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CROSS-BORDER RESOLUTION OF FINANCIAL FIRMS

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Key Points

- The absence of an effective international regime for cross-border resolution of financial firms led to the disorderly failure of a number of global banks during the global financial crisis (GFC), at a high cost to taxpayers and global financial stability.
- Many jurisdictions still lack sufficient resolution powers and arrangements for cross-border cooperation. The Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs) developed by the Financial Stability Board (FSB) should be fully implemented within the Group of Twenty (G20) and expanded to include non-G20 states.
- The FSB should develop a series of model laws on cross-border resolution and endorse a multilateral memorandum of understanding (MMoU) containing reciprocal commitments among the signatories.

Introduction

The 2007–2009 GFC demonstrated the importance of developing a robust framework for the resolution of cross-border financial firms. Inadequate legal powers and poor cooperation between national authorities led to the disorderly and costly failure of several financial firms. In many cases, the resolution of financial firms posed high fiscal costs that were ultimately borne by taxpayers and that exacerbated national and global financial instability (Bank for International Settlements [BIS] 2010). Reflecting lessons learned from the crisis, the G20 and the FSB have made concerted efforts to develop governance mechanisms to promote the timely, efficient and orderly resolution of financial firms in the future. The cornerstone of regulators' and policy makers' efforts in this area has been the development of an international standard for the resolution of financial firms by the FSB's KAs, which FSB members have committed to implement by the end of 2015 (International Monetary Fund [IMF] 2014).

As time runs out on FSB members' self-imposed deadline, the FSB's "Thematic Review on Resolution Regimes" suggests that member states are finding it difficult to implement some aspects of the KAs that are essential to achieving effective cooperation for the resolution of global systemically important financial institutions (G-SIFIs) (FSB 2013). The lack of political will to pass the necessary legislation is largely explained by the states' unwillingness to give up part of their financial sovereignty (Davies 2014). It is therefore important to supplement the KAs with effective safeguards, preventing governments from free riding or reneging on commitments (for example, to respect creditor hierarchies regardless of nationality). Such safeguards would help to ensure that cross-border cooperation is deemed to be a safer option to maintain national financial security than unilateral actions. This brief recommends that the FSB develop a model law on cross-border resolution and an MMoU in order to achieve full implementation of the KAs in as many jurisdictions as possible.

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Background

The GFC revealed that resolving G-SIFIs poses numerous challenges, stemming both from their asset size and structural complexity. In the case of Iceland, the failure of its banking sector greatly exceeded the state's economic capacity, forcing an emergency IMF bailout. Numerous other cases of resolving financial firms during the crisis highlighted that complex governance structures — including subsidiaries, branches and holding companies of individual firms across numerous legal jurisdictions — make orderly resolution impossible without *ex ante* cooperation arrangements and adequate powers in place (IMF 2014).

According to the IMF (2014), the crisis exposed three major gaps in international cross-border resolution regimes:

- national authorities lacked the appropriate tools and powers needed for orderly, cost-effective resolution;
- an inadequate framework for coordination and enforcement measures by foreign authorities; and
- a lack of capacity to allocate losses on banks' creditors without jeopardizing financial stability.

Involving public finances through bailout funding of firms in crises discouraged cooperation (ibid.). Even when *ex ante* crisis management cooperation arrangements existed, states were reluctant to follow through on their commitments due to huge levels of uncertainty and time pressure. Bilateral memoranda of understanding and MMoUs (such as the MMoU on high-level principles for cooperation in crisis management between EU member states) were largely non-binding, ridden with exemptions and ultimately ineffective. Thus, national jurisdictions took unilateral action as the rational choice to protect domestic financial security (BIS 2010; Davies 2014).

The crisis highlighted how national interests dominate global financial concerns, despite the integrated nature of the broader financial system. In cases where financial firms operating across borders became distressed or insolvent, governments protected their own depositors and creditors, without regard for other jurisdictions in which those firms operated (Davies 2014). The case of Iceland highlights the common practice of ring-fencing, as the Icelandic government protected only domestic creditors, leaving foreign creditors in the hands of the host authorities, where their branches were situated (Bloomberg 2008). However, in other situations, such as the US bailout of American International Group (AIG), governments rescued the entire cross-border group, which had spillover benefits for host states where their foreign arms operated (Davies 2014). This crisis demonstrated that national jurisdictions were willing to use public funds to save systemically important financial firms that threatened the stability of their domestic financial system.

Furthermore, they took unilateral and uncooperative actions to protect domestic depositors (ibid.). This incentive structure must be taken into account by financial regulators in their efforts to draft a working framework for cross-border resolution.

