Financial Crisis Management and Corporate Governance[1]

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Introduction

One of the main problems related to the management of financial crises is the risk of creating moral hazard. Bailing out the owners and creditors of systemically important banks creates perverted incentives that increase the risk level in the financial system. To preserve financial stability and at the same time uphold (or create) market discipline is therefore of paramount importance.

Legal mechanisms aimed at reducing moral hazard in systemically important institutions are essential for every jurisdiction. Introducing a Special Resolution Regime (SRR) with the explicit objective of serving as a governance tool is one way of achieving that. An SRR designed with that objective in mind must make it credible that shareholders and debt holders will suffer losses if an institution fails and thereby induce market discipline. Other aspects of crisis management also have governance implications.

Today everyone seems to agree that an SRR should be an important part of the legislative package used to control the behavior of banks, or, more accurately, the decisions by people involved in banks, such as their owners, their management and other employees and their creditors. However, from a policy perspective it is important to have a clear picture of the precise role that an SSR is to play. A policymaker has to identify what the objectives are and how the SRR would fit in with the rest of the legislative package. When

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forming the overall picture it is paramount to have a realistic view on what actually can be achieved with an SRR.

The perspective in this article is one of legislative effectiveness and efficiency; the objective is to identify the most efficient solutions from the point of view of the society as a whole. Banks are private institutions that fulfill important tasks in the economy and the basic assumption is that they should conduct their business according to the conditions of the free market. However, negative external effects from failures call for legislation regarding the operation of their businesses and that legislation has to be designed with a societal perspective.

In my view, an SRR serves two equally important purposes. One of them is to provide the legal instruments necessary to deal with an ongoing crisis. The other is to help prevent crises; to serve as a tool affecting the governance of banks. The focus here will be on this latter goal and on what realistically can be expected from a resolution regime. Since corporate governance in general is a complicated matter and governance of banks perhaps even more so, it can be nothing more than a sketchy attempt to identify mechanisms that have the potential to affect the governance of banks. A more in-depth investigation should, among other things, go into the relationship between management and owners in the governance of banks, since that is a crucial question regarding the effectiveness of measures directed at shareholders, e.g. write down of equity capital in a resolution process. This is a complex issue, not at least since the relationship between management and owners would be affected by the introduction of such mechanisms and a static analysis of present conditions would therefore not be sufficient. However, it feels safe to assume that increased risk for shareholders to lose money after a bank failure will affect shareholder incentives and perhaps also that it can be instrumental in tipping the balance of power between shareholders and management. The role of creditors in the governance of banks will not be analyzed or discussed, except for the underlying assumption that an increased risk for creditors to lose money after a failure will affect governance.

It should be mentioned already from the outset that an important restriction on an SRR is that it must not, from a societal perspective, be detrimental to the functioning of banks in normal times and to stability in times of stress.

Several countries have SRRs in place and others have come far in preparations. Perhaps the best examples of countries with existing systems are the USA and the United Kingdom. One notable example of far advanced prep-

arations is the proposal for a European directive on SRRs.[2] However, other countries and regions have hardly applied any efforts to developing SRRs. The Financial Stability Boards' Key Attributes seek to give guidance to countries in the process of developing an SRR.[3]

The approach here is to discuss different features of an SRR that can make such a legal construction an efficient governance tool. The analysis is independent of any existing or proposed system. Hence, this is not primarily a comment on specific solutions but an effort to identify necessary elements in the legislative product and also in the legislative process. The discussion is to a large extent based on experiences made in Sweden during the domestically created crisis of the 1990s and in the global crisis in 2008/09 and on subsequent inquiries and research. Cross-border considerations are not addressed. To make an otherwise abstract discussion more concrete examples are given, mainly from the proposed EU directive since it is close both in time and geographically.[4] However, it is fair to say that the examples most often are used to contrast the ideas brought forward here.

Of course the legislative product is of primary interest but I do believe it is also important to touch on the legislative process and subsequent policy perspective, since it is necessary to establish a level of ambition and clear goals for the legal system under construction. When it comes to the level of ambition it is simply not possible, in my view, to design a single system suited to handle crises of all magnitudes. The legislator will have to aim for a future system designed to suit specific situations. I will outline three different levels of crises, which call for different actions and hence different legal solutions. Of course, they are only rough sketches and in real life there are no clear distinctions between different levels or magnitudes of crises, but the models can serve as a starting point for a discussion. Since it is hardly possible to achieve all goals for crisis management with one single legal solution, it is important

[2] Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms COM(2012)280/3.

[3] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes) (October 2011), available at: www.finacialstability-board.org/publications/r.

[4] This is written a couple of weeks after the proposal was released in June 2012. Many of the opinions related to the proposal brought forward here are inspired by the Swedish National Debt Office's comments to the proposal.

to have an idea *ex ante* what you want to achieve; what kinds of crises you would like to be able to handle.

The focus in this article will be on an SRR designed to handle individual systemically important banks and there will consequently be an effort made to identify some elements and instruments necessary for such a regime. However, when discussing the limits of such a regime questions regarding system wide events will also be touched upon.

Even though the primary perspective of this article is that of a legislator or a policymaker, the ideas brought forward can be used by others when evaluating existing SRRs or proposing new ones. In that way it is also academically oriented. As I see it, academics, both in law and economics, have to develop instruments suited to critically evaluate legal products independent of narrow legal methods or reasoning.

