Handling Systemically Important Banks in Distress – Some Thoughts from a Swedish Perspective

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Abstract

This article discusses the management of systemically important banks in distress with the primary aim of creating a platform for further discussion. As a backdrop, the experiences gained in Sweden from two crises in less than 20 years are presented. After a discussion of the liquidity factor and central banks' role as lender of last resort, the focus is on handling the initial acute phase of a crisis. The appropriate goals of a crisis management system are discussed, as are ways of achieving immediate control of a bank in distress and principles related to the valuation of a bank in need of assistance. The main point presented is that the analytical building blocks are universal and by identifying them a common ground for further analysis could be established. One conclusion is that the proposed EU regime for crisis management in the financial sector will not be the final word. Finally, some thoughts regarding a pan-European system for crisis handling, based on a common corporate law for banks, are presented.

Keywords: control, crisis management, emergency liquidity assistance, financial crisis, lender of last resort, special resolution regime, Societas Europaea, valuation, Sweden.

1. Introduction[1]

In a time where almost everyone seems engaged in the process of reshaping legislation related to the financial system in general and crisis management

1 Many thanks to Lars Hörngren and Thomas Ordeberg for invaluable comments. This article is mainly based on my 20 years' experience as an active participant in the Swedish

in particular, it may seem presumptuous or even foolish to try to add something to the debate or to the formal EU process that is well under way. However, due to the speed of the current process important aspects may be missed. This is a humble attempt to create a platform for analysis of a crisis management regime, drawing on the experience gained in Sweden from two serious financial crises in the recent past. In addition, the article shares some thoughts regarding the European level, in particular the latest development in the EU legislative process, namely the Communication from the European Commission entitled 'An EU Framework for Crisis Management in the Financial Sector'.[2]

2. The Swedish backdrop

Sweden has gone through two periods of serious financial distress during the past 20 years, which has resulted in a substantial body of experience among government officials, academics and practitioners. The unusual openness of the Swedish authorities regarding the crises has been of considerable importance in this process. The causes and handling of the crises have been thoroughly investigated, which has resulted in official reports as well as academic work.[3] After the crisis of the early 1990s, two Swedish Government Committees were appointed consecutively. The first had the more limited man-

legislative process in this field and on my practical experience with supervision during the recent crisis as a member of the board of the Swedish Financial Supervisory Authority (Finansinspektionen). It should be noted that the Swedish FSA revoked the licence of Swedish banks twice during or around the crisis. The difficulties of handling a situation where a systemically important bank loses its licence are considerable if there is no special legal regime in place; for an account of the recent Swedish handling of such a situation, see G. Sjöberg, 'Mastering the Financial Crisis – The Swedish Approach', in J.A. Kämmerer and R. Veil, *Mastering the Financial Crisis – Policies and Approaches in Europe* (Bucerius Law School, forthcoming in April 2011). This article is based on my experiences as an official rather than as an academic. However, the views expressed here are my own and do not necessarily reflect the official Swedish position.

2 COM(2010) 579. I have tried to take into account material published up to November 2010. The latest Swedish official position regarding these issues is a joint reaction dated 20 January 2010 from the Ministry of Finance, the Riksbank (Swedish Central Bank), the Swedish Financial Supervisory Authority and the Swedish National Debt Office, to the Commission Communication 'An EU Framework for Cross-Border Crisis Management in the Banking Sector'.

3 The major part of the literature is of course written in Swedish. However, I have tried to avoid too many references to sources in Swedish since they are probably of no use to most non-Swedes.

date of examining the causes of the crisis, while the second had a broader mandate, including proposing changes in banking legislation and developing a crisis management regime.[4] Sweden's current banking legislation is based on the principles laid down in the second Committee's proposal for an entirely new Banking Act (not including changes in the legislation due to more recent EU and international influence). An important part of the work of the Committee was to develop a special resolution regime (SRR) primarily for systemically important institutions. Having worked for five years and delivering four reports, the Committee, in its final report, proposed an SSR.[5] I would say that at the time of the proposal, the proposed SRR was at the global forefront. It contained solutions that allowed both shareholders and creditors to suffer losses without letting the institution go into bankruptcy. It also enabled the state to take immediate control of a failing institution via a mechanism that gave the authority in charge all votes at the shareholders' meeting. According to the proposal, this control should enable the authority in charge to decide on all matters within the shareholders' ambit, including decisions about the bank's future business and capital structure.[6] A standing crisis management authority was also suggested. However, the proposal did not result in legislation, even though it was well received. When the first signs of the 2008–2009 crisis emerged, work on the Committee's proposal was still underway in the government offices. It was decided to abandon the work on an SRR and instead go ahead with a system modelled on the 1990s legislation.

It must be stressed that I do not suggest that the SRR proposed in Sweden more than 10 years ago, or any SRR, would be sufficient in a crisis of the magnitude of the recent one. On the contrary: the opposite is one of the main points of this article. Other measures outside the scope of an SRR have

4 Bankkriskommittén, Fi 1993:02 and Banklagskommittén, Fi 1995:09. I was secretary of the first and head secretary of the second.

5 See the Swedish Official Government Report Series, *Offentlig administration av banker kris – slutbetänkande av Banklagskommittén* [Public Administration of Banks in Distress – Final Report of the Banking Law Committee], SOU 2000:66, published in June 2000. For an English presentation of the proposal and its context, see S. Viotti, 'Dealing with Banking Crises – Proposal for a New Regulatory Framework', 3 *Economic Review* (2000) pp. 46–63, available at the Riksbank's homepage: <http://www.riksbank.se/upload/Dokument_riksbank/Kat_publicerat/Artik lar_PV/er00_3_artikel3.pdf>.

6 According to the proposal, a write-down of the share capital had to be decided by a court and a decision to issue new stock had to be made by the shareholders due to the requirements in the Second Company Directive, SOU 2000:66, at p. 244 ff.

to be employed when the entire financial system is at risk. On the other hand, this does not mean that some of the tools offered by the suggested SSR would not have been helpful in the crisis management process. One such example is the possibility to take immediate control of failing institutions.

The 1990s legislation was a rush job.[7] During the acute phase of that crisis it became evident that the lack of a suitable legal regime endangered the possibility of a resolute response to the substantial solvency problems in some institutions. Under considerable time pressure an act was produced which gave the authorities a legal foundation for negotiations and coercive measures.[8] However, it can be said that legislation was enacted 'after the fact' in so far that many of the most urgent measures were taken without sufficient formal legal support or control over the banks in question.[9] Perhaps the most important among these measures was the decision by the government to issue a guarantee promising that all Swedish banks would meet their obligations.[10] The act was abolished after three years.

The Government Support to Credit Institutions Act (Support Act) now in force was enacted on 29 October 2008.[11] The legal solutions in it are very similar, in fact almost identical, to those in the old act. The 2008 Act is generally considered a temporary solution. Recently, a Government Committee was appointed with a relatively broad mandate, including reviewing the powers of different authorities involved in crisis management and proposing a new SSR.[12]

In an international perspective, the appointment of the Committee has come relatively late. This could be a bad sign, since one of the main lessons learned from past Swedish history in this field is to legislate on the basis of experiences of a crisis before it is forgotten. However, it could also be an advantage in that conclusions drawn in other countries can be taken into account and the collective impact of (forthcoming) EU legislation can be eval-

7 Viotti, *supra* n. 5, at p. 50 f.

8 The Government Support to Banks and Other Credit Institutions Act (SFS 1993:765) enacted on 1 July 1993.

9 SOU 2000:66, at p. 84. Viotti, *supra* n. 5, at p. 50 f.

10 This guarantee was issued in September 1992 but the formal decision by the Parliament was not taken until December 1992.

