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# Living Wills as a Catalyst for Action

*Emilios Avgouleas, Charles Goodhart and Dirk Schoenmaker*

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**Abstract**

Living Wills should help the resolution of a cross-border financial institution in difficulties by clarifying and simplifying the legal structure, and making that legal structure commensurate with the functional business parts of the wider institution. An innovation could be to incorporate a proposal for burden sharing between countries in Living Wills. This may enable burden sharing on an institution by institution basis. There remain, however, problems arising from the inconsistencies and incompatibility of the laws relating to the insolvency procedures in the various countries. Many countries are currently introducing special laws covering the process of resolution of systemically important financial institutions. This creates a window of opportunity to introduce a consistent legal regime for the resolution of systemically important financial institutions across the G20 countries. With appropriate modifications in national law the resolution regime may suspend shareholders' voting rights and extend resolution and insolvency procedures to cross-border groups.

* This is a revised version of our earlier February paper. The opinions in the paper are those of the authors and not necessarily those of the School of Law, Morgan Stanley, the Financial Markets Group or the Duisenberg School of Finance. Corresponding author: D. Schoenmaker, Duisenberg School of Finance, Roetersstraat 33, 1018 WB Amsterdam, The Netherlands. E-mail: dirk.schoenmaker@dsf.nl

** University of Manchester, London School of Economics and Duisenberg school of finance respectively.

## *1. Introduction*

Following the 2007-2009 financial crisis, there is much concern about the massive bail-out costs of the financial sector. How can one reduce moral hazard and rein back expectations of future bail-outs? The too-big-to-fail doctrine has been reinforced, if anything, by the handling of the current financial crisis. We believe that the authorities, under the exceptional circumstances in late 2008, had no choice but to support the financial system and thus to keep credit flowing to the wider economy. At this stage (April 2010), we may draw the preliminary conclusion that the support for the financial system and the broader fiscal stimulus for the economy have averted a full-blown depression, which was a real threat until the beginning of 2009.

Amongst the proposals to curtail the too-big-to-fail practice, we believe that the concept of Living Wills is a promising beginning; its further development might allow systemically important banks to fail or, at least, to be unwound in an orderly manner without imposing disproportionate costs on the taxpayer. The objective is to put in place, ex ante, conditions that would allow a wider range of options other than having the whole bank rescued (FSA, 2009). A Living Will is a recovery and resolution plan to be used when a bank may get into difficulties. The G20 has requested Living Wills to be drawn up for the top 30 global banks. The Financial Stability Board is currently working on this exercise.

We see the Living Will exercise as running in tandem with the new Basel proposals to increase capital substantially, especially for large banks to internalise their systemic externalities (Basel Committee, 2009b). Higher holdings of core equity reduce the probability of failure of systemically important banks, while Living Wills reduce the impact of a possible systemic failure. Both elements can reinforce each other to reduce the too-big-to-fail problem.

In this paper, we review some key elements of Living Wills and make policy recommendations for their further development. First, there should be discussions between a bank and its supervisors about winding down its operations in crisis times, and forcing a bank to simplify its often opaque structure. A bank will also have to make contingent funding and de-risking plans to recover its own strength. Second, credible resolution plans should be drawn up to keep a bank alive, if needed. In the case of international banks, these resolution plans could include a burden sharing mechanism for central banks (liquidity support) and ministries of finance (capital support). The burden sharing would then be agreed institution by institution. Third, a bankruptcy scenario might help to bring possible shortcomings in deposit guarantee schemes and inconsistencies between insolvency regimes to the forefront of attention. This would force authorities (including lawmakers) to tackle these inconsistencies. The insolvency procedure for international banks is currently a nightmare for depositors, creditors, and shareholders, but a paradise for insolvency lawyers.

Such Living Wills should be drawn up by banks and authorities. Banks would be the prime actors for developing their own recovery plans. Supervisors will challenge banks on the credibility of the recovery plan. This is typically done by the core supervisory college comprising the home and key host supervisors of a bank (FSF, 2009). The resolution plan should be drawn up by the authorities (supervisors, central banks and ministries of finance) from the countries represented in the core supervisory college. As the Living Will should cover the whole bank, it is necessary to have one overall Living Will rather than a string of national Living Wills lumped together.

The main purpose of drawing up Living Wills is the ex ante effect, as in real life. The drawing up of a Living Will could act as a catalyst for thinking and taking action. A pater familias, who starts to think about handing over his estate to his off-spring and/or surviving partner in case of his death and drafts a will, has to assess the structure and viability of the estate itself. On the structure side, the question he should be asking is: will my children understand the 'business' and make sense of it? Moreover, does the structure allow an orderly hand-over of the different parts of the estate to the various stakeholders (children and surviving partner)? If not, the structure should better be simplified. On the viability side the question will concern the children's ability/willingness accept the 'business'? Is a 'fair' distribution of the estate over my children feasible? If not, it is better to divest the loss-making parts upfront.

In addition to the above considerations as applied to banks, Living Wills may help to persuade banks to restructure their business (i.e. simplify and hive off parts) and encourage supervisors to enforce desirable restructurings when banks do not act voluntarily.

The ex post effect could be less strong due to time inconsistency (Kydland and Prescott, 1977). The burial of an individual may be handled according to the script of that individual's will. However, in case of multiple deaths (e.g. due to a tower inferno, earth-quake or war), authorities need to act swiftly and ignore individual wishes (i.e. wills). Accordingly, in the 2007-2009 financial crisis, authorities across the world ignored soft arrangements, such as Memoranda of Understanding (MoUs), and acted as they saw fit to rescue the financial system, often using unconventional tools.

The paper is organised as follows. In Section 2, we examine the disciplining effects of Living Wills. How can the complex structure of banks be simplified? Section 3 reviews the resolution plans. In particular, we consider the possibility of arranging burden sharing institution by institution. In Section 4, we discuss the inconsistencies between insolvency regimes. We investigate the possibility of a standard insolvency model for systemically important financial institutions. The final section concludes. The paper also includes an annex that sets out the essential elements of a common insolvency framework for systemically important financial institutions.

