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**Item No. 4 on the agenda: Update and determination of scope of certain projects on the 2020-2022 Work Programme**

**(a) Bank Insolvency**

(prepared by the Secretariat)

<i>Summary</i>	<i>Need for and feasibility of the Bank Insolvency Project; proposed project scope and output</i>
<i>Action to be taken</i>	<i>The Governing Council is invited to take note of the information in this report; approve the proposed scope of the project; assign a high priority to the project; and allow the Secretariat to establish a Working Group</i>
<i>Mandate</i>	<i>Implementation of the decision of the General Assembly in relation to the Work Programme 2020-2022</i>
<i>Priority level</i>	<i>Proposal to change the originally assigned priority – 'Medium' – to 'High'</i>
<i>Related documents</i>	<a href="#"><u>UNIDROIT 2019 C.D. (98) 14 rev.2</u></a> ; <a href="#"><u>UNIDROIT 2019 C.D. (98) 17</u></a> <a href="#"><u>UNIDROIT 2020 – C.D. (99) B.6</u></a> ; <a href="#"><u>UNIDROIT 2020 – C.D. (99) B.21</u></a> ; <a href="#"><u>UNIDROIT 2021 – C.D. (100) A.2</u></a>

**I. INTRODUCTION**

1. Pursuant to a mandate given to the Secretariat by the Governing Council at its 98th session, this document seeks to provide a detailed account of the feasibility analysis and exploratory work conducted in the timeframe elapsed between the Governing Council sessions on the bank insolvency project, included in the current Work Programme with medium priority. As a result of the said activity, this document addresses the following matters: (i) the need for an international harmonisation initiative in the field of bank insolvency in light of the lack of international guidance and problems arising from current fragmentation; (ii) feasibility of the project based on institutional support and available resources; (iii) proposed scope of the bank insolvency project; and (iv) proposal for next steps.

## II. BACKGROUND

2. Since the Global Financial Crisis of 2008, the international community has developed a framework to manage the crisis of so-called “too big to fail” financial institutions in order to preserve financial stability. These efforts resulted in the issuance of the Financial Stability Board’s (FSB) ‘Key Attributes of Effective Resolution Regimes for Financial Institutions’ (Key Attributes) as an international standard which informed the adoption of bank “resolution regimes” in jurisdictions around the world. At a regional level, the European Union adopted the Bank Recovery and Resolution Directive (BRRD), and many national legislations updated their bank resolution systems. Despite this significant progress, however, critical gaps remain. In particular, bank insolvency laws remain national to date and vary substantially across countries. This creates problems, not only when dealing with the failure of small and medium-sized banks – which may not be resolved by applying the resolution framework – but also in addressing the failure of large banks, since national insolvency laws still play a key role in the implementation of said resolution tools.

3. Against this background, in the run-up to the drafting of the Work Programme for 2020-2022, the UNIDROIT Secretariat received two separate but partially coincidental proposals concerning the harmonisation of rules in the field of bank insolvency, one from the Bank of Italy and one from the European Banking Institute (EBI) ([C.D. \(98\) 14 rev. 2, Annex 4 and 6](#) respectively).

4. The Governing Council at its 98<sup>th</sup> session (Rome, 8-10 May 2019) agreed on the importance of the topic and on the possible impact of the work to be conducted. It agreed to recommend that the General Assembly include the project on bank insolvency in the 2020-2022 Work Programme with medium priority. The Governing Council asked the Secretariat to conduct further research and provide a more defined scope for the project, as well as further justification of its adequacy as work to be conducted by a global institution ([C.D. \(98\) 17, para. 261](#)).

5. The Governing Council at its 99<sup>th</sup> session (Rome, 23-25 September 2020) was informed by the Secretariat that steps had been taken to reinforce the capacity and expertise of the organisation to carry out the project. In particular: (i) the Financial Stability Institute (FSI) of the Bank of International Settlements (BIS) had shown availability to collaborate with UNIDROIT on this project and willingness to provide research expertise and, where needed, to contribute to the development of the project with financial resources; and (ii) the process for the creation of an UNIDROIT-Bank of Italy Chair was in an advanced stage ([C.D. \(99\) B.6, paras. 4-6](#)). The Governing Council took note of the information provided by the Secretariat during the 99<sup>th</sup> session and agreed with the proposed action plan, leading to the drafting of a feasibility study to be presented to the Governing Council at its 100<sup>th</sup> session ([C.D. \(99\) B.21, para. 117](#)).

