Alternative Investment Management Association

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

Sent by email to: fsb@bis.org

5 September 2011

Dear Sirs,

FSB consultation on Effective Resolution of Systemically Important Financial Institutions

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to comment on the Financial Stability Board's (FSB) Consultation on 'Effective Resolution of Systemically Important Financial Institutions' (the Consultation). Although AIMA's members do not, in the main, expect to be subject to a determination that they are a systemically important financial institution (SIFI)[2], many of AIMA's hedge fund manager members are investors in, purchasers of debt instruments issued by, or creditors of large banks and investment banks, that are expected to be designated as SIFIs, in the course of their businesses. We are, therefore, keen that the FSB's recommendations to national authorities ensure a fair and orderly resolution regime that balances the interests of the SIFI, with those of its shareholders and creditors, as well as the interests of the wider financial markets.

Summary of AIMA's comments

- AIMA supports powers to rescue or resolve SIFIs and G-SIFIs in a way that (a) limits the need for the use of tax-payer funds; (b) promotes financial stability; (c) maximises the value of a SIFI's assets; (d) limits uncertainty for shareholders and creditors; and (e) ensures fair and equitable treatment of all similarly situated shareholders and creditors of SIFIs.

- Any proposed resolution provisions, in particular those relating to write-downs and/or conversion of debt, should provide for equal treatment of similar situated parties and should provide clarity and certainty for asset managers that serve as (i) investors in financial instruments issued by banks and (ii) as depositors and counterparties of credit institutions in their trading operations, e.g. swaps, cash deposits and custody arrangements.

- Claims related to derivative transactions with a SIFI should be carved out of powers relating to write-downs and should be recoverable at full value, in the wider interest of ensuring the success of resolution provisions and preventing "runs" on SIFIs.

- AIMA believes that bail-in may be an effective resolution tool and should be considered by resolution authorities for resolving failing SIFIs.

- Bail-in triggers should be objective and non-discretionary to provide certainty as to the treatment of debt- and equity-holders. Without such certainty, investors (including HFMs) may be unwilling to invest in SIFIs.

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in over 40 countries.
[2] Or a Global Systemically Important Financial Institution (G-SIFI).

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- An appropriate bail-in trigger may be a regulatory capital ratio for regulated entities. For non- regulated entities, which are not part of a financial conglomerate or branches of foreign financial institutions, other criteria might be used where there is liquidity insufficiency.

- The principle of no-creditor worse off (NCWO) should be maintained at all times.

- Creditor hierarchies, legally or contractually provided, must be maintained, with equal treatment being applied on each level to similarly situated creditors.

- Provisions should not be applied retrospectively.

- A true and global level-playing field should be guaranteed.

AIMA's comments

Investment managers (including HFMs) are generally small firms with very low uncollateralised exposures, low levels of interconnectedness in the system and employ low levels of leverage[3]. HFMs, therefore, pose little or no risk to financial stability. In fact, it is well documented that hedge funds are more vulnerable in a banking crisis than vice versa. This is further evidenced by the fact that no national government has ever bailed out a single hedge fund manager.

As the FSB is aware, the HFM business model is much simpler and on a much smaller scale than credit institutions'/banks' business models. The typical hedge fund model is a fund vehicle, which holds the assets of sophisticated high-net worth individuals and institutional investors and an independent fund manager, which makes investment decisions in line with a mandate provided to it by its investment management agreement with the fund. The manager, therefore, neither holds the assets of other parties, nor does it enter into contracts and agreements with third parties in its personal capacity. The fund merely accepts new investors, where appropriate, and makes arrangements with custodians and managers for the money to be managed and held – again, a non-complex business. The fund normally has limited counterparty arrangements, usually with select prime brokers and credit institution counterparties.

HFMs are significant investors in the debt and equity of SIFIs and, as part of their investment business, have significant interaction with these firms. AIMA is, therefore, keen to ensure that the FSB proposes a clear and workable framework for resolving SIFIs, and, to this end, we:

(i) urge the FSB to ensure that the debt write-down and conversion tools (in particular) fully and unambiguously respect the fundamental principles of non-retroactivity, legal certainty, equal treatment, right to property, contract viability, due process and proportionality, and provide for fair compensation; and

(ii) stress the importance of ensuring that the resolution processes are effective to ensure that the legal and contractual order of priority is observed and that creditors' rights are not unnecessarily and unlawfully abrogated.

We provide detailed answers to the questions in the Consultation in the Annex to this letter.

Conclusion

AIMA supports any recovery and resolution tool that carefully and narrowly targets problematic SIFIs, promotes financial stability and does not weaken the global level-playing field or create new regulatory arbitrage situations (certain players being less regulated than others while continuing exactly the same kind of activities). In general, any outcome should be closely aligned with expectations.

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[3] See the UK FSA's 'Assessing possible sources of systemic risk from hedge funds' report – February 2010.

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We thank you for this opportunity to comment on the Consultation and we are, of course, very happy to discuss with you any of our comments in greater detail.

