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2 September 2011

Comments on the FSB consultation paper: "Effective resolution of systemically important financial institutions"

Dear Sir or Madam,

UBS would like to thank the Financial Stability Board for the opportunity to comment on the consultation on effective resolution of systemically important financial institutions published on 19 July 2011.

Overall, we agree with the objectives of the consultative document that national authorities should have or obtain the capacity to resolve systemically important financial institutions (Sifis) without systemic disruption and without exposing taxpayers. We also appreciate the FSB's aim to engage in the substantial efforts that will be needed on both a national and international level to achieve 1) co-ordination among regulators and 2) some convergence of their regulatory approach to key issues to facilitate planning, and to avoid the creation of inefficiencies or overly burdensome regulation.

We have addressed the questions raised in the consultation paper in the attached appendix.

If you have any questions, please do not hesitate to contact us.

Yours faithfully

UBS AG

Tom Naratil S. Hottiger

Tom Naratil	Steve Hottiger
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Enclosure

UBS comments on the FSB consultation paper: “Effective resolution of systemically important financial institutions"

1. Proposed policy recommendations

Section 'Effective resolution regimes'

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.

We generally agree with the objective that an effective resolution regime should allow resolution of any financial institution with the least systemic disruption possible and without taxpayer involvement. We highlight a number of issues touched upon in this section in the following sections with greater detail, such as bail-in, treatment of intra-group guarantees, Service level agreements or back-to back transactions, but nevertheless wish to specifically refer to the following issues in Annex 1:

Section 4.1(v): Service level agreements should also in case of group internal arrangements be set out in writing and as binding and enforceable agreements.
S. 7.2 correctly states the need to protect the management of a firm in resolution from actions taken when complying with decisions of the resolution authority. We note that management may need to take actions already prior to entering the resolution phase, in which it is still fully responsible for its actions. However, the supervisory authority is likely – as proven in the last financial crisis – to exercise strong pressure to require management to take certain actions.
S. 7.5, temporary exemptions from disclosure obligations: given the international reach of the firms, such exemptions should be harmonized through the auspices of the FSB.

S. 8.4: We note that in certain jurisdictions the powers of local regulators as bankruptcy or resolution authorities extend to **local branches** of foreign firms. The insolvency applies to the relevant legal entity and thus the competent authority of a foreign firm is its home regulator/resolution authority where the parent is headquartered. In our view, this should not be generalized and instead international cooperation should be increased to avoid any creditor preferences based on domicile or nationality of the creditor.

SS. 11.10, 11.11: We do not agree with the statement that where regulators believe a firm's resolvability is not appropriate, they should have the power to intervene into the firm's structure as a going concern. This cannot be justified under constitutional principles in most jurisdictions; it would be a disproportionate measure. In addition, many of the obstacles are the fact of law or regulation, and the consequence of inconsistent and contradictory legislation or regulation cannot be imposed on the firms. Rather, it is the task of legislators and regulators to achieve coherent and enforceable resolution regimes across borders. It would be beneficial that the FSB takes a leading role in this, and it would be welcomed if the paper addressed the tasks and obligations of legislators and regulators in this context.

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?

Resolution tools and powers should be harmonized at least among the jurisdictions with important financial centers, and we encourage the FSB to set out a plan and timeline to achieve this.

It should be clearly specified that resolution measures can only be taken unless all other measures, in particular the recovery tools, have failed or proven to be ineffective. There must be a clear distinction between the phases preceding resolution, during which management remains solely responsible for taking measures, including recovery measures. Recovery must not allow regulators to interfere in the structure of a firm, in particular also because the management and board of the firm remain solely responsible for any of the business decisions and actions. Furthermore, to achieve a clear order of priority, the key elements for the trigger must be specifically defined in law, but without being automatic based on some numerical thresholds. A clear procedure for taking such a decision should be specified, and the supervisors, regulators and other involved national authorities such as the Finance Ministry, as the case may be, should be clearly determined.

Section '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?

General Observations

Bail in as ultima ratio and alternative to forced transfer of assets and liabilities to a bridge bank: Bail-in should be distinguished from other tools that are taking effect before bankruptcy such as the transfer of systemically vital functions or the creation of a bridge bank. Bail-in is an ultima ratio tool to recapitalize and keep an institution that is at the brink of bankruptcy afloat and thus to maintain the entire institution as a going concern[1]. It is triggered when the firm is, based on an objective assessment of the regulator, basically insolvent. Bail-in intends to re-capitalize the institution and to restore market confidence. The purpose is not to ensure a controlled wind-down, i.e. the purpose is not the transfer and maintenance of certain systemically relevant functions for a minimum period to a bridge bank and the winding-up of the "rest" of the bank[2]. Consequently, a statutory bail-in should not be used for other purposes, such as for re-capitalizing a bridge institution. Otherwise, bridge banks will not be able to fulfill expectations placed on them. Short term creditors will have no incentive to remain exposed to the bridge bank and it will prove very challenging to create confidence in the survival of the bridge bank. Moreover, the consultative document fails to address how creditors of the "rest bank" should be treated in connection with such a limited bail-in, and their treatment in relation to creditors transferred to the bridge bank.

