[14] and issuing a report on the coordinated treatment of bank insolvencies with cross-border implications.[15]

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[10] FSB, 'Exit from Extraordinary Financial Sector Support Measures: Note for G20 Ministers and Governors Meeting 6-7 November 2009' (7 November 2009).

[11] For a state of play as at mid-2011, see BCBS, 'Resolution Policies and Frameworks—Progress So Far' (July 2011).

[12] Banking Act 2009.

[13] Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz) vom 9. Dezember 2010, BGBl. 2010, I, 1900. For a brief description in English, see BJ Attinger, 'Crisis Management and Bank Resolution: Quo Vadis, Europe?', ECB Legal Working Paper No 13 (December 2011) 28–34.

[14] BCBS and IADI, 'Core Principles for Effective Deposit Insurance Systems' (June 2009).

[15] BCBS, 'Report and Recommendations of the Cross-Border Bank Resolution Group' (March 2010).

The key global initiative, however, has taken the form of a new standard for countries' bank resolution frameworks. This was prepared by the FSB[16] and endorsed by the G20 at the Cannes Summit of November 2011.[17] The new standard requires the establishment of national SRRs, whose scope should cover '[a]ny financial institution that could be systemically significant or critical if it fails';[18] thus, in principle, it is not confined to banks, but can also apply to insurance companies and non-depository financial intermediaries, such as securities houses. The document sets out under 12 main headings, accompanied by four annexes on specific implementation issues, the 'key attributes', or 'essential features', of an effective resolution regime. Its provisions address questions relating to:

- the scope of the SRR,
- the designation of the national resolution authority,
- the resolution-related powers of the latter,
- the treatment of contractual arrangements and clients' assets in the course of the resolution process,
- the necessary safeguards for the protection of the legal rights and financial interests of failed banks' creditors and shareholders,
- the funding of banks in resolution, that is, the identification of the sources of financing which may be used to maintain a failed bank's essential functions during its resolution, as well as
- the legal arrangements for cross-border co-operation in the case of a resolution with extraterritorial effects, including access to information and information sharing.

In addition, the standard establishes a set of resolution-related prior planning requirements, applicable primarily to the world's very largest banks, now dubbed 'global SIFIs' or 'G-SIFIs'; an accompanying list identifies by name 29 G-SIFIs, for which these requirements will need to be met by end-2012.[19] These requirements are intended to prepare the ground for an orderly resolution, in the event of a G-SIFI's failure. They encompass the introduction of multi-jurisdictional crisis management groups, with the participation of the relevant national public authorities of the various countries in which a G-SIFI's group operates, the conclusion of institution-specific cross-border co-operation

[16] FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2011) available at www.financialstabilityboard.org/publications/r_111104cc.pdf.
[17] G20, 'Cannes Summit Final Declaration: Building Our Common Future: Renewed Collective Action for the Benefit of All' (4 November 2011) para 28.
[18] FSB, 'Key Attributes' (n 16) para 1.1.
[19] FSB, 'Policy Measures to Address Systemically Important Financial Institutions' (4 November 2011). The list will be updated regularly and will eventually include, in addition to banks, insurers and non-bank financial entities of global systemic importance.

agreements between the home and relevant host authorities involved in the planning and actual resolution stages, the regular conduct of resolvability assessments by the resolution authorities responsible for G-SIFIs, and the preparation and regular review of recovery and resolution plans by G-SIFIs and the supervisory and resolution authorities responsible for them, respectively. While the FSB and the G-20 demand the application of the resolvability assessment and recovery and resolution planning requirements only in relation to G-SIFIs, national authorities are free to extend this approach to local SIFIs or even to non-systemically-important institutions.

At the European level, the European Commission presented its comprehensive proposal for handling financially weak or insolvent banks, the Draft Recovery and Resolution Directive, in June 2012.[20] The proposed framework requires EU Member States to adopt provisions on preparatory and preventative measures (including the preparation of recovery plans by individual banks and resolution plans by their supervisors),[21] on early supervisory intervention in the event of breach of a bank's prudential requirements (including by way of appointing special managers),[22] and on special resolution powers and tools in situations where a bank is failing or likely to fail.[23] The establishment of 'resolution financing arrangements' (that is, dedicated resolution funds), which should be prefunded by means of levies on the financial institutions subject to the resolution framework, is also envisaged to secure bridge financing for potential restructuring operations under the national SRRs.[24]

Essentially, the prototype for the various SRRs recently adopted or currently under discussion is FDICIA. This applies, most evidently, to the UK's SRR,[25] but is also true of the other systems and proposals mentioned above. Nonetheless, the SRRs of the new, post-crisis generation include additional elements, which go beyond the FDICIA model in significant ways. A good example would be the requirement of pre-crisis contingency planning for a potential situation of distress at the level of individual banks, in the form of so called 'recovery and resolution plans', colloquially known as 'living wills'. Another example would be the requirement that banks raise part of their funding in the form of convertible debt instruments (most famously, 'contingent convertible bonds' or 'CoCos'), whose unilateral conversion in the event of distress can permit a rapid debt-to-equity recapitalisation of the issuing institution, avoiding the need for public funding. Finally, one should not forget the creation of industry-wide resolution funds,

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[20] European Commission, 'Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEE and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010', COM(2012) 280/3, 6 June 2012.

[21] Draft Recovery and Resolution Directive, Title II (Articles 4–22).

[22] ibid Title III (Articles 23–25).

[23] ibid Title IV (Articles 26–79).

[24] ibid Title VII (Articles 90–99).

[25] P Brierley, 'The UK Special Resolution Regime for Failing Banks in an International Context', Bank of England Financial Stability Paper No 5 (July 2009) 4.

which can provide large amounts of financing for restructuring operations, where necessary.

Given the economic importance of the matter and the novelty of the preferred solutions, it is no wonder that the adoption, under the rubric of SRRs, of new tools and powers for the restructuring (or, at least, going-concern liquidation) of failed banks generates considerable interest, theoretical as well as practical. It is in this context that one should examine Gustaf Sjöberg's contribution to the forthcoming volume.

III. THE SJÖBERG THESIS

Sjöberg undertakes an advocacy of SRRs at the conceptual level. Specifically, he maintains that SRRs should be designed to address the situation of a systemically important bank facing acute problems (as distinct from the distress or failure of a small bank without systemic implications). They should serve two objectives: (a) at the time of crisis, to provide sufficient legal tools for dealing with the failed bank(s) while preserving systemic stability, in the sense of securing the continuous provision of the key functions of the financial system; and (b) ex ante, to create an appropriate set of incentives, so as to preserve market discipline and avoid moral hazard. An SRR with the aforementioned focus and objectives would have to display, in Sjöberg's view, three essential design features.

