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International Coordination in Cross-Border Bank Bail-ins: Problems and Prospects

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Bail-in is quickly becoming a predominant approach to banking resolution. The EU Bank Recovery Resolution Directive and the US Federal Deposit Insurance Corporation Single Point of Entry Strategy envisage creditors' recapitalizations to resolve a failing financial institution. However, this legislation focuses on the domestic aspects of bail-in, leaving the question of how it would be applied to a cross-border banking group open. Cross-border banking resolution has been historically subject to coordination failures, which resulted in disorderly resolutions with dangerous systemic effects. The goal of this article is to assess whether bail-in would be subject to the same coordination problems that affect other resolution tools, and to discuss the logic of international legal cooperation in bail-in policies. We demonstrate that in spite of the evident benefit in terms of fiscal sustainability, bail-in suffers from complex coordination problems that, if not addressed, might lead to regulatory arbitrage, lengthy court battles and, ultimately, disrupt resolutions. We argue that only a binding legal regime can address those problems. In doing so, we discuss the recent Financial Stability Board's proposal on Cross-Border Recognition of Resolution Action, and the role of international law in promoting cooperation in banking resolution.

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1. INTRODUCTION

One of the legacies of the recent financial crises is a widespread aversion to government-funded bank bailouts. In its July 2011 consultative document, the Financial Stability Board requested members "to ensure that the costs of resolution are borne by the firm's owners (shareholders) and other unsecured and uninsured creditors, rather than by taxpayers".[1] In response, regulators in Europe and in the United States devised new regulatory frameworks for banking resolution that explicitly banned or sought to minimize the use of public money

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[1] Financial Stability Board, "Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines" (19 July, 2011).

to recapitalize failing banks, thus transferring the costs of recapitalizing a failing bank to the financial sector.[2]

In this context, bail-in is perhaps the most important regulatory innovation. Section 5 of the recent 2014 EU Bank Recovery and Resolution Directive (BRRD), and Section II of the US Dodd-Frank Act, envisage forced private sector recapitalization as one of the main crisis resolution tools, albeit under different forms.[3] Other major financial centres are also considering or implementing bail-in within their national crisis resolution frameworks.[4]

Legally speaking, bail-in is a statutory power in the hands of resolution authorities that permits them to write down part of the bank's liabilities or to convert them into equity in order to preserve the bank as a going-concern. In this regard, it is important to distinguish bail-in from Contingent Convertible Debt Obligations – commonly known as CoCos. Both mechanisms rely on the same strategies to recapitalize a failing bank. However, CoCos are financial instruments in which the trigger event and the conversion rate are identified in advance in the debt contract. Therefore, supervisory authorities do not play any role in the forced conversion.[5]

What differentiates bail-in from other resolution tools is that the recapitalization of the failing bank is achieved without resorting to public money or external investors. Under the conversion option, when the bank is near the point of non-viability (i.e. the equity is almost wiped out), the bank's junior and senior financial creditors are *forced* to become shareholders

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[2] For instance, § 214 of the Dodd-Frank Act states that "No taxpayer funds shall be used to prevent the liquidation of any financial company…".

[3] The Dodd-Frank Act put in place a specific mechanism to resolve failing banks called "Orderly Resolution Authority", administered by the Federal Deposit Insurance Corporation (FDIC). In implementing the requirements of Dodd-Frank, the FDIC chose to adopt the Single Point of Entry Strategy, in which the recapitalization takes place after the failing bank is divided into a good and bad bank (the so-called "closed bank" model). Under the EU BRRD Chapter IV, Section 5, the recapitalization can take place directly in the failing bank (open bank model). See, C. Goodhart and E. Avgouleas, "A Critical Evaluation of Bail-in as a Bank Recapitalization Mechanism (2014), *Centre for Economic Policy Research Discussion Paper 10065* (2014); J. N. Gordon and W.G. Ringe, "Bank Resolution in the European Banking Union: A Transatlantic perspective on What It Would Take", *University of Oxford Legal Research Paper Series No 18/2014* (2014), pp. 19-20.

[4] Among them, Switzerland and Japan.

[5] See, C. Pazarbasioglu, J. Zhou, V. L. Lesle', and M. Moore, "Contingent Capital: Economic Rationale and Design Features", *IMF Staff Discussion Note SDN/11/01, International Monetary Fund* (January 25, 2011), p. 9.

of the bank. Thus, the bank would have liabilities reduced and its debt-equity ratio restored to viable levels. This should enable the bank to continue its operations while restructuring its business. Under the write-down option, the authority can discretionally cancel some of the bank's outstanding debts. By doing so, the bank's debt-equity ratio is likewise restored to a viable level.

Bail-in minimizes many of the problems of bailouts and reduces the too-big-to-fail (TBTF) problem.[6] First, it eliminates the fiscal and political problems associated with the use of taxpayers' money. Moreover, according to the Financial Stability Board, bail-in "reduces moral hazard and enhances market discipline while minimizing the losses of value and economic disruptions associated with insolvency proceedings".[7] In this regard, Coffee argues that bail-ins can act as an implicit tax on banks, and as a privately funded crisis resolution fund, thereby reducing the incentive of shareholders to favour a socially undesirable level of leverage.[8] Furthermore, according to the IMF, the threat of equity dilution for shareholders when a bank issues contingent debt instruments should, in theory, induce shareholders to insist upon more prudent corporate governance, thereby reducing excessive risk taking.[9]

Given these clear advantages, bail-in is quickly becoming one of the most important crisis-resolution tools in the arsenal of financial authorities. However, at present, legislation principally addresses the domestic aspects of bail-in, leaving international coordination to broad guidelines that only partially address the practical problems of crisis resolution.[10] Experience demonstrates that it is precisely the absence of a detailed and binding cooperation

