30 years 1982-2012 IIF
Institute of International Finance

MAKING RESOLUTION ROBUST—
COMPLETING THE LEGAL AND INSTITUTIONAL FRAMEWORKS FOR EFFECTIVE CROSS-BORDER RESOLUTION OF FINANCIAL INSTITUTIONS

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PREFACE

THE FINANCIAL CRISIS HIGHLIGHTED THE IMPORTANCE OF A RAPID AND ORDERLY RESOLUTION REGIME TO STOP CONTAGION OF BANK FAILURE AND PRESERVE GLOBAL FINANCIAL STABILITY. THE INDUSTRY AND THE PUBLIC SECTOR AGREE THAT TODAY GLOBAL–SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (SIFIS) MUST BE ABLE, AT ANY GIVEN TIME, TO EXIT THE MARKET IN AN ORDERLY FASHION WITHOUT CAUSING SYSTEMIC DAMAGE AND WITHOUT USING TAXPAYERS' MONIES. SINCE 2010, THE IIF HAS CONSTANTLY ADVOCATED THAT SHAREHOLDERS AND BONDHOLDERS – AND ULTIMATELY THE INDUSTRY THROUGH DEPOSIT–INSURANCE FUNDS IF NEED BE – SHOULD BEAR THAT BURDEN.

The Financial Stability Board's (FSB) work at the international level is promising given the publication last year of the FSB Key Attributes of Effective Resolution Regimes (Key Attributes). Adopted by the G20, it should serve as a point of reference for reform of every national resolution regime. This standard gives resolution authorities an essential suite of resolution tools. Equally importantly, the Key Attributes aims for a true harmonization of resolution regimes across markets. However, the document does not go far enough. The Key Attributes addresses essential issues of scope and powers of resolution authorities, encourage cooperation among them, and provide guidance for resolution planning and resolvability assessment; but they do not include a clean approach to obligate national authorities to cooperate with each other.

In previous publications, the IIF has proposed ideas for orderly bank resolution that have contributed to the public debate. In May 2010, we discussed a global approach to resolving a financial firm across border and a report published in May 2011, emphasized priority issues in cross–border resolution, including bail–in techniques to reduce loss of value in failing firms, resolution planning, resolution mechanisms; and cross–border issues. In many ways, our thinking is congruent with that of the FSB Key Attributes.

The present report builds on the IIF prior work and the work undertaken at the international level. It supports full adoption of the Key Attributes in major jurisdictions and suggests means to address the crossborder issues of resolving Global SIFIs. It addresses many issues that would be faced during resolution of an international group based upon three main principles: resolving a firm while respecting its group structure, leaving creditors no worse off than in liquidation and ensuring consistent treatment of transactional claims (derivatives and other "financial contracts"), including appropriate respect for netting and collateral rights, subject to safeguards to avoid destruction of value. In doing so, it proposes that the ultimate goal might be an international convention, such as it exists for non–financial insolvencies, while recognizing that the tools exist today to carry out a cross–border resolution.

To achieve a common framework for cross–border resolution, common standards or at least mutual recognition by national resolution authorities of each others' actions will be an essential part of the harmonization process of resolution around the world. The current bilateral administrative agreements and the crisis management groups suggested by the Key Attributes is a good step but national authorities need to take a step further to adopt global outcomes more detailed and more formal international understandings.

The IIF stands ready to help achieving this outcome, which is a necessary as well as realistic approach.

This report suggests essential elements to achieve an effective and credible resolution framework for SIFIs that ought to eliminate any costs associated with the failure of banks to taxpayers' contributions. The IIF is pleased to present this report as a global industry contribution and will continue to advance toward a true international bank resolution regime in order to help ensure that SIFIs can exit the market in an orderly manner without costs born by the taxpayers.

Finally the Steering Committee on Effective Regulation chaired by Peter Sands, and the IIF Board of Directors thank the many members and collaborators who contributed time and knowledge to developing this report through the efforts of a task force chaired by Simon Gleeson of Clifford Chance, under the aegis of the Cross–Border Resolution Working Group under the chairmanship of Urs Rohner, Chairman of Credit Suisse and a member of the IIF Board.

Josef Ackermann
Chairman of the IIF Board
Chairman of the Management Board
and the Group Executive Committee
Deutsche Bank

Peter Sands
Chair, IIF Special Committee on Effective Regulation
Group Chief Executive
Standard Chartered PLC

Charles Dallara
Managing Director
Institute of International Finance

Urs Rohner
Chairman of the IIF Cross-Border Resolution Working Group
Chairman of the Board of Directors of Credit Suisse Group AG

MESSAGE FROM THE CHAIRMAN OF THE IIF CROSS-BORDER RESOLUTION WORKING GROUP

THE QUESTION OF HOW TO RESOLVE INTERNATIONALLY ACTIVE BANKS IS ONE OF, IF NOT THE MOST IMPORTANT CHALLENGE FACING POLICY MAKERS AND REGULATORS TODAY. BY BRINGING TOGETHER EXPERTS FROM A LARGE NUMBER OF ITS MEMBERS (INCLUDING REPRESENTATIVES FROM BANKS, INVESTORS, AND LAW FIRMS), THE INSTITUTE OF INTERNATIONAL FINANCE (IIF) HAS DEVOTED SIGNIFICANT EFFORTS AND RESOURCES TOWARD DEVELOPING SPECIFIC SUGGESTIONS ON HOW TO MAKE CROSS–BORDER RESOLUTION WORK IN PRACTICE.

Without seeking to diminish the complexity and challenges that such a scenario unquestionably presents, our paper and the model Convention it contains are testament to our conviction that internationally active banks can indeed be resolved effectively. Accordingly, policy responses that envisage radical measures such as size limitations, the mandatory break-up of banks, national ring-fencing, and the like should be regarded as unnecessary and disproportionate. Such measures are likely to give rise to unintended consequences and should therefore be avoided, not least in view of the constraints such measures would inevitably place on the freedom of banks to determine their own business model.

With this report on cross-border resolution, the IIF has once again underscored its willingness to play a constructive role in the current international regulatory discussion. Clearly, more work is needed in this area, and we look forward to working with the relevant policy makers and regulators to develop our ideas further.

I would like to thank all of my fellow Cross-Border Resolution Working Group members as well as in particular Simon Gleeson of Clifford Chance and all of the IIF staff involved for their outstanding work and commitment to this important issue, and I look forward to constructive discussions in the weeks and months to come.

Urs Rohner
Chairman of the IIF Cross-Border Resolution Working Group

Chairman of the Board of Directors of Credit Suisse Group AG

MESSAGE FROM THE CHAIRMAN OF THE IIF TASK FORCE ON CROSS-BORDER RESOLUTION

BANKS ARE FUNDAMENTALLY DIFFERENT FROM OTHER BUSINESSES. A MANUFACTURING COMPANY HAS A PLANT FINANCED BY A BALANCE SHEET—WITH A LITTLE LUBRICATION, THE PLANT CAN CONTINUE IN OPERATION WHILE THE BALANCE SHEET IS RESTRUCTURED, AND DISORDERLY DEFAULT CAN BE AVOIDED.

For a bank, the balance sheet is the plant—there is no breathing space between the failure of the balance sheet and the cessation of the business. This interdependence is, of course, why banks are so prone to "runs". Without a workable resolution mechanism, creditors see no alternative to disorderly default which, of course, maximises losses. In this respect banks are unlike any other type of business, and it is for this reason that banks require a unique approach to managing their crises.

Banks are as important to the commercial system as electricity companies are to the power system. However, whereas it is possible to keep the lights on and the power running while an electricity company is financially restructured, in order to do the same with a bank what is needed is a resolution structure. Without this, the impact on the real economy of a bank financial failure is potentially as great as the risk of a sudden interruption to the power system. Economies can survive with disrupted systems, and such damage can always eventually be repaired. However, the immediate damage to GDP, and therefore jobs, wages, and employment, is both significant and, where avoidable, unacceptable.

Consequently, the primary public objective, which is shared by governments and the industry, is to ensure as far as possible that the prospects of such disruption are minimised, and the real loss to the economy resulting from such disruption is minimised. This is why we believe that the development of an effective global resolution regime is the most important aspect of the post-crisis policy agenda.

S. Gleeson

Simon Gleeson

Chairman of the IIF Task Force on Cross-Border Resolution

Partner, Clifford Chance

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EXECUTIVE SUMMARY

CROSS-BORDER RESOLUTION

The IIF strongly supports full adoption of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB Key Attributes or Key Attributes)[1] by the G20 as international standards and their incorporation within the legal systems of all relevant nations for resolution of major bank groups.[2] The conclusions of the Key Attributes are broadly congruent with those of the Institute's prior reports on resolution, aiming to make possible the orderly resolution of a cross–border group with minimum market disruption and without recourse to taxpayer funds.[3]

However, it is important to emphasize that harmonization of national laws and the creation of an agreed toolkit of measures—the focus of the Key Attributes—does not fully address the cross–border issues of resolving internationally active Systemically Important Financial Institutions (SIFIs). SIFIs have been charged by governments with producing, and are producing, Recovery and Resolution Plans (RRPs) to identify how they could be effectively resolved in a crisis. However, what this work has demonstrated is that the most important condition for the effective resolution of a SIFI is that national regulators act collectively in a coordinated and predictable way.

While the institution–specific agreements among regulators that are contemplated by the Key Attributes are a good interim measure, especially given that, for many groups, only two to four major jurisdictions can cover the bulk of group assets, in the long run something more comprehensive and substantial is needed. Similarly, the Crisis Management Groups of regulators and resolution authorities being organized for specific groups can create a good deal of trust and confidence among those likely to be directly involved in resolution. However, they will not necessarily be able to resolve all the ambiguities and questions arising in a cross–border context.

It is of the utmost importance that the processes and decisions of the Crisis Management Groups are coordinated in order that the resolution process is rapid and effective. The legal issues identified in this report need clear, well–established and permanent solutions.

This report suggests an international Convention (the Convention; along the lines of the draft set out as Annex I; see Annex II for specific group structures) as a mechanism for establishing such coordination. There are existing precedents for such Conventions—notably the United Nations Commission on International Trade Law (UNCITRAL) model law on cross–border insolvency Convention[4]—which have obtained broad acceptance among states, and if it is possible to achieve such consensus on international cooperation in general insolvency, it should not be impossible to achieve consensus required regarding bank restructuring, given the solid foundation represented by the Key Attributes.

We understand that previous proposals along these lines have been greeted by a concern that any Convention on bank resolution would necessarily have to address the issue of the commitments of contracting states to bail out financial institutions. We absolutely disagree with this position. The Convention we envisage is an agreement on a set of technical procedures relating to the conduct of a cross–border resolution. These procedures impose no financial commitment on any state and impose no potential burden of support.

Although we recommend a Convention, we believe that the mechanism is less important than the outcome, and whether the Convention route is adopted or not, we believe that it is essential that resolution authorities act to increase the levels of certainty as to the potential outcome of a SIFI resolution. Given the growing focus in some countries on "single–point–of–entry" solutions (i.e., resolution of the top company

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1 Financial Stability Board, Key Attributes Of Effective Resolution Regimes For Financial Institutions, (November 2011), available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf

2 The Key Attributes say relatively little about insurance resolution. This report focuses exclusively on cross–border resolution of bank groups. The very different issues involved in resolution of insurance groups must be addressed separately by the authorities and are being examined separately by the Institute.

3 Institute Of International Finance, A Global Approach To Resolving Failing Financial Firms: An Industry Perspective, pp. 16–18 (May 2010); Institute Of International Finance, Addressing Priority Issues In Cross-Border Resolution, p. 14 (May 2011), available at http://www.iif.com/regulatory/reports/.

4 United Nations Commission on International Trade Law, 1997—UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment, available online at http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html.

of a group or subgroup, possibly leaving subsidiaries on a going–concern basis without bringing them formally into the proceedings), it may in some cases be possible to resolve a group (or perhaps a sub–group) in a single–country proceeding.[5] However, to cover all eventualities (including potentially the reaction of host–country authorities to a home–country proceeding), an international understanding on the lines of the Convention would be very helpful to the comprehension of the process by all concerned.

The importance of predictability in resolution means that it is likely to be necessary to publish some information regarding the structure and effect of the resolution plan. Any publication should be in consultation with the institution concerned, and publication should not involve individualized, firm–specific information.[6] Predictability is one principal requirement of the international investor community, as explained in the discussion of investors' perspective set out as Annex III. There is a growing sense in both the financial services industry and among institutional investors that the international debate on bank capital and resolution has tended to overlook the needs and concerns of such investors. It is important that the appropriate focus on eliminating exposures of taxpayers to bailouts not eclipse the need to consider the interests of financial investors, which largely represent the broad interests of society through pension and insurance funds. Once taxpayer exposure is eliminated, the resolution authorities should have a clear mandate to maximize economic recovery value for these investors in a well defined way. What those investors need to continue to put their money into the industry—which in turn is essential to its ability to finance the real economy—is reasonable predictability and fair treatment of the risks and exposures of their equity or debt investments (especially unsecured debt investments).

COMPETING PRIORITIES

There is also the potential for divergence of views between resolution authorities as to the priority to be given to the competing requirements of minimizing losses the deposit guarantee funds and uninsured creditors and to preserving the performance of critical functions, which is important to cross–border financial stability. In the course of creating institution–specific resolution plans, resolution authorities should ensure that in this area they are particularly careful to discuss their policy priorities and to ensure that they are aligned.

We have not addressed issues of burden–sharing between national governments in this report. At its simplest, that is explained by the primary objective of the report. If we are satisfied (as we are) that it can be made possible to resolve the largest global SIFIs without recourse to taxpayers' money (because the resolution toolkit available to the authorities would provide the means to avoid losses to the public sector),[7] then issues of burden–sharing become redundant—there is no burden to share. Similarly, if resolution authorities are satisfied that resolution is possible they should equally be satisfied that there should be no necessity of government bailout. We believe that it is important that issues relating to the commitment of taxpayer funds should remain in the absolute discretion of governments (within applicable statutory constraints) and therefore entirely outside the resolution dialogue.

LEGAL ISSUES IN RESOLUTION

Resolution is, at its simplest, a technique whereby the losses of a non–viable entity are met by writing down its debts until its assets exceed its liabilities. All insolvency operates by sharing out losses among creditors; the primary difference between resolution and insolvency is that resolution may provide for a rapid write–down sufficient to restore the business of the institution to solvency and therefore to continue as a going concern.[8] Bail–in within resolution offers a means for rapid recapitalization of a group, in whole or in part, that avoids unnecessary destruction of value in the firm, avoids fire–sales of assets that disrupt markets and offers a possible means to recover value for bailed–in creditors whose investments might otherwise be lost altogether in liquidation. The conversion of certain liabilities into equity can be executed either through direct conversions ordered by the resolution authority

5. See Federal Insurance Deposit Corporation, Advisory Committee On Systemic Resolution, Office Of Complex Financial Institutions Dodd–Frank Act Title Ii Resolution Strategy Overview (January 2012); see comment Letter from Securities Industry and Financial Markets Association (SIFMA) & Clearing House Association, to Federal Deposit Insurance Corporation (FDIC) on FDIC's Second Notice of Proposed Rulemaking Under Title II of the Dodd–Frank Act (May 23, 2011) available at http://www.fdic.gov/regulations/laws/federal/2011/11c16Ad73.PDF

6. Note that, for the most part, this report addresses resolution planning, which is to say planning for the eventuality that a group gets to the point that it is at or very nearly at the point of insolvency and so must be resolved in accordance with the Key Attributes. It generally does not address recovery plans that firms are also developing with their supervisors, which are intended to help them avoid getting to the point at which resolution is necessary.

7 See IIF, supra note 3 ¶ 180.

8 There are also non–statutory techniques to recapitalize an institution in distress. These operate via the terms of a private instrument (contingent capital or co–cos) rather than by a broad statutory power. The contractual approach targets a similar objective, while avoiding some of the other complexities of resolution (e.g, cross–default issues, management changes), although many issues are similar (e.g, choice of trigger event, market behavior implications). Most issues of co–cos thus far have been "high–trigger" or going–concern instruments rather than resolution phase instruments. Several jurisdictions (notably Switzerland) have incorporated them into their banking frameworks, and the Basel III accord requires that all non–equity capital instruments have some features of contingent capital going forward. High–trigger co–cos are not addressed in this report.

or through certain bridge bank techniques (such as those granted to the FDIC by the Dodd–Frank Act).[9] The end result is a reduction in a firm's liabilities and a concomitant increase in its equity—a recapitalization without the use of government capital.

The FSB *Key Attributes* recommend broad adoption by major economies of "bail–in within resolution"[10] —in other words, bail–in techniques that would be applied only once recovery strategies have failed. We agree with this recommendation—bail–in should not permit a failing institution to continue in business without entering formal resolution. However, as further discussed in this report, bail–in within resolution should project whole–group (or "highest point–of–entry") resolution in which that approach offers the greatest promise of preservation of value and avoidance of systemic disruption. Approaches which preserve the unity of operating businesses should always be preferred to approaches that would require the disruption of the activities of the group.

This discussion builds on the fruitful and growing body of international thought on resolution issues since the crisis. The FSB *Key Attributes* were endorsed by the G20 leaders in late 2011.[11] A broad–ranging statement that has extensively influenced thinking was the European Commission's Working Document, "*Technical Details of a Possible EU Framework for Bank Recovery and Resolution*,"[12] which proposes extending national resolution regimes to include a "debt write–down tool" capable of being used to write down specified senior and subordinated obligations of a bank or bank holding company and suggests two alternative frameworks under which a broader or narrower class of senior debt would be exposed to losses.

The discussion has recently been followed up by DG Internal Market's "*Discussion Paper On The Debt Write-Down Tool—Bail-In*".[13] Finally, the Dodd–Frank Act in the United States includes an Orderly Liquidation Authority (OLA) for bank holding companies and other non–bank financial firms, based on the long experience of the Federal Deposit Insurance Corporation (FDIC) at resolving individual banks, which in turn has engendered a rich seam of thought on resolution issues.[14]

For this purpose it is important to distinguish "bail–in within resolution" of senior creditors, which is a statutory resolution technique to be applied only where an institution is in resolution, from the conversion or write–down of equity and capital instruments. Such conversion or write–down is based on contractual provisions and should have been completed before any bail–in is carried out. A further distinction needs to be made between traditionally subordinated claims and obligations under contingent convertible (co–co) bonds,[15] which will in some cases be subject to conversion or write–down on a "high–trigger" basis well before the resolution stage is reached. It is also important to stress that secured creditors must in all cases be given the full benefit of their security interests in pledged collateral.

Bail–in within resolution is generally assumed to be an arrangement in respect of senior creditors. However, it is important to emphasize that it does not follow that all institutions must be compelled to maintain a certain proportion of senior creditors in order to be resolvable. The relative absence of unsecured senior debt is not a barrier to resolution of primarily deposit–funded institutions, although the modalities of funding the resolution of such institutions are still being debated at the international level.

In the United States, the deposit insurance fund has long been used to facilitate various modes of resolution of smaller banks. In Europe, the concept of *bail-in of the resolution fund* has recently been launched. Usage of such funds generally implies mutualization of the risk across the industry through the fund, which in turn must be considered carefully for its systemic implications. However, it is important to note that deposit protection funds should only be employed where their employment would result in a lower cost to the contributories than would be the case under a formal default – thus "bailing–in the deposit protection fund" should result in lower costs being incurred by the contributories to the fund than would otherwise be the

9 See SIFMA & Clearing House Association, *supra* note 5.

10 See FSB, *supra* note 1, Key Attributes 3.2 (ix).

11 See FSB, *supra* note 1; *see also* FSB Press Release "FSB issues International Standard for Resolution Regimes" (4 November 2011) available at http://www.financialstabilityboard.org/press/pr_111104dd.pdf; for a good overview of related issues, see Board Of Governors Of The Federal Reserve System, *Study On International Coordination Relating To Bankruptcy Process For Non-Bank Financial Institutions* (July 2011); European Central Bank, *Crisis Management and Bank Resolution -Quo vadis, Europe?*, Legal Working Paper Series No 13, p. 43 (December 2011)

12 DG Internal Market And Services, Working Document, *Technical Details Of A Possible Eu Framework For Bank Recovery and Resolution* available at http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

13 DG Internal Market, *Discussion Paper On The Debt Write-Down Tool – Bail-In*, available at http://ec.europa.eu/internal_market/bank/docs/crisis–management/discussion_paper_bail_in_en.pdf.

14 Dodd–Frank § 210 and seq.; Guynn, Randall D., "Are Bailouts Inevitable?" (01 March, 2012). *Yale Journal on Regulation*, Vol. 29, No. 121, p. 143; Gleeson Simon, & Bates Christopher, *Bank Resolution and Bail-ins in the Context of Bank Groups* (December 2011), available at http://www.cliffordchance.com/publicationviews/publications/2011/12/bank_resolution_andbail–insinthecontexto.html.

15 See FDIC, *supra* note 5 ad note 8.

case. Experience shows that such issues can be resolved effectively. By contrast, we have seen no argument that the serious distortion of business and funding models that would result from compelling deposit–funded banks to raise wholesale debt for the sole purpose of bail–in would be justified. Provided that it is possible to "bail–in the deposit protection fund" the absence of unsecured senior creditors is not a barrier to resolution of a deposit–funded institution.

LEGAL ISSUES IN GROUP RESOLUTION

In applying resolution techniques at the group level, it is essential to remember that bank groups differ significantly between themselves. This is partly why it is impossible to prescribe a single resolution model that will fit all SIFIs—each group is the result of different pressures, regulatory obligations, and client requirements. In particular, although some banking groups are organized as integrated economic undertakings, others are organized in a decentralized way around stand–alone subsidiaries.

(a) Integrated groups operate integrated financial, technical and business structures that have been structured to serve specific client and business segments and to achieve efficiencies in doing so. They must be dealt with both in normal "going–concern" phases and in any eventual resolution on a fully integrated group–wide basis.

(b) A typical decentralized group is more likely to focus on retail business, rely on domestic funding through domestic currency deposits, and be supervised by the host supervisor (without prejudice of the responsibility of home supervisor over the consolidated group). Transactions between different parts of a decentralized group (including intra–group support) are likely to take place on an arm's–length basis, and depositors providing funding will be protected by local deposit insurance schemes. In a decentralized structure particular group members may fail without affecting other parts of the group.

Where a group is structured on a decentralized basis, resolution authorities should analyze the resolvability implications of the parts of the group under their control consistently with the group's decentralized structure. Provided that the resolution structure reflects the architecture of the relevant group, cross–border resolution entails lower complexity under the latter model, hence the concentration of most of the report on the centralized model. Conversely, even in highly integrated groups, there will usually be certain legal entities that have been established for the expressed purpose of enabling their creditors to remain in bankruptcy remote from the group as a whole. Thus, even highly centralized groups will have decentralized components. Such arrangements should be respected.

Another distinction between groups is that some groups arrange their business such that liquidity is administered on a pooled basis through a central treasury function. The central treasury is often an important transmission mechanism for liquidity within a group. Liquidity experts and legal practitioners have reported that, in the overall discussion of resolution regimes, too little emphasis has been put on liquidity issues, which are often eclipsed by balance sheet restructuring. More attention is therefore needed to going–concern liquidity in group structures for planning purposes as well as in the specific conditions of an actual resolution (discussed further under "Liquidity In Resolution" section below).

The Institute has expressed concern that Basel III regulatory changes relating to the supervision of liquidity as currently proposed make such arrangements more difficult, creating "trapped pools of liquidity" that may make it more difficult to avoid insolvencies and to manage international stressed markets. However, it is important that resolution plans for these centralized institutions consider and address access to liquidity across the relevant group in a recovery situation and also carefully examine the sources of liquidity. The resolution planning process should not automatically militate against such pooled treasury management. The recent Joint Forum "Report On Intra-Group Support Measures"[16] made clear that group guarantees, intra–group financing, and other pooling arrangements are not in many cases a barrier to resolution. In each case the arrangement needs to be evaluated by the resolution bodies concerned in accordance with the business model of each banking entity. On the other hand, of course, the funding structures put in place for decentralized groups should also be respected, and there should be no arbitrary imposition of group funding in which the funding structure has been designed to operate on a localized or subgroup basis.

Because SIFIs are multi–jurisdictional, the necessity for coordination of the exercise of legal powers in a SIFI resolution is a separate issue from the importance of predictable coordination. Because governments and resolution authorities are national, no single

16 See The Joint Forum (Basel Committee On Banking Supervision; Bank For International Settlements; International Organization Of Securities Commissions; International Association Of Insurance Supervisors): Report On Intra-Group Support Measures (February 2012), available at http://www.bis.org/publ/joint28.pdf

resolution authority will have the comprehensive legal authority to resolve an internationally active SIFI. Debt write–downs, stays, suspension of cross–default provisions, and branch resolution issues are all likely to involve multiple legal systems, and in practice legal effectiveness will be achieved only if resolution authorities are prepared to exercise powers under national law in pursuit of a commonly agreed resolution strategy.[17] In particular, international standards should be established for dealing with critical issues such as suspension of cross–default provisions in contracts with group members, including unregulated entities in third–country jurisdictions. In the absence of such a regime and its enforceability in relevant jurisdictions, whole–bank resolutions, or bail–ins—which may often be the best vehicles to achieve the overall FSB resolution goals—may not be possible for certain types of SIFIs.

Bail–in techniques, when applied, should closely follow the expectations of creditors on insolvency. However, we would emphasize two key points. First, where a group has made arrangements in which capital can be transferred easily and without restrictions within the group, that should be recognized as part of the resolution procedure. Second, where a group has been structured in order to create ring–fenced components within it, that should also be recognized as part of the resolution procedure.

