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Financial Stability Board Secretariat
Bank for International Settlements
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Dear Sirs,

Consultative Document on Effective Resolution of Systemically Important Financial Institutions (the “Consultation Paper”)

In its recent Consultation Paper on the Effective Resolution of Systemically Important Financial Institutions (or “SIFIs”), the Financial Stability Board (“FSB”) has set out the following objectives:

1. to “address the systemic and moral hazard risks posed by the systemically important financial institutions (SIFIs)”, and
2. to “improve the capacity of authorities to resolve failing SIFIs without systemic disruption and without exposing the taxpayer to the risk of loss.”

The view of the FSB is that these objectives can only be met by new resolution arrangements, incorporating strong resolution tools for use by national authorities. In general, the FMLC, which shares the FSB’s concern with financial stability, accepts that strong resolution tools are both desirable and necessary. The purpose of this letter is to address the FSB’s proposals for a “bail-in” tool, in particular.

The Consultation Paper contains proposals for achieving the objectives outlined. Certain aspects of these proposals have been left unsubstantiated and the Paper explains that where the new tools are yet to be defined as to their scope, in particular along the dimensions listed in paragraph 2.2. of Annex 2, further details will follow. Whilst the FMLC is sympathetic to the difficulties inherent in the exercise of designing, expounding and consulting on a detailed international resolution framework, the Committee has struggled to draw up a fully particularised consultation response given the very significant gaps in these proposals, which include the range of creditors’ claims to be subject to bail-in and an account of how the bail-in powers will be applied.

What follows is a treatment of the list of creditors whose claims may be subject to bail-in powers under the proposals. However, the FMLC would like to preface this analysis with a general comment about the nature of bail-in powers. It is not for the FMLC to comment on the

policy objectives which justify bail-in powers or the respective merits of broad and narrow bail-in powers in achieving these objectives. However, the FMLC firmly believes that where a narrow policy objective has been adopted, the statutory or regulatory power which implements this objective should itself be narrowly defined to target the policy objective to the exclusion of other outcomes. Legal powers which exceed the purpose for which they are given tend to give rise to legal uncertainty in a variety of ways, of which the following are the most evident:

1. ipso facto, such powers are capable of giving rise to unintended consequences;
2. such powers are likely to lead to divergent outcomes, either inter- or intra-nationally, as the regulatory authorities who exercise them and the judicial authorities who review them follow variously either a purposive approach or a literal approach to the powers' use and abuse; and
3. wide powers mean that legal opinions supporting transactions are sharply qualified and this may have a significant impact on market activity for both regulatory and cost-related reasons.

For those reasons, the FMLC urges the FSB to pay close attention to the scope of the bail-in powers which it proposes should be conferred on national authorities, with particular reference to the classes of claim, and of creditor, that may be subject to bail-in. In general, the FMLC is of the view that it is preferable to define, in positive terms, the specific classes of claim that may be subject to bail-in rather than to arrogate to national authorities a general bail-in power in respect of all claims (or all unsecured claims) which is then made subject to exemptions, safe-harbours and the like.

CLASSES OF CREDITOR

The following is a short account of the FMLC's concerns in relation to the list of creditors which appears in paragraph 3.1. of Annex 2 of the Consultation Paper. Further details and comments may be found in the Appendix to this letter.

1. **Depositors.** The phrase "subordinated or senior unsecured *and* uninsured creditor claims against the firm" in subparagraph 3 captures depositors in theory. The FMLC is uncertain whether this is intentional. As far as the FMLC is aware other proposals for national and supranational bail-in regimes consistently exclude retail and other depositors because of the very significant political and systemic consequences of suggesting that those who deposit monies with a bank have a real and practical credit exposure to that institution (which in this case may pre-date its insolvency).¹
2. **Cash lending counterparties.** One of the dominant features of the 2007/2008 financial crisis was that unsecured cash lending between banks dried up as the money markets became impaired. Interbank cash loans are often made on an unsecured basis in the money markets. Prima facie, creditors who make these loans will be subject to bail-in powers under subparagraph 3 and this may further heighten the stress placed on money market liquidity and interbank lending in a crisis.
3. **Foreign exchange counterparties.** The FX spot and forward markets have historically been largely uncollateralised. Where a counterparty purchases a foreign exchange forward, it gains a credit exposure (if the forward is profitable) to the seller. If counterparties to foreign exchange forwards were subject to bail-in, this could have a negative impact on a marketplace which currently benefits from unparalleled liquidity.
4. **Counterparties to derivatives.** Large banks active in the OTC derivatives market do not collateralise all their positions or do not always collateralise them according to