[6] For an overview of the problems posed by bailouts see, Y. Chen and I. Hasan, "Subordinated Debt, Market Discipline, and Bank Risk", 43 *Journal of Money, Credit and Banking* (2011); G. Dell'Ariccia and L. Ratnovski, "Bailouts and Systemic Insurance", IMF Working Paper 13/233 (2013); G. G. Kaufman, "Too big to fail in banking: What does it mean?", 13 *Journal of Financial Stability* (2014).
[7] Financial Stability Board, *supra* n. 1
[8] J. Coffee Jr., "Bail-Ins versus Bail-Outs: Using Contingent Capital To Mitigate Systemic Risk", *The Center for Law and Economic Studies Working Paper 380* (22 October 2010), p. 6.
[9] Pazarbasioglu et al, *supra* n. 5, p. 7.
[10] For instance, Title VI of the EU Bank Recovery and Resolution Directive – "Relation with Third Countries" – simply provides general guidance on international cooperation.

agreement that often derails the resolution of a multinational bank. In the absence of an international regime, it is still uncertain how bail-in could be applied to Global Systemically Important Banks (G-SIBs). Cross-border banking resolution has been historically subject to coordination failures.[11] Without a proper legal regime, it is likely that in the event of a crisis in one of those banks, bail-in would create panic and ultimately lead to a Lehman Brothers-like disorderly resolution.[12]

Coordination is not easy. From an international law perspective, bail-in is a very complex mechanism. First and foremost, bail-in reduces the legal protection usually accorded to bank creditors. Secondly, with a bail-in, the conversion of debt into equity or the write-down of the debt takes place at the supervisor's discretion. Within the limits set by national legislation, the competent authority can decide autonomously when to trigger the bail-in procedure and the conversion rate or quantum of the write down.[13] From a supervisor's perspective, resolution authorities can judge independently when the bank is reaching the point of non-viability, and which creditors should bear the losses. However, this can also potentially increase the risks of asymmetries in national legislation, regulatory arbitrage, and the prospects of litigation.

This article explores whether bail-in will be subject to the same coordination problems that affect other crisis-resolution tools and, if so, how international cooperation could be structured. There are two issues in particular that need to be addressed: how to ensure creditors' cooperation, and how to minimize supervisory conflicts. The economic literature

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[11] D. Schoenmaker, *Governance of International Banking: The Financial Trilemma* (Oxford, Oxford University Press 2013), pp 72-87.

[12] John Plender, "Financial Reforms Will Make the Next Crisis Even Messier", Financial Times (1 September 2014).

[13] Most of the literature suggests that bail-in would be better used to sustain the stability of the bank when the bank is almost on the point of non-viability or even balance-sheet insolvent. Therefore, bail-in takes place at a later phase of the resolution procedure, compared to CoCos. See, Financial Stability Board, *supra* n. 1; and, J. Zhou, V. Routledge, W. Bossu, M. Dobler, N. Jassaud, and M. Moore, "From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions", *IMF Staff Dicussion Note SDN/12/03*, International Monetary Fund (2012), p. 11.

demonstrates that in a banking crisis supervisors tend to protect their national interests and creditors focus on their investment returns with little regard for socially optimal objectives. A workable international legal regime for bail-in needs to minimize those distortions.

At present, an international legal regime is still in the consultative phase. Before the November 2014 G-20 Summit, the Financial Stability Board issued a Consultative Document proposing a few regulatory options to reduce the problems associated with financial nationalism in banking crisis resolution and ease international cooperation in this critical area.[14] We will comment on this proposal.

The paper is in five sections. Following this introduction, the second section analyses the literature on cross-border banking resolution, and introduces the international implications of bail-in. The third section discusses the question of creditors' protection and regulatory arbitrage. The fourth section analyses coordination challenges between home and host authorities during a bail-in and the fifth section concludes.

2. COORDINATION CHALLENGES IN CROSS-BORDER BANK RECAPITALIZATIONS

To understand the coordination problems of an international bail-in, it is first necessary to analyze briefly the challenges supervisory authorities faced under previous regimes. As for any commercial firm, the first supervisory response to a financial institution that has reached the point of non-viability should be liquidation. The bank should be put into receivership and its assets sold and distributed to creditors according to their seniority. However, as the Lehman Brother's bankruptcy demonstrated, for a number of economic and legal reasons, G-

[14] Financial Stability Board, "Cross-border Recognition of Resolution Action", Consultative Document (29 September 2014).

SIBs are often ill suited for a normal bankruptcy.[15] Unlike commercial firms, banks cannot operate as going concern entities during liquidation because creditors will refuse to deal with them. As Gleeson succinctly put it, "the essence of a bank is solvency, and an insolvent bank is by definition not a going concern".[16] Furthermore, when a bank is TBTF, the consequences of its collapse would transcend the impact on individual creditors and negatively affect the entire financial system.

In this situation, supervisors must guarantee that the bank will continue its operations without disrupting the financial system while it restructures its business model and balance sheet. In general terms, an insolvent bank has little capital to sustain its operating losses. Hence, the only way for supervisors to keep a TBTF bank as a going concern is by injecting new capital into the balance sheet. Capital injections are usually achieved by organizing private sector rescues or by relying on government interventions. However, these operations are subject to coordination problems, which sometimes lead to disorderly resolutions and systemic spillovers.

2.1 Creditors' Rescues

Private sector resolution can take many forms, from forced mergers to the separation of the bank into a good and a bad bank. In all cases, a private investor agrees to become a shareholder of the failing bank. However, experience demonstrates that few private investors will take the risk of becoming shareholders of a bank in distress. Moreover, a systemically important multinational bank would not be suitable for a separation as it would be too complex to organize the rescue across different states and business lines.[17] In this situation,

[15] Clifford Chance, "Bank Resolution and Bail-ins in the Context of Bank Groups" (December 2011), p. 6-7.
[16] S. Gleeson, "Legal Aspects of Bank Bail-Ins", *Special Paper 205, LSE Financial Market Group Paper Series* (2012), p. 4.
[17] Ibid, p. 7.

the only private parties likely to cooperate in the resolution are the bank's financial creditors.[18]

Central banks have sometimes relied on creditors' interventions when organizing "lifeboat" operations.[19] This technique is, in essence, a *voluntary* recapitalization of the bank by some of its creditors. This model, however, presents various problems that make success difficult. In the absence of predetermined coercive mechanisms, the interest of creditors in participating in the rescue varies from creditor to creditor. Junior creditors would suffer heavy losses if the bank goes bankrupt, as they would rank last in the creditors' hierarchy before equity holders. Their incentives to agree to an equity infusion would arguably align with that of financial authorities in minimizing systemic risk. Senior financial creditors, on the contrary, may be better off in a bankruptcy scenario, because their credit would rank first during liquidation, possibly before depositors. If they agree to write down their debt they may incur a net loss. Similarly, if they become equity holders, they may risk losing part of their investment in the long term.

