A GLOBAL APPROACH TO RESOLVING FAILING FINANCIAL FIRMS:

An Industry Perspective

Institute of International Finance
May 2010

Arrangements for dealing with failing financial institutions – at both the national and global level – need to be strengthened and clarified. It is necessary to move towards a situation in which it is possible for any firm, irrespective of its size or interconnectedness with the rest of the financial system, to exit the market without causing systemic disruption and without any expectation that taxpayers' money will be used. This will not be easy to achieve but a decisive strengthening and clarification of resolution arrangements is an essential first step.

The cornerstones of building a more resilient financial system are measures to reduce the likelihood that failures will occur in the first place and the systemic consequences when they do so. Enhanced regulation, higher standards for capital and liquidity than before the crisis, challenging and effective supervision and better internal industry practices will go a long way to reducing the likelihood of failure. Improvements in markets and infrastructure will make the financial system more resilient and able to withstand shocks.

But failures will occur from time to time and if this is to happen in an orderly way, the arrangements for resolving failed firms need to change. The development of recovery and resolution plans is an important step, which the Institute supports. There also needs to be a clear expectation that shareholders and unsecured uninsured creditors will bear the losses. All jurisdictions need to have special resolution arrangements which can be applied to failing financial institutions as circumstances warrant. And there needs to be significantly increased international convergence and coordination of national resolution arrangements.

If we are to have confidence in our ability to deal effectively with failing global firms, however, there is a need to go further and take decisive steps towards an international resolution framework. This report provides an outline of what such a global system might entail. It is fully recognized that putting such a system in place will be difficult and require a high level of political ambition. But there is a real need to make progress if we are to retain the wide range of benefits that the global financial system brings to businesses and citizens and avoid a retreat into national markets by re-fragmenting the globally integrated financial market – which is seen by some as the only alternative.

Resolving financial firms can involve additional costs beyond the losses to shareholders and unsecured uninsured creditors. These might include the administrative costs of

running the resolution, any loss of value to residual creditors as a result of the powers exercised by the authorities, and the possible need for working capital for a bridge bank. The industry recognizes that taxpayers should not be left out of pocket through bearing such costs and the Report examines ways to achieve this.

Finding a way through the issues will require a determination to overcome obstacles at both political and technical levels. For this reason, the report recommends the establishment, under the auspices of the G20 leadership, of a high level task force charged with setting out a roadmap for progress in this area.

The Institute of International Finance is pleased to provide this industry perspective on the many and complex issues involved, and looks forward to working with the G20, the Financial Stability Board, and other policymakers as they address these important issues in the period ahead.

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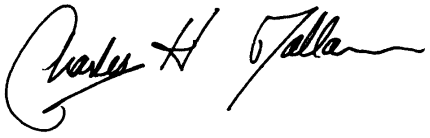

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Executive Summary

Resolution—a key lesson of the crisis

The recent crisis demonstrated vividly that many firms, while international in their approach, are dealt with on failure according to national, legal entity–focused insolvency rules. This is a source of weakness in the global financial system that needs to be addressed as a high priority. Resolution arrangements are key to market discipline. All firms should be able to exit the market in an orderly manner. There should be no expectation that taxpayer money will be used to support failing firms.

Effective national special resolution regimes are an essential prerequisite to ensuring the resilience of the financial system. Such systems need to be harmonized. But there is a need to go further, with the creation of an international framework on cross-border resolution. We propose the establishment of a high-level international task force acting under a G-20 mandate to develop this. The IIF is eager to collaborate fully with the official sector in getting to grips with the difficult technical challenges involved in putting in place an effective international resolution framework.

Since the crisis, a range of improvements has been introduced, including improvements in firms' risk management and governance arrangements, increased levels of financial resources in firms, enhanced supervision and measures to make markets and infrastructure more robust. These measures will be invaluable in reducing the likelihood of failures and in containing the consequences of future failures. But it is essential that these are both built on and supplemented with better arrangements for ensuring that when failures do occur, both the systemic consequences and the need for public money are minimized. There should be no expectation that failing firms will be "bailed out" or recapitalized using public money. Rather, the object is to ensure that any firm is able to exit the market in an orderly way.

Realistically, it will never be possible to have total confidence that the failure of a global firm will not have systemic consequences in particular circumstances or that there will be no need for government intervention, for example, when there is a widespread loss of confidence. But there is a great deal that can, and needs to be, done to minimize the possibility of such occurrences. And in working toward them, market discipline will be strengthened and moral hazard reduced.

Recovery and resolution planning

The development of credible and robust recovery and resolution plans is an essential starting point. An open and transparent process incorporating a broad dialogue between the official sector and the industry will be crucial. The objective of such exercises is to ensure that the necessary information is available to resolution

authorities to manage the winding-down of the firm and to assess the likely implications of this for financial stability. Each case will present different challenges.

The development of such plans may highlight issues connected to firms' structures. While a firm's approach to its organization and structure should be determined by its business model, improvements may be identified as a result of recovery and resolution planning. This should be the basis for a dialogue with supervisors but recovery and resolution planning should not be a pretext for imposing group structural requirements or for ring-fencing national markets.

Key features of resolution regimes

Shareholders and unsecured, uninsured creditors need to be clear that they will bear the losses in the event of a failure and to behave in a manner consistent with this. Effective resolution regimes will support expectations that stakeholders will not be bailed out, while expectations of no bail-out will reinforce the effectiveness of resolution regimes.

There should be no *ex ante* identification of a group of firms deemed systemically important. The need to utilize special resolution procedures should be determined on a case-by-case basis.

Resolution regimes must be designed to:

- Ensure that losses are borne by shareholders and unsecured, unprotected creditors;
- Give the authorities the appropriate range of powers for early intervention;
- Avoid moral hazard;
- Operate effectively in the context of an international resolution framework;
- Help eliminate the need for taxpayer money to be used to forestall failures or pay for the consequences of failure.

The authorities responsible for resolution need a range of powers, including those to:

- Replace the senior management of a firm;
- Order a financial restructuring with such instruments as forced debt-equity swaps or "bail-in" of unsecured debt-holders of the firm;
- Identify any parts of the firm that remain systemically vital (such as payment operations), and take the necessary steps to deal with these effectively. This

may involve transferring such parts of the group to third party acquirers or, if necessary, to a bridge bank;

- Delay the operation of termination clauses in favor of counterparties for a short period;

- Require the maintenance of outsourced services;

- Optimize outcomes for the creditors of the group considered as a whole;

- Coordinate strongly and effectively with resolution authorities of other jurisdictions in which the group is active.

Each jurisdiction must also have deposit and other consumer asset protection schemes that are adequate, credible, and reliable.

The need for an international framework for resolution

There needs to be an international framework on cross-border resolution. There should be established a high-level international task force operating under a G-20 mandate to develop a roadmap for an international resolution framework. Convergence of national resolution regimes is an essential requirement for ensuring that global firms are able to fail and exit the market in an orderly way. All major jurisdictions should have in place special resolution regimes with the principles and features outlined above. Work should also be taken forward as a matter of urgency to develop common criteria and standards for deposit and other consumer asset protection schemes in different jurisdictions.

Progress on the coordination of resolution proceedings is a priority. There should be a lead resolution authority responsible for coordination.

A global framework needs to address, among other things, the complexities arising from the distribution of global firms' assets and liabilities at the time of failure. To ensure equitable cross-border outcomes there should be further exploration of issues relating to integrated groups and the effects of legal entity–based resolution and insolvency regimes.

Innovative approaches should be explored for achieving equitable cross-border outcomes within a group consistent with appropriate creditor expectations. Among the mechanisms to be considered should be asset allocation techniques designed to unwind certain intra-group transactions.

The high level international task force should consider whether there is a need for a set of principles or criteria designed to address in broad terms the question of fairness in the allocation of assets between jurisdictions and entities in the context of the failure of a cross-border integrated financial group.

Resisting ring-fencing

The absence of an international framework for dealing with cross-border failures is partly responsible for the emergence of inward-looking "self-sufficiency" approaches to regulation and supervision based on ring-fencing of national entities, creating a serious risk of fragmentation of the global economy.

There is a consensus among firms that the organization and structure of a group should be determined by its business model. Approaches to regulation designed to ring-fence jurisdictions should be resisted. It is urgent that political will be mobilized in favor of ambitious but achievable international solutions to the problems of cross-border resolution. This would go a long way toward obviating the need for solutions involving ring-fencing.

Funding resolutions

A number of key principles should govern the question of funding resolutions:

- The risk of failures should be minimized and the consequences of failures for markets and counterparties contained through the strengthening of supervision and market structures.
- There needs to be discipline and consistency in ensuring that losses are borne by equity and nonequity capital providers, and by uninsured unsecured creditors. Nothing must be done that will lead to or encourage a general expectation among shareholders or creditors that they will be bailed out in the event of a failure.
- It is imperative that private sector solutions are sought wherever possible.
- There should be no expectation that costs will be borne by taxpayers.

The distinction should be made between liquidity and other financing needs. Central banks will continue to have a role in providing emergency liquidity at appropriate rates. This is quite separate from solvency support.

There is a significant range of sources of "internal" loss absorption. These should be fully utilized.

- Shareholders must be the first to incur losses;
- The potential contribution of contingent capital needs to be fully explored;
- There need to be appropriate levels of "gone concern" capital in the firm;
- Unsecured creditors should bear the losses that fall to them;

- Powers to preserve value by converting unsecured, uninsured debt to equity or "bail-ins" should be available;

- Private sector solutions should be sought so as to maximize value.

Notwithstanding all of the above, additional costs may result from measures necessary to preserve financial stability. They might include the administrative costs of running the resolution, any loss of value to residual creditors as a result of the powers exercised by the authorities, including the transfer of a systemic part of a firm's business (such as its payment activities) together with good supporting assets to a bridge bank and the possible need for working capital or guarantees for such a bridge bank.

The principle that payers' tax money should not be used to meet the costs of failing firms means that mechanisms need to be developed to allow for industry funding of any such additional costs.

