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Prudential, Pragmatic and Prescient, Reform of Bank Resolution Schemes

Janis Sarra¹

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I. Introduction

The 2008-2009 global financial crisis highlighted the interdependency of financial institutions and markets worldwide. Globally, fiscal support packages totalling 3 trillion USD were introduced, placing enormous strain on the public finances of a number of countries. Estimates of global banking writedowns are currently more than 3 trillion USD. When the commercial paper market collapsed, the US alone lost 95 billion USD in value overnight.² In the European Union (EU), in the absence of mechanisms to organize an orderly wind down, Member States had no choice but to bail out their banking sector, and state aid to support banks continues to mount.³ In the G-7 countries alone, there was 2 trillion USD in lost GDP, higher fiscal deficits, millions of lost jobs, and tremendous financial hardship for affected individuals.⁴ Even in jurisdictions such as Canada, with relatively well-managed banking systems, a generalized loss of confidence led to a sharp rise in funding costs.⁵ The largest negative effects of the financial crisis on the Canadian economy stemmed from crises originating in other countries, with adverse contagion effects on the Canadian banking system, making it very difficult for Canadian banks to fund themselves in foreign markets.⁶ Bank supervisory authorities and financial institutions now appreciate that financial systems must be strengthened to enhance their capacity to withstand shocks.

There is considerable international initiative to devise mechanisms to prevent such failures in the future and to create new insolvency resolution schemes to address financial firm failure. Bank supervisors and other regulators are trying to discern the appropriate mix of prudential oversight and private sector governance. This paper examines two discreet issues within this much larger topic. Part II examines the need for regulatory oversight and coordination in preventing liquidity and solvency issues related to banks and other financial institutions. Reform is required to smooth out highs and lows within capital cycles and to address the need for cross-border resolution mechanisms for bank insolvency. Part III then examines the role of bank governance in preventing and addressing bank insolvency, suggesting that governance needs to be prudential, pragmatic and prescient if we are to reduce the frequency

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² Financial Times, October 3, 2008.

³ http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

⁴ Bank of Canada, *Strengthening International Capital and Liquidity Standards: A Macroeconomic Impact Assessment for Canada*, August 2010. The Bank of Canada observes that monetary authorities in many jurisdictions slashed policy interest rates; and the UK and US introduced unconventional monetary policy operations so that liquidity could continue to be injected into their economies as interest rates approached zero. The Bank of Canada cut its target for the overnight rate to a historic low of one-quarter of one per cent.

⁵ *Ibid.* at 5.

⁶ *Ibid.* at 8.

and severity of future bank failures.

i. Context

The underlying causes of failed financial institutions were complex, and continue to be the subject of considerable study. They include the interplay of structured financial products and real economic activity, regulatory gaps, inadequate liquidity and capital adequacy standards, extreme leveraging that accounted for much of the increase in banks' returns on equity, and a failure to understand the complexity of systemic risk. In the banking sector, the shift to self-governance under Basel II resulted in a reduction in overall capital requirements, with commercial banks shifting assets from banking to trading books; and an asset-backed and mortgage-backed commercial paper market premised on ongoing liquidity, with little attention to systemic risk.⁷ The originate and distribute model of lending resulted in less front end assessment of credit worthiness, as lenders were offloading their risk almost immediately. Where credit was granted, it was "covenant light", without the traditional terms and conditions that ensured monitoring and early intervention. In the EU, many banks operated throughout Europe on a "passport" system, but there was no mechanism to deal with the cross-border implications of Europe-wide bank insolvency. There was also a tension between short-term returns and long-term sustainability of financial systems, compounded by bank compensation practices that rewarded high fees for short-term profit.

The situation was exacerbated by moral hazard issues. In the classic bank finance paradigm, stakeholders with an economic interest in the bank have the greatest interest in monitoring; yet the existence of credit derivatives complicated this premise by affecting the motivations of various stakeholders, creating agency issues and negative externalities.⁸ Creditors with material holdings of derivatives for speculative purposes may have economic interests that

⁷ Bank for International Settlements (BIS), "Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package"; Press release, 26 July 2010; Basel Committee on Banking Supervision (BCBS), *An Assessment of the Long-Term Economic Impact of the New Regulatory Framework* (LEI Report), 2010; Basel Committee on Banking Supervision (BCBS), *International Framework for Liquidity Risk Measurement, Standards and Monitoring*, 2009; Basel Committee on Banking Supervision, "Countercyclical Capital Buffer Proposal", Consultative Document, 2009; Basel Committee on Banking Supervision/Financial Stability Board, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, Interim Report (MAG Report), 2009, <http://www.bis.org>; United States Government, The President's Working Group on Financial Markets, "Policy Statement on Financial Markets," March 2008, http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf; Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, 2008, http://www.financialstabilityboard.org/list/fsb_publications/page_3.htm; International Monetary Fund, "The Recent Financial Turmoil – Initial Assessment, Policy Lessons, and Implications for Fund Surveillance," April 9, 2008, <http://www.imf.org/external/np/pp/eng/2008/040908.pdf>; Andrea Polo, "Corporate Governance of Banks: The Current State of the Debate" (SSRN Working Paper, Said Business School, University of Oxford, 2007), <http://ssrn.com/abstract=958796>; Counterparty Risk Management Policy Group III, "Containing Systemic Risk: The Road to Reform," August 6, 2008, <http://www.crmpolicygroup.org/>; G-20 Study Group, "Report on Global Credit Market Disruptions," October 2008, http://www.g20.org/pub_further_pubs.aspx. Mark Carney, Governor of the Bank of Canada, "Looking Back, Moving Forward, Canada and Global Financial Reform", Remarks to the International Center for Monetary and Banking Studies, November 9, 2010.

⁸ Janis Sarra, *Credit Derivatives Market Design, Creating Fairness and Sustainability*, (London: Network for Sustainable Financial Markets, 2008).

encourage them to cause a credit event such that they realize on their “bet”. Collateralized debt obligations meant risk was shed immediately and the positive externalities associated with debt governance were lost. The prudential nature of banks was disregarded in a number of instances. In other cases, banks thought that they had insulated their core prudential banking function by having spin-off entities work in the speculative financial products market, but the contagion effect of liquidity crises and inadequate capital to meet calls on collateral placed the related entities at risk.

Once the crisis was in full flight, the “lender of last resort” legislation that provided funds when banks fail created further moral hazard in that the availability of bailout funds created incentives for banks to undertake riskier activities, knowing that directors and shareholders would benefit from any financial upside to riskier strategies and that taxpayers would bear the consequences of any downside.

These factors, in very broad brush strokes, paint a picture of a financial system that failed to appreciate its interdependency or its effect on real economic activity. The situation was exacerbated because, notwithstanding that the financial system was globally interconnected, the failure of a bank is treated domestically, not internationally. There was no framework for the resolution of cross-border financial group or conglomerate insolvency. Even at the national level, few jurisdictions had an effective framework for the resolution of domestic financial groups. Cross-border resolution of bank failure was also complicated by the potential effect of restructuring or liquidation on foreign operations and the lack of capacity, or in some instances, willingness, to bear a share of the burden of bank insolvency.

II. Regulatory Oversight in Preventing and Addressing Illiquidity and Insolvency

i. Identifying the Structural Problems

Prior to the financial crisis, there was a failure to appreciate the contagion risk associated with failure of a large bank. Banks are highly interconnected in interbank, OTC derivatives and foreign exchange markets. The structure of the market makes banks simultaneously competitors and co-operators, and that degree of interconnectedness undermines the ability of an individual bank to control its liquidity and solvency, in turn increasing risk of systemic failure.⁹

The Basel Committee has reported that the way in which risk was assessed by banks was highly problematic, observing that in certain portfolios, market and credit risk are inextricably linked, and that widely-used conventional approaches that estimate each risk type separately and then aggregate them can lead to sizable bias in overall risk estimates.¹⁰

⁹ Basel Committee on Banking Supervision, Working Paper 16, *Findings on the interaction of market and credit risk*, May 2009, <http://www.bis.org>, specifies: “Economic risk for banks refers to uncertainty about the future value of assets and liabilities. Economic risk drives both market and credit risk, (risk of default) interact in determining asset values, thus risk management needs to explicitly account for their joint influence”, at 6. “Successful management of market and credit risk often relies on liquid markets to hedge risks and unwind positions. There are also significant dangers of associating market and credit risk too closely with the intended use or holding period of an investment, as indicated by the booking of specific positions in the trading or banking book.” *ibid.* at 8.

¹⁰ *Ibid.* at 8. “The frequently used “top-down” approach first aggregates each risk type across positions and

In some instances, banks had left too much risk on their own books; in other cases, they had shed that risk as the original lender, but had acquired considerable risk from the purchase of commercial paper in the interbank market or participation in syndicated highly risky and improperly priced debt. Once banks started to fail from the U.S. sub-prime mortgage meltdown, there was serious contagion within the global financial system. While there had been notable financial crises in recent years, the size, intensity and reach of this crisis was unique.¹¹ Illiquidity at one bank spread rapidly to other banks. This structural risk increased the likelihood of runs on banks and losses by depositors. There was a lack of any effective system-wide oversight, which allowed for the regulatory arbitrage that developed in the shadow banking sector, further contributing to the crisis.¹² Globally, deposit insurance coverage was restricted to the smallest depositors and thus was not of assistance for many stakeholders when banks began to fail.

Derivatives were a significant aspect of the financial landscape. Although not the subject of this paper, it is important to note that the complex nature of the products, such as credit default swaps (CDS), collateralized debt obligations (CDO), index trades and credit-linked notes, shifted the market away from primarily a risk management strategy to a highly speculative market.¹³ Risk became “commodified”. The rapid introduction of new complex products created systemic risks to financial markets, in turn, to real economies, without the monitoring and discipline that occurs for securities markets or traditional commercial lending activity. The lack of transparency of products meant that counterparty risk was not well-understood or appropriately priced.¹⁴ With a complex interlocking set of claims, the financial system became increasingly interconnected, operating on a global scale and concentrated in a few key financial hubs. The over the counter (OTC) CDS market was ill-equipped to deal with bank failures and “cascading swaps” as the market tried to settle CDS.¹⁵

Securitization was also a problem that had not been appropriately identified as a downside risk. Securitization was originally aimed at transforming credit risk into market risk by pooling loans and issuing tradable claims against the pool; a risk management tool that relied

then only combines them at a higher level, often in a linear way. Since it therefore neglects a multitude of market-credit risk interactions, the question arises whether such an approach may lead to appreciably biased estimates or whether overall economic risk is still well approximated components under the top-down approach leads to “conservative” estimates of overall risk”, at 9. Basel reports that the summing of components assumes perfect correlation between market and credit risks; but if they are imperfectly correlated, then diversification effects are ignored and total risk overestimated, *ibid.* at 9, 14.

¹¹ Recent crises include the Mexican financial crisis in 1994–95, the Asian financial crisis and Russian debt default in 1997–98.

¹² Mario Draghi, Chair, Financial Stability Board and Governor of the Bank of Italy; “Next steps on the road to financial stability”, September 16 2010, Financial Times, <http://www.ft.com/cms/s/0/dde36946-c187-11df-8e03-00144feab49a.html?ftcamp=crm/email/2010916/nbe/ExclusiveComment/product>.

¹³ These products can be cash flow based or synthetic, bundled or housed within a variety of special purpose entities.

¹⁴ As Andrew Haldane, Executive Director of Financial Stability for the Bank of England said in April 2009, “An investor in a CDO squared would need to read in excess of 1 billion pages to understand fully the ingredients.”

¹⁵ In 2010, two years after Lehman Brothers failed, the swaps were still settling.

on the liquidity of primary markets for placing asset-backed securities.¹⁶ Securitization differs from traditional bank lending because banks, after having originated the loans, hold them only for a short time before the loans are sold or before the associated risks of the loans are sliced into tranches and then sold. When structured appropriately, securitization allows a bank to manage credit and other risks of its loan portfolio.¹⁷ However, a negative feature of securitization by banks was that, in many instances, once fees on the original loan were extracted by the bank, the financial risk was passed along to various tranches of debt. There was a failure to understand the incentive effects of this originate and distribute model of lending. The collateralized debt obligations resulted in less front end assessment of credit worthiness, as lenders were offloading their risk almost immediately. The incentive effects were that banks' intermediation function, including screening and monitoring of borrowers, was severely impaired and products were mispriced. Once securitization markets became illiquid, banks were exposed to heightened risk from exposures to credit risk, such as loans that could no longer be securitized, and to market risk, from changes in the mark-to-market value of the securitized assets.¹⁸

Rating instruments were also outdated, and investors relied too much on credit ratings that failed to take account of liquidity risk and the lack of transparency on investments. There were conflicts of interest in the way in which credit rating agencies were compensated, creating incentives to not be rigorous in assessing and pricing risk of particular financial products. When the loan quality of US subprime mortgages worsened, the belated realization by agencies resulted in ratings downgrades; investors began to shun the products as they could not accurately price risk; there was a rapid spread to other financial products and concern emerged regarding the financial health of bank counterparties.¹⁹

In identifying the structural problems, it is important to note that a bank's core business is to voluntarily accept a mismatch in the term structure of its assets and its liabilities; and bank viability depends on continuous access to liquidity, be it deposits, short-term funding on the interbank market, funding in secured financing markets or funding from a central bank as the liquidity provider of last resort.²⁰ Banks are compensated for accepting a maturity mismatch by the premium charged to creditors.²¹ Yet too much leverage increases a bank's probability of default, and depositors and creditors will demand a higher risk premium for the higher risk of insolvency.²² An important lesson of the crisis is the need to provide for more rigorous prudential regulation pertaining to banks' liquidity risk management.²³

¹⁶ Draghi, *supra*, note 12 at 2.

¹⁷ *Ibid.* at 19.

¹⁸ *Ibid.*

¹⁹ Basel, *supra*, note 7 at 10.

²⁰ Peter O. Mülbert, "Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms", ECGI Working Paper, April 2010 at 12.

²¹ *Ibid.*

²² *Ibid.*

²³ Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," (Basel: BIS, September 2008), <http://www.bis.org/publ/bcbs144.htm>; Basel Committee on Banking Supervision, "International framework for liquidity risk measurement, standards and monitoring" (Consultative Document, December 2009), <http://www.bis.org/publ/bcbs165.htm>. Directive amending Directives, 2006/48/EC and 2006/49/EC regarding banks affiliated to central institutions, large exposures, supervisory arrangements, and crisis management, (Capital Requirements Directive); Committee of

Mülbert observes that because of the mismatch in the term structure of assets and liabilities, banks are subject to creditor runs; and readily available liquidity reserves can be rapidly exhausted as most bank assets cannot be quickly liquidated.²⁴ Hence, there is a collective action problem in that a race to the money will result in only the first creditors receiving a timely and full payout.

An example is Northern Rock, which in 2008 was the fifth largest bank in the UK, and the first to experience a crisis in that jurisdiction. The bank was solvent, its assets were sufficient to cover its liabilities, but it faced a liquidity problem when institutional lenders stopped lending during the sub-prime meltdown.²⁵ Northern Rock sought a liquidity support facility from the Bank of England, due to difficulty raising funds to replace maturing money market borrowings. The Bank of England could not lend quietly as it would violate the EU Market Abuse Directive, but before it announced the financial support, the media leaked the information, creating a run on the bank.²⁶ £1 billion, 5% of total deposits, was withdrawn by customers the first day the news became public.²⁷ The initial loan was not sufficient to stem the exit of capital, and by early 2008, Northern Rock's loan from the Bank of England had grown to £28bn.²⁸ There was no market in private bids for the bank that offered sufficient value to meet the massive debt and liquidity crisis; and the UK government moved in to nationalize the bank for a temporary period, replacing the board of directors.²⁹ The government lacked legal powers to address the insolvency on a timely basis. Insolvency administration was not viewed as a viable option as depositors' claims would have been subordinated under UK law and the UK's deposit insurance scheme was not pre-funded. In January 2010, HM Treasury legislation restructured Northern Rock, dividing it into a "good bank" and a "toxic bank"; creating two separate entities, a savings and mortgage bank and asset management, allowing the viable business to continue and retaining the toxic assets in the other entity.³⁰

The collapse of Northern Rock appears to have been primarily a governance failure. The bank's senior management and directors failed to meet their primary responsibility of ensuring financial soundness. However, it was also a regulatory failure. The UK Financial Services Authority (FSA) found its supervision of the bank did not meet appropriate standards due to high turnover of its senior supervisory staff, a lack of specialist regulators,

European Banking Supervisors, "Consultation Paper on Liquidity Buffers and Survival Periods," Consultation Paper July 28, 2009, www.c-eps.org/Publications/Consultation-Papers/All-consultations/CP21-CP30/CP28.aspx.

