7 December 2012

By electronic submission to fsb@bis.org

Financial Stability Board
c/o Secretariat to the Financial Stability Board
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Comments on the Consultative Document on *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational*

To the Financial Stability Board:

The Global Financial Markets Association[1] welcomes the opportunity to comment on the Consultative Document on *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational*, published by the Financial Stability Board (the "**FSB**") on November 2, 2012 (the "**Consultative Document**").

I. Introduction

We strongly agree with the objective of the Consultative Document, which is to provide guidance on implementing the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*[2] in an effort to set standards and promote consistency in approaches. We appreciate the opportunity to comment on the draft guidance, and provide our input based on the work on recovery and resolution planning undertaken to date. We agree with the context in which these questions arise, which is that the "recovery and resolution planning and assessment processes are iterative in nature and will likely require further refinement and adjustment over time as more experience is gained and more issues are identified."[3]

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[1] The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org

[2] Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2011) [hereinafter *Key Attributes*], available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

[3] Consultative Document at 4.

We believe that much progress has been made over the past two years in both the United States and Europe in recovery and resolution planning; defining, proposing and establishing effective legal regimes and resolution strategies, including single-point-of-entry (SPE) and multiple-point-of-entry (MPE) resolution strategies; and identifying critical functions and critical shared services. The common goal has been to develop workable mechanisms and strategies to reduce the risk of failure but deal with any failure that does occur in a manner that does not involve taxpayer-funded bailouts or result in a destabilization of the financial system, thereby ending the "too big to fail" (TBTF) problem.[4]

For example, both U.K. and other European authorities have required several European SIFIs to prepare and submit recovery plans. They have also required several European SIFIs to submit information and data that have been used by the supervisory authorities to prepare resolution plans for each SIFI. The EU has issued a proposed Recovery and Resolution Directive,[5] which would require member states to adopt new resolution regimes that would include resolution authority at least as broad as the authority contained in Title II of the Dodd-Frank Act, which is described below. Among other things, it would include a bail-in tool that would enable European authorities to effect a high-speed recapitalization of a failed SIFI similar to the FDIC's preferred strategy for resolving U.S. SIFIs, except that it can be used on a failed SIFI directly or indirectly through use of a bridge entity.

Similarly, the Federal Reserve has required several U.S. SIFIs to prepare and submit recovery plans that include well-defined stress scenarios, triggers, escalation procedures and remedy options. Eleven institutions have filed their initial resolution plans under Title I of the Dodd-Frank Act, and initial resolution plans for more than 110 additional firms are expected by the end of 2013. These plans have identified the critical functions and critical shared services performed by each material legal entity within each SIFI group.

Like the proposed EU Recovery and Resolution Directive, Title II of the Dodd-Frank Act contains a new legal regime for resolving nonbank SIFIs, and the FDIC has announced that its preferred strategy under Title II for resolving U.S. SIFIs is to use this authority to effect an SPE recapitalization and liquidity strategy.[6] That strategy involves the exchange of debt securities at the ultimate parent level of a SIFI group for equity in a new bridge parent company, and the provision of

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[4] Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE JOURNAL ON REGULATION 121 (Winter 2012).

[5] European Commission, Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, Brussels, Com (2012) 280/3.

[6] Remarks by Martin J. Gruenberg, Acting Chairman of the FDIC at the Federal Reserve Bank of Chicago's Bank Structure Conference (May 10, 2012); FDIC staff report to the Systemic Resolution Advisory Committee of the FDIC (Jan. 25, 2012), available at http://www.fdic.gov/about/srac/2012/2012-01-25_minutes.pdf.

temporary liquidity from a secured facility provided by the FDIC. The group's viable operating subsidiaries would be kept out of resolution proceedings. The FDIC has also used the Title I resolution plans to develop resolution plans under Title II of the Dodd-Frank Act.

In fact, firms are increasingly and as a "best practice" making recovery and resolution planning part of their basic, business-as-usual, management practices.

The Consultative Document is a helpful step in providing guidance on how to think about recovery triggers and stress scenarios (Annex 1); the main types of resolution strategies currently under discussion, and the operational planning necessary to implement those strategies (Annex 2); and the identification of critical functions and critical shared services, both central to resolution planning (Annex 3). In Section II below, we identify certain themes that are relevant throughout the Consultative Document and that we think should be central to how regulators approach implementation of the *Key Attributes*. In Section III, we address a number of the specific recommendations in the three Annexes, with particular emphasis on issues that relate to resolution strategies that are effective in solving the TBTF problem.

