4 November 2011

Effective Resolution of Systemically Important Financial Institutions

Overview of responses to the public consultation

In July 2011, the Financial Stability Board (FSB) published for consultation a comprehensive package of policy measures to improve the capacity of authorities to resolve systemically important financial institutions (SIFIs) without systemic disruption and without exposing the taxpayer to the risk of loss.[1] The FSB received over sixty responses from a wide range of respondents, including national public authorities, a variety of trade associations and financial institutions. Responses have been posted on the FSB website, unless otherwise requested.[2] This document provides a brief summary of the main issues raised in the comments received and the approach being taken to these issues in the final text of the Key Attributes of Effective Resolution Regimes for Financial Institutions (hereafter, "Key Attributes") and other supporting documents.

1. Objectives

All respondents endorsed the overall objective of the FSB Consultative Document, namely that authorities in all jurisdictions should have the capacity to resolve SIFIs without systemic disruption and without exposing taxpayers to the risk of loss.

Respondents agreed that special resolution regimes are needed to ensure the continued performance of the systemically critical functions of a failing SIFI, for example by giving authorities the power to use bridge entities or to write down liabilities – tools that are not generally available under ordinary corporate insolvency regimes. Respondents also strongly favoured greater harmonisation of resolution tools and powers and encouraged the FSB to set out a plan and timeline to achieve this. Several industry respondents suggested additional objectives and guiding principles, including the objective of maximising recovery of value for the benefit of creditors.

The Key Attributes are intended to form an international standard that should inform the crisis preparation and resolution regimes of all member jurisdictions. Accordingly, the FSB will ensure a process of rigorous review and monitoring of members' policies to implement those agreed standards. To promote effective and consistent implementation across jurisdictions, the FSB, with the involvement of the IMF, the World Bank and the standard setters, will develop an assessment methodology that provides greater technical detail. The methodology will enable objective and comparable assessments of countries' implementation to be made, while taking into account different national legal systems and market environments and sector-specific considerations.

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[1] The consultative document is published at: http://www.financialstabilityboard.org/publications/r_110719.pdf

[2] The comments are published at: http://www.financialstabilityboard.org/press/c_110909.htm

2. Scope of the Key Attributes

The majority of respondents welcomed the broad scope of Key Attributes and their application to resolution frameworks for all financial institutions that could be systemically significant or critical if they fail. Some respondents, in particular those from or representing the insurance sector and financial market infrastructure (FMI), sought further clarification as regards the scope and application to resolution regimes for non-bank financial institutions.

The Key Attributes are intended as a common standard for resolution frameworks for all financial institutions (see Key Attributes 1.1 and, as regards FMIs, 1.2). Any exemptions could encourage regulatory arbitrage and affect the level playing field across jurisdictions and sectors. The FSB recognises that the response to a crisis needs to be tailored to the specific nature of a firm's activities, business models and risks, and that the resolution powers set out in the Key Attributes will not all be suitable for all sectors and all circumstances. The FSB will therefore continue to work with its members to develop further guidance taking into account the need for implementation of the Key Attributes to accommodate sector-specific considerations, including those particular to FMIs.[3]

3. Resolution powers and tools

All respondents that addressed the issue considered the resolution powers proposed in the Consultative Document to be comprehensive. A few questioned whether the FSB expressed a preference for any particular power. The Key Attributes do not express any preference for any particular one of the resolution options. When the threshold for entry into resolution is met, authorities should have a broad choice of options, with the choice of resolution options to be applied in each individual case depending on the particular circumstances.

The majority supported the proposal in the Consultative Document that entry into resolution should be initiated when an institution is, or is likely to be, no longer viable, and before it is proved to be balance-sheet insolvent. Several of the respondents that commented on the resolution threshold noted that further guidance was needed on suitable indicators for non-viability. As part of its work on implementation guidance, the FSB will examine whether further detail can be provided on suitable criteria for judging non-viability and the threshold for entry into resolution.