11 SFS 2008:814. For a detailed account of the Act and the measures taken under it, see G. Sjöberg, 'Lagen om statligt stöd till kreditinstitut' [Government Support to Credit Institutions Act], *Juridisk Tidskrift* (2008–09) p. 576, and Sjöberg, *supra* n. 1.

12 The Committee is called Finanskriskommittén (Financial Crisis Committee), with directives decided by the government (2011:6). I am a member of the Committee.

uated. However, it has to be remembered that the room for manoeuvre at Member State level could be quite limited, at least in some areas of crisis management, if the present proposals at EU level will be adopted.

Beside the different government reports and proposals, academic publications and statements by officials in different capacities have also raised issues concerning crisis management. Both the present Governor of the Swedish Central Bank, who was central in handling the 1990s crisis as head of the Bank Support Authority, and a former Governor have published their thoughts on what is often called the Swedish Model.[13] Academia has explored both crises; economists are the authors of most of the publications, though lawyers have written some as well. It is possible to see several strands in this literature, e.g., one primarily seeks to describe the course of events and tries to explain the causes of the crises,[14] while another aims to prescribe solutions for handling the next crisis.[15] Yet another category seeks to give general advice on economic policy in order to avoid or limit the effects of a crisis.[16]

The fundamental differences between the 1990s crisis and the recent one are mirrored in the publications. The 1990s crisis was due mainly to domestic factors,[17] whereas the present primarily has external causes (even though

13 Stefan Ingves, present Governor of Sveriges Riksbank, and Göran Lind, advisor to the Bank's Executive Board, summarised the Swedish experience in S. Ingves and G. Lind, 'Stockholm Solutions', *Finance & Development*, IMF, December 2008, at p. 21, and S. Ingves and G. Lind, 'The Management of the Bank Crisis – In Retrospect', 7 *Sveriges Riksbank Quarterly Review* (1996) pp. 5–18. Urban Bäckström, former Governor of the Sveriges Riksbank as well as former State Secretary of the Ministry of Finance, summarised his experiences in his speech 'What Lessons Can Be Learned from Recent Financial Crises? The Swedish Experience', at the Federal Reserve Symposium *Maintaining Financial Stability in a Global Economy*, Jackson Hole, Wyoming, USA, 29 August 1997, available at: <http://www.riksbank.se/templates/speech.aspx? id=3861>.

14 P. Englund, 'The Swedish Banking Crisis: Roots and Consequences', 15 *Oxford Review of Economic Policy* (1999) pp. 80–97; L. Jonung, 'The Swedish Model for Resolving the Banking Crisis of 1991–93. Seven Reasons Why It Was Successful', European Economy, Economic Papers 360, European Commission, February 2009, Brussels.

15 M. Andersson and S. Viotti, 'Managing and Preventing Financial Crises, Lessons from the Swedish Experience', 10 *Sveriges Riksbank Quarterly Review* (1999) pp. 71–89; P. Englund, 'Systemic Risks in the Financial System. Lessons from the Current Crisis', in Expert Report no. 36 to Sweden's Globalisation Council (2009).

16 L. Jonung, 'Lessons from Financial Liberalisation in Scandinavia', 50 *Comparative Economic Studies* (2008) pp. 564–598; L. Jonung, J. Kiander and P. Vartia, eds., *The Great Financial Crisis in Finland and Sweden. The Nordic Experience of Financial Liberalization* (Cheltenham and Northampton, Edward Elgar 2009).

17 The most important factor was excessive lending to commercial property.

excessive lending in the Baltic region contributed to the severity of the impact of global events). To put it drastically: during the 1990s crisis Swedish banks remained liquid even though some of them were not solvent, whereas during this crisis Swedish banks were solvent but not liquid.[18] After the 1990s crisis, there were strong sentiments that someone was, more or less personally, to blame, which resulted in research more focused on micro or individual factors, such as the extent of negligent and criminal lending.[19] It was even contemplated to criminalise negligent lending as a way to avoid further crises.[20] Today's debate focuses on the macro level.[21]

3. The article's aim and scope

No doubt there is a need to rethink the strategies for handling distressed financial institutions (hereafter called banks) that are systemically important.[22] As we have all seen, the difficulties at national level are considerable. In that light, the problems of developing a common system for several countries or a truly European system might seem almost insurmountable.[23] One way forward, however, could be to establish an analytical platform for further thinking in order to identify the economic realities giving rise to the difficulties that are more or less inevitably linked with a situation where one or several banks are distressed and the measures necessary for tackling the difficulties. Such an analysis would have to be relatively independent of existing regula-

18 For a different view, at least on a global level, see R.M. Lastra and G. Wood, 'The Crisis of 2007–09: Nature, Causes and Reactions', 13 *Journal of International Economic Law* (2010) p. 535.

19 G. Sjöberg, *Brottslig och vårdslös kreditgivning 1980-* [Criminal and Negligent Lending 1980-], Report to the Bankkriskommittén, Stockholm, 1995. It was also explored whether negligence in supervision (primarily of lending) had caused the crisis, see G. Sjöberg, *Bank- och Finansinspektionens verksamhet 1980–1993* [The Financial Supervisory Authority's Activities 1980–1993], Report to the Bankkriskommittén, Stockholm, 1994.

20 According to the terms of reference of the Banklagskommitté, criminalisation of negligent lending was to be considered, but no such proposal was made, SOU 1999:82.

21 With notable exceptions, such as bonus payments.

22 This has resulted in a number of suggested approaches, see for a recent and comprehensive example, S. Claessens, R. Herring and D. Schoenmaker, *A Safer World Financial System: Improving the Resolution of Systemic Institutions* (London, Centre for Economic Policy Research 2010).

23 For a comprehensive description of the present system and its deficiencies, see G.G.H. Garcia, R.M. Lastra and M.J. Nieto, 'Bankruptcy and Reorganization Procedures for Cross-Border Banks in the EU – Towards an Integrated Approach to the Reform of the EU Safety Net', 17 *Journal of Financial Regulation and Compliance* (2009) pp. 240–275.

tory regimes in order to provide an independent intellectual framework to build on.[24] In the process, it is necessary to identify the desirable and important objectives of a system for handling distressed banks as well as the means available for this. The analysis of these basic issues should be quite similar at national and European level.

This article is an attempt to take a first step in such an analysis. It seeks to identify some of the important analytical building blocks and available measures in a law-based system for dealing with systemically important banks. The problems of instability and their sources in banks, or rather in the 'animals' that we normally call banks, are taken as given and are not addressed here. Nor does the scope of this article extend to general measures aimed at reducing the risk in banks. However, it must be remembered that a credible system for handling banks in distress is of utmost importance for the governance of banks under normal circumstances.

When a systemically important bank runs into acute problems, prompt action by the authorities is necessary. An acute situation can emerge suddenly without warning or, alternatively, the underlying problems may be known, to a smaller or larger extent, during a period before the acute phase. The legislative implications of the risk that supervisors may fail to take adequate steps regarding one or several banks in difficulty are not dealt with here. This is a question of governance of supervisory agencies which is separate from the questions at hand here, namely providing suitable and measured tools for crisis management. It goes without saying that the supervisory agencies (or other authorities) need sufficient tools to be able to act on incipient problems in a bank in order to avoid a state of acute crisis.[25] But again, this is a different legislative question from crisis management.[26]

24 Taking one or several existing regulatory regimes as a starting point for an analysis does not seem feasible if the desired result is a clear picture of the principles and ends that should underlie legislation.