## *2. Reducing complexity*

The corporate structure of a bank can be extremely complex with a myriad of legal entities (Kuritzkes, *et al,* 2003; Schoenmaker and Oosterloo, 2008). These separate subsidiaries are set up to exploit tax loopholes and regulatory arbitrage. In addition, banks may use the limited liability of certain (off balance sheet) legal entities to ring-fence certain risks. At the same time, the legal entities are interwoven through multiple intra-group transactions and common operational platforms. The result is a complex structure, which is difficult to understand, and impossible to unwind at short notice during times of stress. Basically, banks try to have the best of both worlds: exploiting the benefits of the legal structure (regulatory and tax arbitrage, etc) and exploiting the synergies of operating as an integrated group (intra-group transactions, etc). Faced with a complex and opaque structure, authorities have little choice but to rescue the whole bank, if needed.

One of the goals of a Living Will is to make contingency plans for times of stress. In these plans, banks should develop scenarios under which certain, less important, parts can be sold, or put into liquidation. The systemically important parts may then be rescued, although the choice of the resolution tool may be left to be made ex post (Huertas 2010). This is only possible with a straightforward legal structure, in which the different parts are easily identified and separated. The development of Living Wills may thus lead to a simplification of legal structure. Supervisors have the power to enforce restructuring. Following the BCCI failure, new rules[1] were introduced that allow supervisors to prohibit structures that impede effective supervision. On this basis, supervisors can enforce a transparent and coherent structure. The simplification of structures – in tandem with tight limits on intra-group transactions – may ultimately lead to stand-alone subsidiaries with their own management, IT systems, payment platform, risk management, internal controls, etc. Not only the front-office but also the back-office would then be split up. The operational efficiency of banking groups is primarily realised by the running of a single banking platform in the back-office. In the scenario of stand-alone subsidiaries, the question may be asked what are the remaining synergies of being part of a single group.

Such simplification may help supervisors to get a better overview of, and a more effective handle on, large banking groups. However, markets tend to regard the strength of a banking group as a whole, ignoring the legal structure. As witnessed in the case of Lehman Brothers in 2008 and earlier of Drexel Burnham Lambert in 1990, solvent subsidiaries of a banking group can hardly survive when a major subsidiary is in serious trouble. The name is then contaminated in the market, and market players cease to do business with the remaining solvent parts due to reputation risk (Freshfields, 2003). So further thought needs to be given to the question whether certain key subsidiaries can survive while still bearing the old group name.[2]

Another major element of recovery plans is the development of contingent funding plans. Under different scenarios, including the drying up of certain funding markets, banks develop plans to fund themselves from other sources and to maintain core liquidity holdings. This induces them to have a strategy of using multiple sources of funding. If successfully implemented, banks could rely less, and at a later stage, on the lender of last resort capacity of central banks. This would reinforce market discipline.

Banks also need to adopt contingent capital plans. A first way for a bank to address a drop in its capital adequacy ratio (defined as capital to risk adjusted assets) is to reduce risk. De-risking plans incorporate possible measures to lay off risk, for example by closing positions, selling assets or even selling business lines. A second way is to increase capital. As the issuance of new equity is very difficult when a bank is in difficulties, there are proposals to use convertible bonds. The Squam Lake Working Group (2009a), a group of top US academics, proposed that such bonds convert to equity only if two conditions are met. The first is an official declaration by supervisors that the financial system is suffering a systemic crisis. The second is that a bank's capital ratio falls below a pre-specified threshold. There are, however, several questions. First,

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[1] The Basel Committee on Banking Supervision issued guidelines 'Minimum standards for the supervision of international banking groups and their cross-border establishments' in 1992, which were further refined 'The supervision of cross-border banking' in 1996. In the EU, the post-BCCI Directive (95/26/EC) deals with corporate structures.

[2] After the collapse of Fortis in Autumn 2008, the surviving parts had difficulties in operating under the name Fortis. The Dutch subsidiary, sold to the Dutch government, was renamed Fortis Bank Nederland. The Belgian and Luxembourg part, sold to BNP Paribas, continued under the name BNP Paribas Fortis.

what would be the effect of an official declaration that a financial crisis was occurring, and, if that might be expected to be adverse, might not such a declaration be unduly delayed? Second, what would be the required yield on such bonds, given their risk profile? Third, the announcement of conversion of a bank's bonds into equity or missing interest payments / principal repayments on sub-ordinated debt is a forceful signal to markets that the bank is in trouble. The mere announcement (or even rumours) could easily initiate a wholesale bank run and a severe drop in the bank's share price.[3] So we think there is a limit to the extent that contingent capital can replace real upfront equity capital.

Historically, the main mechanism for contingent capital was to apply double liability to shareholders themselves (Dowd, 1992). This was commonly used in the Scottish free banking system as well as in the USA until 1929, but fell out of favour in the latter, because it did not protect the US financial system. In this historical spirit, Admati and Pfleiderer (2009) propose increased-liability equity. Their proposal is to set aside safe assets to cover a bank's liability to 'demandable deposits'.[4] The bank under this system is allowed to hold any risky assets it wants against its own equity. We are sympathetic with the idea of more equity, but the Admati-Pfleiderer proposal will put the profitability of the banking system under pressure. Maybe rightly so.

All these contingent plans need activation triggers (if liquidity or capital falls below a certain threshold, then the contingency plan kicks in) for banks to act, and failing that, for supervisors to intervene. As with the wider issue of prompt corrective action, the effectiveness of such activation triggers depends very much on the timely spotting of problems and the determination of supervisors to act swiftly (Jones and King, 1995).

### *3. Arranging individual burden sharing*

When a systemically important bank[5] gets into difficulties, the authorities (supervisors, central banks and ministries of finance) come into play to manage the stability of the financial system. The drafting of resolution plans helps authorities to prepare for such times, just as banks prepare themselves with recovery plans. These resolution plans cover several options. The starting point is, of course, for the authorities to determine whether the failure of a troubled bank may have a systemic impact. If not then the bank should be put into liquidation (see next section). But if the failure is deemed to be systemic what options do authorities have? The detailed description of a bank's legal structure, which should be understandable after the ex ante restructuring exercise in the recovery plan, and the availability of data on the activities and

[3] A good example is doubt about the interest payment on the sub-ordinated debt of ING at the height of the financial crisis in Autumn 2008. Some investors questioned publicly whether ING would meet the upcoming interest payments on its sub-ordinated debt. Although ING meant to meet the next interest payment, the supervisor did not permit ING to say so as payments on sub-ordinated debt are conditional on meeting certain capital ratios at the time of payment. After a sharp drop in the share price, the supervisor gave special permission to ING to announce that it was planning to meet its upcoming interest payments.