²⁴ Mülbert, *supra*, note 20 at 18.

²⁵ The *Banking (Special Provisions) Act 2008* was introduced to enable the rescue of Northern Rock and other banks.

²⁶ Julia Black, "Managing the Financial Crisis – The Constitutional Dimension", LSE Law, Society and Economy Working Papers 12/2010 London School of Economics and Political Science Law Department at 10.

²⁷ In one incident in Gloucestershire, two joint account holders barricaded the bank manager in her office after she refused to let them withdraw £1 million from their internet account.

²⁸ National Audit Office, *Nationalisation of Northern Rock*, Report of the Comptroller and Auditor General, (2008-9) HC 298 Session, at para 31, http://www.nao.org.uk/publications/0809/northern_rock.aspx

²⁹ On 17 February 2008, Northern Rock was nationalized as a temporary measure until market conditions improved. *Ibid.*

³⁰ National Audit Office, *supra*, note 28.

and a lack of continuity of oversight.³¹ Ironically, the UK Treasury and FSA had conducted “war games” during training sessions in 2005, including a simulated failure of Northern Rock, during which they discovered that they lacked effective authority to deal with a bank collapse in an orderly manner; yet the government concluded at the time that the risk of failure of major banks was remote and thus was not a priority in its legislative agenda.³²

Also in the UK, Bradford & Bingley was nationalized by the UK government; about 60% of its business had been funded through sub-prime lending.³³ Like HBOS and Northern Rock, it had relied heavily on the mortgage market while other banks had a more diversified and broader base.³⁴ Rapidly growing bank illiquidity and insolvency threatened the UK economy. In April 2008, the Bank of England launched a scheme to allow banks to temporarily swap their high quality illiquid mortgage-backed and other securities for UK Treasury Bills.³⁵ The UK Minister of Finance was given the ability to disburse funds in order to establish a new financial undertaking or takeover a financial undertaking or its bankrupt estate, either wholly or in part.³⁶ Key points of the funding plan included that banks were to increase their capital by at least £25bn and could borrow from the government to do so; an additional £25bn in capital would be available in exchange for preference shares; £100bn would be available in short-term loans from the Bank of England, on top of an existing loan facility worth £100bn; and up to £250bn in loan guarantees would be available at commercial rates to encourage banks to lend to each other.³⁷

The UK bailout came with ties. It required a guarantee that there would be capital available for day to day operations, signalling to creditors that they were protected from future losses. There were limits on remuneration for bank executives and restrictions on giving on dividends. For example, in return for providing fresh liquidity, the UK government secured a promise from RBS and Lloyds not to pay a dividend that year and possibly in additional years, and a promise to help people who were struggling to pay their mortgages.³⁸ They were

³¹ Turner Report, *supra*, note 7 at 21.

³² Black, *supra*, note 26 at 8.

³³ <http://ssrn.stanford.edu/delivery.php?ID=043105127121026120084079000080090121009036000082061091106020015025110009023081070011120058100122042024053113067118010079110072020090034037034102070122099094069094116058002086073126110092117095092003087006&EXT=pdf>

³⁴ *Ibid.* HBOS’ liquidity issues stemmed from its inability to raise funds in the money-markets it normally relied on to raise funds to finance its business.

³⁵ <http://www.bankofengland.co.uk/publications/news/2008/029.htm>.

³⁶ http://www.tryggingarsjodur.is/modules/files/file_group_26/fréttir/Act_No125-2008.pdf. The Minister of Finance was given the ability to contribute up to 20% of the book value of the company’s equity. Pursuant to Article 5, the Financial Supervisory Authority can take over powers of shareholders’ meeting or meeting of guarantee capital holders for the purpose of taking decisions on necessary measures, including limiting the decision-making power of the Board, dismissing directors, taking over the operations of the financial undertaking, or disposing of such an undertaking in whole or in part, including merging it with another undertaking

³⁷ <http://news.bbc.co.uk/2/hi/business/7658277.stm>. On October 13, 2008, the British Government provided a £37bn bank bailout plan to Royal Bank of Scotland, Lloyds TSB and HBOS; <http://www.guardian.co.uk/business/2008/oct/13/marketturmoil-crediterrunch>. The government took a controlling stake of up to 60% in RBS, in return for up to £20 billion. Lloyds, which renegotiated its takeover of HBOS, received up to £17bn.; <http://www.dailymail.co.uk/money/article-1145554/HBOS-profit-warning-makes-mockery-37billion-bank-bailout-taxpayers-shares-cut-just-10billion.html>.

³⁸ *Ibid.*

not to pay any cash bonuses, and agreed to let the government appoint several board members.³⁹

In the US, Lehman Brothers' failure in 2008 was due to the interbank market, rather than a classic run on the bank. Lehman faced an unprecedented loss as a result of having held on to large positions in subprime and other lower-rated mortgage tranches when securitizing the underlying mortgages. Losses accrued in lower-rated mortgage-backed securities throughout 2008, forcing it to sell 6 billion USD in assets, in turn its stock losing 73% of its value as the credit market continued to tighten. In September 2008, Lehman announced a loss of 3.9 billion USD and its intent to sell off a majority stake in its investment-management business. Lehman Brothers Holdings filed Chapter 11 bankruptcy proceedings with bank debt of 613 billion and bond debt of 155 billion.⁴⁰ It filed in the UK, Japan and other jurisdictions.⁴¹ The US government made a decision not to bail out Lehman's and the collapse was a major factor in precipitating a full scale financial crisis, given the highly interrelated nature of the banking and financial products sector. The crisis quickly spiraled out of control, with financial institutions and then businesses falling like dominos. One month later, the US Congress enacted the Troubled Assets Recovery Program (TARP) of 700 billion USD to purchase US bank toxic assets.

The massive injection of public funds during the height of the financial crisis was highly contested in some jurisdictions. In the US and elsewhere, bail-outs did not include the kinds of conditions imposed on the banks in the UK, and there was considerable public protest that the bail-outs were occurring while executives continued to receive bonuses and working people were losing their livelihood, their homes and their pension savings.

The global banking industry has wide variance in capital and governance structures, which means that there is differing risk appetite and incentives to monitor management. Pre-crisis rules on adequate internal controls, risk management and audit functions did not prevent excessive risk taking. Once financial distress occurred, it became evident that there were few structures and systems in place to address bank insolvency. The need for a regulatory response to oversight of banks is evident, but the nature and extent of that response is a complex issue, particularly in light of the wide variation in individual financial institutions and the regulatory authorities that supervise their activities, and given recent, growing, sovereign financial distress.

Basel II had created disclosure requirements covering quantitative and qualitative aspects of overall capital adequacy and capital allocation, as well as risk exposure and assessment, all with a view to promoting market discipline.⁴² Many of its provisions were not really

³⁹ *Ibid.* In order to allow the takeover of HBOS by Lloyd's, the Government volunteered to waive competition rules that would usually have blocked a takeover of that size.

⁴⁰ Its assets were worth 639 billion USD.

⁴¹ In the United Kingdom, its investment bank went into administration with PricewaterhouseCoopers appointed as administrators. In Japan, the Japanese branch, Lehman Brothers Japan Inc. and its holding company filed for civil reorganization on September 16, 2008, in Tokyo District Court. On September 20, 2008, a 1.35 billion USD plan for Barclays to acquire the core business of Lehman, mainly its \$960-million headquarters and 9,000 former employees, was approved. Nomura Holdings agreed to buy the Asian division of Lehman Brothers for \$225 million and parts of the European division for a nominal fee of \$2.

⁴² Analysts disagree more with respect to the quality of bonds issued by banks than with the quality of

implemented and others were deficient to address the above-identified problems.

In addition to the interbank dependency issues and the problems associated with securitization, the international nature of banking was a factor. One of the benefits of the EU passport system, fluidity of capital, is problematic on insolvency. Banks of member states could establish branches without host country approval or supervision, which means that if the supervisory oversight in the home jurisdiction is lacking, that risk is being transferred to the depositors in host member states, with little or no regulatory oversight in that host state. Recently adopted capital adequacy requirements face the same issue, in respect of levels of capital adequacy being adopted in different EU member states.

In May 2010, European governments and the IMF provided a 750 billion Euro bailout package.⁴³ The European Central Bank started purchasing government bonds as a short term stabilization strategy.⁴⁴ Its bond purchase program was to address the shutdown of the covered bond market and support longer-term funding of banks and the financing of the real economy in the euro area. In July 2010, 91 banks were evaluated, representing 65% of the European Union's banking sector; of those, seven failed European bank stress tests.⁴⁵ Concerns continue regarding the health of the European banking system, with many banks dependent on the European Central Bank for financing.⁴⁶ Conditions that accompanied the bailouts tightened the definition of what banks could count as highest-quality “tier one capital”, the main assets they hold to protect against losses. It also required lenders to hold liquid assets sufficient to see them through a 30-day crisis and set a global leverage ratio to limit overall bank borrowing.⁴⁷ For example, the rescue package provided to Greece in 2010 by the IMF and Eurozone was €110 billion in funds,⁴⁸ which included a €10 billion support fund for the nation's banks that faced rising bad loans as the economy was shrinking.⁴⁹ Included in the package was the requirement that there be no debt restructuring; and that the European Central Bank suspend the minimum credit rating required for the Greek government-backed assets used in its liquidity operations.⁵⁰

As a result of the bank failures and the massive bailouts, governments worldwide concluded

bonds issued by other firms; Donald P. Morgan, “Rating Banks: Risk and uncertainty in an opaque industry,” *The American Economic Review* 92 (2002): 874-888; Giuliano Iannotta, “Testing for Opaqueness in the European Banking Industry: Evidence from Bond Credit Ratings,” (SDA Bocconi Working Paper No. 122/04, June 2004), <http://ssrn.com/abstract=570483>.

⁴³ <http://www.bbc.co.uk/news/10104169>.

⁴⁴ “Monetary and fiscal policies in times of crisis”, speech by José Manuel González-Páramo, Member of the Executive Board of the ECB, Conference of the Monetary and Fiscal Policies Network, Goethe Universität Frankfurt, September 2011, <http://www.ecb.int/press/key/date/2011/html/sp110919.en.html>.

⁴⁵ The stress test is a method to help determine whether the banks will be able to survive another major crisis. <http://www.bbc.co.uk/news/business-10711590>.

⁴⁶ *Ibid.*

⁴⁷ <http://www.ft.com/cms/s/0/ab02375c-aafb-11df-9e6b-00144feabdc0.html>

⁴⁸ <http://www.ft.com/cms/s/0/7f0c9e48-57dc-11df-855b-00144feab49a.html>; €30bn of which will come from the IMF.

⁴⁹ <http://www.businessweek.com/news/2010-05-02/greece-bailout-plan-includes-support-fund-for-country-s-banks.html>

⁵⁰ *Ibid.* Greek banks had raised about €94bn from the European Central Bank at the end of September 2010, posting securities as a collateral of nominal value in excess of €135bn. G. Parker *et al*, “UK Banks to be Part Nationalized”, *Financial Times*, October 8, 2008.

that the effectiveness and intensity of supervision needs to be strengthened for banks, particularly for systemically important institutions. The Financial Stability Board (FSB) suggested that jurisdictions needed to strengthen supervisory mandates, independence, resources and methods; and that core financial market infrastructures needed to be reinforced to reduce contagion risks and to ensure that critical infrastructure is not itself a source of systemic risk.⁵¹

The Basel Committee Financial Institutions 2010 Report found that the assumption that institutions were too big or too interconnected to fail introduced additional risk and greater likelihood of cross-border contagion. It found that prudential measures will not limit the potential for increased moral hazard without instituting viable resolution processes for financial institutions. It also found that contingency planning is important for cross-border financial institutions to deal with financial distress, including cross-border cooperation and information sharing. It advocated strengthening risk mitigation mechanisms that reduce systemic risk and enhance resiliency of critical financial functions during a crisis.⁵²

The G-20 leaders in November 2010 agreed on comprehensive financial sector reforms to reduce the risk of future crises, strengthen banking systems and prevent a future need for massive government bailouts. The FSB and the Basel Committee on Banking Supervision conducted studies to evaluate the macroeconomic impact of the proposals, assessing the benefits and costs of the initial transition period and of strengthening capital and liquidity standards over a longer-term period when the proposals are fully implemented.⁵³

ii. Higher Capital and Liquidity Requirements

The Basel Committee on Banking Supervision's measures to strengthen regulatory standards for internationally active banks require banks to carry more capital and liquidity, designed to improve the safety and robustness of the global financial system.

Basel III provides for a "macroprudential overlay" to better deal with systemic risk, with a significant increase in the required level of capital; an increase in the quality of banks' capital; and a stricter definition of core capital. Basel III sets a new key capital ratio of 4.5 per cent.⁵⁴ The reforms will increase the minimum common equity requirement from 2% to 4.5%.

⁵¹ *Ibid.*

⁵² Risk mitigation techniques, in its view, include: enforceable netting agreements, collateralization, greater standardization of derivatives contracts, clearing and settlement through regulated central counterparty clearing facilities, and transparency reporting through trade repositories. It also advocated a reduction in the complexity and interconnectedness of group structures.

⁵³ Basel Committee, "Mag Report", *supra*, note 7. The Basel Committee on Banking Supervision provides a forum for cooperation on banking supervisory matters, to promote and strengthen supervisory and risk management practices globally.

⁵⁴ From 2 per cent level; Basel Committee on Banking Supervision, September 12, 2010, "Group of Governors and Heads of Supervision announces higher global minimum capital standards", <http://www.bis.org/press/p100912.pdf>. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period. The Group of Governors and Heads of Supervision also agreed that the capital conservation buffer above the regulatory minimum requirement be calibrated at 2.5% and be met with common equity, after the application of deductions.

Another objective of Basel III is to reduce systemic risk by reducing procyclicality, i.e. the financial system's tendency to amplify the ups and downs of the real economy, taking account of the inter-linkages and common exposures among financial institutions, especially for those deemed systemically important. Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress.⁵⁵ This countercyclical buffer would build up during periods of rapid aggregate credit growth where national authorities determine the growth is aggravating system-wide risk. The capital held in the buffer could then be released in the downturn of the cycle, reducing the risk that available credit would be constrained by regulatory capital requirements, and reducing the possibility of an adverse cycle of losses and tightening of credit.⁵⁶ While banks are allowed to draw on the buffer during periods of financial distress, they will face restrictions on paying dividends and discretionary bonuses.⁵⁷ The introduction of capital buffers is intended to give banks, in co-operation with supervisory authorities, greater scope to vary the amount of capital they hold in response to economic circumstances.⁵⁸ The countercyclical buffer capital is being implemented according to national circumstances, to achieve the broader macroprudential goal of protecting the banking sector.⁵⁹ These capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures.⁶⁰

In Canada, the prudential supervisor had long required banks to establish internal targets to provide an operating cushion against volatility and unexpected losses from risks, resulting in higher capital than required under the Basel agreement. At the outset of the financial crisis, the average Tier 1 capital ratio at Canadian banks was 10% and their total capital ratio was almost 13%.⁶¹ All Canadian banks were able to maintain capital in excess of supervisory targets, and none required a bailout. The Canadian experience illustrates the importance of good capital adequacy ratios. It may also illustrate, however, that the amount currently set by Basel III may not be sufficient to protect against a further serious banking crisis.

iii. Success Depends on Willingness to Implement

⁵⁵ Bringing the total common equity requirements to 7%.

⁵⁶ Group of Governors and Heads of Supervision press release: <http://www.bis.org/press/p100726.htm>, July 2010, from the one proposed in its December 2009 consultation paper, *International framework for liquidity risk measurement, standards and monitoring*. At the same time, the BCBS substantially relaxed the definition of liquid assets by allowing a broader range of assets to be counted as liquid assets and introducing more lenient assumptions regarding such elements as run-off rates.

⁵⁷ Basel Committee on Banking Supervision, September 12, 2010, Group of Governors and Heads of Supervision announces higher global minimum capital standards, <http://www.bis.org/press/p100912.pdf>.

⁵⁸ In July 2010, the BCBS issued for consultation a proposal for a counter-cyclical capital buffer regime, <http://www.bis.org/publ/bcbs172.pdf>.

⁵⁹ *Ibid.*, reporting that a “countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances”.

⁶⁰ *Ibid.* In July, Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration. The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. By January 2014, banks will have to meet a 4% minimum common equity requirement and a Tier 1 requirement of 5.5%. On 1 January 2015, banks will have to meet the 4.5% common equity and the 6% Tier 1 requirements.

