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**Project on Bank Liquidation  
Work Programme 2020-2022**

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**SUMMARY REPORT  
OF THE EXPLORATORY WORKSHOP ON BANK LIQUIDATION  
(7 and 8 June 2021)**

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1. An exploratory workshop on bank liquidation, jointly organised by UNIDROIT and the Financial Stability Institute (BIS), took place via videoconference on 7 and 8 June 2021. The workshop was attended by over 40 leading experts and relevant stakeholders in the field of bank crisis management, insolvency law and deposit insurance with a view to (i) assess the need of an international instrument in the area of bank insolvency; (ii) determine the most suitable form of such a document; and (iii) define the scope of the project.

### **Introductory remarks**

2. The *Secretary General* opened the workshop by welcoming participants and introducing the general idea for the project: to produce a document that identifies best practices in the area of bank liquidation, with special regard to non-systemic banks, to complement, without any possible overlap and in full consistency with, existing international standards in related matters (e.g., the FSB Key Attributes). The idea is to pick up where existing standards left off. Widespread concern that smaller banks with traditional business models, already struggling with technological developments in the market, might undergo difficult times in the aftermath of the pandemic underpins the need to conduct a close-up analysis of the smaller portion of the banking system, giving special consideration to issues such as institutional arrangements, role of courts and administrative agencies, triggers and liquidation tools, avoidance actions, cross-border matters, and potentially other aspects. While a best practice document is typically completed within a couple of years, the project would aim to be nimble and swift so as to come up with an outcome as early as possible.

### **Session 1: Introduction to the Project and Institutional Involvement**

3. The *Chairman of the Financial Stability Institute* opened the session by explaining why the BIS strongly supports UNIDROIT's bank insolvency project. Reference was made to several critical issues: the co-existence, in certain jurisdictions, of a common resolution framework with a constellation of different insolvency regimes; the difficulties in several jurisdictions in identifying procedures to deal with the failure of banks that are too significant to be subject to regular insolvency procedures, but too small and traditional to satisfy the requirements for resolution ('middle-class issue'); and the existence, in many jurisdictions, of insolvency procedures that may be value-destructing and potentially destabilising. According to the BIS, it is key to tackle these issues by improving the bank insolvency procedures for non-systemic banks. It was emphasised that, in order to do so, there is a need to bring together various disciplines and to apply a global, rather than a regional, perspective. UNIDROIT's project is therefore seen as a very important, very timely and very promising initiative.

4. One panelist added that UNIDROIT is in a very good position to take the lead in this initiative, given its global constituency, its longstanding expertise in the relevant areas of law<sup>1</sup>, its ability to develop different types of instruments depending on the specific needs as well as its experience in partnering with international organisations and serving as a forum for international cooperation.

5. Another panelist mentioned that many technical and some foundational aspects of bank liquidation procedures vary substantially among jurisdictions, which may give rise to significant legal issues around the point of a bank's failure. Such aspects include the overarching objectives of bank liquidation frameworks, the triggers (which may be different from the forward-looking triggers that may be applicable when using resolution tools), the authority in charge of the liquidation procedure (and possible tensions between administrative bodies and courts), creditor hierarchy, the interaction

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<sup>1</sup> Reference was made to the adoption by UNIDROIT of several instruments in the area of securities law, where issues of insolvency law can play a major role.

with deposit guarantee schemes and aspects related to the withdrawal of the banking license. According to this panelist, the introduction of resolution regimes for systemic banks makes the harmonisation of bank liquidation laws even more crucial, given that resolution regimes often use liquidation as a reference point. UNIDROIT's project is therefore particularly welcome.

6. One panelist expressed keen interest in the topic given its relevance for financial stability. It was noted that, due to the focus on systemic banks over the last years, there has been a lack of attention to liquidation regimes for non-systemic banks, while in fact liquidation proceedings are a critical component of overall crisis management arrangements that can contribute to maintaining financial stability. This panelist mentioned that jurisdictions are increasingly seeking guidance on the design of appropriate bank liquidation arrangements and the interaction with bank resolution regimes. It was argued that putting in place a comprehensive and coherent bank crisis management framework would allow the relevant authorities to take appropriate actions in the interest of financial stability, regardless of the size and systemic importance of the failing bank. Overall, this panelist described UNIDROIT's project as a much needed and very timely initiative, even more so given the COVID-19 pandemic and expected consequences. It was noted that the project presents a great opportunity to unify the efforts of leading experts and authorities in developing best practices that would complement – and would need to be fully consistent with – the existing international regulatory framework.

