the global voice of
the legal profession

The International Bar Association's
Task Force on the Financial Crisis

A survey of current regulatory trends

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For additional information on the global financial crisis, including the Interim Report of the IBA Task Force, April 2010, and links to relevant external reports, please visit: **www.ibanet.org/LPD/Task_Force_on_the_Financial_Crisis.aspx**

To discuss these issues further, please visit our online forum: **http://tinyurl.com/financial-crisis-discussion**

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'There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new order, this lukewarmness arising partly from fear of their adversaries… and partly from the incredulity of mankind, who do not truly believe in anything new until they had actual experience of it.'

Niccolo Machiavelli, The Prince

The work of the IBA's Task Force on the Financial Crisis

Hendrik Haag, Chair of the IBA's Task Force on the Financial Crisis

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When the Task Force started its work at the beginning of 2009, the objective was not to propose a new model of global financial regulation to the governments, central banks and supervisory authorities of the world's leading economies. It was clear from the outset that whatever consequences would flow from the painful experience of the financial crisis, the resulting changes to the regulatory infrastructure would emerge from a slow process influenced by a multiplicity of lobbying groups, national organisations, political considerations and practical limitations. However, we were convinced that we, as lawyers, could make a valuable contribution to the process at some stage.

The members of the Task Force are seasoned practitioners in the field of bank regulation who have advised their clients for decades with respect to all aspects of supervision of the financial industry. In that role they have seen many changes to the regulatory frameworks in their countries and worldwide, not only at the fringes but often at the central pillars. Not always were these changes for the better. In addition, the lawyers in the Task Force combine broad experience with respect to the pitfalls, inconsistencies and contradictions to which internationally-active financial institutions are exposed when dealing with regulatory systems in a number of different jurisdictions at the same time. In some instances, what is a legal requirement in one country is strictly forbidden in another (for example, in relation to the timing of market disclosure or the rules for data protection), and it takes good legal advice to protect a client against exposure to regulatory sanctions in situations like that. Vice versa, the lawyers in the Task Force have often helped their clients to benefit from regulatory arbitrage by pointing out variations in supervisory constraints in different parts of the world. However good for business these disparities may be, they can encourage inefficiencies or evasive behaviour on the part of market participants, both of which have costly and potentially dangerous effects. Furthermore, while advising their clients in the wake of the crisis the members of the Task Force had direct insight into the myriad of legal issues generated by the insolvency of a major financial institution. To mention just a few: frozen customer assets, timely compensation by deposit insurance institutions, workout of complex derivative structures affected by insolvency, regulatory

* The author would like to thank Roger McCormick (London School of Economics and Political Science) and Randall Guynn (Davis Polk & Wardwell) for their comments on this chapter.

investigations and many others.

In essence, the driving force behind forming the Task Force was the conviction that experienced lawyers in the field of financial regulation can make a valuable contribution to the process of regulatory reform when it comes to transforming conceptual agreements made by politicians, central bankers and supervisors into rules, regulations and legislation. While lawyers do not tend to have a view on what amount of regulatory capital is appropriate for a financial institution or what the suitable risk weighting is of an asset on the balance sheet of a bank, they do know the legal attributes of the instruments that constitute regulatory capital and how they work if the institution is in distress. They also have a good understanding of the role that rating agencies play when determining the risk category of an asset and how rating opinions are put together. It is this kind of detail which will be of enormous practical importance when the new rules come into force, and it is certainly worth the effort to take a close look before the new rules are in final form. The common goal must be to seize the opportunity presented by the financial crisis for a redefinition of financial regulation to come up with an internationally consistent, appropriately strict but sufficiently flexible set of rules that apply to all major financial centres of the world, and thus create the level playing field that both the financial industry and the regulators have been seeking for quite some time.

When the Task Force started its work at the beginning of 2009 it had expected that, at the 2010 IBA Annual Conference in Vancouver, it would be able to present its final report on the new regulatory framework of the world's leading nations designed in response to the lessons learned from the global financial crisis. As it turned out, at the time of writing this report we are still a few steps away from all of the new rules being implemented, and do not have the initial practical experience of their application. It is obvious, however, that the uambitious plans immediately generated by the severe concerns caused by the spreading crisis – namely finding the solution in a new, far-sighted and worldwide regulatory system with a global regulator at the top – have quickly faded to insignificance. Leaving aside whether this would in fact have been a desirable solution, it soon became clear that national interests would prevail over international harmonisation and cooperation once the dust settled

For many of the leading nations the financial industry plays a very important role in the economy, not least as an employer and a taxpayer. Internationally-active financial institutions are in competition with each other worldwide, and the efficiency – but also flexibility – of regulation is an important factor in mastering this competition successfully. So it was no surprise that when more drastic regulatory measures came into the discussion, national governments readily agreed that they could only consent to this if all other financial centres of importance would follow. Regulatory competition posed a risk that the reform process would turn into a race towards the least burdensome supervisory environment. But there are some remarkable exceptions, often driven by public opinion. The United Kingdom, for example, introduced a bonus tax to roll back the excesses of bonus payments developed in the affluent period of the industry

before the crisis. Most institutions have decided to bear the tax in protection of their employees, but this constitutes a substantial expense for them affecting their overall financial results. On 20 July 2010, Goldman Sachs Group, Inc reported that it had paid US$450 million to the British treasury as its share of the tax. Bank of America Merrill Lynch reported a charge of US$425 million for UK bonus tax in its second quarter of 2010. Deutsche Bank said that it had paid €120 million as UK bonus tax. For the time being, the UK Government is holding onto the bonus tax, although it will obviously have an impact on the attractiveness of the city as a financial centre.

Another example of a government willing to make an unpopular decision is Germany's regulation against short-selling of euro-denominated government bonds. This was a reaction to the euro crisis triggered by euro zone member Greece, which found itself unable to refinance its public debt when the truth about its public deficit statistic came to light. This regulation was blamed by many as being an overshoot and useless at the same time, because euro trading can easily escape to markets outside Germany and beyond the reach of the regulation. But the German Government thought it was necessary to make a point. To avoid erosion of the new idea by public debate, the regulation came as a surprise over night. This was necessary to avoid undesirable arbitrage, but at the same time this was a coup against industry lobbyism. Governments had their experience with the lobby of the financial industry which is certainly one of the most efficient and best prepared of all sectors of the economy.

Mentioning these two examples neither means support nor rejection of this governmental action. These examples are, however, evidence of how erratic and uncoordinated the response to the financial crises in the various countries can sometimes be. Of course, there are also developments indicating more concerted action, not least the efforts of the G20. Good examples of the work of the G20 are the leaders' statement from the Pittsburgh Summit, which took place on 24-25 September 2009, and the G20 Toronto Summit declaration, which took place on 26-27 June 2010. The Pittsburgh statement starts out with the slightly pathetic phrase that the leaders 'meet in the midst of a critical transition from crisis to recovery to turn the page on an era of irresponsibility and to adopt a set of policies, regulations and reforms to meet the needs of the 21st century global economy'. What follows is a list of points on which the G20 leaders have agreed with respect to the causes and effects of the financial crisis, including, for example, 'making sure our regulatory system for banks and other financial firms reign in the excesses that led to the crisis', or 'to reform the global architecture to meet the needs of the 21st century', which is explained as including the formation of the Financial Stability Board and stronger participation of the dynamic emerging markets in the International Monetary Fund. The results of the Toronto Summit seemed a little more concrete. The bulletin mentions as the four pillars for financial regulatory: first, a strengthening of the regulatory framework, spear-headed by the Basel Committee on Banking Supervision; second, establishment of more effective supervision, evidenced first of all by the inauguration of the Financial Stability Board; third, designing a system where there are sufficient

powers and tools to restructure or resolve systemically-relevant financial institutions without taxpayers ultimately having to bear the burden; and fourth, establishing a transparent international assessment and peer review. An extract from the Summit statement gives more detail regarding higher capital and liquidity requirements for financial institutions, in particular an increased Tier 1 capital component with a strong preference for common equity; more intensive supervision; an effective resolution scheme for financial institutions; better control over systemically-important financial institutions; more efficient financial market infrastructure and scope of regulation; and further developments in accounting standards and the peer review process, which is meant to monitor consistent cross-country implementation of financial and regulatory policies and to assess the effectiveness in achieving the intended results.

While the efforts of the G20 should be welcomed as a valuable contribution to the struggle of driving global regulatory reform, its recommendations and commitments are inevitably vague and leave plenty of room for each of the member countries to claim being in compliance with the findings of the summit. In addition, the developments taking place just a few weeks before this report is printed show that the process of regulatory reform has by no means come into its final phase. In fact, many of the key jurisdictions for international finance are still working on implementing new laws and regulations which they think are necessary or appropriate to address the issues exposed by the financial crisis in their countries, as well as to comply with international commitments. In an important country for financial services, the United States of America, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on 21 July 2010. This Act, which brings about the most fundamental reform to the regulatory system in the United States since the 1930s, has been the subject of very controversial parliamentary debates and is the product of a protracted political process. It has many bruises stemming from compromise between party leaders, industry representatives and consumer lobbyists. The situation is similar in other countries. Germany has just proposed key legislation for the resolution of systemically-relevant financial institutions, and also in Switzerland key pieces of regulatory reform are still in the making. In the UK, new laws have been passed to introduce a 'special resolution regime' for banks in financial difficulties, and there are proposals being considered to change the law regarding the insolvency of investment banks, as well as (following the change in government in May 2010) making important changes to the regulatory regime, with the Bank of England returning to the fore at the expense of the FSA. A new Commission will report in 2011 on the question of structural reform of the banks themselves, with a possible splitting of commercial deposit taking from investment banking under consideration.

Because so many important changes remain in a state of flux, the original plan of the Task Force to deliver a profound analysis of the results of the global reform process at the occasion of the IBA Annual Conference in Vancouver in October 2010 could not be accomplished. Instead, we are herewith submitting a collection of reports from eight relevant jurisdictions giving descriptions of the response to the crisis which legislators and regulators have taken in the various countries. The reports look at measures taken

in dealing with the immediate effects of the crisis, such as the imminent failure of systemically-relevant institutions or the danger of the bank runs, but also describe the new laws and regulations adopted to prevent a future crisis or at least to mitigate its effects. These countries are the US, the UK, Germany, France, Spain, Switzerland, Japan and, as an emerging country, Russia. The reports show that the process in each of the countries is strongly influenced by the specific situation of its financial industry, which is obvious, but also by political sentiments and the balances of political power.

Although the world is still far from following a common plan for regulatory reform, supported by the efforts of G20 and the Basel Committee on Banking Supervision there are certainly a number of issues which are on the priority list of lawmakers around the world. In the following, we will provide preliminary comments and observations with respect to these major issues and how they have been addressed. This list of the most relevant issues may also serve as a starting point for the future work of the Task Force when it comes to analysing the effects of the new legislation and to make final recommendations for changes, amendments, or even other areas for which stronger regulatory attendance would be desirable.

The regulatory architecture – fighting fragmentation and inefficiency

Fragmentation and inefficiency of regulatory supervision has been identified as a major concern by the G20 and a number of other countries. This concern does not only relate to the lack of cooperation between the authorities on an international level, but also in some cases to the split of regulatory responsibilities between various authorities inside a particular country. In the United States, for example, there were a number of different institutions involved in supervising the financial sector, including the Federal Reserve, the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation and others. In particular, the role of the SEC has come into the spotlight after the default Lehman Brothers. The Madoff scandal,[2] where the SEC had failed to expose the embezzlement of more than US$50 billion, added to the decline in reputation.

In the US, doing away with the fragmentation of the supervisory architecture played an important role in the debate about regulatory reform. Ambitious plans initially presented by the Obama administration to concentrate power massively on the level of the Federal Reserve did not become reality. It is presently proposed that the Office of the Comptroller of the Currency and the Office of Thrift Supervision should be merged into a new national bank supervisory authority. In the United Kingdom there was less of an issue with supervisory fragmentation. However, the so-called 'light touch' regulation by the Financial Services Authority (FSA) fell into disrepute. While the

2 Bernard L Madoff was the owner of the Bernard L Madoff Investment Securities, LLC, a broker and investment manager. In December 2008, Bernard Madoff was arrested being charged of having operated a Ponzi scheme. The following investigation revealed that liabilities to customers exceeded assets by more than US$50 million.

FSA's practice of putting up new regulation for public comments well before they became effective was considered an efficient and market-friendly way of supervision, it seems that in some instances it had been too easy to convince the FSA that little or no regulation would be better to defend the competitiveness of London's financial market against other financial centres. The importance of the City of London for the UK's economy is hard to overestimate, and it had been the declared policy of the UK Government to attract and keep ever more financial business in London. It has now been decided to abolish the FSA (in due course) and give the Bank of England wide-ranging powers in financial industry supervision. The change will make the new enlarged central bank of the UK a powerful regulatory body with responsibility for both monetary policy and financial regulation.

But not only were fragmentation of supervisory powers and overly-accommodating supervisory policies identified as having contributed to the crisis. At least as important is the lack of international cooperation between supervisory authorities. This applies not only to coping with the threats posed by a global financial institution coming close to insolvency, but also to the absence of concerted international action aiming at an early identification of dangerous trends in the world's financial markets. As mentioned before, the G20 have committed to stronger international cooperation now. In that context, the Financial Stability Board (FSB) was established at the level of the Bank for International Settlements. The FSB has been created to coordinate at the international level the work of national financial authorities and international standard setting boards and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It includes 23 national regulators and other international organisations, such as the European Central Bank, the European Commission, the International Monetary Fund, the Organisation for Economic Coordination and Development as well as the World Bank.

A similar body has been established inside the European Union. It is named the European Systemic Risk Board (ESRB). The ESRB is a new European body responsible for macro-prudential oversight. It shall develop the European macro-prudential perspective to address the problem of fragmented individual risk analysis at national level. Further, it is to enhance the effectiveness of early warning mechanisms by improving the interaction between micro- and macro-prudential analysis. Finally, it shall allow for risk assessments to be translated into action by the relevant authorities. The ESRB will be composed of a general board, a steering committee and a secretariat. The general board includes 27 governors of national central banks, the president and vice-president of the ECB, one member of the European Commission and the chair persons of the three European supervisory authorities. In addition, there are 27 representatives of EU Member States with no voting right as well as the president of the Economic and Financial Committee. This adds up to no less than 61 persons.

The ESRB and SRC are evidence for the difficulties to establish effective international bodies dealing with the innovation and speed of the world's financial markets in a timely fashion. While international cooperation is definitely wanting, supervision and,

most importantly, prevention can only be achieved by bodies with a workable number of members which are safely shielded against political influence. It is debateable whether a global regulator for the world's leading financial institutions would be desirable, but even if it were it is hard to believe that it could be achieved politically. Even if that were possible, it is likely that it would come out as a bureaucratic monster with a leadership proportionately partitioned among the participating states.

The present trend towards creating a more efficient supervisory infrastructure are certainly to be welcomed. However, on an international level there are serious doubts as to whether what has emerged so far represents a big step forward. The bodies are too large and clumsy and not remote enough from the political process. In addition, it is difficult to believe that anyone would have clearly recognised an undesirable development such as the excessive growth of the US sub-prime market for mortgages at a time where it would have been possible to stop the process and scale it back. What would have happened if the ESRB or the SRC had existed in, for example, 2004? Sub-prime mortgages did not just spring from the financial industry's Pandora's box and develop into a monster. They were politically supported because the US Government were keen that people who traditionally could not afford to buy a home were able to do so. Could a systemic risk counsel have stopped that? Very unlikely, because at the time the whole industry played the risks involved down by pointing to the credit ratings of these products. It is generally fair to assume that products or practices in the financial industry that have the potential of turning into a systemic risk are spreading quickly because they are very lucrative. It is also fair to assume that lucrative products create large numbers of jobs. This is where politicians start losing clear sight and why supervisors need to be independent enough to be able to make unpopular decisions.

When one is not convinced that preventing the next crisis will really be possible, it becomes even more important to have efficient instruments at hand in dealing with a crisis. A particular problem in this regard is how to overcome national egoisms. The Lehman Brothers case has shown that national regulators quickly become very self-centred in their thinking when it gets to repatriating or locking in funds necessary to preserve the liquidity of the parent bank or a subsidiary in their own country. This may be understandable, but it is certainly not always helpful. Better cooperation of national regulators based on clear cut rules negotiated beforehand would certainly be a great step forward.

In summary, the world has become a better place in terms of less fragmented and better coordinated supervision of the financial industry, but it is still far from being in a position to deal with the next crisis in a fundamentally more efficient manner, let alone to prevent one. The necessity of rescuing a too-big-to-fail institution with government help will not become a matter of the past soon.

More (and better quality) capital for banks

The financial crisis has raised a number of questions relating to the adequacy of the capitalisation of financial institutions. This relates primarily to equity on the one hand

and to liquidity (including the possibility of refinancing maturing liabilities without interruption by market turmoil) on the other. For regulatory purposes, 'equity' is commonly called regulatory capital. This includes not only equity in the traditional sense but also other forms of capitalisation which may constitute debt for civil law and/or tax purposes (so-called hybrid capital).

An obvious issue is the amount of capital that a bank must have. This is relevant because the regulatory capital helps the bank to digest losses which it has incurred in its business by allowing those losses to be netted off against the amount of regulatory capital. This is only possible, however, where the terms of the instrument constituting regulatory capital allow for a loss participation on a going concern basis. Most of the existing instruments do not – but only upon insolvency – and have fallen in disgrace as a result of the financial crisis. Yet, on the other hand, keeping a bank liquid is a particular challenge where markets have been drying out in a shock as was the case in September 2007. In this scenario, a bank that has more long-term funding is better off than one that has to turn to the market to satisfy its refinancing needs on a daily basis.

The general problem with raising capitalisation requirements is that they cost banks substantial amounts of money. Regulatory capital, for example, is more expensive because investors want to be compensated for the higher risk they are taking in connection with this form of investment. In addition, higher liquidity requirements are costly because they limit the ability of a financial institution to invest into less liquid and potentially higher yielding, financial products.

From the beginning the discussion about increased capital requirements was strongly influenced by lobbyism and political considerations. Banks fulfil a central role in providing financing to the economy that is necessary for growth and job creation. Tighter capital requirements will eventually lead to higher costs of financing. The Institute of International Finance has calculated that the measures presently being designed on the level of the Committee for Banking Supervision at the BIS would, if implemented, slow down the growth of the gross domestic product in the United States, Europe and Japan until 2015 by three per cent, which is expected to result in 9.7 million fewer jobs being created. Whether right or wrong, calculations like this show how sensible the topic is for political leaders. While the deep impression caused by the crisis is still fresh, politicians feel torn between building a safer financial system and keeping the costs of the new safety nets under control. The more it seems like the crisis is over, the stronger the economic growth considerations become. In addition, financial institutions have launched a strong lobbying campaign. For them, higher costs mean less profit and a smaller pot for bonuses. While it is certainly legitimate to point out the implications of increased cost for the financial industry, one should be weary that the 'come on it wasn't as bad as all that' approach demonstrated by some representatives of the industry does not gain too much weight too quickly.

The following is a brief discussion of the parameters presently debated in connection with increased capital and liquidity requirements.

Increased minimum capital requirements

Under Basel I and Basel II the minimum capital requirement was eight per cent of risk weighted assets, of which four per cent had to be so-called Tier 1 capital. This is capital which for the most part is equivalent to traditional equity but has a number of other components. While a high capital quota is important for a financial institution to be able to absorb losses, it is by no means the only decisive factor. For example when Lehman Brothers became insolvent it had a Tier 1 capital quota well above the required minimum, but this did not protect it against its liquidity problems. The Committee on Banking Supervision at the BIS is presently debating new capital requirements. Details are yet unclear except that there seems to be a broad consensus that the percentage of capital underlying risk weighted assets will go up.

Changed composition of regulatory capital

As already mentioned, those components of regulatory capital which do not constitute conventional equity are under profound scrutiny. Many financial institutions had taken up large amounts of hybrid regulatory capital, partly as part of their Tier 1 capital, which only participated in losses upon liquidation (gone concern basis) and not while the bank was still operating (going concern basis). There is now an agreement in principle that in order to qualify for Tier 1 capital, instruments must be able to absorb losses on a going concern basis. This can only be achieved if they are actually written down if the bank incurs a loss. Some of the existing instruments work like that, others do not.

In addition, there was an issue with permanency of the capital. To qualify as Tier 1 capital, there should be no fixed maturity or any other firm obligation to repay the capital at a certain point in time. Under the 1998 accord defining the requirements for hybrid capital instruments, it was acceptable to have a mild step up after ten years. This is an increase of the interest rate giving the issuing financial institution an incentive to terminate and redeem the instrument. The problem with this was that in the perception of the investors, which was shaped by how the bonds were marketed, the bond would be redeemed before the step up becomes operative, that is after ten years. Because issuers were keen to continue issuing similar instruments in the future, they wanted to avoid disappointing market expectations and felt obliged to actually redeem the instrument after that initial ten-year period. Regulators around the world have reacted very negatively to that behaviour, in some instances ordering institutions not to redeem, although they would have liked to do so despite an eroding capital base. This development, in addition to the inefficient loss absorption mechanism on a gone-concern basis, has discredited hybrid instruments to a large extent. Initially, regulators were demanding that Tier 1 capital should only comprise traditional equity components such as share capital, retained earnings and paid in surplus capital. The view seems to have softened a bit recently.

The problem with banning hybrid Tier 1 capital, or cutting back substantially the

extent to which it can be imputed in Tier 1, has a large cost implication for financial institutions. Other than with traditional equity, payments on hybrid capital are normally tax deductible. The criticism to which hybrid capital is exposed appears to be an overshoot in some respects. In relation to permanency, one has to consider that conventional equity in the form of retained earnings has no minimum maturity, and thus no permanency, at all. Instead, it can be distributed to shareholders whenever the bank thinks fit (of course the right to distribute capital has recently been restricted by new bank rules introduced in many countries to avoid irrational dividend payments at a time when the institution badly needs the funds). The important criteria are that there is no obligation to redeem the instrument, in other words that it cannot be terminated by investors but only by the issuing bank. To this end, investor expectation may indeed be a problem. Where the instrument has been marketed with a ten-year maturity suggesting that the issuer would definitely repay after the non-call period, it may be difficult to back away from this suggestion. The ten-year maturity perception also had an influence on pricing. Had investors known that the instrument may be outstanding for a longer time, they would have asked for a higher interest rate. Accordingly, the expectation of an early redemption has been part of the commercial deal.

In essence, the suitability of instruments for Tier 1 is not so much a question of early redemption forced by market expectation but a question of clear communication and pricing. If investors know that the instrument may remain outstanding after ten years, and they are compensated accordingly, the bank will have no reputational problem with not calling the instrument early. Instead of banning these instruments altogether because they do not constitute conventional equity, it would be better to make sure that there is no false perception in the market of what their terms and conditions actually mean.

As already mentioned, loss compensation on a going concern basis should, however, be an indispensable requirement for Tier 1 capital. Subordination upon liquidation may give a benefit to senior creditors in insolvency but it does not help the bank survive stress situations. If the bank incurs losses, it must be able to reduce its liabilities by writing down its Tier 1 capital components, be it reserves or the principal under more debt-like instruments. This thinking of the Committee of Banking Supervision goes into the right direction.

Introducing a leverage test

In addition to a system of minimum regulatory capital as a function of risk weighted assets, which existed since the implementation of Basel I in 1988, it is proposed to introduce an additional leverage test. That test limits the ability of a bank to excessively leverage itself thereby further reducing the portion of its equity used to finance its total balance sheet. The reason why a leverage test became an issue was the risk weighting mechanism under Basel II. Assets that had a very good credit rating were afforded

a very low risk weighting. In other words, for those assets the bank was required to apply only a small amount of its regulatory capital to be compliant. As a result, the Basel II system has lead to a tremendous growth of bank balance sheets. If all assets would be imputed with their book value for measuring regulatory capital sufficiency, the total assets of a financial institution could not exceed 12.5 times of its regulatory capital. In practice, the balance sheet total of some institutions exceeded 30 times the regulatory capital. The new leverage test is meant to prevent this excessive proportion which increases the bank's risk position.

On the other hand, one can fairly say that a leverage test only becomes necessary because of some inefficiencies and flaws in the Basel II methodology. Most importantly, as we know now, the majority of the rating predicates for structured products were simply wrong. In addition, the use of credit derivatives had helped to push risk ratings down, but the counterparties of these credit derivatives were not efficiently supervised. It seems to be a better, and systemically more consistent, idea to change some of the elements of the Basel II risk measuring parameters instead of introducing yet another regulatory complexity.

Enhanced liquidity requirements

When markets dry out, cash is key. This is one of the most important lessons taught by the crisis. Because markets did no longer serve as an efficient refinancing tool for financial institutions, central banks around the world had to open the gates and flood the markets with cheap money. This method has a number of implications, not the least the risk of fuelling inflation. Also, governments and central banks should not play the role of a lender of last resort for a financial sector that is only working properly if markets are friendly. Accordingly, a tightening of liquidity requirements is a logical reaction of the regulators, but the details are once again complex. The more liquid assets (that is, cash and securities that can be expected not to be easily affected by a drying out of the market) a financial institution has to hold, the less capacity it has to invest into less liquid assets such as loans. The concept of a net stable funding ratio which is being proposed, a liquidity rule that requires banks to match the duration of their liabilities and assets more closely, will thus have a substantial impact on the structure of banks' balance sheets. Morgan Stanley has calculated that the implementation of the rule would require an astounding US$1.5 billion of stable funding for the world financial industry to be compliant. Presently it is planned to delay implementation of the net stable funding ratio concept until 2018 and to conduct extensive tests before that time. Higher liquidity requirements are welcome as an important element to make financial markets more resilient, but it has to be understood that there may be adverse implications for the role of banks as financiers. Once again, an economy which has become used to having access to sufficient funding on easy terms will have to face material adjustments.

Anti-cyclical capital buffers

Another important proposal coming out of the Committee on Banking Supervision is the introduction of an anti-cyclical capital buffer. The basic idea of this proposal is to give regulators a right to require banks to hold more capital if there are signs of increased systemic risks, for example as a result of excessive credit growth. The assumption is that where the total amount of credit made available to the economy outgrows the rise of the GDP, the whole system is on a path of leveraging itself. This could be a first indication of a bubble which eventually may pose a threat to the safety of the financial system. If a financial institution is not able to comply with the increased capital requirements, it is given a 12-month grace period before having to face sanctions. As is the case with the other recent proposals by the Committee on Banking Supervision, comments have been invited for submission until 10 September 2010.

It is of course an open question whether and to what extent bank supervisors will use this power. In many countries supervisory authorities are agencies of the federal government. There is concern that their decision to raise capital requirements, with the possible effect of a receding credit volume, may become subject to political scrutiny. It is a fact of life that bubbles are a phenomenon regularly coinciding with a strong growth of the economy. Therefore, the dangers of bubbles are often diminished by politicians, if not brushed aside. It remains to be seen to what extent supervisory authorities are sufficiently independent from political influence. Some countries have transferred or retransferred supervisory powers to their central banks, such as recently the United Kingdom, because of their better insight into macro-economic data and the transactional behaviour of banks in the market. Their greater independence – at least in many countries – may also have played a role.

The rating agencies – scapegoat or accomplice

From the very beginning, the role of the rating agencies has been the focus when exploring the causes for the global financial crisis. The reason for this was the central role rating agencies played in the securitisation market. Rating agencies had existed for a long time as a useful instrument to support investors' decisions. As a result of the Basel II regulatory capital concept for financial institutions, however, rating agencies were moving into a quasi regulatory position. By linking the risk weighting of an asset to an external rating, the rating opinion became an important factor in measuring the capital requirements of a bank. The lower the risk weighting, the smaller the amount of capital needed to cover that asset. Hence the bank could buy more assets with the same amount of capital and thereby leverage itself to an unprecedented degree.

The trillions of structured products resulting from the various securitisation techniques could not have been sold in the market if it had not been for the support by strong investment grade ratings. Financial institutions and other investors had a great degree of trust in the rating of a reputable agency. This trust was supported by

the confidence that regulators where placing in them in the context of the Basel II regulatory capital framework.

However, the system had two fundamental flaws. First, the rating of structured products was fundamentally different from analysing the balance sheet and profit and loss statement of a company with an established business. The rating process implied a variety of assumptions and analytical parameters derived from historical data, most importantly the real estate market. There was often a debate between the structuring arrangers and the rating agencies as to how long one would have to go back into the past to define the worst case scenario. For example, with respect to certain real estate-based assets there was the question of whether the price decline of the 1930s should be imputed or not. Apparently, in a period where the real estate market had been bullish for quite some time, structuring advisors did not like the idea that the flawless record of the past 20 years or so was speckled by real estate crises that have happened a long time ago. Rating agencies found themselves exposed to a lot of pressure. They wanted to have the mandate for the rating of as many structured products as they could get, as this was a very lucrative business. On the other hand, if they proved to be too difficult in arriving at the desired rating predicate structurers might have preferred to go to another agency with their next deal. The same situation occurred in relation to some other features of structured products, such as for example how they were behaving under certain stress scenarios and how proceeds from a realization of the assets were distributed to the various classes of security holders. Again, rating agencies were pressed to be not too difficult failing which they might loose the mandate. This is what is commonly referred to as the conflict of interest in which rating agencies found themselves. On the one hand was their role as impartial experts for the value of a financial product, on the other hand there were businesses just like any other keen to accumulate market share and increase revenues.

The second flaw relates more fundamentally to the concept of Basel II. A rating does not represent any opinion on the liquidity of markets. In other words, a rating is relevant primarily for the buy and hold to maturity investor because it expresses a certain likelihood that all payments on the security will be made as and when due. It does not suggest that a security can be sold on the market or otherwise at any point in time. Of course, a security with a high rating may sell better because there may be greater investment demand. But this is only true if markets are open and liquid. When there were first signs that defaults under the underlying real estate financings in the United States occurred much earlier and in greater numbers than expected, the resulting suspicion as to the safety of structured securities hit almost the entire asset class. The indistinctive scepticism was partly caused by the opaque nature of many structured products which made it virtually impossible to trace the rights under this security back to real loans, representing exposures to certain buildings and regions. Basel II, on the other hand, used the so-called value-at-risk concept as an important corner stone of capital adequacy monitoring. This principle was based on properly functioning markets and did not anticipate a situation where markets would almost

dry out overnight. In particular, where an asset class as a whole falls into disgrace in a short period, all market participants want to hedge their risk by selling the concerned asset at the same time, except that there are no buyers.

What will happen with the rating agencies going forward? First of all, rating agencies will continue to be needed. A major investor acting in today's markets is not in a position to read a 200-page prospectus from start to finish before making an investment decision. Large bond funds have to invest €50 million or more on a daily basis. It would not be possible to do all the analysis necessary for an informed investment decision without support by rating agencies. The performance of rating agencies have been quite reliable when it comes to securities issued by companies with a real business. Rating a structured security representing repackaged real estate loans is a totally different issue altogether. The mistakes that were made here, and that need to be addressed going forward, should not discredit the concept of a rating agency altogether.

Rating agencies work for investors but are paid by issuers or arrangers. This implies a certain conflict of interest which is undesirable but at the same time impossible to avoid. The rating must be ready before a security is offered to the market to raise sufficient investor interest. There is no time for investors to hire a rating agency to rate a product when it is first offered. Also, investors are not used to paying for a rating. They expect this as service by the issuer which the issuer is happy to provide because it expects that based on a good rating its securities will sell better and potentially at a higher price.

The obvious response to this inherent conflict of interest is more regulation. Indeed, the supervision of rating agencies has been tightened in most major jurisdictions around the world. In Japan and Europe, for example, rating agencies now have to register in order that they become subject to regulatory scrutiny. What this scrutiny actually means in practice is still uncertain. At the very least, it is to be expected that the way rating agencies minimise their conflict of interest will be the key focus of supervision. With respect to rating structured securities, one of the first changes made to the business model of rating agencies was a separation from giving advice in structuring a product and the rating itself. In the past, rating was not a digital process where one would submit a financial product and then get back a rating. Rather, issuers and structurers would discuss the concept of the product and how the rating could be improved. This intensifies the conflict of interest because the rating agency is advising on how to get a better opinion of itself.

There is also a debate, particularly in Europe, on the structure of the rating agency market. Some believe there are too many agencies and propose a single rating agency which is a government institution. Others think there should be more competition and favour the formation of one or two additional rating agencies. It is difficult to understand how either model should actually contribute to a safer and more reliable rating process. A government agency is unlikely to be able to provide the service with the speed and efficiency required in today's markets. More competition, on the other hand, will not

necessarily create a race to quality but rather the opposite. Of course rating is a business strongly based on reputation, and an agency that gets its rating opinions wrong will go out of business. But before this actually happens – and it is unlikely that it will ever happen – the more palpable becomes the risk that rating agencies are competing by offering a better rating for the same issuer. That would not be the desired result.

In summary, the role and supervision of rating agencies will remain an issue for the foreseeable future. One has to see whether the measures now put into place will have the desired effect, in particular with respect to structured securities which, although at a lesser degree than in the past, will continue to be issued.

Bankers' bonuses and responsibility – the human factor

The public opinion, but also many regulators and politicians, was very quick in blaming excessive bankers' bonuses for having played a prominent role among the causes having led to the financial crisis. It sounded quite obvious that people who are paid primarily for achieving a short-term economic success in the form of high upfront fees would not focus on the long-term effect a transaction had for their institution. Incentivising the generation of loans without paying any attention to how these loans would perform over their lifetime looked like an obvious violation of prudent governance. This was all the more true since loyalty between bank employees and their institutions had massively eroded in the last decades. The bank employee who spends all his working life at one institution is a matter of the past. Today's successful bankers are spending only a few years, if that, at any one institution and are always on the go seeking better opportunities or higher pay. Why should they care whether their deals would turn out to be beneficial for the bank in the long term if they are no longer there at this time?

Much of this is true, but not all of it. Clearly, the time bankers spend with one employer is much shorter nowadays than it used to be. The reason for this is a much more intense battle for talent in the banking industry combined with much less restraint when it comes to chasing staff from the competition. In a good economy successful bankers are extended offers by other institutions every other week. It is no surprise that those offers are not turned down as a matter of loyalty. Loyalty has also suffered because in a downward cycle of the economy, the immediate reaction of employers is to reduce staff. A banker who knows that he is only useful, and will only be paid, for as long as business is good will try to get the most out of this temporary position for himself. The result is a strong focus on money.

Measures taken by regulators and legislators to stem the perceived problem of excessive bonuses include extra bonus taxes (like in the UK) to incentivise larger fixed salary portions in the overall compensation package, more general rules saying that bonuses must not present a particular incentive for accepting higher risk (like in Germany), or even a direct regulation of the relationship between fixed salary and bonuses as proposed by the European Union in July 2010. According to the new EU

rules, upfront cash bonuses will be capped at 30 per cent of the total bonus and to 20 per cent for particularly large bonuses. In place of upfront cash, between 40 and 60 per cent of any bonus must be deferred and cannot be recovered if the investments made by a particular employee on behalf of his institution do not perform as expected. In addition, at least 50 per cent of the total bonus would be paid as contingent capital of the institution which converts into equity if the bank runs into financial difficulties. Banks that had to be bailed out have to pay back the bail-out funds first before reverting to paying bonuses.

The quite harsh reaction against the traditional bonus practice in the financial industry was largely driven by public opinion. When the public became aware of the large amounts of bonuses paid on the one hand and the magnitude of financial support that governments had to extend to the same institutions on the other hand, there was an understandable reaction of anger. The new rules are not only meant to address the concerns of excessive risk taking by bonus incentivisation. They are at least to the same degree directed at the public to show a determined reaction against allegedly 'greedy' bankers.

There are, however, a couple of issues which let the current trend of stigmatising bonuses appear not convincing. First, there is no real evidence yet that bonuses incentivise the acceptance of excessive risks. Clearly, the origination of many loans in the one or two years before the financial crises broke were fraudulent in that there was no chance that borrowers could ever pay back the loan. But this had little to do with bonuses; it was part of a larger scheme. The issue was that these loans could be securitised and sold on immediately after they were extended so that there was no risk involved. An efficient tool for working against this behaviour is forcing banks to retain some part of the risk when they securitise loans, which is a rule that has already been broadly implemented.

Second, it does not seem wise to force bankers to invest much of their income in securities of their employer. If for whatever reason the institution fails, thousands of bank employees may lose a large portion of their retirement funds even if they had nothing to do with the reason of the failure. This sort of collective liability which hits the most responsible and the least responsible employee to the same extent is not appropriate.

Third, bonus regulation constitutes a substantial interference with the freedom of contract. Financial institutions are more successful than others because they have better people. Often they have better people because they pay better. A one-size-fits-all bonus regulation for financial institutions will restrict competition and innovation in the financial industry which ultimately is to the detriment of the economy as a whole.

The issue seems to be broader than a question of the relationship between bonuses and fixed salary. In the opinion of some Task Force members, many financial institutions suffer from a general corporate governance problem which seems to be relevant for the financial industry as a whole.

There is a lack of corporate memory. Employees in financial institutions move up into positions with large responsibilities at quite a young age. Previous crises are only known from hearsay, and there is no experience of their effect.

The younger generation has strong confidence in the power of mathematical models. There is a trend to rationalise virtually everything with formulas and mathematical curves. However, reality does not always work like that and statistical data of the past does not allow a safe prediction of the future.

There seems to be a general sentiment that in a regulated industry, like the financial industry, everything that is not forbidden is explicitly allowed, if not implicitly encouraged. An unknown banker was quoted saying: 'the financial crisis is the regulators' fault, they have let us do this.' If this is the perception of bankers, regulators will not have the slightest chance of keeping the industry under control. There will always be loopholes and regulators will always be one step behind the actual development of new products.

The real challenge for the financial industry will be to create a climate of innovation and caution at the same time, combined with a basic respect of regulation as something which is not only there to stand in the way of good business opportunities but something which is useful and necessary. There should also be a common desire for the wellbeing of the industry as a whole. The conduct of selling financial instruments to another institution knowing that they may be harmful – which was the case with billions of structured securities sold to less sophisticated institutions – seems to be a quite unique relic in the financial industry. The rules of product liability would threaten the selling party with huge amounts of damage payments if this was not a financial instrument but, for example, a machine. In some ways, business between financial institutions resembles more a battle than fair trade. These issues can only be addressed by a change in corporate governance as a whole. This requires new ideas and strong leadership.

Protecting deposits against the risks from trading

More than 80 years ago, the world learned from experience that credit institutions may become insolvent as a result of trading losses incurred in a market crash, with all the devastating consequences for bank deposits. In the United States, this experience ultimately resulted in the so-called Glass-Steagall legislation which forced a separation of conventional banking business (such as taking deposits and extending loans) from the business of underwriting or dealing in securities, other than US Government and certain other 'bank-eligible' securities. Separating deposits from trading risk was the most radical solution. Other countries have not followed suit. In the US, however, the Glass-Steagall doctrine remained unchanged in substance until 1999, although challenged by the continuous efforts of the banking industry to get the Act repealed since the 1980s. One of the reasons cited in favour of the repeal was that in much of the rest of the world depositary institutions operate simultaneously and successfully in both banking and securities markets. Also, so it was said, the securities activities that

depositary institutions are seeking are low-risk by their nature and would reduce the total risk of an organisation by diversification.

In the financial crisis from 2007 until today, again there has been a linkage between the safety of deposits and losses resulting from securities investments, although the details were quite different. The losses did not result so much from speculative trading securities but rather from investments in complex asset-backed instruments and credit default swaps which turned out to be overvalued because of the wrong assumptions underlying their design. Nevertheless, the losses were so huge that the safety of deposits was at stake which forced governments to step in and bail-out a large number of institutions in order to avoid a meltdown of the system. Accordingly, it is no surprise that the connectivity between securities investments and the safety of deposits was back on the agenda overnight. In the United States, there were a number of voices advocating a return to the Glass-Steagall doctrine, or at least concepts to the same effect, whereas others, including the financial industry, were very much against these proposals. Before the reform in the United States found its final shape, there was quite a fierce debate about these issues. Under the so-called Volcker rule, 'banking entities' would be forced to divest or terminate their short-term 'proprietary trading' in financial instruments other than US Government securities and certain other excluded instruments (but could continue client-related trading, market making and long-term principal investing) in order to insulate the banking system from the risks of such short-term proprietary trading. Banking entities would include banks, bank holding companies and, subject to exemptions for proprietary trading outside the US, non-US banks with a US commercial banking presence. Non-bank financial institutions that are designated as systemically-important would also need to carry higher capital and comply with other quantitative limits (to be specified) on such proprietary trading. Although the Volcker rule did not become law in its original form, banking entities will be forced to divest or terminate their proprietary trading. For a full explanation of the effects of the regulatory reform in the United States, please refer to the first chapter of this report.

Countries that have a strong history of so-called universal banks have sought a different approach. Universal banks are institutions that are engaged in the full breadth of activities that financial institutions normally undertake, including taking deposits, lending and trading. Separating the more conventional deposit/lending business from securities trading would have been a novelty in the history of these countries and would have been a hard sale to the industry but also the public. On the other hand, it was quite clear that there was a need for legislation protecting governments from being forced to bail-out a financial institution to protect deposits. The safety of deposits is a key concern of the public and everything had to be done to improve that safety without recourse to public funds.

If the securities business, which in the countries with universal banks was identified as potentially even more dangerous, would not be separated from the rest of the banking activities at the outset, the solution could be a separation of the two businesses in a

reorganisation proceeding. A proceeding of this nature would allow cutting off the ailing part of a bank's business from the rest to get it organised or liquidated, while all other activities can continue on a financially-sound basis. This of course means that deposits will no longer be considered a form of capitalisation for trading risk. If they are not available in the crisis of the institution, their absence will be assumed from the beginning and will be priced into the counterparty risk of a particular institution.

One of the reasons why the Glass-Seagall legislation was ultimately repealed was the inefficiencies created by the separation of conventional banking business and securities underwriting and dealing. This, of course, creates a lot of synergies in the use of regulatory capital, and elsewhere, if funds stemming from deposits can be employed across the board of a bank's business. However, this works so long as it does and abruptly loses acceptance when deposits are not just used as a cheap source of funds but also as a loss buffer. This would have happened in this crisis had not governments decided to step in. In reverse, this means that every separation of the two business lines, whether in whole or in part, will bring back certain inefficiencies and will cost money, to be borne by the general public when paying for bank and securities services. Much of the liberalisation of bank regulation in past decades was done to generate efficiency gains and synergies. Much of the tightened regulation of 2010 will be blamed for rising costs and prices. But there is no alternative.

Conclusion

When the crisis broke and the first emergency meetings of regulators, central banks and politicians from around the world took place, the expectation was that there would be a fast and radical change of bank regulation around the globe. One of the themes was that there must be a single regulator for global financial institutions to prevent a similar crisis from happing again. About three years later we are now looking at the first results of the reform process. There are very few elements that one could honestly call a radical change. Did we 'waste' the crisis as an opportunity for a complete redesign? Not really. While some of the proposals were squelched by lobbying from the banking industry and political debate between opposing parties, much of the compromise that has been found is based on the perception that an efficient and innovative financial industry is necessary for the wellbeing of the world economy as a whole. Too much regulation is likely to have a negative impact on the ability of the financial industry to perform that role.

Will the new legislation prevent the next crisis? Unlikely. Many of the new rules and tools given to regulators have the potential of identifying developments which may affect the stability of the financial system at an early stage and take measures against that. It remains to be seen how efficiently they work. On the other hand, looking back at the last decades, one has to realise that regulation of the financial industry is cyclical. If the economy is running well and the industry grows, there will be efforts

to remove the security bolts now built in one after another. If nothing has happened for a long time, people tend to forget about the events that had brought the more restrictive rules into place. In that sense, banking regulation is not fundamentally different from airport security.

United States

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This chapter discusses how the global financial panic of 2008 unfolded in the United States, the emergency measures taken to end it, and the financial regulatory reforms that have been enacted to reduce the likelihood or magnitude of future panics.

The financial panic of 2008

The first signs of an impending financial crisis appeared in the US in 2007, when US real estate prices began to collapse and early delinquencies in recently underwritten sub-prime mortgages began to spike. It culminated in a genuine financial panic during September and October of 2008. The most serious recession since the Great Depression of the 1930s followed. The Federal Reserve and other organs of the US Government responded by flooding the markets with money and other liquidity, reducing interest rates, providing extraordinary assistance to major financial institutions, increasing Government spending, and taking other steps to provide financial assistance to the markets.

When real estate prices began to collapse in the second half of 2007, some investors started shorting real estate markets. The leveraged credit market dried up and billions of dollars of pending buy-out deals collapsed. Billions more in mortgage-backed securities (MBS) and collateralised debt obligations (CDOs) were written down. Several CEOs of major US financial institutions lost their jobs. Others saved their jobs by obtaining capital infusions from sovereign wealth funds, hedge funds, private equity funds and other pools of risk capital.

Real estate prices continued to collapse in early 2008, resulting in billions of dollars of additional CDO markdowns, the collapse and rescue of Bear Stearns, and extraordinary measures by the Federal Reserve to de-stigmatise the discount window for commercial banks and make emergency liquidity facilities available to the large investment banks. As the Federal Reserve responded to the crisis by reducing interest rates and flooding the market with money, the value of the dollar plummeted relative to other currencies. By the summer of 2008, the price of oil, agricultural products and other commodities – which are generally denominated in US dollars – soared almost in inverse proportion to any decline in the dollar.

The interbank credit markets seized up. The market value of US financial institutions,

especially US mortgage giants Fannie Mae and Freddie Mac,[1] collapsed throughout the summer. The US Government was particularly concerned about Fannie Mae and Freddie Mac because of their size and importance to the US housing market. On 30 June 2008, these two institutions had combined liabilities of over US$5.5 trillion, on a combined total regulatory capital base of approximately US$100 billion. Moreover, a widespread perception existed that their obligations were backed by an implicit guarantee from the US Government. The US Treasury asked Congress for a blank cheque – the power to inject unlimited amounts of additional capital into Fannie and Freddie, arguing that if the market knew that the Treasury had a 'bazooka' instead of a 'squirt gun', it was substantially less likely that the Treasury would be required to provide any financial assistance at all. Congress gave the Treasury that authority on 30 July 2008.[2]

The market value of Fannie and Freddie, however, continued to collapse throughout August. The Government determined that many of their assets needed to be written down, and concluded that they would not be able to plug the hole by raising additional capital from the capital markets. Alarmed that a failure of Fannie or Freddie could pull down the rest of the financial system, the US Treasury decided to exercise its new 'bazooka' authority on 6 September 2008 – approximately five weeks after receiving it – concluding that such action would calm the financial markets. The Government put Fannie and Freddie into conservatorship and pledged to inject up to US$200 billion of new capital in the form of senior preferred stock and warrants. The terms of the transaction resulted in an immediate dilution of 80 per cent of common shareholder value, and a sharp drop in the value of junior preferred stock. The value of Fannie's and Freddie's senior and subordinated debt, however, soared because it was senior to the Government's investment.

Rather than calming the markets, the 'rescue' of Fannie and Freddie may have added fuel to the worldwide financial panic that continued throughout September and October. In any event, on the following weekend Lehman Brothers and AIG collapsed, and Merrill Lynch was bought at what was then thought to be a fire sale price by Bank of America. The Federal Reserve exercised its emergency powers under section 13(3) of the Federal Reserve Act to rescue AIG, but the Government allowed Lehman Brothers to fail. The terms of the AIG rescue were similar to Fannie and Freddie – the Government received senior preferred stock and warrants, resulting in an immediate dilution of 80 per cent of common shareholder value, and a sharp drop in the value of junior preferred stock. But the value of AIG's senior and subordinated debt soared, and the counterparties on its credit default swaps and other financial contracts were made whole.

1 Fannie Mae is a US Government-sponsored enterprise (GSE) formally known as the Federal National Mortgage Association. Freddie Mac is a US GSE formally known as the Federal Home Loan Mortgage Corporation. Their mission is to help provide liquidity to the US residential market by purchasing or guaranteeing payment on certain residential mortgages.

2 See Housing and Economic Recovery Act of 2008.

After the AIG collapse, the US Treasury asked Congress for express authority to invest up to US$700 billion in toxic mortgage and other assets in order to clean up the balance sheets of the US financial sector. While the Treasury's request for what was later called the Troubled Asset Relief Program (TARP) was pending before Congress, Washington Mutual (the largest thrift in the United States) failed and was sold to JP Morgan, and Wachovia was rescued by Citigroup and then Wells Fargo. Commodity prices, which had spiked during the summer as the dollar fell, reversed course and began to fall as the market began to fear a depression more than a weakened US dollar.

The House rejected TARP on 30 September 2008, resulting in the largest one-day drop in the Dow Jones Industrial Average of 778 points, or US$1.3 trillion in market value. The Senate quickly passed a bill during the first week of October, the House reconsidered its action, and President Bush signed the bill into law on the same day the House approved it.

During the second week in October, the Treasury announced its Capital Purchase Program (CPP), which involved making investments of up to US$250 billion in the preferred stock of US insured depository institutions and their holding companies. The US Federal Deposit Insurance Corporation (FDIC) temporarily increased deposit insurance coverage to US$250,000 per person per institution, as well as announcing the creation of the Temporary Liquidity Guarantee Program (TLGP), which would provide credit support to debt capital market issuances and non-interest bearing transaction accounts.

The next several weeks saw a stampede of US financial institutions seeking to acquire insured depository institutions in the United States in order to qualify for CPP money. The US Government announced an additional US$20 billion in capital support and a related US$301 billion asset guarantee programme for Citigroup in late November. The US Government announced a similar programme of extraordinary support for Bank of America in early 2009 to facilitate BofA's acquisition of Merrill Lynch, which continued to haemorrhage value between signing and closing. Similar failures, rescues and financial assistance programmes were announced throughout 2009 after the height of the panic receded.

The financial panic of 2008, and the economic uncertainty created by various Government actions taken or feared subsequently, have resulted in the worst recession since the Great Depression. It is far worse than the shrinkage caused by the US savings and loan crisis of the late 1980s and early 1990s. Unemployment has persisted for nearly a year at close to ten per cent, and many believe that the percentage of the normal workforce out of work is actually much higher, possibly as high as 17 per cent, because of how US unemployment figures are calculated. They include people who are actively searching for employment, but not those who have become so discouraged that they have given up searching for a job altogether or those who have obtained part-time employment. Fears of future inflation are rampant, while the risk of deflation in the near term is not out of the question.

Meanwhile, the US continues to be in the midst of the largest wave of bank and thrift failures since the US savings and loan crisis ended in the early 1990s. The FDIC resolved over 25 failed institutions in 2008, 140 in 2009 and more than 100 as of July 2010. As of 31 March 2010, the FDIC had nearly 780 insured institutions on its 'problem list', with over US$430 billion in aggregate assets,[3] suggesting that it may be forced to resolve many more closed institutions before the current wave of failures is over. At the same time, the Deposit Insurance Fund, which is used to resolve failed institutions, has fallen to a negative balance.

Emergency responses to end the panic

This section will give only a brief overview of the US Government programmes that were designed or implemented to arrest the financial panic of 2008. Anyone who is interested in a more complete analysis of the programmes proposed or implemented in the United States should consult *The Davis Polk Financial Crisis Manual*,[4] which contains a thorough analysis of the laws, regulations and contracts used in the United States to end the panic.

The US programmes designed to battle the financial panic consisted primarily of the following:

- the Troubled Asset Relief Program (TARP) implemented by the Treasury under the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA);
- various programmes implemented by the Federal Reserve under its traditional discount window authority for commercial banks and section 13(3) of the Federal Reserve Act;
- the FDIC's use of its Deposit Insurance Fund to provide critical assistance to the banking system, including resolving failed banks and thrifts, temporarily increasing deposit insurance coverage to US$250,000 per person per institution and its Temporary Liquidity Guarantee Program (TLGP); and
- the Treasury's rescue of Fannie Mae and Freddie Mac pursuant to the authority granted by the Housing Economic Recovery Act of 2008 (HERA).

Federal Reserve programmes

Despite the greater press and political attention paid to the TARP and the TLGP, the programmes implemented by the Federal Reserve under section 13(3) of the Federal Reserve Act represent the largest portion of US Government intervention. Section 13(3) was used by the Federal Reserve to provide liquidity to Wall Street and

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3 FDIC, First Quarter 2010, Quarterly Banking Profile, March 2010, at 3.

4 *The Davis Polk Financial Crisis Manual: A Guide to the Laws, Regulations and Contracts of the Financial Crisis,* September 2009, available at **www.davispolk.com/files/News/7f041304-9785-4433-aa90-153d69b92104/Presentation/NewsAttachment/3c9302c0-409f-4dd1-9413-24e8cd60cd93/Financial_Crisis_Manual.pdf**.

US companies, rescue Bear Stearns and AIG, and conduct monetary policy. Indeed, it was the Government's tool of choice until the Bush administration asked for new congressional authority – first to inject capital directly into Fannie Mae and Freddie Mac, and then to purchase troubled assets from and inject capital directly into the US financial system as a whole. As a result of such programmes, the Federal Reserve's balance sheet more than doubled from August 2007 to December 2008, and its total assets at 31 December 2008, at the height of the crisis, were more than US$2 trillion, more than twice the highest year-end total in its history.[5]

Section 13(3) permitted the Federal Reserve to make secured extensions of credit to any 'individual, partnership, or corporation'. It was not limited to depository institutions, but it could be invoked only under 'unusual and exigent circumstances' upon the affirmative vote of at least five members of the Federal Reserve. Until 2008, it had not been used since the Great Depression.

Term Securities Lending Facility (TSLF)

The Federal Reserve's first use of its section 13(3) authority during the global financial crisis was to establish the TSLF on 11 March 2008. In the weeks leading up to the programme, the credit markets had become frozen for certain highly leveraged market participants. The TSLF was designed as a term lending facility for primary dealers.[6] It was created to provide liquidity to primary dealers, and specifically to add liquidity to the mortgage-backed securities (MBS) market. The Federal Reserve Bank of New York was authorised to lend up to US$200 billion of Treasury securities to primary dealers secured for a term of 28 days by a pledge of eligible collateral, including MBS. In effect, the programme allowed primary dealers to swap lower-quality securities for higher-quality Treasury securities that could be used more easily to obtain credit in the interbank or capital markets. The TSLF was closed on 1 February 2010, after all loans extended by the facility had been repaid in full, with interest.

Bear Stearns

Despite the implementation of the TSLF, Bear Stearns suffered a classic 'run on the bank'. Its cash reserves fell from over US$20 billion to US$2 billion in approximately one week. By 14 March 2008 Bear Stearns was prepared to file for bankruptcy in the absence of a significant capital infusion. Since no significant capital infusion was forthcoming from the private sector, the Federal Reserve was left as the only player that could quickly rescue Bear Stearns from bankruptcy.

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5 Niel Willardson, *Actions to Restore Financial Stability*, Federal Reserve Bank of Minneapolis: The Region, December 2008 at 16, available at **www.minneapolisfed.org/pubs/region/08-12/willardson.pdf**.

6 Primary dealers are the 18 large financial institutions that are the counterparties with which the Federal Reserve undertakes open market operations. Many of the 18 were also Wall Street's most prominent investment banks.

On 14 March 2008 the Federal Reserve, by the unanimous vote of all available members, authorised an extension of credit to Bear Stearns through JPMorgan Chase Bank under section 13(3). The Federal Reserve Bank of New York made an overnight loan of US$12.9 billion to JPMorgan Chase Bank through its normal discount window facilities. The loan was non-recourse and was fully secured by US$13.8 billion of Bear Stearns assets. The loan was a simultaneous back-to-back transaction, whereby JPMorgan Chase Bank provided secured financing to Bear Stearns and took as collateral the same assets that JPMorgan Chase Bank used to secure its loan from the Federal Reserve.

After the Federal Reserve's emergency loan, the focus turned to finding an acquirer for Bear Stearns – before the opening of business in Asia on Monday morning, 17 March (Sunday evening, 16 March in the United States). JPMorgan initially offered to acquire Bear Stearns for US$2 per share, or approximately US$236 million in total, but later raised its price to US$10 per share, or approximately US$1.1 billion in total, in order to obtain approval for the transaction from Bear Stearns shareholders. Since JPMorgan did not want to acquire certain illiquid Bear Stearns assets, the Federal Reserve was needed to absorb the risks associated with such assets. The Federal Reserve only had the authority to lend and did not have the authority to purchase assets, so any structure had to be based on the Federal Reserve making a loan.

The Federal Reserve Bank of New York was authorised to make a secured loan of up to US$30 billion to a special purpose vehicle, Maiden Lane, in order to purchase 'less liquid' assets of Bear Stearns and facilitate the acquisition of Bear Stearns by JPMorgan. The loan was authorised pursuant to section 13(3). JPMorgan was required to lend Maiden Lane US$1 billion. The Federal Reserve's loan was secured by the assets held by Maiden Lane.

Primary Dealer Credit Facility (PDCF)

Although Bear Stearns had been rescued, there was a fear that other investment banks with similar funding models could also face liquidity squeezes and ultimately the risk of failure. In order to provide these institutions with more liquidity and prevent this outcome, the Federal Reserve announced the creation of the PDCF on 16 March 2008, under section 13(3). The PDCF was a temporary overnight liquidity facility that provided secured loans to primary dealers. The PDCF allowed primary dealers to borrow funds from the Federal Reserve secured by a broader range of collateral than is permissible to secure borrowings under the discount window. Since the primary dealers included the largest investment banks in the United States, the PDCF provided the largest US broker-dealers with temporary access to a Federal Reserve facility that is very similar to the Federal Reserve discount window. In light of improved functioning of financial markets, the Federal Reserve closed the PDCF on 1 February 2010.

AIG

In the third quarter of 2008, AIG started to experience an increasingly serious liquidity crunch, largely because of its securities lending business and the credit default swap portfolio of its affiliate, AIG Financial Products (AIGFP). Under AIG's securities lending programme, AIG lent securities on behalf of its insurance company subsidiaries against cash collateral that was received from borrowers and invested in securities, including residential mortgage-backed securities (RMBS). AIG was responsible for any deficit in the cash collateral pool caused by any losses sustained in investing it or if AIG's credit rating were downgraded. Under AIGFP's credit default swap contracts, AIGFP was required to post collateral if the CDOs protected by its credit default swaps fell in value or AIG's credit rating were downgraded.

Because of drops in the value of RMBS and CDOs in August, AIG was required to post US$3.3 billion of additional collateral into its securities lending programme and AIGFP was required to post US$5.9 billion of additional collateral to secure its credit default swap obligations. After downgrades in AIG's credit ratings in early September, AIGFP estimated that it would need an additional amount in excess of US$20 billion in order to fund additional collateral requirements under its credit default swap obligations. The inability to refinance its commercial paper commitments, sharp declines in AIG's common stock, and regulatory constraints on AIG's ability to borrow from its insurance company subsidiaries left AIG in severe difficulty during the weekend of 13 – 14 September. AIG explored the possibility of a secured lending facility from the private sector, but was unable to obtain the necessary liquidity or capital from that avenue.

On 16 September 2008, pursuant to section 13(3), the Federal Reserve authorised the Federal Reserve Bank of New York to lend AIG up to US$85 billion under a secured revolving credit facility. As a condition to the loan, AIG also agreed to issue to a trust established for the benefit of the Treasury a series of senior preferred stock and warrants equal to approximately 80 per cent of the economics and voting power of the company.

The loan was restructured in November to include loans to two new special purpose vehicles. The Federal Reserve lent approximately US$19.5 billion to Maiden Lane II so that the SPV could purchase MBS from AIG. It lent approximately US$19.6 billion to Maiden Lane III so that the SPV could purchase from AIGFP's counterparties US$62 billion of CDOs that were protected by AIGFP's credit default swaps.

On 17 April 2009, the Federal Reserve Bank of New York restructured its loan by establishing an additional equity capital commitment of up to US$30 billion through the purchase of AIG Series E Preferred Stock and reducing the interest rate on the loan by removing the existing floor of 3.5 per cent on the LIBOR rate. On 1 December the Federal Reserve entered new transactions where it received preferred interests in two SPVs, AIA Aurora LLC and ALICO Holdings LLC, that had been formed to hold the outstanding common stock of AIG's largest foreign insurance subsidiaries, AIA Group and American Life Insurance Company (ALICO). In exchange, AIG's

outstanding balance under the revolving credit facility was reduced by US$25 billion.

Four months later, on 1 March 2010, AIG announced the sale of AIA to Prudential PLC for approximately US$35.5 billion. AIG said it would use cash proceeds from the sale to redeem the preferred interests held by the Federal Reserve in AIA Aurora and repay US$9 billion of the money it had borrowed from the revolving credit facility. That transaction did not close, however, because the shareholders of Prudential voted against the transaction.

On 8 March 2010, AIG announced it would sell ALICO to MetLife, Inc for approximately US$15.5 billion, and said it would use cash from the sale to redeem US$9 billion of preferred interests held by the Federal Reserve in ALICO Holdings.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and Commercial Paper Funding Facility (CPFF)

By the autumn of 2008, money market mutual funds were facing severe liquidity pressure. After the failure of a large money market mutual fund, Reserve Primary Fund, investors began a run on money market mutual funds that lasted for weeks. Redemptions totalled over US$100 billion. In the face of redemptions, money market mutual funds had to start selling assets, including commercial paper. Because of these fire sales, commercial paper issuers started to face liquidity pressures of their own, forcing many of them to draw on back-up lines of credit from banks. This put further pressure on the banking system because most banks had not anticipated that so many of these back-up facilities would be drawn at once. In order to address the fire sales of commercial paper as a result of redemption pressures and the lack of liquidity in the commercial paper market, the Federal Reserve created the AMLF and the CPFF.

The AMLF was authorised by the Federal Reserve on 19 September 2008 to provide funding to US depository institutions and bank holding companies and their US broker-dealer subsidiaries to finance purchases of high-quality asset-backed commercial paper from money market mutual funds. The programme lent more than US$150 billion in its first ten days of operation, but as the markets improved, there was no new borrowing through the AMLF from 8 May 2009 to the programme's closing on 1 February 2010. The CPFF was authorised on 14 October 2008 to establish an SPV to purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers, including any US commercial paper issuer, even those with foreign parents. Both of these programmes were closed on 1 February 2010, after repaying all loans in full, with interest and in accordance with the terms of each facility. The CPFF incurred no losses, and earned nearly US$5 billion primarily from interest income, credit enhancement fees and registration fees. The remaining commercial paper holdings of the CPFF matured on 26 April 2010, and the CPFF LLC will be dissolved after the payment of expenses and the termination or expiration of existing contracts.