In this situation, the preferable strategy for senior creditors may be to not cooperate in the recapitalization, and let junior-creditors or the resolution authority work-out how to keep the bank going. In a TBTF bank, the incentives are further misaligned as senior financial creditors know if they do not agree within a few days the bank will probably be bailed out. [20]

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[18] It is important to highlight the distinction between (1) banking creditors (depositors), (2) investment creditors (swap and credit counterparties, and short term lenders), (3) financial creditors (long-term bondholders and unsecured finance providers). See, Clifford Chance, *supra* n. 15; See also, Goodhart and Avgouleas, *supra* n. 3, p. 25.

[19] Rosa Maria Lastra reports that this technique was used by the English authorities during the secondary bank crisis of 1974. See, R. M. Lastra, "Cross-Border Bank Insolvency: Legal Implications in the Case of Banks Operating in Different Jurisdictions in Latin America", 6 *Journal of International Economic Law* (2003), pp. 85-86; similarly, in 1998 the US bank Long Term Capital Management (LTCM) was rescued by a lifeboat operation involving the biggest New York banks.

[20] The stabilization phase during a resolution must necessarily take place over the weekend, when markets are closed. The extremely short time span does not allow individuating all creditors of a large banking conglomerate in a few days. See, Clifford Chance, *supra* n. 15, p. 4.

Since the optimal strategy for these creditors is not to cooperate, creditors' rescues are extremely difficult to implement.

2.2 Bailouts

Another option is a bailout. When a financial institution is bailed out, it is the government – usually the Treasury – that rescues the failing bank through the use of taxpayers' money. Despite the moral hazard and political challenges attached to their implementation, bailouts offer a quick and easy solution to the failure of a systemically important bank. However, when it comes to resolving a G-SIB with operations around the globe, bailouts become extremely challenging. The core problem is that bailout operations do not have the advantage of an ex-ante legal framework to distribute the burden of the recapitalization. In the words of Freixas, supervisory authorities mostly rely on ex-post "improvised cooperation" that often leads to a disorderly resolution.[21]

In the context of an international bailout, economic theory suggests a country should choose to recapitalize a bank only to the extent that the gains of recapitalization in terms of domestic stability are equal to or higher than the costs in terms of fiscal resources. Hence, each country should simply factor in its own domestic gains and losses in the decision to recapitalize a bank.[22]

If a bank has equal importance in all countries where it operates, and if each supervisory authority has the same interest in recapitalizing the bank, the recapitalization should succeed. However, this will never be the case. Experience demonstrates states are often incentivized to understate their share of the problem in order to reduce their contribution to the

[21] X. Freixas, "Crisis Management in Europe", in J. Kremers, D. Schoenmaker and P. Wierts, eds., *Financial Supervision in Europe* (Cheltenham: Edward Elgar, 2003).
[22] Ibid., pp. 102-119; G. J. Schinasi and V. Gaspar, "Financial Stability and Policy Cooperation", *Banco du Portugal Occasional Papers 01-2010* (2010).

recapitalization.[23] The problem is compounded by the fact that the systemic importance of a G-SIB will vary in each of the countries where it operates.[24] So home and host supervisors will suffer from an asymmetry of incentives when it comes to deciding how the bank should be resolved. In this situation, the burden of recapitalizing the bank will usually fall disproportionately on the home authorities.

However, financial authorities are bound to a principal-agent relationship with their citizens that pushes them to focus primarily on the stability *of their own* national financial system.[25] The principal-agent relationship discourages national authorities from intervening to maintain the stability of the entire G-SIB in all its consolidated structure.[26] Since their only goal is to safeguard national interests - in terms of fiscal outlays or financial stability - home authorities will inject only the amount of liquidity necessary to guarantee domestic stability, thereby leading to a potentially suboptimal resolution procedure.[27]

The coordination problems faced by financial supervisors in the context of a cross-border bank bailout can be represented in game theory as a "Prisoner's Dilemma" situation.[28] For a globally optimal bailout, each state should intervene without considering its own individual

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[23] C. Goodhart and D. Shoenmaker, "Fiscal Burden-Sharing in Cross-Border Banking Crises", 5 *International Journal of Central Banking* 141 (2009), p. 142.
[24] S. Claessens, R. J. Herring, D. Schoenmaker, and K. Summe, "A Safer World Financial System: Improving the Resolution of Systemic Institutions", *Geneva Reports on the World Economy 12* (2011), pp. 29-32.
[25] M. Ojo, "The Changing Role of Central Banks and the Role of Competition in Financial Regulation during (and in the Aftermath of) the Financial Crisis", 17 *European Law Journal* 513 (2011); L. W. Pauly, "The Old and the New Politics of International Financial Stability", 47 *Journal of Common Market Studies* 955 (2009); A. Spendzharova, "Is More 'Brussels' the Solution? New European Union Member States' Preferences about the European Financial Architecture", 50 *Journal of Common Market Studies* 315 (2012).
[26] K. D'Hulster, "Cross Border Banking Supervision: Incentive Conflicts in Supervisory Information Sharing between Home and Host Supervisors", *World Bank Policy Research Working Paper 5871* (2011), available at http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-5871
[27] See, Schinasi and Gaspar, *supra* n. 22; G. J. Schinasi and P. G. Teixeira, "The Lender of Last Resort in the European Single Financial Market," in G. Caprio, Jr., D. D. Evanoff, and G. G. Kaufman, eds., *Cross-Border Banking: Regulatory Challenges* (Singapore, World Scientific 2006).
[28] See, Schoenmaker, *supra* n. 11, pp. 27-33; and Z. Kudrna, "Cross-Border Resolution of Failed Banks in the EU: A Search for the Second-Best Policies", *Institute for European Integration Research Working Paper No. 08/2010* (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1604402

gains. As in the traditional Prisoner's dilemma, where the two prisoners do not know what the other will do, in a real bailout situation without a clear and binding legal framework the two states do not know precisely how the foreign authority will respond. In this situation, each state has an incentive to free ride on the other and not to cooperate. If both countries decide not to cooperate, the G-SIB will be subject to a disorderly resolution, which increases systemic risk in both countries.[29]