CREDITOR PROTECTION IN RESOLUTION

In practice it will be possible for resolution authorities to exercise their powers in this way only if they are satisfied that there is a common, agreed standard for creditor protection across all resolution systems—that is, that acting in support of a foreign resolution authority does not risk leaving their domestic creditors in a worse position than they would be in were the positions reversed. We believe that this can be achieved by the establishment of a “No Creditor Worse Off Than in Liquidation” (NCWOL) standard, which should be agreed by resolution authorities and states as representing the benchmark against which the fairness of resolution outcomes can be measured.

Any resolution outcome that satisfies the NCWOL for all senior creditors of a group should be regarded as meriting the active cooperation of all relevant resolution authorities. Only by ensuring that all claimants against a failing group will be treated consistently and fairly can the authorities coordinate and cooperate to avoid the problems of unequal outcomes, blockages of assets by ring–fencing in different markets, delays that increase value destruction, and disruption of the global financial system such as the world saw with Lehman Brothers.

Predictability

Because SIFI resolution largely displaces traditional insolvency as the likely outcome of failure of a SIFI, it is essential from the perspective of investors, creditors, regulators and governments that the likely course of the resolution of each particular SIFI should be predictable. Predictability is essential to attract the necessary level of investment to the financial sector to enable it to play its essential function in the real economy:[18]

(a) Predictability involves a reasonable degree of clarity as to which instruments may be affected by resolution and in what order. In this regard, it should be noted that attempts to treat differently in resolution creditors who would otherwise rank equally in an insolvency are unlikely to contribute to predictability unless investors can be very clear which creditors will be treated in which way.

(b) In general RRPs must remain confidential, from the public sector side in order to maintain freedom of maneuver and from the private side because of the amount of confidential business information contained in them. However, thought should be given to the production of some common form of public pronouncement, perhaps providing the relevant resolution authorities, to be used to disclose the broad outline of the direction that resolution would take for the relevant entity (particularly structural issues). SIFIs should be able to use such pronouncements to satisfy their disclosure obligations as regards offerings of securities, and to rely on such public documents in developing their own RRPs.

One of the most important issues for investors—in particular for holders of securities or senior debt obligations that are at risk of being “bailed–in”—is the likelihood of resolution being commenced at some point earlier than the onset of formal insolvency. It is clear that in this respect it is possible for those charged with determining the appropriate time for the commencement of resolution activity (whether these are the resolution authorities, the supervisory authorities, or administrative authorities) to be potentially subject to pressure to act too early, and measures should be implemented to protect such authorities from such

17 See *infra* Chapter 1, Section 5.
18 See *infra* the discussion of investors’ perspectives in Annex III.

pressures. In this regard the FSB's Key Attribute 3.1, which states that "[r]esolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so," should be the internationally accepted touchstone.

This standard is similar to that already adopted in certain countries, but it will be important for the creation of confident expectations in the management of resolutions across borders that it be widely adopted. It is to be hoped that the FSB will succeed in inducing national authorities to adopt such standards, and such standard should be an important feature of a future Convention on cross–border bank resolution. A Convention along the lines of the proposed draft could help reinforce this point.

No Creditor Worse Off Than in Liquidation

Respect for traditional creditor hierarchies is essential to meeting market expectations and to providing assurances of basic fairness. In particular, any risk that creditor hierarchies will not be respected makes the task of private funding providers in assessing the risk inherent in bank securities almost impossible. Furthermore, fair resolution of a cross-border group implies that all creditors similarly situated be treated similarly, with no discrimination against creditors in one part of the group or another on the basis of nationality or of the booking office of their claims. Anomalous results, such as those seen in the Lehman Brothers' case as a result of attempting to apply traditional, national insolvency procedures, must be avoided.

A rigid and excessively academic approach to creditor hierarchies sometimes serves as an argument for the ring–fencing of assets and claims in national jurisdictions. This is so value–destructive and unfair to claimants from a group–wide basis. Many of the issues that arise in resolution can be resolved by the application of the NCWOL test, as defined earlier.[19] This test is capable of being applied in group situations as well as to individual entities and in general has the effect of ensuring that the outcome of the coordinated resolution process is that all group creditors of equal rank are better off than they would otherwise have been. To illustrate, assume a resolution result in which the shareholders are wiped out, subordinated debt holders are wiped out, the security interests of secured creditors are respected, and the senior debt participates in the resolution of the estate on a NCWOL basis.

(a) The hypothetical "liquidation" against which the resolution regime would be tested is not necessarily a universal liquidation—many jurisdictions currently have the ability to liquidate national branches as if they were stand–alone entities, and although we expect that over time these jurisdictions will move to a universalist model, the possibility of local liquidation, if it is permitted by local law, cannot be disregarded.[20] In such jurisdictions the NCWOL test must ensure that the creditors are as least as well off as they would have been under the liquidation regime, which would have given the better of the available outcomes. While it would be better not to have separate liquidation of local branches, the NCWOL test ought to operate to induce the authorities not to use ring–fencing powers but rather to allow full participation in the group resolution (pending a true international solution). The FSB should make mitigation of this problem an important goal, and its elimination would be a benefit of a resolution Convention, such as suggested in Annex I.

(b) Creditors of a parent company may face different insolvency outcomes as a result of differential treatment applied to intra–group obligations in the course of the resolution. Some resolution authorities may treat group claims differently from other claims. However, there should be no general principle that creditors of parent companies are disadvantaged relative to creditors of subsidiaries. Once contractual or existing statutory adjustments have been made to intra–group exposures, all creditors of all group members should be entitled to the benefit of NCWOL protection. These issues can be worked out ad hoc, but a clear international solution would be preferable.

(c) NCWOL is not a rule as to how assets should in fact be dealt with but is a rule of fairness as to how creditors should be dealt with. Resolution authorities should be able to agree among themselves that assets and businesses may be restructured and transferred around the group provided that creditors will be properly compensated. From an international point of view, the essential thing is to apply this rule of fairness on a non–discriminatory basis across each class of claimants.

(d) NCWOL applies to all classes of creditors, subject to the special treatment of depositors. Depositors—or rather the deposit insurance scheme—are generally accorded a special priority, at least

19 See FSB supra note 1, Key Attributes 5.

20 In insolvency parlance, a "universal" regime provides for insolvency resolution of an entire group, regardless of the location of operations, whereas a "territorial" regime provides for local actions in each jurisdiction where operations are found.

up to the insured amount. Depositor preference is a well–understood feature of bank resolution; however, provisions that operate to make depositor preference discriminatory, such as *national* depositor preference in excess of insured amounts, should be removed over time. There may be exceptions. It is understood that in New Zealand depositors would participate in the write–down associated with bail–in, although most in the international industry would not advocate such a solution.

RESOLUTION OF TRADING ACTIVITIES: STAYS AND SUSPENSION OF CROSS–DEFAULTS

Trading activities resemble deposit–taking activities, in that a "run" on the institution in resolution can rapidly destroy value. It is therefore useful to have at least a short stay on creditors' exercise of their contractual rights to terminate trading contracts in order to facilitate resolution and also a power permanently to vary termination and cross–default provisions of contracts to facilitate transfers in which resolution creates a viable successor entity to assume relevant contracts.[21] This is essential to contain systemic disruption from a group's failure.

The resolution of certain parts of a SIFI—notably trading businesses—is likely to be materially assisted by the development of an internationally agreed stay regime underpinned by legislation in all major jurisdictions. Such a regime could be supported by appropriate provisions to be included in industry standard documents and supported by the exercise of supervisory powers to control the extent to which banks may subject themselves to contractual terms, which may be incompatible with the chosen resolution strategy for that institution.[22]

However, this involves a difficult balancing act. On the one hand, too much potential variation weakens markets and increases uncertainty; on the other, the ability to vary such rights may in some circumstances be essential to the achievement of the objectives of resolution. The outcome that strikes the best balance between market protection and resolution is to preserve netting and collateral arrangements but also to introduce a regime whereby in certain circumstances such contracts may be briefly stayed or certain termination rights within the contract permanently suspended. We refer to these collectively as "suspensory" powers—in particular, the power to impose a short stay on the enforcement of contractual rights against members of the group being resolved, the power to suspend cross–default provisions in contracts involving members of the group, and the power to eliminate completely termination rights triggered by the resolution procedure *per se* (subject to appropriate transfer of the relevant obligation).

These provisions, although well established in some national laws and recognized in the *Key Attributes*[23] as necessary to achieve the financial stability goals of a modern resolution regime, all involve an interference with private contractual rights. The laws of a country can generally vary contracts governed by the law of that country and can generally suspend the enforcement of rights against its domestic companies. They generally cannot affect enforcement of contracts in other jurisdictions governed by other laws. This can be achieved only either by *mutual recognition* of suspensory powers in other national laws—so that courts in the other country would not allow enforcement of claims in defiance of moratorium powers exercised by a country administering resolution of a financial institution—or by the inclusion of provisions recognizing those powers in the terms of contracts entered into by the financial institution.

Mutual recognition of such powers in different legal systems requires broad agreement between different jurisdictions as to how suspensory powers should operate and subject to what safeguards and considerable work would be necessary to reach such agreement on a global basis. Attempting to address the issue through contractual provisions, although apparently easier, would involve the reopening and renegotiation of an enormous number of existing contracts and would be a long, drawn–out, and uncertain process. Although there are broadly analogous provisions in US and English law on stays, and similar rules will likely be expanded as countries adopt the *Key Attributes* into law, recognition of foreign–law stays by courts of any country is untested, and establishment of an internationally effective stay regime therefore appears to be a substantial undertaking.

However, establishing this regime is essential, because a structure in which half of the counterparties of a failing institution are stayed while the other half are not will create a massive inducement to the non–stayed creditors to run while inflicting significant and unjustifiable harm to those creditors who are stayed. Similarly, inconsistent treatment of cross–defaults would of course be unacceptable. In the context of

21 In addition, suspension of cross–defaults would be essential to make a "single–point–of–entry" solution viable. *See infra* Chapter 1, Section 5.

22 *Id.*; *see also infra* Annex I.

23 *See* FSB, *supra* note 1, *Key Attributes* 4.

SIFIs, stays should either apply to the large majority of creditors or not be applied at all by the relevant authorities. Thus, in resolution planning for affected groups, those authorities that have the discretion to use stays should be clear in their discussions with other regulators of the same group and should determine a course of action that would be feasible under the currently applicable situation, with attention to the governing law of the group's obligations, pending either modification of contracts over time or the creation of an appropriate regime of mutual recognition, as envisioned by the proposed Convention.

(a) Certain other statutory powers––such as the power to reduce certain creditor claims and to convert or suppress subordinated obligations–may be inhibited where the institution concerned has agreements governed by other national laws. It is important that such powers be supported by mutually reinforcing legislation in different countries and that where such powers require a positive act of the resolution authority to be invoked, there should be agreement among resolution authorities to do so. Here again, a Convention to establish a clear international set of expectations would be helpful.

(b) Similarly, the FSB needs to consider establishing international standards for addressing affiliate cross–defaults during resolution. In the absence of consistent standards enforceable in relevant jurisdictions, whole–bank resolutions or bail–ins–which often may be the best vehicles to achieve the overall FSB resolution goals–may not be as readily possible for integrated SIFIs.

In most jurisdictions, "market contracts" or "financial contracts" enjoy a degree of statutory protection in ordinary insolvency in order to protect financial markets infrastructures.[24] It is important that these protections be respected across borders in resolution.

RESOLUTION TRIGGERS

Resolution authorities will, quite properly, wish to say as little as possible about the precise determinants that they will use in making their decisions to act. However, the greater the degree of uncertainty in this regard, the greater the uncertainty premium that will be built into the risk assessment, and thus the pricing, of all exposures to the institution concerned.

Therefore, those charged with making the determination as to when an institution should enter resolution should be as explicit as possible as to the point at which such a determination might be made and in particular should make clear that the commencement of resolution will be as close as possible to the onset of substantial commercial failure.[25] While the standards proposed by the FSB for this purpose inevitably have a degree of subjectivity, international adoption of the same standard will help create uniformity of expectations and of practice that will help create greater predictability over time.

The perception is that, in those countries in which the standard proposed by the FSB approximates the failing institution's being at or near the point of insolvency, the authorities have in fact been conservative about the exercise of their powers, and expectations about practice (albeit generally with smaller, domestic banks) are relatively clear. Generally, the Crisis Management Groups (CMGs) should make the decisions on triggering resolution in order to avoid uncoordinated unilateral actions by national authorities.

LIQUIDITY IN RESOLUTION

Bail–in within resolution provides a means to recreate balance sheet solvency but of itself creates no new liquidity. As a result, a bailed–in institution (or a significant bridge bank acting as a successor) must make arrangements to obtain new liquidity from some source before it opens for business post–resolution. It is generally assumed that source must be the authorities of the home–country resolution authority dealing with the group (or the host for relevant subgroups) or any delegated entity such as those of the European Banking Authority.

Although it is certainly appropriate to foresee special liquidity provision by the authorities on a basis that minimizes risk to the taxpayer, as is the case under the US Dodd–Frank Act,[26] we have concerns as to the implication that the state may, in effect, be required to provide funds to the institution that, although not formally taxpayer support, could be given that cast politically. As a result, the major jurisdictions should explore the creation of alternative arrangements whereby private sector providers of funding to a resolved institution of this kind could receive a

24 E.g, the Qualifying Financial Contracts regime in the United States and the Settlement Finality and Collateral Directive regimes in the European Union.

25 See FSB, *supra* note 1, Key Attributes 3.1 ("Resolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution regime should provide for timely and early entry into resolution before a firm is balance sheet insolvent and before all equity has been fully wiped out. There should be clear standards or suitable indicators of non–viability to help guide decisions on whether firms meet the conditions for entry into resolution.").

26 Dodd–Frank Act § 214.

“super–priority” claim to the assets of the institution (economically similar to US “debtor–in–possession” financing arrangements). Having available such arrangements, which could be used in appropriate cases to ensure that significant private sector liquidity was available to such an institution, could be a highly useful tool for the authorities to have available, although it is likely that temporary public facilities (structured to avoid permanent exposures for the state as in Dodd–Frank) should also remain in the authorities’ arsenal.

The type of extraordinary emergency liquidity support discussed in the prior paragraph should be distinguished from the normal discount window or lender–of–last–resort support for any solvent bank. Such support, on the basis of appropriate collateral, should also be available to a bailed–in group (or “good bank”), and it may be assumed that such a successor firm would need to make use of such facilities rather extensively while it re–establishes its market credibility.

For groups that are organized on a decentralized basis, funding, like resolution, should be addressed in the light of the group structure. In this regard, such groups may find it easier to raise liquidity as part of a resolution, because it is less likely that money provided by central bank or domestic funders will be transferred across borders.

For integrated groups, such liquidity support is likely to require multiple currencies. One solution would be to have a lead (“home”) central bank lend against worldwide assets, obtaining the necessary currency through swap lines with other central banks, a technique that has worked smoothly in recent situations of market turmoil.

IMPLICATIONS OF THE RESOLUTION REGIME FOR THE RRP PROCESS

The RRP process is, at the current stage, predominantly national, with resolution authorities determining how they can apply their domestic powers to entities incorporated or established in their jurisdictions. This is entirely appropriate for this stage in the process; however, it is important that the RRP process not remain nationally focused but be rapidly expanded to consider groups and their operations on a global basis.

We understand that many national resolution authorities are already discovering that they are unable to make significant progress with their national plans because of uncertainty about the potential actions of other authorities in other jurisdictions. A collective approach between regulators is therefore essential. It should be added that such a collective approach is also essential for banks, who in the same way find themselves unable to make significant progress with recovery or resolution planning owing to the same uncertainty. The FSB should develop further guidance on the need for coherent and consistent RRPs for global groups, respecting group structure, through its usual supervisory standard–definition processes: This is an issue that would not necessarily need to be addressed through a Convention. Several specific recommendations are made in the main text.

The “acid test” of success or failure in this area will be multiplicity of RRPs. If an institution with a presence in 30 jurisdictions is, in 5 years’ time, filing 30 distinct and unconnected resolution plans, this will be a leading indicator of a failure by the industry and the resolution authorities to move toward effective resolution planning. Rather, each group should have one coherent resolution strategy covering all major jurisdictions and operations, well understood and agreed by all relevant authorities. For integrated groups, this may be a single RRP. For decentralized groups that expect to resolve different parts of their business separately, there may be several distinct RRPs, although these should be interlinked and logically consistent.

Aside from the pointless burden of preparing multiple plans, it is inconceivable that a major group, or subgroup of a decentralized bank, could be resolved quickly and relatively seamlessly without a single, integrated, coherent group strategy based on agreed assumptions and priorities, including the applicable definition of “critical functions.” That implies the RRP is developed based on the group interest principle. It will also be necessary to have coherent data definitions and information processes across the group to support quick and coordinated action in a crisis.

Consequently, the RRP should be reviewed only by the CMGs, involving supranational bodies such as the FSB, the Basel Committee on Banking Supervision (BCBS) or the International Monetary Fund (IMF) to ensure a holistic perspective.

Impact on the Structure of Bank Debt Financing

It is sometimes argued that banks should be required to maintain a minimum quantum of “bail–in–able” debt in order to ensure that there are uninsured creditors capable of carrying the burden of these losses. This is misconceived. Banks should be able to operate business models that are primarily or exclusively funded by insured deposits, and the international liquidity regime proposed as part of Basel III is predicated on the assumption that deposits, especially insured deposits, are inherently stable funding sources, in part as a result of the operation of the applicable deposit protection scheme or schemes. For such groups, resolution will involve the requirements of the relevant deposit insurance schemes, and the international aspect of resolution should be planned accordingly. Furthermore, in a world where increased emphasis is placed on the stability of bank's sources of funding and the short–term stability of their balance sheets, it would be a perverse outcome if the effect of resolution policy were to drive banks away from deposits as a primary source of funding.

RRP Process: Critical Functions

One key FSB objective of resolution is to avoid damage to the real economy resulting from the withdrawal of banking services relating to payments, cash management, credit provision, risk management and the facilitating role that the banking industry plays in commercial transactions. This has resulted in a focus by resolution authorities on identifying and pre–planning the course of these critical functions in a resolution.[27] One important issue that has already emerged from the construction of RRPs is that, although resolution authorities are focused on the preservation of critical functions, there is still considerable lack of clarity in some countries and substantial divergence of views between authorities as to how these functions are to be defined.

This divergence means that firms cannot be confident that they have correctly identified those of their services that would be regarded by relevant national resolution authorities as "critical." Because ambiguity in this area is highly undesirable for both resolution authorities and institutions, it would significantly assist all parties if some degree of commonality could be achieved both as to the core definition of critical functions. Certainly, for purposes of each group, the group and the relevant authorities should have a clear, common understanding of the critical–functions assessment that would be applied to the group in case of its resolution.

Also, critical functions in one jurisdiction are frequently provided, either partially or completely, from other jurisdictions, and it is frequently impossible for a national resolution authority, acting autonomously, to satisfy this requirement. It would be essential in this regard for regulators and institutions to come together to agree on common definitions of critical functions, and to approach the provisions of such functions on a cooperative basis, in order to ensure that resolution could in fact be effected promptly and smoothly across the group.

Moreover, it should be recognized much more clearly than seems to be the case that many of the very tangible problems of ensuring continuity of what regulators may deem to be critical functions could be avoided without disruption of going–concern value if planning focused more on whole–entity solutions (whether group solutions in the case of integrated groups or subgroup or local solutions in the case of decentralized groups). While it remains appropriate to consider continuity of critical functions per se, it needs to be recognized that critical functions will be best protected at least cost by aligning hypothetical resolution solutions to the actual structure of groups, as stressed throughout this report. The increasing focus on "single–point–of–entry" planning in some cases, which would resolve a group through its holding company or most significant entity (possibly keeping other entities entirely outside of resolution or insolvency processes) appears to recognize this fact, but more recognition is required as the Key Attributes are translated into fully fledged international standards.

This raises the issue of the interaction of resolution plans and group structure. It is clear that the purpose of a resolution plan is to determine how the group as it is currently structured could be resolved. However, it may be necessary for there to be to the possibility for the resolution authority, after conducting a careful resolvability assessment, to determine—in extremis—that the group (or one portion of the group) as currently structured could not be resolved and that part of the group's business should be restructured.

However, there should be a strong bias in favor of avoiding disruption of valid going–concern business structures because of hypothetical resolution issues (especially if deriving from legal issues that are beyond the group's control but might be addressed by the authorities as the Key Attributes are implemented or in accordance with the shared expectations created by a Convention). This is all the more important as there are likely to be grey areas in which the resolution authority cannot demonstrate that the group would be impossible to resolve but may be persuaded that restructuring would make resolution easier.

A further difficulty is that different national resolution authorities may have different—and conflicting—views of their own convenience, and if there is not an increased level of harmonization

27 We would note that the issue of critical functions may be less significant for groups that are highly resolvable with a whole bank bail–in. This type of resolution structure does not require asset or business separation as part of the resolution and allows any needed business restructuring to be deferred to a later date where critical functions can be handled in the normal course of supervision.

between resolution authorities, the group may be faced with different and conflicting mandates to restructure. It should be obvious, but it is important to state, that the social and business costs of trying to solve these issues—which would arise only in the remote contingency of a failure of the group—are far greater than the costs of working out a rational, well-understood resolution plan to manage them. Consequently, a group should be requested to restructure part of its undertaking only by a resolution authority where (a) that authority has discussed the issue fully with other concerned resolution authorities in other jurisdictions and obtained a broad consensus as to how the restructuring should be established and (b) the resolution authority can demonstrate that the restructuring is the only feasible way to achieve the desired end.

In the context of group resolution it is important to focus on functions that are performed by some group companies for the benefit of others. In all groups—even in those structured as decentralized groups—will be services provided either centrally or regionally. It is also not unlikely that the group will have a single "service center" that provides services to all entities—in general, many group members will perform services for many other group members, and there will not be a simple directionality to the provision of these services. As a result, in resolving a group, the resolution authorities of one group member are likely to have to be highly cognizant of the importance of maintaining services to other group members, and in the interests of preserving maximum undertaking value for the benefit of creditors, resolution planning should include actions to ensure that such intra-group services can be continuously provided.

However, again, these structures will differ from group to group, and the techniques to be used may differ from jurisdiction to jurisdiction. This is another area in which it is important that the structures to be adopted are group—and jurisdiction—specific and not centrally prescribed.

INVESTORS' PERSPECTIVES

As our buy-side colleagues explain in detail in Annex III, a primary requirement of pension, insurance and other institutional investors with respect to bank resolution is transparency and predictability of process. Lack of transparency contributes to instability and results in increasing the risk premium for funding. Predictability of process will enhance certainty of results. Since these investors will be called upon to make very large amounts of equity and debt investment in financial groups in the coming years, these issues must be central to policy-making.

As in other parts of post-crisis regulatory debates, the needed transparency runs up against very real issues as to what might appropriately be disclosed without doing more harm than good. Clearly the detailed dialogue between regulators and institutions must remain confidential, but at least some high level information should be disclosed to investors to give a sense of the resolution planning.

The most basic concern of investors is to understand how the authorities would approach a resolution. In order to create investor confidence this disclosure, which could be set at a fairly high level, should come from regulators.

The tradition of constructive ambiguity is strong, and for good reasons, but the very substantial changes being made in the regulatory framework of the market suggest that part of the post-crisis regime must be a greater degree of constructive clarity about intentions with respect to any eventual resolution and about availability of central bank facilities in times of stress.

Institutional investors are, as explained in Annex III, increasingly concerned that resolution authorities should involve investors in resolution discussions. They are concerned that the idea that unsecured senior creditors constitute a pot to dip into to fund resolution will result in pensioners' money replacing taxpayers' money as the basis for resolution. Whereas the most acute resolutions are likely to take place very rapidly with little time for consultation, nevertheless, they make the case that increased dialogue with investors is important for regulators to understand the full implications of their actions and that there may be specific resolutions in which there would in fact be time for active consultation with investors on appropriate courses of action. Although investors recognize that they will incur losses in respect of investments in failed firms, they regard it as important that fairness and equality in distribution should be adhered to and that no class of creditor should be unreasonably disadvantaged relative to any other comparable class.

Finally, an important point that is recognized but should be given more emphasis in the Key Attributes is the avoidance of unnecessary losses for (senior) creditors.[28] A goal of maximizing the value that can be conserved for investors in a given resolution should be one of the key principles for the resolution of financial institutions. Resolution authorities, quite

28 See FSB, *supra* note 28, Key Attributes, Preamble (v).

naturally, have focused on preserving the continuity of a financial institution's important services and protection of depositors while avoiding use of taxpayer funds. Investors providing essential long–term capital to financial institutions do so with the understanding that their investments are subject to regulatory intervention in times of stress. An investor's confidence in committing long–term capital to financial institutions should increase if the investor believes that maximization of value for investors is a core objective of resolution authorities.

CONCLUSION

The Key Attributes provide an infrastructure for structuring the resolution component of the post–crisis architecture. However harmonization of national regimes will not, of itself, produce cross–border cooperation. The G20 should hasten the full adoption of the Key Attributes but must also move forward an instrument aimed at providing an infrastructure for such cooperation. This could take the form of the Convention, initially as a non–binding international standard, perhaps ultimately as a fully binding international Convention, in order to give a global financial system full clarity as to how resolution of a failed SIFI would be carried out. This would benefit all concerned by helping assure appropriate assessment of the risks that investors would encounter in case of the failure of a given group and hence appropriate (and therefore efficiency–maximizing) pricing of funding provided to each group.

INTRODUCTION

The most important lesson of the crisis is that banks must be able to take risks, must be able to fail, and therefore must be capable of being resolved upon failure in a way that does not harm the wider economy. Global agreement has been reached as to the techniques for resolution of global SIFIs, reflected in the FSB *Key Attributes*.[29]

All major financial jurisdictions are committed to implementing the *Key Attributes* in their national legislation. This means that it is possible to resolve a large systemically important financial institution without unmanageable systemic disruption. However, several technical issues must be addressed to ensure that cross–border resolution is not only possible but is also robust. This report considers these issues in detail and concludes that they all can be addressed within the context of the *Key Attributes*. However, the changes proposed are technical rather than fundamental—there are no insuperable barriers to the cross–border resolution of multi–functional, cross–border bank groups.