Such funding mechanisms must minimize moral hazard, maximize fairness, and be practical in achieving efficient outcomes. There is a clear majority within the industry that *ex post* mechanisms for meeting the costs of failure are preferable to the creation of an *ex ante* fund. However, some firms, while seeing the case for *ex post* mechanisms, believe that *ex ante* approaches would represent a better alternative.

The majority consider that *ex post* solutions are desirable because they avoid the moral hazard that is likely to arise from the standing availability of a pre-paid fund that could be interpreted as a bail-out fund. An *ex post* approach is also regarded as potentially better able to place the responsibility for meeting the cost of avoiding potentially systemic events with the sections of the industry that may have been involved in creating the problem and/or those most likely to benefit from the solution. In addition, it is considered to make practical and administrative issues more tractable, particularly in a cross-border context.

The precise modalities should be developed over the coming period. Among the issues to address will be:

- Ensuring that the purposes of such funding are sufficiently well defined and tightly drawn so as to minimize moral hazard;

- Defining the perimeter of responsibility to achieve fairness and avoid inequitable burdens such as might be placed on emerging market firms;

- Defining the basis of contribution;

- Avoiding double counting. It will be necessary to avoid outcomes that have the effect of requiring firms to pay more than is equitable as a result of the complex interaction of parallel arrangements.

The international coordination of resolution funding is essential. The high-level international task force indicated above should have as a priority task the development of principles and criteria for the sharing of burdens between resolution schemes.

Section 1: Background & introduction

1. The achievement of long-term resilience of the financial system requires reform in a number of areas. Most fundamental is the need for better industry practices, enhanced regulation, improved supervision, and effectively functioning markets. Such improvements will reduce the probability that firms will fail and help to contain the consequences of such failures that do occur.

2. It is also necessary to adopt measures aimed at ensuring that every financial firm, whatever its size or the nature of its activities, can exit the market in an orderly fashion in the event of its failure and without the need for taxpayer support. This means that the system itself must be made resistant to the effects of such failure and that there needs to be clarity that the shareholders and unsecured, uninsured creditors of a failed firm will be required to absorb its losses.

3. Under its Special Committee on Effective Regulation, the Institute has established a Working Group on Cross-border Resolution to develop thinking and recommendations in this area.

4. The Institute has previously responded to the Basel Committee's *Report of the Working Group on Cross-border Bank Resolution* and to the European Commission's *An EU Framework for Cross-border Crisis Management in the Banking Sector*.[1]

5. As indicated in those responses, the Institute has continued to work to develop as a matter of priority a more complete industry perspective and proposals for reform in this area.

6. The Financial Stability Board (FSB) has announced its intention to develop as a high priority a package of measures to address the "too big to fail" problem. One of the projects comprising this effort is to improve "the capacity to undertake an orderly resolution of a failing firm." The FSB has stated that a preliminary assessment and possible policy options will be presented to the June G-20 Leaders Summit.[2]

7. It is against this backdrop that the Institute has prepared this report and submitted it to the FSB. The report and the proposals contained therein should

[1] http://www.iif.com/regulatory/.
[2] FSB Press Release, January 9, 2010.

not be considered final. The subject is highly complex and many layered, and work is continuing in the Institute and elsewhere. It will never be possible to have complete confidence that failures of major firms will not have systemic consequences in particular circumstances or that there will be no need for government intervention, for example, in the case of a widespread loss of confidence. But there is much that can be done to minimize the possibility of such occurrences. We believe that the proposals set out in this document provide a firm direction for travel and a clear prescription for progress that can immediately be made in a number of important areas.

Introduction and objectives

A key lesson of the crisis

8. Many lessons have been and continue to be learned from the recent crisis. These include the need for the industry to address the weaknesses and failings that have developed in the practices of many firms. Regulation needs to be strengthened and the supervisory relationship between many firms and their supervisors to be made significantly more effective. Over the past two years, considerable progress has been made in a number of these areas.

9. However, a further essential lesson of the crisis has been the need to ensure that all financial firms, whatever their size and scope of activity, can exit the market in an orderly fashion. Failure of a firm should not cause systemic trauma to the financial system or the wider economy; nor should the avoidance of such trauma necessitate any form of bail-out by governments.

10. The absence of effective resolution mechanisms was a major contributor to the development and intensification of the recent crisis and the highly damaging effects flowed from it. The belief that certain firms were too big to fail caused risk to be mispriced in the period leading up to the crisis. Fear that the system was ill-designed to cope with the failure of very large financial firms was one of the main causes of the dislocation that occurred in particular during the latter part of 2008. It is essential to eliminate, to the greatest extent possible, such moral hazard from the system.

11. There is an inevitable tendency on the part of the authorities to seek through overregulation to compensate for the absence of well-functioning market discipline and to protect taxpayers against losses. Effective resolution is a key component in ensuring systemic resilience and financial stability while retaining the benefits of a well-functioning and efficient financial system.

12. This applies at both the domestic level and internationally. If markets are to function effectively, it is necessary that nationally focused resolution

arrangements form part of a global framework to facilitate the exit of internationally active firms.

13. In the absence of an international framework, some national authorities, rightly or wrongly, fear their jurisdiction will be at risk of being disproportionately prejudiced in the event of a failure. Such thinking underpins the trend toward national self-sufficiency approaches to regulation and supervision that lead to fragmentation of international markets.

A generational opportunity: ambition needed

14. It is often said that achieving effective mechanisms for the resolution of large firms is difficult and that doing so for large cross-border firms is extremely so.

15. We agree that this is a very challenging area. However, a good deal of consensus has already been developed on many aspects during the course of the past eighteen months. We do not consider that the remaining difficulties are insurmountable. It is necessary to be both bold and practical in seeking a solution. This submission proposes an ambitious approach to the problem but one we believe is feasible and achievable within a reasonable period—given the appropriate political will.

16. At stake are two essential components of an international financial system making a strong contribution to sustainable economic growth. These are the operation of effective market mechanisms and well-functioning international financial markets based on reduced, not increased, barriers to cross-border activity.

17. The time is now ripe to build an international framework for the resolution of cross-border financial firms. To realize this generational opportunity, there should be established a high level task force bringing together finance ministries, justice ministries, central banks, and regulators at the most senior levels and operating under a specific G-20 mandate.

18. The objective would be the development and implementation of a road map, with the goal of establishing an international resolution framework for managing the failure of systemically important cross-border institutions. We believe that the establishment of such a task force would be a means of ensuring that the political will that currently exists to address this issue is mobilized and channeled to overcome the undoubtedly significant technical challenges.[3] This document is

[3] A similar concern appears to have informed the comments of Paul Tucker, chair of the FSB Working Group on Cross-border Crisis Resolution when he said recently: "I believe that top-level policymakers have to choose what kind of regime they want. This issue needs to be elevated above the level of middle-ranking technocrats where, through no great fault of their own, it has wallowed for too long." Remarks at the European Commission's Conference on Crisis Management, Brussels, March 19, 2010.

addressed to the international policymaking community. As such its emphasis is national jurisdictions and the international community that they comprise. While much of its analysis and many of its proposals are also likely to be relevant to the context of regional communities such as the European Union, it should not be taken as addressing the specific context of such communities. It is, however, important that regional solutions support rather than supplant a global one.

Structure of this submission

19. In this section, ***Section 1***, we set out the key objectives to be achieved and outline the key components necessary for achieving them.

20. ***Section 2*** considers recovery and resolution planning. The industry continues to view the development of recovery and resolution planning very positively. This is regarded as a key aspect of an effective resolution regime. The quality and design of these techniques will be key to success. The industry is keen to see development based on transparent processes and strong dialogue to share perspectives and experience.

21. ***Section 3*** addresses the question of the need for and key features of resolution regimes for dealing with the resolution of firms, the failure of which might, depending on the prevailing circumstances, give rise to systemic issues. There is a need for special resolution regimes of this kind in all jurisdictions. Section 3 discusses their scope and key features.

22. ***Section 4*** considers in more detail national self-sufficiency approaches to regulation and supervision and why the recent tendency toward increased adoption of inward-looking approaches by the authorities poses risks to the global economy. There is a strong global consensus among firms adopting very different approaches to group corporate structure, that corporate organizational issues should be determined in accordance with the business model of a firm. Regulatory or supervisory requirements to adopt particular structures to support ring-fencing jurisdictions should be avoided.

23. ***Section 5*** deals with the question of how to achieve effective cross-border resolution regimes. There is a need for an international framework for resolution. A High-Level task force should be established under mandate of the G-20 leadership to develop this as a matter of urgency. A multifaceted approach involving convergence of national regimes, coordination of resolution proceedings (including mutual recognition), and further consideration of the achievement of equitable cross-border outcomes is necessary.

24. ***Section 6*** deals with the question of resolution funding. This emphasizes the importance of losses being borne by shareholders and unsecured, uninsured creditors and the need to find private sector solutions to the extent possible. Any

additional costs of resolution should not be borne by taxpayers. The industry should shoulder this burden. *Ex post* mechanisms are preferred to *ex ante* to minimize moral hazard, reduce the practical difficulties, and optimize flexibility and fairness of outcomes.

Objectives and key components

25. The ultimate goal is to ensure that every firm, no matter what its size or the range of its activities, can exit the market in an orderly manner. Losses must be borne by shareholders, the providers of other forms of capital, and unsecured, uninsured creditors. This requires changes to the way in which failures are dealt and to the way in which markets in financial services operate. Such changes are necessary to achieve fully functioning markets free from taxpayer support.

26. As discussed in the companion paper to this one, *Systemic Risk and Systemically Important Firms: An Integrated Approach*, it is necessary that systemic risk be materially reduced through a range of regulatory, industry, supervisory, and market measures. These are designed to reduce the likelihood of failure and significantly increase the resilience of the system when faced with a failure. A key component to both the rendering of the system more resilient *ex ante* and ensuring that it can cope effectively with a failure *ex post* is effective resolution mechanisms. There is an important reinforcing self effect to be achieved: effective resolution regimes support expectations that stakeholders will not be bailed out, while expectations of no bail-out will support the effectiveness of resolution regimes.