6. The Governing Council at its 100<sup>th</sup> session (A) in April/May 2021 was informed that: (i) the UNIDROIT-Bank of Italy Chair had been officially established and a Chair Holder had been recruited; and (ii) a first workshop on bank liquidation would be organised jointly by UNIDROIT and the FSI on 7 and 8 June 2021 ([C.D. \(100\) A.2, paras. 25-27](#)), with a view towards analysing and discussing the feasibility of the project.

7. On 7 and 8 June 2021, UNIDROIT and the FSI jointly organised an Exploratory Workshop, which gathered 40 international experts and stakeholders with a view to (i) assessing the need of an international instrument in the area of bank insolvency; (ii) determining the most suitable form of such instrument; and (iii) defining the scope of the project. The summary report of the Exploratory Workshop is available online (see Annexe I). This document is the result of the conclusions of the said workshop as well as of the thorough feasibility analysis conducted by the Secretariat in the period elapsed from the last Governing Council session.

### III. THE NEED FOR AN INTERNATIONAL HARMONISATION INITIATIVE

8. Pursuant to the proposals of the Bank of Italy and the EBI, the subsequent discussions held in previous sessions of the Governing Council and following the discussion and conclusions of the Exploratory Workshop, this section substantiates the need for an international initiative on bank insolvency by illustrating the existing problems arising from the lack of harmonisation in this area.

9. As confirmed by many participants during the Exploratory Workshop, there is currently a critical gap in the international legal architecture for dealing with insolvent banks, with special regard to liquidation regimes. The absence of international standards on this matter to date may be explained by the priority given to address systemic, large financial institutions with the capacity to cause damage beyond the boundaries of a single jurisdiction (i.e., the Key Attributes). The failure of small and medium-sized banks – which are the predominant type of banks in most jurisdictions around the world – was considered to be a topic of domestic relevance, and hence no international action was undertaken.

10. However, the lack of harmonisation in the field of bank insolvency may create problems for both systemic and non-systemic banks. Specifically, bank insolvency laws are key in three scenarios:

- (i) the *failure of small- and medium-sized banks*, which would generally not be resolved under the harmonised resolution regime;
- (ii) the *application of the resolution* regime to large banks, since several important aspects of bank resolution are *premised on the application of insolvency laws as counterfactual* in order to safeguard property rights in a balanced way; and
- (iii) the *finalisation of the resolution of banks*, since specific resolution tools may be applied that result in the transfer of part of the assets and liabilities of the bank to another entity, while the remaining part of the bank is left to be dealt with under national insolvency law.

11. As a result of globalisation, digitalisation, and the high degree of global interconnection between financial markets, even small banks could potentially have a cross-border dimension, which makes the absence of harmonisation of bank insolvency laws relevant for virtually any bank failure. A clear example of a cross-border dimension is a banking group with group entities (subsidiaries and branches) in different jurisdictions, as is often the case. However, even banks with a more limited geographical reach in terms of group entities and client base may have foreign shareholders and bondholders, securities held in foreign central securities depositaries, liabilities governed by the law of a foreign jurisdiction, and/or exposures to financial and non-financial institutions in foreign jurisdictions.

12. The problems that arise due to the lack of common bank insolvency standards are numerous and potentially critical in nature. The following paragraphs describe some of the most significant ones.

