Comments on the Financial Stability Board Consultative Document
Effective Resolution of Systemically Important Financial Institutions

2 September 2011

I. General remarks

1. The Association of German Banks* supports the objectives and general approach pursued by the Financial Stability Board. The Key Attributes recognise the need for a resolution framework which applies to all financial institutions that could be systemically significant. Restricting such a framework to credit institutions and investment firms would be too short-sighted an approach to effectively address systemic risk. The historical experience with the different financial crises (e.g. emerging markets, sovereign bonds in the 1980s, LTCM, sub-prime sector and AIG as well as the current savings banks crisis in Spain) teaches us that it is impossible to forecast which financial institution, which market or which financial instrument could pose a threat to financial market stability in the future. This is why the tools for preventing and resolving systemic crises should be applicable to a variety of situations and market participants. All financial institutions (e.g. hedge funds and insurance companies), if sufficiently interconnected, play an important role in financial market stability. Systemic risks can also emanate from these institutions.

2. While we welcome the consultative document, we wish to draw attention particularly to the following points in it which we consider especially important:

- The proposed possibility of preventative supervisory intervention in groups or group structures meets with fundamental reservations. The EU CRD calls for risk management at group level. Splitting a group into independent functional units would be at odds with the objective of centralised management and control. Furthermore, it would considerably reduce banks' capacity to extend large loans, which would undoubtedly have an adverse impact on the real economy.
- The intended strengthening of the supervisory or resolution authority with respect to local branches of foreign institutions will foster ring-fencing measures in a crisis of the respective firm, which could hamper effective cross-border resolution due to a

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resulting increase in conflict issues (e.g. scope of local measures in relation to home-authority measures).

- Recovery plans are generally an appropriate instrument to prepare institutions for a crisis situation. Their degree of detail in "normal operation" should, however, be appropriate – they should only be adapted to a specific situation when a crisis occurs. A requirement to identify in advance possible assets and business lines for sale appears questionable. Moreover, strategic information should not be part of recovery plans. We believe that such plans should be drawn up only at group level.
- If resolution plans are to be prepared in advance, these should be discussed between the resolution authority and the institution. The information needed to draw up the plans should be obtained from existing sources.
- As a general comment, debt write-down as an additional resolution tool should not be limited to SIFIs. It should in principle be applicable to all financial institutions. However, the question whether a bail-in order can be imposed on a certain institution that has met the trigger conditions for resolution should be answered by the respective resolution authority in the face of the circumstances of the current situation. Any limitation to SIFIs would lead to a distortion of competition on the capital market between SIFIs that are defined in advance and banks that could also be characterised as national or international SIFIs in the current situation of their imminent failure.
- One of the key elements of an effective bail-in resolution tool is that the triggers are well- defined in advance by law, ideally in an objective way (perhaps combined with a subjective assessment by the authority). Otherwise bail-in creditors will not have the necessary clarity about the conditions under which they could be affected by a bail-in measure and will therefore either not invest or demand collateral or demand a higher price.
- There should be no restrictions on intra-group guarantees (or cross-default provisions). Intra-group guarantees (or cross-default provisions) are a prudentially recognised risk management tool within banking groups on whose effectiveness group members rely.
- A firm's resolvability assessment should not be penalised because of the authorities' failure to make the necessary changes to their legal powers and capacity to use them. Either such part of the assessment should be suspended until the required legal changes are made, or, at the very least, there should be a substantial transition period before any action is taken against a firm due to the absence of legal or regulatory changes outside its control.
- We see no reason to give preference to deposits during bankruptcy. Private and SME depositors are already protected up to a certain coverage limit through deposit guarantee schemes. Should deposits be given preferential treatment above the

coverage limit, this would lead to moral hazard and conflict with the system of limited deposit protection. While national deposit guarantees may differ, the differing obligations of schemes to depositors do not justify national arrangements that give them priority claims over specific sets of assets in their jurisdictions. Expectation of national priority claims could create incentives for ring-fencing and therefore non-cooperative behaviour on the part of authorities and administrators of insolvent estates. This would hamper efforts to put in place meaningful cross-border arrangements ex ante.

II. Questions for public consultation

*1. Comment is invited on whether **Annex 1: Key Attributes of Effective Resolution Regimes** appropriately covers the attributes that all jurisdictions' resolution regimes and the tools available under those regimes should have.*

1. We believe that a framework that is adaptable to a variety of situations and market participants is required. The FSB is therefore right in seeking to apply the framework to all financial institutions. Restricting its scope to SIFIs would be too short-sighted an approach, as smaller institutions and groups of institutions can also be systemically important. In order to avoid distortions of competition, the proposals should therefore apply to all financial institutions which can cause systemic risk and not only to those which are classified as systemically important by means of formal criteria such as size. The current crisis has shown that universal banks can become distressed just like specialist firms and investment firms as well as insurance companies. The proposed framework should therefore offer tools allowing the resolution of any financial entity and group of institutions in a crisis. This limits moral hazard incentives and creates a level playing field.

2. It should be possible to adapt the framework to a number of different market participants and situations. For this reason, jurisdictions should be able if necessary to supplement the toolkit with instruments tailored to the specific circumstances in their own country. It will nevertheless be necessary to ensure that these country-specific instruments are not obstacles to cross-border crisis management and that the door is not opened to the pursuit of national interests.

3. The proposed toolkit should be supplemented by third-party guarantees for contractual liabilities. Guarantees by suitable third parties for the contractual liabilities of a financial institution in need of reorganisation could play a major role in a comprehensive and flexible resolution regime. First, guarantees of this kind would create an effective incentive for all the institution's contractual partners to refrain from exercising any termination rights in existing contracts, such as those arising from close-out netting arrangements in master agreements for financial transactions. Second, and even more important for the institution's ability to continue as a going concern, guarantees would encourage the market to enter into new transactions or extend contracts that were due to expire.

2. Is the overarching framework provided by ***Annex 1: Key Attributes of Effective Resolution*** *specific enough, yet flexible enough to cover the differing circumstances of different types of jurisdictions and financial institutions?*

1. The approach pursued by the FSB of seeking to prevent financial distress at an institution through intervention by supervisors as early as possible must be welcomed. However, the tools presented for discussion appear only partly appropriate. It is, in particular, doubtful whether the associated and in some cases serious interference with – constitutionally protected – positions to prepare resolution of an institution or allow it at an early stage would be justified.

Unlike under the FSB's approach, to uphold the principle of proportionality the first step should be taken not by supervisors but by the institution concerned. In a dialogue with supervisors, the institution should take the action required – possibly by a deadline set by supervisors – to avert any imminent distress, e.g. measures to protect it more effectively against, or reduce, the risks identified as significant by the institution and any associated risk concentrations. Only if the action taken by the institution on its own responsibility does not adequately ensure a sustained improvement in its capital and liquidity resources should the next step be the possibility for supervisors to order measures themselves.