To sum up; this article aims primarily at identifying realistic goals for an SRR and discussing some key features of such a system to make it an effective governance tool. In the next section three different levels of crises are elaborated on in order to create a backdrop to the continued discussion. In the section after that the desired objectives of an SRR are discussed. The penultimate section deals with three key features of an SRR, namely (i) the ex ante perspective, (ii) the need for immediate control of a bank in crisis and (iii) the requirement that the system must function also in a full blown systemic crisis. Finally, conclusions are drawn.

Three Levels of Crisis Management

As mentioned above it is useful to identify beforehand what kinds of crises the system in mind should be able to handle. The measures and instruments necessary and suitable are quite different depending on the ambition of the system. Below, three levels are set out and shortly elaborated on. The point is not to define or analyze different types of crises, but simply to sketch different possible scenarios, thereby creating a starting point for the analysis. Without a clear view of what kind of situations the system, at least primarily, sets out to handle there is an obvious risk of suboptimal solutions. A system designed to handle problems similar to those of the recent crisis, with a near melt down of the whole financial system, carries the risk of being inappropriate under more "normal" crisis circumstances.

There are two related basic rationales behind state interventions to prevent banks from failing – in the sense that they become unable or very close

to being unable to fulfill 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, most often called systemic stability. But the failure, or more accurately the closing down, of a viable banking business could also have other social costs, mainly in the form of loss of private information regarding the borrowers. Both these dimensions are touched upon below, but the focus of this article is on systemic stability.

There seems to be, at least, three possible levels of ambition for a system handling distressed banks, namely to handle:

- Individual non-systemic banks
- Individual systemic banks
- Full blown systemic crises involving more or less all banks

<u>Level one:</u> Individual non-systemic banks. This level encompasses failures of banks that are so small that they under almost no circumstances can individually be of systemic relevance. An SRR designed for this level should be able to efficiently handle failures in non-systemic banks and probably focuses on depositor protection and issues related to what is known as regulatory forbearance.

It should in this context be noted that this article focuses on the governance of banks (and perhaps other financial institutions) but not on the entirely different issue of the governance of supervisory agencies.[5] Depending on the size and the market structure of the country in question an SRR created to deal with failures on this level can meet quite different tasks. One example is the Federal Deposit Insurance Corporation (FDIC) in the USA that via its resolution mechanisms handle hundreds of insolvent banks every year. The FDIC system is virtually a factory for closing down relatively small banks as smoothly as possible.[6] Another example is the Danish system that more or less explicitly limits itself to non-systemic banks. The mechanisms used to take control over failing banks and the method of transferring liabil-

[5] I see what is often called prompt corrective action foremost as a tool for supervisory agency governance.

[6] The list of banks failed during 2009 includes close to 150 banks and the list for 2011 includes close to 100 banks, http://www.fdic.gov/bank/individual/failed/banklist.html. FDIC employs almost ten thousand people, http://www.fdic.gov/about/strategic/report/2011annualreport/AR11final.pdf.

ities and assets to another legal entity is not suited for banks of systemic importance. The Danish system has handled around 20 insolvent banks in the last years.[7]

Systems designed to handle level one situations seem in practice often not fit to handle situations of the second level, namely difficulties in one or several systemically important banks.[8] The reason for this is not clear, but could be that it is much more complicated to handle systemically important institutions, so if the system is developed with non-systemic institutions in mind such mechanisms are avoided.

Level two: Individual systemic banks. At this level, one or a few systemically important banks face difficulties, but there is no immediate danger of a total melt down of the financial system (level three) if the situation is handled promptly and correctly.

Initially, it is appropriate with a few words regarding the meaning of systemically important. Difficulties in a bank have systemic implications in two cases, namely when the bank in itself is so large that its failure will create considerable disturbances to the functioning of the economy as a whole or when there is risk of contagion (when difficulties in one bank lead to problems in other banks).[9] A failure in a single large bank can cause disturbances in the overall economy, e.g. if its depositors (temporarily) lose access to their accounts and thereby are unable to use the payment system or by an ensuing 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 fails without any risk of contagion.[10] Contagion can be caused both by direct links (through contractual relations including credit exposures or the payment system) between banks and by indirect links such as via markets and/or rumors that the problems in one bank also are present in other banks. Direct links between banks mean that if one bank suddenly stops to fulfill its obligations there may be a chain reaction that brings down

7 http://www.finansielstabilitet.dk/selskaber-under-finansiel-stabilitet.aspx.

8 It was, as far as I know, at the outset not even contemplated that the FDIC system could be able to handle the difficulties of the present crisis.

9 For an extensive analysis of systemic risk, see Schwarcz, Steven L., *Systemic Risk*, Duke Law School Legal Studies Paper No. 163; Georgetown Law Journal, Vol. 97, No. 1, 2008. Available at SSRN: http://ssrn.com/abstract=1008326.

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

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 are broken and the legal entity dissolved.

When a systemically important bank runs into acute problems, almost by definition, prompt action from the authorities is necessary. There are two possible alternative scenarios leading up to the acute phase of a crisis. One is a genuine balance sheet solvency problem which is in focus here, the other being pure liquidity problems (without connection to a solvency problem). If the bank is balance sheet solvent it could be sufficient with emergency liquidity assistance (ELA) from the central bank, but if the bank on the other hand is not solvent (on its own or via a mechanism for support from a resolution scheme) ELA should not be provided, since that constitutes support to the owners of the bank.

An acute situation can appear suddenly without warning or, as an alternative, the underlying problems can be known, to a smaller or larger extent, during a period before the acute phase. The focus here is on the acute phase, when a bank faces immediate difficulties to fulfill its obligations and therefore poses a threat to the functioning of the financial system (and it is not sufficient or appropriate with ELA). The way this phase is handled 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 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 an elaborate system for post-acute measures.