- (i) First and perhaps most importantly, there is *a lack of international guidance and codified best practices in the area of bank liquidation*. National legislators, with special regard to developing and middle-income economies, may access substantial information on international best practices regarding the crisis of systemic banks and the avoidance of financial contagion, but there is little or no assistance when it comes to the design of liquidation proceedings for smaller banks. While the regulation of these situations falls, most often, squarely in the realm of national law, it is precisely guidance to national legislators that is most needed currently.
- (ii) The codification of well-functioning systems from around the world and the identification of best practices envisaged therein may facilitate some degree of harmonisation of bank liquidation systems in the mid-term. This may have a positive

effect. Indeed, the lack of harmonised bank insolvency laws may lead to unpredictability and distortion of the level playing field, since the treatment of depositors, creditors, and investors often varies depending on where the failing bank is located. For example, legal systems show great diversity when it comes to insolvency hierarchies and differences may have significant (re)distributive effects with creditors of otherwise identical banks receiving very different recovery levels in different jurisdictions. These aspects might also negatively affect cross-border investments; the unpredictability of the treatment of investors in an insolvency scenario may deter them from investing in foreign banks.

- (iii) The lack of international standards may lead to an undesirable destruction of value and may have potentially destabilising effects, for instance, in jurisdictions that do not have bank-specific insolvency rules or only have limited tools available in insolvency proceedings. In particular, if a bank is subject to a 'piecemeal' liquidation, its assets may be sold at fire sale prices and the sudden disruption of the bank's activities may reduce confidence in the banking sector, which could lead to contagion effects. Contagion could also result from the fact that other banks would need to pay fees to re-fill the deposit insurance fund, which will have been used to pay-out insured depositors.
- (iv) In the absence of efficient insolvency options to deal with small and medium-sized banks, there is a risk that governments return to public 'bailouts' with the associated moral hazard, while the use of public funds is what policy makers intended to avoid following the recent financial crisis. This risk might in turn increase market fragmentation, since jurisdictions might react differently depending on their domestic laws, political considerations, and fiscal positions.
- (v) The lack of harmonisation and cooperation mechanisms may hinder adequate cross-border coordination and cooperation. Since jurisdictions may have different institutional set-ups – e.g., a court may play a leading role in one jurisdiction, whereas the process may be managed by an administrative authority in another – and their insolvency process is likely to diverge, effective cooperation in bank insolvency proceedings with a cross-border element may be a challenge. Further, divergencies in creditor hierarchies may even lead jurisdictions to legally challenge the treatment of 'their' creditors and to refuse recognition to foreign measures by invoking a 'public policy' exception.
- (vi) Differences in national insolvency laws may lead to a lack of trust and increase the risk of 'ring-fencing', that is, the safeguarding by national authorities of assets of the bank for local creditors to the detriment of creditors in other jurisdictions.
- (vii) Although resolution frameworks would not be covered by the project, it is worthy of note that problems with core aspects of bank insolvency may also affect adequate implementation of resolution regimes. For example, the diversity of national insolvency laws may make the application of the no-creditor-worse-off (NCWO) principle difficult. To be sure, the application of the NCWO requires an evaluation of the hypothetical treatment of shareholders and creditors of the failing bank in liquidation proceedings. This is a difficult exercise for resolution authorities due to the differences in creditor hierarchies when different countries are involved. Furthermore, the triggers for commencing insolvency proceedings are not always aligned with the triggers for resolution. Particularly, in jurisdictions where resolution and insolvency are governed by distinct frameworks and different authorities, this may lead to a situation where a bank may be failing but ends up in a 'limbo' situation given that it does not meet the criteria for either regime.

13. It follows from the above that there are compelling reasons for developing an international instrument that would offer relevant information, technical guidance and, ultimately, contribute to the harmonisation of insolvency proceedings for failing banks. International standards could help

domestic insolvency proceedings become more efficient and better able to preserve the value of the bank and may help to ensure consistent and effective management of bank failures, irrespective of their size or business model. By fostering legal certainty and a level playing field, harmonisation could also contribute to mitigate the risk of adverse effects of bank failures.

#### **IV. FEASIBILITY OF THE PROJECT**

##### **A. Consistency with UNIDROIT's mandate**

14. Bank liquidation is a hybrid topic, which includes aspects of banking regulatory law and more traditional private law. Insolvency law, generally, is a key part of private law; in fact, it constitutes the "acid test" of many classic private law matters (creditor protection, secured transactions, etc). While bank resolution systems have a predominantly regulatory nature, the complexity of a system that regulates the liquidation of banks is to be found, primarily, in private law matters. This project has a strong interdisciplinary component, including elements of banking and corporate insolvency law as well as aspects of private international law, corporate law, contract law, capital markets law and securities law. Given UNIDROIT's broad expertise and global constituency and outreach, it is able to ensure that these different domains will be duly taken into consideration. Furthermore, several of these areas outside the public regulatory side already lie at the core of UNIDROIT'S work.