Term Asset-Backed Securities Loan Facility (TALF)

The financial crisis deeply affected the securitisation market. In a period of months, the pendulum swung from a condition in which the financial markets assigned too low a value to the risk of certain securitisation asset classes – such as sub-prime mortgages – to one in which seemingly the only securities that were readily marketable were those with an explicit or implicit Government backing. Issuance of securities backed by credit card receivables and auto loans slowed to a trickle, and the sale of new commercial MBS (CMBS) ceased altogether. The absence of a functioning securitisation market in turn severely constrained the practical ability of banks and other financial institutions to extend new loans to consumers and businesses.

In an effort to revive the asset-backed securities (ABS) markets and provide a critical channel for the supply of new credit to households, the Federal Reserve created TALF, which began operations in March 2009 under the administration of the Federal Reserve Bank of New York. Treasury Secretary Geithner characterised TALF as '[o]ne of the most important' Federal Reserve programmes.[7] Through TALF, the Federal Reserve Bank of New York provided non-recourse loans to borrowers, secured by qualifying non-mortgage-backed ABS and, more recently, CMBS. Initially greeted with tepid interest, the programme gained momentum during the second quarter of 2009. As of 31 March 2010, the Federal Reserve Bank of New York, after loaning approximately US$70.8 billion under TALF, stopped making new loans for non-mortgage-backed ABS and legacy CMBS (or certain 'high quality' CMBS issued before 1 January 2009). TALF was closed on 30 June 2010, after it stopped making loans for newly issued CMBS.

Treasury programmes

The original vision of the TARP was that the Treasury would purchase up to US$700 billion of 'troubled assets' from 'financial institutions'. The TARP facility was expected to be used to purchase mortgages and other real estate-related assets in order to stabilise, enhance or at least establish reliable market values for illiquid assets. That original vision, however, was never implemented. Instead, the Treasury and the Federal Reserve quickly abandoned that plan and used TARP funds to make direct investments in the US financial system through the Capital Purchase Program.

Capital Purchase Program (CPP)

The CPP earmarked US$250 billion for direct investments in US financial institutions. When the CPP was officially announced, regulators had already summoned the CEOs of the nation's nine largest financial institutions to a meeting in Washington to inform them that their institutions had been designated as

7 *Written Testimony of Treasury Secretary Timothy Geithner: Hearing Before the Cong Oversight Panel*, 111th Cong (2009) (statement of Timothy Geithner, Secretary, US Dep't of the Treasury), available at **http://cop.senate.gov/documents/testimony-091009-geithner.pdf**.

systemically important, and that, therefore, they would be required, whether they or their boards felt their institutions needed it or not, to sign the term sheets put in front of them and accept the Government investment. The CEOs of these institutions all signed the one-page term sheets that day, which formed the basis of securities purchase agreements for the purchase of preferred stock and warrants that were later signed by the financial institutions. Unlike the preferred stock the Government purchased from Fannie Mae, Freddie Mac and AIG, this preferred stock was not senior to outstanding preferred stock. Instead, it was *pari passu*. In addition, the warrants were for a relatively small amount of common stock rather than 80 per cent of the company. These terms reflected a fundamental shift in policy from a focus on preventing moral hazard to a focus on restoring public confidence in the US financial system.

After the Treasury set aside US$125 billion for the nine largest financial institutions, it offered the remaining US$125 billion to other US banking institutions, including regional and community banks, but only the banking institutions other than the top nine that were determined to be ‘healthy’. Indeed, after the initial announcement, many regional financial institutions requested CPP investments to avoid being tainted as ‘unhealthy’. There was widespread fear that banks that did not request CPP investments would suffer deposit runs and possibly failure because their customers would conclude that they were unhealthy. The Treasury had invested a total of US$204.9 billion in 707 qualifying financial institutions (QFIs) through the CPP, and US$135.8 billion had been repaid by 31 March 2010. The CPP was closed on 29 December 2009 and will not disburse any new funds.

Systemically Significant Failing Institutions Program/AIG Investment Program

On 10 November 2008, the Treasury announced a restructuring of the Government’s financial support to AIG. As part of that overhaul, the Treasury indicated that it would purchase US$40 billion of newly issued preferred stock, under the Systemically Significant Failing Institutions Program (also called the AIG Investment Program), with the proceeds used in part to reduce the total amount available under AIG’s 22 September 2008 secured revolving credit agreement with the Federal Reserve Bank of New York. Also, on 17 April 2009, the Treasury committed US$29.8 billion to an equity capital facility that AIG could draw from. By 31 March 2010 AIG had drawn down US$7.5 billion from the facility and had not yet repaid any TARP funds.

Targeted Investment Program

The Treasury first issued guidelines for the Targeted Investment Program on 2 January 2009, after previously announcing its investment in Citigroup on 22 November 2008 and beginning discussions with Bank of America about additional TARP investments in December 2008 in anticipation of the closing of its purchase of Merrill Lynch on 1 January 2009.

The Treasury invested US$20 billion via the Targeted Investment Program in both Citigroup and Bank of America by purchasing perpetual preferred securities. The

Treasury's investment supplemented the initial TARP investments made under the CPP in these financial institutions.

In December 2009, both Citigroup and Bank of America repurchased their respective preferred securities, and the Targeted Investment Program effectively ended. Bank of America repurchased its shares on 9 December 2009 as part of a joint CPP and Targeted Investment Program repayment to the Treasury. Citigroup completed the sale of US$20.5 billion of new debt and equity securities and used the proceeds of this sale to repurchase its preferred securities on 22 December 2009.

Asset Guarantee Program (AGP)

The Asset Guarantee Program was announced as a package with the Targeted Investment Program. Under the Asset Guarantee Program, the US Government entered into a definitive agreement with Citigroup to share losses with respect to a pool of US$301 billion in assets of Citigroup. Although the Government agreed to the terms of a similar programme with Bank of America with respect to a pool of US$118 billion of assets, the majority of which were assumed as a result of the Merrill Lynch acquisition, the parties never executed definitive documents for that programme. On 21 September 2009 Bank of America announced that it had reached an agreement with regulators to pay a US$425 million fee to terminate the term sheet.

Pursuant to its agreement with the Government, Citigroup would absorb the first losses in its covered assets portfolio up to US$39.5 billion. The Federal Reserve Bank of New York, the Treasury and the FDIC would share any additional losses with Citigroup, with the Government absorbing 90 per cent of that loss and Citigroup ten per cent of the loss. Citigroup was required to manage the assets in the pool in accordance with guidance from a template issued by the Government, including mortgage modification procedures adopted by the FDIC. On 23 December 2009, the Asset Guarantee Program agreement was terminated in connection to Citigroup's repayment of the Treasury's Targeted Investment Program investment. The Government made no payments and retained US$5.2 billion in preferred shares as compensation for the protection extended by AGP.

Capital Assistance Program (CAP) and stress tests

CAP was announced by Treasury Secretary Geithner on 10 February 2009. There were two main components of CAP:

- stress tests to determine whether certain institutions needed additional capital buffers; and
- a capital assistance programme through which eligible public institutions could apply for capital infusions from the Treasury.

The programme's emphasis on capital composition in the stress tests and preferred stock terms that included the ability to convert to common stock demonstrated the Treasury's continued concern with increasing tangible common equity in recipient

financial institutions.

CAP enabled qualifying financial institutions (QFIs) to issue mandatory convertible preferred stock to the Treasury in order to provide such institutions with contingent common equity 'as a bridge to private capital in the future', as is necessary to 'retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital'.[8] The capital infusions were meant to increase capital buffers at QFIs to guard against economic conditions that are worse than expected. QFIs that issued mandatory convertible preferred stock under CAP were also required to issue to the Treasury warrants to purchase shares of the institution's common stock. Of the 19 banks participating, only GMAC indicated a need for capital, and this need was lower than anticipated at the time the SCAP results were announced. CAP was closed on 9 November 2009.

Public–Private Investment Program (PPIP)

The PPIP was an initiative to address the enduring problem of illiquid and troubled assets on financial institutions' balance sheets. The programme, announced by Treasury Secretary Geithner on 23 March 2009, was originally hailed as a vital component of the Government's plan to heal the financial sector. It received a warm welcome from Wall Street, with the Dow Jones Industrial Average rising seven per cent on the day of its announcement.

Enthusiasm for the PPIP waned almost immediately, however, because of the increasingly anti-Wall Street tone of the new Obama administration and the congressional leadership – the same leadership that had encouraged and authorised the various emergency assistance programmes under the Bush administration. In particular, both the new administration and the congressional leadership became highly critical of all of the bank holding companies that had received capital injections under the CPP, including the systemically important ones that had not requested additional capital but had been required to accept it for the 'good of the system', and those who took the capital solely to avoid being stigmatised as 'unhealthy'. Suddenly, all the banks that had received CPP capital found themselves stigmatised for having taken it, regardless of the reasons for having done so. This caused potential investors to question whether the US Government was a reliable trading partner. They started to fear that the Government might retroactively change the terms of their partnership if it appeared that they might make 'excessive' returns on their investments, as determined by hindsight. This distrust of Government doomed the PPIP.

As originally contemplated, the PPIP had two halves: the Legacy Securities Program run by the Treasury and the Legacy Loans Program run by the FDIC. Both programmes

8 Bd of Governors of the Fed Reserve Sys, Press Release, *Joint Statement by Secretary of the Treasury Timothy F Geithner, Chairman of the Board of Governors of the Federal Reserve System, Ben S Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and John C Dugan, Comptroller of the Currency* (6 May 2009), available at **www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm**.

contemplated the formation of investment funds capitalised with equity from the Treasury and private investors to be leveraged with potentially attractive Government financing in the form of either direct loans or debt guarantees, each fund a public–private investment fund or PPIF.

A key principle underlying the PPIP was a belief that, with the assistance of Government capital and leverage, the private sector could be induced to purchase these troubled and illiquid assets at prices substantially in excess of the then current market price. Both the Government and the banks believed that such market prices simply reflected speculative 'vulture' funds taking advantage of the distress of the banks and the dysfunctional credit markets to purchase assets at fractions of their underlying economic value.

In June 2009 the FDIC indefinitely postponed the Legacy Loans Program for lack of private sector interest. While the Treasury moved forward with the Legacy Securities Program, only very limited private sector interest ever materialised.

Fannie Mae and Freddie Mac

On 6 September 2008, the US Government took control of Freddie Mac and Fannie Mae as conservator, pursuant to the authority granted by HERA that Congress passed only several weeks prior. In connection with the conservatorship, the US Government provided each of the GSEs with up to US$100 billion of direct financial assistance in the form of senior preferred stock and temporary access to the Federal Reserve's discount window. The Treasury also agreed to purchase an unspecified amount of MBS backed by the GSEs in the open market. As part of its fee for providing the financial support, the Treasury took a 79.9 per cent interest in the common stock of each institution. The rescue of Fannie Mae and Freddie Mac is the largest Government-assisted transaction in US history, as these two institutions held or guaranteed a combined US$5.5 trillion of mortgage-backed securities at the time they were put into conservatorship.

To further boost market confidence in the two GSEs, on 18 February 2009, the Treasury announced that the funding commitments would be increased to US$200 billion for each institution. On 24 December 2009, the Treasury essentially offered unlimited support for the GSEs for three more years, stating that it was amending its preferred stock purchase agreements 'to allow the cap on Treasury's funding commitment under these agreements to increase as necessary to accommodate any cumulative reduction in net worth over the next three years'.[9] As of 23 June 2010, the Treasury had injected nearly US$150 billion of capital into Fannie and Freddie, and the Congressional Budget Office has estimated that it will take approximately US$390 billion in total capital injections before these institutions

9 Treasury Issues Update on Status of Support for Housing Programs, available at **www.ustreas.gov/press/releases/2009122415345924543.htm**.

will be stabilised.[10] Unlike the banks that quickly repaid most of the capital injections under the CPP, almost no one expects Fannie or Freddie to ever be able to repay more than a small fraction of its taxpayer assistance.

In addition to the Treasury's financial assistance, the Federal Reserve established programmes to purchase up to a total of US$200 billion of direct obligations of the GSEs and to purchase up to a total of US$1.25 trillion of MBS that are guaranteed by the GSEs. The Federal Reserve had purchased US$432.3 billion of MBS from Freddie Mac and US$703.6 billion of MBS from Fannie Mae by 31 March 2010. Moreover, the Federal Reserve purchased US$67.1 billion in debt from Freddie Mac and US$67.4 billion in debt from Fannie Mae from December 2008 to March 2010. It is not clear whether the Federal Reserve will be able sell such a large portolio of MBS into the capital markets or, if so, how long it will take to do so without disrupting the markets. In any event, it is unlikely that Fannie and Freddie will be in position to buy back any of these MBS in the foreseeable future.

FDIC's Temporary Liquidity Guarantee Program (TLGP)

The FDIC Board approved the TLGP in October 2008 as part of an effort by the FDIC, the Treasury and the Federal Reserve to stabilise the nation's financial system. There are two parts to the TLGP: the Debt Guarantee Program and the Transaction Account Guarantee Program. Through the Debt Guarantee Program, the FDIC guaranteed certain senior unsecured debt issued by participating insured depository institutions, their holding companies or their affiliates. Through the Transaction Account Guarantee Program, the FDIC provided unlimited deposit insurance for certain transaction accounts at participating insured depository institutions.

The Debt Guarantee Program was highly attractive to participating entities, particularly the larger bank holding companies, because it provided access to funding at relatively low cost. Regardless of the participating entity's credit rating, the three major credit rating agencies rated debt issued under the TLGP with their highest ratings based on the FDIC guarantee. Most fixed-rate debt issued under the Debt Guarantee Program bore an annual interest rate between of 1.5 and three per cent.

31 October 2009 was the last day for a participating entity to issue guaranteed debt under the TLGP. The FDIC established a limited, six-month emergency guarantee facility following the expiration of the Debt Guarantee Program on 31 October 2009, which was closed on 30 April 2010. Under the FDIC's general deposit insurance programme, deposits that are not subject to the transaction account guarantee are insured up to US$250,000 per person per institution, until 31 December 2013. The Transaction Account Guarantee Program provided unlimited insurance coverage for any balances in a non-interest bearing transaction account until 30 June 2010.

10 See, eg, Brian M Carney, 'Fan and Fred and the Problem of Narrative', *Wall Street Journal,* 26 July 2010, available at **http://online.wsj.com/article/SB10001424052748703467304575383451809694546.html?KEYWORDS=fan+and+fred#printMode**; Thomas F Cooley, *The Bottomless Pit of Fannie and Freddie*, Forbes.com, 23 June 2010, available at **www.forbes.com/2010/06/23/banking-finance-fannie-mae-opinions-columnists-thomas-f-cooley.html**; Binyamin Appelbaum, 'Cost of Seizing Fannie and Freddie Surges for Taxpayers', *New York Times,* 19 June 2010, available at **www.nytimes.com/2010/06/20/business/20foreclose.html?_r=1&pagewanted=print**.

US financial regulatory reform

The financial panic of 2008, and the scope of emergency public assistance required to stem the tide, created the perfect storm for new financial regulation. On 21 July 2010 the US enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act).

Impact of the Dodd-Frank Act

The Act marks the greatest legislative change to US financial regulation since the explosion of financial legislation in the 1930s, which resulted in the Federal Deposit Insurance Act, the Securities Act of 1933, the Glass-Steagall Act, the Securities Exchange Act of 1934 and the Investment Company Act of 1940, to name only the most important. While the full weight of the Act falls more heavily on large, complex financial institutions, smaller institutions will also face heavier regulation.

Proponents of the Act lauded it as landmark legislation that will reduce the likelihood and magnitude of future financial panics, end taxpayer bailouts of Wall Street, and enhance consumer protection. Critics on the left argued that it was too weak, and did not punish Wall Street enough for causing the panic. Critics on the right argued that it amounted to a vast expansion of Government control over the financial sector without addressing the real causes of the financial panic, ending too-big-to-fail or addressing the continuing public assistance to or moral hazards caused by Fannie Mae and Freddie Mac.[11] Others observed that it was a lost opportunity because it did not simplify the US regulatory infrastructure along the lines of the 2008 Treasury Blueprint,[12] or improve cross-border coordination, but instead created an even more complicated structure, increasing the risks of regulatory arbitrage and inefficiency.[13] Some economists predicted that its short-term effect would be to further contract the supply of credit, reduce GDP and create further upward pressure on already high unemployment,[14] thus pushing against the Federal Reserve's liberal monetary policy and making the same mistake of tightening credit by other means that the Federal Reserve made during the Great Depression.

11 See, eg, Brady Dennis, 'Congress Passes Financial Reform Bill', *The Washington Post,* 16 July 2010, available at **www.washingtonpost.com/wpdyn/content/article/2010/07/15/AR2010071500464_pf.html**; Jeff Madrick, 'Obama's Risky Business', *The New York Review of Books,* 15 July 2010, available at **www.nybooks.com/blogs/nyrblog/2010/jul/15/obamas-risky-business**; Associated Press, *Historic Financial Overhaul Signed to Law by Obama*, NPR, 21 July 2010, available at**www.npr.org/templates/story/story.php?storyId=122793558**.

12 See The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure, March 2008, available at**www.ustreas.gov/press/releases/reports/Blueprint.pdf**.

13 See, eg, Michael Helfer, Panel Discussion, *Regulatory Reform Overview – What's Next?*, at SIFMA Regulatory Reform Summit, 15 July 2010.

14 See, eg, Institute of International Finance, *Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework*, June 2010, available at**www.iif.com/**.

One thing is certain – the Act will contribute to legal uncertainty in the United States in the short run.[15] For the most part, the legislation creates only a general framework, leaving most key issues to be resolved by implementing regulations. Indeed, the Act requires at least 243 new federal rule-makings to implement its provisions. In the next phase of US financial regulatory reform, regulators will face an intense period of rule-making for at least 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty. The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions are likely to persist that will require consultation with the staff of the various agencies involved.

Adding to this legal uncertainty, the legislation did not enjoy bipartisan support. Instead, it was enacted largely along party lines, with nearly unanimous opposition from Republicans. House Minority Leader, John Boehner, for example, called for its immediate repeal and promised to dismantle it if Republicans again took control of Congress and the White House.

Summary of key provisions of the Dodd-Frank Act

The Dodd-Frank Act will not change the fundamental contours of the US financial regulatory structure. It will only cause a limited amount of shuffling of the regulatory boxes. For example, the Office of Thrift Supervision (OTS), which regulated a sector of the banking industry focused on real estate lending, will disappear. A new consumer financial protection agency and a new systemic risk council of regulators, will be created. But otherwise, the US financial regulatory structure will remain the same.

The Act will, however, result in several fundamental changes to the shape and scope of US financial regulation, summarised in the table below:

Key reforms in the Dodd-Frank Act	
Systemic Risk Regulation	Securitisation – Credit Risk Retention
Financial Stability Oversight Council	Executive Compensation
Office of Financial Research	Elimination of the OTS
Enhanced Prudential Standards	Deposit Insurance Reforms
Living Wills	Enhanced Regulation of Banking Entities
Orderly Liquidation Authority	Payment, Clearing and Settlement Systems
Volcker Rule	Consumer Financial Protection
Swaps Pushout rule	Restrictions on Emergency Stabilisation
Bank Capital (Collins Amendment)	Federal Reserve Governance
Derivatives	Pay it Back Act
Hedge Funds	Insurance
Investor Protection	International Sovereign Assistance
Enhanced Regulation of Securities Markets	Mortgage Market Reforms
Credit Rating Agencies	

15 See, eg, 'The Uncertainty Principle', *Wall Street Journal*, 14 July 2010, at A18, available at **http://online.wsj.com/article/SB10001424052748704288204575363162664835780.html?KEYWORDS=uncertainty+principle**; The Uncertainty Principle II, *Wall Street Journal*, 16 July 2010, available at **http://online.wsj.com/article/SB10001424052748704682604575369402612040086.html?KEYWORDS=uncertainty+principle**.

This section will provide only a brief overview of the Dodd-Frank Act. Anyone who is interested in a more complete summary of the Act should consult one of the many summaries that have been published by various US law firms and are available on their websites,[16] including memos and graphical illustrations of the effectiveness and implementation timelines of the various provisions with delayed effectiveness[17] or immediate effectiveness.[18]

Systemic risk regulation

The Act creates a new systemic risk council of regulators called the Financial Stability Oversight Council to serve as an early warning system identifying risks in firms and market activities, to enhance oversight of the financial system as a whole and to harmonise prudential standards across agencies. In other words, it will be responsible for macroprudential policies. A new Office of Financial Research will serve as the information-gathering arm of the Council. The Council is empowered to identify 'systemically important' non-bank financial companies, thus bringing such companies under regulation by the Federal Reserve, and to recommend heightened prudential standards for the Federal Reserve to impose on these companies. The Council also has the power to recommend heightened prudential standards to primary financial regulators to apply to any activity that the Council identifies as contributing to systemic risk.

The Federal Reserve will have expanded power over systemically important bank holding companies, as well as non-bank financial companies that are designated as systemically important by the Council. These systemically-important institutions will be subject to the Federal Reserve's consolidated supervision based on the current model for supervising bank holding companies in the US Bank Holding Company Act of 1956.

The vast majority of the systemic risk provisions require implementing regulation, and many give regulators discretion to modify the statutory standards or issue exemptions. In addition, the Council is not yet operational and has not yet put in place internal rules of procedure. As a result, significant unknowns remain on the scope and content of systemic risk regulation, and the manner in which the Council will operate.

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16 See, eg, *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on 21 July 2010*, Davis Polk Client Memorandum, 21 July 2010, available at **www.davispolk.com/files/Publication/efb94428-9911-4472-b5dd-006e9c6185bb/Presentation/PublicationAttachment/efd835f6-2014-4a48-832d-00aa2a4e3fdd/070910_Financial_Reform_Summary.pdf**.

17 See, eg, *Davis Polk Regulatory Implementation Slides*, 21 July 2010, available at **www.davispolk.com/files/Publication/bc70cd4c-c6bd-472d-ad37-0a63481fe36a/Presentation/PublicationAttachment/6a2f81d8-d5c5-4d5d-9b97-fef48b6821e6/070910_Implementation_Slides.pdf**.

18 See, eg, *Dodd-Frank Wall Street Reform and Consumer Protection Act: Preliminary Assessment of Provisions Effective Immediately or Very Soon After Enactment*, Davis Polk Client Memorandum, 21 July 2010, available at **www.davispolk.com/files/Publication/45ad4c88-8216-4efc-8e9c-6ecca08084a8/Presentation/PublicationAttachment/9a947ba9-a1ac-459b-9a34-70448c7035ea/072110_effective.pdf**.

Financial Stability Oversight Council

(i) Membership

The Financial Stability Oversight Council will consist of 15 members: ten voting and five non-voting. The voting members are the Treasury Secretary, who serves as chairman, and the heads of the Federal Reserve, the Office of the Comptroller of the Currency (OCC), which regulates national banks, the new Bureau of Consumer Financial Protection (Consumer Bureau), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), the National Credit Union Administration (NCUA), the Federal Housing Finance Agency (FHFA) and an independent member with insurance expertise. The non-voting members are the Directors of the Office of Financial Research (OFR) and the Federal Insurance Office (FIO), a state insurance commissioner, a state banking supervisor and a state securities commissioner.

(ii) Powers and duties

The Council is charged with the goal of identifying risks to US financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or non-bank financial companies, or risks that could arise outside the financial services marketplace. The Council is also supposed to promote market discipline and respond to emerging threats to US financial markets.

(iii) Systemic Designation Authority

The Council is empowered to identify systemically important non-bank financial companies, financial activities or practices, financial market utilities and payment, clearance and settlement activities. Bank holding companies with US$50 billion or more in consolidated assets are treated as systemically important; no designation is required. The Act refers to non-bank financial companies which are identified as systemically important as 'non-bank financial companies supervised by the Federal Reserve'. In this chapter, I will refer to them as 'systemically important non-bank financial companies', and together with bank holding companies with US$50 billion or more in assets, as 'systemically important companies'.

(iv) Recommending standards

The Council is authorised to make recommendations to the Federal Reserve concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to systemically important companies, to prevent or mitigate risk to US financial stability that could arise from the material financial distress, failure or ongoing activities of these companies. The Federal Reserve must consider these recommendations in prescribing enhanced prudential standards. The Council may also issue recommendations to apply heightened standards and safeguards for financial activities and practices if the

Council determines that the scope, size or interconnectedness of the activity could create or increase the risk of significant liquidity, credit or other problems.

Systemic Risk Regulatory Scheme

(i) Systemically important non-bank financial companies

The Act defines a 'non-bank financial company' as any company, other than a bank holding company or a company that is treated as a bank holding company, that is 'predominantly engaged in financial activities'. The Council is charged with identifying such non-bank financial companies that are systemically important, which the Act identifies as those that could pose a threat to financial stability either due to the potential of material financial distress at the company or due to the company's ongoing activities. Consideration of the company's ongoing activities was added late in the conference process, thereby expanding the scope of companies potentially designated as systemically important.

(ii) Systemically important bank holding companies

Bank holding companies with US$50 billion or more in assets are automatically subject to enhanced prudential standards. No Federal Reserve action or Council determination is required. There is no authority to lower the US$50 billion threshold. The Federal Reserve has the authority to raise the limit, and the Council may recommend such action, but only with respect to the application of the contingent capital requirement, resolution plans, credit exposure reporting, concentration limits, enhanced public disclosures and short-term debt limits. The Federal Reserve may not raise the threshold for risk-based capital requirements, leverage limits, liquidity requirements and overall risk management requirements. As of 31 March 2010, there are 36 domestic bank holding companies that exceeded the US$50 billion threshold.

(iii) Enhanced prudential standards

Generally

The Federal Reserve is required to establish enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, credit exposure reporting, concentration limits and prompt corrective action to apply to systemically important companies. The Federal Reserve may, but is not required to, establish additional prudential standards, including contingent capital requirements, enhanced public disclosure requirements, short-term debt limits and other prudential standards that it, on its own or pursuant to Council recommendations, deems appropriate. In developing enhanced prudential standards, the Federal Reserve must take into account recommendations of the Council. Standards must be more stringent than the standards and requirements applicable to non-bank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States. For any bank

holding company with US$50 billion or more in assets or any systemically important non-bank financial company, off-balance sheet activities must be taken into account for the purposes of meeting capital requirements. The Federal Reserve is permitted to require contingent capital, and the Council may make recommendations to that effect, but only after a Council study and subsequent report to Congress, which must be submitted within two years after enactment.

Concentration limits

The Federal Reserve must prescribe standards to limit the risks posed by the failure of any individual company to a systemically important firm. The rules issued by the Federal Reserve must prohibit credit exposure of a systemically important company to any unaffiliated company that exceeds 25 per cent of capital stock and surplus, or such lower amount as the Federal Reserve may prescribe by regulation, of the 'company', presumably the systemically important company. Credit exposure is broadly defined to include derivatives, repos, securities loans and any transaction that the Federal Reserve determines to be similar. The Federal Reserve may exempt transactions from the credit exposure definition if in the public interest.

A separate provision prohibits any insured depository institution, depository institution holding company or systemically important non-bank financial company from merging with or acquiring substantially all of the assets or control of another company if the resulting company's total consolidated liabilities would exceed ten per cent of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year. The Act provides an exception for acquisitions where the target bank is in default or in danger of default.

Risk Committees

The Act requires risk committees for systemically important, publicly traded non-bank financial companies, as well as any publicly traded bank holding companies with total consolidated assets of US$10 billion or more. The Federal Reserve may impose the requirement on publicly traded bank holding companies with less than US$10 billion in assets as necessary or appropriate to promote sound risk management practices. Risk committees must have the number of independent directors as determined by the Federal Reserve, and include one risk management expert having experience in risk management at large complex companies.

Resolution plans (living wills)

The Act requires systemically-important non-bank financial companies and large, interconnected bank holding companies to prepare and maintain extensive orderly resolution plans, which must be approved by the Federal Reserve and the FDIC. Plans are non-binding on bankruptcy courts, receivers or similar authorities. No private right of action may be based on any resolution plan.

The FDIC and the Federal Reserve must review a company's resolution plan to determine whether it is credible and whether it would facilitate an orderly resolution under the US Bankruptcy Code. If the resolution plan is found to be deficient, the company must resubmit the plan, including any proposed changes in business operations and corporate structure to facilitate implementation of the plan. If a firm fails to adopt an acceptable plan, the FDIC and the Federal Reserve may impose more stringent capital, leverage or liquidity requirements, or restrictions on growth, activities or operations. After having imposed other requirements, the FDIC and the Federal Reserve may require a company to divest assets if the company's resolution plan is deficient and a suitable, revised resolution plan is not resubmitted within two years.

Resolution plans will almost certainly have an effect long before a financial institution fails. They could result in demands that financial groups simplify their corporate structures, or possibly replace their branch networks with separately capitalised subsidiaries. They could also result in increased demand for risk management information on a real-time basis, such as lists of all counterparties, individual and aggregate exposures, amounts and quality of collateral, legal opinions as to the enforceability of collateral arrangements, and deal-level documentation. In any event, they are almost certain to result in increased risk management and compliance costs.

Stress tests

The Federal Reserve must conduct annual stress tests for all systemically important companies under at least three scenarios – baseline, adverse and severely adverse. The Federal Reserve must require each systemically important company to modify its living will based on the results of the analysis. The Federal Reserve will also publish a summary of the results of the stress tests. Each systemically important company must also conduct semi-annual internal stress tests and report the results of such stress tests to the Federal Reserve and its primary financial regulatory agency and publish a summary of the results as required by implementing regulations.

Limitations on non-bank acquisitions

Systemically important companies must provide prior notice to the Federal Reserve before acquiring control of voting shares of a company engaged in activities that are financial in nature or incidental thereto that has US$10 billion or more of consolidated assets.

Breakup powers

Upon a finding by the Federal Reserve, with approval of two out of three votes of the Council, that a systemically important company poses a 'grave threat' to financial stability, the Federal Reserve must take actions necessary to mitigate such risk, including:

- limiting the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
- restricting the ability to offer a financial product or products;

- ordering termination of activities;
- imposing conditions on the manner in which the company conducts activities; or
- if the Federal Reserve determines that such actions are inadequate to mitigate a threat to US financial stability, requiring the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.

Leverage limits

The Federal Reserve must require a systemically important company to maintain a debt-to-equity ratio of no more than 15 to one upon a determination by the Council that the company poses a grave threat to US financial stability and imposition of the leverage limit is necessary to mitigate such threat. In making a determination, the Council must consider the same factors as applicable to the systemically important designation of non-bank financial companies.

(iv) Systemically-important activities and practices

The Council may recommend heightened prudential standards or safeguards for particular financial activities or practices conducted by any company subject to regulation by a primary financial regulatory agency, including insurance companies, if it finds that the conduct, scope, nature, size, scale or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and non-bank financial companies or the US financial markets. The activity or practice, rather than the financial institution, would be considered significant.

Office of Financial Research

In an unheralded section, the Act adds a new self-funded, largely independent Office of Financial Research (OFR) with the power to gather vast amounts of information from financial market participants and to require standardisation of financial information to be reported to the OFR and other regulators. The OFR has broad information-gathering authority backed by subpoena power, and all data it collects is subject to the Freedom of Information Act. Several of the OFR provisions appear to overlap and even conflict in some places, meaning the scope of the OFR's powers will not be known until developed through rule-making and practice.

Orderly Liquidation Authority

The Act includes a new Orderly Liquidation Authority that will replace the Bankruptcy Code and other applicable insolvency laws for liquidating financial companies and certain of their subsidiaries under certain circumstances. Under the new Liquidation Authority, the Treasury Secretary would have the authority to appoint the FDIC as receiver of any financial company if certain conditions are satisfied. The new Authority is modelled largely on

sections 11 and 13 of the Federal Deposit Insurance Act, which governs the receivership or conservatorship of insured banks, but with several important differences. These differences were designed to harmonise the rules defining creditors' rights with those contained in the Bankruptcy Code, discourage bailouts, ensure due process, protect customer property and reduce the moral hazard that could result if shareholders, unsecured creditors or management are insulated from the consequences they would have suffered in a liquidation under the Bankruptcy Code or other applicable insolvency law. The result is a law that attempts to balance the goals of the bankruptcy and customer protection laws with the goals of preserving or restoring financial stability, public confidence and reasonable risk-taking that may have been disrupted as a result of a financial panic.

The Volcker Rule

The Volcker Rule will require bank holding companies to restructure or divest their proprietary trading and hedge fund and private equity businesses. While the Volcker Rule will restrict the US activities of non-US banks and the worldwide activities of US domestic banking holding companies, it will not apply to the activities of non-US banks 'solely outside the United States', provided that no hedge funds or private equity funds are marketed to US residents. The Volcker Rule will also require systemically important non-bank financial companies to carry more capital and be subject to other quantitative limits (including possibly ownership limits) on these activities. The Volcker Rule was named after Paul Volcker, the former Chairman of the Federal Reserve, who first proposed the restrictions for many months in vain.

Neither the Obama administration nor any of the US financial regulatory agencies nor anyone on Capitol Hill seemed particularly interested in the Volcker Rule until the political firestorm that arose on 19 January 2010 when Republican Scott Brown upset Democrat Martha Coakley in a special election for the Massachusetts Senate seat that had been left vacant by the death of Senator Edward Kennedy.[19] After ignoring the Volcker Rule for months, the administration suddenly announced it as a new central element of its financial regulatory package on 21 January 2010, only two days after Brown's stunning victory. The administration apparently viewed the Volcker Rule as a way to regain the political advantage after the Massachusetts defeat. Wall Street remained unpopular, and the Volcker Rule was viewed as a popular way to bash Wall Street. Indeed, the day after the Brown upset, Arianna Huffington, one of the Obama administration's most prominent, left-wing supporters and critics, had published an editorial in the *Wall Street Journal* urging the administration to turn on Wall Street as a way to regain the political advantage.[20]

The proposal initially received a frosty reception from the Senate Banking Committee, with Chairman Dodd describing it as coming too late in the day.

19 Alexander Burns, *Scott Brown Pulls Off Historic Upset*, Politico.com, 20 January 1010, available at **www.politico.com/news/stories/0110/31674.html**.

20 Arianna Huffington, 'Democrats Should Dump their Banker Friends', *Wall Street Journal*, 20 January 2010, available at **http://online.wsj.com/article/SB10001424052748704320104575014974041048224.html**.

Indeed, the widespread view, even after the administration issued the proposed legislative text, [21] was that the Volcker Rule was 'dead on arrival'. When Senators Merkley and Levin introduced their Prop Trading Act on 10 March 2010[22] it was taken as further evidence that the Volcker Rule was dead, because otherwise the Merkley-Levin bill would not have been proposed separately from the overall financial reform bill. Even on the Friday before the Senate released its 15 March 2010 version of what became the Dodd-Frank Act, senior Senate staffers on both sides of the aisle were saying that the Volcker Rule would not be part of the bill, although some warned that it could be proposed as an amendment during the debate of the bill on the floor of the Senate.

The Volcker Rule picked up steam after the administration succeeded in pressing the Senate leadership over the 13–14 March weekend to include its version of the Volcker Rule in the 15 March version of the Senate bill. The Volcker Rule picked up further momentum when the SEC filed fraud charges against Goldman Sachs on Friday afternoon, 16 April 2010, alleging that Goldman had failed to make appropriate disclosures in connection with structuring and marketing certain CDOs based on certain sub-prime reference assets. The fraud charges were followed by hearings in the Senate, led by Senator Carl Levin, in which Goldman was severely criticised for failing to disclose that John Paulsen, who intended to short the CDOs, had been involved in selecting the reference assets for the CDO pool.

Swaps Pushout Rule

The Swaps Pushout Rule will require US insured depository institutions and the US branches and agencies of non-US banks to push dealing in certain swaps out of these banking units and into separately capitalised affiliates. The range of covered swaps is unclear, but the rule will not apply to insured depository institutions with respect to hedging or dealing in swaps based on reference assets that a national bank is permitted to own.

The Swaps Pushout Rule was originally proposed by Senator Blanche Lincoln, who faced a serious challenge from the left in her Democratic primary election. Like the Volcker Rule, the Swaps Pushout Rule was promoted as an anti-Wall Street measure. But unlike the Volcker Rule, on which US bank regulators remained largely silent, most of the US bank regulators issued public statements opposing the Swaps Pushout Rule as likely to undermine the safety and soundness of the US banking system. Even Paul Volcker publicly suggested that the Swaps Pushout Rule was probably unwise, while expressly

21 *Treasury Proposes 'Volcker Rule' Legislative Text*, Davis Polk Client Memorandum, 4 March 2010, available at **www.davispolk.com/files/Publication/35a35c0a-d2eb-4e0e-97a5-12cb9614a5ca/Presentation/PublicationAttachment/abb79d18-5d6e-4937-958e-5575e129c594/030410_volcker_rule.pdf**.

22 *New 'Prop Trading Act' Would Expand 'Volcker' Prohibitions*, Davis Polk Client Memorandum, 11 March 2010, available at **www.davispolk.com/files/Publication/4e8bde45-e552-4cca-9e86-2fa263df22ac/Presentation/PublicationAttachment/530b9c6c-6e1a-48fc-98fe-31f772098db2/031110_merkley_levin.pdf**.

stating that to the extent proprietary trading in swaps should be prohibited, the Volcker Rule would do the job. In its original form, the Swaps Pushout Rule would have required all swaps activities to be pushed out of insured depository institutions and possibly bank holding company groups altogether. It did not contain any exceptions for using swaps for hedging purposes or to deal in swaps based on bank-eligible reference assets.

The Swaps Pushout Rule remained controversial to the end. Compromise language was finally agreed to during the early hours of the morning (between approximately 02:00 and 04:00am) on the day the Senate and House Conference Committee approved the final bill. The final version contains a number of ambiguities, contradictions and technical errors that will need to be clarified during the regulatory implementation process, or through the congressional technical amendments process.

Bank Capital (Collins Amendment)

The Collins Amendment, originally drafted by the FDIC staff and reflecting the views of Chairwoman Sheila Bair, imposes, over time, the risk-based and leverage capital standards currently applicable to US insured depository institutions on US bank holding companies, including US intermediate holding companies of foreign banking organisations, thrift holding companies and systemically important non-bank financial companies. One of the effects of the Collins Amendment is to eliminate trust preferred securities as an element of Tier 1 capital. Implementing regulations must be issued no later than 18 months after enactment and there are highly negotiated transition periods and grandfathering exemptions.

The Collins Amendment echoes changes that have been proposed but not yet adopted by the Basel Committee on Banking Supervision in the 'Basel III' process and those that are contemplated in the new US systemic risk regulatory regime.

Derivatives

The Act comprehensively regulates most derivatives transactions formerly deregulated by the Commodity Futures Modernization Act of 2000. Largely following the historical jurisdictional divisions between the CFTC and the SEC, the Act categorises the derivatives transactions within its scope as either 'swaps', which are subject to primary regulation by the CFTC, 'security-based swaps', which are subject to primary regulation by the SEC, or 'mixed swaps', which are subject to joint regulation by the CFTC and SEC.

The most significant aspects of the derivatives section are: (i) mandatory clearing through regulated central clearing organisations and mandatory trading through either regulated exchanges or swap execution facilities, in each case, subject to certain key exceptions; (ii) new categories of regulated market participants, including swap dealers and major swap participants; and (iii) the push-out from banks into bank affiliates of many swap activities.

As with other parts of the Act, many of the details of the new regulatory regime relating to swaps are left to the regulators to determine through rule-making, which in most cases will occur during the first 360 days following enactment.

Credit rating agencies

Credit rating agencies have faced criticism for the failure of credit ratings to accurately reflect the riskiness of complex structured products in the lead-up to the financial crisis. As the financial crisis unfolded and the assumptions underpinning rating methodologies for such instruments were shown to be overly optimistic, rating downgrades contributed to a pricing collapse that left the market for structured products virtually non-existent. In evaluating the performance of credit rating agencies and, in particular, nationally recognised statistical rating organisations, critics and regulators have attributed such rating failures to a lack of internal controls, conflicts-of-interest inherent in the issuer-pay business model, a lack of transparency and a perceived absence of accountability for credit rating agencies. In addition, various commentators have asserted that the use of credit ratings in US statutes and regulations has contributed to an over-reliance on credit ratings and an incorrect assumption that such credit ratings bear an implicit Government seal of approval.

The Act seeks to address these perceived deficiencies with new governance and compliance requirements, new liability rules and penalties, allowing certain private rights of action, restrictions on conflicts of interest, accountability for ratings procedures, required procedures and methodologies, enhanced disclosure requirements, removal of certain references to rating agencies in various statutes, and enhanced SEC supervision.

Securitisations – credit retention requirements

Congress adopted the view that securitisation abuses were a major contributing factor to the financial crisis. In an attempt to better align market participants' incentives, the Act creates a framework for a scheme whereby securitisers will be required to retain a portion of the credit risk with regard to the ABS they sell. However, many key details will only emerge in regulations yet to come. Additional provisions require heightened disclosure and reporting relating to ABS under the securities laws.

Executive compensation

The Act includes provisions relating to executive compensation arrangements at financial institutions and public companies. The Act does not impose rigid limits and prohibitions of the nature contained in previous TARP legislation, and most of the principles-based provisions require implementing regulations. Notable provisions include the requirement for listed companies to have independent compensation committees and a mandatory non-binding say on pay vote.

Deposit insurance reforms

Among other things, the Act permanently increases the deposit insurance limit to US$250,000 per person per insured institution.

Payment, clearing and settlement

The payment, clearing and settlement provisions of the legislation are meant to reduce the risks of contagion among financial firms and markets. Recognising that financial market utilities that conduct or support multilateral payment, clearing or settlement functions, and related financial activities, have the potential to create and concentrate risks to the financial system, the Act aims to reduce these risks through greater prudential regulation and oversight of these entities and activities.

The impact of this provision will largely be limited to financial market utilities and those organisations that engage in payment, clearing, and settlement activities. Utilities and these organisations will face the prospect of being designated, or having a portion of their activities designated, as systemically important, thereby subjecting the utility or organisation to the payment, clearing and settlement provisions in the Act, including risk management standards and examinations by regulators.

Consumer financial protection

The Act establishes the Bureau of Consumer Financial Protection as a new executive agency with very broad powers and a substantial budget. The Bureau will assume most of the consumer protection functions exercised by regulators under certain existing federal consumer protection laws. The Bureau will also enjoy independent authority under the Dodd-Frank Act itself with respect to covered persons. Carved out from the Bureau's authority are a number of entities and activities, including persons regulated by the SEC and the CFTC and the business of insurance.

The greatest impact of the new Bureau will be felt by banking organisations with assets of US$10 billion or more, with respect to which the Bureau will have exclusive rule-making and examination, and primary enforcement, authority under federal consumer financial law. Smaller banks will not escape the rule-making authority of the Bureau, but will be largely free of Bureau supervision and enforcement authority. Certain non-bank covered persons will also be subject to the full complement of Bureau rule-making, supervisory and enforcement authority.

The legislation establishes a new framework for federal pre-emption of state consumer financial laws applicable to national banks and thrifts. Most significantly, the drafters sought to curtail the OCC's pre-emption authority by providing that the OCC may pre-empt a state law only in accordance with the holding of the Supreme Court in *Barnett Bank v Nelson*, on a case-by-case basis and on the basis of 'substantial evidence'. The legislation also expands the authority of state attorneys-general and state regulators in two ways: first, by declaring that state consumer financial laws are

fully applicable to subsidiaries and affiliates of national banks or thrifts, contrary to the Supreme Court's holding in *Watters v Wachovia*; and second, by citing the Supreme Court's holding in *Cuomo v Clearing House Ass'n* to clarify that no provision of the National Bank Act relating to state visitorial authority may be construed so as to limit the authority of state attorneys-general to bring actions to enforce any applicable law against a national bank.

The passage of this legislation will likely bring with it a material increase in compliance costs for covered persons, particularly in light of the 50-state consumer protection regime with which covered persons must comply in the absence of blanket federal pre-emption.

Emergency stabilisation powers

The Act makes a variety of changes to the Federal Reserve and FDIC's emergency financial stabilisation powers, designed to balance the ability of regulators to provide liquidity to the markets during times of distress with concerns regarding the potential moral hazard, costs and conflicts of interest associated with such action. The Federal Reserve would no longer be able to provide lending assistance to a single and specific firm unless it is part of a broad-based programme, and new substantive and procedural requirements would govern the FDIC's ability to establish programmes like the Temporary Liquidity Guarantee Program.

Insurance

The Act creates a Federal Insurance Office (FIO) with certain limited powers. Although it will not have substantive regulatory responsibilities, the FIO will facilitate the development of insurance expertise within the Treasury and could portend increased federal involvement in the industry. Even with limited powers, the FIO is likely to provide an impetus for efforts to promote greater levels of national uniformity and will provide a federal focus for the coordination of international insurance regulation. In addition, the legislation enacts relatively non-controversial measures to streamline the market for non-admitted insurance and reinsurance by limiting interstate application of regulation and encouraging implementation of uniform standards in these areas. Representative Barney Frank stated recently that there will be a 'major push' in Congress to provide for an optional federal charter after the passage of broader financial regulatory reform, although he intends to stay neutral in the debate.

Loose ends

The Dodd-Frank Act left a number of important issues unresolved. Most importantly, it did not deal with Fannie and Freddie. Both the Obama administration and the congressional leadership have said that reform of these institutions will have to wait, but promised a reform proposal in the near future. Reform of Fannie and

Freddie always has to wait. Ironically, and almost certainly unintentionally, the Act actually gives the Council authority to designate Fannie and Freddie as systemically important non-bank financial companies, subject to the consolidated supervision of the Federal Reserve and the heightened prudential standards for systemically important financial companies.

The Orderly Liquidation Authority in the Dodd-Frank Act, while an important step forward, failed to create a federal framework for resolving systemically important insurance companies. Instead, it leaves the 50-state framework largely intact. Finally, the Orderly Liquidation Authority does not provide a credible solution for resolving systemically important financial companies with worldwide operations, like AIG. At most, it is a first step in solving that puzzle, requiring further international harmonisation and cooperation or alternative mechanisms such as bail-ins, contingent capital or other recapitalisation programmes that can work on a global basis.

Conclusion

The US and the rest of the world experienced a genuine financial panic in September and October of 2008. The US responded by taking a series of emergency actions to stabilise the financial system. The financial panic of 2008, and these emergency measures, created the ‘perfect storm’ for new financial regulation. The Dodd-Frank Act is the most extensive revision of US financial regulation since the 1930s, although it has left some important issues unresolved.

United Kingdom

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Introduction

This report looks at how the global financial crisis hit the UK and how the UK, so far, has responded to it. It does not deal with tax or remuneration issues, notwithstanding the prominence that they have sometimes achieved in commentary on the crisis. As at the time of writing, following the 'emergency budget' of 22 June 2010, it appears that the UK (in conjunction, to some extent, with France and Germany) will impose some kind of bank levy. Various measures have also been adopted to restrict remuneration structures that are perceived to incentivise 'excessive risk-taking'.

It has also been announced (by the Chancellor of the Exchequer, in his Mansion House speech of 16 June 2010) that the Financial Services Authority (FSA) will eventually cease to exist, at least in its present form, with much of its role in relation to the supervision of banks being transferred (in reality, re-transferred) to the Bank of England (which will carry out the role through a subsidiary).

The most important legislation passed in response to the crisis is the Banking Act 2009. This is concerned mainly with giving new powers to the authorities to deal with failed, or failing, banks. It is considered in some detail below. It is likely that we will also have new legislation dealing with the insolvency of investment banks – in response mainly to the experience of dealing with the Lehman Brothers insolvency in the UK. The new coalition Government in the UK has said that a new commission will look into other issues, notably the need to separate 'casino' (investment) banking from 'utility' (retail) banking; that commission will not report until 2011. Remarks of various politicians indicate that some kind of separation is very likely, the principal questions being in relation to how, rather than whether, it should happen.

How the crisis hit the UK

The beginning of the crisis in the UK: Northern Rock

The report of the House of Commons Treasury Select Committee, 'The Run on the Rock'[2] is, among other things, the definitive 'history' of what happened to

1 Director, Law and Financial Markets Project, LSE; Editor, Law and Financial Markets Review. The contents of this report (© Roger McCormick 2010) are explored in more detail in the author's forthcoming book *Legal Risk in the Financial Markets* (2nd ed) to be published by Oxford University Press in late 2010.

2 Fifth report of 2007–08, published on 24 January 2008.

Northern Rock. The opening paragraph of the Introduction to the report cites (in the first sentence) Robert Peston's 'breaking' of the problems at the bank at 8:30pm on 13 September 2007 (a Thursday). The news that a high street bank needed emergency assistance from the Bank of England started a classic bank run, with lengthening queues of depositors at its branches – all asking for their money back – dominating media coverage for the next four days. Peston had got the story via a 'leak' and his disclosure made it impossible for the authorities, who at the time were working on a rescue operation,[3] to inform the media of a problem and its solution at the same time – always the preferred option. They were wrong-footed. The run was only stopped by the then Chancellor of the Exchequer (Alastair Darling) announcing (after close of business on Monday, 17 September 2007) that the Government would guarantee the bank's deposits. He had little choice.

The report examines Northern Rock's business model in some detail and, in particular, its funding strategy. It had become extremely reliant on funding from wholesale money markets (as opposed to, for example, retail deposits) and this had given it severe liquidity problems when those markets in effect closed during late summer 2007. The report found that the bank's business strategy was 'high risk' and 'reckless'.[4] Particular criticism was made of its 'reliance on short- and medium-term wholesale funding'.

Following the 'run', Northern Rock became dependent on public funding involving a combination of loans and guarantees. On 17 February 2008, the Government announced that it would acquire the shares in Northern Rock. The Banking (Special Provisions) Act 2008 was passed in order to provide the necessary powers. It has been referred to on many occasions as a 'nationalisation', but this is misleading. The Government has not taken any overt role in the operation of the bank (although politicians cannot resist heckling the banks from the sidelines and exhorting them to be more forthcoming with lending to businesses) and it seems clear that it will dispose of the shares as and when expedient.

No director of Northern Rock has been successfully sued for damages, or charged with any criminal offence, on account of what happened to the bank. However, in April 2010, two senior Northern Rock employees, David Baker and Richard Barclay, were fined substantial sums by the FSA (and, in the case of Baker, banned from working again in banks) because of their role in the making of misleading statements (before it became known that the bank was in difficulties) about loans made by the bank that were in arrears. The Financial Times columnist, Andrew Hill, noted: 'these are the first really significant fines levied on bankers for what they did as the crisis was brewing. They won't be the last.'[5]

It was subsequently announced that the FSA was broadening its investigation to include the actions of another Northern Rock employee.

3 There had, for example, been consideration of a takeover of Northern Rock by Lloyds TSB (now Lloyds Banking Group, following it subsequent acquisition of HBOS).

4 See above at 2, para 31.

5 Lombard column, 14 April 2010.

The 'regulatory failure' in the UK and proposed changes

The 'Run on the Rock' report examines the perceived regulatory failures that led up to the bank's demise as well as management failures. There were a number of potential targets for criticism, including the so-called 'tripartite' regulatory system as a whole.[6] This system had been set up at the time the FSA was established, as part of a new political initiative (following the election of a Labour government in 1997) to replace the old system of bank supervision headed by the Bank of England. In the debates in the House of Commons during the passage of the Bank of England Act 1998, Alistair Darling[7] extolled the virtues of the new Government's 'modernisation of the system of regulation' while responding to a question from Keith Vaz[8] who sought reassurance that problems such as those associated with BCCI and Barings would be dealt with much better once the new regulatory system was set up:

> 'On banking supervision… we have made a number of suggestions over the years to improve the situation following the collapse of BCCI and then Barings… we have taken further the steps to ensure that one of the problems that emerged with both BCCI and Barings – that each regulator did not know what the other was doing – will be dealt with… bringing the regulators together will not merely have the advantage of getting rid of a cumbersome and expensive system that is fundamentally flawed in concept, but will ensure that regulation is complementary to the business process and not a hindrance. That will give consumers and the public alike the confidence in the system that is lacking…
>
> The collapse of both Barings and BCCI showed that it is necessary to have a domestic regulator that has sufficient clout and reputation to deal with its international counterparts. That will now be possible with the new FSA… the unprecedented scope and powers of the FSA will, of course, ensure a better co-ordinated approach… The FSA will be at the cutting edge of improving regulation and supervision here and throughout the world… the Bill transfers the supervisory functions [from the Bank of England] to the FSA… The change will be manageable and, at all times, the staff of the FSA will ensure that they keep their eye on the ball and retain a firm grip on day-to-day events in the marketplace.'[9]

Darling and Gordon Brown[10] were of course known to lay the blame for BCCI largely at the door of the Bank of England. The Bank's 'punishment' was the setting up of the FSA and the transfer of the supervision of banks away from Threadneedle Street to Canary Wharf, the home of the new regulator. However, the Bank retained responsibility for overall financial stability while the FSA was given supervision and HM

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6 This raises issues that continue to be controversial, especially as regards the responsibility of the Bank of England for financial stability.

7 At that time, the Chief Secretary to the Treasury.

8 MP Leicester East.

9 11 November 1997, Hansard, Column 721 et seq.

10 At that time, the Chancellor of the Exchequer.

Treasury was responsible for the institutional structure and supporting legislation.[11] The relationship among the Bank, the FSA and the Treasury was recorded in a Memorandum of Understanding.

'The Run on the Rock' would not have made comfortable reading for those who were so confident that the FSA would be the solution to all the problems associated with the old regulatory system and the Bank of England. In fact, the report not only severely criticised the FSA, it also recommended that important new powers be given to the Bank. In the process it also made a hefty side-swipe at the way the tripartite system had been working, although it did not recommend any significant structural change to it. The FSA was taken to task specifically over its 'failure' to act appropriately in response to two 'warning signals' of trouble at the Rock during the course of 2007. These consisted of unusually rapid growth in its business and a fairly significant drop in its share price. In the course of discussions with the Committee, the FSA held to the view that the growth in business was not a 'critical' matter, although it did accept that share price movements could be an indicator 'of a variety of different potential issues'. The Chancellor of the Exchequer (who was now Mr Darling) expressed the view to the Committee that 'regulators should concern themselves not just with institutions that do not appear to be doing terribly well but also with institutions that do appear to be doing terribly well because, if they are out of line, it may be they are doing a very good job but they ought to just be sure that that is the case'. He also said, 'in hindsight, it would have been much better, would it not, if the FSA when first looking at Northern Rock had said, "Hold on, what exactly is your fallback position?" and when Northern Rock said, "We haven't got one" they did something about it.'

The Committee was critical of the FSA:

> 'The FSA has acknowledged that there were clear warning signals about risks associated with Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater "regulatory engagement" with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation.'[12]

The Bank of England, and its Governor, came in for criticism from the media over the Rock as well. However, the Committee did not really hit them very hard at all. In fact, the Bank, if the Committee's recommendations had been implemented, would have become more, not less, influential. It was suggested that the Bank should be given new powers relating to handling failing banks and a fund for the protection of depositors. To achieve this, the Committee recommended the setting up of a new post of 'Deputy Governor of the Bank of England and Head of Financial Stability' who was, among other things, to take on 'horizon scanning' and 'develop a forward looking analysis' in order to 'identify trends and potential

11 The Government's views on the need for regulatory change, and the benefits of the system introduced by the Financial Services and Markets Act (FSMA), are set out in the July 2009 White Paper 'Reforming Financial Markets' (Cm 7667).

12 Para 42.

risks to the financial system' and adapt and improve stress-testing techniques 'both at the system and individual institution level'. The role would also involve 'ensuring a feedback system is incorporated between financial institutions and the regulatory authorities for issues related to financial stability'. The new Deputy Governor would be directly involved in the exercise of suggested new powers to take 'prompt corrective action' if a bank looks as though it is getting into serious trouble (whether solvency- or liquidity-related). Once a 'PCA tripwire' had been 'breached', the authorities (with the Bank at the helm) would need 'an appropriate toolkit of measures to either rectify the problem, or, alternatively, facilitate an orderly failure'. And the Committee was very keen that banks should stop thinking they were 'too big to fail'. A side effect of the new regime would be that the public sector would not be faced with the choice of either propping up a 'failing' bank or risking panic and systemic failure. The new regime would allow the 'failing' bank to be, in effect, taken over – at least for a while – by the 'authorities' with nothing like the risk and delay that would generally be involved in a conventional insolvency law scenario. These suggestions heralded the arrival of the 'Special Resolution Regime', which in due course became embodied in the Banking Act 2009. However, the concern and debate over what to do about banks that are 'too big to fail' remains.

Just a few days after the Treasury Select Committee's report, the Government published the Treasury Consultation Document 'Financial stability and depositor protection: strengthening the framework'.[13] The consultation document echoed many of the things said in 'The Run on the Rock' but, notably, not the idea of giving the Bank of England the powers referred to above. (It was with the advent of the coalition after the May 2010 General Election that the Bank of England really came back into favour as the Government's regulator of choice.) The document suggested, however, that legislation be introduced to formalise the Bank's role in relation to financial stability; various new immunities from suit, and enhanced protection for collateral taken by the Bank, were also proposed. The idea of a Special Resolution Regime (SRR) for 'failing banks' was enthusiastically taken on board and, here, the consultation document openly built on the Treasury Select Committee's ideas. The powers that could be included in an SRR were described as including:

- 'powers to allow the Authorities to direct and accelerate transfers of banking business to a third party;
- powers to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a "bridge bank" as is possible, for example, in the United States and Canada;
- powers to allow the Authorities to appoint a suitable person, or "restructuring officer", to oversee the bank to carry out the resolution;
- existing tools for the provision of financial support to a failing bank through a public sector guarantee or public sector capital injection;
- should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank is appropriate, a modified insolvency process for banks – a "bank insolvency procedure" – to facilitate fast and orderly payment of depositors claims…'

13 Cm 7308.

The 'Authorities' in this context means the tripartite group. Pulling the 'trigger' for an SRR would be an FSA decision (or 'regulatory judgment') 'after consultation with the Bank of England and HM Treasury'.

As indicated above, these proposals ultimately found their way into the Banking Act 2009.

Other UK financial institution failures, near failures and rescues

- Northern Rock was not the only financial institution in the UK to experience liquidity problems as a result of the crisis. The pressure on other institutions built during the autumn of 2007 and two, similarly structured, banks that were formerly building societies had to be rescued in 2008. After a deceptively 'quiet' period in mid-2008, the markets were generally plunged into unprecedented turmoil when Lehman Brothers failed in September 2008 and the crisis entered a new phase. The facts regarding the history of the UK market during this time, in summary, were as set out below:
- Banks with similar business strategies to Northern Rock quickly came under market scrutiny and many of them experienced sharp downward pressure on their share price. There were even regulatory measures put in place (temporarily) to restrict short selling in bank shares (hedge funds being singled out for particular criticism in this regard). Alliance & Leicester and Bradford & Bingley both ultimately succumbed (following a collapse in their share price) and were partly sold to the Spanish Santander bank group (which already owned the Abbey, acquired in 2004).[14] After the fall of Lehman Brothers the Government was forced to acquire a majority (around 58 per cent) equity holding in Royal Bank of Scotland (after it had announced the biggest loss in its history – partly caused by sub-prime exposure and partly by its disastrous acquisition the previous year of the Dutch bank, ABN AMRO). At the same time, Sir Fred Goodwin resigned as Chief Executive Officer of RBS (and subsequently became an extremely controversial figure when details of his generous pension deal became known).
- Halifax Bank of Scotland (HBOS) was (under a deal originally announced in September 2008 and completed in January 2009) acquired by Lloyds TSB (the merged entity now being known as Lloyds Banking Group) and, at about the same time (following a disappointing rights issue), the government acquired a significant equity holding (43.4 per cent) in that group (having already acquired equity in Lloyds TSB and HBOS separately in October 2008). This holding (in the new enlarged group) rose briefly to 65 per cent later in the year but then fell back to the previous level following a repayment by Lloyds Banking Group of some £4.3 billion of Government funding (using the proceeds of a rights issue). The Chairman of the merged group Sir Victor Blank, who was previously the Chairman of Lloyds TSB, agreed in May 2009 to resign in 2010; the merger (which was far from being an immediate financial success for the Lloyds TSB side) was not popular with previous shareholders in Lloyds TSB and Blank was very much associated with it in their eyes, as well as more generally.

14 More recently, Santander has been reported as bidding for a large number (320) of RBS bank branches in England which are up for sale.

- The first Government acquisition of a shareholding in RBS was announced on 13 October 2008: the cost to the UK taxpayer was approximately £37 billion.[15] However, it soon became apparent that that injection of funds would not be enough. In early 2009, the Government increased its shareholding (to 68 per cent of the equity). Barclays Bank remained free of UK Government shareholdings but it did raise a large amount of capital from foreign sources.[16] HSBC also continued to operate without the need for the Government becoming a shareholder.
- The Government investments in banks (including Northern Rock) are held through a new, specially created (and publicly owned) company, UK Financial Investments Limited.
- The acquisition of shares (of various classes) in banks was accompanied by other measures (announced on 19 January 2009) to assist them such as the 'asset protection scheme' under which the Government would guarantee various bad or risky loans ('toxic assets') in return for a fee; a scheme whereby the Government would guarantee certain UK mortgage-backed securities; a scheme for the Government to buy corporate bonds (to stimulate the market in them); and an extension of Bank of England liquidity support.
- Building societies were not immune from the effects of the crisis. Many of them suffered rating downgrades by the credit rating agencies. This led to them being in breach of liquidity facilities that had been made available by the Bank of England. In 2009 both the Dunfermline Building Society and the West Bromwich Building Society encountered financial difficulties. The former was, in effect, rescued by the use of powers under the Banking Act 2009 to sell off the better parts of its business to the Nationwide Building Society and the latter resolved its difficulties by a capital restructuring involving the issue of quasi-equity instruments to its bond holders. Other small building societies were absorbed into larger ones. The shrinkage in the market of mutual societies was particularly unfortunate as they had been seen as good alternatives for investment to the banks and were also important as 'traditional' arrangers and providers of housing mortgages. Many would like to see more of them, not fewer. Their financial difficulties, for the most part, seemed to stem from over-exposure to commercial property risk and the buy-to-let market and, more generally, a desire to grow their balance sheets more quickly than was prudent.
- In mid-2009 Santander decided to re-brand as 'Santander' the many (some 1,300) high street branches of Abbey, Alliance& Leicester and Bradford& Bingley that it now owned. This took effect in January 2010.

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15 Sir John Gieve, at the time the Deputy Governor of the Bank of England, later admitted (in an interview with Robert Peston of the BBC for 'Panorama' programme) that 'several of our large banks… were in real difficulty' at the time of the October 2008 intervention. It seems clear that he was referring to RBS and HBOS. Robert Peston's blog (22 December 2008) expresses the striking view that the two banks were 'only hours away from being unable to open for business'.

16 The share price of Barclays collapsed in January 2009 (by about half in one week – to 88p). A week later it was 51p, but it had recovered to 174p by the end of March 2009. Barclays raised £7.3 bn from funds based in Qatar and Abu Dhabi (thus giving those funds control over 32 per cent of its equity).