Typically, bail-in should only be triggered if other measures have failed or are considered ineffective to **save the firm as a going concern[3]**. Bail-in must, therefore, not be triggered too early, but generally only right before actual bankruptcy (see below, Trigger). There is a certain risk that regulators could revert to bail-in too early, instead of using other tools. Bail in should not be used as an expected "easy way-out" for regulators. Also in this context it is to be distinguished from other forms of debt that can be converted, such as Cocos or loss-absorbing instruments, which would trigger earlier and in addition have been contractually agreed ex-ante. As stated above, we also believe that the operation of a statutory bail in after a forced transfer of certain assets and liabilities into a bridge bank would need to be carefully reviewed before it could be supported, in particular also in relation to the requirement of "no creditor worse off". It is quite plausible that creditors subjected to a bail-in coincident with or shortly after such a transfer would challenge the validity of the transfer and seek to collect their debt from the bridge bank, thus undermining its stability.

Furthermore, it should also be recognized that a bail-in has by definition a **contagion effect**. It is impossible to execute a bail-in without affecting the situation of other market participants. We suggest

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[1]The term "resolution" as such suggests an orderly *break-up* and *liquidation* rather than a *recapitalization* to keep the firm in business as in the case of a bail-in, which is actually a *reorganisation* based on the example of industrial concerns under the US Chapter 11 procedure.

[2] This comment also applies in relation to the section on resolution powers, s. 4.1(x).

[3] Whilst this paper addresses SIFIs, we believe that bail-in as a resolution tool should also be applicable in principle to other banks.

the FSB to consider how these ripple effects could be mitigated. For example, forced markdowns of assets at one institution will likely reduce confidence in other institutions holding similar assets.[4]

Clarity is therefore needed about **when and how the bail-in powers are employed in a way predictable for investors**. Investors need certainty about the circumstances under which bail-in could apply and how they would be treated. Without this the market for unsecured bank debt could become shallow and unreliable, and the cost of funding is certain to increase substantially without any corresponding benefit as a counterweight. As a crisis builds, funding could become completely unavailable due to bail-in risk. The need for certainty extends to how the regime will be triggered (section 4 of Annex 2).

The trigger point must be **defined as clearly as possible**. When a crisis is in flight for a bank, the market will be wondering when the regulator may exercise the trigger (if at all) and will act accordingly, and in the meantime the regulator will be torn between triggering an event of such magnitude, either too early or too late. As in the context of convertible capital, a trigger with a large discretion for the regulator is highly problematic for investors, and this will be reflected in their appetite and pricing demand: if the market knows that a regulator has a great deal of discretion, and worries appear in the market due to a late 2007 or early 2008 scenario or further worsening of the current sovereign debt crisis in Europe, bank debt securities that are subject to theoretical involuntary conversion risk to become very volatile, well before the regulators would even think that they might need to act. If short term debt like commercial paper were affected, an institution might not be able to roll it; if interbank debt is affected it might dry up; if only long-term debt is affected it might dive in price and create further alarm, and if maturing, it may not be possible to replace it. On the equity side, we might see in such a scenario a radical price drop because of the fear that shareholders could be wiped out in exchange for heavily diluted warrants.

The trigger point must come at an appropriately late point in time when other measures have taken place but proven to be ineffective. While the point of non-viability is a good starting point, it has to be kept in mind that bail-in should only be applied after other measures which are taking precedence. This fact should be specified accordingly to increase predictability. The trigger point should thus be at the threshold that already exists in many jurisdictions just before an actual statement of bankruptcy.

In addition, a bail-in should be subject to the following conditions:

i. other tools preventing a bankruptcy have failed or would not appear to be successful in the given situation, in particular other instruments must have been triggered beforehand, such as the conversion of debt contractually agreed (loss-absorbing instruments, Cocos);
ii. the bail-in is necessary to safeguard the value of the failing institution's assets;
iii. based on an ex-ante assessment, bail-in is likely to be successful and will not only preserve the institution as a going concern but also maximizes its value for the benefit of its creditors;
iv. existing shareholders must bear losses before any creditors who have not contractually agreed to a corresponding conversion/write-down
v. application of the principle that no creditor will be worse-off by the use of the bail-in power than he would have been in a liquidation scenario. This principle should govern as a general

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[4] Forced markdowns of assets at one institution will likely reduce confidence in other institutions holding similar assets. Bail-in will be noticed almost instantly by other market participants in such a crisis situation. There is a range of opinions on the drivers for asset valuation in a crisis, but illiquidity can be a key driver in many cases. Normally the way that asset illiquidity propagates problems is through forced liquidation of these assets - they are sold in the market for whatever cash they can realize (e.g. in a hedge fund liquidation), which is often a distressed price that create a new "MTM value" visible in the market and new markdowns for other owners. This value is often further distressed by the expectation that other liquidation events may follow in this asset class, so investors are incentivised to wait for even lower prices. We believe that even if there are no assets sold, a severe asset markdown could inevitably affect market sentiment and therefore tend to drive down other values, perhaps through the mechanism akin to the ABX of 2008.

matter for the assessment whether at all bail-in may be applied and extends to creditors whose debt is subject to contractual write down or conversion mechanisms (the limitation in annex 2, 6.1 is thus unnecessary).