27. Where the failure of a cross-border firm occurs, it is important that the mechanisms for dealing with resolution are consistent with the deepening integration of international financial markets. Convergence of resolution regimes and coordination of resolution measures are challenging but must be a high priority. An integrated international insolvency framework is a longer term goal, the achievement of which must be set in motion now. In the meantime innovative approaches capable of addressing some of the thornier cross-border issues should be explored and developed right away.

28. Key components will include:

- Limiting the risk of failure in the first place. This requires continued improvement in industry practices and well-balanced and resilient capital and liquidity management and structures building on the good progress already made; enhanced, risk-sensitive capital requirements; continued reform and ongoing improvement of industry practices (building on the good progress already made); effective supervision (including scope for decisive and early intervention); appropriate levels of capital and liquidity; balanced

and targeted regulation; robust infrastructure; and sound macroprudential oversight. [4]

- Providing the authorities with the full range of powers necessary to protect the public interest while minimizing the loss of value in a failing firm. This includes the power to intervene at an appropriately early stage.

- Operating in such a way that, in the event of the failure of a firm, losses are borne primarily by the shareholders and, as necessary, the unsecured, non-protected, debt-holders of the firm. This is essential to the reduction of moral hazard.

- Making a determination, on the basis of agreed principles and criteria and taking account of the relevant recovery and resolution plan, whether some aspects of the firm's business – such as its payment activities - are of systemic importance. These may need to be transferred as going concerns.

- Minimizing disruption to essential financial market infrastructure by the exit of a firm. Recovery and resolution planning, as well as infrastructural and systemic reforms, will also play a key role in this.

- Promoting investor confidence through losses being distributed on a predictable basis and in a manner that is legally clear, and fair amongst the different categories of shareholder and debt holder and amongst the individual shareholders and debt holders within those categories.

29. A roadmap should be drawn up setting out the necessary steps in the establishment of an international resolution framework to deal with the failure of firms which are systemically important in more than one jurisdiction or from an international perspective. A high level, cross-authority, group operating under direct G20 mandate, should be set up to undertake this.

30. Arrangements for the resolution of cross-border firms need to ensure fair and equitable outcomes. Stakeholders in one jurisdiction must not be disproportionately prejudiced as compared with stakeholders in another. This must be achieved in a manner consistent with the ongoing integration of international markets and should not result in approaches to regulation or supervision which seeks to ring-fence national jurisdictions.

31. While losses should be borne by shareholders and unsecured, uninsured creditors there may still be additional costs associated with the resolution and wind-down of a firm. These should be strictly limited – to administrative costs,

[4] For a detailed consideration of these and other changes necessary to build a more resilient financial system, see the companion report to this one: *Systemic Risk and Systemically Important Firms: An Integrated Approach*.

the cost of transferring systemic parts of the firm, working capital costs for a bridge bank. There should be no question of protecting creditors from appropriate losses.

32. Taxpayers should not be responsible for these additional costs. The financial industry, or the relevant part thereof, should be the appropriate source of any such funding. To avoid moral hazard, and the perception of a "bail out fund", such funding should be based on an *ex post* mechanism.

Section 2: Recovery and resolution planning

Industry's positive stance

33. As early as July 2009, the Institute spoke out positively in favor of recovery and resolution planning. In *Restoring Confidence, Creating Resilience*, we noted the merit in exploring contingency planning of this kind. In our responses to the Basel Committee's and the European Commission's consultations on resolution issues, we reiterated our openness and positive stance regarding recovery and resolution planning.

34. We continue to be very supportive of this concept. We believe that, done well, recovery and resolution planning can play a very positive role in ensuring that financial firms are able to exit the market without causing systemic disturbance.

35. We note, however, that while there are significant potential benefits associated with such planning, there are also risks if it is implemented in a manner that is not carefully considered and well balanced.

36. Resolution planning should not aim to produce some form of static blueprint or rigid plan game for dealing with hypothetical scenarios. Rather, it should be designed to ensure that the information necessary for resolution authorities to wind down a firm safely is available when needed.

Clarity as to responsibilities

37. It is important to keep the respective responsibilities of firms and authorities clear.

38. *Recovery planning* is primarily the responsibility of the firm. It involves effective and high-quality planning as to how the firm would achieve recovery in the event of a prolonged period of stress. The quality and effectiveness of such planning, including the appropriateness of the scenarios used, should form an essential component of the dialogue between the firm and its supervisor as part of the supervisory review process.

39. *Resolution planning*, on the other hand, should be primarily led by the authorities in dialogue with the firm. It is important to be clear that, in the event of the need for a resolution process it will be the authorities who will be in control of the process, with the firm playing an assistive role. This means that a firm will need to understand fully and clearly its own structure and organization as it relates to its ability to be resolved without causing material systemic damage and convey this to the authorities.

40. The main objective should be to ensure that the authorities are in possession of the necessary information in a usable form, to enable them to resolve the firm as quickly and safely as possible should the need arise.

Quality is key

41. It is essential to the success of recovery and resolution planning that the concept and its practical implementation remain sound and well judged. For example, a vision of "living wills," whereby firms are required to draw up some form of step-by-step instruction manual for their own dismantling is both misjudged in conception—in envisaging some kind of static state of the world that can be relied on for planning purposes—and wasteful of valuable resources.

42. We consider that an approach based on firms making available well-considered information concerning its business to the authorities should be pursued. The aim should be to ensure that authorities have a full understanding of a firm, its business, operations, and structures for resolution purposes, and that during the initial phase of a resolution when the authorities seek to take control they have a clear set of information on how the firm is organized and run, as well as key functions, people, and processes.

43. We do not support an approach whereby a wide range of hypothetical resolution scenarios is imagined and planned for in detail. These are unlikely to prove helpful resolution situation emerge. The way in which potential future failures unfold may not be known in advance.

44. Consideration needs to be given to the type of information that firms should be required to provide. It will be a challenging, although necessary task, to develop clarity about the precise nature and level of detail of the information that should be provided by firms to the resolution authorities.

45. It is essential that the approach to recovery and resolution planning be well coordinated internationally. This is important to avoid competitive distortions and also because a key challenge is the development of robust arrangements for effective resolution of cross-border financial firms. This challenge cannot be met if international groups are subject to different requirements by the resolution authorities in different jurisdictions.

46. For these reasons we welcome the fact that the Financial Stability Board has set up a dedicated Working Group on Cross-border Crisis Management and that a primary concern of this group is to consider issues relating to recovery and resolution planning. ,,

47. We note that in regard to some cross-border groups in some jurisdictions initial discussions on recovery and resolution planning have taken place between firms and their firm-specific crisis management group as part of an FSB-instigated exercise. We would note that there is a good deal of opacity surrounding this process—including the countries and authorities undertaking the discussions, the precise purposes of the exercises, and what the process will be to build on these initial discussions toward an internationally coordinated approach to recovery and resolution planning. We would encourage the FSB to continue this process but introduce a greater degree of transparency and dialogue into it.

48. The Institute has begun an exercise to draw together the experiences and thinking of its member firms in the area of recovery and resolution planning. It is proposed to build on these to further develop ideas and proposals in this area. We believe that the area of recovery and resolution planning is one that can benefit enormously from the sharing of ideas and thinking between the official and private sector. The area is a new one, and experience and thinking are developing rapidly. We would strongly encourage the FSB to engage in a well-structured dialogue with the private sector on this issue.

Group structural issues

49. The industry is clear that the essential purpose of recovery and resolution planning is to ensure that both firms and authorities are well positioned to handle the situation if and when a firm gets into difficulties. This should be possible in the majority of cases without the need for any changes to organizational structures.

50. A firm's organizational and legal structures should reflect and be determined by its business model. This is an important matter for management in the running of the firm. It is also the responsibility of management to have a clear understanding of the organizational structure; of the potential risks and benefits associated with this structure; and of the way in which the risks are managed and mitigated.

51. As regards recovery and resolution planning, management will need to apply the same "know your structure" principles in understanding how organization-related issues in recovery and/or resolution are to be addressed, and in providing the appropriate information and analysis to the authorities.

52. However, in going through the exercise of understanding and explaining its structure for the purposes of recovery and resolution planning, a firm may find that certain changes or alterations would make good business sense to bring the structure better into line with the firm's business model, or that a degree of simplification might be warranted where structures are unduly complex.

53. Firms remain very concerned that if regulatory demands for changes to organizational structure become a normal aspect of recovery and resolution planning, that will lead to a proliferation of requirements for change that could result in a significant mismatch between a firm's organizational structure and its overall business model. This is a real risk that could cause significant harm over the long run.

54. At the same time, firms recognize that organizational structure is relevant to effective recovery and resolution planning. It is reasonable for firms and supervisors to have regard to structural complexity within the organization. Normally, this will be taken into account in the planning itself. However, it is understood that there may be times when supervisors may express concerns that structures have become unduly complex. This should prompt a risk-based and balanced discussion about the possible need and scope for simplification.

55. To the extent that the need for improvements to group-wide structures becomes an aspect of discussions with supervisors, it is essential that they should be coordinated by the home supervisor in the context of the international supervisory college. Multiple or uncoordinated requests for organizational improvements should be avoided. Tax and other issues relevant to the balance of costs and benefits would need to be carefully taken into account.

56. Moreover, such improvements must not be used as a means of introducing national ring-fencing around group entities within different jurisdictions. The possibility of the latter is one of our greatest concerns, which we consider further below.

Danger that recovery and resolution planning will be used to fragment markets

57. As we discuss in the next section of this submission, one of the most worrying trends of the recent period has been the development of inward-looking, national self-sufficiency philosophies of financial regulation and supervision among some authorities.

58. There is, in our view, a significant risk that recovery and resolution planning will be used as a mechanism to impose on international groups a requirement for corporate restructuring designed to ensure that all firms follow a similar approach to the structuring of their groups and the management of their

businesses regardless of how this fits with their business models. As discussed further below, such an approach needs to be resisted.

