United Nations A/CN.9/WG.V/WP.109

General Assembly

Distr.: Limited
24 September 2012

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency Law)
Forty-second session
Vienna, 26-30 November 2012

Insolvency Law

Insolvency of large and complex financial institutions

Note by the Secretariat

Contents

V.12-56104 (E)

Background

1. At its forty-third session in June 2010, the Commission discussed a proposal to study the feasibility of developing an international instrument regarding the cross-border resolution of large and complex financial institutions (A/CN.9/WG.V/WP.93/Add.5 and A/CN.9/709, para. 5). It was agreed that the Secretariat should prepare a comprehensive report on all or any of a number of issues.[1] Because of the continuing nature of the work being undertaken both internationally and nationally on bank and financial institution insolvency and resolution regimes[2] and the volume of that work, it has been a challenge for the Secretariat to monitor all developments in detail. Accordingly, this paper focuses on paragraph (c) of that proposal and outlines the work that has been undertaken (and continues to be undertaken) by international organizations and regionally in the European Union. To some extent, paragraph (d) of the proposal has been addressed in some of the work of international organizations noted below. A second note by the Secretariat, providing details of selected national legal orders and analysing it in terms of the international standards promulgated by the organizations indicated below, particularly as they relate to cross-border issues, could be prepared, if requested by the Working Group, for consideration at its forty-third session in 2013 (see section IV below).

2. This paper considers work that has been undertaken (and is ongoing) by other international organizations, namely the Financial Stability Board, Basel Committee on Banking Supervision, the International Monetary Fund and the European Union. It also considers the relationship between that work and the completed work of UNCITRAL, both in the cross-border field and as it relates to enterprise groups.

I. Introduction

3. The insolvency of Barings bank in 1995 triggered a project conducted by the Group of Thirty, in cooperation with INSOL International, to examine issues that could arise in the cross-border insolvency of a financial institution. The final report, published in 1998, observed that there was no international framework for dealing with the supervisory, legal and financial problems that would arise in a cross-border

---

[1] *Official Records of the General Assembly, Sixty-fifth Session, Supplement No. 17* (A/65/17), para. 259. These issues included: (a) Identify the issues relevant for and particular to the winding down of large and complex financial institutions; (b) Establish a comparative study of selected legal orders in respect of mechanisms to ensure cooperation across borders in the course of a winding down of large and complex financial institutions; (c) Establish and summarize the work undertaken or being undertaken by other institutions, as well as the contents of any such work in this area; (d) Identify areas and legal issues where the principles established in the 2004 UNCITRAL Legislative Guide on Insolvency Law and the 1997 UNCITRAL Model Law on Cross-Border Insolvency could or should be applied directly or by analogy; (e) Identify possible alternative approaches for facilitating and ensuring cooperation across borders in the course of a winding down of large and complex financial institutions; (f) Issue recommendations in respect of possible future work by UNCITRAL or other bodies as well as national legislators or regulating authorities in the fields identified.

[2] Where "resolution" means the restructuring of an institution in order to ensure the continuity of its essential functions, preserve financial stability and restore the viability of all or part of that institution.

insolvency of any kind, and a major cross-border insolvency in the financial sector would therefore pose a substantial risk to the international financial system. The report contained 14 recommendations addressing disaster preparedness; licensing approval and supervisory review; the need for a range of insolvency and resolution tools with legislative support; cross-border cooperation, including information sharing and access and recognition for foreign insolvency representatives; master agreements for netting and legal enforceability of financial contracts; and cooperation between insolvency professionals and supervisors. The report mentioned the recently adopted UNCITRAL Model Law on Cross-Border Insolvency and, whilst acknowledging that application of the Model Law to financial institutions was likely to be limited because of the separate supervisory regime that exists in many countries for dealing with troubled financial institutions, the report nevertheless suggested that many of the principles of the Model Law would be applicable to financial insolvency.

4. The fast-moving global financial crisis that started in August 2007 illustrated that many of the inadequacies of the frameworks and tools available to address the insolvency of banks and other financial institutions and particularly for managing cross-border impact that had been identified in the 1998 study still existed. Since many systemically important financial groups operate globally, an uncoordinated application of resolution systems by national authorities has made it much more difficult to secure the continuity of essential functions and ensure that shareholders and creditors bear the financial burden of the resolution process, rather than the public sector.

5. The impact of the 2007 crisis led to calls by the G20[3] and others for regulators and relevant authorities to strengthen, as a matter of priority, cooperation on crisis prevention, management and resolution and to review resolution regimes and insolvency laws in the light of the recent experience to ensure they permitted an orderly resolution of large, complex, cross-border financial institutions. These calls arose from two related considerations. First, the establishment of an effective framework for the resolution of financial institutions is essential to any strategy that seeks to both secure financial stability and limit moral hazard and secondly, a resolution framework will be ineffective unless it is accompanied by a robust cross-border coordination mechanism.[4]

6. These calls led to work being undertaken by, among others, the Financial Stability Board (FSB); the Cross-border Bank Resolution Group (CBRG), a subcommittee of the Basel Committee on Banking Supervision (BCBS), Bank for International Settlements; the International Monetary Fund (IMF) and the World Bank and, at the regional level, by the European Union, as well as to legislative reform in a number of jurisdictions. A significant number of documents and studies have been prepared by different international and regional institutions; some of those are referred to in this paper and listed in the annex for ease of reference.

7. The discussion below highlights a number of the findings of this work and the recommendations for improving cross-border resolution of banks and financial institutions.

---

[3] Declaration on Strengthening the Financial System (London Summit, April 2009); Leader's Statement of the Pittsburg Summit (October 2009).

[4] International Monetary Fund report, June 2010, p. 5.

