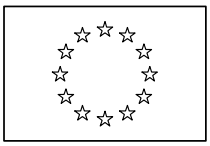

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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE EUROPEAN COURT OF JUSTICE AND THE EUROPEAN CENTRAL BANK

An EU Framework for Cross-Border Crisis Management in the Banking Sector

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(Text with EEA relevance)

1. INTRODUCTION

The recent crisis has exposed the EU's lack of an effective crisis management for cross-border financial institutions. In autumn 2008, Member States agreed to take the necessary action to recapitalise and guarantee banks, and this unprecedented action was coordinated at European level on an ad-hoc basis. The measures were necessary in the exceptional conditions that afflicted the financial system.

National approaches differed, but broadly speaking authorities either used public money to bail out banks, or ring-fenced a bank's assets within their territory and applied national resolution tools at the level of each entity rather than at the level of the cross-border group. This raised the risks of reduced confidence, competitive distortions, high bail-out costs carried by taxpayers[1] and legal uncertainty. The events surrounding the failures of Fortis, Lehman and Icelandic banks in the recent financial crisis illustrate how damaging the absence of an adequate resolution framework can be for financial stability of the whole EU banking system.

There is wide recognition that the EU needs to build a resolution regime that would ensure that all competent authorities effectively coordinate their actions and have the appropriate tools for intervening quickly to manage the failure of a bank, with the objective of minimising the need for States to resort to the kind of exceptional measures that have been necessary in this crisis.

The European Commission is proposing a fundamental reform of the regulation and supervision of financial markets to address the failings exposed by the banking crisis.[2] Measures have already been taken to upgrade deposit insurance, strengthen capital requirements and reform the EU supervisory infrastructure: measures that are essential for a more robust framework for prudential supervision and financial stability.

However, the reforms, to date, must be complemented by a clear framework that will, in future, enable authorities to stabilise and control the systemic impact of failing cross-border financial institutions. Europe needs a strong regulatory framework that covers prevention, early intervention, bank resolution and winding up (see table below).

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[1] Such bank re-structuring measures are considered in the context of EU rules on state aid. They fall outside the scope of this Communication, and are already the subject of Commission guidelines on recapitalisation, the treatment of impaired assets and rescue and restructuring aid to banks.

[2] See the Commission's Communication to the Spring European Council, 4th March 2009: http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_en.pdf.

- The Larosière report concluded that "*The lack of consistent crisis management and resolution tools across the Single Market places Europe at a disadvantage vis-à-vis the US and these issues should be addressed by the adoption at EU level of adequate measures*".[3] This critical lacuna must now be addressed.

- The European Council of June 2009 concluded that work must be advanced to build a comprehensive cross-border framework for the prevention and management of financial crises.

- At the Pittsburgh summit on 25 September, G20 Leaders committed to act together to *"...create more powerful tools to hold large global firms to account for the risks they take"* and, more specifically, to *"develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future"*.

An EU resolution framework for cross-border banks is also a vital complement to the new supervisory architecture that the Commission is proposing.[4] The new European Systemic Risk Board will provide an early warning system for system-wide risks, while the new European Banking Authority will have an important role in coordinating supervisory responses and channelling information as well as ensuring that there is an appropriate follow-up to risk warnings. These new arrangements cannot achieve their objectives unless national authorities can take effective measures at the level of banks to deal with failure and prevent systemic contagion.

2. PURPOSE AND STRUCTURE OF THIS COMMUNICATION

2.1. Purpose

The Commission considers that changes are needed to make possible effective crisis management and resolution or orderly winding up of a failing cross-border bank.[5] The main focus is on deposit-taking banks, which play a unique role as providers of credit, deposit-takers and payment intermediaries. This Communication considers measures to deliver two distinct, but connected objectives.

The first objective is, to ensure that all national supervisors have adequate tools to identify problems in banks at a sufficiently early stage and to intervene to restore the health of the institution or group, or prevent further decline. This will require amendments to the supervisory regime on bank capital. Those core amendments might also be accompanied by a framework to enable asset transfers between group entities as a means of financial or liquidity support before the problems of particular group entities become critical.

The second objective is to make it possible for cross-border banks to fail without serious disruption to vital banking services or contagion to the financial system as a whole. This will mean the development of an EU resolution framework as well as measures to address the

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[3] See Larosière report, p. 34: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

[4] See Commission's new legislative proposals on financial supervision, 23 September 2009: http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package

[5] This Communication is accompanied by a staff working document which provides further details in relation to specific aspects of the potential regime.

obstacles to effective cross-border resolution that arise from the territorial and separate entity approach to insolvency, and arrangements for financing such resolutions, including the sharing of any direct fiscal costs by Member States.