2. The proposed possibility of preventative supervisory intervention in groups or group structures (Annex 1, 11.11) meets with fundamental reservations. The EU CRD calls for risk management at group level. Splitting a group into independent functional units would be at odds with the objective of centralised management and control. Furthermore, it would considerably reduce institutions' capacity to extend large loans, which would undoubtedly have an adverse impact on the real economy. It should also not be overlooked that the current structure of many institutions has its roots in history or has been determined by the need to meet regulatory or fiscal rules. It therefore follows that institutions do not choose to create excessive complexity: group structure is always the result of an individual set of circumstances. What is more, it is in the interests of institutions themselves to streamline their structure so that decision-making processes are transparent and administrative workloads are kept to a minimum. We nevertheless believe that it is advisable for institutions of a certain degree of complexity to have adequate resources in place to continuously monitor their structure and evaluate the potential for simplification.

Any interference in group structures would also be at odds with the group risk management expressly called for at regulatory level. Recovery plans and resolution plans prepared for the group would no longer be valid. Preventative supervisory intervention in group structures is, moreover, incompatible with the principles of a market economy and with national basic rights. Nor can the aim of regulatory efforts be a fragmentation of the financial market. Splitting banking groups into subsidiary companies would not solve the problem of how to wind them down rapidly and efficiently: banks are normally organised along business, not geographical lines.

It is doubtful whether the associated and in some cases serious interference with constitutionally protected positions to restructure a firm in order to improve resolvability at an early stage would be justified. It should be absolutely clear that shareholders and management remain fully responsible for the firm and the steps taken to restore it to health until all recovery options have been exhausted. Therefore, should the FSB nevertheless stick to the idea of allowing preventative supervisory intervention in group structures, the intensity of intervention dictates that this should only be considered as a last resort.

3. We are sceptical, against the backdrop of European and international law, about the idea of branches of foreign financial institutions being handled by the resolution authority of the host country (Annex 1, 1.1 and 8.4). At least under the EU regime, local branches are subject to supervision by the home regulator (in cooperation with the host regulator) as they are not separate legal entities, and no separate insolvency proceedings will take place. There should be no deviation from this approach also in view of the new and extended crisis management framework. This would also be contrary to European Directive 2001/24/EC on the reorganisation and winding-up of credit institutions, which gives the home authority responsibility. This directive has achieved a lot in terms of simplifying insolvency proceedings for branches. The FSB should therefore urge countries which have not yet adopted this approach to incorporate it into national law.

Giving the host authority the power to close a branch independently not only gives rise to the risk of ring-fencing but also can lead to uncoordinated final resolution of a group if different jurisdictions take different measures at different times. Sole responsibility for this should lie with the group's home authority, which should establish the procedure in advance within a reasonable timeframe in consultation with the host authorities, receiving support from them where necessary (see response to question 10).

4. It must be ensured that action can be taken if a threat to a financial institution's continued existence risks compromising financial stability. The triggers should be clearly drawn in order to avoid undue uncertainty. Such action should not be triggered only by a specific, imminent default or by imminent over-indebtedness. A bank should be deemed to be "failing or likely to fail" in the event of a qualified breach of regulatory capital or liquidity requirements. Trigger conditions should be formulated flexibly enough for them to be deemed met in certain circumstances even if the failure does not materialise. It is appropriate

to tie the envisaged triggers to the public interest objective of ensuring financial market stability. Only a threat to the financial system could justify interference by supervisors in a financial institution's structure, for instance. The requirements of the new Section 48b of the German Banking Act, which was introduced to implement the German Restructuring Act, could serve as a model for international legislation. The conditions set out in paragraphs (1) and (2) of this section are tied to one another in an appropriate manner[1].

5. Paragraph 2.4 of Annex 1 states that the resolution authority should have the authority to enter into agreements with resolution authorities of other jurisdictions.

We take the view that it needs to be clarified and determined that the home resolution authority should not be entitled to delegate powers to resolution authorities of other jurisdictions. In other words, credit institutions subject to resolution by the home resolution authority should remain subject to resolution by that authority only. Furthermore, any

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[1] § 48b KWG (German Banking Act):

(1) 1Going-concern risk is the danger of the credit institution collapsing as a result of insolvency if no corrective measures are taken. 2Going-concern risk shall be presumed to exist if

1 the available tier 1 capital represents less than 90 per cent of the tier 1 capital required pursuant to section 10 (1);

2 the modified available capital represents less than 90 per cent of the own funds required pursuant to section 10 (1);
3 the liquid assets available to the institution in a maturity band defined by the statutory order pursuant to section 11 (1) sentence 2 represent less than 90 per cent of the payment obligations that are callable in the same maturity band, or
4 facts are known which warrant the assumption that a shortfall pursuant to numbers 1, 2 and 3 will occur if no corrective measures are taken; this is the case, in particular, if a loss may be anticipated based on the institution's earnings situation, as a result of which the conditions of numbers 1, 2 or 3 would be met.
3If the credit institution is subject to particular own funds requirements pursuant to section 10 (1b) or section 45b (1) sentence 2, these must be taken into consideration when determining whether the conditions of sentence 2 numbers 1, 2 and 4 are met. 4The same applies when determining whether the conditions of sentence 2 numbers 3 and 4 for extraordinary liquidity requirements pursuant to section 11 (2) are met.

(2) 1Systemic risk shall be deemed to exist if there is concern that the credit institution's going-concern risk could have a significantly negative impact on other financial sector enterprises, on the financial markets or on the general confidence of depositors and other market participants in the proper functioning of the financial system. 2Particular account shall be taken of:

1 the nature and scope of the credit institution's liabilities to other institutions and other financial sector enterprises,

2 the volume of the deposits received by the institution,

3 the nature, scope and composition of the risks entered into by the institution as well as the conditions on the markets on which such positions are traded,

4 interconnectedness with other financial market participants,

5 the conditions on the financial markets, in particular the consequences which market participants expect the institution's collapse to have on other financial sector enterprises, on the financial market and on the confidence of depositors and market participants in the proper functioning of the financial market.

(3) BaFin shall assess, after consulting the Deutsche Bundesbank, whether going-concern risk and systemic risk within the meaning of subsections (1) and (2) exists and shall document their joint assessment in writing.

requirements on data protection and banking and business secrecy should be observed. The exchange of confidential information should be limited to the extent necessary and based on clear and transparent provisions clearly defining what should and what should not be covered. It should be ensured that the result of such agreements would not mean a credit institution facing different resolution authorities.

6. With regard to paragraph 2.5 of Annex 1, we see the need to clarify that the resolution authority should not be allocated additional powers that would be exercised over credit institutions already subject to supervision by the regulatory authority. To avoid any additional and excessive administrative burden, it should be ensured that the home resolution authority and the home regulator cooperate to the extent necessary, taking into account the principle of proportionality.

7. The proposed blanket exclusion of liability for supervisors for actions taken by them when discharging their duties in the exercise of their resolution powers in good faith (Annex 1, 2.6) should be examined critically. This is to ensure that active supervisory action to avert a threat to the stability of financial markets should be limited to exceptional situations. For inappropriate regulatory action (such as wrongful dismissal of an executive director), the state must remain liable.

8. Paragraph 4.1 (vi) of Annex 1 states that resolution authorities should have legal powers to override shareholder rights. We agree that, to avert a threat to financial market stability, resolution authorities should be able to take the required measures also without the consent of shareholders. It should not be overlooked, however, that this can involve interference in constitutionally protected positions for which financial compensation may also be due. Measures taken against the will of shareholders can therefore only be considered as a last resort.