Resolution of smaller, domestically oriented banks is already robust—such institutions have been successfully resolved in many jurisdictions without public bailouts and without catastrophic systemic consequences. However, traditional resolution methods face greater challenges as the institution being resolved grows in size, complexity, and interconnectedness.[30] Some of the commonly asserted difficulties are more apparent than real. As this report demonstrates, mere multi–jurisdictionality is not of itself an obstacle to resolution provided the right cooperation among the relevant authorities is in place. In this regard, we believe the Crisis Management Groups (CMGs) proposed by the *Key Attributes* could play a crucial role to ensure an orderly cross–border resolution.

However, what is potentially an obstacle is the lack of visibility as to how resolution authorities would act cooperatively with each other in order to resolve a multi–national SIFI. Overcoming nay–saying and past habits of thought is the fundamental problem: Broad implementation of the FSB program and creation of understanding and consensus on the basic issues will go a long way toward creating the needed assurance among regulators and in the market that resolution of a SIFI can be carried out efficiently and effectively.

A substantial contributor to the perceived difficulty of multi–jurisdictional resolution is the attempt to solve too big a problem. It is not possible to create a single resolution strategy for all SIFIs because those SIFIs differ significantly between themselves as to business model, structure, and group architecture. However, if we start from the position that the resolution strategy for any particular group should recognize and uphold the legal architecture of that group, this difficulty largely disappears. Each resolution plan will involve the deployment of the same tools, but in different ways.

In order to minimize harm flowing from the resolution of a global SIFI, these tools must be used cooperatively in different jurisdictions. However, governments and competent resolution authorities must also acknowledge that, for SIFIs, resolution is the new insolvency, and the likely course of its resolution is a critical issue for investors and capital providers to a SIFI. This means that states must ensure that the course of cross–border resolution is predictable, which necessitates some degree of structured cooperation between national resolution authorities.

This cooperation could most easily be achieved through an international Convention. This report offers a draft model Convention as a complement to the *Key Attributes* in order to focus the debate (see Annex II). The report envisions the draft Convention as a series of declarations of principles as to how resolution authorities would expect to behave, and would expect to exercise their powers, in certain circumstances arising out of a SIFI resolution.

While there are good arguments for eventual adoption of something like the UNCITRAL model

29 See FSB, *supra* note 1.

30 In the recent financial crisis, these factors were heightened as global institutions became even larger and more complex by absorbing significant portions of their failing peers. While this phenomenon was broadly positive and helped contain what could have been wider damage, it has also increased concerns about competition in the industry and about the overall size of institutions, concerns that are reflected in the top "empty" bucket of the FSB's hierarchy of surcharge assessments for Global SIFIs. While the Institute has serious reservations about the surcharge assessments, the concern noted is widespread and must be addressed.

law on cross–border insolvency Convention,[31] it is not necessary to see it as a hard, binding treaty. The concept of a Convention may prove too challenging for some states, at least in the short run. But, even some lesser (or even entirely informal) document would be useful in providing guidance, which would as a practical matter indicate some degree of agreement as to likely courses of action.

The full adoption of the Key Attributes, indicating consensus on the basics of resolution regimes in advanced economies, is an essential first step. But providing some degree of clarity on the full, cross–border dimension, beyond the Key Attributes, seems essential for investors, for firms dealing with SIFIs, for SIFIs in constructing resolution and recovery strategies, and for resolution authorities themselves. This report and the draft Convention offer a private sector vision of how to move in that direction.

One of the most important points made in this report is that resolution techniques must be driven by and be adapted to the structure of bank groups. A bank group is in general carefully structured so that the legal obligations of individual creditors, clients, and debtors are matched to their expectations. In addition, the group's contribution to the real economy depends in many ways both on those financial expectations and on the carefully structured business operations of the group. Thus banks that operate on a decentralized model, in which different parts of the group are clearly separated from each other, will be structured very differently from those banks that operate on an integrated model, in which every part of the institution is connected to every other. These differences of structure are a response to business, commercial, and credit requirements, and one key requirement in planning for resolution of bank groups is to ensure that the group is dealt with in a way that ensures that it can continue to deliver on these requirements.

31 See UNCITRAL *supra* note 4.

BACKGROUND

1. BACKGROUND AND PURPOSE OF THIS REPORT

Cross–border groups bring substantial benefits to the global economy, and resolution should not undermine the ability of the group as a going concern to realize those benefits.[32] A global banking system with groups that have global scope to match the scope of globally active businesses has huge advantages for promoting growth, managing wealth, and meeting the needs of trade, including with developing markets. Yet the responsibility for managing the resolution of a failing cross–border firm remains fragmented among national authorities, and the FSB *Key Attributes*, helpful though they are, could go further to promote predicable, reliable, truly integrated cross–border solutions on a basis that would be fully fair to all international investors, on a non–discriminatory basis.

Group resolution is complex, but this report sets out to show how multiple authorities could effect it on a fair and effective basis within the generally very short time available. It suggests ways that resolution techniques would be applied to a multi–national entity operating under agreements governed by many different legal systems and subject to the regulatory, resolution, and insolvency laws of many different jurisdictions. We have considered technical and political obstacles to such resolution and how they could be overcome. The conclusion is that, with sufficient preparation by both the industry and the public sector, there is nothing in this complexity that amounts to impossibility.

There are many things that banks, resolution authorities, and states could do to make the process simpler, and the proposed Convention would provide a clear blueprint. However, adoption of the Convention is not a strictly necessary measure—the full implementation of the FSB *Key Attributes* will provide a clear paradigm for SIFI resolution. In the meantime, the work being advanced by the major jurisdictions on bilateral and institution–specific agreements will make resolution manageable as a practical matter.

Discussions of cross–border resolution sometimes stumble on two perceived difficulties. One is the result of implicit or explicit postulating of a single solution for all types of SIFIs. In fact, each SIFI will have to be approached as a single issue, and the relevant plan will have to take into account the specific characteristics of each SIFI. The other is the misperception that cross–border resolution would require burden–sharing among jurisdictions. In fact, the opposite is true: With implementation of the FSB *Key Attributes* and clear expectations of how resolution tools would be used in major jurisdictions, fair and non–disruptive outcomes are much more likely to be achieved without taxpayer bailout (and hence without burden–sharing) than under an uncoordinated regime in which the anomalous results of local ring–fencing and inconsistent actions by different authorities remain a threat.

This report identifies areas in which structured international cooperation among governments, supervisors, and resolution authorities is essential to systemic stability. We have collected these along with the issues raised in several other IIF reports[33] in the form of the draft Convention. In fact, the proposed draft is similar to the agreement proposed by the IMF in *Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination* of June 2010.[34] Such a Convention, whether non–binding and used for guidance and creation of common expectations, or eventually established on a binding basis, could set out the broad terms within which resolution authorities should deal with SIFI failures.

This report aims to build on the *Key Attributes*, assess the key legal and financial issues, and provide a practical roadmap to an effective cross–border resolution. The *Key Attributes* lists three primary objectives for an effective resolution regime:

(a) Preserve operations that provide vital services;

(b) Avoid unnecessary loss of value and contagion; and

32 See generally IIF, *supra* note 3, *see also* IIF Response To The Consultative Document On *Effective Resolution Of Systemically Important Financial Institutions*, pp. 3, 9 (2 September 2011), available at http://www.iif.com/regulatory/comment/article+998.php.

33 See generally IIF, *supra* note 3, Preamble.

34 International Monetary Fund, *Resolution Of Cross-Border Banks—A Proposed Framework For Enhanced Coordination* (11 June 2010) available at http://www.imf.org/external/np/pp/eng/2010/061110.pdf; *see also* Board Of Governors Of The Federal Reserve System. *Study On The Resolution Of Financial Companies Under The Bankruptcy Code* (July 2011) available online at www.federalreserve.gov/boarddocs/rptcongress/default.htm

(c) Ensure losses are borne by shareholders and unsecured creditors—not taxpayers.[35]

The *Key Attributes* also acknowledges the importance of avoiding unnecessary destruction of value and, where consistent with other objectives, minimizing losses for creditors.[36] However, the international discourse has only slowly come to acknowledge the importance of conserving value for senior creditors (in large part, pension and insurance investors), and the Institute would urge greater emphasis on creditors' interests in future development of international standards.[37]

The *Key Attributes* also calls for a mandate in law for cooperation, information exchange, and coordination with foreign resolution authorities during a resolution.[38] The suggested Convention would build on that call for national–law mandates and show how that cooperation could be structured.

The minimum requirements for a resolution regime are now well–established—the resolution authority should have the powers to effect recapitalization or bail–in; to use a bridge bank to continue viable businesses and essential functions; to separate assets into good and bad banks; to sell businesses; and, ultimately, to place the institution concerned into liquidation. The challenge for a resolution regime lies essentially in two areas:

(a) The authorities must have the ability to use these tools flexibly to deal with each type of cross–border group. As discussed later, in some cases, this will involve resolution of parts of the group separately; in others, it will require the power to convert a sufficient proportion of the institution's liabilities into equity to replenish its solvency (and thereby re–establish liquidity). See the discussion of additional tools and powers at the end of this section and in the Convention.

(b) This resolution must not trigger forced accelerations, fire–sales, cross–defaults, or similar threats, which can impair or destroy markets and obstruct realizing maximum value from the institution.

There are credible powers to address these issues in several jurisdictions under existing law (although much still needs to be done to improve the transparency and predictability of these capabilities for investors). For example, there are broadly sufficient capabilities under the Special Resolution Regime (SRR) in the United Kingdom and through certain procedures under Orderly Liquidation Authority (OLA) in the Dodd–Frank Act in the United States to accomplish the resolution via bail–in of a domestically focused institution. An EU directive is in preparation but not yet formally proposed as of the time of this writing.

It is not the purpose of this report to advocate *bail-in*, a concept that is persuasively advocated elsewhere.[39] It is important to underscore that bail–in will not necessarily be the right solution for certain groups. However, bail–in does offer a powerful tool that will be appropriate for the resolution of large, integrated groups that are active across many markets and businesses.

Recapitalization through bail–in can reduce home–host cross–border tension if appropriately structured. For example, if host jurisdictions are concerned that, despite the promise of a successful global solution, "their" parts of the bank are undercapitalized or otherwise unsafe, they can, depending on the business model, negotiate for an appropriate amount of capital and liquidity to be down–streamed to host entities or otherwise require raising additional capital at that level if appropriate in accordance with normal supervisory practice. Through this method, the interests of a host supervisor can be aligned with a global solution.

The important point in the planning and execution of resolution is to avoid uncoordinated local resolution or ring–fencing, which would have unpredictable and adverse or unfair consequences for group claimants as whole. A group solution that restores the local subsidiary or branch to health is a powerful alternative that can be used to align local interests with a good global solution, and national regulators should have the ability to cooperate for such an outcome. Moreover, each country has a long–term interest in establishing a system that ensures globally fair results in all resolutions, even though, in carrying out an uncoordinated resolution it might find ways to gain advantage by ring–fencing.

35 *See* FSB, supra note 1, *Key Attributes*.

36 *Id.*, Preamble at 3.

37 See Annex III giving investors' perspectives; *see also* Directorate General Internal Market, *supra* note 13.at 2.

38 *See* FSB *supra* note 1, (vii) at 3.

39 *See* generally IIF, *supra* note 3; *see also* Calello, Paul, & Ervin, Wilson, "From Bail–Out To Bail–In," *The Economist*, print edition (28 January 2010), available at www.economist.com/node/15392186.

2. SIFI RESOLUTION: KEY ISSUES

2.1. The Domestic Baseline: Bail-In

The use of any resolution technique, but especially bail–in, within resolution to resolve a large domestic institution encounters several issues, such as

- Initiation: Who initiates resolution, and under what conditions and safeguards?
- Overall Protocol: What are the rules for determining the choice of resolution method, the total amount of write–down, and the new capital necessary to re–establish the institution?
- Instrument Scope: What instruments are subject to write–down or conversion, and which are protected? Is there a specific capital structure necessary to effect a successful resolution?
- Instrument Compensation: What do investors receive as compensation if they are affected, and from whom?
- Cross-Defaults and Stays: How does this event affect other contracts, and how can the institution be protected from unreasonable demands (e.g., an expensive mass unwind or acceleration of certain contracts or, for a "single–entry" resolution, triggering of cross–defaults that would undo the effectiveness of a group–wide solution) while minimizing impact on counterparties and customers?[40]
- Liquidity: Is there a mechanism to support liquidity necessary to operate the institution in the near term, when the market may be particularly cautious? What other measures can be used to help re–establish confidence in the institution?
- Safeguards and Governance: What rules are used to ensure due process and appropriate protection of investor rights? Who is in charge of the institution in resolution? Are there aspects of corporate law (e.g., shareholder approvals) that could conflict?[41]
- Transparency: Are these rules known in advance and predictable?

Once these issues are addressed, further "feedback" issues are important to assess even before cross–border issues are contemplated. The primary issues to be considered include

- Arbitrage: How would the system control the potential for banks or investors to "arbitrage the system" once the rules are established?
- Funding: What will be the impact on cost or availability of funding?
- Runs: Is such a system prone to a "first–mover advantage" problem (i.e., runs)?
- Systemic Risk: Can the system be operated in a functional manner in a stress event, where multiple institutions may be under stress or need resolution in a short time span?

2.2. Systemic Considerations

Any recapitalization of a SIFI involving the conversion of debt into equity will call into question whether similar debt instruments issued by other institutions might suffer the same fate, generally known as the issue of correlation. Government agencies overseeing the recapitalization of a troubled financial institution through a formal resolution process must therefore be mindful of the broader repercussions of their decisions on the debt market and the importance of providing certainty to those who provide essential credit to the industry.

These issues are discussed in some detail in the FSB *Key Attributes* and the related IIF consultation response.[42] While the issues are not trivial, we believe that the solutions proposed to date are adequate to address them. We do not propose to cover that ground again, except where we believe a modification or expansion of an issue is particularly relevant in the cross–border context.

All of these issues can be managed, but the greater the clarity that can be achieved on how they will be managed fairly and predictably on a cross–border basis the sooner will the market understand, accept, and price in on a reasonable basis the implications for investors in cross–border groups.

40 E.g., contracts may contain *ipso facto* clauses that purport to authorize a party to terminate or accelerate performance on a contract solely by reason of the appointment of a receiver or the insolvency of the institution. If applied, e.g., to derivatives, acceleration could pose a significant threat to the solvency and liquidity of the recapitalized entity and also could lead to greater destruction of value and market disruption. The response of the Dodd Frank Act in the United States is to provide that *ipso facto* clauses are generally not enforceable in the event OLA is invoked and the FDIC is appointed as receiver of a financial institution. *See also infra* Chapter 1, Section 5.

41 A conversion of debt to equity will likely result in a substantial shift in ownership, as current equity holders are replaced by former creditors. Certain of those creditors may not be in a position to accept or hold equity interests. For that reason, the equity interests resulting from conversion may need to be held in trust until they can be sold into the market, and the proceeds can be distributed to such holders. It is also conceivable that certain creditors may hold such a significant position in the debt of the institution that their resulting equity ownership after conversion would trigger regulatory approval requirements. For that reason, it may be appropriate to establish an equity limit of say, 5 percent, per creditor. To the extent any creditor were entitled to a greater percentage, again such interests could be held in trust until such time as they can be sold into the market.

42 *See* IIF Response, *supra* note 31.

3. SIFI RESOLUTION: CROSS-BORDER ISSUES

Any form of resolution of a cross–border group raises additional issues:

1a. Multiple Trigger Points: Can a host nation pull the trigger independently from the home supervisors, or the CMG, and without regard to the value of the overall enterprise? Can the act of initiation be coordinated? If initiation is not coordinated for some reason, can the consequences be handled?

1b. Consistency of Coverage: A related issue is whether regulators have consistent powers to address a distressed institution with different types of legal entities? For example, are there situations in which a European bank is subject to resolution under European law, but its US subsidiaries are too small to enable the US authorities to invoke OLA?

2a. Legal Entity vs. Group Interest: Will the objective of local supervisors be to maximize outcomes for entities (or investors) in their jurisdiction or to seek an overall value maximizing outcome?

2b. Branches: How will branches be treated for purposes of No Creditor Worse Off Than In Liquidation (NCWOL) calculations, and are there circumstances in which local interests can diverge from global interest in a resolution?

3a. Funding via Multiple Entities: Many SIFIs issue debt from multiple entities and often under different governing laws. The actions of a resolution authority in one jurisdiction may not naturally bind in a foreign jurisdiction. This could hinder the ability of an institution to convert or leave behind sufficient liabilities to achieve a strong capital ratio (and could also stress the NCWOL test for the affected classes).

How can these issues be addressed?

4a. Deconsolidation: A complex SIFI will typically only have equity issued at the top of the structure. An uncoordinated local bail–in could create new external equity through bail–in of a local legal entity; it may not be marketable or valid under securities statutes. This issue does not arise in the same way in which the local operations of the group are locally listed or otherwise set up on a distributed basis (what we call the "decentralized" structure in this report).

5a. Cross-Defaults and Stays Across Jurisdictions: How does the power to stay acceleration affect the rights of creditors in third jurisdictions to protect their interest (e.g., in cases in which the contract is under the law of one jurisdiction and the guarantee is from a third jurisdiction and subject to right of acceleration in the event of resolution or failure)?[43]

The balance of this report addresses these issues.

43 See *infra* Chapter 1, Section 5.

CHAPTER 1. INTERNATIONAL LEGAL ISSUES IN CROSS-BORDER RESOLUTION

1. GLOBAL GROUP RESOLUTION: A CONVENTION-BASED APPROACH

The FSB *Key Attributes* have identified the need for cross–border cooperation between jurisdictions and make useful suggestions for informal forms of cooperation, including via firm–specific agreement, which will be essential tools for the near future. However, the *Key Attributes* are not ambitious enough in providing guidance and structure for a fully coordinated international approach and hence create unnecessary ambiguity about what will be coordinated and where local authorities may continue to take action driven by local, as opposed to group–wide consideration.

Thus, this report proposes a Convention, set out in Annex I, to suggest a clearer basis for such cooperation.[44] We are under no illusions that this document will be immediately adopted. However, the purpose is to illustrate that the issues on which additional international agreement would be desirable to establish an effective cross–border resolution mechanism are not as difficult as initially feared—indeed, there is very little in the proposed Convention that could even be considered controversial.

1.1 Group Structure

The key to group resolution is that each group should, with its principal regulators, identify in its RRP the structure of its "resolution group." Once the resolution group has been agreed upon, any resolution should be led by its home resolution authority. For many groups, this is uncontroversial, as they are operated as integrated economic entities and will be most easily resolved as a unit (possibly by the "single–entry" approach).

However, there are several global SIFIs that are not structured as single, integrated economic units. These should also be resolved in accordance with their economic structure, recognizing the way they operate on a going–concern basis. In practice this may imply division into "resolution subgroups," each of which should be resolved as if it were a separate entity. Such groups are likely to raise a significant amount of their funding at individual legal entity level with relatively little raised at holding–company level. If so, neither bail–in nor good–bank/bad–bank approaches are likely to be appropriate at the group level, and resolution at the individual subgroup level is likely to be the correct as well as the only practical approach in any event. Similarly, for such groups, it is conceivable that a subgroup might be resolved without the overall group being at the resolution stage.

This report sometimes refers to the former type of group as an *integrated* group and to the latter as *decentralized* groups. But these concepts are conceptual only: The essential point is that both resolution planning and execution should be organized around the economic basis of the group as it exists, with control of execution at the most appropriate, generally the highest, level of control—usually the home regulator of the resolution subgroup. Where resolution subgroups are established, the lead host regulator of each subgroup should have a leading role, but with close coordination and cooperation with the home and the other subgroup authorities.

1.2. Necessary Powers and Single Resolution

In order to cooperate, national resolution authorities need two things. One is the necessary statutory powers to deal with assets in their jurisdictions.[45] The other is a formal obligation to act in pursuit of the objective of a single resolution.[46] The default setting for all national resolution authorities is likely to be the preservation of the position of *national* creditors without regard either to fairness toward other international claimants or to the FSB's systemic goals. In order to go beyond this, they will in general require a statutory objective to pursue. While the *Key Attributes* show the right

44 *See* IIF, *supra* note 3, ¶ 97; *see* also *infra* Annex I.

45 *See* FSB, *supra* note 1, *Key Attributes* 7.3 which states, "The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority (for example, by ordering a transfer of property located in its jurisdiction to a bridge institution established by the foreign home authority) or, in exceptional cases, to take measures on its own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability."

46 *See* IIF, *supra* note 3 ¶ 139.

direction to pursue, the Convention suggests a clear, unambiguously international objective.

In particular, resolution authorities should have as a minimum

(a) Power to deal with the assets of branches of overseas institutions (in cooperation with the resolution authority of the home jurisdiction) and

(b) Power to deal with the assets of unregulated subsidiaries of global SIFIs, even where such subsidiaries remain solvent.

1.3. Inter-regulator Cooperation

The hardest issue of all is, of course, the issue of inter-regulator cooperation. It is usual for cynics to claim that to expect any such cooperation is unreasonable and thus point to contentious incidents of the crisis as evidence that resolution authorities will always scramble for national advantage and will never cooperate.

We profoundly disagree with this view.[47] The events of the crisis, during which authorities were caught unprepared, are not a good guide to the steps that would be taken by authorities who had prepared contingency plans for dealing with such a situation, especially as the Key Attributes are to be converted to international standards. During the crisis, the absence of a resolution strategy meant that almost all governments regarded themselves as being in effect liable for all of the obligations of failed banks to their citizens. The Key Attributes commit national authorities to achieving a different situation, one in which contingency plans exist, bank resolution regimes in place across the major jurisdictions that protect taxpayer funds, where resolution authorities liaise regularly with each other about the institutions within their purview, and have the ability to cooperate in pursuit of a better outcome. With such a dramatic change in the conditions and capabilities facing regulators in a crisis, we do not believe that the behavior seen in the crisis would be repeated.

In this regard, it is critical that home supervisors are also able to engage the authorities of countries not included in their relevant CMG. This is the key tool for cooperation among supervisors.

In an integrated group structure, the best overall outcome will be one that resolves the group as a whole, maximizing recoverable value and minimizing disruption, despite the fact that the group may be made up in substantial part of separate subsidiaries.[48]

The position of resolution authorities of branches is sometimes harder. If the commencement of resolution proceedings of the foreign parent does not automatically bring a branch into resolution, it is important that the resolution authority be able to pre–empt local insolvency law and to ensure that the interests of the preservation of financial stability and overall fairness to group creditors be given preference over the desire to maximize local recoveries, by recognition of, and cooperation with, the group insolvency. Where local law requires separate branch resolution, which is clearly less desirable, then resolution planning should clearly establish that resolution will be closely coordinated with, and under the lead of, the home authority.

1.4. Providing a Platform for Cross-Border Resolution

All of these issues are proposed in the Convention.[49] Taken together, they provide a platform on which cross–border resolution can be effected. However, there is nothing on this list that could not be implemented unilaterally in domestic legislation by individual states and of the essence what is proposed is already mandated in the FSB principles.

While much the same thing can be accomplished on the basis of specific bilateral agreements, planning, and good will among authorities, as envisioned by the Key Attributes, the Convention highlights how relatively small the changes need to be in order to create a truly robust global bank resolution system. It also suggests grounds for more specific agreement on approaches to group resolution which, even if not strictly binding legally, could usefully guide the authorities in the execution of a resolution, to achieve minimum disruption, maximum conservation of value, and fair outcomes.

47 See FSB Effective Resolution Of Systemically Important Financial Institutions - Overview Of Responses To The Public Consultation (4 November 2011) available at http://www.financialstabilityboard.org/publications/r_111104dd.pdf ("a home country might be unable or unwilling to resolve a cross–border SIFI as a whole, and the possibility that this could have significant consequences in host countries. Such circumstances are amongst the reasons why the Key Attributes provide for host–country authorities to have powers to act independently if necessary to achieve domestic financial stability.").

48 See infra Annex II.

49 See infra Annex I.

2. FUNDAMENTAL LEGAL ISSUES IN INTERNATIONAL RESOLUTION

2.1. A Universal Standard of Fairness

Cross–border insolvencies have historically been difficult to manage. This is primarily because insolvency law tends to embed parochial views of what constitutes "fairness" as between competing claimants.

What makes progress on cross–border resolution possible where progress on cross–border insolvency has historically been difficult is the NCWOL safeguard, which can provide a universal standard of fairness for all claimants by determining which creditors would receive what payment under insolvency. This approach is feasible in financial insolvencies, where it would not be in other types of insolvency, because of the well–known fact, demonstrated in practice by the Lehman Brothers case, that liquidation is highly destructive of value, such that most creditors will be vastly better off in a reasonable and non–discriminatory resolution than they would have been in liquidation.[50]

As a safeguard, the NCWOL regime should provide compensation for creditors who can show that they have done worse than they would have done under an insolvency. In some countries, such as in the United Kingdom, Germany, Switzerland, or Denmark, there are specific look–back provisions to ensure that outcomes can be determined to be fair.[51]

In group situations, the lead resolution authority must be cognizant of the application of the NCWOL principle at the level of each institution whose creditors are affected by the resolution; however, if the resolution is conducted on the "highest possible point–of–entry" principle, this should not involve assessment under more than one or two jurisdictions.[52]

2.2. Group Resolution and Conflicts of Laws

A resolution regime will be useless unless it is immediately accepted as legally effective. Providers of liquidity must be left with no grounds to doubt that the recapitalization of a bailed–in bank or a "good bank" re–entering the market is immediately effective and cannot be credibly challenged.