2.2. Structure

The Communication covers three areas.

1. **Early intervention** (section 3), covering actions by supervisors aimed at restoring the stability and financial soundness of an institution when problems are developing, together with intra-group asset transfer between solvent entities for the purposes of financial support. These actions would be taken before the thresholds conditions for resolution are met, and before the institution is or likely to become insolvent. The new European Banking Authority could play a role in coordinating supervisory early intervention in a cross-border group.

2. **Resolution** (section 4), covering measures taken by national resolution authorities to manage a crisis in a banking institution, to contain its impact on financial stability and, where appropriate, to facilitate an orderly winding up of the whole or parts of the institution. These measures take place outside the framework of banking supervision, and may be taken by authorities other than supervisors, although it is by no means precluded that supervisors might be involved.

3. **Insolvency** (Section 5), covering reorganisation and winding up that takes place under the applicable insolvency regime.

Although these measures are – for the purposes of discussion - presented as conceptually distinct, they do not necessarily constitute separate and sequential 'phases' of a crisis. In practice, there may be considerable overlap between resolution and insolvency, in particular, and supervisory early intervention may move rapidly into resolution measures.

2.3 Interaction with other EU measures

These measures are an important part of the wider EU regulatory system and initiatives to increase its resilience, as explained in the chart below.

	Going concern supervision/Crisis prevention	⇦ Scope of the Crisis Management Communication ⇨		
		Early intervention	Bank resolution	Insolvency framework
Current situation	Capital Requirements Directive 3 pillar approach (CRD) Colleges National authorities Committee of European Banking Supervisors (CEBS) Stress testing	CRD (Art. 130 + 136) Colleges Emergency Liquidity Assistance by National Central Banks (NCBs) 2008 MoU	2008 MoU – determines who (e.g. finance ministries, NCBs) coordinates actions with other competent authorities (coordination via cross-border stability groups)	Winding up Directive: Winding-up of a cross-border branches takes place under insolvency procedures of country of parent bank. Winding up of cross-border subsidiaries takes place according to procedures where subsidiary is licensed.
Possible changes for consideration	Establish European Systemic Risk Board (ESRB) and European Banking Authority (EBA) Leverage ratio Management of risks (remuneration structures) Quantity and Quality of capital Enhanced capital requirements Supervision of liquidity Preparation of Wind-down plans	European Banking Authority New powers towards bank management Joint assessment framework Restoration plans Asset transferability framework Expanded common tools for supervisors (CEBS) Clarify home/host branch supervision (Art. 33 CRD)	New bank resolution tools New framework for cooperation Broader changes to the legal framework in support of new bank resolution tools Mechanisms to finance cross-border resolutions (including possible role for DGS) Application of wind-down plans	Facilitate integrated winding up of a group: – Coordination framework for insolvency proceedings – Lead insolvency administrator – Integrated resolution by a single authority – Asset transfers under post commencement financing

3. EARLY INTERVENTION BY SUPERVISORS

3.1. Early intervention tools

Some elements of a framework for early intervention by supervisors already exist under the current prudential framework for banks in so far as it specifies a minimum set of measures which must be available to supervisors to address failures by credit institutions to meet the requirements of that Directive.[6] These include requiring the institution to increase its own funds above the minimum level specified in the Directive; strengthen its internal organisation and governance arrangements; apply specific provisioning policy; restrict its business or operations; or reduce the risk inherent in its activities, products or systems. Such measures leave control of the institution in the hands of the management, and do not necessarily represent a significant interference with the rights of shareholders or creditors. Recently agreed changes to the Capital Requirements Directive ('CRD')[7] will require consolidating supervisors to plan and coordinate joint assessments, exceptional measures, contingency plans and communication to the public in emergency situations.

However, significant gaps remain which might be addressed with the following additional measures:

- harmonised powers for supervisors to require the preparation in appropriate cases (for example, systemically important financial institutions) of " firm- specific contingency and resolution plans" (sometimes called "living wills") detailing how an institution and its

6 Article 136 of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p. 1).

7 Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast). This has recently been amended under the CRD 2 proposal: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008PC0602:EN:NOT

business might be dismantled and wound up rapidly and in an orderly manner – the need for such plans is currently discussed by the G-20;

- promoting good governance within financial institutions in order to make it simpler and easier to handle a future crisis if and when it occurs;

- the powers - not currently conferred on all national supervisors - to require the submission of a group restoration plan, to change the management of a bank, or to appoint a representative with the particular objective of restoring the financial situation of an institution;

- common indicators or thresholds, and an agreed terminology between EU supervisors, which would clearly define when and how intervention in a cross-border bank should take place;

- the review of supervision of cross-border branches in light of shortcomings in the cooperation arrangements between home and host authorities and concerns about the powers of the host State to intervene effectively in emergency situations.