##### **B. Institutional support**

15. Broad institutional support has been shown for the project and, in particular, in favour of UNIDROIT leading its development. Apart from the Bank of Italy and the European Banking Institute – proponents of the project – several key institutions in the sector of transnational banking regulation have expressed their endorsement and willingness to participate actively in the drafting of an instrument on bank liquidation.

16. Firstly, as shared with the Governing Council in its previous session, the FSI/BIS has demonstrated a keen interest in the topic and firmly supports UNIDROIT'S initiative. It has proactively shared the work of this preparatory stage with UNIDROIT'S Secretariat and has shown willingness to continue to work jointly with the Institute in the project'S development stage, should the Governing Council endorse the proposal to convene a Working Group. Moreover, as explained in this and previous documents, the FSI/BIS has expressed willingness to consider sharing costs associated with the project, where necessary. The FIS/BIS has expressly declared the project extremely important to improve countries' ability to deal with the failure of smaller banks. It is worth noting that the BIS is one of the world'S key institutions in the preservation of financial stability, and its constituents consist of 63 central banks from all over the world. The FSI, which was jointly formed by the BIS and the Basel Committee, has a primary mandate to assist supervisors around the world in improving and strengthening their financial systems. The importance of this institution'S commitment to the project and its willingness to assist in the project'S development working hand in hand with the Secretariat cannot be overstated.

17. Other leading international and transnational organisations expressed strong support for the project during the Exploratory Workshop. In particular, the *International Monetary Fund* (IMF) asserted its keen interest in the topic and referred to the project as a much-needed initiative to complement the existing international regulatory framework, which is centred around systemic institutions. Similarly, *The World Bank* (WB) conveyed a firm backing of the project, highlighting that emerging markets and developing economies often lack appropriate tools to deal with bank failures, especially those of smaller sizes. It considers the project key to addressing current challenges in dealing with the failure of non-systemic banks, but also relevant for systemic banks in light of the unavoidable interconnections. The European Union'S *Single Resolution Board* (SRB) welcomed the Institute'S project with full endorsement in light of the critical drawbacks of the current lack of

harmonisation and the difficulties this causes in applying resolution frameworks. The SRB referred to bank liquidation as a pertinent topic for UNIDROIT and expressed its firm willingness to be involved and support the project going forward.

18. In addition, several national central banks, supervisors, and resolution authorities expressed their support of the project and showed a willingness to contribute actively to the development of a best practices document. This includes the *Bank of Italy*, the *Hong Kong Monetary Authority (HKMA)*, and the French *Autorité de Contrôle Prudentiel et de Résolution (ACPR)*, which, in expressing support for the project, highlighted that the current lack of clarity and the substantial divergencies between jurisdictions with regard to many aspects of bank liquidation leads to significant legal problems. In a similar fashion, the German *Federal Financial Supervisory Authority (BaFin)* labelled the project as potentially very important, the *Central Bank of Brazil* indicated its conviction of the usefulness of a document that is complimentary to the FSB Key Attributes, the Italian *Institute for the Supervision of Insurance (IVASS)* endorsed the project as an excellent initiative, and the Swiss *Financial Market Supervisory Authority (FINMA)* actively contributed to the discussion. Many participants of the Exploratory Workshop, including the IMF, the World Bank, the BIS, the SRB, the Bank of Italy and the HKMA, described the project as very timely, even more so now that vulnerabilities are increasing dramatically around the globe because of the COVID-19 pandemic, which risks leading to a financial crisis where countries may be faced with multiple bank failures at the same time. The *Canadian Deposit Insurance Corporation (CDIC)* and the *Deposit Insurance Corporation of Japan (DICJ)* made very valuable contributions to the discussion and showed a willingness to further contribute to the project. It is worthy of note that several institutions participating in the Exploratory Workshop emphasised the need to involve international standard setters in the project in order to ensure consistency with existing standards.

