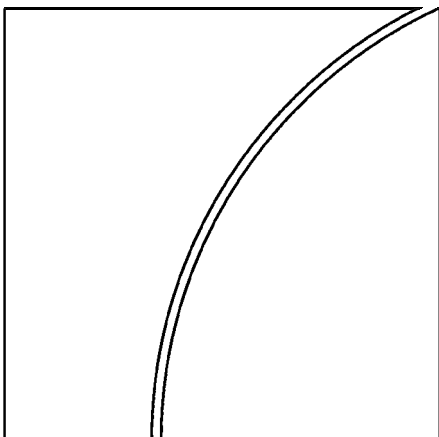


Basel Committee  
on Banking Supervision

Consultative Document



**Report and  
Recommendations of the  
Cross-border Bank  
Resolution Group**

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# **Report and Recommendations of the Cross-border Bank Resolution Group**

## **Executive Summary**

The Cross-border Bank Resolution Group (CBRG) of the Basel Committee on Banking Supervision (Basel Committee) developed the following Recommendations as a product of its stocktaking of legal and policy frameworks for cross-border crises resolutions and its follow-up work to identify the lessons learned from the financial crisis which began in August 2007. The background and supporting analysis for the following Recommendations are explained in the balance of this Report.

### **Recommendation 1: Effective national resolution powers**

National authorities<sup>1</sup> should have appropriate tools to deal with all types of financial institutions in difficulties so that an orderly resolution can be achieved that helps maintain financial stability, minimise systemic risk, protect consumers, limit moral hazard and promote market efficiency. Such frameworks should minimise the impact of a crisis or resolution on the financial system and promote the continuity of systemically important functions. Examples of tools that will improve national resolution frameworks are powers, applied where appropriate, to create bridge financial institutions, transfer assets, liabilities, and business operations to other institutions, and resolve claims.

### **Recommendation 2: Frameworks for a coordinated resolution of financial groups**

Each jurisdiction should establish a national framework to coordinate the resolution of the legal entities of financial groups and financial conglomerates within its jurisdiction.

### **Recommendation 3: Convergence of national resolution measures**

National authorities should seek convergence of national resolution tools and measures toward those identified in Recommendations 1 and 2 in order to facilitate the coordinated resolution of financial institutions active in multiple jurisdictions.

### **Recommendation 4: Cross-border effects of national resolution measures**

To promote better coordination among national authorities in cross-border resolutions, national authorities should consider the development of procedures to facilitate the mutual recognition of crisis management and resolution proceedings and/or measures.

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<sup>1</sup> Throughout this report, the term “national authorities” refers to the competent authorities under the applicable national laws or international guidelines or standards. European Union (EU) directives also designate the responsible national authorities for certain insolvency-related actions and establish the over-arching legal framework applicable within the EU to certain matters addressed by this report, including for example the sharing of information among supervisors and central banks and the recognition of risk mitigation techniques within payment and securities settlement systems and in financial market transactions. Also, the term “national laws” in this report refers, in certain cases, to national laws implementing EU directives.

### **Recommendation 5: Reduction of complexity and interconnectedness of group structures and operations**

Supervisors should work closely with relevant home and host resolution authorities in order to understand how group structures and their individual components would be resolved in a crisis. If national authorities believe that financial institutions' group structures are too complex to permit orderly and cost-effective resolution, they should consider imposing regulatory incentives on those institutions, through capital or other prudential requirements, designed to encourage simplification of the structures in a manner that facilitates effective resolution.

### **Recommendation 6: Planning in advance for orderly resolution**

The contingency plans of all systemically important cross-border financial institutions should address as a contingency a period of severe financial distress or financial instability and provide a plan, proportionate to the size and complexity of the institution, to preserve the firm as a going concern, promote the resiliency of key functions and facilitate the rapid resolution or wind-down should that prove necessary. Such resiliency and wind-down contingency planning should be a regular component of supervisory oversight and take into account cross-border dependencies, implications of legal separateness of entities for resolution and the possible exercise of intervention and resolution powers.

### **Recommendation 7: Cross-border cooperation and information sharing**

Effective crisis management and resolution of cross-border financial institutions require a clear understanding by different national authorities of their respective responsibilities for regulation, supervision, liquidity provision, crisis management and resolution. Key home and host authorities should agree, consistent with national law and policy, on arrangements that ensure the timely production and sharing of the needed information, both for purposes of contingency planning during normal times and for crisis management and resolution during times of stress.

### **Recommendation 8: Strengthening risk mitigation mechanisms**

Jurisdictions should promote the use of risk mitigation techniques that reduce systemic risk and enhance the resiliency of critical financial or market functions during a crisis or resolution of financial institutions. These risk mitigation techniques include enforceable netting agreements, collateralisation, and segregation of client positions. Additional risk reduction benefits can be achieved by encouraging greater standardisation of derivatives contracts, migration of standardised contracts onto regulated exchanges and the clearing and settlement of such contracts through regulated central counterparties, and greater transparency in reporting for OTC contracts through trade repositories. Such risk mitigation techniques should not hamper the effective implementation of resolution measures (cf. Recommendation 9).

### **Recommendation 9: Transfer of contractual relationships**

National resolution authorities should have the legal authority to temporarily delay immediate operation of contractual termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution, a bridge financial institution or other public entity. Where a transfer is not available, authorities should ensure that contractual rights to terminate, net, and apply pledged collateral are preserved. Relevant laws should be amended, where necessary, to allow a short delay in the operation of such termination clauses in order to promote the continuity of market functions. Authorities should

also encourage industry groups, such as ISDA, to explore development of standardised contract provisions that support such transfers as a way to reduce the risk of contagion in a crisis.

### **Recommendation 10: Exit strategies and market discipline**

In order to restore market discipline and promote the efficient operation of financial markets, the national authorities should consider, and incorporate into their planning, clear options or principles for the exit from public intervention.

1. The global financial crisis which began in August 2007 illustrates the importance of effective cross-border crisis management. The scope, scale and complexity of international financial transactions expanded at an unprecedented pace in the years preceding the crisis, while the tools and techniques for handling cross-border bank crisis resolution have not evolved at the same pace. Some of the events during the crisis revealed gaps in intervention techniques and the absence in many countries of an appropriate set of resolution tools. Actions taken to resolve cross-border institutions during the crisis tended to be ad hoc, severely limited by time constraints, and to involve a significant amount of public support.

2. A viable and commonly understood process for resolving cross-border financial institutions and financial groups may help support market discipline by encouraging counterparties to focus more closely on the financial risks of the institution or group. Discipline is enhanced if market participants clearly perceive that authorities are willing and able to effect a managed resolution of a financial institution.

3. An important consideration in recommending national resolution frameworks for cross-border financial firms is to reduce reliance on (implicit or explicit) public support to institutions deemed “too big to fail.” The assumption, and reality, that some institutions are too big to fail has introduced additional risk and a greater likelihood of cross-border contagion into global finance. There are discussions in other fora about measures that national authorities can adopt that would moderate or eliminate the notion of too big to fail. One of the necessary measures to control the likelihood that institutions will require public support or forms of collective private support because they are too big to fail is within the mandate of the CBRG – an effective crisis management and resolution process. It is important to recognise that, as vital as prudential measures may be in controlling the likelihood of relying on public support, such measures cannot limit the potential for increased moral hazard without instituting, among other things, a viable resolution process for cross-border financial institutions.

4. The current crisis has illustrated the importance placed by national authorities on avoiding the disruption and potential contagion effects that could result from a disorderly failure of a cross-border or other large financial institution. Some ad hoc responses to date have been necessitated in part by the absence of viable resolution tools that would avoid those disruptions and potential effects. An effective resolution regime would allow the authorities to act quickly to maintain financial stability, preserve continuity in critical functions and protect depositors. At the same time, an effective regime would maintain market discipline by holding to account, where appropriate, senior managers and directors and imposing losses on shareholders and, where appropriate, other creditors.

5. Existing legal and regulatory arrangements are not generally designed to resolve problems in a financial group operating through multiple, separate legal entities. This is true

of both cross-border and domestic financial groups. There is no international insolvency framework for financial firms and a limited prospect of one being created in the near future. National insolvency rules apply on a legal entity basis and may differ depending on the types of businesses within the financial group. Indeed, few countries, if any, have tools for resolving domestic financial groups – as distinct from individual deposit-taking institutions – in an integrated manner in their own jurisdictions.

6. Challenges in resolving a cross-border bank crisis arise for many reasons, one of which is that crisis resolution frameworks are largely designed to deal with domestic failures and to minimise the losses incurred by domestic stakeholders. As such, the frameworks are not well suited to dealing with serious cross-border problems. Many earlier discussions of these issues have been framed in terms of either a so-called universal resolution approach that recognises the wholeness of a legal entity across borders and leads to its resolution by a single jurisdiction – or a territorial or ring fencing approach – in which each jurisdiction resolves the individual parts of the cross-border financial institution located within its national borders. Neither characterisation corresponds to actual practice, though recent responses, like prior ones, are closer to the territorial approach than the universal one. It is debatable which is optimal in economic or operational terms. However, even in jurisdictions that adhere to a universal insolvency procedure for banks and their branches, such as in the European Union, each national authority is likely to attach most weight to the pursuit of its own national interests in the management of a crisis.

7. The absence of a multinational framework for sharing the fiscal burdens for such crises or insolvencies is, along with the fact that legal systems and the fiscal responsibility are national, a basic reason for the predominance of the territorial approach in resolving banking crises and insolvencies. National authorities tend to seek to ensure that their constituents, whether taxpayers or member institutions underwriting a deposit insurance or other fund, bear only those financial burdens that are necessary to mitigate the risks to their constituents. In a cross-border crisis or resolution, this assessment of the comparative burdens is complicated by the different perceptions of the impact of failure of a cross-border institution and the willingness or ability of different authorities to bear a share of the burden. This assessment will also be affected by whether the jurisdiction is the home country of the financial institution or group or, if a host, whether the institution operates through a branch or subsidiary. For host countries, it will also be affected by asset maintenance, capital or liquidity requirements that may be imposed on branches or subsidiaries. Other considerations, such as the availability of information and the available legal and regulatory tools for intervention, must also be considered and will further complicate the assessment of burdens.

8. One option for reform would be to reach broad, and enforceable, agreement on the sharing of financial burdens by stakeholders in different jurisdictions for crisis management and resolution of cross-border financial institutions and groups. This would be an essential element, along with other important changes in national legal frameworks, for the creation of a comprehensive framework for the resolution of cross-border financial groups. However, the development of mechanisms for the sharing of financial burdens for the resolution of future cross-border financial institutions would give rise to considerable challenges, and broad international agreement on such mechanisms appears unlikely in the short term. An alternative and opposite approach would be to move toward a ring fencing approach to supervision and a territorial approach to resolution in which all transactions and institutions are separately structured for capital, liquidity, assets, and operations within each national jurisdiction. This could provide a more predictable result if financial institutions restructured their operations along national lines. However, it could also be directly counterproductive. Ring fencing measures taken by authorities in one country could increase stress on the banking group's legal entities in other jurisdictions or for the banking group as a whole. As a result, in some cases ring fencing may increase the probability of further defaults and

complicate crisis management. Members are not in agreement on the merits and drawbacks of the opposite approaches.

9. A middle ground that reflects lessons from recent experience, but also looks to preserve a greater share of the value from cross-border provision of financial services by global financial institutions for global financial well-being, may be more realistic at the present time. This middle approach recognises the strong likelihood of ring fencing in a crisis, and helps ensure that home and host countries as well as financial institutions focus on needed resiliency within national borders. It also recommends certain changes to national laws to create a more complementary legal framework for resolution that helps to facilitate the maintenance of global financial stability and the preservation of continuity for key financial functions across borders. In addition to the legal and policy initiatives that are necessary in many countries, there are a number of practical issues that must be considered. These include the challenges created by complex corporate structures, information technology systems that may not provide timely or complete information, and the identification and retention of critical staff. Efforts to further develop cross-border cooperation on crisis management and resolution, for example to explore mechanisms for burden sharing, either on a regional basis, or in relation to specific banking groups, should be encouraged.

10. Suggested statutory reforms are designed to achieve greater convergence in the authority, tools, and processes for crisis management and resolutions under national laws (although the effectiveness of such tools on a cross-border basis will be enhanced if broader legal issues touching on insolvency are also addressed). Specifically, this middle approach suggests that jurisdictions provide national authorities with the tools to manage crises. This should be done by giving authorities mechanisms such as bridge banks and by allowing transfers of financial contracts and other assets, which can preserve continuity (Recommendations 1-4).

11. The complexity of large international corporate group structures also makes crisis resolution difficult and costly. Simplification of group structures could make the insolvency process more orderly and efficient in the event that a firm fails. Crisis prevention has paid scant attention to corporate form and the operation of nationally-based insolvency procedures (Recommendation 5).

12. Although certain large financial institutions provide functions that are systemically relevant, similar in some sense to a basic market infrastructure or a public utility, their business continuity and contingency planning arrangements have not typically been required to include resolution contingencies. The contingency plans for such institutions should address the practical and concrete steps that could be taken in a crisis or wind-down to preserve functional resiliency of essential business operations. A crucial part of such planning is how to ensure access by supervisors to critical information systems with the data necessary to implement those steps. The Financial Stability Board (FSB) working group on Cross-border Crisis Management is currently considering these and other issues (Recommendation 6).

13. Effective crisis management and resolution of cross-border financial institutions require a clear understanding by different national authorities of their respective responsibilities for regulation, supervision, liquidity provision, crisis management and resolution. Key home and host authorities should agree on arrangements that ensure the timely production and sharing of needed information both for purposes of contingency planning during normal times and for crisis management and resolution during times of stress (Recommendation 7).