There is clear evidence from the recent past that the supervisory framework has not been sufficiently robust and that incentives have been lacking to support efficient coordination of supervisory measures aimed at restoring a cross-border group.

Questions[8]

Which additional tools should supervisors have in order to address developing problems?

How should their use be triggered?

How important are wind-down plans ("living wills") as a tool for crisis management?

3.2. Intra-group asset transfers

The transfer of assets as a means of intra-group financial support could assist groups in managing liquidity positions and in some cases could help stabilise entities in a developing crisis.

- There is currently no EU authorisation regime for asset transfers and EU legislation does not provide a general framework of terms and conditions for transfers.[9] In principle, in all Member States asset transfers must be made for fair consideration, irrespective of whether they are between affiliated or unconnected entities. However, the way that this principle is expressed and applied varies between Member States.

- Transfers of assets that are not made on purely commercial terms may detrimentally affect creditors and minority shareholders of the transferor. Such transfers may be subject to

[8] More detailed questions on this and the other sections in this Communication are to be found in the accompanying staff document.

[9] Recital 52 of Directive 2006/48/EC only specifies that the management of exposures should be carried out in a fully autonomous manner, in accordance with the principles of sound banking management, without regard to any other considerations.

challenge from minority shareholders or creditors, and directors may be exposed to civil or criminal liability.[10]

These issues may prevent actions that might be in the best interests of groups, and of cross-border groups in particular. Introducing a concept of 'group interest' for banking groups might be a way of underpinning transfers and addressing the risks of liability for directors. A limited concept of the interdependence and mutual interest of group companies might be worth exploring, whereby transfers would be permitted if specified conditions were satisfied. However, the impact of any such proposal on the principle of limited liability and the separate legal personality of group entities needs to be considered carefully. It would also be important to design adequate safeguards to prevent the possible misuse of asset transfer for criminal purposes.

It may also be appropriate to back such a regime with modifications to insolvency law to provide appropriate safeguards, such as a priority ranking for the transferor in the event of the insolvency of the transferee.

Is the development of a framework for asset transfer feasible? If so, what challenges would need to be addressed?

What safeguards for shareholders and creditors are needed?

4. BANK RESOLUTION

4.1. Why is EU action on bank resolution needed?

Differences in national frameworks

Existing EU measures aimed at resolving a failing bank are minimal in scope and substance. They address only supervisory intervention and the mutual recognition of insolvency proceedings for cross-border bank *branches*. Directive 2001/24/EC on the reorganisation and winding up of credit institutions ('the Winding-up Directive') requires that any reorganisation or winding up of a credit institution with branches in another Member State is initiated and carried out under a single procedure by the relevant authorities, and in accordance with the national insolvency law, of the home Member State of the institution. Cross-border banking groups, composed of a parent company with *subsidiaries* in other Member States are not covered by this Directive.

Subsidiaries are the predominant form of cross-border banking business in Europe, holding assets of almost € 4 trillion.[11] In the absence of any EU measures, therefore, the management of crises is almost entirely governed by national regimes which can be significantly different.[12] For example, in some Member States the relevant powers derive from a specific resolution or insolvency regime for banks, while in others only the general corporate

[10] 14 November 2008 Commission services report on asset transferability, see ttp://ec.europa.eu/internal_market/bank/docs/windingup/rep141108_en.pdf

[11] Assets held by cross-border subsidiaries (2006), Source ECB.

[12] DBB Law "Study on the feasibility of reducing obstacles to the transfer of assets within a cross border banking group during a financial crisis and of establishing a legal framework for the reorganisation and winding-up of cross border banking groups", 2008.

insolvency regime is available. The powers to manage cross-border bank crises are conferred on a range of different domestic authorities including banking supervisors, central banks, government ministries, courts or insolvency officials and in some cases deposit guarantee schemes. The extent of powers and the conditions governing their use also vary according to each national system.

Effective cross-border resolution is made more difficult if the measures available under national law or the procedural requirements for certain corporate actions differ. As a basic example, if one national authority has the power to transfer assets to a third party purchaser by executive order, while another cannot do so other than by judicial proceedings, a rapid and coordinated intervention by those two authorities to deal with affiliated banks or assets in their respective jurisdictions is likely to be very difficult.

The stage at which resolution measures can be taken may also be crucial. Not all national authorities have the power to stabilise and reorganise an ailing bank before the formal point of insolvency (as defined in national law) is reached, and the lack of harmonised threshold conditions which trigger such powers may prevent coordinated action in relation to a cross-border group. This is further discussed in Section 4.4.