7. Finally, another panelist touched upon the current challenges in emerging markets and developing economies, where countries often lack the appropriate tools to deal with bank failures. This can lead not only to potential financial stability issues but may also have longer-lasting negative consequences on the economies of such countries. In line with other speakers, this panelist noted that the development of best practices on bank liquidation, complementary to the FSB Key Attributes, would be key to address current challenges in several jurisdictions in dealing with the failure of non-systemic banks as well as for underpinning the bank resolution framework. Reference was made to the need to address aspects such as creditor hierarchy, tools and the role of deposit insurance schemes. In agreement with previous speakers, it was noted that UNIDROIT's initiative is particularly pertinent now that vulnerabilities are increasing dramatically around the globe as a result of the COVID-19 pandemic.

## **Session 2: The Scope of the Project**

8. *The Chair* opened the session and introduced the topic, noting that determining the scope of a project is often complex but at the same time key to its success. Since the scope directly relates to the substance, the discussion during this session is linked to the discussion in other sessions.

### **1. Objective scope of the project**

9. Regarding the objective scope of the project, it was discussed that it might focus on procedures aiming at market exit rather than restructuring. However, it was noted that the term "exit" is ambiguous and should not necessarily imply a discontinuation of activities. There was agreement that, while the legal entity may exit the market in insolvency, part of its activities may need to be preserved in order to avoid the destruction of value and/or to protect depositors' savings. It was suggested that a difference with resolution may be the availability of funding, which could be more limited and mainly focused on depositor protection in insolvency in some jurisdictions. One participant highlighted that too narrow a focus on market exit may increase fragmentation and expand opportunities for arbitrage.

10. It was recalled that the current lack of harmonised insolvency rules reduces predictability, makes the playing field uneven, may lead to undesirable destruction of value and creates challenges

in applying the resolution framework, since the ‘no creditor worse off’ principle and the ‘public interest assessment’ are premised on diverging insolvency regimes as counterfactual. It was noted that a key issue is whether banks are special in insolvency proceedings even if there is no systemic risk concern, and whether, how and why recognising exceptions to the general insolvency regimes should be a basic question. It was also raised whether deposit insurance or compensation schemes may affect this matter, in terms of financial support or otherwise.

11. Against this background, it was suggested that the aim of the project might be to create common international standards concerning the key features of bank insolvency proceedings, such as the triggers for insolvency and their relationship to the triggers for resolution, creditor hierarchy, and the interplay between judicial and administrative authorities and funding. Moreover, it was raised that due regard should be given to the role of the supervisor and early intervention measures, in order to ensure a smooth continuum in the framework. It was noted in this context that some jurisdictions have a sharper distinction between pre-insolvency and insolvency than others. It was also pointed out that a statutory approach and a contractual approach for introducing provisions governing bank insolvency should be compared.

12. It was underlined that timeliness is critical in bank insolvency proceedings. Sophisticated actors might act quickly to protect their interests and this race to the assets may lead to fairness concerns. It was discussed as well that it would be important to take into account possible constraints deriving from constitutional principles and fundamental rights when formulating best practices. Lastly, it was noted that the project would need to include also corporate law analyses, given that several aspects of the insolvency procedure, for instance, concerning the tools (e.g. transfer tools), are directly linked to corporate law.

## **2. Objectives of bank insolvency regimes**

13. As regards the main objectives of bank insolvency regimes, it was argued that they may include value maximisation but also public interest considerations, such as depositor protection and the safety and soundness of the financial system. For small and medium-sized banks, there may be less focus on financial stability, while other public interest dimensions may be more pertinent, such as legal certainty and fiscal consequences. One participant highlighted that providing appropriate crisis management rather than financial stability could be the goal of this project. It was noted that harmonisation could foster legal certainty and a level playing field, which could be beneficial for all stakeholders and contribute to financial stability. It was also pointed out that, in pursuing such path, a focus on individual tools or powers available to the relevant authority in charge of the insolvency procedure would be important.

## **3. Subjective scope of the project**

14. Regarding the subjective scope, it was discussed whether to focus on banks only or also on other financial institutions. One participant noted that, ideally, the project scope would be defined by looking at the functions (i.e., type of activities) of financial institutions, however jurisdictions generally follow an entity-based approach (e.g., focusing on banks or insurance companies) for the design of their insolvency regimes. Support was expressed by several participants for the inclusion of insurance companies in the scope. It was noted that public interest considerations may be relevant for insurance companies as well and that in many jurisdictions, insurance companies - like banks - are therefore excluded from the general corporate insolvency laws. Furthermore, insurance companies are becoming larger, which makes it more likely that their failure may cause contagion in the financial system. In addition, banks and insurance companies have - and continue to develop - financial products that may be intertwined and have similarities, for instance certain types of hedging products and annuities savings products. Reference was also made to financial conglomerates. Finally, it was noted that the FSB Key Attributes are applicable to all financial companies, including insurance companies, and that several jurisdictions have adopted or are in the process of developing

specific resolution regimes for insurance companies. As for banks, such efforts could lead to a situation of harmonised resolution regimes that are not accompanied by harmonised insolvency regimes.

