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Application of the Key Attributes of Effective Resolution Regimes for Financial Institutions to State-Owned Banks

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Abbreviations

BRRD	Bank Recovery and Resolution Directive (European Union)
CGD	Caixa Geral de Depósitos (Portugal)
CMG	crisis management group
DGS	deposit guarantee scheme
D-SIB	domestic systemically important bank
FSB	Financial Stability Board
G-SIB	globally systemically important bank
G-SIFI	globally systemically important financial institution
IMF	International Monetary Fund
KAs	Key Attributes of Effective Resolution Regimes for Financial Institutions
LAC	loss-absorbing capacity
POB	privately owned bank
PONV	point of non-viability
RA	resolution authority
RRP	recovery and resolution planning
SOB	state-owned bank
SOE	state-owned enterprise
TLAC	total loss-absorbing capacity

Executive Summary

State-owned banks (SOBs) play an important role in financial sectors around the world, and several publicly owned financial institutions are domestic systemically important institutions. SOBs account for a significant part of financial sector assets in many emerging countries such as China, India, the Russian Federation, or Brazil, and in some developed countries as well, such as in Germany.

The "Key Attributes of Effective Resolution Regimes for Financial Institutions" (the KAs) published by the Financial Stability Board provide a framework for dealing with failing systemic institutions. The KAs were a response to the public outrage caused by use of taxpayer funds to resolve failing banks (bailouts) during the 2007–2008 global financial crisis, which caused policy makers to design a new approach to deal with failing banks considered "too big to fail."

The application of the KAs to privately owned banks (POBs) has been extensively discussed, but the use of the same principles to resolve SOBs has received less attention. SOBs have important differences in relation to POBs, which gives rise to questions on how exactly to apply the KAs: the failure of an SOB can raise concerns about the solvency of the sovereign; SOBs are often subject to special legal frameworks, and their resolution may require parliamentary involvement; SOBs typically have public policy roles that go beyond merely commercial activities; and the resolution of a SOB may give rise to discussions related to privatization and economic nationalism.

The purpose of this paper is to offer guidance to policy makers and resolution authorities regarding the application of the KAs to SOBs. It deals with banks that have passed the point of non-viability (PONV) but also discusses early-stage requirements and procedures prescribed by the KAs that aim to improve resolution if it should become necessary. The KAs were developed to apply to "any financial institution that could be systemically significant or critical," which includes SOBs. The key potential issues that could affect the implementation of the KAs for the resolution of SOBs are identified and, where possible, alternatives to address them, or to mitigate their impact, are provided. Among them, the removal of barriers that prevent the resolution authority (RA) from placing a failing SOB under resolution features preeminently. Authorities should also address issues related to resolution funding, which tend to take a prominent role in the case of SOBs, given the fiscal

implications. The paper is also useful for bank resolution practitioners challenged with the implementation of resolution regimes for SOBs. The paper does not intend to be conclusive but rather to frame the discussion on the application of the KAs to SOBs, with the objective of feeding the necessary discussions of these issues by the international community.

Whereas some of the KAs will apply in a straightforward way to SOBs, others will require that certain legal or operational barriers are removed to ensure they can be applied effectively to these institutions. The paper divides the 12 KAs into three groups, depending on the ease of applying them to SOBs. We conclude that four of the KAs can be applied irrespective of the ownership structure of a bank (whether POB or SOB), while six others can be applied to SOBs provided that certain barriers are adequately addressed. Only two KAs (KA 3 and KA 6), which deal respectively with the write-off or conversion of liabilities into equity (bail-in) and with the power of the RA to override shareholders' rights, may require more substantial interventions, such as a delegation of powers from the Parliament to the RA, in order to be fully applied to SOBs.

This paper also addresses the terminology pertaining to public sector capital injections into a failing SOB, which is sometimes inconsistent in different jurisdictions. To structure the discussion, we start from the premise that the first line of defense against a bank failure is capitalization by its shareholders, a principle that holds true for POBs and SOBs alike. Naturally, the capitalization of an SOB by its shareholder involves the use of taxpayer funds, but that does not automatically render such capital injection a "bailout." As we see it, depending on the financial conditions and timing, the injection of taxpayers' funds can be either an ordinary capitalization or a bailout. An ordinary recapitalization happens when government funding is provided in market terms before the initiation of resolution. In contrast, a bailout takes place whenever government funding is provided to the SOB outside of market terms, independently of the moment at which such funding is provided. The bail-in of liabilities held by the government and by parastatal entities could also be seen as a form of usage of taxpayer funds in resolution, especially when such liabilities are not acquired at arms' length.

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Introduction

The bank bailouts put in place during the 2007–08 crisis brought an outcry against the politically unappealing and morally dubious dynamic of treating banks' profits as the rightful property of shareholders but their losses as a burden that society at large must shoulder—the dynamic of *privatizing gains and socializing losses*, as the adage goes. In the soul-searching that followed, the lack of resolution frameworks—or the poorly designed frameworks then existing in some jurisdictions—were blamed for foreclosing the option of resolving failed banks and then forcing governments into the uncomfortable position of having no alternative but to rescue failed banks using taxpayers' funds. The design of resolution frameworks was thus placed at the center of the "too big to fail" problem.

To assist policy makers in establishing mechanisms to deal with failures of large institutions while preserving financial stability, the Financial Stability Board (FSB) published the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the KAs) in 2011. The KAs, which were formally endorsed by the G20, are a set of principles viewed as necessary for an effective resolution regime—meaning one that minimizes taxpayers' exposure and mitigates moral hazard while allowing authorities to preserve financial stability and the financial institution's critical functions. The KAs, as later revised and consolidated in 2014, stand today as the international standard for resolution regimes of financial institutions.

Before the introduction of the KAs, countries typically had only "corner solutions" to deal with failed banks: bailouts or liquidation.[1] Bailouts provoke a number of setbacks: they place the burden of failure on the shoulders of taxpayers, they create moral hazard and the expectation of an "implicit guarantee" to other banks in similar situation, and they may trigger fiscal problems. Liquidations, in contrast, cause a sudden interruption of a bank's activities, destroy value, and are not a feasible option for institutions that perform critical functions because of the significant impacts upon the real economy.

1. The notable exception were those countries that had faced acute banking crises in the previous decades and had developed a wider range of tools to deal with them.

The KAs provide a set of resolution tools and principles that allow authorities to deal with bank failures in a manner that ensures the continuity of critical functions while mitigating the costs to taxpayers. The KAs consist of 12 principles, summarized in table 1.1.

Table 1.1 Summary of the 12 Principles of the KAs

KA		Summarized description
1	**Scope**	Establishes that the KAs are applicable to "any financial institution that could be systemically significant or critical if it fails", including financial market infrastructure and insurance companies.
2	**Resolution authority**	Jurisdictions must have a designated RA tasked with exercising resolution powers. The RA must be independent from supervision, and where the resolution and supervision functions fall within the same authority, they should have separate reporting lines.
3	**Resolution powers**	RAs should have a broad range of powers to allow them to deal with failing institutions, including the power to replace management, operate and resolve the firm, ensure continuity of essential services and functions, override rights of shareholders, transfer assets and liabilities, establish a temporary bridge bank, stay early-termination rights, carry out bail-ins within resolution, impose moratoria, and conduct the orderly liquidation of the failing firm.
4	**Set-off, netting, collateralization, segregation of client assets**	Jurisdictions must have clear legal frameworks regarding set-off rights, netting and collateralization agreements, and segregation of client assets, and such legal frameworks should be enforceable during resolution and not hamper the implementation of resolution measures. Entry into resolution should not, per se, trigger automatic set-off rights or constitute an event of default.
5	**Safeguards**	Resolution should respect the hierarchy of claims while allowing the departure of pari passu treatment for systemic reasons and in a transparent fashion. Legal remedies should be limited to financial compensation rather than allowing courts to constrain the implementation of resolution measures.
6	**Funding of firms in resolution**	Jurisdictions should have access to temporary sources of funding to maintain essential functions needed for orderly resolution. They should have privately financed deposit insurance or resolution funds. Any provision of government funds should be temporary (including placing a failing bank under temporary public ownership).
7	**Legal framework conditions for cross-border cooperation**	The legal framework should empower the RA to cooperate with foreign RAs to achieve cooperative solutions. Legislation should enable the RA to recognize and give effect to foreign resolution actions. National laws should not discriminate against foreign creditors.
8	**Crisis management groups**	Home and host authorities of all G-SIFIs should maintain CMGs to enhance preparedness and facilitate the management and resolution of a cross-border financial crisis affecting the firm. CMGs should include the members of the financial safety net of all jurisdictions that are material to the resolution of the firm.
9	**Institution-specific cross-border cooperation agreements**	Home and relevant host authorities of G-SIFIs (at a minimum) must maintain institution-specific cooperation agreements to allow for the joint planning and managing of crises. Cooperation agreements should define the roles and responsibilities of all authorities before and during crises, and set out information-sharing protocols, communication arrangements, among other matters.
10	**Resolvability assessments**	RAs should engage in resolvability assessments at least of all G-SIFIs and should be empowered to order banks to remove barriers to their orderly resolution, such as streamlining corporate structures, adjusting business practices, and so on—provided, however, that due care is taken with regard to the effects on the soundness and stability of their business.

11	**Recovery and resolution planning**	Jurisdictions should have in place an ongoing process for RRP. There should be adequate provisions regarding the governance of RRP, and plans should be updated regularly.
12	**Access to information and information sharing**	Jurisdictions should eliminate any legal, regulatory, or policy barriers to the exchange of information between supervisors, central banks, RAs, ministries of finance, and deposit insurance schemes, and require firms to have in place systems that are adequate to produce information needed for resolution in a timely manner.

Source: World Bank compilation.
Note: CMG = crisis management group, G-SIFI = globally systemically important financial institutions, KAs = Key Attributes of Effective Resolution Regimes for Financial Institutions, RA = regulatory authority, RRP = recovery and resolution planning.