Defining a "financial institution"

8. The IMF paper notes[5] that for many international financial groups, a banking business will be their main activity. However, many cross-border banks exist within financial groups whose activities extend well beyond simple deposit-taking and lending to include a full range of non-bank financial activities. It notes that some of the most systemically risky international financial groups are, at their core, investment banks and broker-dealers that conduct little or no deposit-taking activity and that some financial groups are headed by large, internationally active insurance companies. Accordingly, such groups will comprise both regulated and non-regulated entities and the substantive elements of resolution mechanisms for bank and non-bank financial institutions will differ, even if the mechanisms for coordinating resolution action may be similar. In some jurisdictions, non-bank financial institutions may be subject to corporate insolvency law so that different parts of a financial group can be subject to different insolvency-related regimes.

9. The definition of what constitutes a financial institution is therefore an expansive one, depending on the jurisdiction, and many have defined the term to include a bank, an insurance company, an investment trust, a loan and finance company, and currency exchange firms.

II. Global initiatives: the work of international organizations

A. Financial Stability Board

10. In April 2009, the Financial Stability Forum[6] developed principles for cross-border cooperation on crisis management, based in part on the recommendations in the work of other organizations,[7] as well as lessons learned from the financial crisis, especially with respect to banks and other financial institutions. The FSF principles recommend that in preparing for financial crises, authorities should: develop support tools for managing cross-border financial crisis; hold annual meetings to consider issues and barriers to coordinated action that may arise in handling "severe stress at specific firms"; share information, particularly with respect to arrangements for crisis management, as permitted by the national legal frameworks of resolution authorities and by confidentiality constraints; encourage firms to maintain contingency plans and procedures for use in wind-down situations and funding plans; and work to remove practical barriers to internationally coordinated resolutions that might be identified, for example, when developing contingency plans. In managing financial crisis, authorities were recommended to: strive to find internationally coordinated solutions that took account of the impact of the crisis on the financial systems and real economies of other countries; share national assessment of systemic implications; share

---

[5] Ibid., p. 6.

[6] The FSF was succeeded by the Financial Stability Board, established by the G20 in 2009 to coordinate, at the international level, the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

[7] The FSF, BCBS, International Organization of Securities Commissions (IOSCO) and G10's Joint Task Force Report (2001) on Winding Down an LCFI (large and complex financial institution).

information as freely as practicable with relevant authorities from an early stage; discuss national measures as promptly as possible with other authorities when a coordinated solution could be found; and share plans for public communication with authorities from other affected jurisdictions.

11. It was noted that although the effects of the crisis had been managed at individual country level, it was paramount that international cooperation among home authorities be developed in order to control the systematic disruptions caused by the financial distress of highly interconnected and integrated firms. It was also stressed that authorities managing financial crisis should be mindful of the need to promote private sector solutions, using public sector interventions only when necessary to preserve financial stability and of the need to maintain a competitive international level playing field in the spirit of the Basel Accords.

12. In its 2009 call for action, the G20 had requested the FSB to explore the feasibility of common standards and principles as guidance for acceptable practices or cross-border resolution schemes, thereby helping to reduce the negative effects of uncoordinated national responses, including ring fencing.

13. In 2010, the FSB developed a set of recommendations on reducing the moral hazard posed by systemically important financial institutions (SIFIs) i.e. institutions whose distress or disorderly failure, because of size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.[8] The recommendations were that: all jurisdictions should undertake legal reforms to ensure an effective resolution regime is in place; each country should have a resolution authority responsible for exercising resolution powers; national authorities should consider recapitalization mechanisms (bail-ins) and write down tools; resolution authorities should be obliged to seek cooperation with foreign resolution authorities; for specific institutions, cooperation agreements between relevant home and host authorities should be prepared; recovery and resolution plans that assess resolvability should be mandatory; planning should be a continuing exercise; authorities should have the powers to require a financial institution to make changes to its legal and operational structure and business practices to facilitate implementation of resolution and recovery measures; resolvability under existing regimes and cooperation agreements should be an important consideration when host authorities determined changes to be made to a hosted institution's operations; relevant information should be maintained on a legal-entity basis; and use of intragroup guarantees should be minimized, while ensuring that global payment and settlement services are legally separable with continued operability.

14. In 2011, the FSB developed "Key Attributes of effective resolution regimes for financial institutions" (the Key Attributes), which were endorsed by the G20 in November 2011. The Key Attributes seek to establish international standards for effective resolution regimes and encourage international convergence and legislative changes will be required in many jurisdictions to implement them; implementation is to be the subject of ongoing assessment.[9] The standards relate to resolution

---

[8] FSB, Policy Measures to Address Systematically Important Financial Institutions, November 2011, para. 3.

[9] Ibid., para. 11. In October 2011, the FSB set up a framework to monitor implementation of these reforms, the Coordinated Framework for Implementation Monitoring, and to intensify public

powers, measures, and authorities and seek to cover any financial institution that could be systemically significant or critical if it failed, including holding firms, non-regulated operational entities within a financial group that are significant to the business of the group, and local branches of foreign firms. Domestically incorporated global systemically important financial institutions (G-SIFIs), which are defined as financial institutions whose distress or disorderly failure, because of their size, complexity and systematic connectedness, would cause significant disruption to the wider financial system and economy, should be subject to certain aspects of the resolution regime, including requirements for recovery and resolution plans, resolvability assessments and institution-specific cross-border cooperation agreements.