Confidentiality of plans

59. There is concern that recovery and resolution planning carried out by firms might not be subject to appropriate rules of confidentiality. This might occur either by design or as a result of disclosure requirements in existing securities or company law. Failure to keep such planning confidential could result in an unjustified perception of vulnerability and fragility both generally and in respect to the particular firm concerned. Moreover, such plans would likely contain proprietary information concerning the firm's strategy, approaches, and organizational advantages. It is essential that appropriate governing rules be put in place to ensure the confidentiality of such planning.

Section 3: Special resolution regimes

Need for special resolution regimes

60. A range of methods and improvements needs to be deployed to ensure that the financial system is made significantly more resilient to the failure of systemically important firms. These include reducing the risk of failure in the first place and increasing the resilience of the system itself.

61. This needs to be achieved through better regulation, strengthened supervision, enhanced transparency, improved management of interconnectedness (including better management of counterparty risk from a systemic point of view), and more robust infrastructure. There also needs to be better preparation for the failure of financial firms, including the introduction of well-designed recovery and resolution planning. In the companion submission to this document, *Systemic Risk and Systemically Important Firms: An Integrated Approach*, we consider in detail the measures necessary to address systemic risk and create lasting resilience.

62. While improvements of this kind can significantly reduce the risk that the failure of a financial firm will occur or that, if it does, it will cause systemic damage, it is accepted that this risk cannot be eliminated entirely.

63. This means that it will be essential to have in place in each jurisdiction a resolution regime designed to facilitate the orderly exit of firms the failure of which would otherwise cause systemic difficulties ("special resolution regime").[5]

[5] While it is necessary to have resolution regimes in each jurisdiction, as discussed in Section 5, these should be closely coordinated internationally, should be the subject of an intense program of convergence, and should form integral components of a cross-border resolution framework.

While it will be desirable that such mechanisms are utilized as infrequently as possible, and that normal insolvency[6] rules should govern financial firm failures to the greatest extent possible, we do not believe in all cases the application of normal insolvency law will be sufficient to avoid systemic damage. It is for this reason that resolution regimes are necessary

Key principles

64. The key principles governing the design of such a regime should include the following:

- No financial firm should be should be considered too big to fail. By this we mean that firms that can no longer continue as going concerns must be able to exit with losses being borne by its shareholders, other capital providers, and unsecured creditors other than insured depositors.

- To achieve this requires not only an effective resolution regime, as described below, but also a more resilient system as described in the companion report to this one, *Systemic Risk and Systemically Important Firms: An Integrated Approach*, and a change in creditor behavior and counterparty risk management is based on the assumption that all firms can fail and that they will not be protected from losses. There is clearly a virtuous circle that needs to be created in this respect: effective resolution regimes will lead to changed creditor behavior, and changed creditor behavior, in turn, will reinforce the effectiveness of resolution regimes.

- Recourse to a special resolution regime should be very infrequent. This is likely for the following reasons:

    a) Firms' internal risk management practices, supervision, regulation, and the resilience of markets and infrastructure continue to be strengthened. As a result, the risk of failure is significantly reduced, along with the consequences of failures.

    b) Recovery planning and early intervention powers will operate effectively to avoid the ultimate failure of firms;

    c) The operation of the financial system—including the expectations of financial firm shareholders, subordinated debt holders, and unsecured, uninsured creditors—will have been rendered significantly more resilient to the failure of a financial firm.

[6] Throughout this document we use the term "insolvency" to refer to the situation whereby the value of the assets of an entity are insufficient to allow it to continue to meet its obligations as they fall due, the resulting requirement for it to cease trading, and the relevant body of laws governing this area.

- If, notwithstanding the above, it is judged in the circumstances that allowing a firm to fail using normal insolvency procedures would create systemic disturbance, powers should be available to take the steps necessary to maintain systemic stability.

- Such powers should be tailored to the prevailing circumstances but should be kept to the minimum necessary to secure the objective.

- There must be no expectation that shareholders and unsecured, uninsured creditors will be protected from losses.

- Private sector solutions should be pursued wherever possible to minimize pricing distortions.

- Resolution regimes should operate effectively, in the context of an international resolution framework, to manage the exit of cross-border financial groups.

Scope of special resolution regime

65. In describing the scope of a special resolution regime, it is necessary to make a distinction between those firms to which special resolution proceedings could, in principle, be applied and those to which such proceedings are, in the event, actually applied. Decisions on the latter would be taken on a case-by-case basis.

Determining the potential scope of a special resolution regime

66. Special resolution regimes should be available to be applied to all firms that have the potential—in the particular circumstances of their failure—to be systemically important. By this we mean those firms the failure of which, if governed only by the ordinary laws of insolvency, would have the potential to cause major damage to the financial system and wider economy.

67. As we have seen during the recent crisis, any firm can, in principle, be systemically relevant depending on the circumstances. Firms that might not be considered to be systemically relevant a priori given one state of the world might prove systemically relevant given a different state of the world. It is important that sufficient flexibility is retained for the special resolution regime to be available for use in regard to any firm or group[7] that might be considered systemically relevant given any particular contingent state of the world.

[7] Throughout this submission we use the phrase "financial firms" and its cognates to refer to entities *and* legal groups of entities engaged in financial service activities.

68. The special resolution regime should, accordingly, be available for use in respect to any firm subject to prudential regulation. As we have said elsewhere[8] the perimeter of "prudential" needs to be monitored and reviewed on an ongoing basis to ensure that it continues to reflect the changing patterns of risk within the system. Accordingly, this perimeter should also be appropriate to determine those firms to which the special resolution regime could in principle be applied.

69. Availability for use, however, certainly does not mean that the special resolution regime should in fact be used for the resolution of any particular firm. That depends on the particular circumstances prevailing at the time that the difficulties develop.

When a special resolution regime should be used

70. A special resolution regime should be utilized only in the case of the failure of a financial firm that would cause major damage, or the risk of such damage, to the financial system if that failure was governed only by the ordinary laws of insolvency.

71. We have said elsewhere that we consider it misconceived and dangerous to seek to formally identify *ex ante* a category of firms to be designated as systemically important. We are currently preparing a separate submission to the FSB on the question of systemic risk in which we will expand further on the arguments we have previously made on this issue.[9] Accordingly, we simply restate here our belief that the creation of such a category of firms is inappropriate because:

- Which firms are systemically important is to a very significant extent time and state dependent. As we have clearly seen during the recent crisis firms that would not be considered systemically relevant in normal circumstances can become highly so given certain prevailing conditions.

- Systemic risk is a multifarious, dynamic, and complex concept. To seek to address it using static, one-dimensional, and relatively crude concepts is likely to be not only ineffective but also to undermine efforts to bring more sophisticated approaches to bear.

- It could give rise to significant moral hazard and/or competitive distortion to create a category of firms formally identified as systemically important.

72. It is necessary, therefore, to determine whether the failure of a firm should be governed by the special resolution regime in the evolving and specific context of

[8] *Restoring Confidence, Creating Resilience,* IIF, July 2009, p. 56.
[9] See, for example, *Restoring Confidence, Creating Resilience*, July 2009 and our Responses to the Basel Committee and European Commission consultation on cross-border resolution issues at http://www.iif.com/regulatory.

that firm's failure. This will require determination by the designated authorities[10] on a case-by-case basis and in accordance with specified criteria as discussed below.

73. While retaining flexibility to respond to individual circumstances, it is important to incorporate as much predictability into the framework as is consistent with achieving the overall aims of systemic stability. Accordingly, it will be important to develop broad guidelines to govern the determination of whether the special resolution regime should be utilized in a particular case. The specific content of such guidelines is something that the Institute's Working Group will be considering further over the coming period and which we do not seek to specify in detail now. In broad terms, however, they should incorporate such elements as the following:

- The nature and degree of a firm's role in relation to key financial system infrastructure;
- The extent to which that infrastructure has been rendered resilient to the failure of important participants;
- The extent and nature of the firm's position as a "node" in the interconnectedness of the financial system—for example, as a derivatives counterparty, as a reference entity for determining the value of assets, etc;
- The extent to which financial system interconnectedness has been rendered resilient to the failure of such "nodal" participants;
- The prevailing stability of the financial system. If confidence is judged to be particularly fragile already, for example, it may be considered appropriate to manage the failure of particular firm under the special resolution regime rather than allowing it to fail in an "uncontrolled" manner, which could, in the circumstances, be a source of systemic risk.

"Trigger" criteria

74. In addition to such criteria governing the question of when the special resolution regime should apply as opposed to normal insolvency rules, it will also be desirable to develop detailed criteria governing the "triggering" of intervention by the resolution authorities.

[10] While we do not consider that it is necessary for this industry submission to address the question of precisely which authorities in each jurisdiction should be entrusted with this role, their input will certainly be required to be input from the firm's supervisor, the central bank as the liquidity provider of last resort, and the finance ministry as representative of the broader societal interest, including the fiscal interests of the state. It will need to be ensured that authoritative decisions can be made in an appropriately timely fashion.

75. There currently exists a body of rules governing the point at which an entity becomes insolvent (in accounting/bankruptcy terms). A number of criteria will need to be developed to guide the decision of the resolution authorities as to whether the point of intervention for special resolution purposes has been reached. This point of intervention is likely to be in advance of that at which a firm would become legally insolvent, as steps will be necessary to preserve value and to forestall the systemic damage that can be triggered as a firm approaches the point of insolvency. At the same time it ought to be, insofar as possible, not so much in advance of the point of insolvency that the rights of shareholders, creditors, and other stakeholders might be considered unduly abrogated.

76. It is important to note here that this "trigger point" for the application of special resolution wind-down measures represents a key point at one end of the spectrum of increasingly intrusive intervention measures that will need to be available to authorities. For example, among the early intervention powers that authorities should have should be the power to remove, replace, and/or add to the board of directors and members thereof, and/or senior management.