9. We generally agree that, in order to avert a threat to financial market stability, the required measures need to be implemented with the necessary speed and legal certainty (Annex I, 7). Legal protection can only be restricted within the limits of the framework set by a country's national constitution, however.

10. Paragraphs 8.5 of Annex 1 states that national laws should not discriminate against other creditors, but then also says that where such provisions exist, they should be disclosed. We believe that national jurisdictions should remove such provisions within a specific timeframe. Until then, any such provisions should be publicly disclosed.

11. Regarding the funding of firms under resolution (Annex 1, 6) we believe it is right to propose that the costs of resolution should be borne first and foremost by the owners of the credit institution concerned. Thereafter, the creditors should be asked to bear a share of the costs, e.g. via debt-equity swaps.

If the private sector is involved, consideration needs to be given to the size of the cost burden that can be imposed on it as a whole, as resolution of large banks is likely to require a considerable financial input in terms of guarantees and funds. It must, moreover, be assumed that because of their dimension systemic crises cannot be shouldered by the private sector alone.

In its Communication of 26 May 2010 on bank resolution funds, the European Commission rightly pointed out that the unilateral imposition of bank levies by individual EU member states because of failure to adopt a coordinated EU approach carried the threat particularly of distortions of competition between national banking markets and also jeopardised cross-border cooperation in crises. This is also true for the international stage. The only very rudimentary proposals for funding of firms under resolution submitted for discussion by the FSB do not, in particular, avoid any possible duplication of burdens or regulatory arbitrage and distortions of competition. As a result, there is the danger of a patchwork of national resolution funds.

The FSB is therefore urged to propose concrete final requirements for the design of national bank resolution funds. The following aspects in particular require uniform regulation:

- Target size of the fund,
- Entities required to contribute to the fund,
- Basis for calculating the annual contributions,
- Collection of, and the basis for assessment of, any minimum and/or extraordinary/special contributions,
- Threshold of the ‘reasonableness limit’ that must be set not least for constitutional reasons,
- Use of collected contributions/task of the bank resolution fund,
- Tax treatment of payments into the fund.

Moreover, we believe it is essential, when setting international requirements, to ensure that cross-border activities of entities, particularly subsidiaries and branches, do not lead to a double burden for institutions if such activities are subjected to contributions.

3. Are the elements identified in ***Annex 2: Bail-in within Resolution: Elements for inclusion in the Key Attributes*** *sufficiently specific to ensure that a bail-in regime is comprehensive, transparent and effective, while sufficiently general to be adaptable to the specific needs and legal frameworks of different jurisdictions?*

1. Contingent convertible instruments, as issued recently (e.g. Lloyds TSB, Rabobank), can only be used as a first buffer to protect the capital of a bank, i.e. as an early intervention option. In contrast, bail-in instruments could be used as a last resort if resolution trigger conditions are met. In a first step, the parties affected most directly by the crisis or even imminent insolvency should be required to bear the costs of restructuring in the broadest sense. These are, above all, the firm's owners (shareholders) and the unsecured creditors, who would usually suffer total loss or at any rate almost total loss in the event of insolvency.

2. Of the measures set out in Annex 2, 3.1, a debt-equity swap in particular is a crucial option in our view. It should also be enforceable by a simple majority (if necessary, also through "clustering" in groups of, for example, secured/unsecured creditors) if it can be plausibly demonstrated that the groups of creditors affected will not be worse off following such a measure than in the event of insolvency and/or breakup.

3. Stipulating that, as evidently envisaged by the FSB, the conversion of debt into equity in resolution proceedings should be carried out solely by order of the resolution authority is, in our view, a case of serious interference that also meets with reservations under constitutional law. This is true at any rate as long as and insofar as it cannot be demonstrated clearly that the aforementioned measure, i.e. a majority-approved debt-equity swap, would not be an equally suitable means of achieving the desired purpose. A mix of comprehensive and targeted approach would therefore be more appropriate in this respect.

4. The combination of subordinated debt to be converted into equity and bail-inable debt to be written down does not appear appropriate to preserve the ranking of claims in potential insolvency proceedings as a general principle of resolution. If the bail-in is successful, shareholders (former subordinated creditors) will profit disproportionately from senior creditors' restructuring contribution.

5. In addition, we wonder whether the exercise of corresponding "bail-in measures" does not automatically always also constitute an event of default that may result in early termination of contracts or close-out netting in the case of financial transactions – something which could inevitably seriously impair the intended resolution measures.

6. As a general comment, debt write-down as an additional resolution tool should not be limited to SIFIs. It should in principle be applicable to all financial institutions. However, the question whether a bail-in order can be imposed on a certain bank that has met the trigger conditions for resolution should be answered by the respective resolution authority in the face of the circumstances of the current situation. Any limitation to SIFIs would lead to a distortion of competition on the capital market between SIFIs which are defined in advance and banks that could also be characterised as national or international SIFIs in the current situation of their imminent failure (e.g. HRE, IKB, DüssHyp). Additionally, with a limitation to SIFIs defined in advance, the purpose of a bail-in mechanism to reduce the indirect state guarantee in the refinancing costs of a bank could be undermined.

4. Is it desirable that the scope of liabilities covered by statutory bail-in powers is as broad as possible, and that this scope is largely similarly defined across countries?

To ensure uniform application and thereby ensure a level playing field, the scope should be harmonised internationally. The classes of bail-in debt need to be exactly defined by law in advance. Triggers should be clear and predictable.

5. What classes of debt or liabilities should be within the scope of statutory bail-in powers?
6. What classes of debt or liabilities should be outside the scope of statutory bail-in powers?

A distinction should be made between 'bank business-related debt' and 'investor-related debt'.

Only investor-related debt should be subject to a bail-in mechanism. However, consideration should be given to whether there should be exceptions for certain products such as certificates that are sold particularly to retail clients.

Investor-related debt:

- hybrid capital instruments,
- senior or junior unsecured bonds ("Inhaberschuldverschreibungen") or bonded loans ("Schuldscheindarlehen")

Bank business-related debt:

- secured debt;
- debt resulting from
  - transaction payments,
  - repos,
  - derivatives,

- trading,
- fiduciary business, etc.

Irrespective of the scope of the respective deposit guarantee scheme, deposits should be excluded from the scope of statutory powers. Such exclusion would reduce the likelihood of a bank run and, therefore, maintain the viability of the bank under bail-in as a going concern, especially with respect to an appropriate liquidity need. This consideration is also applicable to other bank business-related debt classes.

We believe that not all investors in unsecured and senior debt issued by financial institutions should be affected by any bail-in mechanism. We could imagine that it would be appropriate if the line for investors who could be potentially affected were to be drawn along the classification of investors protected/not protected under a deposit guarantee scheme, i.e. only those investors who do not benefit from the deposit guarantee scheme could be subject to a bail-in mechanism. As regards retail clients, a kind of protection should be assumed even if they invest in unsecured debt instead of deposits.

Furthermore, we are not convinced by a bail-in concept regarding senior debt where a write-down mechanism is mandatory and where no replenishment mechanism is determined and/or permitted in the event that the institution recovers. Otherwise an imbalance compared to equity investors or other hybrid capital investors would be caused without any justification.