25 Professor Rosa Lastra sees four stages in the supervisory process, namely: licensing, supervision *stricto sensu*, sanctioning and crisis management, R.M. Lastra, *Legal Foundations of International Monetary Stability* (Oxford University Press 2006), Chapter 3, Section B. According to this definition, this article focuses on crisis management and in particular on its acute phases.

26 In my view, the aim of supervision is to avoid a crisis and that of a crisis management system to handle an ongoing crisis. The exact borderline between the two is not given and, as is noted later, the triggers for a crisis management system are not self-evident. There are a number of good reasons to divide responsibility for supervision and crisis management between separate authorities, as was proposed for the Swedish SRR in 2000.

This article focuses on the acute phase, when one bank (or several banks) faces immediate difficulties in fulfilling its obligations (which in most cases is synonymous with liquidity problems) and therefore poses a threat to the functioning of the financial system.[27] The way this phase is dealt with is crucial to the functioning of a crisis management system. If the part of a system designed to handle this phase fails (or does not exist), the risk of moral hazard in the financial system increases and the credibility of the supervision of troubled institutions and the efficacy of early intervention may be questioned. It goes without saying that if the initial phase of the crisis management process fails, there is not much use in having an elaborate system for post-acute measures. Since the focus of this article is on handling the acute phase, it touches only briefly upon the measures to be applied later in the process.

No doubt it is difficult to design a system for handling acute problems in banks. This, in combination with the temptation for legislators and regulators to refer to the need for 'flexibility' and room for 'practical solutions', is often used as an excuse for an incomplete or unclear regime. Such an approach can be dangerous for several reasons. Obviously, there is a risk that banks may obtain support on too favourable terms when there are no legal measures that can be used to put pressure on them in negotiations. A lack of clear rules also exposes banks and their owners to the risk of unfair treatment. As we shall see, the position of a bank in a temporary liquidity crisis (caused perhaps by forces outside the bank's control) is dire. Moreover, public opinion in times of financial crisis often puts pressure on the authorities to 'act resolutely' towards the banking sector. From the perspective of legal certainty, it is better if the procedures to be applied in these situations are clearly set out in legislation *ex ante*.[28] Over-the-weekend sales on *ad hoc* terms may seem smooth solutions and give the government credit for being forceful but

[27] In the terminology of the latest Commission Communication, the crisis management system comprises three classes of measures, namely (i) preparatory and preventive measures; (ii) early supervisory intervention; and (iii) resolution tools and powers, COM(2010) 579, at p. 4. The focus here is thus on parts of the measures that the Communication calls third class.

[28] The de Larosière Group distinguishes between the legal framework and its application. They claim, on the one hand, that a clear and consistent framework for crisis management is desired, but, on the other hand, that constructive ambiguity and uncertainty are appropriate in the application of these arrangements in future individual cases of distressed banks, see the Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière, Brussels, 25 February 2009, section 127. I disagree on the second point.

they are generally not desirable.[29] To put it in economic terms, quickly executed sales on *ad hoc* terms may be associated with substantial transactions costs and subsequent wealth transfers in the absence of legal certainty concerning the rights of different stakeholders.[30] When we go on to discuss the goals of a crisis-handling system, a given should therefore be that such a system should meet high legalistic demands. I do not see legal certainty as a separate objective but as a (very important) restriction.[31]

4. What should be the goals of a crisis-handling system?

There are two related basic rationales behind state interventions aimed at preventing banks from failing, i.e., from becoming unable, or very close to unable, to fulfil their obligations. Both aim at reducing the considerable social costs related with a failure. The first and by far most important rationale is to preserve the functionality of the financial system (systemic stability). But the failure or, more accurately, the closing down of a viable banking business may also have other social costs, mainly in the form of loss of private information regarding the borrowers.[32]

If a bank's difficulties are due only to temporary liquidity problems, this may ideally be solved by pure liquidity support (see further below). In fact, the possibility to avoid large social costs through relatively simple means is the main explanation for the existence of a lender of last resort function

29 When the authorities force the incumbent owners of a bank to sell their shares and another institute under supervision to buy them (perhaps purporting that it is its duty in order to prevent mistrust in the financial system) both sellers and buyer are given reasons to question *ex post* the transaction on different grounds. Furthermore, the forced selling of one institution to another one unavoidably creates a form of implicit guarantee from the authorities that the sold institution is meeting some sort of qualitative minimum requirements and that its business fits in with the buying institution. Hence, a supervisor will have difficulties questioning the economic soundness of the new entity resulting from the amalgamation.

30 Uncertainty about government policy can trigger a crisis. It has been pointed out that the sudden and unpredictable reversal in resolution policy which marked the failure of Lehman Brothers changed market expectations and led to a general flight to quality, which in turn decreased stability, see Lastra and Wood, *supra* n. 18, at p. 539 with further references. There is also evidence from Venezuela that the lack of a rule-based system ultimately leads to damaging results for the taxpayers, see Lastra, *supra* n. 25, at p. 131 with further references.

31 The importance of legal certainty is discussed below, especially in relation to mechanisms for taking control and for valuation.

32 Lastra, *supra* n. 25, at p. 130.

(LOLR). This article concentrates on situations where a systemically important bank encounters acute problems that go deeper than just lack of liquidity. In this context it should be mentioned that the closure of a bank without systemic importance could also result in social costs of a scale that would justify measures allowing it to live on. It is possible that parts of a bank's business are viable even though the bank has more profound problems than just a shortage of liquidity.[33] However, systemic stability is the focus of this article. Systemic protection is an overriding objective when designing a system for handling distressed banks, but I can see no apparent conflict between the ends set and means used in a system for systemic protection, on the one hand, and the ends and means of a system that includes the option of handling also non-systemic banks, on the other.[34] To include also non-systemic banks in a system is an option, but one that is not further discussed here.[35]

In developing a system for dealing with banks in distress, the analysis has to start with the purpose. Clear objectives are necessary to tackle many of the difficult choices that arise later in the process. In my mind, there are two overriding goals, namely preserving systemic stability[36] and at the same time upholding (or creating) market discipline[37] (that is, avoiding moral hazard).[38] Simply put, the functioning of the financial system has to be preserved but not necessarily the institutions in their existing form and absolutely not with the same owners. Minimising the costs of resolving the situation, both to society and to taxpayers, is often mentioned as a separate objective of a system, but I believe that if the two above-mentioned goals are met this will also mean minimal overall costs to society.[39] Another important objective is that the system (as well as the rest of the regulatory environment)

33 It is not likely that the entire business of a bank that has more permanent difficulties could be regarded as viable. In a market economy the definition of 'viable' refers to the success of the business operations.

34 This is a point separate from the observation that it is difficult or impossible to determine beforehand the institutes that are systemic and to treat these differently.

35 The Swedish proposal of 2000 included such an option, see SOU 2000:66, *supra* n. 5, at pp. 14 and 151.

36 This goal includes the objective of a functioning financial system; it is not meaningful to say that there is financial stability if (critical) banking functions are not performed.

37 This was a key objective behind the proposal for a Swedish SRR in 2000, see Viotti, *supra* n. 5, at p. 52.

38 The objectives of a policymaker regarding reorganisation and liquidation are (against a backdrop of literature review) discussed in Garcia, et al., *supra* n. 23, at p. 246 ff.