In a situation in which the bank and all the relevant creditors were located in a single jurisdiction, simple legislation in that jurisdiction would suffice. The challenge for a cross–border institution is therefore to construct a legal solution that uses a variety of legal techniques to achieve a robust outcome without falling into impossible demands for global harmonization of bank resolution legislation.

In general bank resolution, especially bail–in, requires legislation. However, legislation is an incomplete solution for all but the smallest banks, because for the majority of banks a significant portion of senior debt is likely to be governed by laws other than that of their place of incorporation—for example, most large continental European banks have bonds governed by English or New York law.

It is essential to deal with the "Metliss" problem, which arose in English law but appears in most jurisdictions. In *National Bank of Greece and Athens S.A. v Metliss*,[53] the English courts decided that where a Greek bank owed money under bonds governed by English law, a Greek statute passed for the purpose of varying liability on the bonds would not be recognized by the English courts. Similarly, if the contractual obligations of a UK bank were varied by English law, there is a significant risk that the variation would not be effective against holders of New York law bonds.

It is important not to overstate *Metliss*. In many jurisdictions considerations of comity and general respect for friendly government actions mean that courts will strive to give effect to such provisions. Moreover, there is discussion of an EU resolution regime that, if enacted, would produce a regime in which a bail–in or write–down effected by the law of one member state would be recognized by the laws of other member states. In addition, courts are in some cases prepared to recognize compromises of creditors' rights arising under the laws of other jurisdictions if a similar process would be possible under the domestic law of the court concerned.

In general, financial law accepts and enforces choice of law and jurisdiction. It might be possible in some jurisdictions—including possibly the United Kingdom—to create a resolution regime entirely by private contract by including the relevant provisions in the contracts of the entity concerned. This would

50 *See* IIF *supra* note 3 at 11, *see* also "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd Frank Act", *FDIC Quarterly*, early release for the upcoming 2011, Volume 5, No. 2. This principle is recognized in the FSB *Key Attributes* and in the recent discussion paper issued by DG Internal Market and Services; *see* FSB *supra* note 1 Key Attribute 5; *see* also DG Internal Market *supra* note 13 at 2,3.

51 UK Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009; section 1 para. 19(2) of the German Restructuring Act; article 31 para. 1 of the Swiss Federal Banking Act.

52 The highest point–of–entry principle is applicable in holding–company and integrated–group structures and would seek resolution at the level of the highest substantially capitalized entity in the group structure. This concept would not apply in an "archipelago" structure. *See* FDIC, *supra* note 5.

53 *National Bank of Greece and Athens S.A. v Metliss* [1958] A.C. 509.

be broadly effective. Thus, for example, stays could be implemented, cross–defaults annulled, bail–in provisions given effect, and potentially even creditors transferred by means of explicit provisions to be included within the relevant contracts.[54]

However, even if the regime were based entirely on private law, the contractual provisions would need to be structured so that the initiation of the resolution process is triggered by an external act of an appropriate regulator or other public body and to ensure that any discretion about the extent of any necessary write–down or any compensatory issue of equity is exercised by the authorities rather than the board. This would create procedural and technical issues for the authorities that would have to be resolved with full clarity in order for such contractual solution to be acceptable to the market.

3. RESOLUTION TECHNIQUES: BAIL-IN AND GOOD-BANK/BAD-BANK RESTRUCTURING

There is no question that the good–bank/bad–bank approach to resolution has been used effectively in many situations and in several jurisdictions (particularly the United States, which has a long track record of successful use). It has been applied to institutions as large as Indymac and Bradford & Bingley. The problem is that it is not a technique that has yet been used for the largest global SIFIs. There are two major concerns:

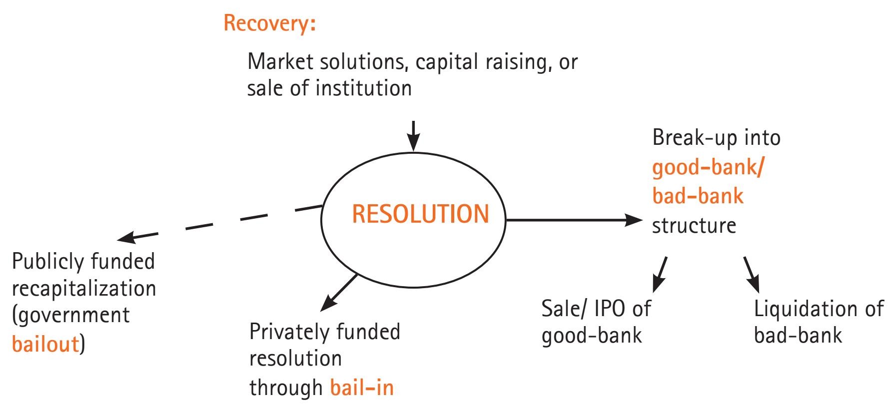
(a) SIFIs are multinational. Their activities and their obligations will be governed by several different laws, and no one resolution authority would today have control of the entire group.

(b) SIFIs will have a much higher impact on other participants in the financial system, and any inefficiencies in the good–bank/bad–bank solution will be much more problematic for systemic stability. This includes the scale of SIFIs, the importance of SIFIs in market networks, and the likely difficulty of finding acquirers of sufficient size willing to purchase assets or operations at a level that approximates fair value in crisis conditions.

In many but not all cases, the appropriate response would be the use of "bail–in within resolution." A bail–in is loosely an attempt to replicate the good–bank/bad–bank structure without having to tear the existing business apart asset by asset.[55] Bail–in operates by identifying and writing down the claims of those creditors who in a good–bank/bad–bank restructuring would expect to be left in the bad bank.[56] In economic terms, bail–in is simply a mechanism for replicating a good–bank/bad–bank structure without the requirement to transfer assets and liabilities between legal entities.

The FSB Key Attributes endorses the concept of bail-in within resolution as an important tool for resolution of financial groups.[57] This report examines the legal, regulatory, and financial challenges of moving from the Key Attributes to a fully predictable cross–border legal regime.

For any crisis, the choice of resolution tools will depend on the severity of the situation, and it is therefore worth considering the path to resolution.



54 See infra Chapter 1, Section 5.

55 See generally IIF supra note 3 ¶ 74 and seq.

56 Id.; see also FSB, supra note 1, Key Attributes 3.5.

57 See FSB, supra note 1, Key Attributes 3.5 ("Powers to carry out bail–in within resolution should enable resolution authorities to: (i) write down in a manner that respects the hierarchy of claims in liquidation (see Key Attribute 5.1) equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses; and to (ii) convert into equity or other instruments of ownership of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation; (iii) upon entry into resolution, convert or write down any contingent convertible or contractual bail–in instruments whose terms had not been triggered prior to entry into resolution and treat the resulting instruments in line with (i) or (ii).

There is a reasonably clear decision path for a supervisor confronting a troubled bank.

(a) *Recovery* through a private sector solution is always the preferred option. This could include raising new capital in the markets, asset disposition, restructuring, divestiture of business lines, or the sale of the whole bank to a solvent buyer.

(b) Where private sector recovery is not possible, the next option is *internal restructuring*—liquidating some assets, withdrawing from certain lines of business, raising cash, and paying down debts. However, the practicability of this course of action is largely determined by the state of the rest of the financial system. For an institution that has suffered an idiosyncratic shock in an otherwise buoyant market, this may be a practical proposition, but in a depressed or non–existent market, this is unlikely to be an option. Thus, the stage at which resolution is necessary may be reached rapidly.

(c) The alternative to resolution is *government bailout*—through the injection of new capital, purchasing certain distressed assets, giving guarantees to the obligations of the institution, or a combination of these methods. However, both the industry and the public sector are determined to eliminate future bailouts.[58]

(d) An option in lieu of government bailout may be a *break-up of the institution* into a "good" bank (or transfer of the "good" assets to a bridge bank, which can be sold, floated, or otherwise restored to health), and a "bad" bank. The effect of this reorganization is generally to effect a write–down of the creditors left in the bad bank while preserving the claims of creditors transferred to the good bank.

(e) However, as *bail-in within resolution* is now recognized, including by the FSB as a possible means of recapitalizing a firm or an integrated group (or subgroup of a decentralized group) from its own resources, it has become the focus of conceptual thinking and resolution planning to a large extent. It will often offer the possibility of conserving as much value from the failed firm while recognizing the traditional creditor hierarchies by writing off or severely diluting existing equity and subordinated debt before converting the necessary portion of senior debt to equity, meanwhile recognizing the security interests of secured creditors and the claims of relevant deposit insurance schemes.[59]

4. APPLICATION OF NCWOL IN A GROUP CONTEXT

As the *Key Attributes* recognize, resolution would be carried out at or very close to the point of insolvency but would need to be managed to avoid a disorderly collapse. As already discussed, each resolution regime that allows for bail–in within resolution by requiring creditors to contribute to the financial institution's balance sheet stabilization or the protection of certain vital banking functions should also respect the principle of NCWOL.[60] It cannot be over–emphasized that NCWOL addresses basic fairness by protecting all creditors from being worse off than they would have been in case of a liquidation—which, in the context of a financial institution, is likely to be highly destructive of value—while providing the basis on which the authorities can salvage as much as possible from the failed institution in the interests of creditors as well as of financial stability.

Note that this discussion addresses only resolution at or near insolvency; it does not address recovery–phase measures envisioned in recovery and resolution plans, including such matters as earlier–phase triggering of conditional capital.

Any special resolution powers may interfere with creditors' claims and thus their property rights and may result in the inevitable side–effect that the interest of some creditors (e.g., those whose claims are transferred to a bridge bank) are prioritized over other creditors (e.g., the "creditors left behind" in a bad bank) that would have ranked *pari passu* in liquidation. The overall principle should be respect for traditional hierarchies, with allowance for specific departures from traditional ranking schemes when justified by a broader, overarching systemic motivation and subject to clear goals of achieving better outcomes for all claimants on the basis of well–understood principles of fairness—basically the NCWOL principle and non–discrimination among claimants based on nationality. Any departures from traditional hierarchies are likely to be with respect to claims that, although perhaps having the same

58 *See* IIF, *supra* note 3 ¶ 163; FSB supra note 1, (IV) at 3; *see* Dodd Frank Wall Street Reform and Consumer Protection Act § 214; *see* DG Internal Market and Services, *supra* note 13 at 2.

59 However, the recent DG Internal Market and Services discussion paper suggests that at least some claims of the deposit insurance scheme be subject to bail–in on an equal basis with senior creditors (after dealing with actual depositors' claims up to covered amounts). While there would be clear advantages to this approach in dealing more fairly with senior creditors' claims, the debate is only beginning on this question and it will not be pursued further here.

60 *See* FSB, *supra* note 1, Key Attribute 5; *see also* for instance European Central Bank, *Crisis Management and Bank Resolution -Quo vadis, Europe?* Legal Working Paper Series No. 13, December 2011, p. 9.

formal ranking, are different in kind from a business point of view. In any case, the classes of claims that may receive differential treatment in resolution should be well understood in advance.[61]

The need for differential treatment of "trading" vs. "financial" claims for systemic purposes is increasingly well understood in international systems. It must be stressed, however, that this does not imply vesting arbitrary or unbridled discretion in the resolution authority.

While creditors may have the equal formal ranking in the traditional scheme whether they transferred or not, they are likely to represent different types of claims (e.g., transactional vs. financing) and thus the selection of certain claims for continuation or transfer, even if cutting across the most abstract version of the hierarchy, is likely to be economically justifiable.

As a general rule, any limitation of creditors' rights has to stand the test of constitutionality and similar safeguards such as the European Convention on Human Rights. Generally, these safeguards require that no one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. A deprivation of property without compensation can normally only be justifiable under exceptional circumstances.[62] This generally means that compensation must bear a reasonable relation to the value of the property expropriated. Hence, if resolution interferes with contractual or property rights, the competent authorities are required to put in place compensation arrangements to ensure that persons affected by a transfer of assets or a debt–equity swap are appropriately compensated.

4.1. Design Parameters of the NCWOL Safeguard

This understanding of the general NCWOL principle calls for several clarifications and specifications.[63]

While the authorities need to follow established rules when exercising resolution powers, such rules need to recognize the need for the authorities to take decisive action to maintain stability in a crisis and to minimize value–destroying delay of a firm's market position and business. The authorities should be able to make use of their resolution powers if and to the extent (a) necessary to protect the critical functions of a financial institution and (b) the overall economic outcome of the resolution is expected to be at least as good as the expected result of an orderly liquidation proceedings. Given the presumption that a resolution plan may need to be implemented over the weekend, the exact amount of compensation (if any) each creditor is entitled to may need to be determined after the fact.

As a consequence, NCWOL should provide for a right to an efficient *ex-post judicial review* if the resolution has put an investor in a worse position than had the bank been left to go through liquidation in normal insolvency proceedings. NCWOL may or may not be linked to a provision requiring authorities to appoint an independent valuer for assessing whether such compensation is necessary and, if yes, in which amount.

To allow for effective protection of a financial institution's critical functions, any judicial review should not interfere with the authority's power to transfer assets and liabilities to a bridge bank or to impose a debt–equity swap but should be limited to enforcement of the right to compensation and resolve valuation disputes.

Using resolution powers may result in the full–valued claims of some creditors in effect being subordinated to the claims of other creditors that would have ranked *pari passu* in liquidation. By example, if certain claims (e.g., deposits exceeding the amount protected by public deposit protection schemes) are transferred to the bridge bank together with a corresponding amount of high–quality assets (e.g., mortgage loans), any shortfall between the assets and liabilities of the original bank would have to be borne exclusively by the creditors left behind. Limiting loss to what a creditor could expect to incur in an ordinary liquidation, NCWOL also limits the extent to which a creditor left behind can be forced to contribute toward the safeguarding of the systemically relevant functions.

But, even though exercise of resolution powers may lead to uneven distribution of value, the fact that some creditors are *not* reduced to liquidation value stems from the intervention of the resolution authority (including, in some cases, funding of the bridge bank). Therefore, NCWOL in fact preserves fundamental fairness because any uneven outcomes reflect the value preserved by the intervention and not an unfair appropriation from creditors, as long as they get NCWOL treatment.

NCWOL provides an important safeguard for creditors. As such, it provides a degree of predictability of outcomes in resolution that should enable better pricing of future bank funding. From a procedural perspective, NCWOL provides a solid ground for prompt

61 See *infra* Chapter 1, Section 5; see also *infra* Annex III.

62 Cf., e.g., European Court of Human Rights, *James and others v. The United Kingdom*, Judgment of 21 February 1986, Series A No. 98, para. 54.

63 See FSB, *supra* note 1, Key Attributes 5.1; see also IIF, *supra* note 3, at ¶17.

and decisive action in resolution. However, because it raises several procedural and practical questions (including but not limited to determination of the compensation), internationally accepted and detailed guidance on its application should be developed on the basis of the *Key Attributes*.

4.2. Group Subordination Issues

A critical aspect of group resolution is reconciling the treatment of different corporate members of a single group with respect to the insolvency hierarchy. The relative treatment of creditors of a parent company and its subsidiary in a group resolution context is not entirely straightforward.

It is conventional to speak of creditors of a holding company as "subordinated" to creditors of its subsidiary.[64] This is because the creditors of the holding company own the equity in the underlying businesses—that is, the net amount that will be left after the underlying business has paid off all of its other creditors.

It is, however, important to note that resolution authorities may well depart from ordinary insolvency practice by treating intra–group creditors differently from ordinary creditors. This would commonly be done by leaving intra–group creditors in the "bad–bank" while transferring other creditors to the "good–bank." The effect would be in practice to subordinate creditors of the entity whose loans had been thus reduced. In a whole–group, "single–entry" resolution, the claims of the parent would likely remain in place but might be subordinated to the claims of the depositors of the subsidiary.[65]

We do not believe that respecting insolvency hierarchy prohibits dealing with intra–group exposures in this way. Differential treatment of intra–group exposures may *a priori* prejudice some creditors of the group (normally at the parent level) at the expense of others. That is inherent in the concept of *group resolution*, to which however, the same premises apply to justify the exceptions at the entity level. Maximizing recoverability will require some deviation from a very formal reading of traditional hierarchies which, if done on the basis of well–understood principles and subject to the principle of NCWOL, should not be troubling. Again, it needs to be emphasized that group bail–in on the basis of this principle is much more likely to avoid unnecessary value destruction than would strictly carrying out traditional insolvency concepts and procedures.

However, intra–group exposures must be addressed on a case–by–case basis with reference to the structure of the individual group concerned. Resolution authorities should not allow it to become accepted that creditors of parent entities will always be *de-facto* subordinated on a resolution, or that creditors of subsidiary entities will always be preferred. In general, bank group financing structures are carefully calculated to balance the interests of competing group creditors, and resolution authorities should work within the existing structure of each group.

Resolution authorities need to bear two further points in mind. First, that in order to facilitate a "highest point–of–entry" approach, provisions that discourage creditors from lending at such level are likely to be counterproductive. Second, investors' expectations should be supported in order to avoid creating uncertainty and thereby increasing the risk premium charged by investors for such senior debt.

Insofar as resolution of a given group would be likely to involve some degree of *de facto* (or *de jure* where the "source–of–strength" doctrine applies) subordination of parent–level creditors, disclosure thereof will help create the necessary transparency and predictability of an eventual resolution.[66]

4.3. Branch Issues

The application of the NCWOL test to creditors of a branch is complex. In the United Kingdom, and in many other jurisdictions, local insolvency law contains provisions that would in certain circumstances permit a domestic branch to be wound up as a separate entity under domestic law. This provision is however circumscribed by the Credit Institutions (Winding–Up) Directive as to EU institutions. Equally, judicial precedent and policy tends in favor of universal proceedings,[67] and the UK courts would generally be unwilling to sanction branch proceedings in which universal proceedings were in process in the home jurisdiction.

On the other hand, US and other laws allow for separate branch winding up. Such proceedings are likely to mean that local branch creditors may enjoy better treatment than other creditors and that this

64 This principle may be reflected in regulation, as in the US "source–of–strength" doctrine; however, it is analytically somewhat different as a matter of corporate law.

65 *See infra* Annex III, Section 2.

66 *See infra* Annex III.

67 The "universal" approach, requiring treating an entity as a whole, including all its branches, is opposed in insolvency doctrine to the "territorial" approach, which allows fragmented proceedings.

appears unjust. While it may be politically difficult to change such rules, an international Convention should allow such rules to be overridden, if all come to see that ultimately all claimants are generally better off—and the system is certainly better off—if a universal approach is taken, permitting equal and fair treatment of all creditors similarly situated. The lessons of the Lehman Brothers case suggest that such would be the best path to take in the interest of all. Even a non–binding Convention (or a more emphatic statement of the Key Attributes when converted into fully fledged international standards) would be helpful to the extent that national authorities would have discretion on whether to insist upon local proceedings and could conclude that fair treatment of their national creditors should be in line with fair treatment of all.[68]

4.4. Approaches to NCWOL

4.4.1. The US Minimum Recovery Right

The "minimum recovery right" in the US Bankruptcy Code is designed to guarantee creditors in insolvency proceedings that they will, at minimum, receive as much as they would have received had the institution been liquidated under the Bankruptcy Code. The right has been developed through long–standing practice in bankruptcy and is reflected in the OLA contained in Title II of the Dodd Frank Wall Street Reform and Consumer Protection Act. An equivalent right is embedded in the resolution of an insured depository institution under the Federal Deposit Insurance (FDI) Act.

Regulations are being developed to implement OLA, addressing issues fundamental to determining the minimum recovery amount, including the process for calculating the hypothetical liquidation value of the institution in insolvency proceedings and judicial oversight of the valuation and claims payment process.

4.4.1.1. The Bankruptcy Code

The minimum recovery right has a statutory basis in the Bankruptcy Code and has been developed through judicial precedent. Under the Bankruptcy Code, for a Chapter 11 reorganization plan to be confirmed over the objection of a class of creditors who are not being paid in full, a "best–interests" test is imposed, which requires that the creditor will receive or retain under the plan, on account of its claim or interest, property of a value as of the effective date of the plan, that is not less than the amount that such creditor would so receive or retain if the debtor were liquidated under Chapter 7.

The Bankruptcy Code also allows the majority of an impaired creditor class to commit the entire class against a dissenting minority. The best–interests test therefore provides the minority some protection, ensuring that the plan will, at a minimum, provide an equivalent value to a liquidation. The best interests test imposes a three–part burden of proof on the proponent of a plan, who must (a) produce evidence proving the liquidation value of each asset in the bankruptcy estate, typically through appraisals and expert analysis; (b) establish that the plan's value distribution to any given creditor is at least equal to the anticipated liquidation value; and (c) establish that the plan's allocation of value among creditors is in keeping with the distribution for liquidation, effectively respecting the typical creditor hierarchy. In order to demonstrate that this requirement has been satisfied, a debtor will typically include a valuation in its disclosure statement. The plan, and therefore the valuation itself, receives independent review by the judge who must confirm the plan.

4.4.1.2. The FDI Act

The FDI Act does not set forth a minimum recovery right as does the Bankruptcy Code or OLA. Rather, it specifies that the maximum liability of the FDIC to a claimant as receiver for an institution being resolved is the amount the claimant would have received if the FDIC had liquidated the institution. In practice, this "maximum" ensures that the claimant will receive what it would have received in a liquidation.

In practice, for non–deposit creditors, there is generally very little recovery in a bank liquidation.

Under the domestic depositor preference provisions of the FDI Act, deposits payable in the United States have priority of payment over all other unsecured claims, including deposits payable solely outside the United States and general unsecured creditors.[69] The assets of a failed institution are typically insufficient to satisfy the claims of creditors junior to depositors.

This maximum recovery right allows the FDIC to pay certain unsecured general creditors in full, however, while relegating others to the minimal recovery that would result from a liquidation. For instance, the FDIC can pay utility suppliers in full, in order to keep the lights on, without having to pay unsecured bondholders in full.

4.4.1.3. The OLA

OLA provides creditors with a minimum recovery right, requiring that a claimant will receive from the

68 See also infra Annex I.
69 See generally IIF, supra note 3 ¶ 40.

FDIC as receiver at least as much as the claimant would have received in a liquidation under Chapter 7 of the Bankruptcy Code. While the FDIC's rights and responsibilities under OLA are largely modeled on the FDI Act, this reflects the drafters' desire to harmonize the rules defining creditors' rights with the Bankruptcy Code. The minimum recovery right represents an important protection for creditors in an OLA proceeding in which the FDIC retains significant discretion to treat similarly situated creditors differently, but unlike an FDI Act proceeding, there are no depositors as creditors with priority of payment and no deposit insurance fund to protect.

Unlike the Bankruptcy Code, however, in which the valuation must meet certain evidentiary burdens, and distributions are subject to judicial review before approval, under OLA, the valuation is determined by the FDIC, and judicial review of claims determinations is only permitted after the fact. The remedy for any claim determined to be valued inadequately would be a court order to pay the shortfall, presumably from clawing back excess benefits from more fortunate creditors and through assessments on large financial institutions.

It is at present unclear what process is to be used by the FDIC in assessing the liquidation (and therefore minimum recovery) value of a claimant. Critics have noted a risk that the liquidation value of a financial institution, especially in a widespread financial crisis, would be near zero. This may come about as a financial institution in liquidation proceedings could face a "meltdown" scenario in which depositors, creditors and counterparties run or may have trouble valuing troubled assets at anything but fire-sale prices.

There is only after-the-fact judicial review and no injunctive relief under Title II in order to enforce the minimum recovery right. The FDIC has broad authority to conduct the administrative claims process, subject to after-the-fact *de novo* judicial review.[70] The cost of such individual proceedings could be prohibitive and exceed the shortfall amount claimed. The policy issue is whether to provide aggrieved parties with an express right to a collective proceeding in court after the termination of the receivership. Proponents have argued that such a collective proceeding, or just the threat of such a proceeding, would provide a check on the FDIC in carrying out its duty to make sure all left-behind claimants receive what they would have received in a liquidation. It would also give them a practical remedy if the FDIC violated this requirement. The opposite argument is that the FDIC is a federal agency that can be trusted to carry out its statutory duties responsibly and that a collective proceeding could subject the FDIC to unnecessary litigation costs and uncertainty.

4.4.2. The UK NCWOL Test

The UK Bank resolution regime applies a NCWOL test in respect of resolution activities. The essence of the UK regime is that if a creditor can demonstrate that in the events that happened he has been left worse off than he would have been in an insolvency, he will be entitled to compensation. This compensation is payable—in effect—out of a resolution fund. Because the protection is secured through a right to compensation, the authority is not prevented from exercising any particular power in any particular way, even if the exercise of that power in that way has the effect of making a particular creditor or class of creditors worse off. In particular, creditors have no right to apply to the court to restrain the resolution authority from the exercise of that power in that way.

Where a creditor claims compensation under these provisions, an expert valuer is appointed to determine the hypothetical recovery that would have occurred had the institution concerned been placed in insolvent liquidation. The valuer is required to proceed on certain assumptions (e.g., the complete absence of any government intervention at all in support of the institution) that have the effect of setting a hypothetical disorderly failure as the counterfactual upon which the valuation is based.

4.4.3. Domestic Depositor Preference: An Anomaly

Domestic depositor preference (beyond insured amounts) is problematic for obtaining a wholly fair and equitable international result in resolution, in accordance with global application of NCWOL, but there are some indications that the relevant US agencies (generally the FDIC and state banking agencies) have the discretion to deem a global result a fair result for their claimants. However, this is an issue that would ideally be addressed in the fullness of time by an international Convention to resolve the ambiguities necessarily created by leaving the issue to administrative discretion.