Level three: Full blown systemic crises. This level means that substantial parts of the financial system in a country or, even worse, in the region or even in the world are in deep distress. The recent crisis is an example. The causes of the crisis are less relevant for the analysis here, but of course crucial when addressing the underlying problems. It should be pointed out that in globalized markets the causes of the crisis in one country (but not in all countries) can be entirely external. It must also already here be stressed that I do not suggest that any SRR (in the ordinary meaning) would be sufficient in a crisis of this magnitude. Other measures outside the scope of an SRR have to be employed when the whole financial system is at risk.

As was said above, difficulties due only to temporary liquidity problems can ideally be solved by pure liquidity support. In fact the possibility to avoid

large social costs with relatively simple means is the main explanation of the existence of a lender of last resort function. Even though this article focuses on situations where a systemically important bank encounters acute problems that have deeper roots than just temporary lack of liquidity, it should be noted that it is not always self-evident where to draw the line between ELA and other measures aimed at enhancing liquidity. In the recent crisis both traditional bank runs (depositors queuing in the streets and deposit withdrawals using more contemporary techniques) and withdrawals of wholesale funding occurred. This was accompanied by an almost total breakdown in the markets used for funding. In fact the lack of available funding (lending to the bank or the bank's sale of assets), regardless of the banks' economic health, was perhaps the most characteristic feature of the crisis. In this context, it is important to reiterate that also banks with their finances in good order and a perfectly viable business can be hit by a liquidity shortage that rapidly can develop into solvency problems if nothing is done. In the current crisis, we have learnt that liquidity problems that under normal circumstances should have been very brief lasted for long periods and affected the entire financial sector. Also for this reason, it is clear that it is not sufficient with only traditional ELA to individual institutions. Measures aimed at enhancing the liquidity situation generally can be needed as well as complementary mechanisms for dealing with (potential) solvency problems. During the recent crisis the measures aimed at generally enhancing the liquidity situation, at least in the Swedish financial system, was much more extensive than was pure traditional ELA.

As already said, an SRR designed with the objective of handling crises of every conceivable magnitude is in my mind not a reasonable alternative. Worst case situations frequently call for political ad hoc solutions on both a domestic and international arena. A further difference between a second and a third level crisis is that a second level crisis could 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 on the third level frequently calls for state money to be used. Another way of expressing this, and perhaps to define 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 with a near melt down of the whole financial system would be so high that the banks could neither pay them *ex ante*, nor compensate the state for the costs it has incurred *ex post*.

The difference between level two and level three crises have an immediate bearing also on the governance of financial institutions. An SRR could and should be used as an instrument to curtail careless bank practices. This is one of the main points in this article. But, it is equally essential that legislation does not give the opposite incentives, namely to take on too little risk. If the framework gives the impression that drastic measures will be taken also against banks that end up in difficulties due to circumstances beyond their control that will have effect on risk taking. Concern among owners and creditors that banks can be subject to drastic resolution measures without a clear connection to the behavior of an individual bank will almost certainly have negative effects on the functioning of the banking sector.

Experience indicates that full blown systemic crises almost invariably are caused also by a significant portion of bad policy making, i.e. circumstances outside the control of banks and their owners and creditors. The conclusion is that an SRR is much more likely to be an efficient and effective governance tool when directed at level two crises, since the chances are higher that the crisis is caused (at least to a large proportion) by bad banking.

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.[11] It can be said that a well designed SRR is necessary but not sufficient to handle level three crises. In addition preparedness for ad hoc solutions and general measures are needed. One example is situations where banks try to survive via shrinking balance sheets in a manner that causes a credit contraction that threatens to destabilize the economy. A minimum requirement is that an SRR developed to handle level two situations does not impede the handling of level three situations. Among other things this means that an SRR to be efficient in a level three context cannot rely too much on "private solutions" since there may be no viable private actors around.

Objectives of a Special Resolution Regime

Regardless of the perspective on the task of designing an SRR, it is necessary to identify clear objectives for the system. Inevitably, there will be a number

[11] For example legal instruments to gain control over banks and for valuation could be used also when there is a need for state funds to be used for guarantees and to buy assets.

of difficult choices during the process; it may concern different possible legal solutions or other issues that can be decided in different ways. Without setting clear objectives for the intended system it is difficult or perhaps even impossible for a policymaker or legislator to handle the decisions that by necessity arise later in the process in a rational and consistent manner. In the same way it is meaningless for an academic to evaluate a system without the analytical base of clear objectives; it is not possible to say whether a system is good or bad if there is no clear yardstick.

There is no point in having an SRR if it is not successful in preserving systemic stability. As indicated above, I see a functioning financial system as included in the objective of systemic stability; it is not meaningful to say that there is financial stability if (critical) banking functions are not performed. However, it is, to put it drastically, not difficult to create financial stability (at least if the state's finances are in good order). The problem is to do it without creating moral hazard. From this observation, the two overriding goals for a SRR can be formulated, namely, to preserve systemic stability and at the same time uphold (or create) market discipline (that is, to avoid moral hazard).

It should be mentioned that the above mentioned goals are set for an SRR and consequently for crisis conditions. The balance struck between stability and efficiency in legislation applicable under normal circumstances is another difficult question that is not addressed here. However, as already mentioned, one important restriction on an SRR is that it should not negatively, from a societal perspective affect banks risk taking during normal times. Or, put in ordinary language, not make banking services unnecessary expensive.