### **C. Resources**

19. The Secretariat has recently bolstered its internal capacity to conduct a project on bank liquidation. In particular, two developments are worth highlighting: (i) a new legal officer with a strong background in banking regulation and substantial experience in a national bank supervisory authority and an international resolution authority has joined the Secretariat; (ii) the Bank of Italy-UNIDROIT Chair Holder has been appointed and the expert has been assigned, in part, to this project. The Chair Holder has already started to carry out initial research on the topic of security rights and derivatives held by small and medium-sized banks and their treatment in bank insolvency procedures.

20. As stated previously in this document, the FSI has confirmed its commitment to contribute to the costs of the project, when necessary, and has offered research expertise to assist the work of the Secretariat during the stage of development of the project.

21. All experts and international institutions, as well as most national agencies that participated in the Exploratory Workshop (for a complete list, see Annexe II) showed their willingness to participate actively in the next stage of development of the project, including partaking, as members or observers, of the Working Group. These experts and institutions conform the key group of global stakeholders specialised and/or competent to deal with matters of bank insolvency and resolution. Thus, there can be no doubt as to the adequacy of the forum, since the presence of the key institutions and experts has been confirmed.

## **V. TYPE OF INSTRUMENT AND SCOPE**

### **A. Type of instrument**

22. One of the matters discussed in the Exploratory Workshop, and which has also been consulted with several institutional stakeholders, concerns the type of instrument that would best meet the needs of the existing loophole in the area of bank liquidation. The result of discussions and consultations clearly indicated that, independent of its possible abstract suitability to deal with the current *status quo*, developing a hard law instrument – such as a convention or treaty – would be neither feasible in the short/midterm nor politically realistic. This view is fully consistent with previous discussions held in the Governing Council on the subject matter. In light of this, it is proposed that consideration be given to approving the development of a soft law text in the form of a legal/legislative guide or similar.

23. The instrument would first conduct a thorough analysis of the different comparative systems of bank liquidation. The variety of solutions envisaged at national level is considerable, both in the legal and institutional design. From the comparison, the Working Group would proceed to identify international best practices. Where there is clear consensus of the best solution, a recommendation could be included; where, arguably, several options may work adequately depending on the factual context, the document ought to simply reflect and explain the different models. The work will need to combine analysis of the banking regulatory framework as well as domestic insolvency systems and other relevant legal branches potentially involved in bank liquidation (secured transactions, financial markets, corporate law, etc.). The identification of the different parts of the law which must play a role in bank liquidation is, by itself, likely to be a valuable contribution for lawmakers in developing jurisdictions. Analysis and recommendations concerning the institutional framework tasked with the application of a bank liquidation system ought to consider and adequately ponder all political sensitivities and technical limitations of a jurisdiction's context.

24. The instrument to be developed would be fully respectful of, and consistent with, existing instruments developed by international standard-setters. Such existing instruments include, in particular, the Key Attributes and IADI's 'Core Principles for Effective Deposit Insurance Systems'. Already existing international standard-setters in the area would be expected to play a key role going forward as part of the proposed Working Group. Naturally, the work would also be mindful of ongoing initiatives connected to this subject matter to ensure proper coordination and avoid overlap.

### **B. Scope**

25. In terms of financial institutions to be covered by the project, it is proposed to follow a sequential approach by focusing, initially, only on banks. During the Exploratory Workshop, support was expressed by several participants for the inclusion of insurance companies in the scope of the project. It was alleged that the same or similar public interest considerations are relevant when dealing with the failure of a bank and of an insurance company, as opposed to failure of a regular company; further, banks and insurance companies occasionally use and offer similar financial products and can play analogous functions; and several jurisdictions are also in the process of developing 'resolution' and insolvency regimes for insurance companies that are similar to those for banks. However, given that several issues when dealing with insurance companies may deserve specific attention, tools and insolvency techniques may need to be different from those for banks, and the fact that international discussions on how to effectively manage the failure of insurance companies is still at an early stage, it is proposed to limit the scope of the project, in a first instance, to banks only, and reconsider the possibility of including insurance companies at a later stage. This decision would in any case need to be expressly adopted by the Governing Council, if it is ever proposed.