4.4.4. Conclusions

It will be obvious from the above explanation that NCWOL has a deep history in US practice, both in the context of reorganization of bankrupts of all kinds and

70 Dodd Frank Act §§ 210(a) (2)-(4).

in the context of resolution of financial institutions, which (except for the domestic depositor preference) is generally aimed at the same goals as the FSB's work on resolution. That doctrine and practice still need to be fleshed out under OLA means that there is some scope for further alignment of US practice with the FSB recommendations, and the active commitment of the FDIC and other US agencies to the international dialogue is encouraging in this regard.

5. STAYS

A substantial question for the predictability and effectiveness of cross–border resolution is uncertainty as to whether the exercise of resolution powers will be recognized under the law of other relevant jurisdictions. For reasons discussed later, transactional "financial contracts" require special treatment if the goals of minimizing market disruption are to be achieved. Therefore, internationally consistent and predictable treatment of such contracts is essential.

Take for example a UK bank with US over–the–counter derivative counterparties. On a resolution of the bank, the Banking Act 2009 provides the Bank of England powers to effect a stay of contractual rights that would otherwise be triggered by resolution. With respect to master agreements governed by English law, there is no doubt that the English courts will give effect to the stay. If, however, a master agreement is governed by New York law, a conflict–of–laws issue arises: Will the New York courts give effect to the stay? As there is no settled law, the answer is uncertain. Questions of comity and public policy may conflict (globally fair resolution may be attacked by specific creditors seeking a better result under local law), and this question may be resolved on the facts of a specific case as they affect local creditors. It is clearly undesirable that resolution authorities' actions be overturnable at the instance of foreign courts.

There are in broad terms two possible solutions to the jurisdictional limitations of national bank resolution statutes. The first is legislative: recognition of foreign resolution actions. The *Key Attributes* paper has ducked this issue, largely due to perceived concerns around political feasibility. While understandable, we believe that this risks missing a real opportunity to create a fully fair and predictable cross–border resolution framework.

The second is regulatory and contractual: To support resolvability, foreign–law governed master agreements (and supporting documentation) could include a provision requiring the counterparty to be bound by resolution actions. With respect to master agreements documented under industry association standards (such as the master agreements published by the International Swaps and Derivatives Association, and jointly by the Securities Industry and Financial Markets Association and the International Capital Market Association) action to produce the relevant provision could be coordinated through relevant trade associations, and we believe that investigations along these lines are being conducted. There will, of course, be many other bespoke contracts that include netting provisions (e.g., prime brokerage and clearing agreements) that would also need to be rendered eligible. Although detailed research into the enforceability of such provisions remains to be done (and much would inevitably depend on the nature and potential use of the resolution powers), in principle there seems to be little doubt that such a contractual provision would be legally effective in respect of ordinary course financial dealings.

Implementation would pose various additional challenges. These include substantial diligence and investment to change existing legal documentation (albeit that industry–agreed master agreements, which document the vast majority of nettable arrangements by value, should be capable of change via industry protocols) and to put systems in place to ensure that foreign law governed documentation is assessed against the requirement.

This approach has much in common with the "hybrid" approach to resolution noted earlier.[71] A multilateral arrangement under which parties to particular master agreements would be expected to adhere to a protocol produced by the relevant industry association would be a decisive step forward. Such protocol would provide that, in the event of resolution proceedings in respect of a particular institution, parties to the contract would not be entitled to exercise rights to close out or terminate contracts in which the exercise of such rights would be contrary to the stay regime that applied in the jurisdiction of the resolution. This would provide a basis for global enforcement of resolution stays. Emphatic backing by the FSB would be helpful to ensure broad and consistent adoption and to provide a context for future judicial interpretation. In the long run, such arrangements might better be solidified in an international Convention (see, e.g., Article XV of the draft Convention in Annex I); however, arrangements such as discussed in this section should be robust enough to provide good assurances to the market over the medium term.

71 See *supra* Chapter 1, Section 2.2.
72 See FSB, *supra* note 1, Annex IV.

5.1. Design of a Stay Regime

The proper treatment of financial contracts during the resolution or bail–in of a SIFI requires balancing the sometimes conflicting needs of regulators, markets, and creditors. On the one hand, there are the goals of market stability, and the needs of regulators to swiftly, flexibly, and decisively exercise resolution powers. On the other hand, there are goals of predictability, the preservation of rights of parties to financial contracts, and the need to protect creditors against arbitrary and value–destroying actions. To balance these competing needs, resolution regimes (and international standards promulgated by the FSB)[72] should provide for the following treatment of financial contracts:

(a) Counterparties should be temporarily stayed for 1 business day following the initiation of resolution procedures from exercising financial contract termination rights premised solely on the financial company's failure, financial condition or entry into resolution in order to facilitate the possible transfer of such contracts to a bridge institution or a solvent third party; and

(b) Counterparties under any contracts so transferred should be permanently stayed from exercising such termination rights or those premised solely on the transfer of financial contracts. Similarly, if the resolution takes the form of a bail–in, counterparties should be permanently stayed from exercising termination rights premised solely on the bail–in of the financial company and exercise of related bail–in powers.

The exercise of resolution authority and the treatment of financial contracts should be subject to NCWOL protections.

5.2. Background

Under many financial contracts, the insolvency or resolution of one party generally gives rise to an event of default or other termination event entitling the counterparty to terminate the agreement, liquidate, accelerate, and net obligations owing between the parties and foreclose on and set off against any collateral (collectively, rights to "close out"). Many insolvency regimes automatically stay the exercise of closeout rights premised solely on the failed company's entry into insolvency proceedings. However, over the past two decades, there has been a concerted and successful effort to protect the exercise of such rights under financial contracts, with the result that the insolvency laws in many jurisdictions now protect the exercise of contractual rights to closeout financial contracts upon the insolvency of a counterparty.

The protection of such closeout rights is designed to prevent the failure of one financial company from causing the failure of other financial companies, and so that firms can avoid uncertainty in the size of their risk positions, which are especially important in a volatile market. It is thus highly relevant to the financial stability goals of resolution adopted by the FSB and G20. Unlike the value of physical assets or real estate, the value of financial contracts can change rapidly and significantly, meaning that the loss a counterparty would be exposed to if unable to close out an insolvent counterparty would be impossible to predict and difficult to hedge against. This risk can arise because

(a) The financial contract moves "in the money" or further in the money to the counterparty, and the resulting exposure is uncollateralized because it exceeds the collateral posted by the failed company, and the failed company does not or cannot provide additional collateral;

(b) The value of collateral posted by the failed company declines in value, resulting in an uncollateralized exposure to the failed company; or

(c) An obligation of the counterparty to the failed company matures, resulting in a payment obligation to the failed company which, if made, eliminates an offset against an uncollateralized obligation owed by the failed company to the counterparty.

These risks are magnified for SIFIs because of the volume of financial contracts they enter into in their roles as dealers, market–makers, or service providers to "end users." Further, financial companies, and SIFIs in particular, frequently hedge exposures under one financial contract with exposures under other financial contracts. For such companies, the inability to close out an insolvent counterparty would result in the creation of significant unhedged and potentially destabilizing exposures. Absent the right to close out upon a counterparty's insolvency, these risks could spread instability throughout the financial system.

However, in the case of the failure of a large financial company, protecting the rights of counterparties to closeout may be insufficient to protect markets. As seen during the failure of Lehman Brothers, the simultaneous closeout by thousands of counterparties of millions of financial contracts can itself have destabilizing effects on markets and exacerbate the loss of value inherent in traditional insolvency proceedings. In the case of Lehman Brothers, the amount of closeout costs is estimated in the tens of billions. While closing out is the rational choice for any individual counterparty, the net effect of so many counterparties' liquidating collateral, attempting to value illiquid assets, and seeking to enter into new transactions to replace or hedge closed–out positions can distort asset prices and interrupt the flow of credit. Of course, had the financial contracts' counterparties to Lehman Brothers been subject to the automatic stay applicable to other creditors and been prohibited from closing out their financial contracts, the effects would have been far worse, likely leading to the failure of one or more of Lehman Brothers' major counterparties and a potential cascade of failures throughout the global financial system.

To maximize the protection of financial markets during a resolution, some insolvency regimes provide for the transfer of financial contracts to either temporary bridge institutions or third–party acquirers (the recapitalization of a firm by bail–in within resolution would have the same effect). This mitigates the risks of both generally applicable automatic stays on closeout rights and of the simultaneous exercise of closeout rights by transferring the financial contracts of a failed company to companies willing and able to perform under the contracts. In order to facilitate such transfers, these regimes temporarily stay closeout rights for a brief period, generally 1 business day, giving the resolution authority the opportunity to consider the most effective use of its resolution powers under the circumstances, including the power to transfer financial contracts. In the event that financial contracts are not transferred during the brief stay, counterparties are entitled to exercise contractual rights to closeout upon the expiration of the stay. This is the approach taken under the US and German bank insolvency regimes and the US OLA regime described earlier, and in a somewhat different way, the UK approach as well.[73]

A third approach to protecting markets is to provide continuity by having regulators take control of the failed firm and inject capital or provide liquidity to ensure that it can meet its obligations as they come due, in a conservatorship or nationalization. This approach substantially mitigates the risks associated with both generally applicable automatic stays on closeout rights and with the simultaneous exercise of closeout rights by ensuring the failed firm continues to perform its contractual obligations. Accordingly, rights to closeout based on the exercise of resolution authority are typically made unenforceable (although all other closeout rights, such as those based on a failure to pay or perform, remain enforceable). While this approach can be effective, it is disfavored for putting taxpayer funds at risk and raises the specter of moral hazard.

5.3. 1-Business-Day Stay to Facilitate the Transfer of Financial Contracts During Resolution

Where a failing financial company has been placed into resolution, the exercise of financial contract closeout rights premised solely on the financial company's failure, financial condition, or entry into resolution should be stayed for 1 business day following the initiation of resolution procedures in order to facilitate the possible transfer to a bridge institution or a solvent third party, or to avoid closeout in cases where the credit of the original counterparty is restored through debt conversion or write down techniques.[74]

We disagree with the FSB that the preferable approach in a resolution is to stay all closeout rights premised on the financial company's entry into resolution or the exercise of resolution powers permanently[75]. As discussed earlier, such an approach exposes counterparties to significant losses that are difficult to anticipate, and therefore to hedge against, which can in turn pose spill–over systemic risks to markets. Because resolutions can be effectively conducted without permanently staying such closeout rights, these risks are unnecessary.

In the alternative, the FSB recommended a temporary stay to facilitate the transfer of financial contracts subject to conditions similar to those that we now endorse.[76] An extensive discussion among lawyers and financial experts concluded that a temporary stay gives resolution authorities sufficient flexibility to tailor their exercise of resolution powers to the circumstances of a particular resolution and protects markets from disruption without exposing counterparties to excessive risks or unnecessarily disrupting contractually negotiated arrangements.

To strike this balance, such a regime should have the characteristics described below. While these characteristics are substantially similar to those described by the FSB in Annex IV to its *Key Attributes*, our recommendations differ in certain key respects.

(a) The stay should apply to all financial contracts, together with all associated collateral, guarantees, and other credit support and any associated rights, claims and interests.

(b) The scope of financial contracts subject to national stay regimes should be harmonized across jurisdictions to increase market certainty and eliminate the distortive effects (both before and

73 *See supra* Chapter 1, Section 4.

74 *See generally* IIF, *supra* note 3; *see also* IIF Response, *supra* note 31 at 41; *see also infra* Annex I.

75 *See* FSB, *supra* note 1, Annex IV.

76 *See* FSB, *supra* note 1, Key Attributes 3.2(x).

during a resolution) flowing from the differential treatment of similar contracts entered into with various entities within a cross–border financial group.

The FSB *Key Attributes* did not define the scope of contracts that should fall within the term *financial contract*, but the scope of this definition directly affects the resolution techniques that can be used.[77] As discussed further in this chapter, we recommend that all financial contracts with a given counterparty be treated the same during resolution and that there be a presumption that all such contracts will be transferred during resolution to a third party (including a bailed–in successor institution in appropriate cases).

Unless the scope of financial contracts is limited to exclude loss–absorbing instruments and other forms of general financing, these requirements would make it impossible to use resolution strategies that leave behind certain debt obligations in order to recapitalize the failed entity or otherwise differentiate between, for example, collateralized swaps and repurchase agreements on the one hand and subordinated debt on the other. Therefore, the definition of "financial contract" should be limited to contracts that are *transactional* in nature and exclude contracts that provide unsecured *funding*. Such a distinction is necessary to preserve the loss–absorbing capacity of capital instruments. This distinction is warranted based on the greater risk of runs by transactional counterparties and the greater risk to financial markets posed by such runs as compared to runs by financing counterparties.

However, in order for the risk of transactional counterparty runs to be reduced, counterparties must be able to determine *ex ante* with high degrees of confidence whether an agreement will be treated as a financial contract during a resolution. Therefore, the definition of "financial contract" must be clear and specific, and we suggest the FSB include greater clarity in future international standards.

(c) The stay should prohibit the exercise of closeout rights that arise solely because of the failure of the financial company, its financial condition (including any changes to or withdrawals or suspensions of ratings during the stay), or the exercise of resolution powers, including the transfer of financial contracts to a bridge institution or acquirer.

(d) The duration of the stay should not exceed 1 business day. A stay of longer duration would expose counterparties to risks that would be difficult to predict and would therefore be difficult to protect against with additional collateral. The length of any stay should be clearly established in advance to allow counterparties to model the risks associated with the stay and to negotiate for adequate collateral or other protections.

(e) During the stay, payment and performance obligations of the failed financial company should not be stayed, and counterparties should at all times retain the ability to exercise any closeout rights not stayed under (c) above, such as those based on a failure of the financial company to make a payment or otherwise to perform under financial contracts. Such an approach is consistent with the goal of preserving the economic function of the failed financial company during and after a resolution and the presumption that all financial contracts will be transferred during a resolution.

(f) By contrast, the payment and performance obligations of counterparties to the failed financial company should be suspended until the earlier of the end of the stay or transfer of financial contract. Such an approach is necessary to protect from disparate treatment counterparties whose payment or performance happens to be required during the stay. Further, this reduces the pressure for financial contract counterparties to run in advance of a resolution by providing assurance that they will not be required to pay on contracts during resolution that may subsequently be left behind.

(g) As a practical matter, resolutions typically are conducted over a weekend, with transfers of assets and liabilities being announced before markets open and before most payment or performance obligations can arise. Further, such obligations under many industry standard forms of documentation are subject to grace periods of 1 or more days, meaning that the failure of the financial company in resolution to make a payment during the 1 business day stay may not ripen into an actionable closeout until after the expiration of the stay.

(h) There should be a strong presumption that *all* financial contracts with all counterparties will be transferred during resolution. Such a presumption would be consistent with results in practice in the United States, although the authorities have cherry–picking powers that can be used to avoid anomalous results or deal with extreme cases. Absent such a presumption, counterparties will have an incentive

77 See generally FSB *supra* note 1.

to run on a troubled financial company given the risk of being "left behind" in a resolution, reducing the resolution regime's ability to reduce the likelihood that SIFIs might fail. Any ability of a resolution authority to cherry–pick among counterparties must be subject to clear conditions of exercise of such power and clear criteria to determine which counterparties to transfer and which to leave behind.[78] It is important to enable counterparties to determine *ex ante* with a high degree of confidence whether or not they face the risk of being left behind during a resolution.

(i) Financial contracts should be transferred only under the following conditions:

- The transferee (including a bridge institution or a bailed–in successor institution) is creditworthy, meaning that it is not subject to insolvency or resolution proceedings and is determined by the resolution authority to be able to perform the obligations under the transferred agreements;
- The transferee is subject to a legal regime that allows counterparties to exercise closeout rights to the same extent as under the laws applicable to the failed financial company, with the result that the transfer does not change the netting of the transferred contracts;

(j) The party to which financial contracts are transferred should assume all rights and obligations of the failed financial company under the transferred contracts, including provisions governing margin (including provisions to post additional margin because of the nature or financial condition of the transferee), default and closeout.

(k) Counterparties to transferred financial contracts should be *permanently stayed* from exercising any closeout rights that arose solely because of the insolvency of the failed financial company; its financial condition (including any changes to or withdrawals or suspensions of ratings during the stay); or the exercise of resolution powers, including the transfer of financial contracts to the transferee. Counterparties to transferred financial contracts should be entitled to exercise any other closeout rights that arise because of the transferee's failure to pay or perform as required under the contract or the financial condition or rating of the transferee.

(l) Counterparties to financial contracts that are not transferred should be permitted to exercise any closeout rights upon the earlier of the expiration of the 1 business day stay or notice that the financial contracts to which they are party will not be transferred.

5.4. Stay on Closeout Rights to Facilitate the Bail-in of a Financial Company

Where regulators exercise statutory authority to recapitalize a failing financial company by converting to equity certain liabilities of the company,[79] a permanent stay on the exercise of Closeout rights under *all* contracts of the financial company that are premised solely on the Bail–in of the financial company should be provided for the reasons discussed earlier.

Such a stay is consistent with the systemic risk reduction goals inherent in Bail–in and necessary to realize the continuity of the financial company's operations and contractual arrangements. To achieve these results, the permanent stay must in addition apply to all contracts—not just financial contracts—so that the recapitalized firm can continue operating as a going concern. It is also appropriate both because of the improved financial condition of the bailed–in entity and the assumption that bail–in will be subject to conditions that only allow its exercise if the result will be a financially viable entity. Finally, counterparties' ability to exercise all other closeout rights, including those based on the financial condition or rating of the bailed–in entity, adequately protect counterparties.[80] Thus, this approach achieves the continuity benefits of a conservatorship but without relying on taxpayer funding or increasing moral hazard.

5.5. Cross-Defaults

The exercise of resolution or bail–in powers with respect to one member of a financial group may give rise to closeout rights under financial contracts, loan agreements, debt instruments, or other contracts of other members of the group. Such cross–defaults would be an issue, for example, in cases in which a parent has guaranteed the obligations of its subsidiaries and resolution or bail–in powers are exercised with respect

78 Consistently with existing law in several jurisdictions, the rule should be that, if cherry–picking powers are exercised to "leave behind" contracts of certain counterparties in a bad bank, the choice would apply to all or none of counterparty's contracts; the authority would not be permitted to pick and choose specific contracts.

79 *See also* DG Internal Market and Services, *supra* note 13.

80 Rating agencies may well suspend or withdraw a bailed–in financial company's rating upon its bail–in or rate the company as "in default" based on the conversion of certain of its debt to equity (notwithstanding the bailed–in company's increased ability to pay on its remaining obligations). The uncertain treatment by ratings agencies of a bailed–in financial company may pose a challenge to the successful exercise of bail–in powers for companies with a material number of financial contracts subject to ratings–based events of default. This issue and its practical implications for bail–ins deserve further consideration.

to the parent. Such cross–defaults are most common in financial contracts, although they do also occur in loan facilities and debt offerings (particularly structured debt). This issue was not addressed by the FSB Key Attributes but is a critical element of SIFI resolution. It will be especially important to address cross–defaults if the efficiencies promised by "single point–of–entry" resolutions are to be pursued for integrated groups or subgroups.

A credible SIFI resolution regime must be able to resolve a SIFI as a group and therefore must be able to address the issue of affiliate cross-defaults. While the issues are less obvious, cross–defaults also require analysis for resolution of decentralized groups, especially if separate resolution of subgroups is considered. To this end, resolution regimes should include the ability to make unenforceable cross–defaults in contracts of affiliates of a financial company being resolved or bailed–in that are based solely on the failure of the financial company, its financial condition (including any changes to or withdrawals or suspensions of ratings during the stay), or the exercise of resolution or bail–in powers.[81] In exchange for becoming subject to this extraordinary but necessary power, creditors must be assured that they will not be made worse off by the loss of such cross–default rights. Under the OLA provisions of the Dodd Frank Act, the resolution authority may make permanently unenforceable cross–defaults in contracts of affiliates of the failed financial company premised solely on the failure of the parent or its entry into resolution if either the guarantee or credit support giving rise to such cross–default is transferred to a bridge financial company or third–party acquirer or the resolution authority otherwise provides "adequate protection."

The IIF urges the FSB to take up this issue and establish international standards for addressing affiliate cross-defaults during resolution. In the absence of such a regime and its enforceability in relevant jurisdictions, whole-bank resolutions or bail-ins—which may often be the best vehicles to achieve the overall FSB resolution goals—may not be possible for certain types of SIFIs.

5.6. Cross-Border Issues

As discussed earlier[82] the enforceability in other jurisdictions of actions taken by a resolution authority is critically important to effective cross–border resolution. For financial contracts and cross–defaults, it is necessary to ensure that stays are immediately enforceable in all relevant jurisdictions. The absence of certainty with respect to enforceability will limit the effectiveness of a resolution regime in reducing systemic risk and stabilizing markets.

Ideally, regulators in relevant jurisdictions would have the statutory authority to recognize, defer to, and enforce the actions of a resolution authority in another jurisdiction to stay closeout rights, transfer contracts or convert debt to equity as described earlier. As a guide for developing such a recognition regime, the international community need only look to the UNCITRAL Model Law on Cross–Border Insolvency enabling insolvency courts in one jurisdiction to recognize and coordinate with insolvency courts in other jurisdictions to facilitate the insolvency of cross–border business entities. In the context of resolution authority, it would likely be necessary to implement such a recognition regime in an administrative context rather than a judicial context. Nonetheless, the UNCITRAL approach should offer significant and helpful guidance on balancing various competing interests. The model Convention included in this report points in this direction.

Cross–border enforceability of resolution actions can also largely be achieved contractually by having parties agree to be bound by the actions of relevant resolution authorities. This approach has the benefit of including in the parties' agreement their intent to be bound by such actions, eliminating the need for resolution regimes to interfere with parties' bargained for contractual arrangements and any challenges to the actions of a resolution authority on constitutional or civil rights grounds. This point is discussed further at the beginning of this section.

In the context of banks with foreign branches, the inconsistent treatment of financial contracts, such as different stay regimes being applied to the head office and its branches, could interfere with or destroy the setoff right of parties that trade with both offices. Therefore, we recommend that changes be made to local law to clarify that branches are subject to the financial contract regime of their home office and not that of the country in which the branch is licensed.

Temporary or permanent stays on closeout rights may be inconsistent with certain European directives, such as the Financial Collateral Directive and the Settlement Finality Directive, and may conflict with laws or insolvency principles in other jurisdictions. To the extent necessary, we recommend that all such directives, laws and regulations be amended to permit

81 The issues that require such a treatment of affiliate cross–default rights are uniquely present in financial companies. Thus, such a power is only necessary for financial company resolution regimes and not for insolvency regimes generally applicable to business entities.

82 See supra Chapter 1, Section 1.

the operation of the stay regimes described earlier. Presumably the European Commission's forthcoming resolution proposals will address these issues.

CHAPTER 2. GROUP RECAPITALIZATION AND LIQUIDITY

1. ACCOMMODATING DIFFERING GROUP STRUCTURES WITHIN A GLOBAL RESOLUTION REGIME

Because one of the more important issues of resolution is efficiency as a means of reducing losses and preserving systemic stability, it follows that a resolution should entail as little disruption to the corporate structure of a group as possible.[83] Annex II includes an explanation of some paradigmatic group structures, for use as references. For many institutions, especially those managed on a relatively integrated basis, any resolution should be applied as far up the corporate structure as possible.

This does not imply a requirement that all resolutions should take place at the holding–company level (as in the "single–point–of–entry" approach). Some groups are structured as integrated economic entities, which would be resolved as single units. In decentralized groups, resolution at the level of individual legal entities (or lead entities of subgroups) is likely to be appropriate. It should be an overriding priority of the resolution authority to give effect as far as possible to legitimate expectations, and if creditors incur exposure to a particular business unit of a group, it would be a breach of ordinary principles to give creditors of those business units recourse to the assets of other parts of the group on a resolution.

The appropriate level at which to effect resolution is essentially defined by the institution itself in the way it configures itself, as reflected in its resolution and recovery plan. Institutions that rely upon a decentralized structure, in which certain companies or subgroups of companies are expressly structured to be independent of group support with their own creditors and assets (and may have partial outside ownership or independent listings), should have that structure followed into resolution. In such cases, the "single point of entry" to resolve the issue should be the top–most company of the subgroup so identified.

It is clear that one major purpose of the RRP[84] should be precisely to determine how the group would be resolved. It therefore follows that all SIFIs will have reached agreement with the relevant resolution authorities as to the extent to which the resolution should be on a decentralized or a single–entity basis.

Because all groups will have entities that are stand–alone (asset holding companies established as part of limited–recourse financing arrangements are an obvious example), and decentralized groups are likely to have integrated subgroups, resolution plans will contain elements of both approaches. Thus, each group and the relevant resolution authorities will have to consider a range of resolution options for each subgroup.

The position is slightly more complex with respect to branches.[85]

These are no more than illustrations of broad classes of group structures, and in each case the theoretical deployment of resolution measures would be dependent primarily on the type and volume of funding raised at each stage within the group, and application of the NCWOL test and principle of recovery maximization.

2. EXECUTION OF RESOLUTION

2.1. International Legal Issues

2.1.1. Effecting Legal Transfers

Three things must be accomplished to ensure bail–in within resolution as defined in the FSB *Key Attributes*.[86] One is to write down the relevant unsecured debt. The second is to issue new equity to the written–down debt–holders.[87] The third is to cram down the existing equity. Both the second and the third may also require legislative change in the country of incorporation of the bank.

Creation of new equity may in some jurisdictions be possible through amendment to the constitution of

83 *See* IIF, *supra* note 3, at ¶ 27, 127.
84 *See supra* Chapter 1, Section 1.
85 *Id.*
86 *See also* DG Internal Market *supra* note 13.
87 Note that this does not apply to "conditional capital" instruments that provide pure write–down in case triggers are passed, rather than conversion.

the company concerned, but in others statutory change may be required.

Cram–down is more problematic. Again, in some jurisdictions this will require legislation in order to amend existing company law concepts. In some it may be sufficient to issue warrants to former equity holders entitling them to whatever residual value may be realized after satisfaction of all other claims.