[4] The Admati-Pfleiderer proposal goes back to the origins of banking when obligations where fully covered with safe assets. The Wisselbank, founded in 1609, in Amsterdam and the Riksbank, founded in 1668, in Sweden started off with full backing of fiduciary money by bullion reserves. As such 100% reserve banking was unprofitable, fractional reserve banking became the norm. While increasing profitability, fractional reserve banking also increases the instability of the banking system.

[5] Note that we do not provide a definition of a systemically important bank. The systemic impact of a bank failure depends very much on the circumstances. The failure of a bank in normal times may well be possible without systemic ramifications (e.g. Barings in 1995), while the failure of the same bank in times of stress may generate large systemic effects.

assets of the various parts of a banking groups, allow the authorities to decide which parts they need to keep alive for systemic purposes and which other parts may be put into liquidation or sold. Next, authorities will first explore private sector solutions to keep the systemic parts afloat. The transfer of parts of a bank (e.g. the deposit book) to other banks is in practice very difficult. The more common approach is a merger of the troubled bank with another bank or a take-over by another bank. A major difficulty in relation to transfers and mergers is the incompatibility between banks' IT systems.

The ex ante planning in the resolution plan should increase the viability of these options. A constant updating of the recovery and resolution plans and the maintenance of a data-room on the bank's assets, liabilities, activities, counterparties and contracts (to determine inter alia the connectedness of a bank to other financial institutions) allow the authorities to make a swift assessment of the situation and also to determine which parts are systemic and which other parts can be hived off. Nevertheless, the authorities may arrive at a point where they have to meet the costs themselves if they want to keep a major systemic bank afloat. In that case, the central bank (liquidity support) and the ministry of finance (capital support) have to do liquidity and capital injections. The tripartite financial stability committee with the supervisor, central bank and ministry is meant to prepare for that in peace time. These committees can be used for drawing up the resolution plans and also to do dry-runs of these plans (crisis simulation exercises).

A horribly thorny issue is how to share the burden (among central banks or ministries of finance) in the case of rescuing a cross-border bank. An innovation we suggest is to incorporate a proposal for burden sharing in the resolution plan. Living Wills will thus enable burden sharing institution by institution. In a well-designed burden sharing system, each country's contribution to the costs (i.e. the share in the burden) is aligned with that country's benefits (i.e. the maintenance of financial stability).

The design of the key for sharing the burden should reflect the financial stability benefits. Goodhart and Schoenmaker (2009) discuss two mechanisms. In a first general mechanism, financial stability is assumed to be a truly public good which affects all participating countries. All countries then contribute according to their relative share (e.g. relative to GDP). However, there is no political support for general burden sharing (Pauly, 2009). In a second specific mechanism, financial stability is assumed only to affect those countries where a failing bank is doing business. The burden is financed directly by the involved countries according to some key reflecting the geographic spread of the business (e.g. assets) of the failing bank. Insofar as assets are a good proxy for the real and contagious effects of a bank failure, the specific sharing mechanism will come close to an efficient solution of the coordination problem for bailing out an international bank. Countries facing systemic disruption are asked to contribute. They will do so if the stability effects in their country exceed their contribution. To be practical, only the countries from the core supervisory college are involved in the resolution plan. A core supervisory college could for resolution purposes turn into a cross-border stability group containing the supervisors, central banks and ministries of finance from the core countries. Such cross-border stability groups are currently suggested for the EU (European Union, 2008).

**Table 1: Geographical spread of activities of some cross-border banks.**

| **HSBC (2008)** | | **Nordea (2007)** | |
|---|---|---|---|
| **Countries** | **Distribution of assets** | **Countries** | **Distribution of assets** |
| Europe | 52% | Nordic countries | 99% |
| • UK | 36% | • Denmark | 26% |
| • France | 13% | • Finland | 32% |
| • Rest of Europe | 2% | • Norway | 13% |
| | | • Sweden | 28% |
| Asia | 24% | | |
| • Hong Kong | 13% | Rest of Europe | 1% |
| • Rest of Asia-Pacific | 11% | | |
| | | Rest of the World | - |
| Americas | 24% | | |
| • USA | 17% | | |
| • Rest of Americas | 7% | | |
| Total | 100% | Total | 100% |
| **Santander (2007)** | | **Unicredit (2007)** | |
| **Countries** | **Distribution of assets** | **Countries** | **Distribution of assets** |
| Western Europe | 75% | Western Europe | 79% |
| • Spain | 49% | • Italy | 42% |
| • UK | 22% | • Germany | 25% |
| • Portugal | 4% | • Austria | 12% |
| Rest of Europe | 8% | Rest of Europe | 18% |
| Rest of the World | 17% | Rest of the World | 3% |
| Total | 100% | Total | 100% |

Source: Annual Reports 2007-2008.

An illustrative example of the impact of burden sharing on the bailout cost is Nordea. Table 1 shows the geographical spread of activities of Nordea and some other cross-border banks. As full burden sharing across the EU, or even wider globally, is politically not feasible at this stage, a start could be made among more likeminded countries at the regional level (Dermine and Schoenmaker, 2010). To illustrate the working of institution by institution burden sharing, Dermine and Schoenmaker (2010) use the equity-to-GDP ratio (based on book value) as an indicator of the unexpected losses that could arise and of the subsequent public bailout costs.

Applying this indicator, Sweden faces a potential bailout cost for Nordea of 5.3% of its GDP (2007 figures). Under a burden sharing system of the core countries, the four Nordic countries (Denmark, Finland, Norway, and Sweden) split the bill almost equally (26%, 32%, 13% and 28%; see Table 1). Burden sharing would thus substantially reduce Sweden's share from 5.3% to 1.5% of its GDP.

The preparation of a burden sharing arrangement in a resolution plan strengthens the cohesion in the core supervisory college. As each core country may have to pay up, it has an incentive to make sure that supervision is properly done to minimise the possibility of failure. So the key host supervisors will be induced by their ministries to take fully part in the supervisory college of a particular bank. In that way, the urgency for making a periodic joint assessment of the soundness of this particular bank by all involved supervisors will increase.

