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Contingent Capital in European Union Bank Restructuring

*Christoph K. Henkel** and *Wulf A. Kaal***

Abstract: The uncoordinated reorganization and resolution of Systemically Important Financial Institutions in different countries pose many challenges. Contingent capital provides a viable alternative for the efficient restructuring and resolution of failing financial institutions. Contingent Capital provides a mechanism for internalizing banks' failure costs and helps return distressed financial institutions to solvency. This article offers a comparative perspective on bank resolution and restructuring in the European Union, Switzerland, the United Kingdom and Germany and shows that Contingent Capital could play a substantial role in bank restructuring.

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I. INTRODUCTION

At the height of the financial crisis, many countries saw no alternative to bailing out some of their most prominent financial institutions.¹ Governments perceived the winding down of banks through the national channels of insolvency as the least favorable course of action.² Defaulting to insolvency could have further deteriorated market confidence in the affected financial institutions and could have triggered bank runs³ and panic in financial markets.⁴ Some countries had no statutory regime to deal with bank failures or lacked a regulatory basis for public bail-outs.⁵ To address these shortcomings, many countries hastily enacted laws⁶ without regard to

¹ DAVID SKEEL, *THE NEW FINANCIAL DEAL – UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 19–40 (2011); Wulf A. Kaal & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers Liability for Taking Excessive Risk in Germany and the United States*, 40 SETON HALL L. REV. 1433 (2010).

² See, e.g., Gunnar Schuster & Lars Westpfahl, *Neue Wege Zur Banksanierung – Ein Beitrag zum Restrukturierungsgesetz (Teil I)*, Der Betrieb, DB 2011, 221. *Contra* SKEEL, *supra* note 1, at 158–73 (arguing that reliance on insolvency regimes would have been preferable). Also, the availability of public bail-out money may have removed the threat of losses, which made insolvency a theoretical threat at best.

³ See, e.g., Marianne Barriaux, *Market Forces: Banking Sector Hit by Northern Rock Fallout*, GUARDIAN, Sept. 14, 2007, (Guardian Financial Pages), at 40.

⁴ James B. Thomson, *On Systemically Important Financial Institutions And Progressive Systemic Mitigation*, 8 DEPAUL BUS. & COM. L.J. 135 (2010).

⁵ See *infra* note 257 and accompanying text.

⁶ U.S. Scholars have referred to recent regulatory measures such as Sarbanes Oxley and the Dodd-Frank Act as Quack Corporate Governance. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Stephen M. Bainbridge, *Dodd–Frank: Quack Federal Corporate Governance Round II*, 95

international commitments, consistency, and coordination.⁷

Policy makers and legislators across the globe agree that avoiding a repeat of the financial crisis is one of the most important legislative objectives.⁸ The United States Congress enacted The Dodd-Frank Act,⁹ and the European Commission proposed various regulatory schemes to address many of these problems.¹⁰ A primary focus of these initiatives

MINN. L. REV. 1779 (2010–11).

⁷ See Grp. of Twenty [G20], *The London Summit: Leaders' Statement*, ¶ 2 (April 2, 2009), available at http://www.wcoomd.org/files/1.%20Public%20files/PDFandDocuments/Highlights/G20_Final_London_Communique.pdf (G20 London Summit); G20, *Declaration on the Strengthening the Financial System* (April 2, 2009), available at http://www.mofa.go.jp/policy/economy/g20_summit/2009-1/annex2.html (G20 London Summit) [hereinafter G20 London]; Thorsten Höche, *Das Restrukturierungsgesetz – Neue Wege in der Bankenaufsicht (mit Seitenblicken auf die Schweiz und das Vereinigte Königreich)* [The Restructuring Act – New Ways of Banking Supervision (with side views of Switzerland and the United Kingdom)]; WERTPAPIER-MITTEILUNGEN: ZEITSCHRIFT FÜR WIRTSCHAFTS UND BANKRECHT 49 (2011) (Ger.); see Hans-Jürgen A. Fezerabend, Stephan Behnes, & Marcus Helios, *Einleitung zum Restrukturierungsgesetz, Der Betrieb*, DB 2011, Supplement No. 4, 5 (explaining the German enactment of various emergency acts following the Hypo Real failure in Germany).

⁸ For example, during a press conference introducing the European Commission's latest proposal to revise capital requirements for European banks, the Internal Market Commissioner Michel Barnier said: "The financial crisis has hit European families and businesses hard. We cannot let such a crisis occur again and we cannot allow the actions of a few in the financial world to jeopardize our prosperity." Press Release, European Comm'n, *Commission Wants Stronger and More Responsible Banks in Europe* IP/11/915 (Jul 20, 2011) (on file with Europa), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/915&format=HTML&aged0&language=en&guiLanguage=en> [hereinafter IP/11/915]. On a more global level, the G20 Summit Leaders conveyed a commitment to address the crisis through international cooperation and harmonization expressing a similar sentiment at the end of the G20 Summit in Pittsburgh in 2009. The Leaders' Statement notes that the G20 members agree "we should develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future." G20, *Leaders' Statement: The Pittsburgh Summit*, ¶ 13 (Sept. 24–25, 2009), available at http://ec.europa.eu/commission_2010-2014/president/pdf/statement_20090826_en_2.pdf.

⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, §§ 201–17, 124 Stat. 1376, 1442–1520 (2010).

¹⁰ DG Internal Mkt. and Serv., *Technical Details of a Possible EU Framework for Bank Recovery and Resolution* 7–10, (unpublished working document), available at http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf [hereinafter DG Working Document]; *Commission Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, at 10, COM (2011) 452 final (July 20, 2011) [hereinafter CRD IV Regulation]; *Commission Proposal for a Directive of the European Parliament and the Council on the Access to the Activity of Credit Institutions and Investment Firms and Amending Directive 2002/87/EC of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate*, COM (2011) 453 final (July 20, 2011) [hereinafter CRD IV Directive].

involved the establishment of a supervisory regime for more efficient regulatory oversight,¹¹ early intervention, and early resolution to minimize the risk of contagion and to protect public funds.¹² Germany revised a substantial portion of its banking laws.¹³ Spain changed its regulatory scheme for orderly bank restructuring.¹⁴ Many other European countries including the United Kingdom¹⁵ and Switzerland similarly adjusted their laws.¹⁶

At the international level, the focus of cooperation shifted from corporate governance reform in a general sense toward reform of systemically important financial institutions (SIFIs).¹⁷ In light of this shift in international cooperation and given the trend toward diverging national rules, regulatory arbitrage could become a risk for the competitiveness and stability of financial markets. This could especially hold true if countries cannot achieve a minimal level of convergence of international banking resolution and restructuring regimes.¹⁸ The European Commission has recognized the threat of regulatory arbitrage and conducted an impact assessment of harmonization in the context of revisions to the capital requirements for banks.¹⁹ The Commission concluded that maximum harmonization with some exceptions would allow the European Union to reduce compliance burdens, ensure a level playing field, create legal certainty, and achieve supervisory convergence.²⁰

Convergence could be especially important for resolution regimes. The uncoordinated reorganization and resolution of SIFIs, subject to

¹¹ See, e.g., *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank*, COM (2010) 579 final (Nov. 20, 2010) [hereinafter COM (2010) 579 final]; see also *infra* Part II.

¹² DG Working Document, *supra* note 10; see also Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376.

¹³ See *infra* note 296 and accompanying text.

¹⁴ B.O.E. 2009, 155 (Spain), amended by B.O.E. 2011, 43 (Spain).

¹⁵ INDEP. COMM'N ON BANKING, INTERIM REPORT CONSULTATION ON REFORM OPTIONS, INTERIM REPORT, 2011, at 1 (U.K.).

¹⁶ See Westpfahl, *infra* note 243 and accompanying text.

¹⁷ See *infra* note 63 and accompanying text; see, e.g., Höche, *supra* note 7.

¹⁸ Peter Spiegel, *EU warns US to speed up bank reform*, FIN. TIMES, June 1, 2011, <http://www.ft.com/intl/cms/s/0/cc0e7382-8bcb-11e0-854c-00144feab49a.html#axzz1aVbBDBPq>. The European Union Internal Market Commissioner Michel Barnier has even gone so far as to accuse the United States of “leav[ing] too much latitude for financial institutions,” allowing financial institutions to “circumvent globally-agreed principles.” *Id.* In his letter to Treasury Secretary Geithner, Commissioner Barnier also called upon the United States to limit bonuses and pension payments for U.S. bankers, which he believes is essential to limiting incentives for U.S. headquartered bank executives to continue to take excessive risk. *Id.*

¹⁹ CRD IV Regulation, *supra* note 10, at 5.

²⁰ *Id.*

multiple resolution regimes in different countries, could undermine their operation as a conglomerate and going concern. Without coordination and convergence, it is possible that a SIFI with operations in multiple countries could petition for reorganization under German law, for instance, and emerge as a more competitive and leaner business while the same SIFI in the United States may be liquidated under the Boxer Amendment of the Dodd-Frank Act.²¹ The European Commission's objective of creating maximum harmonization through a global "single rule book"²² may not be feasible. However, setting up a legal framework for private ordering in the context of contingent capital²³ could provide an adequate level of convergence and at least help ensure a level playing field.

Contingent capital is the predefined conversion of a financial institution's debt securities into equity securities.²⁴ Contingent capital provides an option for the efficient restructuring and resolution of failing financial institutions. It could enable a SIFI to return to solvency, prevent financial contagion, and maintain overall financial stability.²⁵ It could offer an efficient mechanism for reorganizing SIFIs in jurisdictions that focus merely on liquidation rather than reorganization.²⁶

Recent developments in Europe suggest that contingent capital will play a prominent role as part of capital requirements for banks in

²¹ Dodd-Frank Act, Pub. L. No. 111-203, § 214, 124 Stat. 1376, 1442–1520 (2010).

²² *Commission Staff Working Paper, Impact Assessment*, at 5, SEC (2011) 949 final (July 20, 2011), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2011:0949:FIN:EN:PDF>.

²³ See, e.g., BUNDESGESETZ ÜBER DIE BANKEN UND SPARKASSEN [BANKG] [FEDERAL LAW ON BANKS, SAVING AND LOANS] Nov. 8, 1934, SR 952, art. 9(d) (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>; see also *supra* art. 9, 11, 13.

²⁴ For purposes of this article, the term "contingent capital" or "contingent capital securities" (CCS) will be used. Another name for the same concept is contingent convertibles (short CoCos). *Contingent Capital: CoCo Nuts*, ECONOMIST, Nov. 5, 2009, http://www.economist.com/node/14816673?story_id=14816673; Squam Lake Working Grp. on Fin. Regulation, *An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities*, 2 (Council on Foreign Relations: Center for Geoeconomic Studies, Working Paper, 2009); MARK J. FLANNERY, STABILIZING LARGE FINANCIAL INSTITUTIONS WITH CONTINGENT CAPITAL CERTIFICATES (2009); Julie Dickson, Superintendent, Fin. Inst. Can., Remarks at Financial Services Invitational Forum, Economic and Financial Turmoil: Are There Lesson for Boards? (May 6, 2010).

²⁵ DG Working Document, *supra* note 10, at Annex I.

²⁶ It is important to note, however, that while contingent capital may help stabilize large financial firms, it may not help to avoid an economic crisis in every case. See FLANNERY, *supra* note 24; John C. Coffee, *Systemic Risk after Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 833 (2011) ("If a firm's variable costs clearly exceed its revenues, and no turnaround is in sight, the firm will not be saved by converting its bonds into preferred stock. . . . [R]esolution authority provides the superior mechanism for its liquidation. Thus, the boundaries within which contingent capital can feasibly work are set by the firm's ability to recover its variable costs.").

Switzerland²⁷ and throughout the European Union.²⁸ The European Commission has proposed various models of contingent capital and broadly distinguished between a comprehensive and targeted approach as a write-down tool allowing restructuring and resolution of financial institutions.²⁹ The targeted approach provides a tool for the write down and conversion of financial institutions' liabilities. The targeted approach could provide resolution authorities with additional flexibility if a failing institution cannot be wound up under the respective national insolvency regime.³⁰

The European Commission promulgated a new approach in a directive³¹ and regulation³² proposal implementing Basel III and revising the capital requirement rules in the European Union. The Commission recognizes contingent capital as a so-called "Additional Tier 1 instrument,"³³ subject to full and permanent write down at the point of non-viability.³⁴ The European Union-wide recognition of contingent capital as Tier 1 capital may further incentivize national governments to promulgate contingent capital standards. The Commission proposal leaves sufficient discretion for national legislators to implement their own contingent capital standards. The German government has proposed a change to the German Corporation Act to implement provisions for contingent capital.³⁵ The Swiss and English legislators have taken similar approaches. In the United States, the Dodd-Frank Act mandates a study on the feasibility of contingent capital.³⁶

²⁷ See, e.g., BUNDESGESETZ ÜBER DIE BANKEN UND SPARKASSEN [BANKG] [FEDERAL LAW ON BANKS, SAVING AND LOANS] Nov. 8, 1934, SR 952, art. 9(d) (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>; Press Release, Fed. Dep't of Fin., Strengthening Financial Sector Stability (too big to fail) (July 12, 2011), <http://www.efd.admin.ch/dokumentation/zahlen/00579/00607/02255/index.html?lang=en> [hereinafter Fed. Dep't of Fin. Press Release].

²⁸ See DG Working Document, *supra* note 10; see CRD IV Regulation, *supra* note 10; see CRD IV Directive, *supra* note 10.

²⁹ DG Working Document, *supra* note 10, at 87–89.

³⁰ *Id.* at 86.

³¹ CRD IV Directive, *supra* note 10.

³² CRD IV Regulation, *supra* note 10.

³³ *Id.* art. 49(1)(n).

³⁴ *Id.* at 20 (“(27) In line with the decision of the BCBS [the Basel Committee on Banking Supervision], as endorsed by the GHOS [Central Bank Governors and Heads of Supervision] on 10 January 2011, all Additional Tier 1 and Tier 2 instruments of an institution should be fully and permanently written down or converted fully into Common Equity Tier 1 capital at the point of non-viability of the institution.”).

³⁵ Referentenentwurf des Bundesministeriums der Justiz, Gesetz zur Änderung des Aktiengesetzes, available at http://www2.nwb.de/portal/content/ir/downloads/217907/RefE_Aktienrechtsnovelle_2011.pdf?referrer=www.google.com (April 14, 2011).

³⁶ Dodd-Frank Act, Pub. L. No. 111-203, § 115, 124 Stat. 1376, 1404 (2010).

(c) CONTINGENT CAPITAL.— (1) STUDY REQUIRED.—The Council shall conduct a study of the feasibility, benefits, costs, and structure of a contingent

This article provides an overview of regulatory proposals for the restructuring of financial institutions and explains the role contingent capital may play in this context. We point out pertinent issues that require resolution before regulatory proposals may be implemented. We also suggest possible approaches for some of the open issues by providing a comparative perspective of the European Union and national approaches. The first part of this article briefly examines international initiatives on the subject of bank recovery and resolution. The second part reviews the actions taken by the European Union and national legislators in Switzerland, the United Kingdom, and Germany. The third part discusses contingent capital in European bank restructuring. The fourth part evaluates contingent capital as both a preventative tool in European bank restructuring and as a part of bank recovery and resolution. In the final part, we consider triggers and other design features of contingent capital, identify problems, and suggest possible solutions. We emphasize the possible role of international convergence.

II. INTERNATIONAL MITIGATION INITIATIVES, RESOLUTION TOOLS AND FRAMEWORKS

The discussion of the European approach to bank recovery and resolution would not be complete without considering some of the international initiatives taken since the financial crisis. As in most countries affected by the financial crisis, European nations first attempted to deal with the results of the crisis at national levels. However, as many bank failures, such as Lehman Brothers,³⁷ Fortis,³⁸ Icelandic banks,³⁹ Northern

capital requirement for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), which study shall include—

(A) an evaluation of the degree to which such requirement would enhance the safety and soundness of companies subject to the requirement, promote the financial stability of the United States, and reduce risks to United States taxpayers;

(B) an evaluation of the characteristics and amounts of contingent capital that should be required;

(C) an analysis of potential prudential standards that should be used to determine whether the contingent capital of a company would be converted to equity in times of financial stress;

(D) an evaluation of the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital;

(E) an evaluation of the effects of such requirement on the international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such requirement; and

(F) recommendations for implementing regulations.

Id.

³⁷ *US Banking Crisis Financiers Have Put the World at Risk*, HERALD (Glasgow), Sept.

Rock,⁴⁰ or Hypo Real Estate Holding⁴¹ have demonstrated, national measures proved ineffective and failed to address cross-border banking operations or contagion.⁴² In addition, national measures varied greatly.⁴³ Most national measures took the form of public bail-outs without broad international consensus,⁴⁴ thereby increasing the threat of international regulatory arbitrage as well as negatively impacting the global competitiveness of national financial markets.⁴⁵

The 2009 G20 Summits in London⁴⁶ and Pittsburgh⁴⁷ were the first international response with the goal of coordinating policy actions at an international level. Following the G20 Summit, the third Basel Accord established the Basel III requirements.⁴⁸ Since the 2010 G20 Summit in Seoul, the international focus has shifted toward addressing the risk that

16, 2008, at 14.

³⁸ Ian Traynor, *Belgium Acts to Prevent Financial Group's Collapse: Governments Agree to Pour Euros 11bn into Fortis*, GUARDIAN, Sept. 29, 2008, (Guardian Financial Pages), at 26.

³⁹ Yves Smith, *The first casualty of the crisis: Iceland*, NAKED CAPITALISM (Nov. 12, 2008), www.nakedcapitalism.com/2008/11/first-casualty-of-crisis-iceland.html.

⁴⁰ Marianne Barriaux, *Market Forces: Banking Sector Hit by Northern Rock Fallout*, GUARDIAN, Sept. 15, 2007, (Guardian Financial Pages), at 40.

⁴¹ Carter Dougherty et al., *Financial Crises Spread in Europe*, N.Y. TIMES, Oct. 6, 2008, at A1.

⁴² DG Working Document, *supra* note 10.

⁴³ During the crisis many countries introduced emergency laws to establish some existing legal basis for state aid to national and global systemically important financial institutions. See, e.g., the approach taken in Germany by enacting the Financial Market Stabilization Law, Finanzmarktstabilisierungsgesetz [FMStG], Oct. 17, 2008, BGBl. I at 1982; The Amended Financial Market Stabilization Law, Finanzmarktstabilisierungsergänzungsgesetz [FMStErgG], Apr. 7, 2009, BGBl. I at 725; Law to Improve the Financial Market and Insurance Regulatory Authority, Gesetz zur Stärkung der Finanzmarkt und der Versicherungsaufsicht [FMVAStärkG], July 29, 2009, BGBl. I at 2305.

⁴⁴ Sharon E. Foster, *Too Big to Fail, Too Small to Compete: Systemic Risk Should be Addressed Through Antitrust Law*, 22 FLA. J. INT'L L. 31, 33, 49 (2010).

⁴⁵ In the European Union, until the fall of 2010, state aid to support banks amounted to as much as 13% GDP. See Press Release, European Comm'n, An EU Framework for Crisis Management in the Financial Sector, Memo/10/506 (Oct. 20, 2010), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/506&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁴⁶ See G20 London, *supra* note 7; see Höche, *supra* note 7; see Fezerabend et al., *supra* note 7.

⁴⁷ G20, Pittsburgh Summit on Financial Markets and the World Economy (Sept. 15, 2009) [hereinafter Pittsburgh Summit]. In Pittsburgh, the leaders agreed that they “should develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future.” Pittsburgh Summit, *supra*, ¶ 13.

⁴⁸ Bank for Int'l Settlements [BIS], Basel Comm. on Banking Supervision, Consultative Document: Basel III: A Global Regulatory Framework for More Resilient Banks & Banking Systems, (Dec. 2010, rev. June 2011) [hereinafter BIS III].

SIFIs pose to global financial markets.

At the London and Pittsburgh Summit the leaders of the G20 also charged the Financial Stability Board (FSB)⁴⁹ with presenting recommendations for the development of this framework.⁵⁰ The FSB submitted its first major report to the G20 in the fall of 2010⁵¹ and recommended the implementation of internationally consistent bank capital and liquidity standards based on the third Basel Accord.⁵² The FSB further proposed the increase of supervision and regulatory measures to deal with SIFIs. As part of a new regulatory regime, the FSB also suggested the requirement of higher loss absorbency measures for SIFIs that reflect the higher risk that these financial institutions might pose to the global financial system.⁵³ Finally, the FSB report addressed a needed reform of the OTC derivative markets⁵⁴ and proposed the general increase in supervisory intensity and effectiveness of all financial markets.⁵⁵

The G20 leaders followed the FSB recommendations and endorsed the Basel III requirements at the Seoul Summit in November 2010.⁵⁶ All G20 members have since agreed to implement Basel III. The goal is to implement national legislation by January 1, 2013, with an enforcement date of January 1, 2019.⁵⁷ Basel III introduces new capital and liquidity standards and applies to all G20 banks.⁵⁸ Basel III specifically attempts to prevent banks from using off-balance sheet vehicles and risk weighting

⁴⁹ Financial Stability Board [FSB], <http://www.financialstabilityboard.org/>. The Financial Stability Board is an international body that has been established to coordinate the work of national financial authorities and international standard setting bodies. The FSB develops and promotes the implementation of effective regulatory and supervisory policies for the financial sector. Members of the FSB are national regulatory authorities, national and international financial institutions, associations, committees, and experts in the financial sector. For a list of members, see <http://www.financialstabilityboard.org/members/links.htm>.

⁵⁰ Pittsburgh Summit, *supra* note 47, ¶ 13.

⁵¹ Fin. Stability Bd., *Progress Since the Washington Summit in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of the Financial Stability Board to G20 Leaders*, (Nov. 8, 2010), 1–12, http://www.financialstabilityboard.org/publications/r_101111b.pdf.

⁵² *Id.* at 3–5.

⁵³ *Id.* at 6–7.

⁵⁴ *Id.* at 12–15.

⁵⁵ *Id.* at 15–20.

⁵⁶ Grp. Of Twenty [G20], Leaders' Declaration: The Seoul Summit, at ¶ 13 (Nov. 11–12, 2010), available at http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf [hereinafter G20 Seoul Summit].

⁵⁷ *Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of the Financial Stability Board to G20 Finance Ministers and Central Bank Governors*, Fin. Stability Bd. (Apr. 10, 2011), at 1, http://www.financialstabilityboard.org/publications/r_110415a.pdf.

⁵⁸ Wulf A. Kaal, *Hedge Fund Regulation via Basel III*, 44 VAND. J. TRANSNAT'L L. 389, 439 (2011).

methods to hide the true size of their balance sheet.⁵⁹ At its core, Basel III establishes the following capital ratio requirements: (1) tier 1 capital 6%, (2) common equity 4.5%, and (3) total capital 8%.⁶⁰ More importantly, the Basel Accord establishes the requirement of capital conservation buffers to be drawn upon during a financial crisis.⁶¹ Under Basel II, the total capital requirement for banks were merely 8%, i.e., 2% common equity tier 1 capital, 2 % other qualifying tier 1 capital, and 4% tier 2 capital. Starting in 2019, banks will be required to hold a total common equity plus conservation buffers of 7% amounting to a total capital plus conservation buffer of 10.5%.⁶² Adding countercyclical buffers of up to 2.5 % and SIFI capital surcharges, the total capital required under Basel III could reach around 13%.

Since the endorsement of the Basel Accord and following the recommendations of the FSB, international attention seems to have shifted away from the international coordination of national bank resolution regimes toward regulating systemically important financial institutions.⁶³ Early in 2011, at the Paris meeting of the G20 finance ministers and central bank governors, the group agreed to focus on systemically important financial institutions of significance for the global financial markets (G-SIFIs) as opposed to financial institutions of significance only in their respective home countries and identified a number of issues to work on.⁶⁴

The group identified the classification of G-SIFIs as well as the need for a comprehensive multi-tiered framework with more supervisory oversight and a more effective cross border resolution regime as the most important issues to address.⁶⁵ As part of a viable resolution regime for G-SIFIs, the group considered the possibility of capital surcharges, contingent capital, and bail-in instruments as statutory write-down tools within resolution and systemic levies.⁶⁶ To expedite the work on G-SIFIs, the

⁵⁹ *Id.* at 444.

⁶⁰ *Id.*

⁶¹ *Id.* at 446.

⁶² *Id.*

⁶³ *See, e.g.,* Höche, *supra* note 7.

⁶⁴ G20, *Communiqué, Meeting of Finance Ministers and Central Bank Governors*, February 18–19, 2011, ¶ 6, http://www.g20.org/pub_communiqes.aspx (last visited July 18, 2011) (Paris) [hereinafter G20]. G-SIFIs are global systemically important financial institutions as opposed to regional or national systemically important financial institutions. For example, the two biggest Swiss banks, UBS and Credit Swiss, are both global players, while at the same time being Switzerland's biggest banks. Conversely, Japan, on a national level, has various systemically important financial institutions, but these Japanese banks are not of similar global significance. *See, e.g.,* Patrick Jenkins, *G20 Draws Up Two Tier Bank Plan*, FIN. TIMES, Nov. 9, 2010, <http://www.ft.com/intl/cms/s/0/ff3f3a4a-ec46-11df-9e11-00144feab49a.html#axzz1aQH71R8b>.

