



December 1, 2014

Financial Stability Board
Attn: Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Cross-border Recognition of Resolution Action, Consultative Document, September 29, 2014, and Guidance on Cooperation and Information Sharing with Host Authorities of Jurisdictions not Represented on CMGs where a G-SIFI has a Systemic Presence, Consultative Document, October 17, 2014

Ladies and Gentlemen:

Better Markets¹ appreciates the opportunity to comment on the above-captioned consultative documents (the “Cross-Border Consultative Document” and the “Cooperation Consultative Document,” respectively, or collectively, “Consultative Documents”) of the Financial Stability Board (“FSB”).

INTRODUCTION

On September 2, 2013, the Financial Stability Board (“FSB”) prepared a report to the G-20 on “Progress and Next Steps Towards Ending ‘Too-Big-To-Fail.’”² The TBTF Report noted that the “G-20 Leaders called on the FSB to propose measures to address the systemic and moral hazard risk associated with systemically important financial institutions (“SIFIs”). SIFIs are institutions of such size, market importance, and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences.”³

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.

² Financial Stability Board, *Progress and Next Steps Towards Ending “Too-Big-To-Fail”* (Sept. 2, 2013), available at http://www.financialstabilityboard.org/2013/09/r_130902/ (“TBTF Report”).

³ *Id.* at 2.

The TBTF Report outlined a broad range of actions that must be taken by the G-20 authorities for ending the problem of too-big-to-fail financial institutions. The report recognized that one important element of ending too big to fail is reducing uncertainty regarding the cross-border effectiveness of resolution measures. In the report, the FSB made a commitment to develop policy proposals on “how legal certainty in cross-border resolution can be further enhanced.”⁴

The Cross-Border Consultative Document, issued approximately a year following the TBTF report, responds to that commitment and offers two basic sets of policy proposals:

1. Statutory provisions – “a set of elements that jurisdictions should consider including in their statutory cross-border recognition frameworks in order to enable effective cross-border resolution;”⁵ and
2. Contractual provisions addressing stays and bail-ins – “contractual approaches to cross-border recognition that focus on two particular cases where achieving cross-border recognition is a critical prerequisite: temporary restrictions or stays on early termination rights in financial contracts; and ‘bail-in’ of debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity.”⁶

Specifically, the FSB proposed that domestic legal frameworks should include the following seven elements:

1. Giving domestic authorities the legal capacity to give effect to foreign resolution measures and establish which actions may be taken by these authorities;
2. Establishing the process and conditions for giving effect to foreign resolution actions;
3. Identifying the reasons for granting recognition of foreign resolution proceedings or adopting measures to support foreign resolution actions;
4. Adopting resolution processes that are guided by the principle of equitable treatment of creditors;
5. Promoting speed of resolution;
6. Instituting legal protections for foreign resolution authorities; and
7. Requiring and incentivizing firms to adopt contractual approaches pending more permanent statutory solutions.

⁴ Cross-Border Consultative Document at iii (quoting the TBTF Report).

⁵ *Id.*

⁶ *Id.*

As part of element seven of the above cross-border recognition framework, the FSB proposes two contractual approaches for orderly resolution:

1. A regulatory requirement for market participants to adopt the ISDA protocol for the cross-border enforcement of a temporary stay of early termination rights in relation to resolution-based defaults; and
2. Contractual recognition of write-downs, cancellations, or conversions of debt instruments in resolution (“bail-in”) where the instruments are governed by the laws of a jurisdiction other than that of the issuing entity.

Additionally, pursuant to the FSB’s “Key Attributes of Effective Resolution Regimes for Financial Institutions,” the FSB set up groups (“Crisis Management Groups”) of home and key host authorities for FSB-designated global, systemically important financial institutions (“G-SIFIs”). The purpose of each Crisis Management Group is to coordinate the development and implementation of recovery and resolution procedures for designated global SIFIs. In the Cooperation Consultative Document, the FSB noted that for reasons of operational efficiency and effective decision-making, Crisis Management Group membership is limited to key authorities from jurisdictions that are home or host to entities that are material to an effective resolution of the firm. The FSB further noted that as a result, some jurisdictions where the operations of a firm are “locally systemic” may not be represented in the Crisis Management Group.⁷

The FSB has invited comment on the issues raised in both the Cross-Border Consultative Document and the Cooperation Consultative Document.

