



UNDERSTANDING THE LEGAL RATIONALE FOR INFRINGING ON “PROPERTY RIGHTS” IN THE CONTEXT OF MODERN BANK RESOLUTION TOOLS

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Department*

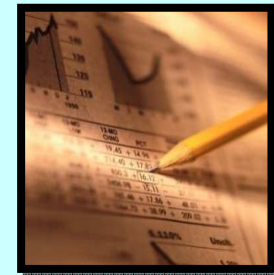
John Pollner, Lead Financial Officer, World Bank

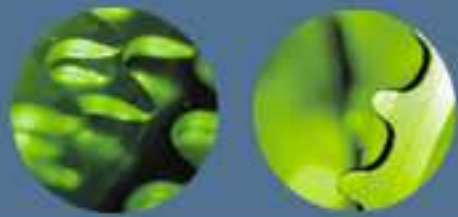
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Banking law, bank licensing and regulatory solvency

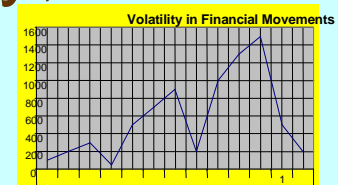
- Regulatory solvency (or the minimum technical solvency requirement, the C.A.R. ratio as in 8% or above) is a strict condition for a bank license.
- **Not meeting the solvency requirement can be cause for closure of the bank.**
- When a bank is closed it means it has caused a risk to the system and to the “public interest”. In this case, the primary concern is stabilizing the financial system and that deposits are safe.

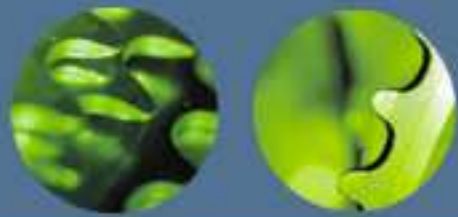




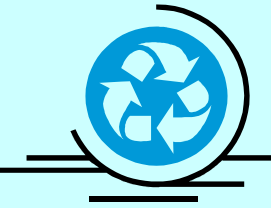
Competing Property Rights

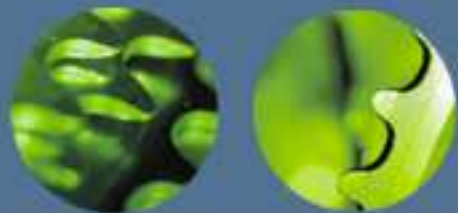
- In stabilizing (or saving) deposits, the financial authorities are protecting a certain class of creditors' property rights that are "preferred".
- These property rights are of higher priority, under the law, vs. the property rights of bank shareholders. This is well accepted.
- Thus, a write-down (or infringement) of the value of shareholders (their "property rights") is admissible since it follows the same principles as creditor rank under bankruptcy, which first protects creditors (e.g., depositors) less able to take risk.





Transferring of Assets and Liabilities for financial stability

- Bank resolution is thus a quicker safer mechanism to avoid financial instability. 
- In transferring bank assets (loans) and deposits to another sounder bank, and in the process writing off shareholder value (that no longer exists), this is not an infringement of property rights but simply following the order of creditors defined in the law. The only difference is the tool for execution (resolution vs. bankruptcy, the latter which would be more destabilizing).



To have “property rights” there must exist economic property

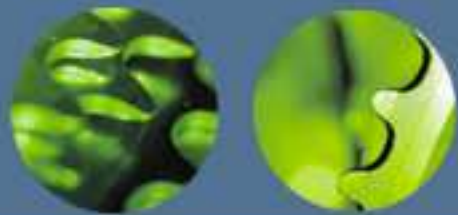
- In the case of bank resolution (as also in final insolvency) if a bank’s losses are so large as to wipe out the equity available (in accordance with the established hierarchy of creditors), then there is no “equity property” to speak of.
- Therefore there are no property rights to protect. Share/equity property does not exist in abstraction or a vacuum. It is a finite economic value and with an insolvent bank and its balance sheet, it implies there is no value left.