Legal and regulatory responses to the crisis in the UK

The Banking (Special Provisions) Act 2008 and the Banking Act 2009

The Banking Act 2009 was the most important legislative response in the UK to the issues raised by the crisis.[17] It replaced and extended the Banking (Special Provisions) Act 2008, which was introduced as a temporary, emergency measure in the wake of the Northern Rock. It is a 'portmanteau' piece of legislation, with provisions covering the following principal areas:

- a new 'Special Resolution Regime' which includes powers for the authorities to take action in relation to 'failing' financial institutions before they are formally insolvent;
- a new bank insolvency procedure;
- a new bank administration procedure,[18]
- changes to the Financial Services Compensation Regime;
- provisions giving the Bank of England powers to oversee certain interbank payment systems;
- enabling provisions for the Treasury to make new regulations concerning (i) the insolvency of investment banks and (ii) financial collateral arrangements;
- the establishment of a new Bank of England Financial Stability Committee and clarification (and extension) of the Bank's immunity from legal action; and
- miscellaneous provisions concerned with the issuance of banknotes in Scotland and Northern Ireland.

The Act is principally concerned with procedures to be followed, and options available to the authorities, when banks encounter serious financial difficulties. It is not directly concerned with new regulations designed to make it less likely that the crisis will be repeated. However, the Act is an important development in so far as it gives the public sector a range of formidable new powers that have an impact on the rights of the citizen and on the risks faced by financial market participants, particularly creditors of, and shareholders in, failing financial institutions. We begin with consideration of the Special Resolution Regime.

The stabilisation options under the Special Resolution Regime

Overview

Section 1 of the Act provides an 'overview' of why the new regime has been brought into the law and what it consists of. Its purpose 'is to address the situation where all or part of the business of a bank has encountered, or is likely to encounter, financial difficulties'. It consists of:

'(a) the three stabilisation options,
(b) the bank insolvency procedure… and
(c) the bank administration procedure.'

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17 Others have included, for example, various (temporary) measures (taken in a large number of countries in addition to the UK) restricting short-selling shares in financial institutions. This was a (somewhat controversial) response to extremely volatile movements in the market price of such shares when the crisis was at its peak.

18 In the scheme of the Act, the new insolvency and administration procedures are part of the SRR.

From the point of view of a shareholder in a bank, a bank's management or others who have dealings with it, the new law presents, at least at first sight, a somewhat daunting prospect: the possibility of de facto nationalisation (albeit with compensation); confiscation or forced change of ownership; giving priority to retail depositors on liquidation of a bank; severe modification of contractual rights and/or transfer of contractual claims and obligations to a party that was not in anyone's contemplation when the contract was signed. There is even a somewhat extreme 'change in law' risk by virtue of the unusual and extensive powers given to the Treasury under section 75 of the Act. From the point of view of the public sector, on the other hand, the Act has many provisions that indicate that if any of these powers are in fact exercised, it will be with extreme reluctance and in the hope that, ultimately, a 'private sector solution' can be found. It is not to be regarded, in itself, as an indication of a change of policy, with the UK Government suddenly becoming interested in owning and running banks.

There are numerous provisions in the Act requiring consultation among the three authorities in the UK's tripartite regulatory structure. It remains to be seen how these (and indeed any provisions that give roles to the Bank of England or the FSA) will be affected by the changes to the UK regulatory architecture announced in June 2010.

The trigger for exercise of stabilisation powers

Not surprisingly, the Act contains a large number of checks and balances (in the form of numerous consultation requirements and the need to have regard to generally framed objectives and a code of practice) that show considerable sensitivity to the potential concerns. The provision relating to the 'objectives' of the powers expressly refers to the need to 'balance' different considerations; an exercise that lies at the heart of most bank 'rescue' operations.

The first question, however, is: what are the trigger points for the stabilisation powers being exercised? There are various series of conditions, the basic ones (and thus the starting point) being set out in section 7, which provides that a stabilisation power 'may be exercised in respect of a bank only if the FSA is satisfied that' two 'general conditions' are met. The first condition is that: 'the bank is failing, or is likely to fail, to satisfy the threshold conditions' (within the meaning of section 41(1) FSMA). The second is that: 'having regard to the timing and other relevant circumstances it is not reasonably likely that (ignoring stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.' The threshold conditions include the requirement that the bank has adequate resources and that it is 'fit and proper' (as to which the sound and prudent conduct of its affairs will be relevant). In deciding whether or not these conditions are met, the FSA is to ignore the impact of any financial assistance provided by the Treasury or the Bank of England.[19]

There was evidently some frustration within the Bank of England over the fact that

19 In connection with assistance from the Bank of England, 'ordinary market assistance offered by the Bank on its usual term' is to be disregarded for this purpose (section 7(4)(b)).

although it had responsibility for financial stability, its role in getting banks to behave properly, to date, had been somewhat limited. In his Mansion House speech of 17 June 2009, the Governor said:

> 'To achieve financial stability the powers of the Bank are limited to those of voice and the new resolution powers. The Bank finds itself in a position like that of a church whose congregation attends wedding and burials but ignores the sermons in between. Like the church we cannot promise that bad things won't happen to our flock – the prevention of all financial crises is in neither our nor anyone else's power, as a study of history or human nature would reveal. And experience suggests that attempts to encourage a better life through the power of voice is not enough. Warnings are unlikely to be effective when people are being asked to change behaviour which seems to them highly profitable.'

The recent Government announcements, involving transferring more power to the Bank (from the FSA) should go some way to allaying these concerns.

Special resolution objectives

There are further 'specific conditions' that apply to specific scenarios. However, before turning to those, it is important to note there are also very generally worded 'special resolution objectives' set out in section 4 of the Act and the authorities are required to have regard to these in using, or considering using, the stabilisation powers (or the bank insolvency and administration procedures). These objectives, therefore, introduce a potential further restraint (although it is specifically stated that they are 'not relevant' for the purpose of deciding whether or not the two conditions referred to above have been met).[20] The special resolution objectives (which are not listed in order of importance but 'are to be balanced as appropriate in each case'[21]) are:

1. to protect and enhance the stability of the financial systems of the UK (including, in particular, the continuity of banking services);
2. to protect and enhance public confidence in the stability of the banking systems of the UK;
3. to protect depositors;
4. to protect public funds; and
5. to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1998).[22]

The code of practice

20 See above section 7(7).

21 See above section 4(10).

22 As the code of practice issued pursuant to section 5(1) of the Act explains (at para 15), persons whose rights are interfered with could include the institution itself, its shareholders (or, in the case of a building society, members) creditors, counterparties or other third parties. 'The primary Convention right at issue is Article 1 of Protocol 1 to the Convention (right of property). Other Convention rights (including Article 6, the right to a fair trial and Article 14 prohibition of discrimination) may also be relevant.'

An arbitrary use of any of the stabilisation powers would be likely to conflict with at least one of the above objectives (particularly the last one). Further reassurance is given by the fact that the Treasury has to issue a code of practice about the use of the powers (and the bank insolvency and administration procedures) and the Act specifies that 'the relevant authorities shall have regard to the code'. The first version of the code was published on 23 February 2009. It has a number of interesting features (including various paragraphs that explain the intentions behind the statutory descriptions of the stabilisation objectives) and, again, demonstrates a concern that the potential for abuse of the new powers should not give rise to alarm. Paragraph 3.20, for example, states that, in exercising the stabilisation powers, the authorities will, in addition to the stabilisation objectives, 'necessarily have regard to restrictions and conventions of public law, in particular the requirement for the Authorities to act reasonably and to have respect for the rule of law and principle of legal certainty'.

Specific powers

The above requirements apply generally to the use of the stabilisation powers. There are further specific requirements that apply to specific powers. If, for example, the Bank of England wishes to exercise its power to sell all or part of a bank's business to a commercial buyer[23] or to a 'bridge bank'[24] it must be satisfied that:

'the exercise of the power is necessary,[25] having regard to the public interest in –

(a) the stability of the financial systems of the United Kingdom,

(b) the maintenance of public confidence in the stability of the banking systems of the United Kingdom, or

(c) the protection of depositors'[26]

and before it makes any decision on the above it must consult the FSA and the Treasury.

However, the above conditions are displaced if the Treasury has told the Bank of England that 'they have provided financial assistance in respect of a bank for the purpose of resolving or reducing a serious threat to the stability of the financial systems of the United Kingdom'.[27] In such a case, the condition of exercise is that:

'(a) the Treasury have recommended the Bank of England to exercise the stabilisation power on the grounds that it is necessary to protect the public

23 The code of practice expresses the view that this is likely to be the preferred option, where a willing purchaser can be found (see para 5.19). Transfer to a 'bridge bank is likely to be used as a temporary measure in order to stabilise the troubled bank's business pending an onward sale to the private sector'.

24 See sections 11 and 12. One of the difficulties with the private sale option in these circumstances is the time taken up with negotiation and the due diligence process. The luxury of sufficient time for normal prudent purchaser enquiries and risk analysis may not be available and the crisis has itself shown that the initial attractions of acquiring a competitor in trouble may later turn out to be outweighed by the seriousness of the 'troubled assets' that then appear on the consolidated balance sheet.

25 As the code of practice points out (para 5.14) 'the test of necessity is a high one'. This also applies to the power exercisable by the Treasury.

26 See section 8(2).

27 See section 8(4).

interest, and

(b) in the Bank's opinion, exercise of the stabilisation power is an appropriate way to provide that protection.'[28]

There is no need for the Bank of England to consult the FSA in this latter case. No doubt they would be fully aware of the situation in any event. Essentially, the Bank would be implementing the will of the Government, but it is interesting to note that its independent decision-making function is preserved. Generally, in relation to these powers, the Bank needs to weigh in the balance not only which of the options seems most appropriate but also whether it would be preferable to commence the bank insolvency procedure (see below). Paragraph 5.18 of the code of practice makes the point that the latter might result in the 'most appropriate outcome', especially if the interests of depositors are protected by either prompt payouts under the Compensation Scheme or 'the bulk transfer of their accounts to another institution'. The need to guard against 'moral hazard' is not forgotten. The same paragraph reminds us that, 'it is also generally important for market discipline that firms – including banks and building societies – should not be immune from failure'.

If the Treasury wishes to exercise its power to take a bank 'into temporary public ownership'[29] (which may mean a transfer to either a nominee of the Treasury or a company wholly owned by the Treasury[30]) it must be satisfied either that:

(a) the exercise of the power is necessary to resolve or reduce a serious threat to the stability of the financial systems of the UK; or

(b) such exercise is necessary to protect the public interest, where the Treasury have provided financial assistance in respect of the bank for the purpose of resolving or reducing a serious threat to the stability of the financial systems of the UK.[31]

The Treasury must consult the FSA and the Bank of England before it makes any such decision. Again, we see the consultation requirements acting as a brake on potential misuse of these sweeping new powers. They are also, one might suppose, a response to the criticism, voiced on numerous occasions as the crisis broke, that the authorities that comprise the UK's 'tripartite' regulatory system did not seem to communicate very well with each other. As the code of practice states, 'the resolution of failing banking institutions will involve intense coordination, cooperation and information sharing between the Authorities at each stage of the decision-making process'.[32] The code also makes the very practical point (which the experience of the crisis will have underlined)

28 See section 8 (5).

29 See section 13. The code of practice indicates that this will probably be the least preferred option (see para 5.21).

30 Government holdings in banks such as Royal Bank of Scotland and Lloyds Banking Group were, as at mid-2010, held by UK Financial Services Limited (which is wholly owned by the Government). This company is also expected to manage the Government's (100 per cent) holdings in Northern Rock and Bradford & Bingley. In a letter dated 3 November 2008 from the Chancellor of the Exchequer to the Chairman of the Treasury Select Committee, it was stated that 'the Government will not be a permanent investor on UK financial institutions and will over time seek to dispose of the investments in an orderly way…'.

31 See section 9.

32 Para 4.1.

that, in choosing among the options available, the authorities will regard as a key factor: 'the amount and quality of information available… on the balance sheet and operations of the banking institution and on any interests of third parties.'[33]

The Banking Liaison Panel

There is a further innovation of the Act that should serve the valuable purpose of limiting the potential for misuse of power or, perhaps more likely, unintended consequences. This is the setting up, pursuant to section 10, of a new 'Banking Liaison Panel'. This is 'to advise the Treasury about the effect of the special resolution regime on –

(a) banks

(b) persons with whom banks do business, and

(c) the financial markets'.[34]

More specifically, the panel may advise on the exercise of certain powers to make statutory instruments as well as, to an extent, compensation orders and orders made under section 75, the code of practice and 'anything else referred to the panel by the Treasury'. The panel must include (among others) one or more persons with 'expertise in law relating to the financial systems of the United Kingdom' and one or more with expertise in insolvency law and practice. The first members of the panel include representatives of the FMLC and also of the Financial Law Committee of the City of London Law Society. There is also a representative of ISDA, the first such individual being a senior partner in a major City law firm. The panel is, effectively, the successor to the Expert Liaison Group that the government had set up to assist it with some of the technically complex parts of the legislation as it passed through Parliament. Because of its composition, it is well-placed to advise on issues of legal uncertainty and legal risk. The code of practice[35] notes that one of the most technically difficult areas of the new legislation, partial property transfers, is expected is to be an area of 'particular interest' to it.

Partial property transfers: 'good banks' and 'bad banks'

Perhaps the most technically demanding issues arising out of the stabilisation powers concern the problems that could arise if a power was exercised to transfer some, but not all, of the property, rights and liabilities of a bank, a so-called 'partial property transfer'.[36] Section 33(2) clearly contemplates that a property transfer instrument may relate to all the property, rights and liabilities of a bank or only to specified property rights and liabilities. Such an instrument might be used, for example, where it was decided to separate bad debts and other assets of dubious quality (often referred to

33 Para 5.22.

34 See section 10(1).

35 Para 2.11.

36 See section 47(1).

through the crisis as 'troubled' or even 'toxic' assets) from the other assets, creating a so-called 'bad bank' and 'good bank'. The use of such an instrument could, however, cause severe difficulties in relation to transactions (of which there are, of course, very many in the financial markets) involving set-off and netting provisions where a counterparty to a bank that is subject to such an instrument has relied on, say, a set-off right that, following the instrument coming into effect, is destroyed (for want of mutuality) because its claim has not been transferred (and remains perfectly valid, but against an insolvent institution whose only assets are those that no one else wants), whereas its obligations have been transferred and may now be pursued, free of set-off, by the transferee. Because of the fundamental importance of set-off rights in the financial markets it was recognised, in the course of the legislation's development, that this problem had to be addressed. Otherwise, City law firms, as well as others, would have felt obliged to include extremely material qualifications in any legal opinions given in relation to a wide range of wholesale market transactions. It would also have become impractical, for the purpose of capital adequacy rules, to measure exposures on a net basis (a practice that assumes set-off rights 'work' in insolvency and in relation to which regulators require appropriately worded legal opinions). The solution was found by providing in the Act that the Treasury may by order (by statutory instrument) do a number of things that prevent partial property transfers having the undesirable effect described above. These include restricting the making of such transfers and imposing conditions on the making of them. More importantly, in the present context, section 48(2) of the Act provides that such an order may address particular issues that arise in connection with 'protected arrangements' Protected arrangements are defined in section 48(1)(e) to mean:

- security interests;
- title transfer collateral arrangements;
- set-off arrangements; and
- netting arrangements.

An order was made under section 48(2) that came into force in February 2009. This was the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.[37] The concern about the effect of partial property transfers on set-off and netting arrangements is addressed in paragraph 3 of the Order. According to paragraph 3(1), a partial property transfer 'may not provide for the transfer of some, but not all, of the protected rights and liabilities between a particular person ('P') under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement'.[38]

37 2009, No 322.

38 There are certain exceptions to this provision (defined in paragraph 1 as 'excluded' rights and liabilities). These include rights and obligations relating to (i) retail deposits, (ii) contracts entered into 'otherwise than in the course of carrying on an activity which relates solely to relevant financial instruments' (iii) damages claims and awards and (iv) subordinated debt .

Paragraph 3(2) similarly prohibits continuity powers[39] terminating or modifying protected rights and liabilities between P and a banking institution.[40] Paragraph 3(3) provides that rights and liabilities between P and a banking institution are protected for the purposes of the foregoing 'if they are rights and liabilities which either P or the banking institution is entitled to set-off or net under a set-off or netting arrangement or title transfer financial collateral arrangement which P has entered into with the banking institution'.[41]

Other paragraphs of the Order deal with, for example, situations comparable to those involving set-off or netting described above. In such situations, but for the Order, there would be a risk that secured liabilities might be transferred without the benefit of the security (or, conversely, that the property might be transferred without the liability), and restrictions on the partial transfer of rights and liabilities under 'capital market arrangements' or which would affect rights under 'market contracts' and certain rules of recognised investment exchanges and clearing houses.

Compensation

Sections 49 to 62 deal with the compensation (if any) to be paid to those adversely affected by the exercise of stabilisation powers. Depending on the precise powers used, the Treasury is required to make either a 'compensation scheme order' or a 'resolution fund order'. The former is concerned with compensation (to transferers) in the conventional sense. The latter is concerned with establishing a scheme to pay (to transferers) proceeds of disposal of assets transferred in specified circumstances and to a specified extent. 'Third party compensation orders' may also be made, providing for compensation to persons other than transferers (for example, counterparties to transactions with a bank). There are provisions for the appointment of an independent valuer[42] and, importantly, the principles of valuation.[43] One of the more contentious principles to date has been the requirement, set out in section 57(3), that in determining the amount of compensation the valuer 'must disregard actual or potential financial assistance provided by the Bank of England or the Treasury (disregarding ordinary market assistance provided by the Bank on its usual terms)'.

39 'Continuity powers' are defined by reference to section 64(2) of the Act, which gives the Bank of England broad powers to, for example, cancel and modify arrangements and contracts entered into by a bank, all or part of whose business has been transferred pursuant to the stabilisation powers.

40 'Banking institution' is defined in the Order and, apart from banks, includes building societies and holding companies of banks.

41 Paragraph 3(4) deals with a potentially complex situation that may arise where some of the property in question is foreign property (for example, rights and liabilities under a contract with a foreign counterparty and not governed by English law) and 'may not have been effectively transferred' by the relevant order or instrument. In such a case an instrument or order that purports to transfer all the protected rights and liabilities shall be treated as having done so effectively (and thus not give rise to a contravention of paragraph 3(1)).

42 Section 54.

43 Section 57.

The predecessor of this provision in the Banking (Special Provisions) Act 2008 gave rise to litigation in relation to the position of the former shareholders in Northern Rock plc. (See *SRM Global Masters Fund (and others) v Commissioners of HM Treasury*;[44] the Court upheld the validity of the procedure laid down by the Act.)

The power to change the law

The last section in Part 1 of the Act that merits special mention is section 75. This is a very unusual piece of legislation (some commentators have termed it a 'Henry VIII clause') in that it confers on the Treasury the power 'by order to amend the law for the purpose of enabling [the stabilisation powers] to be used effectively, having regard to the special resolution objectives'. Such an order (which must be made by statutory instrument) may be made for the general purpose of the exercise of the powers, to facilitate a particular proposed or possible use of a power or 'in connection with a particular exercise of a power'. As regards the latter purpose, the order:

> 'may make provision which has retrospective effect in so far as the Treasury consider it necessary or desirable for giving effect to the particular exercise of a power under this Act in connection with which the order is made (but in relying on this section the Treasury shall have regard to the fact that it is in the public interest to avoid retrospective legislation).'[45]

It is hard to imagine a provision that could (at least potentially) be more arbitrary. The executive is given power by the legislature not only to amend the law 'by order' but also to do so retrospectively. The parenthetical phrase at the end of the subsection is of some comfort; but not much. 'Amend the law' is defined by section 75(4) and

> 'means
>
> (a) disapply or modify the effect of a provision of an enactment (other than a provision made by or under this Act),
>
> (b) disapply or modify the effect of a rule of law not set out in legislation, or
>
> (c) amend any provision of an instrument or order made in the exercise of a stabilisation power.'

The Treasury can thus change common law as well as statute law (a point overlooked by the code of practice).

Two points are made by the code of practice in relation to section 75 that may provide some reassurance:

- we are, again, reminded that the Treasury must 'have respect for the rule of law and legal certainty'[46]; and
- paragraph 6.23 notes that the Banking Liaison Panel has a statutory right to advise on the use of the power to change the law; but 'this does not include a right to

44 [2009] EWHC 227 (Admin) Upheld on appeal: [2009] EWCA Civ 788.

45 See section 75(3).

46 Paragraph 6.20.

provide advice on an exercise of this power that is carried out in connection with or to facilitate a particular use (proposed or actual) of a stabilisation power'.

However, the code of practice is a little disappointing in its efforts to illuminate the rationale for these extraordinary provisions (some examples would have been helpful). The provisions evidently reflect concerns borne out of particular situations experienced during the crisis when it was felt that the existing law was, for some reason, deficient and, somehow, obstructed the efforts of the authorities to 'resolve' difficult problems that they then had. One assumes that specific issues that fall into this category have been covered by specific provisions in the Act. But there is clearly unease that legal risk for the authorities (in the form of law that 'gets in the way' of what they want to do) might reappear if they need to use the new powers and, as a result, the power to change the law (if necessary, virtually, overnight) has been reserved in order to help manage that risk. That such a sweeping power is apparently needed is itself a reflection of both the complexity and the novelty of the legal issues that now tend to be involved in a modern day bank rescue operation.

Bank insolvency and administration

Overview

The Banking Act 2009 introduced new procedures regarding bank insolvency and bank administration.[47] The Act also gives the Treasury power to make new regulations regarding the insolvency of investment banks. The following paragraphs are concerned with 'ordinary' deposit-taking banks (that is, those that are subject to the special resolution regime) as opposed to investment banks. However, it should be noted that, as the law stands, an institution may undertake both deposit-taking and investment banking business 'under the same roof'.

It is still possible for UK banks[48] to be subject to the procedures for insolvency and administration that apply to corporate entities generally but this now seems less likely in practice. This is because section 120 of the Act provides a number of hurdles that would have to be overcome by anyone applying for 'conventional' administration or petitioning for a 'conventional' winding up, by any bank that wishes to be wound up voluntarily or by anyone wishing to appoint an administrator. Taken together, the effect of the hurdles is that the FSA and the Bank of England must be content that a conventional procedure goes ahead and not be 'trumped' by either of them invoking one of the new procedures under the Act. The hurdles are:

47 These are set out in Parts 2 and 3 of the Act.

48 The definition, for the purposes of bank insolvency orders, is contained in section 91 and is the same as that applicable to banks for the purposes of the stabilisation powers referred to above. Bank administration orders, by their nature, are only available in respect of a bank with regard to which the Bank of England has exercised, or proposes to exercise, a property transfer instrument (pursuant to a stabilisation power).

1. that the FSA has been notified:
   (a) by any applicant for an administration order, that the application has been made;
   (b) by any petitioner for a winding up order, that the petition has been presented;
   (c) by a bank that proposes a voluntary winding up, that such a resolution may be made, or (as the case may be);
   (d) by any person proposing to appoint an administrator, of the proposed appointment;[49] and
2. that a copy of the notice to the FSA with the relevant details referred to above has been filed with the court (and made available for public inspection by the court); and
3. that (a) two weeks have elapsed since the FSA received the notice referred to above; or
   (b) both –
      (i) the FSA has informed the person who gave the notice that it does not intend to apply for a bank insolvency order; and
      (ii) the Bank of England has informed the person who gave the notice that it does not intend to apply for a bank insolvency order or to exercise a stabilisation power; and
4) that no application for a bank insolvency order is pending.

Section 117 also provides that on a petition for winding up or an application for administration the court may instead make a bank insolvency order (but only if the Bank of England agrees). The 'whip hand' is thus with the FSA and the Bank of England if proposals are afoot to wind up a UK bank or put it into administration. The 'ultimate weapon' of the dissatisfied creditor may be taken away from him. There needs to be a good reason for this. The Act attempts to supply them. However, it is clear that the policy is to give precedence to the position of retail depositors. According to the Explanatory Notes, the principal reason for the new insolvency procedure 'is to ensure that, where a bank fails, depositors who are eligible claimants under [the FCSC] are paid out promptly'.[50] This is understandable, given the need to limit the possibility of public near-panic that accompanied the demise of Northern Rock. However, good news for one class of creditors is bad news for others. We will deal first with the new bank insolvency order and then with the bank administration order.

Bank insolvency order

Applications for bank insolvency orders (which are orders of the court, appointing a bank liquidator) can only be made by the Bank of England, the FSA or the

49 See section 120 (5).
50 See Explanatory Note at para 241.

Secretary of State.[51] Three possible grounds for such an application (which must nominate someone to be appointed as bank liquidator) are given in section 96. 'Ground A' is that a bank is unable, or likely to become unable, to pay its debts. 'Ground B' is that the winding up of the bank would be in the public interest. 'Ground C' is that the winding up of the bank would be 'fair'. The rules that apply for each authority in this context are:

1. the Bank of England can only apply if:
   (a) the FSA has informed it that the general conditions for the exercise of stabilisation powers (set out in section 7) have been met; and
   (b) the Bank of England is satisfied –
      (i) that the bank has eligible depositors;[52] and
      (ii) that Ground A or C applies;
2. the FSA can only apply if –
   (a) the Bank of England consents, and
   (b) the FSA is satisfied that (i) the general conditions referred to above have been satisfied, (ii) the bank has eligible depositors and (iii) Ground A or C applies;
3. the Secretary of State can only apply if satisfied that the bank has eligible depositors and that Ground B applies.

The Court may make a bank insolvency order on the application of either the Bank of England or the FSA if satisfied that the bank has eligible depositors and that Ground A or C applies. It may do so on the application of the Secretary of State if satisfied that the bank has eligible depositors and that Grounds B and C apply. 'Fairness' is thus an additional requirement in the case of the public interest ground but not for Ground A (inability to pay debts). 'Fairness' is also a ground for making an order in its own right. The Secretary of State is in the driving seat in relation to applications based on public interest. Otherwise, it is the Bank of England (unless the Bank agrees to the FSA taking the lead).

A bank liquidator has two objectives.[53] The first ('Objective 1', which takes precedence over the second[54]) is to work with the FSCS so as to ensure that as soon as is reasonably practicable each eligible depositor (a) has the relevant account transferred to another financial institution, or (b) receives payment from (or on behalf of) the FSCS. The second is to wind up the affairs of the bank so as to achieve the best result for the bank's creditors as a whole.

Sections 100–103 contain provisions relating to the liquidation committee and the powers of the liquidator. Until Objective 1 has been achieved ('entirely or so far as reasonably practicable'[55]) the committee will consist of appointees (one each) of the Bank of England, the FSA and the FSCS. When Objective 1 is achieved, the committee may pass a full payment resolution and, after that, a meeting of all creditors is called

51 Section 95.
52 These are depositors who are eligible for compensation under the FSCS.
53 These are set out in Section 99.
54 Although the liquidator is obliged to begin working towards both objectives immediately upon appointment: section 99(4).
55 Section 100(4) and section 100(5)(a).

and additional members of the committee can be appointed. The committee is given detailed duties as to recommendations relating to the different aspects of (and options under) Objective 1.[56] Many of the liquidator's powers are incorporated by reference (with modifications) from general insolvency legislation.

Bank administration order

Whereas the bank insolvency procedure reflects a clear policy change (to give priority to retail depositors on a bank's liquidation) the new procedures for bank administration are more of a consequential nature: how to deal with the part of a bank's business that is 'left behind' in the so-called 'residual bank' when a stabilisation power is used to transfer some, but not all, of its assets to a commercial purchaser or a 'bridge bank'. The Act enables the Bank of England (no one else) to apply to the court for a bank administration order in such a situation as long as the Bank is satisfied that the residual bank cannot pay its debts or is likely to become unable to pay them once such a transfer has been made.[57] If the court appoints an administrator, the latter will be 'able and required to ensure that the non-sold or non-transferred part of the bank… provides services or facilities to enable the commercial purchaser… or the transferee… to operate effectively'.[58] In other respects 'the process is the same as for normal administration under the Insolvency Act 1986, subject to special modifications'.[59] The objectives laid down for the bank administrator in section 137 reflect this. There are procedures for determining when the objective to support the transferee has been achieved, following which the administrator can concentrate on 'normal' administration. If reasonably practicable, this should involve rescue as a going concern but the administrator is able to look at other options if they would achieve a better result for the creditors as a whole.

Investment bank insolvency

The special resolution regime, set out in the first three parts of the Act, is not concerned with the insolvency of investment banks as such. The Act does not contain any substantive provisions that address investment bank insolvency but it seems clear that the experiences gained as a result of the insolvency of Lehman Brothers[60] (from September 2008 onwards) persuaded the government that modifications to the law in this area may be desirable. Section 233 of the Act accordingly provides that the Treasury may make 'investment bank insolvency regulations' at some point in the future.[61]

56 Section 102.
57 See sections 142 and 143.
58 See section 136(c).
59 See section 136(d).
60 In the UK, the administration of Lehman Brothers International (Europe).
61 A sense of urgency is imparted by section 235(4), which requires any regulations to be made by February 2011, failing which the power to make them lapses. The Government has also made the point that this relatively short timetable gives the markets a degree of certainty that the outcome of deliberations on the pros and cons of changing this branch of the law will be known soon.

What would be the objective of having a special insolvency regime for investment banks? Section 233(3) supplies a statutory answer. In making any regulations on the topic the Treasury is required to have regard to the following:

'(a) identifying, protecting and facilitating the return of client assets,

(b) protecting creditors' rights,

(c) ensuring certainty for investment banks, creditors, clients, liquidators and administrators,

(d) minimising the disruption of business and markets, and

(e) maximising the efficiency and effectiveness of the financial services industry in the United Kingdom.'

The fact that the return of client assets has pride of place tells us something about the nature of the concerns that have arisen in connection with the Lehman's insolvency. Their former clients have had much greater difficulty extracting what they regarded as 'their property' from the insolvency process than might have been expected (see below). Accusations have been made that the UK insolvency process has not been as efficient in this regard as that of other countries (notably, the US). Is there a danger that, if such accusations are true (or simply perceived to be true), the UK will lose some of its competitive edge? Many of the issues and concerns that have arisen in the market were commented on in the consultation paper, 'Developing effective resolution arrangements for investment banks', issued by the Treasury in May 2009 in connection with the possibility of making investment bank insolvency regulations.[62]

The opening sentences of the consultation paper note that: 'the UK, and particularly London, serves as one of the pre-eminent international centres for investment banking and related services. Around half of European investment banking activity takes place through London and, along with New York, London is the global leader for the provision of investment banking services.' The following paragraph tells us that the 'UK's robust and flexible legal and insolvency regimes are two of the most important foundations underpinning the success of the UK financial services sector and its role as an international centre for investment banking'.

The May 2009 consultation paper was followed by a further consultation paper in December 2009, 'Establishing resolution arrangements for investment banks', which developed many of the ideas that were given exposure in the earlier paper and contained firm proposals for legislation. Among the more significant proposals were the following:

- establishing a special resolution regime for investment banks that would involve the return of client assets being given priority;
- giving administrators a 'special defence' against liability if they could show that they had acted according to the special administration regime objectives;

62 See Ereira: 'The UK review of resolution procedures for investment banks in difficulties', LFMR vol 3 no 4 at p 333.

- requiring firms to appoint a 'Business Resolution Officer' (BRO) at board level who would be responsible (in both 'business as usual' and 'distress situations') for coordinating and implementing 'firm-level resolution actions' such as those mentioned below; the BRO would be a key contact for parties such as the regulator who were concerned about an orderly wind-up of a failing firm's business and would be responsible for ensuring that the board complied with relevant responsibilities;
- requiring the preparation of 'Recovery and Resolution Plans' (RRPs) which would be subject to rules to be made by the FSA; an RRP would, in effect, anticipate a firm's demise and put in place plans and procedures to reduce or even eliminate the problems that faced the administrators when they took over the running of Lehman's business; these would, for example, 'attempt a managed wind-down' and be 'based on principles of simplification, rationalization and reconciliation'.[63]
- requiring firms to produce 'Business Information Packs' (BIPs), which would be 'a contemporaneous and accurate repository of information on the investment firm's business'; importantly, these would be produced on a 'legal entity basis', and the information would be presented in a clear manner that can easily be understood by someone not familiar with the firm's business; again, the need to ease the problems faced by Lehman's administrators is clearly to the fore; the BIP must 'allow outside parties to understand quickly how a firm… manages risk' and, for example, have details on 'specific risk management methods including up-to-date details on where the firm is exposed significantly in terms of products, sectors or counterparties'.
- requiring the setting aside of an 'operational reserve'; that is, adequate liquid funds for paying key staff and suppliers in the event of insolvency so that services can be continued;
- (subject to further consideration with the FSA) requiring prominent product warnings in documentation, alerting clients to potential risks in certain kinds of provision (eg, rehypothecation, placing client money with affiliates) affecting the return of client assets; consideration was also to be given to limiting the ability to transfer client money to jurisdictions with unsatisfactory insolvency regimes and/or making transfers to affiliates generally; the experience of the likely losses flowing from LBIE placing client money with a German affiliate was no doubt influential here;
- establishing 'bar dates' for clients claiming a proprietary interest in assets; and
- establishing the new office of 'Client Asset Trustee' (CAT) to uphold the interest of client money and asset holders together with a 'Client Asset Agency' (CAA); the CAT would be an insolvency practitioner specifically concerned with the return of client assets; administrators would remain responsible for dealing with creditors; the CAA would take over some of the FSA's responsibility in relation to client money and client assets.

63 This concept has become known as the 'living will'. The Treasury Select Committee ('Too important to fail, too important to ignore', report of 29 March 2010, at para 150) has commented that: 'As a general proposition, we consider that if an institution is too complex to prepare for an orderly resolution, it is too complex to operate without imposing unacceptable risks to the states in which it does business. Regulators should take account of any structural difficulties in the preparation of a living will. Living wills, if fully applied, will necessarily lead to the structural reform of banks.' The 'living will' idea may thus achieve some of the changes that those who have been calling for the separation of 'casino' and 'utility' functions have been requesting.

A number of these proposals are now reflected in the Financial Services Act 2010. This Act (among other things) requires the FSA to make rules about 'recovery plans' and 'resolution plans'. As at the time of writing, such rules have yet to be published but it seems likely that a number of the ideas referred to above will be reflected in them. The 'living will' – which many feel is likely to have a significant structural impact, perhaps even representing the UK's own 'version' of Glass Steagall in its effect – is therefore expected to come to life in the form of a set of FSA rules.

Lehmans UK litigation

As these ideas for changes to the law (and market-led solutions) were being considered, the Lehmans administration was also giving rise to a number of issues before the courts. Some of them related to the issues raised by the consultation papers (and many of the proposals in those papers obviously have their origins in issues being considered, or at least commented on, in the litigation). One of the most serious issues (or rather a cluster of issues) related to the difficulties the Lehman counterparties had (and still have) in recovering 'client assets' from the administration. Because many counterparties had given Lehmans rights of use over their assets or otherwise allowed Lehmans to rehypothecate collateral, they had, in effect, given up property rights and become mere unsecured creditors.

This kind of problem was partly responsible for driving the fear in the markets that came close to panic at the height of the crisis. An article in *The Sunday Times* of 14 February 2010,[64] examined the role of Hank Paulson[65] in the crisis and, particularly, at the time of the collapse of Lehman Brothers in September 2008:

> 'The biggest problem with Lehman's collapse came when Price Waterhouse Coopers, the administrator to Lehman in Britain, started to seize assets on behalf of creditors, including funds that supposedly belonged to clients. In his book,[66] Paulson says he received a call from Lloyd Blankfein, his successor at Goldman Sachs, who told him that the administrator had spread panic. "He was shocked," said Paulson, "When collateral that was viewed as third party collateral in customer accounts in a broker-dealer gets frozen – that was something that accentuated the panic".'

It is evident from Paulson's comments that this development took him and many others by surprise as well. Further commentary on the Paulson/Blankfein conversation is found in Sorkin's book about the Lehman collapse, *Too Big to Fail*:[67]

> 'Hank Paulson was in his office when Lloyd Blankfein called him at 9:40 a.m. in a panic. Blankfein, anxious by nature, was even more so now, and Paulson could sense it. Blankfein told Paulson about a new problem he was seeing in the market.

64 'I'm the guy who saved Wall Street' (Dey), *The Sunday Times,* Business section, at p 9.

65 US Treasury Secretary at the time of the Lehman collapse.

66 'On the brink' (Headline Business Plus).

67 Andrew Ross Sorkin, *Too Big to Fail,* Allen Lane 2009 at pp 393-4.

> Hedge funds that had traded through Lehman's London unit were suddenly being cut off, sucking billions of dollars out of the market. While the Fed had kept Lehman's broker-dealer in the United States open in order to wind down trades, Lehman's European and Asian operations were forced by law to file for bankruptcy immediately. Blankfein explained that through an arcane process called rehypothecation, Lehman had reloaned the hedge funds' collateral to others through it London unit, and sorting out who owned what had become a logistical nightmare. To stay liquid, many hedge funds were forced to sell assets, which pushed the market even lower.'

One hedge fund manager was described as having to 'tell his investors that their money had become trapped in a mysterious bankruptcy process in London'. According to Sorkin, Blankfein was 'pleading with his former boss[68] to do something to calm the markets' and 'told Paulson that his biggest worry was that so much money was clogged up inside Lehman that investors would panic and start pulling their money out of Goldman Sachs and Morgan Stanley, too'. Blankfein was right to be worried, as the subsequent difficulties with the Lehman administration and 'client assets' showed but, in fact, there was nothing 'mysterious' about the bankruptcy process in London. The problem was that investors who had given rehypothecation rights stemmed directly from the documents that they had signed; they had agreed to give up property rights and had become unsecured creditors instead.

There have been (as at the time of writing) four significant Lehman cases in the UK courts.[69] One was concerned with schemes of arrangement, one with the so-called 'anti-deprivation' rule (on insolvency) and the other two were concerned with issues affecting the 'return of client assets' and various issues associated with 'client money'.[70]

The Landsbanki 'freezing order'

The financial collapse of various Icelandic banks towards the end of 2008 raised important and urgent issues for the UK Government in view of the fact that some of those institutions had businesses located in the UK that had attracted deposits from UK individuals and institutions. Some of these businesses were operated through subsidiaries and some through branches. The subsidiaries were regulated by the FSA and the branches were regulated in Iceland but able to operate in the UK by virtue of the EU 'passporting' system (from which Iceland could benefit since it is a member of the EEA). Particular difficulties arose in connection with the collapse of Landsbanki (the country's second largest

68 Paulson had been CEO of Goldman Sachs before Blankfein.

69 There have been other cases on procedural matters.

70 These cases are considered in more detail in the author's book *Legal Risk in Financial Markets* (2nd ed to be published by Oxford University Press in late 2010).

bank), which operated through a UK branch with the trade name 'Icesave'. On 7 October 2008 the Icelandic Government passed emergency legislation to take over Landsbanki. Concerns were immediately raised in the UK as to whether the Icelandic Government would cause Icesave to honour its obligations to UK depositors.[71] Conversations between Governments were had at the highest level without any mutually satisfactory outcome apparently being achieved. On 8 October 2008 the UK Treasury made an Order (the Landsbanki Freezing Order) under the Anti-terrorism, Crime and Security Act 2001 to freeze all funds that were related to Landsbanki. A number of unintended consequences followed from the making of this Order, with considerable legal uncertainty being created in the financial markets, subsequently reported on in some detail in an FMLC paper produced in May 2009.[72] Although the enabling legislation was passed before the crisis (and the title of the statute, with its references to terrorism, produced a strong reaction from Iceland[73]) its use (to make the Order) in the context of the crisis may fairly be said to be a legislative response to a crisis phenomenon.

Much of the legal difficulty stemmed from the extremely broad terms in which the Order was drafted.[74] It covered all funds 'owned, held or controlled by' Landsbanki or 'related' to Landsbanki as well as a range of Icelandic institutions, including the Icelandic Government and central bank. It contained a range of prohibitions, including a requirement not to 'deal with' frozen funds. Although the expression 'deal with' was defined in the Order, the definition left a number of important questions unanswered. For example, it was not clear whether the operation of a set-off or close-out netting provision would be caught. (As with many points of interpretation, a licence was subsequently made under the Order permitting this.) The issues are detailed in the FMLC paper. This document also contains some useful guidance for draftsmen of future orders (if they should be required).

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71 As at the time of writing, the political and legal 'fallout' from the Iceland debacle continues in the UK, the EU and Iceland itself. Apparently, a senior civil servant in the UK expressed 'deep concerns' at the time about the UK bailing-out of Icesave depositors. The Icelanders themselves have, in a referendum, overturned a proposed law authorising payments to be made to the UK (which may prejudice Iceland's ability to access assistance from the IMF) and various warrants for the arrest of Icelandic bankers suspected of fraud have been issued by the Icelandic authorities. The UK Serious Fraud Office has also launched an investigation.

72 'The Landsbanki freezing order 2008: a legal assessment of the impact on financial markets.'

73 The Treasury Select Committee report into the Iceland banks affair ('Banking crisis: the impact of the failure of the Icelandic banks', 31 March 2009) notes (at para 51) that the use of that legislation 'inevitably stigmatises' those against whom it is used and, in effect, suggests that replacement legislation be considered. The report also noted that the 'passporting' law required further consideration in view of the experience with the Icelandic banks (para 112).

74 It should be mentioned, however, that a basic problem was caused by the fact that the Order came into force before the market could possibly have known of its existence, let alone its detailed terms.

The Turner Review and the initial response of the FSA

The UK's principal regulatory response to the crisis was, initially at least, set out in the Turner Review. The following is a summary of the main points made in the Review by way of reform proposals and other changes.

Capital

The Review tells us that the most fundamental changes that are required relate to capital adequacy, liquidity and accounting. A balance has to be struck between demanding so much extra capital that banks feel constrained from lending in the ordinary course and demanding insufficient extra capital to cure them of their 'excessive risk taking' habits. Wherever that balance is struck, the FSA is of the view that the new levels of capital will be 'significantly higher than that which appeared appropriate in the past'.[75] The point is also made that: 'the future world of banking probably will and should be one of lower average return on equity but significantly lower risk to shareholders as well as to depositors.'[76] One of the more striking changes will be to increase considerably (a 'radical change') the amount of capital held against trading book exposures.

Accounting treatment

The crisis has caused many commentators to question the appropriateness of 'mark-to-market' accounting. A sudden crisis in liquidity can cause a market to seize up very quickly: assets that might previously have been held at a fairly high value (while the market still had confidence) might suddenly have to be written down to a nominal value. This can itself create a domino effect, exacerbating an already difficult situation, as more and more institutions feel forced to liquidate positions. However, the FSA does not propose a radical change of this accounting methodology but suggests that it is balanced by a new requirement to hold an 'Economic Cycle Reserve'. This would attempt to compensate for the pro-cyclicality effect of mark-to-market by establishing a reserve 'in good times' to help deal with the series of problems that arise when the cycle moves into 'bad times'.

Liquidity

It is acknowledged that liquidity risk management did not receive adequate attention in the period leading up to the crisis. Certain proposals on the subject were put forward by the FSA in a paper in December 2008[77] but the Review goes further, proposing a general 'core funding ratio' on which debate is encouraged. The policy objectives include the encouragement of: less reliance on short-term wholesale funding (including from

75 See above at 73, p 55.

76 Ibid, p 57.

77 Consultation Paper 08/22 'Strengthening liquidity standards'.

foreign counterparties); attracting more retail time deposits; and higher quality, more liquid assets (including Government debt).

SIVs and hedge funds

The Review makes the statement (surprising only in that it needs to be made) that 'regulation should focus on economic substance not legal form'.[78] As a result, off-balance sheet vehicles, such as SIVs should now be treated as if they were on-balance sheet for regulatory purposes. But if SIVs are identified as part of the worrying 'shadow banking system', what about hedge funds? The FSA is concerned about any activity that becomes 'bank-like' and sufficiently large to have systemic implications. As of 2009, the FSA was not concerned that hedge funds were, in general, sufficiently 'bank-like' to justify bank-like, prudential regulation and, in any event, did not see them as responsible in any way for the crisis. But regulators need to have power to obtain information about such activities so that they can form a judgment about what, if anything, needs to be done about them as they evolve and to look at the systemic impact of the activity in the aggregate.

Offshore centres

While the Review does not regard offshore centres as responsible for the crisis, it is recognised that tighter controls over their operation will be needed if they are to be prevented from becoming an alternative home for activities that the new regime regulates more severely than before.

Credit rating agencies (CRAs)

The need to reform CRA governance is acknowledged and the FSA is supportive of the initiatives for supervisory oversight being taken at EU level. It is also noted that the EU measures need to be matched in other important centres.

Netting, clearing and central counterparties in derivatives trading

It is noted that the use of clearing mechanisms using central counterparties in derivatives (particularly credit default swap, or CDS) trading would enable multilateral netting and result in a significant reduction in exposures. The FSA supports the various initiatives being taken to set up such systems, although it warns that the overall risk reduction impact should not be overstated since a large number of derivatives will continue to be traded over-the-counter.

78 See p 72.

The more 'intrusive' and systemic approach to regulation

The FSA promises a 'fundamental shift'[79] in its approach to regulation. This will involve a number of changes in emphasis (many of them with strong echoes of lessons learned from the Northern Rock failure), including: less focus on systems and processes and more on key business outcomes and risks and the sustainability of business models and strategies; as regards 'approved persons', more emphasis on technical skills and probity; an increased focus on sectoral phenomena to enable outliers to be more easily identified and also to pick up trends across sectors that might have systemic risk implications; and more intensive analysis of information that is relevant to key risks (including, for example, liquidity risk).

Risk management and governance

The Turner Review, to some extent, anticipated the likely direction of the Walker Review (for which the FSA provided the secretariat). Key issues raised by the former were: risk management should be linked to remuneration structures (as indicated above); there should be an improvement in the skill levels and time commitment of non-executive directors and more emphasis on a willingness to stand up to 'dominant chief executives pursuing aggressive growth strategies'; and ways should be found to improve the ability of shareholders to exert influence over management. There was a specific mention of the possibility that systems going beyond the general Combined Code might be required.

Separation of 'classic' commercial banking (or 'narrow banking') from 'risky trading activities'

This is sometimes referred to as separating the utility and casino functions – or, to use USA parlance, a return to 'Glass Steagall'. The FSA accepted that the 'theoretical clarity' of the argument for separation had received much support. However, it also noted that, as with so many other possible reforms, it is virtually impossible for one country to 'go-it-alone' on the issue; and there are a number of other major jurisdictions whose banking traditions suggest they would be unlikely to follow suit. The point is also made that, although the abuses of the 'originate and distribute' model have, in a sense, given the trading of complex instruments a bad name, there are still very useful aspects to such instruments as risk management and dispersal tools if their use is properly regulated. The Governor of the Bank of England made his views fairly clear in his Mansion House speech of 17 June 2009 when (commenting also on the undesirability of banks just getting too big) he said:

> 'If some banks are thought to be too big to fail, then, in the words of a celebrated American economist, they are too big. It is not sensible to allow large banks to combine high street retail banking with risky investment banking or funding strategies, and then supply an implicit state guarantee against failure.

79 See p 88. See also consultation paper CP 10/3 of January 2010.

> Something must give. Either those guarantees to retail depositors should be limited to banks that make a narrower range of investments, or banks which pose greater risks to taxpayers and the economy in the event of failure should face higher capital requirements, or we must develop resolution powers such that large and complex financial institutions can be wound down in an orderly manner. Or, perhaps, an element of all three.'

'More Europe or less Europe?'

This pithy phrase sums up one of the most important dilemmas considered by the Review: there is considerable reluctance at the political level in the UK to ceding more power (of any kind, including the power to supervise banks) to 'Brussels' and yet, as things stand, the 'passporting' system, as it applies to European banks doing business in 'foreign' European countries, can result in severe problems of the kind experienced with the Landsbanki failure. We can either insist on more local ('host country') supervision than is allowed under the present system or we can give new, broader powers to a pan-EU agency of some kind. However, we do not regard continuance of the status quo (which the FSA regards as having 'major fault lines') as an option. When a bank fails, however 'global' it might be, any rescue or 'bailout' operation falls to the responsibility of its national government. In the context of the, sometimes rather heated, debates within the EU about 'Brussels' acquiring more power that could 'threaten the pre-eminence of the City' this issue is often referred to as a question of 'fiscal sovereignty': he who pays the piper calls the tune.

'Direct product regulation?'

The old 'regulatory philosophy' would never have countenanced direct regulation limiting the ability to develop, and trade in, particular kinds of product. After all, markets are supposed to know best: 'well managed firms will not develop products that are excessively risky, and… well informed customers will only choose products that serve their needs.'[80] This philosophy has been tested to breaking point by the crisis. The head of Deutsche Bank, Josef Ackermann, famously remarked in March 2008 that he no longer believed in the market's 'self healing power'. Other commentators, at the time, made even more apocalyptic statements about the death of free market capitalism. Much of this now looks, as time has elapsed, to be a somewhat exaggerated reaction. But the idea that 'markets know best' is likely to remain at least tarnished for some time. Bankers have even been 'saying sorry' or giving various expressions of regret, some with more conviction than others, for the trouble they have caused. In such circumstances it no longer comes as a great surprise that such a well-known financier as George Soros might propose that CDS should simply be banned. In his

80 See *Financial Times,* 17 June 2009, p 106.

article in the *Financial Times* of 17 June 2009,[81] he explained that he was not content merely to have CDS subject to greater regulation (by requiring them to be traded on regulated exchanges). He felt so strongly about the fact that CDS had resulted in investors who held them being in favour of liquidating struggling companies rather than saving them (because the effect of holding CDS was that liquidation would be in their financial interests) that he concluded that they should be 'outlawed'. In a memorable phrase, he said that being the beneficiary of a CDS was 'like buying life insurance on someone else's life and owning a license to kill them.' It now appears that the change in thinking may, in due course, be reflected in regulatory developments.

The Walker Review

In February 2009, Sir David Walker was asked by the UK Government to conduct a review of corporate governance in UK banks 'in the light of the experience of critical loss and failure throughout the banking system'. The Walker Review published its final recommendations on 26 November 2009. In the Preface to the Review, the important point is made that:

> 'the fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of the differences in the way they were run.'

The Review goes on to assert that 'how banks are run is a matter for their boards, that is, of corporate governance'. Corporate governance, it is argued, is largely a matter of behaviour. If corporate governance is to improve, 'this will require behavioural change in an array of closely related areas in which prescribed standards and processes play a necessary but insufficient part'. This emphasis on behaviour was echoed in the evidence of Group Chief Executive of Barclays, John Varley, to the Treasury Select Committee on 9 February 2010:

> 'Nothing is more important than behaviour; in other words, nothing is more important than culture. A way of thinking about culture is what people do when their boss is not around. Can they be relied upon to make right decisions in terms of compliance and in terms of ethics when their boss is not around? Ultimately, in a large organisation you have to have a reliable compliance system and a reliable system of ethics so that people understand what is good behaviour and what is bad behaviour. That is something that we work on hard.'

Varley also said, in the context of 'lessons learned' from the crisis, that the Barclays board's increased attention to governance was demonstrated by the fact that in 2008 there were 29 board meetings whereas normally there would have been eight. Further, although a tighter regulatory system was to be welcomed, there was, in Varley's view, no substitute for three things:

81 'My three steps to financial reform'.

1. the culture of a bank being sound;
2. the governance structure of a bank, in terms of how the board behaves, being sound; and
3. the suppliers of capital to a bank, whether debt or equity, holding the bank to account.

Walker believes that the best way to encourage the necessary changes is by self-regulation – the use of the Combined Code since this will encourage the relevant people (essentially board members and major shareholders) to feel a sense of 'ownership'. It is not thought that 'regulatory fiat' will work. However, although the problems are identified as mainly behavioural, the solutions proposed are mainly structural – the creation of new committees and responsibilities. The more significant proposals are summarised below:

- Non-executive directors (NEDs) of banks[82] should be given regular 'thematic business awareness sessions' and provided with a 'substantive personalized approach to induction, training and development to be reviewed annually with the chairman'. The aim, of course, is to improve NEDs' understanding of complex financial businesses.
- NEDs should have a higher minimum time commitment (30–36 days is suggested for listed entities) and this should be spelt out in a letter of appointment which should be available to shareholders on request; the chair of a major bank should expect the role to take up around two thirds of his or her time; chairs (who should be elected annually) should also have board leadership and financial industry credentials.
- The FSA's supervisory process should look more closely at the balance of the board, taking into account risk strategies of individual businesses; more intensive interviewing by the FSA of prospective NEDs is envisaged.
- NEDs should be encouraged to be more assertive and, generally, more probing and challenging; the chair should be aware of his or her responsibilities to encourage and facilitate this; the senior independent director should act as a sounding board for the chairman and be an intermediary for relaying concerns of NEDs and shareholders as appropriate.
- Every second or third year the board 'undertake a formal and rigorous evaluation of its performance'.
- A Code on the Responsibilities of Institutional Investors should be developed; generally, steps should be taken to encourage major shareholders to act like 'real owners' of banks.
- Listed banks should have a Board Risk Committee, responsible for 'oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures.'

82 Unless otherwise stated, all the recommendations relate to banks. Walker in fact tends to refer to 'BOFIs – banks and other financial institutions'.

- The board should be served by a Chief Risk Officer (CRO) who should be totally independent and have a firm-wide remit; the CRO would report to the Board Risk Committee.
- Particular due diligence responsibilities are ascribed to the Board Risk Committee for strategic acquisitions and disposals.
- There are also various proposals regarding remuneration of employees.

In a consultation paper issued in January 2010,[83] the FSA confirmed that it would play its part in implementing the Walker proposals.

Going it alone?

The question of whether or not governments could provide an effective 'global response' to the crisis has become more acute with the passage of time following the gradual return to something approaching normality in the markets after the worst of the crisis receded. Following the Obama-Volcker announcement in January 2010, there was concern, in the UK and elsewhere, that the US had decided to 'go it alone', notwithstanding the various G20 pledges of collective action. Alistair Darling, the UK Chancellor of the Exchequer, was reported to have said:

> 'If everyone does their own thing it will achieve absolutely nothing. The banks are global – they are quite capable of organizing themselves in such a way that if the regime is difficult in one country they will go to another one, and that doesn't do anyone any good.'[84]

According to the journalists reporting these remarks, 'Darling's big worry is that Obama's bombshell proposals, based on ideas set out last year by Paul Volcker, former chairman of the Federal Reserve Board, will shatter the consensus within the G20 nations on banking reform'.

Concerns have also been expressed about the concept of 'subsidiarisation' – requiring foreign banks in a given jurisdiction to incorporate locally, with appropriate capital, rather than operate through branches. In the UK, this is seen as a reaction to the 'passporting' problem symbolised by the collapse of the Icelandic banks. In an article in the *Financial Times* of 17 February 2010, Dominique Strauss-Kahn, the Managing Director of the IMF, said:

> '… many countries are approaching bigger-picture reforms from different directions and at different speeds. In the process, a central lesson of the crisis is being forgotten: that co-ordination works better than unilateralism. A simple example. A number of countries have decided that foreign banks, even if they are operating as foreign branches, should maintain higher liquidity locally to withstand a potential freeze in access to local funding. On the face of it, this is prudent. But major banks manage their funding and lending risks globally. If

83 'Effective corporate governance (CP 10/3). See also Fitzsimons 'Effective Corporate Governance?', LFMR vol 4 no 3 at p 276.

84 *The Sunday Times,* 24 January 2010 ('Don't go it alone', 'Darling tells America', by Smith and Dey).

banks have to lock up pools of liquidity in every jurisdiction, their capacity for intermediating capital across borders could fall, and their charges for doing so rise, to the detriment of the world economy.'[85]

Strauss-Kahn went on to warn against 'locally reasonable but globally myopic initiatives'. One might add to his 'simple example' a simple message. The crisis left everyone with a basic choice between very cheap credit and ultra-safe banking. Society cannot expect to have both.

Voices who favoured countries 'going it alone' include Joseph Stiglitz. In an article (also published in the *Financial Times*[86]) that preceded the Strauss-Kahn article by a few days, he acknowledged the desirability of global coordination of reform but felt that the process was moving too slowly. He attributed this to differing priorities: 'France and the UK have emphasized incentive structures; the US the dangers of proprietary trading.' And even though the Governor of the Bank of England, Mervyn King, and 'most academics' had warned of the dangers of 'too-big-to-fail institutions, 'no government in the G20 wanted to annoy its big bankers by raising these issues'. Stiglitz suggests that the resulting 'paralysis' is 'just what the bankers who don't want regulations want'. He feels that governments need to face down the usual threats from bankers that they will take their business elsewhere, pointing out that much of banking is still tied into the real economy – for example, lending to business – and those who engage in such business cannot afford to be 'so footloose'.

Stiglitz is well known to be somewhat sceptical about the benefits of globalisation and is no great friend of international banks. However, his is not a lone voice on this question. Professor John Kay, in his evidence to the Treasury Select Committee on 9 February, expressed the view that the UK should 'go-it-alone' with reforms designed to limit banks engaging in more risk activities – essentially in order to protect the UK taxpayer. Waiting for reforms at EU or other international levels would take too long – if it happened at all. Further, he indicated that although UK banks should be encouraged to operate abroad there should be no obligation to support them in their foreign activities (which should be conducted through subsidiaries) if they failed. Conversely, foreign banks in the UK should have sufficient capital here to be seized to protect counterparties in the UK if they failed:

'... they are going to have to maintain assets in the UK which we could seize in the event of a failure of that institution, because there is no other mechanism by which we can ensure that UK depositors get paid if that happened.'

Mervyn King was apparently of the same view as Professor Kay on 'going-it-alone'. In his evidence to the House of Lords Economic Affairs Committee on 24 November, he stressed the importance of reforms that would deal with the 'too-big-to-fail' problem and said:

85 *Financial Times*, 17 February 2010.

86 'Watchdogs need not bark together', 9 February 2010.

> ‘One last point on this, I think it is something the UK can do on its own and take a lead on it because we do not have the luxury of waiting for everyone else to come up with the answer. In terms of international banking sectors we have a very successful financial centre… The City – London… is a whole lot more than some of those banking activities that have got us into trouble. It is a much wider range and variety of activities. The only hope we have of retaining an international banking sector is if we can get away from the position in which the taxpayer and people around the world who buy UK Government bonds stop worrying about the fact that the UK government might have to stand behind a banking sector that is five times GDP… It would be a serious mistake for us to rely on the rest of the world solving this problem…’.

In his evidence to the Treasury Select Committee, on 26 January 2010, Mr King restated his ‘go it alone, if need be’ position on several occasions. The following exchange took place between the Chairman of the Committee and King at the end of the session:

> ‘Chairman:
>
> Governor… The evidence has been very clear, but perhaps I could just sum up. You have said that the current system takes the capital out of capitalism. It needs radical reform; that reform cannot be instant. The economy needs to be protected and it will take time to agree the way forward, but unless we reform the current cycle, an even bigger financial crisis and an even bigger bailout will simply continue. You have made the point that it has taken a quarter of global GDP to rescue the financial system; how much next time? We have to get on with it, and if it means change in the UK without others changing, we should do that.
>
> Mr King:
>
> Yes.’

One senses that the crisis brought ‘globalization’ to a crossroads. Although politicians may be nervous about ‘going it alone’ with reform, the political imperative to protect the taxpayer against ‘moral hazard’ may force their hand, regardless of the speed of progress at G20 or EU level. The UK’s difficulty with moral hazard was, as Mervyn King pointed out, particularly acute because of the amount of banking activity carried on in London relative to the size of UK GDP. For the UK, the problem was thus more urgent than may have been the case elsewhere. Further, a country like the UK, which plays host to so much banking activity, will not wish to place itself in the position of risking another ‘Iceland problem’ by accepting a continuation of the ‘passporting’ system, without significant changes being made or another ‘Lehmans problem’ by taking too relaxed an approach to ‘local capital’ being maintained. Both these factors point law and regulatory reform in a direction which is essentially ‘de-globalising’. It is a reflection of the fact that, as things stand, it is the domestic taxpayer who picks up the bailout bill when things go wrong, not any international body or community.

Germany

Hendrik Haag, Hengeler Mueller

Introduction

Germany is the largest economy in the European Union. The structure of its financial sector is quite fragmented. There are primarily three types of financial institutions in Germany: (i) the private banks, which are listed on an exchange, and closely held by individuals (sometimes for centuries firmly in the hands of private banker families) or other corporations which are subsidiaries of industrial groups; (ii) the institutions organised under public law, in particular several hundred local savings banks (Landesbanken) and their lead institutions in the various German federal states (Bundesländer); and (iii) more than one 1,100 cooperative banks and their lead institutions (Genossenschafts-Zentralbanken). Due to this fragmentation, the market share of Germany's leading financial institutions in their home market is significantly lower than in other countries of the European Union.

Germany's largest financial institution is Deutsche Bank AG, a listed company and a member of the DAX-30 Share Index, Germany's leading index. It is a true global player with substantial operations in London, New York and elsewhere around the world. The second largest bank is Commerzbank AG, a listed company that has recently merged with Dresdner Bank AG, formerly the number two institution in the country. Commerzbank is also active internationally but to a much lesser extent than Deutsche Bank. The third largest institution is in the private bank sector, Bayerische Hypo- und Vereinsbank AG (HVB). It has been a subsidiary of UniCredit SpA since its take over in 2005. The only other significant private institution in Germany's Top-15 is Postbank, an institution formerly owned by Deutsche Post, Germany's mail service company. Postbank is now in the process of being sold to Deutsche Bank. The former Hypo Real Estate AG (HRE), now named Deutsche Pfandbriefbank pbb), which had to be placed under Government control as a result of the financial crisis, plays a special role among Germany's financial institutions. It is presently undergoing significant downsizing and reorganisation. The remaining institutions in the Top-15 list belong to the cooperative or public bank sector.

For a long time, the sentiment in Germany was that the sub-prime crisis was a US phenomenon. The stories of billions of dollars lent to homeowners with no or bad credit records appeared remarkably strange but irrelevant for Germany and its financial system. The volume of the market for credit derivatives was a phenomenon that only few understood and were able to assess properly. The new

capital adequacy rules under Basel II had allowed banks to unleash enormous amounts of regulatory capital in order to buy AAA-rated credit insurance from players such as American International Group (AIG) and monoline insurers. This had superpowered the risk capacity of the financial sector, along with ever more refined securitisation technology, which enabled banks to shift the risk of heavy loanbooks in exchange for seemingly safer, since tradable, asset-backed securities whose risk weighting was favoured by the Basel II rules. Looking back, it was a sign of remarkable foresight and wisdom when Jochen Sanio, the Head of Germany's Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsichtt – BaFin) voiced his concern with the growing credit derivatives market as early as May 2007.[1] Mr. Sanio expressed his hope that all players in the financial markets fully understood the complexity of these products and had the expertise to cope with them, especially since credit derivatives were reallocating risks in a way that was largely invisible from oversight, including by regulators. It was not clear to everyone at the time that the total credit derivatives market had exceeded US$62 trillion and was larger than the entire global economy. It was also only known to a handful of people that AIG had sold credit protection for more than US$500 billion in notional exposure, far more than it would ever have been able to compensate for if losses were indeed realised.