SUMMARY OF COMMENTS

In this comment letter, we first review the fundamental and enduring problem that lies at the heart of the too big to fail challenge: the continued growth in the size and complexity of TBTF institutions. We further issue a renewed call for measures to address this problem, including structural reforms as well as enhanced capital, leverage, and liquidity requirements for TBTF institutions.

We then address the specific proposals in the Consultative Documents. Those proposals are sound in many respects. To achieve legal certainty in cross-border resolutions, it is essential first and foremost to have in place legally binding and enforceable domestic laws. The legal certainty provided by such statutory requirements would support the administrative efforts of global regulators in implementing efficient and effective cross-border resolution actions. As the FSB has indicated, the “large-scale close-out of financial contracts based on early termination and cross-default rights when firms enter resolution can hinder the effective implementation of resolution strategies.”⁸ We

⁷ The FSB Cross-Border Crisis Management Group is chaired by the Federal Reserve Bank of New York First Vice President, Christine Cumming.

⁸ TBTF Report, at 6.

agree that repo and OTC derivatives safe harbors (early termination rights) should be abolished or severely limited in the context of bankruptcy law and resolution.

However, the FSB proposals fall short in certain respects and may have significant unintended consequences, leading to outcomes that are contrary to the FSB's goals and expectations. For example, we question the soundness of outsourcing the public policy development of stay mechanisms to ISDA, even as a short-term measure. In addition, the bail-in measures proposed by the FSB fail to address inherent conflicts of interest and moral hazards.

In addition, from the standpoint of operational effectiveness, the exclusion of certain authorities from the Crisis Management Groups will actually impair coordination and data exchange, thus hampering global agreements and consistent approaches to resolving TBTF institutions. The basic structure of the Crisis Management Groups must be reviewed and enhanced to make them more inclusive and transparent.

Ultimately, to end TBTF, financial regulators must take at least three essential steps:

1. Reduce the complexity of financial institutions;
2. Implement international and domestic laws for the effective bankruptcy of failed financial institutions, and reform the Crisis Management Group membership and procedures; and
3. Consider requiring any executive compensation at SIFIs which is non-salaried to be awarded in the form of the bank holding company equity and bail-in debt.

We address each of these points in more detail below.

COMMENTS

1. The size and complexity of financial institutions must be reduced.

The primary problem of too-big and too-complex-to fail institutions is that they are too big and too complex. Consequently, the first step in addressing the TBTF problem is to reduce the size and complexity of those institutions through domestic and international structural measures.

A. Large banks continue to grow.

As the facts prove and all agree, the concentration of business within TBTF institutions has only increased since the beginning of the global financial crisis. For example, in 2011, the IMF wrote, regarding global financial institutions, in "Crisis Management and Resolutions: Early Lessons from the Financial Crisis," as follows:

"Many of the structural characteristics that contributed to the buildup of systemic risk in financial sectors are still in place today, and moral hazard has increased. **In most countries, the structure of the financial system**

has changed little. In fact, as large banks acquired failing institutions, concentration has increased on average – for the 12 recent crisis countries, the assets of the five largest banks have risen from 307 percent of GDP before crisis to 355 percent in 2009 – complicating resolution efforts. The large-scale public support provided to institutions and markets – a contingent liability equivalent to one-fourth of GDP at the peak of the crisis – has exacerbated perceptions of “too important to fail” (Goldstein and Veron, 2011). Failing firms may be resolved in a number of ways, but in the recent crisis, few creditors were forced to write down claims because of the risk of contagion. The shielding of creditors restored confidence more quickly, but it did so at the cost of moral hazard and the perpetuation of the too-important-to fail problem (and stretched sovereign balance sheets).”⁹

Similarly, in 2014, the Vice Chairman of the U.S. Federal Deposit Insurance, Thomas M. Hoenig, detailed the problem regarding U.S.-based global institutions as follows:

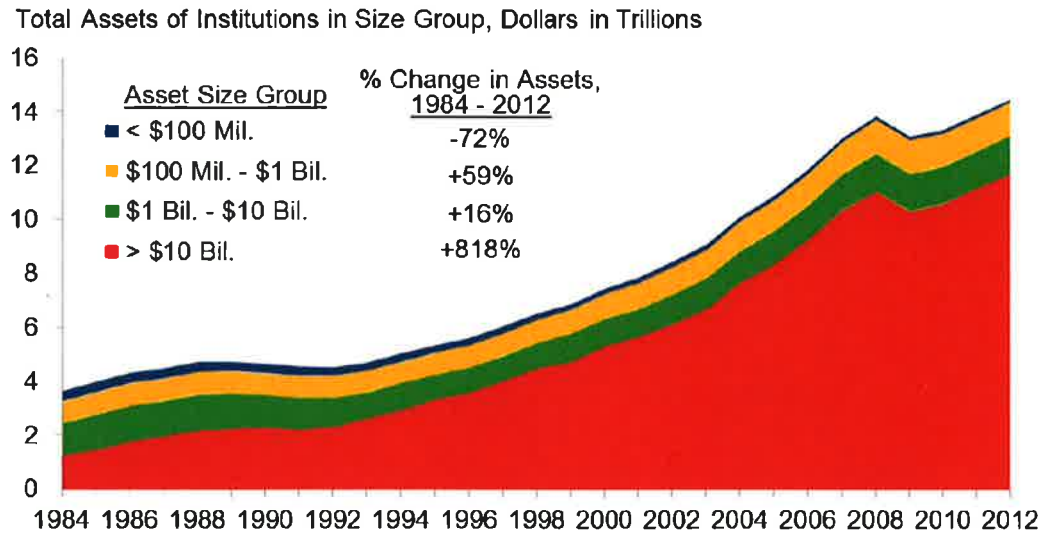
“The chart titled Consolidation of the Credit Channel [below] shows the trend in concentration of financial assets since 1984. The graph shows the distribution of assets for four groups of banks, ranging in size from less than \$100 million to more than \$10 billion. The chart shows that in 1984, the control of assets among the different bank groups was almost proportional. Also, within each group if a single bank failed, even the largest, it might shock the economy, but most likely would not bring it down. Today this distribution of assets is dramatically different. **Banks controlling assets of more than \$10 billion have come to compose an overwhelming proportion of the economy, and those with more than a trillion dollars in assets have come to dominate this group. If even one of the largest five banks were to fail, it would devastate markets and the economy.**”¹⁰

⁹ International Monetary Fund, *Crisis Management and Resolution: Early Lessons from the Financial Crisis* (Mar. 9, 2011) (emphasis added).

¹⁰ Thomas Hoenig, *Speech to the National Association for Business Economics 30th Annual Economic Policy Conference* (Feb. 24, 2014).

Consolidation of the Credit Channel

Change in Assets by Bank Size Groups (1984-2012)



Source: FDIC. Reflects the aggregation of total assets of FDIC-insured institutions by bank holding company and also includes charter-level assets for banks with no holding company.

Regulators cannot solve the TBTF problem without reducing financial companies' complexity and concentration. While problems of effective resolution tools such as stays on early termination rights and 'bail-in' of debt instruments are important steps forward, they are secondary measures for ending too-big and too-complex to fail firms.

B. Structural banking reforms need to take place now to end too big to fail.

Structural banking reforms and enhanced capital, leverage, and liquidity requirements are the essential initial steps that must be in place to make progress in the TBTF area. Whether those measures are the Volcker, Swaps Push-Out, or Foreign Banking Organizations rules in the U.S.; the ring-fencing of core activities approach to non-European Economic Area bank branches in the UK; or the European Commission's proposal on banking structural reform, they need to be in place now – already six years after the beginning of the financial crisis.

Unfortunately, there have already been too many delays and postponements in implementation and enforcement of key structural measures. For example, there are reports that U.S. Federal Reserve officials are discussing delaying the Volker Rule from July 2015 to a later date; U.K. policies do not become effective until 2019; and E.U. rules are still not promulgated. The primary focus of global regulators in ending TBTF and promoting cross-border resolution of those institutions must be to urgently implement structural reforms to reduce the complexity and size of TBTF institutions.

2. **As recognized by the FSB, international and domestic laws must be adopted, which provide for the effective bankruptcy of failed financial institutions.**

One critical element in solving the TBTF problem is increasing legal certainty in the process of cross-border resolution. That in turn requires legally binding and enforceable domestic laws, preceded if necessary by strictly temporary international agreements, that promote speed, predictability, and harmony in cross-border resolutions.

A. **Statutory frameworks, not contracts, must be the long-term solution to the cross-border recognition of resolution actions.**

The legal certainty provided by statutory requirements would strongly support the administrative efforts of global regulators in the implementation of efficient and effective cross-border resolution actions. “[L]arge-scale close-out of financial contracts based on early termination and cross-default right when firms enter resolution can hinder the effective implementation of resolution strategies.”¹¹ Moreover, repo and OTC derivatives safe harbors (early termination rights) should be abolished or severely limited in the context of bankruptcy law and resolution.