While this diversity is not necessarily a problem if the operations of troubled bank are entirely national and the measures comply with State Aid rules, it will certainly hamper effective coordinated action in respect of a banking group operating in several jurisdictions.

Incentives for ring-fencing of national assets

In their responses to this crisis, Member State authorities have tended to ring-fence national assets of a cross-border group and apply national resolution tools at the level of each entity rather than seek a group-wide solution. However ring-fencing local assets may often hinder rather than help resolve a problem in a cross-border group. There will be cases where such actions result in increased losses to the group as a whole.

Member States' incentives to co-ordinate and refrain from ring-fencing national assets during a cross-border crisis are limited by their need to protect the interests of national stakeholders (including creditors, taxpayers and the deposit guarantee scheme). This fundamental obstacle to cooperative resolution of a cross-border group is, inter alia, rooted in the territorial nature of insolvency law. If insolvency law is national, domestic authorities have a legitimate – as well as a strong political – interest to ring-fence the national assets of an ailing bank in order to protect national deposits and maximise the assets available to the creditors of the national entity.

However, any agreement on limiting the rights of Member States to ring-fence the local assets of a cross-border banking group will depend critically on the existence of adequate, fair and legally compliant arrangements[13] between Member States for burden-sharing of any subsequent losses that a banking group as a whole - including its foreign subsidiaries – might incur. Such arrangements would not only support crisis management, but could also assist crisis prevention by reinforcing incentives for co-operation among public authorities. In particular, trust and confidence in cooperation arrangements must be underpinned by the

[13] Financial support for resolution measures would almost certainly engage EU rules on State aid, and any such arrangements would therefore have to comply with those rules.

assurance that the costs resulting from a cross-border resolution can be fairly shared between the various stakeholders. This is discussed in Section 4.8 of this paper.

4.2. Objectives of a bank resolution framework

The different national approaches to bank resolution currently have varying objectives. Corporate insolvency laws typically have two principal objectives: a fair and predictable treatment of creditors and the maximisation of assets available to satisfy creditors' claims. By contrast, in a specific regime for bank insolvency, public policy objectives such as financial stability, the continuity of services and the integrity of payment systems, may take priority. Agreement on a common set of objectives will determine and shape the nature of a new EU framework.

A European framework for bank resolution must therefore be based on agreed and common objectives which should ensure that losses fall primarily on shareholders and junior and unsecured creditors rather than on governments and taxpayers. This is essential for the avoidance of moral hazard which arises from perceptions that banks that are too big or too interconnected to fail and are likely to be rescued by public financing. The overriding policy objective is to ensure that it should always be possible – politically and economically – to allow banks to fail, whatever their size.[14] That overriding objective is unlikely to be achieved unless the resolution framework is able to ensure the protection of (insured) depositors and the continuity of banking and payment services, and generally to manage the systemic impact of a bank failure by minimising contagion and providing the necessary legal conditions for an orderly winding up.[15]

What should be the key objectives and priorities for an EU bank resolution framework?

4.3. What resolution tools are needed?

National approaches to bank resolution fall broadly into two categories: those that operate under general corporate insolvency law, including administration and those that have a special regime for banks. In both cases, the rules are limited to national banking operations. They do not apply extra-territorially.[16] Special regimes can either take the form of a general insolvency regime adapted to banks, or a set of dedicated resolution tools specifically adapted for failing banks. Dedicated resolution tools may include powers to transfer the whole or part of the assets and liabilities of a failing bank to another private sector entity (an assisted or unassisted merger effected by national authorities) or a 'bridge bank'; the power to cleanse the balance sheet of the failing institution by transferring non-performing loans and 'toxic' or difficult-to-value assets to a separate asset management vehicle (or 'bad bank'); and nationalisation.

Within this broad distinction, further differences exist. Some national systems favour a graduated approach while others are geared towards rapid emergency intervention. The first tends to apply from an earlier stage and is designed to encourage shareholders' consent to restructuring measures: the first step is often to replace the management with an

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14 See G20 leaders' statement, Pittsburgh, 24-25 September 2009, http://www.pittsburghsummit.gov/mediacenter/129639.htm

15 On 15 September 2009 the Financial Stability Board issued a press statement announcing that it was setting in train a work programme to address the moral hazard risks and other challenges posed by systemically important institutions. http://www.financialstabilityboard.org/press/pr_090915.pdf

16 However, reorganisation or winding-up measures falling within the scope of Directive 2001/24/EC apply to the *branches* of a credit institution (but not its subsidiaries) in other Member States.