It is acceptable if some senior unsecured creditors are not treated similarly within the same class of creditors provided that

- this exception is limited to banks;
- the affected creditors are clearly defined by law in advance; and
- appropriate grandfathering is in place.

There should be no discretionary power for authorities to expand the affected debt classes to some of the bank business-related debt classes described above. Any discretionary power in this respect would reduce predictability for creditors of a bank and could lead to reactions, e.g. termination of contracts prior to the stage when resolution trigger conditions are met, which could undermine the purpose of the bail-in mechanism.

In future insolvency proceedings, senior unsecured creditors affected by a previous bail-in would have to take an additional loss according to the amount written down or converted within the bail-in mechanism. Theoretically, senior unsecured creditors would thus rank pari passu to any junior creditor or shareholder. Therefore, a cap for senior unsecured debt subject to bail-in should be considered. Such a cap could

- reduce the risk of investors in bail-in instruments being treated as equity holders and therefore increase a reluctant investor's appetite for bail-in instruments;
- reduce the risk of contagion for other market participants if a bail-in is imposed on the issuing bank; and
- be necessary to justify the bail-in order.

The level of the cap should be

- less than the average losses of senior unsecured creditors in bank insolvency proceedings in the past; and
- verified by the bail-out cases in the recent financial crisis.

7. Will it be necessary that authorities monitor whether firms' balance sheet contain at all times a sufficient amount of liabilities covered by bail-in powers and that, if that is not the case, they consider requiring minimum level of bail-in debt ? If so, how should the minimum amount be calibrated and what form should such a requirement take, e.g.,:
(i) a certain percentage of risk-weighted assets in bail-inable liabilities, or
(ii) a limit on the degree of asset encumbrance (e.g., through use as collateral)?

The requirement for a bank to have a minimum amount of debt subject to a potential bail-in seems acceptable provided that the classes of bail-in debt are exactly defined by law in advance.

Bail-inable debt should be at least the amount of the minimum required common equity. In order to achieve the purpose of a bail-in mechanism, bail-in debt should also be sufficient to replace the buffer above the minimum capital ratio [approx. 10 % of RWAs].

8. What consequences for banks' funding and credit supply to the economy would you expect from the introduction of any such required minimum amount of bail-inable liabilities?

The market appetite for and price of bail-in instruments will mainly depend on the design of the bail-in mechanism.

Creditors of bail-in instruments will belong to the class of senior unsecured creditors of a bank who participate in a potential insolvency recovery ratio prior to junior/subordinated creditors and, even more, prior to shareholders.

Therefore, the price level for such bail-in instruments could range below the level for subordinated contingent convertible bonds.

If unsecured or subordinated creditors have to waive claims or accept conversion of debt into equity in a crisis without any say of their own, i.e. solely as a result of intervention by supervisors, the risk premiums for such forms of refinancing by financial institutions will inevitably rise. This is true particularly since there is no such regulation and thus accompanying risk for market participants in other sectors and, compared with the financial sector, it is likely to be much “more attractive” and less risky to invest capital in such sectors. It is, in turn, to be feared that such effects would then also directly impact the supply of credit to the business sector, whether via higher interest rates because refinancing debt or raising capital is more expensive, or because of a simple shortage of loan funds.

However, the willingness to invest in bail-in instruments will be reduced and the issuing bank will be forced to offer a higher premium on such instruments to sell the issue if

- the design of the bail-in mechanism leads to a shifting of the ranking in favour of subordinated creditors or shareholders at the expense of the bail-in investors; and
- the bail-in mechanism can be executed at an early stage prior to the resolution stage.

Under those circumstances, the potential refinancing costs will exceed the costs calculated without a potential state guarantee.

9. How should a statutory duty to cooperate with home and host authorities be framed? What criteria should be relevant to the duty to cooperate?

1. The German banking industry supports the aim of fostering cooperation and cross-border communication between supervisors and resolution authorities on the resolution of financial institutions. For this purpose, clear-cut rules on processes, powers and responsibilities need to be established for cooperation during normal times as well as during times of stress.

2. The group resolution authority should coordinate the work of the resolution colleges and determine their composition. In general, all the resolution authorities responsible for part of the group in the event of its resolution should be represented in the college. Multiple

authorities should coordinate inquiries and avoid duplication or slight variations on the same requests, at least during normal times.

3. Resolution requires major decisions to be taken within a very short period of time (e.g. a weekend), and this also holds true for the resolution of a failing group. It is important to give adequate consideration to the interests of all parties involved while still retaining the ability to act swiftly. This applies particularly to the decision by the group level resolution authority on whether or not to wind up the group in its entirety. We believe it will only be justified to require national authorities to await this decision if they are still able to take measures at national level in the event of an emergency. Cooperation will only be able to function in a crisis, however, if the ground rules and groundwork (e.g. development of group level resolution plans) have been properly laid down in advance.

4. This exchange of information must, however, always be subject to compliance with rules on data protection rules and trade secrets. Information relating to individual institutions should, as a rule, be kept within the circle of supervisors or resolution authorities directly responsible for overseeing them. Supervision depends on open communication between supervisors and supervised institutions. Confidentiality will become even more important, moreover, once work on contingency and recovery planning is underway and national supervisors enhance cross-border coordination. Given the sensitivity of financial markets, the disclosure of confidential information, especially if related to a threat to an institution's existence, also risks sparking severe market disruption.

As things stand, therefore, financial institutions and, in particular, supervisory authorities cannot exclude the possibility of information being divulged to third parties. This seriously undermines the basis of trust which is essential to efficient supervision and international cooperation. Yet open communication and cooperation are prerequisites for the ability to successfully counter threats to financial stability.

5. In group situations, multiple resolution authorities should coordinate inquiries and avoid duplication or slight variations on the same requests, at least during normal times.

*10. Does **Annex 3: Institution-specific Cross-border Cooperation Agreements** cover all the critical elements of institution-specific cross-border agreements and, if implemented, will the proposed agreements be sufficiently reliable to ensure effective cross-border cooperation? How can their effectiveness be enhanced?*

Cross-border crisis management will only work if the measures required are also coordinated quickly between supervisors. This is why clear-cut procedural rules and decision-making structures are required in this area – crisis management should not be thwarted by any national reservations

Cooperation between national supervisors in the supervisory colleges implies that they should seek to reach agreement on joint measures and decisions. In cases in which the supervisors involved are unable to reach agreement, uniform, effective supervisory action must nevertheless be ensured. Particularly where decisions are taken in difficult or even crisis situations, there must be a clear-cut division of responsibilities. Transferring tasks and powers to the consolidating supervisor therefore appears appropriate.

Particularly where cross-border institutions are involved, uniform decisions are especially important. On the one hand, a level playing field must be ensured and, on the other, supervisory arbitrage has to be avoided. If supervisors are unable to reach agreement after a joint decision-making phase, there must be a mechanism which allows functional and effective action. This includes enabling binding decisions to be made for the authorities involved. This is the only way to ensure uniform, cohesive supervision. We therefore believe that it is right if supervisors take part in the decision-making process but the consolidating supervisor has the final say and host supervisors can convey this decision to a higher authority in the event of disagreement.