The above conditions must be understood as part of the reorganization that bail-in actually represents: a reorganization of a financial institution without liquidation, akin to the US Chapter 11 process. The changes in the financial position of the holders of debt claims and equity interests must, therefore, have a comparable binding effect to that provided by the court approval of a plan and the "discharge" similar as under US law. Thus, once a bail-in has been declared and implemented, creditors must not have a right to questions its validity, but may have a right to compensation under certain circumstances. It would have to be determined under the laws of each jurisdiction what procedural aspects and appeal rights need to be included in order to avoid violations of vested and constitutional rights.

Usually a firm that needs a bail-in will also have **substantial liquidity issues** that will continue or even deteriorate following a bail-in, due to depositor withdrawals and critical access to interbank short term lending and commercial paper funding. The paper does not refer to this issue which is critical to the survival of a bailed-in institution. Consequently, bail-in must be accompanied by liquidity measures and a **strong short-term liquidity program** and support. It has been proposed e.g. to use instruments of super-senior credit standing, which should, together with other potential measures, be explored in more detail. It would also entail **central bank support,** e.g. by expanding the range of debt instruments that can be accepted as collateral for short term funding.

We note that the paper falls short of discussing **avoidance issues** as one of the **major impediments of a workable bail-in concept**, in particular if in an international setting. The issue of avoidance actions needs not only to be addressed on a national, but even more so on an international scale. To achieve this, first the principle of equal treatment of creditors must be replaced by the principle of "no creditor worse off" as stated above. Second, creditors must not have a right to attack the validity of the bail-in decision of the regulator and actions to implement it as stated in section 7.3, i.e. the right to raise avoidance actions should be excluded by statute where feasible under national law; third, creditors should instead be able to raise issues of unequal treatment in relation to their creditors' class and fourth, there should be compensation mechanisms appropriate under the circumstances

Further, **international recognition** of such regulatory intervention must be achieved, e.g. through a multilateral **treaty mechanism** (see below, answer to question 9). At the very least, we would expect FSB members committing themselves to ensure that bail-in decisions by national authorities are recognized across their jurisdictions.

Finally, we also believe it is important that unlike in a corporate reorganization, in case of the "bail-in reorganization" of a financial institution, it is not the ordinary courts, but the regulator that should be responsible for the administration of the case.
It is highly critical in our view that the FSB address the above issues in connection with the bail-in and resolution regime discussion as without it we fear the proposals may not work when needed.

Specific observations

In addition to the points mentioned above, Section 3.2 of Annex 2 should address further issues necessary to allow a swift conversion, e.g. lifting or facilitating listing and prospectus requirements, overruling anti-trust regulations, addressing state-aid issues and takeover regulations; regulatory change of control approvals and notifications that regulators should address on an international scale such that a swift change of control on a worldwide basis is possible.

Regulators must also have the power to grant exemptions as to **capital adequacy rules, bulk risk limitations, liquidity requirements as well as other supervisory requirements** at least for a certain period to stabilize the firm after a bail-in.

Also **tax aspects** may play a major role for the success of a bail in. These should at least be stated in form of a place holder in the paper.

We assume that all **aspects of company law** will be addressed under national law.

Section 8, impact on financial contracts. The impact of default mechanisms on standard master agreements is well recognized and discussed specifically under Annex 8. It will have to be addressed by the relevant trade associations of which the major SIFIs are leading members. We believe a change in the standards would be required, as even an internationally coordinated response to the default mechanisms in such agreements may itself be subject to challenge in certain jurisdictions, if such private contracts could be in effect amended by statutory changes retroactively.

Section 12, transitional period. We do not agree with the statement that bail-in should apply to both existing and new debt. Bail-in powers should only apply to debt issued after a cut-off date to protect justified expectations of creditors and investors. Such retroactivity could also be subject to constitutional challenges in a number of jurisdictions. Similar issues exist as mentioned above in relation to interference with existing master agreements.

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?

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

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

We agree that consistent regimes should be developed across countries, that regulators should have the power to write down a broad range of unsecured instruments, from equity to subordinated debt up to senior unsecured debt if necessary. The fact that there will also be contractually agreed conversion or loss absorbing instruments that trigger before a bail in should reduce the likelihood of the recourse to such harsh measures. Thus, it should also have an impact on the cost increases of unsecured senior debt, if bail-in powers are introduced across jurisdictions. In saying so we also believe that there are certain classes of liabilities which should be excluded from the regime in the interests of financial stability and continued access to liquidity and funding for the institution.