Minimizing 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, that will also mean minimal overall costs to society. Taken literally, minimizing costs to taxpayers (in that capacity) is a more or less pointless goal since taxpayers' money should be used if that could reduce the cost to society. Expressed in another way: the goal of minimizing costs to taxpayers is connected with a risk that costs are shifted to the same persons in different roles, namely as banks' customers or counterparts, and also that the costs to society will be higher.

Another objective (or perhaps a restriction) is that the system (as well as the rest of the regulatory environment) has to allow a continuing development of the financial sector. That includes that banks without a viable busi-

ness could be forced to close down. In this context one qualification should be made regarding the first objective. Simply put, it can be said that the functioning of the financial system has to be preserved but not necessarily the institutions in existing form and absolutely not with the same owners.

Without 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 incomplete or unclear regimes. Such an approach can be dangerous for several reasons. Obviously there is a risk that banks can obtain support on too favorable terms when there are no legal measures that can be used to put pressure on them in a negotiation. A lack of clear rules also exposes banks and their owners to the risk of unfair treatment. The position of a bank in a temporary liquidity crisis (perhaps caused by forces outside the bank's control) is dire. Moreover, public opinion in times of financial crises often puts pressure on the authorities to "act resolutely" towards the banking sector. From the perspective of legal certainty, it is better to have the procedures to be applied in these situations clearly set out ex ante in legislation. Over the weekend sales on ad hoc terms may seem as smooth solutions and give the government credit for being forceful but they are generally not desirable.[12] To put it in economic terms, quickly executed sales on ad hoc terms may be associated with substantial transaction costs and subsequent wealth transfers in the absence of legal certainty concerning the rights of different stakeholders.[13] When we discuss the goals of a crisis handling system, a given should therefore be that such a system should meet high legalistic demands. However, I do not see legal certainty as a separate objective, but as a (very important) restriction.

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

[13] Uncertainty about government policy can trigger a crisis. It has been pointed out that the sudden and unpredictable reversal in resolution policy that marked the failure of Lehman Brothers changed market expectations and led to a general flight to quality, which in turn decreased stability.

The proposed EU directive regarding SRRs has in Article 26 a list of things that are all defined as "Resolution objectives". It is also stated that all items on the list are of equal significance.[14] The list includes six items, among other things continuity of critical functions and financial stability, which seems to be more or less the same thing. Included in the paragraph covering financial stability is the objective of maintaining market discipline.[15] To protect public funds is set out as a separate objective as is protection of depositors covered by guarantee schemes and client funds and assets.[16]

As stated above, protection of public funds is a questionable objective and it is at least not equal to financial stability. In a societal perspective the protection of public funds can at most be seen as constraints when pursuing the overriding objective of financial stability. Perhaps there is a difference between what is called resolution objectives and objectives for the process of designing an SRR, but I do not think so.[17] Listing so many and different things and purporting that they are equally important objectives are at best confusing and could in the worst case paralyze the resolution authority. As already mentioned, there is, in my mind, enough with two overriding objectives, namely to preserve systemic stability and at the same time uphold market discipline.

The Key Attributes states that their implementation "should allow authorities to resolve financial institutions in an orderly manner *without taxpayer exposure to loss from solvency support*, while maintaining continuity of their vital economic functions."[18] Even though the Key Attributes seems to make a sophisticated difference between the causes of the losses, there is a clear objective not to expose taxpayers to loss.[19]

Three Necessary Features of a Special Resolution Regime

Below I focus on the three, in my mind, most essential features for the functioning of an SRR as a governance tool, though there are of course several

[14] Article 26(3).
[15] Article 26(2)(b).
[16] Article 26(2)(c) and 26(2)(e and f).
[17] Article 26 says that the resolution authorities shall have regard to the objectives when applying the resolution tools and exercising the resolution powers, Article 26(1).
[18] Key Attributes, Foreword, p. 1.
[19] However, this standpoint seems mitigated by the wording in section 2.3 regarding objectives and section 6 regarding funding of firms in resolution.

other important (and necessary) ingredients when putting together a workable mixture of legal measures. The features dealt with are; (i) the ex ante perspective, (ii) the need for immediate control of a bank in crisis and (iii) the requirement that the system must function also in a full blown systemic crisis.

Ex ante perspective

Apart from providing legal tools for dealing with a crisis at hand it is also necessary that an SRR is permeated with an ex ante perspective. This point is not strictly about the legal technical features of an SRR, but more about the mindset behind the design and the credibility of the end product. On the face of it, an ex ante perspective seems more or less self-evident, since one of the objectives is to bring down moral hazard and thus function as a governance instrument. However, it is easier said than done to consistently apply a credible ex ante perspective on every aspect of a conceived system.

One of the major problems with systemically important banks is that shareholders and debt holders are not perceived to, and in reality do not, suffer losses when banks fail. This gives rise to an increased risk level in systemic banks. When deciding on risk levels and pricing shareholders and creditors take into account a more or less implicit state guarantee. As a consequence, there is not enough market discipline. This means that debt financing is too cheap in a societal perspective, which in turn results in too much debt financing and increased risk through the institutions' balance sheet composition. Consequently, one of the key attributes of an SRR has to be increased risk in debt financing or, put differently, to remove the conceived state guarantee for debt holders. That calls for mechanisms that deprive debt holders of value in the resolution process, or in other words a mechanism for writing down debt even though the bank is not going through a bankruptcy. It goes without saying that this is technically very complicated in a systemically important bank, since losses incurred by debt holders is one of the major sources of contagion.