'administrator' or 'special manager' and submit a restructuring plan to shareholders for approval, and only, as a second step, are measures imposed that override shareholders rights. The second, by contrast, imposes measures without the prior consent of shareholders.

An effective range of tools must give authorities options other than public financial support and liquidation to address problems in an ailing bank. While this paper is open as to – and seeks views on – the most appropriate tools for an EU regime, it is essential that resolution authorities have a sufficiently wide range of common tools which can be applied flexibly and with discretion, and that they can act with adequate speed and control over the conduct of the resolution. A recent IMF working paper[17] suggests that the following tools, which are used in a number of existing national regimes,[18] should be considered in any review of the EU regime:

– powers to facilitate or effect a private sector acquisition of the failing bank or its business;

– powers to transfer the business of a failing bank to a temporary "bridge bank" in order to preserve it as a going concern with a view to sale to a private sector purchaser;

– powers to separate "clean" and "toxic" assets between "good" and "bad" banks through a partial transfer of assets and liabilities.

To the extent that such tools could potentially involve State support, they should be designed and exercised in a way that is consistent with the EU State Aid regime.[19]

Other jurisdictions manage the reorganisation of banks under a framework of special administration, whereby an administrator appointed by the relevant national authority assumes control of the management of a failing bank and considers how it should be restructured. This may also be a useful measure in an EU regime, although the appropriate threshold conditions and timing may be different (see Section 4.4).

What are the key tools for an EU resolution regime?

4.4. Threshold conditions and timing for use of tools

Clear "threshold conditions" that must be met before the powers of intervention are triggered are central to an EU resolution regime. They facilitate coordinated action by national authorities, reduce the risk of challenge, and provide legal certainty for shareholders and creditors as to the circumstances in which action might be taken. Any intervention which affects the interests and rights of shareholders and creditors needs to be proportionate to the seriousness of the problems in the institution and driven by the legitimate considerations of public interest.

In order to safeguard the public interest, intervention should be possible before the bank is "balance sheet" insolvent: that is, before the bank has reached the relevant threshold for the purposes of ordinary insolvency proceedings. If authorities cannot intervene decisively to

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17 IMF Working Paper WP/09/200, "The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union", by Martin Cihák and Erlend Nier.

18 In other countries, such powers exist but are implicit. Judicial authorities may use them in the context of insolvency proceedings.

19 As far as the present financial crisis is concerned, the Commission has adopted a number of guidelines to address this emergency exceptional situation.

protect the public interest before the bank is technically insolvent, this will limit the effective options for stabilisation and resolution, or increase the amount of public funds that will need to be committed in support of such an option. The threshold conditions for an EU regime should therefore allow intervention at the appropriate stage, while being sufficiently rigorous to ensure that intervention which interferes with the rights of stakeholders is justified. That outcome is likely to be achieved by the combination of a regulatory threshold based on a supervisory assessment that an institution is failing to meet core regulatory conditions, and a broader public interest based on for example, financial stability and the continuity of banking services.

What are the appropriate thresholds for the use of resolution tools?

4.5. Scope of the bank resolution framework

A new framework will need to apply to all credit institutions that are part of a cross-border group. This must include cross-border branches because experience has shown that banks operating through cross-border branches can also present a real risk to financial stability in Member States where the branches carry on significant amounts of deposit-taking business.[20] Furthermore, as banking groups often include entities that carry on investment activities and other financial services, and their failure may also pose systemic risks to the financial system, it makes sense for a harmonised EU resolution framework to be extended to investment firms and possibly to insurers.[21] The winding-up of Lehman Brothers and the market disruption it caused,[22] including uncertainty about the location and status of client assets, and about the contractual positions of Lehman's counterparties and the status of their outstanding trades, clearly demonstrated that measures aimed at managing the failure of investment firms are also needed.

However, the resolution measures that are appropriate for deposit-taking banks may not necessarily be appropriate for other kinds of financial institution. For example, the power to transfer assets and liabilities to a 'bridge bank' may be suitable for deposit-taking banks because of the nature of their activities and the objectives of the resolution, but less relevant for investment banks, where the focus of a resolution regime may be to address problems and uncertainties in respect of trading, clearing and settlement, collateral and custody of client assets.

What should be the scope of an EU resolution framework? Should it only focus on deposit-taking banks (as opposed to any other regulated financial institution)?

If so, should it apply only to cross-border banking groups or should it also encompass single entities which only operate cross-border through branches?

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20 As was the case in the Icelandic banking crisis.

21 Investment firms are not covered by either the Winding-Up and Reorganisation Directive or the EC Insolvency Regulation. By contrast, insurers are covered by Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings, which provides for the mutual recognition and coordination of home State insolvency proceedings in relation to branches of an insurer in other Member States.