To obtain a consensus-based solution endorsed by all in the event of disagreement between national supervisors, a mediation procedure should be adopted. Such a procedure enables conflicting views and assessments to be discussed and balanced accordingly. In our opinion, a superordinate authority should assume the role of mediator. However, to allow an effective and cohesive approach, the capacity to act and uniform application of the law must also be ensured. We therefore believe that this can be best achieved by means of a decision by a higher authority (e.g. in the EU by the European Banking Authority) that is binding on all college supervisors.

11. Who (i.e., which authorities) will need to be parties to these agreements for them to be most effective?

All participants of the financial stability net that have a role in the oversight and management of a firm and its resolution process or insolvency should be included. These may include, in particular, the following bodies:

- Ministry of Finance,
- National or Central bank,
- Supervisory Authority,

- Resolution Authority (if not identical with the supervisory authority),
- Deposit guarantee scheme.

12. Does ***Annex 4*****:** ***Resolvability*** **Assessments** *appropriately cover the determinants of a firm's resolvability? Are there any additional factors to be considered in determining the resolvability of a firm?*

1. A resolvability assessment is a crucial part of an effective crisis management framework because it may help uncover existing weaknesses. However, there are great concerns about whether it is possible to reach an internationally similar assessment standard on the basis of very superficial criteria. This would require further definitions that also increase the predictability of the regulatory institutions' rating scale.

2. A firm's resolvability assessment should not be penalised because of the authorities' failure to make the necessary changes to their legal powers and capacity to use them. Either such part of the assessment should be suspended until the required legal changes are made, or, at the very least, there should be a substantial transition period before any action is taken against a firm due to the absence of legal or regulatory changes outside its control.

3. Under the definition in the consultative document, a SIFI would always be resolvable "if it is feasible and credible for the resolution authorities to resolve it without severe systemic disruption and without taxpayer exposure to loss, while protecting systemically important functions." Such a definition is cause for discussion in our view.

It is right that a financial institution's resolvability presupposes that its resolution would cause no severe systemic disruption. However, stipulating at the same time that this should be without taxpayer exposure to loss appears both unrealistic and unjustified. Even if the definition is doubtless designed to protect the taxpayer against the loss of funds provided as solvency support, resolution of a financial institution will as a rule involve "normal" tax risk or perhaps even result in a loss. For instance, tax claims by the state, e.g. within the scope of taxation of "fictitious profits" as a result of debt waivers by creditors, may no longer be successfully enforced in subsequent resolution. In this case, not typical "taxpayer risk" in connection with a bank rescue but the customary risk of default for the state if and to the extent that a taxpayer is no longer fully solvent, would be involved. Concluding that this alone indicates the "irresolvability" of a financial institution would be wrong in our view. The state would after all only face the same credit risk as any other counterparty. Furthermore, this would raise the question of whether protecting taxpayers against exposure to loss does not ultimately constitute clear preferential treatment in that the tax authorities' claims are, as it were, regarded as much “more important” than those of all other market participants (see our response to question 23).

4. Regarding intra-group exposures (Annex 4, 4.3), we refer to our response to question 18.

5. The requirements for management information systems are high. In particular, the necessary information has to be held not only daily but also at the level of individual legal entities. We therefore propose examining what data are already available to regulators and avoiding unnecessary duplication of work between the group level and individual units. In any case, institutions will need a reasonable implementation period to adapt their IT systems to these requirements.

*13. Does **Annex 4** identify the appropriate process to be followed by home and host authorities?*

The coordination of national resolution regimes and tools is key for the resolution of an international group. Therefore, the manner of this coordination should be assessed before a crisis occurs. However, we would have serious concerns about permitting resolution authorities to require changes to an institution’s structure if they had reservations about the legal framework in a third country. The decision in this case would be based on circumstances (i.e. a foreign legal system) over which the financial institution had no control. A power of this kind could end up being tantamount to a ban on business in third countries.

*14. Does **Annex 5: Recovery and Resolution Plans** cover all critical elements of a recovery and resolution plan? What additional elements should be included? Are there elements that should not be included?*

- **Recovery Plans**

1. We believe that it makes sense to improve recovery planning under Pillar II and to focus it more on how additional capital or liquidity can be generated in stressed situations so as to comply with supervisory ratios and ensure that an institution remains a going concern. Recovery planning is one of institutions’ original tasks and should therefore not be transferred to supervisors.

2. The degree of detail of a recovery plan should be such that in a crisis the required measures can be adopted and implemented within a reasonable timeframe. It follows from this that the portfolio of measures should be broad enough to allow a situation-specific response. On the other hand, the causes of a possible crisis naturally vary. It is very difficult to

predict in advance which business units, regions, etc. will be affected. The level of granularity of a recovery plan in "normal operation" should therefore not be too deep. Detailed supervisory requirements for the design of a recovery plan can thus be ruled out.

3. In a crisis, a specific recovery plan must then be drawn up. We therefore take a critical view of the proposal that institutions should already define for normal operation assets and business lines that would be sold in a crisis. Institutions should not be required to make a decision on this and launch corresponding measures until a crisis materialises. It would be extremely difficult for them to do so beforehand and would impose an unreasonably heavy burden, particularly in the case of widespread group structures. Moreover, forecasts about potential sales proceeds in a crisis are highly inaccurate, which ultimately impairs the quality of recovery planning.

4. Recovery plans usually contain sensitive data. For this reason, such plans should not be made public, but should be treated particularly confidentially. We also believe that strategic information should not be part of recovery plans.

5. It is important that recovery and resolution planning be done on a group basis. The entire resolution process should be focused on and channeled through the group, especially the "pre-crisis" phases. Thus the home country authority should take the lead in working with the firm on RRPs, and generally coordinate through the colleges with the host authorities, as the consultative document helpfully recommends at paragraph 11.6 of Annex 1. The circumstances in which a host jurisdiction could insist upon a separate plan should be carefully limited, and the overall process designed to make sure that host-specific plans would only be imposed, if at all, in extreme circumstances. This is essential to assure some basic efficiency of the process for the group and for the CMG, and to avoid the risk of incoherent, duplicative, or conflicting requirements.

- **Resolution Plans**

1. The FSB proposes that resolution plans should be prepared by the resolution authorities. We could also think of some arguments for giving this role to the institutions themselves. Thanks not least to their recovery plan, they know the structures and interdependencies within a group and can thus develop a realistic resolution scenario. We see more advantages if the preparation itself is the responsibility of the resolution authorities. This is particularly due to our shared understanding of the FSB proposal that the business management of a viable credit institution should mainly focus on going-concern strategies and the expertise of resolutions should be developed and expanded within a competent authority. Further, we see that the resolution authorities will gain experience and specialist knowledge in this field, in particular by having a deep insight in all institutions subject to this

requirement. This particular know-how, which is obviously not at the disposal of any single institution, can be used by the resolution authorities. However, it goes without saying that the resolution authorities have to rely on the cooperation and information provided by the institutions.

2. We take a critical view of the proposal for detailed, ready-made plans for resolving an institution. Ultimately, such living wills are a theoretical concept that imposes an enormous administrative workload without any certainty that this concept will actually work in a crisis. It must be questioned whether RRPs can do justice to the variety of potential crisis scenarios. As far as crisis situations are concerned, they thus create a false sense of security or arouse expectations that they are unable to meet in actual practice.