1. Resolution authority

15. The FSB proposed that each jurisdiction should have a designated resolution authority with legal and institutional capacities to implement resolution powers and measures. These authorities should have clear statutory roles, operate with transparency and independence and be able to enter into institution-specific agreements with resolution authorities from other jurisdictions. They should also be empowered to act to achieve a cooperative solution with foreign resolution authorities whenever possible. The host authority should have the powers to support a resolution carried out by a home authority, but also to take measures on its own initiative where the home authority fails to act or has acted without taking sufficient account of the need to preserve the host jurisdiction's financial stability. The legal framework should give effect to foreign resolution measures, either by way of mutual recognition or by taking measures that support and are consistent with the measures taken by the foreign home resolution authority.

2. Resolution powers

16. The FSB stressed the importance of granting resolution authorities wide-ranging resolution powers that will enable them to manage the financial entity in distress. Examples of such powers include transfer of assets, removal/replacement of management, suspension of payments, winding down a firm, and imposition of stays on the exercise of set-off, contractual netting and early termination rights. Resolution authorities should be ready to exercise their powers as early as possible when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. This intervention should occur before a firm is balance-sheet insolvent and its equity has been wiped out. Clear standards or suitable indicators of non-viability should be implemented to provide guidance on when firms satisfy the conditions for entry into resolution.

---

reporting on implementation. See Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability, Report of the Financial Stability Board to G20 Leaders, 19 June 2012.

3. Set-off, netting, segregation of client assets

17. The Key Attributes recommend that the legal framework for set-off, netting, collateralization and the separation of client assets should be clear, transparent and enforceable. Resolution authorities should have the power to temporarily stay the exercise of early termination or acceleration arising solely by reason of entry into resolution.[10] A stay should apply to unsecured creditors and customers, preventing, among other things, actions to attach assets or otherwise collect money or property from the financial institution, subject to certain safeguards such as protecting the enforcement of eligible set-off and netting rights.

4. Safeguards

18. The FSB proposed that resolution powers should be exercised in a way that respects the hierarchy of claims, while providing flexibility to depart from the general principle of pari passu where necessary to contain systemic impact and maximize value for creditors as a whole. However, there should be no discrimination against creditors on the basis of nationality, location of claims or the jurisdiction in which claims are payable and no creditor should be worse off than they would have been in a liquidation under the applicable insolvency regime. Directors should be protected for actions taken when complying with decisions of the resolution authority.

5. Funding of financial institutions in resolution

19. It was recommended that each jurisdiction should establish a resolution fund so that authorities are not forced to rely on public ownership or bail-out funds. Where public funds are required, strict conditions should apply to minimize moral hazard and allocate losses to equity holders, unsecured and uninsured creditors and the industry.

6. Legal framework conditions for cross-border cooperation

20. The document stresses the need for a statutory mandate to empower and encourage resolution authorities, wherever possible, to act to achieve a cooperative solution with foreign resolution authorities. National laws should not contain provisions that mandate national action as a response to foreign intervention or the initiation of resolution in another jurisdiction, unless effective cooperation and information sharing is in place. In exercising their powers, as noted above, resolution authorities should consider the impact on the financial institutions in other jurisdictions. They should have powers over local branches of foreign firms and be able to support resolutions by foreign home authorities, or in exceptional cases, be able to take the initiative where the home authority fails to take action or where that action takes insufficient account of local financial stability. Processes should be established to give effect to foreign resolution measures, such as by way of mutual recognition, and mechanisms to protect the confidentiality of shared information should be developed.

---

[10] The stay is discussed in annex IV to the Key Attributes.

7. Crisis management groups

21. At the international level, it is recommended that all G-SIFIs should maintain crisis management groups (CMGs) to enhance their preparedness for, and facilitate the management and resolution of, a cross-border financial crisis affecting the institution.[11] CMGs are to include representatives of supervisory authorities, central banks, resolution authorities, finance ministries and public authorities responsible for guarantee schemes and should cooperate closely with authorities in other jurisdictions where financial institutions have a systemic presence.

8. Institution-specific cross-border cooperation agreements

22. Use of institution-specific cooperation agreements between resolution authorities for all G-SIFIs is seen as key for monitoring those institutions. The agreements should, among other things, establish the objectives and procedures for cooperation through CMGs, define the roles and responsibilities of authorities in the recovery and resolution phase and during a crisis and set out processes for information sharing, development of recovery and resolution plans, conduct of resolvability assessments and provide for regular meetings and reviews.[12]

9. Resolvability assessments and recovery and resolution planning

23. Resolvability assessments[13] are seen as important for developing strategies to manage crisis financial systems. Group resolvability assessments should be carried out by home authorities and coordinated with the host authorities. These assessments should be complemented with recovery and resolution plans (RRPs), the essential elements of which are set out in the Key Attributes document.[14] RRPs are to be updated at least annually or where there are material changes to a financial institution's business or structure and should be regularly reviewed by the institution's CMG. They should also, particularly in the case of G-SIFIs, take into account the nature, complexity, interconnectedness, level of substitutability and size of the institution.

10. Access to information and information sharing

24. The last key attribute relates to access to information and its sharing. It is recommended that all legal barriers hindering access to, and exchange of, information by national resolution authorities, national central banks and supervisory authorities should be removed. To this end, it is proposed that systems should be put in place to enable (a) sharing of the information relevant for recovery and resolution planning, (b) sharing of information related to G-SIFIs, and (c) handling of sensitive information.

25. In responses to public consultation on the Key Attributes, the FSB expressed the view that while the legal framework for cross-border cooperation, the CMGs and the institution-specific cross-border cooperation agreements fell short of a

---

[11] In November 2011, the FSB released an initial list of G-SIFIs (see the annex to Policy Measures). The G-SIFIs are to meet resolution planning requirements by the end of 2012. The list will be updated annually and published by the FSB every November.

[12] The essential elements of these agreements are included in annex I to the Key Attributes.

[13] These assessments are discussed in some detail in annex II to the Key Attributes.