39 Taken literally, minimising costs to taxpayers (in that capacity) is a more or less pointless goal since taxpayers' money should be used if it can reduce cost to society. Put differently:

has to allow the continuing development of the financial sector. This includes that banks without a viable business can be forced by competition to close down.[40]

One point of reference for further discussion is that the central bank's possibility to act as a LOLR is not sufficient to meet these goals; there has to be, for reasons set out below, a complementary mechanism.[41] Since a bank in distress should be able to directly enter this complementary system without receiving central banks' emergency liquidity assistance (ELA),[42] the transition from ELA to the other regime also has to be dealt with explicitly. A further reason for a complementary mechanism is that it is hardly realistic to assume that all (pure) liquidity problems of a systemic nature as emerged in the recent crisis can be solved solely via ELA in the future, even though the liquidity problems arising during a next crisis need not necessarily be as severe as those experienced recently. A prolonged period of general liquidity problems tends to affect solvency as well, and a subsequent need for complementary measures will arise.

It is also important to establish a level of ambition. Without a clear view of what kind of situations the system, at least primarily, sets out to address, there is an obvious risk of suboptimal solutions. A system designed to tackle problems similar to those of the recent crisis, with a near meltdown of the entire financial system, carries the risk of being suboptimal under more 'normal' crisis circumstances. There seem to be, at least, three possible levels of ambition for a system dealing with distressed banks. The first aims to handle (a large number of) non-systemic banks and focuses on depositor protection and issues related to what is known as regulatory forbearance.[43] Systems designed for this purpose are not suited to situations of the second level, namely

the goal of minimising costs to taxpayers entails the risk that costs are shifted to the same persons in different roles, namely as banks' customers or counterparts, and that the cost to society will be higher.

40 That is, if their owners do not support them with sufficient capital.

41 This statement should not be regarded as an attempt to downplay the importance of a functioning LOLR. On the contrary, as can be seen later, it is my view that the role of ELA is pivotal in the financial system and that there is a tendency in the current debate to overlook this.

42 ELA can consist of both credits and guarantees.

43 The American system run by the Federal Deposit Insurance Corporation (FDIC) is an example of such a system. Close to 150 banks failed during 2009 and FDIC employs around five thousand people.

difficulties in one or several systemically important banks.[44] This second level will be discussed here. In my mind, systems of the third level, i.e., systems designed with the objective of dealing with crisis situations of every conceivable magnitude, are not a reasonable alternative. Such situations frequently call for political *ad hoc* solutions in both the domestic and international arena. A further difference between a second and a third-level crisis is that a second-level crisis can be dealt with using money paid by the banks to an insurance system of some sort, perhaps connected to depositor insurance systems or a resolution fund. A crisis of the third level frequently calls for state money to be used. Another way of expressing this, and perhaps of defining the difference between the two types of situations, is that the latter situation is not insurable; the insurance premiums to cover a full-blown crisis involving a near meltdown of the overall financial system would be so high that the banks could neither pay them *ex ante*, nor compensate the state for the costs incurred *ex post*. As we shall see, distinguishing between a system based on insurance and other types of systems could be the key to solving the European dimension. Even though a system designed to handle situations of the second level is not fit to take care of all problems connected with a full-blown systemic crisis, the legal tools provided by such a system could be useful in parallel with other required state measures.[45] It should moreover be noted that the fact that a well-designed system for dealing with individual banks in distress can help reduce the systemic risk of a new crisis of the magnitude of the recent crisis is a fundamentally different argument.

In this context it should be pointed out that the latest Communication from the European Commission regarding crisis management seems to suggest as the main objective that the use of public funds in crisis management should be avoided altogether. It seems to advocate a system based on private funds able to handle all disruptions to the financial system.[46] As discussed above, these do not seem to be a realistic pair of objectives. It is simply not possible to create an insurance system that covers crisis situations of all magnitudes.

44 As far as I know, at the outset it was not even contemplated that the FDIC system would be able to cope with the difficulties of the present crisis.

45 For example, legal instruments to gain control over banks and for valuation could also be used when state funds need to be used for guarantees and for buying assets.

46 The Commission intends to propose the establishment of national funds. Banks subject to the crisis management framework would contribute *ex ante* to the funds, but *ex post* financing would also be a possibility, COM(2010) 368 and COM(2010) 579.

5. The liquidity factor – A brief economic background

Liquidity is always at the centre of an acute crisis.[47] Traditionally, ELA from central banks has been the means to deal with temporary and pure liquidity shortages.[48] In the ongoing debate on liquidity regulations and crisis management, there is an unfortunate tendency to forget (or at least downplay too much) the pivotal role of a functioning LOLR.[49] The social costs of trying to build a system that is not under any circumstances dependent on ELA could be large.[50] The liquidity component gives rise to several difficult issues relating to the design of a crisis management system, but in the end they are all about the relevance of a liquidity shortage in the valuation of a bank.

As is well known, the composition of banks' balance sheets makes them susceptible to even temporary shortages of liquidity.[51] In the recent crisis, both traditional bank runs (depositors queuing in the streets) and withdrawals of wholesale funding occurred. This was accompanied by an almost total breakdown of the markets used for funding. In fact, the lack of available funding (lending to banks or banks' sales of assets), regardless of banks' economic health, was perhaps the most characteristic feature of the crisis. It has been suggested that the liquidity squeeze was aggravated by expectations of

[47] Or more elegantly put by Professor Charles Goodhart in a speech: 'Failures normally occur in the first instance because of a shortage of liquidity, an inability to pay due bills, even though the underlying problem will, almost always, have been one of insolvency, whether real or just rumored', available at: <http://www.kansascityfed.org/publicat/sympos/2009/papers/Goodhart.09.11.09.pdf>.

[48] ELA was provided by the Swedish Central Bank twice during the recent crisis. Two relatively small institutes received ELA. In both cases it was assumed that a default would result in a serious disruption of the financial system and seriously undermine confidence in the payment system. See for details, Sjöberg, *supra* n. 1. With the notable exception of the Swedish central bank, the unwillingness among central banks in general to discuss or disclose, in clear and unambiguous terms, the policies behind the practices regarding ELA does not help in analysing the need for complementary mechanisms, but this is not discussed further here.

[49] One example is the latest Communication from the Commission, COM (2010) 579, which states (on p. 6) that recovery and resolution plans 'should not assume access to any support from public funds'.

[50] Even though the role of an LOLR in the financial system is important, such a function is, as just mentioned, not enough.

[51] For an account of the risks associated with the traditional composition of banks' balance sheets, both individually and at systemic level, see M. Brunnermeier, A. Crockett, C. Goodhart, A. Persaud and H. Shin, *The Fundamental Principles of Financial Regulation* (London, Centre for Economic Policy Research 2009), chapter 2.

what is called fire sale prices.[52] Sometimes not even assets presumed to be of good quality were sellable at reasonable prices. Seemingly forceful steps are taken to introduce legislation aimed at reducing the liquidity risk, but eliminating this factor altogether will not be possible if banks are to be allowed to continue to be banks in the traditional meaning.