The excluded liabilities, therefore, are all short term which concern transactional business. Many of such creditors will already have left the bank and in order to stabilize the bailed-in institution, it is critical that there is a statutory protection and thus a clear signal to such creditors. The list should include all depositors (not only protected or insured deposits), irrespective whether retail or wholesale, swap repo and derivative counterparties (in principle irrespective of whether cleared through a CCP or not and including claims that are covered by master netting agreements – even if uncollateralized) and other trade creditors, certificates of deposit, short term notes and other short term debt (defined by a specified maximum maturity) used for financing, cash instruments, securities lending transactions, secured debt (including covered bonds; amount excluded should be limited to the amount actually secured, i.e. the value of the related collateral). We note that such exclusions could exacerbate funding difficulties during a stress scenario and the impact on liquidity management (liquidity management instruments that might also be used as collateral for derivative transactions) needs to be analyzed further.

It might be easier to define the instruments that are subject to the bail-in than listing the exceptions.

We accept that by definition, exclusions from the regime establish a new creditor hierarchy and, therefore, believe that consideration should be given to compensation mechanisms to assure that debt is not subordinated to equity. It goes without saying that we believe senior debt should only be subject to bail-in if absolutely needed to protect financial stability, and if so, should always be treated better than subordinated instruments. Subordinated instruments should likewise always receive better treatment than equity.

Whatever approach is chosen, there is a need to develop legal certainty, and for investors to understand where they stand in the hierarchy. It is thus essential that any liabilities subject to bail-in are handled in the order of creditor priority: write-downs should first be imposed on the most junior categories of investors, starting with equity and progressing in order of creditor priority (i.e., from Hybrid T1 to T2 and potentially up to senior debt) as needed to achieve the desired overall capital ratio. In our view, the principle of subsidiarity would, however, not require that the most junior categories of investors (in particular, equity holders) be written off completely before write-downs could be imposed on more senior categories of investors, provided that a junior investor may, in proportion to the hypothetical proceeds in a liquidation of the bank, not be treated more favorably (and should generally be treated less favorably) than any of the more senior investors (i.e., the potential upside in a going concern should be smaller than for the more senior investors). Senior unsecured debt should be converted only if absolutely necessary and after all debt that is junior to it has been written down or converted.

As to debtors of the same rank, any discrimination should be avoided, save of course where debt is excluded from bail in. Where discrimination could nevertheless not be avoided, ranking and treatment should be based on the assessment of a likely outcome in a debt restructuring negotiation.

Furthermore, we believe that the relationship between the various classes of loss-absorbing debt needs to leave sufficient flexibility for the market to develop the appropriate instruments. For instance, we do not believe that contractual instruments that have been written-off or converted into equity before resolution have necessarily to absorb losses alongside other equity before the bail-in. There may be a market for debt instruments that are written-off at a certain trigger, but that may still survive a bail-in (e.g., in the form of warrants or participation in future profits) without having to accept a full loss. Debt instruments converted into equity before the resolution trigger could be diluted by the bail-in. There is no need a priori to write them off entirely. This flexibility is essential to ensure priority of claims between holders of contractual bail-in instruments and equity holders. If such holders are written off entirely at the point of bail-in, they share the fate of equity holders. This issue of respecting that equity holders bear the first losses is particularly important when considering write-off instruments, as these will be written-off at a time when equity holders are still untouched. There need to be possibilities to privilege these written-off/written-down holders of instruments in a bail-in situation vis-à-vis equity holders. There are further possibilities to differentiate between "old" equity investors and "new" equity investors stemming from a conversion of CoCos. For instance, these investors could form a separate class of shares that are excluded from a subsequent bail-in. They could form a separate class that ranks below all creditors but above "old" shareholders in case of insolvency. The bail-in could also be structured to wipe-out "old" shareholders and only have a diluting effect on "new" shareholders. These various examples show that there are various ways to structure instruments to ensure that the original capital structure (i.e., shareholders bear losses before all debt holders) can be maintained even in a bail-in situation. This would ensure that perverse incentives can be mitigated. Otherwise, shareholders and management might be given an incentive to increase risk.

Regarding the instruments affected we believe that there are benefits to a combination of both a limited contractual approach and a broader statutory approach. The latter would only get triggered, if the former proved inadequate. A limited approach is preferable from an investor's perspective: it sets clear terms and conditions for investing in the instruments. The costs of writing down or converting debt into equity are reflected in the applicable interest rate. By contrast, a broad statutory approach only does not yield as much clarity and security ex-ante with the pricing of the bail-in risk for senior debt being more difficult. Enforcing a pure statutory approach in an international set-up is also more difficult.

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

We believe that capital and liquidity requirements as well as necessary steps to recover in a crisis are better addressed through the relevant requirements as well as the recovery and resolution plans that firms must submit, rather than an outright requirement to hold a certain amount of liabilities covered by bail-in powers. We believe it is also unnecessary given the requirements to hold bail-inable debt, be it in form of Cocos or other loss-absorbing instruments, as well as the Basel requirements in relation to T2 instruments that must have a trigger at the point of non-viability. Furthermore, any specific requirements in this area will carry an additional financial cost, which could be material and insurmountable for firms encountering a stress situation.