⁶⁵ G20, *supra* note 64, ¶ 6.

⁶⁶ *Id.*

group asked the FSB to deliver first recommendations on G-SIFI classification and loss absorbency before the G20 summit in the fall of 2011.⁶⁷ The preliminary factors established to categorize G-SIFIs, which may also include insurers, are (1) global activities, (2) size, (3) interconnectedness, (4) substitutability and (5) complexity.⁶⁸ In addition, as an alternative to the requirement of higher loss absorbency capacity, the FSB considered a combination of capital surcharges and “bail-inables”.⁶⁹ In the context of bank resolution tools and regimes, the FSB has also set up a Bail-in Working Group, which is reviewing technical aspects and financial stability implications of both contractual and statutory bail-in instruments and mechanisms.⁷⁰ The FSB published a consultation paper on bank resolution of SIFIs in July 2011.⁷¹

III. EUROPEAN BANK RECOVERY AND RESOLUTION

The European Union initiated a number of long- and short-term initiatives since the financial crisis.⁷² Most of the initiatives were aimed at specific areas of concern that required immediate attention. One example is the European Union deposit guarantee scheme.⁷³ The long-term initiatives were aimed at establishing a more comprehensive response to the financial crisis. The initiatives included establishing an effective European System of Financial Supervisors,⁷⁴ the European Union framework for crisis management in the financial sector⁷⁵ and revision of the Capital Requirements Directive (CRD IV).⁷⁶

⁶⁷ FIN. STABILITY BD., *supra* note 57, at 2.

⁶⁸ *Id.*

⁶⁹ *Id.* at 2.

⁷⁰ *Id.* at 3.

⁷¹ Fin. Stability Bd., *Consultative Document, Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines*, (July 19, 2011), http://www.financialstabilityboard.org/publications/r_110719.pdf; Fin. Stability Bd., Comments Received on the FSB Consultative Document on Effective Resolution of SIFIs, http://www.financialstabilityboard.org/press/c_110909.htm (last visited Apr. 6, 2012).

⁷² The sovereign debt crisis in Europe is not the focus of this paper. Although clearly related to the financial crisis and public bank bail-outs, a comprehensive discussion of the issues and latest developments related to the sovereign debt crisis of Greece, Ireland, Portugal, and the actions taken by the European Union and IMF would go far beyond the focus of this paper. As such, we will also not discuss the European Financial Stability Facility (ESFS) or the European Stability Mechanism (ESM).

⁷³ Council Directive 2009/14, 2009 O.J. (L 68) 3 (EU).

⁷⁴ Council Regulation 1092/2010, 2010 O.J. (L 331) 1; Council Regulation 1093/2010, 2010 O.J. (L 331) 12; Council Regulation 1094/2010, 2010 O.J. (L 331) 48; Council Regulation 1095/2010, 2010 O.J. (L 331) 84.

⁷⁵ COM (2010) 579 final, *supra* note 11.

⁷⁶ See, e.g., European Commission, *Possible Further Changes to the Capital Requirements Directive*, at 1–2 (Comm'n Services, Working Staff Paper, 2010), available at http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf

A. European Union Initiatives

As one of its first initiatives, the European Union amended the Deposit Guarantee Schemes Directive 2009/14/EC in the spring of 2009.⁷⁷ The goal of the amendment was to restore consumer confidence and protection after the turmoil of the crisis.⁷⁸ The directive applies to all credit institutions in the European Union and requires all institutions to join a Deposit Guarantee Scheme (DGS).⁷⁹ Member States are required to ensure that all bank deposits are secured at 100,000 euro,⁸⁰ which is an increase of 80,000 euro over prior Union requirements.⁸¹ In addition, a coverage payout cannot be delayed for more than 20 working days.⁸² Deposit guarantee schemes are further required to be regularly supervised and must perform stress tests.⁸³

Following the findings of the *de Larosiere Report*,⁸⁴ the European Commission also adopted a recommendation on remuneration in the financial services sector⁸⁵ and a recommendation on directors' pay.⁸⁶ With a view towards long-term profitability and performance, the Commission suggested that Member States regulate remuneration of risk-taking staff and seek a balance between core pay and bonuses.⁸⁷ The Commission also

[hereinafter Comm'n Services].

⁷⁷ Council Directive 2009/14, 2009 O.J. (L 68) 3 (EU).

⁷⁸ Press Release, European Commission, Commission Proposes Package to Boost Consumer Protection and Confidence in Financial Services (July 12, 2010), http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm.

⁷⁹ Council Directive 94/19, art. 3, 1994 O.J. (L 35) 5, 8. However, deposits other than consumer deposits, such as deposits of financial institutions, public authorities, structured investment products, and debt certificates are now specifically excluded from coverage; see also *Commission Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes* at 2, 6–9 COM (2010) 368 final (July 12, 2010).

⁸⁰ See Council Directive, *supra* note 81, at art. 1(a).

⁸¹ *Id.* p.mbl. ¶ 3.

⁸² *Id.* p.mbl. ¶ 10.

⁸³ *Id.* p.mbl. ¶ 6.

⁸⁴ The de Larosière Grp., The High-Level Group on Financial Supervision in the EU, Brussels, at 31 (Feb. 25, 2009) (chaired by Jacques de Larosière), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf [hereinafter The de Larosière Grp.]. The de Larosière Group was a group of experts asked by the European Commission to provide advice on the future of European financial regulation and supervision. The work of the group resulted in the so-called *de Larosière Report*. Members of the group were Jacques de Larosière, Leszek Balcerowicz, Otmar Issing, Rainer Masera, Callum McCarthy, Lars Nyberg, José Pérez, and Onno Ruding.

⁸⁵ Press Release, European Commission, Financial Services Sector Pay: Commission Set Out Remuneration of Risk-Taking Staff in Financial Institutions (Apr. 29, 2009), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/674> [hereinafter Press Release]; Commission Recommendation *On Remuneration Policies in the Financial Services Sector*, C(2009) 3159 (Apr. 30, 2009).

⁸⁶ See Press Release, *supra* note 85; see also Council Directive 2011/61, 2011 O.J. (L 174) 1, 70 (EC).

⁸⁷ Kaal, *supra* note 58, at 401; Press Release, *supra* note 85.

deemed a claw-back option for bonuses a necessary requirement⁸⁸ and asked that Member States make remuneration policies transparent for all parties involved.⁸⁹ Similar recommendations followed for directors' pay, including a limit on golden parachutes and a ban on severance pay in case of failure.⁹⁰

Another important European Union initiative was the adoption of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM).⁹¹ After an initial proposal in the spring of 2009, the directive went into force on July 21, 2011. The AIFM sector in the European Union, which represented assets of around 2 trillion euro at the end of 2008, includes hedge funds, private equity funds, and commodity funds, among others.⁹² The directive regulates AIFM and applies to funds managing 100 million euros or more.⁹³ Some estimates suggest that this applies to 90% of assets managed by hedge funds domiciled in the European Union.⁹⁴ The directive regulates all major sources of risk of AIFM,⁹⁵ includes various transparency rules,⁹⁶ and sets corporate governance standards on how to manage risk, liquidity, and conflicts of interest.⁹⁷ Finally, the directive aims to establish a passport regime with a transitional period of three years for non-EU hedge funds in order to perform management and marketing activities in the European Union.⁹⁸

B. Long-Term Initiatives of the European Union

Among the most important long-term initiatives are the establishment of a European System of Financial Supervisors (ESFS)⁹⁹ and the

⁸⁸ Press Release, *supra* note 85; *see also* Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation*, 64 *VAND. L. REV.* 431, 477 (2011).

⁸⁹ Press Release, *supra* note 85.

⁹⁰ Press Release, *supra* note 85; *Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC*, COM (2009) 211 final (April 30, 2009).

⁹¹ Council Directive 2011/61, *supra* note 86, at 1. For a critical assessment, *see* Kaal, *supra* note 58, at 396–97 (assessing the influence of the Directive on the alternative investment community's competitiveness and suggesting hedge fund regulation through Basel III).

⁹² Press Release, European Commission, Financial Services: Commission proposes EU framework (Apr. 29, 2009), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/669&format=PDF&aged=1&language=EN&guiLanguage=en> [hereinafter Press Release: Financial Services].

⁹³ Council Directive 2011/61, *supra* note 86, art. 3, at 15.

⁹⁴ Press Release: Financial Services, *supra* note 92.

⁹⁵ Council Directive 2011/61, *supra* note 86, at 1, ¶ 2.

⁹⁶ *Id.* art. 22.

⁹⁷ *Id.* art. 15.

⁹⁸ *Id.* pmb. ¶ 4.

⁹⁹ Council Regulation 1093/2010, 2010 O.J. (L 331) 12; *see infra* text accompanying

Commission Communication on the European Union framework for crisis management in the financial sector.¹⁰⁰ The latter resulted in the DG Internal Market and Service Working Document on technical details of a possible European Union framework for bank recovery and resolution,¹⁰¹ as well as the most recent Commission proposal on the revision of the Capital Requirements Directive.¹⁰²

1. The European System of Financial Supervisors

Since January 1, 2011, the European Union has a new European System of Financial Supervisors (ESFS).¹⁰³ Many details about the powers of the ESFS remain unclear, but the introduction of this new European Union supervisory architecture generally followed recommendations made in the *de Larosiere Report*.¹⁰⁴ The Report recognized the need to strengthen European supervisory arrangements and recommended the establishment of a Union-level body charged with overseeing the financial system as a whole.¹⁰⁵ The prior system of financial service committees¹⁰⁶ only played an advisory role with no real power,¹⁰⁷ and Union-wide supervision was at best fragmented, inconsistent and ineffective.¹⁰⁸

It is questionable whether the ESFS may be able to address all of the identified shortcomings. The system is primarily aimed at establishing a European single rule book, upgrading the quality and consistency of

note 103.

¹⁰⁰ See *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank*, COM (2010) 579 final (Nov. 20, 2010).

¹⁰¹ DG Working Document, *supra* note 10.

¹⁰² IP/11/915, *supra* note 8; CRD IV Directive, *supra* note 10; DG Working Document, *supra* note 10.

¹⁰³ Council Regulation 1093/2010, *supra* note 74, ¶ 69.

¹⁰⁴ The de Larosière Grp., *supra* note 84.

¹⁰⁵ Council Regulation 1092/2010, *supra* note 74, pmbl. ¶¶ 3–4.

¹⁰⁶ The so-called “Lamfalussy level committees” consist of the Committee of the European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS), and the Committee of European Securities Regulators (CESR).

¹⁰⁷ Commission Decision of 23 January 2009 establishing the Committee of European Banking Supervisors (EC), 2009 O.J. (L 25) 23 [hereinafter CEBS Decision]; Commission Decision of 23 January 2009 establishing the Committee of European Insurance and Occupational Pensions Supervisors (EC), 2009 O.J. (L 25) 28, [hereinafter CEIOPS Decision]; Commission Decision of 23 January 2009 establishing the Committee of European Securities Regulators (EC), 2009 O.J. (L 25) 18. [hereinafter CESR Decision]. See also Press Release, European Commission, European System of Financial Supervisors (ESFS): Frequently Asked Questions (Sept. 23, 2009), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/404&format=PDF&aged=1&language=EN&guiLanguage=en> [hereinafter Press Release FAQ].

¹⁰⁸ See, e.g., Council Regulation 1093/2010, *supra* note 74, pmbl. ¶ 8; Press Release FAQ, *supra* note 107.

national supervision, and strengthening the oversight of cross-border groups.¹⁰⁹ Although the ESFS remains limited to a Union-wide early exchange of information, it improves the prior supervisory system by harmonizing technical standards, coordinating Union-wide supervisory actions, and providing some decision-making powers in emergency situations.¹¹⁰

The European System of Financial Supervisors is considered an integrated network of national and European Union supervisory authorities.¹¹¹ It distinguishes between macro- and micro-prudential oversight.¹¹² The ESFS consists of the European Systemic Risk Board (ESRB) and three European Supervisory Authorities: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pension Authority (EIOPA).¹¹³ The ESAs replace the Committee of European Banking Supervisors,¹¹⁴ the Committee of European Insurance and Occupational Pensions Supervisors,¹¹⁵ and the Committee of European Securities Regulators.¹¹⁶

¹⁰⁹ Council Regulation 1093/2010, *supra* note 74, pmb. ¶ 5.

¹¹⁰ *Id.* art. 18.

¹¹¹ *Id.* pmb. ¶ 9.

¹¹² *Id.*

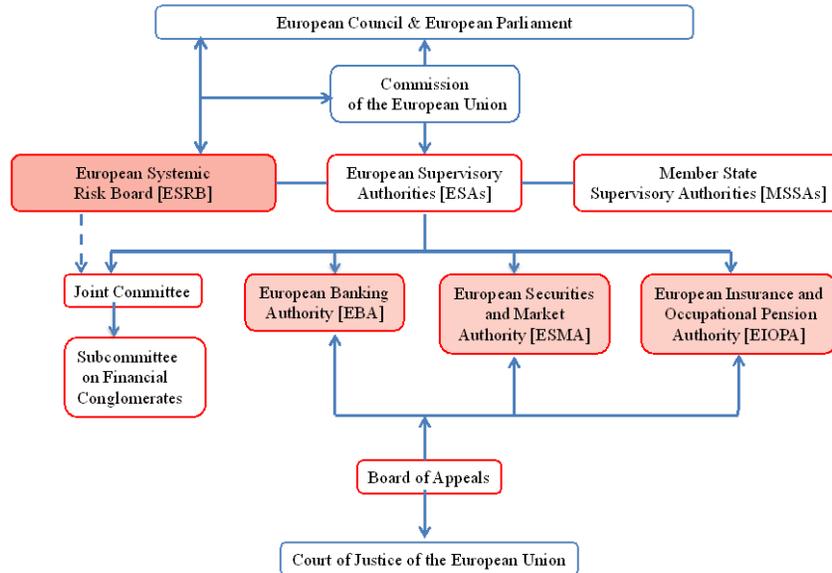
¹¹³ The ESA also includes a Joint Committee of the European Authorities (Joint Committee) and all competent or supervisory in the Member States. *See, e.g., id.* art. 2, at ¶ 2(e)–(f). This article does not focus on all ESAs or include a comprehensive discussion of the role of the ESFS. The goal of the article is simply to provide an overview of the ESFS in the context of actions taken by the European Union in response to the financial crisis.

¹¹⁴ CEBS Decision, *supra* note 107.

¹¹⁵ CEIOPS Decision, *supra* note 107.

¹¹⁶ CESR Decision, *supra* note 107.

EUROPEAN SYSTEM OF FINANCIAL SUPERVISION



The European Systemic Risk Board (ESRB) is the systemic risk regulator¹¹⁷ of the Union charged with the task of monitoring and assessing systemic risk in the Union.¹¹⁸ It is comparable to the Financial Stability Oversight Council under Dodd-Frank.¹¹⁹ The ESRB is tasked with the duty of developing a risk dashboard and a color code for interested parties to help them assess the nature of systemic risk.¹²⁰ It will also work closely with the European Supervisory Authorities in issuing recommendations¹²¹ and warnings.¹²² It cooperates with the Bank of International Settlement (BIS), the Financial Supervisory Board (FSB), and the International

¹¹⁷ Council Regulation 1092/2010, *supra* note 74, pmb. ¶ 15, art. 3.

¹¹⁸ *Id.* art. 15.

¹¹⁹ Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, S. Comm. on Banking, Hous., and Urban Affairs, available at http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

¹²⁰ Council Regulation 1092/2010, *supra* note 74, pmb. ¶ 18; see also Jean-Claude Trichet, Mervyn King, & Andrea Enria, European Systemic Risk Bd., Introductory Remarks to the Press Conference (June 22, 2011), available at <http://www.esrb.europa.eu/news/pr/2011/html/is110622.en.html>; Ralph Atkins, *Debt Crisis Flashing Warning Signs, says ECB chief*, FIN. TIMES, June 22, 2011, <http://www.ft.com/intl/cms/s/0/87831328-9cfe-11e0-8678-00144feabdc0.html#axzz1bRdPbQqQ>.

¹²¹ Council Regulation 1092/2010, *supra* note 74, art. 17.

¹²² *Id.* art. 16.

Monetary Fund (IMF)¹²³ in developing international standards and assessing global risk.¹²⁴ The President of the European Central Bank will chair the ESRB for the first 5 years.¹²⁵ The ESRB will also have two Vice-Chairs,¹²⁶ a General Board,¹²⁷ a Steering Committee,¹²⁸ and two advisory committees¹²⁹ supporting its work.¹³⁰ At the European Union level, the ESRB is accountable and reports directly to the Council and the European Parliament.¹³¹

Conversely to the ESRB, the European Supervisory Authorities (ESAs)¹³² oversee the micro-prudential performance of their respective industries with the goal of fostering convergence and promoting coordination among the European Union Member States.¹³³ Specifically, the ESAs work to guarantee a level playing field and prevent regulatory arbitrage to strengthen international supervisory coordination.¹³⁴ In addition, the Authorities can settle cross-border disputes among national supervisory authorities with binding effect.¹³⁵ The Authorities also serve as an independent advisory body to the European Parliament, the Council, and the Commission.¹³⁶ The principal decision-making body of the ESAs is chaired by a person with no voting power and is comprised of a board of supervisors that includes the heads of the relevant competent supervisory authorities in the member state.¹³⁷

The ESAs are supported by a Joint Committee of European Supervisory Authorities.¹³⁸ The Joint Committee is composed of the chairpersons of the ESAs and serves as a coordinating forum to ensure cross-sectoral consistency and the exchange of information with the

¹²³ *Id.* pmbi. ¶¶ 7–8.

¹²⁴ *Id.* pmbi. ¶ 9.

¹²⁵ *Id.* art. 5.

¹²⁶ *Id.*

¹²⁷ *Id.* art. 6.

¹²⁸ *Id.* art. 11.

¹²⁹ *Id.* arts. 12–13.

¹³⁰ *Id.*

¹³¹ *Id.* art. 19.

¹³² *See* Council Regulation 1093/2010, *supra* note 78. *See also supra* text accompanying note 103. The ESAs are: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pension Authority (EIOPA).

¹³³ *See, e.g.,* Council Regulation 1093/2010, *supra* note 74, pmbi. ¶ 11, art. 19.

¹³⁴ *Id.*

¹³⁵ *Id.* pmbi. ¶ 32.

¹³⁶ *Id.* art. 45.

¹³⁷ *Id.* art. 52; *see also id.* art. 40 (Representatives of the Commission, the ESRB, the ECB, and the other respective ESAs participate as observers).

¹³⁸ *Id.* art. 54.

ESRB.¹³⁹ The Joint Committee is also responsible for settling possible disputes between the ESAs.¹⁴⁰ A Board of Appeal reviews decisions by the ESAs.¹⁴¹ The European Court of Justice is the ultimate authority to review decisions by the ESAs.¹⁴² All competent authorities as well as any natural and legal person involved in or subject to the ESA decision may file appeals.¹⁴³ But, the European Commission may ultimately curtail all powers transferred to the ESAs.¹⁴⁴

Among the ESAs, the European Banking Authority (EBA)¹⁴⁵ has the most prominent role. In cooperation with the ESRB, the EBA initiates and coordinates Union-wide stress tests and peer reviews of financial institutions.¹⁴⁶ It also contributes to “developing methods for the resolution of failing financial institutions, in particular those that may pose a systemic risk, in ways which avoid contagion and allow them to be wound down in an orderly and timely manner, including, where applicable, coherent and robust funding mechanisms as appropriate.”¹⁴⁷ Moreover, the EBA supervises the implementation of the Deposit Guarantee Scheme Directive,¹⁴⁸ ensuring that all national guarantee schemes are adequately funded.¹⁴⁹

The European Securities and Markets Authority (ESMA),¹⁵⁰ on the other hand, supervises any legislation and any matters related to the Alternative Investment Funds Managers Directive¹⁵¹ including issues of corporate governance, auditing and financial reporting.¹⁵² The ESMA oversees and takes appropriate actions regarding takeover bids in the financial sector, clearing and settlement, as well as derivative issues.¹⁵³ In addition to the limitation of its power by the Commission, the ESMA is, however, also subject to limitation by the supervisory authority of the

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.* art. 58 (stating that the Board of Appeal is a joint body of all ESAs).

¹⁴² *Id.* art. 61.

¹⁴³ *Id.* art. 60.

¹⁴⁴ *Id.* art. 1, at ¶ 4; Council Regulation 1094/2010, *supra* note 74, art. 1, at ¶ 4; Council Regulation 1095/2010, *supra* note 74, art. 1, at ¶ 4 (“4. The provisions of this Regulation are without prejudice to the powers of the Commission, in particular under Article 258 TFEU, to ensure compliance with Union law.”).

¹⁴⁵ Council Regulation 1093/2010, *supra* note 74.

¹⁴⁶ *Id.* ¶ 43.

¹⁴⁷ *Id.* art. 27.

¹⁴⁸ Council Directive 2009/14, 2009 O.J. (L 68) 3 (EU).

¹⁴⁹ Council Regulation 1093/2010, *supra* note 74, art. 26.

¹⁵⁰ *Id.*

¹⁵¹ *See* Council Directive 2011/61, *supra* note 86 and accompanying text.

¹⁵² Council Regulation 1095/2010, *supra* note 74, art. 1.

¹⁵³ *Id.*

EBA.¹⁵⁴

The European Insurance and Occupational Pension Authority (EIOPA)¹⁵⁵ is comparable to the Office of National Insurance in the U.S.¹⁵⁶ The EIOPA is entrusted with the supervision of all insurance and reinsurance undertakings, insurance intermediaries, and pension funds.¹⁵⁷ Analogous to the EBA¹⁵⁸ and the ESMA,¹⁵⁹ the EIOPA is also charged with taking a leading role in consumer protection by promoting “transparency, simplicity and fairness in the market for consumer financial products or services across the internal market.”¹⁶⁰ Overall, the EIOPA may be considered the European Supervisory Authority with the least power when compared to the EBA or the ESMA. Not only is the EIOPA subject to the limitations posed by the supervisory powers of the Commission and the EBA, the EIOPA is also prohibited from encroaching on Member State powers as they relate to pension funds.¹⁶¹

2. Proposed Framework for Crisis Management

The most important and far reaching initiatives of the European Union stem from the European Commission communications on crisis management in the financial sector since 2009.¹⁶² These communications resulted in the latest legislative proposal from July 20, 2011,¹⁶³ on the revisions of the Capital Requirements Directive (CRD IV).¹⁶⁴

¹⁵⁴ Council Regulation 1095/2010, *supra* note 74, art. 1, at ¶ 2 (“... without prejudice to the competence of the European Supervisory Authority (European Banking Authority) in terms of prudential supervision . . .”).

¹⁵⁵ Council Regulation 1094/2010, *supra* note 74.

¹⁵⁶ National Insurance Act of 2007, H.R. 3200, 110th Cong. § 1101 (2007) (establishing the Office of National Insurance).

¹⁵⁷ Council Regulation 1094/2010, *supra* note 74, art. 1, at ¶¶ 2–4.

¹⁵⁸ Council Regulation 1093/2010, *supra* note 74, art. 9.

¹⁵⁹ Council Regulation 1095/2010, *supra* note 74, art. 9.

¹⁶⁰ Council Regulation 1094/2010, *supra* note 74, art. 9, ¶ 1.

¹⁶¹ *Id.* art 2, at ¶ 4.

¹⁶² COM (2010) 579 final, *supra* note 11. See also *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank*, COM (2009) 561 final (Oct. 20, 2009); *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank*, COM (2010) 254 final (May 26, 2010), available at http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#funds. The European Parliament also provided recommendations on cross-border crisis management in the banking sector (so-called Ferreira Report). Draft Report with Recommendations to the Commission on Cross-Border Crisis Management in the Banking Sector, Comm. on Economic and Monetary Affairs, 2010/2006 (INI) (Apr. 7, 2010) (by Elisa Ferreira).

¹⁶³ See Comm’n Services, *supra* note 76.

¹⁶⁴ See, e.g., CRD IV Regulation and CRD IV Directive, *supra* note 10, at 10; see also *id.* at 1–2.