⁶¹ Carney, *supra*, note 7 at 3.

One of the real challenges of international sources of law, such as Basel III, is to ensure that they are implemented. They require action by national governments around the world. Higher capital and liquidity requirements should result in lower-risk banks. The measures should reduce the probability and severity of future financial crises; create smoother economic cycles that allow economic growth; lower the risk of overinvestment problems due to under-pricing of risk; and lower the incidence of spread of financial failure to the global financial system.⁶² However, the Basel III requirements are dependent on countries' willingness to implement the measures. The levels of capital adequacy were hotly contested by some jurisdictions throughout the deliberations, resulting in reduction of the amounts originally proposed; and there may be some unwillingness to implement even these standards. One media report has suggested that the passport system is a big loophole to escape higher capital requirements.⁶³

In some instances, there is no capacity to meet the capital adequacy requirements, particularly in some emerging Eastern European and other emerging nations. The World Bank's financing arm was undertaking contingency planning for failure of these nations to meet the new standards, even as the ink was drying on Basel III.

Given the dynamic nature of financial markets, there is also a need for jurisdictions to be committed to evaluating any changes on an ongoing basis, and to be responsive to the need for further adjustment of capital and liquidity standards.

iv. Issue of Who Pays

Despite the benefits, stronger prudential standards also impose costs on the economy, since banks will pass on to their customers the higher costs of carrying more capital and liquidity. The Bank of Canada has observed that if given enough time to meet the new capital requirements by regulators and markets, banks can generate capital internally over time through the retention of earnings; yet they will likely pass on the costs of the higher standards to their customers by demanding higher interest spreads, increasing non-interest fee income, or reducing operating expenses.⁶⁴ They can also lower the risk-weighted asset denominator of their regulatory capital requirements by slowing the growth of assets that do not generate sufficient revenue to justify the extra capital charges; or they can raise additional capital by issuing new shares to investors.⁶⁵ Arguably, given the considerable returns that bank investors enjoyed over the pre-crisis period, they should bear some of the costs of new capital requirements through lower returns on their equity investment.⁶⁶ The costs could also

⁶² Bank of Canada, *supra*, note 4 at 5-6.

⁶³ P. Jenkins, M. Murphy and S. Goff, *Financial Times*, April 17, 2011, discussing the Vickers Commission on banking.

⁶⁴ In Canada, the Bank of Canada has estimated that "Based on conservative estimates of the cost of financial crises to Canada, the Bank calculates the potential benefit from a reduced incidence of crises to be approximately \$1/2 trillion. Even after subtracting the estimated long-run and transition costs of requiring banks to carry more capital and liquidity, the net gains to Canada in present-value terms would still be approximately 13 per cent of GDP, equivalent to about \$200 billion." Bank of Canada, *ibid.* at 2.

⁶⁵ *Ibid.* at 14, reporting that "the new capital rules generally reset the balance between conventional banking-book and trading-book activities at the margin in favour of traditional banking activities, which, all things being equal, should encourage banks to continue their current lending activities".

⁶⁶ The Bank of Canada observed that costs assume that Canadian banks will not need to reduce their current

be borne in part by more modest compensation to senior officers, aligning their compensation more directly to the quality of their prudential oversight and success in maintaining the safety and soundness of the financial institution. Some combination of all of these strategies may spread the costs over different types of stakeholders, rather than have borrowers and depositors bear the costs.

Banks are likely to seek to maintain their return on equity over the longer run, yet the Bank of Canada has observed that higher capital and liquidity requirements should make banks less risky, thereby reducing the required rate of return on both bank debt and equity.⁶⁷ It observes that given the current exceptionally low level of bank deposit rates and the cost of bank debt funding more generally, the wider interest margins will effectively result in higher interest rates (lending spreads) on bank loans, which will be passed along to all bank borrowers, not just to small and medium-sized businesses, because all banks will be affected by the new requirements.⁶⁸

A reduction in the supply of credit could affect the level of economic output during the transition to the new standards. The macroeconomic effects of banks meeting higher capital and liquidity requirements may mean that short-term business consumption and investment expenditure will be dampened because higher interest margins and tighter lending standards.⁶⁹ However, these costs are likely an appropriate price to allow the system to adjust to reduce overall systemic risk. Arguably it is a better approach than the tax-based bailouts that essentially resulted in “privatization of gains” and the “socialization of losses”, which placed the burden of bank failure on taxpayers, rather than the banking sector and its decision makers.

v. More Appropriate Supervisory Oversight

Banks and other financial institutions can shift their risk profile very quickly. Their exposure to risk can also be altered by market developments even without specific actions on the part of the bank. A bank’s holdings of financial assets, which include both debt and equity securities and hybrid instruments, allows a bank to liquidate its long-term debt arrangements, such as commercial and residential mortgages, and shift the value to new assets with a much higher risk profile, creating inappropriate solvency risk. More appropriate supervisory oversight would increase the likelihood that governance structures are in place to minimize such risks.

A number of studies have identified a lacuna in supervisory oversight, in part because the assumption was that the self governance set up under Basel II would result in directors and officers controlling risk internally; and in part because of the difficulty in attracting and

15 to 20 per cent returns on shareholders’ equity, to adjust to the new rules; *ibid.* at 5.

⁶⁷ *Ibid.* at 14.

⁶⁸ *Ibid.*, suggesting that there could be some distributional effects arising from differences in interest elasticities and competitive conditions across lending markets.

⁶⁹ *Ibid.* at 18. The Bank of Canada has suggested that restricting the tightening of capital and liquidity requirements to a single country could cause the effect on GDP of lower consumption and investment to be partially offset by weaker import demand; weaker GDP growth, together with the downward pressure on prices and wages, suggests the probability of a monetary policy response in which the central bank counters the drop in output and inflation.

retaining expertise within supervisory authorities. In the UK, the FSA found there had been limited understanding by its supervisory team of the duties contained in the regulator's "close and continuous" supervision model.⁷⁰

The degree of regulatory oversight requires normative consideration of the extent to which such oversight should be imposed by regulatory standards and supervision and the degree to which regulation should promote governance practices that encourage compliance. Put more bluntly, what is the degree to which the remedies to the agency issues in bank governance should be privately driven or publicly imposed? In respect of financial institutions, regulatory reform is highly influenced by the financial institutions themselves, as they have considerable resources to press for regulatory structures that suit their direct interests. Given that other stakeholders, such as depositors or insurance policy holders, may not have the information, resources or capacity to participate in policy discussions regarding regulatory reform, it is important that government build in these perspectives to the greatest extent possible. Otherwise, the public interest aspects of financial institution oversight may be lacking.

Oversight also needs to be highly dynamic, with an ability to assess its effectiveness and respond in a timely way to changes in financial products, financial institution structures and market changes. In this respect, there needs to be effective monitoring and assessment of any regulatory changes, in order to assess whether they meet the public policy goals articulated at the time they were introduced, and arguably, a deliberative public policy discussion that accounts for the experience of both institutions and individuals. Such processes may be more responsive to changes required, if sufficiently broad perspectives can be brought to the deliberative process. The difficult question is what the appropriate degree of regulatory oversight is that would reduce systemic risk as well as bank-specific risk, having regard to the particular prudential nature of banks and similar financial institutions.

Black and Baldwin have suggested that regulators can attune the logics of risk analyses to the complex problems and the dynamics of regulation in practice, arguing that regulators have to regulate in a way that is responsive to five elements: regulated firms' behaviour, attitude, and culture; regulation's institutional environments; interactions of regulatory controls; regulatory performance; and change.⁷¹ They observe that there are strengths and limitations in using risk-based regulation to manage risk and uncertainty within the constraints of practical circumstances.⁷² These elements can be considered in discerning the degree to which oversight is required to reduce systemic risk.

Given the nature of interests in financial institutions, the need for regulatory or supervisory oversight is considerable. Deposit holders and life policy holders place their savings or purchase their life insurance or annuities in order to assure some future economic security. They do not factor in the risk of the bank or insurance company becoming insolvent in the same way that arguably equity investors do. Unlike many equity investors, the depositor's

⁷⁰ Financial Services Authority, *supra*, note 7.

⁷¹ R. Baldwin and J. Black, "Really Responsive Risk-Based Regulation" (2010) 32 *Law and Policy* at 181-213.

⁷² *Ibid.*, specifically, the different regulatory tasks of detection, response development, enforcement, assessment, and modification.

deposits or the policyholder's life insurance is not invested disposable cash that the deposit or policyholder can afford to lose. Arguably, there is a fiduciary obligation by the bank officers, given the imbalance in power and vulnerable nature of most depositors and policyholders. Hence, some of the arguments that investors should serve as a form of discipline of managers through exit or voice are not applicable to such stakeholders of banks and insurance companies. The prudential nature of the financial institution requires a higher degree of oversight to ensure the safety and soundness of the financial institution, and to protect the economic interests of these stakeholders. It also requires safety nets for vulnerable depositors and life policyholders when regulatory oversight is not sufficient and a financial institution becomes insolvent.

In this respect, one normative question is why much of the focus of addressing collapse of banks has been "financial safety nets" for major banks, with less concern for broader social safety nets for individuals and small businesses harmed by the governance failure of the banks. The nature of banks also means that there are public interest aspects to bank regulation, both in terms of overall system stability, and in terms of creating a system that protects interests across a broad cross-section of society.

A number of jurisdictions have now recognized these issues. The UK announced measures to enhance oversight; regulators are to perform an annual review of the business and strategic plans of high impact firms, taking into account the stress testing carried out by the firm, management actions, and the firm's view of the likeliest scenarios that could threaten its viability.⁷³ Supervisors are to assess the robustness of the firm's plans to maintain adequate capital and liquidity. Supervisory authorities are also to increase the rigour of its ongoing supervision under its risk mitigation program, and increase its focus and resources on prudential supervision, including stress testing, to ensure that firms have appropriate risk management systems and controls.⁷⁴

A High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, identified some serious shortcomings in the existing system of financial supervision in Europe.⁷⁵ It reported that banks operate across borders, but supervision remains mostly at national level, uneven and often uncoordinated. Many technical rules are determined at member state level, and there is considerable variation. Even where rules are harmonized, application is inconsistent. It has observed that the fragmented supervision undermines the EU single market, imposes extra costs for financial institutions, and increases the likelihood of bank insolvency. The report concluded that a stronger financial sector in the EU in the future must have convergence between member states on technical rules, and a mechanism for ensuring agreement and co-ordination between national supervisors of the same cross-border institution. It proposed a rapid and effective mechanism to ensure consistent

⁷³ Financial Services Authority, *supra*, note 7.

⁷⁴ For high impact firms, there should be an on-going supervisory assessment of all appropriate core risk areas, including capital. Capital and liquidity should have specific focus for high impact deposit-takers and investment firms and should not, in future, be de-prioritised below a certain level. *Ibid*.

⁷⁵ "Report of the High-Level Group on Financial Supervision in the EU, February 2009," no. 110, http://ec.europa.eu/internal_market/finances/committees/index_en.htm#delarosierereport ("Larosière Report"). Chaired by Jacques de Larosière, former President of the European Bank for Reconstruction and Development.

application of rules, as well as co-ordinated decision-making in emergency situations.

vi. Strengthen National Bank Insolvency Resolution Frameworks

Bank of England Governor Mervyn King observed that “banks may be global in life, but they are national in death”.⁷⁶ Even where a financial institution has highly integrated debt and asset structures, insolvency workouts are the jurisdiction of individual domestic insolvency systems. There is a tension between international efforts to harmonize regulation in global financial markets and the actual effects of bank failure on national systems, subject to national laws, with the costs borne by taxpayer resources. Responses to bank failures need to be timely and effective; and in the majority of cases, such responses will fall to national regulators and national resolution schemes. Any regulatory innovation must be responsive to these tensions.

The European Bank for Reconstruction and Development (EBRD) has noted that a lack of provisions allowing refinancing and fair and equitable voting on a plan of reorganization are among common weaknesses that should be addressed in future reform efforts.⁷⁷ Mario Draghi, Chair of the FSB, has observed that systemically important institutions will operate with correct incentives only if an effective resolution framework is in place and that many countries lack these powers, the tools and operational capacity. He suggests that statutory powers enabling the resolution authority to bail-in senior debt holders would expand the options for going concern resolution.⁷⁸

The FSB is developing common principles to strengthen national resolution powers for financially distressed financial institutions and to ensure firm-specific contingency planning; suggesting that such principles will reduce contagion, help to achieve greater consistency among national resolution frameworks, and improve coordination of resolution measures across borders.⁷⁹ It suggests that all jurisdictions should have in place a policy framework to reduce the moral hazard risks associated with systemically important financial institutions in their jurisdictions; and should have effective resolution tools that enable the authorities to resolve financial firms without systemic disruptions and taxpayer losses. Effective resolution schemes should include authority to facilitate a “going concern” capital and liability restructuring as well as “gone concern” restructuring and wind-down, including measures such as the establishment of a temporary bridge bank to take over and continue operating certain essential functions.⁸⁰ The G20 has subsequently agreed that every country should have a rapid resolution mechanism for all systemically important financial institutions.

The Basel Committee on Banking Supervision has recommended that: “National authorities

⁷⁶ Quoted in article by Steve Schifferes, “Can banking regulation go global?”, BBC News, March 18, 2009, <http://news.bbc.co.uk/2/hi/business/7950758.stm>.

⁷⁷ <http://www.ebrd.com/pages/sector/legal/insolvency.shtml>. It has developed new policies to improve the legal framework for creditors; and improve the laws and regulatory frameworks to ensure insolvency administrators have clear and effective standards of professional and ethical conduct.

⁷⁸ Mario Draghi, Chair, Financial Stability Board and Governor of the Bank of Italy; “Next steps on the road to financial stability”, September 16 2010, Financial Times, <http://www.ft.com/cms/s/0/dde36946-c187-11df-8e03-00144feab49a.html?ftcamp=crm/email/2010916/nbe/ExclusiveComment/product>.

⁷⁹ Financial Stability Board, *Report to the G20*, 18 June 2010.

⁸⁰ *Ibid.*

should have appropriate tools to deal with all types of financial institutions in difficulties so that an orderly resolution can be achieved that helps maintain financial stability, minimize systemic risk, protect consumers, limit moral hazard and promote market efficiency. Such frameworks should minimize the impact of a crisis or resolution on the financial system and promote the continuity of systemically important functions. Examples of tools that will improve national resolution frameworks are powers, applied where appropriate, to create bridge financial institutions, transfer assets, liabilities, and business operations to other institutions, and resolve claims.”⁸¹

1. UK Initiatives

Prior to 2008, the UK did not have a statutory regime for dealing with failing banks. The *Banking (Special Provisions) Act 2008* temporarily provided the Treasury with powers to facilitate an orderly resolution to maintain financial stability or protect the public interest.⁸² The UK then enacted the *Banking Act, 2009*, which establishes a permanent special resolution regime (SRR), providing authorities with tools to deal with financially distressed banks.⁸³ There are three stabilization options: transfer to a private sector purchaser, transfer to a bridge bank and transfer to temporary public sector ownership. The authority under the *Act* includes the ability to effect the transfer of shares and other securities or property, rights and liabilities; and assess any compensation payable to transferors for the shares or other property transferred and for third parties affected by a transfer.⁸⁴

The *Banking Act, 2009* also establishes a new bank insolvency procedure, to provide for the orderly winding up of a failed bank and the facilitating of rapid payments by the Financial Services Compensation Scheme (FSCS) to eligible claimants, or a transfer of such accounts to another financial institution.⁸⁵ There is a new bank administration procedure where there has been a partial transfer of business from a failing bank. A bank administrator may be appointed by the court to administer the affairs of an insolvent residual bank, created where part of the bank has been transferred to a private sector purchaser or to a bridge bank under the SRR.⁸⁶

The *Act* formalizes the Bank of England’s role in the oversight of inter-bank payment systems, given the inter-linkages between payment systems, banks and other financial

⁸¹ Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Bank Resolution Group* Basel Committee on Banking Supervision, March 2010, recommendation 1.

⁸² The temporary provisions lapsed in February 2009. Lord Turner, FSA, has acknowledged that "'soft-touch' regulation has been consigned to the dust-bin of history" in the light of the "worst global financial crisis since the development of modern capitalism; quoted in Steve Schifferes, "Can banking regulation go global?, BBC News, March 18, 2009, <http://news.bbc.co.uk/2/hi/business/7950758.stm>.

⁸³ The *UK Banking Act, 2009* Notes, <http://www.legislation.gov.uk/ukpga/2009/1/notes/division/3>.