This discussion paper is concerned with the application of the KAs to state-owned banks (SOBs). SOBs often have some policy role, and their failure can unsettle investors and trigger "doom loops" between banking and sovereign insolvency. SOBs constitute a large share of the banking sector in many emerging and developing countries (for example, China, India, Brazil, Turkey) and in some developed countries (for example, Germany). SOBs can operate on a commercial basis or have a developmental objective (such as development banks). In practice, there are few purely commercial SOBs, since governments often use SOBs to promote a public purpose (for example, the provision of financial services in rural areas, lending to underserved segments and to state-owned enterprises (SOEs), or countercyclical lending during recessions) alongside the goal of generating profits. Thus, SOBs become a part of the governance and power structures, and their activities usually have great political as well as economic significance. Furthermore, the failure of the government to recapitalize an SOB can raise concerns about sovereign fiscal sustainability and trigger rating downgrades.

When discussing the application of the KAs in the context of SOBs, it is important to define what constitutes a shareholder recapitalization, a bailout, and a bail-in. Recapitalization by shareholders after loss recognition is the first line of action in the event of bank failure and part of the prompt corrective action (recovery) framework used by supervisors prior to transferring the failed bank to the RA. In the case of SOBs, shareholder recapitalizations are ultimately done by taxpayers. A bailout involves the use of taxpayers' resources to ensure that a failed bank that could not be recapitalized by its shareholders in market terms can continue to perform at least some of its obligations—especially those related to functions that are critical to the real economy.— The KAs discourage its use as a resolution technique.

The KAs aim to shift the cost of bank failures from taxpayers—through bailouts—to shareholders and creditors, through bail-ins. Capital injections by creditors can be provided in the context of bail-ins. These creditors can be private or public (including parastatal entities such as pension funds). The bail-in of public creditors transforms them into shareholders of the failed bank, reinforcing public control over the SOB. That raises questions about how to bail in any private creditors in a manner that ensures reforms in the governance of the SOB.

In this context, the objectives of the paper are to (a) provide a taxonomy of different types of capital injections by the state into an SOB, and (b) discuss the application of the KAs to SOBs with a view to contributing to implementation efforts being carried out by the World Bank, the IMF, the FSB, supervisors, and RAs worldwide. At its core, the idea here is to provide guidance on how to tailor national resolution regimes such that the goals established by the KAs can be attained in the least burdensome manner. Our exercise is therefore one of optimization—maximizing the expected advantages and minimizing the potential obstacles to resolving SOBs. Although the authors recognize the importance of adequate supervision of SOBs and that supervisors must treat SOBs in the same manner as POBs, bank supervision falls outside the scope of this paper and is not discussed. The paper proceeds as follows: Section 2 defines SOBs. Section 3 discusses what is meant by resolution and develops a taxonomy for capital contributions to SOBs. Section 4 discusses the question of how the KAs apply to SOBs. Section 5 addresses the practical challenges in applying the KAs to SOBs. Sections 6, 7, and 8 cover the 12 principles contained in the KAs, discussing how they can be applied to SOBs. Section 9 concludes.

Definition of SOB

2.1. State

This discussion paper revolves around SOBs, which thus must be defined. To do that, we need to elaborate on each one of the three elements that make up the acronym—"state," "owned," and "bank." The first element is the least problematic to define. The crucial aspect is that a sovereign entity, not a private one, rests as the beneficial owner of the bank. The state that owns the bank can in fact be any sovereign political entity participating either directly or indirectly, including through sovereign wealth fund holdings or other SOEs. Worldwide, banks have been owned at the federal, state, provincial, and local levels. There have also been cases of SOBs being jointly owned by two or more political entities, such as Brazil's Banco Regional de Desenvolvimento do Extremo Sul, which is a development bank owned by the states of Rio Grande do Sul, Santa Catarina, and Paraná. Multilateral development banks—those controlled by more than one sovereign entity, such as the Asian Development Bank or the European Bank for Reconstruction and Development—fall outside of the scope of this paper, given their specificities.

Attention must be paid to the type of sovereign entity, especially because regional and local SOBs tend to be easier to resolve than national SOBs. It is often less controversial to place a regional or local SOB under the same resolution framework applied by an authority at the national level to the banking system at large. The reasons for that are many. First, the failure of the subnational entity to recapitalize the institution does not necessarily affect the sovereign debt market. Second, regional and local authorities normally exercise less political pressure on the RA. Third, there are often differences in the legal framework applying to different types of SOBs. In Brazil, for example, the Central Bank exercised its authority to resolve several state SOBs in the 1990s, making widespread use of the asset separation tool and the subsequent sale to other banks. Nonetheless, the use of these same tools and strategies to resolve federal SOBs would require parliamentary approval.

2.2. Owned

The SOB is "owned" by the state, meaning that some sovereign entity holds stocks or shares in the bank. This entity can be the Ministry of Finance (as in the case of Mexico's development banks such as Nacional Financiera, Bancomext, and Banobras, among others), a special governmental vehicle or holding company (as in the case of the Development Bank of Singapore Limited, Russia's Sberbank,[2] and Turkey's Ziraat), or other banks or companies owned by the government.

SOBs are often wholly owned by the state but not always. When the bank has private shareholders alongside the state, one must define how much state ownership is needed to qualify the bank as an SOB. Some studies adopt a specific percentage as the threshold—sometimes 20 percent, sometimes 50 percent of the voting stock—but a more practical way is to define as an SOB a bank over which the state has corporate control. Corporate control is the ability to make decisions regarding a bank's policies and business plans. This tends to happen when the state has more than half of the voting stock, but it can also arise in cases in which the state has shares with special rights (for example, golden shares) or in which the private shareholdings are atomized.

A bank can become an SOB by virtue of the state having acquired the majority of its voting stock, as sometimes happens in the context of a bailout. For example, in 2008 the United Kingdom's failed Northern Rock was nationalized and brought into state ownership after two unsuccessful bids to take over the bank (the bank was then managed at arm's length by the government and eventually rebranded and privatized in 2012). Another possibility of circumstantial state ownership—which in fact arises from the application of the KAs—is the case of bridge banks in which transitory government ownership follows from a previous resolution or is intended as an intermediate vehicle for privatization.

However, most SOBs are created *ab initio* as creatures owned by the state. Typically, their bylaws or some enabling legislation will then determine that the state should always hold control. This tends to happen even in banks organized as mixed corporations, that is, banks in which the government exercises corporate control but shares ownership with private stockholders. Also, banks that were created as SOBs are often involved with the provision of public services (such as the provision of rural financial services, and so on). The need to ensure continuity in the provision of these public services raises additional considerations when resolving SOBs through private capital injection or privatization. Conversely, banks that were nationalized usually retain their commercial mission and are subject to common corporate law, rendering them easier to resolve through outright privatization or through the bail-in of private creditors.

2.3. Bank

The term "bank" is typically employed to refer to entities that take deposits and grant loans—that is, commercial banks—but in a discussion of SOBs the term should also include development banks. Most SOBs take deposits from institutional investors, whereas commercial SOBs and some development banks (especially those with a financial inclusion mandate) offer retail deposits. Examples of large commercial SOBs include Sberbank, Banco do Brasil, and Bank Rakyat Indonesia. Examples of development banks include KfW in Germany, the Korean Development Bank, the Exim Bank of the United States, and the Development Bank of South Africa. Although the need is relatively uncommon, development banks can be subject to resolution. For example, in 2017 Puerto Rico's Government Development Bank was liquidated and its assets split between depositors and lenders.

That said, not every financial entity controlled by the state that is involved with credit allocation should qualify as an SOB and be subject to the respective resolution framework. To understand why, consider that the KAs deal with the problem of resolution in a holistic fashion and prescribe requirements for recovery and resolution planning (RRP) and intervention at an early stage before the institution reaches balance-sheet insolvency. In addition, the KAs deal with tools that require adequate preparation before they can be implemented and whose use makes practical sense only if the regulators (supervisors and RA) have continuous and ample access to relevant data.

It can be inferred, therefore, that a precondition to resolution is that the bank is subject to adequate supervision and regulation. Without that condition, it is impossible to implement the standards established by the KAs. Policy makers must ensure that regulators and supervisory authorities treat SOBs in the exact same manner as POBs, not only to make resolution possible, but also to ensure a level playing field and a healthy competition environment.[3]

2. In the case of Sberbank, the Central Bank of Russia was the main shareholder until 2020.
3. For a complete discussion on the regulation and supervision of SOBs, see Mark Adams, Hanife Yesim Aydin, Hee Kyong Chon, Anastasiia Morozova, and Ebru S. Iskender, "Regulating, Supervising, and Handling Distress in Public Banks" (IMF Departmental Paper 2022/010, Washington, DC, 2022).

A Taxonomy for Contributions of State Capital to Failing SOBs

The economic, political, and social relevance of SOBs means that their failure should be treated by authorities as a question of utmost concern. To safeguard reputation, preserve critical banking functions, and contain systemic failure, governments worldwide have responded to SOB failures with capital injections, relief of impaired assets, and similar measures. This does not mean that SOBs are never liquidated. An SOB liquidation happened, for example, in 2016 when the National Bank of Ukraine and the Ministry of Finance jointly decided to cease Rodovid Bank's operations and place it in liquidation (the bank had been nationalized a few years previously). Moreover, policy preference is not the only reason why an ordinary recapitalization might turn out undesirable. For example, in the case of the German Landesbank, HSH NordBank, recapitalization in 2005 was blocked because of antitrust considerations.

Government contributions are typically the first line of defense against SOB failure, but a fixation on recapitalization may simply create zombie SOBs and hamper fiscal sustainability. Recapitalization of SOBs, as for private banks, should be accompanied by a plan to ensure financial sustainability and management changes. SOBs that are not viable should be resolved. This includes banks that receive subsidies for their commercial operations through either budgetary resources or credit subsidies.[4] It is also important to consider the fiscal implications of recapitalization, particularly repeated capitalizations, versus the implications of the resolution alternatives.