15. On the other hand, it was argued that there are several issues when dealing with insurance companies that may deserve specific attention, for instance as regards creditor hierarchy. Moreover, the tools and insolvency techniques needed to deal effectively with insurance companies might be different from those used with banks. It was suggested that best practices on insurance companies might be better placed in a separate document, depending on the level of shared matters with banks. Regarding conglomerates, it was observed that they might rather fall within the scope of resolution if they are large and systemically relevant. Furthermore, one participant noted that the discussion on those entities and on insurance companies is still at an early stage and another participant indicated that it had not been straightforward to make the FSB Key Attributes relevant for insurance companies. Lastly, from a practical point of view, including insurance companies in the scope might make the project too complex and challenging to steer logistically.

16. It was noted that banks may have different corporate structures (e.g. mutual banks and cooperative banks) and different business models (e.g. universal banking and commercial banking) and that it would be useful to take these models into consideration during the project, even if the issues would likely be similar.

17. It was concluded that there is merit in following a sequential approach, that is, to focus initially on banks only and reassess the need to broaden the scope of the project – by including aspects specific to insurance companies – at a later stage.

#### **4. Territorial scope of the project**

18. Concerning the territorial scope, it was discussed whether the project should focus only on domestic insolvency laws or whether it should include also cross-border aspects. It was proposed that the work may consist of two aspects: (i) comparative analyses of different domestic regimes, highlighting best practices; and (ii) analysis of cross-border issues, such as recognition and enforcement.

19. It was noted that even if the project would primarily focus on highlighting best practices under domestic laws, this primary focus would already contribute to the development of an effective cross-border framework. Developing best practices and thereby facilitating a degree of harmonisation might help, for instance, to reduce asset grabbing and the invoking of public policy safeguards.

20. It was concluded that there would be merit in including cross-border aspects in the project. Reference was made to the fact that banks often operate cross-border and/or have group entities in different jurisdictions. Several participants underlined that these aspects are relevant also for small and medium-sized banks. It was mentioned as well that the topic is related to the issue of timeliness and to the institutional set-up. Moreover, it was noted that there may be a need to look into territorial differences within a single jurisdiction.

#### **5. Type of instrument**

21. Finally, the group reflected on the type of instrument to be developed. UNIDROIT's Secretary-General introduced the topic by explaining that the organisation produces both hard law (e.g. a Treaty or Convention) and soft law instruments (e.g. a Model Law, Legislative Guides, Principles or, more generally, guidance documents). The proposals to consider the inclusion of this topic in UNIDROIT's Work Programme left this question undefined, but discussion at the Governing Council level clarified that only soft law instruments were to be considered.

22. Many workshop participants expressed support for a soft law text in the form of a guidance document that would analyse the sub-topics and identify best practices; a document comparable and complementary to the FSB Key Attributes was seen as most appropriate for this subject-matter and highly welcome.

### **Session 3: The Institutional Setting**

23. *The Chair* opened the session and introduced the topics to be discussed: (i) the question of which authority should be in charge of bank liquidation, and how its function should be framed; (ii) the question of external funding to support an orderly liquidation; and (iii) the operational aspects of handling a bank liquidation. In addition, he invited participants to share experiences from their respective home jurisdictions.

#### **1. Presentations on frameworks in Canada and Japan**

24. In order to stimulate the discussion, the bank liquidation frameworks of Canada and Japan were presented in some detail during the session. The Canadian framework, which is based on the Winding up and Restructuring Act (“WURA”), features the role of the Canadian Deposit Insurance Corporation (“CDIC”) as deposit insurer and resolution authority for its members with powers to transfer assets of a failing bank to a sound one, but also an important role of the court. An example for the interaction between those authorities is the point where the supervisor assesses a bank to be no longer viable, the determination to take control of a failing bank and the court’s broad discretion in decreeing insolvency. The CDIC is obliged to pursue its mandate of insuring deposits and promoting financial stability in a manner that minimises the costs of the corporation. As regards the institutional arrangements, several points were mentioned that distinguish the bank liquidation from the general corporate insolvency framework: the advisory role of inspectors, a function which could be assumed by the supervisor; the distinction between provisional and permanent liquidator; or the fact that creditor meetings are not held unless authorised by the court. Canada, being a federation, is an example for the need of legislation to include provisions that deal with recognition of measures across provincial or state borders. In general, the Canadian framework was characterised as rather lean and thus principled and flexible enough to allow practitioners to achieve appropriate outcomes.