First, to ensure the SRR's operation as a 'governance tool' (which I take to mean that the SRR should establish appropriate incentive structures for bank stakeholders) and, in particular, in order to combat moral hazard, the rules should promise ex ante and in a credible way to inflict losses on shareholders and debt holders in the event that their bank fails. This would force such private stakeholders to behave more responsibly in normal times. It would equally reduce their room for negotiation with the authorities in times of crisis.

Secondly, the applicable rules should enable the authorities to take immediate and legally unchallengeable control over a bank facing acute distress. Beyond the purely managerial responsibilities, the authorities' control should enable them to decide irreversible on all appropriate corporate actions, including the transfer of the bank's ownership.

Finally, while the tools of the SRR may be insufficient to handle a fully-fledged systemic crisis (that is, one characterised by the disruption of large parts of the financial system), which may necessitate the adoption of ad hoc state support measures, they should still be applicable and functional in a situation of this type. The suspension of the SRR's applicability during systemic crises would be counterproductive, because it would strengthen the banks' stakeholders' hand in the negotiating table, probably resulting in more generous support packages than what is warranted. Moreover, the prospect of suspension of the SRR's operation in favour of ad hoc solutions would provide a reason for the various stakeholders of banking institutions (managers, shareholders and creditors) to behave strategically. Conceivably, the stakeholders might even allow a simmering crisis to reach systemic proportions, precisely in order to benefit from the SRR's suspension, the discontinuation of its strict resolution approach and the introduction of an exceptional support package more advantageous to their interests.

Despite Sjöberg's strong reservations about certain technical elements of the recently enacted or proposed SRRs mentioned above, his thinking and proposals to a large extent dovetail with the current policy trend. Nonetheless, they are not bereft of conceptual difficulties and internal tensions. I will try to address the issue from a limited number of angles. Following a short terminological comment (section IV), I will turn to Sjöberg's views on the proper objectives of SRRs (section V). I will then proceed to a discussion of the three levels of bank crisis management, and on Sjöberg's view that SSRs should prioritise the second (SIFI resolution) but also be available in the third (systemic crisis management) (section VI). I will continue with the resolution authorities' ability to immediately assume control over failed banks, which Sjöberg considers crucial, and on which apparently depends the achievement of his first key objective (section VII). Finally, I will comment on the ex ante perspective, which is thought to be a necessary element of a properly designed SSR, and which evidently relates to the achievement of the second key objective, that is, the containment of moral hazard (section VIII).

IV. THE AMBIT OF BANK RESOLUTION

Clarifying what one means by 'bank resolution' might help. The use of the term in the banking literature is not entirely consistent. Two pioneering experts in bank insolvency law, Tobias Asser[26] and Eva Hüpkes,[27] use the term to describe the techniques that can be applied for the reorganisation, disposal or liquidation of banks in the context of formal bank insolvency proceedings, regardless of their precise legal basis (general insolvency law or special insolvency or administrative law) and of who is in charge (the insolvency courts or the banking regulatory authorities). In similar fashion, Sjöberg uses the term 'SRR' to denote the set of standing legal arrangements establishing insolvency and quasi-insolvency

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[26] TMC Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress* (Washington, DC, International Monetary Fund, 2001) ch XI, especially 141: 'Bank resolution procedures are used to dispose of a bank. Generally, therefore, they come into play only while the bank is in receivership or when insolvency proceedings have been opened against the bank.'

[27] E Hüpkes, *The Legal Aspects of Bank Insolvency: A Comparative Analysis of Western Europe, the United States and Canada* (The Hague, Kluwer Law International, 2000) ch IV, especially 83: 'The resolution of a bank insolvency is accomplished, in a broad sense, in either of two fundamental ways—i.e., through the option of reorganization or through the option of a winding-up and liquidation of its assets.'

procedures for the liquidation and/or restructuring of banks facing financial difficulties. But in the case of systemic crises, he explicitly allows for ad hoc state interventions, outside the SRR framework, in support of the banking sector.

Of course, 'resolution' could be understood to include such interventions too. That is, the term could be used in a sense encompassing every conceivable response of the authorities when faced with a bank's actual or imminent failure (in the sense of the insolvency and/or collapse of its business operation).[28] Many types of action would fall under this heading: administrative measures to deal with floundering banking organisations; formal insolvency proceedings aimed at restructuring or liquidating banks which have crossed the relevant legal threshold; private transactions that the authorities instigate and help organise informally, such as merger, acquisition or asset-sale transactions, leading to a transfer of the failed bank's operations, in whole or in part, to a viable institution and their continuation on a going-concern basis; and all sorts of bail-outs, leading to the survival of the failed banks with the support of public monies. This brings into the picture a variety of pre-insolvency actions (or, to use Sjöberg's terminology, actions that do not presuppose legal assumption of immediate and absolute control over a bank by the state authorities).[29]

Sjöberg's usage is consistent with the actual or proposed SRRs of recent vintage, which do not cover the whole field of bank resolution in the latter, wider sense. In essence, these are confined to matters of bank insolvency law, replacing the general corporate insolvency proceedings with a bank-specific system of formal resolution proceedings and tools. Within this narrower field, they prioritise particular schemes of action and seek to exclude others. This is justified, to the extent that, while descriptively the range of possibilities and policy alternatives relating to bank insolvency is very wide, from a prescriptive viewpoint a *properly constituted* system of bank resolution may justifiably rule out certain options or promote particular types of outcome.

For instance, in the European Commission's Draft Recovery and Resolution Directive, 'resolution' is defined as 'the restructuring of [a banking] institution in order to ensure the continuity of its essential functions, preserve financial stability and restore the viability of all or part of that institution'.[30] This legislative definition does not seek to provide a 'neutral' lexical meaning of the term; instead, it is a stipulative definition, limited to the purposes of the specific text or, at most, of European policy making. Significantly, by confining the term's use only to restructuring efforts directed to the stated objectives, the definition effectively

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[28] Thus, e.g., M Dewatripont and X Freixas, 'Bank Resolution: Lessons from the Crisis' in M Dewatripont and X Freixas (eds), *The Crisis Aftermath: New Regulatory Paradigms* (London, Centre for Economic Policy Research, 2012) 106, define a 'bank resolution procedure' as 'any public intervention that is intended to restore the bank's normal business conditions or to liquidate it, thus restoring normal business conditions for all other banks'.

[29] This broad understanding of the term is consistent with its use by the BCBS 'Weak Banks' report (n 7) section 6.

[30] COM(2012) 280/3 (n 20), proposed provisions, Article 2(1).

constitutes an authoritative declaration of a policy preference. In this sense, it reflects the emerging consensus amongst international policymakers on the proper purposes of bank insolvency law.

