Panel Session for UNCITRAL Congress

A Global Architecture for Resolution of Financial Institutions

International trade requires international financing. The resulting interconnectedness of financial networks has increased the risk that local contagion and systemic shocks may spread to the global financial system. Neither domestic nor current international legal regimes adequately address these risks on their own. In an important paper, *Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap,* 10 Brook. J. of Corp. Fin. And Comm. L. 183 (2015), Prof. Irit Mevorach points out that the orderly resolution of financial institutions across national boundaries could be aided by a legal mechanism for recognizing resolution orders. Such a global regime could address local commercial law impediments to global resolution, while at the same time ensuring that global resolution regimes do not displace local law more than is absolutely necessary.

The panel would explore a potentially crucial role for UNCITRAL in developing such a cross-border recognition regime. UNCITRAL's experience with the Model Law on Cross-Border Insolvency offers a unique expertise and ability to balance the imperatives of local, national and regional resolution within a framework that facilitates cooperation and coordination, and provides quick and certain recognition. In particular, the panelists will explore the need to balance the imperatives of systemic safety and soundness against the existing legal doctrines that allocate financial risk among commercial parties.

The panelists would each address the following topics:

1) Irit Mevorach, A Global Procedural Framework for Recognition of Financial Institution Restructuring (based on *Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap,* 10 Brook. J. of Corp. Fin. And Comm. L. 183 (2015).

2) John Pottow, Adequate Assurance of Future Performance: Learning from (and Harmonizing) Banking and Insolvency Resolution (extrapolating to the international level *Implementing Symmetric Treatment of Financial Contracts in Bankruptcy and Bank Resolution,* 10 Brook. J. Of Corp. Fin. And Comm. L. 155 (2015)).

3) Edward Janger, Bank and SIFI Resolution in the US: Domestic Obstacles to International Recognition and a Unique Role for UNCITRAL.

4) Ignacio Tirado, European Bank Resolution and Insolvency Priorities (ECB Legal Research Programme, call of 2016).

5) Riz Mokal, Making Global Bail-in Work – A UK Perspective.

The Speakers:

Irit Mevorach, Professor of International Commercial Law, University of Nottingham. Professor Mevorach. Irit Mevorach is a Professor of International Commercial Law. She holds degrees in law from Tel-Aviv University (LLB with distinction, 1997, LLM, 2001) and UCL, London (PhD, 2006). Irit has been an expert adviser to the UK government's delegation to the United Nations Commission on International Trade Law (UNCITRAL) since 2006, and from 2013 through 2016 represented and advised the World Bank at the Commission in deliberations in the areas of insolvency and cross-border insolvency. Irit was appointed Senior Counsel to the World Bank and headed the Bank's Global Initiative on Insolvency and Creditor/Debtor Regimes (2013-2015). In that capacity, she has advised governments of some ten countries in Africa, Asia, Europe and the Caribbean on reform of business and personal insolvency and creditor/debtor systems, and had led the Bank's Global Task Force on Insolvency and Creditor Rights. Her book 'Insolvency within Multinational Enterprise Groups' (Oxford University Press, 2009) has won the Edwin-Co/INSOL Europe Prize for Outstanding Legal Scholarship (2010). She has been awarded British Academy grants for her empirical and comparative research in the area of cross-border insolvency. Her academic and policy work has influenced law reform in Europe and globally.

John Pottow, John Philip Dawson Collegiate Professor of Law, University of Michigan. Professor Pottow is an internationally recognized expert in the field of bankruptcy and commercial law. His award-winning scholarship concentrates on the issues involved in the regulation of cross-border insolvencies as well as consumer financial distress. On behalf of the United States, Professor Pottow serves as a delegate to the United Nations Commission on International Trade Law (UNCITRAL). He has published in prominent legal journals in the United States and Canada and testified before Congress. An oft-invited lecturer, he has presented his works at academic conferences around the world and frequently provides commentary for national and international media outlets, such as NPR, CNBC, CNN, C-SPAN, Al Jazeera America, and the BBC. He also has litigated bankruptcy cases before the U.S. Supreme Court, including his successful pro bono argument on behalf of the respondent in Executive Benefits Insurance Agency v. Arkison (2014).