As we have noted in our previous comment letter on the *Key Attributes*,[7] we commend in particular the FSB's efforts to assemble a single comprehensive and cohesive package of policy measures to improve the capacity of authorities to resolve SIFIs within and across national borders, while recognizing that there may be different methods to implement those policies.[8] An asymmetric global framework, in which some nations have established clear protocols that promote orderly resolution without taxpayer support while others lack such clarity could be destabilizing during a financial crisis and encourage regulatory arbitrage. To that end, we also appreciate the FSB's efforts to monitor and assess how well the *Key Attributes* are being complied with across jurisdictions.

We also continue to believe that progress on orderly resolution regimes should reduce the amount of any applicable G-SIFI surcharge. If a G-SIFI is resolvable, then the need for a surcharge premised on the lack of resolvability is substantially decreased and therefore any surcharge should be commensurably reduced.

II. Common Themes in the Consultative Document

Strengthening Cross-Border Cooperation. The Consultative Document in a number of instances emphasizes that cross-border cooperation will be necessary

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[7] Joint Trade Association Comment Letter to the FSB on the Consultative Document on Effective Resolution of Systemically Important Financial Institutions (Sept. 2, 2011), available at http://www.financialstabilityboard.org/press/c_110909cc.pdf.

[8] Consultative Document at 3.

for planning, coordinating and implementing the resolution strategy. We strongly agree with that view, and suggest that the Consultative Document should further develop how such cooperation can be secured. The effectiveness of a home country regulator's preferred resolution strategy for a firm in a resolution relies upon the strategy having been clearly previewed, discussed and agreed to by the firm's Crisis Management Group.

The institution-specific cooperation agreements, or COAGs, are essential to this effort, and their importance cannot be overstated. COAGs can provide comfort, pre-resolution, to host-country regulators that the foreign-based G-SIFIs in their jurisdictions are resolvable in their current structures. This level of comfort on the part of host-country regulators also has the benefit of forestalling the temptation to force subsidiarization or other structural changes that would inefficiently trap capital and liquidity.

We also believe that resolution strategies should be developed with an assumption that host country authorities will cooperate when it is in their self-interest to do so, thereby encouraging cooperation in the event of an actual G-SIFI failure. Assuming no cooperation in a resolution plan could cause host country authorities to believe that the home country regulator does not intend to cooperate, and precipitate unwanted behavior in an actual resolution. We believe that the Financial Stability Board should also encourage home and host country authorities to act in the interest of the global financial system as whole.

As a corollary to the Consultative Document's call for greater cross-border cooperation, the Financial Stability Board should recommend that, where necessary, local legislation implementing the U.N. Model Law on Cross-Border Insolvency should be amended to apply to cross-border recognition of orderly resolution proceedings. This will increase the legal certainty that bail-in and other actions taken during a resolution proceeding in one jurisdiction will be recognized in other jurisdictions.

Sources of resolution funding. The Consultative Document raises the issue as to potential sources of resolution funding, which should be detailed in resolution plans. We believe that in the event that private DIP financing was not available, resolution financing arrangements should be designed to provide institutions in resolution with temporary, industry-backed liquidity support, subject to prudent statutory limitations, such as on a super-senior or secured basis and possibly at higher than a normal market rate similar to traditional lender-of-last-resort facilities provided by central banks. Financing arrangements should not be used to provide capital, or any other form of loss absorption, but only liquidity, to a financial institution in resolution. Although this liquidity could be initially provided or guaranteed by public sources, any losses should be recovered from the assets of the firm or, as a last resort, by ex-post, not ex-ante, assessments on the financial industry. We agree that details of such financing arrangements should be covered in resolution plans and firm-specific cross border cooperation agreements.

Developing a "preferred resolution strategy," or presumptive path. The Consultative Document helpfully endorses the development by resolution authorities of a "preferred resolution strategy," and we believe such pre-vetted presumptive resolution strategies for G-SIFIs would help provide a credible alternative to the dilemma between taxpayer-funded bailouts and resolution strategies that carry a high risk of destabilizing the financial system. It is important to emphasize, however, that one size does not fit all. Authorities may need to develop customized presumptive paths for individual SIFIs or groups of similarly situated SIFIs, depending on their legal structures, size, complexity, funding structure, or other characteristics or circumstances.