V. OBJECTIVES OF BANK RESOLUTION

One can think of various reasons for which the enactment of a special set of insolvency rules for banking institutions may be desirable. Some of these could be valid, even if bank insolvency law had the same primary objectives as general corporate insolvency law. The latter is typically thought to pursue the protection of the assets of the insolvent estate from further dissipation, the maximisation of their collection value (whether through their piecemeal disposal or by means of the going-concern liquidation or a restructuring of the insolvent enterprise), the satisfaction of liability holders to the maximum possible extent and always in accordance with a specific order of priority (reflecting the prior contractual engagements and expectations of the liability holders, based on which these are pigeonholed in different classes) and, conversely, the apportionment of final losses in a principled and predictable manner.[31] The key problem here is the avoidance of a race for the assets of the insolvent enterprise by individual creditors, whose uncoordinated attempts to enforce their respective claims by grabbing and liquidating particular assets of the debtor enterprise is likely to result in an economically wasteful and unjustified diminution of the total value of its estate, including through the destruction of its going-concern surplus value. From this standpoint, the primary objective of insolvency law is to maximise the value of the common pool of assets (that is, the insolvent estate) for the benefit of all creditors—an objective pursued through the main institutions of insolvency law (moratorium on individual enforcement actions, collective proceedings, satisfaction of the creditors in order of priority between classes and on a pari passu basis within each class, etc.).[32]

However, the effective implementation of the objective of realised-value maximisation may depend on the specific context, which may not be the same for banks as for industrials or commercial companies. If so, the purpose of the special banking regime would be to provide appropriate solutions to certain technical

[31] cf IMF Legal Department, *Orderly & Effective Insolvency Proceedings: Key Issues* (Washington, DC, International Monetary Fund, 1999) 5–7.

[32] On the best-known theoretical model, these institutions should be understood as a putative 'creditors' bargain': if only they had the opportunity to bargain with each other before lending to the enterprise in question, creditors in general would be likely to converge voluntarily on something similar to the existing arrangements of mandatory insolvency law. See TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *Yale Law Journal* 857–907; and DG Baird and TH Jackson, 'Bargaining after the Fall and the Contours of the Absolute Priority Rule' (1988) 55 *University of Chicago Law Review* 738–89. For alternative views of US and English bankruptcy law, see, e.g., BE Adler, 'Financial and Political Theories of American Corporate Bankruptcy' (1993) 45 *Stanford Law Review* 311–46; and RJ Mokal, *Corporate Insolvency Law* (Oxford and New York, Oxford University Press, 2005) ch 2.

problems of bank insolvency which are not present in other cases. In particular, the nature of the financial assets and the liabilities in banks' balance sheets may justify appropriate derogations from the general rules of corporate insolvency, in order to increase the effectiveness of the stock-taking and collection effort and to avoid untoward secondary effects of the insolvency process. The need for special rules may be especially pressing in relation to the fate of transactions carried out through organised markets and/or payment and settlement systems: their abrupt discontinuation or unwinding as a result of the commencement of insolvency proceedings may involve significant negative externalities and undermine the smooth operation of such markets and systems. Thus, special rules have been introduced in the EU and elsewhere, which modify the time when the official pronouncement of insolvency comes into effect, or which exempt certain financial transactions from the operation of the moratorium, from the right of insolvency officials to step out of transactions, etc.[33]

More obviously, many countries have in place regimes of deposit insurance, whose effect is to provide a predetermined measure of protection to retail depositors, even when the value of an insolvent bank's estate does not suffice for this purpose.[34] Deposit insurance has a specific protective objective, unrelated to those of general corporate insolvency law; this objective can be pursued outside the otherwise applicable bank insolvency framework, through distinct structures and tools. Thus, payments out of the deposit insurance fund typically take place independently of the main insolvency proceedings. Of course, the effect of such payments may be to bring a particular class of liabilities outside the insolvency process or, alternatively, to cause the deposit insurer's subrogation to the claims of the original depositors. The objectives of the insolvency process per se are not necessarily altered as a result.

Even the wholesale exclusion of the general insolvency system and the subjection of banks to SRRs could be compatible with a continuing insistence on the normal objectives of insolvency law. Thus, SRRs could be justified by reference, not to any special objectives of bank resolution, but to the need to ensure administrative coherence and continuity across the banking supervisory, deposit insurance and resolution processes. Administrative streamlining and simplicity in the lines of communication and remedial action are particularly important in the case of transnational banks and banking groups. In this context, the complexities of cross-border bank resolution could also militate in favour of SRRs.

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[33] At the European level, see Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ 1998 L 166/45, as amended; and Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ 2002 L 168/43, as amended.

[34] At the European level, see Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, OJ 1994 L 135/5, as amended.

For Sjöberg, however, as for a great many other policymakers and academic students of banking, the reasons justifying SRRs are not technical or administrative. They go to the heart of resolution policy—that is, to its very objectives. The critical assumption here is that the famed 'specialness' of banks, which provides the justification for their prudential regulation, also dominates their post-failure treatment and determines its objectives.

It is commonplace to describe banking intermediation as a peculiar type of business activity, whose unique features render the banks especially vulnerable to crises. On the standard theory, individual banks can fall victim to crises of confidence (depositors' 'panics') precipitating runs on their deposits which destroy their funding base, even in situations where their underlying situation is otherwise sound. Moreover, banking crises, far from affecting one bank at a time, are notoriously contagious. This property of banking intermediation is untypical of other sectors. In most commercial and industrial fields, the failure of one firm is a boon for its competitors, not a cause of harm. In contrast, a bank's failure can be a source of troubles, with potentially fatal consequences, for some or all of its peers. Further, the failure of banking institutions, especially in the context of a generalised ('systemic') financial crisis, is thought to entail significant external costs, which go beyond the banking market. Over and above the losses suffered by the failed banks' immediate creditors (including depositors) and market counterparties, a systemic financial crisis can lead to large-scale unavailability of depositors' transaction accounts, a collapse of the monetary aggregates and the payments system, a severe disruption of the provision of liquidity to the real economy and a large-scale destruction of economically useful information relating to the failed banks' borrowers. In short, on this account, if bank failures were left unchecked to run their course, their effects could reach catastrophic proportions, inflicting huge loss of value and bringing the whole economy to a state of deep depression. Thus, it would seem imperative for the state to engage in prudential supervision of the banking institutions with a view to establishing their financial and operational soundness, to intervene by financial and other means in order to prevent banks from failing or, when this cannot be avoided, to ensure that their failure is orderly, of limited dimensions and unlikely to thwart the continuous performance of the financial system's critical functions. In other words, the 'systemic' rationale for intervention, to which Sjöberg subscribes explicitly, apparently dictates the special treatment of banks both preventatively (through prudential regulation) as well as reactively (through active crisis management and a special insolvency regime, that is, an SRR).