Edward Janger, David M. Barse Professor of Law, Brooklyn Law School and Maurice R. Greenberg Visiting Professor, Yale Law School (Spring 2017). An authority on commercial transactions, business law, and bankruptcy law, Janger joined the Brooklyn law faculty in 1998 having previously taught at Washington University School of Law and Ohio State University College of Law. He has held positions as a visiting professor at Harvard Law School, the University of Pennsylvania School of Law. He previously served as the Maurice R. Greenberg, and the Anne Urowsky Visiting Professor at Yale. He also coordinated the American College of Bankruptcy's course in International Bankruptcy at NYU Law School, and served as the Robert M. Zinman Scholar in Residence at the American Bankruptcy Institute. Professor Janger's recent scholarship considers, variously, business bankruptcy, international bankruptcy, and consumer financial protection. His recent article, Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy (with Melissa Jacoby) received the Grant Gilmore Award from the American College of Commercial Finance Lawyers. He currently serves as a member to the American Bar Association delegation to

UNCITRAL working Group V (Insolvency), and as a member of the World Bank's Task force on Insolvency and Creditor/Debtor Regimes.

Ignacio Tirado, Professor of Corporate and Insolvency Law at the Universidad Autónoma of Madrid (Spain), Senior Legal Consultant at the World Bank's Financial Sector Practice and Consultant on insolvency-related matters to the IMF´s Legal Department. A qualified lawyer, Professor Tirado was Of Counsel of the Business Restructuring and Insolvency Practice of Hogan Lovells, LLP (Madrid Office, then Lovells LLP), until he joined the World Bank. Ignacio's research interests (present and former) as well as legal practice focuses on Insolvency Law (corporate and sovereign), Corporate Law (business and company restructuring) and financial and securities regulation. Ignacio is a member and a Director of the International Insolvency Institute. He has represented the World Bank in UNCITRAL´s Working Group V (insolvency) and Spain and the III in Working Group VI (secured transactions).

Riz Mokal, Chair of Law and Legal Theory, University College, London. Professor Mokal's scholarship — which ranges over financial sector regulation, bankruptcy, property and trusts, and legal theory — has influenced law reform in the UK, and has been cited with approval by several courts, including the House of Lords, the Australian High Court, and the Courts of Appeal of England & Wales, New Zealand, Ontario, and Victoria. From 2009 to 2013, Professor Mokal was Senior Counsel to the World Bank, and headed the Bank's Global Initiative on Insolvency and Creditor/Debtor Regimes. Since then, he has served as Senior Law Reform Consultant to the Bank. In these capacities, he has advised the governments of some twenty countries in Africa, Asia, and Europe on reform of insolvency and creditor/debtor systems. His work involves policy analyses of national legal and regulatory regimes, helping national authorities to rewrite legislation and strengthen judicial capacity, and engagement with the full range of stakeholders. As part of the World Bank's delegation to the United Nations Commission on International Trade Law from 2009 to 2013 and of the United Kingdom delegation since, he has been an active participant in the Commission's work on insolvency law. His particular focus has been on the bankruptcy of cross-border enterprise groups, the duties of directors in the period approaching bankruptcy, and the enforcement of bankruptcy-derived orders and judgments.

A Global Framework for Resolution of Financial Institutions

Dr. Irit Mevorach, University of Nottingham

The international legal architecture supporting cross-border insolvency and cross-border resolution is incomplete. UNCITRAL in 1997 promulgated its Model Law on Cross-Border Insolvency, a framework for global insolvency and restructuring of international commercial enterprises. The Model Law does not, however, specifically address the cross-border resolution of international financial institutions. The international standard for the resolution of Significantly Important Financial Institutions (SIFIs) identifies domestic best practices and includes high-level principles concerning the cross-border aspects of resolution regimes. However, it does not set forth a detailed cross-border resolution framework with legislative provisions that can be enacted uniformly across countries' legal systems.

Since the 2007-2009 financial crisis, and the subsequent series of collapses of global financial institutions, there have been urgent calls for action, including by standard-setting institutions, to develop a framework for the orderly resolution of financial institutions across national boundaries. Importantly, a recent initiative of the Financial Stability Board (FSB) introduced contractual solutions to enhance cross-border recognition of resolution measures, in particular the stay of termination of financial contracts and bail-in. It also emphasized the need for statutory solutions and delineated additional high-level principles that can guide legal systems as they develop statutory frameworks. These developments in the bank and SIFI resolution context promoted rethinking about the underlying goals of the general insolvency standard (within the UNCITRAL Legislative Guide and the World Bank Principles) on the treatment of financial contracts, and as a result enhanced harmonization in this area. However, the international community and standard-setters have not yet undertaken a project to develop a comprehensive global framework with legislative provisions for cross-border resolution of financial institutions.