Part of the controversies concerning state capital contributions to SOBs has to do with their economic merits and political implications, but part is a function of terminology. Government contributions to SOB capital are sometimes referred to as *bailouts* (in the sense that funding is ultimately shouldered by taxpayers), as *bail-ins* (or more precisely, *bail-ins within resolution*, in the sense that funding is provided through the conversion into equity of the SOB's debt instruments held by the government, directly or through different agencies, within a resolution procedure), or simply as *recapitalizations* (an ordinary equity contribution).

4. Credit subsidies are received through the provision of funding at below-market rates from government entities or through private mandatory investments. Subsidization of commercial activities can have fiscal consequences and raise competition neutrality concerns. Subsidization of developmental activities can be justifiable but, for transparency considerations and to limit distortions, should be done through budgetary allocations.

3.1. The Key Variables: Financial Conditions and Timing

To clarify the terminology, we first need to understand the flow of actions when a government comes across a failed bank. In any troubled bank, SOB or not, the actions by the prudential supervisor and the RA happen on a continuum. Typically, once a bank weakness is detected, the bank supervision authorities issue conditional approvals, written warnings, or remedial instructions. If the bank is undercapitalized, the supervisors require that shareholders restore the bank's capital. If the shareholders respond by providing the necessary capital and making the other required adjustments, the weakness is eliminated and resolution is avoided. Thus, resolution proper comes only after supervisors carry out the early interventions. In practice, resolution begins if the shareholders fail to provide the required capital (and to comply with other remedial measures, as needed) and there are no credible alternatives for avoiding that the bank becomes insolvent.

The term "resolution" designates several types of interventions and proceedings to deal with bank insolvency. There are basically two types of proceedings. The first are those solutions in which the institution ceases to operate (for example, liquidation, merger with or sale to another institution, purchase and assumption of certain assets and liabilities of the institution by another institution with the subsequent liquidation of the rest). The second type of resolution arises when the institution continues to operate but does so under different circumstances. For example, a bridge bank is incorporated to take over the activities of the failed bank, to hold its assets and liabilities until a buyer is found or the bank is finally liquidated.

Government contributions to failing SOBs can be carried out in market terms or outside of market terms. For example, if the government issues bonds on market terms or uses existing financial resources[5] to contribute to the capital of the SOB, those can be considered transactions made on market terms (given that, in principle, the transactions would not be substantially different if done by a private shareholder). If the government instead provides a blanket guarantee on liabilities, issues special securities to inject additional resources in the bank, provides funding at below-market rates to the bank, or adopts measures such as granting the bank the administration of certain funds[6] so capital can be accumulated from the difference between the return of these funds and the government securities in which resources are invested, then these transactions would not be deemed to be made on market terms.

An ordinary recapitalization happens when government funding is provided in market terms before the initiation of the resolution; a bailout takes place whenever government funding is provided to the SOB outside of market terms, independently of the moment at which such funding is provided. Sometimes, bailout funding will be provided to the SOB before the initiation of formal resolution proceedings. The bailout can also occur in the context of an ongoing resolution. This takes place, for example, when the government provides resolution funding to the SOB, allowing it to continue operating without a clear plan for restructuring.

Government bail-ins are capital contributions that take place by converting liabilities held by the government—directly or through government agencies—into equity in the context of a resolution proceeding. For example, if capital is restored by converting shareholders' credits into equity or by writing off claims of shareholders—that is, without injecting new funds in the bank—that is considered a bail-in. The first liabilities expected to be converted in a bail-in are instruments that, at the time of issuance, already contained specific clauses establishing their conversion or write-off, such as instruments that count towards a bank's total loss-absorbing capacity (TLAC), as referred to in the FSB TLAC Term Sheet.[7] If these are insufficient, the bail-in can be extended to other unsecured and uninsured liabilities of the bank.

5. For example, from a sovereign wealth fund; for POBs, this would be the equivalent of the private shareholder tapping its own savings to recapitalize the bank.
6. For example, judiciary deposits or workers' contributions to severance funds.
7. *See* the FSB's website at https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

BOX 1. TOTAL LOSS-ABSORBING CAPACITY (TLAC)

On November 2015 the Financial Stability Board published the "Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution," the TLAC Term Sheet.

In principle, the TLAC Term Sheet is applicable solely to globally systemically important banks (G-SIBs), but several jurisdictions used the same principles to establish different loss-absorbing requirements for their domestic systemically important banks (D-SIBs). One example is the MREL (minimum requirement for own funds and eligible liabilities) introduced in the EU, which, despite a different calculation methodology, has the same objectives as the TLAC.

TLAC-eligible securities include those issued and maintained by the entity subject to resolution, fully paid-in and unsecured, with a remaining maturity of at least one year.

Several liabilities are expressly excluded by the TLAC Term Sheet and cannot count towards TLAC requirements:

- Insured deposits
- Liabilities callable on demand without supervisory approval
- Liabilities funded by the issuer or a related party
- Liabilities arising from derivatives or debt instruments with derivative linked features
- Non-contractual liabilities, such as tax liabilities
- Preferred liabilities
- Other liabilities that cannot be written down or converted to equity by resolution authorities

3.2. The Role of Laws in Distinguishing Ordinary Recapitalizations from Bailouts

A clear distinction between ordinary recapitalizations and bailouts requires that the boundary between recovery and resolution be clearly spelled out in laws and regulations. In Europe, for example, the Single Supervisory Mechanism controls the recovery phase that bank supervisors carry out outside of resolution. If recovery is not feasible and resolution is required, the Single Resolution Mechanism, under the remit of the Single Resolution Board takes the lead in the process. In many countries, the supervision and resolution functions are under the same entity; for those, as prescribed by KA 2, it is important to ensure that the resolution function is exercised in an independent manner, which can be ensured by having its reporting line separate from that of the supervision function. Without such independence, procedures tend to become less structured and the exact point marking the transition from pre-resolution remediation to actual resolution becomes blurred.

Where the law and the regulatory structure fail to provide clear guidance, the distinction between ordinary capitalization and bailout is found only in the financial conditions at hand. The crucial element is whether the capital injection is done at market terms or not. As mentioned, a transaction in which the government issues bonds on market terms or uses existing financial resources is, in principle, considered to be made on market terms. If the government instead provides funding through mechanisms that would not be available to private shareholders, then those transactions would not be deemed to be made on market terms and could be considered a bailout.

BOX 2. THE RECAPITALIZATION OF CAIXA GERAL DE DEPÓSITOS (PORTUGAL)

Caixa Geral de Depósitos (CGD), established in 1876, is the second largest bank in Portugal and the largest Portuguese state-owned bank (SOB). In the aftermath of the global financial crisis, CGD twice required the intervention of its shareholder.

The Portuguese government's funding of CGD in 2012 and 2016 offers a good example of an SOB recapitalization that qualifies as being under market conditions and therefore not a bailout. The European Commission has a mandate to examine whether capital injections by authorities in any of its member jurisdictions are in line with the market economy investor principle. The Commission employed this principle to verify whether a market economy investor would have provided a share capital increase under the same conditions as the Portuguese state did. In its analysis, the Commission concluded (a) that a private investor would have needed additional remuneration, but (b) that CGD could offer a sufficient rate of return to convince a private investor to inject fresh equity into the bank.[a] The more general point is that ordinary recapitalizations such as that involving CGD will not fall within the scope of the key attributes (KAs).

a. See European Commission, Procedure C(2017) 1698 final, Brussels, March 10, 2017, especially items 114, 122, and 179. https://ec.europa.eu/competition/state_aid/cases/267912/267912_1899392_142_2.pdf.

The difference between ordinary recapitalization and extraordinary funding granted in resolution is therefore clear. Ordinary recapitalizations follow standard corporate, contract and banking law, and their financial terms are consistent with market conditions. Extraordinary funding, whether bailouts (by a government and outside of market conditions) or bail-ins (by converting liabilities into equity), are done in the course of a crisis management procedure. But bailouts can be done at any moment (that is, before or during a crisis), whereas the bail-ins dealt with under the KAs are always within a formal resolution procedure.

Although the possibility of bailouts is not completely ruled out, they go against the spirit of the KAs and should be used solely when inevitable and in extreme circumstances. These are the cases for which the tools set forth in the KAs are not deemed sufficiently credible to preserve financial stability and the bank's critical functions and generally fulfill the other goals of effective resolution set out in the preamble of the KAs. Importantly, when a bailout is needed, authorities must strive to minimize the risks of wasting taxpayers' money and spawning moral hazard. In that sense, a bailout should be preceded by a bail-in or by other measures that ensure that shareholders, and some creditors, bear the first losses; this aim is further complicated by the fact that in an SOB shareholders and taxpayers are the same. This and other practical problems concerning the application of the KAs to SOBs are addressed later in this report.

3.3. Bailouts and Bail-Ins

"Bail-in" implies the write-off of existing shareholders and the conversion of liabilities into equity, which has the effect of diluting or completely wiping out existing shareholders, triggering a change of control of the institution. In theory, bail-ins would not be considered a form of "shareholder funding" of a failing bank, because the recapitalization is done by creditors.

In the specific context of an SOB resolution, a conceptual problem arises in distinguishing a bailout from a bail-in. The reason is that often government entities are large creditors of SOBs, not only directly (say, through deposits and investments by government departments and subdivisions) but also indirectly through parastatal organizations (such

as pension funds, social security funds, and the like) that acquire bonds and other securities issued by the SOBs – a practice that is not uncommon in many emerging markets and developing economies. In addition, in some instances, SOB debt held by these institutions is not properly priced, amounting to a credit subsidy.