On this account, the objectives of bank resolution (including resolution in the narrow sense of the formal SRR) are inherently different from those pertinent to other business entities. In Sjöberg's formulation, an SRR should serve two overriding goals: (a) the preservation of systemic stability, including a continuing performance of all critical banking functions;[35] and (b) the simultaneous maintenance of market discipline.[36] According to Sjöberg, the former goal is not difficult to achieve, at least as long as the state's financial position is strong—presumably because even deeply insolvent banks can be refinanced and/or recapitalised with taxpayers' money. This, however, may be a source of significant moral hazard, to the extent that the expectation of a state-financed bail-out reduces the incentives of bank managers and other stakeholders to behave prudently.

Sjöberg rejects the minimisation of costs to society and to the taxpayers as separate objectives, apparently on the ground that a successful resolution process achieving his two overriding goals necessarily entails least-cost solutions. Why exactly this is so, is not spelt out in detail. However, Sjöberg argues that placing undue emphasis on the absolute fiscal cost (costs to taxpayers) of resolution is wrong, since fiscal expenditure of any magnitude can be justified if it results in greater benefits (or greater reduction of costs, which amounts to the same thing) to society as a whole. One can agree that the objective of market discipline leaves no room for unnecessary transfers from taxpayers to bank stakeholders or for bank support packages that are not justified on an economy-wide cost-benefit analysis. The reverse, however, is not self-evident: even a parsimonious and well-calibrated expenditure of public resources in bank restructuring efforts can, nonetheless, include elements of subsidisation of the bank stakeholders and their risk-taking activities, thus negating Sjöberg's second goal.

This possibility raises a more fundamental question about the compatibility of the two objectives in the context of SRRs of the type under consideration. Is it truly possible to reconcile the strictures of market discipline with an SRR which prioritises, in the name of systemic stability and the uninterrupted provision of key financial services, the continuing survival, through mergers or restructuring, of banking institutions which have already proven unable to avoid failure (distress and/or insolvency)?

VI. THREE LEVELS OF BANK CRISIS MANAGEMENT?

Sjöberg distinguishes between three types of situations that an SRR might be intended to handle, namely: (a) individual failures of banks of no systemic

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[35] This raises the following question, which I do not intend to discuss here: What does it mean to preserve a 'functioning' financial system? Does this merely require the continuing supply of payment and account-related services to the depositing public? Or does it further involve a steady level of lending activity, so as to ensure the regular provision of liquidity to the real economy?

[36] Sjöberg recognises a subsidiary objective or, possibly, restriction of his proposed scheme, namely, that the SRR should allow 'banks without a viable business [to] be forced to close down', thus allowing 'a continuing development of the financial sector'. In fact, this is not a separate consideration, but a specific implication of the market-discipline principle.

importance; (b) individual failures of systemically important banks, which have not (yet) triggered a fully-fledged systemic crisis; or (c) fully-fledged systemic crises, engulfing substantial parts of the national, or even the international, banking industry. Apparently, for each type (or 'level') of failure, different considerations apply and the official response should be based on different principles.

For first-level failures, the key issues are the establishment of rules on depositor protection and the avoidance of regulatory forbearance. Sjöberg claims that SRRs calculated to handle first-level failures may prove insufficient for second-level events: due to the scale and complexity of the institutions involved, the latter demand much more complicated technical responses. For this reason, the SRR should be designed with the second level in mind. As for fully-fledged systemic crises, Sjöberg suggests that they cannot be handled through an SRR 'in the ordinary meaning' (which apparently covers only standing, rule-bound resolution methods supported by predetermined financial resources); additional tools will be needed. Indeed, in contrast to a first- or second-level situation, a third-level crisis is said to be 'non-insurable', in the sense that its resolution cannot rely on financial resources set aside in advance by way of industry-based levies and commitments (say, in the form of deposit insurance premiums or prefunded resolutions funds). Moreover, level three crisis management cannot count on private-sector participation, since in the midst of serious systemic disturbances it may be impossible to find suitable private investors (meaning, in effect, other banks with sufficient resources and willingness to take up additional risk) who will pick up the pieces of the distressed banks by contributing in their recapitalisation, acquiring them or taking over their operations. Thus, a crisis of systemic proportions will often necessitate extraordinary solutions, based on ad hoc political judgement, not legal norms. These will typically include the extension of large-scale discretionary financial aid by the state. In Sjöberg's own words, '[a] system that does not allow for state support in one or another form is not realistic'.

Based on this analysis, Sjöberg concludes that (a) the SRR's standing norms should be sufficient for resolving effectively and at an early stage second-level failures (isolated failures of large, systemically important institutions) and (b) they should not contain elements inconsistent with the parallel adoption of any ad hoc measures which might be considered necessary ex post in view of the factual circumstances of a third-level crisis. The second criterion is intended to avoid the need for a formal suspension of the SRR before special measures—including the provision of State aid to individual institutions or to the banking industry at large—can be implemented. The mandatory tools of the SRR should be able to operate in conjunction with a wide variety of state measures for the recapitalisation of the banking sector and/or the enhancement of its liquidity.

In my view, the three-level framework, while useful for the exposition of the diverse challenges posed by different types of banking crisis, is not sufficiently robust, so as to be able to inform the design or the operation of the SRR. As Sjöberg himself admits, it is often impossible to distinguish between the various levels; nonetheless, not only the mix of tools, but even the objectives of resolution change (if they are not entirely reversed) as we move from the second to the third level. Thus, a potentially drastic shift in the preferred resolution approach comes to depend on an obscure and imprecise criterion.

More specifically, the distinction between systemically important and other banks is not at all clear. Admittedly, the failure of a small bank is less likely to trigger systemic problems than that of a large one. In particular, in the former case the direct transmission of losses to other banks through various counterparty exposures will be of little consequence. On the other hand, even a small bank's failure can cause informational contagion, if it is perceived (either accurately or with informational 'noise') as indicative of industry-wide problems. Assuming (as many authors appear to believe, but I very much doubt) that pure (irrational) panics are possible in banking, it may even trigger a baseless loss of confidence in other banks. Interestingly, Sjöberg does not deny that any number of factors can render a bank 'systemically important':

> Difficulties in a bank have systemic implications in two cases, namely when the bank in itself is so large that its failure will create considerable disturbances to the functioning of the economy as a whole or when there is risk of contagion (when difficulties in one bank lead to problems in other banks).

If so, depending on the circumstances almost any institution may generate systemic concerns and it is not possible to determine beforehand which individual institutions are systemically important. Systemic importance thus becomes a question of context and judgement. But then, no true distinction can be drawn between the first and second levels. What is left, is a reasonable call for rules of sufficient sophistication, which so as to enable rapid, decisive and orderly handling of failures even of large and operationally complex (rather than 'systemically important') banking institutions.