This recent improvement of the general insolvency standard regarding the treatment of financial contracts and the increasing cross-sector consistency of best practice standards are likely to accelerate harmonization of national resolution-related laws, which in turn can support a cross-border resolution framework. However, harmonization is a slow process and progress has been mixed. It is also unlikely that full harmonization will ever be achieved. On the policy level, harmonization efforts should be constrained to provide room for local developments of resolution regimes. Domestic resolution systems may evolve over time and countries may develop innovative concepts and measures to address new challenges. It is through such experiences and developments that the regulatory landscape can remain modern and fit for purpose. Additionally, even if resolution regimes converge, a cross-border framework would be necessary to prescribe the degree of coordination in implementing the (harmonized) measures and the manner of cooperation or centralization of the process, in particular whether a certain authority takes the lead in the initiation and conduct of measures.

Currently, the UNCITRAL Model Law is the only global model available for cross-border insolvency and hence an expected point of reference when attempting to design a global framework for

resolution of financial institutions. The Model Law for commercial entities was designed to provide uniformity in the application of private international law aspects, while allowing host countries to retain some control in the administration of cross-border insolvency. The prevailing argument has been, though, that the Model Law was designed for corporate non-bank enterprises, and that it did not address group structures, which are the prevalent form of global financial institutions. Financial institutions are arguably more complex and the Model Law approach therefore might be too simplistic.

It is indeed widely acknowledged that the regulation of bank insolvency has certain specific objectives, and therefore bank insolvency requires certain special rules. It has been argued in this respect that because of the need to consider objectives other than maximization of the estate value, most countries have chosen to treat bank insolvencies differently from ordinary commercial insolvencies. Yet, notwithstanding the specific concerns and special goals of resolving international banks and particularly global SIFIs, it is also important to acknowledge the significant commonalities with general cross-border insolvency. The insolvency standard emphasizes goals beyond value maximization for existing creditors. There is a consensus that an insolvency regime should balance between a range of interests and may pursue social policies. In regards to cross-border insolvency, it is agreed that pursuing the broad range of goals requires coordination between jurisdictions, facilitation of the provision of assistance to foreign proceedings, and recognition of foreign proceedings, by adopting the Model Law in national regimes. The Model Law aims to promote cooperation, greater legal certainty, fair and efficient administration of cross-border insolvency proceedings, maximization of the value of the estate, facilitation of rescue of distressed businesses, protecting investment, and preserving employment.

The Model Law has focused so far on single companies, yet it did not exclude more complex business structures such as groups from its scope. Notably, the practice shows that many cross-border insolvency cases of groups have been addressed effectively under the Model Law. Furthermore, UNCITRAL has tasked itself to address the "group gap" and to expand the Model Law to include additional tools to facilitate group solutions in cross-border cases. Thus, the Model Law is becoming increasingly relevant and can be usefully analyzed and considered in the process of closing gaps in the cross-border insolvency/resolution infrastructure, while bearing in mind the specialness of international financial institutions.

Adequate Assurance of Future Performance: Learning from (and Harmonizing) Banking and Insolvency Resolution

John Pottow, University of Michigan Law School

UNCITRAL will hopefully turn its attention to cross-border financial institution resolution by building upon its successful platform of cross-border insolvency reform. Academics indeed have studied the (comparatively) more regulated system of cross-border insolvency to extract guidance. That work, in turn, compares domestic treatment of failed banks with failed private companies. For example, the United States shares a common attribute with many, though by no means all, systems, namely, that the resolution of financially distressed banks is hived off from the otherwise prevailing insolvency system rules for private company restructuring. Justifications range from concerns of systemic risk to historical path dependency, but for better or worse, banks get special treatment. Indeed, this is true both where there is a specialized regime, and also where there is not.

