From Claessens, S., R. Herring, and D. Schoenmaker,2010, *A Safer World Financial System: Improving the Resolution of Systemic Institutions,*

Geneva Reports on the World Economy Number 12

Chapter 3

Cross-Border Resolution: Case-Studies

The 2007-09 financial crisis has highlighted the lack of an effective crisis management framework for cross-border financial institutions. National approaches differed, but broadly speaking authorities either used public money to bail out banks, or ring-fenced a bank's assets within their territory and applied national resolution tools at the level of each entity rather than at the level of the cross-border group. This undermined confidence in the international financial system, increased competitive distortions, added to bail-out costs borne by taxpayers and added to legal uncertainty. The events surrounding the failures of Fortis, Lehman and the Icelandic banks in the recent financial crisis illustrate how damaging the absence of an adequate cross-border resolution framework can be for financial stability of the global banking system. By contrast, authorities reached a cooperative solution in the bailout of Dexia and the continuation of Western bank operations in Central and Eastern Europe.

In this chapter, we review some major cross-border bank failures to examine (i) the causes of the failures; (ii) the reasons for international cooperation, or the lack of it; (iii) the inadequacy of national resolution powers, and (iv) the impact on global financial stability. We classify the case-studies in line with the Table 3.1 (reproduced from Chapter 2). In the final section, we draw some conclusions from the case-studies.

Table 3.1.

Alternative patterns of vulnerability

	HOME country/parent bank	
HOST country entity	Systemic	Non-systemic
Systemic	Potential for coordination	Conflicts of interest and potential for coordination problems
Non-systemic	Conflicts of interest and potential for coordination problems	Not a big problem

3.1 Case Studies of Cross-Border Bank Failures

Lehman Brothers[1]

Causes

Lehman Brothers was the 4th largest investment bank in the US, more than twice as large and twice as complex as Bear Stearns, which had agreed to a subsidized, shot-gun merger with JPMorgan Chase in March of 2008 when it became unable to meet calls for additional collateral. The Lehman Brothers Group consisted of 2,985 legal entities in 50 countries (Basel Committee, 2010), many of which were subject host country national regulation as well as supervision by the Securities and Exchange Commission.[2]

In 2006 Lehman made a deliberate decision to embark on an aggressive growth strategy and to take on greater risk by substantially increasing its leverage and making concentrated bets on commercial real estate, leveraged lending and private-equity like investments. These were far riskier than its usual line of business because rather than brokering risk, they were holding substantial amounts of risk on their balance sheet, financed largely by short-term repurchase agreements often amounting to hundreds of billions of dollars per day. In the words of one Lehman employee, they had shifted from

---

[1] Basel Committee on Banking Supervision (2010), Summe (2010) and Valukas (2010).

[2] This is an unusually clear example of the law of unintended consequences. The EU threatened to force the large American investment banks to form holding companies in Europe if they did not submit to consolidated supervision by a competent authority. Although it had no prior experience, the SEC somehow convinced the EU that it was a competent supervisory authority and the five largest investment banks became voluntary Consolidated Entities subject to Basel II capital rules. When they measured their required capital under Basel II the five CSEs discovered that they had considerable excess regulatory capital and quickly doubled their leverage, which was surely not what the EU intended.

the “moving business” to the “storage business” (Valukas (2010, vol. 1, p. 44)). They had, in essence, taken on the risk profile of a commercial bank without the benefit of the bank safety net. When the subprime crisis erupted, they saw it as an opportunity to double-down on their bets rather than a threat and consistently violated their declared risk appetite and risk limits to position themselves for a market rebound.[3]

Lehman announced its first loss since going public in 1994 just after the demise of Bear Stearns, but was able to raise $6 billion in new capital. Secretary of the Treasury Paulson, in a private communication to the CEO of Lehman, warned that this was not enough and that if Lehman were to announce a loss in the third quarter with having a buyer or a definitive survival plan in place, its existence was in jeopardy (Valukas, vol. 1, p.5). Unfortunately, the Administration did nothing to prepare for such an eventuality by seeking statutory power to intervene even though it knew it lacked such power.

Lehman Brothers did not succeed in finding a merger partner or in developing a survival plan. Instead it resorted to window dressing its monthly and quarterly reports by arbitraging accounting requirements[4] and it overstated its liquidity pool by including “comfort deposits” that it held with its clearing banks in order to continue clearing operations with them.[5] In many respects it is surprising that so many market participants

---

[3] Lehman exceeded its risk limits by margins of 70% with regard to commercial real estate and 100% with regard to leveraged loans (Valukas, 2010, p. 50).

[4] Valukas (2010) gives a full account of the so-called 105 repo transactions that could be reported as sales rather than borrowings.

[5] By September 12, 2008, two days after it reported $41 billion in its liquidity pool it actually contained less than $2 billion or readily monetizable assets (Valukas, vol. 1, p. 10).

seemed surprised when Lehman failed. It seems likely that the surprise was more due to the abrupt change in perceived US policy than because of confidence in Lehman's strength. Many market participants believed that if the authorities managed to find $29 billion to arrange a merger for Bear Stearns, they should also be willing to advance at least $60 billion to save Lehman. It's clear that the market was not surprised that Lehman was insolvent and had been so at several times during the summer. Figure 3.1 below shows the implied market value of Lehman's assets relative to its total liabilities.