### *4. Making resolution regimes compatible*

Resolution regimes and deposit insurance schemes are typically designed to deal with domestic failures. A general issue is whether bank resolution is based on general corporate insolvency law[6] or on a special resolution regime which ensures higher speed of procedures. The UK, for example, implemented a special bank resolution regime to increase the range of options for the authorities and to speed up the process. Similarly, deposit insurance schemes are currently updated to allow for the swift payout to depositors, when needed. The USA sets an ambitious standard with payouts by the Federal Deposit Insurance Corporation (FDIC) within 2 business days of the failure.

A challenge for the failure of a cross-border bank is the incompatibility of national insolvency regimes. There are different approaches. Under the territorial approach, each country resolves the domestic parts of a cross-border bank within its borders. This basically boils down to ring-fencing the assets within the country. This is the approach adopted in the USA. Under the universal approach, the institution as a whole, that is including its foreign branches (but not subsidiaries), is resolved across borders. This was the approach adopted in the EU by the Winding up Directives.[7] But even in countries with a universal insolvency procedure, each authority may pursue its own national interests in a crisis (Basel Committee, 2009a; Herring and Carmassi, 2010). These different approaches are clearly not compatible. The resolution part of Living Wills will make these inconsistencies transparent.

The first challenge regulators face in this context is how to ensure that national regimes consistently uphold the principle that losses must first fall on shareholders, until these are wiped out. To achieve this goal Living Wills could provide for a modification of the bylaws (i.e. corporate charters) of financial institutions which are subject to Living Wills, suspending shareholders' voting rights in the event of the institution's failure and entrance into the special resolution process, Relevant modification may take place in the context of general corporate restructuring triggered by Living Wills. To safeguard shareholders' rights its institutional failure - normally the state where a financial institution may no longer support its operations and honour

[6] According to the CEPS Report (2010) and the authors' questionnaire survey of G 20 countries' resolution regimes for financial institutions, most EU countries apply ordinary insolvency procedures (with modifications) and corporate bankruptcy rules to failing banks. However, the number of EU jurisdictions adopting either special resolution regimes or giving resolution powers to the supervisory authorities is on the rise.

[7] EC Directive (2001/24/EC) on the reorganisation and winding up of credit institutions and EC Directive (2001/17/EC) on the reorganisation and winding up of insurance undertakings. This Directive is currently under review.

its obligations through the use of own means complying with the terms of its regulatory licence - and entrance into the resolution process would have be clearly defined. In most jurisdictions a company's bylaws (its articles of incorporation or company statute) has contractual force in the way it binds shareholders to the company. Therefore, shareholders would be deemed to have consented in advance and be contractually bound to accept the said suspension of their voting rights, when they subscribe to, buy from the secondary markets, or hold shares in institutions subject to Living Wills.

This modification would indeed infringe on shareholders' property rights but limitations imposed on all kinds of property rights are not unprecedented, Property rights in the modern world are far from being inalienable by higher public interest considerations. For instance, both in periods of national emergency or because of overriding public interest, property rights may be subject to compulsory acquisition orders. The only difference here is that shareholders would not be entitled to compensation for the appropriation of their property rights, a waiver to which shareholders will have agreed in advance by subscribing to, buying, or holding equity stakes in financial institutions which have to draw up Living Wills.

If this provision is enshrined in the institution's bylaws, shareholders should be able to price the risk of their investment in advance and ask for a premium to subscribe or hold shares in a bank or another financial institution in a way that reflects the institution's riskiness. As a result, the consequences of the implementation of this proposal are far reaching. First, holders of equity in such financial institutions should expect no private gain even in the event that an institution proves to be 'too-big-to-fail', significantly enhancing market discipline. Second, the cost of equity capital for financial institutions subject to Living Wills would become much higher reflecting their riskiness. This may impede their growth and restrict their role as the principal development engine of modern economies. Therefore, adoption of the above proposal by the G20 countries would signal their unwillingness to subsidise bank capital any longer and accept, in exchange, lower rates of economic growth.

The second challenge relates to the international coordination and effective carrying out of cross-border bank resolutions, Given the marked inability of regulators to co-ordinate their rescue operations during the 2008 crisis (e.g., Fortis, Lehman (see Claessens, Herring and Schoenmaker, 2010)), incompatibility of national resolution regimes and of insolvency procedures entails serious dangers in the case of cross-border resolutions. An example of the difficulties that may be encountered in the context of a cross-border bank resolution is the conflict of powers over asset transfers which in some jurisdictions are vested with the insolvency authorities and in others with the courts (CEPS, 2010).

In the light of the recent crisis, many countries are in the process of widening or introducing special laws covering the process of resolution of systemic banks. The UK introduced, for example, a Special Resolution Regime for banks in March 2009 (Avgouleas, 2009; Tucker, 2009). We suggest a further widening of these arrangements from banks to systemic financial institutions, as the 2007-2009 financial crisis showed that also non-bank financial institutions can be systemic and, therefore, received capital support (notably insurance companies such as AIG and AEGON).

The principal question that arises in this context is whether this window of opportunity to get the legal basis for this systemic resolution similar across all developed countries (notably the G-20 countries) can be achieved. We will consider the possibility of a standard insolvency model for systemically important financial institutions (SIMSIFI) that could be implemented in the legislation of the G-20 countries.[8] SIMSIFI based harmonisation would modify but not impede the powers of the FDIC[9] or of deposit insurance schemes in other countries, since it is neutral regarding the institutional form of the resolution authority. Coordinated action in cross-border resolution and harmonisation of national resolution regimes is also the approach favoured by the IMF (IMF, 2010; Strauss-Kahn, 2010) and the new Geneva Report (Claessens, Herring and Schoenmaker, 2010). A first outline of such a standard insolvency model is provided in the Annex.

