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LE BUREAU PERMANENT DE LA CONFÉRENCE DE LA HAYE DE DROIT INTERNATIONAL PRIVÉ DEVRAIT-IL ENTAMER DES TRAVAUX PRÉLIMINAIRES SUR LES ASPECTS TRANSFRONTIÈRES DE LA RÉSOLUTION ?

établi par le Bureau Permanent

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SHOULD THE PERMANENT BUREAU OF THE HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW START PRELIMINARY WORK ON CROSS-BORDER ASPECTS RELATING TO RESOLUTION?

drawn up by the Permanent Bureau

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Introduction

1. The collapse of large financial institutions (such as Bear Stearns, Lehman Brothers, the Icelandic banks, or most recently two Cypriot banks) that provide vital economic services to citizens, business and the economy at large (*e.g.*, deposit-taking, lending, and the operation of payment systems), and whose businesses most often have an important cross-border dimension, has revealed that many of these institutions have been regarded as "too-big-to-fail", because of the unacceptable economic and social damage which would result from their collapse under existing insolvency regimes. As a result, since the beginning of the financial crisis in 2007 many other large institutions which might otherwise also have failed have had to be bailed out, in most cases by using public funds.

2. This is widely agreed to be unsatisfactory, both because it entails taxpayers bearing losses that should be borne by shareholders and creditors and because of the moral hazard and competitive distortions that result from a perception that an institution will not be allowed to fail. Accordingly, national and global policymakers, in addition to introducing measures designed to reduce the likelihood of failure, such as enhanced supervision and increased capital requirements, have also been developing regimes intended to ensure that, if a major institution does nevertheless suffer losses that make it unviable, it can be quickly resolved in a way that avoids unacceptable systemic or wider economic damage and allocates losses more appropriately.

3. The key element of these efforts is the strengthening of national *resolution powers* and their cross-border implementation.

> The terms "resolution" and "resolution regime" are understood in a broad sense as referring to any action by a *national authority*, with or without private sector involvement, intended to *maintain financial stability and/or address serious problems in a financial institution that imperil its viability* where, absent resolution, the institution is no longer viable and there is no reasonable prospect of it becoming so.[1] At its simplest, resolution is a technique whereby *the losses of a non-viable entity are met by writing down its debts until its assets exceed its liabilities*. All insolvency operates by sharing out losses among creditors; the primary difference between resolution and insolvency is that resolution may provide for a rapid write-down sufficient to *restore the business of the institution to solvency* and therefore to continue as a going concern, thus avoiding the massive destruction of value, stopping contagion to other institutions, avoiding competitive distortion that flow from the expectation of taxpayer support, and preserving (global) financial stability.[2] Effective resolution regimes have been recognised as a critical component of any effective approach to addressing the too-big-to-fail problem.

4. In September 2009, the G20[3] committed at its Pittsburgh Summit to develop legislative tools and frameworks for the effective resolution of large financial institutions

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[1] See Basel Committee on Banking Supervision (hereinafter the Basel Committee), *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, available at < www.bis.org/publ/bcbs169.htm >, para. 21. The Basel Committee consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States of America. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.

[2] See Institute of International Finance, "Making Resolution Robust – Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions" (June 2012), p. 2. This document also contains a proposal for a draft Convention on resolution matters, which interestingly enough mentions the Hague Conference on Private International Law as a possible organisation to appoint an international mediation panel (see Art. 3(2)(d) of the draft Convention).

[3] Formally established in September 1999, the G20 brings together finance ministers and central bank governors from 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia,

and groups. In March 2010, the Basel Committee on Banking Supervision published a report and a set of 10 recommendations prepared by its Cross-border Bank Resolution Group (CBRG) (BCBS Recommendations).[4]

The "Key Attributes"

5. In November 2011, the Financial Stability Board (FSB)[5] adopted the ***Key Attributes of Effective Resolution Regimes*** (Key Attributes).[6] The Key Attributes set out 12 essential features that should be part of the resolution regime of all jurisdictions for any type of financial institution, including banks, insurers, securities and investment firms and financial market infrastructures, the failure of which could be systemically significant.[7] The implementation of these Key Attributes should allow authorities to resolve financial institutions in an orderly manner, in principle without taxpayer exposure, while maintaining continuity of their vital economic functions.

