Commentary
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Parents and Subsidiaries—Especially of Banks—In Insolvency Mode

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As a consequence of the financial crisis, national and international regulatory bodies have started to ask what the consequences would be of a multinational banking group becoming insolvent. Numerous issues come to the forefront: How should we resolve a group? Should individual entities be resolved separately, especially if these are organized under different legal regimes, or would a single regime be preferable? What measures can be taken to avoid disorderly dissolution? Group governance would play a central role in finding adequate and timely solutions, keeping in mind that the ultimate objective is to save as much of the group as possible, its goodwill, and its client relations. Insolvency of a group is not necessarily insolvency of each of its constituent entities; some will not be insolvent individually and can be disposed of, others will need recapitalizing, and finally the group parent may capture all of the losses and then be dissolved.

Significant changes

Within the euro area, a significant change has occurred, starting November 4, 2014: a single supervisory mechanism (SSM) has entered into force, centralizing banking supervision for the euro area in the hands of the European Central Bank. It is backed up by a single resolution mechanism, administered by a resolution board. The most significant banks within the Union (130 banking groups, representing 85 percent of all euro area banking assets) will be supervised under a largely uniform regime, while smaller banks will remain supervised nationally, following comparable guidelines. As a consequence, within the SSM area, differences between branches and subsidiaries may be expected to largely disappear, at least with regard to prudential supervision.

Under political pressure, banking groups must adopt measures to avoid becoming supported by the taxpayers again. The risks will be internalized, essentially by providing adequate amounts of the groups’ own funds or liabilities that can be bailed in, resulting in a sufficient TLAC (total loss-absorbing capacity) or its European equivalent, MREL (minimum requirement for own funds and eligible liabilities), and finally backed up by a single resolution fund.

By changing the euro area subsidiaries into branches, banks will be able to eliminate costs: branches require no separate boards or auditors, and internal audit, risk, and compliance
functions are organized as part of the group—no need to affect capital or other means to support the branch, as it will be included in the group financing. This will better reflect the reality of large cross-border groups and allow more integrated and efficient management. Regarding governance, the consequences will be considerable: the branches will be fully included in the overall structure of the banking group, and boards will disappear, although leaving some room for local specificities, especially relating to issues other than banking supervision (such as their role in the securities business or local distribution rules). Obviously, there is no separate insolvency of a branch, but in the euro area the regime for significant branches will not apply.

It is noteworthy that these fundamental changes in governance will be dictated by changes in the supervisory system, and the converse is also true, as fragmentation of a banking group into subsidiaries is also largely dictated by the wishes of local supervisors to better protect the interest of local creditors and clients. In many cases, changes in the supervisory regime are likely to result in changes in governance.

**Continuing subsidiaries**

Subsidiaries will continue to exist. They are set up for many reasons: taxation, labor law, presence of minority partners, and contact with local clients and authorities are among the many arguments cited for preferring the subsidiary form. Risk limitation also is often mentioned, but the weight of that argument is low; contagion will flow from reputation damage and intragroup connections, so insolvency usually will not be contained. To avoid risk of insolvency, national regulators have insisted on having subsidiaries treated as separate entities, economically as well as legally—the so-called ring-fencing phenomenon. For efficiency, ring fencing usually receives low marks. It cuts across the group’s liquidity and solvency measures, blocks capital or liquidity at the subsidiary level without a clear purpose in group terms, and often is insufficient in crisis.

Local regulators will try to protect national interests by requiring activity to be incorporated as a subsidiary, which is clearly against the European Union Treaty’s freedom of establishment. They will require full capitalization, subordinate the parent's claims, and impose separate governance structures with sufficient local input. In pre-crisis cases, liquidity may be blocked. Ring fencing is often the negation of group synergies: groups seem to be withdrawing from local markets if the burdens imposed by local regulation and authorities, as balanced against local business activity and profits, become unfavorable. In governance, this approach may be returning to some original group concept where each entity had to be managed in its own interest and without regard to the group interest. Economically, it reduces reality to the short term, as the long-term advantages of group membership are eliminated by short-term risk considerations.