26. It is proposed that the scope of the project be limited to scenarios of ‘market exit’ – that is, proceedings aiming at the exit of the legal entity from the market – rather than restructuring. The reference to market exit does not mean that the activities of the failing bank would necessarily be discontinued. In fact, in order to avoid the destruction of value and protect depositors’ savings, it may be preferable to preserve and continue some activities of the bank during the liquidation process.

27. A range of sub-topics that would merit research and the definition of best practices has already been identified, which will be discussed in more detail in the Issues Paper on matters concerning bank liquidation (see C.D. (100) B.4 ADD, circulated separately). In the following subsections a brief account of some of the possible topics to be covered by the project is provided. Moreover, due regard will need to be given to the fact that banks may have different types of business models and corporate structures. Although the issues may likely be similar, the impact of these different options should be explored and taken into consideration in the course of the project. Furthermore, relevant constitutional principles and fundamental rights – such as the right to property and the right to conduct business – will have to be identified and analysed in order to duly take into account any possible restrictions in the design of international best practices:

#### **(a) Terminology and legislative regimes**

28. The use of key terms such as “resolution”, “insolvency” and “liquidation” varies among jurisdictions and academics globally, which may lead to misunderstandings or misleading characterisations of legal regimes. In the course of the project, it may be analysed how these and other related concepts may be best defined, interpreted, and integrated into a coherent legal framework in which their interaction is clear and the circumstances in which specific tools and powers may be used are, to the extent possible, transparent and predictable.

#### **(b) Objectives of a bank insolvency regime**

29. While the main objective of corporate liquidation proceedings is generally clear (value maximisation), regimes dealing with bank insolvency often place depositor protection as the main objective and include considerations of public interest and the preservation of financial stability. Moreover, objectives of liquidation regimes for banks differ among jurisdictions. These differences in objectives may have an impact on the design of other key aspects of bank liquidation proceedings, such as the type of tools and powers that are available to deal with failing banks, the institutional model, and management of the process.

#### **(c) Institutional framework**

30. Significant divergencies exist among jurisdictions in the institutional set-up for bank liquidation proceedings. Institutional models can either be: (i) predominantly administrative, where the bank insolvency proceeding is managed by an administrative authority with either a small role or no role for judicial authorities; (ii) predominantly court-based, where the proceeding is driven by a court-appointed liquidator, with either a small role or no role for administrative authorities; or (iii) ‘hybrid’ models, in which administrative authorities and courts may each have a distinct role, tailored to their function and expertise. The choice between an administrative- or court-based model entails trade-offs between considerations such as speed, efficiency, specialist expertise and safeguards for creditors. The choice will likely be informed by the objectives that are prioritised in the framework and the available tools.

31. Depending on the institutional model, different actors may be involved in the management of the bank liquidation process. In a court-based model, a private liquidator or insolvency administrator will likely play a key role in the proceedings. Under an administrative model, the administrative authority may either carry out the process itself or appoint and supervise a separate liquidator. In several jurisdictions with administrative-based models, the bank liquidation procedure



is managed by the deposit insurer or resolution authority. In the course of the project, the various options should be analysed and appraised in light of the disparate contexts presented by jurisdictions with diverging levels of development.

#### **(d) Triggers**

32. Ordinary corporate liquidation proceedings are generally triggered on the grounds that: (i) the company's liabilities exceed its assets (balance sheet insolvency); or (ii) the company is unable to pay its debts as they fall due (illiquidity). Due to the special nature of banks, these grounds may not suffice as triggers to open bank liquidation proceedings. In particular, waiting for balance sheet insolvency may lead to the undesirable destruction of value and contagion, while liquidity issues of banks may be temporary and resolvable. In many jurisdictions, bank insolvency regimes therefore include a wider range of grounds for opening bank liquidation proceedings, although the content of these triggers may vary. Generally, two types of additional grounds may be identified: forward-looking triggers and regulatory triggers. These ought to be given adequate consideration in the project. The identification and formulation of triggers for the opening of bank liquidation proceedings may be further explored with due regard to the special nature of banks as compared to ordinary companies.