A criticism then could be that bailing-in these types of public creditors produces a result that does not differ fundamentally from those of a bailout. As the argument goes, the bail-in of public creditors would again shift the burden of bank failure onto taxpayers (or subgroups thereof, such as pensioners) while not eliminating the government control that led to the SOB's demise in the first place. A similar situation in which the practical effects of a bail-in resemble those of a bailout can arise when the liabilities bailed in are held by both public and private creditors, with the majority held by the former. In this situation, private capital is bailed in, but the institution remains under state control.

A solution might be strict regulations on the issuance of LAC by SOBs, requiring transparent pricing and limiting exposures, as well as ensuring that private creditor bail-ins occur only when control is transferred to private hands. By ensuring that the LAC issued by an SOB is held by a broader range of investors, bail-ins can be implemented in a manner that distributes losses more evenly across the economy, instead of affecting a small group of government agencies or organizations. The regulations should also ensure that private capital is bailed in only when the institution's control is transferred to private hands. One possibility could be to treat public sector creditors as related party credits and, as such, bail them in before private creditors. Another possibility could be to ensure that private creditors are bailed in only when a certain threshold of capital write-off has been reached and the liabilities to be bailed in are sufficiently distributed between the public and private sectors.

3.4. Summary

Table 3.1 summarizes the features of ordinary recapitalization, bailouts, and bail-ins in an SOB.

Table 3.1 Features of Recapitalization, Bail-in, and Bailout

	Recapitalization	Bail-in	Bailout
Nature	Non-resolution	Resolution	Non-resolution, resolution
Financial conditions	On market terms	Outside of market terms, but typically set forth a priori in the legal framework	Outside of market terms and less predictable (that is, decisions are usually political and uncertain)
Determination	Voluntary - Discretionary decision by the shareholder (that is, the government)	Mandatory: Follows from determination of the RA and could dilute the state's participation in the SOB (privatization)	Voluntary: Can be determined by the government in response to supervisory concerns in non-resolution procedures. In resolution, it involves the creation of a rescue package by a government entity.
Safeguards for minority shareholders and creditors	Standard corporate and banking law	No creditor worse off than in liquidation	None

Tools	Capital injection, contingent convertible bonds, or similar instruments	Increases capital in the amount of the liabilities converted into equity and dilutes shareholders. Wipes out all or part of equity holders.	Capital injections, blanket guarantee schemes, relief of impaired assets, extended liquidity support, below-market rate loans
Ownership structure	No change of control	Could lead to a change of control	No change of control or change of control from one public entity to another
Rationale	To restore the capital position, to allow an SOB to expand its balance sheet, or to prevent financial and economic disruption	To prevent financial and economic disruption or collapse, and reduce moral hazard and taxpayers' exposure that is associated with bailouts	To prevent financial and economic disruption or collapse

Source: World Bank compilation.
Note: RA = resolution authority, SOB = state-owned bank.

3.5. Policy Implications

When an SOB faces financial difficulties, the best scenario is for its shareholder to increase its capital before it reaches the point where resolution needs to be triggered (the so-called point of no viability, or PONV). As in a POB, this recapitalization avoids resolution, with all the associated market uncertainty and potential impacts to the real economy and to the remainder of the financial system. To avoid misuse of taxpayer funds, however, recapitalization should be done at arms' length—that is, under conditions that would pass a test similar to the European market economy investor principle. The capitalization should be accompanied by a restructuring of the failing bank, with the elimination, where possible, of loss-making activities and adjustments to the SOB business model, to ensure its long-term sustainability.

In situations where the government, as shareholder, is not in a position to recapitalize the SOB before the PONV, the RA should have the power to place the bank under resolution. This can arise because of either the government's lack of financial capacity to recapitalize the bank (typically under situations of extreme financial stress) or its unwillingness to do so, for political or economic reasons.

Applicability of the KAs to SOBs

The KAs' stated scope of application is to "any financial institution that could be systemically significant or critical," and, beyond that, to those financial institutions' "holding companies" as well as to "non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate", and "branches of foreign firms."[8] As there are no written exceptions, there can be no question that systemically significant or critical SOBs fall squarely within the declared scope of the KAs.

Application of the KAs to SOBs is also consistent with the position taken by other international organizations. For instance, a 2015 report by the Basel Committee on Banking Supervision titled *Guidelines for Identifying and Dealing with Weak Banks* emphasizes that "all banks should be subject to the same operational and supervisory standards regardless of their ownership."[9] The same document then clarifies that "for competitive reasons and in order to maintain credibility in the financial sector, it is imperative that the supervision and resolution of weak public sector banks be carried out in a manner that is not more favorable than that applied to private banks."[10]

8. FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Basel, Switzerland, 2014), item 1.1.
9. Basel Committee on Banking Supervision, "Guidelines for Identifying and Dealing with Weak Banks" (Basel, Switzerland, 2015), 57.
10. Basel Committee on Banking Supervision 2015, 58.

Practical Challenges to the Application of the KAs to SOBs

The application of the KAs to SOBs means that local jurisdictions and authorities must uphold and incorporate into their resolution frameworks the specific rules, principles, and practices prescribed under the KAs, including those that aim to minimize taxpayers' exposure and moral hazard. Doing that, however, highlights four practical challenges.

5.1. Resolution Can Hurt a Government's Reputation and Cause It to Realize a Loss

Whether done in a manner that is consistent with the KAs or not, the decision to place an SOB under resolution could affect fiscal accounts. According to the KAs, losses should be absorbed first by shareholders; given that, in placing an SOB in resolution the government stands to wipe out (or at least severely reduce) its own equity holding. A loss will be realized and, depending on its size, it can negatively or even very negatively affect the results and figures of the country's public accounting.

A main problem is that SOBs often operate under the implicit assumption that the state backs liabilities. Even when a state guarantee is not formally enshrined in the law or in the bank's bylaws, investors and rating agencies typically tend to consider that SOB liabilities will be honored by the national treasury. To a certain extent, this can be addressed by having an adequate resolution framework and resolution planning for SOBs, in a manner that sends a clear message to the markets that, in case of failure, authorities do not expect to bail out the SOB. The requirement that the SOB issue debt earmarked to be bailed in, according to the FSB TLAC Term Sheet, is also an important element in adjusting investors' expectations.

Placing the SOB under resolution tends to create a great reputational cost for the government that can lead to increases in funding costs for all its SOEs. Specifically in jurisdictions that have more than one SOB in operation, the failure of one of them can have significant adverse impacts on the others, even if they are healthy.

Taken together, these two considerations explain why SOBs are often treated as too public to fail and why governments usually go to great lengths in terms of spending public funds to recapitalize SOBs and avoid placing them into resolution. Once an SOB passes the PONV, recapitalization should not be an alternative, and authorities should resort to the resolution framework. This is especially necessary when the SOB business model is flawed, in which case it becomes dependent on periodic capital injections or regulatory forbearance. However, governments tend to resist recognizing losses and tarnishing their reputation, which explains in part why they often resist resolution and compliance with the KAs.

5.2. SOBs Are Subject to Special Legal Frameworks

Lack of flexibility of the laws pertaining to SOBs is an important hurdle for applying the KAs. SOBs can be incorporated under public or private law regimes. SOBs incorporated under public law receive the status of a state entity and are then defined as a statutory corporation, a public company, or a similar concept. Their liabilities are explicitly underwritten by the state, of which the SOB becomes an integral part. Statutory corporations are notoriously difficult to resolve, first and foremost because each step of the resolution would, in many jurisdictions, require legislative approval. Also, the single-share capital structures typical of statutory corporations prevent bail-in and other resolution techniques.

SOBs incorporated under a private corporate law regime are theoretically easier to resolve. They are not statutory corporations, often have minority private shareholders, and are publicly listed and sometimes even cross-listed. These SOBs are regulated by corporate and banking law and typically subject to a limited liability structure, similarly to POBs.

Yet, in most cases the creation of an SOB under a private law regime does not preclude the legal obligation of the state to maintain control of the company. In this case, resolution is still subject to legislative authorization, in much the same way as for statutory corporations. A practical alternative for dealing with this problem is to legislate an authorization for RA intervention, as was done for example in Brazil in the 1980s (but only for intervention in state and local SOBs, not federal ones). Even so, the RA's ability to move quickly can still be restricted by other regulations applicable to SOBs, such as the need for audits and approvals by the government's accounting offices and similar bodies.

A potential solution to the requirement of legislative authorization—under either public or private law regimes—is to include provisions in the resolution framework that stay the need for legislative authorization once the PONV is reached and an SOB is put under resolution. Although this is an important measure to ensure the adequate exercise of resolution powers, much in line with the provision established by KA 3.2(v),[11] in some cases it may be a sensitive issue. As discussed, placing an SOB in resolution may have effects on the government's reputation and finances, and the political establishment may be reluctant to grant powers to the bank supervisors and the RA to take such action without a broader discussion.

5.3. Resolution Can Reignite Debates about Privatization

The application of the KAs to SOBs, and especially the use of bail-ins, may result in privatization of SOBs, which is a thorny and politically loaded issue because of the discussion of the role of SOBs. In international policy circles, the prevailing views on state ownership of banks have fluctuated over time. In the postwar period, it was common to assume that the state should play a key role in the banking sector—and indeed, the government did play an outsized role in a significant number of banking systems. In the 1980s and 1990s, however, the pendulum swung back, and SOBs became increasingly associated with poor performance of credit markets, rent-seeking, and other evils that promote credit misallocation and slow growth. A World Bank publication in 2001 famously noted that "whatever its original objectives, state ownership tends to stunt financial sector development, thereby contributing to slower growth."[12]

11. "3.2. Resolution authorities should have at their disposal a broad range of resolution powers, which should include powers to do the following: … (v) Override rights of shareholders of the firm in resolution, including requirements for approval by shareholders of particular transactions, in order to permit a merger, acquisition, sale of substantial business operations, recapitalisation or other measures to restructure and dispose of the firm's business or its liabilities and assets."
12. World Bank, *Finance for Growth: Policy Choices in a Volatile World* (Washington, DC: World Bank, 2001), 123.