Yours faithfully,

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Annex 1

Scope of application
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.
AIMA proposes the inclusion of an additional resolution objective which recognises the primacy of private property rights to otherwise protect private property rights of shareholders and creditors in accordance with international agreements including the UN Declaration on Human Rights and the European Convention on Human Rights and Fundamental Freedoms (ECHR) and, in particular, ensuring the need for fair compensation or a minimum recovery right. <u>1.1. General</u> Article 1 of Protocol N°1 ECHR, for example, comprises three distinct rules. The first rule, which is of a general nature, enounces the principle of peaceful enjoyment of property. The second rule covers deprivation of possessions and subjects it to certain conditions. The third rule recognises that European Member States are entitled, amongst other things, to control the use of property in accordance with the general interest. For the purposes of the latter provision, the European Court of Human Rights decided in the case of *Sporrong and Lönnroth v. Sweden*[4] (paragraph 69) that a fair balance must be struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights. The search for this balance is inherent in the whole of the ECHR and is also reflected in the structure of Article 1(P1-1). In the case of *Marckx v. Belgium*[5], the European Court of Human Rights decided, in paragraph 64 of its decision, that in the general interest a Contracting State may in certain cases induce a legislature to "control the use of property" in the area of dispositions *inter vivos* or by will. In the case of *Olczak v. Poland*, the European Court of Human Rights[6] decided that a wider public interest in the prevention of damage to financial stability and protection of depositors' interests may justify interference in the property rights of a shareholder. The National Bank of Poland had written down the share capital of a bank and recapitalised it with its own funds. The measures taken by the National Bank of Poland were intended to protect the interests of the bank's customers and to avoid heavy financial losses that the bank's bankruptcy would have entailed for them[7]. However, in the case of *Sporrong and Lönnroth v. Sweden*, at paragraph 73, the European Court of Human Rights decided that the Sporrong Estate and Mrs Lönnroth bore an individual and excessive burden, which could have been tendered legitimate if only they had had the possibility of seeking a reduction of the time limits or of claiming compensation. <u>1.2. Company shares and financial claims</u> A share in a company is protected as property under the ECHR Protocol 1, Article 1. Shares are, therefore, protected against deprivation and certain forms of governmental control and interference. Property rights in shares also constitute "civil rights" within the meaning of Article 6(1) ECHR, which means that disputes concerning property rights in shares must satisfy due process guarantees[8]. In the *Sovtransavto Holding v.*

4 *Sporrong and Lönnroth v. Sweden* (Application n° 7151/75; 7152/75) judgement of the European Court of Human Rights of 23 September 1982.

5 *Marckx v . Belgium* (Application n° 6833/74) judgement of the European Court of Human Rights of 13 June 1979.

6 *Olczak v . Poland (*Application n° 50357/99) admissibility decision of the European Court of Human Rights of 7 November 2002.

7 Allocating Costs of Failure Resolution, Eva Hüpkes, in Cross-border Bank Insolvency, edited Rosa M. Lastra, Oxford, 2011,p.116, n ° 5.40.

8 See Eva Hüpkes, p.115, n ° 5.38.

Ukraine case[9], the European Court of Human Rights observed in paragraph 92 that "a company share is a complex thing. It certifies that the holder possesses a share in the company together with the corresponding rights. This is not only an indirect claim on company assets but other rights, especially voting rights and the right to influence the company, may follow the share". Creditors' rights are likewise protected under the ECHR. Any enforceable financial claim constitutes a 'possession' within the meaning of Article 1 of Protocol N°1.

The European Court of Human Rights then continued in paragraph 98 of *Sovtransavto Holding v. Ukraine* that it will need to judge whether a "fair balance" was struck between the demands of the public interest and the need to protect the applicant company's right to the peaceful enjoyment of its possessions. In the case of *Baroul-A v. Moldova*, the court considered that the upholding of the Prosecutor General's action constituted an unjustified interference with the applicant company's right to property, because a fair balance was not preserved and the applicant was required to bear, and continues to bear, an individual and excessive burden[10].

1.3. Rights prior to an insolvency situation

Prior to insolvency, a curtailment of shareholders' rights, as a result of a forced restructuring or merger to preserve an institution's going concern value, must be necessary, proportionate and justified by the wider public interest in the prevention of financial instability and the protection of the depositors' interests[11].

Any proposed FSB policy measures with respect to resolution of SIFIs should, therefore, keep the above mentioned fundamental principles in mind. It is important to design the decision-making process for determining the appropriate resolution measure in a manner that ensures wide legitimacy and gives adequate consideration to all stakeholders' interests, as is the case in, for example, the UK Banking Act of 2009.

A special resolution process that results in a curtailment of shareholder and creditors' rights requires strong legal underpinnings and procedural safeguards[12] as was the case in:

- *Camberrow MM5 AD v; Bulgaria* - the European Court of Human Rights noted that the sale of the bankrupt bank was effected in order to achieve the prompt and more certain satisfaction of its creditors and the swift completion of the bankruptcy proceedings. The court reiterated that in delicate economic areas, such as the stability of the banking system, the Contracting States enjoy a wider margin of appreciation; and

- *Freitag v. Germany* - the European Court of Human Rights decided in its judgement that the obligation imposed in certain circumstances on minority shareholders to surrender their shares to majority shareholders could not, in principle, be considered contrary to Article 1 of Protocol N° 1 as long as the law did not create such inequality that one person could be arbitrarily deprived of property in favour of the other[13].

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?