[14] See annex III.

binding framework for mutual recognition and international cooperation, they represented a significant step. It was acknowledged that the development of more binding mechanisms will not be feasible without first putting in place the convergent regimes and incentives to cooperation that should be delivered by implementation of the Key Attributes.

B. Basel Committee on Banking Supervision, Bank for International Settlements

26. In August 2003, the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements put in place the High-Level Principles for Cross-Border Implementation of the New Accord. The New Accord[15] was a set of guidelines aimed at establishing a framework for measuring capital adequacy and a minimum standard to be achieved by national supervisory authorities. Noting that coordination and cooperation was a major feature of the New Accord, the six high-level principles were developed to elaborate on this aspect. These high-level principles emphasized: the importance of recognizing and implementing national regulatory requirements for banks; the role of home country supervisors in overseeing a banking group on a consolidated basis; the need for requirements established by host country supervisors to be understood and recognized by banks operating through subsidiaries; and the need for coordinated approval and validation work and information sharing as an aspect of cooperation among home and host country supervisors.

27. From December 2007 to September 2009, the Cross-border Bank Resolution Group (CBRG) of the BCBS carried out an audit of legal and policy frameworks for cross-border crisis resolution. The objective of the exercise was to identify the lessons learned from the financial crisis which began in August 2007. Realizing that most of the measures responding to the financial crisis were taken on an ad hoc basis, in March 2010 the Committee prepared a report and a set of 10 recommendations — "Report and Recommendations of the Cross-border Bank Resolution Group"— for national authorities and policymakers to consider when developing legislation and policy on managing cross-border bank resolutions.

28. The report found that: many crisis management regimes are domestically focused and there is no multinational framework, creating tensions between the cross-border nature of financial groups and the national frameworks and responsibilities for crisis management, as well as between national assessments of how a cross-border situation ought to be addressed; the unmanaged growth, particularly cross-border expansion, of complex financial institutions has created problems in the absence of effective supervision of home authorities and where home authorities do not have the resources to respond to such crises; the fast-moving nature of the crisis and resulting time constraints has limited the use of formal supervisory crisis management tools and made cooperation between jurisdictions very difficult, if not impossible; there is a tension between the need for rapid resolution in the public interest and the position of shareholders — in some jurisdictions, special measures cannot be taken without shareholder approval; tension may be caused by the centralization of liquidity management within a

[15] Available at www.bis.org/publ/bcbsca.htm.

cross-border group; group structures create interdependencies within groups that regulators and others need to understand and monitor; cross-border financial institutions may be subject to consolidated supervision by the home authority, as well as to supervision and resolution of individual subsidiaries by the host authority; failure of cross-border institutions is likely to lead to insolvency proceedings for the component entities under different regimes in different jurisdictions serving different policies, priorities and objectives; primacy of national interests leads to a focus on the national part of a group for the benefit of local stakeholders and to potential ring-fencing of assets — while this may allow greater controls on capital, liquidity and risk management to ensure protection of host country creditors, at the same time it may create inefficiencies in the allocation of capital and liquidity within a group.

29. The recommendations developed by the CBRG emphasize the need for appropriate national resolution frameworks to be developed in order to maintain financial stability, protect consumers, limit moral hazard, promote market efficiency and minimize systemic risk. Those frameworks need to coordinate the disparate crisis management and resolution processes that apply to different business lines of financial groups, promote the continuity of systemically important functions and include appropriate tools such as powers to create bridge financial institutions, transfer assets, liabilities, and business operations to other institutions, and resolve claims. Convergence of national resolution tools and measures is recommended.

30. Resolution frameworks should address financial groups and conglomerates within national jurisdictions and promote cooperation among national authorities by developing procedures for mutual recognition of crisis management and resolution proceedings and measures, particularly those involving large interconnected financial groups. Recognition could be developed bilaterally or at regional or international levels.

31. Since the complexity of financial institutions can create problems for orderly and cost-effective resolution, the CBRG recommends that supervisors work closely with relevant home and host resolution authorities in order to understand how group structures and their individual components could be resolved in a crisis and, where those structures are too complex to permit resolution, to develop regulatory incentives to encourage simplification of group structures.

32. The recommendations also address advance planning for orderly resolution as a regular component of supervisory oversight that takes into account cross-border dependencies and the implications of legal separateness; cross-border cooperation and information sharing, both during normal times and for crisis management in times of stress; and strengthening of risk mitigation mechanisms, such as enforceable netting agreements, collateralization and segregation of client positions. In order to complete the transfer of certain financial market contracts to sound financial institutions, it is recommended that the operation of contractual termination clauses be delayed for a short period of time and that contractual rights to terminate, net and apply pledged collateral are preserved. Finally, the recommendations stress the need to provide clear options for the financial institution’s exit from public intervention.

33. While UNCITRAL’s work on enterprise groups is noted in the report as possibly informing work to improve the coordination of resolution proceedings of

financial groups, at the same time it is acknowledged that it does not address the many unique issues implicated in the resolution of financial groups. Nevertheless, national authorities and policymakers are advised to consider whether recommendations made by UNCITRAL in part three of the Legislative Guide on improving the efficiency of insolvency proceedings for corporate groups are applicable to insolvency proceedings of financial groups. National entities are also advised to provide for recognition of foreign insolvency measures, and access of foreign representatives to courts and assets of the debtor in the national entity's jurisdiction.[16]

34. The report also notes that one approach would be to take the steps necessary to establish a comprehensive universal framework for the resolution of cross-border financial groups, in which primacy could be accorded to the jurisdiction in which the institution is headquartered. The report notes that such a framework would need to address a number of complex issues, including some that have been addressed in the Legislative Guide — avoidance powers, treatment of intragroup claims, ranking of claims, rights to set-off and netting, the treatment of certain financial contracts, submission and admission of claims and distribution to creditors.