The 2008 crisis saw a sequence of failures and mismanagement of POBs and a surge in the use of SOBs to revive lending and maintain money creation. As a result, confidence in SOBs started to rebound. Now, SOBs are increasingly portrayed as playing an important and constructive role. A recent IMF paper indicates that SOBs are "likely to remain a feature of financial systems in a number of countries."[13] Yet, the not uncommon episodes of mismanagement and poor governance within SOBs, alongside distortions commonly attributed to the presence of SOBs in credit markets, keep the controversy over privatization alive. These debates matter a great deal because a discussion about privatization tends to resurface almost every time a resolution of an SOB is set in motion. Ideological cleavages can then arise, complicating, politicizing, and slowing resolution proceedings.

Resolution is, by definition, a process that aims at taking the control of the failed institution from its existing shareholders, and this aim should not differ for an SOB. Whereas selling a good, healthy SOB may trigger all sorts of political debates, resolution deals with a bank that is no longer viable and that, without the use of resolution tools, will most likely need to interrupt its activities suddenly. That changes the conversation, and the objections to privatization commonly raised in the sale of healthy state-owned entities should play a smaller role in the context of resolution of unhealthy ones.

5.4. Resolution Can Reignite Debates about Economic Nationalism

A closely related problem is that concerns about economic nationalism can resurface when SOBs fail. A market solution for recapitalizing banks—supposing one is available, a topic discussed later—can involve acquisitions by foreign banks. Allowing foreigners to bid tends to help governments reap more revenue, and foreign institutions can bring additional banking skills. The downside is that acquisitions of domestic SOBs by foreigners can elicit ideological reactions similar to those in response to privatizations. In part because of that downside, privatizations are sometimes restricted to national investors. Yet this strategy can backfire. For example, during the first round of privatizations in Mexico in the 1990s foreigners were excluded, but the privatized banks expanded too rapidly and later had to be renationalized. [14]

Outside of an outright acquisition by a foreign investor, issues related to economic nationalism may also arise i bail-in. Many SOBs, especially those where domestic capital markets are not well developed, issue bonds in the international markets. If these bonds are used as LAC and bailed in during a subsequent resolution, ownership of the institution may be transferred to foreign hands.

The longstanding debate on the openness of financial markets to foreign capital consists in two opposing visions: one that emphasizes the importance of sovereignty and the prevalence of the national interest, and one that highlights the importance of promoting competition and attracting capital and banking know-how. Currently, this latter vision holds more currency within international financial institutions. For example, a research paper published by the World Bank in 2018 concludes that "foreign-owned banks are more efficient than domestic banks in developing countries, promote competition in host banking sectors, and help stabilize credit when host countries face idiosyncratic shocks."[15] However, this same report also points out that "foreign-owned banks can transmit external shocks and might not always expand access to credit."[16] This point is particularly true for credit to small and medium enterprises (SMEs), as several studies show that acquisition of domestic banks by foreign banks resulted in lower credit SMEs.

For the present purposes, an important takeaway is that debates concerning economic nationalism tend to reappear in the events leading to recapitalization or resolution of a failed SOB. For example, the failures of Caixa Geral de Depósitos (CGD) in 2012 and 2016 discussed earlier dealt with recapitalizations carried out at market conditions to avoid the need for resolution and privatization. CGD had been a symbol of the Portuguese state for many years. Although this historical record was not particularly relevant from a technical and formal point of view, from a political standpoint it possibly helped to substantiate the reorganization plan presented to the European Commission by the Portuguese state.

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13. Mark Adams et al., "Regulating, Supervising, and Handling Distress in Public Banks" (IMF Departmental Paper No. 2022/010, Washington, DC, 2022).
14. *See* Gerard Caprio et al., eds., *The Future of State-Owned Financial Institutions: Policy and Practice*, (Washington, DC: Brookings Institution Press, 2005), 5.
15. Robert Cull, Maria Soledad Martinez Peria, and Jeanne Verrier, "Bank Ownership: Trends and Implications" (Policy Research Working Paper 8297, World Bank, Washington, DC, 2018).
16. Cull, Martinez Peria, and Verrier 2018.

6

Application of the KAs to SOBs

This section aims to reconcile the goals under the KAs with the challenges spelled out in the previous section. The problem to be tackled can be described as follows. On one hand, the KAs are sound in prescribing that taxpayers' money should not be used for a failed or weak bank. The reasons have to do with political accountability and fairness but also with incentives, because resorting to bailouts induces laxity in the use of public funds, fuels moral hazard, distorts market competition, rewards inefficient management practices, and promotes capital misallocation. Therefore, SOB resolution should be pursued with caution and should pay heed to the considerations and goals articulated under the KAs. On the other hand, an important takeaway from the preceding section is that the implementation of the KAs in SOBs can be complicated, slowed, and sometimes prevented by the operation of distinctive legislation that treats SOBs differently from POBs as well as by factors related to the political economy of SOBs.

The implementation of the KAs in SOB resolution should uphold the KAs without imposing unjustified burdens on the authorities or counterproductive obligations on the SOBs. When implementing the KAs in SOBs, the overarching aim is to avoid the use of taxpayer money while preserving financial stability, taking into account the particular circumstances involved in SOB resolution.

We divide the KAs into three groups according to the challenges posed to their application to SOBs. The first group comprises the KAs that can be implemented in full with no or minimal challenges (when compared with their implementation in POBs). We identify KA 1, KA 4, KA 5, and KA 12 as the relevant ones in this category, meaning that their provisions should apply equally to SOBs and POBs. The second group address the KAs for which their application to SOBs may present some challenges, and this is the case with KA 2, KA 7, KA 8, KA 9, KA 10, and KA 11. The third group comprises those whose application to SOBs presents challenges of a more sizeable nature; these are KA 3 and KA 6. For organizational purposes, KA 3 and KA 6 are discussed separately, in sections 7 and 8. The others are discussed in this section.

6.1. Application of KAs 1, 4, 5, and 12 to SOBs

Four KAs can be easily implemented in SOBs. The first is KA 1, which deals with the scope of application of the KAs. Under KA 1.1, the provisions of the KAs apply to any financial institution whose failure could be systemically significant or critical for banking functions. In practice, concerns about orderly resolution and network effects often cause RAs to apply the KAs broadly, extending them to smaller banks. Of special relevance here, these same concerns can be particularly important when the weak bank is an SOB, because of the outsized impact their failure can have on confidence in the solvency and soundness of the financial system.

KA 4, which covers set-off, netting, collateralization, and segregation of client assets, also applies easily to SOBs. These provisions have to do with the standard commercial obligations of the bank, regardless of its ownership structure (that is, whether a SOB or a POB).

KA 5, which centers on safeguards in the process of resolution, should also apply to SOBs without giving rise to any specific challenges. There are two such safeguards. The first is the principle of "no creditor worse off" in resolution than in liquidation. To uphold this principle, the law should determine minimum requirements of independence and professional capacity by the individuals or entities that will conduct valuations to determine the value of claims under liquidation. The second is the right of shareholders, creditors, clients, and stakeholders to seek remedy in court. A concern with the preservation of financial stability means that any such remedies should come in the form of compensation, not injunctions that may block, suspend, or reverse resolution measures. All of that should apply equally to the resolution of SOBs and POBs.

Finally, KA 12 sets out mechanisms and principles to facilitate access to information and information sharing with the RA. Not all SOBs are subject to supervision–a situation that does not comply with international standards on bank supervision[17] —yet effective supervision is a prerequisite for resolution. As is the case for POBs, the members of a country's financial safety net—including supervisors and the RA—should have adequate mechanisms to exchange data on SOBs, to allow for proper crisis preparedness, an idea that should be boosted by acknowledgment of adherence to the KAs with respect to SOBs.

6.2. Considerations Pertaining to KAs 2, 7, 8, 9, 10, and 11

KA 2 recommends the creation of an independent RA with broad authority to carry out resolution. KA 2.3 lists certain objectives to be pursued by the RA such as maintaining financial stability, coordinating actions with deposit insurers, avoiding unnecessary destruction of value, and considering financial impacts in other jurisdictions. In practice, the resolution of SOBs inevitably brings questions about the criticality of some of the functions that SOBs carry out. Considerations about the criticality of functions also arise in the context of resolution of systemically important institutions.

The main challenge related to the application of this KA to SOBs is that state ownership of the institution to be resolved may create additional political pressures on the RA. However, this possibility only reinforces the need for independence of the RA, in line with the KAs. In that context, it is recommended that, in designing the governance of the RA, policy makers consider mechanisms to shelter it from undue pressure. One of these mechanisms could be, for example, placing the resolution powers within an independent central bank, whose senior managers have fixed mandates and cannot be dismissed at the will of the government.

KA 7 outlines principles that aim to facilitate cross-border cooperation and streamline resolution when stakeholders are members of more than one jurisdiction, spelling out a commitment to cooperative international regulation, as opposed to the nationalistic approach that once prevailed. These principles cover RA powers (KA 7.1), automatic action as a result of official intervention or the initiation of resolution or insolvency proceedings in another jurisdiction (KA 7.2), RA powers over local branches of foreign firms (KA 7.3), non-discrimination against creditors based on nationality (KA 7.4), recognition of foreign resolution measures (KA 7.5), and confidentiality (KA 7.6 and KA 7.7). In addition, in 2015 the FSB published its Principles for Cross-border *Effectiveness of Resolution Actions*, which complements KA 7, especially KA 7.5.

17. See the Basel Committee on Banking Supervision, "Basel Core Principles for Effective Bank Supervision," available at https://www.bis.org/publ/bcbs230.pdf.

