THE NEW EU FRAMEWORK FOR FINANCIAL CRISIS MANAGEMENT AND RESOLUTION

The work to improve bank crisis management and resolution frameworks is ongoing in several jurisdictions worldwide after the financial crisis revealed serious shortcomings in the respective regimes. The development of an effective framework is particularly challenging in the EU. This complexity arises owing to the objective of achieving stability in a highly integrated financial system, where the competent authorities maintain their fiduciary responsibility towards the respective national taxpayers. This article provides an overview of the current European initiatives to meet this challenge, presenting an assessment from a central banking perspective.

1 INTRODUCTION

In the aftermath of the financial crisis, the major overhaul of the regulatory framework – both at the global and the EU level – consists of several different elements. Much of the reform focuses on crisis prevention, with a view to preventing serious problems from emerging in the financial sector. This includes, inter alia, regulatory steps to improve the supervision of the financial sector (e.g. by reinforcing macroprudential oversight), to strengthen the overall resilience of banks (e.g. Basel III), to bring currently unregulated or under-regulated sectors under the scope of regulation (e.g. work related to shadow banking) and to reduce opaqueness in some financial transactions (e.g. central clearing of OTC derivatives).

Another focus of the ongoing reforms is the enhancement of mechanisms with which authorities can handle problems in banks (i.e. crisis management, including early intervention) and reduce the potential impact of failures, should they occur (i.e. resolution and deposit guarantee schemes). These initiatives principally aim to provide the authorities with tools and powers to intervene in banks at a sufficiently early stage, with a view to minimising externalities of a crisis, such as the interruption of core financial services, contagion to other market players and, more generally, fiscal costs. To some extent, even this aspect of the reforms reinforces prevention as well, for instance, by increasing preparedness by having tools such as recovery and resolution plans in place.

This article provides an overview of the second "class" of reforms in the EU, namely the new framework for financial crisis management and resolution. So far these reforms have been implemented at the domestic level, with little international coordination or harmonisation. Therefore, an overarching European crisis management and resolution framework is being designed by the European Commission, while the Financial Stability Board (FSB) provides a global forum for coordinating resolution regimes at the international level.[1]

2 GENERAL ASPECTS

MAIN SHORTCOMINGS OF THE RESOLUTION REGIMES IN THE EU

During the financial crisis no major banks failed in the EU, but governments had to introduce an unprecedented range of support measures, with the amount of aid offered to banks totalling around 30% of GDP, and the amount of aid actually used reaching around 13%.[2] Although the final fiscal costs may well be lower than originally expected,[3] any such government measures have the potential to contribute to moral hazard over the long term, thereby weakening incentives for market players to exercise general prudence.

1 This is done within the FSB policy initiative for systemically important financial institutions.
2 See Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank entitled "An EU Framework for Crisis Management In the Financial Sector", COM(2010) 579 final, 20 October 2010. For a detailed analysis of state support measures, see Stolz, S.H. and Wedow, M., "Extraordinary measures in extraordinary times – public measures in support of the financial sector in the EU and the United States", *Occasional Paper Series*, No 117, ECB, July 2010.
3 See, for instance, Schildbach, J., "Direct fiscal cost of the financial crisis", *Deutsche Bank Research Papers,* May 2010.

These developments are the result of several different factors. First, from a legal perspective, the failure of financial institutions was not a feasible alternative. This is because, in most jurisdictions, only normal (or a slightly adapted version of corporate) insolvency proceedings were available to banks. Such proceedings do not adequately take into account the special nature of credit institutions and thus are not suitable for limiting credit and liquidity losses in the economy as a whole in the case of failure.[4] Second, even where a well designed special bank resolution or insolvency regime was in place, the lack or inadequacy of private financing arrangements – be it an ex ante resolution fund, a risk-minimiser deposit guarantee scheme, ex post assessments or other innovative recapitalisation means – ultimately required "state aid intervention" to provide the funds for the rescue measures. Third, while the management of the distress of some purely domestic banks proved to be demanding – as testified by the case of Northern Rock in the United Kingdom – the collapse of the Icelandic banks[5] and Fortis in the Benelux countries[6] showed that cross-border banks may pose even more challenges.[7] The reasons for this are again manifold: the several national authorities involved in a cross-border crisis situation have different mandates about when (i.e. triggers to intervene) and how (i.e. availability and extent of tools and powers) they can act and what objectives they are pursuing (i.e. protection of national depositors, accountability to national governments).