2.1. Scope

According to Annex 1 of the Consultation, the scope of the proposed framework under the Consultation (FSB Framework) applies to, inter alia, other financial institutions, including non-bank SIFIs, including holding companies, significant non-regulated operational entities within a financial group or conglomerate and branches of foreign financial institution (see section 1 of Annex 1 of the Consultation).

There exists no universal accepted definition of what is considered to be a SIFI. The FSB acknowledges that it

9 *Sovtransavto Holding v. Ukraine* (Application n° 48553/99) judgement of the European Court of Human Rights of 25 July 2002.
10 Baroul Partner-A v. Moldova (Application n° 39815/07) judgement of the European Court of Human Rights of 16 July 2009, paragraph 51.
11 See Eva Hüpkens, p.115, n°5.38 ; *Olczak v. Poland* (Application n° 30417/96) admissibility decision of the European Court of Human Rights of 7 November 2002.
12 See Eva Hüpkens, p.117, n°5.42 ; *Camberrow MM5 AD v. Bulgaria* (Application n° 50357/99) admissibility decision of the European Court of Human Rights of 1 April 2004.
13 Freitag v. Germany (Application n° 71440/01) judgement of the European Court of Human Rights of 19 July 2007, paragraph 53.

will have to work together with CPSS, IAIS and IOSCO to develop sector-specific guidance for the application of its framework to non-bank SIFIs (see page 11 of Consultation).

The term "significant" non-regulated operational entities within a financial group or conglomerate is not clearly defined. The authorities must be able to determine what is significant or not, depending on their judgment at the time of the intervention. The authorities can give several reasons for their decision, for example, the threat of financial contagion. The decision should be taken on the basis of a proportionality test: the 'systemic relevance' was the most favoured in the responses to the public consultation of a possible EU framework for bank resolution and recovery dated 5 May 2011 (the EC Consultation).

AIMA outlines that stand-alone investment managers that are not subject to banking prudential requirements and supervision should be excluded from the definition of 'SIFI'.

2.2. Triggers

AIMA agrees that there should be one single set of clear and precise triggers for resolution authorities to be empowered to apply resolution tools/exercise resolution powers, as a last resort. The FSB Framework is intended to provide for 'timely and early entry' into resolution before a financial institution is balance-sheet insolvent, with clear standards for suitable indicators or thresholds for entry into resolution. Resolution should be initiated when a firm is (i) no longer viable and other measures, including private market alternatives, have proved insufficient to prevent failures; and (ii) a detailed determination is made by the relevant authorities that the firm's failure would cause a seizing up of the financial system. The detailed determination should be disclosed to the public, even if done on an ex-post basis.

In particular, the measures suggested should combine aspects of capital and/or liquidity insufficiency, both of which are reasonably capable of objective measurement. The FSB should also at this stage, for regulated entities, consider the interface with the proposed new capital definitions, capital requirements, leverage ratios and liquidity ratios of Basel III.

2.3. Compensation

In the Consultation, the FSB does not describe in detail how the compensation of stakeholders (if any) has to be calculated. According to section 7.1 of Annex 1 of the Consultation "*creditors have a minimum recovery right or the right to compensation equal to what they would have received in an ordinary liquidation (bankruptcy) process*". The Consultation does not provide further details (e.g., on the method of valuation, independent valuators, going concern/liquidation assumptions, reference date of valuation, etc.). AIMA believes that additional clarity is required to give shareholders and creditors of a SIFI greater clarity on how their claims will be treated.

2.4. Safeguards

In the Consultation, the FSB does not provide for a detailed description of safeguards in connection with partial transfers of rights, liabilities and collateral. Section III, point 5 (vi) of Annex 8 of the Consultation broadly suggests that "*in designing a legal framework that provides for a temporary stay of early termination rights, the following safeguards should be in place: […] The authorities would only be permitted to transfer all of the contracts with a particular counterparty to a new entity and would not be permitted to choose to transfer individual contracts with the same counterparty and subject to the same netting agreement ("cherry-picking")*".

AIMA recommends that the FSB elaborates this basic principle in more detail (comparable to Section H of the EC Consultation), including specific safeguard provisions for (i) partial property transfers (safeguards for counterparties), (ii) security agreements, (iii) partial transfers (protection of trading, clearing and settlement systems) and (iv) partial transfers (compensation of third parties).

2.5. Legal expectations in the event of cross-border situations.

In case of G-SIFIs with branches, representative offices and subsidiaries in different jurisdictions, resolution powers under domestic law and the rights of the creditors and shareholders may differ substantially. Outcomes may differ depending on the locus of incorporation, the location of assets, liabilities, and collateral, the domicile of the counterparties, and the governing law of the contracts to which the financial firm is a party. The FSB framework should make certain that the outcomes in resolution are aligned with the degree of protection that counterparties can expect under the applicable statutory regimes and contractual arrangements. Counterparties should not be left in ignorance as to which authority will be in control of the resolution.

Bail-in powers

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?