¹ A retail depositor could be caught by bail-in to the extent its deposit exceeds the deposit compensation limit within its jurisdiction.

current mark-to-market values. Corporate swaps do not involve intraday margin calls as companies lack the resources to meet such requirements. Assets are marked to market by estimate and companies could be under-collateralised when a SIFI is bailed-in. As such, their claims would be unsecured and caught by subparagraph 3. This would have a negative impact on the wholesale and retail financial markets.

5. **Counterparties to purchases and sales of securities.** Counterparties to transactions which have been agreed are merely contractually entitled to delivery pending actual settlement. These same counterparties are, during the interregnum between trade and settlement, therefore subject to subparagraph 3 if a SIFI is bailed-in before settlement. Related issues were considered by the FMLC following the collapse of Lehman Brothers (International) Europe Ltd.²
6. **Trade creditors.** In theory, trade creditors could be caught by subparagraph 3 as subordinated unsecured or uninsured creditors. It seems unlikely that the FSB's policy on bail-in includes subjecting these parties, who may have comparatively limited commercial knowledge and/or ability to withstand write-off, to bail-in.

It is the view of the FMLC that it is probably not the intention of the FSB that resolution authorities should subject the list of creditors above to bail-in. It is therefore regrettable that there is a lack of clarity in paragraph 3.1. In addition, the FMLC wonders if any of the above creditors can be bailed in without infringing the no creditor worse off principle in paragraph 6 of Annex 2.

The FMLC notes the use of the phrase "up to all of the... claims" in paragraphs 3.1(2) and (3). Such drafting infers the provision of discretionary powers to resolution authorities to select certain claims for bail-in. Whilst this would enable quick resolution of SIFIs, it could create uncertainty among creditors as to which claims will be affected.

The list above refers to creditors to the extent that they are unsecured because, in theory, adequate collateral provides protection against loss where a creditor is subject to bail-in. The FSB notes this in paragraph 9 of Annex 7. However, relying on collateral to protect creditors from unintended consequences of bail-in can only place more stress on national and international legal frameworks for collateral. Uncertainties in the legislation will increase systemic risk. (You may wish to consider the FMLC's letter to HM Treasury of 7 April 2011 which sets out legal uncertainty surrounding perfection requirements for floating charges and the corresponding impact on the financial markets.³)

FURTHER POINTS TO NOTE

Paragraph 5.3. of Annex 2 provides for creditors of contractual bail-in instruments to suffer the burden of contractual and statutory bail-in. Whilst it is not the role of the FMLC to comment on policy decisions, the Committee urges the FSB to carry out a thorough impact assessment to ensure that the increased risk of write-off will not make financial instruments too costly to insure.

In the interest of reducing legal uncertainty, the FSB may wish to consider, when drafting further proposals for group structures (as foreshadowed in paragraph 9 of Annex 2), the application of bail-in to SIFIs subject to mandatory subsidiarisation when drafting the legal framework for resolution. The final report of the Independent Commission on Banking is expected in September 2011 and will detail plans for ring-fencing in the UK. The European

² FMLC, "FMLC Issue 140: Unsettled OTC Trades," <http://www.fmlc.org/papers/Issue140Sept09.pdf>.