4 For a theory-based analysis of the differences between corporate and bank insolvency regimes, see Bliss, R. and Kaufman, G., "U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation", *Working Paper Series*, No 2006-01, Federal Reserve Bank of Chicago, 2006.
5 For a detailed analysis of the Icelandic case, see *Financial Integration in Europe*, ECB, May 2011.
6 The Fortis case is discussed in Stolz, S. and Wedow, M., op. cit.
7 The management of the distress included the provision of public financial support (e.g. through asset guarantees) to non-financial institutions, as in the cases of LBBW (Germany), ING (the Netherlands), RBS (United Kingdom), Citigroup and Bank of America (United States).

Box 1

EU CRISIS MANAGEMENT FRAMEWORK – SOME PROPOSALS FROM THE LITERATURE[1]

From a theoretical perspective, the aforementioned challenges stem principally from the "financial trilemma", which states that a stable financial system, an integrated financial system and national financial autonomy are incompatible (any two of the three objectives can be combined, but not all three; one has to give).[2] According to this line of thought, the EU – as a highly integrated market with national financial policies – will inevitably have an unstable financial system. One can also interpret this to mean that the stability of the EU financial system can only be increased if national policies become more European, since disintegration (e.g. limiting the single passport regime) cannot be considered as a realistic or desirable solution.

While the need for special resolution regimes with some sort of financing arrangement for the Member States is widely agreed upon in the literature debating this issue, multiple different options have been discussed to overcome the cross-border challenge faced in the EU.

1 Although a fully fledged review of the relevant policy literature exceeds the scope of this article, the papers quoted in this box demonstrate the wide range of possible options that could be considered.
2 For further details, see Schoenmaker, D., "Central Banks and Financial Authorities in Europe: What Prospects?", 2005; Masciandaro, D. (ed.), *The Handbook of Central Banking and Financial Authorities in Europe*, Edward Elgar, 2005; and Schoenmaker, D., "The Financial Trilemma", Tinbergen Institute Discussion Papers, No TI 11-019 / DSF 7, 2011.

As a form of coordination among national governments to handle cross-border bank crises, some have argued for legally binding burden-sharing rules. In their paper, Goodhart and Schoenmaker[3] suggest that specific ex ante burden-sharing agreements are superior to both ex post negotiation on burden sharing and also to a general scheme financed collectively by the participating countries (generic burden sharing). Although this paper focuses rather on state recapitalisations and not – strictly speaking – on bank resolution, it nevertheless triggered discussions in the EU, although ultimately such an approach was not considered to be feasible by policy-makers.

Mayes[4] recommends developing a stringent rule-based framework, resembling the prompt corrective action approach taken by the United States. By implementing it, both supervisors and banks would know that, as the condition of an institution worsens, measures of increasing intrusiveness would be taken, according to a strict timetable, and that ultimately authorities would have to take over the bank while it still had positive capital. This could be backed up by accompanying adaptations of the supervisory arrangements. Accordingly, cross-border banks would be better treated either by revising the home-host responsibilities (by giving the home authority some binding powers over the other competent supervisors) or by moving supervision to a supranational level of responsibility.

The idea of a European authority responsible for crisis management and resolution is supported by several papers. Fonteyne et al. even suggest putting in place an integrated crisis management and resolution framework under the aegis of a "European Resolution Authority" (ERA).[5] Following this rationale, the ERA would be most effective if it were twinned or combined with a "European Deposit Insurance and Resolution Fund".

Some other papers put forward a less politically ambitious viewpoint, seeking some sort of a compromise solution. In this context, it is proposed (see Dewatripon et al.[6]) that a European competition authority should carry out an explicit crisis management coordination function in the event that a European banking resolution authority is not judged to be politically feasible, or its creation is delayed. Accordingly, the EU competition authority could coordinate between national resolution authorities in the case of distress in cross-border banks, by taking full advantage of its already existing state aid control mandate.