⁸⁴ *Ibid.* at 2.

⁸⁵ The FSCS operates under powers conferred by Part 15 of the *Financial Services and Markets Act 2000*. Under these provisions, the Financial Services Authority has the power to set the rules for the scheme, including rules which determine the eligibility for compensation under the scheme and the amounts of compensation payable, to reinforce and supplement existing powers.

⁸⁶ *Ibid.*, Part 3. The Treasury is to make regulations in relation to: the introduction of pre-funding; the use of the Financial Services Compensation Scheme to contribute to the costs of the use of the special resolution regime and the use of the National Loans Fund to make loans to the Financial Services Compensation Scheme.

intermediaries, where payment systems problems have the potential to spread through the financial system.⁸⁷ The *Act* gives the Treasury considerable authority to make regulations concerning the fiscal consequences of the exercise of any stabilisation power, including the ability to modify an enactment with retrospective effect for up to three months prior to the date on which the stabilisation power was exercised.⁸⁸ The Treasury also has authority to amend the law retroactively for the purpose of facilitating the *Act's* special resolution objectives, where desirable or necessary to give effect to the particular exercise of its power under the statute.⁸⁹ The Government can introduce, if needed, a new insolvency regime for investment banks, designed to secure the expeditious return of client assets following the failure of an investment banking institution.⁹⁰

2. New European Union Framework

On 22 September 2010, the European Parliament, following agreement by all member states, approved a new supervisory framework for financial regulation in Europe, effective January 2011. The European Commission (EC) has set out a framework for dealing with bank insolvency and future crises in the financial sector.⁹¹ In particular, it will provide a supervisory framework to allow banks to fail without bringing down the entire financial system, or risking that taxpayers are called on to pay the costs. It is part of the larger G20 strategy that no bank should be "too big or too interconnected to fail". Legislative proposals in 2011 encourage all member states to put in place an efficient crisis management regime, including tools to address bank crises at an early stage. The measures include:

- Preparatory and preventative measures, such as a requirement that institutions prepare bank recovery and resolution plans to ensure adequate planning for financial stress or failure, what the EC has called "living wills".
- Powers to take early action to remedy problems before they become severe, such as powers for supervisors to require the replacement of management, require institutions to adopt changes to business operations and/or corporate structure necessary to ensure that resolution is viable; requirements to limit or modify exposures; or to require an institution to implement a recovery plan or to divest itself of activities or business lines that pose an excessive risk to its financial soundness.⁹² Supervisors' powers will include powers to prohibit payment of dividends.

⁸⁷ Payment systems are networks involving sets of rules, procedures and arrangements for the electronic transfer of money or credit between participating members of the systems. In some cases, payment systems are embedded in clearing and settlement systems for transferring securities and these involve payments in relation to the securities. The Bank of England performs a non-statutory role of the oversight of inter-bank payment systems, in particular promoting the robustness and resilience of key UK payment systems. The FSA continues to have statutory responsibility for the regulation of recognized clearing houses and investment exchanges. *Ibid.*

⁸⁸ *Banking Act, 2009*, s. 74, subject to an affirmative resolution procedure.

⁸⁹ *Banking Act, 2009*, s. 75, subject to an affirmative resolution procedure or a negative resolution procedure, giving the Treasury considerably more authority.

⁹⁰ *Ibid.*, sections 232-236, any such regulations will be subject to a review within a period of two years after coming into force.

⁹¹ European Commission, http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm.

⁹² http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm ; October 20, 2010.

- Resolution tools, such as powers to effect the takeover of a failing bank or a solvent institution, or to transfer all or part of its business to a temporary bridge bank, which would enable authorities to ensure the continuity of essential services and to manage the failure in an orderly way.
- The EC has also set out its ideas for pre-funded bank resolution funds to ensure that the banking sector, and not the taxpayer, pays the costs of future bank failures.

The EC Capital Requirements Directive (CRD) currently provides early intervention powers for prudential supervisors to impose measures on banks that fail to meet requirements of the Directive; however, those powers will be enhanced.⁹³ Each member state will identify a resolution authority to exercise the resolution powers. The EC will require the annual preparation of a supervisory program for each bank on the basis of a risk assessment; greater and more systematic use of on-site supervisory examinations; more robust standards and more intrusive and forward-looking supervisory assessment.⁹⁴ The objective is to allow authorities to take action before a bank is balance sheet insolvent.

An outstanding issue is what is the threshold for intervention? Should it be a requirement that an institution be in serious distress without any realistic prospects of recovery in a specified timeframe?⁹⁵ The EC has suggested that possible threshold conditions aimed at the solvency of an institution include an assessment by supervisors that the bank has incurred or is likely to incur losses that will deplete its regulatory capital; that its assets are likely to be less than its liabilities; that it is likely to be unable to pay its obligations in the normal course of business; or it does not have adequate resources to carry on its business; or a supervisory assessment that the institution no longer meets, or is expected to fail to meet, the conditions of its licence to carry on banking.⁹⁶ There will also be a public interest test, such as “if winding up the institution under ordinary insolvency proceedings did not ensure the stability of the financial system or continuity of essential financial infrastructure services”, then the institution should be wound up once the threshold for insolvent liquidation is reached.⁹⁷

The EC has observed that it will not always be feasible to liquidate a bank under ordinary insolvency proceedings.⁹⁸ In some cases, an orderly winding down through resolution will be necessary in the public interest, for reasons of financial stability, to minimize contagion, ensure continuity of vital economic functions, maximize the value of remaining assets and facilitate their return to productive use in the private sector. It suggests that measures aimed at maintaining the entity as a going concern, such as the power to write down debt or convert it to equity, should be a last resort. Where banks are at a point of failure, the three options are: ordinary liquidation, including sale of all or part of the business; orderly wind-up

⁹³ Capital Requirements Directive Directives 2006/48/EC and 2006/49/EC, Article 136.

⁹⁴ European Commission, Brussels, 20.10.2010 COM(2010) Communication from the Commission to the European Parliament, “An EU Framework for Crisis Management in the Financial Sector”, http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf. EC, at 5.

⁹⁵ EC, *supra*, note 107 at 7.

⁹⁶ *Ibid.*

⁹⁷ *Ibid.* at 7.

⁹⁸ *Ibid.*

of a gone-concern, and restructuring as a going concern.⁹⁹ Resolution powers should include a bridge bank tool that would enable authorities to transfer some or all the business of a failing bank, including its deposits, to a temporary bridge bank;¹⁰⁰ an asset separation tool to enable authorities to transfer underperforming or 'toxic' assets to a separate vehicle ("bad bank") in order to "cleanse" the balance sheet of a troubled bank; powers to write off or cancel shares; a tool to write down or convert debt of a failing bank; and power to impose a temporary moratorium on the payment of claims.¹⁰¹ The EC's guiding principle for compensation is that affected stakeholders should suffer no greater loss than they would have if the institution had been wound up under the applicable insolvency regime.¹⁰²

The overriding objective of the EC initiative is to ensure that banks can fail without jeopardizing wider financial stability, thus minimizing the risk of contagion. It is also aimed at ensuring continuous access for depositors to their accounts, the underlying notion being that essential banking services must continue even if a bank is allowed to fail. Under the proposal, national funds should be set up on the basis of contributions paid by banks, to fund the cost of future bank resolution measures and facilitate advance planning on how the costs of resolving cross-border institution distress should be shared without imposing costs on the tax base.¹⁰³ Such funds are aimed at the moral hazards associated with government bail-outs.¹⁰⁴

The EC has also recognized the challenge of branch banks under the EU passport system by proposing that there must be arrangements to allow authorities to effectively coordinate and cooperate as fully as possible in cross-border bank insolvency proceedings.

The framework consists of a new European Systemic Risk Board (ESRB) to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole. The ESRB is to provide early warning of system-wide risks that may be building up, given cross-sectoral and interconnected banks, and, where necessary, issue recommendations for action to deal with these risks. The framework also consists of three new European Supervisory Authorities (ESA) for the financial services sector, retooled from pre-crisis authorities: a European Banking Authority (EBA) based in London, a European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt, and a European Securities and Markets Authority

⁹⁹ *Ibid.* at 9.

¹⁰⁰ *Ibid.* The purpose of a bridge bank structure is to facilitate continuous access to insured deposits or the preservation of essential banking functions for a limited period, with a view to onward sale to the private sector when market conditions stabilize.

¹⁰¹ *Ibid.* at 10.

¹⁰² The framework will also include safeguards for counterparties and market arrangements that may be affected by a transfer of property, assets or liabilities, together with provisions for judicial review where challenged; and provision for a temporary stay on rights to close out netting where authorities transfer relevant contracts as part of a resolution measure. *Ibid.*

¹⁰³ IP/10/610.

¹⁰⁴ The EC has also set out a roadmap of measures which will be considered in the longer term to create a more integrated crisis management framework, better suited to integrated European banking groups. The Commission plans to examine the need for further harmonization of bank insolvency regimes with a report by the end of 2012 and, alongside the review of the European Banking Authority in 2014, will assess how a more integrated framework for the resolution of cross-border groups might best be achieved.

(ESMA) in Paris. The new authorities will be made up of the 27 national supervisors. The new European Supervisory Authorities, and in particular, the European Banking Authority, have coordination and support roles in crisis situations.

The ESA will undertake micro-prudential supervision, working with the existing national supervisory authorities to safeguard financial soundness at the level of individual financial firms and protect consumers of financial services. It will have the power to draw up specific rules for national authorities and financial institutions; develop technical standards and guidelines; monitor how rules are being enforced by national supervisory authorities; take action in emergencies, including the banning of certain products; mediate and settle disputes between national supervisors; ensure the consistent application of EU law, and, where necessary, settle disagreements between national authorities in areas that require cooperation, coordination or joint decision-making by member state supervisory authorities.¹⁰⁵

The banking proposals are part of a broader initiative to regulate financial services in the future.¹⁰⁶ The EC has observed that in order to strengthen the reforms of the European supervisory architecture, a single European rulebook is needed to provide a common legal basis for supervisory action in the EU, in turn enhancing stability, equal treatment, lower compliance costs and a reduction in opportunities for regulatory arbitrage.¹⁰⁷ Day-to-day supervision of banks will continue at the national level. The EC is to publish a report every three years on the functioning of the new authorities and assess whether further steps are needed to ensure the prudential soundness of institutions and protection of depositors, policy-holders and investors.¹⁰⁸

The new Authorities will be able to make decisions directly applicable to financial institutions as a last resort where the Authority has asked the national supervisor to act and it has not complied; to be done only in cases where there is directly applicable EU legislation. The regulations establishing the new Authorities have a “fiscal safeguard clause”, which prohibits them from taking any decisions that impinge on the fiscal responsibilities of member states. The Authorities may temporarily prohibit or restrict certain financial activities that threaten the orderly functioning, integrity or stability of the whole or part of the financial system in Europe.¹⁰⁹ Thus the balance between member state autonomy and

¹⁰⁵ European Commission, Brussels, 20.10.2010 COM(2010) Communication from the Commission to the European Parliament, “An EU Framework for Crisis Management in the Financial Sector”, http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf. The ESA will be able to address decisions in cases where they are arbitrating between national authorities both involved in the supervision of a cross-border group and where they need to agree or coordinate their position in cases where a national authority is incorrectly applying EU Regulations; and in emergency situations declared by the Council. For example, the European Banking Authority (EBA) and the new European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) are to form a Joint Committee to oversee cooperation and coordination between national supervisors in the case of financial conglomerates, MEMO/10/376.

¹⁰⁶ EC, “Regulating financial services for growth”, http://ec.europa.eu/internal_market/finances/docs/general/com2010_en.pdf. The plan is for the reforms to be adopted by the legislature by the end of 2011, to be in force by the end of 2012.

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.*

the authority of these new entities to act in specified circumstances for the benefit of the European financial system is a fragile one.

The new Authorities will also participate actively in the development and coordination of effective and consistent recovery and resolution plans, guarantee schemes, procedures in emergency situations and preventive measures to minimize the systemic impact of any failure.¹¹⁰ Their goal is to have a specialized and ongoing capacity to respond effectively to the materialization of systemic risks.

The overriding objective of a European resolution framework is that distressed banks of any type and size should be allowed to fail without risk to financial stability, at the same time, avoiding costs to taxpayers. The EC's framework for prevention, crisis management and resolution is aimed at:

- Making prevention and preparation a priority, through comprehensive planning and preventive measures that help authorities and firms prepare for resolution.
- Early supervisory intervention, by providing tools to resolve institutions in a way that minimizes risks of contagion and ensures continuity of essential financial services.
- Enabling timely and decisive action, through well defined powers and processes addressing when and to what extent authorities can intervene.
- Reducing moral hazard by ensuring that the costs of resolution should be borne by bank shareholders and, where needed, creditors, reflecting the normal hierarchy of claims. If necessary, the banking industry as a whole should bear the costs.
- Contributing to a smooth resolution of cross-border groups to ensure minimum disruption to the internal market, including fair sharing of costs and preservation of essential banking services.
- Ensuring legal certainty, appropriate safeguards for third parties and restricting any interference with property rights to what is necessary and justified in the public interest. Creditors should receive treatment similar to what they would receive on a winding-up.
- Limiting competition distortions that could result from interventions. State aid granted under the resolution framework is to be compatible with the Treaty rules and the internal market.¹¹¹

The European Commission is considering supplementary mechanisms designed to enable large complex financial institutions (LCFI) to continue as a going concern, so that they can be reorganized or, where appropriate, have certain activities wound down in an orderly manner that minimizes contagion and protects financial stability. One option is to write down all equity and the conversion of the debt of a troubled bank into equity, to restore its capital position to allow it to continue as a going concern temporarily or permanently.¹¹²

¹¹⁰ The proposed operating cost for the Authorities in 2011 is about € 40 million, financed through: obligatory contributions from national public authorities; a subsidy from the European Union budget; and any fees paid by supervised entities to the new Authorities. The EC has proposed that the share of this cost for Member States and the EU budget should respectively be 60% and 40%, with costs for supervision of credit rating agencies to be recouped via fees paid by the supervised agencies.

¹¹¹ *Ibid.* at 4.

¹¹² European Commission, *supra*.

However, the EC has not yet resolved a number of policy questions, such as: should there be statutory power for authorities to write down or convert debt under specified conditions, or mandatory contractual terms for write down or conversion that would be required to be included in a proportion of the debt issued by financial institutions;¹¹³ the impact on the cost of financing and the need to regulate the liabilities side of the balance sheet; the complexities of applying this tool to a cross-border group, and the need to ensure recognition of any write down or conversion by foreign courts where the debt governed by the law of a non-EU jurisdiction. The Basel Committee has suggested that if home and host authorities deem that a bank's structure is too complex to be resolved in an orderly way, they should demand changes to its legal and operational structure.¹¹⁴ Such a proposal may be unlikely to be adopted, absent shared goals and a shared framework for resolution of bank insolvency.

The EC has observed that an integrated framework for resolution of cross-border entities by a single European body would deliver a rapid, decisive and equitable resolution process for European financial groups, but that it would be difficult to establish an EU integrated resolution model for cross-border banking groups in the absence of a harmonized insolvency regime and of a single European supervisory authority for those entities.

Thus, the EC has proposed a coordination framework based on a network of harmonized resolution tools and a requirement for authorities to consult and cooperate when resolving affiliated entities. There are to be "resolution colleges", where supervisors and national authorities in charge of resolution would meet for the purposes of crisis planning and the preparation of resolution plans.¹¹⁵ It suggests that group level resolution authorities should have the power to decide in cases of group failure whether a group resolution scheme is appropriate; and pending any decision, national authorities would be required to refrain from adopting national measures that could prejudice the effectiveness of the group resolution scheme.¹¹⁶ The production of a group resolution scheme in appropriate cases is aimed at facilitating coordinated resolution; but the EC observes that because resolution powers are applied to individual legal entities and the competence for resolution would remain national, the group resolution scheme would not be binding.¹¹⁷ The EC also advocates development of firm specific cooperation agreements between the national authorities responsible for managing the failure of global firms, with a view to ensuring effective planning, decision-making and coordination in respect of international groups globally.¹¹⁸

¹¹³ *Ibid.* noting that if the power is statutory, the classes of debt that should be covered; for example, difficult legal and policy questions arise in respect of derivatives, intra-group liabilities and the impact that the scope of application would have on the ranking of debt.

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*, without impinging on the fiscal responsibilities of member states.

¹¹⁶ *Ibid.*

¹¹⁷ *Ibid.* at 13, specifying that national authorities that disagreed with the scheme would not be prevented from taking independent action where they considered that necessary for reasons of national financial stability, but in doing so would be required to consider the impact of that action on financial stability in other member states, give reasons for their decision to the resolution college and, where feasible within the time constraints, discuss those reasons with the other members of the college before taking individual action.