25. The Japanese framework was characterised as being of a hybrid nature. Thus, the court has a crucial role in managing the procedure, with the regulator and the Deposit Insurance Corporation of Japan (“DICJ”) being closely involved. Specifically, the role of the court is to institute the proceedings upon the initiative of the regulator, whereas the DICJ, working with the regulator, exercise a due diligence of the failing bank and search a prospective buyer. Bad assets are separated from the healthy business of the failing bank and the latter transferred to a buyer. In addition, the court appoints a supervisor whose mandate is to supervise the process. The presentation concluded by commenting on the differences of focus that disparate authorities may have: while the focus of the court may be on due process, fairness and equity of outcome for creditors, administrative authorities may focus on financial stability and other public interests. There is a natural tension between those two focuses, and thus the need for authorities to cooperate. The project would thus do well to consider how such cooperation could be framed.

#### **2. Institutional arrangements in general**

26. Participants mostly agreed that the institutional question is directly linked to whether a framework is dual-track or single-track. Some sympathies were voiced for the latter, in which liquidation would be merely one potential outcome among a variety of options under an integrated crisis management framework, generally managed by an administrative authority. This is opposed to a dual-track system, which conceives liquidation as a procedural stream separate from a narrower resolution stream, which may be managed by distinct authorities, and which - so it was argued -

may face practical difficulties in clearly disentangling the two, for example through inconsistent entry conditions.

27. There was broad agreement that an administrative model of bank liquidation management would be preferable. Administrative authorities were generally seen as being better positioned to assess the public interests that may be at stake in a bank failure, and to exercise broader restructuring tools that go beyond atomistic liquidation to address it. The need to take public interest dimensions such as financial stability and depositor protection into consideration, both when activating a procedure and when exercising certain tools, was particularly emphasised. Participants remarked that some jurisdictions have a specifically defined ‘public interest test’ in resolution, while other jurisdictions may use restructuring tools without such assessment. Participants also argued that administrative authorities are better suited to make decisions involving public finances.

28. Participants agreed that administrative authorities may be better suited to deal with more practical challenges of bank failure management, such as timing constraints or information gaps. The need for swift action was seen as a particularly important aspect, given the dynamics of bank failures, and certain participants remarked that involvement of courts tends to be time-consuming, especially in emerging markets, even if time becomes less critical the less systemic a bank failure is.

29. Nonetheless, there was also general agreement that jurisdictions’ constitutions set limits to administrative authorities’ powers, and certain matters fall under the exclusive jurisdictions of the courts. These limits need to be respected. A way to approach this would be to apply a functional, rather than authority-based, perspective, resulting in a modular structure that could be adopted to various systems, in accordance with their respective constitutional frameworks.

### **3. Operational matters of bank liquidations**

30. Participants then discussed the more operational aspects of bank liquidations, and recognised that various models exist that may involve public authorities (with or without other mandates, such as supervision or deposit insurance), private practitioners or even public committees or private consortiums. Here, too, there is a need to distinguish between liquidation measures that have a public-law character, those that are more commercial or transactional and those that are judicial (for example, recognising the rank of a particular claim).

31. Other operational issues that were deemed relevant included the selection, appointment and supervision of the liquidator, the extent to which their actions needed approval by other authorities, including courts, and reporting requirements.

32. Conflict of interest risks were mentioned as a liquidation consideration. For example, the issue of the liquidator’s remuneration can impact the length and efficiency of the liquidation process, and requires particular attention, given that it is typically funded out of the failed bank’s assets, and thus could be in potential conflict with other creditors.

### **4. External Funding**

33. The discussion of funding arrangements benefitted from a presentation of the US experience under the Federal Deposit Insurance Act (“FDIA”) as a longstanding statute with extensive judicial precedent. In that regard, reference was made to the IADI Core Principles, which provide that the deposit insurer should have readily available funds, including assured liquidity funding arrangements. Those should be backed by emergency funding arrangements as a backstop, and funded primarily by assessments from the industry.

34. Reference was also made to the US experience with applying those funds in bank failure management, and what constraints apply in that regard. Thus, the US framework includes legislation



that allows for risk-based premiums, provides for a least-cost test as a financial constraint on the manner of deployment of deposit insurance funds, but also allows for a systemic exception to such constraint to deal with circumstances such as during the crisis of 2008-9.