Two central features of developed insolvency systems is imposition of a creditor moratorium and the ability to "assume" (preserve over counterparty objection) valuable debtor contacts. But a glaring exception to these pillars is the special treatment of financial contracts, such as repos, swaps, and the like. In the U.S., under so-called "safe harbors," they are exempt from the bankruptcy stay, and counterparties can "closeout" (terminate) these contracts over debtor objection. This destroys value for "in the money" contracts, contravening the insolvency law mantra of preservation of debtor going-concern value. (The purported justification is that such extraordinary treatment is required in the name of capital market liquidity; clearance of financial transactions should not be "gummed up" by a debtor's bankruptcy stay. This premise is coming under increasing assault by scholars as possibly exacerbating, not reducing, systemic risk.)

By contrast, bank resolution law temporarily suspends closeout netting and imposes a brief "short stay." This allows regulators to assess an insolvent bank's portfolio of financial contracts, package and transfer the valuable ones to solvent transferees (solvent banks), and thereby *both* preserve the going-concern value of the contracts as assets *and* assure smooth transition and continued performance to the counterparty. Some consider it ironic that insolvency law, focused on preserving value, actually fails to protect financial contracts by allowing their destruction through the safe harbors, whereas banking law, focused on safety and soundness, preserves these contracts' value, while remaining blasé to hysteria that any stay or interference with immediate closeout netting will grind the derivatives market to a halt.

Whatever the irony, the bank resolution system gets it right, and insolvency law gets it wrong. This is an important recognition, because if UNCITRAL follows the well-motivated impulse to use its successful insolvency reforms as a "platform" to anchor the design of a financial institutions resolution system, it has to recognize—and fix—the serious problem insolvency law presently has with financial contracts. This is especially so for two reasons: first, financial contracts are the bread and butter of financial institutions, constituting a significant share of their value; and second, many financial institutions do not fit into the narrow definition of "bank" and so must avail

themselves to the insolvency law system for resolution; thus, merely replicating the bank resolution law on its own will be insufficient, even if UNCITRAL wanted to unmoor reform from the insolvency law platform.

The lynchpin of bank resolution system's successful preservation of financial contract value is the assurance that the financial contracts will, post-assignment, be performed, and as such, the counterparties will not be harmed by the original debtor's financial failure. The way this is done in banking law is finding a credit-worthy entity to step in and continue business with the counterparty (which bank regulators can help identify in the comparatively small world of banking).

To integrate this banking regime into the general insolvency system to replace the safe harbors, similar assurances of financial contract performance are required to assuage the counterparties that brief delay in the exercise of their rights will be harmless. Such assurance can be provided both doctrinally and functionally. Doctrinally, the insolvency system could, like the bank resolution system, limit the debtor to a short stay to try to sell (or assume) its book of financial contracts, and, more specifically, comply with insolvency law's requirements of curing of defaults and adequate assurance of future performance. Functionally, one would "assure that assurance," so to speak, by providing financing arrangements that mimic the solvency of transferee banks, by using backstop credit facilities under an insolvency system's post-bankruptcy credit priority rules.

In sum, if international financial institution resolution regimes are to be built out on an insolvency platform—eying the success of UNCITRAL's cross-border insolvency work—then imperfections in the insolvency regimes' treatment of financial contracts must first be worked out or else the project will collapse. While some creditors might howl at suggestions that their closeout rights might require brief deferral, the international winds are already shifting with the ISDA Resolution Stay Protocol, the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, and the UNIDROIT Principles on The Operation of Close-out Netting Provisions, to name just a few. UNCITRAL is well suited to coordinate and advance this effort of integration; it must do so mindful of not repeating failures of the past.

Bank and SIFI Resolution in the US Domestic Obstacles to International Recognition: A Unique Role for UNCITRAL

Edward J. Janger
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There are three distinct regimes for resolving financial institutions in the United States: (1) banks are resolved by the FDIC under the Federal Deposit Insurance Act; (2) systemically significant financial institutions (SIFIs) are resolved pursuant to the terms of Title II of the Dodd-Frank Act, either in bankruptcy, or if that is not feasible by the Orderly Liquidation Authority (OLA); and (3) non-bank financial institutions that are not systemically important are to be resolved in bankruptcy.

Resolution for banks under the FDIA is accomplished by dividing the banks into a "good bank" and a "bad bank." The good assets are transferred to (purchased by) a solvent entity, usually another bank, and the bad assets are resolved by the government. For both SIFIs and non-SIFI financial institutions, the locus of first resort for resolution is bankruptcy court. A key element of SIFI regulation under Dodd-Frank is to require SIFIs to develop a resolution plan, sometimes called a "living will." The living wills set forth a plan for resolving the firm in bankruptcy should one of the operating businesses suffer a financial shock.