The *Key Attributes* lays out many of the tools necessary for an orderly resolution of a failed SIFI. As the Consultative Document recognizes, however, this toolkit will not be effective unless host-country regulators, depositors, creditors, equity holders, counterparties and financial market infrastructures (FMIs), among others, all have a reasonable degree of confidence in the following:

- how a particular SIFI will be resolved in a failure scenario;
- short-term depositors, other short-term creditors, counterparties, FMIs and other claimants on operating liabilities do not need to exercise their contractual rights to run, terminate their contracts, restrict access to their facilities, invoke their loss-sharing provisions or otherwise take self-interested actions that could destabilize the financial system ;
- the resolving authority will seek to maximize the SIFI's value in good faith for the benefit of the equity, long-term debt and other claimants that will be required to absorb its losses, consistent with other systemic risk concerns; and
- all loss-absorbing claimants, including those in host countries, will be treated fairly and reasonably in accordance with their structural or other pre-insolvency priority of claims, and will be no worse off than in a liquidation.

In the absence of such confidence, local authorities will ring-fence local operations, and short-term creditors, counterparties, FMIs and other claimants on operating liabilities throughout the system will run or take other self-interested actions that could spread panic and create a high risk of destabilizing the financial system. In contrast, by formulating a "presumptive path" that reflects the features listed above, resolution authorities can foster cooperation among home and host country authorities and present a coordinated view on their ability to efficiently apply resolution to achieve its objectives.

As the Consultative Document points out, by formulating a presumptive path, regulators need not be locked in to particular actions in the event the market conditions or failure scenario warrants a different result. It is a *presumptive* path, not a

definitive one, and does not preclude the flexibility of resolution authorities to adjust the resolution strategy as necessary under the circumstances.

Priority of Claims. As a corollary to a clear presumptive path, consideration needs to be given to how to reduce or eliminate the incentive for short-term creditors and other holders of operating liabilities of a failed G-SIFI to run during a financial crisis without a taxpayer-funded bailout. There are several ways to accomplish this goal, some of which are more effective than others, including the following:

- One is to give resolution authorities the discretion to treat short-term creditors better than long-term creditors in a resolution proceeding, subject to the no creditor worse off than in liquidation principle. They might exercise this discretion, for example, by applying the bail-in tool to long-term creditors before applying it to short-term creditors.

- Another is to make the claims of long-term creditors structurally subordinate to those of short-term creditors, as in a bank holding company structure where the bail-in tool is applied to the long-term claims at the holding company level before it is applied to the short-term claims at the operating company level. This is how the FDIC's SPE recapitalization within resolution approach would reduce or eliminate the incentive of short-term creditors of a failed U.S. G-SIFI to run.

- Still another is to make the claims of long-term creditors legally subordinate to the claims of short-term creditors.

- A final option is to exclude short-term credit from the bail-in tool altogether. For example, the proposed EU Recovery and Resolution Directive would exclude all credit with an original maturity of 30 days or less. This is how the proposed EU Directive would reduce or eliminate the incentive of short-term creditors of a failed European G-SIFI to run.

In all four options, long-term debt and other capital structure liabilities would act as a shield against the bail-in tool being applied to short-term credit and other operating liabilities. In the first three options, it would not be an absolute shield, but only require the bail-in tool to be applied to the capital structure liabilities before it is applied to the operating liabilities. In the fourth, it would be an absolute shield, excluding operating liabilities from the bail-in tool altogether. We believe that the Consultative Document should encourage resolution regimes to include one or more of these options.

Commitment to maximize value. We agree with the Consultative Document that the objectives of the Key Attributes "need to be kept in mind" by the administrative agencies and other authorities responsible for resolving SIFIs, including the objective to "avoid unnecessary destruction of value and seeking to miminise the costs of resolution to home and host authorities and losses to

creditors."[9] The responsible administrative agency or authority should make a strong public commitment or have a statutory duty to maximize the value of a failed SIFI in good faith for the benefit of the SIFI's claimants, subject to any competing duty to manage systemic risk.

Relative priority of claims. The Consultative Document provides that, "[i]n line with Key Attribute 3.1, the conditions [for triggering a resolution proceeding] should permit timely entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully absorbed."[10] But early intervention can be unfair to equity holders and long-term debt holders, if it means their claims will be written down, especially during a financial crisis when asset and franchise values are exceedingly uncertain. Indeed, equity holders and long-term debt holders may have constitutional or human rights claims that any such write-downs before balance-sheet insolvency unfairly takes their property for a public purpose (to end taxpayer-funded bailouts or preserve financial stability) without just compensation. Regulators may be reluctant to expose themselves or their governments to such litigation claims. This can create a serious impediment to the use of resolution authority before balance-sheet insolvency.