3.1. No retroactive application

According to section 12 of Annex 2 of the Consultation, the bail-in powers should be applicable to all existing and new non-exempted liabilities. In contrast, the EC's approach would allow (beside write-offs of equity and subordinated debt) the additional write-off of new debt issued (or existing debt contracts renewed or rolled over) after entry into force of the power (the Comprehensive Approach) or specific "bail-inable" debt, which includes a respective write-down language in its terms (the Targeted Approach). AIMA recommends the bail-in powers should not apply retroactively. The FSB's proposal to introduce an "*appropriate transitional period before bail-in powers are exercisable in order to ensure that firms can adequately adjust to the statutory bail-in regime*" (section 12 of Annex 2) seems not to be sufficient to prevent a retroactive application.

3.2. No discrimination of creditors

According to section 5.2 of Annex 2 of the Consultation, the "write-off/conversion powers should, *as far as possible*, be applied in a manner consistent with the hierarchy of the capital structure". In addition, section 6.1 of Annex 2 of the Consultation states that *pari passu* treatment of creditors and the statutory order of priorities of the affected debt that would otherwise exist in insolvency should be respected, "*except to the extent necessary to achieve the objectives of the resolution regime as set out in the statute*". AIMA recommends that there should be no discrimination of similarly situated creditors within the same creditors' group.

3.3. The trigger for bail- in

AIMA recommends that the trigger for bail-in needs to be much clearer – certainty for the debt holders is of utmost importance, without which they will not invest (i.e., they cannot price debt effectively). It does not matter where it is set, as earlier (more likely) bail-in will mean increased demanded returns (interest rates) on debt.

Possible triggers can be as a certain regulatory capital ratio or another market trigger. Contractual bail-in (contingent capital instruments or "CoCos") from UBS and Credit Suisse (as required by Swiss law) have used a specific capital ratio as the trigger for bail-in.

3.4. Contractual bail-in

There is a potential concern for investors in bail-in instruments if, for example, the investor's interest has just been converted to equity (by the contract), and that equity interest is immediately or quickly written off via statutory bail-in. The spacing of triggers may need consideration, without which the price of CoCo instruments for issuers (i.e., the interest rate required to be paid) may be substantial.

Switzerland requires credit institutions to have 9% contractual bail-in debt on its books for regulatory capital purposes.

3.5. Quantum of bail-in debt

The required quantum of bail-inable debt should be equal to the amount necessary so that, if it were written down, it would return the bank to compliance with its minimum capital requirements under Basel III, as implemented in the law of each jurisdiction, without the requirement for additional capital buffers.

More bail-inable debt may mean less write-down for investors. It is obviously critical that there is sufficient bail-in debt to ensure that a bank that is deemed to be “too big to fail” can be resolved. If there is not a sufficient amount of bail-inable debt, then the implicit (and indeed explicit) government (and taxpayer) guarantees currently in place will remain. If the Comprehensive Approach were to be adopted, it would be simpler to be confident that the quantum of bail-in debt is adequate, as it would include all non-excluded senior debt.

Clearly, the more discretion resolution authorities have, and the less legal certainty there is regarding key terms, the less the investor demand would be and the more expensive such debt would be for the banks. If, however, the rules are clear, then we believe there would be sufficient investor appetite, as demonstrated by the demand for the recent issues of contingent capital instruments.

AIMA notes that CoCos are already evolving as a market solution. For example, Credit Suisse and Lloyds already have this type of debt in their capital structure. Indeed, Credit Suisse’s offering (see below) would be the first by a publicly traded bank to investors. Contingent capital may arguably be more appropriate for inclusion in a 'recovery plan' (i.e., before resolution). Specific guidelines on the terms of CoCos should be put in place and they should dovetail with the work of the Basel Committee (see, for example, its consultation on contingent capital). Otherwise there may not be sufficient demand for such debt and it may not fit appropriately within banks’ regulatory capital structures.

AIMA thinks that there may be a market for such bail-in-able debt. There has been a substantial market for subordinated regulatory capital, at a reasonably high rate of return. The returns have been even higher after the recent experience of “burden-sharing” and AIMA sees no compelling reason why investors should not be willing to continue investing in first-loss regulatory capital. The main difference with the FSB proposal is that traditional regulatory capital would be lost on insolvency while the proposed new capital could be impaired without the need for insolvency.

The size of the market for this new type of debt would not be a function of the likelihood of the write-down or conversion mechanism being triggered. This function would, instead, affect the pricing on issue and the trading price thereafter. Given the increased risk of impairment, the price is bound to be somewhat higher. The same would be true of all debt if the write-down or conversion mechanism were applied to it under the Comprehensive Approach.

Banks should be able to find an investor base for such capital. Credit Suisse is proving that demand exists, because it has sold $2 billion of contingent convertible notes, reportedly at a yield of 7.87%. This was prompted, *inter alia*, by the Swiss financial regulator’s proposal last October that Credit Suisse and UBS should consider issuing contingent capital notes (in advance of the US and Chinese presidents’ November 2010 statement in support of banks having “higher loss-absorbency capacity”).

To this end, AIMA notes that a recent proposal of the Basel Committee on contingent capital would require all non-common Tier 1 and Tier 2 regulatory capital instruments to include, in their contractual terms, loss absorption mechanisms that create common equity at the point of non-viability. It has been suggested that these securities would be converted to common equity under two conditions:

(i) when an institution is judged by its regulator to have reached the point of non-viability and the supervisor judges that conversion would restore the institution to viability; or

(ii) when the public sector provides funds to restore the failing bank, without which the bank would be non-viable.