For similar reasons, the distinction between second- and third-level crisis failures does not depend on the intrinsic characteristics of the failed institutions, but on the intervening fact of contagion—or, more precisely, on the presence, nature and degree of common problems, afflicting the total banking industry or large segments thereof. A third-level crisis cannot always be prevented by handling 'promptly and correctly' the initial distress of particular bank, because in this situation the troubles are not transmitted sequentially. Instead, common underlying causes affect many banks in parallel and almost simultaneously. Typically, fully-fledged systemic banking crises (including, by the way, the latest, global one) represent the final phase of macroeconomic imbalances and asset bubbles. In terms of policy response, they require measures of general applicability, aimed at the restoration of macroeconomic and financial stability and the normalisation of market conditions, including through the recognition and absorption of the bad-debt overhang. For this purpose, the state authorities (meaning, in this context, not merely the various administrative authorities performing the tasks of banking supervision, deposit insurance and bank resolution, but primarily the senior economic decision makers in the government and the central bank) will need to be involved in a major way.

Bank restructuring certainly has a role to play in the context of a systemic crisis, but it is not the first priority. In the midst of a financial crisis characterised by liquidity squeezes and non-performing asset markets, it is difficult to distinguish between the non-viable ('insolvent') banks and those whose fortunes have taken a turn for the worse because of the negative macroeconomic environment, but which are otherwise viable and fundamentally sound. The ambiguous condition of many banks, in particular due to extraordinary funding difficulties beyond each individual bank's control, as well as the prevalence of fire-sale prices for assets, which impedes an accurate valuation of bank portfolios, becomes a matter of contestation, impeding the restructuring efforts. Moreover, a policy of harsh enforcement and immediate restructuring may aggravate in and of itself the situation. In normal periods, the official policies may insist on strict conditions for lending of last resort, limits on the cover offered by deposit insurance systems, early intervention in distressed banks and rapid resolution, including through unforgiving treatment of bank shareholders and managers, or even junior creditors. Once a systemic crisis has erupted, however, the emphasis shifts to measures intended to forestall further contagion, prevent a collapse of monetary circulation and the payment system, stop runs, pacify the market participants and sustain the flow of liquidity from the financial intermediaries to the real economy. In the latter context, it often appears imperative for the state to validate all and sundry financial claims. A host of extraordinary policies, all marked by the ex post relaxation of the supposed rigours of market discipline, thus come into play: emergency liquidity assistance by the central bank, with few strings attached;[37] blanket guarantees in favour of depositors and other creditors; and even guarantees in relation to new assets and special-purpose vehicles for the management of impaired existing assets, which seek to reduce the asset-side-risks faced by the banks themselves and to protect them from excessive losses.[38] In extreme cases of massive withdrawals of bank deposit liabilities, a mandatory change of the contractual terms of deposits may be attempted, in the form of 'bank holidays' or administrative restrictions in the withdrawal of deposits ('deposit freezes'). Such interventions take place in the name of minimisation of the wider costs of the systemic crisis, which threatens to disrupt profoundly the

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[37] i.e. lending of last resort at low interest rates, with long periods for repayment and on relaxed collateral—exactly the opposite from Bagehot's celebrated formula of one and a half centuries ago. See W Bagehot, *Lombard Street: A Description of the Money Market*, 3rd edn (London, Henry S King & Co, 1873) 196–99.

[38] DS Hoelscher and S Ingves, 'The Resolution of Systemic Banking System Crises' in DS Hoelscher (ed), *Bank Restructuring and Resolution* (Basingstoke and New York, Palgrave Macmillan, 2006) 3–23.

operation of the real economy and the society that the financial intermediaries are supposed to serve.

Sjöberg rightly points out that the financial resources on which an SRR is supposed to rely (that is, the resources of the deposit insurance fund and/or the prefunded resolution fund, if such a fund exists, as well the resources that the private sector might be expected to commit) are bound to prove insufficient in the event of a systemic crisis. However, the SRR's tools of coercion may still prove useful and facilitate the implementation of the authorities' preferred response to the crisis. On this basis, Sjöberg recommends that the SRR should not rely exclusively on private solutions or pretend to disallow wider measures of state support.

Admittedly, in circumstances of systemic crisis an unduly restrictive SRR would have to be side-lined through special legislation. This could give rise to delays and uncertainties, which might worsen the developing crisis. It is less evident, however, that the suspension of the SRR per se would somehow weaken the state's hand in its negotiations with the banks' stakeholders, as Sjöberg fears, since the extraordinary legislation introduced to legitimise the crisis-related measures could always include equivalent coercive tools. In this case too, the main risk is not that the state lacks sufficient powers of coercion, but that it is unwilling to use them. In fact, in a systemic crisis the officials' bias towards forbearance becomes especially acute, for two reasons already mentioned above: first, because it may not be clear that the banks in distress are individually blameworthy and/or unviable; and second, because strict enforcement can be self-defeating, since it can increase the risk of contagion. The main problem, then, with systemic crisis management is not simply that it requires very large amounts of financing, which exceed the SRR's ordinary resources, but that it results in a wholesale relaxation of the insolvency constraint. In essence, this amounts to an almost complete reversal of the policy priorities of the SRR, since in an isolated bank failure (even that of a 'systemically important' institution) the strict enforcement of the balance-sheet constraints may dominate the choices of the resolution authorities (at least in the form of the least-cost-resolution principle), while in a systemic crisis the preferred resolution approach will typically be marked by disregard precisely for such constraints. In Sjöberg's terminology, the two objectives of the SRR do not operate concurrently: while in the first two levels (that is, when the stability of the whole system is not yet under direct threat) the primary goal of the resolution process will be the preservation of market discipline, as soon as we move into the third level the objective of restoring systemic stability takes over, not in conjunction, but largely as a negation of the former objective.

Since the point of transition from the one level to the other is imperceptible and inherently contestable,[39] mingling the 'norm' of individual bank resolution

[39] ibid 12, where the authors point out that the diagnosis of banking sector conditions in a systemic crisis is typically hampered by data limitations.

with the 'exception' of systemic crisis management is tantamount to building into the SRR conflicting objectives and open-ended tools. This will have negative consequences for the incentives of the resolution authorities. In particular, explicitly allowing the SRR's tools to be utilised in conjunction with discretionary financing operations involving public funds (in other words, with bail-out packages) will operate as an open invitation to the resolution authorities to consider a relaxation of their policy stance, by casually claiming that the threshold of systemic crisis has been crossed or is about to be crossed. Sjöberg argues that the availability of the SRR's coercive tools in the context of a third-level crisis will be beneficial, because it will reduce bank shareholders' room for negotiation. However, if the SRR's procedural framework is used in all cases, but the objectives (or, at least, the priorities) and thus the preferred outcomes remain open for consideration, depending on the level of crisis, the main effect will probably be, not to reduce the room for negotiation in third-level cases, but to increase it in first- and second-level ones. The reason is that a discretionary choice as to the general direction of the official intervention will always be possible, but will simply be disguised as a discussion about the potential systemic repercussions of strict enforcement under the circumstances. This will reduce the automaticity of the SRR's operation and open the road to negotiation and, ultimately, to forbearance.

