

**Avoiding systemic crises  
– key elements of a reorganisation  
regime for institutions in the financial sector**

- Executive summary -

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1. Banks, in their capacity as financial intermediaries, fulfil tasks which are key to maintaining the basic functions of an economy. This distinguishes them from other businesses. Notwithstanding this point, the fundamental principle of a market economy that the failure of a business will ultimately lead to its departure from the market – if necessary through the mechanism of insolvency proceedings – must also apply to financial institutions. The question also arises as to how the development of a crisis with systemic implications in other financial sector companies can be effectively countered at an early stage.

The Association of German Banks welcomes the international and national debate over these issues. The crisis has clearly shown that the existing instruments for averting threats to financial stability are inadequate, particularly when it comes to taking swift action to restructure banks which have got into difficulties. There is a lack of internationally coordinated procedures based on, and bound by, the same basic principles.

2. It should not be overlooked, when considering how to avert systemic crises, that fundamental lessons have already been learned from the financial crisis. In particular, banks have improved their risk, liquidity and capital management by reviewing risk models, among other things. A legal framework for a reorganisation plan is only an additional precautionary measure for maintaining the functioning of the financial market.

3. Current proposals focus primarily on large international banks. Limiting measures to these so-called systemically important institutions misses the point of the problem, however, and will not succeed in effectively countering systemic risk. An institution's systemic importance depends on a number of factors and this must be taken into account when adjusting the legal framework. If supervisors are to reduce the probability of crises ex ante and be capable of prompt action if a crisis should arise, their measures need to target systemic risk, not particular institutions. All companies in the financial sector should therefore be covered by the scope of the framework.

- **A legal framework should apply to all financial sector companies which may give rise to systemic risk.**
- **It must be possible to adapt instruments and procedures to a variety of situations and market participants.**

4. In our view, this future legal framework should be divided into three phases:

- **Phase 1:** Improved crisis prevention, especially in the form of a contingency plan maintained by the affected institution and a reorganisation programme carried out on its own initiative at an early stage.
- **Phase 2:** If these efforts fail, a reorganisation plan is implemented to prevent the insolvency of systemically important parts of the institution.
- **Phase 3:** Insolvency proceedings are initiated to wind up those parts of the institution which are not systemically important.



- **Suitable thresholds are needed to trigger each of the three phases (crisis prevention, reorganisation and resolution).**

5. It should be borne in mind that reorganisation measures have always proved most successful when initiated by the ailing company itself and implemented swiftly, without a great deal of publicity and in consultation with the company's largest creditors or groups of creditors. Supervisors should therefore intervene only if the company's own crisis prevention and reorganisation efforts have failed (phase 1) or the threshold triggering phase 2 has been reached.

- **Financial sector companies should endeavour to prevent crises by implementing reorganisation measures on their own initiative and at an early stage (phase 1).**

6. The financial crisis has sparked discussions about requiring financial sector companies to hold so-called living wills. There is as yet no common understanding of this term. We interpret it to mean that institutions should have contingency plans in place as part of their crisis prevention framework and that these plans should be designed in such a way as to reduce the likelihood of reorganisation or resolution becoming necessary. When contingency

plans are reviewed by supervisors, the institution's organisational structure and business model – in other words its strategic decisions – should not be called into question. We assume that contingency planning is already normal practice at most institutions, even if the degree of formalisation differs.

- **Adequate contingency planning by institutions is already required under Pillar 2 of Basel II.**
- **The living will debate should be conducted at European level to avoid the risk of competitive distortion.**
- **A legal obligation for institutions to adopt “resolution-friendly” structures would go too far and be incompatible with the principles of a market economy.**

7. A suitable toolkit is needed to carry out restructuring. Instruments should be flexible enough to adapt to different situations and it should be possible to implement them at short notice. A sensible and central element of such a national toolkit is the ability in phase 2 to spin off systemically important parts of an institution swiftly and unbureaucratically for restructuring purposes.