2.3 The Role of Bail-In in Banking Resolution

Bail-in is, potentially, a very powerful tool in resolving a G-SIB because it could solve the coordination problems present in creditors' rescues and international bailouts.

First, in a bail-in the debt-to-equity conversion or write-down is compulsory - junior and senior creditors have no choice but to accept the supervisor's decision. Bail-in will therefore solve the free-riding problem present in voluntary creditors' rescues, while guaranteeing the bank a sizable debt reduction under otherwise unfavourable market conditions.[30] From a law and economics perspective, bail-in laws would realign the incentives of creditors towards a socially optimal equilibrium, similar to that of bankruptcy law.[31] Secondly, since in a bail-in taxpayers' contributions would be essentially excluded, home and host resolution authorities would not need to fight over the burden sharing of the recapitalization.

At first analysis, if all countries adopted a bail-in regime – as requested by the Financial Stability Board – the resolution of a G-SIB should not pose particular problems. However, in the next two sections, we will demonstrate that creating a workable bail-in regime for cross-

[29] Schoenmaker, Ibid., p. 29.
[30] R. de Weijs, "Too Big to Fail as a Game of Chicken with the State: What Insolvency Law Theory Has to Say About TBTF and Vice Versa", 14 *European Business Organization Law Review* (2013).
[31] According to the creditors' bargain theory, the role of bankruptcy laws is to solve the common pool problems otherwise present in an insolvency, by providing a collective procedure that coordinates creditors' claim. See, T.H. Jackson, "Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain", 91 *Yale Law Review* (1982).

border banks will still present fundamental regulatory challenges, which will ultimately require very strong cooperation. These challenges can be divided into two main areas.

The first set of problems concerns regulatory asymmetries in creditors' protection and their role in promoting regulatory arbitrage. The bail-in of a multinational bank potentially involves multiple jurisdictions: (i) the home country where the bank is headquartered, (ii) the host countries where it has subsidiaries or branches; (iii) and the country where the parent bank or its subsidiaries have issued the liabilities subject to bail-in. Indeed, while small national banks tend to issue debt under local law, multinational banks are more likely to issue debt where it is most convenient, often in a third country – perhaps under New York or English law. Thus, from a legal perspective, an international bail-in has to address the incentives of a third country to conform to the bail-in requirements in terms of creditor's protection and capital market regulations.

A second set of problems concerns coordination between home and host authorities. In this regard, bail-in certainly solves the problems associated with public sector recapitalizations, but it would not change fundamentally the principal agent problem at the core of any cross-border banking resolution mechanism. In an international bail-in, the main concern of supervisory authorities will be to prevent the cost of recapitalization falling on local creditors.

3. CREDITORS' PROTECTION AND REGULATORY ARBITRAGE IN INTERNATIONAL BAIL-INS

Bail-ins resolve a bank in distress through a simple, yet powerful, accounting method: the conversion of (part of) the bank's debt into equity, or the write down of some of the bank's liabilities. Despite the relative simplicity of the concept, from a legal viewpoint, these

operations are complex, as they entail the sacrifice of creditors' rights.[32] Without legal certainty that the conversion or write down is legal, legitimate, and immediately effective, the bail-in will not achieve its objectives.[33] Thus, to make it work from a legal perspective it is necessary for the resolution authority to be given the statutory power to bail-in, and that creditors have accepted in their debt contract that they will waive their normal rights.[34] In a domestic bail-in in which the bank is national and the debt is issued under local law, this should not give rise to legal problems, as only one jurisdiction will oversee the entire procedure.

In a cross-border bail-in, however, the situation is very different. In this particular situation the law governing the debt instrument and the place where the bail-in takes place can easily be different. For instance, a German banking conglomerate might have issued debt under New York law in order to access a wider pool of capital or to benefit from a more favourable legal regime. To be feasible, the bail-in should apply to all liabilities of the ailing bank (in this case, the parent company), and therefore it should include these debts issued in another jurisdiction and governed by foreign law. This means that before starting the bail-in, the home supervisors (that initiate the procedure) must be certain that the creditors and authorities jurisdictionally competent for the debt – in this case, the US courts - will recognize and accept their decision to bail-in.

3.1 An Overview of the Main Legal Issues

In theory, the court with jurisdiction over the debt contract should recognize the validity of the home supervisor's intervention. However, experience demonstrates this is not straightforward.

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[32] Gleeson, *supra* n. 16.
[33] Ibid.
[34] Ibid.

In a normal international commercial bankruptcy the *lex fori concursus* principle would oblige foreign courts to recognize the decision taken by the authority that initiated the insolvency, irrespective of the law governing the contracts.[35] However, bank insolvency and resolution have been historically excluded from any meaningful international coordination, and any attempts to harmonize bank insolvency laws have so far failed. Bail-in would not technically qualify as an insolvency proceeding, but the problem of recognition would nonetheless remain.