In this context, it is important to reiterate that also banks which have their finances in good order and have a perfectly viable business can be hit by a liquidity shortage that can rapidly develop into solvency problems if nothing is done. In the current crisis, we have learnt that liquidity problems which under normal circumstances should have been very brief lasted for long periods of time and affected the entire financial sector. Also for this reason it is clear that only traditional ELA to individual institutions is not sufficient. Measures aimed at enhancing the liquidity situation generally may be needed, as may complementary mechanisms for dealing with (potential) solvency problems. During the recent crisis, the measures aimed at generally enhancing the liquidity situation in the Swedish financial system, for instance, were much more extensive than pure traditional ELA.[53] However, it is wrong to conclude that the aim should be not to rely on the LOLR in any circumstances. As mentioned earlier, one basic rationale behind state interventions aimed at preventing banks from failing is to avoid social costs resulting from the failure of viable businesses due only to temporary liquidity problems.

Difficulties in a bank have systemic implications in two cases, namely when the bank itself is so large that its failure will create considerable disturbances to the functioning of the economy as a whole, or when there is a risk of contagion (when difficulties in one bank lead to problems in others).[54] The failure of one large bank can cause disturbances in the whole economy, e.g., if its depositors (temporarily) lose access to their accounts and are thereby unable to use the payment system or by causing a credit crunch. Even though it may be important to establish that the failure of one single bank can cause systemic problems, it is hard to imagine a case where a large bank

52 See, e.g., D.W. Diamond and R.G. Rajan, 'Fear of Fire Sales and the Credit Freeze', NBER Working Paper No. 14295 (April 2009).

53 The measures that were aimed at the system in general amounted to several hundreds of billions of SEK (several tens of billions of EUR) and the traditional ELA to less than ten billion SEK (less than one billion EUR). Sjöberg, *supra* n. 1.

54 For an extensive analysis of systemic risk, see S.L. Schwarcz, 'Systemic Risk', Duke Law School Legal Studies Paper No. 163, 97 *Georgetown Law Journal* (2008), available at SSRN: <http://ssrn.com/abstract=1008326>.

fails without any risk of contagion.[55] Contagion can be caused both by direct links between banks (through contractual relations, including credit exposures or the payment system) and by indirect links, such as via markets and/or rumours that the problems in one bank are also present in others. Direct links between banks mean that if one bank suddenly stops fulfilling its obligations, there may be a chain reaction that brings down other banks depending on the size of the exposure. Therefore, it is not possible to let a bank with such links (immediately) go bankrupt in the sense that the bank's contractual relations will be broken and the legal entity dissolved. If the bank is solvent ELA from the central bank could be sufficient, but if the bank is not solvent (on its own or via support from a resolution scheme) ELA should not be provided (see further below). Preserving the legal entity and honouring contractual relations have the further advantage of upholding the value of the business. This, in turn, makes it easier to reconstruct the bank (if desirable in a specific case) and also provides an opportunity to minimise social costs in the form of loss of private information.[56]

As was seen in the recent crisis, not only direct links with other institutions can render a bank systemically important. Depending on the circumstances and the development of the crisis situation, a wide spectrum of institutions can be regarded as systemically important.[57] Therefore, a system based on the belief that it is possible to decide beforehand which individual institutions (not categories of institutions) are systemically important and to treat them in a different manner should be avoided.

However, when it comes to general legislation (and not crisis management) the fact that a wide range (in terms of both size and line of business) of institutions can, depending on the circumstances, be of systemic importance should, in my mind, lead to the conclusion that legislators' primary policy should be to limit the exposure of the categories of institutions that are truly systemically important to other kinds of institutions and markets.[58]

55 One such case could be a country having only one dominant bank which has few links abroad.

56 This is especially important in order to preserve access to credit for the bank's customers.

57 One of the Swedish banks that lost its licence during the recent crisis was regarded as systemically important at the time, but would never have been regarded as such during normal circumstances.

58 The boundary problem is addressed in, e.g., C. Goodhart, 'The Boundary Problem in Financial Regulation', 206 *National Institute Economic Review* (2008) p. 48; C. Goodhart, 'The Boundary Problem in Financial Regulation', in *The Fundamental Principles of Financial Regulation*, 11th Geneva Report on the World Economy (Geneva, International Cen-

It does not make sense to enforce stricter regulations for all kinds of institutions that conceivably could be of systemic importance.[59] Again, this is a matter of defining goals and ambitions.[60] An analysis of the functions of the different categories of institutions should serve as a starting point for the exercise.[61] In this context, it should be noted that one of the advantages of limiting the scope of what can be called core systemic legislation is that the need to create artificial governance structures to uphold market discipline through a crisis management system will be limited to the categories comprised.[62] To put it simply, categories of institutions outside the core area could be allowed to fail and thereby moral hazard would be limited.

6. A lender of last resort is not sufficient

The need for a LOLR in a modern financial system seems undisputed.[63] A central bank's ability to create unlimited liquidity[64] coupled with the ability

tre for Money and Banking Studies and Centre for Economic Policy Research 2009), Appendix A; and C. Goodhart and R.M. Lastra, 'Border Problems', 13 *Journal of International Economic Law* (2010) p. 705.

59 For the opposite view, see A. Crocket, 'Rebuilding the Financial Architecture', 46 *Finance & Development* (2009) p. 18.

60 In my view, the present problem is not lack of regulation or proposed regulation. On the contrary, the collective impact and the objectives behind different proposals must be analysed; compare, for example, the work on the proposed Alternative Investment Fund Management Directive which is described in E. Ferran, 'The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis', Working Paper 176, 15 February 2011, available at: <http://ssrn.com/abstract=1762119>. Ferran explores two overarching concerns that are frequently expressed about laws made in the immediate aftermath of a crisis, namely regarding opportunistic use of crisis situations to achieve unrelated goals and crisis-induced regulatory overreaction.

61 I am not suggesting narrow banking as a solution as has been done for many years by various scholars and recently by, e.g., J. Kay, 'Narrow Banking: The Reform of Banking Regulation', Centre for the Study of Financial Innovation, available at: <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf>. Narrow banking was seen as an interesting concept during the Banklagskommitté's (1995–2000) work on the Swedish Banking Act and perhaps influenced the functional approach adopted by the Committee.

62 This means that the number of institutions that can be allowed to go into bankruptcy will increase.

63 Lastra, *supra* n. 25, at p. 113.

64 In the central banks' own currency. More complex issues arise when ELA to domestic banks has to be provided in foreign currency. However, these are beyond the scope of the current analysis.

to (on its own or together with a supervisory authority) monitor the financial sector as a whole and individual banks seeking assistance makes an irreplaceable contribution to crisis handling. Another, often overlooked, factor is central banks' unique ability to absorb market and liquidity risk.[65] This is not the place to discuss the many and often complicated issues related to a LOLR function.[66] I will instead focus on its limitations.

ELA should only be extended to solvent banks.[67] If ELA is extended to insolvent banks, this in reality constitutes support to the banks' owners since they would not have been able to get credit anywhere else.[68] ELA to insolvent banks, indeed the mere expectations of it, creates moral hazard; it gives the owners and management incentives to take on too much risk.[69] Furthermore, it involves the risk of preserving an obsolete market structure by not allowing banks that should go under to do so. ELA to solvent but illiquid banks also poses a danger of moral hazard, but only to the extent that it affects the management of liquidity in the bank. This is far less serious than the risk of affecting the overall risk level and can be counteracted by charges that take the bank's liquidity risk into account.[70]

A decision on whether or not to extend emergency credit is always taken under considerable time constraints and great uncertainty. The circumstances in individual cases may be very different. As an analytical tool, however, four highly simplified typical situations can be identified. The bank is:

65 A central bank can accept as collateral illiquid assets that a private enterprise cannot accept, because – unlike any private agent – it does not have to worry about its own liquidity situation.