We also believe that no limits on asset encumbrance should be introduced. Liquidity requirements already today oblige firms to ensure their liabilities have sufficiently long maturities.

Finally, it would be important to understand how regulators would react to a bank failing to hold the mentioned minimum level of bail-in debt (e.g., where the bank holds ample equity).

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?

We believe it is too early to quantify the impact the introduction of a bail-in regime would have on senior funding markets. We note that the pricing of bank debt spiked with the publication of the European Commission's consultation paper, but it is uncertain whether a move to a bail-in regime has been fully priced in at this stage. It is therefore important to assess the bail-in regime in a 'new world' without any further bail-outs of senior creditors. Before any new G-SIFI framework with bail-inable capital requirement is introduced, a careful impact assessment should be undertaken, taking into account the new Basel III capital requirements as well as liquidity regimes and their stabilizing effect.

Furthermore, as outlined above, such a system with requirements for bail-inable debt can only work if it is consistently and simultaneously introduced in all jurisdictions with major financial centers and markets.

The structure of the bail-in regime will have a bearing on the impact on senior debt. If bail-in is only imposed on the basis that creditors will be left no worse off than they would have been under insolvency, then bail-in could lead to a slight increase in probability of default, but a significant decrease in loss given default. Clarity on the type of instruments within scope of the regime and the hierarchy of likely resolution actions should minimize the impact on funding costs.

We believe as a general matter that there remains concern as to the **marketability and pricing of senior debt,** if it contains a regulatory trigger, even one that is well-worded.

Section 'Cross-border co-operation'

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?

We strongly support enhanced cooperation between home and host authorities. One way of achieving a commitment to cooperate could be to share information/include in CMG process only such countries that commit themselves to cooperate. We also believe that adequate information sharing protocols should be a prerequisite for membership of CMGs. That being said, it is essential that information sharing agreements include sufficient confidentiality agreements to ensure that firms' data is protected.

Given the focus of G20 leaders on this issue, we find it somewhat surprising that the paper concludes that there is no immediate prospect of a multilateral agreement on the resolution of financial institutions. We would encourage the FSB to take the opportunity afforded by the current focus on this issue to call for the parts of the paper focused on cross-border resolution to be implemented as quickly as possible.

We would like to encourage the FSB to take up work for a master agreement/treaty to set up a recognition framework for certain regulatory actions and their impact on civil and commercial law, e.g. in connection with the transfer of assets and liabilities into a bridge bank as well as recognition of bail in measures.

In our opinion, further consideration must be given to the application of bail-in to cross-border and group scenarios. As a general rule, we agree that bail-in should be initiated by the home authority (although we warn that it is not always the case that debt is located at the parent level) and be coordinated through the CMG.

We are concerned by the proposition in 9.2 that **host authorities** should have the power to **exercise bail-in powers at subsidiary level**. This may not only have ramifications for the structure of the group, but could also prove destabilizing, if the host supervisor exercised this power before waiting for the home supervisor to assess the most appropriate group-wide solution. This is similar to situations that occurred in the past, where bankruptcy was declared over foreign branches of a firm which thus would have caused the bankruptcy of the entire firm, had the relevant decrees been recognized abroad. .

We believe if bail-in powers are included in statute, firms will have to include it in their risk warnings as a minimum. We would support that an actual recognition by creditors be included, where the debt issue is outside of the institution's home jurisdiction and subject to foreign law and foreign jurisdiction (s. 9.4.)

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?

See our comments above. In particular, there is also a need for an international agreement/treaty to ensure mutual recognition.

The need and right to cooperate among home and host jurisdictions and in what form also needs to be based in national legislation, which currently is not the case everywhere. In various jurisdictions it is not sufficient that supervisors agree to collaborate with each other. Rather, changes to the law may be required to ensure that also resolution authorities, in particular courts, where applicable, are bound by the agreed process.

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

We believe that the home authority should determine which authorities should be parties to the agreements, together with the firm's management.

The focus should be on the authorities from countries in which the institution holds a more or less balanced amount of assets and liabilities, as only these countries are likely to ring-fence, whilst not excluding other relevant jurisdictions. If a firm holds only/predominantly assets or only/predominantly liabilities in a specific country, this country is much more likely to refer to the home resolution authority.

Furthermore, any agreement should focus on the countries where most assets/liabilities are held or in which the impact of a firm's failure would be felt most.

Section 'Resolvability assessment'

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?

Not commented

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

Not commented

Section '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?

We agree with the clear distinction between recovery plans and resolution plans. Recovery plans contain measures prior to any stage of non-viability and a phase during which management and board of the company remain entirely responsible for the firm, their decisions and actions. Regulators should have the power to require a firm to improve its recovery plan. However, given that this concerns measures outside a threatened insolvency, regulators must not have the power to intervene in the firm's business or operational structure, if they consider such plan insufficient.