#### **(e) Creditor hierarchy**

33. Significant divergency exists among jurisdictions in creditor hierarchies, and this is generally regarded as one of the core issues arising from the lack of harmonised bank liquidation laws. Some jurisdictions have a general creditor hierarchy that is applicable to all firms, other jurisdictions have a specific creditor hierarchy for banks, and again other jurisdictions have introduced specific rules concerning the ranking in insolvency only with a view to facilitate the application of the bank resolution regime.

34. Apart from these formal differences, great divergences exist in relation to the substance of creditor hierarchies. There are important differences, for example, with respect to the treatment of shareholder loans and intragroup liabilities, which may or may not be subject to statutory subordination. Particularly relevant in the context of bank liquidation proceedings is the difference in treatment of claims of depositors. While many jurisdictions have introduced "depositor preference", this may take different forms. Furthermore, there are differences among jurisdictions in the treatment of domestic and foreign deposits.

35. The great divergences in creditor hierarchies are problematic for several reasons. They lead to unequal treatment of creditors in various jurisdictions, uncertainties, and unpredictability in cross-border bank liquidation scenarios. Moreover, in certain jurisdictions, the ranking of creditors in liquidation may differ from the order of loss absorption in resolution, leading to challenges in the application of the NCWO principle and to an increase in litigation risks.

#### **(f) Tools**

36. The range of tools available in bank liquidation proceedings varies across jurisdictions. In some countries, only 'piecemeal' liquidation is possible, whereby the bank's operations are disrupted immediately, customer relationships are resolved, assets and collateral are sold, and creditors' claims are settled against the proceeds from the liquidation. In other jurisdictions, the insolvency regime applicable to banks provides for a broader toolkit in order to minimise the destruction of value and to support the continuity of essential functions of the failing bank (e.g., by the transfer of part of the bank's business to another bank or the use of a bridge bank).

37. In the course of the project, consideration could be given to exploring the range of (non-conventional) tools that may be useful in bank liquidation proceedings – such as transfers tools – in

order to account for the special nature of banks and meet the relevant objectives. The effective use of transfer tools may be connected to the funding options (the type and extent of funding available in bank liquidation proceedings varies among jurisdictions), the type of institutional model, and the possibilities to prepare prior to the bank's failure.

### **(g) Treatment of security rights, derivatives**

38. Derivatives contracts may be treated differently in pre-liquidation, liquidation, and resolution scenarios. Particularly relevant is the extent to which close-out netting is possible. Close-out netting of financial contracts can dramatically shrink the pool of available assets in bank liquidation proceedings. It would therefore seem relevant to account for the treatment of derivatives during the project. The topic is also relevant to non-systemic banks, which have become a big and growing part of the derivatives market all around the world. Furthermore, several issues that are relevant for derivatives contracts are important for non-derivatives contracts as well, such as the bank's right of set-off and the treatment of secured debt. Exploring these aspects in detail would thus create synergies.

### **(h) Cross-border aspects**

39. Cross-border complexities and uncertainties are material barriers to efficient insolvency proceedings for banks. The lack of international standards may be problematic in particular with regard to two key aspects: (i) the arrangements for recognising or giving effect to foreign bank liquidation proceedings; and (ii) cross-border coordination between authorities involved in the bank liquidation proceedings. In the course of the project, consideration could be given to the best ways to facilitate cross-border recognition and support measures. For instance, grounds for refusal of recognition may need to be limited, clearly defined, and adapted to the measures for which recognition is sought. Furthermore, the project may explore how to facilitate effective cooperation between home and host authorities – irrespective of whether the competent body is a court or an administrative authority – for instance, by introducing an explicit legal basis for cooperation. Special consideration may also need to be given to bank liquidation proceedings of one or more entities of a group, both with a cross-border and fully domestic component.

## **VI. PROPOSED WAY FORWARD**

40. In the light of the arguments included in this document, the Secretariat would purport to pursue the following course of action:

- (i) To set, in broad terms, the scope of the project so work can commence after the Governing Council session. While the concrete matters to be included in the analysis should be left in the hands of the Working Group, the Governing Council is invited to narrow the scope, at this stage, in the following manner:
  - (a) The instrument would take the form of a soft law guidance document that would identify best practices and solutions in the area of bank insolvency, possibly in the shape of a legal guide or a principles document;
  - (b) The project would be confined, in a first instance, to banks.
- (ii) To upgrade the status of the project within the current Work Programme from its current medium priority to *high priority*.