C. International Monetary Fund

35. In April 2009, the IMF and the World Bank prepared a study entitled "An Overview of the Legal, Institutional and Regulatory Frameworks for Bank Insolvency", which discusses the principal features of the legal, institutional and regulatory frameworks required to deal effectively with bank insolvency (i.e. only deposit-taking institutions) at the domestic level (cross-border bank insolvency issues fall outside its scope) in periods of financial stability and systemic crisis. The paper addresses types of bank insolvency proceedings available in times of financial stability, the powers and responsibilities of all agencies involved in those proceedings and the steps involved, as well as general considerations, institutional arrangements and regulatory and legal arrangements for systemic crisis management. The underlying rationale for the paper is that recent turmoil in the financial markets highlighted the importance of countries putting in place effective legal, institutional and regulatory frameworks for the resolution of insolvent banks. The paper notes that "while there is no firm consensus on a single standard or model that countries should employ in designing a bank insolvency framework, there is a growing recognition of many of the practices that should be observed for that purpose."[17]

36. In June 2011, the IMF published a paper entitled "Resolution of Cross-Border Banks — a proposed framework for enhanced coordination" in which it discussed the need for a framework for enhanced coordination to mitigate the effects of the uncoordinated application of resolution systems for international financial groups (which might include or be based upon a banking business, but whose activities frequently extend beyond deposit-taking to include a full range of non-bank

---

[16] This recommendation is consistent with UNCITRAL's recommendations on recognition of foreign proceedings and foreign representatives, and cooperation involving foreign representatives, Legislative Guide, part three, chapter III, recommendations 239-254.

[17] IMF and World Bank study, 2009, p. 13.

financial activities, many of which are conducted across borders) by national authorities. The paper responds to the call by the G20 leadership noted above (para. 5) and builds on the work of the CBRG. It also makes reference to the coordination and cooperation framework recommended in part three of the UNCITRAL Legislative Guide and to the UNCITRAL Model Law on Cross-Border Insolvency.

37. Against the background of the effects of the lack of coordination apparent in the handling of a number of financially distressed cross-border financial institutions[18] following the global financial crisis and the existing impediments to the development of a coordinated framework, the paper sets out four major elements aimed at achieving enhanced coordination. These are:

(a) Amendment of laws at national level to require national authorities to coordinate resolution efforts with their counterparts in other jurisdictions to the maximum extent possible, consistent with the interests of creditors and domestic financial stability. It is noted that countries with legislation that bars information sharing with foreign resolution authorities and encourages ring fencing may not be able to implement enhanced coordination without first amending their national laws;

(b) Adoption of core coordination standards relating to the design and application of resolution systems to facilitate use of an enhanced coordination framework, which are agreed upon and implemented by coordinating countries. This proposal is based on the argument that national authorities would only be willing to coordinate their activities if they had adequate confidence in their counterparts. Such coordination standards would include: (i) a minimum level of harmonization of national resolution rules, including non-discrimination against foreign creditors, effective intervention tools, and appropriate safeguards; (ii) robust supervision that would enable host supervisors to accept the leadership of home supervisors and be confident they could implement an international solution and to collaborate with other host supervisors; and (iii) institutional capacity to enable swift action across borders to implement an international solution;

(c) Minimizing the use of public funds and the specification of principles that would guide the burden-sharing process among cooperating authorities where such funds are required. One of the key objectives of the framework is that the final costs of resolution should be assumed by private stakeholders and that public bailouts are to be avoided. However, it is noted that the availability of private stakeholder financing may be limited and thus a combination of public and private sector funding may be required in some cases. Furthermore, it is pointed out that home countries may be unwilling or in some cases unable to provide support for an international financial group that is going through a crisis. Accordingly, host countries should be ready to provide funds to stabilize those financial institutions;

(d) The development, among countries subscribing to the enhanced coordination framework, of coordination procedures designed to enable resolution action with cross-border effect in a crisis. A clear understanding of who will play the lead role in the initiation and conduct of the resolution proceedings is required; it is proposed that that role be taken by the home country authorities and that a host

---

[18] These include increase in moral hazard, destruction of value in the financial institutions, financial instability etc., see IMF, “Enhanced Coordination”, p. 12.

country should accept the leadership of a home country that has similar coordination standards. However, the host country would also reserve the right to act independently, if to do so was required to ensure domestic financial stability. Consistent with part three of the UNCITRAL Legislative Guide[19] it is recommended that communication and sharing of information as early as possible is key to successful coordination. To achieve this, it is suggested that institution-specific and case-specific cooperation agreements, similar to those proposed in UNCITRAL's work,[20] would go a long way towards streamlining the modalities of communication.

38. The approach of a multilateral framework for enhanced coordination draws support from the CBRG report of 2010 that proposed a middle-ground approach to crisis management of cross-border resolution of financial institutions, as opposed to territorial (de-globalization of financial institutions) or universal approaches (a binding international treaty). The paper notes that, notwithstanding that specific features of corporate insolvency are not applicable to the financial services industry, such a multilateral approach could draw on the work of UNCITRAL in corporate insolvency (the Model Law and the Legislative Guide) as it deals with recognition of insolvency proceedings in foreign jurisdictions, cooperation among courts, insolvency representatives and use cross-border agreements when handling multiple cross-border insolvency proceedings in an enterprise group.