From this viewpoint, to the extent that it is intended to discourage forbearance (a necessity for an SRR aspiring to an ex ante role as a 'governance tool'!), the SRR will need to focus exclusively on individual bank failures and its available options will have to be confined to the orderly but strict enforcement of the insolvency constraint.[40]

VII. IMMEDIATE ASSUMPTION OF CONTROL OVER FAILED BANKS: TRIGGER AND STAKEHOLDERS' RIGHTS

Sjöberg is on strong ground when he insists that the SRR should enable the resolution authorities to assume immediate and absolute control of failed banks. This is necessary both in order to preclude further deterioration of the situation and to ensure a more effective restructuring.

As a weak bank's net worth approaches zero, the shareholders and managers become increasingly risk-prone. Their incentives lead them to gamble for resurrection, because they have very little to lose and everything to gain by

[40] In Sjöberg's view, recent proposals place excessive emphasis on the handling of individual systemically important banks, e.g. through recovery and resolution plans, liquidity planning or CoCos, without taking into consideration that the proposed measures would not work well in a level three situation. This, however, is perfectly natural, since on Sjöberg's own account the SRR should be specifically directed to second-level situations! Even from the standpoint of the three-level distinction, it does not hold water to claim that an SSR should eschew principles and tools appropriate for handling level two situations, simply because these do not fit well with the discretionary bail-out or forbearance measures potentially required for crisis management in a level three situation.

speculating with the resources still left under their control. This tendency becomes even stronger once the net worth has become negative. The probability that the stakeholders' gamble will be successful is very low; but the ensuing losses can be monumental and can accrue in a very short period of time. To avoid this development, the legal rules should enable banking regulators to take early and full control of banks in distress.

An additional consideration is that, since the resolution (in the wide sense) of banks in distress does not necessarily entail their placement in formal insolvency proceedings, not even the expropriation of the old shareholders, the latter are interested in solutions that will preserve the value of their shareholdings to the maximum extent possible. In particular, they will insist on solutions that ensure the continuing operation of their institution without change of legal form or cancellation of the existing shares, preferably with the benefit of state financial support. Similarly, senior bank managers will strive to remain in their place. To achieve this result, such stakeholders will act strategically, utilising any available legal means. The implication is that, insofar as certain solutions can be lawfully implemented only with their support or, at least, consent, old shareholders will tend to withhold such support, in expectation of a better deal. Knowing that the failure of their institution may cause embarrassment to the regulatory authorities and political cost to the government will play in their favour. Significantly, at this stage the old stakeholders will have a perverse incentive to amplify the scale of systemic risk posed by their institution, in an attempt to hide its specific shortcomings within a picture of market-wide problems and to force the hand of the regulators in the direction of a bail-out package on terms generous to them (retention of value in a recapitalised bank, retention of their position in its governance). For this reason, the old stakeholders should not be left in control, nor be allowed to act as veto players in relation to the restructuring decisions of the resolution authorities. Instead, to be effective, the SRR must enable the resolution authorities to pursue without obstruction the restructuring and continuation of a failed bank's operations, where this is appropriate, including through the mandatory sale of its business as a going concern (purchase-and-assumption transactions) or of the legal entity itself, or through the write down of share capital.

Sjöberg considers that, for this purpose, the assumption by the resolution authorities of voting rights will be equally effective with the direct assumption of ownership over the shares; it will also be preferable, as less intrusive to the incumbent shareholders' rights pending verification of the situation and precise valuation of the stakes.[41] Retention of the underlying title to the shares by the old shareholders makes possible a reversal of the situation and their restoration to

[41] Sjöberg adds that most legal systems require more rigorous legal proceedings for a final and involuntary transfer of ownership over the shares than for a temporary suspension of voting rights; but this distinction would only be acceptable insofar as such suspension does not include a power of the authorities to sell or cancel the shares. Otherwise, the legal protections should be no less demanding.

their full rights in the event of a successful resolution of a non-balance-sheet-insolvent but nonetheless distressed bank. In addition, it enables the old ownership's participation in capital injections or the trading of their shares. In theory, this can facilitate the implementation of private solutions. However, it creates the risk that certain but not all old shareholders (or their successors) will exercise their pre-emption rights and participate in a potential recapitalisation, thus failing to raise adequate funds for recapitalisation but still precluding a clean break with the past through an effective and complete change of ownership. The resulting delays and uncertainties can dissuade new investors from taking over failed banks. In any event, the difference becomes theoretical, when the restructuring involves the mandatory sale of the business or of the legal entity. Sjöberg himself contemplates the utilisation of tools outside the system of corporate actions of company law, such as compulsory write down of share capital or debt. A complete expropriation of the shareholders is necessary in this case, both because we are already in the field of insolvency law and because it would be a gross violation of the order of priorities to write down debt without first exhausting the resources of the shareholders.

Sjöberg suggests that the immediate assumption of control by the resolution authorities is especially important in the case of banks suffering from underlying insolvency, while those subject to temporary liquidity problems, but otherwise viable could receive emergency liquidity assistance (ELA) from the central bank and survive while remaining under the control of the old stakeholders. The classification of bank problems as ones of liquidity, however, is the typical way in which forbearance is exercised: the authorities turn a blind eye to the underlying problems of the distressed banks (in particular, to the presence of actual and potential non-performing loans) and extend new financial resources to them in the form of loans (liquidity assistance), without seeking to take over their control. Thus, the underlying problems are not resolved (or even acknowledged) and the longer-term position remains problematical.

This raises the issue of the trigger for official intervention under the SRR. This can take a variety of forms, including that of balance-sheet insolvency or negative net worth, breach of specific capitalisation thresholds even though the bank's net worth is still positive, or inability to repay debts as they fall due, that is, cash-flow insolvency. A bank's 'temporary' liquidity problems may amount to insolvency in the latter sense, which has a long and dominant pedigree in general insolvency law. From an economic viewpoint, too, a 'solvent' bank's prolonged inability to ensure refinancing from the market on reasonable terms places in question its viability. Thus, the problem of definition of the SRR trigger is by no means a secondary one or subsidiary to that of avoidance of delay. An imprecise or non-objective trigger may well result in the worst of all possible worlds: under its authority, the authorities' propensity towards forbearance may be combined with arbitrary or discriminatory enforcement against particular viable banks. Consequently, the legal specification of the trigger is prior to the discussion of the immediate effect or the particular tools of the official intervention.

Assuming that, to avoid perverse incentives and increase the effectiveness of the intervention, the trigger kicks in before the threshold of negative net worth has been reached, the economic claims of existing shareholders will need to be given full recognition.[42] More generally, to avoid delay and uncertainty, the assumption of control by the authorities and any ensuing restructuring actions under the SRR should not be subject to contemporaneous legal challenges. Nonetheless, this emphasis on immediate and decisive action raises the prospect of irreversible effects being produced, occasionally on grounds which are later found to be mistaken. The need for guarantees or protections for property rights thus becomes a key consideration for the SRR's design.[43]

Sjöberg relies on requirements of ex post valuation and compensation as a sufficient substitute for the lack of contemporaneous legal remedies. Even though this does not guarantee the full restoration of the pre-existing situation in the event that a bank is proven to have positive net worth and/or to be viable, it is a reasonable compromise position.