Key features of a special resolution regime

77. Here we set out a number of the key features that each resolution regime should contain to be effective. In general terms the key requirements for such a regime are that those parts of the firm that are essential to continued financial stability are able to continue to operate effectively, while the losses incurred by the firm are distributed appropriately among the equity holders and unsecured creditors (including unprotected depositors).

Protected transactions/contracts.

78. It is essential to the effective functioning of financial markets that certain contracts between the institution being resolved and counterparties be protected, that is, that different legs of the contract not be decomposed such that the counterparty is faced with unexpected exposures. In particular, the effectiveness of widespread and important risk mitigation techniques, such as close-out netting, and collateralization must be respected. To ensure the ongoing soundness and efficiency of global financial markets, the property and security rights of secured creditors must be fully respected. Consideration will need to be given to the precise range of transactions, contracts, and arrangements that should fall within this tightly defined and limited exemption.

Transfer of assets, liabilities, contracts.

79. In resolving systemically important firms, it will often be necessary to transfer certain assets either to a private purchaser or to a bridge bank for an interim

period. The aim should be to ensure that the financial system is not destabilized while maximizing the outcomes for creditors to the extent consistent with this.

80. For example, it will often be optimal to transfer the protected deposit liabilities of the failing firm. This will necessitate also transferring assets of a sufficient value to support those protected deposits.

81. Similarly, for a bank that is judged to be systemic as a result of, for example, its payment and settlement system activities, it may be necessary to transfer these activities to another firm or elsewhere. This would likely entail the transfer of relevant accounts along with sufficient assets to support the transactions associated with those accounts. It would also be necessary to ensure that the resources—personnel, operational, technological, etc.—are transferred or otherwise made available to the transferee entity.[11]

Delay of termination clauses.

82. To ensure that these objectives can be achieved we agree with the report of the Basel Cross-border Resolution Group[12] that resolution authorities should have the legal authority to temporarily delay immediate operation of contractual termination clauses in order to complete a transfer and promote the continuity of market functions.

83. However, such a period of delay needs to be kept to a strict minimum. Markets can move quickly during such periods, with the result that delays in the ability of counterparties to operate termination clauses can result in significant additional losses. To, it is essential that authorities are empowered to intervene early and can do so on a well-prepared basis so that any such delay is kept to a true minimum. Such delay periods should be harmonized among jurisdictions to avoid competitive issues or arbitrage opportunities as a result of variations among delay periods. Consideration needs to be given to the clear identification of the appropriate scope of such clauses. Moreover, the laws enabling such authority to delay should also protect netting provisions and avoid giving resolution authorities the ability to "cherry pick" among financial contracts between the same counterparties.

Powers to preserve value.

84. One of the factors that can contribute to a systemic shock arising from the failure of a financial institution is a significant loss of value that can be triggered suddenly and realized rapidly. This is particularly the case in the context of

[11] This will require that it be ensured that the authorities responsible for the winding-down of the rump bank are required and authorized to ensure the continued provision of any shared infrastructural, back - office, and other necessary support services that continue to be provided out of the rump entity.
[12] http://www.bis.org/publ/bcbs169.htm.

financial firms heavily engaged in complex trading activities. Paul Tucker has suggested in a recent speech the possible need for a "super special resolution regime" to help address this question.[13] Others have referred to the desirability of a power to require a creditors "bail-in".[14]

85. The idea would be to give the resolution authorities the power to "haircut" the claims of uninsured, unsecured creditors to provide funding for the recapitalization of the residual entity, thus allowing the entity to continue in business for a period and avoiding the unnecessary evaporation of value. The crucial feature is that haircuts/conversion would be applied upfront to creditors of a going concern. By contrast, under standard commercial banking resolution regimes, the "bad bank" goes into an insolvency process as a gone concern, with de facto haircuts applied to its creditors *ex post* after realization of the assets by the liquidator—a process that almost always destroys value.

86. While consideration of such a proposal is at an early stage—and there are challenges to be addressed—we believe that the incorporation of such a power in special resolution regimes is likely to be desirable and beneficial. Among the issues to be further developed is how to appropriately deal with possible creditor claims of disadvantage.

Other powers of the resolution authorities

87. The objective underpinning a special resolution regime is to ensure that the exit of a financial firm does not give rise to systemic difficulties while minimizing loss of value and abrogating the rights of shareholders and creditors to the smallest extent possible consistent with the primary goal. This will require that a range of further powers be available to the resolution authorities.

88. The earlier the intervention, the more likely it is that problems can be forestalled and loss of value kept to a minimum. On the other hand, early intervention can also give rise to more claims arising from what may be seen as unnecessary abrogation of stakeholders' rights. Accordingly, such powers will need to be given effect within a well-considered framework of constrained judgment supported by protection of resolution authorities from liability for actions taken in good faith.

89. Among the further powers that should be available to the authorities to ensure that these objectives can be achieved are the following:

- Early intervention power to order an increase in capital through the issue of new shares;

[13] Remarks at the European Commission's Conference on Crisis Management, Brussels, March 19, 2010.
[14] See article by Paul Calello and Wilson Ervin, *T*he Economist, January 28, 2010.

- Power to order a financial restructuring with instruments such as forced debt equity swaps or bail-in of unsecured debt holders of the firm;

- Power to require the maintenance of outsourced services;

- Power to order a right of priority in respect to unencumbered assets for a new credit facility made available, for example, by a private sector entity for liquidity provision purposes;

- Duty to coordinate strongly and effectively with resolution authorities of other jurisdictions in which the group is active.

90. *The rights of shareholders and creditors.* One issue that needs to be addressed is the appropriate allocation to certain creditors of the additional losses that might be envisaged to flow from the exercise of resolution powers, including the transfer of certain assets, liabilities, and contracts to preserve financial stability as described in the preceding paragraphs. The transfer of such "good" assets in the pre-insolvency resolution phase could result in additional losses to those creditors left behind in the failed institution. As discussed further in Section 5 below, to the extent such additional costs are incurred to preserve financial stability, it is not considered appropriate that they should be borne by the residual creditors.

91. Consideration should be given to providing wind-down administrators with the authority to optimize outcomes for the creditors of the group considered as a whole.

92. *Client assets.* It is important that the governing regimes in all jurisdictions be configured so that there is appropriate safety, predictability, and timeliness in the handling of client assets on the failure of a firm. On this issue, jurisdictions should coordinate their actions in line with International Organization of Securities Commission (IOSCO) recommendations and guidance—subject to consultation with investors, bankers, and custodians—to avoid unintended consequences.

93. *Effective component of an international framework.* As discussed in detail below, it is essential that national resolution regimes should operate effectively, in the context of an international resolution framework, to manage the exit of cross-border financial groups. There are a range of conditions that must be met for this to be achieved, and these are considered in detail below.

Deposit and other consumer asset protection schemes

94. Schemes to protect the position of defined categories of financial services users are key to ensuring the stability and resilience of national financial systems. It is essential that such schemes are credible and reliable.

95. Such schemes also play a key role in ensuring the stability of the international financial system. They increase the confidence of national authorities that stakeholders in their jurisdiction will not be prejudiced in the event of the failure of a cross-border financial firm. For example, it is essential that the authorities in a host country can be confident that the deposit protection scheme governing the depositors in a branch of a firm incorporated in the home country can be relied on to be available to these depositors in the event of the failure of the firm.

96. Significant divergences in the quality and reliability of depositor protection and similar schemes are likely to cause distortions in international markets—both in the context of the business as usual of failure and resolution. Accordingly, it is recommended that work be undertaken as a matter of urgency to develop common criteria and standards for depositor protection schemes to be applied in different jurisdictions.

The need for convergence of national special resolution regimes

Convergence is necessary…

97. Convergence of major jurisdictions' special resolution regimes incorporating the same key principles and features, combined with significantly enhanced cooperation and coordination between supervisory and resolution authorities, would significantly improve the scope for resolving cross-border financial firms effectively.

98. Such convergence must include as a key component the elimination of conflicting rules, such as those giving preferential treatment to creditors based on geographical location.

99. To take some simple examples:

- Coordination of intervention timing can help avoid distorted outcomes between jurisdictions;

- Elimination of conflicting laws and rules would reduce creditor uncertainty and sources of dispute and perceived unfairness;

- Agreement on which authority will take the lead role would greatly improve effectively coordinated outcomes designed to maximize value preservation and the need for support;

- Ensuring that all group entities continue to have access to key shared services such as IT networks and back office support can make a significant difference to value preservation.

100. Accordingly, we consider that a major effort is required over the coming period to achieve convergence and coordination of resolution regimes. All of the key features and powers of a special resolution regime as discussed above should be made available, at least in the major jurisdictions, within a limited timeframe.

…and challenging…

101. It is recognized that while it is easy to call for the convergence of national resolution regimes, this is very challenging to achieve. It is an area in which differences of views as to the appropriate approaches can be difficult to overcome. For this reason we believe that one of the first priorities of the high-level international task force called for below must be to seek rapid convergence of national resolution regimes. This is discussed further in Section 5.

…but not sufficient

102. However, there remains the question as to whether such convergence and coordination among national authorities can achieve all that is necessary to ensure effective cross-border resolution.

103. We note in this regard that the *Report and Recommendations of the Basel Committee Working Group on Cross-border Bank Resolution*[15] includes important proposals for the implementation of converged resolution regimes and enhanced cross-border cooperation and coordination. Nonetheless, even if all of this is achieved, that report "recognizes the strong likelihood of ring fencing in a crisis" -on account of the national basis of insolvency/legal systems and the absence of burden-sharing arrangements. It accordingly opts for an approach that "helps ensure that home and host countries as well as financial institutions focus on needed resiliency within national borders" (p. 5).

104. While regretting the fatalistic note struck by the Basel Committee report, we nonetheless share the analysis that convergence and cooperation, while important priorities to be achieved, are unlikely by themselves to be sufficient to eliminate the likelihood of ring-fencing approaches.

[15] March 2010.