6. Further to the G20's endorsement, the Key Attributes now serve as an international standard for resolution regimes and as a point of reference for implementation or reform of national resolution regimes. In June 2012, the G20 reiterated its commitment to make national resolution regimes consistent with the Key Attributes.[8]

7. Under the Key Attributes, each jurisdiction is required to designate one or more resolution authorities. The key powers of the authority should include the ability to override the rights of shareholders, replace management and transfer the critical functions of a failing firm to a third party (*e.g.*, split a bank's activities into a "good bank" and a "bad bank", transfer all or part of its business to another bank or a specially formed "bridge bank"), to write down (or "bail in") claims against the bank such as those of senior creditors (which offers a means for rapid recapitalisation, avoids fire-sales of assets that disrupt markets, and offers a possible means to recover value for bailed-in creditors whose investments might otherwise be lost altogether in liquidation), or impose a temporary stay on the exercise of termination rights under financial contracts (subject to the safeguard that no creditor should be worse off than in liquidation).

Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States of America plus the European Union, which is represented by the President of the European Council and by Head of the European Central Bank. G20 members represent almost: 90% of global GDP, 80% of international global-trade, and 2/3 of the world's population lives in G20 member countries (for more information, see < http://www.g20.org/docs/about/about_G20.html >).

[4] See the Report of the Basel Committee mentioned in note 1.

[5] The FSB is an international body that monitors and makes recommendations about the global financial system. For more information on the FSB, see http://www.financialstabilityboard.org. The following jurisdictions are represented on the FSB: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Mexico, the Netherlands, Republic of Korea, Russian Federation, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, United Kingdom, United States of America (these members are most often represented by their central bank, a relevant supervisory authority and / or the ministry of finance). The following international organisations, international standard-setting bodies and other groupings are also represented on the FSB: Bank for International Settlements (BIS), European Central Bank (ECB), European Commission (EC), International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), The World Bank, Basel Committee on Banking Supervision (BCBS), Committee on the Global Financial System (CGFS), Committee on Payment and Settlement Systems (CPSS), International Association of Insurance Supervisors (IAIS), International Accounting Standards Board (IASB), International Organization of Securities Commissions (IOSCO).

[6] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions", October 2011, available at < http://www.financialstabilityboard.org/publications/r_111104cc.pdf >.

[7] For an overview of the 12 Key Attributes, see Financial Stability Board, "Resolution of Systemically Important Financial Institutions – Progress Report", November 2012, available at < https://www.financialstabilityboard.org/publications/r_121031aa.pdf > (pp. 8-9). The 12 key elements relate to: 1. Scope 2. Resolution authority 3. Resolution powers 4. Set-off, netting, collateralisation, segregation of client assets 5. Safeguards 6. Funding of firms in resolution 7. Legal framework conditions for cross-border co-operation 8. Crisis Management Groups (CMGs) 9. Institution-specific cross-border co-operation agreements 10. Resolvability assessments 11. Recovery and resolution planning 12. Access to information and information sharing.

[8] G20 Leaders' Declaration, Los Cabos (Mexico), 19 June 2012, (para. 41). See also the FSB Progress Report of November 2012 mentioned in note 6, which states that overall, progress with the alignment of national resolution regimes and institutional frameworks with the Key Attributes is "encouraging" (p. 5).

8. Under the Key Attributes, the authorities must have the powers and facilities to enable them to meet the need for resolution funding without relying on public ownership or public bailout funds (taxpayers' money). However, temporary public funding may still be needed during a crisis (*e.g.*, when private funds are not available or are insufficient to restructure large financial institutions). Thus, resolution regimes should include provisions to recover from shareholders, creditors and the financial industry the costs of providing such funding, as well as any losses incurred during resolution.[9]

The need to address cross-border aspects

9. Of all institutions, the most important to resolve are those whose activities are both systemically significant and international or global in scope (often referred to as "global systemically important financial institutions" or "GSIFIs"). Such institutions, however, are also the most difficult to resolve. This is because, in the words of the Governor of the Bank of England, financial institutions are "international in life, but national in death"; while they are viable, they can operate in many jurisdictions using ordinary corporate structures and mechanisms of contractual and financial law, but when they cease to be viable their resolution, whether by traditional insolvency proceedings or through the new resolution powers, depends on powers conferred by the law of a particular country. Resolution of GSIFIs is all the more challenging as most often crucial and far-reaching decisions need to be taken under severe time constraints.