3. To nevertheless keep the administrative burden for institutions within limits, the information needed to prepare resolution plans should be obtained mainly from already existing sources (solvency reporting, banking statistics, etc.). Only in justified cases should additional information be collected by supervisors. Moreover, we do not believe that a requirement to continuously gather comprehensive information on creditors and intra-group exposures and update it at regular intervals would be helpful. Instead, institutions should demonstrate to supervisors that they can generate the relevant information within a reasonable timeframe. Any double-burden with a view to information requirements should not be established.

4. RRPs should always be discussed in detail by resolution authorities and institutions. Only in this way can a realistic plan ultimately be prepared. The FSB's idea to allow the authorities not to disclose RRPs to institutions therefore goes too far (Annex 5, 1.14). Keeping an RRP secret from an institution precludes the opportunity to detect flaws in it at an early stage when there is still sufficient time to do so. This means that the know-how available in an institution, which obviously knows its structure well, would be completely ignored. It would also make it impossible for the management to improve the institution's resolvability. RRPs should be understood as a task to be shared by supervisors and institutions that calls for a continuous exchange of views and ongoing consultation if it is to be performed properly.

5. Finally, we would like to reiterate that resolution plans must not enable authorities to interfere in the business model of banks, or to require changing their legal or operational structure. It is not the role and not the responsibility of the authorities to shape ex ante, through resolution plans, the organisation of healthy banking institutions when it is not fully justified. The intervention in the legal and operational structure must be a very last resort when orderly resolution seems otherwise impossible. Gearing an institution's objectives and processes to resolution-friendly structures may not only open the door to potential

competitors or hostile takeovers but – which is even more serious for the economy as a whole – also wipe out value added advantages or economies of scale in the provision of banking products and services.

It should be borne in mind that all additional regulatory requirements for SIFIs ultimately amount to just "penalising" the size of an institution. Such an objective – outside competition law, under whose jurisdiction this actually falls – is an absolute novelty in a free market economy, one that is incidentally not envisaged in any other sector (no other sector is required to have living wills). Many of the needs of a modern market economy and banking sector would be virtually unfulfillable without internationally operating financial institutions. This is because it is frequently only such large international institutions that are willing and able to, for example, handle international M&A or project finance amounting to hundreds of millions or even billions of Euros and also structure it in international financial consortia. So if the intended steering effect of the interventionary or "precautionary measures" were actually to kick in and if what the measures are at any rate also designed to achieve were to happen, i.e. SIFIs reverting back – for cost and competition-related reasons – into small, manageable national players, there would effectively no longer be any institutions really able to shoulder such large, international finance projects.

*15. Does **Annex 5** appropriately cover the conditions under which RRPs should be prepared at subsidiary level?*

As a rule, large international banking groups are organised along business lines and not along regions or legal entities. This means that capital and liquidity in particular are managed centrally and consistently for the entire group. Risk management is also performed centrally. We therefore believe that a requirement to draw up entity-specific recovery plans in addition to group plans would be counter-productive. It is in fact quite impossible for large groups to take interdependencies and implications of individual recovery plans into account for their numerous subsidiaries.

By drawing up recovery plans centrally solely at group level, it can be ensured that

- capital and liquidity are allocated effectively and efficiently both in normal times and in crises
- uniform, coordinated crisis management is implemented and recovery measures are launched centrally,
- coordinated recovery planning is managed and updated using the same processes.

In our view, a requirement to draw up entity-specific recovery plans is therefore unnecessary and unhelpful.

If entity-specific recovery plans are nevertheless to be drawn up, we believe that the plan should be assessed by the legal entity's competent supervisor. The supervisor should also be allowed to call for changes to the plan in justified cases. So that implications for group planning can be assessed, this should be done in agreement with the consolidating supervisor.

*16. Are there other major potential business obstacles to effective resolution that need to be addressed that are not covered in **Annex 6**?*

It is important to stress that decisions on "improving resolvability" raise important level playing field issues. There must be an internationally uniform approach to achieve consistency in the types of measures required of financial institutions in all jurisdictions. The considerations should be reasonably objective and predictable so that firms can apply them in ways that seem appropriate to them, without waiting for supervisory judgment, and minimising the risks of failing to anticipate supervisory judgment correctly.

17. Are the proposed steps to address the obstacles to effective resolution appropriate? What other alternative actions could be taken?

No, as suggested in the response to question 14. The right to interfere in an institution's legal and organisational structures is too intrusive. The solutions proposed and the powers to be granted to resolution authorities in respect of resolution plans imply the risk of excessive intervention by resolution authorities in the business models adopted by credit institutions. Furthermore, for most institutions group-level resolution planning will be preferable.

18. What are the alternatives to existing guarantee / internal risk-transfer structures?

We agree that the organisational complexity of a banking group should be reduced. However, intra-group guarantees (or cross-default provisions) are a prudentially recognised risk management tool within banking groups on whose effectiveness group members rely. Any restrictions, which ultimately constitute interference in contractual autonomy, could create considerable risks – e.g. significantly higher default risk – for the counterparty/group member of the distressed institution and make adjustment of the entire risk management policy necessary. The idea to impose restrictions on intra-group guarantees (or cross-default provisions) should therefore be dropped. Such restrictions would, moreover, be at odds with the intra-group financial support approach pursued by the European Commission.

Moreover, intra-group loan exposures do not in every case impede the separability of legal entities. In the wake of the recent crisis, the large exposure requirements have already been tightened, with the focus on making firms more resilient on a stand-alone basis in a crisis. With respect to the assumption that intra-group guarantees could be an obstacle to effective resolution, it should be noted that these guarantees are required either by the local regulator or by the potential counterparties because of their risk evaluations.

*19. How should the proposals set out in **Annex 6** in these areas best be incorporated within the overall policy framework? What would be required to put those in place?*

No comments.

20. Comment is invited on the proposed milestones for G-SIFIs.

We note that the timelines involve only the technical aspects of co-operation agreements, development of recovery and resolution plans, resolvability assessments and CMG outreach. What is missing in our view is timelines for the legislative and regulatory changes that are necessary to implement the Key Attributes and on which the resolvability assessment will be based, including mandates for authorities and confidentiality safeguards.

21. Does the existence of differences in statutory creditor rankings impede effective crossborder resolutions? If so, which differences, in particular, impede effective crossborder resolutions?

We support convergence of creditor rankings as part of international harmonisation. The unequal treatment of creditors in the past has led to ring-fencing of assets of individual group units. However, it may be assumed that this cannot be achieved in the short term.

22. Is a greater convergence of the statutory ranking of creditors across jurisdictions desirable and feasible? Should convergence be in the direction of depositor preference or should it be in the direction of an elimination of preferences? Is a harmonised definition of deposits and insured deposits desirable and feasible?

While we support greater harmonisation of creditor ranking, current preferences should not be re-established but phased out. All unsecured creditors should be treated equally. The principle of equal treatment of all creditors should be enshrined in law. Deviation from this principle should be permissible only with the agreement of those affected. In the absence of such agreement, supervisory authorities should not be able to deviate from the principle of equal treatment since this could open the door to the pursuit of national interests. In addition, markets would probably take a negative view of the uncertainty thus caused, which would place banks, in particular, at a disadvantage when competing with other financial-sector firms for institutional investors.