## **5. Relation with other international standards**

35. During the session, the project's relation to existing international standards in the area of bank failure management - in particular the FSB Key Attributes and the IADI Core Principles - was discussed. It was clarified that such existing standards would be respected, and that the objective of the project would be to complement those standards as needed, particularly in the area of private insolvency law as applied to banks. UNIDROIT's Secretary-General and the FSI Chair agreed that the project would seek to involve the relevant international standard-setters, which could become active contributors to the project once it commences.

### **Session 4: The Content of the System**

36. *The Chair* opened the session and introduced the topics to be discussed: (i) the triggers for insolvency and how these relate to the triggers for resolution; (ii) the tools that might be useful in insolvency procedures, which may be inspired by the resolution tools; and (iii) creditor hierarchies, the treatment of security rights and derivatives and netting agreements.

#### **1. Triggers**

37. Regarding triggers, it was discussed that those generally used for ordinary corporate insolvency procedures – illiquidity and balance sheet insolvency - would not suffice due to the special nature of banks. In particular, liquidity issues of banks may be temporary and resolvable, and it could be too late to wait for balance sheet insolvency since this may lead to an unnecessary destruction of value and may not be in the public interest. It was noted that many jurisdictions had identified a third trigger for bank insolvency proceedings: the violation of regulatory requirements, which may encompass both quantitative and qualitative factors.

38. It was discussed that automatic triggers on the basis of quantitative criteria do not seem appropriate, considering the need to take into account the specific circumstances of the case and the macroeconomic situation. There may also be legal constraints in some jurisdictions to have automatic triggers.

39. It was considered that triggers for bank insolvency procedures should be forward-looking, in order to prevent contagion and the destruction of value. It may be challenging to decide how forward-looking the assessment should be, taking into account the need to balance varying interests, the principle of proportionality and the relationship with early intervention measures.

40. It was suggested that, in addition, a 'negative' condition might be considered, namely the absence of alternatives to insolvency (e.g. supervisory measures and private or public sector interventions). It was underlined that during the project, the link between supervision and crisis management should be taken into account as well as the special nature of banks.

41. It was discussed that a forward-looking approach and the inclusion of qualitative triggers would mean introducing elements of discretion. While it was acknowledged that this might lead to issues such as supervisory forbearance and might reduce the predictability of the framework, it was agreed that a certain degree of flexibility and discretion is necessary and unavoidable. It was noted that a greater amount of discretion might argue in favour of the involvement of administrative authorities, as opposed to courts, given their technical expertise.

42. Participants furthermore discussed the relationship between resolution and liquidation. There was agreement that uncertainty with regard to the situation of the bank – ‘limbo situations’ – should be avoided. Moreover, it was argued that, if the decision on the opening of insolvency proceedings would not fall within the competence of the resolution authority, a failing or likely to fail or equivalent decision should be taken in order to enable the resolution authority to assess whether the remaining conditions for resolution are met.

43. Finally, the role of the public interest assessment was discussed. It was argued that such assessment may be useful in a dual system in order to decide whether to apply resolution or insolvency procedures, but may be less relevant in a single, all-encompassing regime for dealing with failing banks. On the other hand, it was noted that in a single system, the public interest assessment may be useful as a safeguard when applying bail-in measures. One of the participants suggested that it may be helpful going forward to distinguish between three possible dimensions of the concept ‘public interest’: (i) as generally incorporated in crisis management frameworks (e.g., in the objective of depositor protection); (ii) as potential element of the trigger; and/or (iii) as a threshold for the use of specific tools. In reaction, it was argued that the public interest should not be seen as part of the trigger but rather as element to decide on the measures to be taken.

## **2. Tools**

44. As regards the tools, a discussion took place on the difference between resolution and liquidation. It was suggested that insolvency proceedings may be understood as an umbrella concept, encompassing both liquidation and restructuring, and that there may be many commonalities between the two, also in terms of tools and powers. Many resolution powers derive from traditional insolvency frameworks and resolution-like transfer tools are part of the liquidation framework in many jurisdictions. It was noted also that various deposit insurance authorities have resolution powers as well as a role in liquidation procedures.

45. It was argued that three aspects may distinguish resolution and insolvency: (i) the banking license, which is typically withdrawn in liquidation while it may be kept when certain resolution tools are applied; (ii) the bail-in tool, which is generally considered to be a typical resolution tool; and (iii) types of funding, which are generally more limited in liquidation (e.g., would not include public sector equity and capital injections). With regard to funding, it was noted that deposit insurance authorities may in certain jurisdictions play a key role in facilitating the deployment of the transfer tool in insolvency, by filling the funding gap.