22 For example, uncertainty about the size of the exposures of other financial institutions to Lehman led to a sharp fall in global equity prices in the banking sector, while runs on U.S. money market funds that were believed to have invested in Lehman's commercial paper led to rapid liquidation of their holdings of all U.S. commercial paper into a falling market.

4.6. Stakeholders' rights in bank resolution procedures

Shareholders

A robust framework of shareholders' rights is essential for good corporate governance and also for the free movement of capital. This is especially the case with banks that are public listed companies as shares will be listed and traded on capital markets. A balance should be struck between protecting the legitimate interests of shareholders and the ability of resolution authorities to intervene quickly and decisively to restructure a failing institution or group to minimise contagion and ensure the stability of the banking system in affected Member States.

EU law contains a number of mandatory requirements that confer rights on shareholders. These include pre-emption rights, and the requirements that any increase or reduction of issued share capital is approved by the shareholders' general meeting. Shareholders enjoy equivalent minimum rights within the EU as long as the company is a going concern. The rights of shareholders accorded under EU law would normally not pose an obstacle to re-organisation measures taken under a regular insolvency procedure. Nor would those rights necessarily pose a problem under a bank resolution process which favours a graduated approach designed to encourage shareholders' consent to restructuring measures or where the necessary time to comply with such requirements is available. The difficulty arises if re-organisation takes place under a bank resolution process which seeks to impose measures without seeking prior consent of shareholders. In such a case, the mandatory nature of the rights accorded under EU Company law Directives, may undermine attempts by authorities to quickly handle a bank crisis. Adjustments may, therefore, be needed to those Directives. The nature of those adjustments would have to be such so as to guarantee the ability of national authorities to intervene rapidly in defined circumstances, i.e. triggers or conditions, without having to seek shareholder approval in order to ensure continuity of essential services that have been provided by the bank and minimising the systemic impact of its failure– for example by orchestrating a private sector purchase.

Similarly, any transfer of ownership or assets of an ailing bank without shareholders' prior approval must also comply with the shareholders' right to property under the European Convention of Human Rights. Where rights granted by EU law are affected, appropriate mechanisms for redress and compensation would also need to be addressed.

Shareholders have the right not to be deprived of their shares, or to suffer a diminution in their value, unless the interference is justified in the public interest and in accordance with conditions provided in law and with international law. Uncertainty about whether the terms of intervention strike a fair balance between the demands of the general interest of the community and the requirement of the protection of the fundamental rights of individual shareholders may lead to the risk that resolution measures could be challenged, in any individual case, before national and European courts.

Creditors and counterparties

Bank resolution tools that involve transfer of assets may also interfere with the rights of creditors and market counterparties, and any EU resolution framework would need to incorporate adequate safeguards to protect those interests. Safeguards for creditors, for example, might include compensation mechanisms to ensure that no creditor is left worse off than it would have been had the bank under resolution been wound up under the applicable insolvency law. Safeguards for market counterparties might include restrictions to prevent

disruption to set off and netting arrangements, security interests and structured finance arrangements.

Is it necessary to derogate from certain of the requirements imposed by the EU Company Law Directives, and if so which conditions or triggers should apply to any such derogation? What appropriate safeguards, review or compensation mechanisms for shareholders, creditors and counterparties would be appropriate?

4.7. Application of resolution measures to a banking group

The principal focus of this Communication is cross-border banks. If a single legal entity carries on its cross-border business through branches, the principles set out in the Winding-up Directive ('CIWUD') should apply to extend measures adopted in the bank's home State to branches in other Member States. This might involve legislative change since it is not clear that EU bank resolution measures would necessarily fall within the scope of CIWUD.

However, the application of resolution measures to affiliated entities in a banking group is even more complex. Broadly speaking, if the EU is to move beyond nationally-focussed crisis management and the understandable tendency to ring-fence assets, there are two approaches that might be pursued. The first is to develop a framework for the coordination of measures that would continue to be applied at the national level. The second – a more far-reaching development of the single-market – would be to provide for the integrated resolution of group entities in different jurisdictions by a single resolution authority.

One option the Commission considers worth exploring would be to assess the feasibility of a single resolution authority which would be responsible for the resolution of a cross-border group – determined on the basis of rules – to play the lead role in orchestrating a resolution.

If the option of a European resolution authority is not considered feasible, as a minimum national resolution measures for a cross-border banking group should be co-ordinated.