Inevitably, a standard SIMSIFI would be a special regime with respect to general insolvency laws. Such a regime may only be introduced into national legal orders by means of special legislation to ensure that it will not be vulnerable to legal challenge before national courts. An example of such a special regime is the ISDA master agreement and its close out netting clauses,[10] which provide a mechanism for the reduction of credit exposure in the markets. The EU has passed legislation recognising both all transactions concluded under the ISDA architecture as a single agreement and partially giving force to ISDA clause out netting clauses, overriding traditional insolvency[11] and property law requirements.[12]

The first challenge the SIMSIFI must address is how to ensure that the ordinary substitution or liquidation of the various contractual relationships of the failing institution can at the same time avoid the risk of fire-sales. This is especially important with respect to the closing or substitution of such institution's outstanding derivatives contracts where a hasty closing of the position or fire-sales may disrupt the market and reduce the value of the failing institution's assets. (Huertas 2010).To avoid this risk the SIMSIFI may provide for a period of up to two weeks

[8] Like others, we do not provide a list of systemically important financial institutions, as explained in footnote 5. International bodies, such as the Financial Stability Board, are currently preparing such a list, but do not acknowledge (yet) the existence of a list (Herring, 2009). For legal purposes, however, a fully specified list is needed. It should be ex ante clear to which institutions the Standard Insolvency Model would apply**.**

[9] FDIC's competence as a deposit insurer does not extend to financial institutions which are not banks or thrifts. Also, the FDIC is the primary federal regulator of banks that are chartered by the states that do not join the Federal Reserve System.

[10] Under the ISDA Master Agreement the failure of party A to make a payment required in the context of transactions between the parties, concluded under the ISDA contractual framework, or the bankruptcy of party A gives party B the right to terminate all outstanding transactions. Following that termination, the ISDA Master explicitly allows for close-out netting, namely, the process under which obligations under simultaneously terminated transactions are netted to a single settlement amount, which, naturally, is much smaller than the gross exposures of each party to the other***.***

[11] To give full force to the close out netting clauses under the ISDA Master Agreement, ISDA has, in fact, drafted a Model Act on close out netting, lobbying authorities to implement it. See 2006 ISDA Model Netting Act and 'Memorandum on the Implementation of Netting Legislation: A Guide for Legislators and Other Policy-Makers', March 2006, available at www.isda.org. Among the countries which have introduced legislation to enable or strengthen close out netting (because it was already available) are: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Malta, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden, Switzerland, in Europe, and Turkey, Australia, Brazil, Canada, Israel, Japan, Mauritius, Mexico, New Zealand, South Africa, South Korea and the United States. A current status report on the enforceability of close-out netting worldwide can be obtained from http://www.isda.org/docproj/stat_of_net_leg.html.

[12] The Collateral Directive (2002/47/EC) renders inapplicable certain provisions of Member States' insolvency law that would, *inter alia,* inhibit the effective realisation of financial collateral in the context of bilateral close-out netting. Examples of special provisions introduced by the Collateral Directive in 'violation' of general insolvency law include the abolition of written notice, execution of any document, public filing or registration, and title registration as requirements of financial collateral enforceability under a financial collateral arrangement, which may be made subject to close out netting. Characteristically Article 7 of the Directive provides that close-out netting arrangements can take effect in accordance with their terms: '(a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.' The Settlement Finality Directive (98/26/EC) and the Winding-up Directive for Credit Institutions (2001/24/EC) also strengthen the legal status of close-out netting arrangements.

during which all obligations of the failing institution are frozen. This gives ‘breathing space’ to the resolution authorities to wind down relevant contracts in an orderly manner minimizing systemic risk and the losses to the failing institution and its counterparties.

Moreover, it is doubtful whether Living Wills will prove as effective as intended in the absence of a mechanism that extends parent insolvency proceedings to local and foreign subsidiaries, which are dependent on the parent for their continuous operation as a going concern, or vulnerable in the event of parent failure, due to the effects of reputation contagion. In general, subsidiaries do not seem able to survive the failure of the parent, as was the case with Kaupthing Bank of Iceland, when their continuous solvency and liquidity is dependent on parent guarantees and/or provision of standby credit lines. However, even where subsidiaries are ring-fenced, they may still prove unable to survive the failure of the parent, since their standing is very likely to be contaminated by parent failure and the subsidiary be hit by collapsing confidence in its solvency and continuous operation as a going concern. In such a case, uninsured depositors may rapidly demand their deposits back, or, as was the case with Lehman Brothers’ subsidiaries, they may face a market reluctance to provide them with short-term credit, making them illiquid (see also section 2). As result, the subsidiary might not be able to carry on as a going concern on a standalone basis, forcing the subsidiary or its supervisors to initiate a transfer of assets to a third party purchaser, a temporary nationalisation, or the initiation of insolvency proceedings.

Moreover, in many cases the business of the group is integrated and subsidiaries’ assets are treated as group assets and it may not be possible to separate them in insolvency. This is especially the case where corporate separateness has been created merely in order to facilitate the regulation and supervision of the subsidiary by home or host state regulators (Herring and Carmassi, 2010). In those cases it is clearly unfair to creditors that no pooling of assets is allowed between local and international corporate members of the same financial group. In addition, in such cases, it is doubtful how effective the re-organisation of a parent financial institution in insolvency may be, if domestic and foreign subsidiaries are ignored.

Finally, ring-fencing may prove costly and complicate, instead of simplifying, cross-border group resolutions. The segregation of intra-group internal funding and liquidity flows will create operating inefficiencies and may amplify rather than resolve the problem of cross-border bank failures and even impose extra costs on a host country’s economy (CEPS, 2010).

Yet, there is currently no internationally agreed framework dealing with financial group resolution on a cross-border basis (Basel Committee, 2009a) and the powers of resolution authorities over other entities of the same group in the event of a financial institution’s insolvency are often unclear or very limited. Therefore, there is an overriding public interest, which includes concerns for the protection of confidence in the fairness of the financial system (Herring, 2010), in favour of giving supervisors the option of extending SIMSIFI to domestic and foreign subsidiaries of a failing parent company.[13] This extension of the Standard Insolvency Model also provides a powerful incentive for the group to simplify its corporate structure. The data room, as described in the previous section, would enable the administrator / liquidator to track a financial group’s assets as well as its creditors. Once the SIMSIFI regime would be triggered, all claims against the financial group in difficulties should go through this regime.

[13] This recommendation has also been endorsed by the CEPS Report (2010) with respect to the ongoing revision of the EU Reorganisation and Winding Up Directive.