¹¹⁸ *Ibid.* at 13.

The EC is considering measures that would specify the circumstances and conditions under which institutions may transfer assets within a group, including in situations where group entities are experiencing liquidity stress; to establish an enabling framework for intra-group liquidity management that includes safeguards to preserve financial stability in member states where transferring entities are established, and to protect the rights of creditors and shareholders.¹¹⁹

The EC has observed that its requirement to prepare a recovery plan should be applied proportionately, reflecting the size of the firm, the nature of its sources of funding and the degree to which group or other sectoral support would be credibly available.¹²⁰ Institutions would be required to submit plans to supervisors for assessment of comprehensiveness and ability to restore the viability of the institution. The requirement for up to date resolution plans at both the entity and group level would apply to all credit institutions covered by the regime, with the aim of ensuring the planning necessary to enable the bank's business to be transferred or wound down in an orderly manner in the event of its failure.¹²¹ Resolution plans would require details on group structure, intra-group guarantees and service level agreements, contracts and counterparties, debt liabilities, custody arrangements, as well as operational information about IT systems and human resources. The EC has noted that powers to change the bank's group legal structure and business arrangements are intrusive, and appropriate checks and balances will be necessary, including a right for the firm to challenge any requirement for restructuring imposed by the resolution authority.¹²² Any provision of financing in support of resolution, including capital, liquidity, guarantees or other measures, must comply with the EU Treaty and the state aid framework where it involves the use of state resources and where an advantage could distort competition and affect intra-EU trade.¹²³

These initiatives recognize the challenges of coordinating cross-border proceedings. Essentially, if banks and other financial institutions want the ability to operate in the EU, they will have to bear the costs of preventive planning and ongoing reporting of risks and recovery plans. The transparency and reporting requirements impose substantial transaction costs on financial institutions; however, arguably the costs are appropriate given both the costs of the recent bailouts and the continuing risks associated with their failure to be prudent in their banking activities. The new structures assume good faith compliance by individual financial institutions across state borders, which may not be what will occur in practice.

¹¹⁹ European Commission, Brussels, 20.10.2010 COM(2010) 579 Final Communication from the Commission to the European Parliament, "An EU Framework for Crisis Management in the Financial Sector", http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf. All credit institutions and investment firms covered by the regime would be required to prepare and keep updated recovery plans setting out measures the institution or group would take in different scenarios to address liquidity problems, raise capital or reduce risk; and the plan are not to assume access to public funds

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² *Ibid.* at 6-7.

¹²³ *Ibid.* at 14.

EU banks will be required to contribute to *ex ante* funds, backed by financing arrangements to ensure that financing is available irrespective of the size of a failed bank; and any costs exceeding the capacity of the fund will be subsequently recovered from the banking sector.¹²⁴ Each resolution fund will receive contributions from banks licensed in the same member state, and the contribution would cover their branches established in other member states. The EC would prefer full harmonization based primarily on liabilities as a proxy for the costs of resolution, however, it is also considering whether Member States should be given the flexibility to decide on a different basis for contributions, if it would not distort the EU market. The EC has recognized that there is a need to “calibrate the size of harmonized national funds in view of the burdens imposed by other financial sector reforms”, phasing in funds as the economy recovers.¹²⁵

Bank oversight must be accompanied by initiatives in related areas of financial and capital markets. The International Organization of Securities Commissions (IOSCO) has recommended strengthening its oversight to include identifying and addressing systemic risks; cooperating in development and promotion of adherence to consistent standards of regulation, oversight and enforcement in order to protect investors, encourage fair and efficient markets and reduce systemic risk.¹²⁶

In the midst of these policy reforms in the euro area, the European Central Bank, in order to meet banks’ increased demand for liquidity and to reduce uncertainty, introduced an “enhanced credit support” policy, which included the introduction of new long-term refinancing operations and extended the list of collateral eligible for monetary policy operations.¹²⁷ By allowing banks to continue rolling-over their short and medium-term financing, the liquidity provision of the ECB avoided a fire-sale of assets.¹²⁸ The ECB has observed that during the initial stages of the crisis, the policy response to the crisis involved a transfer of risk from the private sector to the government sector; however, as deficits surged and it became evident that government deficit in countries such as Greece were much larger than previously understood, the attention focused more on the state of public finance and the difficulty in pricing sovereign debt risk. It notes that after the downgrading of Greek bonds by the major rating agencies, the financial crisis that originated in the US turned into a sovereign debt crisis with a European epicentre.¹²⁹ Europe now faces pressing concerns regarding the ability of some euro area countries to honour their debt obligations, and policy measures are required to stabilize the financial sector, a discussion that space does not permit here. The ECB observes that slower than expected recovery and overstretched public finances have made investors and consumers retrench in 2011 and in order to diffuse tensions in the euro area secondary sovereign bond market, the ECB in August resumed some of its exceptional liquidity programs. It notes that “The fundamental reason for this

¹²⁴ *Ibid.* at 18.

¹²⁵ *Ibid.*

¹²⁶ IOSCO, Media Release, June 10, 2010, “Objectives and Principles of Securities Regulation International Organization of Securities Commissions”, June 2010. Principles 10, 11 and 12 specify: The Regulator should have comprehensive inspection, investigation and surveillance powers; should have comprehensive enforcement powers; and should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program, at 6.

¹²⁷ González-Páramo, ECB, *supra* note 44 at 1.

¹²⁸ *Ibid.* at 1.

¹²⁹ *Ibid.* at 3.

public role is that private agents, typically, are not large enough players to internalize the general equilibrium – or even market specific – consequences of their portfolio decisions (as in the case of fire sales). These results warrant ample liquidity injections by central banks and underpin the current wave of regulatory reforms undertaken in the European Union as well as.”

Thus notwithstanding many policy initiatives, EU banks are currently facing sharp rises in borrowing costs and considerably reduced access to financial markets. Combined with high levels of sovereign debt and a slowing global economy, there may be a new wave of bank insolvencies and contagion internationally. The EC initiatives have not yet allowed it to gain control of the euro zone financial crisis. Moreover, while the policy commitment is one of a centralized support strategy for bank and sovereign debt, there are rising tensions between countries that have surpluses, such as Germany, and countries that have huge account deficits, such as Greece and Ireland. The European Central Bank can supply considerable liquidity to European banks, but it is a short-term bridging measure that cannot remedy the continuing financial situation. There is a need to create comprehensive financial reforms; adopt significant changes to fiscal policies; implement sustainable government debt; and address problems associated with the EU’s inflexible exchange rates. Canada’s central bank has argued that what is needed now is a comprehensive capital plan for European banks, including a sizeable funding backstop for European sovereigns, suggesting that European authorities need time to recreate their monetary union based on credible fiscal arrangements and more flexible economies.¹³⁰

3. US Reforms

In the US, the *Dodd-Frank Act* has established a resolution framework for systemic institutions at a group level.¹³¹ A massive piece of legislation, it assigns oversight responsibility to numerous government agencies and requires the promulgation of several hundred additional rules. The *Act* is aimed at ending taxpayer funds to bail out financial firms by creating a mechanism to liquidate failed banks, creating capital and leverage requirements that make it undesirable to get too big. The legislation changes the Federal Reserve’s emergency lending authority to allow system-wide support, but prohibits bailing out an individual company.¹³² The Federal Deposit Insurance Corporation (FDIC) can borrow only the amount of funds to liquidate a bank that it expects to be repaid from the assets liquidated, with the government holding a priority claim for repayment.¹³³ The *Dodd-*

¹³⁰ Mark Carney, Governor of the Bank of Canada, “Recent Economic Developments”, 20 September 2011, <http://www.bankofcanada.ca/2011/09/speeches/recent-economic-developments>.

¹³¹ United States, *The Wall Street Reform and Consumer Protection Act* (Pub.L. 111-203, H.R. 4173).

¹³² The Secretary of the Treasury must approve any lending program; such programs must be broad based.

¹³³ Funds not repaid from the sale of the company’s assets will be repaid first through the claw back of any payments to creditors that exceeded liquidation value and then assessments on large financial companies, with the riskiest paying more, based on considerations included in a risk matrix. Most large financial companies that fail are expected to be resolved through the bankruptcy process. To prevent bank runs, the FDIC can guarantee debt of solvent insured banks, but only after meeting a requirement of 2/3 majority of the Federal Reserve Board and the FDIC board determining there is a threat to financial stability; the Treasury Secretary approves terms and conditions and sets a cap on overall guarantee amounts; and the President initiates an expedited process for Congressional approval, *bid*.

Frank Act strengthens oversight and empowers regulators to aggressively pursue financial fraud, conflicts of interest and manipulation of the system.

The reforms create a council to identify, provide advance warning and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the economy.¹³⁴ It also is aimed at eliminating loopholes that allow what it calls “risky and abusive practices” to go unregulated, including in the OTC and asset-backed securities markets. The Financial Stability Oversight Council will monitor systemic risk and make recommendations to the Federal Reserve for stricter rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity. The Council is mandated to create enhanced prudential standards for systemically important firms. It can require a large, complex company to divest some of its holdings if it poses a “grave threat” to the financial stability of the US, although the mechanism is considered a “last resort” type of authority.¹³⁵ Large bank holding companies that have received TARP funds will not be able to avoid Federal Reserve supervision by dropping their banks.¹³⁶ It requires regulators to implement regulations for banks, their affiliates and holding companies, to limit relationships with hedge funds and private equity funds.¹³⁷ The reforms provide a specific framework for promoting uniform risk-management standards for systemically important financial market utilities and clearing and settlement activities of financial institutions.¹³⁸

The *Dodd-Frank Act* also contains provisions on derivatives and oversight of hedge funds and credit rating agencies, and provisions regarding say on executive pay, with the plan to develop regulatory restrictions to prohibit compensation that encourage excessive risk-taking. Of note is that the statute adds credit exposure from derivative transactions to banks’ lending limits. The derivatives issues are particularly complex, and arguably, the reforms have done little to temper the speculative aspects of the market. The Bank for International Settlements reports that the market for OTC derivatives in 2010 was still thriving, with 582 trillion USD in total notional amount of outstanding derivatives.¹³⁹ Among the important issues in respect of derivatives that have not been addressed to date is the fact that derivatives are not subject to the mandatory stay under insolvency law, arguably giving such

¹³⁴ Through a new Office of Financial Research, it will collect and analyze data to identify and monitor emerging risks to the US economy and make this information public in periodic reports and testimony to Congress every year. *Ibid.*

¹³⁵ The Council will be chaired by the Treasury Secretary and include the Federal Reserve Board, SEC, CFTC, OCC, FDIC, FHFA, NCUA, the new Consumer Financial Protection Bureau, and an independent appointee with insurance expertise. It will make recommendations to the Federal Reserve for increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity, with significant requirements on companies that pose risks to the financial system. It is authorized to require, with a 2/3 vote and vote of the chair, that a nonbank financial company be regulated by the Federal Reserve if the council believe there would be negative effects on the financial system if the company failed or its activities would pose a risk to the financial stability of the US.

¹³⁶ *Ibid.*

¹³⁷ The so-named “Volcker” rule.

¹³⁸ Federal Reserve, *supra*.

¹³⁹ For a discussion of the problems associated with derivatives in the insolvency context, see Janis Sarra, *Credit Derivatives Market Design, Creating Fairness and Sustainability*, (London: Network for Sustainable Financial Markets, 2008). Bank for International Settlements, www.bis.org/statistics.

products an inappropriate preference on the insolvency of the financial institution and perhaps reducing the potential effectiveness of bank resolution schemes.¹⁴⁰

The new US legislation requires large, complex financial companies to periodically submit plans for their rapid and orderly shutdown should the company go under, on potential sanction of higher capital requirements and restrictions on growth, activity and divestment, should they fail to submit acceptable plans. It creates an orderly liquidation mechanism for FDIC to unwind failing systemically significant financial companies. Shareholders and unsecured creditors are to bear the losses instead of taxpayers; and management and culpable directors will be removed. It requires that Treasury, FDIC and the Federal Reserve all agree to put a company into the orderly liquidation process to mitigate serious adverse effects on financial stability.¹⁴¹

The effects of the more than a thousand pages of legislative reforms in the US will not be evident for some time; they require several hundred rules to be promulgated and brought into force. Overall, the bank-related reforms are aimed at increased supervisory oversight of financial institutions. They do not challenge the underlying structure of the industry or its incentive effects in any substantive manner. This fact has become evident recently as the US has embarked on its efforts to move from public support to private sector support, but arguably, the shift is not properly supported by private market capital, which is still experiencing the effects of the negative shocks from the financial crisis.¹⁴²

In terms of the new US bank resolution provisions, Stephen Lubben has observed that the insolvency liquidation provisions under *Dodd-Frank* are more akin to liquidation under Chapter 11 of the US *Bankruptcy Code* than the *Code's* Chapter 7 liquidation provisions, and in that respect, do not really put an end to “too big to fail”.¹⁴³ He suggests that regulators’ willingness to enforce the “living will” recovery plans prior to financial distress will have a large impact on whether or not the orderly liquidation procedures will be effective. He observes that orderly liquidation of a financial institution is dependent on FDIC’s ability to provide ongoing liquidity and thus amounts to a form of public bailout. However, it may be necessary, given the complexity and interdependency of financial institutions. Lubben suggests that the speed with which the process can take place and the availability of financing are two important aspects of the new regime, particularly since the private sector is unlikely in many cases to be able to provide the interim financing that a bank of any substantial size would require during the process.¹⁴⁴ FDIC financing will prevent the bank’s financial distress to spread to counter-parties. However, Lubben suggests that the lack of clarity in when the provisions can or should be accessed has created unneeded uncertainty with regard to the resolution of distressed financial institutions.¹⁴⁵

¹⁴⁰ Sarra, *ibid.*

¹⁴¹ With an up front judicial review.

¹⁴² Bank of Canada, *supra*, note 127 at 3.

¹⁴³ Testimony of Professor Stephen Lubben before U.S. House Financial Services Subcommittee on Financial Institutions regarding Orderly Liquidation Authority and Too Big to Fail, Washington, D.C., June 14, 2011 at 1.

¹⁴⁴ *Ibid.* at 3.

¹⁴⁵ *Ibid.* at 4.

4. Summary

Overall, these reforms address a number of the issues raised by the lack of appropriate bank resolution schemes. The policy discussions draw on broad notions of the public interest in viable but stable financial markets and the need to protect vulnerable participants. Safety and soundness of financial institutions is viewed as absolutely vital to financial and economic markets. Yet the reforms are limited in their scope. They fail to fully comprehend the role of derivatives in financial markets, and thus related reforms are directed towards disclosure and central clearing and settlement systems rather than addressing the profound impact such products have on insolvency resolution processes. They do not address the speculative and distributive features of such products and the interrelationship of those features with bank solvency and protection of vulnerable stakeholders. There is also, arguably, still insufficient attention being paid to the issue of who pays for the safety and soundness of the system and at what point that payment is made, in the form of capital requirements, prefunding of deposit guarantee funds and bank resolution funds, the use of various products and tools, and the incentives created for particular kinds of self-dealing or speculative conduct.

vii. Adoption of a Framework for Cross-Border Bank Corporate Groups and Financial Conglomerates

There is also a pressing need to improve cross-border resolution capacity. Global banks have substantial operations across multiple jurisdictions and thousands of legal entities. In the absence of a global resolution regime, there needs to be enhanced capacity to co-ordinate cross-border restructuring plans for international financial institutions. Such capacity needs to recognize the wide variance in both the structure of financial institutions and in the various jurisdictions' normative commitments to rehabilitation or liquidation as the preferred outcome of insolvent financial institution insolvency.

A number of financial institutions also have subsidiaries in more than one segment of the financial sector, forming part of large financial conglomerates. A financial conglomerate has been defined by the Basel Committee as a group of companies under common control, in which the exclusive or predominant activities consist of providing significant services in two or more financial sectors such as banking and insurance.¹⁴⁶ Most domestic bank and insolvency legislation fails to adequately recognize either the cross-border nature of financial institution insolvency or the structure of the industry in terms of its cross-sector holdings. Most do not offer any guidance as to how a proceeding involving such entities would address the need to deal with multiple types of stakeholders and claims, located in different jurisdictions, with differing statutory priorities given to claims, and involving multiple compensation funds.