VIII. THE EX ANTE PERSPECTIVE—AND WHY IT FAILS

For Sjöberg, a well-designed SRR can serve as a 'governance tool', curtailing moral hazard and thus contributing to the prevention of future crises. An SRR's propensity to serve in this manner is evidently linked to its form, that is, to its incorporation in a set of standing, preannounced rules. If the rules prescribe in advance and in a credible way particular outcomes, these will be taken into account by private actors, change their incentive structure and influence their actual behaviour. In contrast, an improvised, ad hoc response to a banking crisis which has already occurred would lack the necessary generality, permanence and constancy of a rule-based system. For this reason, in principle it would be less likely to influence future behaviour.

For an SRR to operate effectively in this manner, it must satisfy two conditions, namely, that (a) the rules prescribe the eventual outcomes in a relatively determinate way, and (b) the rules are credible. In view of Sjöberg's substantive arguments, either the first or the second of these assumptions cannot hold in a system of the type that he defends.

Sjöberg points out that one of the major problems with banks which are deemed to be systemically important is that their debt holders operate on the assumption that the state will not permit them to suffer losses in the event of a crisis. This dampens market discipline and results in debt financing which does

[42] See E Hüpkes, 'Special Bank Resolution and Shareholders' Rights: Balancing Competing Interests' (2009) 17 *Journal of Financial Regulation and Compliance* 277–301.

[43] ibid; and V Babis, 'Bank Recovery and Resolution: What About Shareholder Rights?', University of Cambridge Faculty of Law Legal Studies Research Paper No 23/2012 (September 2012).

not take into consideration the underlying risks faced by the bank and is, accordingly, too plentiful and too cheap.

Indeed, the support that the state can extend to failed banks is not confined to direct forms of subsidised financing (say, in the form by way of lending of last resort, asset guarantees or capital injections), whose aim is to keep the banks afloat and to pre-empt the commencement of administrative or insolvency proceedings. State support can be more discrete and involve the provision of explicit or implicit protection, not to the banks' themselves, but to their debt holders. In the case of retail depositors, such protection is offered openly and officially in advance, by means of industry-wide deposit insurance schemes. These are not merely tolerated, but actually celebrated and promoted on a mandatory basis as necessary tools for the avoidance of contagious depositor runs on banks. Insofar as other classes of claimants (interbank creditors, senior bondholders and even junior or subordinated bondholders) are concerned, the state's protection is less certain and may offered with reluctance. Ex ante, its very existence may be left in doubt, so as to discourage reliance on an eventual intervention by the state (or the central bank); this is the policy of so called 'constructive ambiguity'.[44] Nonetheless, regardless of any official protestations in favour of market discipline, potential bank debt holders will contemplate the possibility that the state will intervene in their favour in the event of bank failure. Indeed, the probability of intervention will appear to them especially high, when the bank is question is large or appears to be of systemic importance ('too big to fail'). This will influence their decision on whether to extend credit of the particular order of priority to the bank and at what price.

In each and every case, the existence of an implicit state guarantee (actual, perceived or probabilistic) entails for the various claimants a reduction of their expected losses and a transferral of the bank's underlying risk of default from them to the taxpayers. What should be absolutely clear is that the benefit does not accrue only to the debt holders, but also to the debtor banks (whose funding costs fall as a result) and indirectly to their shareholders and managers. The precise distribution of benefits is uncertain and may change over time, with banks and their shareholders benefiting in normal times, while debt holders gain primarily through the eventual satisfaction of their claims during the crisis.

It is exceptionally difficult to pinpoint the subsidy that banks derive from the implicit guarantees offered by the state in relation to the claims of their debt holders, to put a realistic price on the subsidy or to compare costs and benefits from the state intervention. Thus, widely divergent measurement approaches have been used to calculate the implicit funding subsidy to large banks (SIFIs), primarily

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[44] Sjöberg expressly, but oddly, rejects constructive ambiguity, on the basis that it impedes an accurate valuation by existing bank stakeholders and potential new investors of the risk of losing money in the context of a subsequent rescue operation by the state, thus discouraging their participation in the bank's refinancing efforts. However, this argument would only hold in the case of a bank which is already weak and seeks recapitalisation; before the bank reaches this point, the policy will not be counterproductive—although it may well be ineffectual, if the bank's stakeholders discount the possibility of expropriation for the reasons discussed presently.

by comparing the observed cost of funds for such institutions to counterfactual estimates of funding costs in the absence of the state intervention,[45] but also by making deductions from various financial market prices (such as banks' bond prices, equity prices, prices of options on equity).[46] For the UK, the implicit funding subsidy provided by the government to the financial sector during the global financial crisis by way of expected protection of the claims of failed bank debt holders (but not of their shareholders, who suffered a brutal dilution of their stakes) has been variably estimated to be worth anything between £6 billion and £130 billion![47] In any event, the overall effect of state guarantees is undoubtedly very substantial and operates in totally predictable ways: by subsidising risk taking and operating as a free form of insurance against losses (defaults, unavailability of funds, haircuts on claims, etc.), the guarantees reduce the banks' cost of funds, change their financing structure (in favour of debt as against equity financing), lead to an increase in the overall size of their activities and, simultaneously, undermine market discipline. In short, as every form of unpaid-for insurance cover (or, to be more precise, insurance cover paid by a third party), they create moral hazard.

To counteract the moral hazard generated ex ante by the expectation of state-organised rescue operations, Sjöberg proposes that the SRR should promise to inflict ex post pain on debt holders, by depriving them of value through debt write downs. Sjöberg goes one step further than the more familiar—as well as trivial—proposed remedy for the problem of moral hazard, namely, the infliction of losses on shareholders, including through their outright expropriation. In Sjöberg's view, such losses on shareholders are an integral part of the SRR: the authorities cannot proceed to write down debt without first writing down equity, since this would be contrary to fundamental priority rights. In reality, however, his proposals are not totally respectful of priority rights, insofar as they allow for junior debt holders' forcible participation to the cost of bank recapitalisation through write downs and/or debt-to-equity conversions in conjunction with a partial (rather than complete, as the order of priorities would require) expropriation of the old shareholders.

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[45] D Baker and T McArthur, 'The Value of the "Too Big to Fail" Big Bank Subsidy', CEPR Issue Brief, September 2009; Z Li, S Qu and J Zhang, 'Quantifying the Value of Implicit Government Guarantees for Large Financial Institutions' (Moody's Analytics Quantitative Research Group, January 2011); K Ueda and B Weder di Mauro, 'Quantifying Structural Subsidy Values for Systemically Important Financial Institutions', IMF Working Paper No WP/12/128 (May 2012) available at www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf.