Section 4: Self-sufficiency approaches versus further integration of international markets in financial services

105. Internationally active financial services firms adopt a range of approaches to their organization, group structure, and management. Some adopt more centralized approaches to their management, some less centralized. Some implement organizational structures that utilize local, legally separate subgroups to a greater extent than others that make a greater use of branches that are not legally distinct from the home country entity. Some implement approaches whereby local entities are self sufficient to a greater extent in terms of liquidity, capital, business and/or risk management than in the case of others.

106. All such approaches are equally valid. Which is appropriate for a given firm will depend on the type of business carried out and the business model adopted.

107. Irrespective of the approach adopted, member firms of the Institute are concerned about the increasing trend toward approaches to regulation or supervision that seek to achieve enhanced national resilience by reinforcing national boundaries.

108. At the same time the industry acknowledges that there are legitimate concerns that underlie such tendencies. These emanate from the absence of an effective system for dealing with the failure of cross-border financial groups, resulting in the perceived risk that in the event of a failure, stakeholders in a particular jurisdiction may be disproportionately prejudiced. In the next section we set out proposals for addressing this aspect of the matter.

General

109. The approach adopted by a firm to its organization, group structure, and management should be determined by and reflect the nature of the business carried out, and business model adopted, by each firm. No one approach is inherently better than any other and a requirement to adhere to a structure that does not reflect the requirements of the business will result in significant cost, inefficiency and risk. It is an essential aspect of an integrated international market that firms are able to expand the use of successful business models across borders to the benefit of all.

110. This, however, must be subject to a robust "know your structure" requirement; there should be no requirement that an internationally active firm adopt one or other particular approach to the structure or management of its international activities. That said, the management of financial services groups must clearly understand the nature and dynamics of the corporate structure adopted. They must have a clear grasp of the risks associated with that structure and how these

are managed. And they must be in a position at all times to communicate and explain that structure to both supervisory and resolution authorities. If these conditions are met, there should be no requirement that an internationally active firm adopt one or other particular approach to the structure or management of its international activities.

The meaning of "self-sufficiency" approaches to regulation and/or supervision

111. By "self-sufficiency approaches to regulation and/or supervision," we mean approaches whereby authorities seek to isolate their jurisdictions from events occurring in other jurisdictions. They seek to do this by imposing restrictions on the movements of assets or through requirements that must be met locally without placing reliance on the management and performance of the group as a whole.

112. The aim is to ensure that, in the event of the failure of an internationally active financial group, stakeholders in their jurisdiction, including creditors, depositors, and taxpayers, will not be disproportionately disadvantaged as compared with stakeholders in other jurisdictions in which the firm is active. Taking liquidity as an example, such an approach means in principle that not only must the group's liquidity be managed on a local, geographic basis, it must also be calculated on a "bottom up" approach whereby the liquidity requirements of each entity, or subgroup, are calculated entirely independently of the liquidity risk profile of the group taken as a whole.

113. A useful statement of the self-sufficiency approach to regulation is given by the UK FSA in the *Turner Review:*

"The failure of large financial cross-border banks clearly has global economic consequences; but throughout this crisis, fiscal support for potentially failing institutions has been organized on an entirely national basis…. Until and unless there is a willingness to change this approach and to move to a much more unified approach to global financial supervision and even fiscal support, mechanisms such as colleges of supervisors can make an important but still limited contribution….

"…the FSA will in [the] future be more willing to use its powers to require major international banks to operate as subsidiaries in the UK, to increase capital requirements on local subsidiaries, and to impose other restrictions on business operation.… But even if these arrangements cannot guarantee the survival of a subsidiary if its parent collapses, they can provide better for the orderly run down of the local subsidiary and improve the position of local creditors."

The need to resist fragmentation

114. The industry considers the intensified adoption of national self-sufficiency approaches to regulation an obstacle to the effective operation of international firms whatever their business model. As such it will work to the detriment also, of global and local economies and stand in the way of the restoration and maintenance of strong and sustainable global growth.

115. While firms adopt a variety of approaches to their organization and management in line with their business models, all are concerned by the increasing adoption of fragmenting or ring-fencing approaches by regulators designed to protect local economies in narrowly defined terms. Increased recourse to such fragmenting measures is inconsistent with maintaining and enhancing the integration of global financial markets.

116. Such approaches are founded in "prisoners' dilemma" thinking, whereby each jurisdiction acts to maximize its perceived outcomes (narrowly defined) on the assumption that other jurisdictions are also doing so. The result is the suboptimal outcome in which each seeking to maximize its own position leads to all becoming worse off. A logical conclusion of the adoption of national self-sufficiency approaches to regulation is that if one jurisdiction adopts such an approach, then others will follow until such approaches become the norm.

117. Internationally active firms, no matter what their approach to their organizational structure, and the economies they serve derive significant benefits from the overall strength, resilience, and efficiency of their group taken as a whole, provided, of course, these comply with the highest standards of governance, management, and control.

118. While firms may adopt different models and approaches to corporate structure, one of the many things that they hold in common is the adoption of "one firm," or "one brand," approaches to their management. The ability to run a group as a well-managed whole utilizing a common, optimized approach to business and risk management and, on this basis, to present a single face to clients is seen as an essential element in the success of such firms. This also is considered central to good corporate discipline and economic success.

119. The adoption of ring-fencing approaches would also prevent a group from effectively supporting its operations in different countries in a time of need by deploying assets and capabilities from across the globe. Recovery and resolution planning would, as a consequence, become intensely nationally focused; rather than taking into account the resources and possibilities inherent in the strength of the group as a whole.

Alternatives to self-sufficiency approaches to regulation

120. As mentioned above, it is clear that national self-sufficiency approaches to regulation and supervision are rooted in a concern on the part of national authorities that in the event of a failure of a large cross-border firm, stakeholders in their jurisdiction will be prejudiced to the benefit of stakeholders in some other jurisdiction or jurisdictions.

121. In the view of the industry, a clear implication of this is the urgent need to develop resolution regimes that are capable of ensuring the exit from the market, in an orderly and fair manner, of all firms, including large, internationally active ones. This would obviate the need for ring-fencing and other approaches that risk increasing fragmentation of the global financial system.

122. In the next section, the industry sets out its proposals for the effective resolution of cross-border firms. It is clear that an essential component in achieving success in this regard will be the political will to go beyond the measures that it has been possible to achieve up until now. The industry considers that there is a once-in-a-generation opportunity to achieve these measures, also an emphasis on self-sufficiency approaches to regulation saps political energy that should rather be directed to resolution issues and makes the resolution goals harder to achieve by undermining the "shared endeavor" nature of the problem.

Section 5: The resolution of cross-border financial firms

123. It is widely agreed that progress in the establishment of effective mechanisms for the resolution of cross-border financial firms is highly desirable. At the same time such progress has failed to materialize due to the difficulties—both technical and political—associated with the issue.

124. These difficulties are indeed considerable, but they are by no means insurmountable. We believe that we are confronted with a unique opportunity to change the landscape in this regard. To do this, however, a significant marshalling of political will is required.

125. To this end, the Institute believes that it is highly desirable that there should be established a high level international task force bringing together finance ministries, justice ministries, central banks, and regulators at the most senior levels. This taskforce should have the specific aim of reaching political agreement on the key outline of a new international framework on cross-border resolution. The taskforce should be given a specific mandate by the G-20 leadership to develop such a roadmap within a six-month period.

126. A number of different components are necessary to achieve the effective resolution of cross-border financial firms.

Establishment of an international resolution framework.

127. There comes a point when the development of practices and techniques have developed to such an extent that they begin to press up against the framework in which they have developed. At such points it is necessary to either redesign the framework or retreat from the continued development of those practices and techniques. The practices and techniques of cross-border banking appear to have reached such a point. There has now emerged a serious tension between the national character of the regulatory and legal frameworks within which they have developed and the international nature of the activities in question.

128. The issue, in short, is whether to require firms to configure themselves to national insolvency/resolution arrangements or to provide for insolvency/resolution arrangements that can respond to firms' cross-border organization and management. We believe the latter approach to be the right one because it leaves firms free to choose the mode of organization that best aligns with specific business models and thereby supports the further integration of global financial markets.

129. It is essential, in our view, that a new international framework for the resolution of systemically important cross-border firms be developed. Not only is such a framework necessary to ensure the effective functioning of international financial services markets, it can also provide the basis for a new phase in enhanced international coordination and cooperation in the regulation and supervision of such markets.

130. The creation of such a framework would require a strong political lead—in particular from the G-20; input from a range of regulatory, legal, and other disciplines; and international agreement on a set of arrangements that would prove effective in times of stress. To deliver this, it is highly desirable that there should be established a very senior level task force of representatives from finance and justice ministries, central banks, and regulators to develop and implement a roadmap for the progressive establishment of such a framework.

131. While such a roadmap would take time to develop and implement, there are a number of important components of a new international framework that could be developed and put into place over a short period of time. This in itself would constitute enormously significant progress and could be achieved largely on the basis of the political will to do so and without the need for the development of, for example, an international insolvency law. We exhort the international community to take immediate steps to implement these components.

Convergence

132. Convergence involves different jurisdictions moving toward the adoption of national resolution regimes based on similar concepts and incorporating the broad principles, functions, and features set out in Section 1 above. Achieving such broad convergence is important to ensuring that the authorities in each jurisdiction have confidence that the same principles and rules are being followed elsewhere and do not conflict with one another. Moreover, it is unlikely to be possible to effectively resolve large, cross-border institutions unless special resolution regimes incorporating the features described in Section 1 are implemented in each jurisdiction.

133. It is important to seize the opportunity to realize the progress on convergence that has been elusive for so long. It would represent a very significant step forward if real convergence was achieved in the powers available for early intervention, the powers available to wind-down a firm, the rules governing preference payments and priorities (including not giving preference to local creditors over foreign), and requirements for information sharing and cooperation.

134. One key aspect of convergence that would represent major progress would be the elimination of differences arising from provisions concerning the treatment of branches. Currently, there are a variety of approaches applying to the branches of entities located in different jurisdictions. These range from the "universal" to the strictly "territorial." It should be a matter of priority to seek convergence on this matter. Approaches that give preferential treatment to creditors based on geographical location should be relinquished.