KA 7 applies equally to SOBs and POBs; however, the way in which SOBs fall into international recognition frameworks depends in part on the legal regime of the failed SOB. In principle, if the SOB was incorporated under a private law regime (mercantile or commercial law), then it should fall within the concept of a merchant debtor under those frameworks. Yet the treatment applicable to statutory companies can be more stringent. Because of that, SOBs incorporated under public law may find it challenging to implement a reliable statutory recognition framework, especially in cases where a foreign decision is deemed to go against a nation's public order. The 2015 FSB Principles for Cross-border Effectiveness of Resolution Actions contain examples of statutory recognition frameworks deemed relevant for the application of the KAs.

KA 8 contains principles for home and host authorities to create crisis management groups (CMGs) to enhance preparedness and facilitate management and resolution of a cross-border financial crisis affecting the bank. KA 8 is focused on G-SIBs, but the 2021 FSB report titled *Good Practices for Crisis Management Groups (CMGs)*, which details and complements KA 8, clarifies that "some authorities have established CMGs for domestic systemically important banks (D-SIBs) that are not part of a G-SIB group and the practices described in this report may also be relevant to them."[18] Indeed, SOBs are often D-SIBs. Sometimes, this is so because of the SOB's size and interconnectedness at the domestic level, but other times SOBs become systemically relevant on failure—even if not necessarily so before—because their financial condition is assumed to signal something about the situation of the public sector's governance practices and overall financial position.

In internationally active SOBs, political factors and special legal regimes that affect SOB resolution also affect crisis preparedness. Indeed, it seems relevant that the RA of the home jurisdictions of such banks keep close contact with their peers in host countries, given that a failure can have impacts on host countries as well. However, some problems already highlighted in this note—political issues, economic nationalism, and the like—can be exacerbated when these failures have a cross-border dimension. Moreover, in situations where parliamentary approval is required to adopt certain resolution measures, it might be challenging to take actions to protect the foreign operations. One important task that CMGs of SOBs must address is adjusting the expectations of what the home authority can feasibly do and what type of challenges host countries can expect in case of resolution.

KA 9 deals with cross-border cooperation agreements involving G-SIBs, but political considerations related to SOBs may pose challenges to its implementation. As with KA 8, circumstances may suggest expanding the use of such agreements beyond G-SIBs; yet the public nature of SOBs can create a few additional hurdles in such agreements. For example, the principles of information sharing for resolution purposes laid out in Annex 1 to the KAs may clash with national restrictions on the disclosure of government information or even with national security laws to which SOBs may be bound, or they may constitute a political liability for the government.

KAs 10 and 11 deal, respectively, with resolvability assessments and RRP, and, like KA 8 and KA 9, focus primarily on G-SIBs. Nevertheless, their provisions are often assumed to apply to other banks as well, including D-SIBs and SOBs—two categories that often overlap, as previously explained.

KA 11.1 establishes that jurisdictions should require the preparation of recovery and resolution plans "at a minimum" for those institutions that could be systemically significant or critical if they fail. Many SOBs fall into this category and should accordingly be fully bound by KA 11. KA 11.2 determines that the requirement for RRP should apply to G-SIFIs and to "any other firm that its home authority assesses could have an impact on financial stability in the event of its failure." Nonetheless, many jurisdictions prepare recovery and resolution plans only for D-SIBs (as defined by the Basel Committee on Banking Supervision), which is a more restricted group than the KAs recommend.

There are many reasons in favor of extending the preparation of recovery and resolution plans to SOBs: First, the preparation of plans is a relatively inexpensive form of compliance that can generate high benefits because it can contribute greatly to orderly resolution, which is another way of saying that applying KA 11 can generate net benefits

18. FSB, "Good Practices for Crisis Management Groups (CMGs)" (Basel, Switzerland: Financial Standards Board, 2021), 4.

even in smaller SOBs. Second, because SOB intervention is exceptional and relatively rare, RRP with a well-planned approach can anticipate some of the difficult discussions that arise upon the distress and failure of the bank and increase the degree of formality of the recovery and resolution processes, also increasing the legitimacy of RRP and mitigating the risk of court challenges. Third, the experience of drafting plans can help generate awareness of risks within the SOB, potentially contributing to improving the bank's governance and risk management.

The preparation of recovery and resolution plans for SOBs can incorporate some of the important features that have been outlined and developed over the years for G-SIBs, potentially improving SOB governance. For example, a 2013 FSB report titled *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Recovery Triggers and Stress Scenarios* defines criteria for triggering senior management consideration of recovery actions. Having the bank formalize the triggers for recovery can be important in SOBs, as it limits the ability of senior management to conceal the true financial situation of the bank and postpone serious deliberation about entry into resolution.

Sometimes, the features laid out by the FSB may have to be interpreted so as to better apply to SOBs. For example, the concept of critical functions, mentioned throughout the KAs, may need a broader interpretation, to include not only functions vital for the functioning of the real economy, but also public functions such as providing banking and payment services in rural areas, financing strategic sectors, and even financing special segments of the population (such as minorities, as intended for some SOBs whose creation is currently being discussed in the United States).

This does not mean that the FSB report necessarily needs to be reworded to incorporate the critical functions that are typical of SOBs. The list of functions that could "exhibit some degree of criticality" is "not intended to be exhaustive,"[19] so critical functions that are typical of SOBs are not necessarily excluded from the report. As a practical consideration, when implementing this KA in SOBs, authorities should take a broader view of what they consider critical to encompass those functions whose sudden failure is expected to have "a material impact on the third parties."

Some of the operational challenges related to the continuity of critical functions may be more pronounced in SOBs. For example, SOBs structured as statutory corporations are viewed as an integral part of the government, and their cooperation with other government branches might be structured informally (making it difficult to map beforehand) or through legislation (making it inflexible). The general message therefore is the recovery and resolution plans for SOBs will probably end up somewhat different from those generally drafted for POBs.

Another important challenge relates to the implementation of KA 10, which deals with resolvability assessments, and specifically with KA 10.5, which prescribes that RAs should have the power to require a bank to remove barriers to resolution. These may include "changes to a firm's business practices, structure or organisation, to reduce the complexity and costliness of resolution" and "require[ing] that [critical] functions be segregated in legally and operationally independent entities that are shielded from group problems." Given the many challenges already pointed out in relation to SOBs, the effective exercise of these powers by an RA requires the removal of any obstacles of an administrative or political nature that would preclude the RA from making this type of determination about SOBs.

19. FSB, "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Identification of Critical Functions and Critical Shared Services" (Basel, Switzerland: Financial Standards Board, 2013), item 2.1(ii), 6.

Challenges to the Application of KA 3

KA 3 contains principles on the content of the RA's resolution powers as well as the timing of and conditions for their exercise. Two aspects discussed in KA 3 raise questions for SOB resolution. The first has to do with the specific limitations to implementing bail-ins, which are difficult to implement in any bank, let alone in SOBs. The second has to do with general limitations to the RA's powers and tools that follow from the government's controlling position in SOBs as well as the public mission of SOBs.

7.1. Bail-Ins May Be More Complex to Implement in SOBs Than in POBs

Bail-ins are the hallmark of the KAs. They were intended to resolve the problems that bailouts introduced—costs to taxpayers, moral hazard for banks, and lack of market discipline—and are now increasingly becoming part of resolution frameworks worldwide. The most noticeable examples of bail-in regimes can be found in the Orderly Liquidation Authority of the United States and the Bank Recovery and Resolution Directive (BRRD) of the European Union. The former was introduced in 2010 by the Dodd–Frank Act but has not yet been triggered and is of lesser relevance here, given the near absence of SOBs in the United States.

The BRRD, enacted in 2014, responds to episodes of bail-ins that took place in Europe in preceding years. In 2013, the EU and international organizations required the bail-in of uninsured depositors of the Cyprus Popular Bank and the Bank of Cyprus as a condition for disbursing a €10 billion bailout package. In 2015, in Greece, creditors of the Cooperative Bank of Peloponnese were bailed in following the wiping-out of shareholders and the transfer of deposits to the National Bank of Greece. Bail-ins were also implemented in 2014 with subordinated debtholders of Banco Espírito Santo in Portugal, also after its equity holders were wiped out.

Experience with bail-ins after implementation of the BRRD is limited. In 2015, when the BRRD was not in full effect in Europe but had already been adopted in Italy, bail-ins involved

equity holders and subordinated debtholders in Banca Marche, Banca Popolare dell'Etruria, Cassa di Risparmio di Ferrara, and Cassa di Risparmio della Provincia di Chieti. In 2017 Banco Popular was the first failing bank resolved under the BRRD with the adoption of bail-in.[20] In addition to bail-ins used within resolution, "burden-sharing" mechanisms applied to shares and subordinated debt were implemented in Banca Monte dei Paschi di Siena. None of these experiences with bail-ins involve SOBs, but they nonetheless serve as a benchmark or starting point for discussion of possible scenarios to be included in the implementation of the KAs in SOBs.

Bail-ins tend to be implemented in the context of transfer of control of the target bank, but transfers of control in SOBs are subject to additional legal hurdles, given that the public character of these banks is typically enshrined in legislation. If a bail-in were implemented in an SOB, its creditors would have to become shareholders (subject to the safeguard of "no creditor worse off than in liquidation") and all or part of the equity of the state entity controlling the bank could be wiped out, which could amount to a *de facto* privatization of the bank. Thus, a bail-in that causes a change of controlling shareholder can trigger the need for parliamentary authorization, where it will inevitably be analogized with a privatization and provoke political calculations. As mentioned in section 5, a potential solution is to include provisions in the resolution framework staying the need for legislative authorization once the PONV has been reached and an SOB is put under resolution, although passing such a provision may face political challenges.

Alternatives that can streamline the process, such as converting debt into non-voting stocks or writing off credits rather than converting them, are problematic. For one, if only part of the existing bonds is bailed in, the affected bondholders can question the transaction in court, as in 2015 when Portuguese authorities chose to bail-in only 5 out of 52 unsecured bonds owed by the Banco Espírito Santo. Moreover, issuing non-voting stocks to the creditors whose assets were bailed in is a solution that—if feasible would only work for banks that are not legally bound to be 100 percent state owned.