66 See further, for example, T.M. Humphrey and R.E. Keleher, 'The Lender of Last Resort: A Historical Perspective', 4 *Cato Journal* (1984) p. 275, and R.M. Lastra, 'Lender of Last Resort. An International Perspective', 48 *International Comparative Law Quarterly* (1999) p. 339.

67 'Solvent' is used in the meaning of having adequate capital with a correct valuation of assets. Perhaps a further condition should be added, namely that the bank has a viable business. However, this is a more controversial question which is not pursued further here. Professor Charles Goodhart claims it is impossible to distinguish between illiquidity and insolvency, C. Goodhart, 'Myths about the Lender of Last Resort', 2 *International Finance* (1999) p. 339.

68 A central bank in fact provides capital, and not only liquidity, to a bank by making a loan that is not warranted by the bank's solvency (or by making a low-interest loan).

69 For a similar view on the moral hazard connected with ELA, see Lastra, *supra* n. 25, at p. 115 f.

70 See, e.g., E. Perotti and J. Suarez, 'Liquidity Risk Charges as a Macroprudential Tool', Centre for Economic Policy Research, Policy Insight No. 40, November 2009.

a) solvent and systemic;
b) solvent but not systemic;
c) insolvent and systemic; or
d) insolvent and not systemic.

It is more or less self-evident that ELA should be extended in situation (a). The purpose of ELA regimes is to take care of liquidity problems in banks that are solvent. If the bank in question is also of systemic importance, the justification for assistance is even stronger. If ELA is not extended under these circumstances, there seems to be no point in having such a regime. It is less evident that ELA should be extended in situation (b). If it is clear that the bank in question only has liquidity problems, the only policy argument against extending ELA in situations like this is that it could create a more general risk of bad liquidity management in the banking sector.[71] As stated earlier, moral hazard relating to liquidity management is much less serious than the risk of creating excessive risk-taking that could arise if ELA were to be extended in situation (c). Under normal circumstances, it is therefore wrong to extend ELA in situations (c) as well as (d). In both cases, banks face something direr than a 'pure' liquidity problem; the difference is whether the troubled bank poses a systemic threat or not. Unlike situation (d), situation (c) can create great difficulty for a central bank facing a systemically important bank that is in an acute crisis situation. Even if the correct decision from a strict central bank viewpoint is to deny ELA, the threat of a systemic collapse must be taken into consideration. If there is no alternative mechanism to deal with the bank in question, the central bank may be forced to extend ELA. This in itself is an important reason why a complementary mechanism for crisis resolution is needed.

7. Taking control of a bank in crisis

For several reasons, it is important that the state, through the relevant authorities, is able to assume immediate and absolute control of a bank in acute distress.[72] As mentioned earlier, a bank that poses a systemic threat has a strong

[71] This risk, in turn, depends on the terms of the ELA, e.g., the penal element in the interest charged on ELA.

[72] The proposal of 2000 for a Swedish SRR stated that immediate control was necessary to avoid blackmail from the bank in question and moral hazard, SOU 2000:66, at p. 14. Viotti, *supra* n. 5, at p. 50.

position in negotiations regarding the (necessary) measures to avoid a systemic crisis. This, in turn, means that the bank may be able to obtain support on too favourable terms if a negotiation situation cannot be avoided. Avoiding the risk of not being able to agree on reasonable terms for support is one strong reason for assuming control. The need to assume control is not the same in all situations; the weaker the economic situation of the bank, the greater the need. The owners' incentive to take an unreasonable stance in negotiations is proportionate to the value they have at risk. If the bank's capital is zero or even negative, the owners will not have much to lose in driving a hard bargain; if they succeed the bank will be saved and if they fail there is nothing to lose anyway. Another reason for assuming control in an acute crisis is that the managers or owners of the bank might raise the risk level dramatically, thus increasing the risk to the financial system and the potential costs to creditors and/or the state, in an attempt to gamble for resurrection. Such a change in risk level can be achieved in a very short time. In a state of unrest and confusion in the middle of a crisis, decisions that change the risk level can probably also be taken quite far down in the organisation. Frequently, crisis management involves issuing guarantees of some sort for the bank's liabilities.[73] There is a clear advantage for the issuing authority if it or another authority can exercise control over the guaranteed bank.[74]

Since central banks are supposed to extend ELA only to solvent banks, there should in principle be no need for a mechanism that provides control when banks rely solely on ELA for support. But as soon as it is doubtful whether the bank is solvent (involving a consequent transfer to a separate crisis management regime) there is a need for control for the above-mentioned reasons. In practice, this may well be the most likely case as uncertainty is typically great in such situations.

Even though the main objective is immediate and absolute control of a bank, the legal tools used are important. The exact legal thresholds for gaining control are not discussed here, but it has to be made clear that it is nec-

73 If the bank in question faces more than temporary liquidity problems, which should be the minimum threshold for entering into an alternative regime, there will frequently be, at some stage of the process, doubts about the quality of the bank's assets, which in turn warrants guarantees in many situations where an immediate closing of operations is not possible.

74 Under the current Swedish legislation, guarantees are issued after a voluntary contract has been entered into between the bank and the Support Authority. The technicalities are quite complex, see Sjöberg, *supra* n. 1.

essary that control be achieved without delay when a bank is in immediate need of support. Since it is typically large and complex entities that have to be governed with a view to possible continued business, it is a clear advantage to be able (at least to some extent) to use the existing legal structure created by corporate law (and internal regulations and instructions) instead of developing a new legal construction that operates in parallel with the existing one. In doing so, the authority in charge can use the parts of the existing structure that are useful and reliable, and – which is of crucial importance – can more easily maintain continuity of service in systemically important parts. At the same time, the authority in charge is provided with legal tools to change the other parts of the structure. In contrast, developing a new legal 'animal' carries the risk of being less efficient in terms of governance and creating unnecessary ambiguity in relation to counterparties and potential counterparties.

It is necessary to be able to assume control of all aspects of the bank's business, including the bank's capital and business structure and operations through subsidiaries.[75] Control must also entail the possibility to change the management (the persons controlling the bank's business) as well as, if necessary, lower-level staff if they are central to the running of the bank (e.g., persons involved in risk control). The legal tool used to take control must not raise any doubts as to whether the bank will remain the same legal entity and whether contractual obligations will be honoured.[76]

When the option of creating an entirely new governance structure is ruled out, two alternative principal means of assuming control remain, namely to take over ownership of the shares in the bank or to assume their voting rights. Assuming the voting rights has several advantages. As a matter of principle, it seems right to choose the method that encroaches least on the incumbent owners' rights and does not jeopardise the end of the process, e.g., by creating moral hazard.[77] This speaks for an assumption of the voting rights, under the presumption that the shareholders will be treated fairly later on in the proc-

75 The Second Company Directive (77/91/EEC, Article 58, second paragraph) requires decisions regarding a reduction of the share capital and new issues of shares to be taken by the shareholders. In a common European corporate law for banks (see below) this obstacle could be removed.

76 This does not mean that it should be impossible to include in a legal regime the option to write off certain types of debt under conditions clearly set out in the law. The proposal of 2000 for a Swedish SRR included such an option, SOU 2000:66, at pp. 17 and 212 ff. Viotti, *supra* n. 5, at p. 50.