Based on the premise that public bail-outs of financial institutions should never happen again¹⁶⁵ and that banks must be allowed to fail like any other business, the Commission developed a framework for prevention, crisis management, and resolution of banks.¹⁶⁶ At the early intervention stage, the Commission proposed to reinforce the supervisory regime under the current Capital Requirements Directives (CRD),¹⁶⁷ adding more robust standards and more intrusive intervention tools.¹⁶⁸ The Commission further identified the drafting of recovery and resolution plans (living wills) as essential elements of effective crisis management.¹⁶⁹ The Commission noted that:

A requirement for up to date resolution plans would apply to all credit institutions and investment firms covered by the [resolution] regime, with the aim of ensuring the planning necessary to enable the business of the bank or firm to be transferred or wound down in an orderly manner in the event of its failure.¹⁷⁰

The content of such plans may include details on group structure, intra-group guarantees, service level agreements, and other operational information.¹⁷¹ Article 136 of the CRD provides additional preventative powers.¹⁷² Specifically, the ability of supervisory authorities to limit or modify risk exposure, to increase reporting, to restrict or to prohibit certain

¹⁶⁵ In this context, the European Commission has approved €4.6 trillion of state aid measures to financial institutions, of which more than €2 trillion were effectively used in 2008 and 2009. *See, e.g.*, Press Release, European Comm'n, Commission Wants Stronger and More Responsible Banks (July 20, 2011), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/915&format=HTML&aged=0&language=EN&guiLanguage=en>. In total, European Union governments paid state aid amounting to approximately 30% of the combined EU GDP, while the aid used until December 2009 amounts to 13%. *See, e.g.*, COM (2010) 579 final, *supra* note 11, at 2.

¹⁶⁶ COM (2010) 579 final, *supra* note 11; DG Working Document, *supra* note 10.

¹⁶⁷ *See* Council Directive 2006/48, 2006 O.J. (L 177) 1 (EC); Council Directive 2006/49, 2006 O.J. (L 177) 201 (EC).

¹⁶⁸ COM (2010) 579 final, *supra* note 11, at 5.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 6.

¹⁷¹ *Id.*

¹⁷² Council Directive 2006/48, *supra* note 167, at 50 (“Article 136 - 1. Competent authorities shall require any credit institution that does not meet the requirements of this Directive to take the necessary actions or steps at an early stage to address the situation.

For those purposes, the measures available to the competent authorities shall include the following: (a) obliging credit institutions to hold own funds in excess of the minimum level laid down in Article 75; (b) requiring the reinforcement of the arrangements, processes, mechanisms and strategies implemented to comply with Articles 22 and 123; (c) requiring credit institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements; (d) restricting or limiting the business, operations or network of credit institutions; and (e) requiring the reduction of the risk inherent in the activities, products and systems of credit institutions . . .”).

activities, and to require a change to the legal corporate structure and business arrangement.¹⁷³

While many of these steps mimic developments at the international level¹⁷⁴ and in the United States under Dodd-Frank,¹⁷⁵ the European approach is different with regard to recovery and the determination of when a bank should be subject to wind down.¹⁷⁶ The Commission recognized that a bank's breach of capital requirements might not necessarily mean that the institution is encountering serious problems which inevitably would lead to failure.¹⁷⁷ More importantly, the Commission proposal balanced the interest of property rights of shareholders and creditors with liquidation as an intervention in the public interest and concluded that resolution actions may not be taken before all other realistic recovery options are exhausted.¹⁷⁸

Although primarily mentioned in the context of SIFIs,¹⁷⁹ the Commission recognized that supplementary mechanisms enabling a financial institution to reorganize and continue as a going concern¹⁸⁰ may also be necessary to protect financial stability and to prevent anti-competitive results.¹⁸¹ While focused on making the threat of market exit a realistic option, the Commission did not consider liquidation as the only or best option for failing banks.¹⁸² The Commission therefore not only recognized that reorganization is an important option during crisis management in order to maintain crucial activities, but also that it may allow banks to stabilize, return to viability, and stay in the market place without the need for public bail-outs. The supplementary mechanism that the Commission specifically identified as a reorganization option is the debt write-down tool that allows the contractual or statutory conversion of debt to equity.¹⁸³

¹⁷³ COM (2010) 579 final, *supra* note 11, at 6.

¹⁷⁴ FIN. STABILITY BD., *supra* note 57, at 1. *See also* FIN. STABILITY BD., G20 Monitoring Progress – United States (Sept. 2010), *available at* http://www.financialstabilityboard.org/publications/r_110401x.pdf; FIN. STABILITY BD., G20 Monitoring Progress – Germany (Sept. 2010), *available at* http://www.financialstabilityboard.org/publications/r_110401g.pdf.

¹⁷⁵ Dodd-Frank Act, Pub. L. No. 111-203, § 115(d), 124 Stat. 1376 (2010) (“resolution plans”).

¹⁷⁶ *See, e.g., id.* §§ 214, 1442–1520.

¹⁷⁷ COM (2010) 579 final, *supra* note 11, at 7.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 11. The Commission refers to systemically important financial institutions (SIFIs) as large, complex financial institutions (LCFIs).

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.* at 8–9 (“The Commission will consider what reform of bank insolvency law is necessary to ensure that failed banks can be liquidated as a second phase . . . with the ultimate aim of ensuring that liquidation is a realistic option.”).

¹⁸³ *Id.* at 12; *see also* DG Working Document, *supra* note 10, at 51, 55, 86.

The Commission considered the option of a statutory write-down supplemented by either a comprehensive or targeted approach for additional debt-equity conversion.¹⁸⁴ The statutory debt write-down proposed by the Commission would be exercisable by any national resolution authority when an institution meets a predefined trigger condition for entry into resolution.¹⁸⁵ At that point, the authority would have the power to write down all equity and either write down subordinate debt or convert the debt into equity (so-called statutory core power).¹⁸⁶ Under the comprehensive approach, a discretionary amount of senior debt necessary to return the institution to solvency could also be converted into equity, in addition to the prior conversion of subordinated debt under the statutory core power.¹⁸⁷

The alternative to the Commission's comprehensive approach considered by the Commission is the targeted approach.¹⁸⁸ The targeted approach combines statutory and contractual elements of debt conversion. Prior to any financial distress, national resolution authorities would first require financial institutions to issue a fixed volume of "bail-inable" debt.¹⁸⁹ This fixed volume would be converted into equity on a statutory trigger, in addition to the conversion of debt under the statutory core power.¹⁹⁰ In sum, the Commission proposed to establish haircuts for all equity supplemented by a debt conversion of both subordinate and senior debt when the financial institution is in danger of insolvency. The ultimate goal of this supplementary debt conversion mechanism is to "ensure that an institution in difficulty returns to viability so as to maintain market and creditor confidence when the markets next open."¹⁹¹

Finally, analogous to the Dodd-Frank Act,¹⁹² the Commission also proposed to include the option of selling the institution or part of the institution to one or more purchasers without consent of the shareholders.¹⁹³ In order to clean the balance sheet of a troubled bank, the proposal allows the transfer of assets either to a temporary "bridge bank" or, in case of generally underperforming assets, to a "bad bank".¹⁹⁴

¹⁸⁴ DG Working Document, *supra* note 10, at 87–89.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 87.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 89.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 87.

¹⁹² *See, e.g.*, Dodd-Frank Act, Pub. L. No. 111-203, § 210, 124 Stat. 1376, 1460 (2010).

¹⁹³ COM (2010) 579 final, *supra* note 11, at 9–10; *see also* DG Working Document, *supra* note 10, at 52.

¹⁹⁴ COM (2010) 579 final, *supra* note 11, at 10; *see also* DG Working Document, *supra* note 10, at 52–55.

3. Revisions of the Capital Requirements Directives

On July 20, 2011, the European Commission adopted a new proposal on capital requirements for financial institutions.¹⁹⁵ The proposal will replace the current capital requirements directives 2006/48/EC¹⁹⁶ and 2006/49/EC,¹⁹⁷ and it marks an important step toward developing a comprehensive regime for crisis prevention, bank recovery, and resolution in the European Union. The proposal is also the first legal framework to incorporate the third Basel Accord endorsed by the G20 at its summit in Seoul in November 2010.¹⁹⁸ And, if enacted by the European Parliament and the Council, would apply to more than 8000 banks, amounting to approximately 53% of global assets.¹⁹⁹

The proposal consists of both a directive²⁰⁰ and a regulation.²⁰¹ The directive regulates access to deposit-taking activities, including sanctions, effective corporate governance and provisions preventing the overreliance on external credit ratings.²⁰² In addition, the directive also deals with the Basel III agreement as it relates to the provisions on capital buffers.²⁰³ Of particular interest are the measures proposed in the context of management risk taking²⁰⁴ and capital buffers.²⁰⁵

Considering the importance of effective risk control, the Commission proposes the establishment of a “risk committee to deal specifically with risk issues and prepare management body decisions on risk issues . . . [and to] assist the management body in its risk oversight role. . .”²⁰⁶ In addition, the Commission believes the establishment of an independent risk management function is essential in order to provide all levels of management with a complete and more accurate view on risks and possible risk exposure.²⁰⁷

Regarding capital buffers, the Commission proposes a system of dual capital buffers in addition to the capital requirements: a capital conservation buffer and a countercyclical capital buffer.²⁰⁸ The capital conservation

¹⁹⁵ IP/11/915, *supra* note 8.

¹⁹⁶ Council Directive 2006/48, *supra* note 167.

¹⁹⁷ Council Directive 2006/49, *supra* note 167.

¹⁹⁸ See G20 Seoul Summit, *supra* note 56 and accompanying text.

¹⁹⁹ IP/11/915, *supra* note 8.

²⁰⁰ CRD IV Directive, *supra* note 10.

²⁰¹ CRD IV Regulation, *supra* note 10.

²⁰² CRD IV Directive, *supra* note 10, at 2.

²⁰³ *Id.* Other changes relating to the third Basel Accord are part of the proposal for a regulation.

²⁰⁴ *Id.* at 11–12.

²⁰⁵ *Id.* at 12–13.

²⁰⁶ *Id.* at 11.

²⁰⁷ *Id.* at 12 (the proposal refers to “senior management” and “management body”).

²⁰⁸ *Id.*

buffer is aimed at loss absorbency in a financial crisis and has a target amount of 2.5% of risk-weighted assets of the highest quality.²⁰⁹ Financial institutions that fall below the buffer target are subject to limitations on discretionary distributions of earnings.²¹⁰

The additional countercyclical buffer that the Commission recommends seeks to protect financial stability and the economy at large by limiting the effects of various system-wide risks.²¹¹ The countercyclical buffer increases the size of the buffer range up to an additional 2.5%.²¹² The discretion to set the actual size of the countercyclical buffer is, however, left to national authorities and may be set between 0% and 2.5% of risk-weighted assets of the highest quality.²¹³ The ceiling of 2.5% is flexible, providing national authorities with the power to go beyond 2.5% if justified.²¹⁴ Regardless, if a member state sets the buffer above 2.5%, other Member States do have the additional discretion to accept or reject that judgment for financial institutions authorized in their own member state.²¹⁵ It is also noteworthy that in addition to restrictions on profit distributions, institutions whose capital falls below the buffers are subject to limitations on payments on Additional Tier 1 instruments,²¹⁶ bonuses and discretionary pension benefits.²¹⁷

Under the mutual recognition requirement, all Member States may be forced to harmonize the size of their countercyclical buffers Union-wide. If only one Member State, such as Germany, implements sizeable countercyclical buffers all other Member States will be forced to accept this requirement of up to 2.5% for their own financial institutions as long as these institutions are doing business in or maintaining branches and subsidiaries in Germany. Therefore, the financially stronger Member States with the largest financial sectors may dictate the size of countercyclical buffers for smaller Member States, thereby practically reducing any proposed national discretion. The only relevant area where some national discretion may remain is where countercyclical buffers are set above the ceiling for mutual recognition or between 2.5% and 5%. The Commission proposal explicitly allows Member States to implement countercyclical buffers of up to 5%, but limits mutual recognition to the 2.5% ceiling. Even in these instances, the proposed discretion may be misleading. For

²⁰⁹ *Id.*; see also *id.* art. 123, ¶ 1, at 133.

²¹⁰ *Id.* art. 123, ¶ 1, at 124, ¶ 3, at 133.

²¹¹ *Id.* art. 123, ¶ 1, at 124, ¶ 3, at 113.

²¹² *Id.* at 12; see also *id.* art. 126, ¶ 5, at 115.

²¹³ *Id.* art. 126, ¶ 1, at 13–14.

²¹⁴ *Id.* art. 126, ¶¶ 3, 5.

²¹⁵ *Id.*; see also *id.* art. 127, at ¶ 1.

²¹⁶ Additional Tier 1 capital is defined in the proposed regulation. CRD IV Regulation, *supra* note 10, arts. 48–52.

²¹⁷ CRD IV Directive, *supra* note 10, art. 131, at 13.

example, if the U.K. intends to set its countercyclical measure at 5% but Germany requires no more than 2.5%, it seems unlikely that the Bank of England and the British government, long term, would be willing to give German banks, a significant competitive advantage over their national financial institutions, especially if the British government maintains significant ownership in some of these institutions.

Finally, the Commission suggests a limitation on the use of external credit ratings.²¹⁸ Specifically, the Commission proposes that external credit ratings may only be used as one factor and that financial institutions with material credit risk exposure or a high number of counterparties should be required to develop additional internal rating models rather than only relying on external ratings.²¹⁹

In addition to the directive, the regulation²²⁰ proposed by the Commission aims to ensure the effectiveness of institutional capital regulation, It aims to protect depositors and to limit possible pro-cyclical effects while maintaining competitiveness of the European financial markets.²²¹ In order to achieve this goal the regulation not only implements the Basel III agreement,²²² it also focuses on maximum harmonization with the goal of achieving a true “single rule book.”²²³ The proposal seeks to harmonize different national supervisory regimes by almost entirely removing any options or discretion.²²⁴

As part of its proposal, the Commission has also adopted²²⁵ the Basel Committee’s minimum requirements on loss absorbency at the point of non-viability.²²⁶ Accordingly, “all Additional Tier 1 and Tier 2 instruments of an institution should be fully and permanently written down or converted fully into Common Equity Tier 1 capital at the point of non-viability of the institution.”²²⁷ In Article 49(1)(n), the proposed regulation defines one form of “Additional Tier 1 instruments” as a capital instrument in which “the provisions governing the instruments require the principal amount of the instruments to be written down, or the instruments to be converted to Common Equity Tier 1 instruments, upon the occurrence of a trigger

²¹⁸ *Id.* at 12.

²¹⁹ *Id.*

²²⁰ CRD IV Regulation, *supra* note 10.

²²¹ *Id.* at 2.

²²² *Id.* at 10–15. *See also* CRD IV Regulation, *supra* note 10, ¶ 24 & art. 87, at 20.

²²³ CRD IV Regulation, *supra* note 10, at 8.

²²⁴ *Id.*

²²⁵ CRD IV Regulation, *supra* note 10, ¶ 27, at 20.

²²⁶ Press Release, Bank for Int’l Settlements, *Final Elements of the Reforms to Raise the Quality of Regulatory Capital Issued by the Basel Committee* (Jan. 13, 2011), available at <http://www.bis.org/press/p110113.htm>.

²²⁷ CRD IV Regulation, *supra* note 10, at 20, ¶ 27.

event.”²²⁸

Contingent capital is defined as the conversion or write down of a financial institution’s debt securities into equity securities upon the occurrence of a predefined trigger event.²²⁹ As such, contingent capital would qualify as an “Additional Tier 1 instrument” under the Commission’s proposal. However, the Commission proposal seems to distinguish between different forms of contingent capital and additional Tier 1 instruments by defining different write-down and conversion requirements.²³⁰ Article 51(a)(i) sets a statutory default trigger at 5.125% of the common equity tier 1 ratio.²³¹ While upward exceptions are allowed,²³² the proposal also stipulates a specific and seemingly separate²³³ set of conversion and write-down requirements.²³⁴ First, if the instrument requires conversion into a common equity tier 1 instrument it is required to specify (a) the rate of conversion and the limit on the permitted amount of conversion,²³⁵ and (b) a range within which the instrument will convert into common equity tier 1 instruments.²³⁶ Second, if the instrument requires the principal amount to be written down upon the occurrence of a trigger event, the write-down is required to reduce (a) the claim of the holder of the instrument during liquidation,²³⁷ (b) the amount required to be paid in the event of the call of the instrument,²³⁸ and (c) the distributions made on the instrument.²³⁹

²²⁸ *Id.* at 76.

²²⁹ See discussion *supra* Part I; see also discussion *infra* Part IV.

²³⁰ With regard to the distinction by financial institution attempted in Article 51(a), the distinction is ambiguous and requires further clarification or amendment. Specifically, the statutory reference in § 51, ¶ (a) (“of the institution referred to in point (a) of Article 87”) is unclear and indeterminate.

²³¹ CRD IV Regulation, *supra* note 10, § 51, ¶ (a)(i).

²³² *Id.* § 51, ¶ (a)(ii).

²³³ *Id.* The statutory relationship between the three subsections in Article 51 is also open to interpretation. Article 51(a) seems to establish a statutory write-down tool similar to that proposed by the Commission in the DG Internal Market and Service Working Document. DG Working Document, *supra* note 10, at 87. At the same time, the exception to the default trigger event established in Article 51(a)(ii) requires an instrument with a specified trigger event included in the instrument, which is defined by the financial institution and necessarily must be based on contractual terms. This merges two concepts of the proposal in the DG Working Document the concept of a statutory debt write-down tool with that of a contractual write-down tool. It is unclear from the regulation proposal whether the additional trigger event requirements defined in section (b) and (c) are contingent upon the definition in section (a)(ii). In other words, it is unclear whether the requirements of section (b) and (c) only apply to “Additional Tier 1 instruments” that set at least a trigger event of 5.125% as a minimum requirement or whether these requirements are to be viewed as independent.

²³⁴ CRD IV Regulation, *supra* note 10, § 51, ¶¶ (b) and (c).

²³⁵ *Id.* § 51, ¶ (b)(i).

²³⁶ *Id.* § 51, ¶ (b)(ii).

²³⁷ *Id.* § 51, ¶ (c)(i).

²³⁸ *Id.* § 51, ¶ (c)(ii).

²³⁹ *Id.* § 51, ¶ (c)(iii).

C. National Initiatives in Europe

Many countries in Europe, including non-European Union Member States, have actively pursued a reform of national banking and insolvency laws.²⁴⁰ Although Switzerland is not a member of the European Union and the United Kingdom has not adopted the Euro, the Swiss approach and the approach of the United Kingdom to bank reorganization have served as examples for the reform of the German Banking Law as well as many European Union initiatives. The national initiatives in both countries suggest a need for convergence of international and European Union-wide bank recovery and resolution regimes. At the European Union level, there is some evidence that many national laws implemented during the crisis, including the German Banking Reorganization Act,²⁴¹ may need to be amended in order to meet the EU-wide objective of maximum harmonization with the goal of achieving a single-rule book.²⁴²

1. Bank Reorganization under Swiss Law²⁴³

The Swiss Federal Law on Banks and Savings and Loans²⁴⁴ includes specific rules for bank reorganization independent of the Swiss bankruptcy code.²⁴⁵ The reorganization procedure is part of the Swiss Supervisory Authority's (FINMA) intervention powers and may only be ordered if success is reasonably likely.²⁴⁶ In addition, sufficient evidence of pending insolvency, significant liquidity problems, or evidence that the bank is unable to meet capital requirements is required for this procedure.²⁴⁷ The Supervisory Authority may further appoint a trustee charged with drafting the reorganization plan.²⁴⁸ Unless challenged by creditors in court,²⁴⁹ the Authority approves and implements the plan without any court

²⁴⁰ See, e.g., Bundesgesetz über die Banken und Sparkassen, [Federal Law on Banks, Savings and Loans], BANKGESETZ [BANKG] Nov. 1934, vol. 8 (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>; see *infra* text accompanying note 243.

²⁴¹ *Id.*

²⁴² CRD IV Regulation, *supra* note 10, at 10.

²⁴³ Bundesgesetz über die Banken und Sparkassen [BANKG] [Federal Law on Banks and Savings and Loans] Nov. 8, 1934, SR 952 (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>.

²⁴⁴ Bundesgesetz über die Banken und Sparkassen [BANKG] [Federal Law on Banks and Savings and Loans] Nov. 8, 1934, SR 952 (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>.

²⁴⁵ Urs Zulauf, *Schweizer Banken Sanierungsrecht – geeignet für systemrelevante Banken?*, WERTPAPIER-MITTEILUNGEN: ZEITSCHRIFT 1525, 1530 (2010) (Ger.).

²⁴⁶ Bundesgesetz über die Banken und Sparkassen [BANKG] [Federal Law on Banks, Savings and Loans] Nov. 8, 1934, SR 952, at art. 28 (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>.

²⁴⁷ *Id.* art.25, ¶ 1.

²⁴⁸ *Id.* art. 28, ¶ 3.

²⁴⁹ *Id.* art. 31a, ¶¶ 2–3.

confirmation.²⁵⁰ In addition to the Swiss Supervisory Authority's central role in initiating and overseeing a possible reorganization procedure, the Authority may also reduce or avoid claims and may defer or cease any debt payments.²⁵¹ As in the U.S.,²⁵² the principle of "no creditor worse-off than in liquidation" applies; the impairment of creditors' claims is limited to the amount of the claim in liquidation.²⁵³

Similar to many European civil law jurisdictions, in Switzerland the Swiss Supervisory Authority has a dual role as supervisory and resolution authority of financial institutions at the same time. An administrative agency, rather than a bankruptcy court therefore generally oversees insolvency proceedings in Switzerland. The perceived advantage is better knowledge of the banking sector that may result in a more efficient and expeditious procedure. The clear disadvantage is the broad discretion of the agency in overseeing financial institutions. Furthermore, under Swiss law the investigatory and supervisory role of creditors are limited. There is no mandatory requirement to appoint creditors' committees. Finally, Swiss law does not provide for an automatic stay or allow the financial institution or creditors to challenge any of the measures ordered by the Supervisory Authority other than plan approval.²⁵⁴

The Swiss legislature has enacted and amended the Swiss Bank Act.²⁵⁵ The latest amendments specifically focus on the creation of a legal basis for contingent capital that would allow financial institutions to meet capital requirements through the issuance of contingent capital.²⁵⁶

2. *The British Banking Act of 2009*

The British Banking Act may be the most comprehensive legal framework in response to the turmoil of the financial crisis.²⁵⁷ Before 2008, the United Kingdom did not have a permanent statutory regime for dealing with bank failures.²⁵⁸ It introduced the Banking (Special Provisions) Act of

²⁵⁰ *Id.* art. 32.

²⁵¹ *Id.* art. 26.

²⁵² *See, e.g.*, U.S. Bankruptcy Code, 11 U.S.C. § 1129(a)(7)(ii) (2006).

²⁵³ Bundesgesetz über die Banken und Sparkassen [BANKG] [Federal Law on Banks, Savings and Loans] Nov. 8, 1934, SR 952, at art. 31(b) (Switz.), *available at* <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf>.

²⁵⁴ Zulauf, *supra* note 248, at 1531 (Zulauf argues that in light of the expeditious nature of the procedure creditors are provided with too many rights).

²⁵⁵ *See infra* Part IV.C.

²⁵⁶ *Id.*

²⁵⁷ *See, e.g.*, Paul Anning & Matthias Terlau, *Maßnahmen gegen die Finanzmarktkrise – Großbritannien* [Measures to tackle the financial crisis—UK], 55 *Recht der Internationalen Wirtschaft* 54 (2009) (Ger.); Höche, *supra* note 7, at 51.

²⁵⁸ *See* Banking Act, 2009, c.1, Explanatory Notes, ¶ 7 (U.K.), *available at* <http://www.legislation.gov.uk/ukpga/2009/1/notes>.

2008 in response to the Northern Rock failure.²⁵⁹ The Banking (Special Provisions) Act of 2008, however, only provided a temporary regime allowing the Treasury to facilitate an orderly resolution of banks and maintain financial stability.²⁶⁰ The Banking (Special Provisions) Act of 2008 lapsed on February 20, 2009,²⁶¹ and was replaced by the Banking Act 2009.²⁶²

The Banking Act 2009 (the Act) established a permanent special resolution regime (SRR) providing the authorities in the United Kingdom with the necessary tools to deal with banks in financial distress.²⁶³ The Act provides for three distinct options under SRR: (1) a stabilization procedure focusing on asset transfer;²⁶⁴ (2) a new bank insolvency procedure²⁶⁵ focusing on orderly wind-down and liquidation;²⁶⁶ and (3) a new bank administration procedure.²⁶⁷ The decision to exercise a procedure under the SRR requires participation of the Tripartite Authorities: the HM Treasury, the Bank of England, and the Financial Services Authority (FSA).²⁶⁸ The Tripartite Authorities coordinate, cooperate, and share information at each stage of the decision making process.²⁶⁹

Before choosing among the different resolution tools, the Bank of England must conduct a benefits analysis and consider the relative

²⁵⁹ Banking (Special Provisions) Act, 2008, c. 2 (U.K.), available at http://www.legislation.gov.uk/ukpga/2008/2/pdfs/ukpga_20080002en.pdf.

²⁶⁰ See, e.g., Banking Act 2009 (Commencement No. 1) Order, 2009, c.14, Explanatory Note (U.K.), available at <http://www.legislation.gov.uk/uksi/2009/296/note/made>; see also Banking Act, 2009, c. 1, § 262 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2009/1/section/262>.

²⁶¹ Banking Act, 2009, c. 1, §§ 262–64 (U.K.), available at http://www.legislation.gov.uk/ukpga/2009/1/pdfs/ukpga_20090001_en.pdf.