According to Gleeson, bail-in could give rise to what English lawyers refer to as the "Metliss problem"[36] – the absence of legal recognition in the creditor's jurisdiction of the statutory intervention of home authorities.[37] The principle – which also applies in different forms and grades in other jurisdictions – is that you cannot alter legal rights under State A law by virtue of a foreign statute under State B law. For instance, bail-in conversions operated by German authorities on a German bank under German or EU law might not be recognized by the New York courts if the bonds were issued under New York law.[38]

From a purely legal viewpoint, the creditor's court would seek to ensure that creditors are not in a worse position than under local law. However, countries have historically had different approaches to insolvency that might lead to different levels of creditors' protection. For instance, in certain jurisdictions the concept of insolvency may not envisage a bank operating as a going-concern entity; the legal requirements for 'official administration' may differ with regard to the level of remaining regulatory capital; or the legislation may require

[35] See, UNCITRAL, "Legislative Guide on Insolvency Law" (2005), pp.69-75.

[36] *National Bank of Greece and Athens S.A. v. Metliss* [1958], UKHL [1958] A.C. 509 concerns the rights of English holders of Sterling bonds issued by the National Bank of Greece.

[37] Gleeson, *supra* n. 16, p. 12.

[38] Recently, in *Fir Tree Capital Opportunity Master Fund, LP v. Anglo Irish Bank Corp.* [2011] S.D.N.Y. [2011] No. 11 Civ. 0955 the plaintiff (an investment fund) tried to sue AIR under New York law (where the bonds were issued) for the violation of its creditor's rights following the nationalization of the bank by the Irish authorities. In the first phase, the New York court dismissed the claim, arguing that the nationalized bank was granted sovereign immunity as a foreign state entitled under the US Foreign Sovereign Immunities Act.

the presence of a public interest. In certain jurisdictions, the law may not allow creditors to be discriminated against or treated unfavourably compared to (pre-insolvency) shareholders. In practice, this means that in those jurisdictions bail-in could be initiated only when all shareholder equity is diluted.[39] Most importantly, in some jurisdictions, without the explicit consent of the creditor and without due process,[40] the debt write-downs may violate basic property rights.[41]

In other circumstances, the fact that a bail-in is recognized as an insolvency might authorize creditors to require the authority to undo certain transactions which occurred before the bail-in procedure, or to close out their agreement based on the fact that there is a debt restructuring.[42] In the context of a banking resolution procedure, which must take place over a weekend, the possibility that a court might suspend the bail-in until the claims are settled would destroy the very purpose of the procedure, which is to make the bank a going concern able to operate during restructuring.[43]

3.2 Impact on Litigation and Bank Funding Strategies

Before discussing how to achieve coordination, it is necessary to explain the consequences of not having international rules in this area. In the absence of coordination, regulatory asymmetries would have a fundamental impact on the behaviours of creditors and on the funding strategies of banks. To understand why, it is useful to analyse the business dimension of bail-in.

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[39] Zhou et al. *supra* n.13, p. 11.
[40] The 5th Amendment of the US Constitution prescribes that nobody can be deprived of their property without due process.
[41] Gleeson, *supra* n. 16, p. 13.
[42] Zhou et al. *supra* n.13, p. 14.
[43] In this regard, the IMF recognizes that for a quick and effective resolution procedure, it would be advisable to limit the role of the courts. Ibid., p. 12.

3.2.1 Holdouts and Litigation

In order to work, the bail-in must transfer the costs of the recapitalization outside of the banking sector so that the losses are not simply transferred to other banks. The only entities that have the willingness and ability to purchase debt potentially subject to bail-in[44] are sophisticated financial investors with long-term strategies and deep pockets: hedge funds and pension funds, which can distribute the risk of bail-in across their large asset portfolios.[45] Having a concentration of bonds capable of bail-in in the hands of a restricted class of sophisticated creditors would induce creditors to resort to all possible means to protect their interests in times of crisis.[46]

The classic argument for bail-in posits that creditors would be incentivized to monitor the firm and prevent it from taking excessive risks, similar to what equity holders in theory do.[47] Implicit in this argument is that, in times of trouble, creditors would accept the conversion or the write-down. However, experience with sovereign debt and bank bankruptcies suggests bank creditors would fight for every cent of their investments by engaging in long legal battles.[48] Another possible scenario is that creditors would sell their debts to vulture funds

[44] In this regard it is important to stress that under EU law (Article 34 of the BRRD), bail-in could be in theory stretched to apply to uninsured bank deposits. However, it would follow a strict seniority rule and, presumably, it would be applied only to junior creditors and senior financial creditors.

[45] For instance, on the 4th of August 2014, the UK Financial Conduct Authority has officially prohibited ordinary investors from buying CoCos. See, E. Dunkley, "FCA to Restrict Sale of 'cocos' to Individual Investors", *Financial Times* (5 August 2014). Similarly, on the 31 July 2014 the European Banking Authority has warned banks against selling CoCos directly to consumers as a standard financial product.

[46] Various authors have argued that non-insured senior debt have incentive to sell their assets if not given enough guarantees. See, Goodhart and Avgouleas, *supra* n. 3

[47] Pazarbasioglu et al, *supra* n. 5, p. 7

[48] Ivo Welch suggests that banks would strongly contest priority in financial distress of a nonfinancial corporation if they were junior. See, I. Welch, "Why is Bank Debt Senior? A Theory of Asymmetry and Claim Priority Based on Influence Costs", 10 *Review of Financial Studies* (1997), p. 1210

specialized in distressed debt at the first sign of a problem.[49] In this case, Goodhart and Avgouleas argue that the likelihood of litigation would be even higher.[50]

This argument is supported by a basic political economy analysis. In a bailout, the costs of the recapitalization are borne by a diffuse and uncoordinated constituency – the taxpayers. In a bail-in, however, the costs of the recapitalization are borne by a very cohesive group: investment funds. As Goodhart and Avgouleas argue, experience demonstrates that when losses are concentrated in a small class of creditors (with huge financial resources at their disposal), such creditors are more likely to oppose the conversion or the write down and thereby block the bail-in.[51] The recent resolution of Portugal's Banco Espirito Santo highlights precisely this problem. Following forced losses on their credits to Banco Espirito Santo, a group of hedge funds has filed a legal challenge against the Portuguese Central Bank to recover the funds lost as a result of the bank's restructure.[52]