Post-Crisis Attempts at Reform

In the wake of the GFC, the FSB was tasked to develop and implement international financial standards (G20 2009). To this end, the FSB released its 12 KAs, which include:

1. Scope
2. Resolution authority
3. Resolution powers
4. Set-off, netting, collateralization, segregation of client assets
5. Safeguards
6. Funding of firms in resolution
7. Legal framework conditions for cross-border cooperation
8. Crisis Management Groups (CMGs)
9. Institution-specific cross-border cooperation agreements
10. Resolvability assessments
11. Recovery and resolution planning
12. Access to information and information sharing (FSB 2014a, iii)

The cornerstone of the national resolution regime described by the KAs is the resolution authority (RA), an administrative body responsible for safeguarding financial stability (ibid., 5). As both a prudential supervisor and a crisis manager, RAs undertake regular resolvability assessments for G-SIFIs within their jurisdictions, constructing firm-specific recovery and resolution plans (RRPs) with the input of senior management at the firm (ibid., 15–18). RRPs contain contingency plans for different scenarios wherein the firm experiences financial stress, including strategies in the event that the firm faces a critical liquidity shortfall. If the RA is not satisfied that a firm could feasibly be wound down in a crisis, it can ask the firm to address remaining issues, which could extend to mandatory restructuring or the dissolution of subsidiaries.

The KAs, particularly KA 3, call on members to give RAs wide-ranging authority to conduct resolution actions on insolvent or severely distressed SIFIs. Measures include (ibid., 6–10):

- appointing an administrator;
- transferring or selling the firm's assets or liabilities to third parties;
- overriding shareholder rights; and/or
- establishing a "bridge institution" to take over functions which are critical to the health of the financial system.

Furthermore, RAs should be empowered to conduct a "bail-in" of the firm in resolution, which entails recapitalizing the firm (or capitalizing a bridge institution) by imposing shareholder losses, writing-down unsecured creditor claims and/or converting unsecured debt into equity (ibid.). The RA should also hold power to stay temporarily early termination clauses in contracts otherwise triggered by the firm's entry into resolution.

Provisions for Cross-border Cooperation

The KAs also contain several provisions facilitating cooperation and coordination between national regulators. KA 7 states that RAs should hold statutory authority to support resolution actions taken by their foreign counterparts, including the transfer of assets from local branches to a bridge institution established by the home authority (ibid., 12-13). Such mutual recognition is critical when a firm faces resolution under the laws of its home jurisdiction, but has assets, liabilities, branches and subsidiaries in host jurisdictions. Equally important is the assurance that national laws and regulation complement any action taken by foreign RAs; thus, domestic legislation should not contain provisions that trigger automatic action as a result of proceedings initiated in another jurisdiction, and must ensure equal, transparent treatment of creditors without regard for their nationality or the location of their claim.

KA 8 calls for the establishment of a CMG for each G-SIFI, consisting of supervisory authorities from each jurisdiction home or host to the firm (ibid., 14). The CMG is responsible for conducting resolvability assessments, preparing RRPs and facilitating information sharing and coordination between regulators. KA 9 calls for CMGs to be buttressed with firm-specific cross-border cooperation agreements, defining the responsibilities of home and host authorities and coordinating information sharing and cooperation in both steady-state and crisis contexts (ibid., 14-15).

Such provisions are crucial to the efficient resolution of firms operating in multiple countries, but misaligned incentives have hampered their implementation. Reluctant to curtail their menu of policy options during a crisis, governments have yet to implement all of the KAs. Exacerbating this reluctance are national jurisdictions' concerns about sharing proprietary financial information with foreign regulators and apprehension surrounding the standardization of security frameworks and freedom of information requests. The credibility of international commitments remains problematic since, despite the long-standing principle of equitable treatment of creditors, many governments took unilateral action during the GFC to protect domestic shareholders over international creditors. In the words of former Bank of England Governor Mervyn King, international financial regulation proved to be "international in life, national in death" (quoted in Helleiner 2014, 159).

Assessment of Implementation of the KAs

Although the FSB has made impressive progress on defining and ameliorating the challenges facing the global financial system since 2008, particular issues surrounding the resolution of cross-border financial institutions necessitate further attention. A self-reported survey conducted by IMF member states in November 2014 showed the disappointing progress of multilateral implementation, with only a handful of states noting legislative success on issues of stays on termination rights, mechanisms to give prompt effects to foreign resolution actions and implementing full resolution powers. As the FSB itself notes, "only a few jurisdictions (Japan, Spain, Switzerland, US) report having bank resolution regimes that are fully or almost fully aligned with the Key Attributes. All other jurisdictions report having regimes that are not aligned in certain key areas" (FSB 2014b). Table 1 depicts the progress of member states.