But even Mr Sanio was probably not expecting a crisis of the magnitude seen in the early part of 2007. The highly leveraged portfolios of collaterised debt obligations (CDOs) were held in structured investment vehicles (SIVs) and managed by a number of institutions under BaFin's supervision that still had unrestricted access to short-term refinancing on the securities markets and appeared to be stable. Economists and journalists who raised a warning about the financial system leveraging itself more and more each day were blamed as professional pessimists trying to gain public attention. People in the industry were closing their eyes to the first stutters of the financial market machine that had fuelled economic growth around the world for an extended period, not realising that a fateful chain reaction was about to start.

In the pages that follow, this report will discuss the various measures taken by the German supervisory authority, BaFin, and the German Government to cope with the financial crisis. These measures range from ad hoc emergency interference to prevent the financial system from collapse, to quick fixes of regulatory loopholes suddenly exposed by the crisis, to a more long-term repositioning of key elements of the regulatory system to avoid further crises or at least to mitigate their effects and make them more controllable. In addition to action directly motivated by the effects of the crisis as they appeared in Germany, there is also the international debate on the level of the European Union, the Group of 20 (G 20) and the Basel Committee on Banking Supervision, which is shaping the new rules for the industry, as well as the interested public and political leadership.

1 Speech held on 14 May 2007 in Bonn at BaFin's annual press conference.

The outcome is a quite colourful bouquet of laws, regulations and regulatory action not necessarily following a master plan. It seems that this resembles the situation in other countries. It reflects the fact that the crisis was driving regulators and governments ahead of it. It was hard to predict what would happen next.

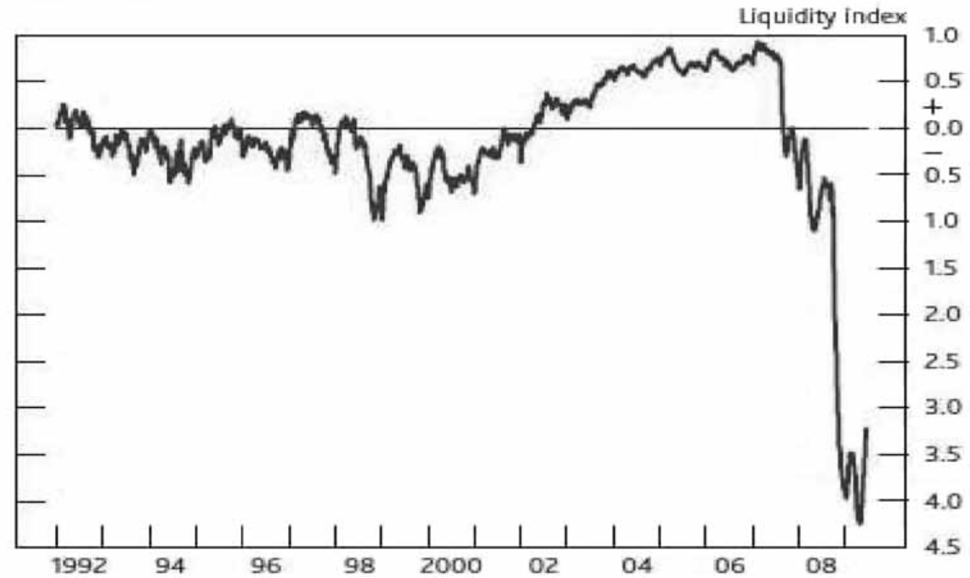
The crisis begins to unfold

It is often said that the crisis marked its beginning with the insolvency of Lehman Brothers in September 2008. The fact is that Lehman Brothers was just the first bulge bracket victim of a liquidity crisis that had started out more than a year earlier. Its centre of origin was the US real estate market. In 2006, lenders in the US had made available more than US$640 billion. in sub-prime loans. As early as August 2006, defaults in sub-prime mortgages started to occur much earlier in the mortgage process, and certainly earlier than rating agencies had expected when extending their rating opinions. From the beginning of 2007, an increasing number of small mortgage lending institutions were filing for creditor protection. On 17 July 2007, in a letter sent to investors, two Bear Stearns hedge funds specialising in sub-prime debt announced that each fund had lost at least 90 per cent of its value. The total investor contribution to the funds had been around US$1.6 billion. The funds had only invested in AAA-tranches of CDOs that were invested in securitites based on sub-prime mortgage loans. There was a growing concern among market participants as to the financial health of other institutions, and the previously liquid interbank lending market dried out abruptly. At the same time, the costs for credit default swaps (CDSs) that were being used to secure the indebtedness of financial institutions surged to unprecedented highs.

The crisis arrives in Germany

The first prominent victim in Germany of this development was IKB Deutsche Industriebank (IKB). Founded in 1924, in recent decades IKB had traditionally been a financier of small- and medium-sized companies (Mittelstand) in Germany. To further IKB's activities in the area of subsidised financing for this clientele, the German credit agency Kreditanstalt für Wiederaufbau (KFW) had purchased a major stake in IKB in November 2001. Since then, IKB had begun to develop a new business area called 'portfolio investments'. This involved the purchase of structured securities, such as CDOs, by SIVs. The SIVs refinanced themselves through short-term securities, for example, by issuing commercial paper, with backstop liquidity lines provided by one or several financial institutions, including IKB. As was the practice at the time, IKB did not consolidate these SIVs on its balance sheet. At the end of July 2007, the SIVs had compiled assets in excess of €10 billion. The largest SIV, the conduit Rheinland Funding, had the benefit of a liquidity line provided by IKB in the amount of €8.1 billion. As suspicion

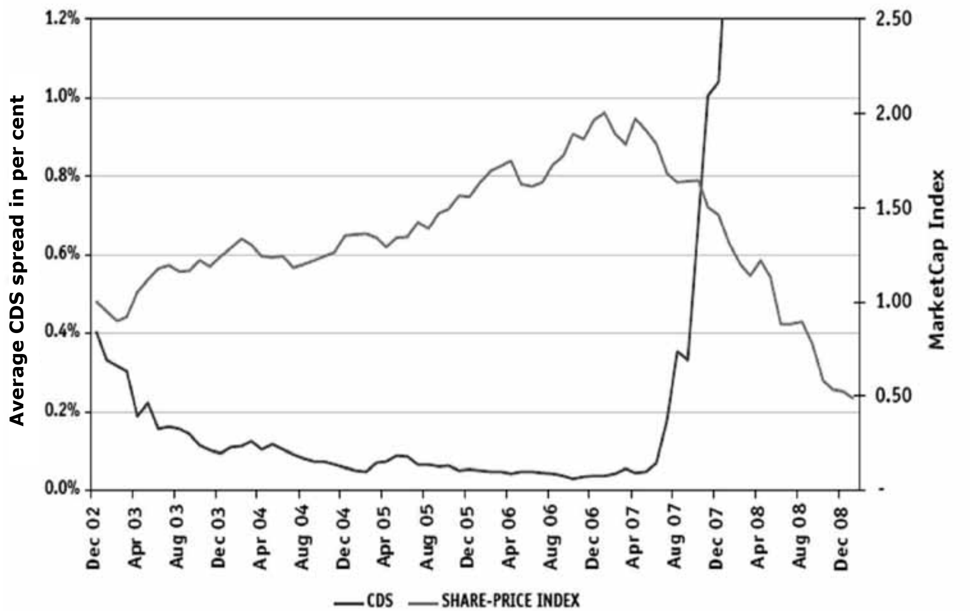
Figure 1. Financial market liquidity*



Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Thornson Datastream and Bank calculations.

* The liquidity index shows the number of standard deviations from the mean. It is a simple unweighted average of nine liquidity measures, normalised the period 1999–2004. The series shown is an exponentially weighted moving average. The indicator is more reliable after 1997, as it is based on a greater number of underlying measures.

Figure 2. Composite time series of select financial firms' CDS and share prices



regarding the value of sub-prime mortgages rose and the refinancing market for SIVs collapsed, IKB was threatened with a call being made on its liquidity line that IKB would not have been able to comply with. In the meantime, other banks had massively shortened their credit lines for IKB.

Over the following weekend, the German banking associations agreed a rescue package for IKB in the amount of €3.1 billion, 70 per cent of which was borrowed from KfW and the remaining 30 per cent. from other institutions. The president of the BaFin had initiated the rescue package by calling the situation the worst systemic crisis since 1971. As the financing gap widened, in November 2007 IKB received an additional guarantee by the banking pool formed for its support in the amount of €350 million. In January 2008, KfW purchased a convertible bond (from IKB) that was converted into equity only a few weeks later. As a result, KfW increased its stake in IKB to over 40 per cent. In February/March 2008, another €1.5 billion was needed. KFW provided more than €1 billion and the banking associations an additional €0.5 billion. Furthermore, KFW committed to purchase shares of IKB in an aggregate value of €1.25 billion. This drove KFW's stake to more than 90 per cent of IKB's outstanding shares. In October 2008, KFW managed to sell IKB to the private equity fund Lone Star. Before the sale, KFW had to take over high-risk structured securities from IKB valued at €600 million. Another €1.5 billion was transferred to a special purpose vehicle. To date, KFW has lost more than €8 billion as a result of its invesmtent in IKB. The federal government contributed €1.8 billion to IKB's rescue and the banking associations an additional €1.4 billion.

IKB's fall was swift and steep. It had dramatically overleveraged itself by investing in long-term structured securities that were refinanced short-term. While possible interest rate mismatches between the portfolio and the refinancing could theoretically be managed, the refinancing risk itself could not. IKB's development is representative of what happened to a number of other banks that tried to expand their business models into new, more profitable areas without fully controlling the risks involved. While this report was being written, the former CEO of IKB was standing trial for having mislead IKB's shareholders by pretending that there was no liquidity problem even shortly before it became apparent that IKB was on the brink of insolvency.[2] Proper shareholder information is important, but the more relevant question is: what are the duties of a management board before entering into a new line of business? Can it be expected that each board member fully understands the risks involved? Is that a practicable proposition in today's world where thousands of different financial products are each designed and managed by highly specialised employees of the bank? Will the business judgment rule have to be redefined for financial institutions? These questions are likely to become the subject of court proceedings in the future.

2 On 14 July 2010, Stefan Ortseifen was sentenced to ten months imprisonment upon probation.

Hypo Real Estate

IKB was only the start and appears almost insignificant in comparison to the rescue of Hypo Real Estate Holding AG (HRE) in Munich. HRE was created in the spin-off of a large part of HVB's commercial real estate finance business in 2003. HRE's shares were distributed to HVB shareholders and listed on the German exchanges. In 2007, after HRE acquired the Irish Depfa Bank plc (Depfa), one of Europe's largest public sector finance banks, the business of the HRE-Group expanded rapidly with total assets reaching €400 billion by the end of 2007. Part of this growth was due to heavy investments in CDOs related to the US sub-prime mortgage market. Also, the Irish subsidiary Depfa pursued an aggressive growth strategy by financing public sector and public sector-related borrowers around Europe and in other parts of the world. As the financial crisis struck, the HRE-Group was exposed in two material respects: as a result of indirect investment in the US real estate market on the one hand, and as a result of a significant maturity mismatch on the level of Depfa on the other hand. Like other institutions primarily focused on public sector finance, where margins are very small, Depfa had generated its profits by refinancing long-term assets with short-term refinancing instruments. As the market dried out, refinancing opportunities disappeared almost overnight. In addition, the regulatory oversight of Depfa seems to have fallen through the cracks of the European banking supervision system. As a bank licensed in Ireland, it was subject to supervision by Irish authorities; however, it seems that those authorities relied on the work of the German BaFin. BaFin, however, only had authority over Depfa's German management and could not directly exert any powers in Ireland. A special audit undertaken by BaFin in February 2008 concluded that, within the European Union, comprehensive supervision of financial holding companies is neither legally required nor possible. In Germany, this gap was closed by new legislation in February 2009.

On 29 September 2008, the situation had become critical for the HRE-Group. At a crisis summit, the president of BaFin, the federal minister of finance, the CEOs of the two largest German banks and the chairman of the banking association (Bundesverbank Deutscher Banken) agreed that the financial industry would provide a joint guarantee in order to secure HRE's solvency. Originally, the amount of €35 billion was considered sufficient. But, only three days later, the CEO of HRE admitted that the situation was becoming rapidly worse. On 5 October 2008 the guarantee was increased by another €15 billion. It was the common understanding that a failure of HRE would put Germany's banking system at stake and could cause a domino effect with other large institutions failing.

Today, the overall rescue package for HRE amounts to well over €100 billion. In the meantime, the Government has taken full control of the bank and has squeezed out all other shareholders. This was possible as a result of a swiftly enacted change to corporate law allowing for squeeze-out mechanisms that were not possible before.[3] One victim of the squeeze-out was US private equity investor, Christopher Flowers, who is still challenging his displacement before the courts.

3 See below 'Taking Control of Troubled Institutions by the Government'.

The crisis spreads

IKB and HRE did not remain the only victims of the financial crisis. The public banking sector proved to be particularly vulnerable to the liquidity crunch. As explained above, traditionally, Germany's banking industry is divided into three different groups: private banks, the public sector banks comprising local thrift institutions (Sparkassen) and their Landesbanken, and finally the cooperative banking sector. The Landesbanken are institutions held by the Sparkassen, their associations and Germany's constituent regional states, the Länder. Originally, the Landesbanken were primarily engaged in public sector finance, the implementation of Government-subsidised financing and servicing their member Sparkassen in certain centralised activities such as securities trading, securities custody and refinancing. Under the existing legal framework for the public bank sector, Landesbanken were not allowed to enter into retail banking in competition to the Sparkassen. To escape these limitations in their business model, from the 1970s many of the Landesbanken had developed a broader commercial banking business, including branches in other parts of the world. However, being cut off from a stable basis of retail deposits and excluded from raising capital on the equity markets due to their public ownership, this expansion could be financed only by profits which, due to the limitations on their activities, were very difficult to generate. It was thus no surprise that the high margins and up-front fees beckoning for investors in structured securities investments attracted many of the Landesbanken, although their risk management resources as well as their capacity to digest losses were less developed than those of traditional private banks.

The excursion into this new territory proved fateful. WestLB AG (WestLB), a large Landesbank in the west of Germany, posted trading losses of €600 million in 2007. A year later, troubled assets worth €23 billion were transferred into an SIV to remove them from WestLB's balance sheet when further write-downs threatened to push the bank out of business. At the same time, the public owners gave guarantees for WestLB's liabilities in the amount of €5 billion. In October 2009, troubled assets with a nominal value of €77 billion were transferred into a bad bank for liquidation. The European Commission approved these rescue measures subject to the condition that WestLB be privatised and separated from public ownership. The bank is now up for sale.

HSH Nordbank (HSH), Germany's northern Landesbank, found itself possessing €17 billion of troubled real estate assets. To secure its refinancing, it has received a shield of Government guarantees worth €30 billion.

Sächsische Landesbank (Sachsen LB) had invested large amounts in risky mortgage-backed securities and related derivatives through structured investment companies, primarily in Ireland. When the liquidity crunch hit, Sachsen LB needed a €17.3 billion credit line from its public owners and was forced into a merger with Landesbank Baden-Württemberg (LBBW). Since losses kept piling up, the merger put LBBW's existence at stake, and the transaction was finally facilitated by another €2.75 billion contributed by Land Sachsen as the former owner of Sachsen LB.

Bayerische Landesbank (BayernLB) needed €10 billion of fresh capital from its

owners and €15 billion in credit guarantees to survive the losses of their troubled assets. In 2010, BayernLB finally moved €30 billion of these assets into a bad bank for further treatment.

Stabilisation measures were not confined to the public banking sector though. In January 2009, Germany's second largest private bank, Commerzbank AG (Commerzbank) agreed to purchase from the leading German insurance company Allianz AG its competitor Dresdner Bank AG (Dresdner). During the merger process it transpired that the credit risks embedded in Dresdner were much higher than assumed. As a result, the merger required a recapitalisation of Commerzbank by Government funds. At the end of the day, Commerzbank received silent participation capital, a Tier 1 capital hybrid commonly used in Germany, for a total amount of €6.4 billion. In addition, the German Federal Government extended credit guarantees for a total of €15 billion and purchased new shares, making it a 25 per cent stakeholder. The merger is now being completed, but it will take years, if not decades, for Commerzbank to transfer back from Government control into the free capital market.

Setting up a rescue fund

When HRE, as a systemically relevant institution, threatened to become insolvent in 2007, there was no mechanism in place to provide it with liquidity in the required amounts. Its rescue had to be organised quickly in order to avoid a chain reaction, which could have severely damaged the German financial system. Germany's political leadership, headed by Chancellor Angela Merkel and the then Minister of Finance Peer Steinbrück, met for a crisis meeting which was attended by the top management of the German financial industry, including the CEO of Deutsche Bank Josef Ackermann. The politicians took the view that this was a problem for which the financial industry itself had a key responsibility and demanded a substantial contribution to resolve the crisis. Under mounting pressure, an ad hoc coalition of financial institutions and insurance companies agreed to subscribe for a total of €15 billion bonds secured by illiquid assets of HRE and another €15 billion secured by a Government guarantee. The Deutsche Bundesbank was providing additional liquidity lines. As mentioned above, in order to finally stabilise HRE, the package subsequently had to be increased by even more guarantees and cash injections.

It was clear that this mechanism of ad hoc rescue packages would hardly work for other institutions which might face a liquidity crunch, especially since the capacity of the country's financial industry had already been substantially squeezed by HRE's €30 billion bond package. The Government had to come up with an institutionalised concept for organising similar rescue packages in the future.

On 17 October 2008, the German Federal Parliament passed the bill on the *Finanzmarktstabilisierungsgesetz* (Law on the Stabilisation of the Financial Markets, FMStG) which was signed by the President of the Federal Republic of Germany and published the very same day. The core element of the FMStG was the establishment

of a stabilisation fund (*Sonderfond Finanzmarktstabilisierung,* SoFFin) to secure the liquidity of the financial institutions in Germany. The SoFFin is to be administered by a special agency (*Finanzmarktstabilisierungsanstalt* – FMSA), a separate body under public law connected to Deutsche Bundesbank. The SoFFin constitutes a pool of assets separate from the Federal Republic of Germany so that expenses need not be directly accounted for in the federal budget. Any loss remaining after the final dissolution of the fund will be borne by the Federal Republic and its constituent 16 regional states.

The volume of the fund is €100 billion. The fund may employ up to €70 billion for the purchase of troubled assets and to recapitalise financial institutions. This amount can be increased by a further €10 billion upon prior approval of the budget committee of the federal parliament. The fund is further authorised to issue guarantees for bonds and other refinancing liabilities of the financial sector up to a total amount of €400 billion.

Institutions eligible for equity contributions and guarantees from the fund include banks, securities firms, insurance companies, pension funds, fund management companies and operators of securities and futures exchanges, in each case provided they have their corporate seat in Germany. Institutions that receive aid from SoFFin must pay a compensation on market terms. Commerzbank, for example, which had received a silent contribution in the amount of €8.2 billion has agreed to pay a return of 9 per cent pa, and HRE is being charged 1.5 per cent pa for guarantees issued by the fund in support of its refinancing. So far, six institutions have obtained support from SoFFin and two more are considering an application. In total, SoFFin has made available cash to recapitalise banks in the amount of €28 billion and has issued guarantees in the amount of €144.5 billion. These amounts appear to have been stable over the last couple of weeks and, if the current trend of stabilisation in the financial system persists, it is anticipated that SoFFin will not need to use all the funds available to it.

Taking control of troubled institutions by the Government

In addition to setting up SoFFin, the FMStG contained a number of important modifications to the law governing German stock corporations contained in another act called *Finanzmarktstabilisierungsbeschleunigungsgesetz* (Act on the Acceleration of Financial Market Stabilisation – FMStBG*,* as last amended on 17 July 2009). Traditionally, the German Stock Corporation Act (*Aktiengesetz* – AktG) is notably shareholder-friendly in that shareholders have strong powers when it comes to making changes to the statute of the stock corporation (*Aktiengesellschaft* – AG), including in relation to the issuance of new shares. In addition, shareholders of German stock corporations have strong subscription rights in relation to newly issued shares which can only be overridden in certain circumstances. It was quite clear that, if the Government wanted to acquire a controlling stake in a troubled financial institution organised as an AG, it needed to circumvent or exclude the statutory shareholder rights in order

not to end up in lengthy negotiations or even litigation. Also, there had to be a legal basis for the management to comply with the conditions and obligations attached to a SoFFin guarantee without violating its independent duties to the company. For example, para 10 (2) FMStFG requires an institution that has obtained SoFFin support to comply with restrictions concerning the use of the funds received, the compensation of its executives and the distribution of dividends. The management board of the company had to undertake to comply with these restrictions in order to receive the support in the first place. The legislator recognised the potential for conflict and identified a need to suspend the usual obligations of an AG's management board with respect to these issues.

Accordingly, in an unprecedented and fundamental change of longstanding principles of German stock corporation law, the FMStG contains, among other things, the following rules:

- The undertaking of the management to be given to SoFFin as a condition for obtaining Government support does not constitute a violation of the management duties towards their company (Article 2, para 1 (1) FMStBG).
- The management board is permitted by law to issue new shares representing up to 50 per cent of the outstanding share capital, without the need to obtain approval of the shareholders in general meeting. Shareholders' meetings require substantial preparation and need to be called at least one month in advance. In Germany, the validity of shareholder resolutions is regularly challenged on the grounds of a violation of shareholder rights. Courts are not shy to rescind a resolution, on the basis of even the smallest infringement of procedural rules, and to force the company to call a new meeting, often years later. Without this change in the law and with the Government intending to take control of a bank, a large number of lawsuits might have been expected to stall Government support for a long period.
- If, in connection with the recapitalisation of a company qualifying for SoFFin support, a general shareholders' meeting must be held (eg, because the intended capital increase is for more than 50 per cent of the outstanding shares), the period for calling the meeting was reduced to one day (with effect as from 2 August 2009, the notice period was extended again to 21 days).
- As mentioned above, the shareholders of a German public company have strong subscription rights. To make the new shares available for subscription by the Government, which was not an existing shareholder, these subscription rights needed to be excluded; this was accomplished by Article 3, para 3 (3) FMStBG.
- Another peculiarity of German stock corporation law had to be addressed to allow SoFFin to subscribe for new shares in an efficient manner. The AktG provides a strict doctrine that fresh fair market value consideration needs to be paid in on an issue of new shares. In particular, on an issue for cash, it is not possible to set against the obligation to pay subscription moneys the value of any existing obligations owed by the company to the allottee of the shares. This would be considered a contribution in kind, effectively a non-cash asset. Issues of shares in

consideration of contributions in kind are generally permitted but the obligation of the company against which the liability for subscription money is set must, in fact, be valuable (*werthaltig*). In other words, this contribution must have a fair market value equal to or exceeding the amount of the subscription moneys owed. In determining the fair market value, it is not possible just to look at the nominal amount of the liability attributed to the company because, apart from anything else, where the company is in financial difficulties, the fair market value of its liabilities may be less than the amount owed. Therefore, the rules relating to the use of contributions in kind as consideration for the issue of shares require an expert opinion to evaluate the non-cash contribution (*Werthaltigkeitsgutachten*). The problem was that if an institution was fundamentally destabilised, SoFFin was forced to inject money immediately without being able to wait even for the abbreviated share issue process to be completed. Under the law as just outlined, any subsequent issue of capital based on these prior contributions of cash would no longer have been a share issue against cash but against a contribution in kind with all the valuation issues involved. The FMStBG changed that rule for the benefit of SoFFin and provided that a prior payment by SoFFin to the company can subsequently be allocated in satisfaction of the subscription money obligation (Article 2 para 3 (4) FMStBG).

- The FMStBG further contains a number of other modifications of existing laws. For example, SoFFin is not required to launch a takeover offer if its shareholding exceeds 30 per cent; nor is a shareholders' meeting required to resolve on a silent partnership contribution which is, as mentioned above, a Tier 1 capital hybrid commonly used in Germany; and, finally, there are restrictions on the right of other creditors or an insolvency administrator to challenge collateral provided to SoFFin in the context of Government support.

The compatability of the FMStBG with European law has been drawn into question in the context of various shareholder suits pending.

Changing the insolvency law

The steep recession caused by the financial crisis soon affected businesses outside the financial sector, the so called 'real economy'. The Government became concerned that companies with a high debt leverage would have to go through impairment write-downs of financial assets eroding their asset base. Unlike the insolvency laws of many other jurisdictions, in Germany the management of a company has to file for insolvency proceedings not only if it becomes technically insolvent, in other words, is unable to pay its debts as they fall due, but also in the event of 'over-indebtedness', that is, where the company's assets no longer cover its liabilities. In making an assessment, management has to use fair market values of the assets. If it is likely that the company will continue to trade, the fair market value may be determined on a going concern basis; otherwise it is done by reference to liquidation values. The over-indebtedness

test applies even where the company has sufficient cash to carry on its business. This may be a concern in particular where a company is financing capital expenditures by debt and the capital goods depreciate faster than the debt is amortised. It may also be problematic where assets need to be written down in the context of an impairment test required by macroeconomic developments.

In order to stabilise the economy as a whole, and the financial industry in particular, the FMStG dispensed with the over-indebtedness test. As a result, a company only has to file for insolvency if it is unable to pay its debts, but no longer if its assets base does not cover its liabilities. This dispensation expires at the end of 2011. It has already been extended once, and a further extension is likely if, by the end of next year, the economy has not fully recovered from its deep decline in 2009.

The last resort: expropriation

The next legislative step was the Supplementary Act to the Financial Market Stabilisation Act (*Finanzmarktstabilisierungsergänzungsgesetz* – FMStErgG). Even for native German speakers the FMStErgG comes close to a new record in word length! The FMStErgG was promulgated on 7 April 2009 and, like the FMStG, contains a colourful selection of different legislative measures aimed at stabilising the financial market and getting control over ailing institutions. It is yet further evidence of how much the Government was driven by market developments, trying to build on progress made with existing laws, closing loopholes and paving the ground for a long-term restructuring of the financial industry.

The matters regulated by the FMStErgG included technical changes of the FMStFG and the FMStBG such as:

- the provision of a legal basis for SoFFin to charge supported institutions for stabilisation measures;
- an extension of the maximum period of SoFFin guarantees from 36 to 60 months; and
- further changes to the existing corporate law on convening shareholders' meetings and voting requirements, in particular:
  - a reduction in the required majority for the issue of new shares from 75 per cent to 50 per cent;
  - simplified rules to reduce share capital in the context of a recapitalisation;
  - an expedition of the registration of shareholder resolutions in the commercial register (necessary to make them effective); and
  - the requirement for more detailed provisions on takeover offers extended by SoFFin or the Federal Republic of Germany to shareholders of troubled institutions.

The most relevant part of the FMStErgG is, however, the Law for the Rescuing Takeover of Enterprises to Stabilise the Financial Market (*Rettungsübernahmegesetz – RettungsG*). The title is slightly embellishing since the content of the law was nothing less than introducing an expropriation mechanism allowing SoFFin to obtain possession of 100 per cent of the shares of the relevant financial institution by displacing minority

shareholders. While existing recapitalisation tools, including the mechanisms described above, which enable SoFFin to quickly acquire a controlling shareholding, have worked generally well to make SoFFin a controlling shareholder, while the bank was a public company there was still a need to hold shareholders' meetings and potentially risk resolutions being challenged before the courts. Only if SoFFin were to become the sole shareholder would these concerns ultimately be dealt with.

Expropriation is a very sensitive issue for a country like Germany that has suffered from totalitarian regimes for most of the 20th century. When the newly established Federal Republic of Germany received its constitution (in Germany called the basic law or *Grundgesetz* – GG), the protection of citizens' right was one of the pre-eminent principles. Article 14 GG states that the right to individual property is guaranteed and that expropriation may only be ordered for the benefit of the public. Courts have traditionally valued this principle very highly and refused to endorse an easy grasp by the state of personal property when this appeared convenient.

The expropriation of shareholdings was a new step. Clause 1, para (1) of the *RettungsG* states that expropriations shall be permitted to secure the stability of the financial markets. This is certainly a very broad concept. In clause 1, para (4) the law establishes further conditions that need to be satisfied to make an expropriation legal:

- an expropriation shall only be permitted if it is necessary to secure the stability of the financial markets and provided there are no other legally and economically suitable remedies available within the timeframe given to stabilise the market which could have the same effect but in a less intrusive way;
- the expropriation must be necessary to secure market stability. In other words, it is only appropriate where the concerned financial institution is of systemic relevance;
- it is not possible to achieve a legally certain, sustainable and economically reasonable stabilisation by the recapitalisation tools available from SoFFin; and
- it is not possible to gain control over the minority interest in the financial institution through other measures, such as a squeeze-out, and SoFFin has unsuccessfully tried to get control through these other measures or these other measures would be too time-consuming to achieve timely stabilisation.

The expropriation itself is effected by an ordinance of the Federal Government. Its effect is that all shares not held by the beneficiary of the expropriation (for all practical purposes this is SoFFin) will transfer to SoFFin as a matter of law. The outstanding subscription rights resulting from, inter alia, convertible bonds expire. The holders of the expropriated instruments are entitled to a compensation which is calculated on the basis of the fair market value of such instruments. If the instruments were listed on an exchange, the fair market value is determined by reference to the weighted average stock price on the exchange during the last two weeks before the expropriation decision was made public, unless the average price has been lower in the last three trading days before such publication. The compensation is due for payment in one sum on the day the transfer of the instruments becomes legally effective.

The creation of the RettungsG was highly motivated by the situation of HRE. As already described, HRE was a systemically relevant institution that had ultimately required financial support in the form of fresh funds and guarantees worth in excess of €100 billion. In 2008, HRE had posted a net loss of €5.461 billion. In order to stabilise HRE, on 28 March 2009 SoFFin acquired 20 million shares which resulted in a stake of 8.7 per cent of HRE's outstanding capital. It was clear that this stake was not enough to control the institution. On the other hand, being under substantial pressure from the public, the Government realised that it could not responsibly put more than €100 billion of public funds at stake without having any say in the troubled bank. Therefore, the RettungsG came into being and entered into force on 7 April 2009.

The RettungsG required SoFFin first to try a voluntary takeover. On 17 April 2009, SoFFin launched a takeover offer for HRE for a price of €1.39 per share. This offer was 10 cents higher than the minimum price under pertinent takeover regulations. By offering a premium, SoFFin hoped to get 100 per cent of the shares in HRE quickly.

At the end of the takeover period, SoFFin found itself holding only 47.3 per cent of the HRE shares. In particular, US private equity investor Christopher Flowers was not prepared to offer his 21.7 per cent stake for sale, primarily because he believed that the share price was artificially depressed and the real value of HRE was much higher. Still SoFFin shied away from using the sharp (and legally debatable) last resort of an expropriation under the RettungsG and initiated a shareholders' meeting in which the capital of HRE would be substantially increased. This was not free of risk since SoFFin held less than 50 per cent of the shares. However, the capital increase was approved and, as a result, SoFFin increased its stake to 90 per cent. This amount was the threshold for a regular squeeze-out (after this threshold had been lowered during the financial crisis from 95 to 90 per cent). On 5 October 2009, all minority shareholders (including the funds of Christopher Flowers) were squeezed out and SoFFin held 100 per cent of HRE's outstanding shares. Of course, the displaced shareholders did not accept this without resistance. The first round of litigation is over, and so far all action taken by the Government and SoFFin was upheld as suitable given the circumstances. It will take years, however, until the Federal Court and potentially the Constitutional Court will have delivered their eventual opinion on the legal implications of the HRE rescue.

Creating a 'bad bank' model

Another landmark development in the legislative ground work for dealing with the financial crisis was the *Gesetz zur Fortentwicklung der Finanzmarktstabilisierung* (Law on the Further Development of Financial Market Stabilisation) of 17 July 2009, which substantially changed and amended the FMStFG.

The centrepiece of this law was the introduction of a bad bank concept. There are two different models. Banks can choose to establish a special purpose vehicle to which troubled assets are transferred. Alternatively, the transfer can be made to an institution under public law for the resolution of assets (*Abwicklungsanstalt*) supervised

by SoFFin, commonly nicknamed AIDA (an abbreviation of *Anstalt in der Anstalt* – institution within an institution).

Resolution companies

Under the resolution company concept, a financial institution can set up a special purpose vehicle and transfer troubled assets to the vehicle for further workout. For its refinancing, the vehicle may issue bonds on the capital markets which are guaranteed by SoFFin and thus AAA-rated.

The key issue in designing the legislative basis for this model was finding a compromise between (a) achieving a true exoneration of the financial institution from the toxic assets for accounting purposes and (b) avoiding SoFFin, as the guarantor of the refinancing bonds, being the only one to bear the risk that the ultimate value of the assets turns out less than the refinancing liabilities of the vehicle. Had the transferring institution retained any risk position with respect to the troubled assets, for example by way of guarantee or obligation to make available additional funds, applicable accounting rules would not have allowed the removal of the assets from the balance sheet of the transferring institution.

A way to achieve both objectives was to create a conditional funding obligation on the part of the transferring institution which would have to be satisfied only from distributable profits. In other words, if the value for which the assets were transferred (generally 90 per cent of the book value or, if higher, the fair market value) ultimately proves to be higher than the adjusted value of the portfolio determined by SoFFin by reference to actual realisations and expected losses, the transferring institution has to use available dividend distributions to make payments to the vehicle so as to cover those losses. If in any year the amount of available distributions is less than would be required to compensate the loss, the difference is carried forward.

The problem with this model was that it could have easily ruled out any distributions of dividends for many years and would have made investments in the protected financial institution very unattractive. Raising new capital through share issues would have been close to impossible. The occurrence of losses in the portfolio was more likely than not. A transfer for 90 per cent of the book value did not in many cases, represent the fair market value. Furthermore, no reduction from the book value was required if this would have left the financial institution with a Tier 1 capital ratio below seven per cent. For these reasons, the model was never used in practice. The deadline for applying for SoFFin guarantees for bad banks in the form of a special purpose vehicle expired on 22 January 2010 without any application having been made.

The AIDA model

As briefly mentioned, the principal idea of the AIDA model is to establish several independent public law institutions (*Anstalten*) within the *Finanzmarktstabilisierungsanstalt*

(FMSA), the insitution which administers and manages SoFFin. As a first step, the ***FMSA*** was constitued as a body which is directly linked to the Federal Republic of Germany but has separate legal personality (not the case originally when the FMSA was first established in October 2008 in connection with the creation of SoFFin – it did not have legal personality). The FMSA has the capacity to establish further public law institutions with limited legal personality (the AIDAs) under its governance.

Each AIDA can be used as a transferee of troubled assets of a financial institution (provided those were acquired by the relevant financial institution on or before 31 December 2008) for the purpose of liquidation and workout. Alternatively, the AIDA can assume the risk in relation to these assets by extending guarantees or taking sub-participations. The transfer can be achieved by an individual transfer of assets, which would be time-consuming and exposed to legal risk. A better method is a split-off of troubled assets with the corresponding assumption of these assets by the AIDA. A split-off has the effect of partial legal succession and does not require any consent by third parties. The tool of a split-off is long-established under corporate law. However, in normal circumstances, where one corporation splits off part of its business to a new subsidiary or another corporation, the company making the split-off remains liable to the creditors connected with the split-off assets. This would obviously prevent a complete discharge by the transferring institution of its troubled assets and would frustrate the purpose of the AIDA. Accordingly, the FMStFG nullifies the joint liability of the transferring entity.

The issue of how losses that were higher than expected could be covered is as relevant in the case of an AIDA as for a special resolution company. Whereas in the case of the latter losses had to be covered by future distributable profits of the transferring bank, in the case of an AIDA the shareholders of the financial institution disposing of troubled assets have to assume an obligation to compensate losses of the AIDA. If there is more than one owner or shareholder, the obligation to assume losses will be pro rata internally, but joint and several vis-a-vis the AIDA itself. Any remaining surplus on the liquidation of all assets will be distributed to the transferring financial institution or the shareholders that have made payments to the AIDA by way of loss compensation.

The payment of loss compensation by owners of the troubled institution is not available where it is a listed company. An alternative possible option for funding loss compensation in such a case is through distributable profits but for the same reasons set out above in relation to a bad bank in the form of a special purpose vehicle; this is not an attractive option. It is thus not a surprise that the first bank that has used the AIDA model was a closely held institution, namely one of the troubled public law institutions referred to earlier, WestLB in Düsseldorf. The state of North Rhine-Westphalia, one of the owners of WestLB, has assumed liabilities for a total amount of €8.26 billion to back up the AIDA. In addition, the other owner-group of WestLB, the local savings banks in North Rhine-Westphalia, contributed €5.7 billion.

The second institution which is currently seeking to establish an AIDA is HRE, now named pbb Deutsche Pfandbriefbank AG. As described above, pbb is now an institution

fully owned by the Federal Republic of Germany. Hence, it will also be the Federal Republic that has to assume the liability for any losses incurred by the pbb–AIDA as a result of the workout of the transferred assets. In the case of pbb, the purpose of the AIDA is to recapitalise and reorganise pbb to allow for its future re-privatisation.

Protecting deposits

For the man on the street, the financial crisis would merely have been something taking place on TV and in the press if it had not been for the concern about the safety of his money at the bank. Traditionally, the standard of deposit protection in Germany is very high. Long before the European Union had made deposit protection mandatory under its Directive on Deposit Guarantee Schemes, Germany had a privately organised deposit protection system established and administered by the Federal Association of Banks (*Bundesverband Deutscher Banken*).

The so-called deposit protection fund (*Einlagensicherungsfond*) offers a full refund of deposits in the event of a financial institution's failure. The cap provided for in the statute of the fund is, for all practical purposes, irrelevant. The coverage per depositor ends only where the covered amount exceeds one third of an institution's regulatory capital, an amount that for a systemically relevant institution is well in the billions of euros. The *Einlagensicherungsfond* is funded by the private banking sector through a levy on the total amount of deposits carried by a participating institution on its books.

Traditionally, the Federal Association of Banks had been secretive about the size of the fund. In the last few decades, the fund had been successfully used for a number of small and mid-size bank failures, but it was clear that if a major German bank failed, the size of the fund would hardly suffice to pay out to all depositors that would otherwise lose their money. In addition, since the onset of the financial crisis, the fund had to digest a variety of bank insolvencies which lead to substantial payouts. It was thus not surprising that the general public became deeply concerned with the safety of their deposits. The liquidity crisis of Northern Rock in the UK in September 2007 had shown that bank runs are not necessarily a thing of the past.

The Federal Government knew that if people lost confidence in the safety of their deposits, the situation in the financial industry could quickly become uncontrollable. For that reason, on 5 October 2008, Chancellor Angela Merkel and Minister of Finance Peer Steinbrück made a surprising public statement: they pledged that no depositor in Germany would have to fear losing a single euro on an account with a German bank. This statement had the intended calming effect. Only cynics wondered how a country with an annual budget of around €300 billion could suddenly issue a guarantee for more than €1,000 billion; and only narrow-minded politicians could raise the question of how this statement could be reconciled with federal budget law under which guarantees of any kind need to have a provision in the budget. Thankfully, this guarantee has never been called upon and it has entered history as a bold political statement, probably meant less literally than it was understood but made at the right time.

Although the *Einlagensicherungsfond* has so far lived up to its role and has never had to refuse compensating depositors, it also had to undergo a substantial recapitalisation. The losses from the failure of the German subsidiary of Lehman Brothers were so severe that the fund had to take up fresh money. In January 2009, the EU Commission approved a €6.7 billion SoFFin guarantee for bonds to be issued in support of the fund. At present, the situation appears to have stabilised and no further substantial bank failures are imminent which could cause further losses for the fund.

For the sake of completeness, it should be mentioned that the *Einlagensicherungsfond* is a deposit protection scheme operated by the private banking sector only. The public banks (Landesbanken and Sparkassen) as well as the cooperative banks (Genossenschaftsbanken) have their own deposit protection systems. The cooperative banks have weathered the crisis reasonably well (except for DZ Bank, the top institution of the sector, which came close to applying for SoFFin rescue measures). The public sector has been hit hard by the losses of their lead institutions, the Landesbanken, but the deposits of Sparkassen customers were never at stake.

The rules for deposit protection in Europe were recently overhauled and the protected amount raised to €50,000 per depositor. The EU Commission is pushing for a further increase to €100,000 per depositor by the end of 2010. In addition, according to an EU Commission proposal, under new legislation payouts are to be made within one week after the bank has closed the counters. The EU initiative further aims at a better funding model for the institutions protecting depositors. This funding model is to be based on levies charged to participating banks whereby the amount of the levy is calculated by reference to the risk profile of the individual bank's business. The EU Commision hopes that the model will create an incentive to embark on lower risk business. It is hoped that, through this financing model, the funds available for deposit protection in Europe may be raised to about €128 billion from the current €23 billion by 2020. However, the problem remains that no deposit protection institution is big enough to cover the failure of several financial institutions. For banks of a certain size it is simply not an option to let deposits become a part of the estate in insolvency proceedings. The discussion of how deposits can be separated and shielded against creditor claims if a bank becomes insolvent is thus one of the key issues in the ongoing financial reform.

Strengthening the supervisory powers of BaFin

As mentioned earlier, one of the fundamental problems in controlling the situation when HRE was on the verge of insolvency was the limited supervisory powers of BaFin with respect to bank holding companies. HRE itself was a German holding company, which controlled several banks in Germany and Depfa in Ireland. Holding companies of a group that includes credit institutions or financial services firms (*Finanzholding-Gesellschaften*) do not themselves require a banking licence. Accordingly, they are not subject to the supervision of the financial regulator BaFin, although in many cases

material decisions for the whole group are taken at the level of the holding company management. For capital adequacy purposes, the largest institution in the group is responsible for reporting to BaFin on compliance by the group with regulatory capital standards; yet that institution is itself a subsidiary of the bank holding company and thus not in a position to influence decisions taken at that level.

In addition, the German Banking Act (*Kreditwesengesetz* – KWG) empowers BaFin to remove bank managers from their executive position in the case of non-compliance or incompetence, but not members of the supervisory board which is responsible for appointing the executive managers. Nor did the fit-and-proper test to be passed by a member of the executive management apply to members of the supervisory board, who are normally the executive managers of the holding company. Accordingly, BaFin felt that its hands were tied when trying to intervene where it thought there was personal incompetence on the part of the HRE management. The message sent by BaFin to the Government was that, had the powers of BaFin been more comprehensive, an earlier intervention would have been possible and the damage caused by the virtual insolvency of HRE would likely have been significantly less.

The response came in the form of the Act on the Strengthening of Financial Market and Insurance Supervision (*Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht*) of 29 July 2009. This Act contained a number of changes to various laws, most importantly the KWG. As a result of these changes, members of the supervisory boards of financial institutions became subject to a fit-and–proper test similar to that of the actual bank managers. The test requires that the members of the controlling body have sufficient personal knowledge and expertise to supervise the management of a financial institution, in particular in light of the scope and complexity of the institution's business.

In addition, the relevant individuals need to be 'reliable'. Reliability means that the relevant individuals have not been involved in any criminal offence related to insolvency proceedings or other crimes or misdemeanours relevant to their position. Even in the absence of a criminal record, a member of the supervisory board can be removed from office if, in violation of their duties as responsible supervisors, she or he did not realise, or ignored, material breaches by their financial institution of the principles of proper management. The same applies if, although recognising the bank's improper business conduct, they do not do all that is necessary to stop that conduct despite specific warnings from BaFin.

Furthermore, no former member of the institution's management may take a seat in the supervisory board if that board already includes two former managers of the relevant institution. This is to avoid collusion between bank managers and their supervisors, in particular where the supervisor is a former manager that may have things to hide. Finally, no member of the supervisory board may have more than five positions in boards of financial institutions. Certain exceptions apply with respect to positions within the same group. Where the group has a financial holding company at the top, the rules also apply to managers and supervisory board members of the holding company.

With this new toolbox, it becomes possible for BaFin to quickly exchange a majority of members of a supervisory board and take complete control of the institution if it believes that this is necessary to manage the risks threatening an institution or the financial system.

Regulating compensation of bank employees

Bankers' pay was given prominent attention by the public very early on in the development of the crisis. The debate concentrated on two different aspects: one was the levels of executive compensation in the financial industry as such, that is, those people who – in the public view – had caused all the mess. Why were these people paid so much money? Why did they receive bonuses when their institutions had billions of euros in losses? Why did they get large pensions after they had to be fired? These questions revealed that the commonly held perception that leaders of large companies deserve a very high income because they have unique capabilities was being widely challenged. Since this was a populist topic which could easily sway the electorate, the Government reacted quickly. The obvious response was that institutions which had to resort to Government support would have to cap significantly the annual salary of their executive leadership. The ceiling was set at €500,000 per year. It has been argued that the cap placed on the personal income of bank managers persuaded some institutions not to apply for help from BaFin in circumstances where it was necessary. Whether or not this is true, it seems that banks, having weathered the crisis without Government support, did so for a good reason.

The broader response to executive pay was the Law on the Appropriateness of Board Member Compensation (*Gesetz zur Angemessenheit der Vorstandsvergütung* – VorstAG). Under the VorstAG, the supervisory board, which is responsible for negotiating the compensation package of executive board members, has to take care that the total compensation reflects both the duties and responsibilities of the relevant board member as well as the overall financial position of the company. Variable components of executive pay should be based on criteria referring to several business areas and not only the one in which the employee is working. In addition, the contract must permit the reduction of the compensation if the financial situation of the company deteriorates. Directors' and officers' liability insurance must have a deductible of at least ten per cent, capped at 150 per cent of the fixed portion of a board member's annual compensation. Members of the supervisory board are personally liable if they agree an inappropriate compensation package with a company executive. Finally, the annual general shareholders' meeting is given the right to resolve on the appropriateness of the compensation package for the management board. The resolution is just a general expression of agreement or disagreement. It has no influence on the independent responsibility of the supervisory board with respect to the compensation package.

The VorstAG also addressed board diversity and independence. In Germany, it is common for senior board members, in particular the former CEO, to become members

of the supervisory board after retiring from a management position. The VorstAG has now established a two-year waiting period for former executive board members, unless an earlier election to the supervisory board is proposed by shareholders holding 25 per cent or more of the outstanding share capital.

While these rules apply to all listed companies, whether or not a financial institution, the BaFin has developed additional rules for companies in the financial sector. On 14 August 2009, BaFin published a revised version of its Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement* – MaRisk). The MaRisk comprises a set of rules refining the overall obligation of a financial institution to maintain an appropriate risk management system pursuant to paragraph 25 of the KWG.

Section 71 MaRisk addresses the parameters of incentive systems for bank staff. According to that provision, incentive systems must be harmonised with the general strategic targets of the institution. In particular, compensation systems must be designed so as to avoid any incentives for incurring inappropriate risks. Employees not working in business generation and other front office roles, in particular those involved in risk controlling and back office functions, have to be compensated in a way that appropriately reflects the responsibility of their position and duties. Compensation systems must be reviewed at least annually. Further, the financial institution must set up a special committee for the definition and development of compensation systems. The committee must comprise employees involved in business generation and other front office roles as well as employees involved in risk controlling and back office functions. The general controlling department must also be involved. Bonuses must not be based solely on the individual performance or contribution of a particular employee if that person is able to incur substantial risks for the institution. In that case, the financial performance of the department as well as of the entire institution have also to be taken into account. The reference period for determining the bonus must include several years and must allow for a reduction of accrued bonuses if the reference factors for the calculation of the bonus turn into the negative.

These rules have been further refined by a circular, published by BaFin on 21 December 2009, concerning the regulatory requirements for the compensation system of financial institutions (*Rundschreiben Aufsichtsrechtliche Anforderungen an die Vergütungssysteme von Instituten*). The circular contains a more detailed description of the various components that compensation systems must or must not have and what the responsibilities of the banks' executives are in that regard.

Also in December 2009, eight large German financial institutions agreed to a voluntary commitment to implement as soon as possible the Principles for Sound Compensation Practices of 2 April 2009 and the Principles for Sound Compensation Practices – Implementation Standards of 25 September 2009, developed by the *Financial Stability Board* (FSB) and endorsed by the G20.

The final step in entrenching compensation principles into supervisory laws will be the Act on the Regulatory Requirements for Compensation Systems of Financial Institutions and Insurance Companies (*Fesetz über die aufsichtsrechtlichen*

Anforderungen an die Vergütungssysteme von Instituten und Versicherungsunternehmen) which is presently pending in the federal legislative process. Through this Act, the principles regarding compensation systems of financial institutions and insurance companies will be promoted to the status of law and not simply guidelines issued by BaFin. The Act gives the Government authority to issue regulations containing more detailed rules for the structure of compensation systems. The enhanced status of the rules as law will enable the imposition of sanctions in the event of a violation of the rules. The new law also gives BaFin immediate power to prohibit the payout of bonuses or to limit the aggregate bonus amount to a certain percentage of an institution's annual profit.

It is expected that the regulations and laws will reflect the outcome of initiatives at the European Union level, which is behind the developments in Germany. On 7 July 2010, the European Parliament approved new rules for bankers' bonuses covering all bonus payments awarded or paid from 2011 onwards. This brings about the first cap on bankers' bonuses worldwide. Upfront cash bonuses will be limited to 30 per cent of the total bonus and to 20 per cent for particularly large bonuses. Instead of upfront cash, between 40 and 60 per cent of any bonus must be deferred and can be reclaimed if the performance factors for which the bonus was paid deteriorate in the future. In addition, at least 50 per cent of the total bonus will be paid in the form of contingent capital instruments. These are instruments which are automatically converted into Tier 1 capital of the institution, normally share capital, available for loss coverage on a going concern basis if certain regulatory parameters are not maintained. Finally, bonuses must keep a certain proportion to the fixed salary components. Each bank will have to establish limits on bonuses relative to salaries to bring down the overall, disproportional role played by bonuses in the financial sector.

Surprisingly, it seems that new rules on bankers' bonuses in Germany, the European Union and other parts of the world are more advanced than any other part of the new regulatory framework expected to take shape since the crisis broke. While the bonus-loaded compensation of bankers played some role in the crisis, it is unlikely to have been the decisive factor. The emphasis placed on this particular aspect of regulatory inefficiency or oversight was mainly driven by public interest and opinion, which has had an ever increasing influence on the focus of politicians.

Facilitating bank bailouts and liquidations

One of the major lessons learned from the financial crisis was that suitable instruments would have to be developed to either rescue banks which have run into trouble or to liquidate them in controlled and orderly proceedings. The tools of conventional insolvency law have proved to be insufficient to deal with the complexities of the insolvency of a global institution. The lessons learned form the insolvency of Lehman Brothers were that it only takes the failure of a midsize bank which is strongly interwoven

with the financial system to send shockwaves through the markets, placing the entire financial system at risk. The existing instruments of bank regulation were not fully appropriate to cope with an imminent insolvency of a systemically relevant bank. These instruments are normally aimed at freezing the business of the concerned bank which may in fact be the starting point of a chain reaction jeopardising the whole system.

Before the failure of Lehman Brothers, it was a common perception that the conventional tools of regulatory interference would not be used against institutions of a certain size because of their systemic relevance. They were considered too big to fail. It is still an open question whether the systemic relevance of Lehman Brothers was underestimated, or whether the US administration thought that if it were to bail out each and every bank that ran into difficulties this would overcharge the financial capacity even of a country as big as the United States. It is a fact, though, that the failure of Lehman Brothers created a dramatic loss of confidence among market participants which caused an immediate drying up of the markets. It became clearer than ever before that the traditional methods of dealing with a bank's crisis – freezing and liquidating – work only for small institutions with no systemic relevance. The financial crisis forced governments and central banks around the world to close the traditional toolbox of crisis management and to do everything to keep the market afloat. As we know, this has worked reasonably well, but the ultimate costs to the public are not yet clear. Politically, this would not be a long-term solution anyway.

For this reason, the debate is now turning towards more innovative solutions of bank bailouts by taking control of the institution at an early stage and reorganising it while it is still playing its role – albeit to a reduced extent – in the system. In June 2010, the German Government introduced a discussion draft of a Law for the Restructuring and Orderly Liquidation of Credit Institutions (*Restrukturierungsgesetz* – KredReorgG). The KredReorgG provides for a two-step reorganisation and restructuring process.

The first step comprises a reorganisation by which potential difficulties of an institution can be identified early and can be addressed by the existing bank management. To this end, the scope of conventional regulatory instruments would be expanded to provide a number of rights and authorities to BaFin with respect to the management of the bank. The reorganisation proceedings are initiated by the credit institution giving notice to BaFin. If BaFin considers the proposed reorganisation appropriate, it applies to the competent court of appeals for confirmation. The court then appoints a reorganisation consultant (*Sanierungsberater*) who is responsible for the implementation of the reorganisation plan, which can include such measures as do not interfere with the rights of third parties – in other words, the reorganisation does not provide for any debt relief. However, it is a special feature of this process that the bank may take up a super senior financing which is intended to re-open the refinancing markets for the troubled bank. The reorganisation proceedings are available for all financial institutions. Its effects are relatively mild and it remains to be seen whether such a reorganisation will be of much practical importance, assuming that the final version of the KredReorgG still contains this option.

A more sweeping result can be expected from the other kind of proceedings, the so-called restructuring proceedings (*Reorganisationsverfahren*). Restructuring proceedings can only be imposed on credit institutions which have reached an existential crisis which can be expected to have material negative consequences for the stability of the financial system. In other words, a restructuring applies only to systemically relevant institutions. In a restructuring, broad interference with third party rights is possible. Among other things, the assets or parts of the assets of the relevant institution can be transferred to another bank or, for a certain period of time, to a public 'bridge bank' if and to the extent this is necessary to avoid risks to the financial system. The positive effect of such a transfer is that stabilisation measures can be concentrated on the transferred assets whereas the remaining assets can be liquidated. The apparent aim of this procedure is to separate the systemically relevant part of a bank, first of all the deposits but also interbank loans sufficiently backed by assets, to a new institution and to let the rest go under. Where the line is to be drawn between the two parts will be the true art work of this procedure, and only future practice will tell whether it works effectively.

Another important piece of the KredReorgG is the creation of a restructuring fund for credit institutions. The restructuring fund will collect a special levy from the financial industry to finance future rescue activities for financial institutions. A similar levy is being discussed in other countries. The restructuring fund will be administered by the *Bundesanstalt für Finanzmarktstabilisierung* (FMSA), the same institution that is administering SoFFin. The amount of the levy to be paid by a financial institution will be determined by reference to its size, systemic relevance, and potentially also the risks it takes according to its business model. It is hoped that this extra cost of risk-taking will be an incentive to adhere to sound business practices.

In substance, the KredReorgG is an attempt to implement the concept of the 'living will' for financial institutions,[4] which has been under discussion for some time. In the case of the KredReorgG the 'living will' is the reorganisation or restructuring plan to be drawn up by the institution. The wisdom behind this is that banks should know well, and certainly much better than regulators, where the problems in their business models arise and what ought to be done to deal with those problems and remedy the situation. As in the case of conventional solvency proceedings, the question remains whether institutions will apply for a reorganisation or restructuring early enough to avoid the fundamental problems caused by a large institution that has lost market confidence. Admittedly, BaFin can itself take the initiative and issue an order for the splitting up of a systemically relevant institution into that part which is intended to survive and that part comprising any remaining assets. Yet it is also not a matter of course that the regulators would act early enough. Although their powers were more limited before the current financial crisis broke, many regulators did not use such intervention rights as they had when they could have done.

4 This means that banks shall develop a plan as to how they should be broken up or liquidated if they enter into a severe crisis.

Management liability

It seems to be quite peculiar for Germany that the issue of management liability has played a prominent role in dealing with the effects of the crisis. Under the German corporate governance regime, the supervisory board has to review whether the management of a financial institution has violated its duties when letting the institution slip into a fundamental crisis. If the supervisory board fails to bring a lawsuit against the management to recover part of the loss incurred by the bank, it may itself be liable. Many boards of German institutions presently find themselves in the uncomfortable position of having to perform that review and to decide whether to sue the existing or – more likely – former management. In the two cases pending against former bank managers, the issue of liability for bad management is not to the fore. Instead, the litigation focuses on misleading information given to the capital markets by minimising problems at a stage when the bank was close to insolvency. However, it is to be expected that the scope of the business judgment rule in financial institutions will be put to the test at some stage. The issue here is: in a world as complex as that of financial instruments, can it really be expected from board members to understand each and every aspect of the risks involved? What form of process must a bank undertake before it enters into new lines of business? What checks and balances need to be designed to make sure that there is not too much concentration of power in certain corners of a financial institution? These are all interesting questions, and the answers that courts will eventually find may make the life of a bank executive distinctly unpleasant. They may also have a negative impact on innovation in the financial industry.

Enhancing capital requirements

Capital requirements for banks have not yet taken their final form. As in all member states of the European Union, so in Germany they will be derived from the changed capital adequacy rules under the changed Capital Requirements Directive (CRD IV), which in turn will be strongly influenced by the global debate on capital adequacy conducted at the level of the G20 and, more importantly, the Committee on Banking Supervision at the Bank for International Settlements (BIS). By now it seems clear that in addition to the conventional capital adequacy test, where assets will be imputed with their relative risk weighting, there will also be a leverage cap limiting the proportion between assets at their book value and total liabilities. In other words, the test will require that an increased portion of the assets be financed by equity. The leverage test applies in addition to the conventional capital adequacy rules as reflected in the current Basel II accord. Under the rules of this accord, banks are able to determine the risk weighting of each asset by reference to external rating or internal risk models which they have developed. The methodology of this modified risk weighting was largely responsible for the extreme attractiveness of credit derivatives. A credit derivative

placed against an asset[5] could substantially reduce the risk-weighting of the asset, thereby unleashing large amounts of capital. The leverage test is an indirect confession that Basel II has failed to achieve its purpose in various respects, or at least has set wrong incentives by transferring risks to the largely opaque credit derivatives market.

At least as important, however, is the ongoing debate about the 'quality of capital'. Critics of the current mix of capital components blame the lack of quality of capital hybrids as being part of the problem. In particular, many of these hybrid capital components are accused of not having absorbed losses on a going concern basis but only upon liquidation, now commonly referred to as on a gone concern basis. Furthermore, the terms of the instruments were one thing, but what issuers told the investors was another. For example, where an instrument was perpetual but had a so called non-call period of ten years[6] (that is a period in which the issuer may not redeem the instrument), investor expectation was that the instrument should actually be repaid after ten years. This expectation made it a matter of capital market reputation not to let the instrument run over the ten-year period. Financial institutions which had issued these instruments found it difficult to frustrate investor expectation because this would have made it impossible for them to issue similar instruments in the future. In addition, loss compensation on a going concern basis would mean that a loss suffered by a bank in a particular year could be partly (generally on a pro rata basis with other loss participating capital components) offset by reducing the principal amount of the hybrid instrument. Most of the instruments currently on the market did not have this feature. Accordingly, these instruments did not do anything to help a bank to digest losses and survive a crisis.

Therefore, rule-makers now favour instruments that provide for a loss participation on a current basis. The securities which seem most fashionable are the so-called contingent capital bonds. These are bonds which automatically convert into share capital if certain financial or regulatory parameters are breached. These parameters are commonly linked to the capital adequacy ratio of the institution. However, the focus on contingent capital bonds appears to be somewhat one-sided. There are other forms of loss participation on a going concern basis which have a long tradition. In Germany, the silent partnership has been used for these purposes for decades. A silent partnership is an instrument by which an investor acquires a stake in the financial business of the bank. If that business produces a loss, the loss is netted, on a pro rata basis with other Tier 1 and upper Tier 2[7] capital, against the principal of the silent partnership. Future profits will be used to replenish the principal amount. The charm of this instrument is that it is not once and forever converted into share capital like a contingent capital bond. Instead, it remains debt for tax purposes and can be repaid,

5 For example, a credit derivative under which the provider of credit protection would pay for the loss if the value of the relevant asset is falling.

6 A so-called NC-10 instrument.

7 Upper Tier 2 capital is a form of regulatory capital providing for loss participation on a going concern basis but also for cumulative distributions which is not permitted for Tier 1 capital instruments. A popular form of upper Tier 2 instrument in Germany is the Genussschein.

if the institution so elects, without the formalities of implementing a normal capital reduction of a stock corporation.

After a difficult start, it certainly looks as if the revised capital rules discussed on the BIS-level will continue to treat silent partnerships as Tier 1 capital, which is justified given the features described above. More restraint, however, is recommended with respect to other Tier 1 hybrids which have been very popular in recent years like, for example, redeemable preference shares.

Financial transaction taxes

Elements of the German Government favour the introduction of financial transaction taxes. In addition to the general bank levy already proposed as part of the KredReorgG, a financial transaction tax would constitute a second source of income for a future restructuring fund. In addition, it is meant to make purely speculative trading more expensive and thus less attractive. The idea behind this proposal is that higher frequency trading, while enhancing the liquidity of the financial markets, creates higher volatility which is often self-energising, thereby aggravating negative trends. It looks unlikely, though, that a transaction tax will proceed under the current German government. The opposition favours the tax, but the next elections are not before 2013.

The euro crisis

Although not directly related to the financial crisis, the eurozone came under pressure as a result of the huge deficit in the Greek budget and miscalculations made by the Greek Government. The euro lost value dramatically against other currencies, in particular the US dollar. This decline made it less attractive for investors outside the eurozone to purchase Government bonds from Member States, which in turn made it even more difficult for the Greek and other southern European governments to refinance the state debt. The steep decline of the euro caused a number of European governments to denounce speculation against the common currency. On 19 May 2010, the BaFin prohibited the short selling of uncovered credit default swaps on government bonds of the eurozone. In addition, short selling of shares of certain systemically relevant financial institutions was forbidden.

This move by the German Government and BaFin was widely criticised by representatives of the financial industry. It was considered a hostile overreaction and one which, in addition, was largely redundant because trading of euro-denominated government bonds can also take place outside Germany, thereby escaping the limitations of the BaFin order. The measure was also denounced as being for the most part political populism, which it probably was. Surprisingly, though, this bold action seems to have made an impression in other European Member States, and the topic of a general prohibition or regulation of short selling in euro-dominated government bonds is now on the European Commission's agenda.

The German Government plans to cast the temporary BaFin order into the form of a law. On 2 June 2010, it published a Government draft Law for the Prevention of the Improper Use of Transactions in Securities and Derivatives (*Gesetz zur Vorbeugung gegen missbräuchliche Wertpapier- und Derivategeschäfte*) which contains a broad ban on short sales in shares or government bonds of countries inside the eurozone.