The global nature of the complex financial institution and the national framework for their resolution is the core of the TBTF problem. There are two obvious ways to address these elements – either by **de-globalizing financial companies** and making them more local or by introducing robust **international resolution laws** and agreements.

As the IMF suggested in 2010, “one solution to this problem would be the conclusion of a multilateral treaty that would obligate countries to defer to the resolution decisions of the jurisdiction where the financial institution or group has its main activities.”¹² However, as history has proved, the IMF correctly notes that “given their [financial regulators’] concerns over financial stability and the potential fiscal cost of bank failure, the authorities of many countries have been unwilling to surrender control over these issues.”¹³ As a result, the IMF suggested focusing on enhancing co-ordination among national authorities as an intermediate solution. But even in this second-best approach the IMF identified material risks:

“When the regulatory authorities are faced with the distress or failure of a financial institution within their territory, they tend to give up primary consideration to the potential impact on their own stakeholders: namely, creditors to branches or subsidiaries located within their jurisdiction, depositors and, in the final analysis, local taxpayers.”¹⁴

¹¹ TBTF Report, at 15.

¹² International Monetary Fund, *Resolution of cross-border banks – a proposed framework for enhanced coordination* (June 11, 2010), at 5.

¹³ *Id.*

¹⁴ *Id.* at 9.

The IMF noted that the first step in promoting the global cross-border coordination should be “the **modification of domestic laws** that would require national authorities to coordinate with foreign jurisdictions.”¹⁵ This position was echoed by Michael Gibson in his U.S. Senate testimony in May 2013 when he noted,

“foreign subsidiaries and bank branches of a U.S.-based systemic financial firms could be ring-fenced or wound down separately under the insolvency laws of their host countries if foreign authorities did not have full confidence that local interest would be protected. Further progress on cross-border resolution ultimately will require significant **bilateral and multilateral agreements** among U.S. regulators and the key foreign central banks and supervisors for the largest global financial firms. It also may require that home-country authorities provide credible assurance to host-country supervisors to prevent disruptive forms of ring-fencing of the host-country operations of a failed firm.”¹⁶

The Cross-Border Consultative Document acknowledges that “statutory frameworks . . . are the preferred longer term solution to the cross-border recognition of resolution actions” when introducing the short term contractual solutions.¹⁷ Moreover, it identifies the critical shortcoming of the contractual versus statutory approach:

“the enforceability of such contractual recognition provisions has yet to be tested in the courts and limitations on their enforceability (for example, on public policy grounds) may not always be clear.”¹⁸

That is very much the overriding concern with the pursuit by the FSB of the contractual approach if it is not followed immediately by a statutory implementation. The FSB should focus all of its resources and authority on implementing domestic and international legally binding and enforceable statutory requirements on cross-border resolution actions and not be distracted by the interim and potential very disruptive contractual approach that, as the FSB itself acknowledged, is untested and may not work during a crisis.

In its report to the G-20, the FSB identified “legal uncertainties about cross-border effectiveness of resolution measures as one of the main obstacles to the resolution of systemically important financial institutions that operate across border.”¹⁹ Consequently, the statutory framework of domestic laws and international treaties must be implemented as soon as possible so as to provide that legal certainty. This, not the contractual approach, should be the objective of the FSB work. Contracts must be used only as expressly

¹⁵ *Id.*

¹⁶ Michael Gibson, Testimony before the Subcommittee on National Security and International Trade and Finance, U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Cross-Border Resolution (May 15, 2013).

¹⁷ Cross-Border Consultative Document, at 11.

¹⁸ *Id.*

¹⁹ Cross-Border Consultative Document, at iii.

acknowledged temporary measures to fill in the gaps pending the implementation of a statutory framework. The prolonged existence of an untested as well as legally and politically questionable contractual approach **without** a clear, robust, and workable statutory and administrative framework is unacceptable and inconsistent with the G20 and FSB mandate.