If a system contains mechanisms to deprive debt holders of value it is necessary also with mechanisms to deprive the shareholders of value. Writing down debt without eliminating shareholder value should not be considered, since this would set aside priority rights and give rise to awkward incentives. A possibility to wipe out shareholder value is important also, or perhaps foremost, from a governance perspective. In so far as shareholders exercise control of risk levels, this can help bring down risk in the financial system. A sec-

ond order effect could be a larger portion of controlling shareholders in banks.

Both the Key Attributes and the proposed directive put much emphasis on the resolution tool called bail-in, as does the general debate regarding crisis management. The terminology is not entirely clear on this point, but it is clear that bail-in is something more than a write down of claims on banks. Bail-in has been used to describe both the increase of a financial institution's equity capital through the conversion of contingent convertible capital with a high trigger point, before it ceases to be a going concern, and recapitalization of a financial institution that has reached the point of non-viability. Both the proposed directive and the Key Attributes use the term bail-in in the latter sense. Here the term bail-in is used mainly to contrast recapitalization of a bank through the conversion of debt into equity capital to a pure write down of debt.

The bail-in mechanism is, as I see it, the result of an amalgamation of two objectives, namely to decrease moral hazard and to facilitate recapitalization. Again, it is not entirely clear how these objectives are supposed to be met in different situations.

One reason that a debt write down is combined with a recapitalization seems to be to overcome the problem of attracting new equity capital in a situation where the economic status of the institution is uncertain, often described as the debt overhang problem.[20] A compulsory conversion of debt to equity makes a search for new (private) equity capital unnecessary. The process is easiest to envisage in the case where the losses have wiped out the entire equity capital and more, i.e. when there is negative equity. The first step is to cancel existing shares; to wipe out the stake of incumbent shareholders. The second step is to write down debt until the "hole" in the balance sheet has been filled. At this stage the institution has no equity capital (neither positive nor negative). This mechanism creates incentives for debt holders (incumbent and potential) to evaluate and monitor banks and is therefore a governance tool. The third step, bail-in, would be to convert enough of remaining debt claims into new equity to ensure that that the bank meets relevant capital requirements. The third step makes the claimholders whose claims have been converted to equity the new owners of the bank.[21] The con-

[20] The concept of debt overhang was first formalized in Stewart C. Myers, The Determinants of Corporate Borrowing, 5 J.FIN.ECON. 147 (1977).

[21] The Key Attributes seem to recognize the different mechanisms involved in step two and three, see Key attributes 3.5(i) and (ii).

sequences of the third step, from a governance perspective, are hard to evaluate. Without going into detail, it can be said that it is a long leap from making the debt holders assume the losses of the institution (mimicking bankruptcy) to making them responsible for the recapitalization and ownership of a bank. It is not possible to assume that the debt overhang problem can be solved without cost. Undoubtedly, a bail-in mechanism adds a layer of uncertainty, which can affect the dynamics of a crisis.

Another reason for combining a debt write down with a forced recapitalization seems to be to minimize state intervention in the restructuring process. As was outlined in an article in the Economist the ideal seems to be that the capital restructuring process take place over a weekend and that the institution comes out newly capitalized and fully viable on Monday morning.[22] Obviously the enormous time pressure gives rise to different problems, including valuation of the institution. To be on the safe side the authority in charge will have to convert considerably more debt to equity than would be necessary with a slower and more careful valuation process. If too little debt is, or is perceived to be, converted the capital strength of the bank will probably be questioned when the bank re-opens again (Monday morning) and the bank will not be able to operate on its own.

The advantages of including a bail-in mechanism in an SRR should be compared with a system that, after a debt write down, allows for a slower recapitalization process under the control (and temporary financing) of a resolution authority. This seems to be an example of where the objectives of the system dictate the choice of mechanisms used.[23] The objective governing here seems to be to limit state involvement, or at least what is called tax payer costs, and the result is reliance on a mechanism for recapitalization that is questionable in system-wide crises and in so far as it can affect the dynamics of a level two crisis.

Even without the bail-in step the possibility of a debt write down would affect the dynamics of a crisis. It seems unavoidable that a bank (that is under a write down regime) that is perceived to be in difficulties will face financing problems earlier than if write down or bail-in was not possible. Access to funding markets involving debt instruments that can be written down or bailed-in will be cut off. We are here again coming back to the difference

[22] Paul Calello and Wilson Ervin, "From Bail-out to Bail-in", The Economist (28 January 2010), available at: www.economist.com/node/15392186?story.

[23] This is of course appropriate; the objectives should influence the choice of tools. The point being made here is that the wrong objectives give the wrong tools.

between a level two and a level three crisis. If the market's response is isolated to one, or possibly a few banks, this might be manageable and perhaps even considered desirable. It would speed up the process and expose the institution to an immediate liquidity shortage. If the bank is about to become balance sheet insolvent, it can be brought into resolution and handled in an orderly manner.

However, if problems are not isolated to one bank but expose the entire system as a result of a common shock, a level three situation, speeding up funding problems is anything but desirable. It would also be very unfortunate if the market's response would affect the dynamics of the crisis in so far that it tipped a level two situation into a level three situation. The impact of disturbances in funding markets is affected by many factors, including the liquidity buffers maintained by individual banks and by the actions that might be taken by central banks and others to support the funding of balance sheet solvent banks. This aspect is a good example of the need to envisage already at the outset how the SRR will work in different circumstances and how it will interact with other parts of the legal environment.