It is likely that different investors will have different levels of appetite for different levels of debt, and it may be possible to have multiple tiers of convertible debt, which would convert in a pre-determined order, until sufficient debt had been converted. It could be that the first levels would automatically convert on defined triggers – perhaps loss of regulatory capital as above – with subsequent layers only converting if required by the resolution authority, based on defined criteria.

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?

AIMA agrees that it is desirable that the scope of the statutory bail-in powers is broad and, as far as possible, harmonised in different countries' local laws. The international nature of the markets and trading of debt on various markets means powers should be the same across jurisdictions to create a level-playing field, avoid regulatory arbitrage and not provide competitive disadvantages to the firms of certain jurisdictions. It is acknowledged that this will be difficult to accomplish in practice due to the complexities of reaching detailed international agreements on such subjects.

As stated above, it is important that the rules are not applied retrospectively, as existing debt holders did not agree to the risk when purchasing the debt at the prices paid. A sufficient transitional period is needed in order to allow those who hold debt, but who no longer wish to take on this new risk of bail-in, to sell out of the debt at a fair market price without significant loss of value.

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

All issued unsecured and uninsured debts and liabilities of the institution, not subject to government insurance or protection schemes should be included. Contractual bail-in instruments should also be included. There is a strong argument for an 'all or nothing' approach, to provide certainty on the application of the FSB Framework. However, full consideration of the different classes of debt and other liabilities is needed to ensure that knock-on effects are understood and, where necessary, avoided.

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

It is important that both secured liabilities (or parts of part-secured liabilities) and insured deposits (or parts of part-insured deposits, covering the small-scale depositors) are outside of the scope of statutory bail-in powers.

Many parties who are counterparties to SIFIs in derivatives contracts will be subject to close-out netting agreements, where profits and losses are set-off across multiple contracts between the parties. These provide valuable risk mitigation to all parties who can ensure that they have a single exposure on derivative contracts to the SIFI and that they can cover this exposure with appropriate holdings of initial and variation margin. In certain circumstances, the counterparties in these types of transactions may find themselves creditors of the SIFI, e.g., where the SIFI becomes insolvent and has not exchanged sufficient variation margin to cover its exposure or where an amount of initial margin is not segregated as it is required to be. It is important, in order to preserve confidence in the market as well as maintain financial stability, that derivative contracts are outside of the scope of bail-in powers (i.e., they are excluded). If they were to remain in scope, there is a severe risk that SIFIs may face a run on their derivative books when the SIFI approaches a point where it may be subject to statutory bail-in powers. Counterparties could be expected to take actions, including closing out their positions, withholding margin and not entering further transactions with the SIFI, preventing it from hedging its exposures and reducing the likelihood that the SIFI could be successfully recovered by the resolution authority.

7. Will it be necessary for authorities to monitor whether a firm's balance sheet contains at all times a sufficient amount of liabilities covered by bail-in powers and, if it is not the case, should 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)?

AIMA believes that SIFIs should hold a minimum amount of bail-inable debt on its balance sheet, monitored by the SIFI's market regulator. As a measure for setting the minimum amount of bail-in debt a SIFI should have, a percentage of the firm's risk-weight assets seems to be sensible. However, the determination of a required minimum level of debt and finding an appropriate percentage level will need to be considered in light of existing capital requirements and the new Basel III requirements. As a starting point, the FSB may wish to investigate further the mandated capital requirements for Swiss banks, which require them to hold 19% capital of their RWA with 9% of that held in CoCos.

It is important to emphasise that it is very difficult for a bail-in concept to succeed in the absence of bail-in instruments. Forcing a bail-in on creditors who did not bargain for equity conversion is a very delicate task if it is to be done in a fair and equitable manner. SIFIs have various types of trade creditors and financial counterparties, each of whom expects to be treated on par with similarly situated unsecured creditors. There is the further complication that SIFIs are comprised of multiple different entities, each with their own creditors. A bail-in would likely have to occur for each of the critical subsidiaries of the SIFI in order for the SIFI to not fail. Therefore, the issuance of bail-in instruments may have to occur at each of a SIFI's critical subsidiaries.

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 consequences for banks' funding and the credit supply to the economy may be significant and AIMA believes a suitable period of adjustment and phasing in of the requirements will be needed.

The coupon/interest rate on bail-in debt will have to be larger than existing debt to compensate for additional risk of disenfranchisement – this will lead to more expensive funding for banks under the framework and, thus, more expensive credit for the banks' clients. The extent of the effect is, however, not clear. Credit supply may be reduced in the economy although, perhaps, not significantly.

As long as there is certainty of treatment for bond-holders, investors will continue to invest, as was seen in the issuance of the UBS and Credit Suisse CoCos, which have been considered a great success. The take up of CoCos for large, financially strong institutions may even increase over existing issuances (if the bank wishes to issue more debt) due to higher rates of return. However, AIMA is concerned that smaller and less sound institutions may struggle to find investors due to additional risk of disenfranchisement, except at much higher interest rates.

Cross-border cooperation

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?