14. There are a number of reforms that will promote resiliency during crisis management and resolution and reduce the potential dislocations attendant upon a disorderly collapse of a

financial market participant. These reforms should include enhancing the effectiveness of existing risk mitigation processes, including netting, collateral arrangements and segregation. The availability of these tools will reduce the likelihood that settlement failures will lead to spill-over effects in multiple countries. Another important reform to support the reduction of risks in a crisis is encouraging greater standardisation of derivative contracts and the clearing and settlement of standardised derivatives contracts through central counterparties. For customised contracts where the use of regulated exchanges or CCPs is not appropriate, relevant trade information should be reported to a regulated trade repository. This reform would reduce the risk of cross-border contagion from settlement failures in capital markets transactions by facilitating transfers of ongoing contracts to new counterparties, which could include a bridge bank, and providing critical information to national authorities on customised transactions. Efforts by industry groups such as ISDA to explore a way to facilitate the transfer through a review of master agreements including incorporating conditions that contracts are not automatically terminated due to government intervention should also be encouraged (Recommendations 8-9).

15. Improved resolution tools will not eliminate the need for temporary governmental support, through liquidity or other funding, to provide for an orderly resolution of some cross-border institutions. This is especially likely in circumstances of severe market distress if there is not the ability or will of the private sector to take on more risk and there is insufficient time to perform due diligence to value assets and liabilities. Various national authorities have been creative in developing ad hoc government assistance for large institutions during this crisis. It is important that authorities consider the strategy or timeframe for exiting these arrangements. The nature of resolution procedures influences how quickly and through what measures government can withdraw such support. At the same time fiscal support from government, deposit insurance or other safety-nets, or alternatively temporary public ownership, may play a pivotal role in the resolution of a troubled financial institution. Continuation of such support during the critical crisis period requires a reasoned explanation and a foundation of public support. Clarity about the amount of fiscal support, its time horizon, risk sharing arrangements and the possible losses associated with it will help garner such support (Recommendation 10).

## I. Background

16. The Group of Twenty Leaders in their communiqué of April 2009 reiterated the call they had made in their Summit on Financial Markets and the World Economy of 15 November 2008 for regulators and other relevant authorities as a matter of priority to strengthen cooperation on crisis prevention, management, and resolution and to review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly resolution of large complex cross-border financial institutions (Action Plan No. 12). In its report of 27 March 2009, the G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG2) called on the Financial Stability Forum (now reconstituted as the Financial Stability Board, FSB) and the Basel Committee to “*explore the feasibility of common standards and principles as guidance for acceptable practices for cross-border resolution schemes thereby helping reduce the negative effects of uncoordinated national responses, including ring fencing.*”

17. On 2 April 2009, the FSB released a set of high-level principles for Cross-border Cooperation on Crisis Management. These principles include a commitment to cooperate by the relevant authorities, including supervisory agencies, central banks and finance ministries, both in making advanced preparations for dealing with financial crises and in managing them. They also commit national authorities from relevant countries to meet regularly alongside core colleges to consider together the specific issues and barriers to coordinated

action that may arise in handling severe stress at specific firms, to share information where necessary and possible, and to ensure that firms develop adequate contingency plans. The FSB principles cover practical and strategic ex ante preparations and set out expectations for how authorities will relate to one another in a crisis. They draw upon recent and earlier experiences of dealing with cross-border firms in crisis, including the 2001 G10 Joint Taskforce Report on the Winding Down of Large and Complex Financial Institutions, and the 2008 European Union MoU on Financial Stability.

18. Consideration is also being given to strengthening bank resolution frameworks in a more specific European context. While the issues are similar if not identical in essence to those at a broader international level, the EU banking market functions under a more closely integrated political and legal framework, and the extent of financial market integration and cross-border banking is more developed. Consequently there is general consensus at the political level about the importance and urgency of putting in place concrete arrangements to facilitate cross-border crisis handling arrangements, with an emphasis on cooperation and consultation, and – in light of a more harmonised legal framework – greater scope to converge national arrangements. In the initial stages, the work focused on developing a memorandum of understanding to set out arrangements between various authorities during a cross-border banking crisis. However, without more convergence and binding agreements – and in the absence of aligned incentives – coordination between national authorities has proved challenging. The current deliberations focus on how to strengthen coordination between supervisory authorities in colleges and, provide crisis management authorities with a more effective and convergent set of bank resolution tools. Such initiatives may promote cooperative solutions to cross-border bank resolution, which go beyond ring fencing by removing disincentives to cooperate. However, since any amendments of the legal framework would entail adjustments to the underlying banking, insolvency and company law frameworks, extensive analysis will be required to find workable and enforceable solutions. With respect to aligning financial incentives, particular focus is on facilitating private sector solutions, although there are also considerations about how to promote burden sharing by reaching (voluntary bilateral) ex ante agreements. It should be understood, however, that some crises present enormous challenges in terms of limited time in which to respond and share relevant information, willingness and ability of private sector parties to participate in a proposed solution, and competence and resources of a particular jurisdiction.

19. The Basel Committee approved the mandate of the CBRG in December 2007. The CBRG was asked to analyse the existing resolution policies, allocation of responsibilities and legal frameworks of relevant countries as a foundation to a better understanding of the potential impediments and possible improvements to cooperation in the resolution of cross-border banks. During the first half of 2008 the CBRG collected detailed descriptions of national laws and policies on the management and resolution of cross-border banks using an extensive questionnaire completed by countries represented on the Group.<sup>2</sup> The CBRG used the questionnaire responses to identify the most significant potential impediments to the effective management and resolution of cross-border banks. Subsequent to the initial data collection, the group updated some of its findings to take into account changes in resolution regimes and preliminary lessons from the current crisis. The Group also engaged in dialogue with representatives of a number of significant financial institutions on cross-border experiences in the current market environment. The Interim Report of the CBRG of December 2008 summarises the key features of existing resolution policies and identifies

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<sup>2</sup> Members of the CBRG are listed at the end of the report. Surveyed jurisdictions are: Argentina, Belgium, Brazil, Canada, Cayman Islands, France, Germany, Isle of Man, Italy, Japan, Jersey, Luxembourg, Macao, Mauritius, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The European Commission and the European Central Bank also participated in the survey.

differences in the national approaches to crisis resolution that may give rise to conflicts in the resolution of cross-border banks.

20. In December 2008, the Basel Committee asked the CBRG to expand its analysis to review the developments and processes of crisis management and resolutions during the financial crisis with specific reference to case studies of significant actions by relevant authorities.<sup>3</sup> In response to this direction and building on this initial stock take, the CBRG provides this Report and Recommendations to identify concrete and practical steps to improve cross-border crisis management and resolutions. The Report and Recommendations have been coordinated with and seek to complement the work of the FSB by providing practicable detailed approaches to implement the FSB's Principles for Cross-border Cooperation on Crisis Management of 2 April 2009. In this Report, the term "resolution" has been interpreted in a broad sense by the CBRG to mean any form of action by the public sector with or without private sector involvement to deal with serious problems in a financial institution that imperil the viability of the institution.

21. During the crisis that erupted in August 2007, the various jurisdictions had a broad assortment of tools. In many cases current powers were not fully used due to the absence of adequate time or the perceptions that the frameworks were inadequate. Indeed, the unfolding of events in a very short timeframe revealed that certain powers and tools were not available that would have been helpful in such a fast-moving crisis. For example, in the United States, no one agency had authority or the powers to resolve all the significant entities in the Bear Stearns, Lehman Brothers, or AIG groups. Moreover, existing tools, such as bridge bank authority, were either not used because there was insufficient time or, could not be used for non-banking financial entities in large and complex groups.

22. The tools and programmes for national and international crisis management of markets and financial systems are far broader than those for the resolution of domestic and cross-border institutions. During this recent crisis, central banks and ministries of finance instituted a variety of liquidity support and other programmes designed to promote lending in otherwise gridlocked markets, to promote recognition of asset valuations, and to stabilise financial systems and foster economic recovery. These tools and programmes are beyond the scope of this group's current mandate and work to date; hence, this paper does not consider their operation and effectiveness in managing a crisis nationally or in a cross-border dimension.

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<sup>3</sup> The Basel Committee asked the CBRG to report on the lessons from the crisis, on recent changes and adaptations of national frameworks for cross-border resolutions, the most effective elements of current national frameworks and those features of current national frameworks that may hamper optimal responses to crises. In doing so, the CBRG was asked to prepare a menu of options addressing the problems with special reference to the following areas:

- The current legal and policy framework for cross-border crisis management and resolution mechanisms as applied in the current crisis;
- Analysis of the implications of the failure of a global player;
- The effect of measures to protect domestic stakeholders' interests and limit cross-border contagion (ring fencing) on bank crisis management and resolution in the current crisis;
- The effect of current legal and policy approaches to cross-border financial transactions in the crisis; and
- The potential for development of more consistent legal and policy frameworks for dealing with financial groups.

23. During this recent crisis, private sector resolutions were achievable for parts of Bear Stearns, Lehman Brothers, Fortis<sup>4</sup>, and the Icelandic banks only with government support and assistance. Severe market turmoil driven in large part by significant uncertainty regarding the financial condition of, and future prospects for, many large internationally active banks propelled a significant deleveraging and a retrenchment of these and other banks from taking on additional risk. As the crisis developed, the deteriorating conditions precluded mergers or expansion by many institutions. Moreover, the Bear Stearns, Lehman Brothers, Fortis and Icelandic banks situations developed rapidly, leaving little or no time for prospective acquirers to conduct due diligence or value assets or liabilities or obtain shareholder approvals. The Icelandic crisis also revealed how limitations of national resources can affect the ability of national authorities to respond to a crisis involving financial institutions that had become “too big” for the home jurisdiction to provide effective consolidated supervision or to take necessary crisis management and resolution actions. Cross-border expansion can create its own risks of unmanaged growth in the absence of effective supervision by home authorities.

24. In some of these cases, the valuation of assets and liabilities proved as much of an obstacle to private resolutions as the time constraints. Banks were unable or unwilling to sell problem assets due to uncertainty over market prices and, in some instances, due to an unwillingness to incur the write-downs likely to occur once a market price was established. Private resolutions were also thwarted by a dearth of potential buyers resulting from the industry’s perceived need to preserve capital and liquidity in light of an uncertain future.

25. As a result, the tools utilised to resolve cross-border institutions during market disruptions tended to be last-minute ad hoc interventions involving public support. While there were many reasons why these measures were necessary (eg time constraints, unwillingness of private parties, uncertainty regarding asset valuation), the crisis also showed that it is important to expand the options available to national authorities. Fortis required government intervention by both home and host authorities, while the Lehman holding company and several major subsidiaries filed for bankruptcy protection. Governments of both the United Kingdom and United States were forced to inject capital into a number of large institutions to stabilise the firms. In Switzerland, the Swiss National Bank has entered into a transaction to assume the risk on certain commercial and residential mortgage assets of UBS by transferring them to an entity financed by the central bank.

## **II. Lessons learned from the case studies<sup>5</sup>**

26. The financial crisis has illustrated the shortcomings of the current cross-border crisis management frameworks. The CBRG conducted case studies of Fortis, Dexia, Kaupthing, and Lehman Brothers. The lessons learned from the case studies formed a basis for the group’s Recommendations illustrated in this report. In particular, the case studies highlighted

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<sup>4</sup> In the Fortis case, the authorities examined both a private and a public solution. As the offers made by the private sector were considered insufficient, the authorities opted for a public solution. In the second stage, the Dutch authorities opted for a nationalisation and the Belgian authorities for a private solution.

<sup>5</sup> The case studies do not purport to be an exhaustive account of all facts which relate to the cases described herein, but deal with a number of aspects that may be relevant for the purpose of (i) evaluating the effectiveness of existing legal and policy frameworks for cross-border crisis management and for (ii) identifying possible options for addressing problems. Consequently the contents of this document are without prejudice to the position of the authorities involved which they may wish to take in any pending or future proceedings, parliamentary investigation or other investigation, relating to the cases described herein.

issues like group structure, liquidity and information sharing among supervisors as examples where improvements are needed. Lessons learned from each case study are highlighted below.

## **1. Fortis**

27. Fortis Group was a Belgian/Dutch financial conglomerate with substantial subsidiaries in Belgium, the Netherlands and Luxembourg. The consolidating and coordinating supervisor was Belgium's Commission bancaire, financière et des assurances (CBFA), as the banking activities within Fortis Group, headed by the Belgium-based Fortis Bank SA/NV, were the largest part of Fortis's operations. Fortis was deemed to be systemically relevant in the three countries, not only because of its large positions in domestic markets, but also because of its function as a clearing member at several major domestic and foreign stock exchanges.

28. In 2007, Fortis acquired portions of the operations of ABN AMRO through a consortium with Royal Bank of Scotland and Santander. In 2008 the international financial crisis intensified to such an extent that Fortis had difficulties realising its plans to strengthen its financial position and to finance the acquisition and integration of its acquisitions of portions of ABN AMRO. Starting in June 2008, there was increasing uncertainty in the market whether Fortis would be able to realise the intended steps. Over the summer, its share price deteriorated and liquidity became a serious concern.

29. In the last week of September 2008, its share price declined rapidly and institutional clients began to withdraw substantial deposits. Fortis lost access to the overnight interbank market, and had to turn to the Marginal Lending Facility of the Eurosystem provided by the National Bank of Belgium (NBB). The combined effect made the finding of a solution imperative, triggering intervention by public authorities.

30. After the Dutch government purchased Fortis Bank Netherlands, Fortis Insurance Netherlands, Fortis Corporate Insurance and the Fortis share in ABN AMRO, the Belgian government raised its holding in Fortis Bank Belgium up to 99%. The Belgian government also agreed to sell a 75% interest to BNP Paribas (BNP) in return for new BNP shares, keeping a blocking minority of 25% of the capital of Fortis Bank Belgium. BNP also bought the Belgian insurance activities of Fortis and took a majority stake in Fortis Bank Luxembourg. A portfolio of structured products was transferred to a financial structure owned by the Belgian State, BNP and Fortis Group.

31. On 12 December 2008, the Court of Appeal of Brussels suspended the sale to BNP, which was not yet finalised, and decided that the finalised sales to the Dutch State and to the Belgian State as well as the subsequent sale to BNP had to be submitted for approval by the general assembly of shareholders of Fortis Holding in order for these three sales to be valid under Belgian Law. After initial rejection by the shareholders, certain transactions were renegotiated and financing of the portfolio of structured products was modified. The renegotiated transaction with the Belgian State and BNP was approved at the second general assembly of shareholders and the latter transaction was finalised on 12 May 2009.