As has been confirmed and underlined by leading international experts and institutions, the topic has enormous practical relevance and work is needed with some urgency in light of the existing – and forthcoming – economic difficulties at a global level, which

will inevitably affect the banking sector, especially its smallest institutions. A protracted recovery runs the risk of transforming a global economic crisis into a financial one, where jurisdictions may be confronted with multiple small and medium-sized bank failures. The project is not only very timely but also one which needs work to begin forthwith.

- (iii) To allow the Secretariat to form a Working Group. Consistent with UNIDROIT's established working methodology, the Working Group would be composed of international legal experts and stakeholders representing different legal systems and geographical regions, chaired by a member of the Governing Council. It is proposed that the Bank Insolvency Working Group be chaired by Professor Stefania Bariatti, given her highly relevant knowledge and experience, both academic and practical, in this field. Under her guidance, the Working Group would undertake its work in an open, inclusive, and collaborative manner. In Annex I, a list of institutions that have confirmed their participation in the project can be found. The Secretariat would conduct the technical work together with the BIS/FSI.
- (iv) To endorse the following tentative work plan:
  - (a) Development of a guidance document on Bank Insolvency over five in-person sessions of the Bank Insolvency Working Group in 2021-2023:
    - i. First session: Autumn 2021
    - ii. Second session: Spring 2022
    - iii. Third session: Autumn 2022
    - iv. Fourth session: Late winter 2023
    - v. Fifth session: Summer 2023

It is envisaged that hybrid or remote meetings may be conducted when deemed necessary. One or more of the in-person sessions may be substituted by remote meetings. Intense inter-sessional work is planned.

- (b) Consultations and finalisation: Second half of 2023.
- (c) Adoption by the Governing Council of the complete draft in 2024.

## **VII. ACTION TO BE TAKEN**

41. *The UNIDROIT Secretariat would invite the Governing Council to take note of the information in this report and to approve the proposed way forward as described herein.*

42. *In particular, the Governing Council is invited to approve the proposed scope of the bank insolvency project, assign a high priority to the project, and allow the Secretariat to establish a Working Group (providing any input on the proposed composition thereof) and a work plan.*

**ANNEXE I****LINK TO THE SUMMARY REPORT OF THE EXPLORATORY WORKSHOP**

The Summary Report of the Exploratory Workshop on Bank Liquidation that took place on 7 and 8 June 2021, including the list of participants to the afore-mentioned workshop, can be found online at the following webpage:

[\[https://www.unidroit.org/english/documents/2021/study84/210607-summary-report-ew.pdf\]](https://www.unidroit.org/english/documents/2021/study84/210607-summary-report-ew.pdf)

**ANNEXE II****INSTITUTIONS THAT HAVE CONFIRMED PARTICIPATION IN THE WORKING GROUP**

As is customary, it is proposed that UNIDROIT invites a number of organizations with expertise in the field of bank insolvency, resolution and deposit insurance to participate as observers in the Working Group. Strong collaboration with existing standard setters in the area is of particular relevance in this project. In light of this, the Secretariat has already confirmed the availability to participate of the following institutions:

1. Bank of International Settlements (BIS)/ Financial Stability Institute (FSI) [*co-host*]
2. *Autorité de Contrôle Prudentiel et de Résolution* (ACPR, France)
3. Bank of Italy
4. Bank of Spain
5. Canada Deposit Insurance Corporation (CDIC)
6. Central Bank of Brazil
7. Deposit Insurance Corporation of Japan (DICJ)
8. European Banking Authority (EBA)
9. European Banking Institute (EBI)
10. European Commission
11. Federal Financial Supervisory Authority of Germany (BaFin)
12. Hong Kong Monetary Authority (HKMA)
13. Italian Institute for the Supervision of Insurance (IVASS)
14. International Association Deposit Insurers (IADI)
15. International Monetary Fund (IMF)
16. Single Resolution Board (SRB)
17. Swiss Financial Market Supervisory Authority (FINMA)
18. The World Bank