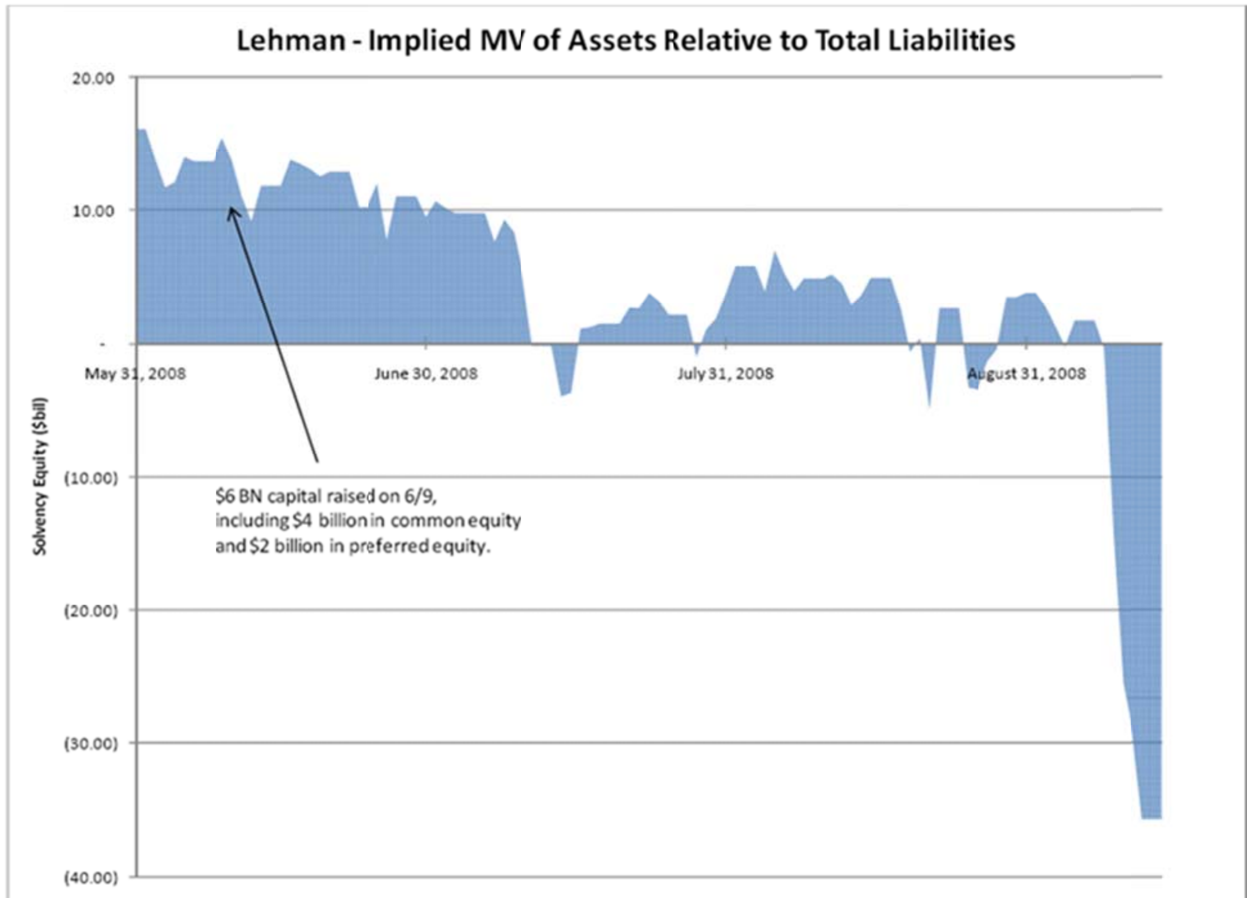
Nonetheless, the collapse seemed to catch officials and market participants unawares. Over the weekend of September 12-14, 2008 US authorities met with CEOs of leading financial institutions from around the world to try to broker a merger for Lehman or at least raise a fund to subsidize a merger for Lehman (much as they had accomplished for Long Term Capital Management in 1998). At one point on Sunday afternoon they believed they had struck a deal with Barclays Capital Management that would be subsidized by many of Barclays' competitors, but the Financial Services Authority in the UK refused to waive the share-holder approval rights required in the UK. Thus with no buyer and (the authorities claimed) no way of funding Lehman[6], the head of the SEC instructed Lehman's board to file for bankruptcy before the opening of markets in Asia, when it would be unable to meet its cash obligations. On September 15, 2009, at 1:45 a.m. Lehman Brothers Holding Inc (LBHI) filed for protection under Chapter 11 of the bankruptcy act, becoming the largest bankruptcy in US history. The administrators of the

[6] The authorities claimed that they lacked legal authority to make a direct investment in Lehman and that Lehman's assets were insufficient to support a loan large enough to avoid collapse.

Lehman bankruptcy in the US have estimated that at least $75 billion has been wasted because of the complete lack of any preparation for bankruptcy (Cairns, 2009).

Figure 3.1

The implied market value of Lehman's assets relative to its total liabilities



Source: Valukas (2010, p. 1580). The implied market value of assets is equal to the market value of equity minus the current value of liabilities.