32. The following lessons can be drawn from the Fortis case:

- The Fortis case illustrates the tension between the cross-border nature of a group and national frameworks and responsibilities for crisis management. This led to a solution along national lines, which did not involve intervention through statutory resolution mechanisms;

- The usefulness of formal supervisory crisis management tools appears to be limited in a situation where the institution needs to be stabilised rapidly and at the same time the continuity of business needs to be ensured in more than one jurisdiction. For example, some formal tools, when disclosed, can further undermine market confidence or may trigger termination and close-out netting events in financial contracts, with counterproductive effects;
- The Fortis case illustrates the tension between the need to maintain financial stability, for which a bank under certain circumstances needs to be resolved in the public interest and with public support, and the position of the shareholders of such a bank (ie dilution of their stake). Currently, Dutch and Belgian financial supervisory legislation does not permit effective special measures to be taken to resolve individual banks in a manner which maintains financial stability in urgent situations and which overrides the rights of shareholders; and
- Despite a long-standing relationship in ongoing supervision and information sharing, the Dutch and Belgian supervisory authorities assessed the situation differently. Differences in the assessment of available information and the sense of urgency complicated the resolution.

## **2. Dexia**

33. Dexia was established in 1996 as a result of a merger between a Belgian and a French bank, respectively Crédit Communal de Belgique and Crédit Local de France, with a significant presence in Luxembourg.

34. During 2008, difficulties came in particular from (i) the financing of long-term assets, and, in particular, of an important portfolio of bonds, by short-term funding and (ii) its US subsidiary, Financial Security Assurance (FSA), a monoline insurer. Following a decision taken by Dexia's Board of Directors on 30 September 2008, Dexia increased its capital by EUR 6.4 billion, of which Belgian and French public and private sector investors subscribed EUR 3 billion each and the Luxembourg State subscribed EUR 376 million under the form of convertible bonds. Following this recapitalisation, Dexia's chairman and the chief executive were replaced.

35. On 9 October 2008, Belgium, France and Luxembourg concluded an agreement on a joint guarantee mechanism – covered 60.5% by Belgium, 36.5% by France and 3% by Luxembourg – to facilitate Dexia's access to financing. On 14 November 2008, additional public Belgian and French guarantees were announced in the context of the sale of FSA, Dexia's US subsidiary, to US insurer Assured Guaranty, to insulate Assured Guaranty from any risk resulting from FSA's portfolio of riskier securities linked to subprime mortgages that were not included in the sale.

36. The Dexia case illustrates that the tension between the cross-border nature of a group and national frameworks and responsibilities for crisis management does not necessarily lead to a break-up of the firm along national lines. This solution did not involve intervention through statutory resolution mechanisms. In the case of Dexia, authorities in Belgium, France and Luxembourg agreed to share the burden of guarantees in order to allow the institution to access financing and provide time for the sale of certain operations and the retrenching of others. In general terms, the division of the burden for guarantees among the three national authorities was premised on the proportions of share ownership held by the institutional investors and public authorities of the three countries. Before the crisis, public sector institutions and municipalities already had significant minority stakes in Dexia. These interests increased by virtue of capital injections during the crisis by these historical shareholders. The main lessons learned were:

- While the centralisation of liquidity management within a cross-border group could lead to some tensions in case of liquidity problems, these tensions can be overcome by adequate cooperation between the relevant central banks; and
- The cross-border nature of the group makes the resolution process more time consuming but this problem is not insurmountable in a case in which home and host authorities clearly state their joint support to the group.

### **3. Kaupthing**

37. The Icelandic bank Kaupthing was active through branches and subsidiaries in 13 jurisdictions: Austria, Belgium, Denmark, Dubai, Finland, Germany, the Isle of Man, Luxembourg, Norway, Qatar, Sweden, Switzerland and the United Kingdom. The internet-based Kaupthing Edge attracted many customers with savings accounts and fixed-term deposit accounts offering high interest rates. As of end of 2007, the bank had total assets of EUR 58.3 billion. According to the bank, about 70% of its operating profits originated outside Iceland in 2007 (31% in the United Kingdom, 26% in Scandinavia, 8% in Luxembourg and 2% in other countries).

38. Concerns increased with other Icelandic banks and the Iceland government decided in September 2008 to buy a 75% stake for EUR 600 million in Glitnir Bank. This led to downgrades of Iceland's long-term foreign-currency sovereign credit rating by S&P and Fitch on 29 and 30 September. The combined size of the local banks' balance sheet raised concerns despite Iceland's initial low debt ratio and high per capita gross domestic product.

39. On 7 October 2008, the Icelandic Financial Supervisory Authority (FME) took control of another bank, Landsbanki, and on 8 October 2008, put Glitnir Bank into receivership after Iceland abandoned its decision to buy a stake in the bank. Iceland's central bank had supported Kaupthing with a EUR 500 million loan and the bank explored the sale of some of its units. Despite Icelandic authorities' assurance that Kaupthing would not require the same measures as its domestic competitors, Kaupthing Edge had been affected by a mass withdrawal of funds in the United Kingdom since the first measures had been taken concerning Glitnir Bank in September 2008.

40. In the period immediately prior to 8 October 2008, Kaupthing, Singer & Friedlander (KSF), the UK subsidiary of Kaupthing, suffered a continual loss of depositor confidence, which resulted in successive daily net outflows, especially from the internet Edge deposit accounts. Following a period of increasingly intensive supervision, on 8 October 2008 the UK Financial Services Authority (FSA) determined that KSF did not meet the threshold conditions for operating as a credit institution and therefore should be closed to new business and that it was appropriate to apply to the court to make an administration order in relation to KSF (which was made on that day). The UK Financial Services Compensation Scheme (FSCS) was triggered by the FSA as it determined that KSF was unable or likely to be unable to satisfy claims against it. On the same day, the UK government used special powers to transfer the deposits in KSF's Edge business to ING Direct. This transfer was funded by the FSCS and the UK government, which now stand in the place of the transferred depositors as creditors of KSF. The UK government also announced that it would protect retail customers of KSF for claims over the compensation limits of the FSCS.

41. In the period immediately prior to 8 October 2008, Kaupthing Bank Luxembourg also suffered a continual loss of depositor confidence, especially from the internet Edge deposit accounts from the Belgian branch. During all this time, Kaupthing Bank Luxembourg reassured the Luxembourg authorities that it wouldn't be affected by the Icelandic problems and that it would have enough liquidity left to pursue its daily activity.

42. On 8 October 2008, Kaupthing informed the German Federal Financial Supervisory Authority (BaFin) that the German subsidiary was initially assured liquidity of EUR 400 million; in addition, FME claimed that Kaupthing would provide the branch with sufficient liquidity to cover all deposits.

43. On 9 October 2008, Iceland's FME took control of Kaupthing. FME said on its website that Kaupthing's domestic deposits were fully guaranteed and that all its domestic branches, call centres, cash machines and internet operations would be open for business as usual.

44. On 9 October 2008, BaFin issued a stoppage of disposals and payments for the German branch of Kaupthing Bank HK, Iceland, and prohibited the branch from receiving payments not intended for payment of debts because there were risks that the branch was no longer able to meet its obligations towards its creditors. In Luxembourg, a tribunal at the request of Kaupthing Bank Luxembourg SA, subsidiary of Kaupthing Bank hf., Iceland, ordered a "sursis de paiement" and appointed administrators. The Luxembourg subsidiary was also operating in Belgium and Switzerland through branches. On the same day, the Swiss Federal Banking Commission appointed commissioners at the Geneva branch of Kaupthing Bank Luxembourg SA and prohibited the making of payments. Small deposits of up to CHF 5,000 were repaid on 16 and 17 October 2008. The Swiss Deposit Insurer reimbursed the insured deposits up to CHF 30,000. By the end of November 2008, the Swiss Deposit Insurer had repaid all insured deposits of the Geneva Branch of Kaupthing Bank Luxembourg SA.

45. On 20 October 2008, the Finnish Financial Supervisory Authority announced that Finnish Banks were financing the EUR 100 million payback to the depositors of Kaupthing Finland. In Sweden, the subsidiary Kaupthing Bank Sverige AB benefited from a loan from the Riksbank and on 13 November 2008, the sale to Resurs Bank of another subsidiary, Kaupthing Finans AB, was announced.

46. KSF had a subsidiary bank in the Isle of Man which was substantially funded by retail deposits. Roughly half of this bank's balance sheet was reflected in a claim on KSF in London. On 23 October 2008, the Isle of Man announced it would spend up to GBP 150 million – which compares to the Island's total published reserves and invested funds (less national insurance and pensions) of GBP 922 million and 7.5% of GDP – to partially compensate savers in the Isle of Man branch of KSF. Shortly before the collapse of the bank, the Isle of Man authorities had raised the level of protection of the Depositors' Compensation Scheme from GBP 15,000 to GBP 50,000. An estimated 10,000 depositors had about GBP 840 million in KSF. Only about GBP 100 million of their funds remain in the Isle of Man. More than GBP 590 million of the bank's assets were frozen in the United Kingdom.

47. The main lessons learned were:

- The Icelandic crisis revealed how limitations of national resources and, potentially, supervisory capacity can affect the ability to respond to a crisis involving financial institutions that had become "too big" for the home jurisdiction to provide effective consolidated supervision or to take necessary crisis management and resolution actions;
- Cross-border expansion can create its own risks of unmanaged growth in the absence of effective supervision by home authorities; and
- Where a group is cross-border in nature with significant intra-group claims there is a need for effective and extensive cooperation and dialogue home to host, host to home and, depending on the circumstances, possibly also host to host.

## **4. Lehman Brothers**

### ***Regulation and Business Structure***

48. The Lehman Brothers group consisted of 2,985 legal entities that operated in some 50 countries. Many of these entities were subject to host country national regulation as well as supervision by the Securities and Exchange Commission (SEC), through the Consolidated Supervised Entities (CSE) programme in the United States. Under this programme, the SEC monitored the ultimate holding company of the group, Lehman Brothers Holdings, Inc (LBHI). The CSE programme met the provisions of the EU's Financial Conglomerates Directive and allowed the US investment banks to operate in Europe subject to SEC supervision. The CSE programme also included the requirement that LBHI maintain regulatory capital in accordance with a capital adequacy measure computed under the Basel II Framework and addressed liquidity risk.

49. The Lehman structure was designed to optimise the economic return to the group whilst achieving compliance with legal, regulatory and tax requirements throughout the world and enabling the firm to manage risk effectively. It consisted of a complicated mix of both regulated and unregulated entities. The flexibility of the organisation was such that a trade performed in one company could be booked in another. The lines of business did not necessarily map to the lines of the companies. The group was organised so that some essential functions, including the management of liquidity, were centralised in LBHI. Structures of this complexity are common in large international financial institutions.

### ***Resolution of a large cross-border financial institution - liquidity***

50. An effective and orderly resolution of a large cross-border financial institution, while maintaining its key operations, requires a source of liquidity so that the firm can meet its ongoing trading and other commitments while it winds itself down or seeks an acquirer. This is demonstrated by the contrasting fates of the US broker-dealer (LBI), which did not immediately file for bankruptcy, and the London investment firm (LBIE). The Federal Reserve Bank of New York agreed to provide liquidity to LBI in order to effect an orderly wind-down outside of bankruptcy which ultimately resulted in the purchase of certain assets and assumption of certain liabilities by Barclays Capital. LBIE, however, relied on LBHI (the holding company) for liquidity, which ceased to be available when LBHI filed for bankruptcy. The ultimate outcome was that LBHI, the remainder of LBI not acquired by Barclays Capital, and LBIE are being wound down by insolvency officials who are experiencing a myriad of challenges. Subsidiaries in jurisdictions such as Switzerland, Japan, Singapore, Hong Kong, Germany, Luxembourg, Australia, the Netherlands and Bermuda are also undergoing some type of insolvency wind-down proceedings in their respective jurisdictions. Coordination among these proceedings has been limited, at best. Based on the Lehman experience, the following factors are particularly relevant to effective crisis resolution:

- If an acquirer for the entire firm can be found in an appropriate timescale, trading counterparties and other parties providing short-term funding will expect some sort of guarantee in the interim for them to continue to do business with the firm until the transaction closes – this can be challenging to achieve in a tight timeframe;
- As the amounts of liquidity needed are likely to be sizable, governmental resources may be required;
- For international firms and groups of this degree of complexity, a prepared, orderly resolution plan would be of great assistance to the authorities;
- Monitoring by regulators and the interplay of insolvency regimes are important;

- Group structures create interdependencies within the organisation that responsible regulators need to understand and monitor for both going concern and gone concern purposes;
- In the event of the failure of a cross-border financial institution, once the relevant component entities enter into insolvency proceedings the insolvency regimes applicable to the major entities are likely to be separate proceedings, serving different policies, with different priorities and objectives; and
- These differences continue to make coordination and cooperation among insolvency officials difficult as such coordination and cooperation may conflict with the duties of the officials to an entity's creditors. To do their job effectively, insolvency officials may need access to information and records that are part of an insolvency proceeding in another jurisdiction.

### ***Problems with returning client assets and monies***

51. Even where the legal regime protects client assets and client monies held by a financial institution, the ability of those clients to quickly access their assets once insolvency proceedings begin is affected by a number of factors including:

- The institution's record-keeping;
- Other claims the institution or its affiliates may have against the client;
- Sub-custody or other arrangements with affiliates that are also in insolvency proceedings; and
- The duties of insolvency officials to creditors generally.

### ***Communication***

52. For a large, complex financial institution there are multiple "home" and "host" regulators. Considering the speed at which a crisis can evolve it can be difficult for all interested authorities to communicate effectively and have access to information and actions taken in other jurisdictions which are relevant for their markets.

## **III. National incentives and crisis resolution: territorial and universal resolution approaches**

53. Overall, this crisis has illustrated that it is national interests that are most likely to drive decisions particularly where there is an absence of pre-existing standards for sharing the losses from a cross-border insolvency. National resolution authorities will seek, in most cases, to minimise the losses accruing to stakeholders (shareholders, depositors and other creditors, taxpayers, deposit insurer) in their specific jurisdiction to whom they are accountable. For financial institutions in which the public purse or a public or quasi-public fund is often called upon for institutional support or protection of certain creditors (at a minimum, insured depositors), the likelihood of the application of measures that seek to protect local interests and stakeholders is increased by the public and policy pressure to allocate financial resources in a way which reduces the burden for their own taxpayers.