Economic literature demonstrates that creditors' battles could lead to a race to the bottom in litigation and to a suboptimal and very costly resolution procedure. In analysing the costs of creditors' battles during a bankruptcy, Hardy argues that claimants do not normally care about the lobbying costs of others, and therefore bear only a small part of the cost of delaying the resolution.[53] Therefore, from a law and economics perspective, an individual legal action only generates negative externalities, as the marginal cost of initiating a legal battle would not change for the single claimant. For example, if one claimant takes legal action, others may feel compelled to do the same to protect their interest. The resolution process may be further delayed, during which time the underlying assets may deteriorate further.[54] In line

[49] Goodhart and Avgouleas, *supra* n. 3, p. 27.
[50] Ibid., p. 29.
[51] Ibid., p. 30.
[52] Martin Arnold, "Investors File Legal Challenge over Portugal's BES Rescue", *Financial Times* (November 1, 2014).
[53] D. Hardy, "Bank Resolution Costs, Depositor Preference, and Asset Encumbrance", *IMF Working Paper WP/13/172* (2013), pp. 12-13.
[54] Ibid., pp. 12-13.

with this argument, Alesina and Drazen argue that bankruptcy proceedings often lead to a painful "war of attrition" in which each claimant has an incentive to endure the losses in the hope that others will drop out first and leave a disproportionate share to the survivor.[55]

Litigation would, in turn, reduce the benefits of the bail-in, as it would increase costs and undermine market confidence in the success of the bail-in procedure. Even a few court decisions favouring creditors would likely drive the bank bond market towards non-complying jurisdictions. Ultimately, supervisors may be required to payoff creditors as in a normal bailout. This would undermine the very purpose of bail-in, which is to reduce moral hazard and prevent taxpayers from bearing the cost of a bank failure.

3.2.2 Regulatory Asymmetries and Arbitrage Opportunities

A core tenet of law and finance theory[56] is that increasing creditors' protection decreases the cost of financing for firms.[57] In other words, investors are willing to receive a lower return on their investment – i.e. lower interest rates – if they have legal protection against expropriation.

Bail-inable debt is, by its very nature, risky. Interest rates for such debt would thus be proportionally higher than for a normal bond, as investors would demand a higher return for their investment. In this situation, the easiest way for banks to minimise the cost of credit would be to issue bail-in debts in locations where creditors are more protected or where it is

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[55] A. Alesina and A. Drazen, "Why Are Stabilizations Delayed?", 81 *American Economic Review* (1991).
[56] See, K. Pistor, "A Legal Theory of Finance", 41 *Journal of Comparative Economics* (2013).
[57] The economic literature on capital markets is extremely vast. See, C. P. Himmelberg, R. G. Hubbard, I. Love, "Investor Protection, Ownership, and the Cost of Capital", *World Bank Policy Research Working Paper* 2834 (2002); A. Shleifer and D. Wolfenzon, "Investor Protection and Equity Markets", 66 *Journal of Financial Economics* (2002); R. La-Porta, F. Lopez-de-Silanes, A, Shleifer, and R. Vishny, "Investor Protection and Corporate Governance", 58 *Journal of Financial Economics* (2000).

easier to initiate a legal battle.[58] Knowing that the conversion would be less likely, creditors should reduce their credit costs accordingly. Arguably, this would amount to an implicit subsidy, similar to what the bank would enjoy with a bailout.

This conclusion is in line with the findings of Holthausen and Rønde, who analysed the behaviours of a bank in a two-country bankruptcy scenario. First, they demonstrated that a bank conglomerate is more likely to select as its headquarters the country that has a more favourable bankruptcy law and which is more inclined to support the bank in time of distress. Second, they analysed the bank's investment decisions and showed that the bank distributed its assets strategically between the two countries so as to reduce the likelihood of bankruptcy. Essentially, the bank tried to become TBTF in the country where supervisors would be more likely to bail it out.[59]

3.3 Regulatory Competition in Creditors' Protection Policies and the Role of Law

Addressing regulatory asymmetries is not impossible, but it does require full cooperation.[60] There are various ways to solve some of the problems outlined above. In order to minimize the impact of bail-in on creditor's rights it would be advisable for bail-in legislation to include the principle that no creditor should be worse off than what it would have been had the bank entered into formal liquidation. Article 74 of the EU Directive on Bank Recovery and Resolution contains precisely this principle. In practice, the creditors that have recovered an amount inferior to what they would have under liquidation can ask for compensation from the bail-in authority after the procedure is completed. More complex problems – such as the

[58] M. Nieto, "Third Country Relations in the Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions", *Banco de Espana Documento N. 1409* (2014).
[59] C. Holthausen and T. Rønde, "Cooperation in International Banking Supervision", *ECB Working Paper 316* (2004).
[60] For instance, similar issues had been deal with under the UNCITRAL Model Law on Cross-Border Insolvency, which, however, explicitly excludes banks.

violation of fundamental creditors' rights – require the introduction of a model law or a treaty.

The first proposal for such a solution came in 2012 from the Institute of International Finance (IIF), which proposed an international treaty that would harmonize bank resolution and insolvency laws.[61] More recently, immediately before the Brisbane G-20 Summit, the FSB issued a consultation paper discussing other possible options for coordinating cross-border banking resolution actions.[62] The FSB document acknowledges the difficulties associated with a multilateral treaty and proposes a two-step solution instead. The first step involves a contractual approach, whereby banks agree to be bound by action taken by foreign resolution authorities.[63] Financial institutions would insert into derivatives contracts clauses that give local courts the power to enforce a temporary stay on early termination rights.[64] The second step involves resolution authorities adopting statutory changes in which they commit to recognize foreign resolution actions as long as they meet certain core standards.[65] Unlike the multilateral Treaty proposal by the IIF, the FSB suggestions rely on bilateral mutual recognition agreements between resolution authorities, which are somewhat easier to negotiate.