B. Cross-border cooperation must improve via reforms in Crisis Management Groups.

Pursuant to the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutes," the FSB set up Crisis Management Groups of home and key host authorities for FSB-designated G-SIFIs. The FSB noted that for reasons of operational efficiency and effective decision-making, Crisis Management Group membership is limited to key authorities from jurisdictions that are home or host to entities that are material to an effective resolution of the firm. In its 2013 report to the G-20, the FSB recognized that the Crisis Management Group membership may not include "host authorities in jurisdictions where a G-SIFI has a systemic presence."²⁰

However, instead of undertaking the reform in the Crisis Management Groups, the FSB is developing a system of eligibility determinations and types of information sharing for different participants. This is a counterproductive way to promote global agreement and buy-in for the cross-border resolution actions that Crisis Management Groups were designed for. If some authorities are excluded from the groups because they are deemed not "key" enough to be present at the table to agree on cross-border resolution models, it is unlikely they will cooperate with other authorities when the crisis event takes place. Instead, they will likely assume that because they are not significant on a global scale, their interests will not be considered in the cross-border resolution activities of "major players." That will promote domestic ring-fencing, collateral seizure, and similar activities that Crisis Management Groups were designed to prevent.

Making matters worse, the current insufficiency or lack of cooperation and information sharing agreements between key and non-key authorities that oversee G-SIFIs also raises concerns regarding the legal uncertainties in cross-border resolution activities. The efficiency of resolution activities is undermined when some authorities overseeing a SIFI are absent from the process and lack a commitment to the cross-border resolution agreement. That casts further doubt on the reliability of a contractual approach for cross-border resolution in jurisdictions that did not commit to the applicable regulatory and international agreements.

An international agreement for cross-border resolution is necessary to provide legal certainty to cross-border resolution actions and to ensure that all authorities have an opportunity to engage in, and commit to, the international resolution initiative. Moreover, without authorities from non-home and non-key host jurisdictions being engaged in the

²⁰ Cooperation Consultative Document, at iii.

development of the cross-border resolution regimes and coordinating resolution activities, the effectiveness of the cross-border resolution activities will be jeopardized.

C. Early terminations rights should be eliminated in domestic and international laws rather than abolished through the problematic approach of relying on contractual agreements

In the September 2013 report to the G-20 Authorities, the FSB stated that “large-scale close-out of financial contracts based on early termination and cross-default rights when firms enter resolution can hinder the effective implementation of resolution strategies. G-20 authorities can encourage ISDA and other industry bodies to review contract provisions to prevent large-scale early termination of financial contracts.”²¹ The FSB committed to developing proposals for contractual and statutory approaches to prevent large-scale early termination of financial contracts by the end of 2014, a mere month away.

However, the FSB acknowledged in the Consultative Document that contractual agreements are binding under contract law only on the parties that agreed to such contracts, and that prudential regulators do not have regulatory authority over entities that are not subject to prudential regulation. Consequently, the FSB suggests that only “banks, investment firms and other financial firms subject to prudential regulation could be required by prudential rules to adopt the necessary contractual language on stay in resolution with all their counterparties.”²²

The FSB is right that the elimination or severe restriction of early termination rights in financial contracts is necessary for the effective implementation of resolution strategies for global systemically important financial institutions. However, if a contractual approach is not immediately followed by a statutory framework, it can be potentially very disruptive to financial stability. The statutory framework of domestic laws and international treaties provides for the ultimate legal certainty in cross-border resolution activities and should be the objective of the FSB work. The FSB should have a commitment from its members for changes in the bankruptcy and other relevant financial regulation laws across the world to ensure the legally binding nature of the stay requirement in multiple jurisdictions in a consistent manner.

Furthermore, the lack of transparency and public engagement in the policy development process adopted by the FSB when advancing the ISDA contractual approach is troubling and problematic. The apparent inclination of financial regulators to rely – apparently blindly – on a swap dealer driven master agreement framework as a substitute for any statutorily mandated regulatory regime is as unwise as it is unacceptable. This is little more than outsourcing de facto rulemaking authority to the swap dealer controlled association.

²¹ TBTF Report, at 6.

²² Cross-Border Consultative Document, at 13.

On November 4, 2014, ISDA released its 2014 resolution stay protocol. ISDA noted that in November 2013, regulatory authorities from France, Germany, Japan, Switzerland, the United Kingdom, and the United States of America requested that ISDA eliminate close out rights triggered by the resolution of a SIFI. In response to these authorities, ISDA “developed the Protocol to provide a contractual approach to cross-border recognition until comprehensive statutory regimes are adopted.”²³ ISDA noted that while “special resolution regimes” are already in place, **“the enforceability of such stays in foreign jurisdictions is not certain, and recognition in foreign resolution actions is permissive, not mandatory.”**²⁴ Consequently, the FSB suggests that contractual approaches can both fill the gap where no statutory recognition framework is in place and reinforce the legal certainty and predictability of recognition under the statutory framework once adopted. Furthermore, with respect to U.S. insolvency proceeding provisions, the ISDA notes that they will become effective only on the date the related U.S. **regulations** become effective and compliance therewith is required.