54. Measures designed to protect stakeholders of the local operations of a financial institution (which may, of course, include the public in any resolution actions) are often referred to as the ring fencing or territorial approach. An alternative process referred to as the

universal approach seeks to achieve a resolution of a legal entity across borders and provide for uniform measures or a process of mutual recognition to effect the implementation of measures across borders. There are many variations of these concepts. Yet, both concepts are entity-centric and do not address the many complexities that arise in the resolution of cross-border financial groups consisting of multiple interconnected legal entities in many jurisdictions. As such, operations of a bank's cross-border business through foreign branches need to be distinguished from operations through separate legal entities (subsidiaries) in foreign jurisdictions. Unlike branches or representative offices, subsidiaries are separately incorporated legal entities under the law of the chartering jurisdiction. Global activities may be subject to consolidated supervision by the "home" authority of the cross-border financial institution. However, the authorities in the chartering jurisdiction remain responsible for first-line supervision and resolution of the subsidiary.

55. National authorities also may seek to protect stakeholders of the local operations of a foreign bank through regulatory and supervisory measures that are applied in the course of its normal operations. These non-insolvency measures applied to domestic branches and subsidiaries of foreign institutions ("supervisory ring fencing") may include the following:

- Some jurisdictions use supervisory ring fencing to impose asset pledge or asset maintenance requirements in order to assure that sufficient assets will be available in their jurisdiction in the event of failure of the parent bank. Branches subject to asset maintenance requirements have some of the characteristics of separately capitalised entities. Alternatively, jurisdictions may encourage or require that operations by foreign banks be conducted through standalone subsidiaries. Such requirements may promote the resiliency of the local operations, but they also may carry costs.; and
- Supervisory ring fencing is also used more broadly to refer to limitations imposed on inter-affiliate transactions, including transfers of assets, to prevent contagion and to protect creditors of a given legal entity. In the case of a domestic subsidiary of a foreign bank or financial group, the local authorities may impose limits on intra-group transactions in order to protect the domestic entity from contagion by the parent and prevent the outflow of funds to the detriment of the domestic entity.

56. In insolvency, subsidiaries of foreign financial institutions will be resolved as separate legal entities under the local law in all jurisdictions. Any effort to achieve a coordinated resolution of the subsidiary operations of a cross-border financial institution will necessarily require accommodations with the local chartering authorities of the subsidiaries.

57. There are two approaches to the resolution (through reorganisation or liquidation in bankruptcy) of a financial institution with branches and assets located in other jurisdictions:

- The universal approach refers to resolutions of insolvencies based on the law of a single country. Generally, this is the law of the place where the insolvent institution has its head office. Under this approach, the decisions of the resolution authority in this jurisdiction are applied for all components and assets of the insolvent firm in other jurisdictions. Of course, the ability of the home resolution authority to apply and enforce its decisions in other jurisdictions is subject to recognition in foreign jurisdictions and the law and policy in those jurisdictions. In the EU/EEA, the European Directives on the Reorganisation and Winding-up of Credit Institutions of 4 April 2001 and of Insurance Undertakings of 19 March 2001, under which EU/EEA-incorporated credit institutions and insurance undertakings are resolved under the law of the home EU/EEA jurisdiction, are based on the principles of unity and universality. These authorities of the home country are solely entitled to decide on the adoption of reorganisation measures or the opening of winding-up

proceedings in application of the home country's laws. The authorities in EU/EEA host countries (where branches or assets are located) must recognise the effects of these measures, without being able, on their part, to take reorganisation measures locally or to open territorial insolvency proceedings against the branch offices set up in their territory. Some consider this EU approach as modified universality because it does not apply to non-EU/EEA-incorporated financial institutions or EU branches of non-EU banks.

- Another approach is based on the principle of territoriality of insolvency. Under the territorial approach, each national jurisdiction applies its own law and governs insolvency proceedings for the components and assets of the insolvent firm located in that jurisdiction. It requires a declaration of insolvency in each country where the insolvent debtor has a branch or merely assets. Under the territorial approach, each insolvent branch is governed by local insolvency law and is administered by a locally appointed administrator. Such territorial insolvency normally only affects assets located in the territory in question.

58. In practice, the resolution of cross-border institutions is pragmatic and not based exclusively on either of the two principles. For example, in practice, many national authorities have chosen to respond to the potential collapse of EU/EEA-incorporated financial institutions not by resorting to the insolvency and re-organisation procedures under the framework of the European Directive on the Reorganisation and Winding-up of Credit Institutions but by pursuing other rescue and resolution measures. Similarly, other national authorities have applied a cooperative territorial approach by providing funding and guarantees proportionate with each authority's national interest in order to provide time for a cross-border institution to access financing and restructure operations. Many systems combine these two approaches. Following the practice of mitigated or modified universality, embodied by the EU Insolvency Regulation of 29 May 2000 (which does not generally apply to financial institutions<sup>6</sup>), the jurisdiction of the EU member state where the debtor's domicile or centre of main interests is situated, has principal competence to initiate insolvency proceedings (referred to as "main insolvency proceedings"). At the same time, the Regulation authorises other member states to open territorial proceedings (referred to as "secondary insolvency proceedings") if the debtor has an establishment (eg a branch) there. A consolidated account of payments to creditors within the EU is drawn up to ensure that creditors receive equivalent payments.

59. The concepts of universality and territoriality strictly only describe the way in which national authorities will apply their insolvency and related resolution processes to individual institutions (a financial institution with branches and assets located in other jurisdictions). These concepts are not really relevant to the situation of financial groups consisting of multiple legal entities. Accordingly whether a jurisdiction follows the universal approach or territorial approach in relation to branches does not govern the resolution of subsidiaries of foreign institutions. In both cases, the subsidiary is subject to separate, local insolvency proceedings. There are however differences among jurisdictions with respect to the treatment of intra-group claims in insolvency. National insolvency law in most countries surveyed allows intra-group transactions to be retroactively ruled void or ineffective if they were carried out during a "*suspect period*" preceding the insolvency proceedings and/or on preferential terms ("avoidance provisions"). Although such provisions are not necessarily specific to intra-group transactions and frequently target transactions with any third parties that are

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<sup>6</sup> The Insolvency Regulation does not apply to credit institutions, insurance undertakings, investment undertakings which hold client assets or collective investment undertakings.

detrimental to other creditors, more stringent rules frequently apply to transactions with affiliates.

60. There is no framework for the resolution of cross-border financial groups or financial conglomerates. At the national level, few jurisdictions have a framework for the resolution of domestic financial groups or financial conglomerates.<sup>7</sup> These consist of a framework for the coordination of the proceedings governing the individual components of the group (“procedural consolidation”). In some jurisdictions judicial practice has led to the development of the concept of a pooling of the assets of the individual entities making up the group (referred to as “substantive consolidation”, “piercing of the corporate veil”). It is generally applied very exceptionally and under narrowly defined circumstances.

61. Some members of the CBRG are of the view that the presence of effective supervisory ring fencing measures and the territorial approach encourage early intervention by authorities. Host authorities in a jurisdiction that uses ring fencing have a strong incentive to ensure the assets of the local branch exceed local liabilities. In this context, ring fencing can have the effect of more closely aligning the supervisory authority of the host country with the assets available to pay stakeholders of the local branch or other office. The threat of ring fencing by foreign host authorities is likely to place pressure on the home jurisdiction to resolve the problem besetting the institution. A ring fencing approach also can contribute to the resiliency of the separate operations within host countries by promoting the separate functionality of the local operating branch or other office. Finally, some members have argued that ring fencing can be carried out without significant damage to the group depending on early action, liquidity contingency planning by the parent and the relative size of the home/host firms.

62. Other members stressed the potential problems arising from the restrictions on capital flows resulting from ring fencing which are likely to cause problems for legal entities of the financial group in other jurisdictions and the group as a whole. Ring fencing can thus exacerbate the problems and increase the probability of default of the parent bank and its subsidiaries. From the perspective of cross-border financial institutions, ring fencing may create inefficiencies in the allocation of capital and liquidity. From the perspective of host jurisdictions, ring fencing may allow greater controls on capital, liquidity and risk management to ensure protection of host country creditors. Some members emphasised that this control can also impose costs on the host jurisdiction if cross-border institutions limit or reduce their operations in those host countries. Finally, ring fencing by host authorities may undermine an orderly resolution brought by the home country authorities, who will be seeking to apply the resolution to the bank and all its foreign branches, by reducing the pool of assets that is capable of being transferred at a premium to a bridge bank or private sector purchaser in the home country.

63. The fact that ring fencing has occurred between national jurisdictions with pre-existing cross-border rules providing for allocation of responsibility for deposit insurance and similar types of public commitments and with long histories of close supervisory cooperation, demonstrates the strong likelihood of ring fencing in crisis management or insolvency resolution. This is particularly so where host supervisors are faced with the prospect of the failure of the home office to whom liquidity has been upstreamed. The crisis has also demonstrated that in a period of market instability there is rarely time to carefully weigh cooperative cross-border management of crises.

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<sup>7</sup> See below Section IV.2.

64. In most cases, national authorities seek to ensure that their constituents, whether taxpayers or member institutions underwriting a deposit insurance or other fund, bear only those financial burdens that are necessary to prevent the risks to their constituents of a disorderly collapse and attendant contagion effects without expending those funds. In a cross-border crisis or resolution, this comparative assessment is complicated by the potential effect of foreign operations, foreign regulators, and their willingness and ability to bear a share of the burden. This assessment also will be affected by whether the jurisdiction is the home country of the financial institution or group or, if a host, whether the institution operates through a branch or subsidiary. For host countries, it will also be affected by asset maintenance, capital or liquidity requirements that may be imposed on branches or subsidiaries. Other considerations, such as the availability of information and the available legal and regulatory tools for intervention, must also be considered and will further complicate the assessment.

65. In the absence of ex ante agreement between home and the major host jurisdictions on the sharing of financial burdens for the resolution of cross-border financial institutions designed to maintain the cross-border functionality of the financial institution, most jurisdictions are likely to opt for separate resolution of a failing financial institution operating within their jurisdiction. At this stage, reaching such broad international agreement appears both unlikely and unenforceable as the practical implications of burden sharing give rise to considerable challenges. However, some further progress in this respect cannot be ruled out in a regional or bank-specific context. In the current environment, if no burden-sharing agreement can be reached, the most practical steps may be to recognise the strong possibility (perhaps likelihood) of ring fencing and implement appropriate crisis management arrangements and supervisory requirements that promote clarity and protect stakeholders. Clear rules that allocate responsibilities will allow stakeholders in multiple jurisdictions to plan more efficiently for the potential consequences of insolvency.

66. The CBRG recommends a “middle ground” approach that recognises the strong possibility of ring fencing in a crisis and helps ensure that home and host countries as well as financial institutions focus on needed resiliency within national borders. Such an approach may require certain discrete changes to national laws and resolution frameworks to create a more complementary legal framework that facilitates financial stability and continuity of key financial functions across borders. While not denying the legitimacy of ring fencing in the current context, this approach aims at improving, inter alia, the ability of different national authorities to facilitate continuity in critical cross-border operations that, absent such efforts, may contribute to contagion effects in multiple countries, while minimising moral hazard. This middle approach merely protects systemically significant functions, performed by the failing financial institution, but not the financial institution itself, at least in its current ownership and corporate structure. It would limit moral hazard and promote market discipline by imposing losses on shareholders and other creditors wherever appropriate.

67. Encouraging greater cross-border cooperation within such a middle ground approach requires improved understanding of the parameters for action by different authorities and greater convergence in national laws. The working group has prepared an extensive database on the national bank resolution and insolvency laws of member states. This can lay the foundation for greater understanding, though it will require regular updating. To support this foundation, the CBRG encourages the development of one or more databases or sources of information on current and future developments in national laws and regional or international laws or policies.

68. Greater convergence in national laws, by promoting a common understanding, more predictability, and reliable frameworks for responsive actions, will likely improve cooperation. In particular, it should help to reduce the precipitous and perhaps unnecessary actions that could exacerbate a crisis. For example, establishing more consistent approaches to early

intervention and triggering conditions for intervention will provide a more predictable framework for planning and, based upon such pre-planning, for cooperation in a crisis. Similarly, the option of a bridge financial institution will allow authorities to have greater confidence that there is a viable resolution option that facilitates continuity in key linkages. These and other steps should improve confidence in national processes and facilitate coordination on any necessary assurances to other authorities and exchanges of essential information.

69. An alternative approach would be to take the steps necessary to establish a comprehensive, universal framework for the resolution of cross-border financial groups. This framework would accord primacy to the resolution of all domestic and cross-border activities of a failing financial group by the jurisdiction in which the institution is headquartered or possibly by a supranational entity. The implementation of a universal framework will require national authorities to address a number of difficult issues.

70. Such a framework would need to be set out in a binding legal instrument or international treaty<sup>8</sup> and provide, inter alia, for the following:

- Terms and conditions for the sharing of the financial burdens of the resolution, which would need to include crisis management and resolution expenditures, such as public funding and deposit insurance or other guarantee coverage;
- Determination of the competent authority for the resolution proceedings of all component parts of the group and for the coordination of these proceedings, including the exchange of information between the authorities of different proceedings;
- Determination of the applicable rules governing the crisis management and resolution stage;
- A process to ensure coordination for the administration and supervision of the affairs of the group entities, including day-to-day operations where the business is to be continued, for instance, through a temporary structure using public financing, post-commencement finance or intra-group assets transfers;
- A commitment of national jurisdictions to undertake the necessary legal reforms, which may require a harmonisation of national rules governing cross-border crisis management and resolutions, including rules on core issues such as a common definition for bank insolvency, avoidance powers, minimum rights and obligations of creditors including depositors, treatment of intra-group claims, ranking of claims, rights to set-off and netting, and the treatment of certain financial contracts, submission and admission of claims, and distributions to creditors;
- A process to ensure the equitable treatment of the creditors, depositors, counterparties and shareholders of group entities, regardless of the jurisdiction in which they are located, which would require careful assessment of the provision of intra-group financing;
- Harmonised and mutually compatible deposit insurance level to ensure the equal treatment of all depositors of the entities; and

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<sup>8</sup> This type of binding instrument could be concluded among groups of countries where there was confidence in the legal infrastructure including the laws, judicial systems and regulatory institutions in those countries or within the relevant regional authority.