Thus, despite the progress made since the development of the KAs in 2011, their implementation remains complicated by two factors:

- the difficulty of coordinating resolution processes across different domestic jurisdictions; and
- the interconnectivity between G-SIFIs and non-FSB membership.

Differences between bankruptcy procedures across G20 member states complicate the construction of legally enforceable transnational regulations. CMGs develop procedures to deal with insolvent cross-border financial institutions, but these policies must hold up to judicial review in each jurisdiction in which they take effect. Given the constricted time frame necessary for effective resolution, ensuring enforcement by all national authorities involved with the process is paramount. Legal uncertainty may threaten the efficacy of the CMGs' carefully crafted RRPs, undermining states' commitment to cooperative action.

In circumventing judicial challenges, the 2014 update to the KAs advocates strongly for the creation of contracts between firms as a workaround for competing domestic legislative processes. In defining resolution powers, the FSB has argued in favour of empowering RAs, including within Article 3.2 (iii) of the KAs that RAs hold power to "[o]perate and resolve the firm, including powers to terminate contracts, continue or assign contracts, purchase or sell assets, write down debt and take any other action necessary to restructure or wind-down the firm's operations" (FSB 2014a). Thus, RAs are assumed to have suprajudicial authority over the legal validity of pre-existing contracts.

Complicating this matter, the FSB has simultaneously advocated for a reliance on contractual clauses as enforcement mechanisms for firms in crisis. These contracts would inform the resolution process for when firms operating across judicial boundaries face crisis. Although not explicit within the KA, it can be assumed that contractual agreements between G-SIFIs regarding resolution could not be terminated by RAs, as outlined in Article 3.2 (iii).

The contractual approach advocated by the FSB is problematic. In empowering regulators to terminate certain pre-existing contracts while encouraging G-SIFIs to build contractual clauses regarding liquidity shortfalls, the FSB risks confusing the validity of contracts as legal bonds between parties. The legal viability of contracts — whether established *ab initio* in accordance with the KA or pre-existing within a firm undergoing resolution — must remain consistent throughout the resolution processes. The development of "tiered" contracts will only complicate attempts by national regulators and authorities to understand where a firm's assets and liabilities lie. The reliable enforcement of these contracts by national authorities — including the judicial system — is crucial to maintaining investor confidence and preventing contagion.

A further concern is the limited scope and constituency of CMGs. In the 2014 update of the KAs, the FSB recognized that far from being peripheral players, organizations such as insurance and financial market infrastructures play critical roles within the global financial ecosystem. In this spirit, further FSB recommendations should recognize the relative weight wielded by some non-G20 states in the global financial system. Thus far, these jurisdictions have been assumed to be ancillary, which complicates the effort to achieve a suite of policy recommendations with global scope. In recognition of this issue, the FSB established six regional consultative groups (RCGs), representing the Commonwealth of Independent States, Europe, the Middle East and North Africa, the Americas and Sub-Saharan Africa. Intended to facilitate discourse between FSB member and an estimated 70 non-member states, the substantive nature of discussions held within RGC groups has not been made publicly available. The incorporation of states into country groups reflects a tangible improvement, but opportunities for increased collaboration exist.

Table One: Implementation Status of Select Aspects of Resolution Regimes for Financial Institutions

FSB Jurisdiction	Existence of resolution regime and administrative RA (KA 1, 2)	Resolution powers (KA 3)	Power to impose temporary stay on early termination rights (KA 4.3)	Resolution powers in relation to branches (KA 1, 7)	Mechanisms to give effect to foreign resolution actions (KA 7)	Non-discriminatory treatment of creditors (KA 7)	Information-sharing powers for resolution purposes and confidentiality protections (KA 7, 12)	Recovery and resolution planning for systemic firms (KA 11)	Powers to require changes to improve firms' resolvability (KA 10)
Argentina									
Australia			(B)	(B)					
Brazil		(B)	(B)					(B)	(B)
Canada		(B)							
China	(B)	(B)	(B)			(B)	(B)	(B)	(B)
France		(B)	(B)	(B)	(B)	(B)	(B)		
Germany		(B)	(B)	(B)	(B)	(B)			
Hong Kong	(B)	(B)	(B)	(B)	(B)		(B)	(B)	(B)
India	(B)	(B)	(B)	(B)	(B)	(B)	(B)	(B)	(B)
Indonesia	(B)	(B)							
Italy		(B)	(B)		(B)		(B)	(B)	(B)
Japan									
Korea									
Mexico								(A)	
Netherlands	(B)	(B)	(B)	(B)	(B)		(B)	(B)	(B)
Russia	(B)							(B)	
Saudi Arabia	(B)	(B)	(B)	(B)			(B)	(B)	(B)
Singapore									
South Africa	(B)	(B)	(B)		(B)	(B)	(B)	(B)	(B)
Spain									
Switzerland			(B)				(B)		
Turkey		(B)							
United Kingdom		(A)	(B)	(B)	(A)	(A)		(B)	
United States									

Source: Adapted from FSB (2014b).