Typology

The action the US authorities took could be interpreted as implying that the collapse of Lehman was not systemically important. But the intensive negotiations they arranged over the weekend suggests otherwise. Moreover, they claimed to have simply lacked the statutory authority to do anything else.

Cooperation

While the US authorities refused to support LBHI, they did support Lehman Brothers Inc (LBI) the US broker-dealer subsidiary for another five days until it could enter the Securities Investor Protection Act trusteeship on September 19 when its prime brokerage activities, asset management business and a substantial portion of its client's assets and obligations were sold to Barclays Capital Inc and others. This removed one of chief systemic concerns in the US. The other concern, Lehman's leading role in the opaque OTC derivatives market, turned out not to be a problem. Most derivatives were promptly closed-out and netted under ISDA Swap Agreements. Although counterparties were not necessarily happy with the prices they received, there were no knock-on effects attributable to the unwinding of the derivatives book.[7]

---

[7] See the appendix A by Kimberly Summe for additional details.

The only domestic impact that could be labeled systemic was due to a “moral hazard” play by managers of the $62 billion Primary Fund, a wholesale money market fund that was forced to break the buck because of its outsized holdings of Lehman’s commercial paper (which yielded a return sharply higher than its rating would warrant). News that one of the oldest money market mutual funds had broken the buck started a run on other money market mutual funds, which led to dumping corporate commercial paper on the market to meet the demand for withdrawals. The collapse of prices in the secondary market caused the primary market for commercial paper to shut down. Commercial paper is the primary mode of finance for much of corporate American and so the Treasury hastily provided insurance for money market mutual funds. (And to maintain parity, the Federal Deposit Insurance Corporation increased the deposit insurance ceiling from $100,000 to $250,000.)

Still many observers interpreted this as a successful application of bankruptcy rules to a large, complex financial institution (Ayotte and Skeel (2009) are a particularly good example). Apart from the unanticipated spillover to the wholesale money market and knock on effect on the commercial paper market, the US had shown that the economy could get on perfectly well without Lehman Brothers.

This relatively orderly outcome was in stark contrast to the chaos created abroad. The immediacy of the impact was in large part due to the highly integrated structure of the Lehman Group which bore very little resemblance to its corporate design. Like many other global firms Lehman managed substantially all of the cash resources centrally at the

holding company. Since LBHI declared bankruptcy before cash could be swept out again to the subsidiaries, they found themselves suddenly illiquid and unable to continue operation. Bankruptcy proceeding were imitated in a variety of jurisdictions including Australia, Japan, Korea, and the United Kingdom.[8] Because London was Lehman's largest center of activity outside the United States, many of the problems showed up most vividly there.

The London subsidiaries, including Lehman Brothers International Europe, its largest broker in Europe, filed for bankruptcy and turned to PwC for administration. Because there is no provision under British law for DIP financing, the administrators had to struggle to find money to keep basic functions such as even the canteen going. PwC was confronted with forty-three thousand trades that were still "live" and would need to be negotiated separately with each counterparty.

The integration of the group was such that a trade performed in one affiliate could be booked in another, without the client necessarily being aware that the location of the asset had shifted. Record keeping fell into disarray when LBHI filed for bankruptcy. At the time of filing, Lehman maintained a patchwork of over 2,600 software systems applications, many of which were outdated or arcane. These systems were highly interdependent, but difficult to decipher and not well documented. Moreover, most

---

[8] Some Lehman Brothers entities did not file for bankruptcy, however. For example, Lehman Brothers operated a bank, today known as Aurora Bank FSB, which employs 1,700 people servicing over $100 billion in mortgages (Summe, 2010, p. 65)

systems to cover operating, trading, valuation, financial accounting and other data had been transferred to Barclays in the sale and Barclays had integrated its own proprietary and confidential data into some of the systems.[9] Thus other affiliates experienced enormous difficulties even in determining what their balance sheets were and who owed what to whom. Although arrangements were ultimately negotiated with Barclays for access to some essential information it made it almost impossible to salvage much going concern value out of the rest of the group (with the exception of the sale of the foreign equity business to Nomura by the PwC). In London, where much of the prime brokerage business had shifted, it was permissible to mingle client funds with the firm's own funds and so several hedge funds suddenly became illiquid.

The fragmented data system impeded the salvaging of going-concern value from the remainder of the Lehman Group because different parts of a line of business lodged in different subsidiaries in various parts of the world had no way of reintegrating their line of business even if it had been viable.

It is clear that significant value was destroyed by the lack of cooperation in the unwinding of the Lehman Group which may continue for a decade.

---

[9] In addition, the technology supporting the prime brokerage business was inadvertently sold to Nomura in the UK, rather than Barclays, who acquire that US business.

Impact

The impact of the bankruptcy of Lehman Brothers is difficult to sort out because it occurred during the midst of a number of different shocks to the system. It occurred just after Fannie Mae and Freddie Mac entered conservatorship, protecting all creditors and counterparties, but causing losses to both common and preferred shareholders. And just before the bailout of AIG two days later. The Dow Jones Average did decline by 150 points the day Lehman declared bankruptcy, but a considerable part of this may have been due to the apparent change in the rules of regulatory intervention. The explanation of the authorities of why they protected creditors and counterparties of Bear Stearns, but not Lehman Brothers was not convincing. The run on money market funds and, subsequently, the collapse of the commercial paper market was a direct result of the collapse of the value of Lehman commercial paper.