It also must be ensured that no disclosure requirements exist that would oblige firms to disclose the contents of recovery or resolution plans. The issue of confidentiality among regulators and cross-border has been highlighted and also needs to be addressed.

Whilst resolution plans should be a competence of the relevant regulators, we also reiterate that the pure obligation and existence of such plans must not allow regulators to interfere into the business model of banks or require changes to their legal or operational structure. Such interference into an institution's set-up, whilst it is a well capitalized going concern, would be disproportionate and represents an infringement of the relevant firm's constitutional rights. Any interference into the operational structure of a firm must remain the last resort, when it is evident that an orderly resolution is not possible otherwise.

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

Section 'Improving resolvability'

We agree that where required, complexity in organization and structure of a financial institution should be decreased. However, we would equally like to stress the point that as long as a financial institution is solvent, management must run the firm on an efficient basis with due regard for their duties to shareholders.
Infringements of the freedom of enterprise and actual interference in the organization and structure of a going concern must be avoided. Regulatory action should only occur after certain trigger levels have been reached, but not on a generalized ex-ante basis or based on a mere statement of the existence of "impediments to resolution".

In UBS's view, it should not be the role of regulators to define the operational model of banks ex-ante and to create resolution-friendly structures for healthy institutions. Such a power would allow the resolution authority to take entire firms apart. In essence, it could lead to resolution authorities defining the structure of credit institutions. We question whether resolution authorities are best placed to set the structure of global firms, considering their jurisdictional remit. The use of such powers would most likely also result in national ring-fencing, which would rather increase than decrease stability of international financial markets.

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

Impediments created by regulation itself as well as by national legislation acts cannot be resolved by the firms and must not give rise to restrictions imposed on the firms. Legislators, regulators and supervisors should be encouraged to work on eliminating such impediments.

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

We do not believe that this is entirely the case. As a general comment, we would like to highlight the advantages of the integrated firm concept, which allows reducing risk and enhancing system stability.

In relation to services, we would like to point out that outsourcing is already subject to specific regulation. Those agreements require robust legal and enforceable agreements including for regulatory purposes as well as the outsourcing firm to maintain major and basic functions themselves, and the ability to recoup the outsourced services.
Firms should be in a position to introduce the proposed mechanisms (ie, prevent termination of SLAs and facilitate transfer to a bridge bank) into contractual arrangements for intra group SLAs.

We support the suggested measures in 2.1(i) and (ii) towards achieving enforceability in crisis situations and in resolution. The resolution powers suggested in Annex 1 Section 4.1 (v) are important supporting measures. It would be helpful if those powers could be invoked in a cross border context where services support activities in other jurisdictions.

We also disagree with both suggestions in section 3.4. A prohibition on cross-default would likely be ineffective, as it would not be difficult to create contractual proxies for a cross-default trigger of events that would be indicators of insolvency, such as a ratings downgrade below CCC, CDS spreads widening beyond 2000bp or ceasing to trade, or the share price going below a certain amount.

We believe that making valuation mechanisms identical would be a false goal. For example, if an entity that has entered into both sides of a back to back option contract defaults, the only means by which the defaulting party will not suffer the bid-offer spread is to have the option terminate at a mid-market value. This would mean that (i) the non-defaulting parties are penalized, since both will suffer half the bid-offer spread if they wanted to re-hedge the trade; and (ii) parties are obliged to value at the theoretical value of a mid-market estimate.

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

In UBS's view, there should be no regulatory restrictions on intra-group guarantees or cross-default provisions. Intra-group guarantees (or cross-default provisions) are a prudentially recognized risk management tool within banking groups on whose effectiveness group members rely. Also, the regulators themselves often require regulatory guarantee-like undertakings and commitments. Contractual guarantees are very often the result of regulatory requirements: if regulations require actually or practically a subsidiary instead of a branch[5], a down-stream guarantee may often be required to actually and effectively run the business. Any regulatory restrictions, which ultimately constitute interference in contractual autonomy, could create considerable risks – e.g. significantly higher default risk – for the counterparty/group member of the distressed institution and make adjustment of the entire risk management policy necessary.

We disagree with the assessment in Annex 6, Section 3 that the existence of intra-group guarantees would make it more difficult to transfer positions due to the necessary client consent. Client consent is anyway necessary (or not necessary) according to the applicable law. The existence of the guarantee does not change this situation. Furthermore, clients will need comfort about the soundness of the firm becoming their new counterparty (e.g., a bridge bank). This is of much greater relevance than a guarantee from an affiliate of a failing firm, which, in such a situation, is likely to be of limited value as the entire group is likely to default. We equally do not agree with the FSB statement that the existence of intra-group guarantees has a contagion effect in a group. Rather, they have the opposite effect. A group is much more likely to fail, if it is not able to support its affiliates. The market does not differentiate between the members of a group, while it is a going concern. The same is true from a regulatory or accounting perspective. Without intra-group guarantees, it becomes very difficult to manage risk efficiently. The dangers of a sudden default of an affiliate increase, even when the group as a whole is financially sound. The market may panic in such a situation and send a financially sound bank into resolution. Even in resolution, intra-group guarantees do not cause problems, if they are adequately documented and at arm's length terms.