An approach to cross-border resolution based on the coordination of national measures would represent a reinforcement of, rather than a radical departure from, current arrangements. The Memorandum of Understanding[23] on financial stability, agreed in June 2008, was in place during the crisis but failed to provide a sufficient or useful basis for cooperation between Member States. The orderly resolution of a failing cross-border bank is much more likely to be possible if there is a legally binding structured EU framework to cement cooperation arrangements during a crisis. Arrangements for the funding of a cross-border resolution of the kind discussed in Section 4.8 below are also likely to enhance the effectiveness of coordination by getting the incentives right.

However, under a cooperation and coordination framework, the resolution of a banking group will necessarily be carried out at the level of each legal entity in accordance with the applicable national regime. Such separate entity resolution, even where coordinated, will not necessarily allow the most efficient reorganisation. This approach also fails to reflect the commercial reality of the integrated EU banking sector that has developed within the framework of the single market. Banking groups are increasingly operationally and

[23] Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross Border Stability (1 June 2008).

commercially interdependent, frequently centralise liquidity management in a way that entails the intermingling of assets, and are organised and operated in a way that reflects business lines rather than legal structure.

These concerns can only be fully addressed by greater structural integration of a resolution framework, possibly by designating a lead authority (determined in accordance with clear ex ante rules) which would orchestrate the resolution of a particular group. That authority, in cooperation with the national authorities involved, would apply the EU resolution measures in each relevant territory. This approach is clearly ambitious, and it is unlikely to be effective or feasible unless a more integrated insolvency treatment of banking groups is made possible. This is discussed in section 5 below.

How can cooperation and communication between authorities and administrators responsible for the resolution and insolvency of a cross border banking group be improved?

Is integrated resolution through a European Resolution Authority for banking groups desirable and feasible?

If this option is not considered feasible, what minimum national resolution measures for a cross-border banking group are necessary.

4.8. Financing a cross-border resolution

Private sector financing

Funding arrangements are fundamental to any cross-border resolution regime. As a primary principle, private funding arrangements or private sector solutions are necessary if the costs of bank failure are not to be borne by taxpayers (see section 4.2). In addition, in the context of the single market the lack of such EU arrangements limits the range of resolution tools that authorities will use in a cross-border context. This may prevent authorities from pursuing the most effective solution and lead to higher aggregate costs that are borne individually by the Member States involved. While securing private sector involvement in bank resolution is generally desirable, the availability of private sector options rapidly diminishes as a crisis deepens.

It would be useful to explore the feasibility of establishing ex-ante mechanisms that could ensure that private sector funds would be available in times of crisis. Deposit guarantee schemes could include the possibility of funding resolution measures. This would have the advantage that the banking sector would contribute directly to ensuring its own stability. However, this should not be to the detriment of compensating retail depositors in the event of a bank failure. In its review of the operation of deposit guarantee schemes to be brought forward in early 2010, the Commission will examine the use of deposit guarantee schemes in the context of the crisis. Alternatively, as some Member States do, the Commission could explore the creation of a resolution fund, potentially funded by charges on financial institutions which might be calibrated to reflect size or market activity….

In addition, a facilitating framework for intra-group financing after the commencement of an insolvency procedure could be explored. In the context of its work on the treatment of

corporate groups in insolvency, UNCITRAL[24] is considering how to facilitate the continuous operation of the business under reorganisation or liquidation by securing continuous access to funds.

Finally, any risk that resolution measures might be subsequently unwound through legal challenge may seriously restrict the willingness of private sector entities to invest in asset purchases or to take over all or part of an ailing bank. A framework that confers legal certainty on the measures taken is therefore likely to facilitate private sector solutions.

Burden sharing

As recent experience has clearly demonstrated, private sector solutions will not always be available. Intense work is therefore needed to develop principles setting out how financial burdens should be shared between Member States where resolution measures are applied to a cross-border banking group. Urgent and rapid progress is needed to establish clear obligations between Member States for the equitable sharing of the fiscal costs of any such resolution.[25] The importance of concrete progress on this issue cannot be underestimated. It would not be desirable at this stage to try to define precise ex-ante formulae for the distribution of costs involved in public rescue operations across borders. However, Member States should know whether they would, in principle, be required to contribute, how such burden sharing would be organised, who would be responsible for triggering discussions on burden sharing and who would co-ordinate such discussions.[26] In addition, reciprocal rights – in terms of access to data etc. - for any Member State accepting the obligation to share a burden should be considered. An ex-ante agreement setting out the principles for fair burden sharing is a necessary "safety-net" that will ensure that the authorities involved have the necessary incentives to cooperate under the crisis prevention and resolution framework. The absence of progress in this area risks putting the fundamental Treaty principles of freedom of establishment and services and free capital movements under intolerable stress.

What is the most appropriate way to secure cross-border funding for bank resolution measures? What role is there for specific private sector funding?