AIMA notes that large cross-border financial institutions are typically organised as groups with combinations of branches and subsidiaries (the latter being able to survive on their own). The parent can be an operating company or simply a holding company. Whereas branches are not separate legal entities, subsidiaries remain fully responsible for their liabilities. Subsidiaries are often connected to the head company through complex ownership structures which determine how the different entities are run and who is responsible for their liabilities. Quite often, in the past, local supervisors have required international banking groups to set up local subsidiaries with local banking licences with the intention that 'local' assets were ring-fenced for 'local' creditors (principally, domestic banking depositors), whatever they may be in the context of international banking, as none of these local subsidiaries were ever restricted from accepting deposits from non-resident customers.

The reorganisation of an international banking group inevitably involves the application of resolution measures to all or some of the group entities located in different jurisdictions. To achieve a group-based approach, a common framework for coordination by national supervisory authorities is needed, based not only on common tools in the different jurisdictions, but also on agreed principles for coordination of all actors and actions affecting the financial group. It is extremely difficult for these principles to be determined post event, as the effect will be to advantage or disadvantage stakeholders in different components of the group.

In order to be able to intervene effectively at the appropriate stage, suitable cooperation rules should be agreed upon between the resolution authorities of the home countries of each credit institution and the resolution authorities of the host countries where the credit institution has subsidiaries. The latter supervisory authorities should have a duty to inform and cooperate if they believe that the resolution mechanisms have been triggered (or if otherwise there are breaches of regulatory authorisation requirements). All resolution authorities (home and host) involved should cooperate with the resolution authorities, if different from the supervisor, while the latter monitors the situation to verify whether the credit institution meets the conditions for resolution. The resolution authority of the host country is more likely to be willing to cooperate in case the necessary protection for creditors' rights in the host country is provided. Countries are unlikely to be willing to make the cooperation framework statutory. This may conflict with their own obligations to protect the stability of their domestic

economies and institutions. Memorandums of Understanding (MoUs) can be agreed but are not binding and, thus, may not be an effective solution. The UNCITRAL Practise guide on Cross-border Insolvency Cooperation may be used as an example for drafting Cross-Border Insolvency Agreements[14].
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?
AIMA believes that Annex 3 broadly covers many of the critical elements of the cross-border agreement, although not all of the important considerations are there. The UNICTRAL Practice guide on Cross-border Insolvency can be a good model for these types of Agreements. Alignment between EU/US regimes can be accomplished using these Cross-border Insolvency Agreements. This could be made more reliable, as a source of cross-border cooperation, if agreed by Treaty or binding international agreement, however, this is likely to be difficult to agree in practice. Nevertheless, see the example of the UK and Iceland, where Iceland was not able or willing to pay out to foreign investors and creditors upon the failure of two large Icelandic banks, and the difficulties the UK has faced claiming against them through courts. Regular cross-border cooperation meetings could help early identification of risk, as an additional point.
11. Who (i.e., which authorities) will need to be parties to these agreements for them to be most effective?
As there are other resolution powers needed that are important to an effective resolution process for SIFIs, the new resolution entity should be independent from the SIFI's prudential supervisors in order to avoid conflicts of interest. The prudential supervisors' power should be limited to prudential review and compliance with the regulatory requirements. Each country could designate one or more administrative authorities to apply the resolution tools and exercise the resolution powers. It is very likely that in cases of State intervention or resolution, a number of national authorities would have to be involved and the FSB Framework should ensure that there are no unwarranted barriers to communication and cooperation between those authorities, especially as many of the steps to be taken will require swift, determined and cooperative action. Each country should also ensure that the different responsibilities and competencies of the respective authorities are clearly defined and well described so that there are no doubts as to the scope and jurisdiction of their powers. Parties whose rights are affected by the resolution measures should be allowed access to the court *post factum* in order, not to reverse the resolution of the SIFI but, in order to obtain compensation in case their individual rights have been infringed. For example, pursuant to Article 6 ECHR, affected parties must be afforded the possibility of an appropriate appeal to a judicial authority. Decisions taken by administrative authorities do not themselves satisfy the requirements of Article 6 ECHR. Such decisions must be subject to subsequent control by a 'judicial body that has full jurisdiction' in accordance with Article 6 ECHR[15].
Resolvability assessments
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?
Yes, AIMA believes that Annex 4 covers all the determinants of a firm's resolvability.

14 http://www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_english.pdf
15 See Eva Hüpkens, p.118, n°5.43.