23. Is there a risk of arbitrage in giving a preference to all depositors or should a possible preference be restricted to certain categories of depositors, e.g., retail deposits? What should be the treatment of (a) deposits from large corporates; (b) deposits from other financial firms, including banks, assets managers and hedge banks, insurers and pension funds; (c) the (subrogated) claims of the deposit guarantee schemes (especially in jurisdictions where these schemes are financed by the banking industry)?

24. What are the costs and benefits that emerge from the depositor preference? Do the benefits outweigh the costs? Or are risks and costs greater?

1. We see no reason to give preference to deposits during bankruptcy. Private and SME depositors are already protected up to a certain coverage limit through deposit guarantee schemes. Should deposits be given preferential treatment above the coverage limit, this would lead to moral hazard and conflict with the system of limited deposit protection. Also, this preferential treatment would lead to other unsecured creditors, for example, service providers or official authorities (tax offices) being put at a disadvantage. There is, in our view, no reason why depositors should be given preferential treatment above the existing coverage limit at the expense of this group.

2. Deposit guarantee schemes should be subrogated to the claims of depositors to the extent paid out by such schemes, as recommended by the BCBS and IADI Core Principles. While national deposit guarantees may differ, the differing obligations of schemes to depositors do not justify national arrangements that give them priority claims over specific sets of assets in their jurisdictions. Expectation of national priority claims could create incentives for ring-fencing and therefore non-cooperative behaviour on the part of authorities and administrators of insolvent estates. This would hamper efforts to put in place meaningful cross-border arrangements ex ante. Therefore, the objective should be to eliminate provisions in national insolvency or resolution arrangements that create obligations for national authorities to act in this pre-emptive way.

3. The rule on global resolution should be that assets of a firm should be made available for the fair resolution of all claims against the failed firm, respecting the established hierarchy without discrimination by nationality. Domestic depositor preference (excluding coverage at overseas branches) is at odds with the principles of group-wide resolution on a basis that is

fair to all creditors. It may have very anomalous effects, such as extending a preference to large institutional depositors at the home office over SME or retail depositors at foreign branches. It also tends to be associated with attempts to ring-fence local assets to the detriment of international creditors.

25. What other measures could be contemplated to mitigate the impediments to effective cross-border resolution if such impediments arise from differences in ranking across jurisdictions? How could the transparency and predictability of the treatment of creditor claims in a cross-border context be improved?

1. We would also welcome the possible establishment of a national group insolvency regime allowing integrated treatment of group entities within the same jurisdiction, provided it merely calls for the appointment of a single administrator for all entities while at the same time maintaining separate proceedings for these. A special regime purely for banks is not required, however. Instead, such a regime should be applicable to all corporate groups.

May we refer in this connection to the UNCITRAL[2] recommendations on group insolvency law which provide some useful ideas for a body of European procedural law governing group insolvencies.

These include, among other things:

- joint application and procedural coordination of proceedings of different legal entities in a group;
- allowing intra-group financing/guarantees after insolvency proceedings have commenced;
- implementation of a joint reorganisation plan;
- contribution orders;
- extension of liability.

2. We believe that a binding framework for cooperation and exchange of information between courts and administrators responsible for the different proceedings relating to individual insolvent entities in a banking group is required. It is important that existing information channels can continue to be used also during insolvency proceedings. In addition, access to data and contract documents outsourced to other group companies must remain possible. For these reasons alone, closer cooperation between the different administrators is called for.

[2] See http://www.uncitral.org/uncitral/en/index.html.

3. Another factor is that in the event of group insolvency claims of group companies against each other have to be identified and any claims against third parties asserted. The idea to appoint a lead administrator responsible for coordinating national insolvency proceedings should be followed up. This could ultimately help to reduce the length and cost of proceedings to the benefit of creditors and considerably facilitate the exchange of information. At the same time, there is the danger that such a lead administrator may lose its impartiality and independence vis-à-vis certain member states or groups of creditors. It should therefore be ensured that potential conflicts of interest between individual entities are identified early and that safeguards against these are also put in place (e.g. by appointing further administrators).

4. Overall, we would welcome it if in the event of bank insolvencies, which are invariably more complex than normal company insolvencies, supervisors were to be given the right to nominate the administrator. This would make certain that qualified administrators who can ensure quick and fair resolution are put in charge of proceedings.

5. We are, however, against any efforts to recommend asset pooling or substantive consolidation for insolvent but still legally independent entities. This would be at odds not only with the principles of company law and contract law. It means that creditors' claims against a more solvent entity would be treated in the same way as those against a less solvent entity, putting the former at a disadvantage. The actually independent entity would thus be given "dependent branch" status in insolvency proceedings. As a consequence of this treatment, assessing the credit risk of such a counterparty would be much more difficult, since not only the entity itself but the entire group would have to be considered. At worst, such a risk assessment would be impossible in future.

6. Harmonisation of substantive insolvency rules does not, on the other hand, appear to be a realistic option for achieving international regulation as national insolvency law is closely related to other areas of national law, particularly property law and contract law. Establishing an international legal framework in this field that fits in with national legal regimes and avoids any unjustified discrimination of creditors and counterparties is unlikely to be feasible in the short to medium term.

26. Please give your views on the suggested stay on early termination rights. What could be the potential adverse outcomes on the failing firm and its counterparties of such a short stay? What measures could be implemented to mitigate these adverse outcomes? How is this affected by the length of the stay?

a) Early termination clauses as a standard risk mitigation instrument/essential element of close-out netting provisions

Early termination provisions (either in the form of clauses granting an early termination right or providing for an early automatic termination) are a standard element of contractual documentation for financial transactions. They serve as highly effective risk mitigation tools.

In particular, such early termination provisions are an essential element of the close-out netting provisions in all standardised master agreements for financial transactions (financial derivative transactions, securities lending or repo transactions), such as the ISDA Master Agreements, the Global Master Securities Lending Agreement, the European Master Agreement and the various national master agreements, such as the German Master Agreement for Financial Derivative Transactions. Identical close-out netting provisions are also used by central counterparties as part of their risk mitigation measures.

The close-out netting mechanism is a uniquely effective risk mitigation instrument in respect of the specific counterparty risk emanating from financial transactions. It enables both counterparties to reduce their respective risk exposure from a gross amount to a - significantly lower - net amount of the reciprocal contractual obligations resulting from the transactions entered into under such a master agreement.