3 See Goodhart, C. and Schoenmaker, D., "Fiscal Burden Sharing in Cross-Border Banking Crises", *International Journal of Central Banking*, 5, 2009.
4 See Mayes, D.G., "Early intervention and prompt corrective action in Europe", *Research Discussion Papers*, 17/2009, Suomen Pankki – Finlands Bank, 2009.
5 See Fonteyne, W. et al., "Crisis Management and Resolution for a European Banking System", *IMF Working Papers*, WP/10/70, 2010, pp. 1-99.
6 See Dewatripon et al., "The role of state aid control in improving bank resolution in Europe", *Bruegel Policy Contribution*, 4, 2010.

INTERNATIONAL AND NATIONAL INITIATIVES

When assessing the EU framework, it is also important to keep in mind ongoing global developments. In June 2010 the G20 agreed at the Toronto Summit that one of the pillars of the financial sector reform should be resolution and the issue of systemic institutions (commonly known as the "too big to fail" institutions) in general. Accordingly, the G20 expressed its commitment to designing and implementing a system with powers and tools to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden. Moreover, the G20 "called upon the FSB to consider and develop concrete policy recommendations to effectively address problems associated with, and resolve, systemically important financial institutions".

Following this request, the FSB submitted its recommendations on systemically important financial institutions (SIFIs) to the Seoul Summit in November 2010. According to the policy document, all FSB jurisdictions should put in place a policy framework for reducing the risks and externalities associated with domestic and global SIFIs. Besides requiring higher loss absorbency, more intensive supervisory oversight and robust core market infrastructures, one of the main elements of this SIFI policy framework is to develop resolution frameworks and other measures to ensure that all financial institutions can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss.

Work towards the implementation of the recommendations on resolution that were set out in the FSB's October 2010 SIFI report is progressing. The FSB has established a steering group responsible for delivering the overall work programme on resolution and for developing the "key attributes of effective resolution regimes", which will identify the essential features that national resolution regimes for financial institutions, including non-bank financial institutions, should have. A public consultation will take place during the second half of 2011 on the measures that the FSB will propose to improve resolution tools and regimes, before the recommendations are finalised and delivered to the November Summit. The EU is actively participating in the FSB's ongoing work and is also taking these global initiatives into account in the design of the European framework.[8]

At the same time, many of the respective national laws have been, or are being, overhauled before the EU framework takes its final shape.

As reflected in the table, some common elements in these frameworks can already be identified, especially in the resolution tools. Nevertheless, there is a clear need for a greater

8 For instance, the FSB-sponsored work on recovery and resolution plans for individual banking groups could help to identify the core components of the banking groups. This exercise could also provide more concrete content for this instrument within the EU crisis management framework, ensuring that there is a sufficient range of options in the plans, since not every theoretical option will be available in reality.

Main elements of selected resolution frameworks in the EU and the United States [1)]

	Germany	Denmark	Netherlands (plans)	United kingdom	United states
Scope	Credit institutions	Credit institutions	Credit institutions, insurers	Credit institutions, other [2)]	Credit institutions and any type of systemic firm
Resolution tools	Restructuring plan (potentially including haircuts on creditors); transfer of assets/ liabilities to another institution, including a bridge bank	Transfer of assets/ liabilities to another institution, including a bridge bank	Transfer of shares, assets/liabilities to another institution, including a bridge bank; temporary public sector ownership	Transfer of shares, assets/liabilities to a private sector purchaser or a bridge bank, temporary public sector ownership	Transfer of shares, assets/liabilities to a private sector purchaser or a bridge bank; forced merger [3)]
Financing	Resolution fund (ex ante funded)	State-owned Financial Stability Company with a guarantee from the DGS	DGS can finance deposit transfers	DGS (currently ex post)	DGS (ex ante) for banks and orderly liquidation fund for others (ex post)

1) Sources: Various websites of ministries of finance and central banks, finansielstabilitet.dk, information provided within the framework of ECB legal consultations. Note: DGS stands for deposit guarantee scheme.
2) Some provisions also apply to bank holding companies and investment firms.
3) If the Federal Deposit Insurance Corporation (FDIC) is appointed as receiver, all the rights, titles, powers and privileges of the company and its stockholders and directors are conferred upon it. Its tools and powers are thus not limited to those shown in the table.

harmonisation of Member States' initiatives,[9] since the national regimes would have to be deployed simultaneously in the case of a cross-border bank experiencing distress.