77 This would be what Eva Hüpkes calls a temporary derogation from corporate governance requirements, E.H.G. Hüpkes, 'Special Bank Resolution and Shareholders' Rights: Bal-

ess. If the incumbent owners can remain as owners during the process (temporarily without control), they can be offered to voluntarily participate in a subsequent capital injection or other restructuring measures in that capacity.[78] This may mitigate the valuation problems always connected with involuntary measures.[79] If it is possible to reach an entirely voluntary solution regarding the terms of participation, there will of course be no problems connected with valuation. Owners (and potential owners) with different views on the risks and possibilities connected with the holding of shares in the bank can trade in the shares and thereby further facilitate a private solution. Another advantage with the possibility of trading is that incumbent owners in need of cash can sell their shares (temporarily at least, without voting rights).

Also for more technical reasons, it seems better and easier to assume the voting rights. It should be remembered that it must be possible to take control very quickly, often within hours. It may be presumed that most legal systems require more rigorous legal proceedings for a final and involuntary transfer of ownership of shares in a bank than for a (temporary) transfer of voting rights. Lengthy legal battles in court must be avoided, at least as long as they may hinder the immediate assumption of control over a bank.[80] A decision by a relevant authority (a court or the authority in charge of crisis management) to take over the voting rights of the shares can be executed immediately, and the authority can thus assume control of the bank.[81] This should not rule out the possibility to legally challenge the authority's decision afterwards. However, mechanisms that require the authority to take certain steps, including valuation and *ex post* compensation to the shareholders, within a specified time frame, may be a sufficient substitute.

If for some reason it is no longer necessary to exercise control over a bank or if a decision to assume the voting rights is reversed, the voting rights can easily be returned. On the other hand, if ownership has been transferred, it is complicated to transfer it back to the final owners in different registers.

ancing Competing Interests', 17 *Journal of Financial Regulation and Compliance* (2008), at p. 283 f.

78 For example, they can be offered the first right to subscribe to new shares.

79 Valuation is dealt with in the next section.

80 According to the proposal of 2000 for a Swedish SRR, the decision to assume control was supposed to be taken by a court of law after an application by the Support Authority, SOU 2000:66, at p. 207 f.

81 Depending on the legal system, different steps must be taken to use the voting power, but it is assumed that most systems make it fairly easy for a single controlling shareholder to gain control.

Assumption of the voting rights will, in practical terms, give the authority in charge of crisis management all votes at the shareholders' meeting, thereby giving it the power which a sole owner of a company would have. That will enable it to apply a wide range of measures. It could be contemplated to give the state or the authority in charge also additional tools outside the company law system which can directly affect the power over the bank under administration.

The important objective regarding control is that the authorities should be able to assume immediate control without unnecessarily jeopardising the rights of the incumbent shareholders.[82] A balance has to be struck between the need for the authorities to move quickly in the public interest and the incumbent shareholders' interest to remain in control.[83] Here, it is important to note that the valuation problems can be sorted out later in a separate process (if finding an amicable solution is not possible). Another important aspect is that the authorities' assumption of power must not jeopardise the bank's ability to continue with its business activities. It must be clear that the bank remains the same legal entity and that contractual obligations will be honoured. Ambiguity in this respect (as well as in all other respects) in relation to counterparties and potential counterparties must be avoided.

The Commission Communication is vague in this regard and does not prescribe any particular legal means to achieve the desired aims, which include asset transfers and write-down of debt.[84]

8. Valuation

When there is a mechanism that deprives the original shareholders of their shares or dilutes the value of their stake, valuation of the bank is important from at least two perspectives.[85] The first ultimately has to do with fairness but also relates to the long-term conditions for private bank ownership. The

82 Some degree of infringement is necessary since ownership rights include control rights.

83 Hüpkes, *supra* n. 77.

84 The Communication mentions different resolution tools, including the sale of the bank or parts of its business without the consent of shareholders, the possibility to transfer assets to a bridge bank or a bad bank, and a debt write-down. The resolution powers are said to be the various legal powers that, in different combinations, authorities exercise when applying the resolution tools. Finally, it states that there will be no rigid description regarding the legal means by which the powers are exercised, COM(2010) 579, at pp. 9 and 10.

85 Valuation is also important if the writing down of debt claims is considered, but this matter is not addressed here.

second concerns the (more immediate) risk that uncertainty about valuation may have adverse effects in an acute situation. In the face of uncertainty about the valuation terms, the prospect of state intervention may give a troubled bank further problems instead of producing the intended reassuring effect.

The fairness perspective may seem vague, but it is simply not acceptable in developed countries that persons are deprived of their property without fair compensation even though it is in a situation of financial turmoil.[86] As stated above, there is a risk that the authorities use their power vis-à-vis the owners of a troubled bank in an unfair manner, the conditions for support being too harsh in relation to the state of the bank. Since fairness is an inherently difficult term to define and operationalise, a slightly different perspective can be applied here to further the fairness argument. Confiscation of property which is seen as arbitrary or unfair (*ex ante* or *ex post*) is likely to negatively affect investors' willingness to invest in the banking sector, which, in turn, can be seen to affect efficiency. As mentioned, these arguments rather concern the long-term conditions for private bank ownership and their implications for efficiency, in contrast to the argument presented below that relates more to the possibilities of dealing with an acute situation.

Ex ante certainty about valuation principles and methods prevents a situation where present and potential shareholders (and creditors) do not take action to solve a difficult situation because it is impossible to calculate the risk of losing money in a subsequent rescue operation by the state. What is sometimes called constructive ambiguity does not seem a palatable option in this regard. It is not hard to imagine that it is difficult to get incumbent shareholders and new investors to put up new capital if the terms of the investment are unclear.

At the heart of the valuation is always the balancing between the public interest in avoiding blackmail during the negotiations about the conditions of support and the interest of the bank owners in not being subject to unjust treatment.[87] It is commonly recognised that it is wrong for a bank (and ultimately its owners) to get support on too favourable conditions given the bank's status, but it is equally wrong to deprive the owners of value without

[86] Compare, for example, Article 1 of Protocol No. 1 to the European Convention for the Protection of Human Rights and Fundamental Freedoms. For an extensive walk through the subject, see Hüpkes, *supra* n. 77.

[87] Treating owners of banks fairly (at least within the meaning of foreseeable and economically motivated) is ultimately, of course, also a public interest.

compensation. The valuation process has to include mechanisms that can balance these opposing interests.

This is not the place to go into the details of valuation processes, but something should be said about the guiding principles. It is often said that institutes in need of support should be seen as (at least more or less) worthless and that the bank's shareholders therefore need not be compensated if their shares are taken over by the state. The argument seems to be that the shareholders are to blame for the bank's misfortunes and that market discipline demands that they lose their stake. As we have seen, however, even perfectly healthy banks can be hit by a liquidity squeeze which, absent ELA of some sort, can develop into a solvency problem. Therefore, the need for public support should not be used to gauge the value of a bank. It is built into the system and commonly accepted that banks may need liquidity support even if they are in no way at fault. At least it used to be that way; no other conclusion could be drawn based on the legal framework adopted by national governments and accepted by the international community.[88] This is an easy and self-evident observation. However, it should be equally clear that there is no sharp borderline between pure ELA and all sorts of other support measures. This means there could be a positive equity value in a bank that receives support even when relatively comprehensive support measures are deployed.