3.3.1. The Logic of Legal Coordination

[61] Institute for International Finance, "Making Resolution Robust – Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions" (June 2012)
[62] Financial Stability Board, *supra* n. 14.
[63] Financial Stability Board, *supra* n. 14, pp. 11-15.
[64] On the 11 October 2014, the International Swaps and Derivatives Association has announced a Protocol to the ISDA Master Agreement, whereby counterparties agree to the cross-border enforceability of temporary stays on early termination and cross-default rights in over-the-counter (OTC) bilateral derivatives contracts.
[65] This was first proposed by the IMF. See, Zhou et al. *supra* n.13, p. 18.

In order to implement such solutions, it is necessary to consider the conditions under which countries would be willing to give up part of their sovereignty to accommodate the need of foreign authorities to maintain the stability of their financial system.

In their seminal study, Dell'Ariccia and Marquez analyse how competition between regulators influences regulatory standards.[66] According to their model, regulators would choose the regulatory framework that maximises domestic interests, without internalizing the externalities of their policies. Thus, in the absence of a centralized regulatory framework, competing regulators would choose not to cooperate by adopting suboptimal regulatory standards. Coordination would be possible only when incentives are perfectly aligned.[67] Accordingly, countries with similar regulatory policies and underlying market dynamics are more likely to cooperate and level up the regulatory playing field.[68] For instance, the US Federal Deposit Insurance Corporation (FDIC) and the Bank of England (BoE) have in principle agreed to coordinate their resolution frameworks, although the details are still unclear.[69] US banks have around 70% of their foreign assets in the UK.

G-SIBs operate in multiple jurisdictions and are thus subject to different regulations. In the absence of regulatory coordination, the most drastic option for supervisory authorities would be to force banks to issue their debt in the jurisdiction where any bail-in would take place – essentially, under local law. Alternatively, banks may be allowed to issue debt in countries that expressly recognize bail-in powers. This is the approach currently adopted by the European Union. Article 45(5) of the EU BRRD states that when the debt is governed by the law of a third country law, the bank must demonstrate that the third country authorities recognize bail-in under local law and that the debt contains in the instrument an acceptance of

[66] G. Dell' Ariccia and R. Marquez, "Competition among Regulators and Credit Market Integration", 79 *Journal of Financial Economics* (2006).
[67] Ibid.
[68] Ibid..
[69] Federal Deposit Insurance Corporation and Bank of England, "Resolving Globally Active, Systemically Important, Financial Institutions" (10 December 2012).

the parent supervisor's power to convert it into equity. This means that, unless third country authorities recognize and conform to the home country requirements, all the long term junior and senior debt issued by European banks will need to be subject to EU law, and therefore issued in European capital markets.

The statutory approach taken by the EU anticipates the FSB's recommendations to force local banks to issue their debt in jurisdictions that guarantee the recognition of bail-in action.[70] This approach will probably reduce dangerous arbitrage opportunities and limit litigation. However, it could also lead to a progressive subsidiarization of the financial sector with reduced capital mobility, as banks would be forced to locate all their liabilities in a few jurisdictions. This could increase the systemic risk potential of banking failures, as the liabilities could be concentrated among fewer creditors. On the other hand, the experience with Basel capital adequacy rules suggests that it would probably be enough to have a few core jurisdictions agree on a common framework to push the level playing field into other non-core jurisdictions.[71] Simmons's theory on regulatory harmonization in capital markets argues that, in a situation of competition for capital, a few leading financial centres can act as a magnet for smaller players wanting to access credit.[72]

4. SUPERVISORY CONFLICTS

A second set of issues concerns the coordination between home and host resolution authorities. G-SIBs operate across the globe with hundreds of different subsidiaries and branches linked to each other in various ways such as by their funding, operating structure,

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[70] Financial Stability Board, *supra* n. 14, pp. 13-15.
[71] See, D. A. Singer, *Regulating Capital: Setting Standards for the International Financial System* (Ithaca and London, Cornell, 2007).
[72] B. A. Simmons, "The International Politics of Harmonization - The Case of Capital Market Regulation", 55 *International Organization* (2001); See also, S. Gadinis, "The Politics of Competition in International Financial Regulation", 49 *Harvard International Law Journal* (2008).

and brands.[73] If one part of the group fails, it is very likely the entire banking group would suffer some problems. If the failing bank is located in the parent company's jurisdiction or it is the parent company itself, coordination can be relatively straightforward. The home authorities would conduct the bail-in locally, while cooperating with the host authorities to minimize negative spillovers in the foreign operations.[74] However, when it comes to bailing-in foreign branches or subsidiaries with solvency problems, the procedure becomes more complex. In this situation, the main issue is to decide which authority is competent to initiate the bail-in and, for the bank, in which entity of the group the liabilities should be located.

4.1 Policy Alternatives in a Cross-Border Banking Resolution

In the context of a cross-border bank resolution procedure, the parent and host authorities have the primary goal of protecting their national interests, however perceived. During a bailout, this would usually entail minimizing fiscal outlays to what is strictly necessary to maintain domestic financial stability. In insolvencies, it would entail maximizing the return for local creditors. In economic terms, national authorities fail to internalize the externalities of their action on the global financial system.[75] In these situations, the lack of coordination between home and host countries often leads to a disorderly resolution and systemic spillovers.

The regulatory responses to this problem can be essentially divided into two basic approaches: universalism and territoriality. Under the first option, the role of supervising and resolving a multinational bank would be transferred to one single authority, which would be competent to maintain the stability of the banking group across its consolidated structure.

[73] Schoenmaker, *supra* n.11, pp.34-67.

[74] In this case, the main issue would be to ensure that the host supervisors do not sell the healthy subsidiary at the first sign of trouble in the parent. See, T. F. Huertas, "Safe to Fail", *LSE Financial Markets Group Paper Series Special Paper 221* (2013), p. 21.

[75] D. Schoenmaker and S. Oosterloo, "Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities," 8 *International Finance* (2005).