3 THE PLANNED FRAMEWORK FOR THE EU

The ECOFIN Council of May 2010, recalling its previous conclusions, stressed the need to develop an integrated approach to crisis prevention, management and resolution by: i) developing an enhanced EU policy coordination framework;[10] ii) enhancing the EU regulatory framework; and iii) improving the design of mechanisms to ensure that systemic risk is mitigated and that the financial sector bears the net costs of financial crises. These three aspects are interrelated and thus the regulatory framework being developed by the European Commission discussed in this article also touches upon the two other aspects.

COORDINATION INSTEAD OF INTEGRATION

Following previous communications on crisis management, on 6 January 2011, the DG Internal Market and Services of the European Commission released a document for public consultation,[11] in which it presented its proposal for the new framework. Bearing in mind the theoretical possibilities described above, the plans do not go as far as to ambitiously suggest a fully integrated framework under the control of a single European resolution authority. The proposals instead try to pursue a more realistic approach, taking into account the current fiscal and supervisory responsibilities of Member States, as well as the lack of harmonisation across national insolvency laws.

Nonetheless, the plans – which the Commission titled a "coordination framework" – do include substantial changes, in particular the harmonisation of supervisory and resolution powers and the provision of rules for cooperation in crisis situations, as explained below in further detail. The overriding objective of the framework is to create a credible alternative to bailouts by ensuring that "ailing institutions of any type and size, and in particular systemically important institutions, can be allowed to fail without risk to financial stability whilst avoiding costs to taxpayers". The following section briefly presents how this objective is to be achieved.

MAIN ELEMENTS OF THE COMMISSION'S PROPOSAL

As far as "institutions of any type and size" are concerned, the planned scope of the framework would extend to all credit institutions, and possibly also to some investment firms and, to some extent, bank holding companies.

Regarding the intention of "allowing them to fail", it is first of all important to see that the plans include elements that aim to avoid failure in the first place. The framework would not only cover resolution and liquidation, but rather all phases of a bank crisis, including preparatory and preventive measures and also early intervention powers. Thus, the idea is to oversee banks from "birth to death" in a comprehensive manner. As for the provisions on supervision, preparation and prevention, these aim at improving the crisis preparedness of both the authorities and firms themselves. The most important elements in this context are the intra-group financial support arrangements and the recovery and resolution plans (see Box 2 for further details). In the event that problems arise with a bank that is in breach of the prudential requirements, a harmonised set of early intervention measures (e.g. clear powers to prohibit payment of dividends, impose

9 For instance, in terms of financing, there are currently two bank resolution funds in place in the EU that are financed by ex ante levies imposed on banks or other types of financial institution (in Germany and Sweden), while another is planned (in Cyprus). Belgium and the Netherlands have actually set up a modified deposit guarantee scheme (DGS) with a mandate to also support resolution measures. Sweden is analysing how the resolution fund could be coordinated with the DGS, while the Banque Centrale du Luxembourg has proposed a Financial Stability Fund that would combine DGS and resolution fund functions.

10 In this policy framework, the ECOFIN Council would play a strong role in coordinating financial stability policies in an EU-wide systemic crisis, and cross-border stability groups would be set up for all large EU cross-border financial groups.

11 DG Internal Market and Services, "Technical details of a possible EU framework for bank recovery and resolution", working document, European Commission, 6 January 2011.

additional reporting requirements, require the replacement of managers or directors or require the cessation of certain risky activities, etc.) would be made available to supervisors. These steps would be taken before an institution's problems become severe, with the aim of returning the bank to a normal state of health.