²⁶² Banking Act, 2009, c. 1 (U.K.), available at http://www.legislation.gov.uk/ukpga/2009/1/pdfs/ukpga_20090001_en.pdf. See also Banking Act 2009 (Commencement No. 3) Order, 2009, available at <http://www.legislation.gov.uk/uksi/2009/2038/contents/made>; Banking Act 2009 (Commencement No. 4) Order, 2009, available at <http://www.legislation.gov.uk/uksi/2009/3000/contents/made>.

²⁶³ Banking Act, 2009, c.1, §4 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2009/1/section/4>.

²⁶⁴ The stabilization procedures offers three different options, all of which focus on asset transfer: (1) transfer to a private sector purchaser, (2) transfer to a bridge bank, and (3) transfer to temporary public ownership.

²⁶⁵ Banking Act, 2009, c. 1, §§ 90–135 (U.K.).

²⁶⁶ *Id.* § 96.

²⁶⁷ *Id.* §§ 136–68.

²⁶⁸ The tripartite structure of the Supervisory Authorities of the U.K. financial system bears clear resemblance to the so-called “three key turn” under Dodd-Frank, see, e.g., SKEEL, *supra* note 1, at 130.

²⁶⁹ See, e.g., HM Treasury, Banking Act 2009 Special Resolution Regime: Code of Practice, at 11, available at http://www.hm-treasury.gov.uk/d/bankingact2009_code_of_practice.pdf.

advantage of the stabilization option over insolvency and wind-down.²⁷⁰ The stabilization procedure may only be initiated after the Financial Services Authority (FSA) determines that three conditions are met.²⁷¹ First, the FSA must conclude that the institution is failing or unlikely to satisfy certain threshold conditions.²⁷² Second, the FSA must find that it is not reasonably likely that the bank will take or be able to take any action to meet the threshold conditions.²⁷³ Third, the FSA must also decide that there is no realistic prospect that the bank will operate as an authorized deposit taker.²⁷⁴ In addition to the aforementioned conditions, the Bank of England is required to establish that the stabilization procedure is necessary to protect the stability of the financial system of the United Kingdom, to ensure public confidence in the stability of the system, and to protect depositors.²⁷⁵

Stabilization may be the best option when transfers to a private sector purchaser, to a bridge bank, or temporary public ownership seem more cost effective or any such transfers would provide a better platform and starting point for reorganization.²⁷⁶ However, insolvency may be the best option if contagion is a real threat and liquidation would affect overall system stability as well as creditors' and depositors' confidence. The factors in favor of exercising the insolvency procedure include, for example, considerations of whether a wind down would be fair and equitable or whether it would be in the public interest.²⁷⁷ The new bank administration procedure is a procedure that specifically deals with the wind down of the insolvent residual bank that remains after a partial asset transfer to a bridge bank or private sector purchaser was executed.²⁷⁸

Although the Act does not explicitly refer to contingent capital, debt-equity swaps or write-down tools, the Act does allow the use of company voluntary arrangements,²⁷⁹ which may fulfill the very same purpose as any traditional debt-equity swap in bankruptcy.²⁸⁰ In addition, one bank in the

²⁷⁰ *Id.* at 15, ¶ 5.18.

²⁷¹ Banking Act, 2009, c.1, §7 (U.K.).

²⁷² Financial Services and Market Act, 2000, c. 8, § 41 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2000/8/contents>.

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ *Id.* § 8.

²⁷⁶ *Id.* ¶¶ 5.19–5.22.

²⁷⁷ Banking Act, 2009, c. 1, §96 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2009/1/section/262>.

²⁷⁸ *Id.* ¶¶ 7.5–7.8, at 29. The administrative procedure is based on the administrative procedure under Schedule B1 of the Insolvency Act 1986.

²⁷⁹ *Id.* § 113.

²⁸⁰ *Id.* § 154; see also Insolvency Act, 1986, c. 45, § 1(1) (U.K.) (“The directors of a company . . . may make a proposal under this Part to the company and to its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs (from here

U.K., the Lloyd's Banking Group²⁸¹ has already issued contingent capital and a second, Barclays²⁸² is attempting to do the same. The Lloyd's Banking Group issued its contingent convertibles as enhanced capital notes, which are classified under Basel II as subordinate debt or lower tier-2 capital,²⁸³ and do not require any additional regulatory validation. Furthermore, the U.K. is currently also considering additional banking law reform, which specifically centers on making the U.K. banking system more stable and more competitive.²⁸⁴ Contingent capital may be used as a supplementary measure to create effective loss-absorbing debt.²⁸⁵

3. *The German Banking Reorganization Act of 2010*

Late in 2011, Germany followed other European countries and enacted its own bank reorganization law.²⁸⁶ The law includes three main sections addressed in this article: (1) the Financial Institution Reorganization Act (*Kreditinstitute-Reorganisationsgesetz*),²⁸⁷ (2) the Amendment to the German Banking Act (*Kreditwesengesetz*),²⁸⁸ and (3) the Law Establishing the Reorganization Fund for Financial Institutions (*Restrukturierungsfondsgesetz*).²⁸⁹

Most noteworthy, the law creates a two-tiered approach to bank reorganization. The first tier focuses on voluntary reorganization procedures solely initiated by the financial institutions prior to or outside of

on referred to, in either case, as a 'voluntary arrangement').")

²⁸¹ JACKIE INEKE ET AL., MORGAN STANLEY RES., INVESTMENT GRADE CREDIT: EUROPEAN BANKS 25 (2011).

²⁸² Patrick Jenkins, *Barclays Set to Follow Swiss Lead*, FIN. TIMES (Feb. 14, 2011), <http://www.ft.com/intl/cms/s/0/7f3c49ea-386e-11e0-959c00144feabdc0.html#axzz1THW9e9vY>. See also *infra*, note 517 and accompanying text.

²⁸³ George M. Furstenberg, *Contingent Capital to Strengthen the Private Safety Net for Financial Institutions: Cocos to the Rescue* 10 (Deutsche Bundesbank, Discussion Paper Series 2: Banking and Financial Studies No. 01/2011, 2011), available at http://www.bundesbank.de/download/bankenaufsicht/dkp/201101dkp_b_.pdf.

²⁸⁴ INDEPENDENT COMMISSION ON BANKING, INTERIM REPORT CONSULTATION ON REFORM OPTIONS, EXECUTIVE SUMMARY I (2011).

²⁸⁵ *Id.* at 7.

²⁸⁶ Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung [RStruktG] [German Banking Reorganization Act], Dec. 9, 2010, BGBl I at 1900.

²⁸⁷ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBl. I at 1900 (Ger.) [hereinafter [KredReorgG][Financial Institution Reorganization Act]].

²⁸⁸ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BUNDESGESETZBLATT, Titel I [BGBl. I] at 2776 [hereinafter [KWG] [German Banking Act]].

²⁸⁹ Gesetz zur Einrichtung eines Restrukturierungsfonds für Kreditinstitute [RStrukFG] [Law Establishing the Restructuring Fund for Financial Institutions], Dec. 9, 2010, BGBl. I at 1900 (Ger.).

any formal insolvency proceeding. The second tier allows for increased early regulatory intervention by the Federal Financial Supervisory Authority (BaFin),²⁹⁰ including asset transfer.²⁹¹ Analogous to the European Union Commission proposal,²⁹² the German law follows an early intervention strategy and attempts to address the issue of “too big to fail” or “too interconnected to fail.” As in the United States, the possibility of insolvency proved to be an insufficient threat for financial institutions during the height of the financial crisis in Germany. Financial institutions in Germany relied on state aid to be bailed out. The reliance on a public bail-out without the threat of any significant losses shared by management, shareholders and creditors may have created an asymmetric incentive for excessive risk taking by financial institutions.²⁹³ The German law tries to address this failure by making market exit without state aid for financial institutions a credible and not merely a theoretical option.

(a) The German Financial Institution Reorganization Act

The Financial Institution Reorganization Act (*Kreditinstituten-Reorganisationsgesetz*)²⁹⁴ establishes a reorganization procedure specifically aimed at financial institutions in Germany. This procedure is different from a formal insolvency procedure under German law. This is of particular importance because the German Insolvency Act (German Bankruptcy Code)²⁹⁵ until recently continued to be primarily associated with liquidation as the only option for insolvent businesses and corporations.²⁹⁶

Unlike the U.S. Bankruptcy Code, the German Insolvency Act does

²⁹⁰ Bundesanstalt für Finanzdienstleistungsaufsicht [BaFin]; *see* Finanzdienstleistungsaufsichtsgesetz [FinDAG] [Act Establishing the Federal Financial Supervisory Authority], Apr. 22, 2002, BGBL. I at 1310 (Ger.).

²⁹¹ Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung [RStruktG] [German Banking Reorganization Act], Dec. 9, 2010, BGBL I at 1900. (The German Banking Reorganization Act includes two additional sections that are noteworthy. The first section qualifies the powers of the Federal Agency for Financial Market Stabilization (“Bundesanstalt für Finanzmarktstabilisierung (FSMA)”). The second amends the statute of limitations for the liability of board members of public limited companies for wrongful acts or negligence.)

²⁹² *See supra* Part III.B.2., note 163 and accompanying text.

²⁹³ Coffee, *supra* note 26, at 798–99; *see* Charles W. Calomiris & Richard J. Herring, *Why and How to Design a Contingent Convertible Debt Requirement 1* (Apr. 19, 2011) (Working Paper, on file Univ. of Pa.), *available at* <http://ssrn.com/abstract=1815406>.

²⁹⁴ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900 (Ger.).

²⁹⁵ Insolvenzordnung [InsO] [German Insolvency Act], Oct. 5, 1994, BGBL. I at 2866.

²⁹⁶ Schuster & Westpfahl, *supra* note 2, at 221; Lars Westpfahl, *Vorinsolvenzliches Sanierungsverfahren*, 2010 ZEITSCHRIFT FÜR UNTERNEHMENS – UND GESELLSCHAFTSRECHT [ZGR] 385, 392 (Ger.).

not clearly distinguish between Chapter 7 liquidation and Chapter 11 reorganization procedures. As a result, the German law traditionally stands much closer to the original meaning of bankruptcy, implying the idea of liquidating the debtor's present assets and distributing these assets among creditors on an equitable basis.²⁹⁷ In addition, the German regulatory intervention regime for financial institutions did not allow for any procedure that would have reliably permitted operating a bank as a going concern during the financial crisis. One of the few tools available was a so-called moratorium to restrict deposits and withdrawals or to temporarily close the bank for business.²⁹⁸ It is unlikely that any one person or investor would conduct business with a financial institution limited in that manner.²⁹⁹

The German Financial Institution Reorganization Act entered into force on January 1, 2011, and is in part modeled after the Swiss Law and the UK Banking Act of 2008 and 2009.³⁰⁰ However, some similarities to the U.S. Bankruptcy Code can also be observed.

The German law emphasizes a voluntary reorganization petition filed by the financial institution in distress with the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin)).³⁰¹ The law further distinguishes between two independent procedures, the stabilization procedure (*Sanierungsverfahren*) and the reorganization procedure (*Reorganisationsverfahren*).³⁰²

²⁹⁷ In Germany, the opinion that a financial institution cannot be reorganized after petitioning for bankruptcy protection persists. See Westpfahl, *supra* note 300, at 392; Reinhard Bork, *Grundfragen des Restrukturierungsrechts – Prologue zu einer Reform des deutschen Insolvenzrechts*, 2010 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT UND INSOLVENZPRAXIS [ZIP] 397. See also Heribert Hirte, Bela Knopf & Sebastian Mock, *Das Gesetz zur Erleichterung der Sanierung von Unternehmen* (Teil I), 2011 Der Betrieb [DB], 632 (arguing that with the new reform of the German Insolvency Act, taking effect on March 1, 2012, the German legislature has now substantially increased creditors' autonomy by introducing a broader business reorganization procedure). On the U.S. view, see SKEEL, *supra* note 1. For a discussion of the original meaning of bankruptcy, see CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 1039 (2d ed. 2009).

²⁹⁸ See Gesetz über das Kreditwesen (Kreditwesengesetz) [KWG] [German Banking Act] Sept. 9, 1998, BGBL. I at 2776, as amended, § 47; see also Schuster & Westpfahl, *supra* note 2, at 392; Bork, *supra* note 297, at 406.

²⁹⁹ See Schuster & Westpfahl, *supra* note 2, at 221; see also Gregor Bachmann, *Das neue Restrukturierungsrecht der Kreditinstitute*, 2010 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT [ZBB] 459 (Ger.); Jens-Hinrich Binder, *Institutionalisierte Krisenbewältigung bei Kreditinstituten*, 2009 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT [ZBB] 19, 21 (Ger.).

³⁰⁰ See discussion *supra* Part III.C.1. and III.A.2.

³⁰¹ See Gesetz zur Reorganisation von Kreditinstituten (Kreditinstitute-Reorganisationsgesetz) [KredReorgG] [Financial Institution Reorganization Act] Dec. 9, 2010, BGBL. I, at 1900; see also *supra* text accompanying note 294.

³⁰² Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 1(1) (Ger.).

(i) *Stabilization Procedure*

The stabilization procedure (*Sanierungsverfahren*)³⁰³ does not allow for a discharge of prior claims, the impairment of creditors' rights, or any encroachment of third party rights without party consent.³⁰⁴ However, the stabilization procedure permits the issuance of new shares, debt conversion, and debt rescheduling or debt subordination. The focus of the procedure is the voluntary participation of all creditor groups interested in recapitalizing the financial institution. Unlike the British stabilization procedure under the Banking Act 2009, the German stabilization procedure does not permit asset transfers at this stage and is controlled by the debtor. The main advantage of the stabilization procedure is the possibility for new lenders to receive a priming lien or super-priority for loans.³⁰⁵ Super-priority is extended for the duration of three years and effective only in case of the commencement of liquidation proceedings during that period.³⁰⁶ However, the total volume of all loans qualifying for super-priority during the stabilization procedure is limited to 10% of the bank's own funds.³⁰⁷

Any financial institution in Germany³⁰⁸ may initiate a stabilization procedure by voluntary petition.³⁰⁹ The financial institution must notify the Federal Supervisory Authority of its existing financial distress and need for reorganization. Along with the petition, the institution must submit a detailed stabilization plan and nominate a trustee (*Sanierungsberater*).³¹⁰

³⁰³ *Id.* § 2.

³⁰⁴ *Id.* § 2(2).

³⁰⁵ *Id.* This is clearly very similar to U.S. Bankruptcy Code 11 U.S.C. § 364(d), which permits the debtor in possession, after court approval, to incur debt "secured by a senior or equal lien on property of the estate that is subject to a lien." Note, however, if the financial institution files for bankruptcy within 3 years of the stabilization procedure, subordinated creditors may challenge the super-priority by claiming that the petitioner did not meet the conditions for the stabilization procedure and that the loan volume did not comply with the legal requirements. See § 3(2). One is further reminded of the absolute priority rule under U.S. Bankruptcy Code 11 U.S.C. § 1129(a)(8). See, e.g., David A. Skeel, *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 484 (1992).

³⁰⁶ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 2(2) (Ger.).

³⁰⁷ *Id.*

³⁰⁸ Gesetz über das Kreditwesen (Kreditwesengesetz) [KWG] [German Banking Act] Sept. 9, 1998, BGBL. I at 2776, as amended, § 1(1). In Germany, financial institutions are required to maintain their headquarters in the country in which they are registered. *Id.* § 33(6); see also art. 11, ¶ 2a; Council Directive 2006/48, *supra* note 167, art. 17.

³⁰⁹ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 2(1), (Ger.).

³¹⁰ *Id.* §2(2). Please note, the translation of "*Sanierungsberater*" as trustee is not a literal translation. Instead, the literal translation as "advisor" appears somewhat misleading in the U.S. context. Both the "*Sanierungsberater*" and the "*Reorganisationsberater*" display powers and functions similar to a trustee under U.S. bankruptcy law. It is important to note, however, that a trustee under the U.S. Bankruptcy Law also has some additional and more

Upon petition, the Authority reviews the petition, the proposed plan, and the qualifications of the nominated trustee. If all requirements are satisfied and no additional amendments to the plan are made, the Authority moves to petition³¹¹ the competent court for approval of the reorganization under the stabilization procedure and requests the confirmation of the reorganization plan.³¹² The court reviews the petition and the proposed plan independently for a second time.³¹³ If satisfied, the court confirms the plan and orders the appointment of the trustee.³¹⁴ Like the concept of a debtor in possession (DIP) under U.S. law,³¹⁵ the trustee may be a member of the board or other person directly associated with the financial institution petitioning for reorganization.³¹⁶ The main duty of the trustee is to supervise and implement the reorganization plan. The trustee may also act as an advisor to the troubled financial institution itself and directly participate in the corporate governance of the institution.³¹⁷

Unlike U.S. law, the court's confirmation of the plan does not complete the reorganization under the stabilization procedure. Instead, the successful implementation of the stabilization plan is a prerequisite.³¹⁸ During the implementation phase, the trustee continuously reports to the Federal Supervisory Authority and the court³¹⁹ and must provide detailed updates on the status of the implementation of the plan.³²⁰ The court may further order additional measures if it deems them necessary and depending

far-reaching powers when compared to those of the “*Sanierungsberater*” and “*Reorganisationsberater*” under German law.

³¹¹ *Id.* § 2(3).

³¹² The competent court is the Higher Regional Court (*Oberlandesgericht* or OLG) in Frankfurt/Main. See Finanzdienstleistungsaufsichtsgesetz [FinDAG] [Act Establishing the Federal Financial Supervisory Authority], Apr. 22, 2002, BGBL. I at 1310, § 1(3).

³¹³ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 3(1) (Ger.)

³¹⁴ *Id.* § 3(1). A court hearing is not required with the exception of cases in which the Federal Financial Supervisory Authority determined that the trustee nominated by the financial institution is not qualified. See § 2(3); see also § 1(3); § 1(2) (in conjunction with Zivilprozeßordnung [ZPO] [Federal Code of Civil Procedure], Dec. 5, 2005, as amended, §128, para. 4 (Ger.)); Gesetzentwurf Sept. 27, 2010, BT 17/3024, at 44 (Ger.).

³¹⁵ 11 U.S.C.A. §§ 1101, 1107 (2006).

³¹⁶ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 3(3) (Ger.). In addition, the court may order the trustee to participate in the management of all business aspects of the financial institution during the level 1 reorganization procedure. See *id.* §5(1), no. 2. If the trustee is a member of the board or associated with the financial institution, the Federal Financial Supervisory Authority may, however, petition the OLG Frankfurt to replace him. Good cause is not required for replacement. *Id.* § 3(3).

³¹⁷ *Id.* § 6(1).

³¹⁸ *Id.* § 6(3).

³¹⁹ *Id.* §§ 4(2), 6(2).

³²⁰ *Id.*

on the progress of plan implementation.³²¹ Specifically, the court can prohibit or restrict any activities of current executive officers or members of management, including present ownership.³²² The court may also appoint the trustee as an active member of management who participates in corporate governance during the reorganization.³²³ It can restrict or prohibit withdrawals and the distribution of profits,³²⁴ review existing remuneration and bonus agreements, and prohibit any payment for services not due.³²⁵ Most importantly, the court can pre-empt any required approval of the corporate supervisory board in the context of the reorganization.³²⁶

To complete the reorganization of any financial institution under the stabilization procedure, the trustee is required to notify the Federal Financial Supervisory Authority first.³²⁷ Following this notice, the trustee may notify the court of the completion, which then formally orders the conclusion of the procedure.³²⁸ If the stabilization procedure did not return the financial institution to solvency and has proved unsuccessful, the financial institution may be liquidated or may petition for protection under the reorganization procedure, which is the second independent reorganization procedure under German law.³²⁹

³²¹ *Id.* § 5.

³²² *Id.* § 5(1), no. 1.

³²³ *Id.* § 5(1), no. 2.

³²⁴ *Id.* § 5(1), no. 3.

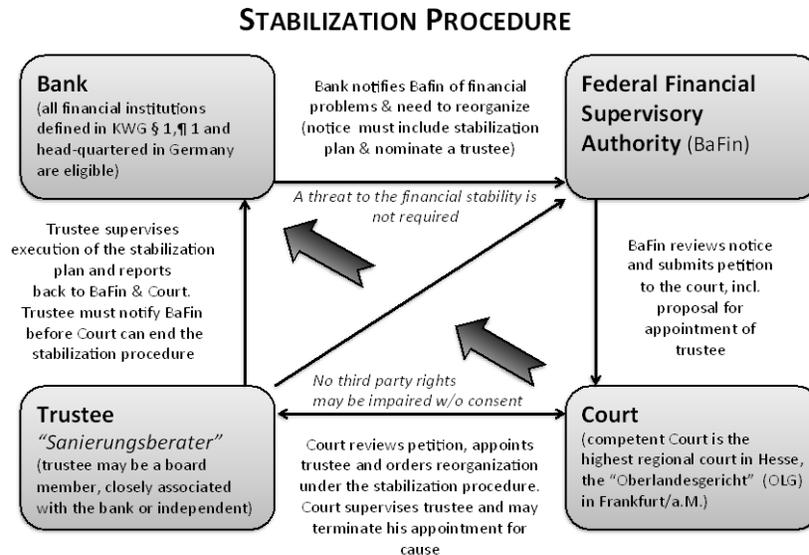
³²⁵ *Id.* § 5(1), no. 4.

³²⁶ *Id.* § 5(1), no. 5.

³²⁷ *Id.* § 6(3).

³²⁸ *Id.*

³²⁹ *Id.* §§ 6(3), 7.



(ii) *Reorganization Procedure*

The reorganization procedure (*Reorganisationsverfahren*) is only available to systemically important financial institutions.³³⁰ All other financial institutions must be liquidated or are limited to petition for protection under the stabilization procedure.³³¹ Given the threat of failure of a systemically relevant bank, the main focus of the reorganization procedure is the systemic relevance of any financial institution in distress and the avoidance of any possible threat of contagion to the entire financial system in Germany. Under German Law, systemically relevant banks have two options for reorganization. The banks may either reorganize under the

³³⁰ *Id.* § 7(2); see also Yvonne Stengel, *Das Kreditinstitute-Reorganisationsgesetz: Rechtliche Aspekte der zukünftigen Sanierung und Reorganisation von Kreditinstituten*, DER BETRIEB, Supp. 4, 2011, at 11, 12; Karsten Müller-Eising et al., *Das Banken-Restrukturierungsgesetz*, BETRIEBS-BERATER, Jan. 10, 2011, at 66, 70; Höche, *supra* note 7, at 54; Manfred Obermüller, *Das Bankenrestrukturierungsgesetz – Ein kurzer Überblick über ein langes Gesetz*, 3 NEUE ZEITSCHRIFT FÜR INSOLVENZRECHT 81, 88 (2011). Please note the term “systemically relevant” may be used interchangeably with the term “systemically important.”

³³¹ [KredReorgG] [Financial Institution Reorganization Act] § 3(3); see *supra* text accompanying note 333.

stabilization procedure or the reorganization procedure. The stabilization procedure is not required as a precondition for the reorganization procedure. Instead, if the systemically relevant bank is convinced that reorganization under the stabilization procedure is not an option, the bank may instead immediately petition the German Federal Financial Supervisory Authority (BaFin) for protection under the reorganization procedure.³³² In terms of systemically important financial institutions the voluntary reorganization procedure has one specific shortcoming. Unlike the involuntary reorganization procedure initiated by the Supervisory Authority under the German Banking Act,³³³ groups of financial institutions, financial holding groups, or conglomerates are not eligible to petition for protection under the voluntary reorganization procedure.³³⁴ Financial institutions in group structures and holdings will qualify as systemically important institutions. In case of failure, these entities may also pose the highest risk to the stability of the financial markets.

The German reorganization procedure is similar to the stabilization procedure. It is independent of the German Insolvency Act,³³⁵ while at the same time exhibiting similar aspects.³³⁶ The procedure also compares to Chapter 11 under U.S. Bankruptcy Law³³⁷ and the Arrangement Procedure under British Law.³³⁸ For example, claims must be filed and validated.³³⁹ Claims may be impaired, reduced, avoided, or deferred, and debt can be restructured without each individual creditor's consent.³⁴⁰ Nevertheless, employees' income, retirement claims, and certain secured interests³⁴¹ are exempt and protected.³⁴² In that sense, the reorganization procedure for

³³² Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBl. I at 1900, § 7(1) (Ger.).

³³³ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776.

³³⁴ Schuster & Westpfahl, *supra* note 2, at 282–83.

³³⁵ See KredReorgG [Financial Institution Reorganization Act]; see Insolvenzordnung [InsO] [German Insolvency Statute] Oct. 5, 1994, BGBl. I 2866; see Schuster & Westpfahl, *supra* note 2, at 221; see Lars Westpfahl, *Vorinsolvenzliches Sanierungsverfahren*, 2010 ZEITSCHRIFT FÜR UNTERNEHMENS – UND GESELLSCHAFTSRECHT [ZGR] 385, 392 (Ger.).

³³⁶ See Schuster & Westpfahl, *supra* note 2, at 225.