The Key Attributes does not address the issue of contagion through a bail-in. The proposed directive is surprisingly unclear in respect to bail-in. The Articles covering the implementation of the bail-in tool[24] make no clear distinction between debt write down and equity conversion. Write down and conversion are in several instances used as if they had equivalent effects and could be used interchangeably. This, of course, adds to the uncertainty. Furthermore, there is no description of the role of the holders of the new equity. They would seem to be the legal owners of the bank, but they appear to have no role in its management. Instead all the powers are to be given to an administrator, whose task it is to put the bank back on sound footing. From a governance perspective it may appear strange to block the new owners from exercising influence, even though they have been creditors to a failed institution. Separation of powers and economic interest for a prolonged period of time is seldom a good idea.[25]

[24] Articles 41–47.

[25] It may also seem strange that the state, through administration, takes responsibility for reorganizing a capitalized bank and then hands it back to private sector owners once the job is done, as the proposed directive seems to suggest. It is another thing if the value of the reorganization work can be accounted for in the terms of a subsequent recapitalization (see further down).

There is also an ex ante dimension regarding the scope of an SRR. From a policy perspective it is desirable to identify the truly important functions of the economy and the types of institutions that perform them and limit their exposure to other types of institutions. Such types of institutions should be included in the scope of an SRR. For example it can be argued that the identification (ex post) of AIG as a systemically important institution not necessarily should lead to the inclusion (ex ante) of that type of insurers in the scope of an SRR (or in tighter regulation). It can be argued that it would be better to limit the exposure of truly important institutions, such as banks, to other institutions thus preventing the latter from becoming so big that they can threaten ex ante systemic institutions.

In this context it is appropriate to say something very brief about valuation. When reducing the claims of shareholders and debt holders the matter of valuation is always important. It is not only a question of legal certainty how the valuation process is designed. To clearly set out 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 seems not to be a palatable option in this area. 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.[26] Also in this respect it is important with an ex ante perspective.

One conclusion of what is said above is that there is a clear link between the credibility of an ex ante perspective and the ambitions of an SRR. If there is doubt that the technical solutions offered by the system will work in a level three crisis or that they risk tipping a level two crisis into a level three crisis that will cast doubt on the systems credibility. The ambition to take care of also systemic wide disturbances could make the system less credible and thus less efficient as a governance tool.

Immediate 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. A bank that poses a systemic threat has a strong position in negotiations

[26] Valuation will also be touched upon last in the next section.

regarding the (necessary) measures to avoid a systemic crisis. This, in turn, means that the bank may be able to obtain support on too favorable terms if a negotiating 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 standpoint in negotiations is inversely proportionate to the value they have at risk. If the bank's capital is zero or even negative there is not much to lose for the owners on driving a hard bargain; if it succeeds the bank is saved and if it fails there was nothing to lose anyway.

Another reason for assuming control in an acute crisis is the risk that the managers or owners of the bank 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 of risk level can be achieved in a very short time using different financial instruments. 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 organization.

Frequently, crisis management involves issuing guarantees of some sort for the bank's liabilities.[27] There is a clear advantage for the issuing authority if it or some other authority can exercise control over the guaranteed bank. Since central banks are supposed to extend ELA only to balance sheet 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 in doubt whether the bank is solvent (with 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 typically is great in such situations.

Even though the objective is immediate and absolute control of a bank, the legal tools used are important. The exact legal thresholds for when the authority can take control will not be discussed here, but it has to be made clear that it is necessary that control can 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,

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

it is a clear advantage to be able to (at least to some extent) use the existing legal structure created by corporate law (and internal regulations and instructions) instead of creating a new legal construction working in parallel with the existing one. To step into the shoes of the existing structure means that the authority in charge can use the parts of the structure that are useful and reliable, and, of crucial importance, more easily maintain continuity of service in systemically important parts. At the same time the authority in charge is given legal tools to change the other parts of the structure. In contrast, creating a new legal animal bears 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 operations through subsidiaries. That has to include control over the bank's capital and business structure.[28] Control must also entail a possibility to change the management (the people controlling the bank's business) as well as staff at a lower level if they are central to the running of the bank (e.g. people involved in risk control) if that is called for.[29] The legal tool used to take control must not raise any doubts as to whether the bank remains the same legal entity and whether contractual obligations will be honored.[30]

When the option of creating an entirely new structure for decision making is ruled out two alternative basic principles for assuming control remain, namely to take over the ownership of the shares in the bank or to assume their voting rights. To assume the voting rights has several advantages. As a matter of principle, it seems right to choose the method that intervenes least in the incumbent owners' rights without jeopardizing the means of the process, e.g. creating moral hazard.[31] Under the presumption that the sharehold-

[28] The Second Company Directive (77/91/EEG, article 58 second paragraph) requires decisions regarding a reduction of the share capital and new issues of shares to be taken by the shareholders.

[29] The proposed directive seems to make it compulsory to replace senior management in an institution under resolution, Article 29(1)(c), which seems unnecessary. The assistance of (parts of) senior management could be very useful at least at the initial stages of the process.

[30] 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, see above under the heading ex ante perspective.

[31] Above, in the context of control after a bail-in, it was said that separation of powers and economic interest is seldom a good idea and this could seem like a similar case. However,

ers are treated fairly later in the process, that speaks for an assumption of the voting rights. 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.[32] That may mitigate the valuation problems always connected with involuntary measures. If it is possible to achieve 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 of 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. A further 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 has to be remembered that it must be possible to take control very quickly, often within hours. It can be presumed that most legal systems require more rigorous legal proceedings for a final and involuntary transfer of ownership of the 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 the bank. 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 thereby the authority can assume control of the bank.[33] This does not mean that there should be no 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 have control over a bank or if a decision to assume the voting rights is reversed it is simple to give the voting rights back. On the other hand, if the ownership has been transferred by

in this case control is assumed before the bank is recapitalized and the economic interest of the incumbent owners can more or less be neglected. After reorganization and recapitalization under state management, control of the bank should as promptly as possible be given to the owners.