The Communication from the Commission does not specifically address the matter of valuation in different situations.[89] However, legal certainty is mentioned as one of the objectives of a resolution regime. This is said to include appropriate safeguards for third parties and restrictions on interference with property rights to what is necessary and justified in the public interest. Furthermore, it is said that the system should aim to ensure that creditors receive a treatment similar to that which they would have received if the bank had been wound up.[90] These statements do not give much concrete guidance. For example, the outcome of treatment equal to that involving a winding-up situation depends entirely on the circumstances surrounding the

88 However, the Commission states that recovery plans 'should not assume access to any support from public funds', COM(2010) 579, at p. 6. It is not clear whether ELA is included or not.

89 Under the heading 'Debt write down', the Communication discusses, in general terms, policy questions, including a write-down of all equity. Valuation is not directly addressed, COM(2010) 579, at p. 11.

90 COM(2010) 579, at pp. 3 and 4.

winding up. Moreover, the statement regarding treatment of creditors does not square with the discussion about debt write-down.

9. The European level

To deal with a crisis situation (involving one or several banks) having (global or European) cross-border systemic implications is perhaps the greatest challenge to financial regulation.[91] This is not the place to discuss the organisational features of decision-making and burden-sharing systems.[92] These matters are complex and will no doubt require extensive deliberation and negotiation. However, a good starting point seems to be a common understanding of the factual problems that need to be addressed by a (common) crisis management system.

The level of complexity is dependent on the ambitions of the system. As mentioned above regarding setting goals for a crisis management system, it is important to establish the level of ambition already from the outset. Perhaps the most critical issue is how the operations undertaken during crisis management should be financed. A system that involves the use of different countries' public funds will, for known reasons, be very complex. The level of complexity (from a financing viewpoint) is significantly reduced if the ambition is limited to handling situations where an insurance solution suffices, i.e., a system that relies on the banks themselves for paying insurance premiums that will cover the costs of the system.[93] However, a common insurance

[91] The situation has been described as a trilemma, i.e., three objectives have to be balanced: financial stability, financial integration and national fiscal sovereignty, see D. Schoenmaker, 'The Financial Trilemma', Duisenberg School of Finance – Tinbergen Institute Discussion Papers No. TI 11-019 / DSF 7, 10 February 2011.

[92] However, this is done elsewhere, see Commission Communication COM(2010) 579, at p. 12 ff.

[93] The Swedish stabilisation fund has received a lot of attention. As part of the support programme, the Swedish Parliament (Riksdag) decided to establish a stabilisation fund in order to finance measures aimed at supporting financial stability. The fund is administered by the Swedish National Debt Office, which is also responsible for organising support for banks. Initially, the Parliament decided to provide SEK 15 billion to the fund through a special appropriation. Banks and other credit institutions should pay yearly risk-adjusted fees to the fund in order to accumulate a sum corresponding to, according to the initial plans, 2.5 per cent of GDP within 15 years (today this would equal around SEK 77.5 billion or EUR 7 billion). Another aim was and is to include the deposit insurance fund, currently worth about SEK 20 billion, in the stabilisation fund. However, at the moment the amalgamation of the two funds is subject to further deliberation by the Financial Crisis Committee (see *supra* n. 12), as are the plans for risk-adjusted fees. Although the fund was

system without common legislation and supervision together with common crisis management legislation and organisation does not seem feasible. Ways to create a pan-European system applicable to banks should therefore be seriously explored.

Fully harmonising the different existing sets of legislation and models for supervision is complicated and perhaps not even desirable. National solutions regarding smaller and more country-specific banks may well be called for. Limiting the ambitions and only including the biggest and obviously systemically important institutions in a common system may be a practical as well as efficient solution; efficient both in that dual regimes allow for country-specific solutions if called for and in that a new element of regulatory competition is introduced.

A practical issue of critical significance, which is not addressed in depth here, is how to determine when an individual institution is systemically important and thus requires transfer to the new system. In this context it may be noted that a large number of countries have agreed on capital adequacy rules that apply to what is called 'internationally active banks'.[94] Thus, as regards such rules, a harmonised international framework has been set up. However, these capital adequacy rules apply to internationally active banks without further distinguishing between those banks which may or may not be systemically important. The Financial Stability Board's recommendations regarding systemically important financial institutions represent an attempt to introduce a specific policy framework for systemically important institutions. The recommendations address the resolution of such institutions but are limited to those that are 'clearly systemic in a global context'. Moreover,

initiated through the Support Act, the level of the annual fees was decided by way of an amendment to the Act enacted on 30 December 2009. The fee is 0.036 per cent of the liabilities and appropriations of the institution. In addition to the fees, charges for bank guarantees and possible returns on other support measures are transferred to the fund.

Solutions based on private funding at European level have been suggested by others. Deutsche Bank CEO Josef Ackermann proposed a European Rescue and Resolution Fund (Davos, January 2010) and IMF Managing Director Dominique Strauss-Kahn suggested a European Resolution Authority mainly pre-financed by the industry (March 2010). The final aim of the Commission seems to be a single EU fund (COM(2010) 579, at p. 15).

94 See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988, updated to April 1998), at paragraph 7 ('Basel 1'), and *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2004), at paragraph 20 ('Basel II'). A revised version of these standards ('Basel III') is currently being finalised.

it is noted that judgment is needed to determine what constitutes global systemically important financial institutions.[95]

For several reasons, the best way to create an entirely new pan-European system seems to be through a common corporate law for banks. The links between corporate law, on the one hand, and specific banking regulation and a crisis management regime, on the other, are so strong that it is not possible to base systems on different principles. Because of this, it would not be fruitful to try to create a common European system for crisis management without coordinating the applicable corporate law (and banking law). By creating a new legal basis, i.e., a common corporate law for banks, nationally regulated banks can also be transferred to another common legal and supervisory regime. The existing legal entity is then transferred from the national legal system to another legal domicile with a different regime. If correctly designed, the common corporate law for banks can thereby be used as a vehicle to transfer banks from the national to the common regime. The biggest institutions that are clearly systemically important in several countries should be required to transfer to the new system, but it could be open to other institutions as well.

Whether the common corporate law for banks should be (or should be mainly based on) the already existing Societas Europaea or an altogether new creation is not discussed here.[96] That decision involves complicated considerations, e.g., regarding timing and the degree to which corporate law should be adapted to financial regulation.

10. Conclusion

It is often said that the devil is in the details and I have no doubt that designing the actual rules for crisis management will be difficult, but in order to cope with the details a clear picture of the underlying principles and ends is necessary. I have sketched a number of issues that, in my view, merit consideration by anyone who intends to draw up a crisis management framework. One key element in the process of achieving a common European system for crisis management, including the biggest and obviously systemically impor-

95 See Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines*, 20 October 2010, at p. 1.

96 The idea of using the Societas Europaea as a common legal framework was, I believe, first raised by Professor R. Lastra, Centre for Commercial Law Studies, Queen Mary, University of London.

tant institutions, is the creation of a common corporate law for banks. In short, it can be said that a common corporate law is both necessary as a legal foundation for the new comprehensive regime and useful as a vehicle to transfer institutions from a national regime to the new regime.

As mentioned in the beginning, this article is only a first step in a more comprehensive process of identifying the proper set-up of such a system. I do believe that such an analysis is needed. I do not believe that the latest Communication from the European Commission should or will put an end to the discussion. Nor do I believe that the rules that eventually emerge from the continued work on these issues within the EU will be the final word. In matters as complex as these it seems improbable that the EU lawmakers – or anyone else – will get it right the first time.