Outlook

At the time this report was written, legislation dealing with the effects of the crisis or aimed at preventing another one is still under way. While a large number of laws have already been instituted in Germany, the debate is ongoing. The effects of the crisis are not yet fully digested, and some institutions are still Government-controlled and dependent on state funding or credit protection. The danger is that, since the economy is running better than expected and financial institutions are generally recovering faster than was predicted a few months ago, the debate about crisis prevention and making the system safer may lose momentum. More intensive research needs to be done for the public and law-makers to fully understand what caused the crisis. Without an in-depth understanding of the causes, all rule and law-making can look only at particular aspects and effects of the events in the world financial markets since 2007. Some of the new rules may prove to be too restrictive, others too accommodating, some may be easy to circumvent, others may stifle innovation in the financial industry and thereby cause damage to the economy as a whole. The effects of the new rules need to be carefully watched and analysed. While memory of the crisis fades, pressure to relax regulation will mount. Too strong a regulation may not be economically desirable, but over-regulation has never been blamed for a financial crisis. It is a difficult choice to make.

Switzerland

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Distinctive features of the Swiss financial system

Overview

The Swiss financial system is characterised by a number of historically based features that have important bearing on the domestic economy as a whole. The banking system is large, and Swiss banks' total balance sheet financial assets were nearly seven times the level of the Swiss GDP in 2007. This is significantly higher than that of most other OECD countries. For instance, Switzerland's largest bank is much larger in relation to GDP (328 per cent) than is the case with the largest banks in virtually any other OECD country. The Swiss insurance sector is also quite sizeable. Banking and insurance businesses are major contributors to domestic economic activity, accounting for approximately 11 per cent of GDP and five per cent of total employment over the last decade. It is perhaps interesting to note that value added from wealth management commissions alone contributed to nearly four per cent of the GDP.

Although the Swiss banking sector is segmented into international banks, regional commercial and savings institutions and private banks, the large size of the financial system reflects the presence of several very large internationally focused institutions that have made Switzerland a major international financial centre. UBS and Credit Suisse Group (CSG), the 'Big-2', accounted for about 60 per cent of total Swiss bank assets booked domestically or over 3.5 times GDP shortly before the crisis, while their total worldwide assets were about six times GDP. Both are universal banks, historically focused on commercial banking and wealth management, that have engaged in investment banking relatively late by means of an aggressive acquisition tour starting in the late 1980s to early 1990s. Today, their focus on wealth and asset management as well as investment banking is conducted through an extensive network of foreign branches and subsidiaries predominantly located in Europe and North America. Interbank and other wholesale financial markets, as well as a relatively strong domestic and international deposit base, supply most of their funding. Looking at the business development of the Big-2 over the last two decades it is, however, illuminating that 'traditional' banking activities have significantly decreased since the beginning of the 1990s. For instance, deposit-taking activities have decreased from 50 to around 35 per cent on their balance sheets, and commercial lending as well as mortgage business activities have gone down from 60 to 30 per cent, respectively.

The insurance sector is likewise dominated by two large internationally focused institutions, Swiss Re and Zurich Financial Services (ZFS). Two-thirds of their premium income arises from foreign business.

In any event, Switzerland's eminent role as an international financial centre goes beyond its largest institutions. About two-thirds of cross-border wealth management is conducted by financial institutions domiciled in Switzerland. Apart from the Big-2, this wealth management is carried out through many private banks, a substantial number of which are owned and/or controlled by foreign financial institutions. The international focus and the large presence of foreign-controlled banks have led to a comparatively high level of foreign currency denominated assets and liabilities relative to the size of the financial system and GDP. Foreign currency denominated instruments (predominantly interbank business) accounted for approximately 60 per cent of total Swiss banking system liabilities at the end of 2008. This is more than three times GDP and nearly 80 per cent of liabilities owed to banks. It is perhaps fair to say that this concentration makes the Swiss financial system and the economy particularly vulnerable to liquidity shortages in foreign currencies.

Traditionally, fiduciary standards have been high in the Swiss financial sector, and rigour in protecting client interests has been a key factor sustaining Switzerland's prominent position in international wealth management. Fiduciary standards include not only protection of confidentiality with respect to client information but, at least as important, stringent standards that govern fund custody and management. Switzerland's laws and regulations on the fiduciary responsibilities of financial institutions and their employees, including civil and criminal sanctions for violations thereof, are among the most stringent in the OECD.

Most of the other Swiss financial institutions, including the 24 cantonal banks whose liabilities are mostly guaranteed by the respective cantonal government and whose businesses are subject to mandates on their local lending practices, are primarily focused on domestic and mortgage lending and other commercial banking activities that account for about two-thirds of domestic lending. Conversely, securities and other trading activities, as well as investment banking activities and foreign currency trading activities, are very limited and effected only by a few larger institutions. For instance, only the Big-2 and the Zurich Cantonal Bank have direct access to the Continuous Linked Settlement (CLS) system. All other banks settle forex transactions through these three banks. Deposit-taking is a much larger source of funding for these small- to medium-sized financial institutions compared to the Big-2. Except for the two or three largest insurance carriers, Swiss insurance companies are likewise focused on domestic customers.

The regulatory framework

As in other countries, major segments of the Swiss financial system have until recently been supervised by separate financial regulators. Only as of 1 January 2009, the Federal Office for Private Insurance (FOPI), along with the Federal Banking Commission (FBC) and the Control Office for the Prevention of Money Laundering, have been consolidated into a single regulatory body – the Financial Market Supervisory

Authority (FINMA). This consolidation, planned long before the financial crisis, has been effected by the Federal Act Concerning Federal Financial Market Supervision (FINMASA). FINMASA has created FINMA and has placed the enforcement of seven federal laws central to the supervision of the financial services industry under FINMA's unified regulatory roof: the *Pfandbrief* Law; the Collective Investments Scheme Act; the Banking Act; the Securities Exchanges and Securities Dealers Act; the Money Laundering Act; the Insurance Contract Act; and the Insurance Supervision Act. FINMA now provides an integrated structure to regulate and supervise the financial markets and major financial institution segments similar to the Financial Services Authority in the United Kingdom. FINMA is also responsible for regulating Swiss stock exchanges, securities dealers and other financial intermediaries including hedge funds licensed in Switzerland. It is structured as a public corporation that is solely financed through fees by the institutions it supervises without financial support from the Government. The FINMA board of directors, which is appointed by the Swiss Government, is responsible for setting the strategic goals of the regulator and approving major decisions. Although FINMA is legally accountable to the Swiss legislature and required to report to it, its independence is formally guaranteed by law.

In addition, cantonal authorities play a key role as guarantors and owners of cantonal banks. They also contribute significantly to pension fund regulation. Traditionally, self-regulatory organisations, such as the Swiss Bankers' Association, and other self-regulatory concepts, such as rules and regulations of the SIX Swiss Exchange (while the SIX Swiss Exchange is a licensed institution subject to FINMA supervision, its body of rules and regulations is largely based on self-regulation), have been very important elements in the Swiss regulatory system.

Another distinct feature of the Swiss regulatory system is its reliance on external audit firms and commissioned experts to conduct examinations, on-site inspections and investigations of banks and other financial institutions under its jurisdiction. Auditors and commissioners are mandated by FINMA and provide reports on their findings that are reviewed by FINMA (a so-called dual system). Costs incurred in connection with such reviews and tasks are usually levied on the relevant institution. Consistent with the FBC's practice established as early as 1998, FINMA, however, continues to apply a special regime for closer oversight of the Big-2, with FINMA staff being more directly involved in on-site inspections and regular meetings or retreats between FINMA officials and senior management of the Big-2.

Furthermore, insurance regulation has been subject to a major revision that was initiated with the adoption of a substantive revision of its regulatory framework in 2004. At that time, the previous regulatory approach based on product supervision was replaced with one on risk-based supervision and solvency requirements. The revision has extended supervision to groups and conglomerates (the FOPI previously applied group supervision to a few selected very large insurers only), corporate governance, risk management, internal controls and market conduct of insurers. Standards for corporate governance, risk management and internal controls have been specified

and monitored under the Swiss Quality Assessment (SQA) and related efforts. More importantly, the revised insurance regulations have also required insurance carriers to comply with the Swiss Solvency Test (SST), a risk-based procedure for assessing the resources needed by an insurer to meet its commitments in adverse circumstances. Although the SST was initially critised by market participants, and its implementation has caused a considerable headache to a number of insurers, it has, relatively quickly, been internationally recognised as an industry standard. A revised version of the SST incorporating market risks became mandatory for the largest insurance carriers at the beginning of 2006 and for smaller carriers in 2008.

With a view to the size of the major financial institutions and their potential impact on GDP, macroprudential regulation and oversight would appear to be particularly important in Switzerland. A basic framework for macroprudential oversight has been established that makes the Swiss National Bank (SNB), Switzerland's central bank, and FINMA jointly responsible for its execution. The current division of responsibilities between the SNB and the FBC is specified in a memorandum of understanding (MOU), issued in May 2007, that now applies to FINMA as the FBC's successor. Under its terms, the SNB is responsible for monitoring developments in the banking system as a whole as they affect the overall economy, for the conduct of monetary policy and for the oversight of interbank and securities clearing systems. FINMA is responsible for setting prudential standards. The MOU specifically provides for the sharing of information on macro risks, risk exposures of financial institutions and on their respective capital adequacy. From a macroprudential perspective, it is perhaps fair to say that the SNB assumes a more leading role, together with FINMA, that is predominantly the enacting body. Although the SNB and the FBC, at the time, developed a sophisticated framework for top-down stress tests for the banking sector, these tests, as in other countries, have turned out to overstate the resilience of the financial system. For instance, the SNB and FBC conducted a retreat together with the Big-2 in May 2007, in which the two banks presented their stress-testing scenarios and findings which, in light of the applied benchmark, the IMF's FSAP (Financial Sector Assessment Progam) Banking Sector Stress Testing, were considered as sufficiently cautious and supported the, as it turned out, erroneous view that the Swiss banking sector was resilient. Currently, FINMA is in the process of developing additional building-block tests at the institutional level to supplement the SNB's top-down approach.

Root causes and impact of the crisis

The crisis began to be felt in Switzerland around the fourth quarter of 2007 as the credit quality of US collateralised debt obligations (CDOs) based on sub-prime mortgages deteriorated, the effects spilled over to major interbank markets, and the Big-2 first revealed higher exposures to the afflicted assets than previously expected, with subsequent write-down announcements. Pressure increased in 2008 when several major financial institution failures in the UK and US triggered further write-downs

and losses by the Big-2. The losses of the Big-2 from write-downs, mainly from CDOs, turned out to be very large, particularly for UBS, which took cumulative write-downs of approximately US$53.1 billion through the second quarter of 2009. Although the UBS losses were not exceptional compared to those of major US banks, its write-downs were larger than for any major European bank. Moreover, UBS' write-downs were extraordinary in relation to its capital – they were greater than for any surviving US institution and well above the ratios of any other European bank. CSG's write-downs were essentially in line with those of other European banks. The Swiss banks' aggregate write-downs were also larger as a ratio to GDP than for any other OECD country except Iceland.

According to the 2009 OECD survey on Switzerland, the basic source of the Big-2 losses was their adoption of a strategy (in their investment banking units) involving the pursuit of rapid growth in revenues through the trading of complex structured instruments based on mortgages and other assets whose individual risk was supposed to be hedged through diversification – a strategy shared by major international bank peers. The Big-2 also shared the weaknesses of other major international banks in seriously underestimating the risks entailed by their activities in the structured instruments business: the probability of credit deterioration in the assets underlying the structured instruments was understated or not even identified; the ease with which the banks would be able to reduce their risk exposure in times of market turmoil was overstated; and too much reliance was given to ratings of major rating agencies. However, in an ex post analysis, the Big-2 went further than most banks in leveraging their balance sheets to boost revenues. The average ratio of Tier 1 capital to book-value assets for the Big-2 fell from seven per cent in 1995 to around four per cent in 2000, to drop further to about two per cent in 2006. Despite their comparatively high leverage, the Big-2 were, and still are, relatively well capitalised on a risk-adjusted basis. With reference to Citicorp and RBS, two financial institutions that also had comparatively high capital adequacy ratios (CARs) while taking large write-offs in the crisis, the 2009 OECD survey on Switzerland appears to provide an interesting analysis. The combination of high CAR with high leverage is characteristic for those banks which grew their leveraged trading activities most aggressively in complex structured instruments. The high CAR encouraged a sense of confidence that risks were being contained, but the low ratios of capital to book-value assets proved to be a better measure of vulnerability during the crisis.

In light of the relatively high ratio between Swiss banks' total balance sheets to GDP, it is not surprising that the problems of the major Swiss financial institutions led to an increase in market assessments of Switzerland's sovereign risk. The risk premium on Swiss sovereign debt rose sharply along with those of other affected jurisdictions during 2008, although it has since fallen back. Some believe, perhaps with a view to the Swiss banks' total balance sheets to GDP ratio, that the Swiss financial institutions' problems are perceived to be more closely connected to Swiss sovereign risk than in other jurisdictions.

The UBS bailout

Although UBS started to improve its capital base relatively early in the crisis (December 2007) by entering into a binding agreement with investors from Asia and the Middle East to issue mandatory convertible notes (MCN) with a face value of CHF13 billion, asset deterioration and liquidity needs continued and triggered additional capital funding requirements in April 2008. Following its announcement to write down another US$19 billion, and shortly before the next extraordinary shareholders' meeting in which it called for the supply of CHF15 billion in additional equity funding, UBS, on a voluntary basis, published a shareholder report on 18 April 2008. This shareholder report set out the key factual findings, including the principal causes of the sub-prime losses UBS identified in retrospect following an internal review of the various businesses incurring the sub-prime losses. UBS' unprecedented 50-page mea culpa report was in fact a summary of the findings of an internal investigation required by and reported to the FBC on 7 April 2008. The report blamed UBS' losses on risk management, senior manager oversight, and a failure to react quickly enough when the sub-prime market started crumbling. UBS also attributed some of the blame to its collapsed hedge fund division and said the bank had focused too closely on maximising revenue in the fixed income division. The report detailed numerous failures in the build-up of the write-downs which largely hit three of the group's divisions. The relevant divisions were UBS's hedge fund arm, Dillon Read Capital Management and, in the investment banking group, the CDO desk and the foreign exchange and cash collateral trading desk. Of the total sub-prime losses, the CDO desk, which had been beefed up heavily in the year before the onset of the credit crunch, accounted for roughly 66 per cent, Dillon Read was responsible for 16 per cent, and ten per cent emerged from foreign exchange trading.

Irrespective of UBS' effort to restore its asset and liquidity base, problems continued in summer 2008 and prompted an emergency rescue package orchestrated by FINMA, the SNB and the Swiss Government. On 16 October 2008, the FBC, the SNB and the Swiss Government jointly announced support measures and an agreement under which a special investment vehicle (the SNB Stability Fund), essentially a corporate law limited partnership structure available under the Collective Investment Schemes Act, was created to acquire from UBS up to CHF60 billion of sub-prime and other materially impaired structured assets, defined in designated asset classes. The asset classes concept required UBS to either transfer all assets within a specified class or to retain such class on its books in its entirety. The limited partnership was financed in part by equity provided by UBS equal to ten per cent of the value of the assets acquired and was subsequently written down. The remainder was financed by a non-recourse US$ loan (in light of the fact that the assets acquired by the limited partnership were denominated in US$) granted by the SNB at an interest rate of 250 basis points above the one-month LIBOR. The limited partnership has an initial term of eight years, extendable to 12 years, presumably allowing for sufficient time to sell the assets in more favourable market conditions.

Another component of the agreement was a purchase by the Swiss Government of CHF6 billion in MCN issued by UBS. The MCN carried an interest rate of 12.5 per cent, were convertible into shares no later than 30 months after their issuance and the Swiss Government was entitled to resell the MCN in the market. Together with the write-downs of the toxic assets and the transfer of the UBS equity injected into the limited partnership, the plan restored UBS' capital to the original level and gave the Swiss Government the option under the MCN to an equity stake in the bank of up to 9.3 per cent. The Swiss Government's participation was moreover conditioned to a 'say on pay' on employee compensation; that is, the condition referred to a pre-approval of UBS's (deferred) compensation programme by the FBC.

The total loss for UBS is thereby capped at its ten per cent equity contribution of the assets acquired by the limited partnership. The SNB will receive partial compensation in the form of UBS shares (up to 100 million share units) if the loan is not fully repaid upon termination of the limited partnership. Moreover, the SNB is entitled to the first CHF1 billion of the value of the fund at maturity above the loan amount (essentially a preferred return), with profits shared equally between the SNB and UBS above such amount. The assets effectively transferred to the limited partnership amounted to just under CHF38 billion, as a change in accounting rules towards the end of 2008 allowed UBS to transfer certain asset classes (mainly US student loans) from the trading book to the bank book. As from 2009, the limited partnership has consistently sold its assets into the market and has thereby reduced the SNB loan to CHF17.7 billion by the end of March 2010.

From a moral hazard or taxpayer versus shareholder perspective, it is interesting to note that the agreement described above between UBS, the regulators and the Government has limited moral hazard by making shareholders bear part of the losses while at the same time ensuring that these losses borne by shareholders would not materially weaken the capital base of UBS. The potential maximum loss – including losses from dilution – for shareholders would amount to (i) the initial ten per cent equity contribution into the limited partnership vehicle and (ii) any SNB profits made from exercising its option to acquire UBS shares (above another five per cent of the transferred assets at a share price of US$20) in case there are further losses in the limited partnership. Obviously, more substantial upfront costs could have been loaded to UBS shareholders that would have further limited moral hazard on existing and future shareholders. However, this would have required a larger stake in UBS from the Swiss Government and the taxpayers, respectively. In addition, the 'all or nothing' rule for the transfer of assets within the designated classes has helped to limit adverse selection risks which presumably would have only been otherwise achieved through a Government intervention in the management of the banks. Adverse selection risks have further been reduced by the loss participation (equity contribution) of UBS shareholders in the limited partnership.

Effects on the rest of the Swiss financial system

Essentially due to their different business models, other domestic commercial and private banks have been little affected by the Big-2 problems. Various domestic banks could, to some extent, compensate the general downturn in the Swiss economy by receiving a substantial inflow of funds from the Big-2 in 2008. In particular, state-guaranteed cantonal banks that initially welcomed the inflow of significant cash positions encountered considerable cash management challenges as customers preferred to hold on to their cash accounts. This trend continued through the summer of 2008 (although banks lowered their interest rates to less than one per cent on cash deposits), until some of the funds were subsequently transferred back to the Big-2, facilitated by the SNB's stability measures.

It is said that a number of different factors help to explain the overall limited damage suffered by the Swiss financial system. The commercial and particularly residential real estate markets did not go through the downturn experienced by most other jurisdictions, as demand remained comparatively high. In addition, the stringent mortgage lending practice by Swiss banks, which has historically been quite conservative and has been further tightened as a result of several market corrections in the 1990s, has remained largely the same in the years prior to the crisis (and thereafter). The concentration of domestic banks on traditional lending and limited trading activities has prevented them from suffering a larger impact from the declining financial market prices. Moreover, the Swiss franc, traditionally considered as a safe haven currency in times of turmoil, has remained robust, although evidence exists that carry trades may have contributed to such robustness. While other factors such as a long record of macroeconomic stability, current account surplus and fiscal prudence may have been relevant as well, the relatively early decision in October 2008 to transfer toxic assets from UBS to the SNB Stability Fund has certainly helped to restore confidence. In general, the measures taken by the SNB and FINMA since the crisis materialised would appear to have played a critical role in limiting its impact on the domestic economy. Most likely, the SNB's easing of monetary policy and the injection of US$ liquidity, beginning in November 2007, have been essential in ensuring that Swiss financial institutions could obtain US$ needed to fulfil their obligations (as more than half of Swiss banks' assets are denominated in foreign currency, mostly US$, in turn a result of the large size of the Swiss banking sector relative to the size of the Swiss economy). These measures, together with the statements made by the Swiss Government that further measures would be taken, including an increase in the nominal amount in the deposit protection schemes and, if necessary, a direct Government guarantee of bank obligations, helped to stabilise confidence in the overall financial system.

The initial regulatory reaction with respect to the capital adequacy and leverage ratios

In light of the Big-2 concentration, the need to better contain systemic risk is obviously the key priority for Swiss financial reforms. It is perhaps fair to say that the potential costs of rescuing one or more of the large financial institutions upon a failure would stretch the financial resources of the Swiss Government to the limit or could exceed its capacity; that is, the institutions would be too big to be rescued. Such risk scenario could be bolstered by currency constraints, as the comparatively large foreign currency assets and liabilities of the largest institutions in relation to the overall financial system and Swiss GDP could magnify the impact of systemic risk to the Swiss economy. The 'too-big-to-fail' (TBTF) status of the Big-2 also means that moral hazard is large and inevitable, and cannot be expected to be fully internalised by the institutions themselves. The Big-2 phenomenon and its ramifications did, of course, exist before the crisis and may have added to a comparatively prudent, though as it turned out not sufficiently effective, regulatory approach.

On an international level, the FBC has taken a relatively conservative approach ever since the introduction of the Basel II accord (Basil II). The FBC implemented Basel II in 2005/06 together with a 'Swiss Finish' – an extra buffer of 20 per cent for Swiss banks over the minimum capital requirements of Basel II which at the time was deemed overly burdensome and a competitive disadvantage for the Swiss financial institutions. In the middle of the crisis and the UBS bailout, the FBC required the Big-2, on 16 October 2008, to commence with the incorporation of two additional capital adequacy requirements (intended as a combination of preventive and corrective measures):

(i) a **risk-weighted capital requirement**: a capital adequacy target ratio between 50 and100 per cent above the international minimum requirements (Pillar I) of Basel II (that is, at least 12 to 16 per cent of the BIS minimum). The FBC's argument was that this extra buffer would be necessary and appropriate by applying the additional capital adequacy requirements under Pillar 2 of Basel II (supervisory review process). In particular, such flexibility would be necessary to allow the measure to develop a stabilising and, at the same time, counter-cyclical effect. In good times, the banks would need to increase their target level to 200 per cent (100 per cent Pillar 1, 100 per cent Pillar 2), and the buffer would be available for use in bad times down to a regulatory intervention level of 150 per cent; and

(ii) a **leverage ratio**: the leverage ratio defines the proportion of core capital to total assets and is at a minimum of three per cent at group level and at four per cent on a single entity level. The FBC took the position that in good times the minimum leverage ratio on a single entity level should be five per cent; however, it agreed to a politically driven carve-out. As the Big-2's domestic lending activities are important for the Swiss economy, domestic lending and certain other domestic claims are exempt from the leverage ratio. Conversely, a prudent aspect of the introduced leverage ratio is that all assets acquired through investment banking

are to be fully included in the calculation. The FBC concurred with the general perception that a leverage ratio could be viewed as 'backstop', as CAR underlying risk measures would inevitably be imperfect. While both banks need to comply with these regulatory measures by 2013, the Big-2 indicated in their 2009 annual reports that they had already complied with the leverage ratio requirement of three per cent at group level for the business year 2009.

The re-introduction of a leverage ratio reflects the conclusion that the problems of sustaining highly leveraged balance sheets suggests that CARs, however refined their modelled calculations may be, do not provide sufficient protection against risks, especially under extreme market circumstances. The case for a prudential leverage ratio in Switzerland seems particularly strong given the very high ratios of the Big-2 before the crisis (the leverage of the Big-2 increased 100 per cent from 1995 (16.6) to 2005 (33.4), together with an increase of their balance sheets from CHF730 billion to CHF2,340 billion in the same period). The SNB has recommended and continues to recommend that the ratio of capital to assets for the largest Swiss banks should be no less than five per cent in 'good times'.

Although these measures were announced considerably before the regulatory reform marathon gained momentum on an international level and, therefore, were generally considered a swift and positive regulatory reaction to restore stability, commentators have continued to argue for an even stricter regulatory environment given the eminent role of the Big-2 in the economy. For instance, the 2009 OECD survey on Switzerland states that the implementation of the new standards could be accelerated and even higher CAR minima may ultimately be needed. The Big-2 would then have overall capital ratios above the lower minimum on the basis of the Basel II definitions that would put them roughly at the median of the capital ratios of the largest 25 international banks in the OECD, which may not yet be adequate with a view to their importance for the Swiss financial sector. In addition, the new requirements would establish a rudimentary mechanism subject to further improvements such as: (i) a reconsideration of the profit criterion in the new rules which, if literally applied, could lead to a relaxation of capital requirements if a bank underperformed the industry due to its own weaknesses; or (ii) the incorporation of a systemic risk indicator such as the size of a bank's assets relative to Swiss GDP. With respect to the leverage ratio, several considerations support a somewhat higher floor for systemically relevant financial institutions than the thresholds required by the FBC and now FINMA. Some commentators express doubts as to whether the three per cent group and four per cent single entity leverage ratios would be sufficient to minimise potential losses, in particular, if a financial institution enjoys a de facto Government guarantee. Other commentators indicate that the specified group-level minimum is only modestly above the level that the Big-2 maintained before the crisis and is below the ratio maintained by a significant number of international banks.

Despite the various critical comments expressed since October 2008, it should be noted that the FINMA predecessor's prompt reaction to introduce these new requirements clearly helped to restore confidence in the financial sector at a relatively early stage.

Improvements in liquidity management

It seems to be a generally accepted finding that inadequate liquidity requirements and management were key factors in magnifying the systemic risks that emerged during the crisis, and liquidity oversight and management need to be given higher priority by banks and their regulatory bodies. The Basel Committee on Banking Supervision (BCBS), the Committee of European Banking Supervisors (CEBS) and other regulatory committees stress several principles for better liquidity regulations for the largest financial institutions, including that (i) the adequacy of liquidity buffers needs to be calibrated to the result of realistic stress tests approved by supervisors and carried out with the banks; and (ii) liquidity buffers should consist of cash and other assets that can be expected to remain highly liquid in periods of market pressure, and which are eligible as collateral at central banks' lending facilities. The SNB and FINMA have contributed to such development on an international level, and they have introduced a revised liquidity regime for the Big-2 in 2010 (see below at page 138).

Deposit protection scheme and additional reorganisation proposals

In the midst of the crisis, the Swiss Government passed an emergency law in December 2008 to enhance protection for Swiss bank depositors. It increased the depositors' bankruptcy privilege to CHF100,000 per depositor and bank, and raised the maximum amount covered by the Swiss Banks' and Securities Dealers' Deposit Protection Association (DPA) from CHF4 billion to CHF6 billion. The DPA is a banking industry self-regulatory organisation. Moreover, the emergency law required banks to hold assets in Switzerland in an amount equal to 125 per cent of the amount of the protected deposits, which essentially constitutes an additional liquidity measure directly aimed to support bank creditors, presumably with an indirect additional liquidity cushion effect on the overall liquidity management requirements of Swiss banks. On 11 September 2009, the Federal Department of Finance opened public consultation on a draft Bank Deposits Protection Law (DPL). While the proposed DPL aimed to make the emergency law permanent, it also contained a number of fundamental changes to the existing deposit protection scheme such as the switch to a pre-financed deposit protection fund. In addition, FINMA would have received broader competences to intercept and reorganise, including competences to separate banking activities from each other or to transfer certain activities to other institutions and bridge banks. The draft DPL however, was criticised as inadequate, costly and inefficient in subsequent hearings, whereby criticism focused on the deposit schemes as such and not so much on the envisaged changes in FINMA's resolution authority. While the plans for the fundamental revision of the deposit protection scheme were generally considered too controversial to constitute an adequate Swiss solution and discontinued later on, it nevertheless seems worth reiterating some of the proposals for the purposes of a broader international policy discussion.

Background

Deposit protection in Switzerland is based on a two-pillar system established in the Banking Act. The system applies to banks incorporated, domiciled and licensed in Switzerland as well as to licensed Swiss branches of non-Swiss banks. The first pillar is a bankruptcy privilege that gives depositors a preferred claim in the bankruptcy of a Swiss bank, now a maximum of CHF100,000 per depositor, which must be paid from the assets of the bank in priority to its other unsecured creditors. The second pillar consists of a guarantee undertaking for deposits as defined in the DPA. Swiss banks that accept deposits are required to become members of the DPA. If a bank fails, the DPA solicits contributions from its member banks, based on the relative size of the member's deposit base, to cover the guaranteed amount of deposits. The contributions paid by member banks will be transferred by the DPA to the administrator of the failed bank for payout to depositors. Although these two pillars are interrelated, their scope is somehow different. For example, a depositor with a non-Swiss branch of a Swiss bank would be protected by the bankruptcy privilege, but not by the DPA's deposit guarantee. Even prior to the crisis, the DPA guarantee was also criticised as a potentially weak and pro-cyclical means, because member banks would be further impaired by the payment of DPA guarantee contributions during a widespread banking solvency crisis.

Establishment of a pre-funded deposit protection fund

The proposed DPL would have made the 2008 emergency amendments to the Banking Act permanent, and it would have replaced the DPA's deposit protection with a pre-funded deposit protection fund (DPF).

The DPL would have required banks to contribute cash and to pledge assets to the DPF in a total amount equal to three per cent of the privileged deposits of all Swiss banks. Swiss banks hold approximately CHF325 billion in privileged deposits that would have been protected by the DPF. The target amount for the DPF would have been approximately CHF9.75 billion, respectively. The DPF would have been established as an independent fund under public law. Banks would have needed to fund two-thirds of this amount through annual contributions and one-third through pledging assets to the DPF. The latter would have constituted eligible collateral if it had been acceptable to the SNB in securities repurchase ('repo') transactions. Accordingly, pre-funding could have been replaced at least in part by less expensive collateral without affecting the level of protection afforded to depositors.

Presumably, full funding of the DPF would have been achieved over a period of more than 20 years. Subject to individual adjustment based on a bank's specific business risk profile, each bank would have made an annual contribution in an amount equal to four per cent of its share in the target amount for the cash portion of the DPF. Such funding of the cash portion would have lead to an industry-wide contribution of approximately CHF260 million per year.

If the DPF had sustained a loss before it had been fully funded, banks would have been required to contribute an amount equal to a maximum of two per cent of privileged deposits to the extent needed to cover the DPF's shortfall incurred by payments made for deposit protection purposes. The DPL would also have required each bank to hold additional reserves to cushion this contribution obligation for DPF shortfalls. In case of additional shortfalls, the DPL would have allowed the DPF to either request a loan (at market-based interest rates) or a guarantee from the Swiss Government to finance or secure unfunded deposit protection payments. In each case, the DPF would have been required to pay an annual commitment fee to the Swiss Government, and the DPF would have charged each bank its proportional share of the commitment fee.

Recurring annual costs associated with the proposed risk-based and pre-funded scheme were projected at nine to 33 basis points of the privileged deposits on a single bank level (depending on the risk profile of an individual bank) and at 12 basis points on an average industry-wide level, probably excluding additional refinancing costs of the annual contributions (including loss of interest) and opportunity costs.

Deposit protection and TBTF

According to the International Association of Deposit Insurers, explicit bank deposit protection measures have been adopted in more than 100 countries, and many countries have increased their deposit protection schemes amid the financial crisis. Although many of these schemes are said to reinforce investors' confidence or strengthen the resilience of the banking sector, critics continue to contend their viability and effectiveness. They argue, for instance, that deposit protection schemes: (i) increase moral hazard; (ii) cannot cope with systemic financial crises because the failure of a single large bank or a few medium-sized banks would result in losses far greater than most deposit protection funds; (iii) impose undue costs on banks resulting in lower interest rates on deposits or higher interest rates on loans, or both, and hinder banks' accumulation of additional capital; and (iv) result in the unproductive hoarding of funds by governmental agencies. It seems doubtful whether 'strong' or 'costly' deposit protection significantly increases moral hazard in the banking sector, at least in the context of 'too big to fail' (TBTF). Generally, the financial crisis has shown that governments are reluctant to allow banks to fail for reasons of 'national interest' or for unwelcomed ramifications on the national economy. Such implicit governmental guarantees would appear to be a far greater contributor to moral hazard theory than the existence of comprehensive deposit protection or its subsequent increase in a pending crisis. Many economic arguments against deposit protection – for example, penalty on profits, hindering of capital accumulation and misallocation of funds – are directed at the scope of existing schemes, how and when they should be funded, and by whom, rather than at the core issue, that is whether deposit protection schemes are in fact needed in a policy environment of implied or explicit Government insurance of TBTF risk. Whether a deposit protection scheme is an additional or ancillary valid

means to contain systemic risk from exceptionally large financial institutions becomes particularly evident in connection with the Big-2. At the end of 2008, the Big-2 together held privileged deposits of more than CHF60 billion, approximately ten times more than the maximum protection amount under the DPA (about six times more than the increased maximum amount under the proposed DPL) or more than ten per cent of Switzerland's GDP in that year.

From this perspective, deposit protection seems not relevant for TBTF, or 'too interconnected to fail' or exceptionally large banks, as they are perceived to be protected by the broader cover of Government insurance, in any case. Furthermore, a deposit protection fund would hardly be large enough to protect all its depositors if such a bank were nevertheless liquidated. In light of this, deposit protection would rather seem to be a means to protect depositors in banks that are not systemically relevant and eligible for standard bankruptcy proceedings with a view to mitigating institution-specific herding behaviour (such as bank runs) that may irrationally prejudice customers' conduct in the whole sector. It delineates from the above that the issue of a suitable and efficient deposit protection scheme may merit further study once policy decisions have been made on the scope of any administrative agency's resolution authority, for instance, in the event that such authority includes a 'no bailout' strategy. The issue is illustrated by an alleged statement of a customer lining up in front of a failing bank: 'you don't run if you think your bank is not allowed to fail, you don't run if you think there is no money left for you, you only run if you think your bank will fail and there is some money left for you to grab'.

Revised insolvency scheme applicable to banks

Pursuant to the current provisions of the Banking Act which were enacted in 2004, FINMA may commission a person with the restructuring of a bank (restructuring commissioner, *Sanierungsbeauftragter*), if 'well-founded prospects' exist that a distressed bank may in fact be restructured. The new provisions proposed by the Swiss Government in connection with the DPL envisaged deleting such statutory obligation of FINMA to delegate restructuring activities to a designated commissioner, and would have given FINMA broader and general resolution authority to decide on any measures necessary or appropriate in connection with restructuring proceedings (which would have included the right, but not the obligation, to appoint a restructuring commissioner).

Perhaps the most important amendment to the bank-specific restructuring proceedings would have been FINMA's authority to have certain bank services of a failing bank continued (for the benefit of the depositors). The proposal suggested initiating restructuring proceedings not only with a view to carry on the bank's aggregate businesses under its current structure, but also to limit business continuity to certain business lines while others are liquidated or restructured; continuing businesses would either be transferred to a bridge bank or merged into an existing bank. Consistent with the Banking Act, the restructuring plan would need to be approved by FINMA. In case the restructuring

plan would affect creditors' rights, FINMA would be required to submit the plan to the creditors who may reject it within deadlines set by FINMA. Assets and liabilities (including real estate and existing contracts) of the failing bank could be transferred to a bridge bank or an existing third party bank by operation of FINMA approving the restructuring plan. No other measures, approvals, consents or formalities would be necessary for the transfer to be valid. In particular, the provisions of the Swiss Merger Act would not apply. The proposed concepts had some similarities with the US Federal Deposit Insurance Corporation's 'whole bank purchase' or 'clean bank purchase' procedures.

Contamination risk by means of termination clauses was addressed in the draft DPL to the effect that neither any change of control nor any contractual assignment resulting from such forced business transfer could have been considered as events of default allowing any third party to terminate the agreement concluded with the failing bank or for any close-out netting to apply. The draft DPL held that a respective contractual clause would be void and incompatible with Swiss *ordre public*. It goes without saying that these provisions were aimed at facilitating an expeditious transfer of bank assets (and liabilities) in times of distress. However, they would also have substantially infringed freedom of contract and the rule of law; that is, that contractual agreements concluded prior to the insolvency of one party would be valid and enforceable (also against any restructuring commissioner or liquidator) in the insolvency of such party.

The draft DPL further enabled FINMA to request the DPF to allocate certain fund assets in order to facilitate or expedite these restructuring tasks; that is, the purpose of the deposit protection funds would have been expanded to include other presumably preventive measures generally associated with deposit protection and bank runs, respectively. The DPF would have had an obligation to approve such a request if: (i) the restructuring of the distressed bank limited its own risk of loss; (ii) the protected deposits were covered by assets (of the failing bank); and (iii) the allocated DPF fund assets were not used for the expansion of existing, or the development of new, banking businesses. The DPF would have been restricted to provide fund assets for these purposes if the requested funds had exceeded 25 per cent of the protected deposits of the failing bank or ten per cent of the DPF's target amount (whichever is greater).

It is perhaps fair to say that the draft DPL may have gone beyond what could have been achieved by balancing the various political, economic and legal considerations. By making an effort to include the risk of systemic banks and, eventually, to mitigate systemic crisis risk under a deposit protection scheme, the Swiss Government presented a very cost-intensive scheme which appears to overrun the current needs and political wills but is yet too weak to achieve the proposed new goals. It should also be noted that the draft DPL was published a year after the bailout of UBS; that is, a year after an implicit state guarantee was called, which may have confirmed critics and industry representatives in their dissenting view. Nevertheless, the concept of a pre-funded scheme would not seem per se to be an inappropriate or imprudent proposal, because it would be likely to be counter-cyclical and would spread the cost of losses over a longer period of time.

International harmonisation and coordination

It is plausible that, in theory, a meaningful response to the phenomenon of a global financial institution would be a single global regulator with global resolution authority. In reality, there would be reliance on national expertise and local circumstances comingled with national, regional or other political interests. No regulator would cede national authority to an international regulator – currently a Gordian Knot that perhaps awaits the bold stroke of the next generation. Although the model of supervisory colleges is often described as the solution for the past, which may be relevant for the present but not for the future, the college of supervisors concept nevertheless seems to be a pragmatic and realistic opportunity (that may be institutionalised relatively quickly, in particular, with respect to information exchanges) to provide national regulators with a more global platform allowing them to harmonise national resolution authorities, to coordinate cross-border resolutions and to have a venue for crisis management in the event that systemic risks materialise.

In its 2009 survey on Switzerland, the OECD suggests considering a variety of additional steps likely to contain the risks for the largest institutions. Apart from a general comment on more stringent prudential controls and strengthened supervisory oversight which would reduce the likelihood of a catastrophic failure of one or more of the largest Swiss financial institutions, the OECD survey – obviously with a view to the significant cross-border activity of the largest institutions – elaborates on further steps to improve cross-border cooperation and sharing of responsibilities for supervision of large cross-border financial institutions (LCBFIs).

The Swiss authorities have developed effective cooperation with foreign central banks and financial supervisors over the past several years to help with the supervision of the largest financial institutions. These include regular formal and informal information exchanges and discussions with regulators of the global financial centres, including the US and UK regulatory authorities. The FBC was one of the early promoters of cross-border multilateral supervisory college arrangements, chairing 13 colleges at the beginning of 2008. Core colleges with banking supervisors from the US and UK have been in existence for the Big-2 since 2000 and separate bilateral regional colleges with banking regulators from major Asian economies have more recently been established. Colleges have also been instituted for the major Swiss insurers. The colleges have largely focused on information sharing, although those for the Big-2 have started to consider collective actions in certain areas. Clearly, FINMA faces an almost unique challenge in terms of the small size of the peer group for the two most complex financial institutions, and it is sensibly addressing this through seeking to enlarge the size of the effective peer group through dialogue with foreign supervisors of comparable financial institutions. Moreover, the colleges enable FINMA in its efforts to enhance (informational) independence from the largest banks, and the necessary resources should be devoted to the continuation and expansion of such initiatives. Accordingly, a general comment on short-term recommendations should include the fact that FINMA and other regulatory agencies should be encouraged to at least

maintain and probably intensify the frequency and volume of information exchange with other supervisors, notwithstanding the resource costs involved.

From a policy perspective, colleges of supervisors would have the flexibility to address information sharing among involved parties, including details on LCBFI group structures and intergroup dependencies, development of contingency plans for funding LCBFI in the event of market distress, ring-fencings (potential impediments such as restrictions on the ability of subsidiaries to lend or transfer funds to their home parents) or living wills (contingency arrangements for the unwinding of LCBFIs in case of failure). Moreover, any such international activity by regulators towards harmonised cross-border regulation requires a participating regulator to have the respective authority in accordance with domestic legislation, that should include the authority to recognise and enforce (resolution) decisions by foreign authorities in its jurisdiction.

In any event, the international harmonisaton efforts – certainly needed from a Swiss perspective to better contain systemic risks from its LCBFIs – are not sufficient to reduce the risk adequately in light of the exceptionally severe damage the LCBFIs could impose on the Swiss economy in a worst case scenario.

2009: the regulatory reform discussion year

Economic developments

Financial strains have eased considerably since their peak in early 2009 as markets have started to assess the prospects of major financial institutions more optimistically. The financial conditions of the Big-2 and the major insurance carriers have improved since the summer of 2008 as substantial capital injections from private and other sources were made in the amount of approximately US$28 billion for UBS (in addition to the Swiss Government capital injected in connection with the bailout) and nearly US$12 billion for CSG. Both banks have reduced and have been required to reduce their exposure to risky assets by downsizing their balance sheets, accordingly. However, total assets of Swiss banks continue to remain at the level of five times of the Swiss GDP, and the largest financial institutions continue to retain sizeable trading exposures.

What is the right approach?

In line with the global discussion on regulatory reform, a great number of potential approaches have been discussed among Switzerland's law-makers and regulators. In a news conference on 18 June 2009, Philipp Hildebrand, Chairman of the SNB Governing Board, while supporting FINMA's recent measures on the capital adequacy and leverage ratios proposed the following approach to bridge banks and size limits:

> 'The SNB therefore believes that careful consideration must also be given to alternative approaches. These include rules governing the organisational structure of large financial institutions. The aim of such rules would be, in a crisis

situation, to split off those units of a bank that are important for the functioning of the economy and wind down the rest. This does not mean, however, that this type of approach would question the universal banking model as such. The SNB is aware that rules governing the organisational structure of large financial institutions are not easy to draw up. Legal and operational aspects would therefore need to be analysed with the requisite care and any regulations drawn up in close collaboration with the banks affected.

We are convinced that everything needs to be done to implement one of these approaches for facilitating the wind-down of large financial institutions. If significant progress is not achieved within a reasonable timeframe, measures that address the size of the banks should also be examined. One way in which the size of a bank can be influenced is through capital regulations. Capital requirements that are dependent upon size reduce a bank's incentive to inflate its balance sheet without restraint. Measures with a direct impact on the size of banks are also conceivable. A size restriction would of course be a major intervention in an institution's corporate strategy. Naturally the SNB is aware that there are advantages to size. For this reason, the advantages and disadvantages of such a measure would have to be examined and weighed up very carefully. Nevertheless, in the case of the large international banks, the empirical evidence would seem to suggest that these institutions have long exceeded the size needed to make full use of these advantages. It should be noted that although the instrument of size restriction is far-reaching, it is by no means new in economic policy. For decades it has been one of the tools for preventing market dominance in the area of competition policy. Within the context of financial stability, the objective of such a measure would be to reduce risks to the stability of the banking and financial system, rather than to maintain competition.'

The statement is noteworthy for various reasons. On the one hand, it would appear that the 'threat' of size limitation is instrumentalised to support a bridge bank concept; it is obvious that an important potential drawback is that risks incurred by LCBFIs are determined not only by their aggregate size but also by the nature of their activities and their connections to financial markets and other financial institutions. On the other hand, competition law measures are introduced to address TBTF considerations. Interestingly, competition or antitrust law considerations have only very recently been introduced to the TBTF discussion.

Another approach has favoured the implementation of the 'Volcker Rule' in Swiss banking by directly restricting the scope of business of a systemically-critical institution, for instance by requesting the Big-2 to divest their investment banking divisions into separate legal entities with no recourse on the original institution. Obviously, this would fundamentally change the Big-2's character as universal banks, although they would retain wealth and asset management and much of the business financial service activities that used to be their main focus. The rationale of the argument is essentially the same as advocated in other markets; the causes for the near failure of

UBS would originate in its investment banking unit. Irrespective of whether or not the opposing view that favours a universal banking system on the basis of its overall macroeconomic benefits (or by reference to the downsides of the breakup model, for example disproportionate restrictions of constitutional rights (freedom of commerce), result-oriented regulation that supports regulatory arbitrage (shadow banking), or the increase of Peltzman-effect), certain aspects of such an approach may nevertheless appear to deserve further analysis. For instance, certain commentators supporting this approach believe that in a regulatory environment that separates investment from commercial banking, hedge fund activities may be better regulated by more transparency – though not by restrictions on risk-taking – and rating agencies would not need to be regulated as commercial banks would be prohibited to engage in proprietary trading. In essence, the theory is that by imposing one (big) statutory ban on the bank's scope of activities, many other or additional regulatory initiatives would become obsolete.

Other approaches have essentially referred to OECD suggestions by requesting to shift some of the riskier Big-2 group activities to subsidiaries that would be structured so that they had no legal claim on the Swiss parent or the group's systemically most important components. In theory, such holding or even non-operational holding structures can insulate the systemically most important components of the group from losses in its other subsidiaries to a degree that is not possible for universal banks.

It is evident that aggregate size limits or restrictions on the scope of business of the Big-2 could impose costs on the Swiss economy. From a strictly cost benefit perspective, it seems rational that the local (macroeconomic) benefits of having major global institutions domiciled in the home country may justify certain local costs in connection with these restrictions to better contain systemic risks from the largest institutions. However, limits or restrictions could directly lower the profitability and growth of the banks and may lead to a transfer of business now conducted in Switzerland to subsidiaries abroad. This would also directly lower employment and value-added in the Swiss financial sector. Moreover, the disproportion between the size of the Big-2 and Switzerland's GDP underscores the need to get out of the politically motivated TBTF trap. In any event, any policy decision on TBTF would need to weigh the overall costs and presumed effects of these restrictions to the Swiss economy against the potential damage that would be incurred in the event of failure of one or more of the largest financial institutions. A cross-border resolution or insolvency framework would certainly complement and facilitate stronger regulation of LCBFIs. While there is little doubt that international harmonisation and coordination of resolutions authorities is an effective means to contain contagion from a failing LCBFI, a realistic short-term outlook suggests that colleges of regulators may currently constitute a viable interim solution towards the long-term goal of an international framework. The SNB and FINMA have continuously emphasised the importance of such arrangements to limit the risks posed by the largest financial institutions under their supervision.

In November 2009 the Swiss Government, with a view to better limiting systemic

risks by large Swiss enterprises, commissioned a group of experts (Expert Commission) with the task of providing a report by the summer of 2010 which should: (i) contain a definition of 'too-big-to-fail'; (ii) analyse the benefits large enterprises have for all sectors of the Swiss economy and the consequences their collapse may have from a macroeconomic perspective; (iii) illustrate how risks associated with large enterprises may be contained for the Swiss economy; and (iv) propose potential legal and regulatory action items and priorities.

Corporate governance and incentives

Most likely triggered by the UBS bailout package (see above), FINMA has been among the first national financial supervisory authorities to take specific steps towards developing prudential rules for compensation that better address prudent risk-taking. For instance, a draft circular on compensation schemes was published in June 2009 and came into effect on 1 January 2010 (Compensation Circular). The Compensation Circular requires that performance-based compensation systems be sustainably based on a financial institution's longer-term performance and consider specific business risks incurred by such institution. The Compensation Circular applies to all FINMA licensed financial institutions, such as banks, securities dealers, collective investment schemes and insurance companies, including their consolidated Swiss and non-Swiss affiliates. As of 1 June 2010, financial institutions that are required to have a minimum CAR or solvency ratio of at least CHF2 billion must comply with the Compensation Circular. Financial institutions whose minimum CAR or solvency ratios are below such a threshold are not obligated to comply with the Compensation Circular; however, FINMA recommends that these institutions nevertheless adhere to the principles expressed therein.

The Compensation Circular, adhering to a combination of a principle and rule-based approach and, essentially, implementing the FSB Principles for Sound Compensation Practices of 25 September 2009 (FSB Principles), specifies the responsibility of the board of directors for ensuring that compensation principles are implemented, and requires it to produce a separate report on compensation on the basis of a 'comply or explain' approach. The report needs to be published to shareholders in accordance with corporate law disclosure requirements and, in any event, must be submitted to FINMA. In addition, the Compensation Circular requires that internal control bodies are involved in procedures with respect to the design and operation of the compensation system. Deferred compensation should be aligned with long-term value creation and the time horizons of the risks associated with the business, including a deferral period for executive management of at least three years. In line with the FSB Principles, the Compensation Circular also requires a clawback on any unvested portion in the event of a negative performance of the institution and/or the relevant line of business in any year during the vesting period.

UBS has been required to adhere to the principles set forth in the Compensation Circular in the beginning of 2009. FINMA has indicated that, subject to the

developments in international financial centres, including the implementation of the respective FSB Principles, it will consider strengthening or, as the case may be, relaxing the principles contained in the Compensation Circular. Conversely, FINMA has acknowledged that the Compensation Circular, although considered to be an effective step towards regulating certain behavioural risks associated with the financial crisis, may conflict with certain rules of law contained in labour and tax law which may require further consideration by the Swiss legislator or courts.

Regulatory resources and supervision

On 14 September 2009, FINMA published its report on the financial crisis and financial market supervision; in essence, a self-assessment of the regulator's activities and measures taken during the crisis. One of the more striking observations in the FINMA report is the statement that the reports issued by the auditor of UBS did not contain any general information that could have helped in foreseeing or avoiding the crisis. It had been a matter of widespread international comment that, in general, audited financial statements provided little warning of the problems to come as they are explicitly not forward-looking. However, the auditors play an additional and quite separate role under the Swiss dual system that assigns a supervisory audit function to them (see above). Although it seems clear that one factor contributing to the problems at UBS was serious shortcomings in the bank's own information and risk management, the question was raised as to whether the auditors performed their own supervisory duty adequately or, if they did, whether the mandate given to them by FINMA was appropriately specified. Clearly, serious shortcomings have emerged in countries where supervisors perform their own inspections directly, and it may not be self-evident that a change from the dual system to the use of direct inspections is necessary or appropriate, but a number of eminent commentators advocate a fundamental review of the dual system, at least for the Big-2 if not for all Swiss banks.

2010: change continues

In April 2010, FINMA's board of directors approved the Guidelines on Financial Market Regulation (FMR Guidelines) which define FINMA's regulatory and policy process. The FMR Guidelines have been coordinated with the Swiss Government and are based on the FINMASA that sets forth various principles for FINMA's regulatory activities. In accordance with these principles, FINMA may only regulate to the extent necessary to fulfil the goals of prudential supervision (that is, protect creditors, investors and policy holders, safeguard the operational efficiency of the financial markets and uphold the reputation and competitiveness of the Swiss financial centre). Moreover, these principles inter alia require FINMA to apply a cost benefit analysis on any regulatory measure, assess regulatory options and make projections on effectiveness. Clearly, some of the principles merely reflect existing regulatory practice. However, the FMR

Guidelines underscore and highlight one aspect that tends to be neglected in the broad discussion on wider systemic reform: transparency of the regulatory process and adequate training as well as education of staff. To this end, the principle-based language in the FMR Guidelines outlines that FINMA must ensure transparency in the regulatory process; involve affected financial institutions and third parties by means of hearings; use and publish discussion and position papers; as well as ascertain appropriate and adequate training, motivation and career development of FINMA staff. It is needless to say, the latter is core, and a key precondition to any effective supervision. David Green, the former Head on International Policy FSA, consolidates various of these issues in his expert opinion on FINMA's conduct during the crisis addressed to the Swiss Government, as follows:

> 'Supervision is a risk taking business. It operates within an uncertain and unpredictable world with extremely limited rescources on the basis of information that can often be incomplete or wrong, using tools whose impact depends on the behavioural response of others.'

Liquidity requirements

FINMA and the SNB announced on 21 April 2010 that they had agreed on a substantially revised liquidity regime applicable to the Big-2 effective as of 30 June 2010. The revised framework will replace existing liquidity requirements from 1988 and, essentially, adopt the recommendations expressed by various international regulatory bodies and associations. The core element of the new framework is a stringent stress scenario defined by FINMA and the SNB. The stress scenario covers a general crisis in the financial markets coupled with a loss of confidence in the banks from creditors. The new liquidity regulations require the Big-2 to be able to cover outflows estimated in such a scenario over a period of at least 30 days – in particular, holding an adequate reserve of first-class liquid assets. As of 30 June 2010, the Big-2 must engage in a monthly reporting to FINMA in which they must demonstrate that they comply with the new liquidity requirements. The new framework particularly improves on its predecessor in considering liquidity needs arising from off-balance sheet as well as balance sheet exposures, and by focusing on severe rather than milder disturbances, for example a better set of historical data. The SNB and FINMA plan to reform the liquidity management requirements for all domestic banks at some point in the future. It is currently assumed that a revised framework for other domestic banks and smaller financial institutions need not be nearly as elaborate as the one now put in place for the Big-2 and, in line with considerations expressed by the OECD, smaller institutions may simply be required to maintain a standardised liquidity buffer of suitable assets rather than one based on internal and individually agreed models.

It would appear that the SNB and FINMA, for the time being, do not deem additional or supplementary liquidity measures necessary or appropriate given the systemic importance of the Big-2 and the large size of their foreign currency assets

and liabilities. For instance, suggestions have been made that systemically-important banks be subject to a minimum ratio of those liabilities likely to be most sustainable over the economic cycle to their assets. The qualified liabilities would include the most stable components of their deposits and marketable obligations, but exclude money market funds and most wholesale funding sources. Such a 'core liquidity ratio', which is essentially a deposit to loan ratio, would backstop the liquidity buffers determined by liquidity stress tests. Although the argument in favour of specific 'core liquidity ratio' may have its merits, it currently remains to be seen what additional benefit may be achieved by it in excess of a revised (and increased) leverage ratio. If an overall core liquidity ratio is not deemed appropriate for the Big-2, some believe that considerations should nevertheless be given to imposing analogous limits on each of the major foreign currency components of their portfolios. The rationale is that this would provide a form of insurance-like retention limit against a sudden deterioration in access to foreign exchange markets, particularly if the resulting need for foreign currency were greater than anticipated by the liquidity stress test – perhaps an additional measure to help limit the amount of emergency foreign currency demands on the SNB in the event of a crisis as experienced by the end of 2007 and 2008 in US$.

Interim report of the TBTF Expert Commission

The Expert Commission published its interim report on 22 April 2010. While the Expert Commission describes the interim findings as work in progress and, in particular, subject to international developments expected to occur through the summer of 2010 (FSB, CEBS, BCBS (Basel III) etc), the initial assessments made in the report are likely to indicate the directions of the most recent trends in Swiss prudential regulations.

Following a review of various industry sectors in Switzerland, the Expert Commission believes that TBTF is an issue limited to the financial sector, provided that insurance carriers are not deemed to constitute systemic risk with respect to their insurance activities. The Expert Commission has based its initial analysis primarily on the regulatory environment for insurers (Swiss Solvency Test) and historical data sets; however, it acknowledges that if insurers engage in non-insurance financial businesses, including capital market activities, this would enhance the interconnectedness to the financial system and entail systemic risk. The Expert Commission considers the current supervision of non-insurance and capital market activities as a regulatory weakness and suggests that the regulator should require the subjection of certain capital market activities by insurers, such as life and non-life risk transfers into the market and CDS, to separate and appropriate prudential supervision.

The Expert Commission has also formed a preliminary view on a potential statutory definition of TBTF, aimed to be included in the Banking Act and designed to operate as decisive criteria to distinguish systemically non-relevant from systemically relevant financial institutions for which stricter preventive and corrective measures should apply.

The underlying analysis of a defined TBTF term includes considerations on macroeconomic cost benefit analysis, on the advantages of a universal banking system, on size limitation and on risk prevention rules. The Expert Commission also refers to the size of privileged deposits of a bank as well as the size of a bank's balance sheet in relation to Swiss GDP and the bank's overall risk profile as additional criteria to establish the systemic relevance of a financial institution. In a broader context, the Expert Commission identifies size, interconnectedness and substitutability as core criteria for systemic relevance. Accordingly, it suggests a preliminary draft wording for the respective TBTF clause in the Banking Act that is as follows (author's translation):

> 'Systemic relevant banks are banks, financial groups and bank-like financial conglomorates whose failure would have a material impact on the Swiss national economy and on the Swiss financial system.
>
> The systemic relevance of a bank is dependent upon its size, its interconnectedness with the financial system and the national economy as well as the ability to substitute its services at short notice. It [the systemic relevance] will, inter alia, be assessed based on the following criteria:
>
> (a) the market share in domestic banking, in particular, in deposit-taking and lending as well as in the payment system;
>
> (b) the amount of privileged deposits pursuant to Art 37h [bankruptcy privilege/not insured], that exceeds the [insurance] system limit;
>
> (c) the proportion between the balance sheet total of a bank and the annual GDP of Switzerland;
>
> (d) the risk profile of a bank that is determined by its business model, its balance sheet structure, quality of its assets, its liquidity and leverage ratio.'

Interestingly, the Expert Commission only briefly touches upon competition law and merger control considerations, and declines further elaborations with respect thereto, because it believes that other measures would be significantly more effective. It would appear that an early exclusion of competition law doctrine used as a 'sparring partner' to further explore the relevance of size and, in particular, substitutability may undercut a viable and reasoned determination of whether and how the three identified core criteria may work in regulatory practice. Except for merger control, size is admittedly not a relevant criteria in competition law. However, competition law would provide a longstanding and profound legal doctrine on the interdependence of size, interconnectedness and substitutability that would perhaps contribute to a better understanding and help to implement desirable regulatory reform language. For instance, size per se would not seem to matter as, in theory, any large enterprise can be substituted if sufficient time and money is available. Essentially, the same may hold true for the issue of whether a bank's business activities within its sector are interconnected with other financial institutions to a degree that its failure would contaminate or significantly affect other banks. Again, consistent analysis would suggest that this criterion delineates from the overriding question of how easily and

quickly such interdependence may be substituted with other industry players. In light of this more traditional perspective, it seems that 'size' would be a placeholder for the proportion between the size of a bank's business and the resources its home state may make available in the event of an emergency rescue (GDP), rather than an absolute criterion. Given the apparent difficulties in assessing these criteria, it is obvious (and it has been repeatedly confirmed in practice throughout the crisis) that any decision, if a bank is systemically relevant will, ultimately, require some discretion from the authority with jurisdiction over the subject matter, unless a law-maker decides to promulgate 'hard tests' or strict criteria, which in itself would require some arbitrary or discretionary macroeconomic assessment, for example, one policy question would be: is a bank systemically relevant because its substitution would cost ten, 20 or 30 per cent of GDP? As Philipp Hildebrand notes: 'ultimately, it will be a political decision to choose the level of risk Switzerland is willing to accept, both for the financial and for the real sector.'

In addition, even if the Big-2 were reorganised into bank holding companies with licensed bank subsidiaries in the largest markets, which would probably reduce 'size' and thereby TBTF risk ('banks live global, but they die local'), the Big-2, through their Swiss bank holding or Swiss bank subsidiaries, would continue to hold a local market share in deposit-taking and lending activities of around 30 per cent and an even higher percentage with respect to payment systems; that is, they would be very likely to continue to be systemically relevant Swiss banks.

In any event, it will be interesting to see if and how such initial draft language will be amended when the Expert Commission submits its final report later in 2010.

With a view to mitigating the recurrence of yet another TBTF scenario, the Expert Commission proposes to consider a set of core measures and additional measures that would apply to systemically relevant banks. The core measures would be categorised into preventive, pre-insolvency (reorganisation) and insolvency measures and accompanied by additional measures relating to financial infrastructure.

Among the core preventive measures, the focus would be on enhanced capital adequacy ratios (which have not been defined yet and are likely to be influenced by Basel III), including the availability of broader conditional capital as well as contingent convertible capital concepts, and liquidity buffers to absorb losses and money outflows (withdrawals). With respect to capital requirements, the Expert Commission elaborates on the revision of corporate law standards that, so far, have limited Swiss corporations in their flexibility to issue authorised but not issued capital or contingent convertible capital. In any event, capital requirements will need to be coordinated with the proposed recommendations of the BCBS. It also seems to be the Expert Commission's view that progressive capital adequacy and liquidity requirements would facilitate the aim to control or reduce the size of a bank's balance sheet. Target levels and ratios should be complied with in good times and work as buffers/reserves for bad times; that is, have a counter-cyclical effect. The Expert Commission also suggests revising the cluster risk regime of the Banking Act and establishing stricter concentration rules to

enhance risk diversification and reduce contagion risk (currently, risk concentration rules apply if a position for a single counterparty (or group of counterparties) equals or is greater than ten per cent of the bank's eligible capital).

The pre-insolvency (reorganisation) and insolvency measures analyses converge on bridge banking, quick separation, resolution and recovery planning, to name but a few. In essence, the Expert Commission supports organisational requirements that should ascertain a 'credible insolvency threat', that is, counterparties must anticipate that a failing large bank may be split upon the insolvency at predetermined breaking points to the effect that such risk is priced *ex ante* into transactions or products. It is yet unclear if and to what extent organisational requirements would be supported by transparency and disclosure rules, which would most likely be important to gain credibility, market acceptance and facilitate the 'pricing' of the risks. Large banks would have to ascertain that their structure is at all times designed for business continuity under insolvency scenarios and recovery and resolution planning is up to date, failing which, in each case, FINMA would receive authority to step in and modify the legal and organisational structure of a large bank or banking group. Such step-in resolution authority would entitle FINMA, inter alia, to: (i) order a bank to incorporate and organise systemically relevant activities into separate legal entities; (ii) limit interdependence between systemically relevant activities and centralised functions such as treasury, IT services and risk management; and (iii) limit geographic asymmetry between assets and liabilities (that is, require a bank to comply with an enhanced level of self-sufficiency).

Additional measures relating to financial infrastructure include the establishment of centralised counterparties to reduce domino effects and contagion risk. Although centralised counterparty considerations have been widely discussed in connection with the OTC derivatives market, the Expert Commission addresses a distinct feature of the Swiss financial sector in connection with centralised counterparty solutions: only three Swiss banks (the Big-2 and Zuercher Cantonal Bank) have direct access to the CLS system. All other local banks settle forex transactions through these three banks.

The Expert Commission has so far contemplated a number of other potential measures that it has dismissed as ineffective or inadequate. Such dismissed measures include direct limitations on size, based either on market share or balance sheet, as well as statutory breakup provisions for banks into 'utilities' and 'casino' banks or Glass Steagall concepts (including bans on proprietary trading). Furthermore, business model limitations, such as narrow banking, and burden sharing concepts, or banks with parallel or two corporate seats and two lead regulators/insolvency regimes, were turned down on the same merits. According to the Expert Commission, these measures would unduly reduce or exclude the nature of banking; that is, the risk-taking, as costs would become prohibitive. The Expert Commission also parked tax measures as inappropriate means to mitigate systemic risk; however, tax measures would need to be revisited if such a concept were to prevail on an international level.