This “good bank” solution, i.e. the swift, relatively uncomplicated spin-off of the systemically important parts of an institution for restructuring, is especially promising. It enables commercially viable and systemically important functions to be effectively insulated from the institution's insolvency. The healthy part of the institution can continue to operate by being sold to another company or, in the absence of a private purchaser, by being temporarily transferred to a state vehicle, a so-called bridge bank. This keeps the systemic consequences of the insolvency to a minimum. The “bad” part of the institution can then be wound up in an orderly manner with minimum disruption to the market.

It should nevertheless be borne in mind that transferring shares to a third party against the will of the shareholders encroaches on constitutionally protected rights. Such a measure could therefore only be used in the last resort. The first step would be to call on shareholders to take corrective action.

- **The existing instruments available to supervisors need to focus more on restructuring.**
- **It should, in particular, be made possible to temporarily transfer the systemically important areas of an institution to a bridge bank and to split the institution into a good bank and a part which will be wound up. The good bank should be sold and the remainder liquidated.**

8. The instruments and powers of intervention necessary to restructure financial institutions in phase 2 should be vested centrally in the competent authority. Financial stability can only be ensured if supervisors are in a position to act swiftly. But they need an apparatus behind them which is adequately equipped and has expertise in the field of restructuring. The management of a bridge bank or good bank should be entrusted to competent third parties (restructuring consultants or other experienced persons with the necessary personal skills and credibility and with extensive experience in banking).

- **The instruments and powers of intervention necessary to restructure financial institutions should be vested centrally in the relevant authority.**
- **The management of a bridge bank or good bank should be entrusted to competent and qualified third parties.**

9. It would be worth considering extending permanently the current responsibilities of the German Financial Market Stabilisation Agency (FMSA)\* so that it can make available at short notice any restructuring funds needed to maintain financial stability, especially if the institution's shareholders or owners have not proved capable of doing so themselves. A special fund administered by the FMSA should be set up for this purpose. The management of a bridge bank or good bank, on the other hand, should be entrusted to competent and qualified third parties.

- **Funds needed at short notice to restructure a financial sector company could be made available through a special fund administered by the German Financial Market Stabilisation Agency (FMSA).**

10. In addition to the institution's owners, who bear primary responsibility, the holders of other instruments classified as capital should also make an appropriate contribution to reorganisation. It should be ensured that the owners and other holders of capital instruments do not profit from funds made available by third parties (e.g. an FMSA-administered fund).

- **An institution's owners are primarily responsible for making available the funds needed to reorganise the company.**
- **The holders of other instruments classified as capital should also make an appropriate contribution to restructuring the institution.**

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\* The Financial Market Stabilisation Agency is a public-law agency located at the Deutsche Bundesbank. It administers the Financial Market Stabilisation Fund, which was established in October 2008 to stabilise and recapitalise ailing companies in the financial sector.

11. It should be possible to take any necessary recapitalisation measures swiftly, without having to make concessions to shareholders for which there is no economic justification. Debt-for-equity swaps should be provided for. For legal reasons in Germany, however, debt may only be converted into shares with the agreement of the affected creditors. The inclusion of a clause in the terms of a bond issue could therefore be considered to the effect that the bonds will automatically convert to equity if a previously agreed threshold is reached (e.g. on failing to comply with a capital ratio or if a decision is issued by supervisors).

- **Debt-equity swaps are an important reorganisation tool.**
- **A major prerequisite for their use is the ability to carry out a capital increase without the approval of shareholders if need be.**
- **Legal uncertainty at EU level should be eliminated by amending the Second Company Law Directive.**
- **Debt-equity swaps could be provided for under the terms of a bond issue if certain conditions are met.**

12. Introducing a right to temporarily suspend termination clauses while reorganisation measures are being carried out may be an effective means of preventing such measures from triggering the termination of contracts which are essential for the continuation of the business activities of the bank subject to reorganisation measures. However, at least in the case of close-out netting provisions in master agreements for financial transactions, such a right to suspend termination clauses might have severe repercussions for the bank undergoing a reorganisation, its counterparties and the financial market as a whole. This is because termination clauses are a key element of close-out netting provisions in standard netting arrangements. They ensure that each counterparty can terminate the agreement if events occur that affect the risk exposure from transactions entered into under the netting agreement with the other counterparty. As a consequence of such a termination, all existing reciprocal claims are then set-off against each other in order to arrive at a single net obligation of one party vis-à-vis the other. This close-out mechanism allows counterparties to manage the risks associated with the relevant agreements on a net basis, thereby significantly reducing the exposures of both counterparties.