¹⁴⁶ A parent undertaking of an entity in the financial sector, an entity that holds a participation in an entity in the financial sector, or an entity linked with an entity in the financial sector, at least one of the entities in the group is within the insurance sector and at least one is within the banking or investment services sector; Basel Committee, Report by the Tripartite Group of Bank, Securities and Insurance Regulators, *The Supervision of Financial Conglomerates*, July 1995, <http://www.bis.org/publ/bcbs20.pdf> at 13-14. The report also specifies "Such an entity is likely to combine businesses which are subject to different schemes of supervision and might also include financial activities which, in many countries, are not conducted in an entity which is subject to solo prudential supervision (e.g. leasing, consumer credit, certain financial derivatives). Where the consolidated and/or aggregated activities of the entities in the group within the insurance sector and of the entities within the banking and investment services sector are significant, *ibid.*

Bank groups and financial conglomerates often have highly interconnected debt and asset structures. Even where a domestic financial firm is not insolvent, it can be affected by the insolvency of related entities. There should be a model banking law, similar to the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency. The UNCITRAL Model Law, although not expressly prohibiting its application to financial institutions, does contain a provision that suggests that the law can exclude entities such as banks from the ambit of the provisions;¹⁴⁷ and most jurisdictions that have adopted the Model Law have done so. Any such model banking law or guidelines could adopt the express objectives of the UNCITRAL Model Law; specifically, to provide mechanisms for dealing with cross-border cooperation between courts and bank authorities; the fair and efficient administration of cross-border insolvencies that protects the interests of creditors, debtors, and other interested persons; the protection and the maximization of the value of debtors' property; and the rescue of financially troubled businesses to protect investment and preserve employment. Any principles addressing cross-border insolvency should account for the particular structure of the banking sector. The objectives should be refined to recognize depositors and compensation funds as important stakeholders.

Under the UNCITRAL Model Law, the court has broad powers to grant post-recognition relief, where satisfied that it is necessary for the protection of the debtor's property or the interests of creditors; and it has authority to impose whatever terms and conditions it deems appropriate.¹⁴⁸ There is a list of the forms of cooperation that may be provided between representatives involved in the proceedings, including the appointment of a person to act at the direction of the court; court-to-court communication; coordination of the administration and supervision of the debtor's assets and affairs; and coordination of proceedings or of concurrent proceedings.¹⁴⁹ Adoption for purposes of the financial sector should also include depositors and other stakeholders of the financial institution as part of the criteria that the court would consider. The Model Law is largely a procedural mechanism to allow cross-border cooperation, but it does have substantive protections, such as allowing the courts to decline approval of an action where it is manifestly contrary to the public policy of the jurisdiction. UNCITRAL has recently promulgated guidelines on the treatment of business enterprise groups in insolvency, which may assist in formulating similar guidance for financial conglomerates.¹⁵⁰

Financial conglomerates are exposed to risks related to controlling a group, including contagion risk. The EC is also considering reform of oversight of financial conglomerates,

¹⁴⁷ Article 1 of the Model Law specifies: Article 1 This Law does not apply to a proceeding concerning *[designate any types of entities, such as banks or insurance companies, that are subject to a special insolvency regime in this State and that this State wishes to exclude from this Law]*. UNCITRAL, Model Law, <http://www.uncitral.org/pdf/english/texts/insolven/insolvency-e.pdf>.

¹⁴⁸ The court, in recognizing a proceeding, must determine whether it is a foreign main proceeding or a foreign non-main proceeding, the difference being the scope of automatic relief available to the foreign main proceeding, such as an automatic stay of proceedings and the foreign representative's ability to apply to the court directly for relief.

¹⁴⁹ For a discussion, see Janis Sarra, "Maidum's Challenge, Legal and Governance Issues in Dealing with Cross-Border Business Enterprise Group Insolvencies", in (2008) 17 International Insolvency Review 73 at 122.

¹⁵⁰ UNCITRAL Working Group V, April 2010, <http://www.uncitral.org>.

which requires amendment to Directive 2002/87/EC ('FICOD'), which in 2003 introduced group-wide supplementary supervision.¹⁵¹ The objective of the Directive was to control potential risks arising from “double gearing”, which is the multiple use of capital across different sectors such as banking and insurance. It was to offer additional supervision where there were group risks due to risk of contagion, management complexity, concentration, and conflicts of interest that may arise when several licenses for different financial services are combined.¹⁵²

During the financial crisis, group risks materialized all across the financial sector, emphasizing the importance of supervision of inter-linkages within financial groups.¹⁵³ The EC has observed that effective supervision of conglomerates differs across sectors, increasing the need for robust supervision of financial conglomerates. Certain smaller EU financial groups with a simple structure and few licenses in both sectors may be excluded from supplementary supervision, reducing their compliance costs.¹⁵⁴ Compliance costs for bigger groups, with more than hundred licenses, active in both sectors, could increase as such groups, representing about €9 trillion assets in the financial sector, are likely to be included in the scope of the supplementary supervision.¹⁵⁵ Increased compliance costs could also be incurred by financial conglomerates. The EC states that the primary aim of this proposal is to fix gaps that have evolved in supplementary supervision due to definitions in the sectoral directives such as the CRD and the insurance directives.¹⁵⁶ In order to ensure that the necessary supervisory tools can be applied, it will introduce the term 'mixed financial holding company' into the relevant provisions on consolidated/group supervision in the sectoral directives.¹⁵⁷ To date, consistent treatment under supplementary supervision has been hampered by the lack of relevant information to properly assess group risks.¹⁵⁸

¹⁵¹ Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 ('FICOD').

¹⁵² EC, Directive of the European Parliament and of the Council amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regard the supplementary supervision of financial entities in a financial conglomerate, August 16, 2010. While the banking and insurance directives aim at calculating sufficient capital buffers for the protection of customers and policyholders, FICOD regulates the supplementary supervision of financial entities that have a mutual relationship that affects the risk profiles across sector. FICOD supplements the sectoral directives, the Banking Directive 2006/48/EC4 ('CRD') and various insurance directives.

¹⁵³ *Ibid.* The Australian Prudential Regulation Authority is considering how to supervise and control the potential contagion coming from non-regulated entities of financial groups; see http://www.apra.gov.au/media-releases/10_06.cfm.

¹⁵⁴ The EC suggests that this exclusion may be available to about ten smaller financial groups with combined assets of approximately €69 billion. Asset management companies are included in Articles 3(2) and 30(c); 'total assets under management' is introduced as an alternative indicator in Article 3(5); and a possibility to adopt guidelines on the application of Articles 3(2) and 3(5) is introduced. (ii) A waiver for smaller groups in a new Article 3(3a) is introduced, allowing for guidelines for the application of the waiver to smaller groups. (iii) Article 3(3) distinguishes the applicable conditions for groups below and above the EUR 6 billion threshold and adds requirements as to possible guidelines for the application of the waiver to larger groups and thus ensures a level playing field. *Ibid.*

¹⁵⁵ EC, Directive of the European Parliament and of the Council amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC.

¹⁵⁶ *Ibid.* at 6.

¹⁵⁷ Provisions governing the identification of financial conglomerates give rise to other issues: the directive does not require the inclusion of 'asset management companies' in the threshold tests. Second, the threshold tests can be based on different parameters with respect to assets and capital requirements. The provisions are ambiguous as regards the calculation of the tests arising from, for example, different accounting

The EC also proposes to amend its Directive on insurance and reinsurance groups to include mixed financial holding companies.¹⁵⁹ It has observed that comprehensive monitoring of group risks in large, complex, internationally operating conglomerates, is only possible when competent authorities gather supervisory information and plan supervisory measures beyond the national scope of their mandate.¹⁶⁰

One mechanism that has proven helpful in dealing with cross-border insolvencies of corporate groups in sectors outside of the financial sector are the use of protocols, which are cross-border agreements of the principal parties to the proceeding, endorsed by the courts of the jurisdictions where there are proceedings, which set out a series of procedures for notice, stakeholder participation, the relationship of insolvency professionals in different jurisdictions, and court-to-court cooperation and communication.¹⁶¹ Such protocols could be helpful for cross-border proceedings of financial conglomerates where the insolvency engages multiple insolvency statutes, given the different nature of entities within the financial conglomerate.

III. Bank Corporate Governance

The corporate governance of banks and other financial institutions differs from the governance of corporations because of prudential regulation, banks' significance to the financial system, the different nature of stakeholders with investments at risk, and the existence of deposit insurance. Bank governance also differs because banks' liquidity producing function is based on maturity mismatches, but depends on continued access to liquidity from deposits, turnover of commercial paper and interbank lending.¹⁶² Leverage in banks has different implications from that of corporations, and governance decisions must take account of these important distinctions.

When a bank is experiencing liquidity problems or financial distress, its shareholders have incentive to encourage higher risk strategies, because they enjoy any upside value generated by the strategies and do not bear the consequences of downside as their investments are already at risk or lost. Even shareholders with substantial block holding positions in banks, often in European jurisdictions, may not have the incentive to monitor managers, where their interests are already underwater. Governance structures fail to account for the residual

treatments of assets. Third, the threshold conditions, given their fixed amounts, are not risk-based, and very small groups with a few licenses in each sector are subject to supplementary supervision, while the largest most complex groups can technically be identified as not being a conglomerate. *Ibid.*

¹⁵⁸ Directive of the European Parliament and of the Council, amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regards the supplementary supervision of financial entities in a financial conglomerate, at 10. Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate provides competent authorities in the financial sector with supplementary powers and tools for the supervision of groups of many regulated entities.

¹⁵⁹ Directive 98/78/EC on supplementary supervision of insurance and reinsurance undertakings in an insurance or reinsurance group, of the European Parliament and of the Council of 27 October 1998.

¹⁶⁰ *Ibid.*

¹⁶¹ See for example, the protocol in the Nortel Networks CCAA proceeding.

¹⁶² Liquidity's function is to enable financial transactions between short and long term maturity.

interest in the financial institution at that point, which is held by depositors and creditors.

Restructuring can take many forms, some of which may address governance problems that created or contributed to the financial distress and others that may not. Workouts can involve a compromise of claims, a restructuring of debt and equity, forbearance and renegotiated terms of credit, sale of part or all of the business to new equity holders through stalking horse processes or credit bidding, and/or replacing directors and officers and implementing new governance structures. The underlying premise is that if there is a viable business plan that enhances the overall value of the bank's business and offers greater protection to economic stakeholders, then there should be a mechanism to remedy governance problems and facilitate such a plan.

In the myriad of reports generated in the first year of the financial crisis, the corporate governance of banks was not mentioned. However, in 2009, the Larosière Report concluded that banks' corporate governance was one of the most important failures underlying the crisis.¹⁶³ Boards of directors had failed to understand the nature or scale of risks and thus were ineffective in their monitoring and oversight. There was a lack of effective control mechanisms that contributed significantly to excessive risk taking; and the polycentric nature of financial regulation created a gap in oversight of bank corporate governance.¹⁶⁴

The opaque nature of many structured financial products meant that directors in their decision making regarding managerial compensation were rewarding conduct that ran counter to the bank's stability and soundness. Moreover, derivatives held by banks were very sensitive to exogenous factors that increased risks without decisions to do so by directors; hence, directors and officers were often not in control of the risk profile.¹⁶⁵ Banks are heavily dependent on the confidence of depositors and creditors in their governance, and the failure of confidence arising out of the liquidity shortages made them subject to runs on the bank.

An independent review of corporate governance in the UK banking industry by the UK government also found that there were serious deficiencies in governance and prudential oversight in the period before the crisis.¹⁶⁶ Due to the opaqueness of banks' balance sheets, incentive contracts with managers were ineffective in aligning the interests of managers and

¹⁶³ "Report of the High-Level Group on Financial Supervision in the EU, February 2009," no. 110, http://ec.europa.eu/internal_market/finances/committees/index_en.htm#delarosierereport.

¹⁶⁴ *Ibid.*

¹⁶⁵ Mülbart, *supra*, note 20 at 12, who observes that a bank holding a substantial portfolio of derivatives and securities with embedded options is subject to sharp changes in its risk-profile even if the bank does not take new positions; because complex derivatives often have exposure to risk factors that are sensitive to market conditions; thus, even incremental market changes may affect the value of the derivative, *ibid.*

¹⁶⁶ Sir David Walker, Chair, "A review of corporate governance in UK banks and other financial industry entities, Final recommendations," November 2009, http://www.hm-treasury.gov.uk/walker_review_information.htm; Nestor Advisors, *Banks Boards and the Financial Crisis* (London: Nestor Advisors, 2009); Renee Adams, "Governance and the Financial Crisis," (ECGI Finance Working Paper No. 248/2009, April 2009), <http://ssrn.com/abstract=1398583>; Financial Services Authority, "Effective corporate governance," (Consultation Paper 10/3, January 2010), <http://www.fsa.gov.uk/pubs/cp/cp103.pdf>.

shareholders.¹⁶⁷ The study reported that boards of directors found it difficult to assess whether management actually met their performance targets, concluding that where a significant amount of management's total remuneration is equity based, managers will focus on short-term results and have an incentive to increase the bank's leverage.¹⁶⁸

Some of the largest bank failures indicate governance concerns. At Northern Rock, directors either acquiesced or were culpable in their failure of oversight. The UK Financial Services Authority fined David Jones, former finance director of Northern Rock PLC £320,000 and imposed a ban for continued misreporting on a monthly basis to the bank's assets and liabilities committee and, on a quarterly basis, to the Council of Mortgage Lenders.¹⁶⁹ There were also warning signals regarding Lehman's governance prior to its collapse; and subsequent to its failure, the court-appointed examiner found financial reporting manipulation.¹⁷⁰

i. Bank Governance Reform

Whatever one's normative perspective on the degree of regulatory intervention required, the events of the past two years indicate that some further development in respect of bank governance is required, which likely should involve both enhanced supervisory oversight and a more nuanced model of bank self governance. The degree to which the private financial services sector should remedy the identified governance problems continues to be hotly contested.

After the 1997 Asian financial crisis, the Basel Committee on Banking Supervision, World Bank and other transnational organizations developed principles and standards of effective governance.¹⁷¹ The Basel Committee on Banking Supervision observes that from "a banking

¹⁶⁷ Ross Levine, "Bank Governance, Regulation, and Risk Taking" (SSRN Working Paper, 2008), <http://ssrn.com/abstract=1142967>.

¹⁶⁸ Mühlbert, *supra*, note 20 at 17, 19, suggesting that managers be required to hold firm-specific stock on a long-term basis.

¹⁶⁹ Financial Services Authority, "FSA bans and fines former Northern Rock finance director £320,000 for misreporting mortgage arrears figures" <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/126.shtml>; FSA Press Release, 27 July 2010, reporting that Jones's misconduct started in mid January 2007 when he agreed, along with the former deputy CEO, to allow false mortgage arrears figures to appear in explanatory text published with the 2006 annual accounts.

¹⁷⁰ In 2003, the US Securities and Exchange Commission (SEC) fined it \$80 million for improper analyst compensation based on investment banking revenue; and for giving favourable market-moving research in exchange for underwriting. *Ibid*.

¹⁷¹ Basel Committee on Banking Supervision, "Enhancing corporate governance for banking organisations," (Basel: BIS, 2006), 4 n. 10, <http://www.bis.org/publ/bcbs122.htm>; Banca d'Italia, "Supervisory Provisions concerning banks' organization and corporate governance," (Decree of March 4, 2008), <http://www.bancaditalia.it/vigilanza/banche/normativa/disposizioni/provv>; International Finance Corporation World Bank, "Corporate Governance Financial Institution," http://www.ifc.org/ifcext/corporategovernance.nsf/Content/CGTools_FinancialInstitutions; OECD, *Principles of Corporate Governance* (2004), www.oecd.org/daf/corporateaffairs/principles/text; Eduardus Tandililin *et al*, "Corporate Governance, Risk Management, and Bank Performance: Does Type of Ownership Matter?" (EADN working paper no. 34, 2007), <http://www.eadn.org/eduardus.pdf>; Luc Laeven and Ross Levine, "Bank Governance, Regulation, and Risk Taking" (SSRN Working Paper, 2008), <http://ssrn.com/abstract=1142967>.

industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by the board of directors and senior management that affects how they set corporate objectives; operate the bank's business on a day-to-day basis; meet the obligation of accountability to their shareholders and take into account the interests of other recognized stakeholders; align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors.¹⁷²

Good governance is linked with effective oversight of a bank's business activities; the Basel Committee encourages banks to comply with eight high-level principles, offering detailed standards in its guidelines. The principles are aimed at all types of bank capital and governance structures, including publicly traded or privately held, but recognize a proportional aspect to banks' ability to comply. Directors should be qualified for their positions, and be able to exercise sound judgment about the affairs of the bank, including appropriate responsibility for the operations and financial soundness of the bank. These qualifications include the skills to understand the bank's risk profile, approve its overall business strategy, risk policy and risk management procedures; select, monitor and, where necessary, replace key executives; provide oversight of the senior management; have oversight of strategic objectives and values; set and enforce clear lines of responsibility throughout organization; ensure sound internal audit controls; understand the bank's operational structure and complexity of structured products; and meet regularly with senior management and internal auditors. The guidelines call for an appropriate number of independent non-executive qualified directors that have "an adequate collective knowledge of each of the types of material activities of the bank".¹⁷³ The guidelines recommend that large banks have an audit committee, with a majority comprised of independent directors that have a clear understanding of their governance duties regarding risk management.