³³⁷ See, e.g., U.S. Bankruptcy Act, 11 U.S.C. § 1101(1) (2006) (the concept of a debtor in possession (DIP) is exhibited in the German provisions of the Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBl. I at 1900, § 3(3) (Ger.), which in resemblance of a DIP permits that the appointed trustee (“*Sanierungsberater*”) may be a member of the distressed bank).

³³⁸ Banking Act, 2009, c.1, §§ 113, 154 (U.K.).

³³⁹ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBl. I at 1900, § 14 (Ger.).

³⁴⁰ *Id.* at §12.

³⁴¹ *Id.* Creditor claims protected by any voluntary or statutory deposit insurance cannot be impaired (“*Einlagensicherungsfonds*”).

³⁴² *Id.* One intention for the protection of employees' and other rights was the desire to

financial institutions under German Law provides many aspects of bankruptcy protection at a pre-insolvency stage. Generally, the impairment of creditors' rights is permitted without consent.³⁴³ But most important, the reorganization plan may permanently impair shareholders' rights.³⁴⁴ Assets may be sold or temporarily transferred,³⁴⁵ equity may be increased while pre-emptive rights of shareholders are excluded from any increase,³⁴⁶ and debt may be converted into equity (debt-equity swap).³⁴⁷ The conversion of debt into equity does, however, always require explicit creditor consent.³⁴⁸

In addition, the German law includes a potentially controversial provision, allowing appropriate compensation of shareholders in case of impairment.³⁴⁹ While a court-appointed expert determines the amount of compensation,³⁵⁰ this procedure may run counter to the motives of the law.³⁵¹ Time is of the essence in any bank reorganization and the appointment of an expert may significantly slow down the procedure, making it less effective. Waiting for court approval may take time as will the analysis of shareholders' claims by the expert. This is even more important as it is doubtful that creditors, at any time, may receive more than the value of their claims. Moreover, the impairment of shareholder rights generally seems appropriate when creditors' rights are also written down or

avoid class-action suits. Whether or not this will be successful seems questionable, specifically knowing that any systemically relevant financial institution may have a vast number of creditors who are neither members of a protected class or may have any protected claims. *See* Schuster & Westpfahl, *supra* note 2, at 227.

³⁴³ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 8(3) (Ger.).

³⁴⁴ *Id.* at §§ 9–11.

³⁴⁵ *Id.* § 11(1). *See also* Aktiengesetz [AktG][German Company Law], Sept. 6, 1965, BGBL. I at 1089, § 179(Ger.).

³⁴⁶ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 9(1) (Ger.).

³⁴⁷ *Id.*

³⁴⁸ *Id.* Creditors' consent may not be replaced by majority vote of its class in the creditors' committee. Cramdown is not permitted. Furthermore, the limit on hold-out in § 19(1) does not apply. Regardless, it is debatable whether consent may be replaced if the debt instrument includes provisions permitting decision-making by majority vote in accordance with the Gesetz über Schuldverschreibungen aus Gesamtemissionen [SchVG] [Law on the Issuance of Debentures], July 31, 2009, BGBL. I at 2512, § 5(3), No. 5, as amended (Ger.). The majority vote under SchVG, § 5(4), does require a qualified vote of 75% of creditors entitled to vote, which goes beyond the simple majority vote required under KredReorgG, 19(1). *Id.* At the same time, while SchVG, §19 refers to the German Bankruptcy Code in case of insolvency, SchVG does not include any reference to the KredReorgG. *See also* Schuster & Westpfahl, *supra* note 2, at 227 (arguing in favor of filling the described gap through contract law and private ordering).

³⁴⁹ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 9(2) (Ger.).

³⁵⁰ *Id.*

³⁵¹ *Id.*; *see also* Obermüller & Kuder, *supra* note 297, at 2019.

otherwise impaired.³⁵²

Like the stabilization procedure, the reorganization procedure also requires a voluntary petition.³⁵³ The financial institution must petition the Federal Financial Supervisory Authority,³⁵⁴ submit a reorganization plan, and nominate a trustee (*Reorganisationsberater*).³⁵⁵ After being notified, the Supervisory Authority must review the petition. The Authority has the discretion to submit the petition to the competent court after it determines that the existence of the financial institution is in danger, and that failure carries the risk of contagion and endangers the stability of the entire financial system.³⁵⁶

Under the German Banking Act,³⁵⁷ a bank is deemed to be in danger of failure if the financial institution's own funds,³⁵⁸ core capital,³⁵⁹ or modified available funds or liquidity³⁶⁰ have fallen below 90% of the required thresholds³⁶¹ or if there is reason to believe that failure to comply with the required thresholds is imminent.³⁶² The German Banking Act provides five non-exhaustive examples for determining the risk of contagion and systemic threat.³⁶³ The Financial Supervisory Authority may consider: (1)

³⁵² See, e.g., Gesetzentwurf der Bundesregierung, Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen [ESUG] [Draft Legislation of the German Government, Law to Simplify the Reorganization of Corporations], Feb. 23, 2011, § 245(3), No. 1, available at http://www.bmj.de/SharedDocs/Downloads/DE/pdfs/RegE_ESUG_23022011.pdf?__blob=publicationFile.

³⁵³ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBl. I at 1900, § 7 (Ger.).

³⁵⁴ *Id.* § 7(1).

³⁵⁵ *Id.* § 7(5).

³⁵⁶ *Id.* § 7(2).

³⁵⁷ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776.

³⁵⁸ *Id.* § 48b(1), no. 1 (“Going-concern risk shall be presumed to exist if (1) the available tier 1 capital represents less than 90 per cent of the tier 1 capital required pursuant to section 10(1) . . .”).

³⁵⁹ *Id.* § 48b(1), no. 2 (“Going-concern risk shall be presumed to exist if . . . (2) the modified available capital represents less than 90 per cent of the own funds required pursuant to section 10(1) . . .”).

³⁶⁰ *Id.* § 48b(1), no. 3 (“Going-concern risk shall be presumed to exist if . . . (3) the liquid assets available to the institution in a maturity band defined by the statutory order pursuant to section 11(1) and sentence 2 represent less than 90 per cent of the payment obligations that are callable in the same maturity band, or . . .”).

³⁶¹ *Id.* § 48b(1), nos. 1–3.

³⁶² *Id.* § 48b(1), no. 4 (“Going-concern risk shall be presumed to exist if . . . (4) the facts are known which warrant the assumption that a shortfall pursuant to numbers 1, 2 and 3 will occur if no corrective measures are taken; this is the case, in particular if a loss may be anticipated based on the institution’s earnings situation, as a result of which the conditions of numbers 1, 2, or 3 would be met.”).

³⁶³ *Id.* § 48b(2) (“Systemic risk shall be deemed to exist if there is concern that the credit institution’s going-concern risk could have a significantly negative impact on other financial

the nature and amount of the bank's liabilities toward other financial institutions,³⁶⁴ (2) the amount of deposits,³⁶⁵ (3) the nature, amount and risk composition assumed by the bank while taking current and relevant market conditions into consideration,³⁶⁶ (4) the bilateral netting of the bank,³⁶⁷ and (5) the financial market conditions and possible consequences of any failure for other financial institutions, the financial market, and the confidence in the stability of the financial markets by depositors and other market participants.³⁶⁸

Given this weighting, the German Banking Act seems to primarily consider the violation of regulatory requirements for the determination of system relevance and contagion but does not necessarily emphasize insolvency. This is very similar to the stabilization procedure under the SRR of the British Banking Act of 2009. Of further importance is the German focus on market reception and confidence in the viability of a financial institution.³⁶⁹ The German law does not stipulate any threshold conditions or determining factors for market reception or confidence. As a result, it will always be difficult to determine any of these factors in a reliable and objective manner. In addition, while the Supervisory Authority has broad discretion to determine the merit of a petition under the reorganization procedure,³⁷⁰ it is unclear³⁷¹ whether the Supervisory Authority will have the sole discretion to determine a threat or whether it will have to consult the German Central Bank.³⁷² In this context, while the German legislature was influenced by the British Banking Act of 2009, it did not develop a similar system of tripartite supervisory authorities or a system similar to the "three key turns" under Dodd-Frank.³⁷³

sector enterprises, on the financial markets or on the general confidence of depositors and other market participants in the proper functioning of the financial system. Particular account shall be taken of: (1) the nature and scope of the credit institution's liabilities to other institutions and other financial sector enterprises, (2) the volume of the deposits received by the institution, (3) the nature, scope and composition of the risks entered into by the institution as well as the conditions on the markets on which such positions are traded, (4) interconnectedness with other financial market participants, (5) the conditions on the financial markets, in particular the consequences which market participants expect the institution's collapse to have on other financial sector enterprises, on the financial market and on the confidence of depositors and market participants in the proper functioning of the financial market.").

³⁶⁴ *Id.* § 48b(2), no. 1.

³⁶⁵ *Id.* § 48b(2), no. 2.

³⁶⁶ *Id.* § 48b(2), no. 3.

³⁶⁷ *Id.* § 48b(2), no. 4.

³⁶⁸ *Id.* § 48b(2), no. 5.

³⁶⁹ *Id.*

³⁷⁰ See Gesetzentwurf Sept. 27, 2010, BT 17/3024 (Ger.).

³⁷¹ Schuster & Westpfahl, *supra* note 2, at 225.

³⁷² *Id.*

³⁷³ See, e.g., SKEEL, *supra* note 1, at 130 (explaining the concept of the "Three key turn")

If the Financial Supervisory Authority determines that the requirements for the reorganization procedure are fulfilled, it submits the petition to the competent court.³⁷⁴ The court must consider whether the requirements of the procedure have been met, including the formal requirements of the reorganization plan, such as the establishment of the creditors' committees and their voting rights.³⁷⁵ After a hearing in which the Supervisory Authority, the German Central Bank, and the petitioning financial institution are heard, the court may issue a declaratory order establishing that the petitioning bank is in danger of failing with a risk of contagion. Simultaneously the court may also order the immediate reorganization and appoint the trustee (*Reorganisationsberater*).³⁷⁶ All court orders are sealed and the hearings are conducted in private.³⁷⁷ In addition, the court may stay termination rights of all obligations and contracts, such as derivatives, swaps or repurchasing agreements. The stay starts on the date of the initial petition to the Financial Supervisory Authority and terminates at the end of the next business day following that petition date.³⁷⁸ Assuming the petition was filed on a Friday, termination rights and close-out-netting may be stayed for up to 96 hours.³⁷⁹

The reorganization plan is comparable to a Chapter 11 plan, but yet

as part of the basic framework of bail-out under the Dodd-Frank Act); *but see* Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBL. I at 2776, §§ 8–8e.

³⁷⁴ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 7(5) (Ger.) (“Soweit für das Reorganisationsverfahren nichts anderes bestimmt ist, gelten die Vorschriften über das Sanierungsverfahren entsprechend. § 46d Absatz 1 bis 4 des Kreditwesengesetzes gilt entsprechend. Für Kreditinstitute, die in anderer Rechtsform als einer Aktiengesellschaft verfasst sind, gelten die folgenden Vorschriften sinngemäß.”).

³⁷⁵ *Id.* § 7(1), (5).

³⁷⁶ The trustee, in analogy to the stabilization procedure, may be installed as a member of the management of the failing financial institution. At the same time, part of the trustee’s role is to work toward and help in the acceptance of the reorganization plan. This establishes a hybrid role of the trustee that is very similar to the debtor in possession (DIP) under U.S. Bankruptcy Law. While this has been very successful in the United States, many in Europe continue to fear a conflict of interest. *See, e.g.*, Frank Frind, *Unabhängigkeit – Kein Wert Mehr an Sich? - Die Auswahl und Berufliche Stellung des Insolvenzverwalters Nach den Neuen Regelungsentwürfen zur Änderung der InsO*, NZI 705 (2010).

³⁷⁷ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 22(3) (Ger.).

³⁷⁸ *Id.* § 13.

³⁷⁹ *Id.* (“Schuldverhältnisse mit dem Kreditinstitut können ab dem Tag der Anzeige nach § 7 Absatz 1 bis zum Ablauf des folgenden Geschäftstages im Sinne des § 1 Absatz 16b des Kreditwesengesetzes nicht beendet werden. Eine Kündigung gegenüber dem Kreditinstitut ist in diesem Zeitraum ausgeschlossen. Die Wirkung sonstiger in diesem Zeitraum eintretender Beendigungstatbestände ist bis zu seinem Ablauf aufgeschoben. Abweichende Vereinbarungen sind unwirksam . . .”). Gesetz über das Kreditwesen [KWG] [German Banking Act] Sept. 9, 1998, BGBL. I at 2776, 16(b) (“Der Geschäftstag eines Systems umfasst Tag und Nachtabschlüsse und beinhaltet alle Ereignisse innerhalb des üblichen Geschäftszyklus eines Systems.”).

different. The trustee verifies creditors' claims, but he also directly contacts the creditors informing them of their rights. The plan requires the establishment of a creditor committee consisting of various creditor classes. Generally, the plan is drawn up by the creditors and may include the transfer of assets or even the liquidation of the bank.

Plan approval requires a simple majority of all creditors in each class and a majority exceeding 50% of the sum of the claims in each class.³⁸⁰ If a class of creditors objects to the plan, the objecting class can be crammed down. However, cramdown is only possible if the majority of all other classes have approved the plan. Regardless of cram down, the objecting class is allowed an adequate share in the distribution of the plan,³⁸¹ where the principle of "no creditor worse-off than in liquidation" applies.³⁸²

As a separate class, shareholders are also required to approve the plan.³⁸³ The trustee convenes an extraordinary shareholder meeting during which the plan is approved.³⁸⁴ Shareholder approval requires a simple majority vote of the attending shareholders if no pre-emptive rights or equity positions are impaired by the plan.³⁸⁵ If the latter is the case, either a two-thirds majority of the attending shareholders or a simple majority of the shareholders representing 50% of the share capital is required.³⁸⁶ Should shareholders reject the plan a cramdown option is also available.³⁸⁷ Shareholder approval is assumed if the majority of all classes of creditors approved the plan.³⁸⁸

Once approved by the creditor committee, the court confirms the plan and concludes the reorganization procedure.³⁸⁹ This is similar to the Chapter 11 reorganization procedure³⁹⁰ but unlike the stabilization procedure in which the trustee has the power and responsibility to initiate conclusion proceedings.³⁹¹

³⁸⁰ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 22(3) (Ger.).

³⁸¹ *Id.* § 19(2).

³⁸² *Id.*

³⁸³ *Id.* § 18.

³⁸⁴ *Id.* § 18(2). The main reason to require a shareholder meeting is the European Union Council Directive 77/91, 1976 O.J. (L 26) 1 (EC) and various European Court of Justice cases, e.g., Case C-19/90 & C-20/90, *Karella v. Minister for Indus., Energy, and Tech.*, 1991 E.C.R. I-2691; Case C-381/89, *Syndesmos v. The Greek State*, 1992 E.C.R. I-2111; Case C-441/93, *Pafitis v. Trapeza Kentrikis Ellados AE*, 1996 E.C.R. I-1347.

³⁸⁵ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900, § 18(3) (Ger.).

³⁸⁶ *Id.*

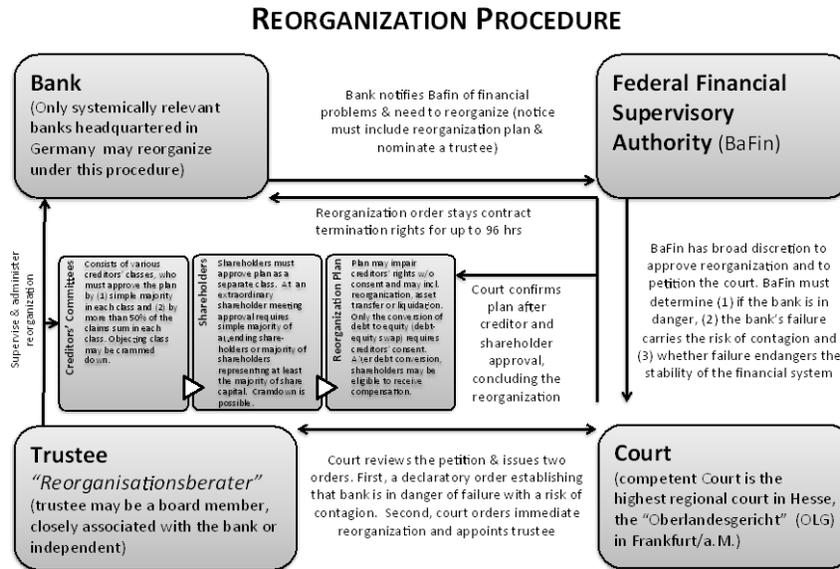
³⁸⁷ *Id.* § 19(4) (cramdown).

³⁸⁸ *Id.*

³⁸⁹ *Id.* § 22(1).

³⁹⁰ U.S. Bankruptcy Code 11 U.S.C. § 1141(a) (2006).

³⁹¹ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution



(b) Regulatory intervention powers and procedures

The amendments to the German Banking Act³⁹² significantly increase the Federal Financial Supervisory Authority's (BaFin) intervention powers.³⁹³ The Supervisory Authority will likely exercise primary oversight over the reorganization of systemically relevant banks by relying on the powers established in these amendments, including the involuntary petition for reorganization. Furthermore, in context of these increased powers the likelihood that any systemically important bank may file a voluntary petition under the German stabilization or reorganization procedure seems remote at best. This is confirmed by the fact that the German Banking Act, unlike the German Financial Institutions Reorganization Act, also applies to groups of financial institutions,³⁹⁴ financial holdings,³⁹⁵ and conglomerates³⁹⁶ headquartered in Germany.

Reorganization Act], Dec. 9, 2010, BGBl. I at 1900, § 6(3) (Ger.).

³⁹² Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776.

³⁹³ Dirk Auerbach & Kristen Donner, *Änderungen bei den aufsichtlichen Eingriffsinstrumenten des KWG durch das Restrukturierungsgesetz*, DER BETRIEB, Jan. 4, 2011, at 17.

³⁹⁴ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776, § 480 ("Measures relating to subordinated enterprises of groups of institutions").

³⁹⁵ *Id.* § 48p ("Measures at financial holding groups").

³⁹⁶ *Id.* § 48q ("Measures at financial conglomerates").

The intervention powers of the Authority are very broad³⁹⁷ and include a variety of new reporting duties³⁹⁸ and supervisory powers.³⁹⁹ For example, the Authority may prohibit or limit withdrawals and distribution of profits,⁴⁰⁰ prohibit or limit balance sheet measures to offset net loss or show net profit,⁴⁰¹ limit payments of returns on funds,⁴⁰² order risk reduction as it relates to certain types of activities,⁴⁰³ prohibit or limit the payment of bonuses,⁴⁰⁴ and require a financial institution to draft a restructuring plan.⁴⁰⁵

Under the new law the Authority may also transfer part or all of the systemically relevant assets from a distressed bank to a bridge bank.⁴⁰⁶

³⁹⁷ Auerbach & Donner, *supra* note 393, at 17–18; Stengel, *supra* note 330, at 15; Höche, *supra* note 7, at 53.

³⁹⁸ See, e.g., Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776, § 45(1), no. 1 (providing that BaFin may order the institution “to produce a substantiated description of the development of its key business activity over a period of at least three years, including projected balance sheets and projected profit and loss accounts, as well as of the development of its prudential ratios and to submit said description to BaFin and the Deutsche Bundesbank”).

³⁹⁹ *Id.* § 45(1), nos. 2–4 (providing that BaFin may order the institution “to review measures for improving protection against or reducing the material risks identified by the institution and the associated risk concentrations and to report these to BaFin and the Deutsche Bundesbank, including consideration of strategies for exiting from individual business areas or severing the institution or group entities”).

⁴⁰⁰ *Id.* § 45(2), no. 1 (providing that under certain circumstances, BaFin can “prohibit or limit withdrawals by the proprietors or partners and the distribution of profits”).

⁴⁰¹ *Id.* § 45(2), no. 2 (providing that under certain circumstances, BaFin can “prohibit or limit balance sheet measures that serve to offset a net loss or to show a net profit”).

⁴⁰² *Id.* § 45(2), no. 3 (providing that under certain circumstances, BaFin can “order that the payment of all types of returns on own funds instruments apart from those pursuant to section 10(5a) be fully or partly waived without replacement if they are not fully covered by a net profit for the year”).

⁴⁰³ *Id.* § 45(2), no. 5 (providing that under certain circumstances, BaFin can “order the institution to take measures to reduce risks insofar as they arise from certain types of activities and products or through the use of certain systems”).

⁴⁰⁴ *Id.* § 45(2), no. 6 (providing that under certain circumstances, BaFin can “prohibit the payment of variable remuneration components or limit such payment to a certain proportion of the net result for the year; this shall not apply to variable remuneration components specified in a collective agreement or, within its scope of application, in an agreement between the social partners applying the provisions of the collective agreement, or on the basis of a collective agreement, in a plant-level or service agreement”).

⁴⁰⁵ *Id.* § 45(2), no. 7. BaFin also has the power under KWG § 45c(1) to appoint a special administrator or trustee (“*Sonderbeauftragter*”) who may directly participate in the corporate governance of the failing bank and may even replace the CEO of the bank. *Id.* § 45c(1). See, e.g., Auerbach & Donner, *supra* note 393, at 18–20.

⁴⁰⁶ The concept of asset transfer is not new under German law and follows a similar concept established for insurance companies and mortgage lenders. See Gesetz über die Beaufsichtigung der Versicherungsunternehmen [VAG] [Insurance Act], Dec. 17, 1992, BGBl. I at 2, as amended Mar. 1, 2011, § 14 (Ger.); Pfandbriefgesetz [PfandBG] [German Mortgage Banking Law], May 22, 2005, BGBl. I at 1373, as amended, § 32 (Ger.). Under

Toxic assets and additional liabilities may be left behind in the residual or bad bank, which will be liquidated. A transfer order can only be executed if the financial “institution’s viability as a going concern is jeopardized (going-concern risk)”⁴⁰⁷ and the stability of the financial system is threatened.⁴⁰⁸ In addition, the order must be necessary. The transfer cannot be ordered if the systemic risk could be avoided in an equally certain manner in any other way.⁴⁰⁹ The Authority has discretion to set a deadline before issuing any transfer order.⁴¹⁰ If a deadline is set, the failing bank must present a viable recovery plan before the end of the deadline. The plan must show that the bank is able to avert the going-concern risk within 6 weeks after the deadline and prove that long-term viability is certain. The plan must also include proof of adequate funding and sufficient liquidity.⁴¹¹ Considering the turmoil of the financial crisis, it is doubtful that the Authority will ever have the privilege to exercise this discretion as time will be of the essence to prevent contagion.⁴¹²

A bridge bank is required to be a legal person⁴¹³ headquartered in Germany⁴¹⁴ and must fulfill the same legal requirements that apply to the organization of the distressed or transferring bank.⁴¹⁵ The bridge bank may be any financial institution willing to participate in the rescue of the failing

the VAG and the PfandBG a transfer requires a contractual agreement between transferee and transferor. This is not required under the KWG

⁴⁰⁷ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl.I at 2776, § 48a(2), no. 1.

⁴⁰⁸ *Id.*

⁴⁰⁹ *Id.* § 48a(2), no. 2 (“the systemic risk arising from going concern risk cannot be eliminated in an equally certain manner in any other way than through the transfer order.”).

⁴¹⁰ *Id.* § 48c(1) (“If the risk situation persists, BaFin can, before issuing the transfer order, set the credit institution a time limit within which the credit institution must present a viable plan indicating in what way going-concern risk will be averted (recovery plan).”). *See also* Manuel Lorenz, *Der Regierungsentwurf eines Gesetzes zur Restrukturierung und geordneten Abwicklung von Kreditinstituten – Überblick und erste Einordnung*, 13 *Neue Zeitschrift für Gesellschaftsrecht* [NZG], 1046, 1051 (2010).

⁴¹¹ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl.I at 2776, § 48a(2), no. 2 (Ger.).

⁴¹² *See*, Schuster & Westpfahl, *supra* note 2, at 283.

⁴¹³ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776, § 48c(5), no. 1 (“The transfer order shall not specify a legal entity as the transferee legal entity if (1) the legal entity is not constituted in the form of a legal person.”).

⁴¹⁴ *Id.* § 48c(5), no. 2 (“the legal entity has its head office outside Germany”). It is highly questionable whether this requirement conforms to the Law of the European Union, namely the principal of free movement of capital, TFEU, art. 63.

