Comments on Consultative Document on Effective Resolution of Systemically Important Financial Institutions - Recommendations and Timelines

Financial Stability Board,

The Financial Stability Board (FSB) published a press release on its website on July 19 seeking comments on its *Consultative Document on Effective Resolution of Systemically Important Financial Institutions.* This Consultative Document contains proposed policy recommendations and timelines.

After reviewing and discussing relevant policy documents, BOC found many conflicts between the Consultative Document and current laws and regulations of China, in particular the Enterprise Bankruptcy Law of the People's Republic of China ("PRC Enterprise Bankruptcy Law"), and also found unavailability of corresponding provisions in China's legal system in some respects. Therefore, China need make considerable modifications and additions to its current legal framework if it accepts to be bound by the document, which will have significant effects on the current financial rules and legal system of China.

Taking into account economic, financial and policy conditions and legal systems of emerging countries, BOC comments on the *Consultative Document on Effective Resolution of Systemically Important Financial Institutions - Recommendations and Timelines* as follows:

I. Key Attributes of Effective Resolution Regimes for Financial Institutions

(I) Considerations regarding differences in national situations

With regard to Annex 1: Key Attributes of Effective Resolution Regimes for Financial Institutions", we think that the Consultative Document draws upon the U.S. lessons in resolution of Lehman Brothers and European experience in resolution of large financial institutions during financial crisis. As for China, due consideration should be given to the state-owned nature of G-SIFIs and their resolution procedures should differ from those for non-state-owned financial institutions in Western countries. For example, it is difficult to define the difference between state-owned equity and public resources, between state take-over and bail-in; in cross-border cooperation, the scope and nature of information

disclosure and sharing between home and host countries are defined differently across countries. To sum up, such country-specific elements should be fully considered when each key attribute is defined.

(II) Considerations regarding differences in legal system

Further coordination is required between Annex 1 and China's current legal system in the following aspects:

1. Clause 5.1 requires that the legal framework governing netting should be clear, transparent and enforceable, but China's legal system (including bankruptcy law) does not explicitly recognize netting. Enforceability of the clause remains uncertain in China.

2. Clause 7.4 sets out the principle that "judicial review should be *ex post*"; that is, authorities may carry out resolution before judicial review for higher efficiency and flexibility. However, the PRC Enterprise Bankruptcy Law provides that the financial regulatory authority under the State Council may apply to the People's Court for the reorganization or bankruptcy of a financial institution (commercial bank, securities company or insurance company) that is unable to pay off its debts and its assets are not sufficient to cover all the debts or it is obviously incapable of paying off its debts under Article 2 of the law. In contrast to the principle provided in the Consultative Document, the judicial review is *ex ante*.

(III) Considerations regarding differences in cross-border coordination

The Consultative Document involves cross-border coordination in many respects and grants certain resolution powers to overseas regulatory authorities. Such provisions are excessively stringent and may significantly affect assets and operations of BOC overseas institutions, for BOC has a large number of overseas institutions. For example, Clause 8.4 of Annex 1 provides that the resolution authority should have resolution powers over local branches of foreign financial institutions and the capacity to use their powers to take measures on their own initiative to preserve the local jurisdiction's financial stability; Clause 8.6 provides that jurisdictions should provide for transparent and expedited processes to enable a foreign resolution authority to gain rapid control over assets (located in their jurisdiction) of a financial firm being resolved in the foreign jurisdiction.

II. About Bail-in within Resolution

(I) Considerations regarding differences in national situations

With regard to Annex 2: Bail-in within Resolution: Elements for

inclusion in the Key Attributes. We are of the opinion that bail-in is to reduce reliance on public resources and mitigate impact on financial markets and real economy through self-resolution of financial institutions, such as debt-to-equity swap and debt write-off. For China's financial institutions, the paramount issue is the ownership structure. State ownership of equity as seen in China determines substantial involvement of public sectors in bail-in. Therefore, many attributes should take into account China's national situations and recommendations should be well considered one by one. Exceptional arrangements may be considered for emerging countries or countries with special conditions.

(II) Considerations regarding differences in legal system

Further coordination is required between Annex 2 and China's current legal system in the following aspects:

1. Clause 3.1 provides that resolution authorities may write down unsecured creditor claims or convert them into equity claims. This considerably affects interests of creditors and no similar provisions are available in the PRC Enterprise Bankruptcy Law.

2. Clause 9.2 provides that host authorities should be able to exercise bail-in within resolution powers at subsidiary level with respect to foreign financial institutions. This may leads to transfer of ownership in the subsidiary.

(III) Impact on existing financial contracts

Many provisions of the Consultative Document require that SIFIs should review and modify existing contracts, which is a heavy burden on such financial institutions. It is uncertain whether counterparties consent to such requirements. For example:

1. Clause 8.1 provides that the exercise of bail-in powers within resolution should not constitute an event of default that permits the exercise of early termination and closeout rights. However, according to the 1992 ISDA Master Agreement, such resolution may trigger default under Clause 5(a)(vii), so exceptions should be included in relevant supplementary agreements.

2. Clause 9.1 provides that, as a general principle, bail-in within resolution should be initiated by the home authority with respect to debt issued by the parent firm in resolution (and/or subsidiaries in resolution in the jurisdiction of the parent).