These governance guidelines were published in 2006. Many are responsive to agency issues raised by bank governance structures. Unfortunately, principles do not equal change. The principles aimed at effective bank governance existed before the crisis, but they were not effectively adopted such that they may have prevented some bank failures.¹⁷⁴ One question is whether there now exist the appropriate incentives to bring such governance standards into practice, or whether there continues to be a problem with encouraging compliance with these non-binding international norms.

ii. Accountability to Stakeholders

There needs to be a deeper understanding of prudential oversight and the obligation of directors to ensure the safety and soundness of the bank or other financial institution. One approach is to substitute shareholder supremacy with stakeholder supremacy either by substituting the shareholder-only-oriented goal of value maximization with that of depositor-

¹⁷² Basel Committee on Banking Supervision, *Enhancing corporate governance for banking organisations*, (Basel: BIS, 2006), <http://www.bis.org/publ/bcbs122.htm> at 4. OECD, *Principles of Corporate Governance* (2004), www.oecd.org/daf/corporateaffairs/principles/text at 11.

¹⁷³ *Ibid.*

¹⁷⁴ Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis," *Financial Market Trends* (2009), http://www.oecd.org/document/48/0,3343,en_2649_34813_42192368_1_1_1_1,00.html.

restrained value maximization, or, slightly less far-reaching, by requiring directors and officers to take the interests of depositors into account.¹⁷⁵ Directors should act in best interests of the financial institution as a whole and its beneficiaries, including depositors, creditors and investors. Such interests include ensuring appropriate limits on leverage; reasonable liquidity; protection of depositors; and addressing the agency issues. Bank corporate governance should take account of both types of stakeholders and the stability of the financial system, due to the systemic nature of bank activities.

Another public policy question issue in need of serious consideration is the social utility of derivatives versus the harms; and the extent of a bank's accountability to stakeholders where activities are highly speculative. Arguably, there should be a partial restriction of their use by financial institutions that have prudential obligations. The scope of any such limits is in urgent need of a public policy discussion.

Governance responses should recognize differing interests in the financial system. Interests that are affected are beyond private financial markets participants; they include employees, creditors, equity holders, depositors, and the broader public interest. Moreover, where the government has become a shareholder as a result of using public funds for a bail out, there may be a need to design principles of accountability for governments acting simultaneously as regulator, shareholder and creditor.

iii. Director Obligations and Incentives

The regulatory overlay of monitoring needs to be complemented by effective oversight within the banks' corporate governance structure. There need to be appropriate incentives for directors to pursue the bank's best interests. Boards must devote more time to governance and oversight. Directors must be willing and able to ensure that the risk management framework and risk appetite of the financial institution are appropriate. A number of policy questions should be explored. Should there be minimum length of board meetings, or limits on number of directorships held? Should regulators condition the availability of a due diligence defence on time spent on director duties? Should there be financial literacy qualifications? Arguably, board and director performance appraisal should be linked to risk management and assessment as well as profitability. There should be mechanisms to increase the relationship of decision makers with stakeholders, which could include election, review, and tying promotion to stakeholder support of overall governance.

The classic view of director and officer performance-based compensation is that it aligns the interests of officers and shareholders, particularly where compensation is comprised of a substantial component of equity-based compensation, such as options and allocation of shares. However, compensation practices that allowed officers to cash in equity based compensation on an ongoing or short-term basis created the opposite incentives. Performance targets that are linked to short-term realization create incentives for banks to move from longer term lower risk assets, such as mortgages, to higher risk structured financial products. As noted above, the Basel guidelines, which were not effectively adopted, called for boards to ensure that compensation policies and practices are consistent with the

¹⁷⁵ Macey and O'Hara, "The Corporate Governance of Banks" at 102-103; Mülbart, *supra*, note 20 at 20.

bank's long-term objectives and strategy; and that remuneration of non-executive directors and executive directors and senior managers should be set in such a way that incentives do not overly depend on short-term performance and trading gains.

Director and officer remuneration should be linked with long term health of bank. Compensation should be structured to reduce incentives to take excessive risk. It should reward effective oversight of regulatory compliance, independent monitoring of audit and operational functions, and responses to market changes.¹⁷⁶ Officers should be incentivized to better understand risk in particular circumstances; identify risks of structured financial products; understand inappropriate risk concentration; shift risk stress tests from focus on past events to identifying new risks and potential outcomes and adjustments; and ensure a continuous understanding firm's risk position compared with risk appetite.

Remuneration systems should also focus on staff whose activities can have a material impact on the risk exposure of the financial institution. For employees with responsibility for risk and compliance functions, remuneration should be linked to achieving safety and soundness. Regulators could create guidance or standards that specify criteria for the link. Another governance strategy is to accord more authority to the risk management function within financial institutions to counterbalance risk-takers, including direct access to the board of directors, to allow timely review, evaluation and action to refine strategies and a predictive mechanism for discerning and addressing evolving risks.

Globally, the majority of bank boards are comprised of inside directors or cross-sector appointment of directors that are not independent.¹⁷⁷ Yet, prescience requires financial skills, and a capacity for independent second look at decisions. Does a director's willingness to test or challenge strategies need independence from the banking sector or is there another approach that will ensure challenges occur? Any governance improvement must ensure the appropriate balance of diversity, independence and skills of directors. Regulators face time lags and information asymmetries, and thus governance norms should complement and enhance legal standards.

In summary, the issue of director obligations requires considerably more scrutiny and public policy debate. Arguably, there should be a requirement for directors to take account of the sustainability of the bank, adopting less risky strategies and increasing the quality of bank long-term risk management strategy. Any corporate governance reform must not lose sight of the prudential nature of banks and thus of director obligations. There is a need to change incentives to ensure management and directors are more prudent.

iv. Early Intervention in Governance Where There are Solvency Concerns

Another option is to have a system of early intervention where governance issues are identified, including the authority to remove the directors and senior management of a failing financial institution and hold them to account. The EU proposals discussed above have the potential to effect this governance shift. A working example of an effective system

¹⁷⁶ Arguably, gatekeepers also made responsible for their part of regulatory compliance, although that discussion is beyond the scope of this paper.

¹⁷⁷ Basel Committee, *supra*, note 7.

is the Canadian system of early intervention, described in some detail here. It works with the directors and officers of banks at early stages of problems, affording them considerable opportunity to remedy problems before the government intervenes to remedy the financial instability.

In Canada, the Office of the Supervisor of Financial Institutions (OSFI)¹⁷⁸ has an intervention process that enables it and the Canadian Deposit Insurance Corporation (CDIC), Canada's national deposit insurance fund, to identify areas of liquidity and solvency concern at an early stage and intervene effectively so as to minimize losses to depositors.¹⁷⁹ OSFI supervises and regulates all banks in Canada and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and private pension plans, a total of 1,836 firms.¹⁸⁰

Canada's statutes governing banks and other financial institutions provide a wide range of discretionary intervention powers that allow the supervisor to intervene to address governance concerns that may arise with federally-regulated deposit-taking institutions (banks).¹⁸¹ OSFI conducts risk-based assessments of the safety and soundness of banks and other financial institutions.¹⁸² All assessments made throughout the intervention process consider the unique circumstances of the financial institution, including the nature, scope, complexity and risk profile. There are 5 levels of assessment.

The first level is *No significant problems/Normal activities*, whereby OSFI determines that the institution's financial conditions are sufficient and that circumstances do not indicate significant problems or control deficiencies. The bank's performance has been satisfactory to good, with most key indicators comparable or in excess of industry norms.¹⁸³ OSFI assesses the financial condition and operating performance, reviewing information obtained from financial reporting requirements and management reporting to the board; and offers a composite risk rating.¹⁸⁴

¹⁷⁸ OSFI has primary responsibility for regulating and supervising federally regulated deposit-taking institutions.

¹⁷⁹ OFSI, "Guide to Intervention for Federally Regulated Deposit-Taking Institutions", http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/practices/supervisory/Guide_Int_e.pdf.

¹⁸⁰ OSFI Annual Report, 2009-2010, http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/osfi/ar0910_e.pdf at 11. OSFI was established in 1987 by Parliament under the *Office of the Superintendent of Financial Institutions Act*.

¹⁸¹ *Bank Act, Canada Deposit Insurance Corporation Act (CDICA), Office of the Superintendent of Financial Institutions Act, Trust and Loan Companies Act and Cooperative Credit Associations Act*

¹⁸² OFSI, *supra*, note 171. CDIC administers its Act and by-laws as required under its legislated mandate and monitors member institutions and takes necessary action depending on the condition of the member institutions as assessed in accordance with CDIC's powers and objects.

¹⁸³ *Ibid.* The institution may have access to additional capital and is able to address supervisory concerns that might arise.

¹⁸⁴ *Ibid.*, at 13, requesting that the institution's management provide a copy of the supervisory letter to external auditors. A Supervisory Letter is issued by OSFI to an institution to report the findings and recommendations resulting from OSFI's supervisory work and to communicate its Composite Risk Rating (CRR) and intervention stage rating (if the institution is staged). An institution is issued a supervisory letter at least once a year, and more often if there are changes in the institution's CRR or intervention stage rating, at 13. Advising the institution of any corrective measures that the institution will be requested to undertake.

Then Stage 1 is an *Early Warning Stage*, where OSFI has identified deficiencies in the institution's financial condition, policies or procedures that could lead to problems if they are not promptly addressed. Example conditions include the combination of the institution's overall net risk and its capital and earnings compromises the institution's resilience; or the institution has issues in its risk management that, although not serious enough to present a threat to solvency, could deteriorate into more serious problems if not addressed.¹⁸⁵ OSFI notifies management, the board and the external auditor by way of a supervisory letter, requiring bank officers to take measures to mitigate or rectify the identified deficiencies. OSFI may meet with management, the board of directors and/or the external auditor to outline concerns and discuss remedial actions; may send a notice of assessment surcharge to the institution; monitor the institution on an escalating basis by increasing the frequency of reporting requirements and/or expanding the level of detail of information that the bank is required to submit; conduct enhanced or more frequent supervisory reviews, or direct the institution's internal specialists to conduct reviews that focus on particular areas of concern such as asset or loan security valuations. OSFI may also determine the need for a prudential agreement with the institution for the purpose of implementing measures designed to maintain or improve the safety and soundness of the institution.¹⁸⁶ At this stage, OSFI also has authority to require the financial institution to increase its capital or impose business restrictions or compliance directions on the bank in appropriate circumstances.

The CDIC would not normally intervene at Stage 1, but it might place the bank on its "watchlist"; or levy a premium surcharge if it fails to comply with the policy of deposit insurance that requires the bank to have in place appropriate, effective and prudent practices with respect to corporate governance, risk management, liquidity and capital management, and controls.¹⁸⁷ CDIC can also request that the bank or entity that controls it provide an undertaking to rectify areas of concern.

At Stage 2, called *Risk to Financial Viability or Solvency*, the bank poses material safety and soundness concerns. At this stage, OSFI has identified problems that could deteriorate into a serious situation if not addressed promptly, although there is not an immediate threat to solvency. Examples here include: the combination of the institution's overall net risk, capital and earnings makes it vulnerable to adverse business and economic conditions that may pose a serious threat to its financial viability unless effective corrective action is implemented; and the bank has risk management issues that could deteriorate into more serious problems if not addressed promptly. OSFI measures at this stage include requiring the institution to

Monitoring any corrective measures may include requesting additional information and/or conducting follow-up supervisory reviews.

¹⁸⁵ *Ibid.* at 5.

¹⁸⁶ A prudential agreement is an agreement between the institution and OSFI for the purpose of implementing any measure designed to maintain or improve the safety and soundness of the institution. *Ibid.* at 12

¹⁸⁷ Or it fails to maintain and provide CDIC with records and information; the member institution's governing statute; or, the terms of an undertaking that the bank provided to CDIC. After consulting with OSFI and after giving the bank an opportunity to make written representations; it can levy a premium surcharge where the bank is engaging in a practice that is prescribed in the CDIC by-laws as warranting such an additional premium. The amount of the premium surcharge must be fair in the circumstances and cannot exceed an amount equal to one sixth of one per cent of the member's insured deposits for the year.

incorporate in the business plan appropriate remedial measures aimed at rectifying problems within a specified time frame; imposing more frequent reporting requirements; conducting follow-up supervisory reviews more frequently and/or enlarging their scope; requiring the external auditor to enlarge the scope of the review of the financial statements; requiring the institution to conduct a special audit to be performed by an outside auditor; and/or developing a contingency plan to enable OSFI to be ready to take rapid control of the institution or its assets in case of further deterioration.¹⁸⁸

The CDIC at Stage 2 may send the chief executive officer or board chairperson a formal report if the bank is not in compliance with a CDIC by-law or is in breach of its policy of deposit insurance, including the condition requiring that member institutions have appropriate, effective and prudent practices with respect to corporate governance, risk management, liquidity, capital management and controls.¹⁸⁹ If CDIC is not satisfied with progress made in rectifying the situation, CDIC must inform the bank and the Minister of Finance. CDIC may, subject to the Minister's advice that it is not in the public interest to do so, terminate the member institution's policy of deposit insurance, on notice;¹⁹⁰ conduct a preparatory examination if CDIC believes that the making of a payment in respect of deposits held by the bank is imminent and that it would be in the best interest of depositors and CDIC that preparations be made to make that payment as soon as possible;¹⁹¹ or apply to court for an order directing the bank to comply with the *CDICA*.¹⁹²

Stage 3 is where OSFI determines that the future financial viability of the bank is in serious doubt because the bank has failed to remedy the problems that were identified at Stage 2 and the situation is worsening. The financial institution has severe safety and soundness concerns and is experiencing problems that pose a material threat to its solvency. The combination of the institution's overall net risk, capital and earnings makes it vulnerable to adverse business and economic conditions or there are control deficiencies that pose a serious threat to its solvency unless effective corrective action is promptly implemented. OSFI may direct external specialists or professionals to assess certain areas such as quality of loan security, asset values, sufficiency of reserves, etc.; enhance the scope of business restrictions that have already been imposed on the bank and/or expand the level of detail of information that the bank is required to submit to OSFI; place OSFI staff at the institution to monitor the situation on an ongoing basis; expand contingency planning; and communicate to management and the board of directors the importance of considering resolution options such as restructuring the institution or seeking a prospective purchaser.

The CDIC at this Stage can minimize its exposure by providing support for a restructuring transaction by taking such measures as acquiring assets from the bank; making or guaranteeing loans or advances, with or without security, to the bank; and making or

¹⁸⁸ OSFI may assign the cost of the auditor's work to the financial institution, *ibid.* at 6.

¹⁸⁹ *Ibid.*, pursuant to section 30 of the *CDICA*.

¹⁹⁰ *Ibid.* at 7, with at least 30 days notice.

¹⁹¹ *Ibid.*, with the approval of OSFI.

¹⁹² *Canada Deposit Insurance Corporation Act*. CDIC's by-laws or the policy of deposit insurance or restraining the member from breaching the *CDICA*, CDIC's by-laws and/or the policy of deposit insurance, OSFI, *ibid.*

guaranteeing a deposit with the bank.¹⁹³

Finally, at Stage 4, the OSFI has determined that non-viability or insolvency is imminent and the bank is experiencing severe financial difficulties and has deteriorated to such an extent that the institution has failed to meet regulatory capital requirements in conjunction with an inability to rectify the situation on an immediate basis. The statutory conditions for taking control have been met; and/or the institution has failed to develop and implement an acceptable business plan such that insolvency is inevitable within a short period of time. OSFI can assume temporary control of the institution or its assets, unless the Minister advises OSFI that it is not in the public interest to do so. OSFI can request that the Attorney General of Canada apply for a winding-up order in respect of the institution where its assets or the institution is under the control of the Superintendent.