⁴¹⁵ *Id.* (“If the credit institution is constituted in the legal form of a corporation, the transferee legal entity shall be constituted in the same legal form.”). *See also id.* § 48g(6) (“Where the transferee legal entity does not have the authorisation required pursuant to section 32 to maintain the transferred operations as a going concern, the transfer order shall be deemed to be authorisation for the transferee legal entity with the same scope as the authorisation granted to the credit institution.”).

bank or, in the alternative, the bridge bank may be specifically organized as a special purpose vehicle under government control.⁴¹⁶ The bridge bank must consent to any transfer of assets and must give consideration to the distressed bank if the overall value of transferred assets is positive.⁴¹⁷ Generally, the consideration will include shares of the bridge bank, but may also consist of cash.⁴¹⁸ However, because the required consideration must only be commensurate with the value of the transferred assets,⁴¹⁹ there may often be significant disagreements over the issue of valuation.⁴²⁰ This is of particular significance if shares of the bridge bank are given as consideration requiring the need to evaluate the value of the bridge bank as well.⁴²¹ The calculation of the value of the transferred assets may not, however, include support payments from public sources or include payments provided as part of any public bail-out.⁴²² Conversely, if the value of the transferred assets is negative, the distressed or residual bank is required to compensate the bridge bank in cash.⁴²³

⁴¹⁶ Gesetz zur Einrichtung eines Restrukturierungsfonds für Kreditinstitute [RStrukFG] [Law Establishing the Restructuring Fund for Financial Institutions], Dec. 9, 2010, BGBl. I 1900, 1921, as amended §§ 5–7 (Ger.); *see also* Karsten Müller-Eising et al., *supra* note 330, at 69.

⁴¹⁷ Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776, § 48d(1) (The transfer order shall provide for a consideration to the credit institution if the overall value of the assets to be transferred is positive. The consideration shall consist of capital shares in the transferee legal entity. If granting capital shares is unreasonable for the transferee legal entity or threatens to defeat the purpose of the transfer order, the consideration shall be determined in cash.).

⁴¹⁸ *Id.*

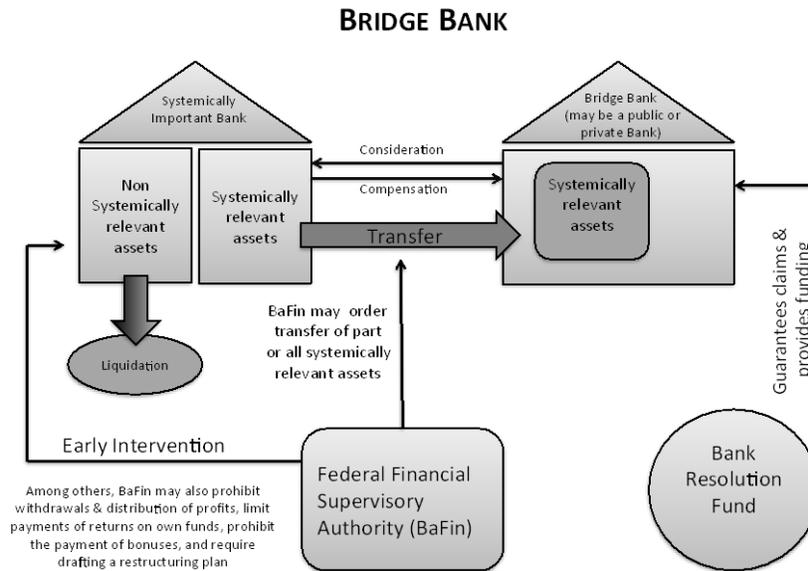
⁴¹⁹ *Id.* at § 48d(2).

⁴²⁰ Schuster & Westpfahl, *supra* note 2, at 284.

⁴²¹ *Id.*; *see also* Gregor Bachmann, *Das neue Restrukturierungsrecht der Kreditinstitute*, *Zeitschrift für Bankrecht und Bankwirtschaft* [ZBB] 459, 467 (2010).

⁴²² Gesetz über das Kreditwesen [KWG] [German Banking Act], Sept. 9, 1998, BGBl. I at 2776, § 48d(2) (At the time at which the transfer order is issued, the consideration must be commensurate with the value of the transferred assets. Any support payments from the Restructuring Fund or government agencies that were provided or promised to avert or overcome the going-concern risk shall not be taken into consideration in the credit institution's favor. Central bank operations that are concluded on standard terms and conditions do not constitute support payments within the meaning of sentence 2.).

⁴²³ *Id.* § 48d(6) (Where the aggregate value of the assets to be transferred is negative, the transfer order shall stipulate that the credit institution must compensate the transferee legal entity in cash (compensation liability). The maturity and insolvency seniority of the compensation liability shall be based on the maturity and seniority of the liabilities included in the spin-off. In the case of differing maturities or seniority levels, the relationship of the liabilities with different maturity or seniority levels to one another shall be the determining factor. Subsections (2) to (4) shall apply *mutatis mutandis*.).



After the transfer is complete and effective, the bridge bank is jointly and severally liable to all creditors;⁴²⁴ the liability includes both the transferred assets as well as those assets remaining with the distressed bank.⁴²⁵ Regardless, the liability of the bridge bank is limited to the amount of the claim a creditor would have received in a liquidation of the distressed bank prior to the transfer.⁴²⁶ Furthermore, the bridge bank is only liable to the extent that creditors cannot satisfy their claims through the distressed bank.⁴²⁷

The effectiveness of the transfer may also trigger additional supervisory powers for the Supervisory Authority. For example, the Authority may direct and instruct the distressed bank on how to exercise the voting rights on the shares received as consideration from the bridge

⁴²⁴ *Id.* § 48h(1) (The credit institution shall be liable for the liabilities included in the spin-off only in the amount of the sum which the creditor would have received had the credit institution been wound up and no spin-off had taken place. Liability shall exist only to the extent that the creditor cannot obtain satisfaction from the transferee legal entity.).

⁴²⁵ *Id.* § 48k(3) (Notwithstanding § 48e(1), the transfer order may stipulate that only part of the assets, liabilities and legal relationships shall be transferred to the transferee legal entity (partial transfer). In this case, notwithstanding § 48e(1) no. 2, the transfer order shall specify only those spin-off assets that are covered by the spin-off; alternatively, it may specify those spin-off assets that will remain with the institution.).

⁴²⁶ *Id.* § 48h(1).

⁴²⁷ *Id.*

bank.⁴²⁸ In addition, the bridge bank shares can only be sold or transferred after approval by the Authority,⁴²⁹ and the Authority has the power to monitor the viability of the transferred business assets.⁴³⁰

(c) The Law Establishing the Reorganization Fund for Financial Institutions

The German Banking Reorganization Act of 2010 also established a reorganization fund (the fund) for financial institutions (*Restrukturierungsfondsgesetz*).⁴³¹ The fund is a so-called Federal Special Fund established under Art. 110, section 1 of the German Constitution (*Grundgesetz*) and is part of the Federal Agency for Financial Market Stabilization (FMSA).⁴³² The fund has no legal rights, but has the capacity to sue and be sued.⁴³³ The purpose of the fund is the stabilization of financial markets in Germany.⁴³⁴ As part of its powers, the fund is charged with establishing bridge banks and initiating public ownership in these bridge banks, if necessary.⁴³⁵ The fund also guarantees claims against any bridge bank⁴³⁶ and may provide funding for bridge banks.⁴³⁷ In order to avoid issues of moral hazard and public bail-out, financial institutions do not have a legal claim for support payment from the fund. Rather, only bridge banks or private sector banks that aid in the recovery of a distressed bank may receive financial support from the fund.⁴³⁸

The most controversial issues surrounding the establishment of the fund is the source of its funding and its size. While the Federal Ministry of Justice can supplement the available funds with loan guarantees of up to 20

⁴²⁸ *Id.* § 481(2) (“BaFin can instruct the credit institution to exercise the voting rights to which it is entitled at the shareholders’ meeting of the transferee legal entity in a particular manner . . .”).

⁴²⁹ *Id.* § 481(3) (“[T]he credit institution may not, without prior written permission from BaFin, dispose of the capital shares in the transferee legal entity to which it is entitled.”).

⁴³⁰ *Id.* § 48m(1) (“On request, the transferee legal entity shall promptly provide BaFin with information on all circumstances required to assess the viability of restructuring for the business units transferred to the transferee legal entity.”).

⁴³¹ Gesetz zur Einrichtung eines Restrukturierungsfonds für Kreditinstitute [RStrukFG] [Law Establishing the Restructuring Fund for Financial Institutions], Dec. 9, 2010, BGBL. I at 1900 (Ger.) [hereinafter [RStrukFG] [Restructuring Fund Law]].

⁴³² *Id.* § 1. See also Satzung der Bundesanstalt für Finanzmarktstabilisierung [FMSASatz] [Statute of the Federal Agency for Financial Market Stabilization] Feb. 21, 2011, BGBL. I at 272, §§ 1–3 (Ger.).

⁴³³ [RStrukFG] [Restructuring Fund Law] § 9.

⁴³⁴ *Id.* § 3(1).

⁴³⁵ *Id.* § 5.

⁴³⁶ *Id.* § 6.

⁴³⁷ *Id.* § 7.

⁴³⁸ *Id.* § 4. See also Schuster & Westpfahl, *supra* note 2, at 287.

million euro,⁴³⁹ the reorganization fund is primarily financed by means of a bank levy on all German banks.⁴⁴⁰ The German government assessed the rates of these bank levies for the first time in July of 2011.⁴⁴¹ The proposed levies are re-evaluated each year and rise in line with the business volume of each bank.⁴⁴² Financial institutions with liabilities of up to 300 million euro do not contribute any funds.⁴⁴³ Banks with a business volume above 300 million euros must contribute two basis points with a maximum of six will be levied on each bank.⁴⁴⁴ In addition, banks' open futures rates will account for 0.03 basis points of the levy.⁴⁴⁵

The German levy system is problematic because financial institutions without systemic relevance are required to contribute to the fund, yet are not able to receive fund support payments.⁴⁴⁶ The fact that all banks, regardless of systematic relevance, will at least indirectly benefit from stable financial markets by avoiding another crisis is the only possible argument in support of a general levy requirement. The levy may also impact the competitiveness of German banks in more general terms, especially if German banks with subsidiaries or branches in other European countries are required to contribute to rescue funds in these other countries. As a result, a more harmonized, Union-wide solution could be preferable. Another point of contention is the size of the fund with a maximum volume of 70 billion euros.⁴⁴⁷ It is questionable if this amount will suffice during a financial crisis. The availability of these funds and the time it will take to raise them is of even greater concern.⁴⁴⁸

IV. CONTINGENT CAPITAL IN BANK RESTRUCTURING

Policy makers and legislative bodies in Europe and the United States⁴⁴⁹ are increasingly recognizing the possible use of contingent

⁴³⁹ [RStrukFG] [Restructuring Fund Law], § 12(6).

⁴⁴⁰ *Id.* § 2.

⁴⁴¹ Press Release, Federal Ministry of Justice, Cabinet Adopts Restructuring Fund Ordinance (July 21, 2011) (Ger.), available at http://www.bundesfinanzministerium.de/nn_103466/EN/Topics/Financial-markets/Articles/20110721-Restructuring-Fund.html?__nnn=true.

⁴⁴² *Id.*

⁴⁴³ *Id.*

⁴⁴⁴ *Id.*

⁴⁴⁵ *Id.*

⁴⁴⁶ See also Wolfgang Schön, Alexander Hellgardt, & Christine Osterloh-Konrad, *Bankenabgabe und Verfassungsrecht – Teil I: Verfassungsrechtliche Zulässigkeit als Sonderabgabe*, WM - Zeitschrift für Wirtschafts- und Bankrecht, 2010, 2145 (Ger.).

⁴⁴⁷ Gesetz zur Einrichtung eines Restrukturierungsfonds für Kreditinstitute [RStrukFG] [Law Establishing the Restructuring Fund for Financial Institutions], Dec. 9, 2010, BGBl. I at 1900, § 12(10) (Ger.).

⁴⁴⁸ See, e.g., Stengel, *supra* note 330, at 16.

⁴⁴⁹ Edmund L. Andrews, *Bernanke*, in *Nod to Critics, Suggests Board of Regulators*,

capital.⁴⁵⁰ One of the main benefits of contingent capital could be its role in helping to avoid insolvency and stabilizing financial markets. Although many academics support the use of contingent capital, disagreements on the design features⁴⁵¹ and the mandatory or voluntary nature of contingent capital persist.⁴⁵² Determining the optimal design features of contingent capital may require a concerted effort of policy-makers worldwide. A common denominator on how to use contingent capital to avoid a future crisis could be, generally speaking, for a financial institution to issue a

N.Y. TIMES, Oct. 2, 2009, at B3 (quoting Bernanke stating, “that giant financial players might be forced to adopt contingent capital,” and noting that the contingent capital is “gaining popularity within the Fed.”); Daniel K. Tarullo, Federal Reserve Governor, Speech at the Exchequer Club in Washington, D.C. to the Federal Reserve: Confronting Too Big to Fail (Oct. 21, 2009), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm> (commenting that contingent capital is an effort “worth pursuing”). In the E.U., see IP/11/915, *supra* note 8 (“The proposal will require banks to hold more and better capital to resist future shocks by themselves.” The proposal also translates the bank capital agreed to in the Basel III agreement.).

⁴⁵⁰ CRD IV Regulation, *supra* note 10, at arts. 48–52.

⁴⁵¹ Coffee, *supra* note 26, at 806 (promoting contingent capital as an alternative to bankruptcy or bail-outs, Coffee suggests a contingent capital design where “(1) the conversion ratio would be deliberately designed to protect the debt holders from loss by instead diluting the existing equity holders; and (2) the debt security would convert into a fixed return preferred stock with cumulative arrearages and significant voting rights.”); FLANNERY, *supra* note 24; Robert L. McDonald, *Contingent Capital with a Dual Price Trigger* 20 (Northwestern University Kellogg Sch. of Mgmt., Working Paper, Apr. 11, 2011), available at <http://ssrn.com/abstract=1553430>; George Pennacchi, *A Structural Model of Contingent Bank Capital* (Fed. Reserve Bank of Cleveland, Working Paper 10-04, Apr. 2010), available at <http://ssrn.com/abstract=1595080>; George Pennacchi et al., *Contingent Capital: The Case for COERCs* 9, 13 (INSEAD Working Paper No. 2010/89/FIN, Oct. 27, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656994; Squam Lake Working Group, *supra* note 24, at 4 (2009); Suresh Sundaresan & Zhenyu Wang, *Design of Contingent Capital with a Stock Price Trigger for Mandatory Conversion* 4 (Fed. Reserve Bank of N.Y., Working Paper, Apr. 30, 2010), available at <http://www.newyorkfed.org/research/economists/wang/BankDebtTrigger.pdf> (recognizing that a value transfer between equity and contingent capital “disturbs equilibrium by moving the stock price up or down, depending on the conversion ratio specified,” and that the proposals typically ensure that there is no value transfer at maturity, but do not ensure there is no transfer before maturity).

⁴⁵² Coffee, *supra* note 26, at 808 (“[W]ork even when regulatory oversight fails and a crisis sneaks in under the regulators’ radar screen.”); Letter Comment from Mary Frances Monroe, Vice President, Office of Regulatory Policy, American Bankers Association, to Basel Committee on Banking Supervision 3 (Oct. 1, 2010) (on file with Am. Bankers Ass’n) (Mandatory contingent capital would “hinder unduly the flexibility of banks to create a capital structure that best meets the needs of the bank and its investors Other banks may not be able to, or may find it inefficient to, issue contingent or convertible instruments for a variety of reasons – including, for instance, restrictions under their chartering instruments, tax issues related to the deductibility of payments on the instruments, lack of market access, or insufficient investor interest. These banks should not be harmed by a perception that they are not as well capitalized as others simply because they need to or choose to meet their capital needs through other acceptable channels.”).

certain percentage of its long-term debt capital as convertible debt securities that convert into equity when triggered at the point of financial weakening of the financial institution.⁴⁵³

Among the potential benefits of implementing contingent capital is the minimization of moral hazard, avoidance of financial contagion, and limitation of systemic risk by financial institutions that may be too big to fail. Contingent capital is an automatic mechanism for increasing capital while reducing debt with the long-term benefit of lowering leverage. Contingent capital may also support general risk control in financial institutions⁴⁵⁴ and may contribute to minimizing moral hazard by holding shareholders responsible and internalizing bank failure costs. Moreover, given the threat of loss due to conversion and the implicit dilution of stock holdings, contingent capital has the potential to reduce incentives for shareholders to encourage management to take higher risks for higher returns.

Using contingent capital may also be less expensive and less time consuming than bankruptcy and could establish a preferable mix of incentives by creating ownership stakes in the holders of contingent capital. The holders of contingent capital may become actively involved in the reorganization of the financial institution after contingent capital has been converted. Comparing contingent capital to equity, contingent capital could be cheaper, provided the interest expense is deemed tax deductible. It would be a non-dilutive form of financing that would not bring the threat of change of control with it. If deemed tax deductible, the tax advantages of contingent capital are likely the same as those in debt financing. Tax authorities may also treat contingent capital as a hybrid.

⁴⁵³ Coffee, *supra* note 26, at 795, 833; McDonald, *supra* note 451; FLANNERY, *supra* note 24.

⁴⁵⁴ Raghuram G. Rajan, *Too Systemic to Fail: Consequences, Causes, and Potential Remedies* 28 (Bank for Int'l Settlements, BIS Working Paper No. 305, Mar. 2010), available at <http://www.bis.org/publ/work305.pdf> (“[I]nstalling sprinklers When the fire threatens, the sprinklers will turn on.”). *Contra* Christian Koziol & Jochen Lawrenz, *Contingent Convertibles: Solving or Seeding the Next Banking Crisis?*, J. BANKING & FIN. 5, 35 (2011) (Koziol and Lawrenz suggest that CoCo bonds may “create negative externalities, in the sense that the (destabilizing) risk-shifting problem induced by CoCo bonds may overcompensate the (stabilizing) effect of providing a pre-committed recapitalization to banks.” Through the use of a “dynamic continuous-time framework,” the authors conclude that “the beneficial impact of CoCo bonds crucially hinges on the assumption if bank managers have substantial discretion over the bank’s business risk.” The authors contend that if complete contracts can be written, CoCos are clearly beneficial, however, if allowing for incomplete contracts, the authors argue that “CoCo bonds always distort risk taking incentives. Therefore, equity holders have incentives to take excessive risks. Thus, CoCos may be an example where individually rational decisions can have systemically undesirable outcomes.”).

A. European Commission Proposal

The European Commission has proposed a framework for prevention, crisis management and bank resolution.⁴⁵⁵ The Commission issued a working document for discussion and consultation purposes,⁴⁵⁶ which distinguishes between a comprehensive and targeted approach.⁴⁵⁷ The Commission also proposed the recognition of contingent capital as “Additional Tier 1 instruments.”⁴⁵⁸

Analogous to the FSB⁴⁵⁹ and the Vickers Report,⁴⁶⁰ the European Commission proposed haircuts for all equity supplemented by a debt conversion of both subordinated and senior debt at a point when the financial institution is in danger of insolvency. In other words, the Commission recognizes the benefits of contingent capital but only as a supplement to a system of regulatory write-down tools or bail-inables. The Commission presupposes a statutory power to write down subordinated debt and to convert subordinate debt into equity.⁴⁶¹ It is in this latter context that the European Commission has proposed its comprehensive and targeted approach for supplementary debt write-down tools.

Under the comprehensive approach, national resolution authorities could be given a statutory power to write down or convert to equity “all senior debt deemed necessary to ensure the credit institution is returned to solvency” upon the occurrence of a pre-defined trigger event.⁴⁶² Under this proposal, national resolution authorities would also have the discretion to determine which classes of debt would be converted or written down and at what conversion rate.⁴⁶³ In addition, the size of the write down would depend on the financial situation of the institution, its assets and liabilities,

⁴⁵⁵ The Internal Market and Services Directorate General (DG MARKT) is one of the directorates which make up the European Commission. A main role of the DG Market is to coordinate the Commission’s policy on the European Single Market. Its primary function is to seek the removal of unjustified obstacles to trade and in the field of services and financial markets. See, DG Internal Market and Services, *available at* http://ec.europa.eu/dgs/internal_market/index_en.htm (April 14, 2012).

⁴⁵⁶ DG Working Document, *supra* note 10.

⁴⁵⁷ *Id.*

⁴⁵⁸ CRD IV Regulation, *supra* note 10.

⁴⁵⁹ FIN. STABILITY BD., REDUCING THE MORAL HAZARD POSED BY SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: FSB RECOMMENDATIONS AND TIME LINES 1 (Oct. 2010), *available at* http://www.financialstabilityboard.org/publications/r_101111a.pdf (noting that the risk associated with SIFIs includes moral hazard – their interconnectedness can cause “significant disruption to the wider financial system and economic activity.”).

⁴⁶⁰ U.K. INDEPENDENT COMMISSION ON BANKING, INTERIM REPORT: CONSULTATION ON REFORM OPTIONS 180–81 (Apr. 2011), *available at* <http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf>.

⁴⁶¹ DG Working Paper, *supra* note 10, at 87.

⁴⁶² *Id.*

⁴⁶³ *Id.*

and the amount of funds needed to restore viability and maintain market confidence.⁴⁶⁴ The Commission argues that the proper functioning of credit markets requires that short-term debt, as defined by a specified maximum maturity,⁴⁶⁵ swap repo and derivative counterparties, other trade creditors, as well as retail and wholesale deposits and secured debt should be excluded.⁴⁶⁶ In summary, the Commission considers the comprehensive approach adequate to “create maximum flexibility for the resolution authorities to return an institution to viability, install new management, and implement a recovery or restructuring plan to retain market confidence and access to funding.”⁴⁶⁷

The alternative to the comprehensive approach is the targeted approach.⁴⁶⁸ Under the targeted approach national resolution authorities would require financial institutions to issue a fixed amount of debt that pre-qualifies for write-down or conversion to equity on a pre-defined statutory trigger.⁴⁶⁹ The Commission suggests that the pre-qualified amount of debt could include a fixed minimum for all institutions between 4 and 19 per cent of risk-weighted assets.⁴⁷⁰ Although these numbers seem unrealistically high, the Commission seems to justify the proposal with an attempt to ensure that “debt contracts are not able [to] evolve in a way that would reduce the effectiveness of the regime and would provide certainty for both the institution and creditors about what would happen in a resolution.”⁴⁷¹

The European Banking Authority (EBA) will most likely play a dominant role in ensuring that similar and consistent treatment of prequalified debt is harmonized at the level of the European Union. Some commentators have suggested that the market reaction to the European Commission proposal was negative.⁴⁷² Uncertainties regarding knock-on-effect and interaction with other proposals (including Basel III) are among

⁴⁶⁴ *Id.* at 88.

⁴⁶⁵ *Contra* Coffee, *supra* note 26, at 833 (arguing that the amount of contingent capital that should be triggered ought to be defined by short-term debt).

⁴⁶⁶ DG Working Paper, *supra* note 10, at 88.

⁴⁶⁷ *Id.*

⁴⁶⁸ *Id.* at 89.

⁴⁶⁹ *Id.* (“[s]uch debt would need to include a contractual term which would specify that the relevant resolution authority could use a statutory power to write down the debt when the institution meets the trigger conditions for entry into resolution.”).

⁴⁷⁰ *Id.* n. 24.

⁴⁷¹ *Id.* at 89.

⁴⁷² EUROPEAN BANKING FEDERATION (EBF), POSITIONING IN RESPECT OF THE EU COMMISSION CONSULTATION ON TECHNICAL DETAILS FOR A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION 1, 5, 53–61 (Mar. 3, 2011), *available at* http://www.ebf-fbe.eu/uploads/documents/positions/BankingReg/3%20March%202011-EBF_Response_to_COM_Crisis_Management_Consultation%20%28final%29.pdf.

the most serious open questions.⁴⁷³ Given the complexities that contingent capital presents from a regulatory and taxation standpoint, many open issues will have to be addressed.⁴⁷⁴

The implementation of the debt write-down in the European Commission proposal also has the potential of increasing funding costs for financial institutions⁴⁷⁵ and could make funding more volatile.⁴⁷⁶ Contingent capital securities could also promote greater concentration of larger banks with the associated anti-competitive results.⁴⁷⁷ On the other hand, the targeted approach could contractually set terms of conversion and timing that results in greater clarity and more accurate pricing.⁴⁷⁸

⁴⁷³ PETER M. WERNER & EDWARD MURRAY, INT'L SWAPS & DERIVATIVES ASSOC. (ISDA), POSSIBLE EU FRAMEWORK FOR BANK RECOVERY & RESOLUTION 1, 19–21 (Mar. 3, 2011), available at http://www.isdadocs.org/speeches/pdf/EU_CrossBorderCrisisMgmt_ISDA_Response_Mar11.pdf (ISDA responds to the EU's "comprehensive EU framework for troubled and failing banks" and avers the following with regard to the debt write-down ("bail-in") proposal: (1) international coordination for debt write-down is essential; (2) the proposal presents numerous complex issues such as interaction with other proposals (including Basel III), regulatory issues, and tax issues; (3) the legislative timetable is "unrealistic" and debt write-down should be tabled until some of these issues have been resolved because of the need for international coordination and the complex issues presented. ISDA also contends that the debt write-down proposal would impact derivative transactions and argues that derivatives exposures "are not an appropriate form of debt to make subject to the write-down power." And lastly, ISDA emphasizes the importance of clarification and certainty with regard to the scope of the debt write-down regime.).

⁴⁷⁴ *Id.* at 19–20.