Current implementation status

- Implemented
- Partially implemented
- Not implemented
- Not applicable

Status of pending reforms

(A) Reforms agreed but not yet in force

(B) Reforms under development

Recommendations

The resolution of cross-border financial institutions challenges the hope of a consolidated regime of global financial management. Thus, the FSB faces a twofold challenge:

- encouraging adherence to the KAs; and
- expanding the resolution regime to include non-G20 member states

To address this challenge, this brief recommends that the FSB develop a set of model laws on cross-border resolution and endorse an MMoU.

Model laws have been used to promote regulatory harmonization in cases where international "hard law" is insufficient or inappropriate, most notably by the UN Commission on International Trade Law (UNCITRAL). The UNCITRAL model law on cross-border insolvency has been adopted by 22 states, including the United States, United Kingdom and Japan. Another inspiration is the International Organization of Securities and Commissions (IOSCO) MMoU, developed to encourage transnational cooperation on securities and futures regulations. The FSB should develop a series of model laws, focusing on:

- information sharing;
- recognition of foreign resolution processes;
- harmonization of creditor hierarchies;
- bail-in provisions, including the enforcement of bail-in proceedings initiated in another jurisdiction;
- stays on the exercise of termination rights; and
- a technical assistance program, funded through a modest levy on members, which could provide support to states lacking internal capacity.

To facilitate implementation, the FSB should construct an MMoU reflecting the principles of the KAs and the model laws. Beyond the key features identified above, the MMoU should develop a common standard for what constitutes a threat to financial stability, thereby fostering consistent decision making. As signatories agree only to respect its provisions in regards to other signatories, potential for free riding is limited. States thus far reluctant to pass legislation — be it regarding information sharing with foreign regulators or granting recognition to the actions of foreign RAs — could join the MMoU with the assurance that it will only involve coordination with states ensuring reciprocal commitments. To support adherence to the MMoU, the FSB should follow IOSCO's example in establishing two groups of signatories (referred to as "Annexes" here, as in IOSCO's terminology):

- "Annex A" would constitute full signatories, with demonstrated proof of national laws meeting the requirements set forth in the MMoU.
- "Annex B" would constitute jurisdictions who have expressed their intent to comply with the requirements of the MMoU and become full signatories. Annex B countries would be eligible for technical assistance to help with implementation.

The addition of a third group, non-compliant states, could leverage "naming and shaming" to place additional pressure on states to adopt the necessary reforms. With the participation of the world's largest financial markets, signing the MMoU should have a coercive impact as a signifier of good global citizenship, with reputational benefits (in addition to broader systemic stability) encouraging broader participation both within and beyond the G20.

Global macroeconomic decisions require broader opportunities for non-member state contributions, with such input critical to the future success of transnational regulatory coordination. The construction of a legitimate framework must include contributions by non-G20 member states, by inviting non-members to working groups, allowing non-FSB member states recognition at plenary, and assigning secretariats to specific regional groups. A bottom-up approach would allow for broader consultations with national authorities working with capacity limitations. Such processes would allow for the early integration of emerging economies, supporting the development of best practice as states develop domestic financial architecture.

Conclusion

When domestic governments and regulators react independently to a G-SIFI's failure, cross-border resolution is chaotic. Such unilateral action destabilizes the broader financial ecosystem, leading to a value-destroying cycle endangering public funds. Motivated by the tumultuous handling of failed firms during the GFC, G20 leaders empowered the FSB to develop a series of reform measures. To date, haphazard implementation across G20 member states continues to complicate effective reform. Most governments have designated RAs with appropriate domestic powers, but are reluctant to undertake the necessary legislative reform to ensure that cross-border planning, information sharing and resolution can occur.

This brief recommends a two-part strategy for the FSB to entrench the KAs and extend their scope beyond the G20. A series of model laws concerning such critical issues as information sharing, recognition of foreign resolution actions, harmonization of creditor hierarchies, enforceable bail-in provisions and stays on the exercise of termination rights would chart a path to legislative consistency. Subsequently, an MMoU reflecting the KAs and the model laws would serve as the stamp of legitimacy for states committed to reciprocity in upholding financial stability. Participation by non-FSB countries should be encouraged, with an expanded role for emerging economies in FSB initiatives such as regional and working groups. This strategy will develop a robust global regime for the resolution of cross-border financial institutions.

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