This problem arises only if an "absolute" priority rule is used rather than a "relative" priority rule. As a result, the solution to this problem is to substitute a relative priority rule for an absolute priority rule.

A debate has raged for nearly a century over whether value should be distributed in an insolvency or resolution proceeding based on an absolute priority rule or a relative priority rule.[11] An absolute priority rule means that if there is a shortfall in the amount of value available for distribution in an insolvency proceeding, junior claims that remain after the last drop of value has been distributed in accordance with the pre-insolvency priority of claims receive nothing. In other words, such junior claims are written off, simply and permanently. In contrast, under a relative priority rule, the junior claims remaining after all the apparent value has been distributed receive a warrant or other junior security that allows them to participate in the upside of the assets being distributed if the true value of the distributed assets turns out to be higher than expected. If asset and franchise values can be determined with certainty, there is no difference between these two rules. But if shares in a going concern or bridge entity or other assets are distributed at a time when asset and franchise values are uncertain, as would be the case in a bail-in during a financial crisis when asset and franchise values are exceedingly uncertain, there could be unrecognized value that could inure to the benefit of the holders of warrants or other junior securities.

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[9] Consultative Document at 21, paragraph 4.1, footnote 11.

[10] Consultative Document at 23, paragraph 4.4.

[11] See James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Securities Holders in a Corporate Reorganization*, 28 COLUMBIA LAW REVIEW 172 (1928).

The absolute priority rule is the dominant approach in the United States and most other jurisdictions. Even in these jurisdictions, however, creditors often contract around the absolute priority rule in favor of a relative priority rule in a corporate reorganization proceeding when asset and franchise values are uncertain.[12] They do so in order to facilitate agreement on a mutually beneficial plan of reorganization.

To facilitate compliance with its recommendation to trigger resolution proceedings before balance-sheet insolvency, we believe that the Financial Stability Board should recommend the use of a relative priority rule instead of an absolute priority rule in resolution regimes designed for SIFIs during a financial crisis. This should reduce or eliminate resistance by equity and long-term debt holders and the reluctance of regulators to involve resolution proceedings before balance-sheet insolvency.

Due Process. As a corollary to the presumptive path and other recommendations designed to encourage public confidence in the process, we believe it is essential for the Consultative Document to recommend enhanced due process protections that are consistent with the need for speedy action in resolving a failed or failing SIFI. Traditional ex-ante judicial review is inconsistent with the need for speed and flexibility during a financial emergency. But the need for speed would not be frustrated by robust ex-post judicial remedies for any failure by the responsible administrative agency to carry out its duties in good faith or for any abuse of its authority.

The need for financial stability during a financial crisis necessarily requires that resolution authorities be given extraordinary discretion and that traditional ex-ante due process protections be compromised. But that sort of discretion carries with it the potential for abuse. Ex post judicial review and remedies, based on an abuse of discretion standard of review, would strike the right balance between the need for speed, flexibility and fundamental fairness.

Resolvability Assessments. The Consultative Document raises in various instances the resolvability assessments that are expected to be launched in 2013 and how those will be conducted. We strongly believe that the industry should be consulted as the standards for resolvability are developed and as those assessments are conducted. As much as possible, resolvability assessments should be transparent to the firms being reviewed, and the standards articulated in advance. While the assessments are still being developed, and as iterations of the recovery and resolution plans are reviewed, it may be advisable to suspend the assessments, or at least suspend any requirement for firms to make structural changes based on those assessments.

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[12] Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE LAW JOURNAL 1930 (2006).

III. Specific Recommendations on the Annexes

We and our members are strong supporters of recovery and resolution planning as a key building block in the emerging system of enhanced prudential regulation for G-SIFIs. Based on the industry's experience with recovery and resolution planning for regulators already underway, we respectfully suggest some modifications and refinements to the Annexes aimed at further strengthening the resolution plans.

Annex 1, Guidance on Recovery Triggers and Stress Scenarios. We agree with the guidance in Annex 1, in particular that the breach of triggers should only cause an internal escalation and review process rather than any automatic, compulsory recovery response. In fact, monitoring and escalation should be taking place even before any triggers are actually breached. We believe that all triggers should be early warning indicators rather than directly linked to specific recovery actions. We believe that triggers should only result in individually-tailored actions taken by management at those firms.

We also believe that any notices, determinations and regulatory actions taken under the triggers and recovery actions should be treated as highly sensitive, non-public, confidential supervisory information. Public disclosure of trigger breach or recovery action could further weaken any firm subject to the requirement and could precipitate a crisis.