III. Regional approaches: the European Union

39. Over the course of the financial crisis, it became apparent that neither banks nor authorities in the European Union were prepared to address the issues that arose. Contingency planning was insufficient; not all Member States had the power to intervene, stabilize and reorganize ailing banks at an early stage; tools and powers to handle bank failure were inadequate; and the significant systemic damage caused by the failure of large, independent banks required authorities to use taxpayers' money for rescue. Most significantly, while the cross-border operation of banks has become highly integrated to the point where business lines and internal services are deeply interconnected across EU borders, the authorities' powers to intervene has remained national, leading to inefficient and potentially competing approaches to bank resolution.[21]

40. In 2009, the Commission announced plans for an EU framework for crisis management in the financial sector, together with a timetable for action (COM (2009) 561 final). The first stage was to adopt a legislative proposal on bank recovery and resolution (by mid-2011). The second step was to examine the need for further harmonization of bank insolvency regimes, with the aim of resolving and liquidating them under the same substantive and procedural rules (by end 2012). The third step would include the creation of an integrated resolution regime, possibly based on a single European resolution authority, which would depend on

---

[19] UNCITRAL Legislative Guide, part three, chapter I, para. 17.

[20] UNCITRAL Model Law on Cross-Border Insolvency, article 27; UNCITRAL Legislative Guide, chapter III, paras. 48-54 and recommendations 253-254; UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation.

[21] SWD (2012) 167 final, p. 2.

the adoption of a single set of substantive rules with respect to resolution and insolvency (by 2014). The process has involved several rounds of public consultation, close collaboration with the FSB and the G20 and monitoring of other international developments.

41. In June 2010, the European Parliament adopted an own-initiative report containing recommendations on cross-border crisis management in the banking sector (A7-0213/2010), which stressed the need for a Union-wide framework to manage banks in financial distress. In December 2010, the Council (ECOFIN) adopted conclusions calling for a Union framework for crisis prevention, management and resolution (17006/1/10), that should apply to banks of all sizes, improve cross-border cooperation and consist of three pillars — preparatory and preventive measures, early intervention and resolution tools and powers. At the end of May 2012, the Commission indicated that it will initiate a process to map out the main steps towards a full economic and monetary union (including), among other things, moving towards a banking union that includes integrated financial supervision and a single deposit guarantee scheme (COM (2012) 299).

42. On 6 June 2012, the Commission issued a legislative proposal for the recovery and resolution of credit institutions and investment firms (COM (2012) 280/3), which includes a draft directive. The proposal sets out the steps and powers, resources, operational capacity and expertise necessary to enable relevant authorities to address banking crises pre-emptively and ensure bank failures across the EU are managed in a way that avoids financial instability and minimizes costs for taxpayers.

43. The proposal consists of the three elements noted in the ECOFIN report: (a) preparatory steps and plans to minimize the risks of potential problems, checking the resilience of the financial institutions ability to handle “adverse economic developments,” (preparation and prevention), (b) in the event of incipient problems, powers to arrest a bank’s deteriorating situation at an early stage so as to avoid insolvency (early intervention), and (c) if insolvency of an institution presents a concern as regards the general public interest, a clear means to reorganize or wind down the bank in an orderly fashion while preserving its critical functions and limiting, to the maximum extent possible, any exposure of taxpayers to losses in insolvency (resolution). Resolution is intended to provide an alternative to normal insolvency procedures that will respond appropriately to the need to avoid disruption to financial stability, maintain essential services and protect depositors. It is also intended to remove the implicit certainty that has existed with respect to publicly funded bails out for financial institutions. The second and third stages emphasize the need to enhance cross-border coordination and cooperation as a key part of the framework. The powers discussed are to be available to relevant authorities in relation to any bank, regardless of its size or the scope of its activities.

44. The framework acknowledges the importance of cross-border groups as a driver for the integration of financial markets in the EU and establishes special rules for those groups in each of the above three phases, as well as for the transfer of assets between entities affiliated to a group in times of financial distress.

1. Scope

45. The proposal covers crisis management in relation to all credit institutions and certain investment firms in the EU. It will apply to holding companies where one or more subsidiary credit institutions or investment firms meet the conditions for resolution and where the application of the resolution tools and powers in relation to the parent entity is necessary for resolution of one or more of its subsidiaries or of the group as a whole.[22]

2. Resolution authorities

46. Member States are required to confer resolution powers on appropriate authorities with adequate expertise and resources to manage bank resolution at national and cross-border levels.

3. The three elements

(a) Preparatory and preventive stage

47. Each institution will be required to draw up a recovery plan setting out the arrangements and measures that will enable it to take early action to restore long-term viability in the event of a material deterioration of its financial situation; financial groups will be required to develop both a group plan and a plan for each group member. These plans are to form the basis of a "resolvability" assessment by resolution authorities; if significant impediments are identified, the institution or group may be required to take measures to address those impediments such as reducing complexity by changing its legal or operational structures, limiting maximum individual and aggregate exposures, and restricting or preventing the development of new business lines or products. Group resolvability is to be jointly assessed by all relevant resolution authorities and thus will require effective coordination and cooperation.

48. The proposed directive (recital 22) notes that the provision of financial support from one entity of a cross-border group to another entity of the same group is currently restricted under many national laws. Although those laws are designed to protect the creditors and shareholders of each entity, they do not take into account the interdependency of the entities of the same group or the group interest. Accordingly, the proposal makes provision for group members to extend financial support to other members in the form of loans, guarantees or provision of assets as security to a third party, based upon agreements drawn up and approved (in accordance with national laws) in advance of financial difficulties occurring. Such agreements are voluntary, allowing groups to assess whether such arrangements would be in the group interest and to identify the group members that should be party to the agreement. Where the liquidity or solvency of the group member providing the finance is threatened, the supervisor of that group member will have the power to prohibit or restrict the provision of that finance.