These living wills are designed to facilitate and follow a so-called "single point of entry" strategy, under which the federal government does not bail out the firm through liquidity injections, but instead the investors, "bail-in" the insolvent entity. Namely, under single point of entry, if a subsidiary of a bank holding company suffers a financial shock, the group looks to the holding company as a source of strength. The holding company is expected to carry sufficient loss absorbing capacity ("TLAC") to recapitalize the insolvent entity. The parent transfers assets to the subsidiary, and then, if necessary, file for bankruptcy itself. If the holding company files for bankruptcy, the equity of the subs transfers to a trust that assumes the short term, but not the long term obligations of the holding company. The result yields a recapitalized subsidiary, and a solvent parent – thus, in theory, calming the markets and stopping a run.

Central to this goal is that the ability of the operating subsidiary to continue to perform its obligations, and that the bankruptcy of the holding company not constitute a default under its various contracts. An important aspect of the SPOE structure is that only the holding company files for bankruptcy, and the operating companies continue to perform their obligations. It is contemplated that the recapitalization of the subsidiary and the transfer of assets to the holding company would be accomplished quickly. Typically, under the FDIA, banks are resolved over the weekend, but during that period there is a short moratorium to permit assumption by or transfer of the financial firms contracts to a solvent entity. This short moratorium does not exist under US bankruptcy law for "financial contracts" which are subject to the so-called "bankruptcy safe-harbors." The Lehman experience illustrates that this makes orderly resolution of a financial firm difficult in bankruptcy.

This problem has been largely remedied for systemically important financial institutions because of the creation of the ISDA Resolution Stay Protocol. The Stay Protocol implements a short moratorium by contract to allow for orderly treatment of financial institution assets. Indeed, where both of these fail, the Dodd-Frank Act offers the OLA as an administrative backstop. There is also legislation pending in Congress to implement a short stay by law. Gaps remain, however. First, issues such as fraudulent conveyance may endanger the finality of the bail-in transfers, while concerns about adequate assurance of performance may delay the assignment and assumption of key contracts, at least across national boundaries. Second, the Dodd-Frank regime and the Stay Protocol are only reliably available for SIFIs. Not all financial institutions fall into that category. Third, the category of contracts "excepted" from the bankruptcy moratorium under the U.S. "safe harbors" and Recommendations 101-107 of the UNCITRAL Legislative Guide is broader than those covered by the Stay Protocol. Fourth, the manner in which the stay protocol might be implemented in diverse international courts remains uncertain.

These gaps are uniquely within UNCITRAL's competence to fill. UNCITRAL currently has two existing instruments that could, relatively easily, be supplemented to fill these gaps. To the extent that national regimes currently use bankruptcy law as their resolution forum, the UNCITRAL Model Law for Cross-Border Bankruptcy provides an effective recognition framework under which resolution orders might be recognized across borders. Where financial institutions are involved, it might be necessary to provide mechanisms for accelerating recognition and cooperation, but there is no need to reinvent the wheel. With regard to the need for short stay treatment of financial contracts, adequate assurance of performance and finality, the UNCITRAL Legislative Guide for Insolvency could be supplemented to include provisions relating to the insolvency of financial firms. These provisions could be brought into conformity with current best practices for financial firm resolution, such as: the European Union Bank Recovery and Resolution Directive, European Union Directive on Financial Collateral Arrangements, the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, and the UNIDROIT Principles on The Operation of Close-out Netting Provisions.

Such an effort would require cooperation and consultation between insolvency experts, bankers and bank regulators. The work of this project would build on the work of UNCITRAL Working Group V, but steps would need to be taken to coordinate this project with the efforts of the FDIC, FSB, the EU and others. This is a challenge, but one worth undertaking.