However, such a proposal could create serious opposition from regulators. In the absence of a clear framework for sharing the burden for the resolution of a cross-border financial group (as proposed in the previous section) and for safeguarding the equal treatment of domestic and foreign creditors, regulators will find it hard to extend the universal approach, especially to subsidiaries established cross-border. The regulators of the foreign subsidiary may lack confidence in the insolvency proceedings held in another jurisdiction, be unable to enforce foreign judgments, or may just be concerned to protect domestic creditors' interests. Furthermore, this proposal goes counter to the traditional legal doctrine of separateness of incorporation, which certain jurisdictions, such as the UK, hold sacred in the event of the bankruptcy of a group entity, even when there are strong arguments in favour of lifting the corporate veil (e.g., Adams v. Cape Industries plc [1990]). In other jurisdictions, such as the USA, intra-group pooling of assets ('substantive consolidation') is allowed by bankruptcy courts, [14] but the conditions under which 'substantive consolidation' is allowed remain unclear.[15] Germany, on the other hand, has a fully developed law on corporate groups since the German Stock Corporation Act 1965 (*Aktiengesetz*). The Act shows in many areas little 'respect' for the principle of separateness of incorporation, but it only applies to corporate groups (*Konzernrecht*) comprising plcs and does not extend to ltds. Under German law on corporate groups, in the event of insolvency proceedings, the parent may be made liable for the debts of the subsidiary.

There are also certain jurisdictions, such as Italy, which allow for co-ordinated resolution proceedings for the subsidiaries of failing banks within the same jurisdiction, although pooling of assets is not allowed. In the UK under the Special Resolution Regime created by the Banking Act 2009, the resolution authorities may extend their resolution powers to the holding company of a failing bank (Article 82 of the Banking Act 2009). Of course, in the European Union these difficulties may be overcome through the enactment of harmonisation legislation at the European level that recognises the concept of 'financial group' and makes it part of any cross-border resolution arrangements.[16]

Any extension of the Standard Model to other group entities, especially group entities located in other jurisdictions, and the 'pooling of assets' would require: (a) a burden sharing mechanism, (b) an agreed framework for the recognition of foreign insolvency proceedings and foreign decisions, and (c) a mechanism for the identification of domestic and foreign subsidiaries which may be included in bankruptcy proceedings in the event of parent failure. On (a), we discuss a way to structure a burden sharing mechanism in the previous section. On (b), the Annex provides an outline of a mechanism for the recognition of foreign insolvency proceedings, which should be based on mutual recognition. On (c), the inclusion of domestic and foreign

[14] In the USA 'substantive consolidation' comes from 'federal common law' permitting a bankruptcy court to treat a group of affiliated companies as if they are one, merging their assets and liabilities for purposes of the bankruptcy proceedings. Essentially, US bankruptcy courts use their general 'equity powers' provided in s. 105 of the Bankruptcy Code to order 'substantive consolidation' (11 U.S.C.A. § 105). Courts may even merge assets of non-bankruptcy affiliates with those of bankruptcy affiliates if the court finds that substantive consolidation is required.

[15] Generally, a debtor in bankruptcy must be found not to be operating its affiliated companies as separate entities, therefore it would be unfair to the creditors of weaker affiliates not to have the advantage of the assets of stronger affiliates in the bankruptcy. There have been two lines of cases on substantive consolidation. One line of cases sets out very broad standards for imposing substantive consolidation, and the other line of cases sets out elaborate and specific standards.

[16] The European Commission has consulted on the issue of 'banking group' and cross-border (intra-group) assets transfers. (European Commission, 2009). The Commission proposals have drawn qualified support from the IMF. Nonetheless, the IMF, like the Commission itself, is concerned about the impact of relevant legal modifications on the principle of separateness of incorporation (IMF, 2010).

subsidiaries in insolvency proceedings should be based on the *contractual* approach. Namely, the subject bank of a Living Will should agree *ex ante* with the college of supervisors which of its domestic and foreign subsidiaries are dependent on the continuous operation of the parent as a going concern or vulnerable to parent failure, and thus insolvency proceedings concerning the parent company should also extend to those subsidiaries.

Finally, a bank's Living Will should specify the relevant deposit insurance arrangements for its depositors. Deposit insurance schemes are typically run along national lines. Most depositors of international banks fall under the respective deposit insurance scheme of their country of domicile. However, cross-border branches fall under the home country deposit insurance scheme in the EU. The legal obligation under the Deposit Guarantee Schemes Directive (94/19/EC) is clear: the home country deposit guarantee scheme should cover the depositors in the home country as well as depositors in cross-border branches. Nevertheless, the Icelandic authorities chose to give priority to Icelandic depositors over the UK and Dutch depositors after the failure of several Icelandic banks in 2008. This highlights concerns about the stability and viability of deposit guarantee schemes.

### *5. Conclusions*

In most large developed countries, the set of systemic financial intermediaries is almost identical with the set of cross-border financial intermediaries. So a need to resolve a systemic financial institution in difficulties will <u>usually</u> imply an equivalent requirement for handling cross border problems. Yet when there was a need for such resolution in the recent crisis, e.g. Lehman, Fortis, Dexia, the Icelandic banks, the authorities, almost without exception, acted purely on the basis of narrow national interest. Moreover, when such institutions were saved (Bear Stearns, AIG, HBoS, RBS, HRE, Irish banks, etc., etc.), the rescue was done entirely by the home country (and its taxpayers) with no contribution at all from host countries who nevertheless benefited from the absence of adverse externalities/spill-overs. Even after this experience, however, the tendency in most countries seeking to introduce Special Resolution Regimes for such systemic financial institutions by new legislation has been to craft the proposed Bills as if all such resolution requirements were purely a domestic problem. How much notice, for example, of cross border problems has been taken in the current House and Senate Bills for financial regulatory reform in the USA?

This gross incompatibility between the (global) cross-border reality and the national regulatory/legal attempts to respond represents a glaring weakness in the world's financial system. It should not be allowed to persist. The purist solution of a single world government is unattainable. Proposals to limit cross-border problems by making all systemic branches/subsidiaries into stand-alone separate entities completely controlled by their host regulator are generally unacceptable, especially in the EU.

We propose building on the Living Will concept, so that there is a way forward, with each systemic cross-border financial institution having an ex-ante resolution programme, agreed amongst the countries involved. The main elements of such a resolution programme are an arrangement to share the fiscal burden in the case that (parts of) an institution is rescued and a common insolvency framework in the case that (parts of) an institution is put into liquidation. A major barrier, to such an exercise, however, is the patch-work of different legal structures, controlling such insolvencies, in all such countries.