46. It was suggested to consider that the design principles for resolution and insolvency are different: one participant noted that while preventing or curing failure could be considered the driving principle for resolution, in insolvency the equal treatment of creditors plays a central role. Another participant suggested to distinguish between resolution and insolvency tools and powers by looking at the extent to which it is possible to interfere with creditor expectations, for instance by deviating from the *pari passu* principle.

47. It was concluded that there may be merit in an integrated approach, that would examine which tools and powers are available both in resolution and liquidation. In particular, the transfer of assets and/or liabilities without shareholder consent could be used in insolvency, in order to preserve and maximise value. Apart from the transfer to a private purchaser, also the bridge bank tool and asset management tool were mentioned as useful tools in conjunction with both resolution and liquidation procedures.

### 3. Creditor hierarchies

48. Regarding creditor hierarchies, it was noted that there is significant diversity among jurisdictions, both procedurally – concerning the existence or absence of bank-specific creditor hierarchies – and substantively.

49. It was argued that divergencies are pertinent in particular with respect to subordinated and junior creditors. Regarding subordinated creditors because jurisdictions may follow either a statutory or a contractual approach. Regarding junior creditors, challenges may arise from differences in deviations from the *pars conditio creditorum* principle.

50. In particular, divergencies in the ranking of depositors and the deposit guarantee scheme may have fiscal consequences and create issues for cross-border recognition, since the public policy ground might be invoked to challenge the treatment of creditors in a host jurisdiction under the creditor hierarchy in the home jurisdiction. Furthermore, it was argued that the difference in treatment of intra-group exposures may be problematic, noting that these are automatically subordinated in some jurisdictions while this is not the case in others. It was added that divergencies could be problematic also in the simple scenario where group entities are established in different jurisdictions.

51. A discussion took place as to whether the treatment of security interests could raise issues. On the one hand, it was highlighted that problems may arise in determining whether a valid security right exists. On the other hand, it was argued that conflict of laws rules might be useful to some extent and that the validity of the security right may be a pre-insolvency issue and therefore fall outside the scope of this project.

52. It was emphasised by several participants that the divergencies in creditor hierarchies are problematic not only for insolvency procedures but also for dealing with systemic banks falling under the resolution regime, since the 'no creditor worse off' principle in resolution is premised on the counterfactual scenario under national insolvency law. Cross-border recognition challenges may arise in resolution as well.

53. Moreover, it was underlined that differences between the resolution waterfall and the hierarchy in insolvency may lead to operational complexity and increase litigation risks. It was raised that it would be important to try to achieve harmonisation at least between the different regimes within the same jurisdiction. At the same time, it was noted that a full alignment might not be possible. For instance, certain liabilities are mandatorily excluded from bail-in in certain jurisdictions, while it may not be possible to guarantee the same level of protection in insolvency.

54. Overall, the harmonisation of creditor hierarchies is seen as a crucial, but very challenging, element of the project. The topic of creditor hierarchies is challenging, in particular, due to the close relationship with policy considerations, general corporate insolvency law and constitutional law, although it was noted that the latter might be more relevant in relation to bail-in than to the creditor hierarchy as such. Nevertheless, some jurisdictions have shown that it is possible to make progress on harmonisation (e.g., in the European Union, with the introduction of Article 108 of the Bank Recovery and Resolution Directive). Finally, it was noted that it might be helpful to analyse hierarchy as a relative concept only, instead of looking at absolute ranks.

### 4. The treatment of security rights and derivatives

55. The special characteristics of derivatives were highlighted. Firstly, derivatives have specific functions in the market, such as risk shifting. Secondly, derivatives contracts are standardised and the set-up as a "hub-and-spoke" type of system - with a central role for the ISDA master agreement - makes it possible to treat multiple transactions as one single contract. This facilitates close-out

netting in resolution and liquidation. Thirdly, rules governing derivatives are included in contracts drafted centrally by ISDA, so a contractual approach is followed instead of establishing rules in a treaty or statutes (although it was noted that it may also be considered in this project whether there may be merit in articulating a statutory approach). Fourthly, derivatives contracts are treated in a special manner in resolution and liquidation, where they may *de facto* enjoy a form of 'super-priority' if they are exempted from automatic stay.

56. It was discussed that the topic is relevant not only for systemic but also for non-systemic banks, which have become a big and growing part of the derivatives market all over the world. It was further noted that systemic and non-systemic banks are subject to the same rules since close-out netting provisions are included in the globally used ISDA standard contracts.