Bail-in within resolution

Industry associations and a clear majority of global financial institutions supported the introduction of statutory bail-in within resolution as an additional resolution option to allow for creditor recapitalisation, be it by way of an exchange of claims for equity in the distressed firm or by transferring its systemically important and other viable operations to a bridge institution and exchanging claims against the firm for equity in the bridge.

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[3] For the purposes of the Key Attributes, the term "financial market infrastructure" is defined as "a multilateral system among participating financial institutions, including the operator of the system, used for the purposes of recording, clearing, or settling payments, securities, derivatives, or other financial transactions". It includes payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs), and trade repositories (TRs). See CPSS-IOSCO - Consultative report on Principles for financial market infrastructures - March 2011.

Several respondents seem to have read the draft Key Attributes as obliging countries to use bail-in powers, whereas in fact it is the intention of the Key Attributes that bail-in should have no special status. It would be one resolution option among others, available to resolution authorities for use where it was most appropriate in the particular circumstances, and would generally be exercised in conjunction with other resolution measures, such as removal of problem assets or replacement of senior management, in order to ensure the viability of the financial institution that emerges from the resolution process.

A significant minority of the comments on bail-in appear to reflect a misunderstanding that bail-in would be the only resolution measure that would impose losses on creditors. This is not the case. All resolution options need to be capable of imposing losses to be consistent with the overriding objective of avoiding solvency support by taxpayers, and transfer powers can also deliver this objective. For example, creditors left behind in administration or receivership face losses in cases where partial transfer powers are exercised, whether transfer is to a private sector purchaser or a bridge institution. Bail-in simply provides authorities with another option for allocating appropriate losses to creditors.

A number of respondents suggested that the FSB define, in positive terms, the specific classes of claims that may be subject to bail-in rather than for national authorities to have a general bail-in power in respect of all unsecured claims. The Key Attributes do not define the types of liabilities that should be subject to bail-in. However, they stress that statutory bail-in within resolution should be applied in a manner that respects the hierarchy of claims in liquidation (see Key Attributes 3.5(i) and 5.1).

4. Cross-border issues

Legal nature of cross-border framework

All respondents stressed the importance of effective cross-border coordination and supported the recommendations set out in the Consultative Document, including those in Annex 3 on essential elements of institution-specific cross-border cooperation agreements. Opinion was divided, however, on how such coordination could best be achieved.

On the one hand, several suggested that efforts should focus on memoranda of understanding (MoUs) setting out the mechanisms for coordination and methods for resolving disputes, and considered statutory cooperation and coordination agreements to be unachievable.

On the other hand, a significant minority, consisting of respondents from or representing the banking sector, advocated a binding international agreement and a mutual recognition framework. Some of those that advocated this approach suggested an obligation for authorities to cooperate, subject to adequate safeguards that give individual jurisdictions the flexibility to act when necessary to safeguard domestic financial stability. Others wanted the FSB to go further and set a more ambitious framework reinforced through multilateral legally binding means, such as an International Concordat or Treaty.

The FSB considers that the proposals for a legal framework for cross-border cooperation, Crisis Management Groups (CMGs) and institution-specific cross-border cooperation agreements set out in the Key Attributes (see Key Attributes 7, 8 and 9 and Annex I), while falling short of a binding framework for mutual recognition and international cooperation, represent a significant step. Development of more binding mechanisms will not be feasible

without first putting in place the convergent regimes and incentives to cooperation that, when implemented, the Key Attributes will deliver.

Responsibilities of home and host authorities

As regards resolution of a cross-border financial group, a majority of industry stakeholders suggested resolution should be carried out by the home authority on a group-wide basis, and based on the concept of group interest. Several emphasised that cooperation or group-level resolution would require solutions to the problem of burden-sharing.

Those responses that supported the home country authority having primary or exclusive responsibility for resolution did not, however, consider circumstances under which a home country might be unable or unwilling to resolve a cross-border SIFI as a whole, and the possibility that this could have significant consequences in host countries. Such circumstances are amongst the reasons why the Key Attributes provide for host country authorities to have powers to act independently if necessary to achieve domestic financial stability. Legal and other constraints would also make it difficult to disregard corporate separateness of subsidiaries and treat a financial group as single economic entity, without far-reaching reform of company law and insolvency regimes.