Any significant restriction of the enforceability or validity of these close-out netting provisions or any legal uncertainty in this respect can have serious consequences for the risk management of the counterparties. In addition, such legal uncertainty over the effectiveness of netting agreements affects the competitiveness of the relevant financial market as a whole. In particular, any institution falling into the potential ambit of a resolution regime including such a suspension right would face serious disadvantages in the financial markets. Counterparties would not be prepared to enter into financial transactions with such an

institution or would do so only on significantly less favourable terms as they would need to take into account the potential effects of a suspension on their risk management.

Furthermore, a suspension right could easily be circumvented if it existed only under national law by subjecting the relevant agreement to the laws and the courts of a jurisdiction without such suspension rights. In any event, a suspension right in respect of netting agreements for financial transactions is not the right tool to ensure the business continuity of a bank subject to reorganisation. By its very nature, a suspension can only affect existing transactions. It cannot, however, ensure that counterparties will be prepared to enter into any new transactions in the future. Yet new transactions may be vital for the continuation of the business or for successful reorganisation.

In order to minimise the adverse effects described above, a right to suspend contractual termination clauses in the case of netting arrangements should only be considered subject to the following conditions:

- **Narrow and clear definition of the area of application:** The right to suspend contractual termination clauses should only be triggered in connection with specific resolution measures (transfer of assets and liabilities to a bridge bank).
- **Clear and short time frame:** The effect of the suspension must be subject to a clearly defined and sufficiently short time frame (ideally not exceeding two days). To avoid any legal uncertainty, the exact beginning and end of the suspension period has to be defined as clearly as possible using objective criteria.
- **No extension to other contractual rights:** The right of the counterparty to exercise other contractual rights (including termination rights based on non-performance of contractual obligations other than any rights solely arising because of the reorganisation measure triggering the suspension right) must remain unaffected by the suspension.
- **International coordination:** The key aspects of a suspension right would need to be harmonised on an international as well as European level (including an amendment of the Financial Collateral Directive and the Directive on the Reorganisation and Winding-up of Credit Institutions) in order to avoid conflicts with existing international and European rules, competitive disadvantages and regulatory arbitrage.

13. In the field of insolvency law, the exchange of information between the administrators of different insolvent group units must be better coordinated across national borders. This coordination should be regulated by an EU directive to be implemented in national law in all member states. European harmonisation of substantive insolvency law, on the other hand, is probably not a realistic option in the near future.

- **The existing insolvency regime should be adjusted, but no special insolvency legislation for financial sector companies should be created.**
- **Responsibility for insolvency procedures for dealing with financial sector companies should be consolidated more centrally at national level.**
- **Procedural law on insolvencies should make it possible to coordinate different national procedures across borders so that international groups can be wound up in a timely manner. An EU directive should be drawn up for this purpose.**
- **The harmonisation of substantive insolvency law is not a realistic option in the short or medium term.**

14. There should be greater convergence between national mechanisms for reorganising financial sector companies, not only to ensure that measures will be as effective as possible, but also to avoid unnecessary distortion of competition. The recent consultations launched by the European Commission should work towards this end. When restructuring cross-border groups, national solutions seeking first and foremost to save “their” part of the group should be avoided. A coordinated and holistic European approach is needed. There should be better coordination between national authorities of their exchange of information and of the measures adopted. Any conflicts should be resolved at an early stage; the limits of international cooperation should be clearly defined.

- **Cooperation and communication between the authorities involved in cross-border financial crises should be placed on a firm footing.**
- **It would be desirable to establish a binding framework for the cooperation and exchange of information between courts and insolvency administrators.**

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