<u>European Bank Resolution and Insolvency Priorities</u>

Ignacio Tirado, Universidad Autónoma of Madrid

One domain where corporate insolvency and bank resolution systems separate and, at the same time, intertwine, involves the hierarchy of claims: on the one hand, the regulation of distressed financial institutions tends to have a set of priorities that does not coincide with those generally included in ordinary insolvencies; on the other hand, bank resolution systems often make express reference to the general hierarchy of claims envisaged in the insolvency law. When the bank has international connections, the inconsistency of the system of priorities in different countries makes the application of bank resolution systems even more complex. Addressing the inconsistencies between different regimes as well as the problems of conceptual interpretation (cross-comparison of priorities) and practical implementation is paramount for the adequate understanding of bank resolution regimes. In particular, the following needs to be analyzed:

Analysis must begin with a discussion of the conceptual differences between the system of priorities in corporate and bank insolvencies. In the case of general insolvency law, the content of priorities shows the jurisdiction´s level of consistency with market principles (gauged, for example, by the level of respect of pre-insolvency entitlements) as well as a set of social values (who gets what of what's left is, in part, a decision of social policy). The regulation of bank insolvency, however, is specially concerned with the maintenance of financial order and the avoidance of systemic contagion. In terms of priorities, this is reflected in the inclusion of early intervention mechanisms and in the pre-determination of certain types of creditors that must early, inevitably, and publicly take losses, so that the rest of creditors are protected, panic does not spread, and the system continues to operate in an orderly manner. Total Loss Absorbing Capacity –TLAC- or the minimum requirement for own funds and eligible liabilities –MREL- rules are unique to banks, and they represent systems of pre-insolvency priorities. This is complemented –in the most advanced systems- by a definition of "bail-in-able" claims (ie, those claims that must bear the losses when –normally- the entity is insolvent). When a third layer of creditors is concerned, bank insolvency mingles with corporate insolvency, and often a reference to the general system of priorities is included in the bank resolution system. But things are, in practice, far from easy. The application of general corporate law priorities to the insolvency of a bank presents a number of problems.

Problems become bigger when, as is the case for the larger financial institutions, there is a cross-border element to the bank´s insolvency. It is not uncommon that private international law rules differ from the approach taken in case of corporate insolvency. Insolvency law's focus on COMI often gives way to the place of authorization of the entity, with a single point of entry. Applicable law, however, tends to remain with each of the territorial jurisdictions where the banks are active. This entails different systems of priorities, and the need to make the treatment of similar creditors consistent. The definition of security rights, the diverse typology of the security rights and of certain classes of creditors, the concept of administrative expenses, or even the characterization of depositors all have to be managed in a way that is consistent and allows for an orderly and value-preserving resolution. There is potential for conflict depending on how the different priority regimes apply to relevant liabilities, which provides a further source of complication.

There is more. Concerns about the institutional framework and the protection of basic rights of creditors must be addressed. Bail-in powers are often implemented by administrative authorities, without any court involvement. This may present problems of constitutionality in some countries. The challenge is also conceptual: is it justified, constitutionally, to impose a write-off of what many systems consider a right--credit--in cases where the loss of economic value of the claim has not been properly established? Problems of discrimination between economically homogenous creditors may also arise. Good examples of the problems that may arise can be found in recent years in the midst of the financial crisis. Maybe Iceland´s decision to protect national depositors and bail in international deposit holders is a clear case (*Icesave* case).[1] Further, the cross-border application of certain measures may also present problems of breach of the fundamental rights of creditors and their access to justice. Often, decisions will be adopted by "colleges" of national resolution authorities that have no separate legal personality and uncertain legal nature. How creditors may defend their rights (especially their constitutional right of property) is under-theorized and begs rigorous comparative analysis. Even within regionally integrated structures, like the Eurozone, the resort to the European Court of Justice or to the European Court of Human Rights is available under at-best unclear circumstances.

Accordingly, if UNCITRAL is to consider moving forward in establishing tools for cross-border resolution of distressed financial institutions, it has much work to do on the comparison of priority provisions. Scholars have begun that work, myself included but there is much more to do.

[1] Case E-16/11 EFTA Surveillance Authority v Iceland, 28 January 2013

Making Global Bail-in Work – A UK Perspective

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"Cross-border banks are international in life, but national in death."

Background

The paternity but not the truth of this aphorism is disputed. As the GFC broke in 2007, national regulatory authorities were only able to provide mostly local responses to the distress of major cross-border banking groups. Even when individually rational, such responses often proved collectively value-destructive, imposing avoidable costs both on direct financial stakeholders including depositors and on various sets of taxpayers. Such uncoordinated responses also failed adequately to mitigate 'common lender' (a group entity based in one jurisdiction reduces operations as a result of the distress of another member of the group based in a different jurisdiction) and 'wake-up call' (investors adversely affected in one jurisdiction withdrawing from other jurisdictions they considered relevantly similar to the first) effects. The result was the creation of additional cross-border channels for the transmission of risk and loss.