**Recovery and resolution mechanisms**

Are there alternatives? The usual answer may be that banking crises should be better prevented by imposing requirements that strengthen the banks’ financial condition and reduce their risk profile, while risk management should be considerably upgraded. In a cross-border context, better coordination and cooperation will help, although experience is not very convincing.
The recovery and resolution mechanisms that are now on the agenda in many jurisdictions may offer a new perspective. The financial crisis has taught us that when a bank—or any other business firm—becomes “insolvent,” that should not necessarily trigger the application of the general bankruptcy rules. These rules lead to massive value destruction, usually resulting in a breakup of the group, and to the annihilation of its goodwill and going-concern value, ultimately making all participants worse off than under an orderly liquidation. In both the United States and Europe, systems have been in force that allow an insolvent company or group to be split into a “good” and a “bad” part, with only the second part being liquidated. In the banking field, these techniques are now expressly laid down in the law under the title of recovery and resolution schemes. For these schemes to work requires careful analysis and planning from the board, especially in a group context. The recovery phase may be even more important than the resolution phase, the former being largely the responsibility of the bank’s board, while resolution is decided by the resolution authorities.

**Board responsibilities**

In the recovery phase, the board is responsible for preparing the bank for a possible resolution. This work should be done in a structured way and should result in the recovery plan, established promptly and updated regularly, to be approved by the prudential supervisor. Although this requirement applies specifically to the banking activity, it might be useful to consider it for important firms in other sectors as well.

A first requirement is the knowledge of the group. Since groups are often composed of hundreds or even thousands of legal entities, it is important to make available a clear map of the group structure and the interrelationships among these entities, along with a recommendation to simplify the structure. Board members should be familiar with at least the main entities and the business relationships existing between them. The group may have to be adapted with this resolution in mind: it is best to locate core groupwide services in a separate, bankruptcy-remote entity, providing for central continuity support in such areas as IT, staff, infrastructure, and so on, while intragroup supplies have to be ensured. If needed, disinvestments should be considered while their impact on the rest of the group is assessed.

On the financing side, the recovery plan should state the capital needs of the group for different stress scenarios: providing for authorized capital is a minimum precaution; more important is the planning for liabilities that could be bailed in. By issuing subordinated or convertible loans (CoCos or contingent convertibles), the loss-absorbing capacity can be increased, allowing for smoother resolution if necessary. Both actions—on capital and on borrowing—require careful preparation and planning a long time in advance. They are best undertaken when the sky is clear. Contract clauses should pay attention to the legal consequences of a threat to continuity, and special rules should apply to derivatives.

Intragroup lending in case of a threat of discontinuity is a clear point of concern. Although in normal times group law generally allows intragroup contracts to include cash pooling, provided the board considers that they will typically be repaid both in capital and in interest, they may become threatened in the run-up to insolvency. It is up to the board to assess the circumstances and to implement its decision, while reimbursement may become...
problematic. The resolution rules seem to be more lenient, being satisfied that a “reasonable prospect” can be accepted.

Remuneration should also receive attention; variable remuneration will usually be suspended and, in case of insolvency, may be reclaimed. Information to the public is also of crucial importance, although it is open for discussion whether the board or the supervisor should dispense the information. Listed banking groups would be subject to the regulatory disclosure requirement that they disclose information about significant events. Information has to be strictly organized to avoid multiple messages being placed in the market, and parallel information such as leaks should be strictly avoided.

Once difficulties—and not only financial difficulties—appear, the board has to be ready to change gears in a timely manner. And then it has to accelerate its efforts, if it is to remain in full control of the process.

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http://tinyurl.com/kfsc2yo

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As an academic at the Ghent Law School, Eddy Wymeersch founded the Financial Law Institute (www.law.ugent.be/fli). He has participated in several committees advising the Belgian government, especially on financial supervision and on corporate governance. He was a member of the European Corporate Governance Forum and chair of the European Corporate Governance Institute and is a member of the IFC Corporate Governance Private Sector Advisory Group. He studied law at Ghent University and Harvard Law School and speaks fluently Dutch, English, French, and German and has given conferences in these languages in most European states, in the United States and Canada, in Japan, the Republic of Korea, Russia, Saudi Arabia, and Abu Dhabi.