Leverage ratio

Subsequent to its initial reaction on capital adequacy in October 2008 (see above), FINMA came to acknowledge in May 2010 that the exclusion of domestic lending from the leverage ratio is inconsistent with the underlying rationale. The exclusion would also create confusion in comparing the proposed ratios with more conventional measures likely to be adopted by other countries. Further considerations would suggest that a higher group ratio of at least four per cent should be set, and domestic lending should be included in the assets used for the calculation. A regulatory action review report published by the Swiss Government on 12 May 2010 indicates that, subject to the developments on an international level presumably pending until the end of 2010, additional adjustments to the CAR and leverage ratios, including a respective increase, may be recommended and implemented by the end of 2012.

The 2010 proposed revision of the Banking Act

Following the emergency legislation of December 2008 and the setback on the proposed DPL in September 2009 (see above), the Swiss Government on 12 May 2010 again opened the consultation process on a revision of the Banking Act. The recent draft legislation envisages transforming the currently transitional regime on deposit protection otherwise scheduled to lapse at the end of December 2010 into permanent legislation. Accordingly, no fundamental change to the Swiss deposit protection scheme is likely to occur, and even though the Swiss Government highlights that post-funding may add to the pro-cyclical impact of the scheme and contagion risk, the depositors' bankruptcy privilege will remain at CHF100,000 with a maximum amount covered by the DPA of CHF6 billion. In addition, Swiss banks will continue to be required to hold assets in Switzerland in an amount equal to 125 per cent of the privileged deposits (see above).

More importantly, and perhaps as a result of the SNB's and FINMA's continuing call for reforms through the crisis, the draft revisits the need for broader FINMA authority with respect to business continuity and bridge banking in the event of a pending failure of a bank. By approving a plan of restructuring, FINMA may operate the institution or parts thereof as a going concern, liquidate immediately, or authorise whole bank or clean bank purchases or any other form of transfer it deems appropriate, including interim solutions such as bridge banks. FINMA's approval constitutes and effects the transfer of assets and liabilities as well as contracts. As already contemplated by the proposal in September 2009, no other consents, approvals, registrations and formalities otherwise required under Swiss law (such as land register registrations or shareholder approvals) will be necessary for the transfer to be valid and binding. Interestingly, the consultation paper and the draft no longer specifically address statutory consequences in connection with FINMA's forced business transfer authority and its impact under contractual change of control, early termination and close-out netting provisions; that is, unlike the previous draft

of 2009 that considered a respective contractual clause as void and incompatible with Swiss *ordre public,* the new draft remains silent on this issue. Accordingly, it seems that, from a Swiss regulatory perspective, the *ex officio* transfer of close-out netting arrangements under a market standard master agreement may not restrict or otherwise affect the parties' termination thereunder. In the absence of an express statutory basis, FINMA should not have the general power to challenge privacy of contract, however. By contrast, the draft does provide a statutory basis for FINMA's authority to request debt equity swaps under the reorganisation plan if other less repressive measures, such as contingent convertible ('CoCo') bonds, do not appear to be successful or sufficient.

In addition, the consultation paper with respect to the draft Banking Act proposes to expand FINMA's competences not only with respect to banks but to harmonise resolution authority over financial institutions by subjecting investment funds and insurers to the sole jurisdiction of FINMA (the current legislation on investment funds and insurance companies either lacks specific resolution or bankruptcy-related provisions, or contains complex and dual competences between bankruptcy courts and the regulator that may prevent or delay effective measures in emergency situations).

Moreover, the draft revisits various measures that are designed to facilitate and, to some extent, anticipate the growing international consensus on cross-border coordination and harmonisation. Certain adjustments with respect to finality of transfer instructions, including better certainty on night-time settlement, will be aligned with the recent revisions of the EU Finality Directive, and the draft provides better certainty on the scope of finality standards applicable to direct and indirect participants in payment and settlement systems whose system operators are either domiciled or monitored in Switzerland (such as SIX x-clear AG, SIX SIS AG, SIX Interbank Clearing and CLS – the latter is monitored by SNB). While the draft adheres to the overriding principle of providing FINMA with sole resolution authority for the Swiss business of bankrupt or insolvent international groups, the amended statutory regime intends to give FINMA additional discretion to recognise and enforce declarations of bankruptcy and bankruptcy-related measures issued by the competent foreign authority at the actual place of business of a bank. FINMA shall receive the authority to a non-Swiss administrator or receiver access to assets located in Switzerland without FINMA's engaging in local insolvency proceedings, if claims of creditors domiciled in Switzerland, otherwise privileged or non-privileged in a Swiss bankruptcy, are adequately protected in the non-Swiss insolvency proceedings of the failed bank's home state. Accordingly, the draft, to some extent, adopts cross-border resolution mechanisms similar to the ones contained in various other jurisdictions, such as the Chapter 15 proceedings in the US and, to this end, enhances FINMA's ability and flexibility to better coordinate international resolutions proceedings.

Size of bank, resolution authority and operational risk management

It is quite interesting to note that in most global discussions on wider systemic reform that favour business continuity and bridge banking regulatory competences as part of a broader resolution authority, little or no light is shed on its practical consequences on operational risk management and, in particular, on information technology. In its financial crisis analysis report of 14 September 2009, FINMA concluded that a fragmented, non-scalable IT infrastructure of UBS negatively affected transparency, in particular with respect to complex structured and derivate products, and contributed to the failure of UBS' risk management prior to and at the beginning of the crisis. Not surprisingly, a large portion of action items on UBS' renewal plan, announced in late 2008, focused on IT infrastructure. The plan was implemented in order to overhaul the approach the bank takes to risk management, strategy and planning, the processes used to value and estimate risk positions, the integrity of underlying data and the system architecture needed to support all of these processes.

The renewal plan is merely an example for what many believe to be a necessary approach for 'good' risk management: central operational risk managment functions based on centralised data. This is, in any case, in line with Basel II requirements on operational risk management that require banks to have an independent central operational risk management unit, which is responsible for the design and implementation of the operational risk management framework. Moreover, Basel II requires banks to have contingency or business continuity plans to ensure their ability to operate under exceptional circumstances and to limit the potential consequences of severe business disruptions. It goes without saying that any regulatory reform on broader resolution authority comprising the breaking up or liquidation of banks in an orderly manner would need to include detailed business continuity planning and authority in order to be effective. It is at least doubtful if a timely business transfer or a bank's breaking up is feasible or reasonably practical under a given stress scenario unless broader contingency planning exists, for example by means of mandatory industry-wide regulatory minimum standards, pre-agreed reciprocal support arrangements (which perhaps would need to be anticipated in 'living wills'), or the availability of back-up data centres and workplaces.

Whether or not business continuity planning is formally included by law-makers or regulators in broader resolution authority or informally addressed by regulators based on existing resolution powers would appear to be of lesser concern, provided the formal or informal rules or regulations facilitate communication and interaction between regulators and market participants. Any effective intervention with respect to infrastructure and information technology would seem to necessitate practical know-how on the regulatory side that may not be sufficiently acquired without appropriate coordination. For instance, the SNB initiated addressing the respective activities of major Swiss stakeholders as early as 2006. The group, inter alia, comprises the Big-2, PostFinance, FINMA and the financial market infrastructure operator SIX Group. The associated activities have been coordinated by the Steering Committee

on Financial Business Continuity Planning (BCPSC). The principal aims of the BCPSC are to coordinate the contingency planning and management efforts of the individual institutions in the area of operational risk management, and strengthen the operational resilience of the Swiss financial centre. In its first report published in 2006 (2006 report), the BCPSC concentrated on business processes that were classified as particularly critical in terms of financial stability. It assessed business continuity planning in the Swiss financial industry and identified a number of ways in which it could be improved. In addition to the findings of the 2006 report, the Swiss Bankers' Association's Recommendations for Business Continuity Management, published in 2007, provided a major impetus to these efforts. These recommendations, aimed at all banks in Switzerland, are not essentially binding. However, FINMA required banks and securities dealers to carry out a business impact survey and to define a business continuity strategy by the end of 2009 as a mandatory regulatory minimum standard. Although the 2006 report focuses on technical requirements and system stability, such as maximum downtime limits, back-up data centres and pandemic risk, it includes considerations on industry-wide alarm and crisis organisation and coordination with the clearing and telecommunications industry, as well as preliminary work on reciprocal support by financial institutions in the event of a crisis; that is, practicalities that are of significant importance to the stability of the financial system in a technical crisis but also when it comes to emergency business transfers in times of distress that should have little or no impact on the operations of the transferred or remaining banking business. The BCPSC published its second report in September 2009, in which it highlights that the level of preparations in the area of operational risk has risen even higher in the last few years and requires an intensification of the joint efforts made by regulators and industry participants.

The way forward – additional considerations

Avenir Suisse, one of the leading Swiss think tanks for economic and social issues, published an interesting discussion paper in March 2010 which purports to take a neo-liberal approach. Avenir Suisse takes the view that the short-term rescue of any TBTF financial institution would ultimately lead to a misallocation of resources with a long-term negative impact on the national economy, and that any strategy that essentially aims only to mitigate but not exclude TBTF risk should be abandoned for the benefit of a credible 'no bailout' strategy. Accordingly, it puts a clear focus on resolution authority and, without making an express reference, revisits a statement made by an economist of the OECD in 1995: 'bankruptcy laws and other procedures governing financial default are key elements in the functioning of market economies.' Avenir Suisse observes that existing bank insolvency laws, in principle, would provide the regulator with resolution authority to avoid 'groundings' of banks including systemically relevant institutions, and they would contain the basic ingredients for core resolution powers, such as a regulatory authority, to take control of troubled or failing

institutions, afford super privileges for fresh money at the expense of other privileged creditors and affect debt-to-equity swaps. Although Avenir Suisse agrees that certain rules of the existing resolution regime may need to be amended or revised for TBTF institutions as a result of the financial crisis, it believes the 'real' issue is that such a fundamentally viable resolution regime is not applied; that is, one of the main causes for a TBTF regime is – in economic literature terminology – time inconsistency.

In respect of financial market regulation, governments would face a dilemma on time inconsistency similar to the one in monetary policy (short-term gain versus long-term pain – many national banks which had previously applied a strategy of constructive ambiguity with respect to their role as lender of last resort prior and into the crisis were forced to abandon this strategy). In order to incentivise financial institutions *ex ante* not to take excessive risks, politics would need to put up a 'credible threat'; such institutions must fail if risks materialise. However, from an *ex post* perspective, it always seems more efficient to avoid systemic effects and to protect uninsured creditors from prospective losses from the failure of a large bank. As large banks and their shareholders anticipate the dilemma, the 'threat' lacks credibility and loses its disciplinary effect. According to Avenir Suisse, the financial crisis has shown that the existing TBTF policy environment has failed, most likely due to such a dilemma, and would need to be replaced by a new (*ex ante*) adamant and non-discretionary resolution authority that precludes subsequent renegotiations. As a discussion point, Avenir Suisse proposes to establish, by federal law, a new resolution authority whose two principal components would include a pre-defined intervention scheme (for example by using deteriorating capital ratios as attachment points) pursuant to which a designated administrative agency (FINMA) would take systemically relevant institutions into receivership in order to minimise long-term losses to shareholders and unsecured creditors. The motivation behind the proposal is obviously to provide incentives for banks to address problems while they are still small enough to be manageable, failing which the agency must step in at a time where it still has a reasonable chance of controlling or mitigating prospective long-term losses. This concept, to some extent, resembles the US Prompt Corrective Action laws under which Federal Deposit Insurance Corporation (FDIC)-regulated institutions may be taken into receivership by the FDIC. Again, the proposal is not new but merely a proposed codification of existing practice – the FBC ordered the Big-2 in 2008 (see above) to comply with a CAR ratio of 150 per cent which it considered a lower intervention level under an intervention scheme similar to the US Structured Early Intervention and Restructuring (SEIR).

The second component relates to the receivership proceedings and the prospective loss participation of shareholders and unsecured creditors. In essence, shareholders would be 'expropriated' and claims by creditors (irrespective of whether the creditors are domiciled in or outside of Switzerland), subject to a clearly defined claims hierarchy, would be swapped to equity for purposes of loss absorption. As such 'bail in' by shareholders and stakeholders intends to reduce any future bailout risk by taxpayers, the claims hierarchy would technically include all unsecured claims, obviously with

the highly subordinated debt and hybrid instruments at its junior top end. Although Avenir Suisse is silent on what the criteria for such claims hierarchy may be and, in theory, the law-maker could establish autonomous tests, practical considerations suggest, at the very least, coordinating with the criteria for the inclusion in Tier 1 and Tier 2 capital currently being discussed under Basel III.

Clearly, the viability of a stricter resolution authority also depends on reputational factors associated with the agency that is entrusted with its enforcement. Any agency may build on its reputation by means of quality and communications, as well as of recurring measures taken to underscore the credibility of the 'bail in' threat. In this context, Avenir Suisse believes that the annual submission of rapid resolution and recovery plans ('living wills') by systemically relevant banks would certainly support the new strategy. However, whatever the agency may do to establish such a reputation, the most important issue remains whether policy-makers are prepared to commit to an *ex ante* 'unshakeable' position that exludes any *ex post* bargaining with a systemically relevant bank being on the brink of a failure. Interestingly, Avenir Suisse also remains silent on the viability and suitability of a deposit protection scheme under a 'no bailout' strategy (see above).

The think tank's proposal has its merits as it undertakes to restore the market system not by less or more but better regulation. Better regulation means that there may perhaps be no serious alternatives to significant intervention in the financial market, which does not mean that the Swiss financial market would need as detailed and comprehensive regulations as the recently passed Dodd-Frank Act in the US. However, the law-makers' intervention should ultimately seek to promote accountability on the part of the risk-takers, and not merely to shift the risk to taxpayers. To this end, the often-heard statement that supervision is designed to accommodate simultaneously the political desire to deal with market failure yet still leave markets some kind of freedom could perhaps be supplemented by including the freedom for an orderly failure.

Obviously, such a concept does not necessarily exclude or render supplementary measures such as capital requirements, leverage ratios and liquidity requirements ineffective. From a pragmatic perspective, these supplementary measures may find a larger consensus on a global level (Basel III) as they seem to modify and further develop existing generally accepted regulatory philosophy, and require no fundamental change of strategy. Whatever their ultimate calibration or attachment points may be, these measures may help to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thereby reducing the risk of spillover from the financial sector to the 'real' economy. However, these regulatory measures should not be construed merely as insurance retentions to discipline adverse risk-taking under any implicit insurance policy or guarantee by a state and its taxpayers.

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France

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Introduction

In common with the banking sector across the world, the French banking industry was not spared the adverse effects of the financial crisis which followed the bursting of the sub-prime bubble in 2007. The effects were felt in France as early as mid-summer of that year and continued through 2008 when the liquidity crisis started to affect the French banking sector. 2009 was then a year of healing.

The French banking industry avoided exposure to major failures as compared to financial markets in key neighbouring countries. Its universal banking model, coupled with a robust supervisory and regulatory framework, was able to weather the storm with the help of emergency Government measures which eased access to liquidity. Now those measures are for the most part integrated in an international approach either at the EU level or, on the global stage, in the form of measures implemented as part of the G20 agenda.

This report will describe:

- how the effects of the financial crisis unfolded in France;
- the global context within which measures were taken in France during the crisis;
- the nature of those measures; and
- more recent actions taken or under consideration to strengthen the French regulatory framework or implement EU initiatives.

How has the global crisis unfolded in France?

The chain of causation leading to the financial crisis is described in the Financial Crisis Interim Report of the IBA Task Force, and in other international reports such as the de Larosière report.

Mounting interest rates resulting from tighter monetary policy aimed at meeting inflationary pressures led to the bursting of the sub-prime housing bubble. Overleveraged institutions, faced with a liquidity crunch and scarcity of available capital, attempted to dispose of assets and were faced with valuation issues exacerbated by a lack of market transparency and the complexity of a number of financial instruments.

As early as 27 July 2007, Oddo Asset Management announced that, in accordance with the provisions of the French Monetary and Financial Code (CMF), it had suspended subscriptions in three funds for which it acted as manager, and had decided to dissolve those funds subject to that decision.

The next month, BNP Paribas Investment Partners announced that it was temporarily suspending calculation of the net asset value of three ABS-related funds for which it acted as manager. It also announced suspension of subscription and redemption in respect of those funds. This decision was justified by the complete evaporation of liquidity in certain segments of the US securitisation market which made it impossible to value certain assets fairly regardless of the quality of their credit rating. It was a decision that was made notwithstanding the fact that BNP Paribas was only marginally exposed to sub-prime investments. The bank did subsequently resume valuation of those assets.

That year, BNP Paribas reported a record profit of €7.8 billion; yet for the fourth quarter it recorded €589 million of write-downs and €309 million of provisions, with €262 million of write-downs and €115 million of provisions in the third quarter.

The new year brought scant relief. In January 2008, Société Générale reported it had been the victim of a rogue trader and also announced depreciation of substantial sub-prime-related assets.

2008 also witnessed a number of banks being exposed to severe strain as the difficulties of monoline insurers became apparent.[1] Some French banks had a major interest in monoliners (such as Financial Security Assurance Inc (FSA) and CIFG), and/or were otherwise exposed to products guaranteed by them. In July 2008, for example, Natixis announced record write-downs in the amount of €1.5 billion for the second quarter of the year. These were related primarily to monoline exposure.[2]

The tale of woe in the banking system continued. Control of Dexia was assumed through a tripartite arrangement among France, the Netherlands and Luxembourg and the bank became the recipient of a package of state guarantees. It recorded a net loss of over €3.3 million for 2008 and also announced, in early 2009, that increasing uncertainties had lead to a collective impairment of €300 million to its US RMBS portfolio.

Natixis reported over €2.6 million losses for 2008 before restructuring income and expenses. It strengthened its capital structure as a result of a €3.7 billion capital increase successfully completed in September 2008 and a €1.9 billion capital injection by its two main shareholders, BFBP and CNCE. This took the form of deeply subordinated perpetual securities (TSDIs). This capital injection equated to the bulk of funding received by BFBP and CNCE as part of the first tranche of French state support for the banking system subscribed by the SPPE sovereign fund.

Some banks proved more resilient than others. In May 2008, Crédit Agricole SA completed a €5.8 billion rights issue to raise the Group's target Tier 1 ratio from eight to 8.5 per cent and reported its decision to refocus its CIB business line in its three

1 2007 monoline-related exposures were reported to be €7.1 billion for Calyon, €2.9 billion for Natixis and €7.9 billion for Société Générale. CDO valuation adjustments resulted in a drop of CIB-related revenue of 31 per cent at Calyon, 19 per cent at Natixis and 18 per cent at Société Générale (see AGEFI – *Les provisions des banques françaises à la loupe* – Frédérique Garrouste, 17 April 2008).

2 On 6 March 2008, CNCE reported that the financial crisis' effects were limited to CIFG and to certain CIB activities of Natixis, which had an impact of about €800 million on its net income for 2007.

sound areas; notably financing, brokerage and fixed income, in order to reduce its risk profile in capital market activities. Its resilience, it claimed, was reflected in its cost/income ratios which were lower than those of other French banks in most of its specialised business lines: consumer finance, asset management, insurance and finance activities.[3]

A global crisis requiring global action

This unprecedented crisis was a global crisis. It is important, therefore, when examining measures specific to France, to bear in mind the international and regional context. Some of the key measures addressed at these levels are examined below.

The G7 guiding principles

On 10 October 2008 the G7, in the context of the 2008 IMF annual meetings in Washington DC, established a series of guiding principles, namely to:

- take decisive action and use all available tools to support systemically important financial institutions and prevent their failure;
- take all necessary steps to unfreeze credit and money markets and ensure that banks and other financial institutions have broad access to liquidity and funding;
- ensure that banks and other major financial intermediaries can, as needed, raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses;
- ensure that national deposit insurance and guarantee programmes are robust and consistent so that retail depositors will continue to have confidence in the safety of their deposits; and
- take action, where appropriate, to restart the secondary markets for mortgages and other securitised assets. It was acknowledged that the accurate valuation and transparent disclosure of assets and consistent implementation of high-quality accounting standards are necessary.

Implementation by the Euro Group

On 12 October 2008, a plan was presented by the Euro Group at the initiative of the President of the French Republic.

That plan included clear commitments from governments to take state action to:

- ensure appropriate liquidity conditions for financial institutions;
- facilitate the funding of banks, through the issue of guarantees, insurance and other similar arrangements;
- provide financial institutions with additional capital resources so as to continue to ensure the proper financing of the economy;

3 See Crédit Agricole SA release of 4 March 2009.

- allow for an efficient recapitalisation of distressed banks;
- ensure sufficient flexibility in the implementation of accounting rules given the then current exceptional market circumstances; and
- enhance cooperation procedures among European countries.

Measures undertaken in France during the crisis

The guarantee scheme in France

In record time, the French Parliament adopted legislation in the form of an amending Budget Law which was promulgated on 17 October 2008 (Law no 2008-1061 of 16 October 2008 – *Loi de Finance Rectificative pour le Financement de l'Economie*). The features of that legislation, which include a combination of guarantees, funding and availability of equity instruments in favour of credit institutions, are examined below.

Creation of the 'Societe de Financement de L'economie Française' (SFEF)

SFEF[4] is a company governed by private law, with 34 per cent of its share capital held by the French state and the remaining balance held by a group of seven banks. SFEF is not a bank but has the authority to exercise a number of credit institution prerogatives, including the authority to provide loans or guarantees or to benefit from the netting statutes,[5] subject to the limitations contained in the 17 October 2008 law.

Funding of SFEF is through the proceeds of bond issues which may be guaranteed by the French state, subject to remuneration.

SFEF grants loans to credit institutions which have concluded an agreement with SFEF and with the French state. Under such agreements, as consideration for the state guarantee, the credit institution is bound to a number of undertakings including financing being made available to households, enterprises and local governments (*collectivités territoriales*).

Such agreements also include:

- undertakings to increase outstanding credits by about three to four per cent per annum to the end of 2009; and
- commitments of compliance by senior management with ethical requirements in conformity with public interest. Among these ethical requirements, credit institutions undertake to comply with the MEDEF-AFEP Code of Conduct governing remuneration.

Credit institutions benefiting from SFEF support must also comply with own funds requirements. Facilities made available by SFEF are remunerated.

Some €265 billion has been made available for the SFEF scheme. Loans made available

4 When originally created, SFEF was named '*Société de Refinancement des Activités de Crédit*' (SRAEC). Its Articles of Association have been approved by Order of 21 October 2008 and by Order of 22 December 2008, the latter approving the change of corporate name of SRAEC to SFEF.

5 Article L. 261-36 to L. 266-40 of the CMF.

by SFEF to credit institutions may have a maturity of up to five years and are secured with high-quality claims provided by the credit institutions benefiting from such facilities.

The guarantee of the French state may also, on an exceptional basis, be made available to directly guarantee instruments issued by credit institutions, subject to providing to the French state security equivalent to security that might be provided to SFEF.

The state guarantees contemplated above relate to instruments evidencing claims issued prior to 31 December 2009 with a maturity not to exceed five years.

The SFEF scheme was authorised by the EU Commission on in October 2008 under the State Aid Regime.[6]

Strengthening of own funds of credit institutions

The 17 October 2008 law also contemplated – for the purpose of ensuring stability for the French financial system – that the French state may grant its guarantee to secure financing by a company the capital of which is entirely held by the French State and the purpose of which is to subscribe securities issued by credit institutions which constitute core regulatory own funds.

For this purpose, a public company has been created known as the '*Société de prise de participation de l'Etat*' (SPPE).

The injection of core regulatory capital by SPPE has been made in the form of deeply subordinated securities '*titres super subordonnés*' (TSS) or in the form of preferred shares.

TSS rank, in terms of seniority, between shares and bonds and may, subject to certain limits and banking commission approval, be eligible for purposes of core regulatory own funds. Preferred shares may also be included in the calculation of core regulatory capital, subject to banking commission approval, to the extent that they are treated (from an accounting perspective) in a manner identical to shares. They may absorb losses on a continuing basis in the context of operations and rank upon liquidation in terms of subordination in a manner equivalent to shares. TSS have the advantage of avoiding dilution.

On 20 October 2008, a first portion of TSS, of up to €10.5 billion, was injected into the six principal financial institutions. A second portion of an equal amount was issued in 2009 in the form of preferred shares.

The SPPE scheme was authorised by the EU Commission in March 2009 under the State Aid Regime.

State guarantees securing Dexia financing

A state guarantee facility was also made available to secure finance raised by Dexia SA, Dexia Banque International Luxembourg, Dexia Banque Belgique and Dexia Credit Local de France during the period 9 October 2008 to 9 October 2009, provided such

6 European Commission Brussels 30.10.2008 State Aid N 548/08 French Republic: Scheme for refinancing financial institutions (State Aid N548/2008 – Decision C (2008) 6617 dated 30 October 2008).

financing matured prior to October 2011. Dexia Crédit Local de France is a French credit institution.

The guarantee of the French state is callable jointly but not severally with the guarantee of the French Republic, Belgium and the Grand-Duchy of Luxembourg within the limits of 36.5 per cent of eligible amounts. The sums guaranteed in this way amounted, for France, to €55 billion. The aggregate amount of guarantees for the three states shall not exceed €150 billion, and guarantees are remunerated.

A state guarantee may also be granted with remuneration in respect of obligations of Dexia related to assets on the balance sheet as of 30 September 2008 of FSA Asset Management LLC, provided Dexia receives any proceeds derived from such assets. Such guarantee may not exceed €6.39 billion. Such guarantee lapses in the event that Dexia loses control of FSA Asset Management LLC. This guarantee may only be called jointly with the guarantee of Belgium.

Those guarantee schemes together with the equity capital injection in Dexia by the three governments was approved provisionally for a six-month period by the EU Commission on 19 November 2008 under the State Aid Regime,[7] subject to a restructuring plan being submitted within six months of the first aid being provided.

FSA-related guarantees were the subject of a decision of the EU Commission on 13 March 2009. Decisions have been extended several times pending finalisation of a full Article 108, paragraph 2 EU Treaty investigation. A final decision was issued by the EU Commission in February 2010 approving Dexia's restructuring plan (see below). The ceiling of the state guarantee issued under the facilities described in paragraphs (i) to (iii) above may not exceed €360 billion.

Redemption of TSS and preferred shares subscribed by SPPE and SFEF becoming dormant

The year 2009 saw an improvement in the financial markets and a number of banks taking steps to withdraw from the state guarantee scheme.

For example, BNP Paribas announced in September 2009 the launch of a €4.3 billion rights issue allocated inter alia to retire non-voting shares in the aggregate subscription price of €5.1 billion subscribed by SPPE on 31 March 2009. It also announced, on 8 March 2009, an agreement between Belgium, Fortis Holding and BNP Paribas contemplating acquisition by BNP Paribas of 75 per cent of Fortis Banque shares. October saw announcements by Crédit Agricole SA that it would fully redeem the €3 billion in highly subordinated notes subscribed by SPPE in December 2008, and by Société Générale that it was launching a 4.8 capital increase, the purpose of which was to retire preferred shares and TSS subscribed by SPPE and strengthen its core Tier 1 capital in order to target certain acquisitions.

In February, 2010, Dexia announced that it was exiting earlier than expected from state funding guarantees and also that it had reached agreement with the European Commission on its restructuring plan. The agreement reached includes

7 European Commission Brussels November 19 C(2008)7388 final State A id NN 49/2008 Belgium, NN5O/2008 France, NN/2008 Luxembourg.

an undertaking to focus on its core banking activities and its traditional markets in France, Belgium and Luxembourg. A number of divestitures are further contemplated under that agreement together with ring-fencing of its bond portfolio in a specific division of the bank.[8] Dexia also announced a draconian 15 per cent cost-reduction objective and agreement to restrict dividends, hybrids and acquisitions for two years.

In March 2009 BPCE,[9] which was the largest user of Government-supported facilities having borrowed about €7.1 billion, raised €1 billion for the purpose of redeeming a portion of funds owed to the French State under the Government-supported recapitalisation programme. About €750 million had already been reimbursed in 2009 and, following such redemptions, about €5.3 billion would still be owed to the French State. It is expected that BPCE will have fully exited those facilities by 2013.

In 2009, BPCE also raised a total of €40.2 billion on the money markets, including €11.3 billion through SFEF. BPCE reported gross operating income of €4,868 million against a €241 million loss in 2009.

As a result of the improved conditions in the financial markets, SFEF ceased its activities in October 2009. State guarantees have in any event become less attractive in the light of more favourable market conditions.

Since its inception, SFEF has raised the equivalent of about €80 billion on the market.[10]

The 2010 Budget Law permits the reactivation of SFEF, at the discretion of the Government, in the event of exceptional difficulties being experienced by credit institutions in accessing financial markets.[11]

The economic stimulus package

In early December 2008, the French Government announced a major €26 billion economy stimulus plan consisting inter alia of:

- support to the automobile industry including aid to subcontractors (€2 billion);
- support for the construction/housing industry (in excess of €2 billion);
- the launch of major construction projects (including acceleration of projects previously approved) to be undertaken by the state, local government or public enterprises (€10.5 billion);
- support to productive investments through guarantees or accelerated depreciation;
- support to treasury of enterprises, in particular small- to medium-sized enterprises (in excess of €10 billion);

8 Including inter alia Dexia Crediop, Dexia, Sabadell and Dexia, Banka Slovensko. Dexia also divested itself of its 20 per cent in Crédit du Nord/Société Générale. It had also divested itself in November 2008 of Kommunal Kredit in November 2008.

9 In July 2009, BPCE Group was created combining the Banque Populaire network and the CNCE network.

10 See *Banque de France Documents et débats N° 3,* January 2010, p 58.

11 *Loi N° 2009-1673 du 30 décembre 2009 des finances*, Article 119.

- €200 premium to households who will perceive the '*revenus de solidarité active*' (€760 million);
- support for employment in small- to medium-sized enterprises through total exemption of employer contributions for new employment in 2009 (€700 million); and
- employment policies supported contracts (*contrats aides*) and professional training (€500 million).[12]

Furthermore, the Government created the Strategic Investment Fund (*Fonds Stratégique d'Investissement*) (FSI) whose purpose is to strengthen equity funding and to stabilise the capital of French enterprises.[13]

On 22 December 2009 the President of the French Republic made an announcement in respect of a €35 billion borrowing aimed at financing the following priority areas:

- higher education and training (€11 billion investment programme);
- research (€8 billion);
- targeted industrial sectors and small- and medium-sized enterprises (€6.5 billion);
- sustainable growth (€5 billion); and
- digital development (€4.5 billion).

An amended Budget Law was promulgated in March 2010 to allocate €34.5 billion in budget appropriations and commitments for these purposes.[14]

Conduct of business rules vis-a-vis local governments in respect of structured loans

As in many jurisdictions, local, as well as central, government felt the impact of the crisis. In France, a number of local government authorities, attracted by initial low-cost features of the relevant products, entered into complex loan transactions with financial institutions. As the crisis unfolded, the debt burden increased, creating major problems.

Responding to the crisis, the Government induced financial institutions to adhere to a code of conduct known as the Gissler Charter, adopted on 9 December 2009. The Gissler Charter is aimed at ensuring the appropriate marketing of structured loans to local authorities and greater levels of transparency. Under the Charter:

- credit institutions undertake, in their marketing of products, to present those products according to an agreed classification of indexes and to refrain from marketing to local authorities:
  - financial products exposing to a risk on principal or products based on high-risk indexes; and
  - financial products with cumulative index effects;

12 Source '*La Crise Financière*', *Documents et débats Banque de France €système*, February 2009 no2.

13 See further below.

14 *Loi N° 2010-237* du 9 Mars 2010 *de finances rectificative pour 2010.*

- local authorities are recognised as non-professional investors and benefit from:
  - reinforced obligations as to disclosure by the credit institutions in relation to the risks attached to structured products; and
  - reinforced obligations in relation to the giving of advice;
- local authorities undertake to abide by reinforced transparency rules regarding their borrowing and debt policies and to provide additional financial information in respect of structured products in which they subscribe. These commitments involve enhanced transparency and disclosure rules by the executive committees of local authorities to their deliberative body.

Ban on short selling

In a press release dated 19 September 2008, the *Autorité des Marchés Financiers* (AMF), the French securities market regulator, ruled that any investor transmitting a sell order with deferred delivery for specified securities must hold 100 per cent of the securities to be sold on its account with its financial intermediary. (Articles 516-4 and 516-5 of the AMF General Regulations permit the AMF to set requirements regarding cover to be put into place for a specified type of financial instrument or market).[15]

Specified securities include shares (*titres de capital*) issued by credit institutions and insurance companies[16] traded on a French regulated market (Euronext, Monep, Matif).

Such measures relate to transactions for own account as well as transactions for the account of third parties, whether transactions on a deferred basis or as an option, except for transactions carried out by investment services providers as market makers, liquidity providers or as a counterparty to block trades on securities.

Securities held under a stock loan, where that stock loan is permitted, will be sufficient cover.

A person holding a net short position in excess of 0.2 per cent of the capital of a

15 See the draft FBR Law ('*Projet de loi de régulation bancaire et financière*') adopted by the French National Assembly on 10 June 2010. Article 2 contemplates that, under exceptional circumstances threatening the stability of the financial system, the President of the AMF may take measures restricting trading conditions of financial instruments for a period of 15 days, which period may be extended by a decision of the AMF Board (*Collège de l'AMF*) for a period of three months. Such decisions may be further extended by order of the Minister of Economy upon recommendation of the AMF President. That draft law, in its current form as adopted by the National Assembly, also contemplates that delivery of securities will occur at D+1 instead of D+3 as contemplated today. AMF has recently imposed sanctions for failure to comply with the three-day settlement date requirement (AMF Sanction Committee in re Avendis Capital SA, Accent Tonique BV et Accent Grave BV, dated 13 November 2008). Those provisions, if enacted, would strengthen the authority of the AMF, the extent of whose existing powers have been brought into question by a number of professionals, to issue restrictions in respect of short selling. The draft law also provides that the Government will deliver to Parliament prior to the end of September 2010 a report addressing the possibility of banning short selling by foreign subsidiaries of hedge funds.

16 That is, Allianz, Aperil Group, AXA, BNP Paribas, CIC, CNP Assurances, Crédit Agricole, Dexia, Euler Hermes, HSBC Holdings, Natixis, NYSE Euronext, Paris RE, Scor, Société Générale.

relevant entity must disclose that position to the AMF and the market no later than D+1 through any appropriate means.

Any transaction carried out by a person either for own account or for the account of third parties in violation of these rules constitutes a market abuse.

This short selling restriction has been extended several times. At the time of the last such extension, on 27 January 2010, the AMF stated that it is contributing actively to the work performed in the context of CESR, the objective of which is to define a permanent and harmonised short selling regulatory framework in Europe.[17]

Risk surveillance

Internal control of credit institutions and investment firms is governed by Regulation 97-02 of 21 February 1997 (Regulation 97-02). This legislation was strengthened in 2009 and the early part of 2010 through amendments related to risk surveillance.

Entities subject to Regulation 97-02[18] must designate a person responsible for the risk trail (*filière risques*) within the enterprise.[19]

Where that person is not a member of the executive body (*organe exécutif*), he must directly report to that body and may not carry out any commercial, financial or accounting function. It is his responsibility to alert the executive body (or the audit committee as appropriate) of any occurrence which may have a significant impact on risk control.

Where the size of the enterprise so justifies, that person coordinates all elements of the risk trail. He must ensure that the level of risk incurred by the enterprise is consistent with the development policy (*orientation de l'activité*) set by the Board of Directors.

The functioning of the risk trail must have sufficient resources in terms of personnel, information systems, and access to internal and external information necessary to carry out its functions. Personnel within the risk trail function must have adequate experience, qualifications and seniority to exercise its functions.

Appropriate procedures and systems must be put in place to address comprehensively all risks associated with the banking and non-banking operations of the institution, including credit risk, market risk, global interest rates, intermediation risk, settlement risk, liquidity risk and operational risk.

17 Following a consultation paper issued in July 2009, CESR issued a feedback statement on 2 March 2010 entitled 'CESR Proposal for a Pan European Short-Selling Disclosure Regime Ref CESR /10-089'. Under that proposal, there would be two tiers of disclosure, the initial disclosure being set at 0.2 per cent of issued capital and public disclosure of individual short positions above five per cent will also be required. A supplemental report was published on 26 May 2010 entitled 'Technical Details of the Pan-European short – selling disclosure regime'.

18 The Financial and Banking Regulation Law provides for a new Article L. 210-10 in the French Commercial Code establishing a specialised committee monitoring risk along the lines of audit committees acting under the responsibility of the board or supervisory body. These committees would be established in credit institutions and insurance and reinsurance companies.

19 Amendment of Regulation 97-02 by order dated 19 January 2010.

Those systems and procedures must provide the institution with a comprehensive view of the risk both in terms of internal factors such as complexity of the organisation of the institution, the nature of its operations, professionalism of personnel and reliability of systems, as well as external factors such as economic conditions and regulatory framework.

Regulation 97-02 has also been amended[20] to include the risk of internal and external fraud as part of operational risk; compliance and internal control procedures must be modified so as to address the risk of fraud in an appropriate manner.

The Board of Directors must define criteria and thresholds triggers of significant incidents and these must be communicated to the Prudential Control Authority (*Autorité de Contrôle Prudentiel* – ACP) for evaluation as to whether they are appropriate to the activities and risks incurred. Any significant fraud identified must be communicated promptly to the ACP.

As regards internal and external risks of fraud, a fraud is deemed significant where it may result in a loss or gain higher than 0.5 per cent of the institution's core regulatory own funds. That amount must be higher than €10,000.

Liquidity risk

On 5 May 2009, an order was issued establishing a new framework for the identification, measurement, management and control of liquidity risk. That new framework came into effect on 30 June 2010.

Relevant firms and institutions which are subject to Regulation 97-02 must introduce measures for identification measurement, analysis and management of liquidity risk so as to ensure that the institution or firm at all times has sufficient liquidity to meet its commitments and obligations as and when due.

There are two approaches contemplated under the regulatory framework:

- The standard approach consists of calculating a regulatory liquidity ratio for one month, supplemented with a provisional funding and information schedule related to supplemental funding sources and financing costs.
- The advanced approach is based on the firm or institution using its own internal methodologies which must, in particular, develop indicators and limits related to an inventory of liquid assets and stress scenarios at different intervals.[21]

Variable compensation of financial market professionals

Variable compensation

France has taken measures to implement the Financial Stability Board (FSB) Principles for Sound Compensation Implementation Standards, together with the EU Commission Recommendations of 30 April 2009. Member States were to promote the

20 Amendment of Regulation 97-02 by Order of 14 January 2009.

21 See the 2009 Annual Report of the French Banking Commission, available at **www.acp.banquedefrance.fr**.

implementation of these recommendations by the end of 2009.[22]

The measures were introduced in November 2009[23] through an amendment to Regulation 97-02.

Under the new measure, relevant institutions and firms must apply compensation policies and implement procedures, aimed at preventing risk in line with professional standards,[24] and which reflect the FSB Principles.

The size of the variable compensation pool and its allocation within the relevant entity should take into account the full range of risks, including liquidity risk related to the business line under consideration and the quantity of capital required to support the risk taken.

Under risk management procedures, firms must be able to implement a considerable contraction of variable compensation allocated to a fiscal year or years where losses are incurred.[25]

Those firms[26] which are subject to the above rules must ensure that with regard to financial market professionals whose activities may have a material impact on risk exposure:

- a substantial proportion of compensation is variable and paid on the basis of individual, collective and firm-wide measures that adequately measure performance;
- variable compensation is not guaranteed in excess of one year;
- a substantial proportion of variable compensation is subject to conditions under deferral arrangements over a period of years, phasing of payments to be no quicker than *pro-rata temporis*;
- a substantial proportion of variable compensation is awarded in shares or share-linked instruments, or index-linked instruments so that these instruments create incentives aligned with long-term value creation and the time horizons of risk, or for unlisted companies other equivalent instruments. Awards in shares or share-linked instruments must be subject to an appropriate acquisition period or share retention policy;

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22 The EU Commission has circulated a proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/ and 2006/49 as regards capital requirements for the trading book and for resecuritisations and the supervisory review of remuneration policies. Those amendments contemplate inter alia that CESR shall cooperate closely with the Committee of European Banking Supervisors (CEBS) to ensure the existence of guidelines on remuneration policies for categories of staff involved in the provision of investment services. CEBS shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in point 22 of Annex V of Directive 2006/48 as amended.

23 Amendment of Regulation 97-02 by Order of 3 November 2009.

24 Those are inter alia the FBF Professional Rules issued on 5 November 2009, the Code of Conduct for Governance (*Code de Gouvernement des Sociétés Cotées*) of listed companies published by AFEP-MEDEV in December 2008 (the AFEP-MEDE Code of Conduct) and Recommendations on Corporate Governance published by AFG in January 2008. It is contemplated that the FBF Professional Rules may be adjusted at a later stage in the light of any changes in the environment in which they were drawn up, and of the international framework of market activities, to take account of the decisions and practices of the main countries concerned, notably at the time of the review to be carried out by the FSB in March 2010.

25 This language falls short of using language used in the FSB Principles and the Implementation Standards which contemplate a reduction of payouts of amounts previously earned, including through malus or clawback arrangements.

26 Those firms (*entreprises assujétties*) include inter alia credit institutions and investment firms.

- in the event of negative contributions of the line of business under consideration, any unvested portion susceptible of being paid to the relevant employees subject to performance, related to the fiscal year under consideration during which losses are incurred, is substantially reduced or not paid out.

Firms subject to the Regulation must require their employees to refrain from resorting to personal hedging strategies or compensation or liability-related insurance to undermine the risk alignment embedded in their compensation arrangements. Such firms must also ensure that the compensation of members of their executive body is allocated and paid in compliance with the above principles.

Compensation policy is to be set by the Board of Directors. A specialised compensation committee must be established, to prepare meetings of the Board, unless the size of the firm otherwise justifies. A majority of that committee must be composed of independent members.

Each year, relevant firms must submit a report to the ACP and certain information must be made publicly available.

Taxes on bonuses

A tax on the variable compensation of those employed in credit institutions and investment firms has been introduced.[27] The tax is triggered in relation to those employees operating as financial market professionals whose activities may have a material impact on risk exposure.

The tax is levied on variable compensation paid to such financial market professional employees and their supervisors for the fiscal year 2009 in relation to that portion of variable compensation which exceeds €27,500 where that compensation is based on individual or collective performance. The tax rate is 50 per cent.

Creation of a Strategic Investment Fund (Fonds Stratégique d'Investissement – FSI)

In October 2008, the President of the French Republic announced the creation of the Strategic Investment Fund endowed with resources of €20 billion in the form of cash and securities.[28]

The capital of the FSI, which is a *Société Anonyme,* is controlled by the French State and the *Caisse de Dépôts et Consignations* which holds 51 per cent of its capital.

The objective of the FSI is to invest in the development of:

27 Amended Budget Law no 2010-237 of 9 March 2010, Article 2.

28 Out of that €20 billion capital, €6 billion was to be immediately funded, the balance to be endowed with the transfer of participations such as CDC Participations in about 20 private companies including Accor, Air Liquide, Alcatel-Lucent, Altran Technologies, Assystem, Danone, Eiffage, Eutelsat Communications, Imerys, Lagardère SCA, Nexity, Schneider Electric, Séché Environnement, Sodexo, Technip, Ubisoft Entertainment, Vivendi, Zodiac Aerospace, Valeo, Vallourec, and state participations in companies such as France Télécom, Aéroports de Paris, STX France Cruise (former Chantiers de l'Atlantique).

- small-scale growth enterprises;
- medium-sized enterprises (valued at about €100 million to €2 billion) with substantial valuation potential;
- sound medium-sized enterprises with the potential to emerge as sector leaders; and
- large- and small-scale enterprises playing a substantial role in their sector.

The FSI is investing:

- in profitable projects;
- on a long-term basis;
- as minority shareholder;
- for a limited period of time with the intent to rotate investments;
- in enterprises where FSI is committed to the governance of the enterprise where it holds a participation; and
- as a matter of priority in strategic sectors for the economy in terms of technologies and strategic employment.

By the end of 2009, FSI had taken stakes in companies such as Valéo (€24 million), Daher (€68 million), Farinia Group (€20 million), 3S Photonics (€10 million), Gemalto (€160 million), Nexans (€58 million) and Dailymotion (€7.5 million).

More recent actions taken or under consideration

A number of measures have been taken, or are under consideration, aimed at strengthening the French regulatory framework or implementing EU legislation.[29] Some of those measures also contemplate coordination with the new EU legal framework.[30]

Reorganisation of the French banking and insurance regulatory framework

Since the 1970s/1980s, there has been a trend in France to shift administrative authority and, in certain cases, authority to issue regulations, to independent administrative authorities.

29 Most of those measures are incorporated in the draft Financial and Banking Regulation Law (P*rojet de Loi de Regulation Bancaire et Financière* – the Financial and Banking Regulation Law) which was adopted by the French National Assembly on 10 June 2010. The draft law needs to be voted upon, and may be amended, by the French Senate before enactment.

30 The European Commission has adopted a Communication (COM (2009) 252 final) dated 27 May 2009 on Financial Supervision in Europe. The Communication proposes a set of ambitious reforms to the current architecture of financial services committees, with the creation of a new European System of Financial Supervisors (ESFS), composed of new European Supervisory Authorities, and a European Systemic Risk Council (ESRC). Also see the following European proposals dated 23 September 2009: (i) Proposal for a regulation on Community macroprudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB); (ii) Proposal for a decision entrusting the European Central Bank with specific tasks concerning the functioning of the ESRB; (iii) Proposal for a regulation establishing a European Banking Authority (EBA); (iv) Proposal for a regulation establishing a European Insurance and Occupational Pensions Authority (EIOPA); and (v) Proposal for a regulation establishing a European Securities and Markets Authority (ESMA).

The creation of the AMF in 2003 reflects that trend. The AMF is an independent administrative authority which has merged the functions of the *Commissions des Opérations de Bourse* (COB), the *Conseil des Marchés Financiers* (CMF) and the *Conseil de discipline de la Gestion Financière* (CDGF).

The AMF is entrusted with a threefold mission, namely to protect savings, to ensure investor information and to ensure the smooth operation of financial markets. It has the power to issue regulations and does so through the issue of its General Rules relating to the operation of markets and financial instruments, the control of financial operations and the information provided to the public in respect of financial instruments. The AMF has the authority to impose sanctions.

In addition to the AMF, a single Prudential Control Authority, the *Autorité de Contrôle Prudentiel* (ACP) has been created under an Order of 21 January 2010.[31] The ACP comprises a merger of four existing authorities, namely:[32]

- the *Comité des Entreprises d'Assurance* (CEA), which had licensing authority in the insurance sector;
- the *Comité des Etablissements de Crédit et des Enterprises d'Assurance* (CECEI), which had licensing authority in respect of credit institutions and investment firms;
- the Banking Commission (*Commission Bancaire*); and
- the '*Autorité de Contrôle des Assurances et de Mutuelle*' (ACAM).

Where the AMF is an independent authority with legal personality, the ACP is specifically characterised as an independent administrative authority without legal personality. Like the AMF, however, the ACP is governed by a board (*Collège*) and also has a separate sanctions committee (*Commission des Sanctions*).

The ACP's stated purposes include supervision and control, the preservation of the stability of the financial system and the protection of those clients, insured participants and beneficiaries, which are subject to its control. The ACP has:

- the authority to grant licences to credit institutions, investment firms, insurance companies and certain market infrastructures;[33]
- control functions (including inter alia in respect of the financial situation of entities under its control and compliance with solvency requirements and the compliance function);
- the authority to take administrative policy measures; and
- the authority to impose sanctions.

The ACP does not have the power to issue regulations. This power is vested with the

31 Ordonnance no 2009-79 of January 21 2010.

32 France has favoured a sector approach in respect of supervision as opposed to an integrated approach such as in the UK or in Germany where one single body is in charge of supervision of the financial sector. See in this respect '*Assemblée Nationale Rapport fait au nom de la Commission des Finances, de l'économie générale et du contrôle budgétaire sur le Projet de Loi de régulation bancaire et financière*' dated 25 May 2010, p. 32.

33 The above is a summary of the provisions enshrined in Article L. 612-1 and following of the CMF. Some of those powers are shared with the AMF, the latter having jurisdiction over portfolio management firms.

Minister of the Economy.[34]

The ACP and the AMF are required to share, under the authority of a coordinator, common resources in controlling the marketing of financial products, services and operations, and the monitoring of evolution of products and marketing campaigns, all with a common point of entry. The ACP and the AMF have entered into an agreement in this respect.

An accounting standards authority, the *Autorité des Normes Comptables* (ANC) has also been created as an independent administrative authority.[35] Its purpose is to facilitate the normalisation of accounting standards.

Measures contemplated under the draft Financial and banking Regulation Law

The draft Financial and Banking Regulation Law was adopted by the National Assembly on 10 June 2010 but is subject to amendment by the Senate, which at the time of writing is yet to vote. The main measures contemplated in this draft legislation[36] are as follows.

Ratification of the provisions contained in the order creating the ACP

The draft law ratifies the creation of the ACP and requires it to provide information on a quarterly basis to Parliament on the progress of negotiations conducted within the BIS regarding future Basel III prudential requirements. That information must be provided as and when needed at each stage of the discussions, whether in the form of a material hearing or a series of negotiations.

An impact assessment is to be made of the effect of such proposed revisions on the offer of credit and financing of the French economy. That impact assessment is to be made no later than 31 March 2011.

The purpose of these provisions is to ensure that any Basel III discussions which may have an adverse impact on the growth of the French economy are brought to the attention of Parliament; and to facilitate the transposition of relevant EU financial directives.

The draft Financial and Banking Regulation Law also contains provisions aimed at strengthening the control of Parliament over the ACP, which would be required to submit an annual report to Parliament and to the Government. Parliamentary committees would

34 Under Law no 2003-706 of 1 August 2003 on financial security (*Loi de sécurité financière*), the Minister of Economy has exclusive jurisdiction in respect of regulations regarding capital of credit institutions, conditions governing relationship with customers, competition law matters, management and organisation standards regarding relations with customers, instruments and credit rules, protection of depositors, accounting organisation and compliance with completion and concentration matters (Article L. 611-1 of the CMF).

35 Ordonnance no 2009-79 of 22 January 2009. Although that order does not specify explicitly the status of that authority as independent administrative authority, that characterisation appears from the general framework of the relevant order. The ANC merges the *Conseil National de la compatibilité* and the C*omité de Réglementation Compatible.*

36 That draft legislation is to be adopted by the French Senate before becoming law. That adoption is expected in the early autumn of 2010.

have the power to require hearings of ACP representatives. The ACP Board would also include two experts in the financial, legal, banking and insurance sector designated by the President of the National Assembly and the President of the Senate.

Implementation of EU Directive no 2009/111 of September 2009 addressing articles 129 to 131bis of Directive no 2006/48 of June 2006 relating to the taking up a pursuit of the business of credit institutions

3.2.2.1 Introduction in the CMF of provisions aiming at strengthening exchange of information between the ACP and other national supervisors in the context of supervision on a consolidated basis of EU parent credit institutions in respect of compliance with own fund requirements.

3.2.2.2 Introduction in the CMF of provisions contemplating the recognition of Committees of European Supervisors with the objective of improving cooperation aiming at facilitating implementation of ordinary decisions of supervisory authorities and dealings in the context of emergency situations.

Creation of a financial regulation and system risk board – Cofreris

The *Conseil de Régulation Financière et du Risque Systématique* (COFRERIS) is to be created to facilitate the exchange of views of all relevant stakeholders for the purpose of crisis prevention. Such exchanges are intended to identify in advance potential risk factors for different sectors as well as those having a potential impact on the financial sector as a whole.

It is hoped that this will facilitate prompt diagnosis of a pending crisis, and fluidity of data processing, to enable prompt and decisive action to be taken where necessary.

Cooperation of the AMF with its EU counterparts

Under the draft Financial and Banking Regulation Law, provisions will be introduced in the CMF aimed at improving:

- liaison with the new EU sector agencies in the process of being created in the EU;[37] and
- the legal framework governing exchange of information among market infrastructures in France and foreign regulatory authorities which are counterparts of the AMF.

37 See footnote 38.

Regulation of rating agencies

An EU Regulation[38] on credit rating agencies was issued on 16 September 2009. That Regulation is directly applicable in France and other EU Member States. The Regulation contemplates inter alia that ratings used either for regulatory purposes or in a prospectus to be used for admission to trade on a regulated market must be issued by credit rating agencies established in the Community and registered in accordance with the Regulation.[39]

It further contemplates that such a credit agency may be subject to compliance with certain conditions and may endorse a credit rating issued in a third country. Exemptions to endorsement are contemplated subject to certain conditions. Such credit rating agencies must apply for certification.

The Regulation provides that by 7 June 2010, each Member State shall designate a competent authority for the purpose of the Regulation.

The Financial and Banking Regulation Law designates the AMF as the competent authority for registration and supervision of credit rating agencies.[40]

Provisions have also been introduced in the draft law, addressing liability of credit rating agencies vis-a-vis clients and third parties for damaging consequences resulting from the fault or negligence of the credit rating agencies in the performance of their obligations under the Regulation. In practice, a regime of tort liability is being introduced in this area.

Exclusion or limitation of liability clauses of credit agencies are also to be prohibited and void.

Credit rating and credit rating activities are also introduced in the list of ancillary investment services.

38 Regulation (EC) N° 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies. That Regulation was published in the Official Journal of the European Union on 11 November 2009. It came into force on the 20th day following that publication (i) except for Article 4 (1) which shall apply from 10 December 2010 (credit ratings used for regulatory purposes by credit institutions, insurance or reinsurance undertakings, UCITS or institutions for occupational retirement provisions where issued by a credit agency established in the community and registered in accordance with the Regulation) and (ii) except for points (f), (g) and (h) of Article 4 (3) which shall apply from 7 June 2011 (related to endorsements by credit rating agencies established in the Community and registered in accordance with the regulation of credit ratings issued in a third country requiring that third country credit rating agency be authorised or registered in that country and be subject to supervision therein where the regulatory authorities in that country are prevented from interfering with the content of the credit ratings under its applicable regulatory regime provided that a cooperation arrangement is in place with the home Member State and the regulatory authority of that third country).

39 See Article 4 (1) of the Regulation for further details.

40 The report, made on behalf of the *Commission des Finances, de l'Economie Générale et du Contrôle Budgétaire* of the National Assembly related to the Financial and Banking Regulation Law filed with the Presidency of the National Assembly under Number 2550 on 25 May 2010, provides that Article L. 544-3 of the CMF addressing that matter may be revised on second reading depending on the evolution of the European legal corpus currently in process.

Treatment of Credit Default Swaps (CDS)

The authority of the AMF to impose sanctions in respect of insider dealing, price manipulation and disclosure of false or misleading information relating to financial instruments listed on a regulated market or a multilateral trading facility is to be extended to cover a financial instrument linked to one or more of the above financial instruments.

Specific provisions to that effect have been introduced in the draft Financial and Banking Regulation Law.[41]

The draft law also contains provisions requiring the Government to submit before the end of 2010 a detailed report addressing the possibility of prohibiting CDS in the eurozone, of which the underlying risk constitutes the default of sovereign debt, where the investor does not hold securities evidencing that underlying risk.

Independently from the legal framework expected under the Financial and Banking Regulation Law, LCH Clearnet SA announced in March 2010 the launch of a clearing offer for CDS operating in the eurozone and has issued a CDS Clearing Rule Book, relying on the DTCC Trade Information Warehouse (TIW). LCH Clearnet is licensed in France as a clearing house (ie, CCP) and, as a credit institution, has access to central bank money.[42]

Support to small- and medium-sized enterprises

Development of direct access to market-related financial resources

The draft Financial and Banking Regulation Law includes provisions aimed at enhancing the attractiveness of Alternext equity markets. Alternext, a market organised by Euronext Paris SA aimed at small- to medium-sized companies, does not constitute a regulated market within the meaning of Article L. 421-1 CMF. Instead, it is an organised Multilateral Trading Facility (MTF) within the meaning of Article 525-1 of the General Rules of the AMF and Article L. 433-3 II CMF.

Under the proposed legislation, the standing market offer requirements (*garantie de cours*) applicable to shares listed on Alternext are to be replaced by mandatory bid procedures. Mandatory squeeze-out procedures are also to be introduced in respect of such shares.

The share repurchase regime, which is applicable to regulated markets, will also now apply to shares listed on Alternext. Threshold reporting is to be made more flexible.

Credit insurance

The draft Financial and Banking Regulation Law also contains provisions permitting Banque de France to transfer to licensed insurance companies information regarding the financial situation of enterprises which is in the possession of Banque de France.

Banque de France maintains substantial records[43] regarding the financial situation of enterprises. The information in those records may only be communicated to credit

41 Those modifications take the form of an amendment to Article L. 621-15 of the CMF.
42 In France, a clearing house needs to be licensed as a credit institution.
43 *Fichier Bancaire des entreprises* (FIBEN).

institutions and financial institutions.

In exchange for access to that information, such credit insurers must undertake to provide to the ACP information regarding their rating methodology and models.

In agreeing to provide that information, Banque de France would indeed be in a position to set the conditions under which that access to information would be provided.

During the crisis, a number of small- to medium-sized enterprises lost their credit insurance cover as credit insurers adopted restrictive policies. This had an adverse impact on the financial viability of a number of clients of credit insurers.

To address those problems, the Government introduced a number of support measures to open the credit insurance market.[44]

Improvement of residential housing financing

1999 witnessed the introduction into French law of the concept of *obligations foncières*,[45] inspired by the German '*Pfandbriefe*'. *Obligations foncières*, or legal covered bonds, are issued by a *société de crédit foncier*. They benefit from a special security regime and have been in high demand during the financial crisis for the purpose of use as collateral, giving access to central bank money.

During the crisis, spreads on these covered bonds never differed from 200 basis points over OAT government bonds. Their issue remained strong while the interbank market was weak. The French market absorbed during the crisis about €80 billion of covered bonds and their amount outstanding is about €264 billion, including €119 billion of mortgage-backed credits.[46]

Although the aggregate outstanding amounts of these covered bonds remain

44 Credit insurance plays an essential economic function in France through providing cover for an insured enterprise against supplier credit risk. Credit insurers underwrote about €320 billion of risk in 2008 representing about 25 per cent of inter-company credit in France. With cover suddenly withheld or reduced in the midst of the credit crunch, those suppliers which lost their cover suffered severe strain. In November 2008 the French Government introduced a publicly supported reinsurance scheme (*Complément d'Assurance Public*) (CAP) enabling those enterprises which had received notice of reduced cover, or which were offered a lower cover in respect of new risk, to receive supplemental insurance substituting for that deficiency. Such supplemental insurance was then reinsured by the *Caisse Centrale de Réassurance* which benefits from the guarantee of the French Republic. The extra insurance cover is available on payment of an additional premium. A similar scheme has been introduced in respect of uninsurable risk for which a credit insurance application has been rejected (CAP1).
In return for that service, credit insurers agreed to a greater degree of transparency by providing reasons for a rejection of, or a reduction in cover relating to, an application. Insurers have also agreed to provide their credit ratings free of charge to the rated entity. The 2009 amended Budget Law provided for a €200 million credit line to cover CAP1 risk, in addition to the credit cover in the amount of €250 million available for CAP. Those services are available to enterprises with an annual turnover below €1,500 million. A similar cover is available in respect of exports (Ministry of Economy publications).

45 Law no 99-532 of 25 June 1999 related to savings and financial security (*épargne et sécurité financière*).

46 See the report made on behalf of the *Commission des Finances, de l'Economie Générale et du Contrôle Budgétaire* of the National Assembly related to the Financial and Banking Regulation Law filed with the Presidency of the National Assembly under Number 2550 on 25 May 2010, p 46 and following.

high, the size of the market remains modest in France compared with the volume of corresponding bonds in neighbouring countries. Indeed, in Europe as a whole, covered bonds benefiting from a priority lien constitute the first class of assets after sovereign bonds, of which the aggregate amount in 2008 was about €2,384 billion.

The regulatory regime for *obligations foncières*[47] is to be improved by virtue of proposed amendments under the new Financial and Banking Regulation Law. In addition a new type of bond, known as residential housing bonds (*obligations d'habitat*) is to be introduced. The regime for each of these bonds will be examined in more detail below.

OBLIGATIONS FONCIÈRES

Obligations foncières are issued by a *société de crédit foncier* (SCF). SCFs are credit institutions licensed as *sociétés financières* (financial companies),[48] the exclusive purpose of which is:

- to grant or purchase secured loans, exposures over public entities, instruments and securities, as defined in Article L. 515-14 through Article L. 515-17 of the CMF; and
- to issue '*obligations foncières*' (that is, bonds) benefiting from the priority lien referred to in Article L. 515-19 of the CMF, for the financing of such loans, exposures, instruments and securities.

For purposes of financing the above, an SCF may also raise bonds or other financing resources which do not benefit from the priority lien.

They may also use their asset and loan portfolio as collateral to access liquidity either in the form of repos, security interest or otherwise under the techniques contemplated under the provisions transposing the EU collateral directive[49] or Articles L. 313-23 through L. 313 6 of the CMF.

SCF are governed by Article L. 515-13 through Article L. 515-33 of the CMF,[50] which grant a preferential treatment for creditors of an SCF who benefit from the priority lien referred to in Article L. 515-19 of the CMF.

The protection of investors is enhanced by the '*obligations foncières*' being issued by SCF as a credit institution, because an SCF is subject to the usual regulatory prudential capital requirements and other protective regimes applicable to credit institutions, including regulatory supervision.

As far as forward financial instruments are concerned, Article L. 515-18 of the CMF provides that, in order to hedge the management of (i) loans and exposures referred to in Articles L. 515-14 to L. 515-17 of the CMF (that is, loans which are part of the loan portfolio of the SCF); (ii) '*obligations foncières*' issued by the SCF; or (iii)

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47 *Obligations foncières* benefit from exemptions under Article L. 22(4) of EU Directive 85/61/CEE which is transposed in France under Article R. 214-6 of the CMF. That provision contains an exemption from the rules governing UCITs enabling a UCIT to hold up to 25 per cent of its assets in the form of securities of the same issuer where such securities are *obligations foncières*.

48 Credit institutions may be licensed either as (i) banks; (ii) mutual or cooperative banks; (iii) *caisses de crédit municipal*, (iv) financial companies (*sociétés financières*); or (v) specialised financial companies (*sociétés financières spécialisées*).

49 Articles L. 211-36 to L. 211-40 of the CMF.

50 Such provisions are supplemented by those of Article R. 515-2 to Article R. 515-14 of the CMF.

other preferential resources of the SCF,[51] an SCF may enter into forward financial instruments, as defined in Article L. 211-1 of the CMF.