Conclusions

In many ways, the Lehman bankruptcy was unnecessarily disruptive. The firm was badly supervised and regulated, and benefited from widespread expectations that creditors and counterparties would be protected if worse came to worst. The US acted unilaterally and provided an orderly resolution for the US broker/dealer arm of Lehman to facilitate a merger with Barclays Capital. There was no cooperation, however, in the unwinding the subsidiaries in the 49 other countries, including the major operations in the UK.

AIG[10]

Causes

AIG had formed a giant financial conglomerate with an unparalleled global footprint operating in more than 130 countries around the world with more than 110,000 employees. The holding company, rated AAA at the beginning of the decade, had more than 4,000 subsidiaries and other legal entities that were entangled in a complex web of cross-ownerships. Although the largest share of AIG's revenue came from its property and casualty insurance, it also owned businesses that provided all other kinds of insurance, foreign banks, consumer lending companies, asset management companies and a financial products division-- AIG Financial Products (AIG FP). Although AIG FP never contributed more than 3% of AIG's total revenue (Geneva Association, 2010, p. 17) it subjected the group to enormous, highly leveraged, often unhedged risks. Many of these transactions were conducted through a subsidiary located in London. AIG FP evaded oversight by the British Financial Services Authority because AIG purchased a US thrift institution in order to be subject to consolidated supervision by the Office of Thrift Supervision, which was deemed an "equivalent regulator," even though it was completely ineffectual.

As of September 2008, the notional value of AIG FP's derivatives portfolio, which was concentrated largely in US housing market and corporate CDOs and CLOs was $2.7

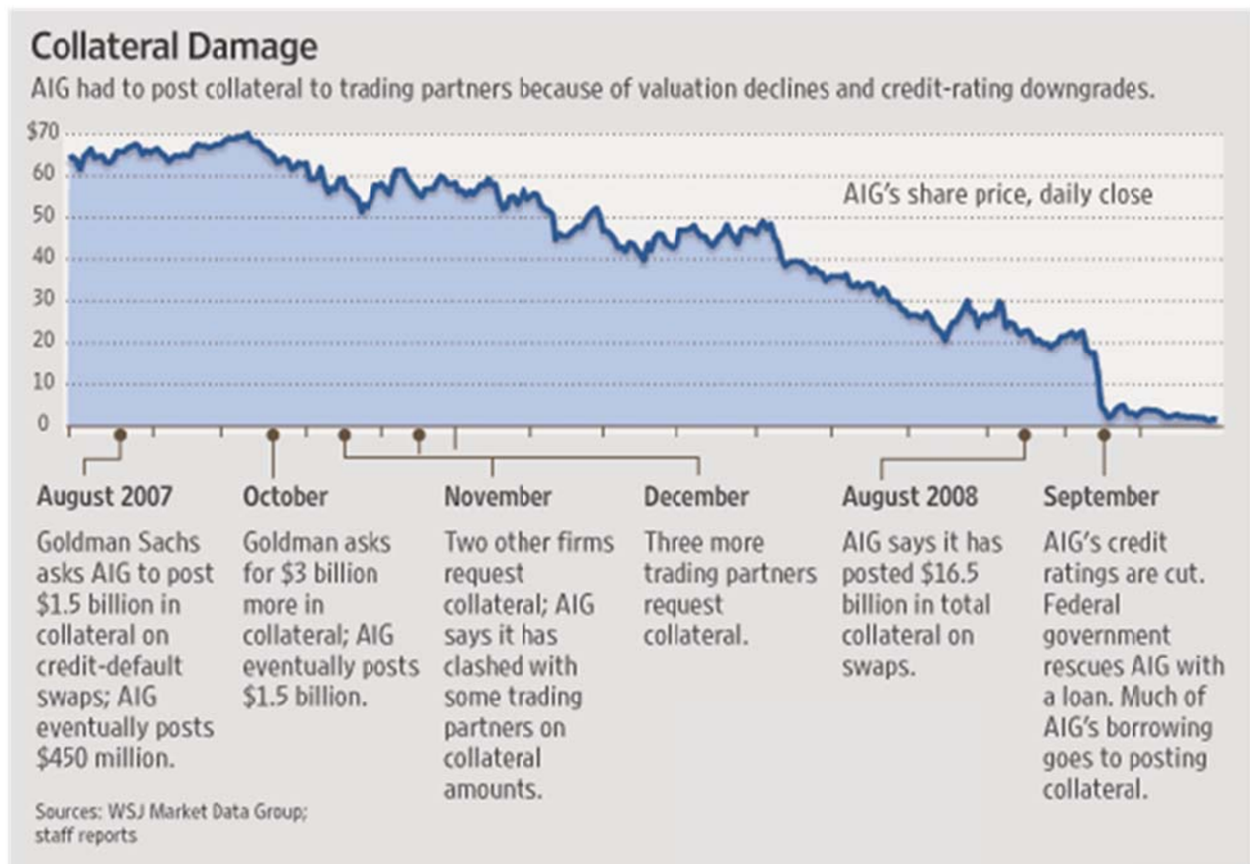
---

[10] Geneva Association (2010).