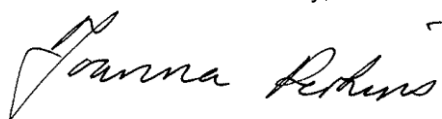
³ FMLC, "FMLC Issue 1: the Implementation of EU Directive 2009/44/EC on Settlement Finality and Financial Collateral Arrangements," <http://www.fmlc.org/papers/Issue1Ltr2HMTApr11.pdf>.

Commission has also indicated that national regulators in EU Member States will be given discretion to ring-fence retail banks in the Capital Requirements Directive IV.⁴ The text of the European Commission's proposals will need to be examined in this light.⁵

Paragraph 3.1(4) of Annex 2 provides for resolution authorities to convert all subordinated or senior unsecured and uninsured credit claims. This raises the question of whether the conversion of large amounts of debt could transfer ownership of a SIFI to bailed-in bondholders. In practice, this depends on a number of factors, inter alia (i) the proportions of debt held by bondholders, (ii) the relative conversion value of new equity to existing capital, (iii) whether the shareholdings are sufficient to constitute control over a SIFI for the purpose of national and/or supranational merger control regimes, and (iv) the presence of grace periods. Contractual terms as to how debt is held or is to be converted determine whether merger review will defeat speedy resolution. However, this will not be the case if transactions can be derogated from, as contemplated, for example, by Article 5(3) of EC Merger Regulation 139/2004. Whilst complex in practice, it is possible that debt conversion could trigger a change of control of a SIFI. Indeed, the restructuring of Eurotunnel resulted in a change of control to leading creditors. (Another issue may be whether a conversion of sufficient size might give rise to difficulties in the case where there are requirements on prior notification to regulators of changes in control.)

I would be very happy to discuss the above matters with you further. Please do not hesitate to contact me if you would like to do so.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Joanna Redins', with a stylized flourish at the end.

FMLC Director

⁴ Michel Barnier, "Speech to press conference in Brussels on 20 July 2011," <http://europa.eu/rapid/searchResultAction.do?search=OK&types=speech&guiLanguage=en>.

⁵ The proposals can be accessed from http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

Appendix⁶

Claims	Comments
<p> Holders of ordinary shares</p>	<p> Their claim is limited to surplus assets over liabilities in any event. Bail-in can only benefit them.</p>
<p> Holders of preference shares</p>	<p> Disclosure of the effect of bail-in can be made in inter alia prospectuses and terms of shares.</p>
<p> Holders of subordinated debt</p>	<p> Disclosure of the effect of bail-in can be made in inter alia prospectuses and terms of bonds.</p>
<p> Unsecured creditors:</p> <ol style="list-style-type: none"> 1) Bondholders 2) Depositors (unless special depositor protection regime applies) 3) Counterparties to other transactions: <ol style="list-style-type: none"> a. Financial transactions (e.g. loans, repurchase agreements and stock lending) b. Derivative contracts c. Purchases and sales of securities 4) Trade creditors 	<p> Disclosure of the effect of bail-in can be made in inter alia prospectuses and terms of bonds.</p> <p> In the absence of any special priority, depositors are unsecured creditors. It would be a surprising result if bail-in could reduce their claims.</p> <p> These counterparties may have the benefit of collateral (see below). Bailing-in their claims could create systemic problems.</p> <p> These counterparties may have the benefit of collateral (see below). Bailing-in their claims could create systemic problems.</p> <p> Generally on a delivery versus payment basis, but if not there could be unexpected market results if these claims were subject to bail-in.</p> <p> Theoretically within the scope of bail-in. However, it is unlikely that G20 ministers intended that bail-in could apply to day-to-day claims, such as that of a landlord of premises or a supplier of office supplies.</p>

⁶ The FMLC would like to thank Peter King of Weil, Gotshal & Manges LLP for his help with this Appendix.

5) Employees	Presumably not intended to be covered by bail-in.
Secured creditors	Annex 2 of the Consultation Paper does not refer to the application of bail-in to the claims of any secured creditors, and by implication they are excluded.