⁴⁷⁵ ASSOC. OF BRITISH INSURERS (ABI), THE ABI'S RESPONSE: DG INTERNAL MARKET SERVICES: TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION 1, 5–6 (Jan. 2011), available at http://www.abi.org.uk/Media/Consultation_Papers/Consultation_Responses.aspx [hereinafter ABI] (ABI notes that regardless of its members' positive or negative views, the implementation of the debt write-down will increase banks' funding costs. Though the concept may provide greater certainty and discretion to regulators, it will result in greater uncertainty in the market. Because this creates greater risk, it will increase costs, and this will "have the unintended effect of promoting greater concentration into larger banks." Ultimately, there is concern that the increased complexity will affect implementation and will not benefit an efficient funding sector.).

⁴⁷⁶ DAVID HISCOCK, INT'L CAPITAL MKT. ASSOC. (ICMA), RESPONSE SUBMISSION RE: EUROPEAN COMMISSION CONSULTATION PAPER – TECHNICAL DETAILS OF A POSSIBLE EUROPEAN CRISIS MANAGEMENT FRAMEWORK 1, 2, 4 (Mar. 3, 2011), available at <http://www.icmagroup.org/ICMAGroup/files/c7/c7a2c1bd-f34c-4aaa-b75b-5ab648c16345.pdf> (ICMA expresses concern that the bail-in regime will effectively increase rates for depositors by encumbering higher quality assets. Banks will be confronted with increased competition for retail deposits, thus increasing the use of other forms of secured funding. As a result of increased rates and competition, funding will become less stable. ICMA notes that one positive aspect of the targeted approach is that investors may precisely express investment preferences. This creates "a fairer transition to a new regime than simply imposing bail-in on existing investors.").

⁴⁷⁷ ABI, *supra* note 475, at 6.

⁴⁷⁸ ASS'N. FOR FIN. MARKETS IN EUR. (AFME), RESPONSE TO THE EUROPEAN COMMISSION

Financial industry representatives on the national and international level have criticized the Commission proposal. Some suggest contractual arrangements for contingent capital should be triggered before a statutory bail-in is applied.⁴⁷⁹ Others oppose the proposed resolution tools involving full or partial write-downs on the basis that they could threaten covered bond markets.⁴⁸⁰ The key to the proposal seems to be the treatment of secured debt, derivatives, and covered bonds.⁴⁸¹

In the context of the comprehensive approach, some point to higher costs of senior debt instruments and their marketability and propose assurances that would guarantee that the priority claim of capital instruments remains intact when covering loss.⁴⁸² In the context of the

CONSULTATION ON TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY & RESOLUTION 54–56 (2011), *available at* http://www.afme.eu/AFME/What_We_Do/Final%20AFME%20Response.pdf (pointing out the two approaches to debt write-down proposed by the European Commission: (1) the “targeted” approach, which “would require banks to hold a fixed amount of ‘bail-in-able’ debt but that would exclude senior debt from the scope of any write-down;” and (2) the “comprehensive” approach, which would allow RAs to write-down senior debt. AFME states its members primarily support the “ease and clarity of the targeted approach, in relation to the comprehensive approach, although neither option is completely without difficulties.”. The targeted approach could contractually set terms of conversion and timing resulting in greater clarity and prices that are a more accurate reflection of risk. AFME also recommends that the targeted approach be coordinated with Basel III, and ultimately, that the protection provided be studied. AFME suggests that the comprehensive approach could be available to regulators as a “last resort” when the targeted approach proves inadequate.). *See also* DG Working Document, *supra* note 10, at 89 (“Targeted approach: An alternative to a comprehensive approach would be for resolution authorities to require credit institutions to issue a fixed volume of ‘bail-in able’ debt which, in addition to the power to write off all equity, and either write off existing subordinated debt or convert it into an equity claim, could be written down or converted into equity on a statutory trigger.”).

⁴⁷⁹ SWED. MINISTRY OF FIN ET AL., SWEDISH ANSWERS TO THE DG INTERNAL MARKET AND SERVICES WORKING DOCUMENT “TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION” 44 (2011), *available at* <http://www.riksbank.com/templates/YearList.aspx?id=20368&all=1> (Generally asserts that the untested bail-in regime should not be relied upon. If the bail-in tool can be shown to be effective, it may be useful as a wind-down tool. Specifically, it argues that the wind-down tools should include a statutory bail-in tool to “impose market discipline on unsecured debt holders as they can impose losses on those creditors.” Further, it suggests that “[c]ontractual bail in instruments must trigger before a statutory bail in is applied. Regulatory capital instruments must bear losses before any higher ranking debt.” Such a scheme should still leave “the troubled banks well capitalized.”).

⁴⁸⁰ REALKREDITRÅDET (ASS’N OF DANISH MORTG. BANKS), CONSULTATION RESPONSE CONCERNING TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION 2, 9 (Mar. 7, 2011), *available at* <http://www.realkreditraadet.dk/Holdninger/H%C3%B8ringssvar.aspx?M=News&PID=1755&NewsID=543>.

⁴⁸¹ *Id.*

⁴⁸² EUROPEAN ASS’N OF PUBLIC BANKS (EAPB), COMMENTS OF THE EUROPEAN ASSOCIATION OF PUBLIC BANKS ON THE TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION 8–9, *available at* <http://www.eapb.eu/file?file=6701>.

comprehensive approach, some point to higher costs of senior debt instruments and their marketability, and propose assurances that would guarantee that the rank of these capital instruments in bankruptcy remains intact and equal ("*parri passu*") to all other unsecured and unsubordinated debt.⁴⁸³

B. Basel Committee Proposal

The Basel Committee on Banking Supervision (The Basel Committee), suggested in an initial proposal that internationally active banks be required to have a clause in their debt instruments that, upon the occurrence of a triggering event, provides for a mandatory write-off or conversion to common stock.⁴⁸⁴ The proposal recommended ensuring the loss absorbency of regulatory capital at the point of non-viability.⁴⁸⁵ The proposal also required that such a clause could not conflict with the respective legal environment of each respective European Union Member State.⁴⁸⁶

After the revision of the European regulatory structure, many commentators assumed the newly created European Banking Authority (EBA) would allow national regulators to use their existing Tier 1 definitions.⁴⁸⁷ The European Commission, however, proposed a regulation on prudential requirements for credit institutions and investment firms.⁴⁸⁸ The proposal in effect harmonized the requirements for Tier I capital.⁴⁸⁹ Almost simultaneously, the Basel Committee decided to use retained

⁴⁸³ *Id.*

⁴⁸⁴ Basel Comm. on Banking Supervision, Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability (2010), available at <http://www.bis.org/publ/bcbs174.pdf>.

⁴⁸⁵ *Id.* at 4–5 (“Proposed minimum requirement Scope and post trigger instrument 1. All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event. 2. Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non- joint stock companies). 3. The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument’s terms and conditions should the trigger event occur. 4. The trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority. 5. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.”).

⁴⁸⁶ *Id.* at 3.

⁴⁸⁷ David Enrich, *Europe Blinks on Bank Test – Regulators Seen Easing ‘Stress’ Gauge, Undercutting Effort to Restore Confidence*, WALL ST. J., Mar. 9, 2011, at A1, A10.

⁴⁸⁸ CRD IV Regulation, *supra* note 10, arts. 48a, 49(1)(n), 51(b).

⁴⁸⁹ *Id.*

earnings and ordinary shares rather than contingent capital to meet heightened capital requirements for SIFIs.⁴⁹⁰ Thereafter, the European Commission proposed harmonization in the context of Tier 1 capital, allowing convertible instrument capital as Tier 1 capital.⁴⁹¹ The proposal would permit contingent capital securities as an “Additional Tier 1 instrument.”⁴⁹² This could be a first step toward a basic framework for harmonized contingent capital standards. This framework could enable European Union Member States to provide national regulatory guidance on contingent capital or allow private ordering of contingent capital designs.⁴⁹³

C. Swiss Approach

The Swiss approach to contingent capital distinguishes between high and low triggers for contingent capital securities (CCS) and allocates a maximum of 9 percent of the total core capital to CCS with predefined triggers.⁴⁹⁴ The Swiss Act on Banks and Savings Banks⁴⁹⁵ defines “criteria and determination of systemic importance”⁴⁹⁶ in Article 8 before defining “convertible capital” in Article 13.⁴⁹⁷

The Swiss approach in Article 13 could perhaps become a model for other European legislators and perhaps even the U.S. legislator. It gives the

⁴⁹⁰ Louis Meera, *Europeans Lose Out to U.S. with Basel Committee’s Contingent Capital Vote*, BLOOMBERG, June 27, 2011, <http://www.bloomberg.com/news/2011-06-26/basel-committee-decision-on-contingent-capital-backs-u-s-stance.html> (noting that this was a victory for U.S. regulators over their European counterparts and quoting Karen Shaw Petrou, managing partner of Washington-based Federal Financial Analytics Inc., a bank consulting firm: “Europeans were pushing for a mix of common equity and contingent capital and they lost at a global level.”).

⁴⁹¹ CRD IV Regulation, *supra* note 10, art. 49(1)(n) (the proposed regulation defines one form of “Additional Tier 1 instruments” as a capital instrument in which “the provisions governing the instruments require the principal amount of the instrument to be written down, or the instruments to be converted to Common Equity Tier 1 instruments, upon the occurrence of a trigger event.”). Additional Tier 1 capital is defined in the proposed regulation. *See* CRD IV Regulation, *supra* note 10, art. 49(1)(n).

⁴⁹² CRD IV Regulation, *supra* note 10, arts. 48a, 49(1)(n), 51(b).

⁴⁹³ On the calibration of market mechanisms, private ordering, and mandatory rules see Wulf A. Kaal, *Initial Reflections on the Possible Application of Contingent Capital in Corporate Governance*, 26 NOTRE DAME J.L. ETHICS & PUB. POL’Y 101 (2012) [hereinafter Kaal Corporate Governance]; *see also* Wulf A. Kaal, *Contingent Capital in Executive Compensation* (on file with author) [hereinafter Kaal Executive Compensation] (on the use of contingent capital for dynamic regulation of financial institutions).

⁴⁹⁴ SWISS CONFEDERATION, FINAL REPORT OF THE COMMISSION OF EXPERTS FOR LIMITING THE ECONOMIC RISKS POSED BY LARGE COMPANIES 59–60 (2010), *available at* <http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en>.

⁴⁹⁵ BUNDESGESETZ ÜBER DIE BANKEN UND SPARKASSEN [BANKG] [FEDERAL LAW ON BANKS, SAVING AND LOANS] Nov. 8, 1934, SR 952 (Switz.), *available at* <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf> (as of Mar. 1, 2012).

⁴⁹⁶ *Id.* art. 8.

⁴⁹⁷ *Id.* art. 13.

Board of Directors of systemically important banks⁴⁹⁸ the authority to issue “mandatory convertible bonds within the scope of the provisions of the articles of incorporation”⁴⁹⁹ but requires disclosure of the “conversion-triggering event.”⁵⁰⁰ It also envisions the use of tranches and multiple trigger events.⁵⁰¹

The Swiss Banking Act requires that CCS are offered to shareholders and participation certificate holders in proportion to their then current holdings.⁵⁰² If, however, the market environment requires it or if CCS are issued at a discount to facilitate a complete placement, a shareholders’ meeting may authorize the issuance of CCS to non-shareholders.⁵⁰³ If these requirements are fulfilled, the shareholders’ meeting of the respective SIFI would in effect allow the exclusion of “subscription rights of the shareholders and participation certificate holders.”⁵⁰⁴

D. The English Proposals

In the United Kingdom, Lloyds Bank was the first bank to issue contingent capital securities in 2010.⁵⁰⁵ The issuance, through a non-U.S. bond-exchange offer, raised £8.5 billion of contingent core Tier 1 and core

⁴⁹⁸ *Id.* art.7(2) (“The purpose of the provisions of this section, in concert with the generally applicable statutory banking regulations, is to reduce further the risks posed by systemically important banks to the stability of the Swiss financial system, to ensure the continuation of economically vital functions and to avoid government bail-out measures.”). Given the structure of the BankG, the use of contingent capital with sequential triggers seems to be possible in the Swiss model, although certain limitations in the Swiss model might require adjustments for contingent capital with sequential triggers. See Wulf A. Kaal & Christoph Henkel, *Contingent Capital with Sequential Triggers*, 49 San Diego. L. Rev. 221 (Mar. 2012) [hereinafter Kaal & Henkel Sequential].

⁴⁹⁹ *Id.* art. 13(3).

⁵⁰⁰ *Id.* art. 13(5).

⁵⁰¹ *Id.* art. 13(3)(b) (“The trigger event or, in the case of tranches, the trigger events.”).

⁵⁰² BUNDESGESETZ ÜBER DIE BANKEN UND SPARKASSEN [BANKG] [FEDERAL LAW ON BANKS, SAVING AND LOANS] Nov. 8, 1934, SR 952, art. 13(4) (Switz.), available at <http://www.admin.ch/ch/d/sr/9/952.0.de.pdf> (as of Mar. 1, 2012).

⁵⁰³ *Id.*

⁵⁰⁴ *Id.* English translation of an earlier version of the Swiss Banking Act at art. 12(2) (on file with authors) (“The Board of Directors can cancel the subscription rights of shareholders or participation certificate holders for good cause, particularly if this helps with the rapid and smooth placement of shares or participation certificates.”). See also art. 13(1) (“The General Meeting can decide on a contingent increase in the share or participation capital by stipulating in the articles of incorporation that the debt securities arising from mandatory convertible bonds are converted into shares or participation certificates if the trigger event occurs.”). See also FINAL REPORT OF THE COMMISSION OF EXPERTS FOR LIMITING THE ECONOMIC RISKS POSED BY LARGE COMPANIES 67–68 (Sept. 30, 2010), available at http://www.sif.admin.ch/dokumentation/00522/00715/index.html?lang=en&___= (“The Board of Directors can exclude or limit the former shareholders’ pre-emptive subscription rights for good cause.”).

⁵⁰⁵ von Furstenberg, *supra* note 283, at 10.

Tier 1 notes.⁵⁰⁶ As a result of investor demand for the exchange offer exceeding \$2.7 billion, which was almost three times the amount on offer, Lloyds issued the maximum of \$986 million of enhanced capital notes.⁵⁰⁷ The enhanced capital notes were designed to convert into equity in case Lloyds' core Tier 1 capital ratio fell below 5 percent.⁵⁰⁸ Barclays, a bank based in the United Kingdom, has also contemplated the issuance of contingent capital securities to the public.⁵⁰⁹ Barclays has already issued contingent capital to its executives but with minimal governance improvements.⁵¹⁰

Other banks in the United Kingdom are considering the issuance of contingent capital if and when regulatory guidance is provided.⁵¹¹ While insolvency law in the United Kingdom already allows for so-called "Company Voluntary Arrangements," an instrument comparable to traditional debt-equity swaps,⁵¹² the Bank of England did propose precautionary and non-viability contingent capital.⁵¹³ Many open questions still need to be addressed in the context of contingent capital instruments.⁵¹⁴

E. German Draft Amendments to the Corporation Act

While German law does not provide per se for contingent capital securities, a debt-equity swap between creditors and financial institutions in reorganization is already an integral part of the German Financial Institution Reorganization Act.⁵¹⁵ Unlike contingent capital securities, however, a debt-equity swap requires creditors' consent under the German Law.⁵¹⁶ The German Ministry of Justice seems to have recognized this as a shortcoming

⁵⁰⁶ Kathy Sandler & Margot Patrick, *Lloyds Raises \$14 Billion in Bond Exchange*, WALL ST. J., Nov. 24, 2009, at C2.

⁵⁰⁷ UPDATE 1-Lloyds gets Strong Demand for U.S. Bond Exchange, REUTERS, Dec. 8 2009, <http://www.reuters.com/article/2009/12/08/lloyds-idUSGEE5B70QB20091208>.

⁵⁰⁸ *Id.*

⁵⁰⁹ Jenkins, *supra* note 282. Another bank that has issued contingent capital is the Dutch Rabobank.

⁵¹⁰ See Kaal Executive Compensation, *supra* note 493.

⁵¹¹ See Kaal Corporate Governance, *supra* note 493.

⁵¹² See, e.g., Banking Act, 2009, c. 1, §§ 113, 154 (U.K.). See also Insolvency Act, 1986, c. 45 (U.K.).

⁵¹³ BANK OF ENG., FINANCIAL STABILITY REPORT 56 (2010), available at <http://www.bankofengland.co.uk/publications/fsr/2010/fsrfull1012.pdf> (suggesting that contingent capital will result in higher loss-absorbency and proposing two types of contingent capital: precautionary and non-viability).

⁵¹⁴ INDEPENDENT COMMISSION ON BANKING, INTERIM REPORT: CONSULTATION ON REFORM OPTIONS 180–83 (2011) (U.K.), available at <http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf> (questioning who would buy contingent capital and the "possible dynamic effects" on banks "at or near to the trigger point").

⁵¹⁵ Gesetz zur Reorganisation von Kreditinstituten [KredReorgG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBl. I at 1900, § 9(1) (Ger.).

⁵¹⁶ *Id.*

and proposed amending the German Corporation Act.⁵¹⁷ The proposed amendments seem to facilitate the implementation of contingent capital and would provide a statutory basis for the issuance of contingent capital securities in Germany.⁵¹⁸ Implementing the amendments would require substantial changes in other areas of German law.⁵¹⁹ This may not be easily achieved unless required under European Union law and internationally recognized. The implementation of the amendments to the German Corporation Act could, to a large extent, also depend on the work of the Basel Committee and its use of contingent capital in Basel III.⁵²⁰

V. CONTINGENT CAPITAL DESIGN—TRIGGERING EVENT

The efficient calibration of triggering events is central to the design of contingent capital. The optimal design for a trigger event that converts debt into equity is unclear.⁵²¹ Scholars discuss various trigger events that may

⁵¹⁷ Referentenentwurf des Bundesministeriums der Justiz, Gesetz zur Änderung des Aktiengesetzes, Nov. 11, 2010 (Ger.), *available at* <http://www.der-betrieb.de/content/pdf/0,395158>; *see also* Hans Diekmann, Andre Nolting, Aktienrechtsnovelle 2011, *Neue Zeitschrift für Gesellschaftsrecht (NZG)* 6, 8–9 (2011); Karsten Müller-Eising, Aktienrechtsnovelle 2011 – Änderungen zur Vorzugsaktie und zum bedingten Kapital für Wandelanleihen, *Gesellschafts- und Wirtschaftsrecht (GWR)* 591, 593 (2010); Handelsrechtsausschuss des Deutschen Anwaltsvereins Stellungnahme zum Referentenentwurf eines Gesetzes zur Änderung des Aktiengesetzes (Aktienrechtsnovelle 2011), *Neue Zeitschrift für Gesellschaftsrecht (NZG)* 217, 220 (2011).

⁵¹⁸ The reform of the German Corporation Act is centered around Sections 192, 194, and 221 AktG. Under prior German Law, the instrument of “Mandatory Convertible Bonds” (“Pflichtwandelschuldverschreibung”) had already been recognized.

⁵¹⁹ Steffen Schneider & Markus Söhnchen, *Rettung von Kreditinstituten in der Krise durch Contingent Convertible Bonds - Pflichtwandelschuldverschreibungen für Banken (“CoCo-Bonds”)*, FORUM-INSTITUT FÜR MANAGEMENT GMBH, *available at* http://www.forum-institut.de/fileadmin/data/Bereich_3/Rettung_von_Finanzinstituten_in_der_Krise.pdf. *Id.* (opining that the new Act would require a change of the Kreditwesengesetz [Banking Act], the Limited Act, the Corporation Act, the Insolvency Act, and the Schuldverschreibungsgesetzes.).

⁵²⁰ *Id.* *See also* discussion *supra* Part IV.B. on Basel Committee’s decision not to integrate contingent capital.

⁵²¹ Sundaresan & Wang, *supra* note 451 (recognizing that a value transfer between equity and contingent capital “disturbs equilibrium by moving the stock price up or down, depending on the conversion ratio specified,” and that the proposals typically ensure that there is no value transfer at maturity, but do not ensure there is no transfer before maturity. Because the value transfer will not always push the stock price across the trigger, there are two possible scenarios (equilibria): (1) “all investors believe conversion will not happen, leading stock price to stay above the trigger,” and (2) “all investors believe conversion will happen, leading stock price to hit the trigger.” Sundaresan and Wang aver that “[s]ince two prices are possible whenever firm value drops to [a] certain level, by combining these dual equilibria around trigger at different times in the future, numerous expected equity values are possible even well before conversion.”). *See* Coffee, *supra* note 562; FLANNERY, *supra* note 24; McDonald, *supra* note 451; *see also* Darrell Duffie, *Contractual Methods for Out-Of-Court Restructuring of Systematically Important Financial Institutions* 1, 4 (Nov. 9, 2009)

be categorized as follows: (1) transactional triggers, (2) automatic triggers, (3) statutory triggers, and (4) regulatory triggers. Constituents favor trigger designs in accordance with their own utility preferences. For instance, interest groups representing the banking industry seem to favor transactional triggers that are privately negotiated,⁵²² subjective, and flexible.⁵²³ Some authors favor automatic triggers that convert debt into equity when a certain stock price, index value, CDS spread, capital ratio, or other trigger is reached.⁵²⁴ Others, including the Basel Committee, prefer statutory triggers that allow for regulatory discretion.⁵²⁵ Lastly, regulatory

(Preliminary Draft: Submission Requested by the U.S. Treasury Working Group on Bank Capital), *available at* <http://media.hoover.org/sites/default/files/documents/06EndingGovernmentBailoutsAsWeKnowThemDuffie.pdf> (focusing on possible triggers of Distress - Contingent Convertible Bonds/Debt (essentially CCS). If the trigger is an accounting capital ratio, it may not be able to capture the true financial condition of the bank because of accounting failures. The ratio of tangible common equity (TCE) to tangible assets may be more effective because it excludes the “relatively useless assets during a solvency crisis.” If the trigger is determined by market value, the impact of a short seller speculative attack could be mitigated by using a trailing average share price (e.g., the preceding 20 days). To eliminate a “bank run,” the trigger should be set to convert debt into equity before a liquidity crisis begins. Duffie also discusses mandatory rights offerings.).

⁵²² Monroe, *supra* note 452, at 4 (“Contingent capital instruments should be based on terms and conditions, including triggering events, negotiated by banks and their investors. To do otherwise would be to require banks to issue securities for which no viable market exists at reasonable prices, thereby forcing banks to offer extraordinary return to compensate investors for extraordinary risk. This would cause a damaging hit to banks’ profitability and, therefore, to their ability to attract other forms of capital.”).

⁵²³ Swedish Ministry of Finance, *supra* note 479, (favoring contractual trigger and arguing contractual trigger should come before statutory trigger); Monroe, *supra* note 452, at 4–5 (favoring negotiated terms of contingent capital: “A regulatory trigger would be very subjective, allowing for a high degree of latitude by supervisory authorities without reference to specified criteria. Experience teaches that under political pressure regulators could be just as prone to forebear as they would be to exercise such a trigger. Regulatory triggers may also preclude the ability of a bank to “cure” a trigger event, a common feature of other capital instruments.”).

⁵²⁴ Coffee, *supra* note 26, at 831; Flannery, *supra* note 24, at 11–12; Mark J. Flannery, No Pain, No Gain? Effecting Market Discipline via “Reverse Convertible Debentures” 30 (Nov. 2002) (unpublished manuscript), *available at* <http://bear.warrington.ufl.edu/flannery/No%20Pain,%20No%20Gain.pdf> [hereinafter Flannery No Pain] (“Frequent trigger evaluations eliminate moral hazard incentives and expose the RCD to surprisingly low default risk.”); McDonald, *supra* note 451, at 2 (proposing “a form of contingent capital for financial institutions that converts from debt to equity if two conditions are met: the firm’s stock price is at or below a trigger value and the value of a financial institutions index is also at or below a trigger value.”); Paul Glasserman & Behzad Nouri, Contingent Capital with a Capital-Ratio Trigger (Aug. 31, 2010), *available at* <http://ssrn.com/abstract=1669686> (analyzing the case of contingent capital with a capital-ratio trigger and partial and on-going conversion).