The governing law under the ISDA resolution stay protocol is the law of **England and Wales**. Traditionally, private contracts include a choice of law provision that favors the strongest of the private parties, with potentially detrimental consequences for the public interest when a dispute arises. Moreover, no choice of law provision in a private contract contemplates its use in a time of crisis. That is why outsourcing the adoption of public law requirements to private contracts and utilizing the contractual approach for anything but a short-term transition to a statutory approach is inadequate. The financial regulatory authorities should review and agree on the legal framework for cross-border resolution and recovery actions that best protects the public interest, both globally and domestically.

Parties adhering to the Protocol (entities that signed the document) opt “in to resolution regimes that stay and, in certain cases, override certain cross-default and direct-default rights included in derivatives contracts that arise upon the entry of a bank, or **certain of its affiliated entities**, into receivership, insolvency, liquidation, resolution or similar proceedings.”²⁵ That means that not all affiliates of financial institutions will be subject to the mandatory stay. Unless FSB intends to publish a list of adhering parties and all their affiliates which are subject to the stay protocol requirements, this will increase legal uncertainty and costs for OTC derivatives counterparties seeking to understand whether a particular affiliate is subject to the stay provisions. This is an unacceptable situation.

Finally, it is not clear what regime counterparties are being asked to opt into. ISDA notes that a counterparty will “be opting in to the resolution regimes of other FSB jurisdictions, but only if they meet certain creditor protection safeguards (e.g., a stay period of no more than two business days and protection of netting). Such creditor protection

²³ ISDA, *Frequently Asked Questions on the ISDA 2014 Resolution Stay Protocol*, available at <http://assets.isda.org/media/f253b540-25/958e4aed.pdf/>.

²⁴ *Id.*

²⁵ *Id.*

safeguards are tested both at the time a resolution regime is designated as eligible for opt-in under the Protocol and upon its implementation during a resolution proceeding.”²⁶

While the importance of consistency in the regimes that FSB is promoting is clear, it is unclear why the FSB would delegate the power of determining consistency among its resolution regimes to an OTC derivatives industry group rather than relying on government agreements and the negotiation process. The FSB peer review of resolution regimes is designed to provide transparency about consistency of the resolution regimes and the FSB members should enter into the agreement of mutual recognition of each other’s regime once they determine they are compatible. That should be the only method used for determining the compatibility of resolution regimes.

3. **Consider requiring any non-salary executive compensation in any part of the SIFI to be awarded in the form of the bank holding company equity and bail-in debt.**

The primary danger of the bail-in regime is the conflict of interest and moral hazard that the structure introduces if not implemented properly. Charles Goodhart and Emiliios Avgouleas identified potential disadvantages of the bail-in process, stemming to a large degree from the misalignment of the bail-in stakeholders’ incentives, which are more contagious and procyclical; more litigious; slower and more expensive as a process; requiring greater subsequent liquidity injections; leading to deterioration of governance; requiring higher funding costs to banks; providing a worse outlook for bank borrowers; and worsening ex post outcome.²⁷

While the broad idea of the model is clear, the technical details of its implementation are much less clear. In this respect, three key unintended consequences of a ‘bail-in’ regime must be well understood:

1. The holders of bail-in debt could be very likely the exact parties that regulators are attempting to protect.
2. Contagion risk could be the result of a large number of bail-ins at the same time by the same “bail-iners.”
3. By insulating or providing bankruptcy remoteness to subsidiaries of SIFIs, regulators may very well be fueling the non-regulated, short-term funded shadow banking activities.

To reduce the above risk in the bail-in regime, the domestic and global regulators should consider requiring that any non-salary executive compensation in any part of the SIFI be awarded in the form of the bank holding company equity and bail-in debt.

²⁶ *Id.*

²⁷ Emiliios Avgouleas and Charles Goodhart, *A Critical Evaluation of Bail-Ins as Bank Recapitalization Mechanisms* (July 2014), at 19.