- An agreement, supported by conforming statutory changes, to give full force and effect to decisions and actions across borders.

71. The implementation of such a framework would require major changes to national legal frameworks and also raise conceptual problems related to corporate separateness and the different legal approaches to the treatment of group interest. It would also need to address the many practical problems that typically arise in a complex cross-border resolution because of the inherent complexity of groups, the difficulty of obtaining information if record-keeping and risk management systems are not well-maintained, the necessity of identifying assets, liabilities, and counterparties on a legal entity basis, sorting out inter-company transactions, and obtaining control over assets. Addressing these challenges will require additional supervisory and regulatory measures, as well as coordination among national authorities, to promote improvement in the information technology systems and processes of cross border financial institutions.

72. The work undertaken by the United Nations Commission on International Trade Law (UNCITRAL)<sup>9</sup> on the insolvency and on the treatment of domestic enterprise groups may provide further guidance on how such a framework could be established. The work of UNCITRAL confronts many challenges. One of the problems is that the concept of “center of main interests”, which determines in which jurisdictions proceedings may be initiated, is not uniformly and universally applied. Its application would, as noted above for other prerequisites for a universal process, require binding agreements. National authorities and policymakers should examine whether the recommendations, which UNCITRAL is developing for judicial bankruptcy proceedings governing groups of enterprises, could inform the work underway to improve the coordination of resolution proceedings of financial groups and conglomerates.<sup>10</sup> While valuable, the UNCITRAL work alone will not likely address the many unique issues implicated in the resolution of specifically enterprise groups and conglomerates.

## **IV. Recommendations to address the challenges arising in the resolution of a cross-border bank<sup>11</sup>**

### **1. Effective national resolution powers**

73. The orderly resolution of a cross-border financial institution requires effective and compatible national resolution frameworks. The CBRG has identified significant differences across countries in the frameworks for resolving banks. Differences also exist within

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<sup>9</sup> Working Group V (Insolvency Law). UNCITRAL also is in the progress of finalising recommendations aimed at improving the efficiency of domestic group insolvency proceedings (foreseen for adoption in 2010). These include introducing the possibility of joint application and procedural coordination of proceedings of different legal entities in a group, allowing intra-group financing/guarantees after insolvency proceedings have commenced, appointment of a single administrator, implementation of a joint reorganisation plan, contribution orders, extension of liability, or substantive consolidation (pooling of assets).

<sup>10</sup> On 17 July 2009, UNCITRAL adopted a Practice Guide on Cross-Border Insolvency Cooperation (see <http://www.uncitral.org/uncitral/index.html>). The purpose of the Practice Guide is to provide readily accessible information on current practice in insolvency proceedings with respect to cross-border coordination and cooperation for reference and use by judges, practitioners and other stakeholders. However, the Practice Guide does not contain any actual recommendations, the elaboration of which is still to be decided.

<sup>11</sup> The Recommendations are principally designed for cross-border banking institutions, while they are also applicable for all types of financial institutions active in multiple jurisdictions. Non-banking institutions may have other alternative measures to deal with the issues in their legal regime.

countries between the approaches for resolving different types of financial institutions. Some of these differences have their source in differences in the substantive company laws and legal frameworks for supervision. Some of these differences reflect the specific oversight imperatives for different financial institutions that may in turn require some variations in crisis management and resolution tools with different protections for different types of claimants. For example, some laws governing securities firms impose special protections for customer securities while other laws governing insurance contracts impose specific protections for policyholders.

74. The CBRG's analysis has also demonstrated that not all national frameworks include the tools, such as bridge financial institutions, to facilitate the continuity of essential functions during and after intervention. Nor do they all adequately facilitate private-sector or market-based solutions, such as rapid transfers of part or all of a failed institution's business. Countries without such mechanisms often place failed institutions in liquidation or provide some form of government assistance.

75. As systemically important credit and broader financial intermediation has spread across a variety of different types of firms and formerly more distinct business sectors, previous distinctions between the perceived greater public interest in resolving banking institutions compared to other financial firms have broken down. Accordingly, a resilient crisis management and resolution framework should incorporate such other financial firms whose collapse could have systemic consequences.

#### **Recommendation 1**

**National authorities should have appropriate tools to deal with all types of financial institutions in difficulties so that an orderly resolution can be achieved that helps maintain financial stability, minimise systemic risk, protect consumers, limit moral hazard and promote market efficiency. Such frameworks should minimise the impact of a crisis or resolution on the financial system and promote the continuity of systemically important functions. Examples of tools that will improve national resolution frameworks are powers, applied where appropriate, to create bridge financial institutions, transfer assets, liabilities, and business operations to other institutions, and resolve claims.**

Countries should have in place special resolution regimes to deal with failing financial institutions, especially those whose collapse can have systemic consequences. These regimes should protect the public interest, while providing a fair process to protect creditor interests. Such special resolution regimes should enable the authorities to respond rapidly, flexibly and under conditions of legal certainty to a wide variety of circumstances. They should include the following features:

- A process for early intervention with clear conditions governing their application;
- Powers to operate and resolve the failing financial institution, including powers to terminate unnecessary contracts, continue needed contracts, sell assets and transfer liabilities, and take other actions necessary to the operation or winding up of the financial institution's affairs;

- Options to facilitate continuity for essential operations, including transfers of assets, liabilities, and contractual relationships to healthy private sector institutions or bridge financial institutions and measures to facilitate continuity of essential business with third parties;
- An objective to protect public expenditures, subject to the need to mitigate systemic consequences for the national financial system;
- A mechanism to fund ongoing operations during the resolution process, for instance, by relying on a deposit insurance fund<sup>12</sup> or alternative financing mechanisms. These latter mechanisms could include financing provided on a preferred recovery basis, such as debtor-in-possession or post-commencement financing available under the same national bankruptcy laws, or public funding combined, if possible, with a process for institution-specific or industry reimbursement;<sup>13</sup>
- Powers to put in place temporary funding and liability guarantees of part or all of a financial institution's business and, as a last resort, to take financial institutions into temporary public ownership in systemic cases or to create and operate temporary bridge financial institutions;
- A public policy commitment to prefer solutions that limit moral hazard and promote market discipline by imposing losses on shareholders, subordinated debt holders, and if appropriate other responsible creditors and counterparties of the financial institution, subject to appropriate compensation mechanisms, while providing safeguards for secured and other senior creditors, and protection of critical capital market transactions, such as securitisation structures and covered bond programmes;
- Powers to remove the directors and senior management of a failing financial institution and hold them to account and, where appropriate, to recover monies from individuals or entities responsible for the institution's failure;
- A liquidation option for financial institutions whose failure would not have wider systemic consequences or if there is unlikely to be a bidder for any of the financial institution's business;
- A process, such as through a deposit insurance system, providing for the prompt payment of insured deposits (see footnote 12); and
- Clarity and predictability for the treatment of financial market contracts by preserving appropriate termination, netting, and collateral rights or, at the option of the resolution authority, providing for continuity through transfers to other market participants or a bridge financial institution.

<sup>12</sup> See Basel Committee on Banking Supervision and International Association of Deposit Insurers, Core Principles for Effective Deposit Insurance Systems (2009).

<sup>13</sup> Within the EU public funding in the form of lines of credit from a central bank would have to comply with the prohibition of monetary financing contained in Article 101 of the EC Treaty. The ECB Governing Council, which is responsible under the EC Treaty for ensuring EU national central banks' (NCBs') compliance with the prohibition, has stated that (1) national legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as monetary policy, payment system or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is not compatible with the monetary financing prohibition and (2) national legislation foreseeing the financing by NCBs of a public sector national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would not be compatible with the monetary financing prohibition, if it is not short term, it does not address urgent situations, systemic stability aspects are not at stake, and decisions do not remain at the NCB's discretion.

## **2. Frameworks for a coordinated resolution of financial groups**

76. As demonstrated by the financial crisis, the absence of a process for the coordinated resolution of the legal entities in a financial group or financial conglomerate limits the options available to national or regional authorities for crisis management and further limits the possible coordinated resolution of such cross-border groups or conglomerates. While other challenges, such as the lack of time or inadequate information, may render any process difficult, the absence of a coordinated resolution mechanism for the legal entities in financial groups and financial conglomerates means that the only alternatives often are either a disorderly collapse or a bail-out.

77. Most systemically important financial services are provided by companies that are part of a financial group. Regulation is based on the type of businesses conducted by a company and financial groups are typically subject to separate rules, and perhaps separate regulators, for the banking, insurance and securities businesses conducted by companies in the group. These separate rules also often apply different accounting standards, liquidity requirements, and regulatory objectives for these businesses.<sup>14</sup> These differences create potentially complicating factors that affect the resolution of domestic or cross-border financial groups. These complications, of course, become more difficult for cross-border financial groups because of the different regulatory, supervisory, and legal rules that apply to the legal entities that comprise the group. For example, providing liquidity lines may be possible for holders of banking licenses within one group, and/or within one jurisdiction, but the rules may not allow groups to provide the same support to their insurance subsidiaries or to non-bank entities within the same group, or to subsidiaries in other jurisdictions. As a different example, there is no uniform framework for identifying the Member State having jurisdiction over the insolvency of different types of financial institutions within the EU. Deposit-taking institutions are subject to the Winding Up Directive on credit institutions. Insurance undertakings are subject to the Winding Up Directive on insurance undertakings. Other entities are subject to the EU Insolvency Regulation except that EU investment firms that hold client assets fall outside the scope of the Banks Winding Up Directive, the Insurance Companies Winding-up Directive and the Insolvency Regulation. The absence of a uniform framework necessarily becomes a significant complicating factor during crisis management and resolution for a cross-border financial group.

78. Existing national legal and regulatory arrangements are not designed to coordinate the resolution of problems in all of the significant legal entities of a financial group operating through a multiplicity of separate legal entities. Insolvency rules apply on a legal entity basis and may differ depending on the types of businesses within the financial group. Most jurisdictions covered by this report do not have a framework for the resolution of financial groups located within their borders. There are some limited exceptions. In Italy, for example, the authorities have the power to extend the special resolution regime for banks to domestic non-bank affiliates so long as the parent company falls under the special regime. Under the Italian procedures, the supervisor can initiate a proceeding at the same time for several group entities and appoint the same receiver, but it does not remove corporate separateness and does not lead to a pooling of the assets.

79. Disparate crisis management and resolution processes for the different business lines of the financial group – particularly where the group may be systemically significant to the national financial system – are likely to impair the ability of national authorities to respond coherently and prevent a disorderly collapse. If the crisis management and resolution

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<sup>14</sup> See Joint Forum, Risk Management Practices and Regulatory Capital, Cross-Sectoral Comparison, Bank for International Settlements (2001).

framework does not provide a viable resolution process for such groups, then the only alternative will continue to be ad hoc actions by national authorities. Such responses, while often effective in avoiding a disorderly collapse as shown during the crisis, limit the discretion and flexibility of national authorities, render cooperation with other authorities more difficult and often increase moral hazard. A regime to allow for the compatible and coordinated resolution of a financial group operating in multiple legal entities is an essential feature of a national resolution process. However, it is not a sufficient condition. To be capable of responding to a crisis involving, multinational financial groups it is necessary to achieve an improved coordination of the national resolution processes (cf. Recommendations 3 and 4).

## **Recommendation 2**

**Each jurisdiction should establish a national framework to coordinate the resolution of the legal entities of financial groups and financial conglomerates within its jurisdiction.**

Taking into consideration the special nature of regulated activities, national legal frameworks must be able to achieve the same resolution flexibility as recommended for the resolution of individual financial institutions under Recommendation 1. As a result, national authorities should consider a special resolution regime for such financial groups and conglomerates to provide an effective mechanism for decisive intervention, when necessary, and for assuring continuity in systemically significant functions performed by the group or conglomerate.

To achieve these, current law and policies should be reviewed to determine whether national authorities have the power to implement a special resolution regime for the legal entities of systemically significant financial groups or financial conglomerates that ensure protection of the public interest in a crisis, while mandating effective measures to reduce moral hazard. If not, consideration should be given to adoption of such frameworks, including the details of which component of a national authority should be granted the power and a framework for coordination between different national authorities. An effective framework must be able to provide a crisis management and resolution process for the main operating entities within the financial group or conglomerate that includes the features, as appropriate to the regulated activity, identified in Recommendation 1. If different authorities within a single jurisdiction are responsible for different legal entities or regulated activities, the framework should require coordination between those responsible authorities.

National authorities and policymakers should examine whether the recommendations developed by UNCITRAL for judicial bankruptcy proceedings governing groups of commercial enterprises could be applied to financial groups and conglomerates. UNCITRAL has made a number of recommendations aimed at improving the efficiency of group insolvency proceedings (see footnote 9). These include introducing the possibility of joint application and procedural coordination of proceedings of different legal entities in a group, allowing intragroup financing/guarantees after insolvency proceedings have commenced, appointing a single administrator for multiple proceedings of different components of the group, implementing a joint reorganisation plan.

### **3. Convergence of national resolution measures**

80. The effective coordination of cross-border solutions may be problematic if countries apply different crisis management approaches. Some countries place greater emphasis in their national laws on protection of the institution and others on the protection of creditors.

Furthermore, the insolvency regimes of different jurisdictions may have different objectives (some may have a pro-debtor bias, while others may be pro-creditor); they may apply different ranking of priorities or different treatment of claims. Few resolution frameworks place emphasis on the protection of systemically significant financial functions independent of the institution itself. These differences are reflected in the different statutory tools, grounds for intervention, and scope of authority for restructuring troubled financial institutions provided to national authorities. While there is no necessity for all countries to adopt a common approach to crisis management and resolutions, it is essential for improved cross-border cooperation that countries agree that the process should facilitate the continuity of key financial functions, such as clearing and settlement, and an orderly resolution.