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

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

the authorities, it is a complicated task to transfer it back to the final owners in different registers.

The assumption of the voting rights will in practical terms give the authority in charge of the crisis management all votes at the shareholders' meeting, thereby giving it the power a sole owner of a company would have. That will enable it to use a wide range of measures. However, it is necessary to give the state or the authority in charge additional tools outside the company law system that directly can affect the power over the bank under administration. The assumption of voting rights only gives the authorities the instruments that general company law provides, which, for example, does not include compulsory write down of debts or share capital.

The important objectives regarding the control aspect are that the authorities should be able to assume immediate control without unnecessarily jeopardizing the rights of the incumbent shareholders.[34] A balance has to be struck between the need for the authorities to move quickly in the public interest and the interest of the incumbent shareholders to remain in control. Here it is important to note that the valuation problems can be sorted out later in a separate process (if it is not possible to find an amicable solution). Another important aspect is that the authorities' assumption of power must not jeopardize the bank's possibility to continue its business activities if that is desired.

The Explanatory Memorandum to the proposed directive sets out that "resolution authorities will have the power to take control over an institution that has failed or is likely to fail, take over the role of shareholders and managers, transfer assets and liabilities and enforce contracts".[35] The memorandum thus recognizes the need to take control, but the directive proposal itself directs much of the attention to what is called the resolution tools without much explanation of how the assumption of control will be achieved. Maybe this is partly a matter of exposition, but clarity in this respect is essential and by trying to describe the legal process of assuming control better in the directive one may also discover ways to improve it.

Regarding valuation, the directive proposal states, as a starting point, that an independent valuation should be completed *before* resolution action is taken.[36] It can be questioned if this is a realistic assumption. Experiences

34 Some degree of infringement is necessary since ownership rights include control rights.
35 Explanatory Memorandum, p. 12.
36 Article 30(1).

from Sweden, made during the 2008/09 crisis, indicate that it can take several weeks to assess the value of even a small bank. Where urgency necessitates it, the proposal leaves open the alternative to give the resolution authorities power to do the valuation. However, it does not seem possible to take resolution action without first making a valuation of the institution. This would not be an acceptable delay of the decision to assume control. Even though it may seem as a technical point, this requirement could jeopardize the functioning of the SRR.

The System Must Function Also in a Full Blown Systemic Crisis

As was mentioned in the beginning of this article it is not possible or at least not desirable to design an SRR that can take care of all conceivable crises scenarios. However, it is important that a system designed mainly to manage, what is here called, level two crises does not impair the possibility to handle more serious disturbances to the financial system. It is, of course, also important that the system is not designed in a way that risks tipping a genuine level two crisis into a level three crisis. This is, as was the point regarding the ex ante perspective, more of a mindset issue than a question of concrete technical solutions.

It is important that different ad hoc and general measures can be used as an extension of the SRR when it fails to meet the requirements of the situation. Or put differently, it is essential that the SRR can function and be used also in a level three crisis even though the solutions offered are not sufficient. Otherwise, a situation could arise where it is necessary to, more or less abruptly, abandon the SRR and rely entirely on ad hoc solutions, which for example could mean that the coercive measures necessarily entailed in the SRR cannot be used. In turn, this means among other things that the state's strength in negotiations is weakened and that support might be given on too favorable conditions. This could in worst case be used by different actors to play the system in order to worsen the crisis and ultimately decrease the credibility of the system's ability to handle a crisis situation and once again create moral hazard.

A system that does not allow for state support in one or another form is not realistic. If the entire financial system is in deep difficulties it is not possible for an SRR to rely (entirely) on solutions that depend on private means or initiatives. The system must be designed to function and interact with dif-

ferent kinds of state measures, such as capital injections into individual banks or general measures to increase liquidity or lending capacity in the system.

The proposed directive states that both recovery and resolution plans covering individual banks should include preparations for systemic wide events.[37] It is further stated that plans shall not assume any extraordinary public financial support.[38] This runs against all experience, since by their very nature system wide events will trigger policy actions, for example, in the form of general public support measures. To make plans on an assumption to the contrary carries the risk that the entire planning will be in doubt when reality shows that measures not planned are necessary. In worst case this will mean that the entire system is abandoned and replaced with ad hoc solutions.

Another example from the proposed directive regards liquidity planning. Banks are required to hold liquidity buffers and it seems logical that the recovery planning could be based on the assumption that a bank can meet a liquidity squeeze by selling assets from the buffer. Otherwise it does not make sense to have the buffer and this is perfectly rational when it comes to individual banks in trouble, i.e. level two crises. However, when it comes to a systemic crisis it is impossible for many banks to be sellers of the same liquid instruments at the same time without risking a breakdown of the markets for these instruments. Again, the measures (liquidity buffers and recovery planning) are primarily aimed at level two crises but are not fit to handle level three crises. It is difficult to say whether the authorities, when realizing that the planning regarding liquidity is flawed, can stick to the recovery plan in other aspects. The worst case scenario is again that both the planning and the system are abandoned altogether.