The provision of intra-group financial support should remain a voluntary management decision of the entities concerned, which depends crucially on the legal structure and business model of the group. In UBS's perspective, the authorities have the responsibility to assess the resolvability implications of these business models.

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

We reiterate our concern that some of the measures to improve resolvability that are proposed represent intrusions into a healthy financial firm's operational and legal structure. The freedom of enterprise and organization must be preserved. Any interventions must be proportionate and ruled out where a firm is well capitalized and not experiencing any systemic difficulties.

Section 'Timelines for implementation of G-SIFI related recommendations'

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

UBS is of the opinion that the member countries of the G20 should make the legislative actions recommended by the consultative document a stated priority, and indeed, that the legislative actions should be explicitly included in the implementation timeline.

By the same token, we firmly support reasonable timelines for recovery and resolution plans which recognize that the submission of the first drafts are likely to be followed by intense discussions and deliberations between firms and regulators, as well as among regulators.

The current proposal, according to which G-Sifis have recovery plans in place by the end of 2011, therefore, seems difficult to achieve, especially given that the G-Sifi designation process is still subject to

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[5] For example, non-EEA headquartered firms will not be able to undertake pass-ported business within the EEA out of a branch, and are thus required to transact such business out of a subsidiary. In order to support such subsidiaries, they will either benefit from a direct down-stream guarantee or guarantees are issued to the clients of the firm. Similar situations exist for certain business undertaken by foreign firms and banks in the U.S. and elsewhere.

consultation. In addition, any deadline for the initial submission of completed recovery and resolution plans should recognize that the discussions are likely to identify issues regarding both internal and external impediments, that the issues will need to be discussed and addressed by firms, legislators and regulators over time and in various forms, and as a result any assessments of "feasible and credible" should not be linked to the completion of a first generation plan.

Section '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 crossborder resolutions? If so, which differences, in particular, impede effective crossborder resolutions?

We agree that clarity and predictability over the order of seniority or statutory ranking of claims in insolvency are imperative for the functioning of the market and the allocation of losses. As a matter of principle, we believe a consistent international creditor hierarchy would be beneficial, but do not believe that it is feasible for such harmonization to take place nor that they substantially impede effective crossborder resolution. However, agreement on certain principles would be welcomed (see above, section on Bail-in).

As to the principles to be agreed in this context, we believe that **first**, the **position of existing creditors** should be maintained. Altering the rights of existing creditors would not only be inequitable, but would also have a significant impact on banks access to funding markets.

Second, we believe that the differing positions of deposit guarantee schemes should be maintained. The main principle in this context should be that there is **no discrimination based on nationality or domicile of a depositor** in this context.

Third, we would highlight that **depositor preference** should be limited to the insured amount. Where such insurance exists, the preference should only apply to the insured deposit amount that has not been paid by the insurance, i.e. not the uninsured portion. This may be the case, if the insurance does not have the capacity to effectively protect insured deposits of a failing SIFI.

We note that the system in **Switzerland** is different from that described in the Consultative Document, Annex 7, section 5: there is no actual insurance for depositors, but an advance payment granted to depositors up to the amount of their privilege in bankruptcy (CHF 100,000). The privilege in bankruptcy applies to all depositors up to the privileged amount, including depositors of branches abroad (both protected through earmarking of assets).

Subject to the first two points above, we thus give preference to a system of simple depositor preference up to ensured or privileged amounts.

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 harmonized definition of deposits and insured deposits desirable and feasible?

See our answer to question 21. Subject to the second principle, convergence should be in the direction of maintaining depositor preference limited to the insured or privileged amount rather than to eliminate it. Depositors have proven unable to monitor the behavior of banks and to provide incentives for banks to act prudently. However, we believe that such a limited preference could be useful to prevent bank runs. This is at least one of the experiences from the financial crisis in 2008.

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)?

We believe that there is no advantage in limiting the depositor preference to retail deposits, if there is a limit on the depositor preference as described above, but that the differentiation would add unnecessary complexity to the system. If the limit is appropriate for retail customers (i.e., comparatively low in absolute terms), the benefit of the privilege will anyway be very limited for large corporates.

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?

We believe that the consultation paper adequately addresses the risks and costs of depositor preference. On balance we believe that the benefits likely outweigh the costs, if the privilege is limited as described above.

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?

We do not see any further measure in sense of giving preferences to further classes of unsecured creditors (which could mitigate the risk of bank-runs), as this would obviously have substantial negative consequences on liquidity, cost and structure of funding.

We note, however, the need to protect set-off rights and the need to ensure that netting agreements are protected and cherry picking is avoided (see below, answers to question 26 ff.).