13. Does Annex 4 identify the appropriate process to be followed by home and host authorities?
AIMA believes that Annex 4 does appropriately identify the process to be followed by home and host authorities. In each case, each authorities will have to look at the strategies it may use to resolve a SIFI, considering whether a single or a combination of strategies would likely to be most appropriate (feasible and credible) in the circumstances for a particular firm.
Recovery and resolution plans
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?
The Recovery and Resolution plans (RRPs) are an important part of the FSB's framework. The proposals in this regard could be a lot more detailed and, in particular, provide stricter guidance regarding coordination between home and host resolution authorities. Most important for HFMs is being able to quickly identify segregated client assets via the RRPs upon entering into resolution procedures, to ensure prompt return of those assets.
15. Does Annex 5 appropriately cover the conditions under which RRPs should be prepared at subsidiary level?
A financial group which is determined to be a SIFI must establish a RRP, but it is not clear whether a subsidiary should have its own part of the RRP, its own RRP or contributes to the group's RRP. RRPs should be made available to counterparties, where possible, in order to guarantee due process in case of a resolution. It is important for HFMs to be able to make an assessment on: (a) how likely a firm is to be resolved, considering the support of the group; and (b) whether their claims will be dealt with as part of an individual firm's resolution or part of a group's resolution. Further, HFMs will benefit from knowing whether, under specifying circumstances, there will be a transfer of assets within the group with the objective of improving intra-group liquidity, while safeguarding the rights of creditors and shareholders and impact on the RRPs. Finally, an HFM should have effective access to a court with the power to review the merits of a decision to impose a limitation on its property rights in the public interest. In the case *of Credit and Industrial Bank v. the Czech Republic*, the European Court of Human Rights noted that an interference with the right to peaceful enjoyment of possessions under Article 1 of Protocol No.1 may not give rise to a lack of procedural protection which has already been found to give rise to a violation of Article 6 of the ECHR[16]. In the case of *Marini v. Albania*, the court decided, in paragraph 164, that the shares held by the applicant undoubtedly had an economic value and constituted 'possessions' within the meaning of Article 1 of Protocol N°1. The court further decided that the rights guaranteed by Article 1 of Protocol N° 1 may entail certain measures necessary to protect the right of property. The court decided that the excessive length of the proceedings created an uncertainty which upset the "fair balance" that must be struck between the demands of the public interest and the need to protect the applicant's right to the peaceful enjoyment of his possession (Paragraphs 171- 174) [17].
Improving resolvability
16. Are there other major potential business obstacles to effective resolution that need to be addressed that are not covered in Annex 6?
No, none that we are aware of at this time.

16 *Credit and Industrial Bank v. The Czech Republic* (Application n°.29010/95), judgement of the European Court of Human Rights of 21 October 2003, paragraph 82.

17 *Marini v. Albania,* (Application n° 3738/02), judgement of the European Court of Human Rights of 18 December 2007.

17. Are the proposed steps to address the obstacles to effective resolution appropriate? What other alternative actions could be taken?
Yes, these seem useful and AIMA supports steps to address the business obstacles to effective resolution.
18. What are the alternatives to existing guarantee / internal risk-transfer structures?
We are not aware of alternatives other than those proposed, however, ensuring that the market has knowledge of intragroup guarantee / internal risk-transfer structures would be useful for market participants.
19. How should the proposals set out in Annex 6 in these areas be best incorporated within the overall policy framework? What would be required to put those in place?
AIMA believes that the FSB should recommend that national legislation include requirements for appropriate information systems that report certain information to regulators and other firms and SLAs which remain legally enforceable in crisis situations and in resolution. The FSB's proposals regarding Intra-group and global payment operations seem to be a matter of good regulatory (COB) practice for G-SIFIs and should be encouraged to be implemented by national regulators.
Timelines for implementation of G-SIFI related recommendations
20. Comment is invited on the proposed milestones for G-SIFIs.
AIMA agrees with milestones set out for G-SIFIs. We would encourage the FSB and national governments to act as soon as possible with respect to measures to resolve SIFIs and G-SIFIs to reduce risks to tax-payers and improve overall financial and market stability. Certain jurisdictions are further advanced than others with certain bits of this work – see the US Dodd-Frank Act and EU proposed framework, noting that other countries have not yet started making substantive proposals. Existing resolution regimes (e.g., the UK Banking Act) may need to be amended in light of the FSB proposals and this should be factored in to the timing of implementation of the proposals.
Discussion note on creditor hierarchy, depositor preference and depositor protection in resolution (Annex 7)
21. Does the existence of differences in statutory creditor rankings impede effective cross-border resolutions? If so, which differences, in particular, impede effective cross-border resolutions?
In case of a resolution of a G-SIFI with branches, representative offices and subsidiaries in different jurisdictions, the creditors that are permitted to participate in the proceedings are very similar, but different statutory rankings of creditors may apply based upon domestic public policy considerations The general rule applies everywhere that, except for claims which are made preferential or subordinated by law or contract, all general claims rank equally between themselves and shall (in the event insufficient assets are available to meet their claims), abate in proportion between themselves. Creditors, who have agreed contractually to be subordinated, will bear the losses ahead of any other general class of shareholders. Equity holders are generally first in line to bear the losses. However, the different statutory systems in creditors' ranking can impede on creditors' ranking. AIMA recommends that creditors with the same ranking should be treated similarly. AIMA believes that legal certainty is the most important objective here. It must be clear for the creditors, who sit below depositors, *ex ante* which law shall apply to their individual situation. To make a resolution possible in such a cross-border context, close cooperation and coordination among national authorities is essential. The creditors in the host country will continue to search for adequate protection under their domestic laws or laws applicable to certain contracts or rights which may prevent the resolution. The equal treatment of similarly situated creditors will simply depend on the facts of where the