What is said above also means that a system that relies entirely on private restructuring measures of different kinds, e.g. strong banks buying weaker banks or parts of them, is not credible in a more serious scenario. As has been touched on above, the use of different convertible instruments also can be questioned, mainly on the grounds that such instruments may enhance the risk of contagion in systemic crises. This could mean that the state has to step in and use public funds in order to disarm the risk of contagion.

A third example (very similar to the second) from the proposed directive can be used here. Again, the intended content of the detailed resolution plans

[37] Articles 6(2)(b) and 9(2).

[38] With the exception of central bank facilities (Article5(3)), but central bank facilities for liquidity support are rarely so clearly defined and predictable that they can form the basis for an obviously credible recovery plan.

is the starting point. It seems to be assumed that resolution plans should entail plans for the sale of assets and businesses to other institutions in an orderly and prepared manner. This could be useful in the event of a failure of an individual institution. However, in a systemic crisis it is highly unlikely to find willing buyers of (parts of) failing institutions. In a situation like that, no private operator has the capacity to buy significant parts of other institutions. This should be recognized in the planning process and, consequently, planning with respect to individual institutions should be limited to idiosyncratic failures.

Conclusions

As has been stressed above it is essential for every jurisdiction to have legal mechanisms with the explicit objective of serving as a governance tool and aiming at reducing moral hazard in systemically important institutions. To meet that objective, by using a Special Resolution Regime, it must be credible that shareholders and debt holders will suffer losses in the resolution process.

When designing an SRR it has to be recognized that there is fundamental differences between the handling of failing individual systemic institutions and the handling of full blown systemic crises that affect whole countries or regions, what is above called level three crises. It is potentially dangerous to pretend that SRRs designed to take care of individual institutions also would be sufficient in a system wide crisis. A crisis of this magnitude always calls for state intervention and this has to be recognized in the planning for such a situation and in the design of an SRR. It simply does not make sense to pretend that a system can be made credible without the explicit backing of the state.

This puts the objectives of the system in focus. As noted above it is important to set clear objectives when designing the system. Inappropriate objectives carry the risk of taking the system in the wrong direction. If an important objective is to minimize the use of public funds the temptation to pretend that the state does not carry the ultimate responsibility for financial stability perhaps becomes too strong and hence the legal mechanisms tries to minimize state intervention. The number of objectives should be kept to a minimum and strictly adhered to both when designing the system and when applying the SRR tools and powers.

The main point in this article is that SRRs could and should be used as a governance tool, in order to curtail careless bank practices. In order to

achieve that, by bringing down moral hazard, it is essential that the system is credible and realistic in the way set out to impose losses on shareholders and creditors. To work as a governance tool (and not as some sort of punishment) a credible system must be in place well before the breakout of a crisis. Also, in the interest of legal certainty, it is important to have the rules clearly set out in advance.

From a governance perspective there is a difference between a crisis in an individual bank and a systemic crisis, what is here referred to as level two and level three crises. Experience indicates that level three crises almost always are caused by a large portion of bad public policy, i.e. circumstances outside the control of banks and their owners and creditors. The conclusion is that an SRR is much more likely to be an efficient governance tool when directed at level two crises, since the chances are higher that the crisis is caused (at least to a large proportion) by bad banking. If the system gives the impression that drastic measures will be taken also against banks that end up in difficulties due to circumstances beyond their control that will have a negative effect on desirable risk taking. This is a difficult balance to strike, not least in the immediate aftermath (or even in the midst) of a crisis, but it must be borne in mind that the aim is not to eliminate risk taking in financial institutions.

As has been said earlier it is necessary with mechanisms for eliminating shareholder value and for debt write down (not necessarily connected with bail-in). In a level two crisis there should be no problems connected with either of these mechanisms. In a level three crisis the risk of contagion could jeopardize the possibility for a debt write down and perhaps even of eliminating shareholder value. To refrain from a write down or just make a partial reduction is a decision that has to be taken in the situation at hand. If it, ex post, was not possible to use the system in a level three crisis that is too bad but the ex ante governance effect should be obtained anyway.

When it comes to bail-in the consequences are much harder to predict. The primary reason to use bail-in, and not just debt write down, seems to be to reduce state involvement in the resolution process. However, there is a danger that a system heavily dependent on the bail-in tool cannot be used in a level three crisis and it might even be the case that the threat of a bail-in tips a level two crisis into a level three crisis. Bail-in should perhaps be left open as a legal option for a suitable situation, but the uncertainty added is considerable. It can be questioned if the lack of state commitment bail-in is supposed to create really makes up the disadvantages connected with the bail-in tool.

A minimum requirement is that an SRR must not jeopardize the handling of a systemic crisis. Level three crises frequently call for general ad hoc measures and it is important that such measures can be implemented as an extension of the SRR when it fails to meet the requirements of the situation. Even though the solutions offered are not sufficient it is also essential that the SRR can function in a level three crisis. The SRR must give room for flexible solutions and not be locked to rigid legal mechanisms that may fail to meet the situation at hand which could render the legal framework provided by the SRR entirely useless. In turn that would mean that the authorities had to rely entirely on ad hoc solutions to solve difficulties in individual institutions, with grave consequences both for legal certainty and for the effective handling of failing institutions.

To conclude: SRRs should be aimed at handling level two crises through simple and clearly defined legal mechanisms. In level three situations the system should be able to interact with general state ad hoc measures. The ultimate responsibility for the handling of financial crises always rest with the state. All legal solutions that pretend otherwise are doomed to fail at some stage. This is something that market players know and are prepared to use. The end result can thus turn out to be far more costly to tax payers than a solution based on a realistic description of the role of the state.