trillion. $440 billion of this was in Credit Default Swaps (CDS) guaranteed by the parent holding company. As part of the contract to sell CDSs, AIG was required to maintain its credit rating. If it were to be downgraded it was obliged to add new collateral as compensation against the increased risk that it might not be able to pay out claims when (and if) they fell due. This proved to be the firms undoing. As shown in Figure 2, the firm's share price fell steadily from August 2007 because it was obliged to post additional collateral as the group suffered downgrades from the ratings agencies and because the securities against which it had borrowed had declined in value. Despite the clear warnings of impending danger from the stock market, AIG did not come to the attention of the authorities until September of 2008. This was partly because it had cleverly positioned itself to avoid competent oversight and partly because the US lacks a national insurance supervisor who might have taken a more serious interest in the group. Moreover, the authorities were overwhelmed with the problems of Fannie Mae, Freddie Mac, and Lehman Brothers and were simply not prepared to deal with the collapse of another financial giant so soon.

The management information systems at AIG were so decrepit that even management did not realize the full magnitude of its problems. When they finally approached the New York Fed and Treasury for assistance, they asked for a mere fraction of the $183 billion they ultimately received. In the wake of the turmoil following the bankruptcy of Lehman Brothers, the Treasury and Fed believed that it was essential to bailout AIG to avert a worldwide financial crisis.

The conjunction of the two incidents – just two days apart – made clear that the authorities lacked tools to resolve a faltering non-bank. They had only two unpalatable alternatives: send the firm to bankruptcy court and hope that spillovers could be contained or provide an extraordinary bailout. In the case of AIG they took the latter course and became owner of 79.9% of the group.



Typology

The officials clearly believed that the failure of AIG would have dire systemic implications for both the United States and the rest of the world. Because the insurance units were all separately regulated and effectively ring-fenced, their concern appeared to be centered on the derivatives book. It is impossible to know whether the bankruptcy of AIG FP would have caused other failures, but it is interesting to note that none of the 30 largest counterparties of Lehman Brothers failed after its bankruptcy.

Cooperation

The US neither sought nor received cooperation, in part because they had not foreseen the crisis and had so little time to arrange some sort of solution. The authorities were extraordinarily reluctant to disclose how the money paid to AIG was used, but finally, under enormous pressure from Congress and the TARP oversight board, AIG revealed that $62.1 billion was paid to 16 counterparties. The largest payment, $16.5 billion, was made to Société Générale. In fact, only 25% of the largest counterparties were headquartered in the US. Congress was outraged that the Fed had not bargained for a reduced settlement, but once the threat of bankruptcy was removed, the Fed stressed that it had very little leverage.

Impact

This extraordinary intervention calmed the markets, but left participants confused about the apparently ad hoc nature of US policy. Many questioned what difference between Lehman Brothers on the one hand and AIG and Bear Stearns on the other, had led to such different outcomes. To the extent the authorities were trying to reduce moral hazard by sending Lehman Brothers to the bankruptcy court they completely undercut the message by bailing out AIG two days later.

Conclusions

Chairman Bernanke, who is famously even-tempered, expressed public outrage that he had been forced to bail-out AIG and that taxpayer funds had been used to pay retention bonuses to some of the very traders who had brought the company to the brink of collapse. Both Secretary of the Treasury Hank Paulson and Chairman of the Federal Reserve Board Bernanke urged Congress to provide them with new tools that would allow them to resolve non-bank SIFIs without causing either chaos or enormous cost to taxpayers. Although both bills in Congress attempt to deal with the problem of resolving non-bank SIFIs, neither dared to propose a national insurance charter that would provide effective oversight for national insurance firms.

Fortis[11]

Causes

Fortis was a Belgian/Dutch financial conglomerate with large subsidiaries in Belgium, the Netherlands and Luxembourg. In May 2007, Fortis acquired, together with the Royal Bank of Scotland and Santander, ABN-AMRO for EUR 71 bn. This was the result of a hostile takeover battle, where the trio won against Barclays Bank even though the top management of ABN-AMRO supported Barclays Bank. The trio won, however, thanks to a bid which was higher than the largely equity offer of Barclays and moreover included 80% cash. This offer involved the splitting of ABN AMRO's activities between the three banks, which 'disappointed' the Dutch public authorities. For Fortis, the deal was risky, since it meant buying the Dutch activities of ABN AMRO as well as its private banking and asset management operations more generally, for a price of EUR 24 bn, while the market capitalization of Fortis was around EUR 40 bn at the time. The deal, together with a EUR 13 bn equity issue, was however approved by Fortis' shareholders in August 2007. Difficulties surfaced openly in June 2008, with the announcement of a new equity issue by Fortis and the cancellation of dividend payments, both in contradiction with earlier promises. This immediately led to a sharp drop of the stock price of Fortis and liquidity became a serious concern. There was increasing uncertainty in the market whether Fortis would be able to realize the intended steps.

---

[11] Dewatripont and Rochet (2009) and Basel Committee on Banking Supervision (2010).

Typology

Fortis was systemically important in all three countries, because of its large presence in each country and its function as clearing member at several exchanges.