claims or goods are based *(lex situ)* or which law applies (*lex contractus).*
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?
A greater convergence of statutory ranking of creditors is desirable, but we believe that it is not yet feasible at this stage. There are projects underway in the EU to see whether a greater harmonisation among EU Member States is possible. Depositor preference and deposit insurance arrangements exist in nearly all major jurisdictions, although significant differences exist as regards their operation and cover, and they are often restricted to local incorporated banks. It will be a difficult political question to try and align the EU Consumer Deposit Guarantee regime, and even more difficult to accomplish this on a worldwide level. Markets will adjust funding costs based on the likely amount it will receive on insolvency if the rules regarding statutory ranking of creditors change.
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)?
Statutory deposit guarantee schemes are mainly designed to protect small-scale depositors and engender confidence and limit the likelihood and severity of bank runs. If deposits for corporates and financial firms come above other unsecured creditors, more money and assets may be held on deposit instead being invested in debt. This may push up the cost of funding. However, it will depend on the risk-return demands of investors/depositors and banks should be able to adjust their offerings to ensure they have adequate funding.
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?
The depositor preference engenders a trade off between the cost of funding for the bank and the likely return upon the bank's failure for other creditors if there are increased numbers of depositors, and the protection or preferential treatment of the deposits of certain special classes of creditors (e.g., retail creditors). This is partly a question for the bank but also partly a question for policy-makers about which classes of creditors are deserving of greater protection upon insolvency.
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?
As discussed in response to question 21 above, we understand that mostly jurisdictions have broadly the same rules regarding the ranking of creditors. Where they do differ, bodies like the FSB may be instrumental in aligning rules in this regard, particularly in the context of G-SIFIs.
Discussion note on conditions for a temporary stay on early termination rights (Annex 8)
26. Please give your views on the suggested stay on early termination rights. What could the potential adverse outcomes be 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?
Often financial contracts, for example, derivatives contracts provide a risk mitigation mechanism in the form of close-out netting and collateralisation. Market participants very strongly rely on risk mitigation techniques in order to reduce their net exposure to one another and should, therefore, expect that their rights, including early termination rights, will be protected. The Basel Committee Cross-Border Resolution Group March 2010 advised in its Recommendation n°9 "[…..]

Relevant laws should be amended, where necessary, to allow a short delay in the operation of such termination clauses in order to promote the continuity of market functions".

AIMA recommends that such a stay, if any, should not have an impact on the other parties' contractual rights and should maintain a true level-playing field. In other words, NCWO as a result of such a stay. This stay should be reduced to the minimum amount of time necessary in order to restore confidence of the market and take the required resolution measures.

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?

If a stay must be imposed, we would prefer to see an automatic stay rather than providing resolution authorities with broad discretion. An automatic stay on early termination rights would provide more certainty than a discretionary stay which, as discussed above, allows market participants to better assess their circumstances and risks upon insolvency of a SIFI.

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?

A distinction must be made between, on the one hand, early termination rights because of a breach of contract and, on the other, early termination rights as a risk mitigation mechanism. One may want to suspend the first termination rights in order to allow the survival and the resolution of the SIFI (i.e., similar to a Chapter 11 Proceeding in the US).

The final report and recommendations of the Basel Committee's Cross-Border Bank Resolution Group emphasised the importance of risk mitigation techniques and encouraged their international recognition. Some of the most important protections that help to reduce counterparty credit risk, include: (a) the netting or "set-off" of payment obligations; (b) the provision of securities as 'collateral' in support of financial obligations to make payments or deliveries; (c) the clearing of contracts for sale and purchase of financial instruments via central counterparty clearing houses; and (d) the protection of settlement 'finality' for payments and deliveries made in settlement systems. The absence or unenforceability of such protections can result in losses and exacerbate liquidity constraints for clients and counterparties, and spread the problems throughout the financial system. Any stay of these risk mitigation termination rights should be limited to a strict minimum as mentioned above.

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

Any delay to the operation of contractual early termination rights should be as short as possible, so that clients, counterparties and debt-holders are not kept in 'limbo' regarding their treatment, without being able to act. Ideally the resolution of large complex cross-border SIFI should take place between close of business on one day and the opening on the next business day (for a weekend this would amount to 36 hours from the close of business in North America on Friday evening and the opening of business in Australia/Asia on the Monday).

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

In broad terms, if a temporary stay is necessary it should be applied to all counterparties equally to provide a level-playing field. There is a possible argument for an exemption for central counterparties and FMIs on public-interest and financial stability grounds.

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?

AIMA believes the essential safeguards are assurances that the principle of NCWO will be upheld and that resolution, including a stay on early termination rights, will be conduct promptly.

32. With respect to the cross-border issues for the stay and transfer, what are the most appropriate mechanisms for ensuring cross-border effectiveness?
Cross-border coordination and recognition of stays under each legal regime is key. However, it is an illusion to think one can install worldwide legal measures. In the absence of a bilateral or a multilateral treaty in order to enforce the resolution, the authority would need an enforceable judgement in order to execute this stay in third countries, which will take time and, therefore, may not be suitable. A solution could be found, as recommended by the Basel Committee's Cross-Border Resolution Group in March 2010, to develop mandatory standardised contract provisions, either in national laws or voluntarily taken up by industry groups such as ISDA.
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?
No, we are not aware of any additional or alternative considerations beyond those described.
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?
It seems to be limited to the extent to which the other country would accept or enforce a stay on a foreign institution. The latter would be possible within the framework of the EU but outside of the EU one would need an enforceable court decision or a bilateral or multilateral treaty. Mandatory standardised contract provisions may be a solution.