In some countries, such as Denmark, there is an explicit look–back requirement to ensure that fairness to relevant creditors is respected.

2.1.2. Existing International Insolvency Regimes

Several international coordination measures currently in force enable corporate restructuring proceedings under the law of one state to be upheld and enforced in the courts of other states. The most important are the EU Credit Institutions Winding Up Directive (WUD)[88] and the UNCITRAL model law on cross–border insolvency.[89]

While these measures are not directly applicable to the problem of cross–border financial institutions, they do show a pattern of international measures that, if slightly varied, would provide exactly the robust platform necessary for cross–border recognition of bank resolution.

2.1.3. Regulatory and Securities-Law Issues

If a resolution regime involves the conversion of debt into equity, it is likely to be necessary to include provisions that allow the regulator to cap the amount of an individual shareholding (and to convert the excess into a claim on the eventual proceeds of disposal of the shares). Large banking groups have regulated subsidiaries around the world, and it could undermine resolution if, for example, it would trigger prior filing or approval requirements if it results in a single creditor's acquiring in excess of a 10 percent shareholding.

In most jurisdictions, the offering of securities to investors triggers prospectus and other requirements. Clearly none of this is possible in a resolution. Any resolution tool including conversion into new securities based on satisfaction of the NCWOL test will require that all relevant securities–law concerns be addressed. While it is possible that such solutions could be effected by mutual recognition, a clear, uniform international standard procedure, presumably allowing the relevant authorities to carry out the resolution either without regard to such requirements or by delivery into a vehicle that would later meet such requirements, is required. Once again, the principle of assuring the greatest recovery for the greatest number of claimants with the least disruption should trump traditional formalities, subject to minimum fairness rules. The administration of the procedure by responsible authorities should also provide grounds for appropriate exemptions from conduct–of–business and investor protection requirements.

2.2. Single Point of Entry

The simplest way to resolve an institution is to recapitalize it at the group holding–company level (see Annex II for further exposition of structural concepts). This obviates the necessity for asset transfers within the corporate structure and means that recapitalization can be effected by downward transfers within the group as needed. For a single entity whose financial creditors are primarily at the holding–company level, this means that the optimal strategy is the "highest possible single–point–of–entry" strategy. In this relatively simple approach, only one legal entity is subject to resolution, which simplifies many of the other issues mentioned earlier. The rest of the corporate structure can be strengthened where necessary through internal transactions. By converting a parent holding company's extensions of credit to a foreign subsidiary into equity, the foreign subsidiary is recapitalized and potentially kept out of foreign resolution proceedings. Using a similar approach, a parent holding company would recapitalize its bank subsidiary to prevent it from entering into resolution proceedings, which would have caused foreign regulators to ring–fence the bank's foreign assets or branches.

However, there is no rule that stipulates that the single point of entry must always be at the top of the group. For decentralized type groups, the single point of entry would be expected to be the entity (or perhaps the subgroup holding company of the entity) affected by the default.

2.3. Multiple Point-of-Entry Structures

In other situations, the resolution authorities may execute a resolution using a multiple–entity resolution method. For example, if much of the third–party debt

88 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions, OJ L 125, 5.5.2001, pp. 15–23.

89 Because WUD applies across the European Union and UNCITRAL has been implemented in Australia, Canada, Great Britain, Japan, New Zealand, Poland, South Korea, South Africa, and the United States, these cover a large proportion of the relevant bank groups.

is issued by other funding vehicles, it may be necessary for legal or economic reasons to resolve both the funding vehicles and the holding company in order to properly execute a recapitalization. This is a more complex approach but allows resolution to work across a broader range of corporate structures.

3. TRANSMISSION OF CAPITAL WITHIN GROUPS

Different groups are likely to approach the utilization of capital in different ways. In particular, some groups may be structured in such a way that capital may be deployed with minimal restriction throughout the group, whereas others may be structured so as to ensure that certain capital items are always available to support certain obligations. These considerations become important when analyzing resolution plans. In particular, whether capital available to one entity within the group can or should be made available to another entity higher up in the group structure is another question that cannot be answered in the abstract but must be addressed in the context of the structure of the particular group concerned. It should be noted in this context that there is nothing philosophically impossible about moving capital up a corporate chain—in going–concern conditions, an entity can pay any extra capital up the chain in the form of dividends until it reaches the group holding company, at which point it can be down–streamed to the entity that is short of capital.[90]

Any proposal to move capital around a group in resolution should take into account the overall group interest[91] as part of its prime objective to avoid the danger that uncoordinated local actions weaken the group, undermine the optimal group solution, or contradict actions taken for resolution of the top company or sister entities in the group. This point is recognized by the FSB, but coordination should be clearly mandated by international standards, not left on a discretionary basis.[92]

3.1. Resolution Triggers and Predictability

Hitherto, authorities have sought to create the considerable constructive ambiguity around the triggering of resolution. Authority for "early intervention" (or "prompt corrective action" in the United States) may be subject to different triggers in different jurisdictions. Truly "early" intervention shades into traditional supervision powers, although there is an argument for permitting or requiring progressively more rigorous interventions (e.g., by limiting dividends or other payouts) to try to head off the necessity of resolution (an example of such concepts may be found in the Dodd–Frank Act and proposed regulations thereunder).

As argued earlier, actual intervention to trigger the drastic reordering of property and corporate rights should occur only at the latest possible moment that is consistent with orderly and manageable resolution. For this purpose, the FSB test of "when a firm is no longer viable or likely to be no longer viable and has no reasonable prospect of becoming so" is appropriate, and the FSB is right to call for "clear standards or suitable indicators of non–viability to help guide decisions on whether firms meet the conditions for entry into resolution." However, the FSB's confusing corollary statement that the regime should provide for "timely and early entry into resolution before a firm is balance sheet insolvent and before all equity has been fully wiped out" appears to confuse "early intervention" as discussed earlier with triggering resolution, and it should be corrected.[93]

In practice, no resolution authority will commit itself to a mechanical trigger for the commencement of resolution proceedings. This is not undesirable. However, it does mean that legal systems, even if acting within FSB standards, will have to accommodate a degree of uncertainty as to the onset of resolution, and different national resolution authorities could take differing views as to a particular entity.

US law provides the federal banking agencies with substantial discretion as they exercise regulatory authority over financial institutions. The law provides relatively limited opportunities for parties to challenge these regulatory actions, even in those instances in which the actions eliminate the ownership interests of shareholders in otherwise solvent institutions. Those few courts that have looked at the issue have been reluctant to interfere with the exercise of those powers. In particular, they have been unwilling to conclude that constitutional principles preclude the exercise of those powers by the regulatory authorities.

EU law concerning early intervention and the triggering of resolution is still in the development stage. The law already in place, like US law, gives regulators discretion to engage in a variety of early actions upon

90 An alternative is the indirect creation of capital by the forgiveness of intra–group debt. This is an effective mechanism (cancellation of debt results in an automatic increase in shareholders funds) but relies on forgivable debt being in place and on the directors of the company that is to forgive the debt being confident that the "giving away" of a company asset is within their powers and duties.

91 See IIF, *supra* note 3, at 28.

92 See FSB, *supra* note 1, Key Attributes 4.3.

93 See FSB, *supra* note 1, Key Attributes 3.1.

the occurrence of various triggering events. While the European Court of Human Rights provides protection for property rights, the law still gives legislators the ability to authorize actions necessary to promote the public interest. The European Court of Justice, however, has held that shareholder rights may actually trump the public interest, at least in some circumstances.

The limited judicial oversight of regulatory intervention places a substantial burden on the regulatory authorities. There is a danger that too early intervention will disrupt reasonable expectations of equity holders and creditors, not only in the institution affected but in other institutions as well. It may inhibit rather than encourage management actions to turn around a deteriorating situation, and could restrict investor interest. Systemic issues may inadvertently be created by an intervention that was intended to be systemically stabilizing. On the other hand, too late of an intervention may result in substantially increased losses which may itself cause disruption.

Although the lack of predictability that this ambiguity creates is undesirable, a regime involving automatic resolution on the occurrence of hard, pre–specified triggers would not be advantageous for any participant. However, three propositions would help guide action:

(a) Where a home resolution authority of a SIFI group has commenced resolution proceedings in respect to a group parent company, national resolution authorities of members of that group should operate from a presumption of cooperation. In some cases—such as the single point of entry approach—host authorities may not need to do anything other than to issue a statement on the status of the entity in their jurisdiction. In cases where a going concern outcome is intended, they should agree on any steps needed to assure that the local entity is robust, especially in cases where the local operation has been affected by the issues that lead to the resolution event. In some cases, they may need to take immediate action to support a group resolution, such as invoking a stay in their jurisdiction. In other cases, they may also need to undertake a local resolution for group members established or operating in their jurisdictions.

(b) Where a host resolution authority of a member of a SIFI group has commenced resolution proceedings, there should be as similar presumption of cooperative action. Such proceedings should occur only after consultation and discussion with the home resolution authorities.

(c) Where resolution powers have been exercised in respect of a group member, resolution authorities in respect of other group members should, as soon as possible, publicly state their position regarding the exercise of their resolution powers, after prior consultation and agreement.

4. DISCLOSURE

While, as stated earlier, authorities cannot and should not tie their hands on triggering a resolution (provided their authority to do so corresponds to FSB norms), the dilemmas created by constructive ambiguity are real and are likely to have real costs for firms raising funding. Therefore, there should be a debate among firms and FSB member organizations to define appropriate pre–resolution disclosures by the relevant authorities that would necessarily be quite general but would at least give investors in the market a sense of how the home authority would approach a resolution (over–simplify, single–entry, or multiple–entry), and how the principal host authorities concerned with the group would coordinate any resolution actions (the latter point being especially important until FSB standards on resolution are fully completed). This would be related to, and complementary of, the debate on disclosures about RRPs.

5. LIQUIDITY IN RESOLUTION

5.1. Context

Bail–in within resolution or good–bank/bad–bank restructuring gives resolution authorities a powerful tool to recapitalize a financial institution in appropriate circumstances without exposing taxpayers to losses. While a restoration of solvency through recapitalization should, in theory, provide a firm basis to restore liquidity, liquidity is often subject to its own dynamics. This is especially true in a crisis, in which defensive “hoarding” behavior is commonplace. A strong liquidity program that addresses the near–and medium–term constraints of a successor firm in a resolution will be essential to restore the confidence of counterparties and clients.

Several countries have attempted to ensure that a pool of liquidity is available for resolution purposes on an ex-ante basis, for example, by means of a deposit insurance fund or creating a new specialized “resolution fund.”[94] There are, however, several difficulties involved with ex-ante resolution funds, such as determining the appropriate size of such a fund, the possible creation

94 See FSB, *supra* note 1, Key Attributes 6.3.

of moral hazard, the cost of these funds to banks, and the related implications for loan growth and domestic GDP levels. The IIF view is that *ex-ante* resolution funds are generally inadvisable, although *ex-post* assessments on the industry for any funding by the state that turns out to be unrecoverable would be appropriate.[95] In this section, we consider *ex-post* resolution funding approaches, including potential sources of private liquidity and funding from central banks.

For example, the Dodd–Frank Act in the United States says that liquidity can be provided to the system as a whole through "broadly available facilities" but severely restricts the authorities' ability to provide funds to a troubled individual bank. However, once a bank enters resolution, substantial authority is given to the FDIC to provide large amounts of liquidity on effectively a super–senior basis. Under OLA, the FDIC can borrow funds from the Treasury to provide liquidity for the operations of the receivership and a (successor) bridge financial company. The act also provides that "the FDIC may make available funds for orderly liquidation." If recoveries from the disposition of assets are insufficient to repay amounts owed to the federal state, there will be a subsequent assessment on the industry to repay those amounts. Once the new bridge institution has stabilized, the FDIC is to attempt to sell the institution or viable operations and assets. This model would work for resolution with a bail–in tool as well as with a bridge.

This type of liquidity to support effective resolution would be in addition to that provided generally to healthy institutions on a collateralized basis to maintain adequate liquidity in the system and mitigate contagion risks.

5.2. The Role of the Private Sector

In the United States, the funding required to prevent an ordinary company under bankruptcy protection from collapsing is commonly referred to as *debtor-in-possession (DIP) financing*. This type of funding ranks senior to pre–existing financial obligations (i.e., it is "super senior"). A failure to obtain such funding—which keeps the bankrupt company operating as a going concern—is likely to push it into liquidation and thus destroy much of the value of the enterprise. The Bankruptcy Code provides for a debtor company to obtain DIP financing with court approval, but there is no procedure specifically for private DIP financing in a bank resolution (including under OLA).

DIP financing is an element currently not recognized by English law or that of any other EU country. The current regime lacks the flexibility to provide new financing in DIP form.

DIP funding could be useful in providing an alternative means to support a resolution with private sector liquidity in some cases or possibly as a second–stage measure for appropriate restructurings. Some changes to the legal regime in certain countries would be required to establish it with clear conditions and requirements to provide confidence to the market. Provision for private DIP funding could be seen as a second–tier issue in the sense that it may require policy discussion in some countries and is less essential than getting clear international consistency on the other aspects of cross–border resolution discussed in this report.

Another tool to create a strong liquidity profile in short order from the private sector would be consortium funding on a super–senior basis. If firms were asked or encouraged to lend to a restructuring pool on a super–senior basis, credit decisions would be vastly easier than in cases in which banks are asked to lend into a bad–bank solution.[96] This does leave a liquidity question given that institutions may be nervous about committing significant amounts of their own capacity in a crisis in which liquidity will be at a premium.

In addition, the proposed Basel III framework, which imposes minimum liquidity standards, creates several additional challenges that would, however, increase the difficulty of finding private sector funding for an institution undergoing resolution. First, the Basel regime generally penalizes funding among members of the financial system. Second, there is uncertainty about how banks can use the required liquidity buffers in the event of liquidity shortages in the market (although recent indications from regulators that they could be drawn down are promising). Third, the proposed framework limits the availability of the highest quality assets (i.e., most liquid assets) in times of stress, as these assets will be dedicated to meeting the standard. Particularly regarding the last point, in order for central banks to ease market illiquidity in times of stress, it would be beneficial for the market if central banks would accept less liquid assets so as to increase the pool

95 See IIF, *supra* note 3, at 36.

96 In the case of Lehman Brothers, a private consortium of banks was assembled in order to own and fund a "bad bank" that, in turn, would have supported some of the merger options being pursued. The banks were willing to do this in significant size at short notice, despite considerable credit and liquidity concerns. However, it is unlikely that this structure could be used repeatedly, due to the high expected credit loss content and the high liquidity cost of the structure; it would simply be too damaging to the standing of the lending institutions. Accordingly, we recommend a super–senior facility that could be used to raise funding from central banks and others as a more appropriate and sustainable structure.

of highly liquid assets available outside central banks, as opposed to raising the demand for "traditional" highly liquid assets, which potentially contributes to hoarding. This would also require that the Basel liquidity rules grant highly liquid status to such classes of assets, at least in stressed conditions.

A series of powerful liquidity options will be essential for resolution, particularly for large financial institutions in a crisis. Both creditors and taxpayers would therefore benefit from a comprehensive mechanism that would facilitate making financing available on a super–senior basis to ensure that funding is available during the difficult period that will follow any resolution (or to carry out an orderly liquidation).

5.3. An Enhanced Policy for Assuring Liquidity in the Market

Although the main focus to enhance the resolution tool box should be placed on ensuring the continuing operations of a group after it has been resolved, policy makers should consider additional measures to preserve confidence, encourage liquidity in the banking system, and ease lending to creditworthy businesses and consumers. Liquidity shortages will particularly have an impact on the availability of funding for an ongoing bank resolution.

In a stressed market scenario, the privately funded liquidity will be reduced for the restructured bank or bridge structure that went through a resolution process at a time of severe stress. In several countries, a wide range of innovative liquidity programs have been established to contribute to stabilizing credit markets.

5.4. The Role of the Central Bank as Lender of Last Resort

To ensure a successor entity is provided with liquidity in the post–resolution phase, the central bank should play a role similar to its traditional role as a liquidity provider of last resort (LOLR) during the post–resolution phase.

The core of the LOLR function is to mitigate financial instability through the provision of liquidity support to individual financial institutions facing liquidity problems but that are otherwise solvent. Given that the successors to failing financial institutions after resolution would be "solvent," they should be eligible for LOLR financing. This would send a clear signal to the private sector that the firm is resolvable, and the "continuing" institution is considered solvent by a credible third party that has assessed the resolution plan. Furthermore, it may take some time to organize private DIP financing, and therefore this liquidity would function to bridge to other facilities to ensure the institution can go back to normal funding markets relatively quickly.

In the post–crisis world, it may be advisable for central banks to avoid constructive ambiguity about the specific facilities that will be put in place in times of crisis. Not only will transparency augment their ability to limit the potential escalation of a crisis, it will also give investors a useful insight into a resolution process. A recent study by the IMF outlines several relevant guidelines for the role of central banks in cross–border liquidity shortages.[97] It argues that central banks have an important role to play in preventing systemic stress arising from the disruption of cross–border foreign exchange funding.

5.5. Cross-Border Issues

A cross–border resolution would entail additional difficulties for central bank facilities, especially where the institution in resolution has extensive cross–currency transactions.

Swap lines with the other relevant central banks would be required as the currency composition of the liabilities of the institution would be unlikely to match that of the assets. Such swap arrangements have worked well in the recent crisis and should be institutionalized.

The crisis proved that cross–border funding disruptions could have significant consequences but also that the swap arrangements between central banks during the crisis were effective in countering global shortages of key funding currencies and central banks should consider making them a permanent feature of the landscape.[98]

5.6. Conclusions

The lessons learned from the 2008 crisis are starting to shape a more globally consistent crisis management framework, but much more needs to be done to overcome some of the challenges outlined in this section to ensure the availability of liquidity in an orderly resolution. The effectiveness of the resolution toolkit foreseen in this report and in the *Key Attributes* and the particular approach taken by a resolution authority or by a firm's home regulator most likely will

97 International Monetary Fund, *Central Banking Lessons From the Crisis*, (July 2010).

98 *See generally* Board of Governors of the Federal Reserve System, *Central Bank Liquidity Swaps*, available at http://www.federalreserve.gov/monetarypolicy/bst_liquidityswaps.htm.

be affected by the availability of funding arrangements in the firm's host countries.

However, all good resolution planning will come to naught if due consideration is not given to provision of liquidity during the crucial transition from a failing distressed to a strong, recapitalized post–resolution bank that is operating with the confidence of its counterparties or until the orderly disposition of any bridge bank. Normal private sector provision of operating and liquidity funding may be insufficient given the damage in confidence and the high uncertainty associated with such an event. Accordingly, liquidity planning should be an integral part of an orderly resolution process and should be available in substantial size. The size should be sufficient to re–establish confidence that the restructured institution is a going concern and has ample short–term funds to continue operation and complete its transition. Such liquidity will ideally come from the private sector, using the enhanced structures described earlier. But it is also important for central banks and resolution authorities to have additional capabilities to ensure a wide range of circumstances can be addressed.

6. IMPACT OF GROUP RESOLUTION ON THE STRUCTURE OF BANK DEBT FINANCING

For largely deposit–financed banks, losses that cannot be recovered from the value of the failing firm's estate may fall wholly or partially on one or more deposit protection schemes. In general, deposits that are protected in this way fall outside the scope of normal resolution procedures, and resolution authorities should respect deposit protection structures. However, because in general deposit protection arrangements are ultimately financed by other financial institutions, resolution authorities have the mandate to minimize the costs that may fall to the insurance fund.

The recent DG Internal Market and Services consultative paper[99] suggests that under some circumstances the deposit fund should be subject to bail–in along with other senior creditors (without affecting its discharge of guaranteed deposit obligations). This arrangement would have the advantage of making available additional funding through the bail–in mechanism, but it could also complicate the cross–border issues insofar as other countries' deposit guarantee schemes may be affected by the same resolution. Where a bank is largely funded by insured deposits, losses upon resolution will fall on the deposit guarantee fund, which is the largest creditor. As long experience of the FDIC in the United States illustrates, the resolution authority in such circumstances will look for ways to minimize losses of the deposit insurance fund.

The implications of doing so are just beginning to be evaluated, as noted in the European Commission's recent paper on bail–in. Whether this type of operation should be called "bail–in of the fund" or be considered part of the resolution process may be debated. However, in a multi–jurisdictional context, the political issues involved in allocating losses between different national deposit protection funds would be very substantial, and it is hard to imagine these being overcome in the time available without a broad degree of agreement between the governments and resolution authorities concerned as to at least the principles that should be applied in these circumstances. We urge the relevant states to commence a dialogue regarding the establishment of such principles.

For groups with a less deposit–driven funding base, losses that exceed the whole of the institution's equity and subordinated debt are likely to fall on senior unsecured (i.e., non–deposit protected) creditors. Clearly this will occur only in the event of fairly extreme circumstances because, in general, bank levels of capital and subordinated debt are now sufficiently high that such losses are extremely unlikely. The mechanisms for imposing such losses on senior unsecured creditors are twofold. In broad terms, this can be accomplished by either bail–in within resolution or good–bank/bad–bank techniques.[100]

It is sometimes argued that banks should be required to maintain a minimum quantum of "bail–in–able" debt in order to ensure that there are uninsured creditors capable of carrying the burden of these losses.[101] This is misconceived. Banks should be able to operate business models that are primarily or exclusively funded by deposits, and the international liquidity regime proposed as part of Basel III is predicated on the assumption that deposits, especially insured deposits, are inherently stable funding sources, in part as a result of the operation of the applicable deposit protection scheme or schemes. For such groups, often organized on a decentralized basis, resolution will be driven by the requirements of the relevant deposit insurance schemes, and the international aspect of resolution

99 See DG Internal Market and Services, *supra* note 13 at 8.

100 *Bail-in outside resolution* means the conversion of debt securities (subordinated or otherwise) whose terms permit or require their nominal value to be reduced as a result of a specific event that is distinct from, and occurs prior to, the onset of resolution.

101 See DG Internal Market and Services, *supra* note 13 at 5, 13.

planned accordingly.

7. COMPETING PRIORITIES BETWEEN RESOLUTION AUTHORITIES IN THE RRP PROCESS

The FSB's *Key Attributes* is premised on coordination by the home regulator and cooperation between authorities in the preparation and execution of RRPs. SIFIs and other internationally active firms are currently working to develop RRPs. This complex process is a key part of the overall resolvability assessment and requires significant and sustained investment of resources.

There is clear recognition in the FSB approach that a series of domestically driven RRPs is at least duplicative, inefficient, and unnecessarily burdensome on a firm and, more seriously, may lead to inconsistent requirements and a failure to effectively manage risk. What the FSB does not mandate, but should, is a single view of the policy approach that should be reflected in group–wide RRPs including, for example, the balance to be struck between group and legal entity planning and between recovery and resolution planning. It is not sufficiently focused on the need for close linkage between RRP design and group structure and the need for the latter to inform the appropriate resolution tools.

The FSB could develop further guidance on the need for coherent and consistent RRPs for global groups, respecting group structure, through its usual supervisory standard–definition processes. This is an issue that would not necessarily need to be addressed through a Convention.

For instance, to foster a level playing field among the global SIFIs, it would be appropriate for a supranational authority, such as FSB itself, Basel Committee, or IMF, to be a member similar to the European Banking Authority's role for the European College of Supervisors.

7.1. Drivers for Divergent Recovery and Resolution Planning

The FSB has agreed to a high–level framework for dealing with distressed SIFIs, but there seems to be increasing divergence in the way regulators prioritize and structure planning for recovery or resolution. Meetings with firms, at which home and host regulators together discuss expectations and requirements, are clearly revealing differences in priority and approach. It is also common that joint meetings with regulators are followed by bilateral discussions at which individual regulators stress that their requirements must be met over and above those agreed by the regulators as a group. These differing requirements reflect several factors.

First, there may be genuine differences between jurisdictions on the best policy for handling a failing firm. What assumptions may a firm make about early intervention, the break–up of the entity, the replacement of management, deposit protection, and so on? Such differences are influenced by differences in objectives and legal powers (and limits on those powers) associated with resolution (in particular as between recovery and resolution and between resolution to preserve or to liquidate the failing institution).

Second, divergence may be exacerbated by differences in regulatory responsibility (primarily, the distinction between supervisors and resolution authorities). The supervisor will naturally focus on the recovery elements and seek to avoid failure and resolution. The resolution authority may focus on the outcome of failure, perhaps regardless of its probability.

Third, recovery and resolution planning is, for many regulators, new ground. Many are feeling their way on what is practical and valuable. Many lack significant experience in dealing with failing or failed firms. The result may be contradictory or counterproductive demands or plans of doubtful utility.

Fourth, there is no common cross–jurisdictional approach to the structure, scope, form, or even the language of recovery and resolution planning, and little consideration appears to have been given to applying recovery and resolution planning requirements to subsidiaries of foreign–headquartered groups. This manifests itself in unharmonized (and occasionally conflicting) requirements and timetables—which in turn result in significant unintended administrative burdens in seeking to reconcile the requirements.

Finally, and most importantly, a regulator with a domestic mandate and domestic accountability may tend to prioritize domestic issues over global or group issues. This inevitable fact cannot be managed effectively by the largely hortatory calls for cooperation. The G20 should give high priority to enacting legislation meeting the call of the *Key Attributes* for mandates in national law for international cooperation and coordination, but it should also consider providing broader guidance as to how that cooperation should take place, to avoid self–regarding local solutions, as suggested in the Convention proposed in this report.[102] In the medium term, provision is also needed for much greater recognition of foreign

102 *See* FSB, *supra* note 1 at 3 (viii); *see also infra* Annex I.

proceedings, as suggested by the Convention (somewhat on the precedent of the UNCITRAL model law for non-financial insolvencies).