The Key Attributes strike a balance between the need to achieve a cooperative group-wide resolution and the need to provide host jurisdictions with the authority to protect the financial stability of its own jurisdiction. They require jurisdictions to have in place mechanisms to give effect in their jurisdiction to actions taken by a foreign resolution authority, provided that creditors are treated equitably in the foreign resolution proceeding (see Key Attribute 7.5).

As regards the powers of host authorities in relation to a domestic branch of a foreign institution, a number of industry respondents stated forcefully that host authorities should only be able to exercise resolution powers in relation to local branches of foreign institutions in "emergency situations". The Key Attributes require that special resolution authority extends to foreign bank branches (see Key Attribute 7.3). This would ensure that host authorities can cooperate with a foreign home authority in the application of special resolution tools to local operations, including transfers to a foreign bridge institution or private sector purchaser, or take independent domestic action where that is necessary to achieve domestic stability in the absence of effective international cooperation and information sharing.[4]

5. Resolvability assessments and measures to improve resolvability

The vast majority of respondents welcomed the draft guidance on resolvability assessments, noting that this is a crucial element of any resolution framework. In the spirit of levelling the playing field and increasing consistency in assessments across different jurisdictions, there were calls for greater detail in the guidance. Several respondents emphasised that home country regulators should make the ultimate determinations of resolvability of a financial group and that resolvability assessments should draw on national assessments and be coordinated within the CMG by the home authority. Several noted the need for strong cooperation between home and host authorities in this exercise. The Key Attributes provide

[4] This should not apply where jurisdictions are subject to a binding obligation to respect resolution of financial institutions under the authority of the home jurisdiction (e.g., the EU Winding up and Reorganisation Directives).

that group resolvability assessments should be by the home authority of the global SIFI (G-SIFI) and coordinated within the firm's CMG taking into account national assessments by host authorities (see Key Attribute 10.3).

Industry stakeholders expressed strong support for the recommendations on continuity in global payment operations and for the recommendations on legal-entity specific information (Annex 6 to the Consultative Document on measures to improve resolvability). Elements of that Annex have been incorporated in the Key Attributes, and will be further reflected in the implementation guidance.

However, a number of firms and industry associations highlighted concerns about the possible actions that they might be required to take to make themselves less complex and reduce the obstacles to an effective resolution. A number of respondents expressed strong reservations about any proposed supervisory intervention into group structure, noting that there was no optimal group structure and existing structures should be respected. A few argued, in particular, that intra-group transactions can increase resilience, and that this positive impact should be balanced against concerns about the possible effect of intra-group exposures on resolvability. The FSB will continue to consider questions of group structure and intra-group transactions as part of its ongoing work on resolvability.

The Key Attributes do not express any preference for any particular group structure or business model. Nevertheless, given that structural factors may limit authorities' choice of resolution options, the Key Attributes require that authorities have powers to address such factors where financial and legal operational structures render a firm unresolvable (see Key Attribute 10.5).

6. Recovery and resolution plans

Respondents strongly supported a requirement for recovery and resolution plans (RRPs), and a substantial number considered that such a requirement should apply to all financial institutions (and not just to G-SIFIs) in a way that is proportionate to the nature, size, complexity and specific circumstances of each firm. The majority of industry respondents expressed strong support for a "single plan approach" under which the home country authority leads the development of the group resolution plan of a G-SIFI in coordination with the members of the G-SIFI's CMG.

The development of a group resolution plan led by the home authorities is a core component of the Key Attributes. However, to safeguard host country interests, the FSB also needs to consider circumstances under which a home country may not have the capacity or willingness to coordinate the effective resolution of a cross-border SIFI as a whole. For that reason, the Key Attributes provide that host resolution authorities may maintain their own resolution plans for a foreign firm's operations in their jurisdictions and should cooperate with the home authority to ensure that the plan is consistent with the group plan (see Key Attributes 11.8 and 11.9).