Cooperation

The coordinating supervisor was the Belgian CBFA which remained lead supervisor of Fortis, despite the importance of the growth in Dutch activities after the acquisition of ABN AMRO. Fortis' weakness proved fatal after the Lehman failure and subsequent market meltdown. By September 24, 2008, interbank lending to Fortis had collapsed and significant deposit withdrawals were starting to take place. The crisis was managed by each of the three nations acting separately most of the time. When Fortis was first recapitalized, the Belgian, Dutch and Luxembourg governments provided capital injections of respectively EUR 4.7, 4.0 and 2.5 bn to the national banking parts (Fortis Bank, Fortis Bank Netherlands and Fortis Bank Luxembourg respectively) but not to the Fortis Group as a whole. This agreement failed however to calm the markets, obliging the National Bank of Belgium, as home central bank, to keep providing massive Emergency Liquidity Assistance to Fortis in the next days. A second round of negotiations then followed, with the Dutch government buying the Dutch activities of Fortis as well as its ABN AMRO activities on October 3, for a combined total of EUR 16.8 bn. Fortis was thus torn apart along national lines: the Dutch parts nationalized by the Dutch government and the solvent Belgian/Luxembourg parts sold to BNP Paribas. In

December 2008, the Brussels Court suspended the sale to BNP and decided the finalized sales to the Dutch government and the sale to the Belgian government and subsequently to BNP had to be submitted to shareholder approval in order for these sales to be valid under Belgian Law. Shareholder approval was obtained for the BNP-deal, though after renegotiating the sale to BNP. The decision of the Brussels Court was later overturned by the Court of Appeals, which decided that no shareholder approval was needed.

Impact

The day was saved by the rescue of the Fortis parts fostering stability in the Belgian and Dutch banking system. Nevertheless, the lack of full cooperation increased uncertainty about large cross-border banks in Europe and increased the cost of the rescue operation.

Conclusions

The cooperation between Belgian and Dutch authorities started as expected though not covering the entire group. The governments were willing to engage in burden sharing for the national parts of Fortis, but not the rest of the holding company.) Later on domestic objectives got the upper hand (returning ABN AMRO to Dutch control) and cooperation broke down (despite a long-standing relationship in ongoing supervision). The case also showed the problem that supervisors face if they do not have effective resolution powers overriding shareholders' rights.

Dexia[12]

Causes

Dexia resulted from a merger between a Belgian bank, Crédit Communal de Belgique, and a French bank, Crédit Local de France. It had also a significant presence in Luxembourg. The holding company of the Dexia group was based in Belgium. The French subsidiary, Crédit Local de France, had bought a monoline insurer in the US, Financial Security Assurance (FSA). Dexia's main business line is the financing of local authorities. During 2008, Dexia experienced difficulties with (i) the financing of long-term assets by short-term funding; and (ii) the CDOs in its US subsidiary, FSA. Dexia was also more exposed to Lehman than other banks.

Typology

Dexia was systemically important in Belgium. It was not directly systemically important in France and Luxembourg, but it was the major bank for local authorities in France and Luxembourg (so more politically important).

[12] Van de Woestyne and Van Caloen (2009) and Basel Committee on Banking Supervision (2010).

Cooperation

Dexia's vulnerabilities appeared after the Lehman failure and subsequent market meltdown. On 30 September 2008, Dexia increased its capital by EUR 6.4 bn, of which Belgian and French public and private sector investors subscribed EUR 3 bn each and the Luxembourg government EUR 376 mn. A week later on 9 October 2008, Belgium, France and Luxembourg reached agreement on a joint guarantee mechanism for its new financing. The burden sharing was done on a voluntary basis and based on the proportions of share ownership held by the public authorities and institutional investors in the three countries. The burden was shared as follows: 60.5% by Belgium, 36.5% by France and 3% by Luxembourg. On 14 November 2008, the Belgian and French government gave additional guarantees for the sale of the US subsidiary, FSA. The guarantee was to cover possible losses up to $ 4.5 bn and was shared by Belgium (62%) and France (38%).

Impact

The bailout of Dexia fostered banking stability in the three countries and prevented pressure on the financing of local authorities. It also fostered the wider stability of the European banking system.

Conclusions

The Belgian, French and Luxembourg authorities have cooperated effectively and given joint support to Dexia. The joint exposure of Belgium and France to the US subsidiary provided an effective incentive for cooperation. The burden sharing was done on a voluntary basis by the three countries.

Icelandic Banks[13]

Causes

Iceland experienced a deep and rapid financial crisis when its three major banks all collapsed in the same week in October 2008. The Icelandic banking system was deregulated and privatized in the 1990s and early 2000s. Banking quickly became a large part of the economy. This happened in an economy where neither the government nor the private sector had sufficient understanding of the necessary risk management processes and scope of banking supervision needed when a banking sector becomes such a large part of the economy. Eventually, the banking system grew to about ten times the size of the economy until it began suffering increasing liquidity problems.

---

[13] Sources: Basel Committee on Banking Supervision (2010); Danielsson and Zoega (2009); and Special Investigation Committee (2010).