Since the GFC, an impressive cross-border regulatory architecture has been created, but significant lacunae remain. A brief assessment of this architecture, and of 'bail-in' requirements in particular, demonstrates the need for an international instrument to plug these gaps. The assessment draws inspiration from the treatment of globally systemically important financial banks ('GSIBs'). And it examines the particular approach of the UK, which is home to four and host to another 14 of the 30 banking groups characterised as GSIBs by global regulatory authorities. With such an outsized financial sector, the UK has an important stake in and perspective on the resolution of cross-border bank distress.

Post-GFC resolution approaches

As a matter of post-GFC consensus, the tools required for successfully resolving distressed banks are bail-in (conversion of particular types of unsecured debt into equity), a moratorium or 'stay' on contractual termination ('closeout') rights that become available simply because of the onset of distress or commencement of the resolution process, and the ability to transfer some or all of the business to a healthy buyer (or temporarily to a bridge bank).

Regulatory authorities led by the Financial Stability Board ('FSB') have identified 30 GSIBs with eleven home states. GSIBs have been identified using a combination of size of exposure, interconnectedness, lack of readily available substitutes for their services, cross-jurisdictional claims and liabilities, and complexity. Each GSIB is subject to higher capital buffer requirements, total loss absorbing capacity ('TLAC') made up of sufficient equity and debt to absorb losses and recapitalise relevant parts of the group without resort to taxpayer funds, group-wide resolution

planning and resolvability assessments, and higher supervisory expectations. Each GSIB is placed within the purview of a 'crisis management group' ('CMG') composed of relevant authorities in its home and key host jurisdictions.

Most GSIBs operate on a centralised basis, and their CMGs have agreed resolution strategies based on a 'single point of entry' ('SPE'). The remaining GSIBs operate through regionally distinctly managed and financed sub-groupings. Their resolution strategies envisage regional 'multiple points of entry' ('MPEs') that would replicate the SPE model at the respective regional levels and with unavoidable additional complexity. Under the SPE model, one group member – usually the holding entity – is subjected to a bail-in to recapitalise either it or the transferee of the distressed bank's critical functions. The closeout stay enables value to be kept within the distressed entity long enough to enable such a transfer, and consequent upon a successful transfer and in the absence of a subsequent substantive default, closeout rights are lost.

Bail-In: The UK approach

The Bank of England's November 2016 policy identifies three resolution approaches: (i) bail-in to keep the bank open, which would be necessary for the largest and most complex banks which would likely be performing non-substitutable functions and/or have businesses too large to be assumed by another; (ii) partial transfer for banks that perform significant critical functions in the financial markets and for whose businesses buyers might be found; and (iii) liquidation in all other cases. Banks likely to fall under the first of these approaches are subject to a TLAC about twice the minimum capital buffer, and TLAC resources must be subordinate to those liabilities that the bank must continue to discharge if it is to continue to perform critical functions. Banks likely to fall under the second approach are subject to lower TLAC requirements since only the critical parts of their business that are transferred would require recapitalisation.

Remaining lacunae

Two critical gaps remain in relation to the cross-border recognition of resolution measures. The first relates to the cross-border recognition of stays on closeout rights and respect of substantive rights in resolution so long as there is no substantive default under those contracts. This is accomplished through the ISDA Stay Protocol, examined by Prof. Pottow;

The second relates to the cross-border recognition of bail-in measures. Where liabilities that would otherwise be part of TLAC resources are governed by non-UK law, the Bank of England requires that the governing contracts include a term by which the creditor would agree to the Bank exercising bail-in powers. It quickly became apparent that this would not always be practical, such as when such clauses would be contrary to the governing foreign law. This has necessitated the Bank in June 2016 promulgating the aptly named "Contractual Recognition of Bail-in: Impracticability" document exempting banks from seeking to introduce recognition clauses. The resulting lacuna is manifest.

The need for an international instrument

An obvious solution lies in an international instrument providing for the cross-border recognition of both closeout stays and bail-in. As the author of the Model Law on Cross-Border Insolvency that provides for the recognition of and assistance for foreign insolvency proceedings, UNCITRAL has unparalleled experience in the creation of such an instrument and is uniquely placed to convene the required regulatory and legal expertise.