Notably, even if a bank becomes non-viable and reaches resolution stage, the plans foresee an option for authorities to maintain it as a going concern, via the so-called bail-in mechanism (see Box 3 for further details). Nonetheless, it is clear that even if authorities have such lines of defence in place, which indeed can reduce the possibility of failure, some banks will still fail or get very close to failure. For these cases, the idea of the framework is to develop tools for authorities so that they can avoid not the failure itself, but a disorderly collapse that has destabilising consequences for the system as a whole.

Accordingly, to avoid "risks to financial stability", the resolution tools would include measures such as selling the business of a distressed bank to another healthy private purchaser or transferring the assets and liabilities to a bridge bank or "bad bank" (asset separation). The idea here is to maintain the critical financial services of the affected banks, such as continuous access to current accounts and payment services. Authorities could take these steps when the predefined triggers for resolution are met. Although the final rules for these triggers are unknown at the time of writing, it is clear that they will be set at a level well above balance sheet insolvency.

Box 2

THE PLANNED APPROACH FOR CROSS-BORDER BANKING GROUPS – RECOVERY AND RESOLUTION PLANS, INTRA-GROUP FINANCIAL SUPPORT AND RESOLUTION COLLEGES

The European Commission's plans include the consolidated treatment of banking groups in all phases. As for crisis preparedness and prevention, the proposal states that parent credit institutions shall draw up group recovery plans, which describe how the viability of the group as a whole would be restored in stress scenarios. In particular, the recovery plans aim at preserving the continuity of critical financial services under severe adverse conditions and identifying the necessary measures to ensure that the group remains a "going concern". The parent banks would have to submit these plans to the consolidating supervisor, who, in turn, would assess the appropriateness of the plan, involving the other relevant supervisors. In the case of disagreement, the European Banking Authority (EBA) could play a mediation role.

Similarly, group resolution plans would also be prepared by the group-level resolution authority, in cooperation with the other relevant resolution authorities. The ultimate aim of the resolution plans would be to identify actions to be taken by the competent resolution authorities in order to achieve an orderly resolution or winding down, in the event that the de-risking measures identified in the recovery plans are not feasible, fail or prove insufficient to preserve the group as a going concern (i.e. focusing on the "gone concern" perspective). Therefore, if impediments to effective resolution are identified, the authorities would be expected to reach a joint decision on how to address them. The possible measures to be taken are clearly far-reaching (among others, they might include requiring changes to the legal or operational structure), which could make finding consensus difficult in certain situations. For such cases, the plan does not envisage EBA mediation, but that the group-level authority could ultimately take the final decision for the group as a whole, although it needs to take into account the views of other authorities.

Another highly important issue in crisis preparedness is intra-group financial support. Asset transferability within groups is currently restricted by certain national laws or surrounded by legal uncertainty. This creates an environment in which group liquidity management may be suboptimal and the survival of a group may be hampered by supervisory ring-fencing. The other side of the coin is that some restrictions are justified, since national laws are designed to protect domestic creditors and shareholders from transfers that endanger their rights. The Commission's proposal for overcoming these sensitive challenges envisages that parent banks and bank subsidiaries could enter into group financial support agreements, setting out the conditions for intra-group loans, guarantees, transfers of assets for collateral, etc. These agreements would be approved by the supervisor of the transferor and should be included in the recovery plan of the potential transferee and the recovery plan for the group as a whole (with EBA mediation, if need be). The Commission's plan includes several safeguards to ensure that the support provided according to the agreement does not endanger the financial stability of the transferor's country, including the right of the transferor's supervisor to prohibit a transfer if financial stability concerns arise.

Resolution measures could also be taken on a group-level basis. To this end, the proposal envisages resolution colleges (an institutionalised version of cross-border stability groups (see footnote 10)) as a forum involving the respective resolution authorities. If conditions for group resolution are met (e.g. at least two banking entities in the group meet the resolution triggers), the group resolution authorities would be able to decide whether to initiate a "group resolution scheme", along the lines of the ex ante approved group resolution plan. However, (host) resolution authorities could decide not to comply with the scheme and take individual measures if they consider it necessary in order to safeguard domestic financial stability.