Four factors combined in making the Icelandic banking system more fragile than its counterparts abroad. First, unlike many other nations with an outsized banking system, such as Switzerland, the Netherlands and the United Kingdom, the institutional experience of running a modern banking system in Iceland spans less than a decade, not centuries. Second, the banks had invested their funds in their own shares and in each other's shares. This shared capital, financed by the banks themselves, is not protection against losses as it is intended to do. Third, there were widespread accusations of political favoritism when the banks were privatized; their senior management and boards were typically composed of Icelandic citizens with little or no experience in international banking. Finally, given the size of the country and tight political connections between the private sector and the political superstructure, supervision was weak. These factors are complicated by the fact that because of its EEA membership, Iceland essentially has the same banking regulations as other EEA/EU countries. It is, therefore, more a case of failure of supervision rather than a failure of regulation.

The reasons for the failure of the Icelandic banks are in many ways similar to the difficulties experienced by many financial institutions globally, such as the seemingly unlimited access to cheap capital, excessive risk-taking, and lax standards of risk management. The crucial difference is scale. While many countries have their share of troubled banks, in those cases the problems are confined to only a segment of their banking system, in economies where the overall assets of the banks are much smaller relative to GDP. In those countries the government has adequate resources to contain the fallout from individual bank failures.

A particular feature of the financial system is the setting up of high interest internet savings accounts by Icelandic banks in the U.K, and later in the Netherlands and other European countries. The banks had relied on the wholesale market for funding and when this became more difficult decided to attract deposits by offering high-interest deposits in Europe. The two largest banks in Iceland followed this strategy, Kaupthing and Landsbanki. Kaupthing with its Kaupthing Edge, opted to operate these accounts by a subsidiary, with the exception of Kaupthing Edge in Germany meaning that they were regulated and supervised in the host country. By contrast, Landsbanki, in the name of Icesave, operated these saving accounts under local branches of the Icelandic entity, meaning they were primarily regulated, supervised and insured in the home country, Iceland. Icesave started in the UK and its deposits there grew to over £4 billion. Later, Landisbanki sought funds in other jurisdictions, primarily in the Netherlands, where it raised €1.7 billion. Under the Second Banking Directive, the host country supervisors had no powers to supervise (the solvency of) these branches.

Typology

The three Icelandic banks are clearly systemic in their home country, but no so in the host countries.

Cooperation

When concerns increased with the Icelandic banks in September 2008, the Icelandic government bought a 75% stake for EUR 600 in Glitnir Bank, the smallest of the three large banks. The part nationalization of Glitnir undermined the confidence in the Icelandic banking system and the Icelandic state. The government and the banks had repeatedly claimed that all of the three main banks were liquid and solvent. The failure of Glitnir undermined confidence in the government's ability to assess the condition of its banks and in the other two banks. The immediate effect was to cause credit lines to be withdrawn from the two remaining banks. There was a run on the Icesave branches of the Landsbanki in the UK and the Netherlands. Both Kaupthing and Landsbanki had significant operations in the UK. The UK and Icelandic authorities had been for some time in discussion on how to solve the difficulties facing those two banks. The UK authorities then used a clause in its antiterrorist laws to freeze the assets of Landsbanki in the UK, which then triggered the bankruptcy of the remaining Icelandic bank, Kaupthing. Similar 'discussions' happened with other supervisors from EU countries in which Kaupthing was operating (Basel Committee, 2010).

The government had prepared emergency legislation, granting it widespread powers to maintain the domestic operations of the banks. This legislation was passed by Parliament October 6th. It created "new banks" from the ruins of the old ones, containing domestic deposits and domestic loans. The foreign operations were left in "old banks" which are in administration and on their way to formal bankruptcy. This has created legal issues that

have to do with equal treatment of domestic deposit holders vis-à-vis foreign deposit holders. It basically has undermined the EU Deposit Insurance Directive which requires equal treatment of domestic and foreign depositors of a bank, including its branches (but not its subsidiaries). After passing the legislation in early October, the Icelandic Financial Supervisory Authority (FME) took control of Landsbanki and Kaupthing, leaving the foreign supervisors and depositors in the cold. The FME put Glitnir Bank into receivership after Iceland abandoned its decision to buy a stake in the bank.

Impact

The collapse of the three banks had a major impact on the Icelandic economy. Given the limited size of the Icelandic banks there was no impact on wider European banking stability. Depositors in Iceland got preferential treatment.

Conclusions

The Icelandic crisis reveals how limitations of national resources and supervisory capacity diminish the effective supervision and resolution by the home country. Effective cooperation between home and host supervisors was absent. Notwithstanding EU legislation, Iceland protected only its domestic depositors.

Central and Eastern European Banking System[14]

Causes

When the global financial crisis swept the world in 2008, many countries in emerging Europe proved vulnerable because of high levels of private debt to foreign banks and foreign-currency exposure. Policymakers in the region became increasingly concerned that foreign-owned banks, despite their declared long-term interest in the region, would seek to cut their losses and run. The banks themselves were also getting worried: Uncertainty about what competitors were going to do exacerbated the pressure on individual banks to scale back lending to the region or even withdraw, setting up a classic collective action problem. Under these circumstances, bank behavior was clearly key to macroeconomic stability.

Typology

The setting is with Western European banks with major subsidiaries which were of systemic importance in Central and Eastern Europe. Most of the Western European banks were also of systemic importance in their home country.

[14] Sources: IMF (2009a) and IMF Survey (2009b).

Cooperation

In the face of these risks, the European Bank for Reconstruction and Development (EBRD), the IMF, the European Commission, and other international financial institutions initiated a process aimed at addressing the collective action problem, starting in Vienna in January 2009. In a series of meetings, the international financial institutions and policymakers from home and host countries[15] met with some systemically important EU-based parent banks with subsidiary banks in Central and Eastern Europe.