Moreover, the creation of non-voting stocks and write-offs may be challenged in court by disgruntled creditors contending that the bail-in failed the "no creditor worse off than in litigation" test. Furthermore, one of the goals of bail-ins is precisely that of changing the failed bank's corporate governance, all in the hope of avoiding the repetition of the problems that led to its demise. Thus, a bail-in without a change of control is in some sense incomplete. To deal with that in SOBs, a solution could be to pass a law permitting the SOB's change of control independently of parliamentary authorization in the specific case of bail-ins.[21]

As is the case for POBs, the successful implementation of bail-in in SOBs requires loss absorbency capacity. Bail-ins tend to be more useful in banks that have enough TLAC, or TLAC-like, instruments. In this sense, jurisdictions should consider extending their requirement of "resolution capital" also to their SOBs—preferably with contractual provisions establishing write-off in case of failure, to avoid issues related to the potential transfer of control.

A bail-in of private creditors of an SOB that does not result in losing control of the institution could be considered a "bailout" of the state by private creditors and trigger political backlash. Not all bail-ins of private creditors will result in SOB privatization or the state losing control, given that the state's share will not necessarily be diluted to less than 50 percent of the voting stock. This could also be the case when a mix of public and private creditors are bailed in, which could be perceived as using private creditors' funds to keep the institution afloat in public hands and could be politically unpopular. Because of that, it is preferable to bail-in private creditors in tandem with a transfer of control of the entity by wiping out first the capital of existing shareholders, including capital held by the state.

In contrast, forcing state bodies and parastatal organizations to acquire LAC of an SOB outside of market terms may put taxpayers' funds at risk in a manner similar to a bailout. The practice seen in some emerging markets and developing economies of forcing state bodies or parastatal organizations such as pension funds or social security funds to invest in LAC issued by SOBs outside of market terms

20. Banco Santander was authorized to acquire Spanish Banco Popular for €1, after the bank suffered massive deposit withdrawals during the preceding days. Not only did shareholders see their equity written off (€1.3 billion) but also holders of convertible contingent and subordinated bonds witnessed the value of their investment fall from more than €2 billion to zero. The restructured Banco Popular, a major SME lender and the fifth-largest bank in Spain, was able to open and operate normally on the day following the transaction.
21. The RA should also have the power to change the ownership structure of an institution if the institution cannot be effectively resolved under the current structure, whether through a bail-in or another resolution tool. This point has also been made in relation to resolution of cooperative banks. See, for example, Eva Gutiérrez, "The Reform of Italian Cooperative Banks: Discussion of Proposals" (IMF Working Paper 08/74, Washington, DC, 2008).

amounts to a misuse of taxpayers' funds to finance the SOB, in which it is very similar to a bailout. To avoid such misuse, jurisdictions must have measures in place to ensure that any liabilities of SOBs are issued at arms' length.

Experiences with bail-ins also help us advance a second conclusion concerning the implementation of the KAs in SOBs: bail-ins, especially of retail investors,[22] can be met with great resistance and even public outcry, and these effects will presumably also be strong in SOBs. Here, the Italian experience offers a telling example. The 2015 bail-ins in Banca Marche, Banca Popolare dell'Etruria, Cassa di Risparmio di Ferrara, and Cassa di Risparmio della Provincia di Chieti involved retail customers who anticipated having bought safe assets. These creditors then exerted great political opposition to the bail-ins. As a result, in 2016 the Italian government enacted a decree refunding such bondholders up to €100,000 (which is the same coverage offered by the deposit insurance scheme). Moreover, in the years that followed, Italian authorities often resorted to the BRRD permission to declare bail-ins not in the public interest when they threatened financial stability, critical functions, or the protection of depositors. In particular, because of an assessment by the Single Resolution Board, the liquidation of the Banca Popolare di Vicenza and the Veneto Banca in 2017 were carried out without bail-ins. The point is that the blend of political and economic concerns that discouraged bail-ins in these two cases can be assumed to come up as well when the failed banks in question are SOBs, probably with even greater strength. That assumption underlines the importance of requiring SOBs to maintain adequate LAC, following the TLAC standard, in a transparent manner, so as to mitigate the need to extend bail-ins beyond the instruments pre-assigned for that purpose.

Despite some criticisms, bail-ins have proved effective in preserving financial stability while reducing taxpayers' costs. It has been argued that bail-ins in one institution could create expectations for additional bail-ins in other banks, and these dynamics can ultimately undermine investor confidence, even in healthy banks.[23] But this is not always the case, as demonstrated by the case of Banco Espírito Santo in Portugal, where bail-in proved effective at limiting costs to taxpayers while preserving financial stability, with no short-term panic or contagion effects. Successful experiences can also be found in Slovenia, where in 2013 bail-ins involved subordinated bondholders and shareholders of several local banks, and in Spain, where in 2017 Banco Popular was resolved in accordance with the BRRD and without the use of public funds. Moreover, there are partial solutions to the cases where those fears exist. For example, in Indonesia bail-in powers can be used only when a statement of systemic crisis is issued. Another partial solution is to pre-establish in the law a limited range of credits that are amenable to bail-in. Yet, there is some evidence that the adoption of resolution measures has real effects on the economy through declines in credit provision,[24] although this may be due not to the implementation of resolution itself, but to a correction of the failed bank's underwriting practices after the replacement of managers.

In any case, bail-ins may be the only remedy available when the sovereign's fiscal position is weak and no other funding mechanisms are available for the resolution of an SOB. When the public purse is so heavily constrained, the alternatives accessible to regulators can become very limited. Aside from bail-ins, the only alternative might be defaults, but the experience in places such as Iceland in 2008 shows that defaults tend to be anything but orderly. National jurisdictions could also use some creative solutions to overcome the political barriers against bail-ins. For example, to avoid a full privatization, the state could hold a gold share with limited but important powers after the bail-in is consummated.

7.2. RAs' General Resolution Powers and Tools

One of the overarching goals of enacting the KAs is to empower RAs to make use of a range of powers and tools to deal with bank failures without having to negotiate or obtain consent of creditors and shareholders. In the interest of permitting effective resolution, protecting taxpayers, and curbing moral hazard, this lineup of powers and tools should be upheld to the fullest extent possible with respect to SOBs. When dealing with SOBs, these powers must be clearly stated in the legislation, and measures must be put in place to address opposing views between the RA and other

22. It should be noted that the KAs do not favor the bail-in of retail (insured) depositors, and the establishment of the TLAC standard aims at avoiding the conversion of the credits of retail investors into equity, but this is still a theoretical possibility in several jurisdictions.
23. Giovanni Dell'Ariccia et al., "Trade-offs in Bank Resolution" (IMF Staff Discussion Note 18/02, Washington, DC, 2018), 6.
24. *See* Thorsten Beck, Samuel Da-Rocha-Lopes, and Andre Silva, "Bank Bail-In: The Effects on Credit Supply and Real Economy," VOXEU column, May 27, 2017, http://voxeu.org/article/bank-bail-effects-credit-supply-and-real-economy.

areas of the government. This is typically done by ensuring that the RA has sufficient independence and legal protection, in line with the KAs.

Although KA 3.2(v) prescribes that the RA should have the ability to override rights of shareholders of the firm in resolution, in the case of SOBs parliamentary approval of transactions resulting in private ownership will often be needed. These include “requirements for approval by shareholders of particular transactions, in order to permit a merger, acquisition, sale of substantial business operations, recapitalisation or other measures to restructure and dispose of the firm’s business or its liabilities and assets.” As it turns out, for reasons that have to do with the lack of flexibility of the laws governing SOBs, most of these actions will still need parliamentary approval and enactment of new legislation.

To speed resolution, legal changes should be introduced to place resolution powers over SOB in the hands of the RA, eliminating the need for parliamentary approval in the context of resolution. One alternative would be to include in the resolution legislation a provision authorizing the government (for example, the minister in charge of the institution, prime minister, or president) to decide these matters independently of the Parliament. Another possibility would be to grant the RA the power to order that the legal form of the institution under resolution is changed to a joint stock corporation. This is the case in Germany, where the law also establishes that the change of legal form is possible only if the resolution measure could not otherwise be implemented successfully and if the change of legal form is not disproportionate. Yet another alternative is to push for more restrained interpretations of the legislation requiring parliamentary approvals. For example, the Brazilian Supreme Court has recently decided that the requirement for legislative authorization for the sale of a parent SOE does not necessarily trigger a need for legislative authorization when the SOE is selling subsidiaries. On the basis of that decision, one could imagine a situation in which the parent SOB remains under government control, but its relevant assets are de facto privatized within a broader resolution process without legislative authorization.

To be effective with respect to resolution of SOBs, the resolution law should also stay the exercise of early termination upon change in the SOB’s legal form or corporate structure. A focal point for jurisdictions seeking to comply with the KAs is to include in their resolution laws a provision to stay the exercise of early-termination rights that may be triggered upon entry of a firm into resolution, as set out under KA 3.2(x). Contracts signed by SOBs often contain early maturity clauses in case the bank should cease to be a part of the public sector. To mitigate this obstacle, and in addition to provisions to stay early-termination rights in accordance with KA 3.2(x), the resolution framework should authorize the RA to declare such types of early maturity clauses ineffective or to stay their application.

In the interest of enhancing resolution procedures, countries are well advised to have in place a deposit guarantee scheme (DGS) and to ensure that it covers POBs as well as SOBs. KA 3.2(xii) prescribes that the RA should have powers to transfer insured deposits—and presumably, the expectation is that a country will have in place some form of deposit guarantee scheme. This is indeed the case in many countries, even if only due to a recent development (Costa Rica, for example, introduced a DGS covering both POBs and SOBs in 2020 in the context of OECD accession).[25] However, and despite recommendations issued by the World Bank, the IMF and other international organizations, some countries have no deposit insurance scheme in place, and others do not cover SOBs.