⁵²⁵ See, GOLDMAN SACHS GLOBAL MKTS. INST., CONTINGENT CAPITAL: POSSIBILITIES, PROMISES, AND OPPORTUNITIES 4 (2011), *available at* <http://www.goldmansachs.com/our-thinking/global-economic-outlook/global-econ-outlook-pdfs/contingent-capital.pdf> [hereinafter Goldman Sachs]. See also SWEDISH MINISTRY OF FINANCE, THE RIKSBANK, THE

triggers converting debt into equity can be precipitated by, for instance, the results of a bank stress test. This might occur when a financial institution decides to write off a portion of its assets or when a regulator determines that a financial institution is not financially viable without a public sector injection of equity capital.⁵²⁶ Some authors suggest several and often interrelated triggering events.⁵²⁷ Contingent capital with sequential triggers can combine elements from various trigger designs.⁵²⁸

A. Trigger Events – Uncertainty – Market Development

Given the range of public sector injections into struggling financial institutions during the financial crisis, the European Commission suggests that a mandatory minimum issuance of contingent capital could range from 4 to 19 percent of risk-weighted assets.⁵²⁹ Others believe the range of mandatory contingent capital issuance should approach between 4 and 8 percent of risk-weighted assets.⁵³⁰ Mandatory issuance of contingent capital does not guarantee that a viable market in contingent capital securities will develop. The nascent market in European contingent capital securities developed through the involvement of hedge funds and other private market participants.⁵³¹ The expansion of an international market in contingent capital securities will depend on many factors, including perhaps

SWEDISH FINANCIAL SUPERVISORY AUTHORITY & THE SWEDISH NATIONAL DEBT OFFICE, SWEDISH ANSWERS TO THE DG INTERNAL MARKET AND SERVICES WORKING DOCUMENT “TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION” 1, 43 (March 3, 2011), *available at* <http://www.riksbank.com/templates/YearList.aspx?id=20368&all=1> (arguing that the wind-down tools should include a statutory bail-in tool.); Ceyla Pazarbasioglu et al., *Contingent Capital: Economic Rationale and Design Features*, IMF Staff Discussion Note 18 (January 25, 2011), *available at* <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf> (advocating a statutory bail-in regime as opposed to contingent capital); FINANCIAL STABILITY BOARD, KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS 1, 9-10 (OCTOBER 2011), *available at* <http://www.financialstabilityboard.org/publications/r111104cc.pdf> (among other suggestions, arguing in favor of “apply[ing] one or a combination of resolution powers, with resolution actions being either combined or applied sequentially.”).

⁵²⁶ FLANNERY, *supra* note 24 (recommending that conversion of debt security be tied to a decline in the bank’s equity ratio); BIS III, *supra* note 48, at 7.

⁵²⁷ FLANNERY, *supra* note 24; Flannery No Pain, *supra* note 524; McDonald, *supra* note 451, at 2 (proposing “a form of contingent capital for financial institutions that converts from debt to equity if two conditions are met: the firm’s stock price is at or below a trigger value and the value of a financial institutions index is also at or below a trigger value.”); Glasserman & Nouri, *supra* note 524 (analyzing the case of contingent capital with a capital-ratio trigger and partial and on-going conversion).

⁵²⁸ Kaal & Henkel Sequential, *supra* note 498.

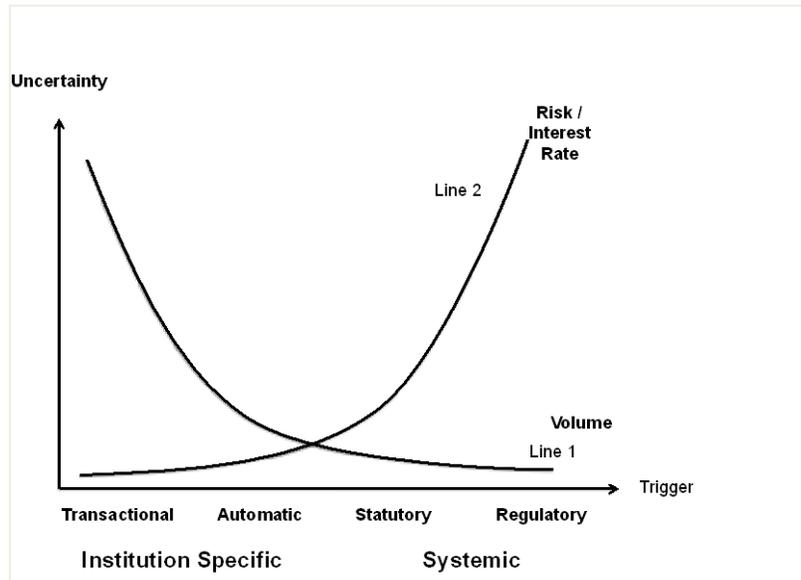
⁵²⁹ DG Working Document, *supra* note 10, Annex, n. 24.

⁵³⁰ Goldman Sachs, *supra* note 525.

⁵³¹ See Kaal Corporate Governance, *supra* note 493.

a level of convergence in CCS designs and issuance volumes.⁵³² Developing a critical mass for the market in contingent capital securities could require banks and other financial institutions to purchase their competitors' contingent capital securities.⁵³³ That could raise ethical, antitrust, and incentive concerns.⁵³⁴

Potential Effects of CCS



The interplay between the structuring of trigger events, the resulting level of uncertainty for market participants, and the development of a market in CCS has not been systematically studied. Graph 1 shows a possible inverse relationship between the volume of CCS issuance and risk or a higher interest rate as a proxy for risk taking. Line 1 shows that, as the uncertainty generated by the trigger designs increases, the volume of CCS could decrease. Line 2 suggests that risk and the interest rates of CCS (before conversion) will increase with the level of uncertainty in the trigger design promulgated by policy makers and legislators.

A large variety of trigger designs and a combination of trigger designs is possible. Graph 1 categorizes trigger designs into institution specific and systemic. Institution specific triggers may be transactional or automatic. Systemic triggers can be statutory or regulatory. A regulatory systemic trigger may generate the highest degree of uncertainty, as suggested in

⁵³² Goldman Sachs, *supra* note 525.

⁵³³ See Kaal Corporate Governance, *supra* note 493.

⁵³⁴ *Id.*

Graph 1. This can be a trigger that converts CCS into equity upon, for instance, a regulator's decision that additional capital is needed.⁵³⁵ Regulatory triggers can also be based on stress tests, or the determination that the respective bank is not viable without a public sector injection of capital or a write-off.⁵³⁶ A statutory systemic trigger is a trigger that by law converts CCS to equity when, for instance, a legally defined mortgage delinquency rate is reached. This would not provide regulators with discretion. Instead, statutory systemic triggers may be based on somewhat more objective measures, such as a delinquency rate, defined by law. The lack of regulatory discretion in the statutory systemic trigger would presumably give market participants more certainty as to possible trigger scenarios than a regulatory systemic trigger.

In this model, institution specific triggers would grant the most certainty to market participants. An automatic institution-specific trigger could be based on reaching a certain predefined threshold in the share price, credit default swap spreads, or debt equity ratios.⁵³⁷ Assuming that SIFIs would be required to disclose all CCS contracts with counterparties, including any triggering events therein, transactional institution-specific triggers may involve the lowest level of uncertainty for market participants.

B. Timing Trigger Events

The timing of triggering events is a crucial element in the design of contingent capital securities. If conversion is triggered too early without a real need for an equity capital injection (and additional voting shareholders), the impact of the equity capital injection may have dissipated and may no longer be available when actually needed. If conversion from debt to equity is triggered too late, the financial institution may already be in the resolution stage and conversion at that stage would not supply the company with sufficient equity to turn the company around. It is also unclear if contingent capital securities should be converted incrementally to soften the negative effect an early or late conversion may have. Jack Coffee prefers an incremental conversion in a series of steps.⁵³⁸ Others argue

⁵³⁵ See, e.g., Flannery No Pain, *supra* note 524, at 182–87 (supporting conversion of debt security tied to decline in bank's equity ratio). *Contra* McDonald, *supra* note 451, at 3 (rejecting the use of accounting figures in the trigger or conversion formulas); Coffee, *supra* note 26, at 831 (arguing against the use of account numbers in triggers).

⁵³⁶ BIS III, *supra* note 48.

⁵³⁷ Some have argued that these market based triggers could be subject to manipulation, see Ceyla Pazarbasioglu et al., *Contingent Capital: Economic Rationale and Design Features*, IMF Staff Staff Discussion Note (Jan. 2011), available at <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf>.

⁵³⁸ Coffee, *supra* note 26, at 830 (arguing for incremental conversion in a series of steps because that incremental conversion enables an early trigger for conversion. He uses the following example: “[A]n incremental design might hypothetically convert 25% of the convertible bonds on a 25% stock price decline from the stock price on the date of the

contingent capital provisions should permit “carefully designed partial or temporary write-downs within reasonable bounds.”⁵³⁹

C. Dual Triggers in Going and Gone Concern

Scholars have previously proposed models for contingent capital that involve dual triggers. McDonald suggests a model for contingent capital where debt converts to equity if both (1) “the firm’s stock price is at or below a trigger value,” and (2) “the value of a financial institution’s index is also at or below a trigger value.”⁵⁴⁰ McDonald provides an example of contingent capital with dual triggers and compares this model with other alternatives. McDonald also discusses various issues related to evaluating contingent capital proposals including the effect of market manipulation, capital errors,⁵⁴¹ and problems with reliance on accounting measures. A central strength of the dual trigger proposals is their reliance on market prices. A major disadvantage is the index trigger, which could potentially create incentives to manipulate the index or to try to force an entity into bankruptcy.⁵⁴² However, McDonald’s dual-price trigger may act like a single-price trigger in times of stress. Outside of a crisis scenario, the dual-price trigger contingent capital acts more like standard subordinated debt.⁵⁴³

Sequential triggers, on the other hand, may allow the conversion of

bonds’ issuance; another 25% might convert on a further 25% decline; and the balance would convert if the stock price fell 75% (or more) from the original price.”).

⁵³⁹ Monroe, *supra* note 452, at 4.

⁵⁴⁰ McDonald, *supra* note 451, Abstract.

⁵⁴¹ Such as contingent capital converting into equity when not required and contingent capital failing to convert into equity when it is required.

⁵⁴² McDonald, *supra* note 451, at 13 (“The difference between the converted and unconverted bond is greatest when the bond is close to maturity and the payment of par is a few days away. This is clearly a case where traders might try to manipulate the index to avoid conversion [. . .] Under some circumstances bondholders could have an incentive to try to force the institution into bankruptcy before conversion can occur. Suppose the share price is very low but the index price is above the trigger. Bond-holders may believe that they will receive a greater percentage of principal as subordinated bondholders in bankruptcy as opposed to the value of shares they would receive in default.”). See also Mark J. Flannery, *Stabilizing Large Financial Institutions with Contingent Capital Certificates* 18-19 (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1485689 (“A market-valued trigger might attract market manipulation. A speculator could purchase some CCC, short the stock, and receive under-valued shares when the conversion trigger was tripped. If short sales could force a solvent firm’s share price to zero, CCC might destabilize financial firms rather than stabilizing them.”).

⁵⁴³ George Pennacchi, *A Structural Model of Contingent Bank Capital*, *supra* note 451, at 12 (arguing that “dual-price trigger contingent capital acts like single-price trigger contingent capital in a crisis but acts like standard subordinated debt in a non-crisis.”). See also George Pennacchi, *A Structural Model of Contingent Bank Capital*, *supra* note 451, at 28 (concluding that “yields on dual-price trigger contingent capital fall between those of comparable single-price trigger contingent capital and subordinated debt”).

contingent capital into equity in a going and gone concern scenario.⁵⁴⁴ Given that the European Commission structures its resolution regime into going and gone concern with a significant role for contingent capital in both going and gone concern,⁵⁴⁵ sequential triggers in going and gone concern could help improve incentives for decision makers in the financial institutions and policy makers.⁵⁴⁶ Sequential triggers within the European Commission's targeted and comprehensive approach⁵⁴⁷ could take various forms. The first trigger converting contingent capital securities into equity could be based on various models that had previously been discussed in the literature.⁵⁴⁸

If the financial health of the financial institution does not return up to a predefined threshold, the voting rights of such common stock (as a result of conversion from debt into equity) could be changed to give the former holder of contingent capital securities more influence in the resolution phase of the financial institution.⁵⁴⁹ This has several benefits. Given the risk that policy makers may not structure the trigger appropriately, the negative effects of inadequate or untimely conversion of debt into equity at a time when the company requires a capital injection could be cushioned with a second trigger before the reorganization or resolution of the company.⁵⁵⁰ A second trigger pre-reorganization of the entity could add an element of prudential regulation because it would apply only to a small portion of SIFIs rather than all internationally active banks. It would only come into effect if the first trigger was unsuccessful, and it would merely increase the dilution of shareholder voting rights as a remedy of last resort before bankruptcy.⁵⁵¹ The interplay of conversion from debt to equity before resolution as a preventative act and the use of a second trigger in the resolution stage would have to be carefully calibrated. More research is needed to determine the best incentive structure for contingent capital holders and management.⁵⁵²

⁵⁴⁴ Kaal & Henkel Sequential, *supra* note 498.

⁵⁴⁵ DG Working Document, *supra* note 10, at Annex I.

⁵⁴⁶ See Kaal & Henkel Sequential, *supra* note 498 (proposing sequential triggers where the first trigger would be a preventative tool while the second trigger before the resolution phase would provide additional voting rights for contingent capital holders to secure success of the first trigger and set appropriate incentives for shareholder and management).

⁵⁴⁷ *Id.*

⁵⁴⁸ See generally Coffee, *supra* note 26.

⁵⁴⁹ Kaal & Henkel Sequential, *supra* note 498.

⁵⁵⁰ *Id.*

⁵⁵¹ *Id.*

⁵⁵² See further Kaal Executive Compensation, *supra* note 493.

VI. CONTINGENT CAPITAL AS A PREVENTATIVE TOOL IN EUROPEAN UNION BANK RESTRUCTURING

Proposals on bank restructuring by the European Commission,⁵⁵³ the Basel Committee,⁵⁵⁴ and the Financial Stability Board⁵⁵⁵ focus on statutory debt write-down or bail-inables within resolution. Although the potential of contingent capital as a preventative tool is widely recognized,⁵⁵⁶ the European Commission and national legislators have not yet adopted contingent capital as a mandatory part of capital requirements for financial institutions. Instead the European Commission merely favors the recognition of contingent capital as Tier 1 common equity, leaving the implementation of contingent capital to the markets and the discretion of national legislators.⁵⁵⁷

For instance, the Swiss approach to contingent capital stops short of making the issuance of contingent capital a mandatory requirement for Swiss SIFIs. The Swiss Banking Act requires Swiss SIFIs to be prepared for future crises⁵⁵⁸ but leaves it up to management to determine if such preparation should entail the issuance of contingent capital or raising additional capital.⁵⁵⁹ In practice, however, issuing contingent capital securities could be less expensive than raising additional Tier 1 capital. With total Swiss capital requirements at 19 % of risk weighted assets, well beyond the capital requirements under Basel III, Swiss SIFIs could be well advised to issue contingent capital securities. The Swiss Banking Act requires a regular review of its provisions to ensure comparability with international standards.⁵⁶⁰

At the European level, the European Union bank resolution regime could be further enhanced with contingent capital. The European bank resolution regime could work more effectively and more comprehensively

⁵⁵³ See DG Working Document, *supra* note 10.

⁵⁵⁴ See Bank for Int'l Settlements [BIS], Basel Comm. on Banking Supervision, Consultative Document: Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement (2011), available at <http://www.bis.org/publ/bcbs201.pdf>.

⁵⁵⁵ See FIN. STABILITY BD., *supra* note 71.

⁵⁵⁶ See, e.g., Press Release, *supra* note 27; see also DG Working Document, *supra* note 10; see CRD IV Regulation, *supra* note 10; see CRD IV Directive, *supra* note 10.

⁵⁵⁷ See, e.g., CRD IV Regulation, *supra* note 10, arts. 48a, 49(1)(n), & 51(b).

⁵⁵⁸ BUNDESGESETZ ÜBER DIE BANKEN UND SPARKASSEN [BANKG] [FEDERAL LAW ON BANKS, SAVING AND LOANS] Nov. 8, 1934, SR 952, art. 9 (Switz.), available at <http://www.admin.ch/ch/d/ff/2011/7487.pdf>.

⁵⁵⁹ See Swiss Banking Act, SR 952.0 art. 11, 14

⁵⁶⁰ The Swiss Banking Act specifically requires a regular review of all provisions after the implementation of the initial amendments. The first review is scheduled, at the latest, three years after the implementation, and followed by a two-year interval thereafter. The goal of the review is a comparison with international standards in other countries. See *id.* art. 52.

with contingent capital as a preventative tool. Contingent capital could play an important role in an effective resolution regime, it could provide additional loss absorbing capital before any regulatory intervention is necessary, and contingent capital could be a reliable source of common equity.⁵⁶¹ This is of particular significance if SIFIs are mandated to organize in a manner that ensures the continuous operation of their systemically important sectors.⁵⁶²

Contingent capital could work well within the European Commission proposal on bank resolution. It could be part of bank capital requirements. Alternatively, contingent capital could become part of resolution and recovery plans prior to financial institutions entering the vicinity of bankruptcy. The issuance of contingent capital could take place at the earliest possible stage, when the institution is still sound on a micro-prudential basis.⁵⁶³ It could also be part of mandated recapitalizations if financial institutions are unable to pass stress tests.⁵⁶⁴ Conversion of CCS from debt to equity should take place when problems are first detected but before early intervention powers of regulatory authorities are triggered.⁵⁶⁵

Contingent capital may help SIFIs to reorganize without the involvement of courts and regulators. Compared to preferred stock, Tier 2 debt, and other subordinated debt, contingent capital can help firms to recover from distress without going into resolution.⁵⁶⁶ It could provide a soft-landing similar to reorganization as a going concern through the debtor in possession under Chapter 11.⁵⁶⁷ The restructuring of a financial

⁵⁶¹ Kaal & Henkel Sequential, *supra* note 546.

⁵⁶² See, e.g., BUNDESGESETZ ÜBER DIE BANKEN UND SPARKASSEN [BANKG] [FEDERAL LAW ON BANKS, SAVING AND LOANS] Nov. 8, 1934, SR 952, art. 9, ¶ 2(a)(2) (Switz.) (“2. Systemically important banks must specifically: (a) dispose of common equity, which will namely: . . . 2. Contribute substantially to the continuing operation of all systemically relevant functions in case of impending insolvency.”); *id.* art. 9, ¶ 2(d) (“2. Systemically important banks must specifically: . . . (d) provide for a resolution plan that can be implemented immediately and in case of impending insolvency ensures the continuing operation of all systemically relevant functions. The resolution plan must address structural, infrastructural, management and control concerns, and shall ensure group internal capital flow and liquidity.”); *id.* at art. 10, ¶ 10(2) (“2. The systemically important bank shall prove that it fulfills the specific requirements of art. 2, subsection 2(d) and is able to continue the operation of its systemically important functions in case of impending insolvency. If the bank cannot provide this proof, FINMA shall order the implementation of all appropriate measures.”) (translations provided by the authors).

⁵⁶³ John C. Coffee, *supra* note 26, at 831 (providing a rationale for why an “early and incremental conversion” may be advantageous).

⁵⁶⁴ See, e.g., Brooke Masters, Peggy Hollinger & Alex Barker, *EU to Speed Recapitalization of Smaller Banks*, FIN. TIMES, Sept. 23, 2011, <http://www.ft.com/intl/cms/s/0/49d6240e-e527-11e0-bdb8-00144feabdc0.html?ftcamp=rss#axzz1bBppLalv>.

⁵⁶⁵ Specific trigger designs may require additional research, Member State consensus, and market development. See discussion *supra* Part V.

⁵⁶⁶ FIN. STABILITY BD., *supra* note 75, at 12; see *supra* text accompanying note 555.

⁵⁶⁷ Kaal & Henkel Sequential, *supra* note 546 (elaborating on the use of contingent

institution would be initiated on a voluntary basis by the institution itself and without any public involvement. Contingent capital would provide additional downside protection.

Contingent capital as a preventative tool would not impede the statutory core power or debt write-down tool of bail-inables within resolution. If the contractual debt write-down and conversion at an early stage does not achieve the desired result, regulatory authorities would not be prevented from intervening and initiating a write-down or haircut aimed at all shareholders, debt investors, and other private parties involved.

VII. CONVERGENCE

Without a degree of similarity and convergence in bank resolution and contingent capital rules, regulatory arbitrage could have an adverse effect on establishing contingent capital as an integral part of financial markets. Although many proposals on contingent capital are based on similar ideas, a coherent trend toward convergence of contingent capital standards seems still elusive. This could partially be due to a first mover problem. Single jurisdictions could be hesitant to implement contingent capital requirements without first knowing how other jurisdictions and financial institutions that compete with their home institutions may structure their contingent capital rules.

The European Commission Regulation Proposal which defines Tier 1 capital⁵⁶⁸ could be a first step toward setting up a basic framework for harmonized contingent capital standards. While the Commission proposal only harmonizes the definition of Tier 1 capital, Member States are free to set up rules for contingent capital or leave contingent capital designs up to private ordering.⁵⁶⁹ The European Commission Regulation Proposal and its harmonization of the Tier I capital definition could fill a void left by the Basel Committee. The Basel Committee rejected requests from EU Member States to use contingent capital to satisfy the new capital buffer requirements under Basel III.⁵⁷⁰ Instead, the Basel Committee decided to require SIFIs to use retained earnings and ordinary shares to meet heightened capital requirements.⁵⁷¹ While this approach will not fully

capital as a pre-reorganization tool).

⁵⁶⁸ CRD IV Regulation, *supra* note 10.

⁵⁶⁹ For a discussion on the benefits of private ordering and the calibration of market mechanisms, private ordering, and mandatory rules see Kaal, Corporate Governance, *supra* note 493; *see also* Kaal, Executive Compensation, *supra* note 493 (discussing the use of contingent capital for dynamic regulation of financial institutions).

⁵⁷⁰ Meera, *supra* note 490.

⁵⁷¹ *Id.* (noting that this was a victory for U.S. regulators over their European counterparts and quoting Karen Shaw Petrou, managing partner of Federal Financial Analytics Inc., a Washington-based, bank consulting firm: "Europeans were pushing for a mix of common equity and contingent capital and they lost at a global level.").

replace a requirement under Basel III to use contingent capital to satisfy a new capital buffer, it leaves enough flexibility for counterparties and the legislators in the respective EU Member States to implement contingent capital.

Despite an active discourse on harmonization and convergence of contingent capital criteria in Europe, the debate in the United States on the use of contingent capital in bank restructuring is just in the beginning stages.⁵⁷² Although the Dodd Frank Act authorizes the use of contingent capital, its design features and the extent of its potential applications are unclear.⁵⁷³ The Federal Reserve Board, through Section 165(b)(1)(B) of the Dodd-Frank Act, can impose “a contingent capital requirement” on both “nonbank financial companies supervised by the Board of Governors” and certain “bank holding companies.”⁵⁷⁴ However, this authority is contingent on the outcome of a study on the feasibility of contingent capital.⁵⁷⁵ The SEC study, mandated by Section 115 (c) of the Dodd-Frank Act, requires an evaluation of the international competitiveness of United States companies that implement contingent capital.⁵⁷⁶

Single jurisdictions may be deterred from implementing contingent capital requirements without knowing or being able to anticipate how other jurisdictions will structure their contingent capital rules. This could be a special concern because legislators may want to structure contingent capital rules in a way that enables their national financial institutions to compete with other international financial institutions that would be subject to the

⁵⁷² Coffee, *supra* note 26, at 846.

⁵⁷³ Kaal & Henkel Sequential, *supra* note 498.

⁵⁷⁴ Dodd-Frank Act, Pub. L. No. 111-203, § 165(b)(1)(B), 124 Stat. 1376 (2010).

⁵⁷⁵ *Id.* § 165(c)(1) (“CONTINGENT CAPITAL.— (1) IN GENERAL.— Subsequent to submission by the Council of a report to Congress under section 115(c), the Board of Governors may issue regulations that require each nonbank financial company supervised by the Board of Governors and bank holding companies described in subsection . . .”). The content of the study is described in Section 115 (c) of the Dodd-Frank Act. (“(c) CONTINGENT CAPITAL.— (1) STUDY REQUIRED.—The Council shall conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), which study shall include— (A) an evaluation of the degree to which such requirement would enhance the safety and soundness of companies subject to the requirement, promote the financial stability of the United States, and reduce risks to United States tax- payers; (B) an evaluation of the characteristics and amounts of contingent capital that should be required; (C) an analysis of potential prudential standards that should be used to determine whether the contingent capital of a company would be converted to equity in times of financial stress; (D) an evaluation of the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital; (E) an evaluation of the effects of such requirement on the international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such requirement; and (F) recommendations for implementing regulations.”).

⁵⁷⁶ *Id.* § 115 (c)(1)(D)–(E).

contingent capital rules in their home state. Without a certain level of convergence in contingent capital rules, regulatory arbitrage could have an adverse effect on establishing contingent capital as an integral part of financial markets.

VIII. CONCLUSION

Disparate bank resolution and restructuring regimes in Europe and the United States could face many challenges in future crises. Contingent capital may offer a viable and efficient alternative for the prevention of bank failure and facilitates the efficient restructuring and resolution of failing financial institutions. Similar to a Chapter 11 reorganization procedure, contingent capital could offer a soft landing for banks in distress and may be specifically well suited for systemically important financial institutions. The European Commission has recognized the possible role contingent capital could play for the European banking sector. Contingent capital may also enhance and harmonize disparate resolution regimes throughout the European Union and could help ensure the competitiveness of the financial sector. The exact calibration of design features is crucial for the establishment of a future market in contingent capital securities. The uncertainties involved in the trigger mechanisms may require a reevaluation of trigger designs currently under consideration. Given the European initiatives on contingent capital and the nascent market in European contingent capital securities, the Board of Governors of the United States Federal Reserve would be well advised to consider implementing contingent capital standards. Contingent capital securities could help ensure the future competitiveness of financial institutions in the United States.