57. Overall, it was indicated that it would be unavoidable and essential to account for the treatment of derivatives in the project. Reference was made in this context to the fact that assets may rapidly diminish in value in the phase prior to insolvency and that the stakes are therefore extremely high. Cross-border harmonisation in this area would be helpful to counter the risk of arbitrage. It was concluded also that several issues that are relevant for derivatives are important for non-derivatives as well, such as netting and set-off.

## **Session 5: Cross-border Elements of Bank Insolvency**

58. The *Chair* introduced the topics to be discussed: (i) arrangements to recognise or give effect to foreign insolvency measures and public policy exceptions; (ii) cross-border coordination between national courts and/or administrative authorities; and (iii) the entity-view vs. the group-view in insolvency proceedings.

59. It was generally accepted that the cross-border dimension in the banking insolvency and resolution arises from features that are typical for banking: foreign subsidiaries or branches, assets abroad, securities held in foreign CSDs, and claims that are subject to the governing law of another jurisdiction. Even for smaller banks, these features may give rise in insolvency proceedings to legal uncertainty about coordination between proceedings and the extent to which foreign measures are effective in the country where assets or claims are located.

### **1. Arrangements to recognise or give effect to foreign insolvency measures**

60. The discussion outlined the existing types of arrangements for recognising or giving cross-border effect to insolvency measures, and the requirements and constraints that apply. For example, the way jurisdictions apply the doctrine of international comity may vary and the process can be very time-consuming. The availability of statutory recognition or other tools to give effect to foreign insolvency measures may depend on a range of factors, including the nature of the cross-border dimension (e.g., assets located in the foreign jurisdiction or assets governed by the foreign jurisdiction's law) or whether the foreign jurisdiction has measures that correspond to those it is being asked to recognise. Recognition may also be constrained by the legal mandate of the competent body in a particular case or the considerations they may take into account. It was noted that it would be helpful to understand current laws and practises in this area, and the range of issues and challenges that are encountered.

61. In the absence of statutory measures, contractual measures have a significant role: for example, the ISDA-led initiative to include contractual recognition clauses for stays on early termination rights under specified resolution regimes in standard derivatives documentation. Such clauses now apply to over 90% of derivatives contracts worldwide. Requirements in certain jurisdictions (e.g. Switzerland) for foreign-issued bail-in eligible debt to contain contractual recognition clauses by which a foreign creditor acknowledges the jurisdiction of the issuer's home

resolution authority were also noted as a measure for supporting the cross-border effectiveness of resolution.

## **2. Cross-border coordination between courts and administrative authorities**

62. It was suggested that any cross-border coordination framework, to be effective, should clearly cover cases where a jurisdiction is asked to recognise a foreign action that is not within its own legal framework. It must also include an explicit legal basis for coordination, irrespective of whether the competent body is a court or an administrative authority.

63. Any framework should include tools or procedures to give effect to foreign insolvency measures. This could be achieved, for example, by establishing a principle of recognition and clarifying the scope thereof by including a list of the decisions under the relevant legal frameworks that may be subject to recognition. However, it was acknowledged that any recognition principle must be subject to limits that accommodate public policy concerns in the jurisdictions covered by the framework. The grounds for refusing recognition should be limited, as clearly defined as possible, and adapted to the measures for which recognition is being sought. The grounds for refusal should incorporate concerns such as equitable treatment of creditors or the expected recoveries of domestic creditors in a local procedure (which may be an issue to the extent that creditor rankings are not harmonised).

64. Another option proposed was the adoption of guidelines by authorities and/or courts that establish commonly agreed structures for information-sharing, giving notice, parallel sessions, etc.<sup>2</sup> This approach is based on an agreement between the relevant competent bodies and may not have a statutory basis. However, it would have a similar content and could be an effective first phase, at least at a regional level. Irrespective of the format, a framework would need to provide for involvement of host authorities in the home proceedings, including such features as notice, access to courts and standing.

65. It was also noted that more work is needed to understand and address the case where a judicial decision in one country needs to be implemented or matched by an administrative authority in another, or vice versa. (This contrasts with cases where a court decision in one country is recognised and given effect by the courts in a different jurisdiction, or where an administrative resolution authority implements decisions of its counterpart in another country. There is currently greater understanding of the mechanisms that apply in such cases.)