The application of the KAs to SOBs at large starts with integrating every SOB within the country’s broader regulatory and supervision framework. Particularly problematic for implementing effective resolution are the unsupervised SOBs, which still exist in some jurisdictions. In unsupervised banks, failure can be met with only standard bankruptcy (which is often unsuitable and slow, as illustrated by the 2008 case of Lehman Brothers, among others), merger with other public institutions, or government recapitalizations. In addition, lack of supervision is per se incompatible with the KAs.

Application of bridge banks in resolution of SOBs may appear problematic from a conceptual point of view, given that both bridge banks and SOBs are controlled by the state. KA 3.2(vii) determines that RAs should have the power

25. It should be noted that Costa Rican SOBs also enjoy a broad and unlimited government guarantee, stated in the Organic Law of the National Banking System.

to create bridge banks, but those would be curious cases in a failure of an SOB. Bridge banks are typically created, owned, and operated by the government to absorb the critical functions of failed organizations for which the RA has not been able to find a suitable private acquirer in the short term. After the “good bank” is transferred to a bridge bank, the non-performing assets, or “bad bank,” is set for liquidation. As can be seen, in the case of an SOB the structure of a bridge bank would ultimately allow the government to continue owning the good assets that it already owned through the SOB, while getting rid of the bad assets.

Nonetheless, there is one important difference in the form in which those assets are owned by the government, in that an RA manages the bridge bank directly whereas an SOB tends to be controlled by a political entity such as the Ministry of Finance. The use of a bridge bank could make sense if the political entity that controls the SOB lacks banking expertise, which the RA has. This is particularly likely when dealing with local or regional SOBs. Moreover, the legislation must establish clear “sunset clauses” for bridge banks, which oblige the RA to either sell them or place them into liquidation within a determined time frame. These clauses are particularly important if a bridge bank is used to resolve an SOB. The use of an asset management vehicle (as set out under KA 3.2(viii)) would be subject to similar considerations, with the addition that the asset management vehicle can in theory be a private entity that in some cases and contexts, may have superior managerial capacity than either the political entity or the RA.

Implementation of KA 6

KA 6.1 prescribes that jurisdictions create policies to fund resolution in a manner that avoids having to resort to bailouts. The reduction of taxpayers' exposure is one of the guiding principles of the KA, and perhaps the most important one. With that in mind, it becomes clear that adherence to the rules and principles of the KAs in relation to funding the resolution of SOBs should at least start a conversation about change of control and privatization. Ideological debates aside, a common problem of searching for market solutions for a failed bank is that they may simply not be available. The reasons for that may be the lack of development of local financial markets (a common problem in emerging markets and developing economies), the existence of a macroeconomic downturn that leads to flight to quality and reduction in appetite for riskier projects, or low quality of the assets held by the failing SOB. In any of these scenarios, the government will be in the position of having to find alternative funding mechanisms to offer support for what is overall qualified as a market solution.

Whether a market solution is pursued or not, and whether the market solution counts on alternative funding arrangements, the existence of a sound regulatory framework tends to reduce the costs for the public purse. Two important tools for funding resolution are the existence of a resolution fund that can be tapped into during the crisis, and the existence of a DGS with a broad mandate that sets a ceiling to depositors' claims (mitigating the risk of litigation) and may be tapped to facilitate private solutions as a means to reduce the need to compensate depositors' claims (reducing the public outlays). The DGS should be funded by the banking industry and, importantly, it must cover SOBs, which is not always the case. Some jurisdictions also resort to resolution funds, in line with the KAs, but these are still rare and, as recommended by the IMF, resolution funds should be created only after a jurisdiction has a well-capitalized DGS.[26] Bail-in is another important source of funding (although in itself it helps little in injecting new funds into the institution). However, as already explained, regulation plays an important role in making sure that creditors—and especially the holders of instruments earmarked for bail-in—understand the risks they are subject to, or else their bail-ins will result in political disputes, as in the case in Italy. Regulation will also reduce taxpayers' exposure by forcing SOBs to maintain adequate levels of TLAC-like instruments and bank capitalization.

26. Oana Croitoru, Marc Dobler, and Johan Molin, "Resolution Funding: Who Pays When Financial Institutions Fail?" (IMF Technical Notes and Manuals, Washington, DC, 2018), 17.

Conclusion

Although some KAs will be little affected by the fact that a bank is state-owned, other KAs will require that certain legal or operational barriers are removed to ensure they can be applied effectively. Table 9.1 describes the main considerations for policy makers when addressing the applicability of each independent KA to SOBs.

Table 9.1 Considerations for Applicability of KAs to SOBs

KA	Description	Considerations in relation to SOBs
1	**Scope**	No difference between POBs and SOBs.
2	**Resolution authority**	SOBs pose additional concerns regarding the independence of the RA. Policy makers should strive to have mechanisms in place to protect the RA from undue political pressure often associated with SOBs.
3	**Resolution powers**	Two of the powers listed in KA 3 raise questions in case of SOB resolution: the first is the implementation of bail-ins, which can be constrained by legal impediments to change of control and meet other forms of opposition. The second relates to the power of the RA to override rights of shareholders of the firm in resolution, which also may face legal barriers, usually in the form of required parliamentary approval for any significant changes in a SOB structure.
4	**Set-off, netting, collateralization, segregation of client assets**	No difference between POBs and SOBs.

5	**Safeguards**	No difference between POBs and SOBs.
6	**Funding of firms in resolution**	Common sources of funding for resolution include the conversion or writing off of LAC instruments and financing from a resolution fund or deposit insurance fund. Policy makers should ensure that SOBs are subject to the same LAC requirements as POBs, and that SOBs participate in the deposit insurance and resolution funds.
7	**Legal framework conditions for cross-border cooperation**	This KA aims at facilitating cross-border cooperation and facilitating resolution of cross-border institutions. The legal regime of a failed SOB may interfere with cross-border recognition of resolution decisions, especially when arguments such as "public order" may be invoked. This situation requires close cooperation between authorities to develop realistic expectations about the implementation of cross-border resolution of SOBs.
8	**Crisis management groups**	Political issues and economic nationalism can be exacerbated when an SOB failure has a cross-border dimension. These issues need to be addressed and discussed in the CMG, so that member jurisdictions are aware of what to expect in case of resolution.
9	**Institution-specific cross-border cooperation agreements**	The public nature of SOBs can create hurdles in such agreements. For example, legislation may preclude authorities from exchanging information about SOBs with foreign authorities.
10	**Resolvability assessments**	Although the KA recommends that RAs have the power to order firms to change their business practices, structure, or organization so as to reduce their complexity in case of resolution, this may not always be feasible in SOBs that perform public-interest functions.
11	**Recovery and resolution planning**	The main challenge in preparing recovery and resolution plans for SOBs is the identification of critical functions. SOBs may have a broader mandate, performing "public functions" side by side with their commercial operations, and RAs need to consider these activities when mapping what needs to be continued in a resolution.
12	**Access to information and information sharing**	No difference between POBs and SOBs.

Source: World Bank compilation.
Note: CMG = crisis management group, LAC = loss-absorbing capacity, POB = privately owned bank, RA = resolution authority, SOB = state-owned bank.

In view of these particularities, it seems that when developing a policy to deal with crisis management of SOBs, the following aspects should be taken into consideration:

1. As in the case of POBs, the best scenario when an SOB faces crises is for its shareholder to increase its capital before the SOB reaches the PONV. When dealing with SOBs, recapitalization should be done at arms' length, under conditions that would likely be acceptable to a private investor under the same circumstances. Jurisdictions should not resort to forceful recapitalization by parastatal entities (such as pension funds or social security funds) as a means to provide funding to SOBs.
2. In situations where the state, as shareholder, is not able to prevent the SOB from reaching the PONV, the RA should be able to place the bank under resolution.
3. The KAs apply to the resolution of SOBs, although specific

circumstances and challenges must be dealt with.

4. The resolution framework should address and eliminate any special governance rules that apply to SOBs, sweeping away all the privileges and costs that create asymmetries between POBs and SOBs, including governance rights (for example, board appointments by the President or civil society).
5. Lack of legal flexibility, and legislation requiring parliamentary approval before transferring the control of an SOB or disposing of certain of its assets can be major obstacles to the effective resolution of an SOB, and the resolution framework should eliminate them. Where complete elimination is not feasible, a second-best solution would be to include in the resolution legislation authorization for the government to decide these matters independently of the Parliament.
6. Most SOBs develop functions that go beyond a purely commercial mandate, and an effective resolution strategy should foresee mechanisms for the continuity of such functions, provided that they are sustainable (otherwise, jurisdictions should transfer them to adequate government organizations funded by the state budget).
7. Given national interests associated with SOBs, special attention must be paid to cross-border arrangements for those SOBs that operate internationally, especially those related to recognition of decisions by a foreign RA.
8. Jurisdictions should extend the requirements for RRP and resolvability assessments to SOBs, although many RAs may find it challenging to decide on the removal of certain barriers to resolution, especially when these involve politically sensitive issues.
9. The implementation of bail-in in SOBs presents additional barriers related to the dilution of the public shareholder.
10. SOBs should be subject to LAC requirements similar to those of POBs, provided that in SOBs these should ideally have contractual provisions establishing their write-off in case of resolution, thus avoiding issues related to transfer of control. Moreover, government bodies and parastatal organizations should invest in such instruments only in arms' length conditions and in an adequately diversified manner.
11. In addition to the temporary stays set forth in KA 3.2(x), the resolution framework of SOBs should also contain provisions to stay early-termination clauses associated with the SOB's control structure.
12. Bridge banks in the resolution of SOBs should be used with caution and not as a mechanism to rid the SOB of its bad assets, to the detriment of its creditors, while keeping the good bank in the state's hands.
13. SOBs should contribute to and be covered by deposit insurance funds and—where they exist–resolution funds, alongside POBs, as these can be reliable sources of funding for resolution.

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