Most industry respondents noted that the confidentiality of shared information should be of utmost importance. RRPs will contain highly sensitive information, and firms have expressed their reluctance to disclose those contents and suggested that the home country resolution authority should limit access to the RRP by foreign resolution authorities to those recovery

and resolution sections relevant to the particular jurisdiction, and that strategic information should not be part of the plan.

The FSB is aware of the sensitivities involved in sharing firms' strategic information. To mitigate the firms' concerns, while not undermining home-host cooperation, the Key Attributes specify that where appropriate and necessary to respect the sensitive nature of information, information sharing may be restricted to the top officials of the relevant home and host authorities (see Key Attribute 12.1). Institution-specific cross-border cooperation agreements are also required to set out the arrangements that protect the confidentiality of shared information (see Key Attribute 9.1(iii)).

7. Funding

Respondents supported the overriding objective that an effective resolution regime should make resolution feasible without resort to public funding, but were divided on the means by which that should best be achieved. There was significant interest in the proposal that 'super-senior status'- that is, a priority claim in any subsequent insolvency for investors that provide post-resolution funding - might be explored a means of facilitating access to funding for struggling institutions, and several suggested that statutory backing for contractual super-seniority might be prudent. There was also substantial support for the establishment of private-sector funded resolution funds, and several that took this position suggested that the FSB give clear guidance on the design of national resolution funds.

Several respondents sought clear assurance that liquidity support would be available. While the FSB recognises that liquidity is required for effective resolution, it cannot be prescriptive on liquidity support arrangements of central banks.

As national authorities establish funding arrangements, the FSB will assess whether more detailed guidance can be provided, and whether to articulate a recommendation for a statutory preference (a 'super-senior' priority claim to protect those that provide funding to an institution in resolution, for example to a privately recapitalised bridge bank or a bailed-in institution), bearing in mind that the details of any such preference would require careful consideration at a technical level.

8. Creditor hierarchy and convergence

A large number of respondents called for strong assurance that the hierarchy within the capital structure and statutory ranking of creditor claims would be respected, whatever resolution measures an authority applies. Nevertheless, a number of respondents also expressed the view that, in order to maximise the value for the benefit of creditors as a whole or to contain the potential systemic impact of a firm's failure, it may be necessary to depart from absolute respect for the ranking of priorities and the principle of equal (*pari passu*) treatment of similarly situated creditors within the same class, and to treat creditors of the same priority ranking differently in justified cases. In particular, depositors and other parties who provide critical funding for a SIFI's continued operations may need to be paid in full or guaranteed to be transferred to a creditworthy bridge entity, in order to ensure continuity of the systemically important parts of its business or to prevent runs throughout the system that could result in a destabilisation or collapse of the financial system. Resolution authorities should have this flexibility, subject to transparent principles and safeguards. The Key Attributes reflect these

positions in that they call for resolution powers, as far as possible, to be applied in a manner that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of the creditors as a whole (see Key Attribute 5.1). The reasons for any such departure should be transparent.

The Consultative Document (Annex 7, Discussion note on creditor hierarchy, depositor preference and depositor protection in resolution) sought views on whether differences in the statutory hierarchy of claims across jurisdictions represent an impediment to effective cross-border resolution and on whether, in particular, greater convergence in the treatment of deposit claims could be pursued at the international level.

A majority of respondents saw greater convergence as a desirable objective, although they acknowledged the significant difficulties involved. While respondents were split on the pros and cons of a general depositor preference, most that addressed the issue expressed concern about any preference based on nationality, residence or the jurisdiction where a deposit was booked, and noted that some countries currently incorporate such a preference in their national regimes. The Key Attributes accordingly provide that national laws should not discriminate against creditors on any such basis, and that the treatment of creditors and insolvency rankings should be transparent (see Key Attribute 7.4).

9. "No creditor worse off" principle

Respondents strongly endorsed the principle set out in the Consultative Document that no creditors should be worse off in a resolution (including cross-border resolution) than they would be in liquidation, and noted that further guidance should be developed on how the hypothetical liquidation value of assets would be calculated for such purposes. Many considered that such principles for valuation should specifically exclude liquidation values based on ring-fencing of local assets or on fire-sale prices.