10. Actions taken by a resolution authority in one jurisdiction can impose costs on others by damaging the critical functions of other entities in the group through the loss of liquidity or loss of access to important infrastructure. In other words, a purely territorial approach to resolution inhibits financial integration and can lead to fragmented, stand-alone units that do not benefit from cross-border economies of scale and scope. At the other extreme would be a universal approach, whereby resolution proceedings initiated against a financial group as a whole would be undertaken by a global resolution authority. The universal approach would have the potential to minimise resolution losses in a crisis and, in normal times, could provide efficiencies through financial integration. The designation and recognition of a global resolution authority seems, however, politically challenging and, at least at this stage, rather unlikely. An intermediate – co-operative – approach seems much more realistic. The objective of such an approach is simple: "While acknowledging that individual jurisdictions will act in their own self-interest, it aims to create an environment in which the benefits of co-operating outweigh the benefits of acting unilaterally. Such an environment increases the likelihood that jurisdictions will co-operate in resolution efforts. […] [T]he key elements required to achieve this [are]: (i) making co-operation feasible; and (ii) enabling the benefits from co-operation to be identified under severe time constraints. These key factors will reduce the divergence of

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[9] For an overview of the status of implementation of the Key Attributes in a number of FSB member jurisdictions (Australia, Germany, Netherlands, Spain, Switzerland, United Kingdom, United States of America), see < https://www.financialstabilityboard.org/publications/r_121031aa.pdf >, pp. 5 *et seq*. As regards the European Union, on 6 June 2012, the European Commission released its proposal for a "Directive establishing a framework for the recovery and resolution of credit institutions and investment firms" (RRD), available at < http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf >; the RRD proposal is currently under discussion. In the United States of America, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 introduces a new Orderly Liquidation Authority (OLA) regime, which will be operated by the Federal Deposit Insurance Corporation (FDIC). The OLA regime comprises a new set of insolvency rules that will apply to certain financial institutions whose failure may impact the financial stability of the United States of America. The purpose of the OLA is specifically as a last resort to: (a) supplement the provisions of the US Bankruptcy Code by providing a targeted and controlled mechanism for the resolution of SSFIs when the liquidation cannot be appropriately handled under another applicable law; and (b) ensure risks of failure are borne by shareholders, creditors and other counterparties; and (c) prevent any recourse to taxpayer funding though government bail-outs. Final Rules were approved by the FDIC on 6 July 2011.

interests among different countries in a crisis and should promote coordinated resolution efforts."[10]

11. The challenge that the authorities face in relation to (G)SIFIs is described by the FSB as follows:

> "Cross-border resolution is impeded by major differences in national resolution regimes, absence of mutual recognition to give effect to resolution measures across borders, and lack of planning for handling stress and resolution. The complexity and integrated nature of many firms' group structures and operations, with multiple legal entities spanning national borders and business lines, make rapid and orderly resolutions of these institutions under current regimes virtually impossible. Legislative changes are likely to be needed in many jurisdictions to ensure that resolution authorities have resolution powers with regard to all financial institutions operating in their jurisdictions, including the local branch operations of foreign institutions. Cross-border cooperation and effective pre-planning of resolution will be difficult if not impossible if the authority over failed institutions, including foreign bank branches, resides with the courts. As part of its statutory objectives, the resolution authority should duly consider the potential impact of its resolution actions on financial stability in other jurisdictions. It should have the legal capacity to cooperate and coordinate effectively with foreign resolution authorities, to exchange information in normal times and in crisis, and to draw up and implement [Recovery and Resolution Plans] RRPs and cooperation agreements on an institution-specific basis."[11]

12. The Key Attributes address cross-border aspects of resolution primarily in Section 7, which is entitled: "Legal framework conditions for cross-border cooperation". According to this section, resolution regimes should empower and encourage resolution authorities wherever possible to act to achieve a *co-operative solution* with their foreign counterparties. Authorities should be able to *give effect in their jurisdiction to resolution measures taken by a foreign resolution authority*. Section 7.5 of the Key Attributes is of particular interest and reads as follows:

> "Jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority. Such recognition or support measures would enable a foreign home resolution authority to gain rapid control over the firm (branch or shares in a subsidiary) or its assets that are located in the host jurisdiction, as appropriate, in cases where the firm is being resolved under the law of the foreign home jurisdiction. Recognition or support of foreign measures should be provisional on the equitable treatment of creditors in the foreign resolution proceeding."[12, 13]

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[10] A. Lai and A. Mordel, "The Resolution of Systemically Important Financial Institutions", in: *Bank of Canada – Financial System Review*, June 2012, p. 37 (available at < http://www.bankofcanada.ca/wp-content/uploads/2012/06/fsr-0612-lai.pdf >), at pp. 39-40.