Regarding "avoiding costs to taxpayers", the plans basically contain two relevant provisions to ensure that the costs of resolution are covered by the private sector. First, there would be a requirement for Member States to set up ex ante resolution funds to finance resolution with additional ex post back-up facilities. Although less explicitly, the bail-in resolution tool would, to a certain extent, also shield state budgets from risks. This is because this tool would be applied when neither the orderly liquidation nor the other resolution tools are suitable for handling the failure of an institution, owing to financial stability concerns that would arise with the exit of the firm. In this case, bail-in could be seen as a way to ensure that, instead of governments, the respective creditors provide the necessary funds to recapitalise the bank.

Box 3

CONTINGENT CONVERTIBLE CAPITAL, THE POINT OF NON-VIABILITY AND BAIL-IN

Although there are several different ways in which a bank may be restored to health or resolved, some form of recapitalisation, either alone or in combination with other measures, is, for obvious reasons, a common way of handling such problems. However, raising capital on the markets is normally a lengthy procedure that also requires approval at a shareholders' meeting. At the same time, the longer it takes to recapitalise a bank and return it to soundness, the higher the risk of a drop in confidence in the bank itself and of contagion to other market players. Although the issue of speed could be solved if the shareholders pre-authorise the board of directors to issue share capital in such cases, some other obstacles would still remain. In some cases, existing shareholders could be reluctant or unable to inject capital themselves and external investors may lack the appetite to do so, or would need considerable time for due diligence.

Another important aspect of the current regulatory discussions is that if a government opts to recapitalise a bank with high-quality capital, this would simply dilute some of the original investors' share of the capital structure, but effectively shield others who hold more senior types of capital or debt. Against this backdrop, the various regulatory concepts on the agenda aim to serve two purposes: i) to achieve rapid recapitalisation (in terms of quality or quantity of regulatory capital); and ii) to protect taxpayers while also limiting moral hazard. The three most important tools are explained below.

Contingent convertible capital instruments ("CoCos") are, generally, debt instruments that are automatically subject to conversion into equity or to a permanent haircut upon the realisation of a predetermined trigger event. This is an existing instrument: the first CoCo was issued in November 2009 by Lloyds Bank, followed by Rabobank in March 2010 and later by other institutions. Some national frameworks (for instance, the US Dodd-Frank Act[1] and the Swiss plans) already incorporate them. At the global level, the FSB is currently discussing whether the additional loss absorbency required for systemically important financial institutions could be (partly or fully) met with CoCos.

Conversion or write-down is also the central element of the "point of non-viability" mechanism, endorsed by the Group of Governors and Heads of Supervision in January 2011. This rule foresees minimum requirements to ensure that all classes of capital instrument fully absorb losses at the point of non-viability before taxpayers are exposed to a loss. Accordingly, all non-common equity capital instruments (i.e. non-common tier one and tier two) at internationally active banks would have a clause in their terms and conditions that they are to be either written off[2] or converted into common equity, if authorities decide either that such a measure is necessary or to make a state capital injection.[3] As a result, these securities would become fully loss absorbent, and even if there is later public support in the form of common equity, the holders of these instruments would be first in line to assume losses and their investments would be diluted upon additional capital injections.

Bail-in (or debt write-down, using the European Commission's wording) is, in principle, an extension of the point of non-viability concept, but also a statutory resolution tool. As such, it would provide the authorities with the power to write down senior (unsecured) debt or to convert it into equity, to the extent that it is deemed necessary to ensure that the credit institution is returned to solvency, and thus maintain the institution as a going concern. This resolution tool would generally become available once an institution meets the trigger conditions for entry into resolution, and after the power to write off all equity and to write off or convert (junior) subordinated debt has been exercised.

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L.111-203, H.R.4173.
2 After a write-off, the affected investors would get newly issued common shares as compensation, which would make the mechanism similar to a conversion.
3 Individual jurisdictions are exempted from the point of non-viability requirement if their national laws allow the capital instruments to absorb losses at the point of non-viability, but only if a peer review confirms such a capacity.