The FSB shares the view that the "no creditor worse off" principle constitutes an important protection for creditors. The principle is stated clearly in the Key Attributes (see Key Attribute 5.2), and the FSB will assess as part of its work on implementation whether more detailed guidance on its application is desirable. Such guidance might address, in particular, how the principle should apply in the context of cross-border resolutions and in circumstances where there is a departure from the general principle of equal (*pari passu*) treatment of creditors of the same class (see Section 8).

10. Temporary stay on early termination rights

The Consultative Document (Annex 8) discussed whether the resolution regime should provide for the imposition of a temporary stay on contractual early termination and acceleration rights under financial market contracts pending entry into resolution, subject to adequate safeguards.

Respondents were generally in favour of such stays, provided the scope was clear and narrowly defined. There was general support for the safeguards identified in the Consultation Document as appropriate to accompany a temporary stay and protect counterparties. Several

respondents suggested additional conditions or qualifications, including that any transfer of contracts would be only to a solvent and creditworthy entity, which should be subject to the same or a substantially similar legal and fiscal regime.

Many respondents noted that cross-border recognition and enforcement of any stay remained to be addressed. Several respondents suggested that some aspects of this problem could be addressed by contract, but noted that possible contractual solutions will depend on the details of the resolution regimes that will apply.

Those respondents who opposed any suspension of early termination rights believed that even a limited stay would create market uncertainty and affect the operations of regulated exchanges, central counterparties and other FMIs. Some of the concerns expressed by respondents did not distinguish between the imposition of a stay on the right to terminate and a broader stay (moratorium) on rights and obligations under the contract.

The Key Attributes make clear that any stay on the exercise of early termination rights should be limited to the right to terminate early for reasons only of entry into resolution or in connection with the use of resolution powers and should not extend to other obligations under the contract (see Key Attribute 4.3). Limited in this way, the restriction on early termination rights does not affect other rights of counterparties under netting and collateralisation agreements and does not interfere with payment or delivery obligations to FMIs.[5] If a firm in resolution fails to meet any margin, collateral or settlement obligations that arise under a financial contract or as a result of the firm's membership or participation in an FMI, its counterparty or the FMI would have the immediate right to exercise its early termination right as against the firm in resolution. The technical issues raised in responses to the Consultative Document will inform ongoing work on implementation.

11. Due process and judicial review

Respondents generally supported the principle that rights to judicial review of resolution actions and available remedies should be framed in a way that does not undermine effective resolution and the necessary legal certainty of resolution actions. Many respondents stressed the need to provide for adequate protection of private property rights of shareholders and creditors, and commented that the protections of creditors, claimants and third parties conferred by judicial review and due process should not be diluted unnecessarily. This means that, at a minimum, there must be robust rights to judicial review to enforce creditors' rights and address manifest abuses of authority. This is not inconsistent with the provision in the Key Attributes (see Key Attribute 5.5) that the legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith, and that redress should be restricted to compensation. Some respondents expressly supported a restriction of this kind.

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[5] See footnote 3 and Key Attributes, footnote 2.

12. Timeline for implementation

A large number of respondents called for greater clarity about the timeline for national implementation of the Key Attributes and for the alignment of resolvability assessments with that timeline. There was strong support for peer reviews to assess progress toward full implementation.

Initial RRPs and resolvability assessments should be completed and institution-specific cooperation agreements should be in place for all G-SIFIs by end-2012. The FSB will monitor progress through regular reporting from CMGs. The FSB Peer Review Council will by 2013 undertake an initial review of whether the G-SIFI-specific requirements relating to resolvability assessments and institution-specific cooperation agreements have been implemented. A first peer review of implementation of the Key Attributes is planned for 2012. By this time, all members should have taken steps towards implementation of the Key Attributes, even if full implementation may not have been achieved by this time due to a jurisdiction's legislative process. Following the G-20 Summit, the FSB will begin, with the involvement of the IMF, the World Bank and sectoral standard setters, to work on a methodology that provides greater technical detail and sector-specific guidance on the various elements of the Key Attributes and can be used to assess implementation.