[11] FSB, Consultative Document, Effective Resolution of Systemically Important Financial Institutions – Recommendations and Timelines, July 2011, available at < http://www.financialstabilityboard.org/publications/r_110719.pdf >, p. 14

[12] The full text of Section 7 reads as follows: "7.1 The statutory mandate of a resolution authority should empower and strongly encourage the authority wherever possible to act to achieve a cooperative solution with foreign resolution authorities. 7.2 Legislation and regulations in jurisdictions should not contain provisions that trigger automatic action in that jurisdiction as a result of official intervention or the initiation of resolution or insolvency proceedings in another jurisdiction, while reserving the right of discretionary national action if necessary to achieve domestic stability in the absence of effective international cooperation and information sharing. Where a resolution authority takes discretionary national action it should consider the impact on financial stability in other jurisdictions. 7.3 The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a

13. Whether by way of *mutual recognition* (where measures introduced by the resolution authority in one jurisdiction, typically perhaps the home jurisdiction of the entity or head group company, are recognised as having direct effect under the laws of other jurisdictions) or by way of *cross-border co-operation* (where the resolution authority in each jurisdiction has the necessary powers in relation to matters governed by its laws, including powers to introduce ancillary measures to ensure that measures of foreign resolution authorities have cross-border effects and participates in arrangements to ensure that such powers are used in a co-ordinated manner), the creation of an effective and comprehensive regime for resolving a GSIFI must address challenging cross-border aspects. A mutual recognition regime is contemplated by the RRD proposed by the European Commission.[14] Globally, the immediate way forward is perhaps more likely to be through co-operation, including the sharing of information, and the co-ordinated use of ancillary powers. The Key Attributes require, as a minimum, that national resolution regimes should not contain automatic triggers leading to actions that could hamper co-operative measures aimed at stabilising or resolving a cross-border financial institution.

14. Either approach raises complex private international law issues. Against this background, it is suggested that the Permanent Bureau undertake preliminary work to (i) develop a clear(er) understanding of how resolution measures introduced under the laws of another State are currently treated by conflict of laws rules (to the extent they exist); and, in light of this, (ii) to start fashioning a possible regime for either mutual recognition or international co-operation (or a combination of both) which could operate effectively and predictably.

15. It is further suggested that this work be undertaken in close co-operation with relevant experts in the fields, including practitioners.

16. Within the Permanent Bureau, this work would involve one diplomat lawyer and one legal officer.

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foreign home authority (for example, by ordering a transfer of property located in its jurisdiction to a bridge institution established by the foreign home authority) or, in exceptional cases, to take measures on its own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability [this section includes a footnote, which reads: This should not apply where jurisdictions are subject to a binding obligation to respect resolution of financial institutions under the authority of the home jurisdiction (for example, the EU Winding up and Reorganisation Directives)]. Where a resolution authority acting as host authority takes discretionary national action, it should give prior notification and consult the foreign home authority. 7.4 National laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. The treatment of creditors and ranking in insolvency should be transparent and properly disclosed to depositors, insurance policy holders and other creditors. 7.5 [see text above]. 7.6 The resolution authority should have the capacity in law, subject to adequate confidentiality requirements and protections for sensitive data, to share information, including recovery and resolution plans (RRPs), pertaining to the group as a whole or to individual subsidiaries or branches, with relevant foreign authorities (for example, members of a CMG), where sharing is necessary for recovery and resolution planning or for implementing a coordinated resolution. 7.7 Jurisdictions should provide for confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities."

[13] According to *Section 9* of the Key Attributes, Institution-specific cross-border co-operation agreements should be in place between the home and relevant host authorities that need to be involved in the preparation and management of a crisis affecting a global systemically important financial institution. Finally, under *Section 12* of the Key Attributes, jurisdictions should remove legal, regulatory or policy impediments that hinder the domestic and cross-border exchange of information that is necessary for effective resolution.

[14] The RRD proposed by the European Commission (see note 9) also envisages a co-ordination framework that goes further by providing for a temporary stay (of short duration) following the entry into resolution proceedings by two or more of an SIFI's legal entities, during which time the authorities in the host country are not permitted to take unilateral actions that could prejudice the effectiveness of a group-level resolution strategy.

Conclusion

17. This brief Note recalls that *resolution* is a fundamental component of ongoing high-level discussions and efforts to secure financial stability and reduce the likelihood that (G)SIFIs will fail. Resolution regimes, however, can only work if they effectively address the difficulties and challenges raised by the cross-border nature that naturally underlies the issue at stake. While the issue has been identified, workable approaches at the global level are yet to be developed and implemented. Against this background, the Permanent Bureau suggests that it be mandated by the Council on General Affairs and Policy of the Hague Conference to start preliminary work on cross-border aspects relating to resolution. Subject to available resources, this work should include:

– reaching out to relevant experts, including practitioners;
– developing a clear(er) understanding of how resolution measures introduced under the laws of another State are currently treated by conflict of laws rules (to the extent they exist), and, in light of this, start fashioning a possible regime for either mutual recognition or international co-operation (or a combination of both) which could operate effectively and predictably; and
– reporting to the Council on General Affairs and Policy in 2014, so that the Council could then take a decision as to whether or not develop legislative rules in this field (incl. the possible nature of these rules).