A. The holders of bail-in debt could be very likely the exact parties that regulators are attempting to protect.

There are three types of bank creditors:²⁸

- Banking creditors – such as retail and wholesale depositors;
- Investment business creditors – such as swap counterparties, trading counterparties, and those with similar claims; and
- Financial creditors – long-term creditors of the bank such as bondholders and other long-term unsecured finance providers.²⁹

Under U.S. and UK models of bail-in, the financial creditors are the ones who will be exposed to potential write-downs. Jeffrey Lacker, the President of the Federal Reserve Bank of Richmond remarked on this:

“[I]t seems regrettable to have to identify one class of creditors that is eligible for losses, with the presumption being that all other receive support, rather than the usual approach of providing explicit government guarantees, such as deposit insurance, to some creditors and presuming that all others are at risk. Broad protection for many subsidiary creditors seems likely to weaken market discipline and exacerbate the too-big-to-fail dynamic that led to the crisis.”³⁰

From the standpoint of public policy in the U.S and UK, the ultimate ownership of the bail-in debt would determine the certainty and effectiveness of the bail-in process. Global regulators do not want banks to hold each other’s bail-in debt by placing a limit on how much TLAC-eligible debt banks can hold. The preferred outcome for financial regulators is the holding of the bail-in instrument by the long-term holders, such as pension funds and life insurance companies. Those businesses have the balance sheet structure that makes them natural holders of long-term assets due to the inherent long-term liabilities they carry. The general sentiment is that short-term investors are the least preferred investor in this asset class because they do not have a long-term horizon for the investment and consequently will have no incentives to exercise the necessary due diligence and oversight of the banking operations, contributing to the escalation of the capital “flight” and the spread of the contagion risk.

²⁸ *Id.* at 22.

²⁹ *Id.*

³⁰ Jeffrey Lacker, *Rethinking the Unthinkable: Bankruptcy for Large Financial Institutions* (Oct. 10 2014), available at https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2014/lacker_speech_20141010.cfm.

B. Contagion risk could be the result of a large number of potential simultaneous bail-ins by short-term holders of the bail-in debt.

The currently available data on ownership of the bail-in debt instrument, although scarce, sheds doubts on the certainty of the envisioned regime. Avinash Persaud, in the brief “Why bail-in securities are fool’s gold,”³¹ cites the BIS quarterly review and notes that “in the absence of the scrutiny that will come when one of these instruments is ‘converted,’ there is little information on who is buying them. Early indications suggest it is investors focused on short-term gains, namely retail investors, private banks, and hedge funds, not the buyers regulators want.”³²

He further cautions that this short-term nature of the bail-in debt holdings could undermine the underlying idea of market discipline that bail-in tries to introduce. “Because they [short-term investors] are short-term in focus they will not, as it was hoped of holders of these instruments, invest in monitoring long-term developments and emerging concentration of risk. They will assume that they are not holding these instruments long enough for it to matter to them and anyway someone else is doing that.”³³ Angel Ubide confirms this argument by explaining that when an event changes perception of risk, short-term investors in these bail-in securities will trample over each other to reach the exit before bail-in.³⁴ This, in turn will lead to the spread of the contagion risk.

The regulators may want to promote the bail-in debt to long-term investors but that also contains disadvantages. Charles Goodhart notes that “with a purely domestic bank, the effect of shifting from bail-out to bail-in will, therefore, primarily transfer the burden of loss from one set of domestic payers, the taxpayers, to another, the **pensioners and savers**.”³⁵ The same argument of shifting the losses from taxpayers to households was raised by Arthur Wilmarth, Professor of Law, George Washington University Law School, during the “Financial Stability After Dodd-Frank: Have We Ended Too Big To Fail?” conference in November 2014 in Washington DC.³⁶ This concern was only elevated when Moody’s and Fitch gave an investment grade rating to the bailable-in debt issued by HSBC.³⁷ This highlights the consequence of such a classification: the ability by pension fund and strict mandate asset managers to hold those securities when pursuing a reach-for-yield strategy.

³¹ Avinash D. Persaud, *Why Bail-In Securities are Fool’s Gold* (Nov. 2014), at 3.

³² *Id.*

³³ *Id.*

³⁴ *Id.* and Angel Ubide, *Anatomy of a Modern Credit Crisis Banco de Espana* (2008), at 5.

³⁵ Emiliios Avgouleas and Charles Goodhart, *A Critical Evaluation of Bail-Ins as Bank Recapitalization Mechanisms* (July 2014), at 24.