(b) Early intervention stage

49. The proposal expands the powers of the supervisors to intervene at an early stage where the financial situation or solvency of an institution is deteriorating,

---

[22] Explanatory memo, COM (2012) 280/3, p. 9.

which may include powers to request an institution to implement the arrangements and measures set out in the recovery plan, to draw up an action plan with a timetable for implementation, and to appoint a special manager to replace management of the institution.

(c) Resolution stage

(i) Triggering application of resolution

50. Common parameters for triggering the application of resolution tools are established. These allow action to be taken when an institution is already insolvent or very close to insolvency and if no action is taken, will become insolvent in the near future, provided there is no other solution that would restore the institution within an appropriate time frame and the resolution measures can be justified in the public interest.

(ii) Governing principles

51. The following principles are to be respected when implementing resolution powers. Shareholders must bear the loss first, with unsecured creditors bearing the residual losses. Creditors of the same class might be treated differently only if justified in the public interest and in order to underpin financial stability. Where creditors receive less than they would have received had the institution been liquidated under normal insolvency proceedings, they should be compensated for the difference from the resolution fund.

(iii) Resolution tools

52. A number of resolution tools are suggested, including sale of the business (sale of the whole or part of the assets of a credit institution on commercial terms without the consent of the shareholders or compliance with procedural requirements otherwise applicable); use of a bridge institution (temporary transfer of a part or the whole of the business of the financial institution to a publicly controlled entity, with a view to its ultimate sale); asset separation (transfer of the impaired or problem assets of a financial institution to an asset management vehicle for the purposes of ensuring their use and effective management); and bail-in (the writing down of the claims of some or all unsecured creditors of a failing institution and conversion of debt claims to equity).

53. The tools are to be used individually or in combination and may be supplemented by specific national tools and powers, provided they are compatible with the Union resolution framework and the Treaty and do not pose obstacles to effective group resolution (e.g. ring fencing of an institution would not be compatible with the framework).

(iv) Restrictions and safeguards

54. To ensure these tools can be applied effectively, a temporary stay on the exercise by creditors and counterparties of rights to enforce claims and close-out, accelerate or otherwise terminate contracts against a failing institution can be imposed. The intention is to provide a very short period (no longer than until the close of business on the day following its imposition) in which to allow the identification and valuation of contracts that need to be transferred to a solvent third

party, without the risk that financial contracts would change in value and scope as counterparties exercised termination rights. Transfer to a performing third party should not qualify as an event of default triggering termination rights. Authorities are prevented from cherry-picking (splitting linked liabilities, rights and contracts): either all linked arrangements (including netting and set-off arrangements, title transfer financial collateral arrangements, security arrangements, structured finance arrangements) must be transferred or none of them.

55. While concerned parties have a right to due process and the decisions taken by resolution authorities should be subject to judicial review, that review should not affect any administrative act or transaction concluded on the basis of a decision that might subsequently be annulled. Remedies should be limited to compensation for damages suffered.

(v) Cross-border resolution

56. Measures are included to require enhanced cooperation between national authorities, taking into account the division of responsibilities between home and host authorities, and the creation of incentives for applying a group approach in all phases of preparation, recovery and resolution. Resolution colleges with clearly designated leadership are to be established to develop group resolution plans, assess impediments to effective application of the resolution tools and powers, develop common approaches to the application of those tools, provide a framework for agreement on group resolution schemes, and coordinate decisions and actions by resolution authorities.

57. Where third countries are involved, Union authorities would have the necessary powers to support and recognize foreign resolution action with respect to a failed foreign bank and to apply resolution tools to national branches of third country institutions where separate resolution is necessary for reasons of financial stability or the protection of local depositors. Such support would only be provided if the foreign action ensured fair and equal treatment for depositors and creditors from a Member State and did not jeopardize financial stability in that Member State. Cooperation agreements with foreign resolution authorities will be required so that Union authorities can support those foreign authorities and ensure effective planning, decision-making and coordination in respect of international groups. Framework administrative arrangements should be concluded with third countries by the European Banking Authority and bilateral agreements in line with those framework arrangements should be concluded by national resolution authorities.

58. Lastly, it is proposed that a bank resolution fund be established by every Member State to cover costs incurred by resolution authorities in implementing resolution tools. The objective is to improve various aspects of cross-border cooperation and reduce the burden on taxpayers. Financial institutions and certain investment firms within each Member State are expected to contribute to this fund.

IV. The work of UNCITRAL and its relevance to bank and financial institution resolution

59. The level of activity focusing on bank resolution mechanisms that has been undertaken since the 2007 financial crisis recalls the activity on domestic

insolvency regimes that occurred following the financial crises of the 1990s to identify the weaknesses in those regimes and the best practices that should form the basis for legislative reform. That activity led ultimately to the development of the UNCITRAL Legislative Guide on Insolvency Law.

60. The work summarized above touches upon many of the issues discussed at that time, not only in the context of UNCITRAL's work on the insolvency of enterprise groups, particularly across borders, but also on elements of the Legislative Guide as it relates to domestic commercial insolvency regimes, albeit that in both cases that work did not touch upon the issues unique to financial institutions. Although the definition of "enterprise" in part three of the Guide notes that specially regulated entities not covered by insolvency law are not intended to be included, it is also noted that banks often form part of multinational enterprise groups.[23] Nevertheless, there are similarities, as noted in the IMF Report. Similarly, much of the discussion in the CBRG report on the difficulties of addressing financial groups echoes issues discussed by Working Group V in the preparation of part three of the Legislative Guide, particularly as they relate to the conceptual problems associated with corporate separateness and different legal approaches to the treatment of group interests, as well as to application of the concept of centre of main interests to enterprise groups and the need for extensive cross-border cooperation in insolvency.