Again there is a window of opportunity. Many countries, the EU, and the IMF now see the need for new and revised legislation to cover insolvencies of systemically important financial institutions. Could we not take this opportunity to devise, introduce and enact harmonised laws in all major countries? There are precedents; the acceptance by the law of many countries of the close out netting clauses of an ISDA Master agreement for settling outstanding derivative contracts in the event of one of the parties' failure to make a payment or bankruptcy is one such. Nevertheless the development and acceptance of a standard insolvency model for systemically important financial institutions (SIMSIFI) would be a most difficult exercise, precisely because it would need many powerful countries to introduce significant changes in their carefully and historically shaped legal structure. We provide the outline of such a standard insolvency model in this paper. We intend to revert to the details of this legal problem in a further paper.

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***Annex: Standard insolvency model for systemically important financial institutions (SIMSIFI)***

**Background**

Although there is no precedent of widespread international harmonisation of insolvency laws, the single agreement principle behind the ISDA architecture comprising a master agreement, a schedule, and multitude of confirmations, and the laws enacted in over forty jurisdictions to give effect to close out netting clauses, overriding general contract law and insolvency law provisions, may provide an indicative and rather unique example.

Under the ISDA Master Agreement the failure of party A to make a payment required in the context of transactions between the parties, concluded under the ISDA contractual framework, or the bankruptcy of party A, gives party B the right to terminate all outstanding transactions. Following that termination, the ISDA Master explicitly allows for close-out netting, which is the process under which obligations under simultaneously terminated transactions are netted to a single settlement amount**.** Party B's claim over the settlement amount must be satisfied without stay or delay, and free from avoidance, claw-back or cherry-pick risk. Party B's claim is enforced against insolvency officials as well as against other creditors. Therefore, laws recognising close out netting essentially modify traditional insolvency and security laws giving priority to the party having a claim under the ISDA Master over the settlement amount. Party B's claim may be satisfied without any requirement of registration of claim, giving of notice, initiation of judicial proceedings, or taking into account other creditor claims against party A, even if insolvency proceedings have been initiated. The public policy rationale for this preferential treatment is that close-out netting limits the exposures of financial institutions and other parties in derivatives markets, containing systemic risk.

The similarities, of course, between the rationale underpinning the recognition of close-out netting clauses under national laws and the overriding public interest supporting the introduction of SIMSIFI are more than evident. In addition, the introduction of SIMSIFI is strongly supported by the desire to limit the 'too big to fail' effect and the corresponding fiscal risk. The Cross-border Bank Resolution Group (CBRG) has already recommended coordinated action for the bankruptcy of legal entities of the same financial group within a single jurisdiction.

The inefficiencies associated with the winding up of the complex web of entities comprising the Lehman Brothers group (Herring, 2009), the long time that shall be required to settle all claims, and eventual creditor losses, prove the point made above and show that there cannot be any kind of meaningful winding up of a large and complex financial group without cross-border coordination and, arguably, agreement in advance of the law applicable to the winding up process.

Furthermore, as mentioned in sections 2 and 4 above, even a ring-fenced subsidiary may suffer from the crisis of confidence that will follow the collapse of the parent company. For example, consumers may withdraw their deposits at such a rapid pace or markets decline to provide the subsidiaries with short term funding (Lehman Brothers). As a result, the ring-fenced subsidiary becomes essentially insolvent, although the subsidiary's operation is not dependent on the provision of liquidity by the parent or its solvency is not dependent on a parent guarantee.

To remedy these shortcomings the SIMSIFI should be a dual track regime. The college of supervisors and institutions should have the option to agree ex ante whether they shall use it on an individual institution basis (consolidating branches into the process) or on a group basis consolidating the assets of subsidiaries. In this context, as it may be unnecessary to include all parts of the group, the college of supervisors may agree with the subject bank of the Living Will which subsidiaries are important for the operation of the group or shall not survive the collapse of the parent company. In advocating this approach we essentially adopt the principles of 'unity' and 'universality' of insolvency, based, however, on mutual recognition mechanisms with regard to recognition of foreign proceedings and judgments.

If the SIMSIFI is applied to cross-border insolvencies of financial groups, the difficulties arising from the conflict of laws and the major obstacles presented by discrepancies between pro-debtor and pro-creditor jurisdictions (Lastra and Olivares-Caminal, 2009), would be eliminated. The removal of the obstacles may allow the college of supervisors to reach agreement on the insolvency procedures that should be followed for each member of the group, in addition to a description the resolution procedures for each entity in the Living Will (which according to Herring (2009) must be an essential requirement).

The 'unity' and 'universality' of proceedings are also at the centre of the forthcoming UNCITRAL Working Group V recommendations for cross-border group insolvencies (Mevorach, 2010).[17] The UNCITRAL recommendations for domestic groups may also prove a useful guide. UNCITRAL suggests that, in the case of groups of companies, national legal orders should introduce provisions allowing for joint application and procedural coordination of proceedings of different legal entities in a group, for intra-group financing/guarantees after insolvency proceedings have commenced, appointment of a single administrator, implementation of a joint reorganisation plan, contribution orders, and extension of liability, or substantive consolidation (pooling of assets).

An example of legislation that makes the principles of the 'unity' and 'universality' of cross-border provisions binding is the EU Insolvency Regulation,[18] which, however, does not deal with groups, and leaves most financial institutions outside its ambit. Regarding the identification of the Member State in which insolvency proceedings may be initiated and (universally) recognised by other Member States, the EU Insolvency Regulation introduces the 'centre of main interests' of the debtor test.[19] Accordingly, 'main proceedings' can be opened in the Member State where the debtor has its 'centre of main interests'. 'Main proceedings' can encompass all the debtor's assets on an EU-wide basis (Article 3(1)). 'Secondary proceedings' can be opened subsequently in any Member State where the debtor has an establishment (Article 3(3)) by either the insolvency officer of the 'main proceedings' or any other person authorised to open secondary proceedings under local insolvency law.

The EU has special law for insolvency proceedings initiated against credit institutions and insurance companies, which operate cross-border branches. These Winding up Directives (see section 4) also adopt the principles of 'unity' and 'universality' (for foreign branches). The chief

[17] Working Group V (Insolvency Law), Thirty-seventh session, UNCITRAL Legislative Guide on Insolvency Law, Part three: Treatment of enterprise groups in insolvency, Note by the Secretariat, 31 August 2009, A/CN.9/WG.V/WP.90.
[18] Council Regulation (1346/2000/EC) on Insolvency Proceedings.
[19] The 'centre of main interests' must be in the EU.

objective of both Directives is avoidance of forum shopping. Under both Directives, the home Member State (which authorises a bank) has sole right to implement reorganisation measures or winding up proceedings under the laws of that Member State, subject to exceptions, and those laws will be automatically and immediately effective throughout the EU.