81. The consequences of these differences in approach are further aggravated by procedural and substantive differences in national insolvency laws. Some countries use general corporate insolvency law for the reorganisation and winding up of financial institutions, while others have special proceedings for banks and other financial institutions which provide for tailor-made resolution measures. There are important public policy and legal differences between proceedings involving normal bankruptcy proceedings and those involving cross-border financial institutions. As noted in the preceding sections of this Report, many countries do not provide the special resolution tools needed to achieve continuity of key functions in a resolution or reduce the potential for a disorderly resolution. Differences in resolution regimes also affect the ex ante behaviour of financial market participants. For instance, if one jurisdiction treats unsecured bond holders more favourably than other jurisdictions in the event of a resolution, bond holders will likely be more willing to offer such financing during periods of financial distress in the most lenient jurisdiction.

82. Improvements in the ability of national authorities to manage and resolve cross-border financial crises require convergence in the tools available to national authorities. As detailed in Recommendations 1 and 2, those tools must include the powers to facilitate continuity in the key financial functions of the troubled financial institution in order to avoid a disorderly collapse that increases the likelihood of contagion effects across borders. As emphasised in Recommendation 2, these tools should include the authority to resolve the legal entities of financial groups and financial conglomerates in a coordinated manner to reduce the likelihood of such contagion. Convergence among national regimes also promotes a level playing field. Nonetheless, the development of similar procedures for national authorities responsible for crisis management and bank resolution could improve coordination and cooperation by defining the terms and conditions under which such steps may be expected.

### **Recommendation 3**

**National authorities should seek convergence of national resolution tools and measures toward those identified in Recommendations 1 and 2 in order to facilitate the coordinated resolution of financial institutions active in multiple jurisdictions.**

The management and resolution of failing financial institutions remains a domestic competence. The global nature of many financial institutions requires close cooperation among national authorities. Having similar tools at the national level, as set out in Recommendations 1 and 2, and similar early intervention thresholds may facilitate coordinated solutions across borders. The CBRG suggests that national authorities and international groups pursue and monitor developments toward the convergence in these legal frameworks.

#### 4. Cross-border effects of national resolution measures

83. Crisis intervention takes place within national legal frameworks, and crisis management tools have been designed to work mainly in a national context. However, national competence does not extend to assets situated in other countries, and any extra-territorially orientated measures require cooperation with other relevant jurisdictions. Recognition of the legal status of, or actions by, foreign courts or authorities (subject to national policy or other limitations) has long been a feature of judicial and supervisory cooperation.

84. Some national resolution mechanisms (eg provisions that allow the transfer of assets and liabilities to a bridge bank or to other institutions) may be important tools for facilitating the continuity of essential business operations. However, their effectiveness in a cross-border context may be hampered because the actions of the home jurisdiction will not necessarily be recognised and promptly implemented by host countries. The absence of coordination in the implementation of such mechanisms may make it difficult to coordinate a cross-border solution.

85. Notwithstanding the differences among national laws and approaches, it may nevertheless be beneficial in certain circumstances to be able to coordinate national proceedings. Some but not all national jurisdictions have the authority to recognise a foreign bank resolution measures. For instance, the Swiss FINMA has the power to recognise foreign bank resolution measures, including protective measures and bankruptcy decrees, in order to give a foreign administrator or liquidator control over assets located in Switzerland. Recognition is subject to the condition that the decree is enforceable, that Swiss creditors are treated equitably with non-Swiss creditors, that recognition does not result in violation of Swiss *ordre public*, and that there is reciprocity. In the event of recognition, FINMA will appoint a liquidator or administrator to carry out ancillary proceedings which are limited to the branch assets located in Switzerland. In the context of these proceedings, the secured and privileged (domestic and foreign) creditors of the bank will be paid. The remainder of the liquidation proceeds will be turned over to the foreign proceedings. The UK insolvency law provides a similar approach for non-EEA institutions. In the United States, the Bankruptcy Code provides procedures for recognising foreign proceedings. However, these provisions are expressly not applied to banks. Notwithstanding that exception, the relevant State or federal branch liquidator is empowered to transfer remaining assets of the branch to the home country liquidator after all recognised claims of US branch creditors have been paid. In Europe, the winding up directive established the principle of recognition of other member states' proceedings for branches. There are important public policy and legal differences between proceedings involving normal bankruptcy proceedings and those involving cross-border financial institutions. Nonetheless, the development of similar procedures for national authorities responsible for crisis management and bank resolution would improve coordination and cooperation by defining the terms and conditions on which such steps may be expected.<sup>15</sup>

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<sup>15</sup> The Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency notes that even where banks and insurance companies are generally excluded from the model law as enacted by a particular country, the enacting country might wish to treat, for recognition purposes, a foreign insolvency proceeding relating to a bank or an insurance company as an ordinary insolvency proceeding in certain circumstances. The guide notes that in enacting the exclusion for banks and insurance companies, a country may wish to make sure that it would not inadvertently and undesirably limit the right of the insolvency administrator or court to seek assistance or recognition abroad of an insolvency proceeding conducted in the territory of the enacting country, merely because that insolvency is subject to a special regulatory regime. See Guide to Enactment at paragraphs 63-64.

#### **Recommendation 4**

**To promote better coordination among national authorities in cross-border resolutions, national authorities should consider the development of procedures to facilitate the mutual recognition of crisis management and resolution proceedings and/or measures.**

Further work toward more effective mutual recognition of foreign crisis management and resolution proceedings should be undertaken at the bilateral, regional or international level. National authorities, or multinational groupings, may wish to consider putting in place bilateral or multilateral procedures to allow for recognition of foreign representatives and foreign crisis management and resolution proceedings and/or measures, subject to defined legal, public policy or other limitations. Specification of the grounds for such recognition, its scope (whether purely procedural or extending to any substantive issues), and the effect of such recognition in the recognising jurisdiction will clarify the terms for official cooperation and coordination. Similar procedures also could be considered for specific cross-border institutions.

These procedures could define the parameters for recognition of the representative capacity of a foreign national authority or for the effectiveness of resolution measures across borders. They could define the public policy limitations for such recognition, and if consistent with law and policy leave appropriate discretion for recognition of substantive steps taken by such authorities. One example is the cross-border recognition of a temporary delay on immediate close-out as set out in Recommendation 9. Another important procedural example would be to adopt steps specifying the grounds under which one jurisdiction would recognise the transfer of ownership or property from a failing financial institution directly to a private firm, to a national insolvency authority, or to a bridge financial institution or another public entity. Mutual recognition could also extend to substantive decisions on claims and other resolution decisions. The scope of recognition of crisis management and resolution proceedings in other countries is governed by national law, but consideration of enhancements of such recognition will promote improvements in coordination among national authorities.

#### **5. Reduction of complexity and interconnectedness of group structures and operations**

86. Large international group corporate structures operating in multiple jurisdictions and their internal and external exposures and relationships make crisis resolution difficult and costly. Simplification of group structures would help to deliver a more orderly resolution in the event that a firm fails. The corporate ownership structure, capital and funding arrangements within large groups are established for a variety of reasons, such as the efficient use of capital and liquidity, tax benefits, statutory and regulatory requirements, legal protection, or as the legacy of previous corporate structures resulting from acquisitions. Group structures and intra-group relationships are also designed to serve a number of corporate objectives, such as providing ratings management, risk management and operational management structures which can be directed from the group's corporate centre.

87. Although these structures generate significant efficiencies for the group, they tend to increase complexity and may create contagion by intertwining the financial health of one company with others within the group. Moreover, they can be used to take advantage of differences between regulatory regimes and can be used as a conduit for placing funds and products in unregulated entities (eg SPEs, SIVs). In a crisis, this can be beneficial or detrimental to different groups of customers. Events during the crisis have raised the issue of

the value (whether implicit or explicit) that can be ascribed to parental guarantees, or even general assumptions that parental support will be forthcoming. Such arrangements can serve a useful purpose for supervisors when an individual subsidiary encounters financial difficulties, but their value in a situation where the group as a whole is in a distressed condition is clearly more questionable. Conversely, the group's (or parent company's) potential liability for actions taken to preserve the reputation of another part of the group needs to be more explicitly built into both the supervisor's and the group's own analysis and stress testing. For example, some investment management firms (or the banks which owned them) provided financial support to money market funds to mitigate potential reputational risk from losses.

88. Responding to the differing regulatory infrastructures within different countries, the legal structures used may, or may not, correspond to significant direct capital, liquidity or supervisory responsibilities by the host countries. In effect, in some jurisdictions branches or offices may have to meet many of the requirements normally imposed on locally-incorporated subsidiaries, while in other jurisdictions subsidiaries may function much more like branches integrated into the parent institutions' business and management.

89. Supervisors should seek to better understand the extent to which an entity within the group, rather than the group itself, can remain a going concern or experience an orderly resolution that protects its customers in the event of problems at, or a collapse of, the other companies in the group. Such enhanced supervisory planning will enable authorities to better assess the extent to which changes are needed to the way in which financial groups or conglomerates manage and structure themselves and to which local operations of international groups should be separately and strongly capitalised. For instance, the authorities may require that institutions establish clear lines between deposit-taking and other banking operations, so that the depositor book can be easily transferred to another institution in times of failure with minimum disturbance to the confidence of depositors. The resolution of troubled deposit-taking entities may also be facilitated through the imposition of requirements on other former group companies to continue, if possible, to provide essential services to any healthy institution (including a bridge bank) to which some or all of the business of the deposit-taking entity has been transferred.

90. Most supervision of liquidity management within groups has been predicated predominantly on consideration of the group as a going concern. But it seems clear that the supervisor also needs to take account of the "gone concern" scenario and the resulting position of the legal entities. Doubts about an institution's ability to effectively manage liquidity centrally during a liquidity crisis can lead jurisdictions to compensate by requiring additional liquidity buffers or by ring fencing liquidity or assets.

91. Going forward supervisors are likely to use their powers to require certain internationally active firms and groups to operate as subsidiaries with increased capacity for self sufficiency including identifying access to adequate liquidity.<sup>16</sup> Holding increased capital and liquidity will have an economic cost and ultimately these costs need to be weighed against the costs which result from financial and economic instability. If groups are allowed to operate in a more integrated manner and manage their liquidity, at least in part, on a group basis, there needs to be good cooperation between home and host supervisors and thorough and more coordinated licensing and supervision of entities. This includes regular sharing of

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<sup>16</sup> In the EU, by virtue of the freedom of establishment and free movement of services under the EC Treaty, supervisors would not be legally able to require that operations by EU-chartered banking or financial groups be conducted through subsidiaries instead of branches.

relevant supervisory information as well as a clear understanding of the effects of the operating model on crisis management and resolution.

#### **Recommendation 5**

**Supervisors should work closely with relevant home and host resolution authorities in order to understand how group structures and their individual components would be resolved in a crisis. If national authorities believe that financial institutions' group structures are too complex to permit orderly and cost-effective resolution, they should consider imposing regulatory incentives on the institutions, through capital or other prudential requirements, designed to encourage simplification of the structures in a manner that facilitates effective resolution.**

National authorities should review business models and group structures of financial firms operating in their jurisdictions in the light of their effect in crisis situations and resolution scenarios, and should consider providing regulatory incentives to achieve the reduction of unnecessary complexity. For example, institutions with highly interconnected or complex structures that pose additional risks could be held to higher levels of risk management.

Among the issues for cooperation between national authorities and for their consideration in establishing incentives, supervisory approaches, and crisis management planning are the following:

- The legal, financial and operational intragroup dependencies arising from, for example, the centralisation of liquidity, risk management or other business functions;
- The separability and possibility of a sale or spin-off of (self-sufficient) individual units or business lines;
- The structure of the group's funding, linkages between regulated and unregulated entities, source-of-strength arrangements, as well as cross-border funding, liquidity, and other payments processes;
- Participation in payment and settlement systems, including the type and importance of this role as well as the size and range of provision of or reliance upon payment and settlement services, such as correspondent banking, prime brokerage and custodian services;
- The operation of national regulatory, corporate and insolvency regimes in home/host jurisdictions including the scope of potential ring fencing measures, the treatment of intra-group claims, safe harbour provisions for financial contracts, the treatment of depositors and other creditors under the relevant resolution frameworks, and market, regulatory and legal constraints that may require early disclosure of an impending crisis;
- Interconnectedness of key information technology systems, including depository, payment, and similar systems; and
- The rationale (regulatory, tax, legacy) for the corporate structures, booking arrangements and the use of special purpose vehicles.

## **6. Planning in advance for orderly resolution**

92. The crisis that began in August 2007 demonstrated the many challenges to achieving orderly resolution of multiple complex cross-border financial institutions in a global financial crisis. The crisis has underlined that thorough crisis prevention must pay attention to

corporate form and the operation of nationally based insolvency procedures. Although certain large financial institutions provide functions that are systemically important, similar in some sense to infrastructures or public utilities, their business continuity and contingency planning arrangements have not typically been required to include resolution contingencies. While no successful business operates in a wind-down mode, resolution contingency planning should therefore become a part of the supervisory process for large and complex cross-border institutions.

93. Local supervisors may believe that entities under their jurisdiction have ample funding resources in a crisis until they become aware that other jurisdictions are also relying on the same liquidity pool. For that reason among others, supervisors from different countries need to cooperate closely in order to ensure the consistency of group-wide as well as local contingency funding plans. In addition, home and host supervisors should inform each other of regulatory or legal restrictions that affect the transfer of assets between entities and across borders or otherwise affect the group operations as a whole.

94. Actions taken in a crisis are influenced by expectations of how weak or failing institutions will be handled in a crisis. Sometimes ring fencing measures are driven by a lack of information about how the resolution process functions in the jurisdictions where the financial institution operates. As a consequence, supervisors may make conservative assumptions and ring fence as a precaution.

95. Expectations about the availability of assets or liquidity by cross-border institutions, as well as national authorities may be upset by the complex practical and legal issues involved in defining where specific assets, particularly securities and other financial claims, are legally booked or held. While a description of these issues is beyond the scope of this report, the uncertainty that this will engender in defining available assets in a particular jurisdiction will complicate decision-making both by institutions and national authorities in any crisis or resolution.