61. Some of the common issues referred to in the work noted above include: the need for coordination and cooperation across borders and some form of recognition of foreign resolution activities that will accord legal effect; the usefulness of cross-border cooperation agreements, whether entity-specific or between supervising authorities; the need for funding and, in particular, for intragroup funding to be permitted under applicable laws; the need for the integrated treatment of groups and the challenges raised by the single entity principle; the need for effective standardized commencement criteria for bank resolution and for effective tools and powers to facilitate resolution; safeguards such as that no creditor should be worse off than in liquidation and that there should be no discrimination against creditors on basis of nationality or location; and the desirability of greater convergence of bank insolvency regimes or at least some specifics of those regimes, such as avoidance powers, treatment of ipso facto clauses, and application of the stay.

62. Although the IMF report identifies the need for a bank resolution framework to be included in an international treaty or binding legal instrument that could assure convergence of national resolution regimes thereby facilitating cross-border cooperation and coordination, the difficulties of developing such an instrument are noted — as they have been in UNCITRAL's work relating to treatment of cross-border groups. The possibility of developing such an instrument is part of the current mandate of Working Group V and remains to be addressed. In the absence of such an instrument, however, the approaches adopted in part three of the Legislative Guide and the Model Law on Cross-Border Insolvency indicate the best way forward, providing a source of inspiration for devising bank resolution mechanisms and addressing cross-border issues.

63. The work summarized above shows the emergence of a number of common principles that are to be reflected in the resolution mechanisms being developed,

[23] Legislative Guide, part three, para. 9.

such as those contained in the CBRG report and recommendations and the FSB Key Attributes, implementation of which is being monitored by the FSB. Legislation is constantly being developed. These recommendations and attributes may be viewed as performing to some extent a function with respect to bank and financial institution resolution regimes similar to the function performed by the Legislative Guide on Insolvency Law with respect to commercial insolvency law, addressing key objectives, core principles and other elements that should be addressed in an effective and efficient insolvency regime, albeit in somewhat less detailed manner.

64. The question to be considered in the light of the work outlined in this paper is the extent to which aspects of the proposal noted in paragraph 1 above might be pursued by UNCITRAL and in what manner. As already noted in paragraph 1, a second paper examining details of selected national legal orders addressing bank resolution regimes, particularly as they relate to cross-border issues, could be prepared for consideration at the forty-third session of the Working Group in 2013. Since that legislation should respond to the Key Attributes, information may be readily available from the FSB's implementation monitoring process and may indicate the progress that has been made, particularly with respect to cross-border aspects of the new regimes. A related issue for consideration might be the extent to which the work undertaken by the FSB and other organizations covers the field, particularly with respect to the establishment of cross-border recognition and cooperation mechanisms, whether applicable to individual financial institutions or to financial groups, and whether further study by UNCITRAL might be considered. Such a study could be relevant to further deliberations on the mandate of Working Group V, as noted above, insofar as it relates to the cross-border treatment of groups.

Annex

List of documents

G20

03/2009 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG 2)

Group of Thirty

1998 International Insolvencies in the Financial Sector, G30 Working Group, ISBN 1-56708-099-5, available from www.group30.org/rpt_22.shtml

Basel Committee on Banking Supervision (BCBS), Bank for International Settlements

Publications available from www.bis.org

08/2003 High-Level Principles for Cross-Border Implementation of the New Accord

09/2009 Report and recommendations of the Cross-border Bank Resolution Group — consultative document

03/2010 Report and Recommendations of the Cross-border Bank Resolution Group

Financial Stability Forum

04/2009 Principles for cross-border cooperation on crisis management available from www.financialstabilityboard.org/publications/r_0904c.pdf

Financial Stability Board (FSB)

Publications available from www.financialstabilityboard.org/publications

06/2010 Promoting global adherence to international cooperation and information exchange standards

07/2011 Effective resolution of systemically important financial institutions: recommendations and timelines — consultation document

10/2011 Key attributes of effective resolution regimes for financial institutions

11/2011 Effective resolution of systemically important financial institutions — overview of responses to the public consultation

11/2011 Policy Measures to Address Systematically Important Financial Institutions

International Monetary Fund (IMF)

04/09 (with the World Bank): An overview of the legal, institutional and regulatory framework for bank insolvency

06/2010 Resolution of Cross-border Banks — a proposed framework for enhanced coordination, available from www.imf.org/external/np/pp/eng/2010/061110.pdf

European Union

10/2009 European Commission: Communication on an EU framework for cross-border crisis management in the banking sector COM (2009) 561

2009 Commission Staff working document: An EU Framework for Cross-border Crisis Management in the Banking Sector (SEC 2009 (1407))

05/2010 European Commission: Communication on bank resolution funds COM (2010) 254

06/2010 European Parliament, Committee on Economic and Monetary Affairs: report with recommendations to the Commission on cross-border crisis management in the banking sector (A7-0213/2010), (Ferreira Report)

10/2010 European Commission, Communication on a new EU framework for crisis management in the financial sector COM (2010) 579 final

12/2010 European Council (ECOFIN): conclusions calling for a Union framework for crisis prevention, management and resolution 17006/1/10

01/2011 European Commission working paper (DG Internal Markets and Services): Technical Details of a Possible EU Framework for Bank Recovery and Resolution

05/2011 European Commission, Overview of the results of the public consultation on technical details of a possible EU framework for bank resolution and recovery

05/2012 Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank Action for Stability, Growth and Jobs, COM(2012) 299 final, available from http://ec.europa.eu/europe2020/pdf/nd/eccomm2012_en.pdf

06/2012 European Commission: Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms COM (2012) 280/3 and Commission Staff Working Document Impact Assessment accompanying that document, SWD (2012) 166 final and summary of the impact assessment SWD (2012) 167 final