With regard to stress scenarios, we would recommend that supervisory guidance to G-SIFIs in employing stress scenarios should aim to create a level playing field among institutions so that the stress test results can be compared across firms. We recognize that each firm will also have their own scenarios and assumptions, but an effort by supervisors to promote some common assumptions will promote fairness and equal treatment of firms.

Annex 2, Guidance on Developing Resolution Strategies and Operational Resolution Plans. Subject to our comments in Section II above, we generally support the guidance in Annex 2 on developing resolution strategies and operationalizing resolution plans.

SPE and MPE Strategies. The Consultative Document helpfully details the pre-conditions for invoking the SPE and MPE approaches. We welcome the flexibility to develop different preferred resolution strategies for differing G-SIFI structures. We agree with the guidance that a firm should not have to comply with both the SPE and MPE strategies, and that a firm should not have to prepare a resolution plan for all possible failure scenarios. A resolution authority should pick the approach most appropriate for a firm's resolution plan, and should not require a firm that can be resolved under a SPE strategy to also prepare to be resolved under a MPE strategy. This would lead to excess costs, inefficiencies, and potentially counterproductive measures being taken.

Information Availability and Sharing. The Consultative Document notes that resolution authorities should have ready access to information that would be needed in the event of a crisis, as well as notice of any material changes in positions of the firm.[13] We recommend that there should be a coordinated approach among the CMG for a firm to prepare this information in one format for all applicable regulatory stakeholders. Moreover, the guidance does not address data protection regimes that could inhibit an authority's ability to share information.

Overrides of Ipso Facto *Clauses and Cross-Defaults.* Consistent with the Key Attributes, entry into resolution and the exercise of resolution powers should not constitute an event that entitles a counterparty of the firm in resolution to exercise contractual acceleration or early termination rights, provided the substantive obligations under the contract continue to be performed.[14]

Resolution regimes that allow for the override of *ipso facto* clauses and cross-defaults are limited to the extent that those overrides are not recognized and cannot be enforced outside the home country resolution. We believe that host countries should put into place laws or regulations that allow the host country resolution authorities to recognize actions taken in the home country, such as overrides of *ipso facto* clauses and overrides over cross-defaults that are triggered based on the home country action. For example, under Title II of the Dodd-Frank Act, the FDIC, as the resolution authority, has the power to override *ipso facto* clauses in contracts that would otherwise allow for the termination of the contract upon the insolvency or receivership of the firm. Similarly, Section 210(c)(16) of the Dodd-Frank Act allows the FDIC, as the resolution authority, to override cross-default provisions in subsidiary and affiliate contracts that are linked to or supported by the company in resolution.

Similarly, we recommend that local law should provide for the enforcement of the transfer of assets and liabilities to eligible entities notwithstanding consents, approvals, or change of control provisions that would otherwise apply.

Post-Resolution Actions. In addition to developing a post-resolution strategy, regulators should also articulate in advance how they would approach the governance of a firm that had been subject to resolution actions. In particular, to what extent would private management be put into place while the post-resolution strategies are implemented? And to what extent would the creditors be consulted on key decisions affecting the value of the firm?

Annex 3, Guidance on Identification of Critical Functions and Critical Shared Services. We support the guidance in Annex 3, and underscore the importance of coordination among regulators in requesting information. We

[13] Consultative Document at 24, paragraph 4.5.

[14] Key Attributes at 10, paragraph 4.2.

recommend that regulators coordinate so that the information they request from firms is consistent and to the extent possible, in a single format. Such coordination can avoid duplicative and overlapping requests that make compliance with the requests inefficient and costly.

Categories of Critical Functions. While we agree that the five broad categories of critical functions listed in the Appendix appear to cover all relevant and critical G-SIFI activities, we recommend that the category of "payments, clearing and settlement" should be split into three separate categories. The category seems to encompass too broad a range of activities, and we would suggest splitting this category into (1) payments, (2) clearing and settlement, and (3) custody. We believe that these are separate critical functions that more naturally align with a subset of activities.

Definition of Critical Shared Services. We broadly agree with the definition and framework for "critical shared services." We do, however, suggest that an amendment be made to the part of the definition that states "for one or more business units or legal entities of the group" to replace this with "for one or more critical functions, business units or legal entities of the group." We believe it is important to recognize the critical shared services that are provided to one or more critical functions in resolution planning.

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The GFMA thanks the FSB for the opportunity to comment on the Consultative Document. If you have any questions, please do not hesitate to e-mail or call the undersigned.

Sincerely,

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