Section '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 be the potential adverse outcomes on the failing firm and its counterparties of such a short stay? What measures could be implemented to mitigate these adverse outcomes? How is this affected by the length of the stay?

We generally agree with the analysis and thrust of the discussion in Annex 8.

Admittedly, the suggested temporary suspension of close out netting rights runs contrary to the core concept of close out netting. The essence of close out netting is an early termination of the respective transactions and netting of mutual rights and liabilities of parties and their replacement with a single net claim. This mechanism leads to substantial reduction of the counterparty risk by reducing the mutual claims to one net sum and is thus beneficial for both the troubled credit institution and its counterparties. Furthermore, legal certainty over the effectiveness of close-out netting in a jurisdiction is a major factor for the competitiveness of financial institutions operating in the jurisdiction. We therefore believe that the impacts of such suspension on the banking sector should be further assessed.

If a temporary stay on certain qualified financial contracts ("QFCs") is recommended, it should be subject to clearly circumscribed limitations, specifically subject to strict and short time limits, and in connection with certain safeguards regarding the transactions covered by the same netting agreement asset also set out in section III.5:

1) the stay should be brief (e.g., 48h hours);
2) the counterparty should be allowed to suspend its performance on the QFC during the pendency of the stay;
3) the counterparty should be allowed to close out upon a performance or other default on the QFC (as distinct from, but not an ipso facto default); and
4) a transfer should only be allowed to a creditworthy third party or, with appropriate assurances of performance from the resolution authority and its government, to a bridge institution established by the resolution authority.
5) timely notifications on these measures are given to all counterparties.
6) the detailed requirements and conditions must be identical in all major financial centers
7) no cherry picking, i.e. the relevant agreements containing close out netting rights and all transactions under them must be transferred to an eligible transferee either as a whole or not at all, regardless whether the protected arrangements are created by trust, contract or other means
8) should the regulatory authority decide within the period of stay not to transfer the relevant agreements, the counterparty has the right to immediately close out its transactions against the failed institution upon expiry of the suspension period.

Furthermore, specific consideration should be given to the treatment of **CCPs**, in particular given the increasing systemic importance of CCPs under the new derivatives regulations being introduced on a worldwide scale: CCPs rely on close-out netting as a highly effective instrument to mitigate risks emanating from the default of their members (usually referred to General Clearing Members -GCMs). If, as intended, a large part of derivatives will be centrally cleared outnumbering uncleared contracts, we do not see how cleared contracts could be excluded from a stay. Such exclusion would likely substantially hamper resolution.
The same arguments apply to **payments and securities settlement systems**, financial market infrastructures (FMIs) and an exclusion should also apply to **central banks**.

Also, it must be ensured that a temporary suspension of close out netting rights does not affect the **capital requirement rules**, i.e. that the financial institution (being a counterparty to a troubled credit institution) under a temporary stay can continue to use the single net claim as the basis for complying with the capital adequacy requirements.

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?

As outlined above, a **trigger** event should be defined as **clearly and objectively** as possible to avoid uncertainties.

The measure should also be restricted to **two resolution tools** only: (1) transfer of assets and liabilities to a bridge bank or a third party and (2) in connection with a bail-in. The infringement of the rights of the counterparties by a stay can only be justified if it serves an overriding interest and is beneficial to all market participants.

Since a trigger event needs to be clearly defined, the stay should also operate **automatically**. Discretionary powers would result in considerable uncertainty and thus negatively affect counterparties and the financial markets.

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?

See our answer to question 26. Early termination rights triggered by other default events or actions should remain unaffected by a stay. In particular, this applies to simple failure to pay, perform contractual obligations, deliver or breach of other material causes.

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

As stated above, international consistency is required. There seems to be consensus developing on a period of 48 hours.

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

See above answer to question 26.

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?

Yes, we agree, but would also suggest taking the opportunity for further aligning the legal frameworks to protect and ensure the validity and enforceability of contractual close-out netting provisions.

32. With respect to the cross-border issues for the stay and transfer, what are the most appropriate mechanisms for ensuring cross-border effectiveness?

Harmonization of the relevant legal frameworks, including ancillary aspects such as contract law, company law, insolvency law and the rules on conflict of laws would be the avenue in the medium term. It could also be part of the multilateral agreement mentioned above. In view of the general difficulties for such harmonization, the efforts should be limited to the specific issue of close-out netting.

The most promising avenue that is not mentioned is standardization of master agreements and terms by the relevant industry bodies such as ISDA, which are basically controlled by the SIFIs, to make sure the standard terms of the contracts give effect to the statutory stay provisions. We are sure that the industry would cooperate closely with the regulators in this context. An edict by a banking regulator that a bank may only enter into derivative and other financial contracts, if a temporary stay is included and where possible must act to terminate those that do not, would likely not be sufficient to stop enforcement of a legal right in court.

We do not favor the other mechanisms mentioned, such as administrative powers given to jurisdictional authorities, courts or automatic universality.

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?

See comments above under Question 32.

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?

See comments above under Question 32.

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