However, under the Standard Insolvency Model, the subject bank of Living Wills and the college of supervisors should be able to choose to initiate group insolvency proceedings in jurisdictions other than the jurisdiction of the parent's establishment. Furthermore, in the absence, of international harmonisation, the recognition of foreign proceedings and decisions may follow the Convention on the Recognition and Enforcement of Foreign Arbitral Awards - the 'New York' Convention (Westbrook, 2009). If the Convention's precedent is followed the SIMSIFI does not need to be introduced in every jurisdiction concerned. The members of the supervisory college merely undertake to enact laws in their jurisdiction that recognise foreign insolvency proceedings and decisions, although they involve group entities situated in their jurisdiction, provided that the jurisdiction, where the insolvency proceedings are held, has introduced the SIMSIFI.

### The Model

In general terms the recommendations of the Basel Committee Cross-border Bank Resolution Group (CBRG) regarding the powers that national authorities must have and the cooperation structures they must employ with respect to bank resolutions are broadly endorsed here (Basel Committee, 2009a). As a result, it is recommended that Living Wills provide the conditions under which parts of the group may be taken into (temporary) public ownership or parts of the group or assets are transferred to a bridge bank or a similar facility. Also resolution plans agreed in Living Wills must allow for the removal of directors and of senior management and mechanism to hold them accountable. However, further modifications are required to the CBRG framework in order to build a single insolvency model for complex systemically important financial institutions with cross-border presence and to extend resolution regimes to the winding up of cross-border financial groups.

*Jurisdiction and Procedural Rules*

Living Wills shall clearly describe the authority that takes the lead in the event of insolvency proceedings for the bank or the financial group concerned ('Insolvency Authority'). This authority will normally be the home state authority. However, the college of supervisors may have the power to agree with the institution drawing up the Living Will, if a form of burden sharing has also been agreed, that insolvency proceedings may be carried out in another country than the home country (the country of the authorisation of the institution concerned or of the parent company), subject to the mutual recognition mechanism described above.[20]

The only grounds to object to a foreign decision should be the possibility of inequitable treatment of domestic and foreign creditors. In the event that there is a conflict between the provisions of the EU Winding up Directives, the EU Insolvency Regulation and the Living Wills mechanism for the recognition of foreign insolvency proceedings and decisions, the mechanism provided in the Living Wills under the SIMSIFI prevails for the institutions subject to Living Wills (the EU would have to amend accordingly the Winding up Directives and Insolvency Regulation). Furthermore, the SIMSIFI provides for:

(a) a joint application and procedural coordination of proceedings governing the different entities of the group (procedural consolidation); and

[20] The CBRG has also suggested mutual recognition of decisions on claims and cross-border resolution decisions (Recommendation 4).

(b) the appointment of a single administrator for multiple proceedings concerning different entities within the Group.

*Substantive Insolvency Rules*

1. The SIMSIFI should provide that for a period of up to two weeks the payments of the failing institution are frozen in order to be either orderly liquidated or substituted.

2. The SIMSIFI incorporated in Living Wills should provide for:

(a) a single definition of bank insolvency;

(b) the implementation of a joint reorganisation plan or asset sales or distribution;

(c) the continuity of critical functions and contracts as well as for the preservation of intra-group contracts for the provision of infrastructure facilities and of other critical services; and

(d) the rights of netting and set off to be respected.

3. The SIMSIFI should describe:

(a) the rights and obligations of creditors, of deposit protection schemes and of uninsured depositors;

(b) the ranking of claims and distributions to creditors;

(c) the treatment of intra-group claims, especially between entities that are not subject to restructure and insolvency proceedings instituted under the Living Will; and

(d) the mechanism that will be used to fund ongoing operations. This may be the mechanism usually relied upon by the lead jurisdiction, whether this is the deposit insurance fund, or any other facility, subject to an equivalent means test that should be agreed by the college of supervisors. Funding mechanism may also refer to debtor in possession funding mechanisms.

4. The SIMSIFI should allow:

(a) intra-group financing guarantees after insolvency proceedings have commenced;

(b) the pooling of assets of the different entities within the Group, which are identified in the Living Will, although such power entails the lifting of the corporate veil;

(c) debtor in possession financing;

(d) intra-group asset transfers and of business relationships even if this is a cross-border transfer;

(e) the special treatment of financial contracts and ability to transfer OTC and cleared financial contracts; and

(f) the termination of non-critical contracts.

Avgouleas, E. ; Goodhart, C. ; Schoenmaker, D. / Living wills as a catalyst for action. Amsterdam : Duisenberg School of Finance, 2010. (DSF Policy Paper; 4). @techreport{acdc3ede92304570b6202fd4d56ed22d, title = "Living wills as a catalyst for action", author = "E. Avgouleas and C. Goodhart and D. Schoenmaker", year = "2010" Even "a catalyst in" is sometimes used in the relevant sense. From Natalie La Balme, "Constraint, Catalyst, or Political Tool," in Decisionmaking in a Glass House (2000): Some observers feel that public opinion can also act as a catalyst in the decisionmaking process. Even "a catalyst on" is not unknown in such situations, although instances are few.Â  At the same time, the Renaissance acted as a catalyst on the intellectual development in parts of Europe, especially urbanized regions such as the Italian city-states and the Low Countries. All of these formulations involve descriptions of things that act as catalysts with regard to a process or development, which is essentially the sense that the OP asks about. In such contexts, using any of the five prepositions discussed here might be defensible. A positive side effect will be accelerating the capabilities and lowering the costs of Indian data centre capacity. Countries are path dependent; history matters.Â  We must avoid protectionismâ€"animals bred in captivity find it hard to live in the jungle. But we must also participate in the global re-evaluation of free monopolies, privacy defaults, data opt-ins, foreign ownership risks, cyber vulnerabilities, home bias, public company governance, and much else.Â  We live in a society, not in an economy. Some MNCs routinely avoid taxes by using transfer pricing or royalty payments using the convenient fiction that different units of multinationals are really separate companies (Appleâ€™s European profits were allocated to a paper internal head office with an effective tax rate of 0.005%).