The risk-mitigating effect of close-out netting is recognised by existing international regulatory requirements (in particular, in connection with the internationally harmonised capital requirements). In order to benefit from this recognition, the relevant regulatory requirements specifically require counterparties to rely on standardised master agreements containing enforceable close-out netting provisions in the event of a default, bankruptcy, liquidation or any other similar circumstance (see for example Art. 78 (2) and Annex III, part 7 (b) of EU Directive 2006/48/EC of 14 June 2006 relating to the taking-up and pursuit of the business of credit institutions [Banking Directive]).

b) Potential impairment of the counterparty's risk-mitigating capabilities because of a stay

A stay, even a very short one, on contractual early termination provisions will directly affect the close-out netting mechanism. This will necessarily impair its function as risk mitigation instrument. The relevant counterparty relying on close-out netting for risk mitigation purposes will – for the duration of the stay – have to address the fact that its risk exposure vis-à-vis the party in respect of which a stay has been declared may change without it being able to resort to a termination of the contractual relationship to minimise the counterparty risk. Because of the volatility of the relevant markets, the changes in risk exposure may be considerable. This will pose a considerable challenge to the counterparty's risk-management capabilities. This applies correspondingly to central counterparties (CCPs).

c) Minimisation of adverse effects

Because of the potentially severe adverse effects on the counterparties (and the financial market as a whole) of a stay affecting close-out netting, the idea of stay on close-out netting as an element of a resolution mechanism has to be considered carefully. At the very least, the potential negative effects of a stay need to be limited as far as possible. To this end, such a stay would need to be subject to at least the following conditions and/or limitations:

- The scope and purpose of such a stay needs to be circumscribed as narrowly and clearly as possible. Specifically, the ability to introduce a stay needs to be connected to only one specific resolution mechanism, the transfer of assets and liabilities to a bridge institution: a stay and the connected adverse effects on the counterparties can only be justified if it serves an overriding purpose in the general interest. This would only be the case if the stay is intended to allow the transfer of assets and liabilities to a bridge bank in order prevent contagion in the financial system.
- The duration of the stay has to be as short as possible and should not exceed two days (48 hours): a suspension of the close-out netting mechanism of this length will already pose a significant challenge to the counterparties.. A longer period would result in a clearly unreasonable exposure to the risks and uncertainties which could have far reaching repercussions.
- The provisions regarding the stay have be accompanied by provisions safeguarding the legal effectiveness of close-out netting provisions in general as well as specific affirmations that any transfer of assets and liabilities has to cover the entirety of transactions entered into under a master agreement (protection of the unifying effect of master agreements/ protection against "cherry picking").
- Uncertainty over whether a stay has been imposed or the exact beginning and end of such stay has to be minimised. To this end, the trigger event for a stay has to be defined as clearly as possible Where a stay is imposed in a specific case, the counterparties and the market have to be informed thereof immediately and

simultaneously. The exact time when such a stay begins and ends s has to be defined in advance and as clearly and objectively as possible.

- The stay has to be as short as possible: a period of no more than 48 hours appears to be a time span that could be acceptable to the markets (subject to the other restrictions and limitations).

We welcome the fact that the discussion note appears to cover most of the above-mentioned conditions/limitations for a stay. As to the serious concerns raised by a discretionary power to impose a stay, see response to question 27 below.

27. What specific event would be an appropriate starting point for the period of suspension? Should the stay apply automatically upon entry into resolution? Or should resolution authorities have the discretionary right to impose a stay?

- **Specific trigger event**

As outlined above, we strongly recommend that the trigger event be defined as clearly and objectively as possible to avoid any uncertainties. To this end, the relevant event should be connected to an objective factor/notification of the public that a specific action by a specific official authority has been taken in connection with the applicable resolution framework.

In this connection, we strongly believe that the possibility to impose a stay as part of resolution measures should be restricted to only one resolution tool, namely the transfer of assets and liabilities to a bridge institution. The infringement of counterparties' rights by the imposition of a stay can only be justified if it serves an overriding interest and purpose ultimately beneficial to all market participants. Such an overriding interest can be assumed to exist in the event of a transfer of assets and liabilities to bridge institution, but not in connection with other measures.

- **Clear preference for automatic stay/strong objections against discretionary powers**

We strongly recommend to only consider the introduction of a provision imposing an automatic stay as opposed to discretionary powers: discretionary powers would result in considerable uncertainty and allow arbitrary/intransparent decisions. Both would have serious repercussions for counterparties and the financial markets as a whole.

Of course, an automatic stay would not need to affect the necessary discretionary powers of the regulatory authorities regarding the decision on whether, and if so, what kind of resolution tools are to be initiated within the resolution framework.

28. What specific provisions in financial contracts should the suspension apply to? Are there any early terminations rights that the suspension should not apply to?

As to the general concerns raised by a stay affecting close-out netting provisions, see our above comments in response to question 26.

If a stay is to be introduced which would also affect close-out netting provisions in master agreements for financial transactions, the effects of such a stay would need to be limited to

- early termination rights triggered by the initiation of insolvency proceedings or similar measures, etc. (such as restructuring or reorganisation) which might otherwise arguably be triggered by resolution measures, or
- the transfer of assets and liabilities as part of a resolution measure.

Early termination rights triggered by other default events or actions have to remain unaffected by a stay. In particular, a stay cannot affect termination rights triggered by

- a failure to pay or perform other contractual obligations (e.g. delivery of securities, etc. or a failure to post additional collateral) or other material causes, or
- a transfer of assets and liabilities which results in a separation of transactions and/or rights and obligations resulting from transactions entered into under a master agreement (i.e. transfers disrupting the unifying effect of a master agreement/resulting in "cherry picking")

29. What should be an appropriate period of time during which the authorities could delay the immediate operation of contractual early termination rights?

A period of no more than 48 hours appears to strike the right balance between the need to enable the resolution authorities to take the necessary measures to ensure a transfer of assets and liabilities and the need to minimise the impact of a stay on the counterparties and the financial markets (see above response to question 26).

30. What should be the scope of the temporary stay? Should it apply to all counterparties or should certain counterparties, e.g., Central Counterparties (CCPs) and FMIs, be exempted?

In view of the central role CCPs will assume in the future financial market architecture and the paramount need to ensure that CCPs can implement effective risk mitigation techniques, specifically the possibility to ensure effective insulation against the insolvency of any user of a CCP (clearing member), an exception for recognised CCPs may be merited.

31. Do you agree with the proposed conditions for a stay on early termination rights? What additional safeguards or assurances would be necessary, if any?

The principles set out in the proposal appear to address most of the concerns raised (see also our response to question 26 as well as well as our concerns regarding discretionary powers to impose a stay).

However, we believe that any framework setting out a stay on close-out netting provisions should also be accompanied by provisions underlining, confirming and protecting the effectiveness of close-out netting as a risk mitigation instrument. This should entail a call for further harmonisation of the legal framework ensuring the validity and enforceability of contractual close-out netting provisions.

Currently, the legal frameworks covering close-out netting can differ significantly between jurisdictions. This causes not inconsiderable legal uncertainty. Greater legal certainty over all key elements of close-out netting will greatly serve to improve the risk management capabilities of all market participants, which again would have a stabilising effect. Such greater legal certainty will be particularly welcome since the introduction of provisions implementing a stay as part of a resolution mechanism may result in unwanted new uncertainties or an exacerbation of already existing uncertainties in the different jurisdictions.

32. With respect to the cross-border issues for the stay and transfer, what are the most appropriate mechanisms for ensuring cross-border effectiveness?
33. In relation to the contractual approach to cross-border issues, are there additional or alternative considerations other than those described above that should be covered by the contractual provision in order to ensure its effectiveness?
34. Where there is no physical presence of a financial institution in question in a jurisdiction but there are contracts that are subject to the law of that jurisdiction as the governing law, what kind of mechanism could be considered to give effect to the stay?

The key element appears to be further international harmonisation of the relevant legal framework, including ancillary aspects such as contract law, company law, insolvency law and conflict of law rules. In view of the general difficulties harmonisation efforts will encounter in these areas (see our response to question 25), these would have to be restricted in scope to the specific issue of close-out netting.