³⁶ George Washington University *Financial Stability after Dodd Frank: Have We Ended Too Big to Fail?* Available at

http://www.law.gwu.edu/News/2014_15_Events/Pages/FinancialStabilityafterDoddFrank.aspx

³⁷ *Bond Manager Questions Rating Agencies Over “Unsound” Judgment*, CHIEF INVESTMENT OFFICER (Oct. 9, 2014), available at

[http://www.ai-](http://www.ai-cio.com/channel/NEWSMAKERS/Bond_Manager_Questions_Rating_Agencies_Over_Unsound_Judgement.html)

[cio.com/channel/NEWSMAKERS/Bond_Manager_Questions_Rating_Agencies_Over_Unsound_Judgement.html](http://www.ai-cio.com/channel/NEWSMAKERS/Bond_Manager_Questions_Rating_Agencies_Over_Unsound_Judgement.html).

Gregory Turnbull-Schwartz, a fixed income manager at Kames, cautions that “the rating agencies would have effectively colluded in getting yet another unsound investment product stuck into people’s retirement funds. Let’s hope that regulators are doing their job behind the scenes and that these do not end up in indices despite the rating agencies’ current lax approach to the matter.”³⁸ Ironically, this concern was echoed by the Chairman of HSBC, Douglas Flint, who told the House of Lords in October that

“these [bail-in rules] are about distribution of the burden of failure; they are not about avoiding the burden of failure. At the end of the day, the burden of failure rests with society. Whether you take it out of society’s future income through taxation or whether you take it out through their **pensions or savings**, society is bearing the cost.”³⁹

That starkly presents the public policy and public interests here.

When distribution of losses is analyzed in the cross-border context, the uncertainty concerns only get amplified due to “public policy grounds,” as identified by the FSB in the Consultative Document. The experience of the Argentinian debt-restructuring provides a glimpse of potential issues that may unexpectedly appear during the restructuring process. Building on the IMF observation⁴⁰ that a significant proportion of the costs of bank resolution could involve settling conflicts of interest among creditors, Charles Goodhart speculates that “this is particularly likely to be so in so far as bail-in will concentrate ownership amongst ‘vulture’ hedge funds, whose *métier* is the use of legal means to extract large rents.”⁴¹ In addition, one commentator pointedly warned that, “while the TLAC proposals contain sensible mechanisms to encourage cross-border co-operation in a banking crisis, the fact that the Chinese authorities are thus far sitting out the reforms does not bode well for global harmony.”⁴²

The political viability of non-legally binding cross-border resolution co-operation is highly doubtful when pensioners and savers of the bail-in debt in the home country (most likely in the U.S. and UK) will take significant losses for failure of a subsidiary in a host country (which could be anywhere in the world). However, a re-designed incentives structure within the SIFI – where executives are required to hold the bank holding company equity and bail-in debt – might act as a mechanism to increase both internal policing and market discipline. Consequently, a regulatory requirement that any non-salary executive compensation at any part of the SIFI group should be awarded in the form of the bank holding company equity and bail-in debt should be considered.

³⁸ *Id.*

³⁹ James Titcomb, *Mark Carney: No More Bank Bail-Outs*, TELEGRAPH (Nov. 10, 2014), available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11220192/Mark-Carney-No-more-bank-bail-outs.html>.

⁴⁰ Daniel C. Hardy, *Bank Resolution Costs, Depositor Preferences, and Asset Encumbrance*, IMF Working Paper 13/172 (July 2013).

⁴¹ *Id.*

⁴² Sam Flemming, *Ancient Regime of Bank Bailouts is Not Yet Confined to History Books*, FINANCIAL TIMES (Nov. 11 2014), available at <http://www.ft.com/cms/s/0/bf974972-6993-11e4-9f65-00144feabdc0.html>.

CONCLUSION

Ending too-big-too-fail requires three actions from financial regulators:

1. Reduce the size and complexity of financial institutions;
2. Adopt international and domestic laws for the effective bankruptcy of failed financial institutions, and reform the Crisis Management Group membership and procedures; and
3. Consider requiring any non-salary executive compensation in any part of the SIFI group to be awarded in the form of the bank holding company equity and bail-in debt.

Structural banking reforms need to take place to end too big to fail. Cross-border resolution regimes must rely on international and domestic laws and not on private contractual agreements. The contractual approach, if not immediately followed by a statutory framework, can be potentially very disruptive to financial stability. Early termination rights should be eliminated in domestic and international laws as a sound bankruptcy and resolution policy. Finally, the bail-in regime introduces multiple conflicts of interest and moral hazard dangers. To mitigate those risks, financial regulators should consider requiring any non-salary executive compensation at any part of the SIFI to be awarded in the form of the bank holding company equity and bail-in debt.

We hope these comments are helpful.

Sincerely,



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