Although the FSB has not been as ambitious as it could have been, especially with respect to the substance of international cooperation and mutual recognition, differences of view of local authorities should be largely reconcilable. It is perfectly possible for the home regulator to ensure that competing demands are appropriately balanced and prioritized, but it is not easy in practice for the home regulator to ensure agreement among the supervisors and resolution authorities of host jurisdictions, and it is even more difficult to direct a particular approach where there is no formal agreement as to the coordination of the recovery and resolution planning process.

On the evidence to date, it is questionable whether the FSB's approach premised on coordination by the home regulator will be reflected in practice without a more formal and binding framework for inter-regulator agreement as to the scope, structure, format, and use of home (group-wide) and host (subsidiary) RRPs, as proposed in this report and in the draft Convention.

While it is challenging to achieve consensus on the policy balance to be struck in developing an RRP between, for example, home and host concerns or between recovery and resolution, it is important to recognize these tensions and to reconcile them where possible. This is because the differences are more than mere matters of inconvenience. They go to the heart of the plan, to the assessment of resolvability and to regulatory responses to that assessment.

A lack of coordination of the recovery and resolution planning process with respect to integrated groups may encourage a parochial approach to resolvability analysis contrary to the strengths and business model of the group structure by host state regulatory authorities, which in turn is likely to encourage a nationalistic approach to measures to improve resolvability.[103] It is also likely to discourage coordination when the need for resolution arises, as each authority will feel more comfortable putting its own resolution plan into action than deferring to the home state authority. The dynamics of coordination of RRPs are of course somewhat different for decentralized groups, but coordination in advance to understand how local subsidiaries would be handled in any resolution affecting the group is equally important.

Regardless of a group's business model, the home and hosts need to coordinate in advance about how they are going to handle each presence of the group in the host countries, or there is likely to be an uncoordinated and unsatisfactory result in the event of an actual resolution. Lack of such planning in any case ultimately will compromise the consistency and fairness of outcomes in cross-border resolution, the importance of which are discussed elsewhere in this report.

7.1.1. Group Resolvability

This report stresses the fundamental importance of group structure in resolution. The parochial view of a resolution authority should not be allowed to drive a decision about structure, in particular whether or not a firm should be required to organize in a particular jurisdiction via a stand-alone subsidiary. The IIF has elsewhere[104] expressed its position on the issue of subsidiary and branch structures. For these purposes, it is sufficient to observe that resolvability is above all a matter to be considered at group level under the coordination of the home supervisor. The most efficient structures for each group and each type of business must be decided by competition over time, not by administrative fiat, especially where focused not on going-concern regulation (for which group consolidated views are often appropriate) but on remote and unpredictable contingencies in resolution.

Second, there is the very practical matter of sequencing remedial recovery or resolution action as a firm approaches crisis. It is clear that uncoordinated demands for domestic action may precipitate or exacerbate a crisis. Contemporaneous, conservative demands for liquidity in different jurisdictions are an obvious example, but there are many others, including inconsistent requirements in respect of business activity, asset sales, public statements, capital conversion, and so on. The variety of circumstances that may give rise to a crisis suggest the limits of theoretical planning, but the importance of discussion between responsible supervisors and resolution authorities as a crisis unfolds and the necessity for the home supervisor to be empowered to "make the call" in the interests of the group is clear.

There is a temptation to view RRPs as providing a range of measures to be implemented as a firm passes along a spectrum from business-as-usual, through a stressed period, to resolution. On this view, the information gathered should be sufficient to ensure

103 See FSB, *supra* note 1, *Key Attributes* 10. The FSB suggests that group resolvability assessments should be conducted by the home authority of the institutions and be coordinated at the CMG level to take into account national assessments by host authorities. The FSB also points out that host resolution authorities that conduct resolvability assessments of subsidiaries of the firm should coordinate with the home authority.

104 See IIF, *supra* note 3, at ¶ 139.

that, at any point along the spectrum, the responsible authority has what it needs to make the necessary decisions. Experience is already showing that this is too simple a view. In practice, international firms are being asked to compile plans that reflect the aggregate of all the policy choices made in (at least) the major jurisdictions in which they operate, even where the choices are incompatible.

For example, in the United States the FDIC and Federal Reserve's approaches concentrate on resolution and include requirements for groups to prepare detailed analysis of how their US–incorporated entities can be resolved. The focus on this within cross–border CMGs and in bilateral discussions suggests that they view this as a priority over and above group–level planning, which results in difficulties in satisfying the need for group planning and can disrupt the planning process. While less focused on recovery planning for now, this may be a result of viewing recovery planning as an extension of normal supervision. This differs from the approach in Europe, whereby groups will be expected to balance the preparation of recovery plans with resolution information gathering. European authorities undertake their own analysis of potential use of resolution tools based on the information provided by groups rather than requiring this analysis be provided.

This problem is compounded by a tendency to see RRPs as providing very high levels of pre–crisis comfort. RRPs will provide authorities with a "head start" in their contingency planning, and they should be a source of valuable information for decision–making, but resolution authorities and firms should accept that it is unrealistic to expect a blueprint for resolution or the elimination of the need for difficult decisions to be made "on the run" and in the midst of a crisis.

7.2. A Coordinated Approach to Developing RRPs

As already observed, the content of RRPs should depend upon consistent policy choices. The FSB Key Attributes provide a substantially common basis for those policy choices.[105] It should also depend upon consistent and coordinated preparatory work by supervisors and resolution authorities. The FSB could help by converting the Key Attributes from their current hortatory and somewhat hesitant form into international standards that member countries would be expected to follow, pending adoption of a Convention along the lines suggested in this report.

In order to achieve consistency and workability, an RRP should be prepared and structured, on a "top–down" basis, by the home authority in conjunction with the host authorities.

This preparatory work should include a high–level comparative analysis of the relevant resolution frameworks and reconciliation of the authorities' respective requirements for RRPs in order to enable the creation of a single RRP, that takes into account the group and the relevant subsidiaries which are of international or national systemic importance ("material subsidiaries"). The output of this preparatory work should be a single template, covering the group as a whole and any systemic group member, completion of which will satisfy the requirements of the home and each host state.

The flow of timely and accurate information to supervisors and resolution authorities will be assisted by a consistent interface. Ideally, there should be a single gateway, a single basis for reporting, a single set of information requirements, and a single standard for periodic update. That consistency of data requirements has yet to emerge.

7.3. A Common Template and Language for RRPs

It is clear that a common template and format will be needed in order to create a viable single–group RRP. That template will need to be sufficiently flexible to allow for the creation of a plan that satisfies the requirements of several regulatory authorities, and therefore needs to take account of a variety of legislative frameworks, pending further harmonization thereof in accordance with the FSB's principles. Notwithstanding differences in the detail of resolution statutes, there is no reason (given the commonality of existing and developing resolution frameworks) why this should not be entirely feasible. Annex III of the Key Attributes makes an excellent starting point for the production of a common framework for all jurisdictions concerned with a given group.

A key challenge will be agreeing upon a consistent approach to determining critical functions, which is discussed in the next section.

To ensure consistency across the RRPs of each SIFI, they should be reviewed by the CMGs jointly with a supranational authority, such as FSB, Basel Committee, or IMF.

105 See generally FSB, *supra* note 1.

8. IDENTIFICATION OF CRITICAL FUNCTIONS AND CRITICAL OPERATIONS

It is a requirement of the FSB and RRP planning that "critical" functions be continued to avoid disruption of the economy by the failure of a bank. While much of the discussion in this report focuses on the broader questions of how to avoid destruction of value and market disruption and thus tends to emphasize resolution to carry forward as much as possible of a firm's activities, this section examines specifically how to define those critical functions that would need to be carried forward if a firm could not be resolved other than by an orderly winding up that would include separating critical functions to be continued, perhaps on a temporary basis until another financial institution could cover the failing firm's clients. The issues here are therefore quite different: Definitions of critical functions need to be no wider in scope than truly necessary, both to avoid unnecessary burdens on the firm in the going–concern state and to avoid unduly complicating a resolution, especially in case of a winding–up.

Although there is broad agreement that bank resolution should ensure the continuation of critical functions, there is little clarity as to what is meant by critical functions. Discussions of critical functions are either at an early stage or appear to be being conducted on a confidential, supervisory basis. The US authorities require firms developing resolution plans to focus on four areas: (a) capital markets; (b) funding and liquidity; (c) retail and commercial banking; and (d) payments, clearing, and settlement. The US authorities expect RRPs to, at a minimum, address and provide for the continuation and funding of those operations. The UK Financial Services Authority (FSA) includes its own taxonomy of critical economic functions.[106]

Regardless of what approach is ultimately taken, it is important that there be broad international consensus on this issue for avoidance of a proliferation of conflicting criteria. This would be an appropriate area for the FSB to build on the foundations of the Key Attributes and to develop, in consultation with the industry, global guidance about criticality and a taxonomy of critical functions against which resolvability is assessed.

8.1. Measurement of Functions

Assessing the systemic importance of a financial institution requires determining the criticality of the functions it performs for the financial system and economy. Business–line–based definitions that are aligned with the organization structures the firm uses to manage its daily activities are likely to facilitate precision in identifying the activities associated with a function. On the other hand, economic–purpose–based definitions that group similar economic activities together (such as the UK FSA is requesting in its draft RRP guidance) should facilitate estimation of the impact of the function on aggregate economic activity. In other words, there is a trade–off between ease of measurement and ease of estimation. In making the trade–off, at least for the near future, the emphasis must be on ease of measurement, because good estimates require good data.

Financial institutions collect, aggregate, and report data by business function, not by economic function. Collecting data by economic function would be costly and redundant. Financial institutions are not organized around economic functions for valid business reasons and tend not to use economic–function data in their management decisions. Data collected on an economic–function basis would therefore not be consistent with each firm's overall data management and would therefore be of questionable accuracy. Financial institutions tend to combine activities that have similar processes (i.e., production technologies). Aggregating activities by production process may lead to more meaningful estimates of economic impact than aggregation based on an abstract concept of economic function, which tends to be predicated on a view of demand.

Resolution issues cannot be looked at in isolation from going–concern needs: Banks face great challenges to meet their data requirements for business and risk–management purposes and have complex information technology development programs under way that require very substantial investment and draw upon scarce human resources.[107] These programs are in part aimed at meeting FSB–defined goals with respect to group–wide risk aggregation. Therefore, RRP plans and resolution requirements generally must be compatible with these priorities.

It is notable, however, that developments are

106 See FSB, *supra* note 1, Key Attributes 11.6 (discussing resolution plan intending to facilitate the effective use of resolution powers to protect systemically important functions that should include identification of financial and economic functions for which continuity is critical and suitable resolution options to preserve those functions or wind them down in an orderly manner).

107 IIF, Mckinsey & Company Risk It And Operations: Strengthening Capabilities p. 29 Seq. (June 2011).

well advanced toward the development of new data standards that will, in time, make data needed for all risk–related purposes easier to obtain and to manipulate.[108] For the moment, however, it is important that RRP–driven data requirements be carefully linked to risk–management information technology improvements and not create conflicting demands or demands that divert resources from such developments.

8.2. Substitutability

The FSB suggests that systemic importance depends on size, interconnectedness, and "substitutability."[109] Of these, size gets the most attention as it is straightforward to measure. Interconnectedness is receiving increasing attention, because it is more closely related to the knock–on effects that are usually associated with contagion. Substitutability tends to be downplayed because it is difficult to measure.

A common measure of size is market share, with benchmarks such as "in the Top 5 market participants" or "a 5 to 10 percent market share" used as the threshold for systemic importance.

The Institute recommends using a higher market share number, such as "in the Top 3 market participants" or "a 20 percent market share," given that a lower threshold would overestimate a firm's significance in the market and, in effect, underweight substitutability, which is fundamental to the purposes of the critical–functions analysis, even though it is difficult to quantify.

Other market participants could readily expand their activity to replace the services provided by a failing participant having a lower market share, given that financial services provision is highly scalable at the margin. In such cases, disruptions to the financial system would be minimal. Substitutability should also be considered on a functional basis, because different financial services can provide the same functionality, providing greater substitutability than might be indicated by looking at the market for a single product or service. With greater substitutability, a higher threshold to determine systemic importance is appropriate.

Substitutability increases with time, as does the cost to the economy of a financial disruption. These tendencies are offsetting. It is therefore inappropriate to compare disruptions from a short–term lack of substitutability with the long–run economic costs of that disruption.

8.3. Criticality

To mitigate systemic risk and social disruption, only those functions critical to the financial system need survive a resolution. Defining critical functionality on a business–line basis simplifies resolution, because separability is greater for business lines than for economic functions given that interconnections within a business line tend to be greater than between business lines, and defining functions to survive on an abstract economic basis may require substantial disruption of arrangements that are entirely viable, well–controlled, and sensible from a going–concern point of view.

Functions may be valuable even if not critical. Valuable functions should be continued to minimize investor losses as well as lessen the degree of disruption to the institution. In some cases, a "whole bank" bail–in strategy may be chosen to eliminate immediate restructuring issues entirely. This would allow any desired restructuring to be handled on a post–resolution basis where more time will be available to consider strategic options and legal consequences.

Survivability should be considered on a business–line basis to ease separability complications. While there is an additional consideration of legal entities that are not necessarily the same as business lines, and, again, disruption of legal entity structures (which can be costly) should be avoided in RRP separability and survivability/continuity of critical activity analysis.

Determining which part of the institution would necessarily have to be supported through resolution (even winding–up) is simplified when functions align with business lines. Business lines tend to be the "natural" unit within a financial institution. Stress testing the effectiveness of mitigants of systemic risk is likely to increase in frequency as regulators develop methodologies to simulate financial systems. Participating in such exercises will likely be simpler and less costly if critical system functionality is aligned with business–line units.

108 Robleh D Ali, Robleh D., Haldane, Andrew G., Nahai–Williamson, Paul, *Towards a Common Financial Language*, presented at the Securities Industry and Financial Markets Association's "Building a Global Legal Entity Identifier Framework" Symposium, New York (March 2012), available at http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech552.pdf

109 Basel Committee On Banking Supervision, *Global Systemically Important Banks: Assessment Methodology And The Additional Loss Absorbency Requirement Rules Text*, pp. 4–7 (November 2011), available at http://www.bis.org/publ/bcbs207.pdf

ANNEX I. BANK RESOLUTION CONVENTION

[BANK RESOLUTION CONVENTION]

The Signatory States [ ]:

Recognizing the importance for the global economy of financial stability and the global banking system as a means to raise standards of living, ensure full employment, enable the increase of real income and effective demand, develop the full use of the resources of the world and expand the production and exchange of goods;

Desiring to mitigate the impact of a failure of an internationally active financial institution or group on economic growth, employment and social welfare without commitment of taxpayers' funds and to procure that the incidence of losses to investors, customers, creditors and counterparties of such an internationally active financial institution should be distributed as fairly as possible;

Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to [enabling and promoting cooperation on the effecting of such resolution];

Have through their Representatives agreed as follows:

Article I. Powers and Authorities

Each signatory state shall designate a resolution authority, and shall take such action as may be necessary to ensure that the legal framework within which that resolution authority operates complies with the [FSB Key Attributes].

Article II. Group resolution

1. The resolution authorities of the signatory states shall, in respect of any internationally active financial group to which this Convention applies (a "Group"),

(a) Identify the lead resolution authority for any Group.

(b) Identify the lead resolution authority for any subgroups of a Group where the institution and the relevant resolution authorities in the Crisis Management Group have agreed that resolution at the subgroup level is a feasible resolution strategy within the applicable Resolution and Recovery Plan process relating to that institution ("subgroups"). For the purposes of this Convention subgroups are regarded as Groups.

(c) Identify for each authorized entity within a Group the lead resolution authority in relation to that entity.

Article III. Institutional and Group Resolution

1. The home resolution authority of a Group may elect group resolution where it determines that either

(a) There is a significant prospect of the disposal of the relevant Group or the majority thereof as a going concern to a purchaser or purchasers or

(b) The efficient and timely liquidation of the business of the Group will be most effectively accomplished through a single resolution procedure rather than through individual insolvency or resolution proceedings.

2. Where the home resolution authority of a Group has determined that group resolution is the preferred resolution mechanism, the signatory states in which any member of the Group is established, or in which any member of the Group has an establishment, agree that they and their national resolution authorities will cooperate with the Group's home resolution authority to achieve resolution on that basis. In particular,

(a) Their resolution authorities will work cooperatively with the resolution authority of the home signatory state;

(b) They will give their resolution authorities such powers and authorities as may be necessary to enable them to exercise their powers in pursuit of the accomplishment of the group resolution;

(c) They will not, and they will ensure that their resolution authorities or other public sector entities will not, impede the accomplishment of such resolution; and

(d) In the event of disputes arising in course of the group resolution process with the home resolution authority, the other national authorities shall defer to the decisions of the home resolution authority, subject however to [compensation of such other national authorities if an international mediation panel appointed by [the Hague Conference on Private International Law][UNCITRAL]] determines that the home resolution authority has failed to carry out its duties in accordance with the principles of fairness embodied in this [Convention].

3. Where the home resolution authority of a Group has elected group resolution, resolution authorities in jurisdictions in which members of that Group have operations shall exercise their powers, as far as possible, to seek to prevent creditors or other persons from obstructing the resolution of any entity comprised in the Group in their jurisdiction.

4. In the event that the home resolution authority opts for institutional resolution, resolution of other legal entities in the Group will fall to the home resolution authorities of the various institutions and/ or subgroups which comprise the Group.

Article IV. "No Creditor Worse Off"

1. Resolution authorities shall not be required under this Convention to take any step whose effect would be to leave any creditor of the relevant institution (or, in a group resolution, of any group entity) in their jurisdiction worse off than that creditor would have been in the liquidation of the entity of which that person is a creditor.

2. Where there are a number of possible ways in which a liquidation of the relevant entity might be conducted, a creditor is no worse off if he is better off than he would have been under any of the different liquidation alternatives.

3. This safeguard does not apply to creditors who are members of the Group.

Article V. Consultation Before Resolution

The resolution authorities of all relevant signatory states shall be consulted in the most appropriate form before any resolution process is commenced in respect of an institution. In cases of extreme urgency such consultation may be conducted as soon as is reasonably possible after the commencement of resolution. Any resolution authority shall in any event immediately inform all relevant signatory states of the commencement of resolution.

Article VI. Authorization of Institutions

1. In a group resolution, signatory states will not, and will ensure that their regulatory authorities do not, limit or withdraw the authorization of an institution which is a member of that institution's group merely by reason of the commencement of the group resolution procedure without consulting the home state's resolution authority.

2. In a group resolution, signatory states will not, and will ensure that their regulatory authorities do not, withhold or impose conditions upon transfers of ownership or control of entities which are entered into pursuant to a resolution process.

Article VII. Fair Treatment of All Creditors

A resolution authority in a signatory state shall deal fairly with all creditors, and shall treat creditors located in other signatory states no less favorably than that creditor would have been treated had it been located in its own jurisdiction. This principle shall extend to creditors who are public authorities.

Article VIII. Regular Provision of Information

Resolution authorities shall keep authorities in other signatory states regularly informed, in an appropriate manner, of their proposed approach to the resolution of any entity, Group or subgroup of which they are the home resolution authority and of each step taken in the resolution.

Article IX. Fiscal Issues

Issues relating to the compensation of investors, the costs of resolution and/or any financial obligation arising in relation to the resolution of any Group or any member of any Group are outside the scope of this Convention, and no provision of this Convention shall have the effect of requiring a signatory state to assume any liability or make any payment to any person.

Article X. Effects on Certain Contracts and Rights

1. Where a resolution authority takes action in respect of an institution with branches in another state, it will respect as far as possible accrued rights in property acquired under the laws of that state, subject, insofar as contractual claims (including security interests) are concerned, to the no creditor worse off principle set out in Article IV.

2. Where any resolution of a Group or entity to which this Convention applies requires the variation

of contractual rights or of rights *in rem* which are subject to the laws of a signatory state other than the state in which the resolution is conducted, the resolution authorities of that other state should be granted, and should be prepared to exercise, powers under its domestic law to carry out the actions required in connection with the resolution in accordance with the resolution plan of the home state as expeditiously as possible.

Article XI. Powers and Obligations of Domestic Resolution Authorities to Cooperate

1. Signatory states agree to provide in their domestic laws for their resolution authorities to

(a) Be able to exercise their powers in support of a resolution conducted by a home signatory state entity, and

(b) To be subject to a presumption that they will act in this way [subject to the fulfillment of their other statutory and legal objectives].

2. In particular, a resolution authority in a signatory state will be enabled to use its full range of resolution powers once a resolution has been declared under this Convention, regardless of whether the conditions for exercise of those powers under their domestic legislation would otherwise have been fulfilled. These powers shall include at least

(a) The power to direct and accelerate a transfer of part or all of a failing Group's or institution's business to a private sector purchaser, including both some or all of its assets and some or all of its liabilities;

(b) The power to transfer control of part or all of a failing entity's business to a bridge bank;

(c) The power to vary the terms of any obligation incurred by any relevant entity;

(d) The power to dispose of assets or have them disposed of and to obtain satisfaction from the proceeds of or income from those assets, in particular by virtue of a lien or a mortgage;

(e) The power to demand the assets from, and/or to require restitution by, anyone having possession or use of them contrary to the wishes of the party so entitled.

Article XII. Protected Rights

1. No resolution authority in a signatory state shall exercise its powers so as to interfere, in any other signatory state, with

(a) The rights of creditors to demand the set–off of their claims against the claims of the institution, where such a set–off is permitted by the law applicable to the institution's claim;

(b) Any security claim which is valid by the appropriate law;

(c) Any settlement finality or equivalent regime protecting the closeout or settlement provisions of any exchange, clearing house or payment system;

(d) Proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralized deposit system held or located in a signatory state;

(e) The treatment of goods acquired by the institution after the opening of resolution proceedings;

(f) The powers of any liquidator or insolvency office–holder, except in accordance with this Convention;

(g) The conditions under which netting or set–offs may be invoked;

(h) The impact of any stay on contracts to which the institution is a party, subject to Article XV below.

Article XIII. Resolution and Insolvency

While a Group is subject to a group resolution proceeding, signatory states agree that they will not permit action taken under their insolvency laws to obstruct or prevent any step of a group resolution or an institutional resolution undertaken in the territory of any other signatory state save where such provision would be equally effective to obstruct or prevent the action concerned if the action were taken under the resolution laws (including this [Convention]) of that signatory state. This prohibition shall extend to actions brought in the courts of the signatory state by individual creditors of the institution (in an institutional resolution) or any member of the Group (in a group resolution), or by any other third–party claimant against such institution or member of the Group.

Article XIV. Set-off and Security

Where a creditor of an institution, or (in a group resolution) of a member of the relevant Group, has a right of set–off or a security claim which would be valid in the insolvency of the grantor of the security or the counterparty to the set–off, the validity of that set–off or security claim shall be recognized by all relevant resolution authorities, and in the application of Article VII, such creditors shall be regarded as creditors for such amounts as remain after the recognition of such rights.

Article XV. Stays and Cross-defaults

Where the resolution regime of a signatory state provides for a stay of rights under any contract entered into by an entity which is a member of a group, or for cross–default provisions in a contract relating to any member of a Group to be suspended or waived, for the purpose of achieving the objectives of the resolution, signatory states shall ensure that such provisions shall be given effect under their laws.

Article XVI. Termination of Group Resolution

Where a group resolution arrangement will manifestly fail to achieve either of the objectives which are its aims, the relevant signatory states may agree that the best outcome will be achieved by reversion to individual institutional resolution. If such a determination is made, asset transfers made pursuant to the group resolution scheme shall, as far as possible, be unwound prior to the commencement of individual institutional resolution arrangements, save that fair provision shall be made for expenses or liabilities incurred by individual legal entities which have benefitted other entities within the Group.

Article XVII. Authentication and Amendment

1. Except where provision for modification is made elsewhere in this Agreement, amendments to the provisions of this Convention shall become effective upon [acceptance by all the signatory states][and other amendments to this Convention shall become effective, in respect of those signatory states which accept them, upon acceptance by two–thirds of the signatory states and thereafter for each other signatory state upon acceptance by it].

2. Any signatory state accepting an amendment to this Convention shall deposit an instrument of acceptance with [the Secretary–General of the United Nations within such period as the signatory states may specify]. The signatory states may decide that any amendment made effective under this Article is of such a nature that any signatory state which has not accepted it within a period specified by the signatory states shall be free to withdraw from this Convention, or to remain a signatory state with the consent of the signatory states.

Article XVIII. Withdrawal

Without prejudice to the provisions of [ ] any signatory state may withdraw from this Convention, or may separately withdraw on behalf of any of the separate customs territories for which it has international responsibility and which at the time possesses full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Convention. The withdrawal shall take effect upon the expiration of six months from the day on which written notice of withdrawal is received by [the Secretary–General of the United Nations].

Article XIX. Accession

A state not party to this Convention, [or a state acting on behalf of a separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Convention] may accede to this Convention, on its own behalf or on behalf of that territory, on terms to be agreed between such state and the signatory states. Decisions of the signatory states under this Article shall be taken by a two–thirds majority.

Article XX. Non-application of the Convention Between Particular Signatory States

This Convention shall not apply as between any signatory state and any other signatory state if either of the signatory states, at the time either becomes a signatory state, does not consent to such application. The signatory states may review the operation of this Article in particular cases at the request of any signatory state and make appropriate recommendations.

Article XXI. Commitments

1. Whenever it is considered that effect is not being given to any of the provisions of this Convention, the matter shall be reported to the signatory states either by the signatory state not so giving effect to the relevant provisions or by any other interested signatory state [or by any affected private entity].