## **3. Entity and group view and treatment of intragroup transactions**

66. There was broad agreement that the typically integrated group structure of banks, coupled with their cross-border operations, makes proceedings under territorially- and entity-focused insolvency laws particularly challenging. There was some discussion of the problem that intra-group support measures may represent in insolvency. Financial support measures, some of which may incorporate recovery plans or 'living wills', may include guarantees, loans or equity arrangements, debt-equity swaps or cancellation of debt. In addition, operational support measures, such as a common IT system or common legal services or a tax unit, are also significant. Such financial or operational measures may collide with insolvency law. For example, a debt-equity swap may not work under the applicable insolvency law, or transfers made during the suspect period may be avoided in an insolvency proceeding. There also may be an inherent clash between intragroup support measures and the obligation of each insolvency administrator to maximise the value of the

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<sup>2</sup> Recent examples of this include the Guidelines of the Judicial International Network of courts ("JIN"), and similar guidelines been adopted by courts in Singapore, New York and Brazil.

estate. Furthermore, divergencies exist in the ranking of intra-group financing in the creditor hierarchy (see par. 50).

67. It was suggested that options that could address the integrated nature of banking groups include procedural consolidation or, more ambitiously, substantive consolidation. The latter however may disadvantage some creditors who have contracted with a specific group entity. Branches could be included in the legal entity liquidation (as under CIWUD); group insolvency plans could be recognised; or intragroup financial support measures could be subject to a safe harbour so that they can no longer be avoided in insolvency. The latter was highly recommended by some participants.

68. **There was broad support for including cross-border issues in the proposed project.** It was noted that although the cross-border dimension is key to an effective framework, existing cross-border procedures may not work well and there is a lack of international guidance in this area. The UNCITRAL Model Laws on Cross-border Insolvency and on Enterprise Groups provide a carve-out option for banks and the EU measures such as the Credit Institutions Winding Up Directive (“CIWUD”) do not apply outside the EU. Several participants referred to the ‘gap’ that currently exists, and which may hamper effective bank failure management.

69. Several participants referred to the existing work on this topic, including the 2010 report of the BCBS Cross-border Bank Resolution Group and the 2015 FSB Principles for Cross-border Effectiveness of Resolution Actions. The latter contain practical proposals for implementing Key Attribute 7.5, which specifies that jurisdictions should have transparent and expedited processes to give effect to the foreign resolution measures by recognition or by taking measures under the domestic resolution regime. The Principles cover statutory and contractual mechanisms for recognition of foreign resolution measures, and have been relied upon by a number of countries in implementing resolution frameworks. For example, the Swiss framework confers discretion on FINMA (which is responsible for dealing with failing and insolvent banks) to recognise foreign bank insolvency measures provided specified conditions are met. Those conditions do not include reciprocity.

70. Various views were expressed about the nature of an instrument to support cross-border recognition and coordination. While the ideal might be a multi-lateral treaty or harmonisation of insolvency frameworks, this was generally acknowledged to be unrealistic. The preferred format might therefore be a soft law instrument, perhaps in the shape of a Model Law, that would include at a minimum the ability, but ideally the duty, to cooperate provided certain conditions are met. More broadly, it was argued that a bespoke Model Law for banks would need to go beyond what is provided in the Key Attributes and accompanying Principles, to cover both liquidation and resolution, and to include groups rather than only single entities. The work should also consider territorial divisions within certain federal countries.

71. However, some urged caution, arguing that a comprehensive proposal of that nature is unlikely to be feasible or acceptable to many countries, and it might be more realistic to pursue a simpler, albeit less complete, project. It was also noted that many of the points made regarding recognition and enforcement are mainly associated with resolution, and may be less relevant for a project focused on liquidation. Cross-border recognition should be easier in the context of generic liquidation proceedings with special rules for banks. A participant noted that collective proceedings under insolvency law might be sufficient.

72. There was some discussion of the challenges of developing any kind of Model Law on cross-border insolvency arising from differences in national contract and property law and legal traditions, but the need to address the lack of harmonisation in insolvency and liquidation, which is particularly problematic in certain jurisdictions, remains. Some form of harmonisation that goes beyond conflict of law rules would be needed, but while resolution procedures have been harmonised in the European Union and as an international standard through the Key Attributes, harmonisation of insolvency rules

has not been attempted to date. However, several participants expressed optimism that that this could be achieved, and a project to do it was timely.

73. The need to work closely with the FSB was emphasised. The cross-border dimension inevitably leads to the areas of work that authorities have been developing for the last decade under the Key Attributes. Work on these issues would proceed in close cooperation with the relevant international standard setters and international bodies. It was also expected that the organisations and experts that have been involved in the FSB work would be involved in the drafting of any instrument, best practices or principles, which should ensure consistency.

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