3. Clause 9.4 provides that home authorities should require that institutions incorporated in their jurisdiction include in debt contracts

provisions whereby the creditor recognizes the home authority's bail-in powers to write-down creditor claims or convert them into equity claims.

To ease the burden on SIFIs in negotiation, it is recommended that the foregoing requirements only apply to new agreements without reviewing and negotiating on existing agreements.

III. About Cross-border Arrangements

All parts of this document will involve cross-border cooperation in effective resolution of SIFIs. Overall, provisions on resolution powers of overseas authorities are too broad, such as resolution of subsidiaries (financial contracts) in the host jurisdiction. Abuse of such powers may have a material adverse impact on the interests of SIFIs. It is recommended that the scope of application be strictly limited to adequately protect legitimate interests of financial institutions' overseas subsidiaries.

IV. About Resolvability Assessments

With regard to Annex 4: Resolvability Assessments, we are of the opinion that accurate resolvability assessments are central to preventing greater systematic impact, protecting interests of taxpayers and safeguarding financial markets and real economy. Elements provided in this document are feasible, but the key issue lies in information sharing mentioned in Clause 4.11. Cross-border cooperation should give due consideration to how to eliminate barriers to information sharing caused by, for example, differences in legal systems of host and home countries. Principles for addressing such barriers should be explicitly provided if the existing legal system of the host or home country cannot be altered.

V. Discussion Notes

(I) Temporary stay on early termination rights

1. Temporary stay on early termination rights in financial contracts plays a significant role in mitigating effects on stability of financial markets. It can reduce market panics and irrational activities, provided that regulatory authorities clarify solutions to the market and safeguard interests of relevant creditors. Meanwhile, such temporary stay should not affect collateral management under the going concern consumption. For example, all counterparties shall be equally treated when collaterals are allocated at market valuation under ISDA/CSA agreements.

2. Temporary stay on early termination rights in financial contracts may automatically become effective when regulatory authorities resolve banks or other institutions or be announced by regulatory authorities during

liquidation. It is recommended that temporary stay on early termination rights in financial contracts apply to all SIFIs subject to liquidation.

3. As some countries' laws explicitly recognize the early termination rights of the non-breaching party under ISDA/REPO agreements, such as the "Safe Habor" clause of the USA. If temporary stay on early termination rights is required, it is recommended that relevant countries directly modify laws to improve effectiveness and enforceability of temporary stay clauses in addition to including them into contracts.

(II) Considerations regarding cross-border arrangements and bridge institutions

1. With regard to solutions to cross-border arrangements, it is recommended that the contractual approach is preferred. This approach avoids disputes between both parties to the contract and problems about time-sensitive applicable laws and legal approaches.

2. It is recommended that the minimum capital requirement and credit rating requirements be laid out for bridge institutions (if such institutions have capital and credit rating) and the security conditions available to the non-breaching party after transfer should not be less favorable than before transfer (such as the letter of guarantee issued by the parent of the breaching party to the non-breaching party before transfer), so as to ensure the non-breaching party will not suffer more losses due to contract transfer; otherwise greater adverse impact will be imposed on financial markets.

V. Other Recommendations

Determination, regular review and modification required by regulatory authorities.

The Consultative Document sets out effective resolution requirements over SIFIs in many respects and provides an important guidance and basis for these institutions to regulate business processes and strengthen risk monitoring. In order to improve the initiative of SIFIs in intensifying risk mitigation and ensuring compliance, it is recommended that quantitative assessment indicators and methods be refined for effective resolution requirements set out in the Consultative Document to clarify regulatory requirements, and be regularly reviewed in line with relevant improvements made by financial institutions. It is also recommended that specific requirements regarding supplementary capital of these institutions be modified.

2. Refining the mechanism of cross-border resolution

Wide disparities between countries in legal requirements for bank bankruptcy resolution (including debt discharge procedure and sequence and insurance mechanism) (see the foregoing sections for examples) compromise the consistency of G-SIFIs in resolution assessments, tools and implementation. Therefore, it is recommended that the Consultative Document provides further analysis on the effects of regulatory disparities on resolution of G-SIFIs. In addition, as resolution of multinational banking groups involves bankruptcy liquidation, debt restructuring, claims discharge and cross-border judicial cooperation, explanations should be provided as detailed as possible for understanding disparities arising from different cultures and laws across countries or jurisdictions, so as to ensure consistent understanding of resolution provisions.

3. Prudential establishment of resolution mechanisms and policies

The Consultative Document provides that, in order to ensure successful implementation of the resolution plan, regulatory authorities will replace the directors and management of G-SIFIs that cannot continue operations to exercise resolution powers, including reorganization, spin-off and liquidation. This adds to uncertainties in governance process, regulatory relationship and market order; in particular for China and other emerging countries whose legal systems and operating environments are not yet mature, the impact so brought is not ignorable. Therefore, it is recommended that resolution mechanisms and policies be prudentially established, taking into full account specific national conditions in respect of banking laws and regulations, market environments and governance mechanisms.

To sum up, the *Consultative Document on Effective Resolution of Systemically Important Financial Institutions - Recommendations and Timelines* will have a considerable impact and effects on the current financial environment, policy base and existing legislation of China. Therefore, given the differences in national situations and market environments between China and developed countries, it is recommended that the Financial Stability Board give due consideration to difficulties in achieving effective resolution that arise from differences described above. We would like to maintain close communication with Chinese supervisory authorities and the Financial Stability Board with respect to relevant matters.

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