Key issues in bank crisis resolution frameworks

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Bank insolvency regimes

Fundamental choice of regime:
• Rely on corporate insolvency law – still bank specific rules required as a minimum (i) to establish official administration (ii) appoint administrator (iii) address the operation of deposit insurance (e.g. subrogate for the deposit insurance agency for the claims paid to depositors)
• Establish a special legal regime for bank insolvency – facilitating timely action and ensuring consistency between the supervisory and the insolvency related functions of the banking authorities
• Corporate insolvency invariably takes place in court; special bank insolvency procedures may be court-based or administrative in nature
Insolvency for corporate groups

• Most national laws lack a codified legal framework to deal with insolvency of groups
• Treating companies as other than separate legal entities raises difficult issues in the treatment of creditors and may create uncertainty in market assessment of credit risks
• However, financial institutions typically concentrate functions such as funding, liquidity management and risk management, large credits, in order to attain scale and scope economies, making it sensible to regard the institution as a unique entity in case of failure
• Critical issues: to determine when consolidation applies, the conditions when pooling of assets may occur, and under what administration regime
Bank insolvency procedures

All regimes for bank crisis resolution entail two phases:

• *Official administration.* An official authority assumes direct managerial control of a bank, conducting all the necessary restructuring operations and, when these don’t work, placing the bank in liquidation.

• *Liquidation proceedings.* Realization of assets, and equitable distribution of proceeds to creditors (dissolution of the bank as a separate legal entity).
Purposes and actors

- The purposes of bank insolvency procedures include the safeguard of the stability of the financial system, including (i) the functioning of the payment system (ii) safeguarding (retail) depositors (iii) preserving credit flows
- For this reason the banking authorities are almost universally empowered to initiate bank insolvency, often exclusively – in court-based regimes, insolvency may also be commenced by courts, bank owners, management and creditors
- In administrative procedures, they also manage the procedure and directly take decisions
- Critical issue to be resolved: the division of responsibility between banking authorities – central bank, supervisor, deposit insurance agency
Other critical issues

1. Threshold to commence insolvency proceedings at an early stage: most common illiquidity threshold or balance sheet threshold; often, also regulatory thresholds that allow to begin the procedure when net financial position falls below a specified level, e.g. based on capital, leverage or other prudential ratios.

2. Judicial review: legal framework should be clear, notably regarding scope of review of administrative decisions.

3. Action for damages against banking authorities: admitted in some countries, but limits required.
Official Administration

Legal issues arising in official administration:

• Scope of official administrator’s powers and impact on shareholders’ rights

• Implications for bank license: in some cases revocation is mandatory, in others more flexibility as to the revocation and its timing

• Imposition of a moratorium on individual collecting actions by creditors against the bank
Liquidation

If there is no prospects of reorganization or if a reorganization fails, a liquidation proceedings will follow.

Administrative regimes (i) are official centered procedures; (ii) limit legal remedies of affected parties; (iii) have partial application of bankruptcy rules.

Court based bankruptcy procedures are primarily liquidation procedures.
Cross-border Insolvency

Universal vs. Territorial Insolvency System

• Universal: one jurisdiction distributes assets to claimants or runs the reorganizations. The rest collect assets, coordinate claims and share information with the principal jurisdiction

• Territorial: each jurisdiction separately liquidates local assets
EU common framework

- EU: universal model, home country for branches, host country for subsidiaries

Council regulation 1346/2000 on insolvency and two directives on reorganization and winding up of credit institutions and insurance undertakings

They establish home country responsibility, and prescribe universality, single entity approach to liquidation, equal treatment of creditors – but make no attempt at harmonizing substantive rules
Strengthening EU approach

Universality insolvency rule meeting consolidated supervision to build common system, with following key elements:

- centralised supervision of cross-border banks
- centralised deposit insurance
- creation of special legal system applicable to European Company Statute

- the alternative territorial solution - national resolution managed by national supervisors, or courts, even if monitored by the supranational EU and European Central Bank structures – leads to the financial system “disintegrating”