135. As discussed above the implementation of adequate, credible, and reliable deposit and other consumer asset protection schemes is essential. It is recommended that work be taken forward as a matter of urgency to develop common criteria and standards for depositor protection schemes to be applied in different jurisdictions.

136. Achieving convergence of national resolution regimes in different jurisdictions is a key objective that should be taken forward as a matter of priority by the high-level international task force discussed above.

Enhanced coordination

137. Significant progress on the coordination of resolution proceedings also should be achieved in the period ahead. The concept of a lead authority should be developed and given effect. This authority would be responsible for coordinating actions among the resolution authorities from the different jurisdictions. The objective should be to avoid conflicting actions, to ensure that resolution

measures and steps are well coordinated, and to optimize outcomes for the creditors of the group considered as a whole.

138. As we said in our response to the consultation report of the Basel Committee's Working Group on Cross-border Bank Resolution,[16] we strongly support steps that move national authorities closer to mutual recognition of crisis management and resolution proceedings and/or measures in other countries. Based on conditions that include the need for reciprocity and a requirement for the equal treatment of domestic and foreign creditors it is, in our view, both appropriate and desirable that the resolution of a cross-border firm be effectively governed by the home state administrator.

139. This might be considered to be an approach somewhat in line with the idea of "modified universalism" recently put forward by Paul Tucker, the chair of the FSB Working Group on Cross-border Crisis Management, as a pragmatic approach that could be implemented.[17] A pure universalist approach is one whereby "home" authorities are endowed with complete authority to resolve the institutions for which they are responsible. A modified universalist approach relies to a greater extent on the deference of host authorities. As Paul Tucker puts it:

    "A 'modified' form of universalism would involve host authorities choosing to defer to and cooperate with a resolution brought by the home country authorities, provided that certain conditions held. Separate insolvency proceedings might be employed by host countries, but allowing the proceeds to be remitted to the home country, 'lead' resolution."

    This would depend on certain conditions being met, including the equitable treatment of all creditors regardless of their jurisdiction and broad harmonization of resolution regimes across the major jurisdictions.

Exploring equitable cross-border outcomes

140. Progress on convergence and harmonization of national resolution regimes and on the coordination of resolution measures will be very valuable. However, there remains a further issue that requires urgent consideration: that is, the potential tension that exists between international groups that adopt a more or less integrated approach to the running of their global business on the one hand and resolution and/or insolvency regimes that adopt a strict legal entity basis for their operation on the other.

[16] http://www.iif.com/regulatory./
[17] Remarks at the European Commission's Conference on Crisis Management, Brussels, March 19, 2010.

141. Many cross-border firms organize themselves along business lines and run themselves to a greater or lesser extent as integrated organizations. This means that, while legal personality issues are, of course, respected, resources can be deployed broadly throughout the group to achieve efficiencies.

142. Yet, in the event of a failure of the group (or entities within the group), it is the legal personality issue that drives the arrangements and the outcomes of the resolution and/or winding-up.

143. This means that there is a potential mismatch between the conception underpinning the ongoing business models and the conception underpinning the resolution model.[18] It is because of this that national authorities often regard themselves as being at undue risk in the event of a failure and are, in consequence, attracted by ring-fencing approaches to regulation.

144. To the extent that such a mismatch prevails, it runs the risk of giving rise to nonequitable outcomes. One example of where this might occur involves a group operating under a centralized liquidity management model that seeks, in the period leading up to the point of failure, to deploy assets as effectively as possible in different parts of the group to increase its resilience as stresses emerge from different directions. That groups should do this may be desirable from an overall systemic stability perspective, but it may give rise to potentially worsened outcomes for some creditors in the context of a legal entity-by-entity approach to resolution and/or insolvency.

145. A global framework needs to address, among other things, the complexities arising from the distribution of global firms' assets and liabilities at the time of failure. This issue should be the subject of priority consideration over the coming period. There should be two components to this work: first, identifying in detail the nature and scope of the issue, and, second, exploring innovative and workable solutions to address it.

(i) The nature and scope of the issue

146. Concerning the nature and scope of the problem, it is necessary to identify in detail the modalities of the relationship between different approaches to the management of cross-border groups and the legal entity–based nature of resolution and insolvency regimes, as well as to consider the implications thereof. Consideration might be given to the type of transactions that are in question, how they are treated from a regulatory and supervisory perspective, and how they are considered from a resolution or bankruptcy point of view.

, *The Economist,* January 28, 2010.

147. There is a widespread belief that the more integrated the approach of a cross-border group to its management and organization the greater the degree of tension that arises with resolution and bankruptcy frameworks that are predominantly national in scope. We believe that there will be considerable merit in exploring this issue further so as to define more precisely the lines of the issue and thus provide a firmer basis for a possible solution.

148. The IIF's Working Group on Cross-border Resolution will be working further on this issue over the coming period. It would be desirable for the official sector to also take up this issue as a matter of priority, and the IIF stands ready to collaborate fully in this endeavor.

(ii) Exploring possible solutions

149. To the extent that this work sheds further light on the details of the problem, it will be necessary to give consideration to innovative approaches to resolving it. The objective would be to develop approaches that achieve equitable cross-border outcomes which are in line with the reasonable expectations of creditors. This is important to provide national authorities with the confidence that in the event of the failure of a cross-border firm, stakeholders in their jurisdiction will not be disproportionately prejudiced.

150. As we have indicated, it is a key requirement of effective resolution regimes that losses be borne by the shareholders and the uninsured, unsecured creditors of that firm. This means that a primary aim must be to ensure that equitable results are achieved for the shareholders and creditors in the different jurisdictions. (To the extent that there may arise additional costs associated with the resolution, and therefore the need for external funding, it will also be important to find ways of ensuring that this is also achieved on an agreed-upon and equitable basis among the resolution funding arrangements in the different jurisdictions. This is discussed in more detail in Section 6.)

151. We believe that there is potential to develop practical solutions to this issue that would be on the one hand innovative while also capable of being developed and implemented in the short term without the need for an international insolvency regime.

152. What might be envisaged in this context is a mechanism to unwind certain transactions in advance of a bankruptcy or legal/accounting insolvency. The result would be to "reset" the distribution of assets and other sources of value within the group so that stakeholders in different jurisdictions are placed in an equitable position for the purposes of the resolution. The effect would be that the *starting point* for the resolution and distribution of assets would no longer simply be the location of the assets at the time of failure but rather an

alternative distribution based on certain criteria of reasonable expectation and equity.

153. A number of questions would need to be answered:

154. *How might such a mechanism work legally?* Conceptually, what could be envisaged might not be dissimilar to the settlement finality legislation that is used to ensure robustness in settlement systems. The essence of the settlement finality model is that a particular set of rules regarding asset allocation are implemented before the application of the ordinary rules of insolvency to determine the size and composition of the pool of assets to which the insolvency rules will be applied. In effect, an extra step is interposed in the process of resolving the failed entity, and the effect of that step is to reallocate assets either toward or away from it.

155. In the same way, it is particularly important to note that any such asset reallocation process would be separate from, and independent of, the applicable insolvency rules—one way of looking at it would be to say that it is given effect by the transactions concerned being deemed to have taken place the moment before the insolvency commenced. It will be necessary to have close regard to the expectations of creditors and ensuring reasonable certainty of outcomes.

156. *Where might the criteria for fair asset allocation come from?* It could be envisaged that a set of principles or criteria might be developed over the coming period designed to address in broad terms the question of fairness in the allocation of assets among jurisdictions and entities in the context of the failure of a cross-border financial group. These would then require specific application in the context of a particular firm by group-specific agreements made among the group's authorities in different jurisdictions. Legally, this would require a provision in the resolution regime in each jurisdiction giving effect to the asset allocation agreement made between the authorities.

157. *What might be the criteria for fair asset allocation?* This is the key question and the one that would need to be the subject of careful consideration. The starting point and key objective would be to ensure that the reasonable expectations of creditors are not undermined by approaches to management and organization that take a whole-group approach. Various approaches could be considered. For example, it might be sought to give effect to the longer term, stable distribution of assets across the group rather than the "snapshot" distribution that happens to be in place at the time of failure.

158. It is stressed that the above is no more than an outline of questions that need to be considered over the coming period. Thinking in the industry on this subject is at a very early stage. We have not yet sought to develop concrete proposals or a consensus around the precise issues to be addressed or the proposed way

forward. , In particular, consideration would need to be given to ensuring that no mismatch arises between creditors' reasonable expectations and actual outcomes achieved.

159. The Institute's Working Group on Cross-border Resolution will be working further on these questions over the coming period and looks forward to a continued dialogue with the official sector on the topic.

Section 6: Funding resolutions

160. Much discussion over the recent period has focused on the issue of the best way to approach the provision of funding for resolving failing firms and the consequences of crises more generally. This is an important topic that raises a number of challenging issues.

161. We take as an essential starting point that strong progress continues to be made in addressing the deficiencies and weaknesses that prevailed in the period leading up to this crisis. The objective is to design an optimal funding arrangement for a world in which regulation has been enhanced, supervisory relationships are strong, weaknesses in industry practices have been eliminated, infrastructure has been strengthened, and effective resolution regimes are in place.

162. In other words, the issue of resolution funding is located in the context of a reformed financial system significantly more resilient to systemic risk, and the introduction of a framework of resolution capable of facilitating the orderly exit of all financial firms whatever their size, scale, or the nature of their activities. Shareholders and creditors in such a world will manage their exposures on the basis that they will not be protected from their losses in the event of the failure of a firm.