This European Bank Coordination ("Vienna") Initiative has played a major role in averting a systemic crisis in the region. A combined effort of appropriate host government policies, massive international support and parent bank engagement has helped stabilize the economies in the region. Continued parent bank support has accompanied balance of payments support from the IMF and the European Union (about EUR 52 billion to Hungary, Latvia, Romania, Serbia and Bosnia-Herzegovina) as well as from other international financial institutions. This took the form of parent banks recapitalizing subsidiaries as needed and broadly maintaining exposures to countries, even though with some variations across countries and banks. In turn, bank groups have benefited from a stabilizing macroeconomic environment.

---

[15] The meetings were held with 15 systemically important European banks with major subsidiaries in Central and Eastern Europe and their home and host country supervisors, fiscal authorities and central banks from Austria, Belgium, France, Germany, Greece, Italy, Sweden, as well as Bosnia Herzegovina, Hungary, Latvia, Serbia, and Romania.

Impact

The coordinated response has fostered stability of the European banking system, both in Western Europe (where the parent banks are located) and in Central and Eastern Europe (where major subsidiaries are located).

Conclusions

The setting was a typical coordination problem with high stakes. By setting all parties together (relevant Western and Eastern European governments and banks) and providing leadership (the international financial institutions), a win-win situation could be created. The financial support of the international financial institutions for the Eastern European countries worked as an effective lubricant to get the deal.

3.2 Concluding Comments

These six cases illustrate a wide range of causes, consequences and outcomes. In each case resolution was, out of necessity, improvised. In some cases, the improvisation succeeded in limiting spillovers (but at substantial cost to taxpayers). In other cases, the resolution process protected domestic interests without regard to spillover effects in the rest of the world. The results are summarized in Table 3.2.

Table 3.2.

Summary of 6 case-Studies

Case	**Systemic in home country**	**Systemic abroad**	**Coordination**	**Short-term impact on financial stability**
Lehman Brothers	Yes	Yes	No	Substantial instability
AIG	Yes	Yes	Unilateral bailout of units in 130+ countries by US government	Enhanced stability
Fortis	Yes	Yes	Partly, improvised cooperation, “make do” solution. Bailout on basis of national entities, not for the Group as a whole	Enhanced stability in Belgian & Dutch banking system, but raised questions about how other cross-border SIFIs might be handled
Dexia	Yes	No	Yes, joint solution based on proportions of shares held by governments & institutional investors in 3 countries	Enhanced stability

Icelandic Banks	Yes	No	No. Iceland protected only Icelandic depositors	Instability largely limited to Iceland (some unrest with retail depositors in foreign countries)
Central & Eastern European Banking System	Mixed	Yes	Yes, joint solution based on European Bank Coordination Initiative	Enhanced stability in both Eastern & Western Europe

It seems clear that cooperation was most likely when the likely spillover effects were limited to a few countries with a tradition of cooperation or a regional mechanism for brokering a cooperative solution. In no case did countries appear willing to agree to share the costs of a bailout ex ante.

References

Ayotte, K. and D.. Skeel, Jr., 2010, forthcoming, "Bankruptcy or Bailouts*?", Journal of Corporate Law*: 27. http://ssrn.com/abstract=1362639

Basel Committee on Banking Supervision, 2010, *Report and Recommendations of the Cross-Border Bank Resolution Group*, Basel.

Cairns, A., 2009, "Breaking the Insolvency Mould,"*International Corporate Rescue* 6, no. 2: 115, Chase Cambrioa Publishing.

Danielsson, J. and G. Zoega, 2009, *Collapse of a Country*, Mimeo, 2nd edition.

Dewatripont, M. and J.-Ch. Rochet, 2009, "The Treatment of Distressed Bank, in M. Dewatripont, X. Freixas and R. Portes (eds), *Macroeconomic Stability and Financial Regulation: Key Issues for the G20*, CEPR, 149-164.

Geneva Association, 2010, *Systemic Risk in Insurance: An Analysis of Insurance and Financial Stability*, Special Report of the Geneva Association Systemic Risk Working Group, Geneva.

IMF,2009a, "European Bank Coordination Meeting: International Coordination Helped Avert a Systemic Bank Crisis in Central and Eastern Europe," September 25, Press Release IP/09/1359.

IMF Survey, 2009b, "Interview–Global Economic Crisis; Agreement with Banks Limits Crisis in Emerging Europe," October 28, IMF Survey Magazine.

Special Investigation Commission, 2010, "Report of the Althingi Special Investigation Commission," Althingi, Iceland.

Summe, K., 2010, "Lessons Learned from the Lehman Bankruptcy," Chapter 5 in K. Scott, G. Shultz, and J. Taylor (eds), *Ending Government Bailouts As We Know Them,*Stanford University: Hoover Press.

Valukas, A., 2010, *Report of Anton R. Valukas, Examiner, to the United States Bankruptcy Court Southern District of New York In re Lehman Brothers Holdings Inc,et al.Debtors*, March 11.

Van de Woestyne, F. and A. van Caloen, 2009, 'Fortis, Dexia … Le Séisme', Luc Pire, Brussels.