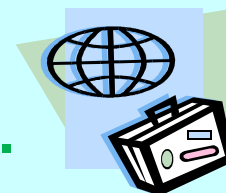
Resolution Authority's right to determine compensation

- The above legal rules on creditor hierarchies (applied in the resolution context) mean that the Resolution Authority's "rights" to determine compensation are rule-based and meant to: (a) protect creditors according to legally accorded rank, (b) resolve a bank with minimum disruption to the financial system, and (c) resolve a bank while minimizing extra costs and balance sheet losses.
- Resolution Authority actions are thus not rights but rather obligations, to comply with the above mentioned parameters and conditions.



“Property Economics” and Financial System Stability

- Thus, property as a “legal term” cannot take precedence over property as an “economic quantum.” If such quantum is zero, there is no legal basis for affirming a property right. The resolution authority has the obligation to make the economic/financial valuation of such quantum.
- Even if the quantum is not zero but much smaller than the original equity value, if this causes regulatory insolvency, bank instability and removal of its license, it means such property rights are subject to write-down in the interest of the public good, if it makes whole the vast majority of claims.





An Example: German Law

- Article 14 of the German Constitution does not grant limitless property rights.
- In Article 14, the Government has the right to go around or override property rights by law if the importance of the general public good (e.g., financial stability; protecting depositors) outweighs the intrusion on specific private property (e.g., shareholders, creditors).





Legal Basis for Bank Resolution in Germany

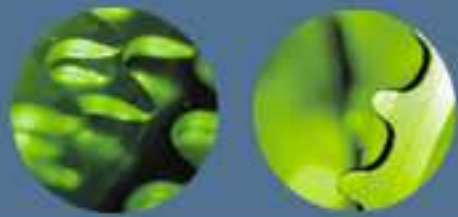
- The German Banking Act of 2009 (sec. 46) gives new resolution powers that take effect if a bank is approaching insolvency (this does not mean zero net worth or greater liabilities than assets, since bank insolvency is defined as failure to meet obligations or adequacy of the legal solvency margin (capital adequacy ratio)).
- The law provides the proper legal basis for supervisory measures that can affect private property rights, as granted by the constitution.



Bank resolution operations and property rights – German Law

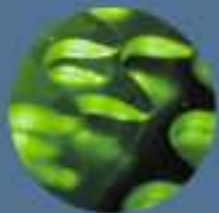
- An asset/liability transfer from a failing bank to a sound bank (which may affect shareholder/creditor property rights) is done in accordance with the Banking Act in a situation where the Financial Authorities have a situation where financial stability is jeopardized by the possible insolvency of a bank.





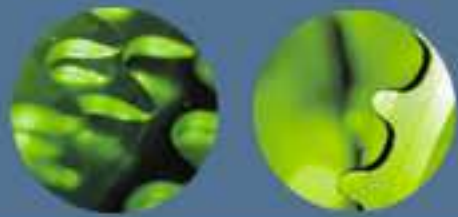
Protection by the Constitution for Resolution Tools - Germany

- The new resolution powers are in line with Constitutional clauses:
- **Constitution, Article 14 [Property, Inheritance, Expropriation]:**
 - (1) Property and the right of inheritance are guaranteed. Their content and limits are determined by statute.
 - (2) Property imposes duties. Its use should also serve the public weal.
 - (3) Expropriation is only permissible for the public good. It may be imposed only by or pursuant to a statute regulating the nature and extent of compensation. Such compensation has to be determined by establishing an equitable balance between the public interest and the interests of those affected. Regarding disputes about the amount of compensation, recourse to the courts of ordinary jurisdiction is available.



Creditors' rights to challenge the resolution process

- Process can be challenged ex post but not halted (otherwise stability objective is not met).
- Shareholders/creditors have rights to challenge “compensation level”. Modernized resolution laws allow this without halting the process.
- “Counterfactual” is: (a) what would happen if bank was not “resolved” (likely more losses), or (b) what would compensation have been under normal bankruptcy/insolvency proceedings.



Comparison to compensation under bankruptcy

- Financial Authorities, experts and market valuers can provide a sense (based on experience) of value recovery during bankruptcy, as the alternative mode of compensating creditors.
- **Asset value under bankruptcy deteriorates at a very fast rate. Assets not under a “going concern” will capture less value from investors.**
- The same hierarchy of creditor rights apply so shareholders still are last and may receive zero.





Bank resolution mechanisms

For questions or comments:
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