Four principles

163. There are four key principles that form the underpinning of our approach to resolution funding:

    i. Avoiding failures in the first place must be the central focus and the main priority. As noted elsewhere in this report, continued improvement in industry practices, high quality regulation, strengthened supervision; robust infrastructure, and sound macroprudential oversight are key components in this.[19]

[19] For a detailed consideration of these and other changes necessary to build a more resilient financial system, see the companion IIF Report to this one: *Systemic Risk and Systemically Important Firms: An Integrated Approach*.

ii. There must be rigor in imposing loss on equity and nonequity capital providers and on uninsured, unsecured creditors. This may involve the use of a variety of instruments and techniques, including creditor bail-ins and contingent capital. Nothing must be done to encourage a general expectation among shareholders or creditors that they will be bailed out in the event of a failure.

iii. It is imperative that private sector solutions are sought wherever possible.

iv. To the extent that additional costs arise after losses have been absorbed by shareholders and unsecured, uninsured creditors and after appropriate steps have been taken to maximize the value of the assets of the firm, there should be no expectation that these be borne by taxpayers.

164. The distinction should be made between emergency, lender-of-last-resort liquidity provision and other funding provided to facilitate a resolution. The discussion set out below is concerned with resolution funding, not emergency liquidity provision as traditionally provided by central banks to (solvent) firms in difficulty. Central banks' role in emergency liquidity provision, at appropriate rates, remains the correct response to firm-specific liquidity problems.

Who bears the losses in an individual firm failure?

165. Firms will, and should, occasionally fail in well-functioning markets. The objective of the proposals set out in this paper is to ensure that firms can exit the market in an orderly manner without causing significant stress to the system as a whole.

166. As we have discussed, a primary aim is to ensure that losses incurred by the firm are borne by the shareholders and unsecured, uninsured creditors of the firm. This is essential to avoid a recurrence of the moral hazard that affected the system in the run-up to the crisis. ,

167. At the same time, however successful the attempt to render the overall system resilient to systemic shock, and to ensure that stakeholders carry the losses, it cannot be guaranteed that additional costs will not arise as a result of steps taken as part of the resolution to protect financial stability.

168. It is essential that such costs be kept to a minimum. Resolution arrangements and the funding of these must not undermine this goal. In particular, there must be no question of funding arrangements giving rise to a general expectation that stakeholders will be protected from their losses.

169. A natural corollary of the principle that taxpayers should not bear the costs of failure is that any such additional systemic stability costs should be borne by the

financial industry or the relevant segment thereof. There remain a number of very challenging issues that will need to be addressed.

Capital

170. Shareholders and other providers of capital need to be first in line to bear the losses associated with a firm's failure. As well as requiring appropriate levels of common equity and other "going concern" capital to help forestall failure, this means that appropriate levels of Tier 2 "gone concern" capital should be available to absorb losses once the firm has entered the resolution phase.

171. Consideration is currently being given to the various forms of capital, including preference shares and convertible debt, that should be included in the own resources of a financial firm. It is important that there is sufficient focus on ensuring that appropriate levels of loss absorption, including that on a "gone concern" basis, are available within financial firms' own resources to minimize the likelihood of the need for external funding to preserve systemic stability. There should be in place an adequate amount of gone concern capital to ensure appropriate loss absorption amongst the firm's stakeholders.

172. The potential contribution of contingent capital in addressing stress and/or failure in financial institutions needs to be fully explored in this connection.

Unsecured *creditors*—bearing losses, preserving value

173. In addition to ensuring that unsecured uninsured creditors[20] are not in general protected from the consequences of the failure of a firm, it is desirable to give further consideration to the introduction of new mechanisms to support the effectiveness of loss absorption by such stakeholders.

174. One source of significant losses that can turn a failure into a potentially systemic event is the rapid evaporation of value that can occur in face of the likely sudden cessation of a business, particularly in the context of complex trading activities. To the extent that such unnecessary loss can be prevented, the risk of systemic shock will be reduced and the need for further financial support reduced.

175. As we have discussed in Section 3 we think that there is likely merit in including in the powers of the resolution authority the power to intervene early to "haircut" the claims of uninsured creditors to provide funding for the recapitalization of the residual entity. Such bail-in approaches would allow a firm to continue in business for a period, thus avoiding the unnecessary evaporation of value.

[20] For clarity, it is not sought to address here the modalities by which insured creditors would be compensated.

Private sector solutions

176. It is essential that private sector solutions be found wherever possible when firms are failing. The authorities need to have, and to exercise, powers to transfer parts of a business to private third party acquirers. In this way the value of the business can be maximized and any possible need for external funding reduced.

Additional costs

177. Even in a situation in which maximum losses are borne by shareholders and unsecured, uninsured creditors, additional costs may arise as a result of necessary steps to preserve financial stability. To be clear, these costs should not include payments designed to protect stakeholders against their losses. Rather, they should be firmly limited and aimed at effecting the orderly exit and wind-down of the firm. They might include the administrative costs of running the resolution; making good any loss of value to the residual creditors as a result of the powers exercised by the authorities, including the transfer of a systemic part of a firm's business (such as its payment activities) together with good supporting assets to a bridge bank; and the possible need for working capital or guarantees for such a bridge bank.

178. As indicated above the industry considers that there should be no expectation that any such additional costs should be borne by the taxpayer.[21] The industry itself or the relevant part thereof should meet such costs. However, deciding on the best way for providing such funding poses many challenges and will require further close consideration.

The modalities of industry funding for additional costs

179. In developing the best mechanism for providing the funding that may be necessary to meet such additional costs that arise with the failure of a firm, there are a number of issues to be taken into account:

- *Moral hazard.* The mechanism adopted must not give rise to the expectation that shareholders and other creditors will be bailed out. This also implies that neither the firm nor its counterparties will be encouraged to behave in ways that might be based on such an expectation.

- *Fairness.* Any mechanism must adhere as closely as possible to principles of fairness. For example, it might be considered fairest that the greatest costs

[21] It is noted that attitudes vary from government to government with some approaches envisaging a possible role for government funds in certain circumstances. It is important that any such approach should not operate to increase moral hazard.

should be borne by that section of the industry most responsible for the risk that arose or that benefits most from the solution. .

- *Practicality.* The arrangements put into place must be capable of effective implementation, including on a cross-border basis.

- *Efficiency.* The solution developed should represent the most efficient use of resources and not give rise to undue opportunity cost.

180. Taking all of these factors into consideration, a clear majority within the industry is of the view that an *ex post* arrangement—that is, one in which the industry commits to provide funding after the event to meet any additional costs of a resolution necessary to secure systemic stability—would be the most practical and effective. However, some firms, while seeing the case for *ex post* mechanisms, believe that *ex ante* approaches would represent a better alternative.

181. The majority considers that, while any approach poses difficult issues, those associated with *ex ante* funding mechanisms are greater than those associated with an *ex post* approach.

- It is important to note that the very availability of a standing *ex ante* resolution fund could significantly increase *moral hazard*. Authorities may be less resolute in making the very difficult decisions that are likely to lead to creditors bearing their full share of losses if there is a fund on hand that could be used to bail them out. The existence of such a fund is likely to make it more difficult to establish a clear expectation in the market that firms will be allowed to really fail. For example, the existence of a fund of the amount envisaged by the IMF Interim Report (2%–4% of GDP—see below) would give rise to significant moral hazard.

- An *ex ante* approach would be potentially *less equitable* and responsive to the nature of the failure in question. Ideally, the costs of avoiding systemic failure should fall to those institutions that benefit most from such an outcome and, arguably, to those that may have contributed—even indirectly—to the failure. Such an alignment will never be perfect, but it may be more achievable with an *ex post* rather than an *ex ante* structure.

- To the extent that contributions to an *ex ante* fund were required from a limited and clearly identified group of firms, this could give rise to further moral hazard by creating a *list of paying firms potentially considered "too big to fail."*

- The establishment, maintenance, and disbursement of a global *ex ante* fund would inevitably raise many *difficulties of an operational, administrative, and*

jurisdictional nature, some of which could be mitigated by an *ex post* approach. Such difficulties would be particularly pronounced in the context of the resolution of a cross-border firm.

182. While generally in favor, therefore, of an *ex post* approach, the industry has identified a number of important issues that will have to be tackled to make such an approach operate soundly and effectively.

- *Moral hazard.* It will be essential that such an approach not be interpreted as on open-ended commitment that would, in the event, be used also for the purpose of protecting shareholders and creditors from losses. It will be necessary to define as clearly as possible in advance the purposes for which such funding might be used, possibly on the basis of a formal agreement with the industry.

- *Scope of responsibility.* While *ex post* mechanisms provide greater flexibility to tailor payment responsibility to the nature of the particular failure, nonetheless, it will be necessary to identify the scope of potential responsibility in advance. Which categories of firm should be responsible for which categories of failure? Should the boundary be drawn at the regulatory perimeter? Might it include others such as buy-side participants or rating agencies? There would be a need to avoid inequitable burdens on categories of firms, such as those from emerging markets.

- *Basis of contribution.* Work will be required to identify the appropriate basis for the calculation of amounts individual firms would be required to contribute.

- *No double counting.* It will be necessary to avoid outcomes that have the effect of requiring firms to pay more than is equitable as a result of the complex interaction of parallel arrangements in different countries. Consideration will need to be given to the interaction of established deposit and other consumer asset protection schemes and new resolution funding arrangements and to the interaction of arrangements in different jurisdictions, which is particularly important for cross-border groups.

International coordination.

183. International coordination of resolution funding is a key challenge. Achieving effective cross-border resolution depends on being able to ensure that funding will be available to meet any additional financial stability costs arising out of the failure of cross-border firms.

184. One of the significant obstacles to the achievement of burden-sharing arrangements in the past was the belief that any such agreement between

countries would carry the implication of the taxpayer standing ready to bail out shareholders and creditors, including in other jurisdictions. To the extent that "additional cost" funding is necessary only in the context of an overall resolution regime in which stakeholders bear the losses, this risk is minimized, particularly if agreement can be reached on an equitable distribution of assets and liabilities.

185. In this context it is believed that there is considerable scope for the authorities, under the auspices of the FSB, to develop criteria for burden sharing between funding resolution schemes. This would make a significant contribution to the implementation of an effective framework for cross-border resolution. We believe that this is something that should be taken forward as a matter of urgency by a high level international task force to be established under mandate of the G-20.