#### **Recommendation 6**

**The contingency plans of all systemically important cross-border financial institutions should address as a contingency a period of severe financial distress or financial instability and provide a plan, proportionate to the size and complexity of the institution, to preserve the firm as a going concern, promote the resiliency of key functions and facilitate the rapid resolution or wind-down should that prove necessary. Such resiliency and wind-down contingency planning should be a regular component of supervisory oversight and take into account cross-border dependencies, implications of legal separateness of entities for resolution and the possible exercise of intervention and resolution powers.**

All institutions with significant cross-border operations should strengthen and maintain on a regular basis Management Information Systems (MIS) capable of providing information critical to supervisory and institutional risk assessment and management in the context of any possible resolution. This information should include organisation structures, counterparty exposures by counterparty and legal entity, payments and exchange systems on which the firm operates, *etc.*, and provide access to the supervisors to those systems to assist in the supervisors' evaluation of the institution's risk management and possible resolution contingency planning, and to enhance the firm's ability to identify risks while experiencing severe financial distress. The appropriate information may vary by institution. Supervisors should have access, as needed, to the information.

Among the information that should be assessed in developing such contingency plans, and made available to supervisors in assessing such plans, are the following:

- The information that may be required by the authorities in managing the cross-border elements of a financial crisis (eg lists of counterparties, inventory assets per legal entity and geographical location) and how these can be accessed quickly;
- The holding of assets and the effect of legal and regulatory restrictions on their transfer within the group in a stressed scenario;
- Group-wide contingency funding plans;
- Operating requirements and planning assumptions in stress scenarios assuming protective measures by foreign authorities;
- Information needed to net and settle or transfer financial market contracts;
- Arrangements relating to customer asset protection;
- Staff and operational capabilities;
- Back-up and resiliency plans for record retention, data integrity, and other information technology systems; and
- Such plans should be regularly updated to ensure they remain accurate and adequately reflect the institution's structure, risks, and dependencies across key jurisdictions.

A regular exchange among the relevant national authorities should ensure the mutual understanding of all aspects of the legal and regulatory framework that are critical for both contingency planning and management and resolution of a crisis. Critical assumptions on measures that may be taken by domestic and foreign authorities in a crisis, such as ring fencing, the treatment of depositors and other creditors and the treatment of financial contracts, should be verified with relevant foreign authorities. Such exchanges may be undertaken by crisis management groups as proposed by the FSB Principles for Cross-Border Cooperation on Crisis Management of 2 April 2009. It may be necessary to include authorities that often are not members of supervisory colleges, such as deposit insurers, finance ministries and insolvency authorities in charge of bank resolution. The home country authorities and regulators for each major international financial institution should ensure that the extended supervisory college or crisis management college meet at least annually to discuss aspects of the institution-specific contingency plan.

Among the issues for such exchanges may be the following:

- The legal and policy framework, including the resolution process for failing financial institutions, corporate disclosure and reporting requirements, competition requirements, including limits on market share and bank asset size, deposit insurance schemes, including coverage and the existence and type of depositor preference rules;
- The framework for providing liquidity, including the collateral accepted by the central bank (the terms and conditions for accepting collateral) for normal operations and for facilities that provide liquidity under stress;
- The terms of and restrictions imposed on any support provided by the government;
- The operational and technical specificities of payment and settlement systems, eg whether membership in a payment, clearing and settlement system is discontinued or suspended, or whether the default event that triggers discontinuation of membership will be automatic or subject to a specific decision by the system; and

- Critical assumptions on the potential measures that may be taken by national authorities in a crisis, such as ring fencing or territorial resolution measures, the treatment of depositors and other creditors, the treatment of financial market contracts. Where practicable, the potential responses of national authorities in a crisis should be discussed with those authorities.

## 7. Cross-border cooperation and information sharing

96. The supervisory responsibility of the home country of the parent of a banking group and the host country of that parent's subsidiary is governed by the Basel Concordat. While the intent of the Concordat is that no bank's (foreign) establishment be left without effective supervision, the complexity of financial group structures has obscured the precise roles and responsibilities of the various home and host supervisors, and their responsibilities for supervision at the consolidated or subordinate entity level. The Concordat provides that the home-country supervisor (of the parent) is responsible for the supervision of the group on a consolidated basis (along with that of the individual institutions authorised in its jurisdiction), and the host-country supervisor (of any foreign subsidiary) is responsible for the subsidiaries authorised in the host country.<sup>17</sup> The Concordat further states that the responsibility for the supervision of a branch with respect to solvency resides primarily with the home supervisor. The responsibility with respect to the supervision of liquidity usually resides with the host supervisor.

97. However, this division of supervisory responsibilities either within a single jurisdiction or between different countries may not necessarily be consistent with the division of responsibilities relating to crisis management and resolution, including the provision of central bank liquidity both in domestic and foreign currencies.<sup>18</sup> These complexities and the potential confusion regarding responsibilities may affect the effectiveness and even willingness of authorities to cooperate and share information in accordance with the Basel Committee's 1996 Paper on the Supervision of Cross-Border Banking (reiterated in its Core Principles Methodology, Principle 25). The principles require that the home regulator inform the host of any significant problems that arise in the head office.

98. In a crisis, the authorities responsible for the resolution of an internationally active bank need to obtain firm-specific information that may not be regularly exchanged in the course of normal supervisory cooperation, for example, specific information with respect to clearing or netting exposures, operational details, and more detailed or higher frequency information regarding liquidity. In addition, the exchange of cross-sectoral information, for instance, between a central bank and a supervisor may also be necessary.

99. Some countries address information sharing only in the context of normal supervision. They do not clearly differentiate what provisions or arrangements will apply in crisis situations. In a crisis, there could be a need to exchange information across different authorities such as between the home supervisor and a foreign central bank or among different sectoral supervisors. Some supervisory authorities do not have a clear authority for, or are prevented by law from, sharing information directly with a foreign authority other than a

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<sup>17</sup> See Basel Committee on Banking Supervision, Principles for the Supervision of Banks' Foreign Establishments (1983).

<sup>18</sup> Because of the need for central banks to provide for liquidity in a currency other than the currency of issue, central banks have entered into swap arrangements with each other.

supervisor (“diagonal information sharing”). The onward disclosure of information obtained from another authority (“L-shape information sharing”) is frequently restricted, or requires the approval of the authority that produced it. This restriction allows the owner of the information to ensure reciprocity and check that the domestic conditions for information sharing are verified. This restriction can, however, delay information sharing in a crisis. Restrictions on L-shape information sharing are likely to restrict transmission by a home supervisor to a host supervisor of information obtained from another host, or the transmission of information obtained from, or prepared jointly with, another domestic authority.

100. Supervisors have entered into various arrangements to share information, including exchanges of letters and Memoranda of Understanding (MoUs).<sup>19</sup> They set out expectations for supervisory cooperation and exchanges of information during normal supervisory activities. They are not legally enforceable and generally do not indicate how supervisors might cooperate in a crisis. Some MoUs on crisis management cooperation have been established, such as those among EU countries. However, given recent experience there are reasonable concerns that MoUs will not be followed in times of crisis as national authorities are accountable to national governing bodies with respect to how they take local interests into account.

101. In some cases, intervention actions such as ring fencing may be taken by national authorities without comprehensive information about a foreign institution’s operations or a foreign authority’s probable willingness or ability to respond. During the current crisis, some supervisors have detected shortcomings in the sharing of information and in the timely communication of problems affecting specific institutions. There are several reasons for these shortcomings. Sometimes supervisors have difficulties in obtaining, processing and analysing information and thus are unable to share information in a timely manner with other supervisors. Home country authorities may be reluctant to provide complete information that they perceive as negative to host authorities, because they fear it would spread distress or prompt the host authorities to take measures considered adverse to the national interests of the reluctant authorities. However, host supervisors that are unable to obtain that information from the reluctant authorities may be more, not less, inclined to take action to protect local depositors and creditors and ring fence assets. In some cases, better information sharing could reduce the need for ring fencing (although it may on the contrary reinforce ring fencing responses unless alternative cooperative solutions are available).

102. Continuing efforts are being made at the global (eg FSB) and regional (eg EU) level to promote and strengthen the use of supervisory colleges for enhancing supervisory cooperation. However, due to overriding national mandates supervisory colleges are not decision-making bodies. They are a useful tool to facilitate the multilateral exchange of supervisory information and views and assessments not only between home and individual host supervisors, but also among host supervisors. They help establish an organisational and personal network among supervisors so as to facilitate on-going communication and a coordinated and effective supervisory effort in a crisis.

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<sup>19</sup> See Basel Committee on Banking Supervision, *Essential Elements of a Statement of Cooperation between Banking Supervisors* (2001).

### **Recommendation 7**

**Effective crisis management and resolution of cross-border financial institutions require a clear understanding by different national authorities of their respective responsibilities for regulation, supervision, liquidity provision, crisis management and resolution. Key home and host authorities should agree, consistent with national law and policy, on arrangements that ensure the timely production and sharing of the needed information, both for purposes of contingency planning during normal times and for crisis management and resolution during times of stress.**

Responsibilities in supervision and regulation and the associated information needs should be reviewed in light of the responsibilities that fall on a jurisdiction in case of the failure of an institution. The college of supervisors may be an appropriate forum to discuss such responsibilities. Key home and host supervisors should agree on a common process that defines what information needs to be exchanged, and when and how this should best be done, with particular regard to confidentiality, security, relevance and accessibility. There is a need for information to be exchanged before a crisis and separately at the time of and to assist in dealing with a crisis. Authorities should exchange information on the relevant aspects of their legal and regulatory frameworks and the different national authorities' powers and responsibilities for regulation, supervision, liquidity provision, crisis management and resolution. It will be useful to make this data available for all home and host supervisors with an interest from one or more common databases or from the websites of the relevant authorities.

Material adverse developments should be shared among key authorities as and when they arise.

## **8. Strengthening risk mitigation mechanisms**

103. The crisis has revealed that, while the cross-border derivatives activities of large financial institutions can provide significant benefits to the international community, those activities can also be the source of significant risks of cross-border contagion. A prime example of this risk is AIG's extensive positions in the credit default swap (CDS) markets. Threatened downgrades of AIG's credit rating in September 2008 created credit and counterparty risks to buyers of credit protection around the globe and imposed tremendous margin collateral requirements on AIG that severely strained its liquidity and undermined its viability. This and other examples illustrate the importance of risk reduction and improved functioning of the financial markets for effective crisis management and resolution of cross-border financial institutions.

104. Policymakers can do more to reduce interdependencies among individual market participants in order to better insulate market participants from the failure of a financial institution. A wider use of risk mitigation mechanisms (eg standardisation of over-the-counter (OTC) bilateral contracts, clearing and settlement through central counterparties (CCPs), netting agreements, collateralisation and segregation of client positions) and strengthening of legal frameworks to ensure their enforceability help achieve this objective. Much progress has been made over the last two decades in achieving legal certainty for close-out netting of financial contracts and collateral arrangements. Legal reform efforts have successfully been adopted in most major jurisdictions, especially for the termination, liquidation, and close-out netting of OTC bilateral financial contracts upon an event of default, including an insolvency event, at a banking institution. Less progress has been made in some emerging market jurisdictions. Further convergence and the strengthening of national frameworks are strongly desirable.

105. In the United States, a wide range of OTC financial contracts among a similarly wide group of large non-financial and financial counterparties can be terminated, liquidated, and closed out upon the insolvency<sup>20</sup> of one of the counterparties. Collateral (of any type) securing such contracts may be liquidated and applied in accordance with the contract's terms. For contracts subject to the rules of a clearing corporation, members must pay net covered clearing obligations or the clearing corporation can liquidate pledged collateral. Similarly, in the context of the European markets, the Settlement Finality Directive, the Banks Winding Up Directive and the Financial Collateral Directive, which have been implemented in all Member States, have provided legal certainty for financial markets. The Settlement Finality Directive provides for the enforceability of transfer orders and collateral in designated payment, securities clearing or securities settlement systems even in the event of a participant's insolvency. The Financial Collateral Directive, among other things, provides an effective regime for pledging collateral, title transfer arrangements, and close-out netting of financial collateral arrangements.<sup>21</sup> The Winding Up Directive further enhances netting arrangements and provides the applicable law for netting, repurchase, and other financial market agreements.

106. Credit risk protection through collateral pledged against potential losses in derivatives transactions is a cornerstone of risk management. The value of collateral to credit risk protection is premised on the creditor's ability to promptly access and liquidate the pledged collateral in the event of default. Another fundamental tenet of the markets is that the client's claim to and prompt recovery of client assets and client money must be protected. Both of these interests can be threatened by unlimited re-hypothecation of collateral because it can be unclear which assets are due back to the client, which can delay return of client assets. The Lehman insolvency raised a number of issues concerning unlimited re-hypothecation and appropriate disclosures for clients, and has raised questions as to whether national authorities should consider limits on re-hypothecation.<sup>22</sup>

107. Across countries, the scope of the relevant laws protecting financial contracts differ somewhat. For example, in the United States, insurance companies are not covered by the above-mentioned provisions. In the European Union, Member States can exercise a full or partial opt-out for coverage of certain types of non-financial entities from the scope of the Financial Collateral Directive which has been exercised by a few Member States. The Financial Collateral Directive has recently been amended to cover not only cash and securities collateral arrangements (and related close-out netting arrangements), but also collateral consisting of credit claims. These amendments are to be implemented by member states by no later than 30 November 2010. Finally, as noted in the following section of this report, there are substantial differences in the powers of national authorities to transfer derivative contracts to bridge financial institutions, other public entities or other private financial institutions after intervention or initiation of insolvency proceedings. These differences have significant effects on the ability of national authorities to provide continuity to financial market operations and avoid potentially destabilising contagion effects.

108. Large cross-border financial institutions are also typically central to global trading activities, particularly relating to OTC derivatives. This means that these institutions

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<sup>20</sup> The term insolvency is used broadly to refer to a bankruptcy, receivership, conservatorship, administration or similar proceeding.