Summing up, the above three tools are similar in the sense that they all enhance the quality or the quantity of capital in times of stress. The major differences lie in their timing (i.e. CoCos are generally triggered in early phases and the point of non-viability mechanism and bail-in conversion are employed close to failure), scope (i.e. bail-in covers a much broader range of instruments) and the role of the authorities (i.e. CoCos could be operated with little or no involvement of the authorities, while the point of non-viability mechanism and bail-in rely heavily on their decisions). These commonalities and differences call for a thorough regulatory analysis of the potential synergies, overlaps and, in extremis, conflicts between them.

NEXT STEPS AND AREAS FOR FURTHER WORK

Based on the responses to the public consultation (of 6 January 2011) and an impact assessment, the European Commission intends to adopt a legislative proposal for a directive on crisis management in the coming months. By the end of 2012 the Commission also plans to assess (e.g. by publishing a report and possibly a legislative proposal) whether a reform of bank insolvency regimes is required and whether the scope of these regimes should be extended to other types of financial institution (insurers, central counterparties, etc.). In addition, the Commission will explore how a more integrated framework for the resolution of cross-border groups might be best achieved (e.g. through the creation of an EU resolution authority and/or EU resolution fund) by 2014.

Further work in these areas appears to be duly justified. With regard to the insolvency frameworks, national bankruptcy laws include several elements that are interrelated with, inter alia, intra-group transfers by a troubled firm, and more generally, resolution itself, which is very much akin to a special bankruptcy procedure. More importantly, the Commission's plans rightly emphasise that failing banks should be liquidated if possible, with resolution being only the second best option. Given the lengthiness of liquidation proceedings, which reduces franchise value and the overall realised value for paying out creditor claims, substantial reforms are needed to ensure that liquidation becomes a feasible option, even for larger banks.

Furthermore, when defining the scope of the resolution framework, the fact that the failure of any kind of financial institution can become systemic in certain situations clearly needs to be taken into account. In finding the right scope for the framework, there seems to be a need to strike the appropriate balance between flexibility (which means authorities would be able to exercise some discretion in when to apply resolution tools to any potential bearer of systemic risk) and proportionality (which calls for avoiding an unnecessary administrative burden on both banks and authorities and thereby for a more limited and focused scope). As shown in the table, the scope of the US framework (following the recent reforms) is highly flexible, reflecting the experience of the recent crisis, when non-banks had to be bailed out because of their importance.

Finally, regarding the prospects of a more integrated framework, it is logical to keep the improvement of private financing arrangements on the agenda.

4 CONCLUSIONS

In its reply to the Commission's consultation document, the ESCB supported the overall thrust of the Commission's plan.[12] In particular, the ESCB agreed with the overriding policy objective of the new regime and highlighted the need for enhanced crisis management and resolution tools embedded in a framework with well designed triggers to tackle problems in banks more effectively. In order to achieve this, the respective national regimes should be as

12 The official ESCB reply to the consultation document is available on the ECB's website.

harmonised as possible and arrangements for even closer coordination between Member States in crisis situations need to be found.

The planned crisis management and resolution framework has the potential to be a major milestone in strengthening both financial stability and integration within the EU financial sector. Once fully in place, the new regime should ensure that each individual Member State has effective tools at its disposal, and that, in the event of cross-border bank problems, the application of these tools is closely coordinated by Member States.

The success of the new crisis management and resolution policies will heavily depend on the practical implementation of the new regime, and the extent to which they will be able to disentangle the far-reaching interlinkages between the supervisory and fiscal aspects. In geographic terms, it will also be highly important to coordinate relevant policies and frameworks with third countries, especially the United States, in order to enable the smooth resolution of global groups as well. The ongoing work of the FSB will substantially facilitate these efforts.

EU central banks will also have a crucial role to play in ensuring effectiveness. In general, their macro-prudential expertise will be required for the identification and assessment of emerging systemic risks, as well as for various elements of the new arrangements, such as recovery and resolution planning or the decision on whether the conditions for resolution are met. In addition, depending on the national institutional set-up, some central banks will play an important role in the new regime, for instance as conductors of resolution measures. The perspective of central banks will be very relevant, since the objective of crisis management and resolution is to ensure that individual bank problems do not result in high social costs, in terms of financial instability or fiscal burdens.