Amounts due in respect of forward financial instruments entered into by an SCF for hedging its assets and liabilities, after set-off, if need be, benefit from the priority lien referred to in Article L. 515-19 of the CMF, as well as amounts due in respect of forward financial instruments entered into for hedging or managing the global risk on its assets, liabilities or off-balance sheet items. However, those forward financial instruments which are entered into for hedging the transactions contemplated in Article L. 515-13-II of the CMF (that is, loans and other resources which do not benefit form the priority lien referred to in Article L. 515-19 of the CMF) do not themselves benefit from such priority lien.[52]

Notwithstanding any legal provisions to the contrary and, in particular, the provisions of Book VI of the French Commercial Code (which contains the French insolvency law):

- proceeds from loans or related claims (*créances assimilées*), exposures, instruments and securities referred to in Articles L. 515-14 to L. 515-17 of the CMF (that is, loans which are part of the loan portfolio of the SCF) and financial instruments referred to in Article L. 515-18 of the CMF (that is, forward financial instruments entered into for hedging purposes), after set-off, if need be, as well as claims resulting from deposits made by the SCF with credit institutions, are applied in priority to the payment of *obligations foncières* and of any other preferential resources referred to in Article L. 515-13-I 2° of the CMF;
- in the event an SCF is subject to a Conciliation Proceeding, a Safeguard Proceeding, a Judicial Reorganisation Proceeding or a Judicial Liquidation Proceeding, claims related to transactions benefiting from the priority lien referred to in Article L. 513-1-I 2° of the CMF (that is, *obligations foncières* and other resources benefiting from the priority referred to in Article L. 515-19 of the CMF) are paid when they fall due (that is, at their contractual maturity), and in priority over all other claims (interests being included), whether secured or not by a lien or security, whatever their maturity is. Any claims of the other creditors over the assets and rights of the SCF are subject to the full discharge of obligations secured by a priority lien, as defined in such Article L. 515-19 of the CMF. Safeguard Proceedings, Judicial Reorganisation Proceedings or Conciliation Proceedings do not result in the acceleration of claims on such SCF; and
- the opening of a judicial liquidation of an SCF does not result in the acceleration or termination of the *obligations foncières* or any other resources benefiting from the priority lien referred to in Article L. 515-19 of the CMF. The claims related to such transactions are paid when they fall due (that is, at their contractual maturity). In return, the *obligations foncières* and any other preferential resources are discharged before any other claims.

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51 This list, however, is not comprehensive.

52 See further Article L 515-8 of the CMF. Any contract entered into by an SCF, the purpose of which is to obtain resources benefiting from the priority lien referred to in Article L. 515-19 of the CMF, must expressly provide that such resources benefit from such priority.

In order to improve access to liquidity by an SCF, the Financial and Banking Regulation Law will introduce two new features:

- SCFs will now be allowed to issue promissory notes[53] referred to in Articles L. 313-42 to L. 313-48 of the CMF. This is the regime which was successfully used by SFEF during the crisis. Such promissory notes have proved to be particularly efficient as a financing tool; and
- SCFs are allowed to repurchase their own *obligations foncières*. This is in derogation of the provisions of the Civil Code and of the Commercial Code which otherwise prohibit such action. The repurchase is allowed up to an aggregate amount no higher than ten per cent of the aggregate outstanding of all resources benefiting from the super-priority lien described above; and is conditional on the bonds being posted as collateral with Banque de France. During the repurchase, the bonds are deprived of voting rights.

Introduction of residential housing bonds (*obligations d'habitat*)

Under UCIT EU Directives, collateral in the form of loans constituted by credits secured by a surety (*caution*) may represent no more than 35 per cent of the total collateral. Otherwise, mortgage-backed credits are required.

In 1999, mortgage-backed credits represented 70 per cent of the aggregate of residential housing credits, and credits secured by a surety, 30 per cent. The market has witnessed that ratio being reversed in the last few years. It is now cheaper and more attractive to apply to a cooperative institution, the business of which is to issue sureties securing residential housing, rather than taking out a mortgage which is expensive to create.

It is in that context that the market developed the concept of contractual covered bonds. These bonds did not, however, benefit from the statutory super-priority lien granted to *obligations foncières*.

Those contractual covered bonds were therefore not eligible under the above exemption from the UCIT Directive which permitted a UCIT to hold up to 25 per cent of its aggregate assets issued by the same issuer in the form of *obligations foncières*.[54]

Those bonds were therefore not eligible as ESCB collateral, although a temporary exemption was granted by the ESCB in order to meet demand during the financial crisis.[55]

It is in that context that the framework for housing bonds (*obligations d'habitat*) is being introduced in the French legal framework through the Financial and Banking Regulation Law. The purpose of that legislative change is to grant to contractual bonds a legal status similar to that of the *obligations foncières*, thereby rendering them eligible as ESCB collateral.

53 This discretion only applies in respect of financial resources which do not benefit from the super-priority lien.

54 See footnote 29.

55 See the report made on behalf of the *Commission des Finances, de l'Economie Générale et du Contrôle Budgétaire* of the National Assembly, related to the Financial and Banking Regulation Law, filed with the Presidency of the National Assembly under Number 2550 on 25 May 2010, p 48 and following.

Under the proposed legislation, residential housing bonds (*obligations d'habitat*) are issued by a *société de financement de l'habitat* (SFH).[56] SFHs are credit institutions licensed as *sociétés financières,*[57] the exclusive purpose of which is to grant loans for the financing of residential housing and to hold securities and assets defined by Decree.

SFHs may:

- grant to any credit institution loans secured by an assignment of, or pledge over, residential housing loans secured by a first ranking mortgage or a surety issued by a credit institution or an insurance company;
- acquire promissory notes issued by a credit institution in the manner contemplated by Articles L. 313-43 to L. 313-48 of the CMF and which by derogation may use residential housing loans as collateral;
- grant residential housing loans secured by a first ranking mortgage or a surety issued by a credit institution or an insurance company; and
- issue bonds benefiting from the statutory super-priority lien referred to in Article L. 515-19 of the CMF described above in respect of *obligations foncières.*

For purposes of financing the above, an SFH may also raise other financing resources which do not benefit from the above priority lien under certain conditions.

Credit institutions licensed as *sociétés financières* may under certain conditions apply to obtain the status of an SFH by notice to the ACP no later than 12 months following promulgation of the Financing and Banking Supervision Law. The ACP must satisfy itself that the articles of association of the credit institutions concerned are compliant.

From the date of determination of that application by the ACP, the relevant provisions regarding an SFH will apply by operation of law and without any further formality to:

- contractual covered bonds issued prior to such change of status where the only purpose of those bonds is to finance qualifying residential housing; and
- contractual counterparties mentioned in Articles L. 515-18 and L. 515-22 of the CMF.

The super-priority lien defined in Article L. 515-19 is substituted by operation of law to security constituted over the assets of such institution previously granted to secure such contractual covered bonds together with contractual counterparties.

Establishment of the European Financial Fund

By Council Regulation dated 10 May 2010, a European Union (EU) stabilisation fund was established to preserve financial stability in the EU. This arose from a realisation that the worsening of the financial crisis had led to a severe deterioration in the borrowing conditions of several states beyond what could be explained by economic fundamentals.

56 For that purpose, the SFH would benefit from the collateral arrangements contemplated under the provisions transposing the EU collateral directive (Articles L. 211-36 to L. 211-40 of the CMF or Articles L. 313-23 to L. 313 6 of the CMF).

57 Those companies are governed by Articles L. 515-14, L. 515-16 and L. 515-17 to L. 515-32-1 of the CMF subject to certain restrictions.

At the same time, the representatives of the eurozone Member States committed to provide assistance through a special purpose vehicle (SPV), that is guaranteed on a pro rata basis by participating Member States, up to €440 billion in accordance with their share in paid-up capital of the ECB and pursuant to their national constitutional requirements.

In June 2010, France granted authority to its Minister of Economy to give the guarantee of the French Republic on account of its share in the EU Stabilisation Fund for an amount not to exceed €111 billion. That guarantee will be granted to an SPV established for that purpose and which will provide finance or grant loans to EU Member States, the currency of which is the euro. The guarantee will also cover financing to be raised by that SPV.

The guarantee may not be granted after 30 June 2013.

Conclusion

The French banking system has emerged from the turmoil of 2007–2009 all the stronger, although some of its institutions have been subject to severe stress.

The focus on universal banking, combining a robust retail banking sector, which benefits from strong shareholder support, with CIB activities operating in a well established regulatory and supervisory environment, has been at the root of France's ability to overcome the severe difficulties and substantial losses of the last few years.

Those losses were essentially attributable to structured products (a substantial portion of which was related to sub-prime products), monoline exposure, market counterparties, such as the Lehman or Icelandic banks' inability to syndicate in a market lacking liquidity and certain risks such as LBOs in the process of syndication. Operational risk and compliance failures also resulted in losses.[58]

The French Government, together with its European counterparts have taken swift measures to enable banks to strengthen own funds requirements and to ensure continuous dialogue between the French bank supervisor and major French banks in the context of Basel II Pillar 2 measures.

SFEF has also been instrumental in enabling French banks to face liquidity needs in the distressed environment in which they found themselves.

Those actions resulted in the restoration of confidence, leading to a phase-out of emergency measures in 2009 as liquidity improved.

The events of the last few years have shown that the remedies for a global crisis lie only in global, and regional, action. The need for improvement of the supervisory framework at the European level, in close coordination with Member States, has become compelling.

In that context, the adoption of Basel III measures will constitute a particular

58 See report *Commission Bancaire pour l'année 2008*, p 47.

challenge in the context of strengthening regulatory capital levels.[59] Without waiting for those measures, the French Banking Commission established, in 2004, a semi-annual committee of European supervisors for BNP Paribas, Crédit Agricole Group and Société Générale.

It is in that environment that stress tests have been conducted successfully in the summer of 2009 under ESCB coordination.

The crisis has also shown the importance, and challenges, of reform and harmonisation of accounting standards. Reduced complexity, better coordination between IASB and FASB and improvement of rules related to risk provisioning are of the utmost importance.

59 The French Banking Federation has expressed concern regarding the Basel proposals currently under consideration as to the potentially adverse consequences on growth in France and Europe. If adopted, these proposals may indeed be inappropriate and excessive. Proposed global minimum capital and liquidity requirements may curb banks' abilities to lend to companies and in particular SMEs and households. A new impact assessment study has been requested and the need to establish a level playing field has been stressed (see FBF press release dated 30 April 2010. See also 'Reforming of prudential rules position of French banks with regard to current proposals: general comments').

Spain

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Overview of the Spanish banking sector

The scale of the recession in Spain was in line with global trends. With the abrupt decline in Spanish economic activity, the biggest in decades, the GDP in the opening months of 2010 stood at 4.6 per cent below its peak in the second quarter of 2008. While the global crisis had a major impact, the decline in Spain can be attributed, at least in part, to a number of domestic factors, including:

- the decline in domestic spending;
- the persistence of serious structural deficiencies in the Spanish labour market;
- the intensity of the rise in unemployment;
- the excessive concentration of resources and growth in the real estate sector; and
- high private sector debt.

If anything has been highlighted by the current global crisis, it is the close relationship between different global economies in general, but particularly so for the narrow links in the world financial system. Three years on from the beginning of the turmoil in summer 2007, the Spanish banking system is, by and large, in a sound position in which to restructure.

The situation of Spanish credit institutions in the face of the global financial crisis has been comprehensively analysed by market participants. At the beginning of the crisis, Spanish credit institutions enjoyed a healthy financial situation. Yet the banking system was not immune to the crisis and, in particular, was drastically affected by its exposure to the real estate sector. There has been a slowdown in credit, with differences in intensity across institutions and sectors. Generally, some institutions were more resilient than others.

It is commonly accepted that nearly three years after the international crisis started, the resilience of the Spanish banking sector, historically subject to regulation and supervision based on prudent and stringent application of international standards, has, until recently, been outstanding in comparison with that of other developed countries. Institutions of such size as to be critical for the health of the system have maintained a solid position, enabling them to continue their domestic and international expansion and to do so without requiring public support or intervention. The Spanish banking sector has thus been in a favourable position.

However, the position of some medium- and small-sized credit institutions, and economic conditions within the country, could be jeopardised in the coming months due to:

- persisting liquidity and financing difficulties;
- the impairment of certain assets owned by credit institutions; and
- increased loss of confidence and reduction in their business activities, consequences both of the extended duration and intensity of the crisis, and the sharp decline in economic activity in Spain generally.

Despite the general resilience of the Spanish banking sector, several economic, fiscal and banking measures were adopted in the interests of the financial system. They include the setting up of a fund to facilitate the orderly restructuring of the Spanish banking sector by reinforcing medium-term profitability and solvency through integration processes. The Spanish approach has been to prioritise private restructuring. Credit institutions, while they are still viable, have been allowed to take the initiative in carrying out their restructuring in private under the supervision of the Bank of Spain. The objective has been to minimise the use of public funds.

A number of complex legislative initiatives have been taken in the corporate, fiscal and accounting fields, as described below. Representing the biggest overhaul of the Spanish banking sector in recent history, they include:

- the adoption of new regulations on mergers, spin-offs and transfer of assets between credit institutions;
- new rules on the integration processes of credit institutions;
- the creation of a legal framework for institutional protection systems; and
- key changes to the accounting and risk framework applicable to credit institutions.

In the midst of the legal and regulatory turmoil needed to adapt the Spanish financial sector to a new reality, a number of credit institutions, principally savings banks, have, over the last two years, initiated negotiations with a view to establishing potential alliances.

Unlike in other countries, the international financial crisis has not caused massive losses for deposit-taking institutions in Spain. Therefore, widespread bailout programmes have not been used and, as a result, so far Spain has neither nationalised nor capitalised any financial institution. Only two precautionary special measures were adopted by the Bank of Spain in the last few years with respect to two medium-sized savings banks: Caja Castilla-La Mancha in 2009 and Cajasur in 2010. The Bank of Spain decided to replace the management of Caja Castilla-La Mancha in March 2009 with the participation of the Savings Bank Deposit Guarantee Fund. This fund granted €3.8 billion of aid, of which €1.3 billion consisted of preference shares and €2.5 billion were in the form of additional guarantees of asset value. It also granted €350 million of bridge financing. The business of Caja Castilla-La Mancha was subsequently assigned in an auction process to Cajastur, which is now one of the entities involved in merger/protection plans approved by the Bank of Spain.

On 21 May 2010, the Bank of Spain approved the intervention of Cajasur after its failed merger with Unicaja and appointed a provisional administrator. This transaction

was funded by the Fund for Orderly Bank Restructuring with temporary aid of €800 million in non-voting equity units. It also provided a potential €1.5 billion in liquidity support. The business of Cajasur has just been assigned to the Basque savings bank BBK in a competitive process.

Spanish institutions proved extremely resilient and the majority remain resilient to this day. However, if the necessary measures for reactivating employment growth within a reasonable timeframe are not adopted, bad debts will continue to mount and more financial institutions will face difficulty in providing the financing needed for economic recovery. According to the Bank of Spain's figures, doubtful assets of the resident private sector in Spain grew sharply (45.3 per cent year-on-year as at December 2009 and 23 per cent year-on-year as at March 2010), as did the doubtful assets ratio for the resident private sector (five per cent as at December 2009 and 5.3 per cent as at March 2010). The doubtful assets ratio is higher in those sectors whose performance is most closely linked to the economic cycle (that is, the construction and property development sectors). The Spanish banking industry is facing potentially significant risk through its exposure to these sectors, which are undergoing a very sharp adjustment. The level of that exposure is estimated by the Bank of Spain as €445 billion as at December 2009.

In the current situation, Spanish institutions need to readjust their liabilities, raising their relative weight of deposit, in intensifying competition. Spanish institutions' debt issues are mostly medium- and long-term, easing the debt refinancing risk. Also the institutions have stepped up their efforts to attract deposits. Spanish institutions have been obtaining more funds from the European Central Bank. The volume of funds obtained is in line with the relative size of the Spanish economy in the euro area, and only represented two per cent of the consolidated balance sheet as of December 2009, although the figures have substantially increased in recent weeks. Spain's larger institutions were able to access the senior debt markets until recently, but given the difficulties in funding markets, especially for institutions perceived as weak, the volume of debt issues backed by state guarantee has increased.

The Bank of Spain has confirmed in its last official Report on Banking Supervision in Spain that the total solvency ratio of Spanish institutions is 12.2 per cent, with the Tier 1 ratio at 9.7 per cent and the core capital ratio at 8.1 per cent. In the view of the regulator, the improvement has been particularly robust in terms of their top-quality own funds which places them in a favourable position for undertaking BCBS changes in Basel II, while risk-weighted assets have remained unchanged.

As will be apparent from the analysis below, the bulk of measures adopted to confront the accelerated economic and financial downturn have been exceptional. The map of the Spanish financial system is changing beyond recognition as a consequence of the different challenges it has faced over the last few years.

The Spanish banking model

During the last few decades the Spanish financial system suffered a number of crises, including one in the late 1970s, on the occasion of Spain's transition from dictatorship to democracy, and another at the beginning of the 1990s, which involved the bankruptcy of some credit institutions. As a result, the Bank of Spain developed a strict and prudent banking supervision model, geared towards ensuring the stability of institutions during normal financial conditions as well as more turbulent times.

The Bank of Spain performs an intensive supervisory function, based on in-depth scrutiny and the maintenance of a high degree of proximity to the credit institutions being supervised. This includes the regular performance of stress tests and continuous presence of the Bank of Spain's inspectors in the institution's premises.

Elements of the Spanish banking model were peculiar to Spain and, ultimately, proved beneficial to the Spanish banking system during the global financial crisis. In 2000, Spain established a counter-cyclical provisioning mechanism, backed by the Bank of Spain in boom times, and under which Spanish credit institutions were forced to build buffers by anti-cyclical provisioning. Unlike other European institutions, Spanish banks did not have high levels of exposure to American sub-prime mortgage issues and hybrid, securities-related, products. This was partially because of the narrow-minded attitude of the Bank of Spain; the Spanish regulator turned down many initiatives by the Spanish banks because of risk of assessments matters.

Delinquency does not occur according to a consistent pattern but, instead, is accentuated during economic downturns. The Bank of Spain realised that if provision was made only in the downturn years the impact of loan loss provisions in profit and loss accounts in upturn years would be disproportionately low; and, with more dividends being declared than under a more conservative approach, the health of the relevant financial institutions would appear greater than in reality they were. Conversely, in downturn years the impact of these provisions would be disproportionately higher.

The Bank of Spain concluded that failing to consider latent losses caused cyclical movements in financial institutions' results, and, because of the institutions' mood stemming from those results, in interest rates. This increased, through the lending market, the impact and depth of economical cycles.

To mitigate these risks, as mentioned above, in 2000, the Bank of Spain introduced a counter-cyclical buffer, the so-called 'statistic provision'. These provisions are an accounting requirement of the Bank of Spain intended to oblige banks to disclose their loan losses without having to wait until they are identified later through the occurrence of a loss event, such as default.

The Bank of Spain established an objective system for calculating provisions. The system adopts a rule-based model and the Bank of Spain guidance on specific provisions is transparent and public, setting minimum provisioning requirements on the basis of objective features such as the time past-due and loan characteristics. This contrasts with the system in most countries where provisions are determined according to the judgment of the banks' managers and endorsed globally by the auditors.

Also, the Bank of Spain has obliged credit institutions to adopt pre-emptive measures in the form of a larger pool of provisions. The Spanish banking model provides for dynamic provisions based on a transparent and automatic mechanism, which allows earlier detection and coverage of credit losses in loan portfolios. The idea behind the mechanism is simple, recognising that there is a gap between credit risk being taken and credit risk appearing in the profit and loss account of banks. Thus, the dynamic provision regulation fosters the accumulation by banks of provisions during upturns – when credit grows sharply and specific defaults are low – so that the accumulated stock can be used when bad loans start to increase. The flow of provisions reflects the macroprudential approach inherent in the Spanish provisioning system. Between mid-2007, when lending entered a phase of deceleration, and end-2009, the flow of specific provisioning as a percentage of loans grew more than tenfold according to Bank of Spain figures, while the flow of total provisions merely doubled.

The counter-cyclical mechanism of dynamic provisioning is based on the comparison between expected losses and specific provisions (this expected loss model is the approach that the IASB is moving towards) and Spanish banking institutions have benefited from this provisioning model, especially when doubtful assets and bad debts increased sharply. That success does not mean that the system can be considered a silver bullet. The lesson of the crisis and the final proposal of the IASB may make a review of the calculation methodology used for Spanish provisioning advisable.

As a result of the introduction of the counter-cyclical buffer, the Spanish banking sector itself made a substantial preventive asset write-down effort in the years before the economic crisis. According to the Bank of Spain, the generic provision used by the banking system as a whole from January 2008 to March 2010 amounted to €18.2 billion. The ability of the Spanish banks to generate profits from ordinary activities has enabled them, in the same period, to absorb asset write-downs of around €41.9 billion in their income statements.

According to the last Report on Banking Supervision in Spain issued by the Bank of Spain at the end of 2009, there were 353 credit institutions registered with the Spanish regulator, of which 48 were domestic banks (one less than in 2008) and 46 savings banks. The total amount of foreign bank branches remained stable.

The number of operational offices of credit institutions active in 2009 was 44,532, a reduction of 3.5 per cent from the previous year. On average, the number of operational offices per inhabitant over 16 was reduced from 12 offices per 10,000 inhabitants, to the present 11.6. In 2009 the Spanish banking industry employed 269,168 people, 3.1 per cent less than in 2008, but the number of employees per office remains the same as a result of the reduction in the number of offices.

For the first time, in 2009 the ATM network suffered a reduction of 1,294 cash terminals, 2.1 per cent less than the previous year, giving rise to an average of 15.6 ATM for every 10,000 inhabitants over 16 years old. In addition, the number of credit and debit cards issued by Spanish banks decreased by 3.4 million, to 96.3 millions (a 3.4 per cent reduction compared to 2008), equivalent to 2.5 cards per inhabitant over 16 years old.

At the end of 2009, there were 99 consolidated groups (those that include, in addition to the parent, one or more other fully or proportionally consolidated financial institution(s)), of which there were three conglomerates (Santander, BBVA and La Caixa).

Measures adopted in Spain in response to the financial crisis

A number of legal and fiscal measures have been adopted in Spain over the last two years in response to the financial crisis. These are examined below.

Bank deposit and investment guarantees

By Royal Decree 1642/2008 of 10 October 2008, the Spanish Government, following the trend of other European Member States, extended the guarantee protection of deposits and investments up to €100,000 from the original €20,000 per bank deposit/investment holder and institution. This guaranteed amount doubled that recommended by the ECOFIN and has recently been confirmed by Royal Decree 628/2010 of 10 May 2010. This decree not only confirmed the level of protection but also reduced the timeframe in which an institution has to notify to the Bank of Spain of its inability to pay its deposits and the time for making such payments by the Guarantee Deposit Funds. The new provisions also require the Guarantee Deposit Funds to perform stress tests to evaluate the reaction to the crisis of several institutions.

The Financial Assets Acquisition Fund

The Financial Assets Acquisition Fund (FAAF) was created by Royal Decree-Law 6/2008 of 10 October 2008 and further developed by Order EHA/3118/2008 to provide support for bank lending or credit activities in favour of non-financial companies and individuals.

It is a temporary entity without legal personality, which is administered, managed and led by the Spanish Ministry of Economy and Finance, through a board and an executive committee which, among other decisions, decides on the type of investment, asset acquisitions and terms and conditions under which such purchases are made. The Bank of Spain acts as an agent and depository of FAAF. The Fund is financed out of the state budget. It has an initial allocation of €30 billion, which may be increased to €50 billion.

FAAF acquires top-quality assets from credit institutions using market criteria, giving priority to those assets backed by new credit. The aim is to ensure that companies and citizens have access to funding. The Fund makes its acquisitions in accordance with the principles of:

- objectivity;
- security;
- transparency (results of auctions are published);

- efficiency (investments are made in high quality assets and there must be no plans to buy up toxic assets);
- profitability; and
- diversification of assets and entities.

For example, a portfolio of assets cannot hold more that ten per cent of securities issued by the same institutions or the transactions entered into with a credit entity cannot make up more than ten per cent of the portfolio of the reverse purchase agreements; 25 per cent of the total volume awarded in the auctions is reserved for such entities contributing to new loans to non-financial companies and households.

The acquisition follows a voluntary competitive selection procedure consisting of auctions conducted in accordance with the Order referred to. The auctions are called by the executive committee of the Fund establishing the offer terms at least seven days in advance of the day of the auction. Such offers are considered a firm commitment to sell the offered assets. The investment is made either through bank asset purchases of covered bonds and covered bonds backed-asset securitisation bonds (listed, with a credit rating of triple A) or through repurchase agreements in covered bonds, asset securitisation bonds and mortgage securitisation bonds.

Although FAAF was established with great expectations, the reality is that only four auctions took place during 2008 and 2009, putting the Spanish Government's total bank asset acquisitions to €19,341,533,369. According to the board of FAAF, in 2010 the Fund expects to transfer to the Spanish Treasury more than €3 billion on payments received from the investments made.

Government guarantee schemes

On 21 November 2008, the Spanish Ministry of Economy and Finance issued Order EHA/3364/2008 developing Royal Decree-Law 7/2008 of 13 October 2010 in respect of urgent economic–financial measures under the concerted eurozone action plan. This authorised the issue by the Spanish Government of guarantees of up to €100 billion in 2008 but with the possibility of an increase in this facility to €200 billion should market conditions require. These regulations set out the terms on which, and the procedures pursuant to which, certain senior debt instruments issued by solvent banks were to be guaranteed.

This scheme was initially approved by the European Commission for an initial period of six months and has been subsequently extended for further periods.

The principal features of the guarantees include the fact that once issued, the guarantees are irrevocable, unconditional and enforceable upon the maturity of the guaranteed obligation (which must contemplate a balloon payment). Beneficiaries of the guarantee are not required to proceed against the issuer's assets before enforcing the guarantee (that is, the Spanish Government waives the so-called *beneficio de excusión* provided under Article 1830 of the Spanish Civil Code). Only principal and ordinary interest accruing under debt instruments are guaranteed. Exchange rate risk, penalties,

costs and expenses may not be guaranteed. The costs of the guarantees vary between 0.5 per cent and 1.048 per cent per annum of the face value of the debt instrument.

To be eligible for guarantees by the Spanish Government, the debt instruments must be senior, unsecured commercial paper, bonds or notes issued in Spain. Despite being potentially eligible for guarantees under this scheme, interbank debt is expressly excluded from the scope of the regulations. The debt instrument must contemplate a balloon payment, listed on an official Spanish secondary securities market and its terms must generally be between three months and three years (although exceptionally debt with up to a five-year maturity may be guaranteed provided there is a prior favourable report issued by the Bank of Spain). Secured obligations shall be complied with on their relevant maturity date. The type of transactions, either individual or under issue programmes, include issues of bonds, promissory notes and debentures.

Interest on the debt may be fixed or variable, but must in any event be within the 'range of market terms', and the principal amount of each issue must be at least €10 million. Both individual issues and debt issue programmes are permitted. The issues may not incorporate options, derivatives or any other feature that complicates the valuation of the risk being assumed by the Spanish Government as guarantor. The Government will charge a fee depending on the type of security and issuer.

The guarantee shall cease, and therefore will have no effect, should the terms and conditions of the secured obligations be modified without the previous consent in writing from the Government.

The institutions eligible to participate in the guarantee scheme are generally Spanish credit institutions, and consolidated groups of Spanish credit institutions, that:

- have, according to the Bank of Spain's official records, a share of at least 0.1 per cent of the aggregate outstanding amount of loans and credits to Spanish residents; and
- have issued in Spain, during the five years preceding the entry into force of the Royal Decree-Law of 14 October 2008 securities similar to those that fall within the scope of the scheme.

Institutions wishing to apply for these guarantees must adhere to the form approved by resolution of the General Directorate of the Treasury and Financial Policy.

Applications on behalf of credit institutions and consolidated groups of credit institutions are only accepted if the amount of the guarantee applied for is at least €100 million. That guarantee may then be applied towards one or more issue of at least €10 million each. The maximum amount that may be guaranteed by the Spanish Government in respect of each credit institution, or each consolidated group of credit institutions, will be based on its proportion of the aggregate outstanding amount of loans and credits to Spanish residents. The applicant within a consolidated group has to be the institution with the highest rating among those belonging to the group and residing in Spain. The Spanish Government will guarantee only those issues made by the relevant applicant. The amount to be guaranteed by the Government may be limited to minimise the risk of foreclosure of the guarantee.

The Government is also authorised, at its own request and following a prior report from the Bank of Spain, to purchase equity holdings in Spanish credit institutions resident in Spain to boost their own funds. Acquisitions may include preferred shares or share quotas of these credit institutions. Unlike in other countries, however, Spain has not capitalised credit institutions directly.

Other economic, fiscal and banking measures

A number of emergency and stimulus measures have been adopted over the last two years aimed at curbing the increase in unemployment, protecting small- and medium-sized companies and boosting the Spanish economy.

This package of measures included a moratorium on payments of mortgages introduced by Royal Decree 1975/2008 of 28 November 2008, which applies to mortgages for a principal residence of up to €170,000 entered into force before 1 September 2008. This moratorium is subject to certain requirements mainly relating to the employment status of the debtor. The debtor must be either:

- a formerly employed person who has been made redundant on or before 1 January 2010;
- a self-employed person who has been forced to close his/her business or is able to evidence a certain level of losses; or
- a pensioner having a family to support.

These moratorium measures are envisaged as temporary (in principle until 2011) and only partial (up to a maximum of 50 per cent, with an upper limit of €500 per month on the monthly instalments payable during that period). The amounts will be offset by prorating them, from March 2012, among the monthly instalments remaining for the total repayment of the mortgage loan with an upper limit of 15 years.

Certain tax measures were also adopted such as tax rebates for mortgage debtors with an annual income of less than €33,000, which allowed them to pay less tax instead of waiting for the filing of their tax returns; and a tax exemption in respect of the tax on any gain on the sale of a person's home if bought between 2006 and 2008 and sold before the end of 2010.

Further, an extension on non-interest payments of up to two years was granted for purchasers to invest the amounts saved to buy properties in a saving accounts before 31 December 2010.

Companies have also benefited from measures giving discounts in their social security contributions where they hired unemployed workers on indefinite-term contracts, or promoted job creation in certain strategic sectors or affected the capitalisation of the unemployment subsidy.

The Spanish Government also approved several measures facilitating support and guarantees by the Spanish Official Credit Institute (ICO) for small- and medium-sized companies including in relation to payment for public works . Increased risk aversion, arising from the financial crisis, translated into Spanish credit institutions having much stricter lending policies. As a result, many companies, particularly small- and medium-

sized ones, saw their ability to obtain funding restricted. The ICO's programmes, aimed at smoothing small- and medium-sized companies' access to credit, have attempted to correct this market failing.

The Spanish Commercial Code was also amended to establish the effectiveness for corporate law purposes of the changes in value of hedging instruments used in cashflow hedges. By virtue of these amendments, fair value changes in cashflow hedges are prevented from being taken into account for the purposes of capital reductions, profits and situations of compulsory winding-up. Additionally, an amendment was introduced in the Companies Law so that, for a period of two years from the approval of the changes in 2008 and solely for the purpose of determining losses for the mandatory reduction in share capital, the impairment of losses recognised in the annual accounts derived from property, plant and equipment, from investment property and from inventories is not to be counted.

A new Law 3/2009, of 3 April 2009, on structural modifications of commercial companies (*Ley sobre modificaciones estructurales de las sociedades mercantiles* – LME), introduced a profound reform of the Spanish legal system in various areas of corporate law. These included:

- unification of the rules applicable to corporate restructuring transactions of the different types of commercial companies;
- amendment of the rules for challenging a merger;
- the subsidiarisation of industry being regulated as a new form of spin-off, subject to relevant provisions (including for credit institutions);
- the extension of the quantitative (ten per cent for listed companies and 20 per cent for unlisted companies) and temporal (five years) limitations for the acquisition of treasury stock by public limited companies;
- the abolition of pre-emptive rights in the case of non-monetary contributions, and in certain cases, the removal of the requirement of an independent expert's report in these types of transaction;
- the abolition of the pre-emptive rights of holders of convertible debentures; and
- the provision of the power to exclude pre-emptive rights of shareholders on the issue of convertible debentures.

The changes in the Spanish corporate and accounting rules affecting Spanish credit institutions have been accompanied by a number of significant measures adopted by the Bank of Spain, which take into account the lessons learnt from the financial crisis. These include the amendments to Circular 4/2004 on public and confidential financial reporting rules and formats. Circular 4/2004 was amended in November 2008 and, more recently, on 20 June 2010 by Circular 3/2010 of the Bank of Spain. Among the main changes are:

- a change in the definition of group for the purposes of accounting consolidation;
- a full application of fair value;
- the possibility of reclassification of financial instruments;
- the regulation of new transactions in which payments are made in equity instruments;
- a new treatment of borrowing costs; and

- further changes in the financial statements and in the approach to tax effect on the balance sheet or on the treatment of general provisions.

In Spain, the system of specific provisions to be set aside by Spanish credit institutions is based on statistics from the Bank of Spain credit register that indicate that loans belonging to a specific portfolio will have different impairment ratios depending on the moment when the breach of contract happened. Thus, the impairment estimation for a homogeneous portfolio is based on calendars that establish the minimum provisions needed for non-performing assets. In 2010, the Bank of Spain approved certain amendments that include a review of the impairment guidance regarding specific provisions for non-performing assets to be made by Spanish credit institutions. A new, complete and consistent framework for the treatment of collateral in credit operations was introduced together with a simplification of the calendars used to estimate the percentage of specific provisions that credit institutions must set aside as a minimum for non-performing assets and recognising impairment for the amounts not covered by collateral. The new rules guide credit institutions on how to value the repossessed assets and the minimum impairment estimation when, after a period of time, these assets are kept in the balance sheet for long periods, which is considered to be a sign of their deterioration. These new measures will involve in 2010 and 2011 an increase in specific provisions made by Spanish credit institutions.

The Fund for the Orderly Restructuring of the Banking Sector

Introduction

One of the main effects of the financial crisis was that access to market funding and liquidity became drastically harder, especially for those facing exposure to the real estate development sector. Accordingly, some medium- and small-sized entities faced liquidity and financing problems, jeopardising their viability, and compromising the solvency of the whole Spanish banking system. The Spanish financial system had sufficient tools available to the banks, savings banks and credit cooperative deposit guarantee funds, together with the Bank of Spain, to face the individual crises of a number of institutions, but those mechanisms were not enough to deal with the kind of systemic risk that has been faced. Additional instruments were needed to cope with the lack of credit and to implement a strategy based on the orderly restructuring of the Spanish banking system.

Before examining in detail the measures implemented to effect this restructuring, it is worth mentioning that such measures take account, as far as possible, of traditional methods of crisis handling, seeking to exhaust private solutions and minimise the cost to the taxpayer. Recapitalisations aimed at maintaining non-viable institutions have, in general, been avoided and encouragement has been given to the assumption of responsibility by shareholders and managers, transparency, and the protection of depositors. Those principles are aligned with the Common Crisis Management Principles agreed in June 2008 by the finance ministers, central banks and supervisory authorities of the European Union.

Government response – the FOBR

The Spanish Government's response to the liquidity crisis was to create the Fund for Orderly Bank Restructuring (the FOBR) through Royal Decree-Law 9/2009 of 26 June 2009, as amended by Royal-Decree-Law 6/2010 of 9 April 2010.

These regulations seek to implement a banking restructuring strategy and thereby increase the strength and solvency of the Spanish banking sector. With pressure on profit and loss accounts as a result of higher funding costs and lower levels of banking activity, the FOBR was approved to facilitate adjustment back to medium-term profitability for those credit institutions that needed it and to adjust the capacity of certain credit institutions.

The FOBR is a legal person with full public and private capacity to implement its objectives. Its core duties are the management of the credit institution restructuring process and the reinforcement of shareholders' equity in certain consolidation processes. Although it has been created for an indefinite period of time, the European Commission has clearly stated that it should be a temporary institution to cope with the present financial storm.

The Spanish restructuring model

The Spanish restructuring model is based on the three Guarantee Deposit Funds and the use of the FOBR. The restructuring process has three distinct stages:

- the search for a private solution by the credit institution itself;
- the adoption of measures aimed at dealing with any weaknesses affecting the viability of the credit institution, with the participation of the Guarantee Deposit Funds; and
- restructuring through the intervention of the FOBR.

The FOBR legislation not only provides the Bank of Spain with the necessary tools to act when there are serious problems of stability, but also provides for the possibility of pre-emptive action, geared to preventing such problems materialising. This takes the form of institutions and their managers being urged to assess their own situation and, with the approval of the FOBR, to adopt the decisions needed to ensure their viability. This avoids the more traumatic effects (both for the institution itself and for economic activity in the regions in which it pursues its business) of supervisory intervention.

The Bank of Spain is then entrusted with ensuring that the operations approved have a sound business plan, which contributes to strengthening the Spanish financial system, and is accompanied by measures aimed at a realistic adjustment of bank resources to the new market conditions, using the smallest volume of public funds possible. In this phase, it is not the role of the Bank of Spain to decide which integration processes should go ahead, but to examine the proposals received in its capacity as the supervisor of the banking system's solvency. The review by the regulator is made on the basis of strictly professional criteria, irrespective of any other interests and taking into account whether the plans submitted offer sufficient guarantees of soundness and viability.

Funding

The FOBR has mixed funding from the General State Budgets and from the contributions of the Deposit Guarantee Funds of the banks, savings banks and credit cooperatives. Its initial allowance was €9 billion, of which €6.75 billion was charged to the General State Budgets and €2.25 billion represented the contribution from the relevant Deposit Guarantee Funds. In 2009, the FOBR was authorised to provide guarantees up to the top quantity of €27 billion. The maximum amount provided in the General State Budgets is the same for 2010.

In addition, the Fund may secure funding on the securities markets by issuing fixed-income securities, receive loans, apply to open credit facilities and undertake other borrowing transactions.

Given that outside resources obtained by the FOBR have the unconditional and irrevocable guarantee of the Kingdom of Spain, its maximum concrete borrowing capacity is set every year on the General State Budgets. In normal conditions, it may not exceed the sum of three times the funding available at any time. Exceptionally, if circumstances change, the Minister for the Economy and Finance may give authority to exceed this limit, but it may never exceed ten times its funding (that is €99 billion). This amount does not reflect an estimate of potential losses for the Spanish banking sector.

The guarantee afforded to outside funding procured by the FOBR is understood to be granted irrevocably and unconditionally, once the requirements set out in the FOBR legislation have been satisfied, and is effective for each of the transactions guaranteed (that is unsubordinated debt securities insecurities, maximum maturity of seven years after issuance, fixed or floating rate and admission to trading). This makes the funding research for FOBR easier, because it sets the main characteristics of the liabilities to be accepted, so less analysis is needed before deciding whether to accept every transaction. It also facilitates the obtaining of funding – given that the transaction is granted by the solidity of the Kingdom of Spain it is attractive for investors looking for ensured profitability.

Unassigned property of the FOBR must be materialised into public debt or into other high-liquidity, low-risk assets. Any return of any kind of the Fund assets will be added to its funding. Expenses incurred for the management thereof will also be charged to its funding. The Bank of Spain will be responsible for the cash service of the FOBR.

Treatment of FOBR debt instruments

The Bank of Spain has confirmed that the treatment of the debt instrument issued by the FOBR is as for public sector entities and other non-profit making institutions, in accordance with Rule 5.1.2 of Circular 4/2004 and, therefore, carries a weighting of 0 per cent. Debt instruments issued by the FOBR with a Government Guarantee under section 12, Rule 47 of Bank of Spain Circular 3/2008 have the same weighting. Issues of debentures/bonds by the FOBR satisfy the necessary requirements for guaranteed assets ('collateral') in the monetary policy operations of the European Central Bank. According to the Bank of Spain, the FOBR issues should be classified within the III

liquidity group, which has a haircut of 4.5 per cent for issues of between three and five years of maturity, and of 5.5 per cent for issues with maturity of between five and seven years.

To date, the FOBR has only issued an initial €3 billion of securities in 2009, qualified by the rating agencies with top scores as a result the high solvency of the Fund (Moody's Aaa, Standard and Poors AAm and Fitch AA+).

The funds provided by the FOBR incur interest of 7.75 per cent, must be repaid in five years and are provided subject to the restructuring of the institutions receiving them.

Management

The FOBR is governed and managed by a Governing Committee consisting of eight members, five proposed by the Bank of Spain (one of them the Deputy Governor who presides over it) and three designated by each of the Deposit Guarantee Funds. All of them are appointed by the Minister of the Economy and Finance, for a renewable term of four years, and they may be removed in the same events as warrant removal of the members of the Deposit Guarantee Funds.

Public control

As the FOBR is, to a large extent, funded from the public purse, centralised control on behalf of the public is essential. A representative of the General Controlling Department of the Government designated by the Ministry of Economy and Finance on the proposal of the General Controller, attends meetings of the Governing Committee with the right to speak but not to vote.

Also, strong parliamentary control is provided. Royal Decree-Law 9/2009 requires the FOBR to report quarterly to the Minister for the Economy and Finance. In addition, every quarter, the Secretary of State for the Economy has to appear before the Committee for the Economy and Treasury of the Spanish Congress to report on the banking sector and the activities of the FOBR. The Chairman of the FOBR's Governing Committee must also appear before this parliamentary committee to report each transaction undertaken by the Fund within 30 days after the relevant transaction.

Credit institution restructuring and integration processes

The FOBR operates in the context of two key elements:

- the intervention of non-viable institutions; and
- the integration processes.

According to FOBR legislation, when a credit institution's financial situation is such that its viability might be jeopardised, it has to report the situation immediately to the Bank of Spain. At the same time, the institution has to propose a strategy to remedy the situation. In reporting its strategy the institution must also identify the expected

date of the implementation of the plan. This must be within three months, unless the Bank of Spain expressly authorises otherwise.

The strengthening of the institution's equity and solvency may be achieved either by facilitating its merger or absorption by another institution of recognised solvency or by full or partial transfer of its business or business divisions to other credit institutions.

The Bank of Spain, once satisfied that there are no deficiencies in the credit institution's organisational structure or in its internal control mechanisms, decides within ten days whether or not to approve the action plan. The temporary aid given by the FOBR is to reinforce the own funds of the institutions acquiring preferred shares. The system is therefore designed to allow a fast and effective intervention.

The relevant Deposit Guarantee Fund (depending on whether it is a bank, savings bank or a credit cooperative), provides financial support for the implementation of the approved plan. The FOBR may grant funding, on market terms, to the Deposit Guarantee Fund, to enable it to provide this financial support. According to the Bank of Spain, at the end of June 2010, the Deposit Guarantee Funds had available assets of approximately €5 billion.

If the credit institution:

- does not submit the action plan to the Bank of Spain or advises of the impossibility of finding a viable solution; or
- has its action plan refused by the Bank of Spain; or
- seriously fails to comply with the terms of the action plan;

then the FOBR will arrange for the direct orderly restructuring of that credit institution. The Bank of Spain orders the provisional replacement of the institution's administration, appointing the FOBR as interim administrator which, in turn, designates a person or persons to exercise the appropriate functions and powers on its behalf.

Within one month, the FOBR draws up a detailed report on the equity situation and the viability of the institution together with a restructuring plan. This time limit can be extended for up to a maximum of six months if the circumstances are especially complex.

Within the same period, the FOBR must prepare a financial report for the Minister for the Economy and Finance setting out the financial impact of the proposed restructuring plan on the Fund charged to the General State Budgets.

The restructuring plan comprises:

- financial support measures, (that is, the grant of guarantees or the acquisition of any type of assets appearing on the institution's balance sheet), aimed at facilitating merger or absorption processes, or the transfer en bloc or in part of its assets and liabilities according to procedures that ensure competition, including the auction system;
- management measures to improve internal procedural and control systems; and
- where appropriate, the transfer in full or in part of deposits in current or in term accounts held by the administered institution to other credit institutions.

When the measures referred to above involve the acquisition of assets by the FOBR, the Fund may continue to manage them or may entrust their management to a third party. If it decides to entrust their management to a third party this must be done using procedures that ensure competition.

Investments made by the FOBR while implementing a restructuring plan will not be subject to the legal restrictions or obligations applicable in the case of aid provided by the Credit Institution Deposit Guarantee Funds. In particular, the FOBR is not subject to:

- the statutory restrictions on the right of attendance at general meetings or the right to vote in respect of any shares;
- the restrictions on the contribution to the share capital of credit cooperatives by legal entities;
- the restrictions in relation to the computability of equity in respect of any securities that the Fund acquires or subscribes; and
- the obligation to submit a takeover bid under security market legislation.

When the FOBR acquires non-voting shares in a savings bank, it has the right to be represented at the general meeting in the same percentage as that represented by its stake in the equity of that savings bank. Such an exceptional right is not transferable to subsequent acquirers of the securities. These non-voting shares held by the FOBR are considered as Tier 1.

Reinforcement of equity in credit institutions

Spanish regulations relating to the FOBR also allow the Fund to support processes of integration between credit institutions seeking to improve their efficiency and solvency. Difficulties in obtaining equity on the international markets have hindered banking rationalisation and the emergence of efficiencies which might have been expected to result from it. In such circumstances, the interim capitalisation of credit institutions undertaking an integration process (even if not a full restructuring as described above) has become a necessity; whether that integration process is by means of a traditional merger or the so-called 'institutional systems of protection' (SIP – described in more detail below).

Thus, the FOBR may, at the request of credit institutions resident in Spain, acquire securities issued by those credit institutions, where they are not affected by an imminent solvency crisis but where they nevertheless need to strengthen their equity for the sole purpose of carrying out an integration among themselves. The institutions must draw up an integration plan containing specific restructuring measures to be adopted and a process of integration which will involve an improvement in efficiency, the rationalisation of management and administration, and a resizing of product capacity with a view to improving their future prospects. The integration plan is subject to the Bank of Spain's approval and stringent mechanisms have been set up for the monitoring and control of its implementation.

Before acquiring the securities, the FOBR must send a report to the Minister of Economy and Finance, who may object to the acquisition within a period of five days.

The securities issued to the FOBR are preference shares convertible into ordinary shares, non-voting shares or contributions to the company's capital and they are regulated as if they were ordinary shares with the following particular features:

- The acquisition of convertible preference shares by the FOBR requires suspension of the pre-emptive subscription rights of the shareholders of non-voting shares at the time that the issue resolution is adopted.
- The issuing institutions must undertake to purchase the securities subscribed by the FOBR as soon as they are in a position to do so on the terms undertaken in the integration plan. The FOBR may request that they be converted into ordinary shares, non-voting shares or contributions to capital of the issuer. Such provisions must be exercised within a maximum period of six months from the end of the fifth year after the preference shares were purchased.
- The preference shares issued under this provision will be computable as Tier 1, without them having to be listed on a secondary market. For these purposes, the restrictions on the computability of equity will not apply.

The subscribed securities will be divested by the FOBR through their repurchase by the issuing company or their transfer to third parties.

The body appointed by the institutions involved in the integration process will send a quarterly report to the Bank of Spain, which may, in the light of the content of that report, require that the particular actions be taken to ensure that the integration plan is brought to a successful conclusion.

If it becomes apparent that the integration plan cannot be implemented within the required timescale, the credit institution may ask the FOBR for an extension of a further two years. This extension must be approved by the Bank of Spain. In the absence of any such extension and if the implementation plan cannot be implemented, then the FOBR starts the compulsory restructuring process described above.

Finally, the obligation to apply for a declaration of insolvency will not apply to a credit institution involved in either a compulsory restructuring or a voluntary integration as described above.

Despite the various measures examined above, the FOBR has discarded widespread recapitalisation of the banking sector. To ensure that the banking sector is in a good position, Spanish institutions have begun an adjustment process by strengthening their own funds, increasing deposit-taking and containing operating costs., The process of restructuring Spanish credit institutions is being addressed on an individual basis and at relatively low cost to Spanish taxpayers.

The Institutional Protection Systems and the restructuring of the Spanish savings banks

SAVINGS BANKS – HISTORICAL BACKGROUND

Much has been discussed over the years regarding the role of Spanish savings banks (the *cajas*) and their role in the country's financial sector.

Savings banks are a specific type of credit entity accounting for nearly half the volume of the Spanish financial sector. Historically, savings banks are locally

orientated entities of variable (but generally limited) size, with strong economic and social ties to their home region. Although savings banks fully participate in the market, they are a special category within the financial services industry, as they are structured as foundations rather than companies. As a result, they are governed by representatives of collective stakeholders; mainly depository customers, employees and local authorities. Surpluses are allocated to social welfare and cultural projects. Owing to their distinctive nature and the social function they exercise, but also to specific legislation on their establishment, governance and corporate transactions they undertake, the legislation regulating them is mainly regional in scope but operates within the basic national framework.

Recent reappraisal

A much-needed reappraisal of the role of savings banks has been forced upon the Government as a result of the financial situation of some of their number arising from:

- a tightening in financing conditions on the wholesale markets due to increase of risk perception and finance costs;
- an adjustment in business volume and excess capacity;
- intrinsic constraints on the Spanish savings banks which prevented them from generating core capital by any means other than capitalisation of profits (the issue of non-voting quotas not being successful); and
- the tougher capital requirements as a result of the Basel international banking regulations.

This reappraisal has resulted in a perceived need for the wholesale restructuring of the country's 46 savings banks so as to strengthen their financial position. The proposal is to resize and recapitalise the savings banks, taking advantage of synergies and affecting mergers or institutional protection systems (SIPs) as appropriate.

The legal regime underpinning Spanish savings banks has therefore been substantially modified to facilitate this restructuring. On 13 July 2010, the Spanish Official Gazette published Royal-Decree Law 11/2010 on governing bodies and other aspects of the legal regime of Spanish savings banks. It is the most significant overhaul of the legal framework for savings banks in decades and includes curbing the influence of local politicians who control them, demutualisation, and the establishment of shareholder structures in which the participation will be capped at 40 per cent of the votes. Demutualisation will not be compulsory but if the trustees wish to maintain control in the traditional way, they must dispose of their banking operations. The Spanish model mirrors the process undergone in Italy several years ago.

The new regulations have clarified or expanded the requirements for the integration processes in the form or mergers or the creation of the abovementioned SIPs.

Institutional protection systems – SIPs

An SIP exists where there is a solidarity arrangement whereby the members of a group undertake to support each other, in terms of liquidity and solvency if necessary, as permitted by the EU Capital Requirements Directive.

Under such an arrangement, groups of entities agree to set up a central common institution (a credit institution with the status of a bank) which combines management, product development, strategic development and supervision of the group. The central body must be one of the credit institutions integrating within the SIP or another credit institution, also being part of the SIP, which is participated in by all of the integrating institutions. Institutions mutualise at least 40 per cent of their results, thereby sharing joint business income, and agree to a reduction in their number of branches and staff. The Bank of Spain must decide whether there is compliance with the regulatory requirements enabling advantage to be taken of the 0 per cent risk-weighting between the members of an SIP.

The possibility of creating an SIP and the terms and conditions applying to it, were further developed in May 2010 by Royal Decree-Law 6/2010, on 9April. SIPs are widely defined in such regulations and, therefore, those that are being established come in various forms. That said, they are essentially the same as a merger in terms of end result. The Bank of Spain has, for example, recently pointed out common attributes such as the allocation to the central institution of the power to define the principal policies and strategies of the group; the high degree of commitment between participants to support each other in terms of solvency and liquidity; and the participants' sharing of a high percentage of the profit from their activity.

The degree of pooling of solvency must be at least 40 per cent of profits, although in practice, in the case of solvency, mutual support reaches 100 per cent in the agreements which have been drawn up. Furthermore, the obligation to remain in the SIP for at least ten years ensures the stability of the agreement and means it is most unlikely that any participant would consider withdrawing from the agreement in the future.

Savings banks – a process of rationalisation

The Bank of Spain has confirmed that, at the end of June 2010, the savings bank sector was going through 12 integration processes involving 38 of the 45 Spanish savings banks existing at the beginning of 2010. That number could be increased to 39 taking into account that Cajasur was put under the administration of the FOBR. Only six savings banks, representing eight per cent of the savings banks' total assets as of 31 December 2009, have not been involved in mergers or SIP processes.

The FOBR, as part of its role to assist the restructuring of the Spanish banking system, may facilitate mergers or SIPs for savings banks. Seven of the 12 processes requested aid from the FOBR totalling €10.19 billion and five were undertaken without public aid (the intervention of Caja Castilla-La Mancha, which was placed under administration by the Bank of Spain pursuant to previous legislation received €3.78 billion of aid from the Deposit Guarantee Fund).

Figure 1 summarises the different processes being undertaking by Spanish savings banks:

Integration processes which have been authorised, are pending authorisation and are at the negotiations stage, according to the Bank of Spain.					
Institutions		**Type**	**Total assets (€bn)**	**Per cent of TA of sector**	**FOBR aid (€bn)**
Approved by Bank of Spain, with FOBR aid					
1	Catalunya/Tarragona/Manresa	Merger	79.33	6.1 per cent	1.25
2	Sabadell/Terrasa/Manlleu	Merger	28.46	2.2 per cent	0.38
3	España/Duero	Merger	46.35	3.7 per cent	0.53
4	CAM/Cajastur+CCM/Cantabria/Extremadura	SIP	127.27	9.9 per cent	1.49
5	Caixanova+Banco Gallego/Galicia	Merger	77.48	6.0 per cent	1.16
6	Madrid/Bancaja+Banco de Valencia/Laietana/Insular de Canarias/Ávila/Segovia/Rioja	SIP	337.26	26.3 per cent	4.46
7	Murcia/Penedés/Sa Nostra/Granada	SIP	72.11	5.6 per cent	0.92
Approved by Bank of Spain without financial aid					
8	Navarra/General de Canarias/Municipal de Burgos	SIP	45.72	3.6 per cent	
9	Unicaja/Jaén	Merger	35.16	2.8 per cent	
Authorisation in process, without financial aid					
10	La Caixa/Girona	Merger	260.56	20.3 per cent	
11	Cajasol/Guadalajara	Merger	31.45	2.4 per cent	
12	CAI/CC Burgos/Badajoz	SIP	20.81	1.6 per cent	
Figures may not tally exactly due to rounding.					

Other banks and credit cooperatives

Inititiatives relating to banks and credit cooperatives other than Spanish savings banks have also been approved or are in the process of being approved. For example, Banco Sabadell launched a takeover bid for Banco Guipuzcoano and they are currently in a merger process without FOBR aid. A merger and an SIP of credit cooperatives have been approved and negotiations for at least a further three processes of mergers or SIPs involving over 15 credit cooperatives are under way and will most likely continue in the coming months.

Conclusion

The capacity and cost structures of Spanish credit institutions will have to be adapted to a new environment in which the demand for financial services is more moderate. In this context, the Bank of Spain has encouraged the rationalisation of the banking sector through integration including for institutions which are not in difficulty but

wish to ensure their future viability by improving their medium-term efficiency.

The reform of the savings banks regime will allow the sector to improve its profitability and prepare itself for more competitive market conditions. Under the new regime, the savings bank sector will be downsized. They will push through measures to raise efficiency through cost containment and the introduction of improvements in their risk control and management mechanisms; and will need to continue to be innovative in product marketing and in the implementation of technological and organisational improvements. The reforms will allow them to raise high-quality funds that enable self-sustainable growth, subject to a strict regulatory environmental.

What next?

The current economic crisis has shown the strength of Spanish banking supervision. The banking sector, under the continuous and close surveillance of the Bank of Spain, is in a favourable position in comparison with other developed countries. The main Spanish credit institutions maintain a solid position in the international markets, with high solvency standards; notably, the Committee of European Banking Supervisors (CEBS) revealed at the time of publication of the results of the EU-wide stress testing exercise that two high-scoring banks were Spanish.

However, the continuing problems in liquidity and financing, combined with other factors, such as the loss of confidence among institutions, the depreciation of certain assets (especially real estate products), and the reduction in business activity may severely affect some small- or medium-sized credit institutions, jeopardising the stability of the banking system and affecting the duration and intensity of the crisis and the Spanish economy in general.

The current economic situation in Spain is grim. The unemployment rate is around 20 per cent. Following a budget surplus of 1.9 per cent of GDP two years ago, the country faces a deficit of 11.2 per cent of GDP now. With scarce growth in real economic activity, a dramatic crisis in the construction and real estate industry, a lower GDP and continued defaults, the weaker Spanish financial institutions will find themselves in a difficult situation. The scale of the fiscal deficit some months ago obliged the Spanish Government to strengthen and accelerate a fiscal programme in May 2010 in a concerted attempt to reduce the deficit to 6 per cent of GDP by 2011, and to reduce it to 2008 levels subsequently.

A lower growth in demand, a fall in volume activity, the squeeze of margins (such as low interest rates, increased bad debts, higher capital requirements for both market and regulatory reasons and tighter financing conditions) will be hard to sustain. Also, the management of the doubtful assets in the real estate sector will still be particularly important. The outlook is complex and it is essential that all Spanish credit institutions, particularly those that have taken more risk, prepare themselves and adopt the measures needed to ensure their profitability. Consequently, more necessary adjustments of the Spanish financial market will take place in the coming

months. In addition, weaker institutions will turn to the FOBR to restructure their business under the strict control of the Bank of Spain.

That said, the restructuring and recapitalisation of Spain's financial institutions is well under way. In recent months, this has largely taken the form of bank consolidation and mergers; several merger or institutional protection schemes are ongoing, especially affecting savings banks. It is now just a case of formalising and implementing the agreements reached between the different institutions. Issues remain relating to the implementation of the different SIPs and these are being discussed individually in each process. Whether or not these SIPs prove to be a success will be known only once the technical examinations, the negotiations between the different institutions, the decisions of the relevant governing bodies and the labour issues have been dealt with. However, if any of these processes do falter, the Bank of Spain will act, using the mechanism envisaged for this purpose in the FOBR legislation.

Many of the measures described in this paper were adopted by the Spanish Government or the Parliament on an interim basis and taking into account the urgency of the situation as the financial crisis evolved. A question which remains is whether some of those measures, principally the stimulus package, mortgage moratorium and some tax benefits will remain or at least have their application extended.

The restructuring and reform of the financial system, along with the budgetary adjustment, public pension reform and labour market reform are urgent measures needed to restore confidence in the Spanish economy and its financial system. Economic difficulties are not over yet and the Spanish financial system faces significant challenges ahead.

Japan

Anderson Mori & Tomotsune, Masaakira Kitazawa[1]

Introduction

The purpose of this article is twofold:

- first, to review the impact of the global financial crisis in Japan, examining in particular the effects of the bursting of the Japanese 'bubble' in the late 1980s and considering the extent, if at all, to which the regulatory changes made as a result of that earlier domestic crisis alleviated the impact of the global events that followed; and
- second, to give an overview of recent developments in the Japanese regulatory regime in response to the global financial crisis.

History teaches us that future financial crises will occur regardless of any protective measures policy-makers may implement. Unfounded optimism, leading to excessive increases in the value of particular assets, whether listed stocks, real estate, asset-backed securities or other investments, are not new. Japan's experience of a domestic crisis, followed relatively swiftly by a global one, may, however, prove a useful case study for future reference.

What crisis?

Did the financial regulations implemented by the Japanese authorities to tackle the fallout from the bursting of the Japanese bubble cushion Japan from the impact of the global financial crisis? If so, there may be lessons to be learned by policy-makers worldwide.

Bursting of the Japanese bubble

In the late 1980s, Japan aggressively acquired assets worldwide. Columbia Pictures and the Rockefeller Center are examples of the iconic assets which came under Japanese ownership. This buying spree was fuelled by the Japanese bubble, which saw the value of real estate and other assets, such as shares, spiral out of control.

In 1990 the bubble inevitably burst, leaving mountains of bad assets on the books of many Japanese corporations. Banks were particularly hard hit and, all of a sudden, were left with enormous amounts of non-performing loans.

It took more than ten years for banks to dispose of these bad assets and shortly thereafter the world was facing up to the global financial crisis.

1 Masaakira Kitazawa is a partner of Anderson Mori & Tomotsune. He thanks Mr Takamiki Nishikawa of his firm for assisting him in compiling the materials for this article.

The role of Japanese banks

In Japan, banks have historically played, and continue to play, a dominant role in both personal and corporate finance. The same can be said of some of Japan's developing neighbours.

According to a report[2] by the 'Roundtable Committee on Fundamental Issues of the Financial System Council',[3] the Japanese continue to hold more than 50 per cent of their financial assets in the form of bank deposits, in spite of interest rates which are persistently low; and borrowings from the bank sector still account for more than 30 per cent of overall funds raised by Japanese companies.

Also, banks are significant investors in corporate bonds and commercial paper (CP), holding nearly 50 percent of bonds and more than 30 percent of CPs. These figures have remained substantially unchanged since the late 1980s.[4]

The effects of this massive reliance on banks was felt acutely when the Japanese bubble burst and bank liquidity dried up. To alleviate the financial fallout and to reduce the chances of future such crises, Japanese regulators introduced a panoply of significant and sophisticated regulatory measures. These included the introduction of safety net schemes aimed at rescuing failed or failing banks, such as nationalisation, the injection of state capital into distressed banks and placing banks under state trusteeship. See further below.

Bank losses during the global financial crisis

As at the end of December 2009, the losses suffered by Japanese banks in respect of sub-prime-related products, that is CDOs, RMBS and similar products, were calculated to be about one trillion yen (1,000,000,000,000Y).

Losses in respect of securitised products in general, that is sub-prime related products plus CLOs, CDOs, RMBS unrelated to sub-prime, and leveraged loans, were about two trillion five hundred billion yen (2,500,000,000,000Y).[5]

These are not insignificant sums. However, to put these figures into perspective, according to the *Second Report of the Financial Markets Strategy Team; Towards an Open Country*

2 *Report by the Roundtable Committee on Fundamental Issues of the Financial System Council; Designing the Japanese Financial System in Light of the Global Financial Crisis,* (the 'FSA Report'), 9 December 2009, p 2; **www.fsa.go.jp/en/news/2009/20091216-2/01.pdf**).

3 This Roundtable Committee was established as a forum under the aegis of the Financial System Council of Japan's Financial Services Agency ('FSA') to discuss the future of Japan's financial system in light of the experiences gained from the global financial crisis. A total of eight meetings of the Roundtable Committee have been held since July 2009, and the FSA Report summarises these discussions – **www.fsa.go.jp/en/news/2009/20091216-2.html**.

4 Bank deposits accounted for 52 per cent of financial assets in 1998 and 53 per cent in 2008; bank borrowings accounted for 41 per cent of corporate funding in 1998 (2008 – 36 per cent); and banks held 32 per cent of bonds and 47 per cent of CPs in 1998, compared, in 2008, with 48 per cent and 35 per cent, respectively (FSA Report).

5 **www.fsa.go.jp/en/regulated/subprime/index.html**.