Is establishing ex-ante crisis funding arrangements practical? If not, how could private sector solutions best address the issue? Is there scope to achieve greater clarity on burden sharing? If so, would the first priority be to define principles for burden sharing?

5. INSOLVENCY

At present, any liquidation in the context of a resolution will necessarily be carried out in accordance with national insolvency procedures, and any coordination depends on the

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24 Working Group V of UNCITRAL – United Nations Commission on International Trade Law.

25 A recent report to the Economic and Finance Committee recommended that the EU framework for financial stability should include voluntary ex ante arrangements for burden sharing regarding cross-border financial groups, supported by an EU-wide terms of reference, with newly established cross-border stability groups playing a key role in monitoring their implementation (Lessons from the financial crisis for European financial stability arrangements, EFC High-Level Working Group on Cross-Border Financial Stability Arrangements, July 2008).

26 Such measures must, of course, comply with State Aid rules.

voluntary cooperation between different national insolvency authorities and officers.[27] Cooperation between national insolvency authorities is often uneasy and imperfect, and cannot deal effectively with financial conglomerates, international holding structures and the organisation of financial groups according to business lines.[28]

As a minimum, therefore, an EU bank resolution framework should be supported, by a binding framework for cooperation and exchange of information between courts and insolvency practitioners responsible for proceedings relating to affiliated entities in a banking group. Other options that might be explored include provision for the coordination of national proceedings by a 'lead administrator'.

Integrated treatment of corporate groups

It may, however, be desirable to go further in facilitating a more integrated treatment of corporate groups in insolvency. This might involve – in clearly specified circumstances - treating the group as a single enterprise in order to overcome the perceived inefficiency and unfairness of the traditional single entity approach. While techniques to achieve this are available under some national law, their application is necessarily restricted to entities within the same jurisdiction, and subject to the same insolvency regime. If similar measures were to be developed for use in insolvency proceedings for cross-border banking groups, the fact of different insolvency regimes - with different substantive rules on, for example, priority and avoidance powers – would need to be addressed.

A harmonised EU insolvency regime for banks

Techniques for a more integrated treatment of groups in insolvency might assist in addressing some of the inequities that might arise from winding up highly integrated banking groups on a separate entity basis. There is a growing body of academic and professional opinion that suggests that separate entity insolvency cannot adequately deal with complex corporate structures where form does not follow function, and that international work on the harmonisation of insolvency rules is now needed. Without such harmonisation, it will remain very difficult to re-structure a cross-border banking group.

The difficulty and sensitivity of such work should not be underestimated. Insolvency law is closely related to other areas of national law such as the law of property, contract and commercial law, and rules on priority may reflect social policy. Accommodating particular national concepts such as "trusts" or "floating charges" in a unified code would be complex.

Such a project might take the form of a separate and self-contained insolvency regime that would be available, and would replace the otherwise applicable national regimes, for the reorganisation and winding up of cross-border banking groups in the EU. Such a regime

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[27] Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions prohibits the application of separate insolvency measures to branches under the law of the host State. It ensures the mutual recognition and coordination of procedures under home country control, imposes a single-entity approach by which all the assets and liabilities of the 'parent' bank and its foreign branches are reorganised or wound up as one legal entity under, subject only to exceptions specified in the Directive, the law of the home State. However, this directive does not provide for the consolidation of insolvency proceedings for separate legal entities within a banking group, and makes no attempt to harmonise national insolvency law.

[28] The complex and protracted insolvency of Lehman Brothers is a clear illustration of the difficulties faced by administrators in complex winding up procedures.

would only fully address the problems associated with the separate entity approach under national insolvency law if it permitted an integrated treatment of the group entities. Careful thought would need to be given to the application of such a regime and the extent – if at all – to which it should be optional for systemically important cross-border banking groups. Any imposition of a new EU insolvency regime on existing entities would raise transitional problems, including the impact on creditors and counterparties.

Is a more integrated insolvency framework for banking groups needed? If so, how should it be designed?

Should there be a separate and self contained insolvency regime for cross-border banks?

6. FOLLOW-UP

The Commission invites both general views and detailed comments on the matters discussed in this Communication by 20th January 2010. Further details on the issues raised in this Communication, together with specific questions are to be found in the accompanying staff working document.

The Commission plans to organise a public hearing in early 2010 in order to present the results of the consultation and to set out how it intends to proceed. This will feed into the preparation of a roadmap of follow up initiatives in the areas of early intervention, resolution and insolvency in order to build a crisis management framework that would ensure that, in future, all competent authorities effectively coordinate their actions and have the appropriate tools for intervening quickly to manage the failure of a bank.