CDIC's activities at this stage may involve cancelling the policy of deposit insurance of the bank if CDIC is of the opinion that the bank is or is about to become insolvent;¹⁹⁴ initiating the financial institution restructuring provisions (FIRP), following receipt of the formal OSFI report that the bank has ceased, or is about to cease, to be viable or circumstances exist that would allow the Superintendent to take control and grounds would exist to make a winding-up order.¹⁹⁵ The CDIC asks the Minister of Finance to recommend that the Governor in Council issue a FIRP order if a restructuring transaction is likely to be expeditiously entered into and is consistent with CDIC's objects. It may also apply for a winding-up order under the *Winding-up and Restructuring Act* where CDIC concludes the bank is or is about to become insolvent, unless the Minister advises that it would not be in the public interest to do so. The CDIC may act as a liquidator or receiver if appointed as such. CDIC gives public notice of the termination or cancellation of the member institution's policy of deposit insurance if the public interest requires that such notice be given.¹⁹⁶

As at March 31, 2010, there had been 50 staged institutions, the majority of the staged institutions were in the Stage 1 Early Warning stage.¹⁹⁷ The year prior there were 56 interventions. For the year ending March 31, 2008, there were 25 staged institutions, of which 22 were at stage 1 and three were at stage 2.¹⁹⁸ OSFI's early intervention allows governance issues to be addressed long before insolvency, resulting in almost no bank failures in Canada. While there are arguably other reasons for the soundness of the Canadian system, such as the structure of the sector, it is likely that the early intervention has been helpful in remedying governance issues on a timely basis. OSFI issues a Composite Risk Rating (CRR) that represents its overall assessment of an institution's safety and soundness, with four ratings of low, moderate, above average and high risk. As at the end of March

¹⁹³ *Ibid.* at 9.

¹⁹⁴ *Ibid.*, subject to the Minister's advice that it is not in the public interest to do so, and after notifying the Superintendent.

¹⁹⁵ Under a FIRP, an order may be made by the Governor in Council, on the recommendation of the Minister, to vest the shares and subordinated debt of a federal member institution in CDIC and/or appoint CDIC as receiver of the member for purposes of carrying out a transaction or a series of transactions to restructure a substantial part of the bank's business.

¹⁹⁶ *Ibid.* at 10.

¹⁹⁷ OSFI Annual Report 2009-2010, *supra*, note 180.

¹⁹⁸ OSFI Annual Report 2007-2008, http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/osfi/ar0708_e.pdf.

2010, OSFI assigned a low or moderate CRR to 88% of all rated institutions and rated 12%, 48 financial institutions, as either above average or high risk. Those numbers were 89% and 11% respectively as at March 31, 2009.¹⁹⁹

The five stages under Canadian banking law ensure that governance is corrected, business plans adjusted and liquidity risks are addressed long before insolvency. Given the importance of banks to the financial system, this prudential approach makes sense. Where the financial supervisor has had several levels of intervention prior to a financial institution filing under insolvency legislation, arguably, at the point of an insolvency filing, the directors and officers have had a full opportunity to remedy the governance problems of the firm. Hence, it does not make sense to afford them yet another opportunity to remain in control. This situation is in contrast to normal corporate insolvency proceedings in many countries, whereby commencement of insolvency proceedings often represents the first stage of remedying the governance, financial and operational problems of the insolvent company.²⁰⁰

The EU bank resolution framework, discussed above, includes a number of governance initiatives, including a requirement to prepare resolution plans to ensure adequate planning for financial stress or failure. Supervisors may also be given the authority to appoint a special manager for a limited period of up to one year to take over the management, or assist the existing management, of a bank that is failing to meet the requirements of the CRD and has not developed or implemented a credible recovery plan. The special manager would exercise all the powers of the management, but its primary duty would be to restore the soundness of the institution.²⁰¹

vi. Deposit Insurance or Guarantee Schemes

Another issue that relates to governance are deposit insurance funds. Deposit insurance guarantee funds have been aimed at protecting small investors, providing a guarantee, to a capped amount, on bank savings or the value of insurance policies. They also serve as a confidence enhancing aspect of financial services, reducing the risk of runs on a bank. The amount of coverage under such funds has traditionally been limited, in order that banks not have an incentive to shirk their prudential obligations.

One problem during the crisis was that deposit guarantee funds in many jurisdictions were not prefunded. The assumption was that if a bank failed, other banks in the jurisdiction would be available to meet the deposit guarantee promise. The structure did not account for multiple bank failures in the same jurisdiction. The lacking of funding then meant that governments had little choice but to offer bailout funding, as depositors' savings would be lost otherwise. However, such a strategy carried with it moral hazard; banks understood that

¹⁹⁹ OSFI Annual Report 2009-2010, *supra*, note 180.

²⁰⁰ Janis Sarra and Gordon Dunning "Assuring the Future: Reform of the Insolvency Framework for Insurance Companies and other Financial Institutions under the Canadian *Winding-up and Restructuring Act*", *Annual Review of Insolvency Law, 2010* (Toronto, Carswell, 2011) at 40.

²⁰¹ The EC has observed that shareholders' rights would not be otherwise affected, and shareholder approval would be required for any action by the special manager that would require consent if taken by the directors. The decision to appoint a special manager should not imply a state guarantee or expose supervisors to liability for the actions of the special manager. The extent of liability of the special manager merits further analysis. *Ibid.*

they were not required to prefund, and the lack of protection for such depositors meant that the banks could count on the risk of depositor losses to leverage government bailouts at a time of financial distress.

A number of jurisdictions have now moved to increase the amount of coverage for deposit insurance or guarantee schemes. For example, the EU amended its Directive deposit-guarantee schemes to require member states to raise the existing minimum coverage level of 20,000 € to 100,000 € by 31 December 2010.²⁰² The US Federal Deposit Insurance Corporation raised the minimum coverage level of 100,000 USD until December 2013 to 250,000 USD; and it set up a temporary liquidity program, allowing US banks to issue certain senior unsecured debt guaranteed by the FDIC.²⁰³

Deposit guarantee schemes do not have the same purpose as bank resolution guarantee funds; however, some countries use their schemes to provide certain forms of resolution financing, including some EU member states. In Canada, the CDIC can control its exposure by providing support for a restructuring transaction; making or guaranteeing loans or advances, with or without security, to the bank; and making or guaranteeing a deposit with the bank.²⁰⁴ The EC has proposed that deposit guarantee schemes could be used for bank resolution measures involving the transfer of deposits to another entity, provided that the amount of funds used does not exceed the amount that would have been necessary to repay depositors; any additional costs should fall to the resolution funds.²⁰⁵

Deposit guarantee funds can weaken the incentives for stakeholders to monitor governance and temper higher risk business practices because the insurance offers baseline protection for depositors.²⁰⁶ However, the amounts protected by deposit insurance schemes are relatively modest, targeted at the most vulnerable small depositors. Even with the recent increases in the amount of deposit insurance required, significant market players or small to medium businesses are not protected for most of their investments; hence they may not have an incentive to shirk monitoring through deposit insurance, and may hold officers more accountable. Given that deposit insurance guarantee funds do not protect banks' deposits in other banks, arguably, interbank incentives to monitor are not reduced by the existence of deposit insurance.

vii. Appropriate Oversight of Securitization

Banks should retain a sufficiently strong economic interest in the securitized assets they sell. In general, this requirement would mean retaining some exposure to securitization cash flows where payoffs are especially sensitive to how well the bank performs its origination,

²⁰² Directive 2009/13/EC amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, *Official Journal* 2009 L 68/3.

²⁰³ Federal Deposit Insurance Corporation, "Temporary Liquidity Guarantee Program," <http://www.fdic.gov/regulations/resources/TLGP/index.html>.

²⁰⁴ OSFI, *supra*, note 180 at 9.

²⁰⁵ European Commission, Brussels, 20.10.2010 COM(2010) Communication from the Commission to the European parliament, "An EU Framework for Crisis Management in the Financial Sector", http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf at 17.

²⁰⁶ Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence," (World Bank Policy Research Working Paper no. 3404, 2004), <http://www.wds.worldbank.org>.

monitoring and servicing activities.²⁰⁷ Such requirements could address some of the immediate agency issues associated with the speculative market.²⁰⁸ The US *Dodd-Frank Act* requires that companies that sell products like mortgage-backed securities retain at least 5% of the credit risk, unless the underlying loans meet standards that reduce riskiness. It requires issuers to disclose more information about the underlying assets and to analyze the quality of the underlying assets. This minimal requirement should be applied to all securitization.

Arguably, requiring 5% “skin in the game” may be limited in its effectiveness in creating appropriate incentives to monitor the products, as the threshold of retaining economic interest is so low, it may simply be viewed as the price of participating in the market, and not create the hoped for incentives to monitor the quality of credit decisions. There needs to be a public policy discussion as to whether this amount is large enough to change conduct or prevent harms.

A further requirement for well functioning financial markets is that investors in securitization instruments should have a good understanding of the associated risks, and thus the opaque nature of financial products needs to be made considerably more transparent.

IV. Concluding Thoughts

The global discussion on preventive measures in respect of financial institutions continues. One approach to discerning policy options is to consider what is prudential, prescient and pragmatic for financial institutions going forward.

i. Prudential

In terms of prudential obligations, directors and officers of financial institutions should act in the best interests of the organization in the long term, taking account of the interests of beneficiaries: depositors, life insurance policyholders, deposit insurance funds, creditors and investors. Taking account of diverse interests may serve as a mechanism to adopt less risky strategies and increase the quality of bank long-term risk management strategies. Prudential conduct may mean limits on leveraging and reasonable liquidity; and addressing agency problems in order to maintain confidence in financial system. Prudential obligations should include protection of depositors and insurance policyholders. One policy question is should directors and officers have a direct fiduciary obligation or duty of care to deposit holders? Bank corporate governance should take account of both stakeholders and the stability of the financial system, due to the systemic nature of bank activities. Governance could be more responsive to the conflicting interests of managers either by direct representation of broad interests on the board of directors or by regulator imperative. One question for public policy discussion, given the prudential nature of banks, is whether there should be at least some director elections by non-shareholding stakeholders?

²⁰⁷ Basel Committee on Banking Supervision, Working Paper 16, Findings on the interaction of market and credit risk, May 2009 at 42.

²⁰⁸ There needs to be a more systemic analysis and public policy debate in respect of credit derivatives and the shift in risk to end purchasers that are frequency less sophisticated parties, a discussion beyond the scope of this paper.

It makes sense to implement remuneration schemes that counteract incentives at all levels for short-term returns to potential detriment of sustainability. Financial reward should be separated from excessive risk taking. Directors and officers should be able to demonstrate to the regulator that they have sufficient knowledge and control over the bank's risk profile. There should also be authority to remove the directors and senior management of a failing financial institution and hold them to account for failure to meet their prudential obligations. A financially distressed financial institution should ensure that there is sufficient expertise and resources to govern resolution of the distress.

The debate about effective bank corporate governance raises the question of why corporate law should intervene over and above standards for acceptable level of risk taking established by prudential regulation. Arguably, there is need to change incentives for management and directors to be more prudent, which in turn might overcome shortcomings in regulatory resources and ability. At the same time, it is important that new regulatory measures do not seriously impair financial activity necessary for liquidity function, creating a further credit crisis.

ii. Priscient

There should be mechanisms to increase the relationship of decision makers with stakeholders, such as election, review of activities or tying promotion to stakeholder satisfaction. Public disclosures under financial services law could enhance the quality and accessibility of disclosure to stakeholders and regulators. Strategic planning should link risk management to achievement the financial institution's overall objectives. Regulators could create guidance or standards that specify criteria for that link. There should be enhanced oversight of regulatory compliance, and independent monitoring of audit and operational functions and corporate responses to market changes. There should be public policy discussion of the extent to which gatekeepers should also be made responsible for their part of regulatory compliance.

Financial institutions and regulators need to develop a better understanding of risk in particular circumstances; including identifying the downside risks of new structured financial products as they come on the market; and understanding inappropriate risk concentration. Risk stress tests should shift from their focus on past events to identifying new risks and potential outcomes and adjustments. Directors and officers should have continuous understanding the firm's risk position compared with its risk appetite. Employees responsible for risk monitoring and assessment should have more authority to counterbalance risk-takers, including direct access to the board where there are concerns about the level of risk. Risk management employees should be considered senior management, meeting regularly with the board to allow timely review, evaluation and action to refine strategies. Financial institutions should develop predictive mechanisms for discerning and address evolving risks and real time communication to board; rather than take false comfort in regulatory capital ratios. Priscience requires financial skills, but also a capacity for an independent second look at decisions.

There is also a need to link financial sustainability with other aspects of social, environmental sustainability measures, including requiring reporting and use of widely accepted standards.

It is important to reduce conflicts of interest within the complex structure of global financial institutions and their interactions; such as professionals advising on investments while managing investment funds. Remuneration should be more directly linked with the long term health of the bank, reducing incentives to take excessive risk. Remuneration systems should arguably also focus on target staff whose activities can have a material impact on the risk exposure of the financial institution. For employees in risk and compliance functions, remuneration could be tied to achieving sustainability.

iii. Pragmatic

Pragmatically, there should be governance and regulatory structures that operate on a timely and effective basis. Governance standards should ensure the appropriate balance of independence and skills of directors. One way to accomplish this goal would be to enhance board diversity; do banks need some regulatory rule or guidance on this issue?

The Basel principles for governance regarding the specialized skills and qualities of directors are aimed at ensuring that they engage in oversight of strategic objectives and values; set and enforce clear lines of responsibility throughout organization; ensure sound internal audit controls; and understand bank's operational structure and complexity of structure or products, all important principles. Pragmatically, how do we transfer non-binding international principles into accepted practice? One mechanism is to ensure appropriate incentives for directors and officers to pursue the bank's best interests, though compensation, fear of liability or a combination of the two. Boards must devote more time to governance and oversight. Directors must be willing and able to ensure the risk management framework and risk appetite of the financial institution are appropriate. Board and director performance should be linked to risk management and sustainability of the financial institution as well as profitability.

Financial institutions and persons that create or recommend derivatives products should meet due diligence standards in examining and disclosing material adverse risk in derivative products being sold in the public market. New products could be certified as transparent before being sold. There should be remedies for purchasers from failure of those individuals recommending products to meet due diligence and disclosure obligations. Financial institutions that recommend derivatives products must train employees responsible for distributing risk products to understand and communicate the risk and understand conflicts of interest.

Another pragmatic change would be mandatory disclosure during a restructuring proceeding of the real economic risks at stake, including disclosure of the amount of debt that has been hedged by creditors that seek to exercise their voting or oversight rights in a restructuring proceeding. Lack of transparency now means that the debtor bank and other creditors are not aware of who is bearing the real economic risk of bank failure, inhibiting the potential for a viable business restructuring plan.²⁰⁹ The court's consideration of any restructuring plan

²⁰⁹ Moreover, the normative justification for carving out derivatives from stays under restructuring proceedings is unclear, given the shift from their risk management function to speculative product. It creates a statutory preference for particular creditors over the claims of traditional secured creditors, employees, trade suppliers, and tort claimants.

should take account of economic interests at risk, either by requiring that voting on a restructuring plan is premised on the real economic interests in the bank's insolvency or granting courts authority to weigh actual economic interests when considering parties' exercise of voting rights.²¹⁰

As noted above, regulatory and governance responses to the financial crisis should recognize differing interests in the financial system; interests affected are beyond private financial markets participants and include employees, creditors, equity holders, depositors, and the broader public interest.

These suggestions all require further public policy debate. The initiatives globally reflect a growing consensus that the harms caused by the financial crisis need a timely and coordinated response. In the context of that response, bank supervisors and other regulators are working to find the appropriate mix of prudential oversight and private sector governance. The comprehensive reforms, if implemented on a timely basis, are likely to address a number of the issues raised by the financial crisis. Equally, however, they raise a number of important policy questions about whether the reforms have addressed the full range of contributing factors and whether they go far enough in altering the pre-crisis incentives in the banking sector.

²¹⁰ *Ibid.* In Canada, this exercise is a balancing of prejudice and equities in the proceedings. In civil law jurisdictions, some codification of both the authority and the criteria would have to be enacted. I also recommend that insolvency restructuring legislation be amended to include credit derivatives associated with creditor claims against the debtor company within the mandatory stay of proceedings, except with leave of the court on the basis of unfair prejudice, the standard currently used in many jurisdictions for other creditors to be exempted from the stay. The court could then exercise oversight of the clearing process in a measured way that assists with the risk management aspects of the products and slows the speculative market. There should also be timely claims bar dates, so that for CDS with physical settlement, the debtor need only bargain with parties as of that date, and not face a continually revolving door of CDS settlements that make the negotiating parties a moving target.