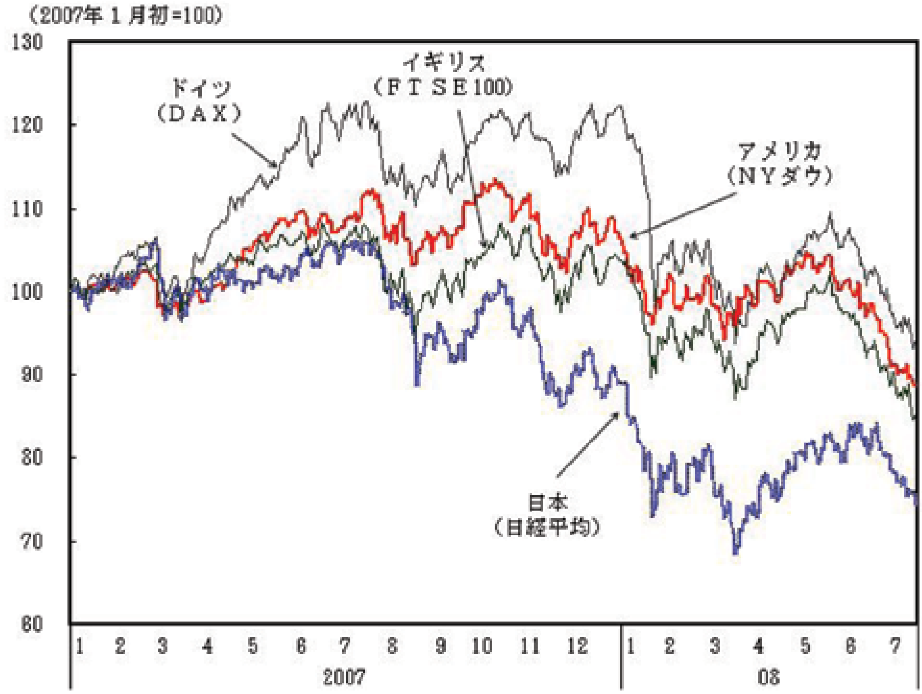
with Financial Strength issued on 12 June 2008,[6] the losses incurred on the disposal of non-performing loans accumulated during the Japanese bubble over the period between 1992, when steps were taken to address the crisis, and 2004, when the crisis was resolved, amounted to almost one hundred trillion yen (100,000,000,000,000Y). In other words, the economic impact of the sub-prime problem and the global financial crisis on Japanese banks could be said to be only one–2.5 per cent of the economic impact of the Japanese bubble.

The inconvenient truth

With the high levels of debt generated from the domestic crisis finally resolved, a tight safety net scheme established and successfully tested, and the direct economic impact of the global crisis on Japanese banks relatively small, one might have expected the overall impact of the global financial crisis within Japan to have been comparatively modest.

The reality, however, was quite the opposite. Figure 1[7] shows the shift in the DAX (black), FTSE 100 (green), NY Dow (red) and Nikkei Average (blue) indices from the beginning of January 2007 to the end of July 2008, with the beginning of January 2007 shown as 100.

Figure 1



6 **www.fsa.go.jp/en/news/2008/20080814.html** – the Financial Markets Strategy Team was established in September 2007 as an advisory group to the Minster for Financial Services to discuss Japan's financial strategy in the light of market turmoil triggered by the US sub-prime mortgage problem.

7 *2007 Economic Survey of Japan*, Cabinet Office, Government of Japan.

Thus, among major stock markets, the Japanese market suffered the largest adverse impact from the global financial crisis.

What is the reason for this apparent contradiction? To understand this, we need to examine how the regulatory framework for Japanese banks was restructured as a result of the bursting of the Japanese bubble.

Lessons from the Japanese bubble – regulatory reform

Two-track financial system

In 1998 Japan experienced sweeping reforms. Under the Financial System Reform Law,[8] the Japanese Glass Steagall regime was, after much tinkering, finally abolished. Banks could now own securities firms, and vice versa.

One of the underlying themes of these reforms was the Japanese Government's desire to establish a two-track financial system, consisting of (a) market-based, and (b) bank-based finance. It was hoped that the promotion and further development of market-based finance in Japan, in addition to the traditional and pervasive bank-based finance system, would provide alternative sources of funds for Japanese companies, thus making the Japanese economy more resilient in any future crisis.

However, expertise in the financial markets within Japan was confined to a relatively small group and to jump-start market-based financing and develop it to a level where it could be competitive with bank financing, the participation of Japanese banks was regarded as crucial.

In order to achieve this two-track financial system, and to provide additional investor protection, Japanese regulators legislated on a number of fronts.

The Japanese Financial Services Act

First, measures aimed at developing the market for market-based finance were adopted. This culminated in 2006 with several capital market-related laws being merged into the Financial Instruments and Exchange Law (the FIEL),[9] the Japanese version of the Financial Services Act in the UK.

Under the FIEL, the protection available to investors was expanded by imposing fuller disclosure requirements. Also, new and innovative financial products, such as derivatives or collective investment schemes, were included within the scope of the legislation.

8 Law no 107 of 1998, whereby certain legislation, including the Banking Law, the Securities and Exchange Law and the Insurance Business Law, was amended in an attempt to replicate the earlier sweeping 'Big Bang' reforms of the City of London.

9 Law no 25 of 1948, as amended. The FIEL was, essentially, rewritten as a result of the 2006 amendment.

SAFETY NETS

Second, measures to establish bank-based financing on a firmer footing, by putting safety nets in place, were implemented. The Act concerning Emergency Measures for the Revitalisation of the Financial Functions (the Financial Revitalisation Law)[10] and the Act concerning Emergency Measures for Early Strengthening of Financial Functions (the Early Strengthening Act)[11] were passed in 1998 as emergency measures to deal with, inter alia, the collapse of the Long Term Credit Bank of Japan and other financial institutions. These measures enabled the Japanese Government to inject capital into, nationalise, or put under trusteeship, distressed financial institutions.

These financial sector safety nets for banks were established on a permanent basis in 2000 by amendments to the Deposit Insurance Act.[12]

Table 1 contains a summary of what these bank safety nets have achieved from 1998 to date.[13]

	Number of Banks	Amount (trillion yen)	Examples
Capital Injection	46	10.9	Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Bank, Mizuho Bank, Resona Bank, Chuo Mitsui Trust, Sumitomo Trust and Banking, Yokohama Bank
Trusteeship	11	3.5	Tokyo Star Bank
Nationalisation	3	6.6	Shinsei Bank (formerly the LTCBJ), Aozora Bank (formerly the Nippon Credit Bank) and Ashikaga Bank

Table 1

Virtually all of the banks which later converged to form Japan's three 'Mega Banks' (ie, the Daiichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan, which became Mizuho; Sakura Bank and Sumitomo Bank which resulted in Sumitomo Mitsui; and Sanwa Bank, Tokai Bank, Toyo Trust and Banking and Mitsubishi Trust and Banking, which, together with Mitsubishi Bank, converged to form Mitsubishi UFJ) received capital injections in March 1999 pursuant to the Early Strengthening Act. The sole exception was Mitsubishi Bank.

In addition to the aid provided to distressed banks, the Deposit Insurance Corporation of Japan bought, through the Resolution and Collection Corporation, a total of roughly three hundred and fifty billion yen (350,000,000,000Y) worth of assets from 192 banks over the period 1995 to 2005 pursuant to the Financial Revitalisation Law, which provides for the purchase of assets from sound financial institutions (see Table 2).[14]

10 Law no 132 of 1998, as amended.
11 Law no 143 of 1998, as amended.
12 Law no 34 of 1971, as amended.
13 Based on the latest available information published by the Deposit Insurance Corporation of Japan, a Government-owned organisation that was established in 1971 with the purpose of operating Japan's deposit insurance system – see **www.dic.go.jp/english/index.html**.
14 **www.dic.go.jp/english/e_katsudou/e_katsudou4.html**.

Date: 28 June 2005

(Unit: billion yen)

	Accumulating Total of Purchase (as of 31 March 2005)		
	No of financial institutions	Principal of claims	Purchase price
City, long-term credit and trust banks	20	2,831.6	287.3
Regional banks	59	572.8	40.4
Members of Second Association of Regional Banks	41	434.0	13.7
Shinkin Banks and Credit Cooperatives	72	165.7	11.9
Total	192	4,004.1	353.3

Table 2

Protection of Depositors

At the same time as providing safety nets for financial institutions, increased protection was afforded to investors.

For example, in addition to the existing deposit insurance scheme under the Deposit Insurance Act, which protected the deposits of deposit-holders with banks up to a certain amount,[15] a new Investor Protection Scheme was introduced in 1998 to protect investors in the event of the failure of securities companies.

Under this scheme, the Japan Investor Protection Fund, established pursuant to the FIEL, protects investors (excluding institutional investors) from the loss of any monies or securities deposited with securities companies in connection with securities transactions up to the amount of ten million yen (10,000,000Y) per investor.

Tighter rules on Special Purpose Vehicles (SPVs)

Moved, in part, by public outrage following the 'Livedoor affair',[16] in September 2006 the Accounting Standards Body of Japan issued new rules, whereby banks and financial institutions were required to be consolidated with their affiliated SPVs and the SPVs themselves were subjected to tighter disclosure requirements.[17]

15 From April 2002, 10 million yen per deposit-holder per bank. Until then, there was no limit as to the insured amount, but this was changed after the Japanese bubble burst and Japanese banks faced difficulties as a result.

16 Livedoor, like Enron, was involved in various schemes involving SPVs, which did not appear on its books. Livedoor and its management were implicated in several violations of trading regulations. The company was eventually de-listed. Its management was removed and prosecuted.

17 PITF no 20 *Practical Solution on Application of the Control Criteria and Influence Criteria to Investment Associations*. No English translation of this document is available. See **www.asb.or.jp/asb/asb_e/technical_topics_reports/kumiai/kumiai.jsp**.

In the light of these developments, some banks were quick to dispose of their investments in such SPVs before the sub-prime issue arose. This may have helped to limit the exposure of Japanese banks to the effects of sub-prime, as we have seen above.

Provisional conclusion

Considering the restructuring of the regulatory framework for banks arising as a result of Japan's earlier domestic crisis, and bearing in mind that Japanese banks were accordingly in relatively good shape to weather the coming storm, why, of all major markets, did the Japanese stock market suffer the largest adverse impact from the global financial crisis?

In simple terms, the answer is the failure to achieve the central goal of the new regulatory regime, namely the establishment of a functional two-track financial system. This was primarily because the Japanese market lacked a broad base of investors. The economy continued to suffer from an over-reliance on banks, which remained dominant in bank financing and which were also the major investors in the new field of market-based financing. In reality, however, this new field did not develop as strongly as expected by the authorities.

Here, however, we encounter another paradox. The global financial crisis, and the US sub-prime mortgage problem which triggered it, was primarily a problem involving market-based financing. Yet why then was the Japanese economy, which largely continued, in spite of the efforts of the authorities, to operate on the basis of the 'bank financing model', so severely impacted?

For the answer, we must look more closely at how the global financial crisis affected Japan.

Impact of the global financial crisis on Japan

As identified in the FSA Report, in some respects Japan was well-placed, relative to some jurisdictions, to face up to the impact of the global crisis.

Basel II

Japan's Financial Services Agency required Japanese financial institutions to implement the Basel II regulatory framework in March 2007. This was in advance of most major economies (the EC implemented Basel II in January 2008,[18] while the US has yet to implement it). The more stringent risk management regime resulting from this caused Japanese financial institutions to dispose of some low-rated securitisation products, thus reducing their exposure to sub-prime and the global financial crisis.[19]

18 The EU Capital Requirements Directive; **www.capital-requirements-directive.com**.

19 See *Kinyu Business*, autumn 2007, published by Toyo Keizai, Inc, featuring an interview with the Commissioner of the FSA.

No yen liquidity crisis

Japanese banks have a stable funding source with respect to yen, with deposits accounting for a large portion of funding. Consequently, Japanese banks did not face any liquidity crisis and there was no run on banks, as in Iceland, or as in the case of Northern Rock in the UK.

SMEs

The Japanese Government promoted the facilitation of financing for companies, particularly small- and medium-sized enterprises (SMEs[20]), through an expansion of the quota for emergency credit guarantees by credit guarantee associations[21] and the enhancement of emergency operations by the Japan Finance Corporation.[22]

Despite these inherent advantages, the adverse impact of the global crisis on Japan was significant.

Sharp fall in the stock market

As mentionedabove, the Japanese stock market was severely affected, more so than in other major economies. Because the 'market financing model' was not as fully developed as the authorities had envisioned, the investor base in the Japanese market was not broad enough and, as a result, fire sales by mostly foreign hedge funds led to steeper stock price falls than in the US and Europe.

Adverse impact on banks

This sharp downturn in the stock markets adversely affected Japanese banks, which continued to hold significant investments in stocks, a legacy of the times when banks held equity holdings in their major customers/borrowers to cement business relationships. As stock portfolios are included in the capital adequacy calculations of Japanese banks, bank capital was directly hit by the stock price downturn.

It was noted in the *Results of the Fifth Quantitative Impact Study* by the Basel Committee on Banking Supervision[23] that the equity exposure of Japanese banks was high compared with banks in other G10 countries.[24] According to a Nikkei newspaper article

20 Under Japanese law, an SME in the context of the manufacturing industry is defined as a business employing 300 or less employees, or which has equity of three hundred million yen (300,000,000Y) or less. SMEs in other specified industries are defined through similar basic principles, for example the number of employees and the amount paid.

21 Credit guarantee associations are public institutions established under the Credit Guarantee Corporation Law (Law no 196 of 1953, as amended) to make it easier for SMEs to raise funds from financial institutions by providing guarantees on business loans. See **www.zenshinhoren.or.jp/pdf/English_Annual_Report.pdf**.

22 A public corporation wholly owned by the Japanese Government providing policy-based financing.

23 **www.bis.org/bcbs/qis/qis5results.pdf**.

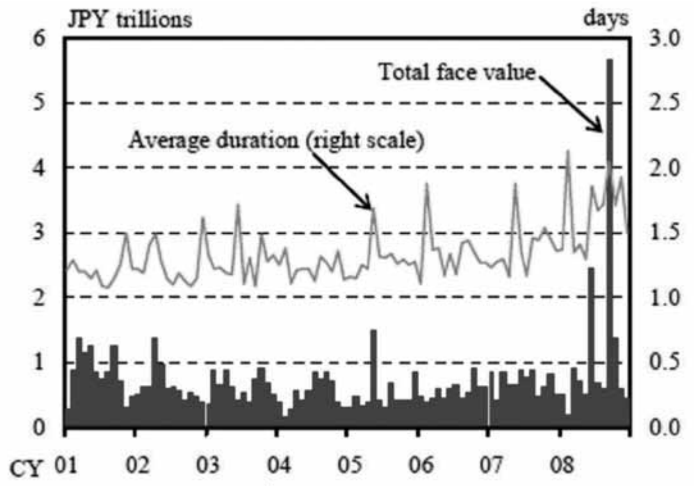
24 Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, Switzerland, UK and the US.

in July 2009, the equity exposure of major Japanese banks alone was estimated to be ten trillion yen. This, in turn, fuelled concern over the lending capacity of Japanese banks.

JGB REPO MARKETS

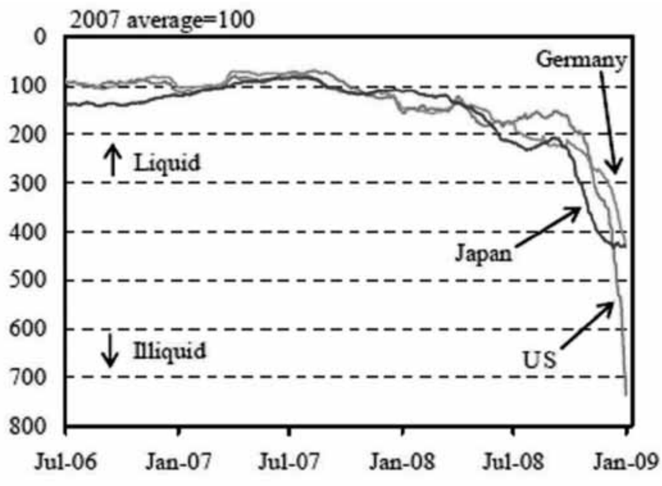
The repo market for Japanese Government bonds was similarly thrown into turmoil as a result of reduced liquidity, resulting in an increased number of fails. See Figures 2 and 3 below, extracted from the *Bank of Japan's Financial Markets Report* of 2010.

Figure 2 Settlement fails of JGBs



Source: Bank of Japan, 'Figures on Settlement of Japanese Government bonds'.

Figure 3 Government bond market liquidity

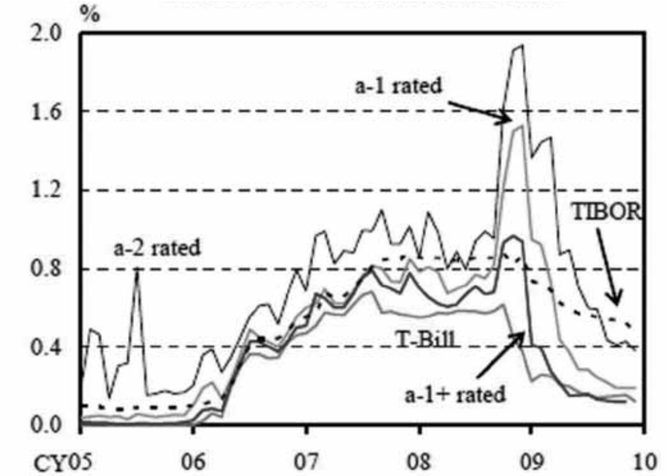


Note: The ratio of intraday high-low spread to trading volume for government bond futures (60-day moving average).
Sources: Bloomberg; QUICK.

CORPORATE BONDS AND CP MARKETS

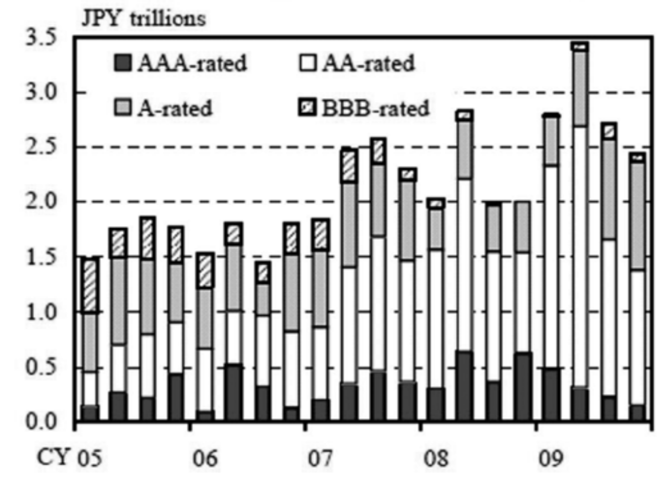
The market for corporate bonds and CP markets also suffered, although the corporate bond market recovered somewhat in 2009. See Figures 4 and 5 below, extracted from the *Bank of Japan's Financial Markets Report* of February 2010. Here again, as banks were dominant in these markets, there was a sharp drop in liquidity when they were forced to consolidate.

Figure 4 CP issuance rates



Note: Three-month maturity. Monthly weighted average.
Sources: Bloomberg; Japan Bond Trading; Japan Securities Depository Center; Bank of Japan.

Figure 5 Corporate bond issuance by rating



Sources: I-N Information Systems; Capital Eye.

A problem peculiar to Japan

At the risk of oversimplification, it is worth highlighting one problem arising from the global financial crisis, which is perhaps peculiar to Japan and which had its origins in the somewhat unusual status of banks in the Japanese economy. As mentioned above, the crisis caused a sharp down turn in Japanese stock markets, reducing the capital adequacy of banks and restricting their lending activities. At the same time, and for reasons broadly similar to those causing the downturn in the stock market, liquidity in the money and capital markets was reduced. This tendency was exacerbated by an over-reliance on banks as investors and meant that larger Japanese companies, which customarily raised funds on the capital markets, were unable to do so. In the circumstances, therefore, the larger companies sought to borrow from the banks, which only served to restrict still further the availability of loans to SMEs. As bank loans were the principal source of financing available to SMEs, the latter were particularly heavily hit by the global financial crisis.

SMEs account for 99.7 per cent of the total number of Japanese corporations and employ 69 per cent of the total workforce,[25] accounting for about 45 per cent of sales by all Japanese corporations.[26] This sequence of events may have created a downward spiral of Japanese stock prices even more severe than other major economies.

Thus, the financial crisis, which was, initially, a problem faced by the market financing model and the effects of which, therefore, should have been relatively contained in Japan, spread outside the financial sector into the 'real' economy.

Japan's response to the global financial crisis

Set out below are some of the key measures taken by the Japanese authorities in response to the global financial crisis.

Moratorium Act (2009)[27] and related regulation

The Act on Provisional Measures for the Facilitation of Financing to Small- and Medium-Sized Businesses (the Moratorium Act) was implemented as of 4 December 2009 and is examined below. Amendments to various regulatory instruments were made as a result of the Moratorium Act, including in relation to:

- Cabinet and Ministerial Ordinances;
- the supervisory guidelines used by the FSA in supervising financial institutions (the Supervisory Guidelines); and

25 *2006 Establishment and Enterprise Census of Japan*, conducted by the Statistics Bureau of the Ministry of Internal Affairs and Communications; see **www.stat.go.jp/english/data/jigyou/index.htm**.

26 The *2009 Financial Statements Statistics of Corporations by Industry*, issued by the Policy Research Institute of the Ministry of Finance; see **www.mof.go.jp/english/e1c002.htm**.

27 For further information regarding the Moratorium Act, see the following newsletters issued by Anderson Mori & Tomotsune:
www.amt-law.com/en/pdf/bulletins2_pdf/091112.pdf
www.amt-law.com/en/pdf/bulletins2_pdf/100202.pdf.

- the inspection manuals used by the FSA for conducting inspections of financial institutions (the Inspection Manuals). A 'Checklist on the Chapter for Facilitation of Financing', which provides a detailed list of what inspectors should look for when conducting financial inspections, was introduced in the Inspection Manuals, effective as of 1 February 2010.

The Moratorium Act requires financial institutions to do the following:

1. as a 'best efforts' requirement:
   (i) to endeavour to provide new credit to SMEs; and
   (ii) to endeavour to take steps to alleviate the burden of debt, upon receipt of a request for the postponement of repayment of debt by an SME or a borrower of a residential housing loan; and
2. as a 'legal obligation':
   (i) to establish a framework to give effect to the steps described in 1(ii) above; and
   (ii) to disclose and report to the authorities steps taken in connection with 1(ii) and 2(i) above.

The amended Supervisory Guidelines set out various detailed points of which Financial Institutions need to take note when taking those steps referred to in 2(ii) above.

Under the Banking Act[28] and the Inspection Manuals, banks are required to:

- make a self-assessment of their bank loans, classifying them as:
  - performing loans;
  - loans that require monitoring;
  - dangerous loans; or
  - claims in bankruptcy, reorganisation or like procedures;
- to prepare adequate reserves; and
- disclose the same on a half-yearly basis.

One type of loan that requires monitoring is a 'Loan with Loan Conditions Relaxed'. Even where a bank has relaxed loan conditions, if the borrower has prepared a drastic management rehabilitation plan with a high probability of success, and a rehabilitation of management in accordance with such plan has commenced, then the bank may opt not to classify such loan as a 'Loan with Loan Conditions Relaxed' and treat it instead as a performing loan.

Pursuant to the current amendments to the Supervisory Guidelines, a loan to an SME may be classified as a performing loan if a management rehabilitation plan expected to turn around the company in about five to ten years is in place. Furthermore, even if such a plan is not currently in place, if it is likely that a management rehabilitation plan will be implemented within one year from the date of relaxation of loan conditions, then loans to SMEs may be similarly classified as performing loans.

It seems that the purpose of this measure is to make it easier for banks to relax the loan conditions on their loans to SMEs, while at the same time enabling them to classify the relevant loans as performing. It has, however, been pointed out that this would

28 Law no 21 of 1927, as amended.

have a negative effect on the balance sheet of the banks and banks may not disclose their loans appropriately. The Moratorium Act, in effect, allows banks to brush loans to SMEs under the carpet for up to ten years. Under Japanese case law, a period of ten years was generally thought to be an inappropriate period for a rehabilitation plan due to the uncertainties of time. As the regulators now regard such a long period as acceptable, there is a risk of moral hazard in dealing with SMEs. Under pressure to disclose their treatment of SME loans, bank officials may not dare to refuse relaxation of loan conditions in circumstances where they normally would; and, through the use of ten-year rehabilitation plans, they can render a loan which would otherwise be classified as requiring monitoring as one which is performing.

The amended Inspection Manuals (the Checklist on the Chapter for Facilitation of Financing) require financial institutions 'under appropriate risk management, to take risks appropriately and actively perform their functions as financial mediators'. It is expected that future financial inspections will be conducted with this in mind.

The amended Inspection Manuals also require financial institutions to adopt appropriate systems to:

- effect the provision of new loans;
- effect amendments to loan conditions;
- provide management advice to borrowers; and
- provide support and consulting to improve business.

These systems are to be by means of:

- adopting, and raising awareness of, internal rules;
- appointing a person in charge;
- education;
- reports to the board of directors and statutory auditors; and
- monitoring and internal audits on the status of implementation.

If a financial institution:

- rejects a request for a new loan or an amendment to loan conditions:
- requires the provision of additional security or guarantees: or
- effects collection of debt, enforcement of security or disposition of the loan.

The action taken by the financial institution is required to be reasonable in view of the circumstances of each individual borrower and such reasonableness must be able to be examined post facto. This might serve to curb banks' ability to refuse new loans, to require new security, to collect its loans, enforce security rights and dispose of the loans. It may result in banks accumulating more non-performing loans.

According to research conducted by Tokyo Shoko Research, Ltd, a civilian research firm, requests for the protection provided under the Moratorium Law were made by about 16 per cent of all SMEs in Japan and accepted by banks in respect of loans totaling about ten trillion yen, an acceptance rate for SME requests of about 80 per cent measured by value.[29]

29 See **www.tsr-net.co.jp/news/analysis/2010/1202379_1612.html**.

Enhancement of safety nets

The Act on Special Measures for Strengthening Financial Functions,[30] which had been introduced pursuant to the Early Strengthening Act as a temporary measure, effective up to March 2008, was re-enacted in December 2009. The original act was introduced for the purpose of enabling Japan's 'regional' banks to dispose of bad assets with the aid of Government funds, and this purpose was considered to be of relevance still after the global financial crisis.

Also, the Banks' Shareholdings Purchase Organisation (BSPO) resumed the purchase of stock from March 2009. The BSPO was established in 2002 after Japan's earlier domestic crisis to purchase shares from Japanese banks, thus allowing them to dispose of their shares held under traditional cross-holding structures and improve their capital adequacy ratios without adversely affecting stock markets. From March 2009 to March 2010, the BSPO bought a total of about four hundred billion yen (400,000,000,000Y) from Japanese banks.[31]

Bank capital adequacy

The Japanese Government's position on strengthening the capital requirements of Japanese banks is in line with that of other G20 nations. Japan supports the G20 position, established in the Pittsburgh Summit of 2009 and reaffirmed in Toronto, to 'commit to developing by end-2010 internationally agreed rules' and that 'these rules shall be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012.' In other words, it is, in general, in favour of the 'phased-in approach', but has not committed itself as to any specific timing for implementation of such rules.

Regulation and supervision of unregulated sectors

Registration of rating agencies

In common with several other jurisdictions, Japan has adopted a legal framework in relation to securitised products that enables the registration of rating agencies.[32]

Pursuant to the Act for Partial Amendment to the Financial Instruments and Exchange Law, etc, enacted on 17 June 2009 and promulgated on 24 June 2009,[33] regulations on the 'credit rating business', referred to in the FIEL were introduced.

Corporations or other persons engaged in the credit rating business may obtain registration from the Prime Minister, and those having obtained such registration must comply with the following obligations as 'credit rating agencies':

30 Law no 128 of 2004, as amended.

31 **www.bspc.jp/pdf/kaitori.pdf**.

32 For further information regarding the Moratorium Act, see the following newsletter issued by Anderson Mori & Tomotsune: **www.amt-law.com/en/pdf/bulletins2_pdf/090803.pdf**.

33 Law no 58 of 2009.

- registered credit rating agencies must:
  - establish a business management system (including measures to control quality of its business and measures to ensure appropriate performance of business operations such as prevention of conflicts of interest);
  - formulate and publish the rating policies, etc;
  - prepare and keep books and records, submit business reports and make explanatory documents available for public inspection;
  - comply with Government orders to improve business operation and other actions made for the purpose of supervision; and
  - undergo, or be subject to, inspections by the Securities and Exchange Surveillance Commission or other competent agencies;
- registered credit rating agencies are also subject to a number of restrictions, including the following:
  - where a close relationship[34] exists between the credit rating agency, its directors or employees and the persons involved in the rating (*kakutsuke kankeisha*), the credit rating agency must not provide, or make publicly available, credit ratings of any of the matters defined by the relevant Cabinet Office Ordinance in which such persons involved in the rating have interests; and
  - except in limited cases,[35] a credit rating agency must not provide, or make publicly available, a credit rating where it has given advice to persons involved in the rating regarding any of the matters defined by the relevant Cabinet Office Ordinance which have a material effect on the credit rating.

Registration of the credit rating business is not mandatory and depends only upon voluntary participation. Unregistered rating agencies are still allowed to conduct a credit rating business. While the credit-rating regulations under the FIEL do not apply to unregistered rating agencies, financial instruments dealers and registered financial institutions are subject to certain codes of conduct, such as disclosing the fact that they are using credit ratings assigned by unregistered rating agencies.

TRANSPARENCY

To address the difficulty of identifying the source of risk due to increasingly complex transaction structures, Japan introduced measures to ensure the traceability of underlying products.

These measures were introduced in advance of other major economies by amendments to the Guidelines for Financial Instruments Business Supervision, effective February 2008,[36] and additional self-regulation in this area is also currently being discussed within the Japan Securities Dealers Association.

The Japanese authorities are also considering the possibility of requiring the originator of securitised products to continue to hold a proportion of the risks associated with the

34 As defined in the relevant Cabinet Office Ordinance.

35 As provided in the relevant Cabinet Office Ordinance.

36 See **www.fsa.go.jp/en/news/2008/20080206.html**.

assets removed from its balance sheet as a result of securitisation. It is hoped that this measure may reduce the conflict of interest related to securitised products.[37]

Compensation

The compensation of senior executives is not as politically charged an issue as it is in, for example, the US or the UK This is because compensation levels of Japanese bank executives are lower than the significant levels enjoyed in Wall Street or the City.

Nevertheless, the FSA introduced new regulations whereby listed companies are required to disclose the names and compensation amounts of individual directors who receive compensation of one hundred million yen (100,000,000Y) or more.[38] Previously, only the total amount of compensation payable to all directors was required to be disclosed, not the amounts paid to individual directors.

Recent developments

Mandatory clearing system for specified derivatives

A bill amending the FIEL passed the Diet as of 12 May 2010 and was promulgated on 19 May 19 2010 (the 'Amendment'). The Amendment includes provisions to improve the stability and transparency of settlement of over-the-counter (OTC) derivative and other transactions, including the mandatory use of a central counterparty (CCP) with respect to clearing of the OTC derivatives.

At the G20 Pittsburgh summit (September 2009), the G20 leaders agreed that 'all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories'.

Following this statement, essentially reiterated in the G20 Toronto Declaration, on 21 January 2010, the FSA presented its proposed regulatory framework in the final version of the 'Development of Institutional Frameworks Pertaining to Financial and Capital Markets'.[39] After discussion within the FSA Policy Council (*kinyu cho seisaku kaigi*), the Amendment was drafted to adopt the necessary regulations.

The Amendment requires certain OTC derivatives transactions, as designated by Cabinet Office Ordinance, to be cleared through CCPs. According to its explanatory material, the FSA envisages designating, inter alia, CDS transactions referring to an index of iTraxx Japan as requiring mandatory clearance by CCPs.

The Amendment also implements certain measures to strengthen the infrastructure for CCPs, such as, in respect of domestic CCPs, subjecting the operators to licensing requirements and requiring major shareholders to notify or obtain the authorisation of the authorities.[40]

37 FSA Report, p 15.

38 See **www.fsa.go.jp/en/news/2010/20100326-1.html**.

39 See **www.fsa.go.jp/en/news/2010/20100122-3.html**.

40 See newsletter issued on May 2010 by Anderson Mori & Tomotsune for further details of these developments – **www.amt-law.com/pdf/bulletins2_pdf/100520.pdf**.

SUPERVISION OF SECURITIES COMPANIES ON A CONSOLIDATED BASIS

The Amendment also includes provisions to strengthen the group-wide regulation and supervision of securities companies.

First, in the light of the increasing size and complexity of how securities companies operate their businesses as a group, there is a risk that the financial or business difficulties of one entity within such group may lead to the sudden failure of the group as a whole. To counter this risk, the Amendment requires large securities companies with assets above a certain threshold to consolidate and supervise their subsidiaries and affiliates on a group-wide basis and submit reports to the regulatory authorities on the activities of the group as a whole.

Second, to counter the risk that securities houses may fail as a result of financial difficulties faced by their major shareholders, the Amendment authorises the regulatory authorities to require shareholders who have a majority stake in securities companies to take steps necessary to improve the business or financial situation of the relevant securities company.

CONSOLIDATED SOLVENCY MARGIN STANDARDS FOR INSURANCE COMPANIES

Mirroring the above developments, to counter the risk of one entity within an insurance group bringing down the whole group, solvency margin standards applicable to an insurance group as a whole, from the insurance company or holding company down, will be introduced, and are expected to come into effect from 2012.

Summary

Japanese regulators introduced significant measures to seek to mitigate the effects of the Japanese bubble and, hopefully, avoid similar future crises. Despite their earlier efforts they have had to be equally active in dealing with the global financial crisis. If the Japanese experience tells us anything, it is how difficult it is to find a regulatory 'fix' to prevent another crisis from occurring or to alleviate the effects of any such future crisis. Regulations are generally reactive and tend to deal with only a part of a complex problem; and the markets will always be one step ahead.

Russia

Vadim Zaripov, Pepeliaev Group

The beginning and development of the financial crisis in Russia

Autumn 2008: the global financial crisis hits Russia

In 2008 the crisis in the US mortgage market began to grow into a global financial meltdown, which threatened to develop into a global production crisis. The restructuring of the global economy that occurred in the wake of the financial crisis resulted in the need for Russia to set more stringent requirements to ensure the sustainability of its economy and to enable it to neutralise the fallout from the global markets.

After ten years of steady economic growth and social welfare gains, Russia began to face some very serious economic challenges. Across the globe, the economic crisis resulted in a downturn in production, higher unemployment and a decline in earnings.[1]

The crisis began in 2008 in the private sector – provoked by excessive private borrowings and a major trilateral shock. This trilateral shock consisted of a deterioration in foreign trade conditions, a reduction in capital outflow and a worsening of the conditions for external borrowing.

Russia began to feel the influence of the global financial crisis in September 2008. At that time, Russian companies announced staff reductions. According to Reuters, headcount reductions took place despite promises given by civil servants and positive forecasts by analysts.

In October 2008 the Russian economy began to demonstrate signs of a downturn. On 9 October 2008, the international rating agencies Fitch and Moody's downgraded the ratings and outlook for the Russian banks Renaissance Capital and Soyuz. On 10 October 2008, Standard & Poor's (S&P) also announced a change in the outlooks for 13 other Russian banks and financial companies from 'stable' to 'negative'.

On 16 October 2008, the price of Urals oil dropped below US$70 per barrel. This price was used to balance the 2009 budget.

A message from Russian President Dmitry Medvedev to the Federal Assembly scheduled for 23 October 2008 was postponed until further notice because the President wanted to add anti-crisis amendments to the message.

On 31 October 2008, after a meeting at Novo-Ogarevo country residence, Prime Minister Vladimir Putin announced a new package of measures to support the economy. It was the first time since the onset of the crisis that the Russian Government had announced potential spending cuts for the budget and state monopolies.

1 The programme of anti-crisis measures of the Russian Government for 2009 (dated 19 March 2009) **www.kreml.org/other/207973731**.

According to the Ministry for Economic Development's 'Overview of the Economy from January–October 2008', GDP fell by 0.4 per cent in October 2008 as compared to September 2008. This was the first time since the beginning of the global crisis that GDP had declined month-on-month. This was attributable to a slowdown in production, construction and fixed-asset investments.

On 5 November 2008, Dmitry Medvedev delivered his Message to the Federal Assembly and noted that the global economic crisis was far from over.[2]

On 6 November 2008, the price of Russian Urals oil slipped below the psychological level of US$60 per barrel. The risk was that if oil prices remained critically low the budget would become unbalanced as early as the first quarter of 2009.

On 15 November 2008, the Russian stock market underperformed major world stock exchanges based on weekly results. Russia's benchmark stock indices crashed 15–18 per cent. The price of Urals oil plunged 11 per cent over a week and sank below US$50 per barrel for the first time since January 2007.

On 18 November 2008, President Dmitry Medvedev said that Russia in general and the real economy in particular were in crisis. He also said that large-scale unemployment was possible. For the first time, the President read aloud the total amount of the anti-crisis rescue package – over RUB 5 trillion.

The Russian economy was slowing down. 'Stagnation' was mentioned in future projections. On 18 November 2008, the Federal Statistics Service announced a decline in the production growth rate in October 2008 by 3.9 times down to 1.6 per cent per month, as compared with 6.3 per cent in September 2008. The crisis had reached the real sector of the economy, which was strongly dependent on capital inflows. The low production growth rate in October 2008 was attributable to a downfall in metallurgy, the chemical industry and the production of construction materials.

According to the Federal Statistics Service, in December 2008 the slump in Russian production reached 10.3 per cent, including a staggering 13.2 per cent drop in the manufacturing industries and in mechanical engineering.

In the fourth quarter of 2008, the drop in output of all types of industrial products averaged 33.6 per cent.

2009: the turnaround year

In January 2009 the decline in industrial production accelerated to 16 per cent year-on-year and amounted to 19.9 per cent compared with December 2008.

The manufacturing industry experienced the most significant decline in January 2009, dropping 24.1 per cent compared with January 2008. The fall in production and electric power distribution amounted to seven per cent in January 2009 compared with January 2008. The production of car tyres went down by 83.1 per cent and wheel tractors by 89.1 per cent in January 2009, compared with January 2008.

2 The Message to the Federal Assembly of Russia dated 5 November 2008, **http://archive.kremlin.ru/appears/2008/11/05/1349_type63372type63374type63381type82634_208749.shtml**.

As of 1 January 2009, many enterprises accumulated substantial inventories of unsold products, ranging from one to three months of production cycles.

The insolvency of consumers and lack of credit facilities at production enterprises exacerbated the financial and economic position of Russian manufacturers. Many of them had to reduce their working week and the number of staff engaged in production. In many instances, they had to suspend production completely.

On 24 March 2009, at a session of the Ministry for Economic Development, the Finance Minister Alexei Kudrin said that the Ministry of Finance was expecting a second wave of the crisis to hit the financial system in the near future as a result of defaults on loans in the real sector.

According to the Federal Statistics Service, Russia's GDP slumped 9.5 per cent in the first quarter of 2009 compared with the first quarter of 2008.

The economic downturn slowed in the second half of 2009. According to data published on 15 July 2009, the downturn of the Russian economy was beginning to decelerate. Industrial production in the country slowed down by 12.1 per cent in June 2009, 17.1 per cent in May 2009, 16.9 per cent in April 2009, 13.7 per cent in March 2009, 13.2 per cent in February 2009 and 16 per cent in January 2009.

Compared to the first six months of 2008, the production of oil, meat and pharmaceuticals increased in the first six months of 2009. Inflation slowed down somewhat.

GDP rose 0.5 per cent in July 2009 compared with June 2009. The main factor accountable for this growth was an upturn in investments for the first time since the onset of the crisis.

In May 2009 the industrial sector stopped declining and began to grow. In addition, the slump in industry had bottomed out. On 24 August 2009, it was announced that the recession and decline in GDP were over.

On 30 December 2009, at a session of the Presidium of the Russian Government, Prime Minister Putin announced that the active phase of the crisis was over and that economic growth had resumed in the second half of the year.

2010: Russia pulls out of the crisis

In January 2010 the Russian economy grew 5.2 per cent compared to January 2009. Although the Russian economy was demonstrating positive growth across many sectors, the investment and construction sectors were still struggling. Industrial production grew in January 2010 by 0.7 per cent compared to December 2009.

At the beginning of 2010, the recovery of the Russian economy, which got under way in the middle of 2009, gained momentum. In the first quarter of 2010, GDP growth slowed down somewhat as a result of weak investment demand. In April 2010, however, the majority of macroeconomic indicators showed an accelerating growth rate. In year-on-year terms, GDP rose 2.9 per cent in the first quarter of 2010 against a 3.8 per cent decrease in the fourth quarter of 2009. From January until April 2010, GDP grew 3.5 per cent compared to the same period in 2009.

At the beginning of 2010, the majority of indicators showed positive trends against the figures from the same period in 2009.

In January–April 2010 industrial production exceeded the level of the corresponding period in 2009 by 6.9 per cent. The output of manufacturing industries surged 8.3 per cent in four months against the same period in 2009. The production of electrical machinery, electronic and optical equipment, chemical products and vehicles posted the strongest gains.

Over these four months, consumer demand was on the rise. Retail turnover edged up two per cent year-on-year against January–April 2009. January–April 2010 results showed that personal spending grew by 6.5 per cent year-on-year. Real salaries rose 3.8 per cent during this period.

By the end of April, the unemployment rate went down to 8.2 per cent as compared to 8.8 per cent in April last year.

In March and April 2010, fixed-asset investments exceeded the levels recorded in the same period in 2009. The downturn in construction works began to ease. Likewise, residential construction showed signs of improvement.

Exports rose 1.6 times from January–April 2010 as compared to January-April 2009. From January–April 2010 imports soared 21.5 per cent year-on-year.

Inflation began to slow down during this period. Over the first four months of 2010 prices rose 3.5 per cent (as compared to 6.2 per cent in the same period of 2009).[3]

In April 2010 industrial production demonstrated robust growth, up 10.4 per cent compared with April 2009.

World Bank experts predict that the Russian economy will develop at a steady pace. In a regular report concerning the situation in Russia, the World Bank complimented the Government of Russia on successful activities on the whole in overcoming the crisis. These activities enabled the country to avoid serious social unrest.[4]

On 20 April 2010, Prime Minister Putin delivered a report of the Russian Government to the State Duma about the anti-crisis measures taken. He reported that the anti-crisis programme had cost the country over RUB 3 trillion. Although some actions failed to yield results, the majority of the measures were successful. The Government managed to halt the recession, avoid cutting the budget, support companies by extending loans and increase household income. According to Prime Minister Putin, the anti-crisis programme implemented by the Government in 2009 was of an unprecedented nature. Putin said that the Russian economy was on the mend, pointing to that fact that in the first quarter of 2010 industrial production had grown by 5.8 per cent and earnings by 7.4 per cent year-on-year. Inflation had continued to slow down. As a result of the measures taken, the threat of a large-scale crisis in the banking system did not materialise. Interest rates on loans were gradually going down. Prime Minister Putin

3 'The scenario conditions for the functioning of the Russian economy. Main parameters of the forecast for the social and economic development of Russia for 2011 and the planned period of 2012 and 2013' dated 4 June 2010, **http://government.ru/docs/10861/**.

4 'The World Bank began to believe in Russia', **http://top.rbc.ru/economics/24/03/2010/383833.shtml от 24.03.2010**.

noted that the Russian Government would continue to take anti-crisis measures as long as they were needed.

The Russian economy performed better every month in 2010. The federal statistics show that fixed-asset investments, household income and retail turnover are growing, while unemployment is going down.

On 22 June 2010, the head of the Federal Statistics Service said that Russia had almost reached the pre-crisis growth rate of the economy. Growth for the first five months of 2010 amounted to over ten per cent compared to the first five months of 2009. Unemployment was continuing to decrease. Unemployment and economic growth are two factors which show that the country is overcoming the crisis.

Measures taken to improve the Russian economy during the crisis

Urgent measures taken by the Russian Government to support the Russian economy

On 29 September 2008, Prime Minister Putin conducted a meeting known as 'On Working Out the Concept of Long-Term Social and Economic Development of Russia Until 2020 and Main Areas of Activities of the Russian Government until 2012'.

Prime Minister Putin said that the global economy and financial system were suffering from serious difficulties and as a result it would be very hard for Russian banks and companies to extend existing loans and obtain new loans from Western financial institutions. Therefore, to support the Russian financial system and limit the negative influence exerted by the global financial crisis on the domestic economy, as well as to protect the assets of Russian companies pledged to foreign credit institutions, the Russian Government and the Bank of Russia proposed a number of anti-crisis measures:

1. The Bank of Russia was allowed to extend loans to banks without collateral. Such loans were extended to 28 banks. This made it possible to support the liquidity of the banking sector in a short period of time.
2. In order to support the interbank lending market, the Bank of Russia was entitled to enter into agreements with several banking institutions to reimburse a portion of any losses sustained in connection with the extension of loans to other Russian financial institutions, should such losses occur.
3. The budget for 2008 and 2009 provided for RUB 250 billion to support the Russian stock market, including through capital increases to Vnesheconombank, which was to play a significant role in the recovery, as described below.

In his speech, Prime Minister Putin announced that the Ministry of Finance had established a working group, including civil servants, experts and representatives of private business, to urgently develop medium- and long-term solutions to pull the domestic financial market out of crisis.

The Prime Minister also noted that the anti-crisis package provided for the allocation of RUB 950 billion to two Russian banks over a ten-year period in order to foster an increase in the capital of Russian banks and improve liquidity. Sberbank would receive

RUB 500 billion from the Bank of Russia and the remaining RUB 450 billion would be extended to Vnesheconombank. Of this RUB 450 billion, Vnesheconombank was required to transfer RUB 200 billion to Vneshtorgbank. Vnesheconombank was permitted to extend the remaining RUB 250 billion to commercial banks as subordinated loans.

The Prime Minister said that it was also necessary to support the real sector of the Russian economy and provide it with access to financial resources. Many Russian companies had been accustomed to obtaining loans from abroad. However, such loans were no longer available, and the repayment deadlines for existing obligations were fast approaching. It became necessary to provide domestic assistance to help companies to refinance existing foreign loans and thus to protect the assets of Russian companies from being undervalued and sold at reduced prices. For this purpose, the Bank of Russian extended USD 50 billion to Vnesheconombank. The right to refinance foreign loans was granted to those companies that had taken out loans before 25 September 2008.

On 13 October 2008, Prime Minister Putin held a session of the supervisory board of Vnesheconombank. He underscored the importance of ensuring the sustainability of the Russian banking system and preserving the conditions necessary for the stable operation of Russian companies, which was a key priority, and that Vnesheconombank was to play a leading role in achieving this goal. As a result, the bank's authorised capital was increased by RUB 75 billion at the end of 2008. This money was earmarked for the purchase of Russian securities and hedging transactions on the domestic financial market. Another RUB 175 billion was transferred to Vnesheconombank from the Fund of National Welfare in order for the bank's management to help maintain the stability of the Russian stock market, including through buying corporate bonds issued by Russian companies.

On 29 October 2008, Putin held a meeting devoted to economic issues. During this meeting he stressed that it was important to ensure the sustainable work of the key industries in the real sector, including construction, retail, agriculture, small businesses, the defence complex and oil production.

In the construction sector, this meant buying apartment buildings that were close to completion and using them as accommodation for military servants and residents whose existing houses were considered unfit for habitation. This also meant supporting mortgages by increasing the authorised fund of the Agency of Residential Mortgages. In the agricultural sector, this entailed increasing the authorised capital of Rosselkhozbank and Rosagroleasing, as well as reimbursing farmers for the higher fuel and lubricant prices. In the oil production industry, this meant reducing the tax burden.

On 31 October 2008, Prime Minister Putin held a meeting on economic issues. During this meeting, it was noted that a number of solutions to mitigate the negative influence of the global financial crisis on the Russian economy had been taken. Government and industry-specific ministries were continuing to analyse the situation thoroughly. There were meetings and sessions with the representatives of industries and

the business community and with top managers of Russian companies and banks. This enabled the Government to thoroughly assess the problems faced by the real economy.

A comprehensive action plan, which was to be adjusted over time depending on the change in the situation in the global markets and the Russian economy, was drawn up to support Russia's real economy and key industries. This plan became a launching pad for the joint work of the Government, federal agencies and the Bank of Russia in overcoming the negative consequences of the global financial crisis.

Prime Minister Putin outlined three main goals of the proposed plan:

1. To develop a regulatory framework to protect the lawful interests of investors and creditors, as well as to prevent the bankruptcy of companies.
2. To actively seek the most efficient means to support companies operating in various sectors of the economy. First of all, support would be provided in the following sectors: construction, machine-building, military, extractive industries, retail and agriculture. In addition, measures to support the domestic exporters of industrial products and customs tariff measures protecting car manufacturers and agriculture were proposed.
3. To support small- and medium-sized businesses.

Principle measures taken by the Russian Government and the Bank of Russia in 2008 to improve the Russian economy

In 2008 the Russian Government and the Bank of Russia took a number of measures aimed at preventing destructive processes in the economy:

1. Intensification of social welfare programmes for families and job creation. Increase in the maximum unemployment benefits:
2. Preservation and escalation of industrial and technological potential:
   (a) General support for the real sector and work with strategic companies:
      (i) preparation of a list of core enterprises;
      (ii) tax incentives:
         - reduction of profit tax rate from 24 to 20 per cent;
         - payment of tax on the basis of the profit actually received;
         - extension of the deadlines for paying VAT on subject transactions;
         - exemption from VAT of imports of technological equipment, where no equivalent is manufactured in Russia;
         - reduction of the tax rate used under the simplified taxation system that applies mainly to small businesses; and
         - increase in the depreciation premium;
      (iii) facilitating the accessibility of financial resources;
      (iv) maintaining demand:
         - by ensuring that domestic products are bought on a priority basis under state and municipal programmes involving mass-produced goods;

- by establishing discounts (from five per cent to 25 per cent) for the suppliers of Russian products when placing a state order (until 31 December 2010); and
- by increasing state-financed aid for the export of industrial products;

(b) support of specific industries:
   (i) agriculture;
   (ii) support of auto manufacturing and agricultural engineering projects: reduction of customs import duties for mechanical transport;
   (iii) providing financial aid to defence enterprises: expanding the practice of granting an investment tax credit to defence enterprises;
   (iv) transport industry;
      - state support of airline companies;
      - ensuring duty-free import of foreign-made aircraft accommodating up to 50 people and over 300 people; and
      - optimisation of import customs duties for foreign-made aircraft when concluding agreements and contracts for the supply of similar domestic aircraft and the cancellation of import customs duties for foreign-made components used in the production of domestic aircraft;
   (v) residential construction, housing and public utilities: increase in the property deduction when calculating personal income tax from RUB 1 million to RUB 2 million on the purchase of accommodation;
   (vi) other measures:
      - shortening the timeframes for monitoring and the period for which export customs duties are introduced for crude oil and certain categories of goods derived from oil from two months to one month; and
      - providing a tax holiday for mineral extraction tax when extracting oil in territories north of the Arctic Circle, in the Sea of Azov, the Caspian Sea, the Nenets Autonomous Area and the Yamal Peninsula of the Yamalo-Nenetsky Autonomous District and optimising the conditions for applying the direct method of accounting for oil in order to apply benefits when extracting oil in new and worked-out deposits or when extracting superviscous oil;

3. relaxing administrative pressure on business:
   (a) Expanding state support for small- and medium-sized businesses;
4. ensuring the sustainability of the financial and banking systems:
   (a) expanding the resource base and increasing the liquidity of the banking system:
      (i) increasing the maximum threshold of state-guaranteed compensation for household bank deposits (from RUB 400,000 to RUB 700,000);
      (ii) placing temporarily available funds of the federal budget on deposit in commercial banks.
      (iii) vesting the Bank of Russia with the right to extend loans up to one year

without collateral to Russian lending institutions that meet certain criteria;
- (iv) extending subordinated loans to commercial banks, banks with state participation and Vnesheconombank;
- (v) improving the procedure for restructuring commercial companies, including lending institutions, by cancelling the unconditional right of creditors to early repayment of debt in the event of restructuring;
- (vi) increasing the authorised capital of Vnesheconombank;
- (vii) increasing the interest rates of overnight currency swaps and deposit transactions of the Bank of Russia;
- (viii) raising the refinancing rate. From 1 December 2008, the rate was lifted from 12 per cent to 13 per cent. Earlier, from 12 November 2008, the refinancing rate was increased from 11 per cent to 12 per cent;
- (ix) vesting the Bank of Russia with the right to participate in stock market trading;
- (x) simplifying the securitisation and refinancing of mortgages;

(b) simplifying the procedure for granting state guarantees. The projected upper limit was increased. It is now possible for the Ministry of Finance to grant state guarantees on loans to certain companies (including strategic defence companies) up to RUB 10 billion per guarantee;

(c) rehabilitation of the banking system:
- ensuring the rehabilitation of credit institutions through the Deposit Insurance Agency and Vnesheconombank. RUB 200 billion was allocated to the Deposit Insurance Agency. A number of large credit institutions were rehabilitated for the total amount of RUB 214.5 billion (as of 1 December 2008); and
- vesting the Bank of Russia with the right to conclude agreements with banks, whereby the Bank of Russia reimburses the banks for part of those losses sustained on loans extended to companies whose banking licence has been revoked.

Main measures taken by the Russian Government and the Bank of Russia in 2009 to improve the Russian economy

1. Strengthening of social security; preservation and creation of jobs:

(a) social security:
- (i) organising the work of advice bureaus and hotlines for employees; publishing information leaflets and brochures;
- (ii) co-financing regional programmes aimed at reducing tension in the employment markets in the regions of Russia:
  - professional training of employees if there is a threat of mass staff reductions;

- creation by employers of temporary job opportunities (public sector work, temporary employment, internships); and
- facilitating the development of small businesses and self-employment options for the unemployed;

(iii) increasing unemployment subsidies;

(iv) prohibiting salary cuts for employees of state-financed institutions;

(b) support of education: subsidies granted to support educational loans;

2. preserving and increasing industrial and technological potential:

(a) overall support for the real sector and work with core enterprises;

(i) financial aid to strategic enterprises;

(ii) tax incentives:

- introduction of a simplified declaration procedure for VAT refunds;

(iii) maintaining demand:

- regulating the procedures for purchases made by natural monopolies and state corporations, including establishing preferences for the suppliers of Russian products;
- state support of the export of industrial products; and
- supporting technological modernisation of domestic industries;

(b) support of specific industries:

(i) agriculture;

(ii) support of car manufacturing and agricultural engineering projects by:

- subsidising part of the interest rates charged by Russian lending institutions on loans extended to Russian companies engaged in auto manufacturing and transport machine-building;
- subsidising the expenses incurred by Russian Railways for the transportation of domestic cars to the Far East;
- extending credit lines to finance the operating activities of car manufacturers up to a total of RUB 70 billion; and
- changing customs import duties for second-hand and new cars of special purposes.

(iii) transport industry:

- granting an extension to airline companies for the payment of customs duties for a period of up to six months for imported foreign-made aircraft and their components (including engines), together with an exemption from any requirement to provide collateral to secure the payment thereof;

(iv) residential construction, housing and public utilities:

- from 2009 allowing families that receive state benefits for maternity (family) to use this money for housing and accomodation (repaying the principal and interest on credits and loans, including mortgage loans);
- restructuring mortgage loans for people who have lost their jobs; and

  - developing a set of anti-crisis measures in the construction industry;
  - (v) forestry:
    - protecting the domestic market for timber and paper products in 2009 and 2010, including changing customs import duties for timber and paper products; and
    - granting subsidies to companies engaged in forestry for out of season reserves of wood, raw materials and fuels;
  - (vi) other industries:
    - adjusting customs export duties for mineral fertilisers;
    - establishing a single leasing company to provide coal mining companies with mining transport equipment; and
    - making state investments aimed at supporting high-tech sectors of the economy;

3. relaxing administrative pressure on business;
   - (a) reducing administrative barriers when performing entrepreneurial activities:
     - as of 1 July 2009, introduction of a simplified notification procedure for commencing entrepreneurial activities for 13 types of activities, primarily affecting small- and medium-sized businesses; and
     - as of 1 January 2010, limitation of the number of audits of small businesses to three audits per year; extraordinary audits should be performed only with the permission of the prosecutor;
   - (b) state support of small- and medium-sized businesses:
     - increasing the amount of financial aid to be provided to small- and medium-sized businesses by Vnesheconombank;
     - ensuring small- and medium-sized businesses will be allowed to purchase goods from natural monopolies and state corporations; and
     - creating favourable conditions for the financing of small- and medium-sized businesses by commercial banks;
4. increasing the sustainability of the national financial system:
   - (a) expanding the resource base and increasing the liquidity of the banking system:
     - placing temporary funds from the federal budget on deposit with commercial banks;
     - extending subordinated loans to commercial banks, banks with state participation and Vnesheconombank (in 2009 RUB 200 billion to Vneshtorgbank, RUB 130 billion to Vnesheconombank and RUB 225 billion to commercial banks);
     - participation by the Bank of Russia in stock market trading;
     - introduction of a 'soft' margin for the fluctuation of the rouble exchange rate;
     - limiting the federal budget deficit to eight per cent of GDP in 2009; and
     - extending loans to banks by the Bank of Russia;

   (b) increasing the availability of bank financing for companies in the real sector and providing additional state guarantees.
   (c) rehabilitation of the banking system:
      - rehabilitation of lending institutions through the Deposit Insurance Agency; and
      - the Bank of Russia agreed to reimburse the banks for part of the losses sustained in connection with loans extended to companies, whose banking licences were revoked;
5. cooperation between the Government and Russian regions to implement anti-crisis measures.
   (a) allowances to support measures ensuring that the budgets of Russian regions are balanced.
   (b) expanding opportunities to obtain state-financed loans.

Preventive measures to fight against the crisis and prevent additional negative consequences

The following actions were the main anti-crisis and modernisation steps taken by the Russian Government in 2010.

Maintaining social stability and ensuring a comprehensive social welfare programme for the Russian people

From 1 January 2010, pensions were substantially increased by introducing a mechanism for increasing the monetary assessment of the pension rights of a pensioner. Social benefits and payments will be increased by ten per cent in 2011.

Another important aspect of this action point is the introduction of measures to reduce tension among employees, including:

- creating more jobs in the public sector and providing more temporary employment opportunities for those employees who are at risk of losing their jobs;
- proactive professional re-training of employees who run the risk of being fired; and
- facilitating self-employment opportunities and creating incentives for formerly unemployed citizens who establish their own businesses to create new job opportunities for the unemployed.

Maintaining economic recovery and sustaining existing positive trends

In order to ensure that positive trends in the key sectors of the Russian economy continue, anti-crisis measures will continue to be implemented. At the same time, the approaches to choosing such measures and monitoring their efficiency will be monitored and amended as necessary to best meet current requirements.

First of all, the most effective anti-crisis measures from 2009 will remain in place.

Expenses for such measures will amount to RUB 233 billion. In particular, lending support for the regions and state guarantees for loans given to core enterprises will continue. In addition, certain other measures have been preserved by resolutions passed by the Russian Government, including the purchase of airline company vehicles by federal agencies, the provision of subsidies to airline companies to remain in operation for passenger transportation when the licence has been revoked, and some other measures.

New measures will be adopted after a review of the performance of the anti-crisis policy in 2009. The main goal of the anti-crisis measures in 2010 will be to ensure the best possible results while at the same time substantially decreasing the funds allocated in the state budget for this purpose.

The following are the main types of measures to be taken by the Russian Government in order to sustain the positive trends in the economy in 2010.

Increase in the financing of companies; restructuring the debt of the real sector

One of the key tasks is the stabilisation of the situation in the banking sphere and providing companies with access to commercial lending on acceptable terms. A number of measures will be introduced for these purposes, including amending the laws governing the relationship between creditor and borrower, in both public and private transactions, in order to assist them to reach reasonable compromises, and improving the laws governing bankruptcy.

Maintenance of domestic demand

An important short-term risk for economic development is the stagnation of domestic demand on the part of both households and the corporate sector. Unemployment, reduced earnings among certain groups of people and the complicated financial condition of companies have had a negative impact on demand. In turn, the stagnation of demand limits the ability to achieve economic growth through reliance on the domestic market.

In addition to the measures in effect from 2009, the Russian Government will take further actions specifically aimed at motivating domestic demand and supporting nascent economic growth. Initially, measures to increase demand will focus on products in those sectors of the economy that suffered the most during the crisis in 2009, those sectors that have a multiplicative effect on the demand for products in allied sectors of the economy and those sectors that provide employment opportunities. These sectors include, among others, auto manufacturing and residential construction.

A measure will be introduced that provides the purchaser of a new car with a subsidy when they recycle an old car, in an attempt to support the auto manufacturing industry (subsidies of up to RUB 50,000 per customer will be introduced and the total amount of money allocated from the budget is up to RUB 11,050,000,000).

From 2010, those eligible for state maternity benefits will be permitted to use such benefits for housing purchases. This is expected to substantially increase domestic demand

in the housing market. Theoretically, up to RUB 102 billion of the total amount allocated from the budget to maternity benefits could be used for residential construction.

Development of small- and medium-sized business

The creation of new small businesses will be a key factor in sustaining economic recovery and in expanding the base for economic growth. To this end, the state programme in support of small businesses was revised in 2010, and the list of support measures implemented under the programme has been expanded. Financial assistance will be provided first to small businesses in the production sector and those engaged in corporate innovation activities. The programme for financing small businesses that commenced in 2009 will be fully up and running by the end of 2010.

Special consideration will be given to the improvement of customs and tax control and to the activities of law enforcement authorities in respect of small businesses. A radical simplification of the procedure for obtaining licences will be considered.

The provision of state financial assistance to start up a private business will be also maintained within the framework of regional programmes to facilitate employment.

Restructuring the economy of single-industry cities

The Russian Government has approved a list of single-industry cities for which recovery programmes will be developed and implemented.

Modernisation measures

- Creating the right economic conditions to enable a shift from the anti-crisis functioning of the economy to a focus on modernisation. Such conditions are dependent on maintaining macroeconomic stability and expanding business activities and making them more efficient by improving law enforcement, minimising administrative barriers and introducing an incentive-based tax system.
- Implementation by the Russian Government of measures to more quickly modernise the economy. At issue is how to stimulate innovation and investment activities in the economy, how to develop further the transport, energy and telecommunications infrastructures, how to increase domestic demand for domestic products, how to improve the situation in underdeveloped regions and how to create new regional 'growth points'.[5]

5 Main areas of anti-crisis actions of the Russian Government in 2010, see **http://premier.gov.ru/anticrisis/3.html**.

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