[46] AJ Warburton, D Anginer and V Acharya, 'The End of Market Discipline? Investor Expectations of Implicit State Guarantees' (January 2013) available at www.ssrn.com/abstract=1961656; Oxera Consulting, 'Assessing State Support to the UK Banking Sector' (11 March 2011) available at www.oxera.com/Publications/Reports/2011/Assessing-state-support-to-the-UK-banking-sector.aspx; J Noss and R Sowerbutts, 'The Implicit Subsidy of Banks', Bank of England Financial Stability Paper No 15 (May 2012) available at www.bankofengland.co.uk/publications/Documents/fsr/fs_paper15.pdf.

[47] See Bank of England, *Financial Stability Report* No 28 (December 2010) 51; Oxera Consulting, 'Assessing State Support to the UK Banking Sector' (n 46); Noss and Sowerbutts, 'The Implicit Subsidy of Banks' (n 46).

This aspect of the SRR could be fixed, but there is a more general issue of internal contradictions. It is questionable, whether the law establishing the SRR can, or should, insist on strict enforcement of the solvency constraint. Sjöberg himself insists that the infliction of losses on debt holders (say, by activating debt-to-equity conversion, so called 'bail-in', mechanisms) can be a major source of contagion. He considers that this renders bank resolution very complicated. This, however, is not a matter of technical complexity, as much as one of conflicting (or time-inconsistent) objectives. Ex ante, to contain moral hazard, the law may mandate strict enforcement, including through full expropriation of shareholders and the allocation of their fair share of losses on debt holders, always following the established order of priorities, if a bank has negative net worth. Ex post, this policy may be found to be at loggerheads with the authorities' desire to ensure a soft landing. In other words, the probable negative second-round consequences of inflicting losses on debt holders create a cleavage between the two postulated objectives of resolution policy, since the first objective (preservation of systemic stability) now appears to be better served by rescuing the debt holders—a policy openly contrary to the second objective (market discipline).

Assuming (and this is a very bold assumption) that the conflict should be resolved ex ante in favour of market discipline, one still wonders whether a policy requiring the unforgiving treatment of bank stakeholders can be credibly entrenched through the enactment of an appropriately designed SRR.

Sjöberg rightly insists that a mostly discretionary regime of bank insolvency, insufficiently defined in the law and relying instead on ad hoc solutions, can hardly be justified on the basis that banking crises require 'flexible' and practical responses. Absent clear legislative signposts and mandatory intervention tools, government officials and regulators may be tempted to grant support to distressed banks on unduly favourable terms. At the same time, the lack of a procedure whereby bank managers and shareholders can be forcibly removed from their governance role may encourage them to hold out for better terms in negotiations with the Government. From this perspective, the legal certainty achieved through the enactment of an SRR is commendable, not only because it provides reassurance against the risk of unfair treatment, but also because it changes the dynamics of such negotiations and prevents unwarranted wealth transfers to bank stakeholders acting de facto as veto players. In particular, the legislation can strengthen the hand of the resolution authority by vesting it with wide powers of intervention, thus discouraging hold outs by stakeholders. It is less evident that the SRR can bind the resolution authority itself to a policy of strict enforcement.

Even when the law arms them with wide powers, thus enabling them to eschew negotiation with banks' stakeholders, the officials in charge of bank resolution may display a penchant for delay and forbearance. Banking regulators are known frequently to err on the side of forbearance. Their subjective incentives may predispose them to underestimate the scale of banking problems—especially if these have simmered under their watch—and to prefer crisis-management tools that maintain in life failed banks and/or cause the least disruption to their operations over more aggressive and conflictual forms of resolution. From their viewpoint, the need to minimise the expenditure of public funds will not necessarily be the determining consideration. The law may prescribe that the resolution authority selects the resolution method by applying a 'least-cost' criterion; however, the cost-benefit analysis necessary for this purpose will almost always be ambiguous and amenable to manipulation. Systemic concerns and societal costs may be invoked, as well as the potential upside of forms of rescue where the state recapitalises directly the distressed bank. Even the crossing of the threshold that the law sets for the operation of the SRR (e.g. balance-sheet insolvency or critical undercapitalisation) may not be crystal clear, since in times of crisis the valuation of distressed assets will give rise to controversies, with many people claiming that current market values cannot determine a bank's viability, because they are driven by the prevailing liquidity problems and significantly overstate the true extent of losses.

Moreover, SRRs do not exhaust, either conceptually or in practice, the legal options relating to distressed bank resolution. Other forms of state intervention are always possible. Implicitly or even explicitly, the SRRs leave room for the provision to failed banks of public financial assistance in non-predetermined forms, for instance, in the form of exceptional financing packages, sanctioned, if necessary, by special legislation or budgetary appropriations. In fact, Sjöberg himself considers wider schemes of public financial assistance unavoidable in the case of fully-blown systemic crises. Thus, even if, within its four corners, the standing legal framework of the SRR excludes negotiation between bankers and the state, the possibility of negotiated solutions *outside* the SRR is left open. This weakens the law's apparent commitment to the expropriation of existing stakeholders in the event of failure.

In practice, market participants will have good reasons to suspect that bank bail-outs can still occur—indeed, that they are quite likely to take place, especially in relation to larger institutions or more profound disturbances. They will anticipate the ex post relaxation of the strict-compliance postulate of the SRR—and this is bound to dent its supposed ex ante effectiveness as a 'governance tool'. Moreover, one should remember that, through its deposit insurance component, the SRR involves protection from losses for at least one class of debt holders, namely, depositors. This further reduces the scope of market discipline. Taken in its entirety, the bank resolution system is inherently bound to operate as a source of moral hazard. The precise extent of this effect will depend on the coverage ratio of the formal deposit insurance system and the credibility of the SRR's threat to allocate losses to other stakeholders. The latter will depend in part on the automatic or discretionary character of the resolution options; but it will also be in an inverse relationship to the severity of future bank crises.

In short, the SRR cannot be a truly effective 'governance tool' or a sufficient method for imposing discipline in the banking market. At most, it can provide a procedural framework for orderly resolution coupled with a set of substantive pointers, whose effect is to confine and structure the exercise of discretion by the resolution authorities and to increase the risk of expropriation for stakeholders in the event of failure (but not to turn it into anything like a certainty). By losing their veto power over the outcome of negotiations aimed at avoiding liquidation, the latter may be in a weaker position than in the past. But they can still attempt to influence developments in the direction of a broad bail-out policy. Perversely, a strict SRR may give them incentives to *increase* the dimensions of a systemic crisis (so as to discourage the appearance of willing bank buyers and make more attractive politically the provision of blanket guarantees, which also cover junior debt holders and even shareholders).