<sup>21</sup> The Basel II Framework impose legal certainty requirements such as legal opinions for the enforceability of netting financial contracts and the application and liquidation of collateral to net obligations under those financial contracts.

<sup>22</sup> See HMTreasury (UK), *Developing Effective Resolution Arrangements for Investment Banks*, 31-32 (2009).

concentrate a preponderant share of the risks in the clearing and settlement systems for payments and securities transactions. Since these concentrated trading activities continue around the globe and around the clock, any sudden interruption in the settlement of pending trades or payments transactions by one of the financial groups creates grave risks for other financial institutions in all countries and with virtually no time to react.

109. One important market is that for credit derivatives. Principally composed of CDS, these products allow market participants to pursue a number of objectives. First, CDSs allow lenders to hedge their exposure to certain credit losses or to risk concentrations of their loan portfolio efficiently. Second, a lender might decide to take risks by purchasing or selling a CDS on a reference entity to which it is not exposed. Finally, CDSs allow participants to take positive or negative credit views on specific reference entities. However, these benefits can come at a substantial cost. The growth in CDS can create additional speculative exposures when not related to hedging a business risk of the protection purchaser and can lead to skewed incentives for market participants in a crisis.

110. Exchange trading and/or use of CCPs to aggregate and mutualise risks is a crucial step toward reducing systemic risk on a global scale. On the other hand, it should also be recognised that OTC markets as of today play a central role in individual risk management of institutions, allowing them to control and adjust their risk positions following their individual needs. In addition to limiting counterparty risk and eliminating obvious process and settlement problems, clearing houses would enhance the liquidity and transparency of the derivatives market by actively managing the daily collateral requirements and the netting of positions between and among clearing house members. Consequently, a significant reduction of the risk of cross-border contagion can be provided by national authorities encouraging standardisation of most OTC derivatives, together with utilising settlement and clearing systems with CCPs. Important developments are underway to establish and implement CCPs for CDSs and other derivative products. These efforts require authorities to establish standards and regulatory oversight to ensure that exchanges or CCPs do not themselves evolve to create new risks.

111. For customised contracts where the use of regulated exchanges or CCPs is not appropriate, it is encouraged that relevant trade information is reported to a regulated trade repository. The availability of this information for such customised transactions, along with the risk reduction benefits of regulated exchanges and CCPs, could be crucial in assessing the potential dependency between the positions of different market participants and the potential consequences from instability or failure by one or more financial institutions in a crisis.

112. The Lehman case revealed uncertainties about the effective segregation of client assets and monies. For instance, dealers in the OTC market collect initial margins from customers but often those amounts are not segregated into bankruptcy-insulated accounts. If a dealer defaults, the initial margin posted by customers that is not segregated is treated in bankruptcy as a general unsecured claim of the customer. The size of these exposures can be quite significant.

## Recommendation 8

**Jurisdictions should promote the use of risk mitigation techniques that reduce systemic risk and enhance the resiliency of critical financial or market functions during a crisis or resolution of financial institutions. These risk mitigation techniques include enforceable netting agreements, collateralisation, and segregation of client positions. Additional risk reduction benefits can be achieved by encouraging greater standardisation of derivatives contracts, migration of standardised contracts onto regulated exchanges and the clearing and settlement of such contracts through regulated central counterparties, and greater transparency in reporting for OTC contracts through trade repositories. Such risk mitigation techniques should not hamper the effective implementation of resolution measures (cf. Recommendation 9).**

In order to facilitate resolution and wind-down of individual financial institutions and reduce contagion, national authorities should strengthen and seek greater convergence of rules, laws, and practices governing risk mitigation mechanisms for financial operations. In particular:

- National authorities should promote the convergence of national rules governing the enforceability of close-out netting and collateral arrangements with respect to their scope of application and legal effects across borders;
- Consideration should be given to adopting limits on re-hypothecation of customer or other collateral. Unlimited re-hypothecation can serve to artificially increase leverage during normal operations, prevent the predictable application of collateral protection to ostensibly collateralised positions, and increase the fragility of market operations during periods of instability or illiquidity;
- National authorities should promote greater standardisation of derivatives contracts, the trading of such contracts on regulated exchanges and/or clearing through regulated CCP systems with electronic trade recordation and back-up capabilities. National authorities should take steps to encourage the standardisation of OTC contracts so that they can be more effectively migrated onto regulated exchanges or CCPs. An important component of moves towards greater use of exchanges and CCPs is that authorities need to understand thoroughly the margining and risk mitigation rules and practices of exchanges and CCPs as well as the default, insolvency, and close-out settlement rules and practices;
- For those contracts that are not sufficiently standardised to permit trading on exchanges or clearing and settlement via CCPs, national authorities should encourage recording of key trade-level information on regulated trade information repositories. This step is essential in order for authorities to understand the correlations and relationships between different market participants in a crisis and to better plan for crisis management or crisis resolution;
- Authorities should use regulatory incentives to achieve these goals for all financial market contracts;
- National authorities should mitigate the potential risks from exchanges, CCPs and clearing houses by promoting the provision of appropriate guarantees, reserve funds or risk sharing mechanisms; and
- National authorities are advised to clarify how customer funds and securities will be segregated in insolvency, improve transparency, and ensure rapid return and access to clients of their funds and securities. The segregation of client positions serves to insulate market participants from failures of financial institutions, permits customers to regain access to their assets quickly and helps to minimise market disruptions.

## 9. Transfer of contractual relationships

113. The initiation of formal resolution or insolvency procedures may trigger the simultaneous closing out of large volumes of financial contracts. This, in turn, could destabilise markets and undermine orderly resolutions of failing institutions. Counterparties may be required to use the asset values determined in the closing out of financial contracts to establish market prices for similar assets subject to contracts with third parties. This “fire sale” valuation will transmit the debtor’s instability far beyond its counterparties. In these circumstances, financial stability would be better protected by transferring the debtor’s financial contracts to a solvent third party, a bridge bank or another public entity. Thus, after carefully considering the circumstances that need to be addressed (ie defining systemic crisis), authorities need to have the requisite powers to override termination clauses and transfer financial contracts to a sound counterparty.

114. The power to transfer various types of OTC and cleared financial contracts from a troubled institution either prior to or after the institution enters bankruptcy, administration, or other types of resolution proceedings to another private sector entity, a bridge bank or another public entity is an effective means for achieving the continuity of critical operations. Its presence in national frameworks varies greatly. In some jurisdictions there is no such power or authority. In other jurisdictions this authority exists or is in the process of being implemented.<sup>23, 24</sup>

115. In most jurisdictions an action such as the appointment of an administrator or liquidator would be an enforcement event or event of default triggering immediate rights to close-out and net financial contracts. As a result of these differences, resolution strategies may be ineffective because foreign jurisdictions may not recognise the actions of other authorities with respect to financial contracts.<sup>25</sup> For example, the powers of the FDIC may not be enforceable in all jurisdictions. This may present special difficulties where the contract or collateral is potentially subject to non-US law. The short delay in US law against non-defaulting counterparties exercising netting and close-out rights would not be permitted in the laws of EU jurisdictions under the Financial Collateral Directive. Difficulties would also arise with respect to financial institutions that have non-bank affiliates that engage in OTC

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<sup>23</sup> In addition to the countries noted in the discussion, Canadian authorities have bridge bank authority and Belgium has recently amended its law to empower relevant authorities to transfer property and business lines as part of the bank resolution process.

<sup>24</sup> For example, in the United States, the FDIC as receiver or conservator of an insured bank has the power to enforce or repudiate certain qualified financial contracts within a reasonable period of time. The FDIC as receiver or conservator also has the power to transfer to a financial institution (defined to include a bridge bank) all the qualified financial contracts (including related collateral or other credit enhancement) between the bank and a counterparty and such counterparty’s affiliates. The FDIC as receiver has until 5 PM eastern time on the business day after appointment as receiver to notify such persons of the transfer of such contracts. Such persons have no right to terminate or close-out and net such contracts until 5 PM on that following business day. Thereafter, full close-out and netting rights are available in respect of qualified financial contracts left behind in the receivership, but are not available for contracts transferred to a healthy financial institution or bridge bank. In the case of either repudiation or transfer, the FDIC must repudiate or transfer all or none of the qualified financial contracts between the insured bank and a counterparty and that counterparty’s affiliate.

<sup>25</sup> Take the example where the UK authorities intervene in an institution to exercise their authority to compel the transfer of some or all of the property of a UK bank to a bridge bank or other private sector institution, which may include the transfer of all of the financial contracts of that institution and related collateral or credit support subject to a netting arrangement. Some contracts may be governed by foreign law, rather than English law, may be held by counterparties outside of the United Kingdom or booked at branches outside the United Kingdom. If those counterparties challenge the action of the authorities in a court outside the United Kingdom, the foreign court may not recognise the actions of the UK authorities. The UK Special Resolution Regime has provisions which address the non-recognition of the transfer of foreign property including foreign contracts.

derivatives contracts. As the special resolution regimes applicable to banks would not generally apply, authorities would not have the ability to transfer those contracts to another financial institution or to a public entity in the interest of maintaining financial stability and preserving the franchise value of the troubled institution.

116. The ability of a receiver to capture trapped liquidity in “in-the-money” OTC financial contracts may also differ across borders. Under market agreements such as the ISDA master agreement, the non-defaulting party has the right to terminate contracts subject to the netting agreement, but is not required to do so. Moreover, even if the non-defaulting counterparty has closed-out and netted the contracts, it can withhold payment of amounts owing until the defaulting counterparty cures the default. In the United States, the FDI Act has been amended to ensure that the non-defaulting counterparty of an insured bank is unable to withhold those amounts otherwise owed to the estate under certain qualified financial contracts notwithstanding such clauses. Under the Bankruptcy Code, the debtor can petition the court to transfer and assign its in-the-money contracts. In fact, Lehman Brothers Holding Inc has obtained permission of the court to do so in the US bankruptcy proceeding. Such transfer and assignment may also be possible under the UK Banking Act of 2009. In other jurisdictions, this may not be possible without amendments to the law. Other arguments are also being raised in the US court at least as to whether the relevant clauses in standard market contracts are entirely compatible with the principles of insolvency law.

#### **Recommendation 9**

**National resolution authorities should have the legal authority to temporarily delay immediate operation of contractual termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution, a bridge financial institution or other public entity. Where a transfer is not available, authorities should ensure that contractual rights to terminate, net, and apply pledged collateral are preserved. Relevant laws should be amended, where necessary, to allow a short delay in the operation of such termination clauses in order to promote the continuity of market functions. Authorities should also encourage industry groups, such as ISDA, to explore development of standardised contract provisions that support such transfers as a way to reduce the risk of contagion in a crisis.**

While the current protections for financial contract termination and close-out netting may reduce the risk of contagion during normal markets, if all counterparties of a failing bank exercise the right to terminate immediately financial contracts, net exposures, and liquidate collateral upon the initiation of resolution measures, it will undermine financial stability and accelerate contagion during crises. Authorities should have the power to transfer financial contracts in order to maintain continuity immediately after intervention. The ability of relevant authorities to impose a brief delay on the exercise of early termination and netting rights would maximise the possibility of transfer to a sound financial institution, a bridge bank or another public entity provided that:

- The contracts are transferred to a new sound counterparty (for example, a creditworthy private sector purchaser, a government-owned bridge bank or another public entity);
- The early termination rights are preserved as against the transferee in relation to any subsequent default by the transferee; and
- The early termination rights and netting rights are preserved for contracts that are not transferred to a new counterparty prior to expiration of the brief delay period.

In addition, national and international authorities should explore through statutory amendments or through private sector review of market documentation the means to fairly facilitate the ability of a defaulting counterparty or its estate to realise the benefit of "in-the-money" derivatives contracts.

The case for amending the relevant EU directive and, where necessary, in other jurisdictions to permit a short delay in immediate close-out should be considered. Also, authorities may encourage efforts by industry groups such as ISDA to explore a way to deal with the issue in a master agreement. They could include incorporating conditions that contracts are not automatically terminated due to government intervention or due to a change in control so long as compliance with the contract conditions is otherwise maintained.

## **10. Exit strategies and market discipline**

117. While various national authorities have been creative in developing ad hoc government assistance for many large institutions, not all have outlined a strategy or timeframe for exiting these arrangements. In one or more jurisdictions a step-up in the dividend rate on preferred stock capital injections was included to provide a strong incentive to repay the capital in the interim. While restrictions on compensation, dividends, stock repurchases and other corporate actions have also provided incentives to repay the government investment, it is unclear for the firms most in need of this capital assistance whether and how they will be able to do this, and what actions the government might take if repayment difficulties are encountered. Still, it was envisioned and is hoped that government investments will ultimately be replaced by private capital.

118. Loss of confidence in the ability to manage the resolution procedures could arise from uncertainties about exit strategies. In particular when public intervention and fiscal support from government, deposit insurance or other safety-nets, or alternatively temporary public ownership, play a pivotal role in the resolution of a troubled financial institution, continued public understanding and support is necessary. In order to maintain necessary support, efforts to develop an understanding about the amount of fiscal support, its time horizon, risk sharing arrangements and the possible losses that may be borne by the public are important.

### **Recommendation 10**

**In order to restore market discipline and promote the efficient operation of financial markets, the national authorities should consider, and incorporate into their planning, clear options or principles for the exit from public intervention.**

National authorities should adopt crisis management and resolution strategies that reduce moral hazard by minimising public expenditures. Losses should be allocated among shareholders and other creditors, where possible; and private sector resolutions rather than public ownership should be facilitated. Where temporary public ownership is necessary, authorities should seek to return assets to private ownership and management as soon as possible. At the time of public intervention, national authorities should seek to develop public understanding about the amount of fiscal support that may be necessary, estimates of the time horizon for intervention, risk sharing arrangements and the possible losses borne by the taxpayers.

Government rescue operations should include careful consideration of exit strategies. An abrupt or too hasty exit from public intervention could impair the financial and operational condition of a troubled financial institution. A too lengthy exit could lead to moral hazard problems. The time horizons of exit strategies and the risks arising from the termination of public intervention should be well balanced.

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