(a) The signatory states shall, if requested so to do by any interested signatory state, and without prejudice to any bilateral consultations that may be undertaken, consult with the signatory state concerned and all interested signatory states with respect to the matter with a view to reaching solutions satisfactory to all signatory states concerned in order to further the objectives set forth in this Convention. In the course of these consultations, the reasons given in cases where effect was not being given to the provisions of subparagraph (a) or (b) of paragraph 1 shall be examined.

(b) As the implementation of the provisions of subparagraph (a) or (b) of paragraph 1 by individual signatory states may in some cases be more readily achieved where action is taken jointly with other signatory states, such consultation might, where appropriate, be directed towards this end.

(c) The consultations by the signatory states might also, in appropriate cases, be directed towards agreement on joint action designed to further the objectives of this Convention.

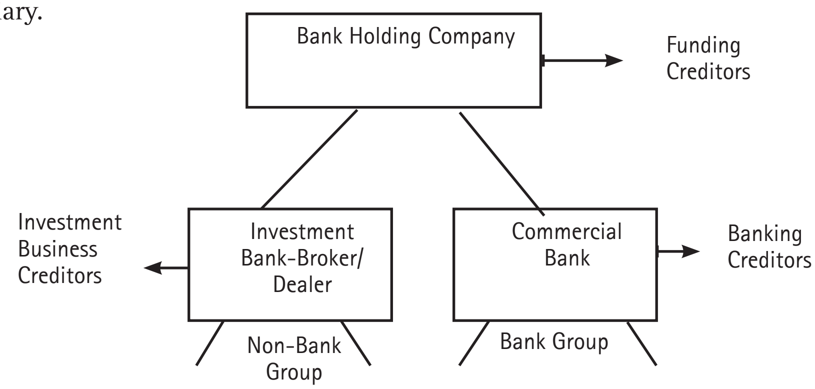
ANNEX II. SPECIFIC GROUP STRUCTURES

Bank groups are protean—not only are they very different one from another, but also they may change significantly as the business of the bank changes. Each large bank group is to some extent unique. However, it is to some extent possible to separate bank groups into broad types, and we suggest here a taxonomy that may enable some progress to be made in addressing resolution options.

> For the purposes of the examples that follow, we have divided creditors into three broad types:
>
> a. **Banking creditors,** meaning retail and wholesale depositors and creditors arising out of the provision by the bank of payment and custody services.
>
> b. **Investment business creditors,** meaning swap counterparties, trading counterparties, exchanges, clearing systems and other investment business counterparties (including repo counterparties). Very roughly, this category would correspond to counterparties to "financial contracts" as discussed earlier.
>
> c. **Funding creditors,** meaning long–term creditors of the bank, including bondholders and other long–term unsecured finance providers.

(A) THE "HOLDCO FUNDED" MODEL

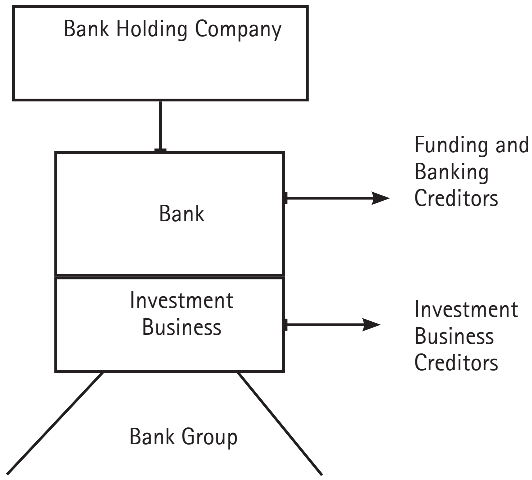
Here a holding company holds a bank and an investment business. A portion of the external funding of this entity—including equity, capital instruments and unsecured debt—is raised primarily at the holding company level. Business activities, such as commercial banking and trading activities, are done in the main bank or another subsidiary.



This type of structure is not uncommon in the United States, and the FDIC has pointed out certain useful features in the course of their analysis. One is that the liabilities most frequently cited for bail–in are concentrated in a single legal entity. The customer and counterparty relationships are typically conducted at a level below the holding company. This structure may allow resolution to take place using a "single–point–of–entry" procedure at the holding company only, while the other legal entities stay in business. It is likely that at least one of these local entities has been affected adversely by recent events (as the cause of the stress on the group), and may need liquidity or capital to restore its position. This can be satisfied where necessary by down streaming any needed resources from the recapitalized holding company. This type of approach could reduce the amount of inter–jurisdictional coordination needed, and simplify the resolution process. It cannot be used for all institutions, as this initial organization is not seen frequently for Systemically Important Banks outside of the United States.

(B) THE "BIG BANK" MODEL

Here a more or less "empty" holding company holds a bank with a large balance sheet. Assets not held within the bank itself are held by subsidiaries of the bank. Funding often raised primarily at the bank level, since any funding raised at the holding–company level is considered structurally subordinated to bank level funding.

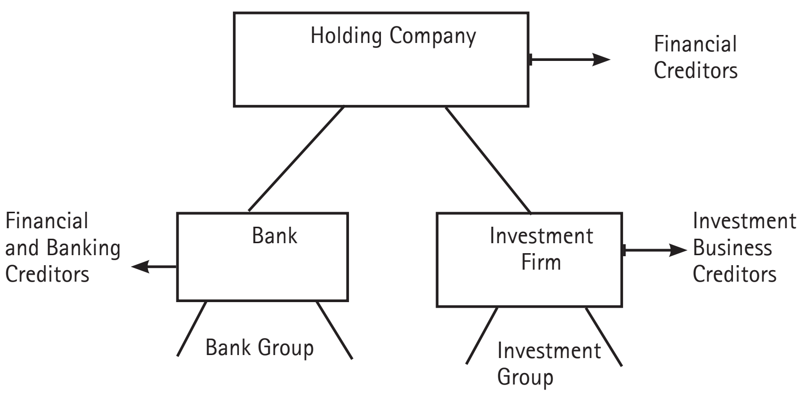


In general the "big bank" is likely to do its derivatives, markets, and trading business out of the main legal entity, since this will be the most creditworthy member of the group and will ensure that counterparties have the lowest risk exposure (and therefore the lowest costs of dealing with it). A common variant of this structure is where the bank itself is the holding company for the group.

In the context of this institution, two issues arise. One is that it is very unlikely that financial contracts of investment business creditors will be written down as part of the resolution, for the reasons discussed above.[110] Also, insured bank depositors certainly will not be included for policy reasons, although deposit guarantee schemes have been considered as an alternative in recent months.

(C) THE "BANK/NON-BANK" MODEL

Here, a holding company owns a bank and a non–bank investment firm. There may be little interaction between the two sides of the group below the level of the holding company. In this case, it is possible that all three components—the bank, the investment firm and the holding company—may have raised senior debt.



For purposes of this discussion, assume the loss has been incurred in the bank.

At the level of the bank itself, the issues here are no different from the "big–bank" model. But the position of the investment firm raises the "dead–in–parts" problem. It is highly likely that the bank and the investment firm share the same branding; the same advertising campaign; and the same information technology, processing, and payment systems. As a result, it may well be the case that the survival of the brokerage will be entirely dependent on the survival of the bank.

Clearly, if the resolution can be conducted entirely at the group level, that is likely to be the optimal solution. However, if that is not the case—if, for example, there are insufficient creditors at the holding–company level—then there may well be scope for the creditors of the bank to argue that a group resolution would impose on them a cost in respect of which the creditors of the investment firm are beneficiaries.

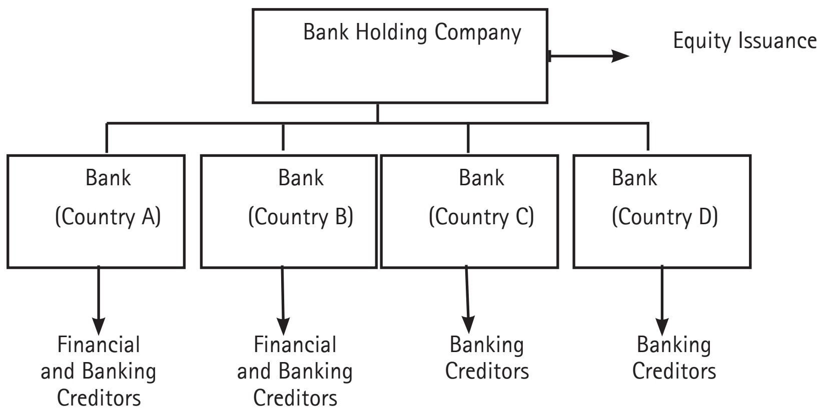
110 See supra Chapter 1, section 5.

(D) "GLOBAL MULTI-BANK" MODEL

Here, a more or less empty holding company owns several banks—generally incorporated in different jurisdictions and subject to some degree of restrictions on their interconnection. In this case, some debt may have been raised at the holding-company level, although it is likely that some (but perhaps not all) of the subsidiary banks will also have raised external financial debt. Each bank is also likely to have depositors covered by local deposit guarantee arrangements.

Because we have hypothesized that the holding company is "empty," it must follow that the loss causing the crisis must have been experienced in one or other of the bank subsidiaries.

This group is very likely to have an "archipelago structure"—that is, to have specifically structured its activities so that they are not mutually dependent, and the structure is designed to permit a failure in one part of the group without affecting others. The group RRP is likely to provide that resolution of Bank A should be conducted by the resolution authority in Country A on a stand-alone basis.

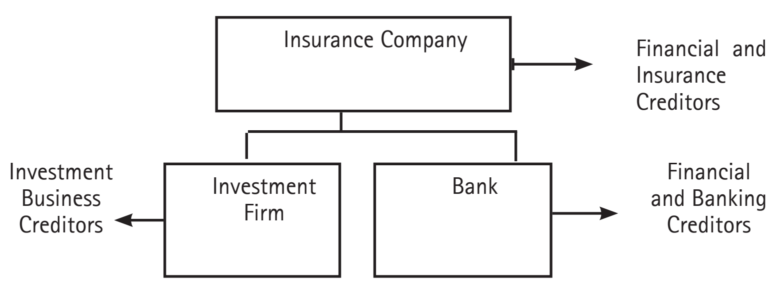


It could be that if Banks A, B, and C were all destabilized, the common decision of the various resolution authorities might be that a solution at group level would be preferable to the conduct of multiple independent resolutions.

(E) "FINANCIAL CONGLOMERATE" MODEL

Here, an insurance company owns the bank parent.

The key point is that the majority of the creditors of the parent are likely to be "protected" creditors, and the insurance parent would be subject to a very different, insurance-focused, resolution regime (not addressed here). The result would be that the group RRP would need to foresee the resolution of the other parts of the group at a level lower than the insurance parent.



ANNEX III. INVESTORS' PERSPECTIVES APRIL 2012

THE FOLLOWING NOTE REPRESENTS THE THOUGHTS OF ONE LONG–TERM INSTITUTIONAL INVESTOR ON SOME OF THE TOPICS DISCUSSED IN THE TASK FORCE REPORT. WHILE WE BELIEVE THAT OTHER INVESTORS WOULD AGREE WITH MANY OF THE COMMENTS MADE IN THIS NOTE, WE ALSO BELIEVE THAT FINANCIAL INSTITUTIONS AND RESOLUTION AUTHORITIES SHOULD SOLICIT THE VIEWS OF A BROAD RANGE OF INVESTORS ON THE IMPORTANT TOPIC OF CROSS–BORDER RESOLUTION.

I. OVERVIEW

Like other market participants, investors seek strong, robust, and competitive financial markets with stable financial institutions. Such markets and institutions facilitate the ability of investors to focus on investment returns for their beneficiaries. As a result, investors in the first instance support cost–effective steps (e.g., capital and liquidity standards) designed to prevent the market disruption that results when a systemically significant financial institution fails or is at risk of failure.[111]

Nonetheless, investors also recognize that regulators need to develop robust processes and tools to resolve financial institutions that fail. While regulators principally are concerned about the systemic risks of failure, investors are more concerned about maximizing recoveries for their beneficiaries. Just as importantly, however, in determining whether to invest in a financial institution, an investor will want to evaluate and understand how its investment will be treated if subjected to resolution.

Accordingly, investors seek disclosure of all relevant information about resolution planning, want the actions of debtor financial institutions and regulators to be as transparent as possible, and desire resolution rules and processes to be predictable. Investors also seek to be accorded the same treatment as similarly situated creditors in a workout or insolvency and want to have meaningful input into the workout or resolution process. A resolution system that is transparent allows investors to better assess the risk associated with making an investment in a financial institution that could later be subjected to resolution. Predictability, fairness, and an ability to meaningfully participate in a resolution process should encourage investors to provide capital to financial institutions at a lower cost than would otherwise be the case.

II. TRANSPARENCY

The Financial Stability Board's (FSB's) *Key Attributes* [112] contains several recommendations that improve the transparency of resolution regimes and thus would be welcomed by investors. The FSB recommends that home and host resolution authorities adopt institution specific cooperation agreements to allow the sharing of information and the development of mechanisms so that resolution authorities can coordinate the resolution of global financial institutions.[113] *Key Attributes* states that the existence of such agreements should be made public[114] and provides that the signatory authorities should establish rules setting forth the extent to which the content of the cooperation agreement should

111 As a general matter (without commenting on the particulars of any individual proposal), investors have supported prophylactic measures designed to reduce the likelihood of a financial institution's failure. Such preventive measures include the sorts of changes encompassed by the Basel III framework: enhanced capital provisions, and in particular the growth of Common Equity Tier 1; the tightening of eligibility standards for Tier 1 and Tier 2 capital; the adoption of capital conservation buffers that limit the payment of dividends by financial institutions; the promulgation of countercyclical buffers; the adoption of a global leverage ratio; and the development of liquidity standards. The FSB has agreed that increasing the loss absorption capacity of global systemically important financial institutions is an integral part of the policy framework to reduce moral hazard. *See* FSB, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions* (20 October2010); FSB, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, (4 November2011); *see also* Group of Thirty, *Enhancing Financial Stability and Resilience, Macroprudential Policy, Tools and Systems for the Future* (October 2010). We acknowledge that the IIF and several financial institutions have reservations about some specific regulatory proposals, including technical issues arising from liquidity ratios, and more basic reservations about certain issues, such as the acceleration of reforms in some countries or SIFI surcharges, but we believe that the IIF and financial institutions share the broad desire of the investor community to see more robust regulation, more resilient financial institutions, and a sound and productive international financial system with substantially reduced moral hazard.

112 FSB, *supra* note 1, *Key Attributes*.

113 Id. at Section 9.1.

114 Id. at Section 9.2.

be publicly disclosed.[115] Key Attributes also requires resolution authorities to prepare annual resolvability assessments that evaluate the feasibility of resolution strategies[116] and further requires financial institutions to adopt recovery plans[117] and resolution authorities to adopt resolution plans.[118]

Cooperation agreements, resolvability assessments, recovery plans and resolution plans principally are designed to allow resolution authorities to be more transparent with each other and with the regulated financial institution, and it is acknowledged that much of the information contained in such assessments and plans is sufficiently detailed and sensitive that it cannot be disclosed to the public markets. Disclosure of the specific details of a financial institution's recovery plan may be especially sensitive, both for commercial reasons and for reasons relating to employee morale. Nonetheless, both financial institutions and resolution authorities should be encouraged to use these tools, where possible, to provide additional information and guidance to investors—especially if such information sheds light on possible pathways to be taken by resolution authorities.

For example, if the cooperation agreement between the home and host resolution authorities provides that responsibilities for the resolution of a particular financial institution will be allocated between home and host authority in a particular way—say, if a host jurisdiction is given authority to resolve a particular subsidiary—it would be important for investors to be apprised of that fact. As a second example, even if details of specific resolvability assessments are not shared with the financial markets, it would be helpful for investors to understand the criteria used by resolution authorities in developing such resolvability assessments, particularly if resolvability criteria differ for different types of financial institutions. As a final example, even though financial institutions and resolution authorities probably will be reluctant to disclose details of their resolution plans, disclosure in a high-level summary of the key features of a financial institution's resolution plan and the way in which the institution intends to implement such plan would be extremely relevant and useful information to investors. Additional disclosure and transparency are especially important for investors if the resolution authority has specific tools that it anticipates using—whether through the bail-in of creditors or the transfer of assets to a bridge institution—in support of a financial institution's resolution plan.

Key Attributes states that jurisdictions should allow financial institutions temporary exemptions from disclosure requirements where disclosure could affect the successful implementation of a resolution.[119] Such exemptions are claimed to be necessary to preserve market confidence. We believe that the opposite is true—transparency and market confidence are best preserved systemically if investors and financial markets are confident that information concerning resolution measures is promptly and robustly disclosed to the public.

III. PREDICTABILITY

Long-term investors understand that the erosion of confidence in a struggling financial institution, and the potential for rapid loss of value in insolvency have led resolution authorities to emphasize the necessity of speed and flexibility when fashioning remedies under resolution regimes. Regulators expect to employ a wide range of powers in resolution, including the ability to remove and replace management, terminate contracts, transfer or sell assets, establish bridge banks, bail-in existing creditors or shareholders and wind-down failing institutions.

The discretion accorded resolution authorities creates concerns for investors, however, because investors are looking for predictability in the operation of resolution regimes, and the breadth of remedies that can be employed by regulators has not to date been matched with a successful regulatory track record in exercising broad resolution remedies on a coordinated global basis. Indeed, most global resolution experiences to date have not been reassuring to investors.

While there is a long history in the United States of the Federal Deposit Insurance Corporation exercising conservatorship powers similar to those powers described in Key Attributes, the banks involved were smaller in size and did not require a coordinated response between regulators from different national jurisdictions. For a number of decades, regulatory authorities in the United States have had broad powers to regulate financial institutions well before the point of seizure and in part based on triggers that are subjective in nature. To a large extent these broad powers have not been exercised by regulators. The combination of a lack of a regulatory track record in the coordinated resolutions of global financial institutions, together

115 Id. at Annex I, Section 1.5.
116 Id. at Section 10.1.
117 Id. at Section 11.5.
118 Id. at Section 11.6.
119 Id. at Section 5.6.

with the wide (but often unused) discretionary powers provided to regulators, gives rise to an inability of investors to assess how global resolutions would work in practice.

It also should be noted that an investor's concerns about predictability is as much a concern about predictability of process as it is a concern about predictability of results. Investors want to know that resolution rules will not be changed on them or applied by different jurisdictions in unexpected ways. Investors thus should support efforts by resolution authorities to adopt resolution conventions such as the proposed Bank Resolution Convention set forth in Annex I of the Task Force Report. Resolution authorities in home and host countries can decide in advance whether a financial institution will be resolved either as a group resolution or as an institutional resolution.

If investors can be provided a roadmap of the resolution process by resolution authorities well in advance of stress, they can better assess (and price) the risk of investing in various financial institutions. An investor's decision may be influenced by the fact that the resolution of a particular financial institution will (or will not) be controlled by the financial institution's home authority or by the fact that the resolution will (or will not) be handled on a group basis. Predictability as to process leads to planning and better risk assessment. Predictability is best achieved if resolution authorities can agree on Conventions that are binding on the constituent jurisdictions, but even in the absence of binding Conventions, investors can take some comfort in statements of principle adopted by regulators that are widely followed in practice.

IV. INVESTOR PARTICIPATION

Resolution authorities stress the need for speed and flexibility because they assume that financial institutions will fail quickly due to a run on the bank by depositors, swap counterparties, or other short–term liquidity providers. While it is true that financial institutions can fail precipitously, it is also true that the conditions creating such failures usually build up over a course of time, well before regulators took over the institution or insolvency proceedings were commenced. The buildup to insolvency provides resolution authorities an opportunity to consult with key creditor constituencies about the possibility of a private sector consensual restructuring of the financial institution, and such consultation should be encouraged.

There have been restructurings of financial institutions, such as CIT Group and Long–Term Capital Management, with discrete and readily identifiable financial creditor groups, where the restructuring came not through the seizure by regulators, but rather through the concerted actions of creditors and private sector investors. Regulators assume that investor groups cannot be organized quickly enough to participate in resolution discussions or that the capital structures of financial institutions are too complicated to have anything other than fragmented creditor participation, but investors will be motivated to organize quickly and well in advance of insolvency if there is a likelihood that financial regulators seriously will consider their views. Creditors whose debt securities are subject to regulatory bail–in powers will be especially anxious to participate in restructuring discussions with regulators.

Financial regulators also have an incentive to consult with investors. The resolution regimes proposed by the FSB emphasize a graduated approach, with resolvability assessments being prepared by regulators and recovery plans being prepared by financial institutions well in advance of distress. We realize that resolution authorities will likely be cautious in wanting to engage with financial creditors if such discussions threaten to accelerate the destabilization of a financial institution. Nonetheless, consultation with investors either in advance of distress or at the early stages of financial difficulty can aid regulators in their assessment of what regulatory steps are appropriate and how proposed regulatory actions would be viewed by financial markets.

Such consultations could be especially useful for resolution authorities if the financial institution in question has large amounts of bail–in–able indebtedness. Investor participation could help regulators consider remedies that are less likely to have a destabilizing effect. Investors in turn would be provided an opportunity to participate in market informed restructurings that might be more palatable and more protective of investors than remedies unilaterally imposed by regulators.

V. FAIRNESS

As Key Attributes makes clear, financial regulators generally support the principle that creditor hierarchies are to be respected in liquidation.[120] The baseline investor protection in Key Attributes is that an investor is entitled to receive no less than it would have received from a liquidation of the financial institution under the relevant insolvency statute. [121]

120 Id. at Section 5.1.
121 Id. at Section 5.2.

For a US long–term investor that has purchased securities of a bank, bank holding company or a systemically important financial institution, the "no creditor worse off than in liquidation" standard is consistent with where an investor could find itself under existing US law. [122] Even though the baseline standard is generally consistent with existing law, investors will not take much comfort from this standard because a resolution authority will be valuing the assets of a failed institution for liquidation purposes at the heart of a financial meltdown, when buyers of the assets will be difficult to find and will have little reason to pay full going–concern value.

While investors understand the reasons that resolution authorities would seek to protect insured depositors and trading counterparties in the resolution of a financial institution, systemic risk can be created by treating long–term capital providers differently from other unsecured creditors. First, treating long–term capital providers differently from other creditors creates a risk that there will be a movement of capital from long–term debt to short–term debt as the credit of a financial institution deteriorates. Second, unequal treatment of long–term capital providers will raise the cost of long–term capital for all financial institutions, which in turn runs counter to the desire of financial regulators to bolster the long–term capital of financial institutions. If long–term capital becomes more expensive, the tendency of financial institutions to fund long–term asset growth with less expensive, but riskier, short–term capital will be further exacerbated.

One resolution power given to regulators in *Key Attributes* is the ability to bail–in, or write down, claims of financial creditors.[123] This regulatory approach to bail–in provides regulators wide discretion as to the amounts, timing and circumstances under which debt can be bailed–in. The Task Force Report makes a plausible case that bail–in at resolution can ultimately redound to the benefit of long–term debt providers by preserving the going–concern value of the financial institution in resolution. Although an investor will have all or a portion of the indebtedness it holds converted to equity, the expectation is that the investor's recovery will be greater through a bailed–in recapitalization than if depositors and contractual counterparties are permitted to either flee or liquidate collateral with an ensuing loss of franchise value. As bail–in is untried, and subject to regulator discretion, it remains to be seen whether it would actually work in practice. We believe that bail–in at resolution is most likely to work if the financial institution has a sufficient amount of indebtedness subject to bail–in to adequately underpin the recapitalization of the financial institution as a going concern.

If resolution authorities decide to exercise bail–in rights at the financial institution's point of non–viability, resolution authorities should make clear to investors how debt and equity investments will be bailed–in across the financial group. For example, if a global financial institution is organized as a holding company with subsidiary banks that are separately capitalized with their own financial creditors, should creditors of solvent Bank Subsidiary A be bailed–in to rescue insolvent Bank Subsidiary B? This sort of question should be explicitly considered as part of any resolvability assessment prepared by the Crisis Management Group (CMG) for the financial institution, and the CMG's planning determination as to how to implement a multi–jurisdictional bail–in should be conveyed to the financial markets. To the extent that broad principles of how bail–in is to be applied across or within entities in a financial group can be developed by resolution authorities with input from financial institutions and investors, predictability would be enhanced and creditors would better be able to price bail–in risk into capital markets securities.

Finally, we would re–emphasize that resolution authorities should include the maximization of value for investors as one of the core principles for the resolution of financial institutions. The IIF has made this point forcefully,[124] but it deserves renewed comment from investors. Resolution authorities, quite naturally, have focused most of their attention on preserving the continuity of a financial institution's systemically important services and protecting depositors, while avoiding the use of taxpayer money in support of resolution. Investors providing long–term capital to financial institutions do so with the understanding that their investments are subject to regulatory intervention in times of stress. An investor's confidence in committing long–term capital to financial institutions should increase if that investor believes that the maximization of value for investors is a core objective of resolution authorities.

VI. CONCLUSION

Successful resolution regimes must not only provide a means to prevent systemic risk arising from the failure of a financial institution but also must be

122 *See* Chapter 1, Section 4 of the Task Force Report.
123 FSB, *supra* note 1, *Key Attributes* Section 3.5.
124 *See* IIF, supra note 31.

sufficiently predictable and transparent so that investors can understand and price the risk associated with providing long–term investments in financial institutions. Institutional investors generally are under various regulatory requirements to maximize returns for their beneficiaries and, therefore, cannot put their investments at risk simply in the name of mitigating systemic risk associated with a financial institution's failure. If, instead, fair, transparent and predictable resolution regimes are designed (including a voice for institutional investors), then institutional investors should be willing to continue to purchase capital markets instruments of financial institutions at a lower cost of capital than is currently the case. In this regard, it is easier to price such instruments if their operative provisions and the rules of the resolution regime are clear and predictable. In contrast, such instruments will be more expensive if the rules of the resolution regimes are unclear and unpredictable. In other words, like any option, regulatory discretion has its price.

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