Under the second option, each segment of the bank would be supervised and resolved on a legal entity basis by the local competent authority.[76] Both approaches present different tradeoffs, which were conceptualized by Dirk Schoenmaker in his *financial trilemma.*[77]

The trilemma posits that, in a cross-border banking resolution, it is impossible for states to simultaneously achieve three policy objectives: financial integration, national financial sovereignty and financial stability. A universalist approach would guarantee supervisory coordination (and hence, stability) during the resolution process while maintaining the benefits of financial integration. However, to achieve this goal, it would be necessary for at least the host country to give up its national sovereignty over the crisis resolution process. Financial authorities would therefore be prevented from protecting their national interests in terms of creditors' protection or fiscal outlays. A territorial approach, on the contrary, would guarantee national control over the resolution procedure, but to the detriment of financial integration and capital mobility. Indeed, to be feasible, this option may require the banking group to be broken up along national lines in terms of funding and capital in order to guarantee sufficient resources during the resolution process.

Bail-in would not be different from other crisis-resolution mechanisms, as resolution authorities would also probably focus on maximising national interests. The difference is that in a bail-in the national interest would probably equate with the minimization of creditor losses and systemic risk containment. In this situation it is imperative to devise a cooperative framework that reduces supervisory frictions, while achieving the best result for the stability of the banking group.

The recent FSB proposal recommends that home and host authorities coordinate the resolution by enacting statutory reforms that impose on each resolution authority the obligation to support the resolution actions of a foreign authority in the context of its own

[76] Claessens et al., *supra* n. 24, pp. 83-100.
[77] Schoenmaker, *supra* n.11.

domestic system. Article 84 of the BRRD allows individual countries, the European Banking Authority, as well as the Single Resolution Board to sign cooperation agreements with foreign regulators. Similarly, Title II Section 210N of the Dodd-Frank Act authorizes coordination with foreign authorities. However, at present only the US FDIC and the BoE have agreed in principle to a supervisory agreement for international bail-in. Hence, the question is how coordination could be structured for the rest of the world.

4.2 Universalism vs. Territoriality in International Bail-Ins

In terms of cooperation, bail-in would confront financial authorities with the same trade-offs between capital mobility and sovereignty that are present in international bailouts and insolvencies. From a technical viewpoint, supervisory authorities would face a choice between (i) a universal approach to the bail-in – the Single Point of Entry (SPoE) – and (ii) a "territorial" approach – the Multiple Point of Entry (MPoE). This is not dissimilar from what they would face in a normal insolvency procedure. Choosing one of the two options would largely depend on the particular legal and organizational structure of each banking group and, ultimately, on the location of the liabilities.[78]

4.2.1 Single Point of Entry

Under the SPoE approach, the home authorities would force the parent company of a foreign branch/subsidiary to bear the entire cost of its recapitalization as part of the resolution process. The benefits of the SPoE are straightforward when a cross-border bank is organized as a parent bank with foreign branches, as the assets and capital of the branch are those of the parent bank. Furthermore, from a supervisory perspective, the home authorities are in the best

[78] See, Huertas, *supra* n. 74.

position to monitor and identify in advance possible problems.[79] However, the situation is different when a bank is organized with subsidiaries. Subsidiaries are independent entities in terms of capital and liquidity, and are supervised by the host authorities. Crucially, this means that subsidiaries are, in principle, free to issue their own debts.

From a practical perspective, for the SPoE to work for a subsidiary the parent or holding company would need to hold the equity and all (or a very large part) of the junior and senior liabilities subject to bail-in issued by the subsidiary.[80] This would not be difficult as most multinational banks already operate with substantial intra-group borrowings by the subsidiaries from the parent bank, which raises the funds. Whenever a subsidiary suffers a loss, the parent or holding company would absorb the loss by writing-down its loans to the subsidiary for an amount equal to the loss suffered by the subsidiary. The subsidiary would have its outstanding liabilities reduced for an amount proportionate to its loss, thereby returning to a situation of solvency. Alternatively, the parent company could convert its debt in the subsidiary into equity or simply inject new equity.[81]

Hence, in a SPoE it would be the operating parent or the holding company that would suffer losses in the balance sheet. If the parent becomes insolvent as a result of this procedure, the main bail-in would take place at the parent company level.[82] To make sure that the holding company has enough strength to absorb the losses in its subsidiaries, the holding company would need sufficient loss-absorbing capacity in the form of equity and convertible

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[79] Ibid., p. 16.

[80] Financial Stability Board, "Recovery and Resolution Planning: Making the Key Attributes Requirements Operational", (2012), pp. 15-16.

[81] This could be done by transferring marketable securities from the parent to the subsidiary in exchange for new equity in the subsidiary. See, T. Huertas, "The Case for Bail-Ins", in Patrick Kenadjian, ed. *The Bank Recovery and Resolution Directive: Europe's Solution for "Too Big to Fail"* (Berlin: de Gruyter, 2013), p. 182.

[82] As Huerta notes, the bail-in at the parent of HC level does not by itself recapitalize the subsidiary. Without converting into equity or writing down the claims of the parent towards the subsidiary, the subsidiary would remain insolvent. Ibid., pp. 182-184.

debt.[83] In this regard, Goodhart and Avgouleas argue that without an ex-ante binding cooperation mechanism, the parent bank will not have enough of an incentive to raise the amount of debt necessary to cover all of the bank's subsidiaries, as bail-inable debt is, in general, expensive.[84]

Most commentators agree that the SPoE is, in theory, the best solution to reduce coordination problems and minimize systemic risk.[85] The SPoE is a very elegant and safe resolution mechanism, and it is particularly suited for banking conglomerates that rely on a holding company atop the group, as do virtually all US banks. Not surprisingly, in the United States the FDIC has chosen this approach in devising the legislative framework for crisis resolution under the Dodd-Frank Act.[86] From an international perspective, a SPoE bail-in would amount to a legalized source of strength for the subsidiary, as it would *oblige* the parent bank to intervene to maintain the stability of the entire banking group.[87] Thus, it would guarantee a perennial discount window for the foreign operations of the group, thereby relieving the host supervisors from some of the hurdles of the resolution.

4.2.2 Multiple Point of Entry

The other option is a Multiple Point of Entry approach (MPoE). In a MPoE, the recapitalization would take place at the local entity level by bailing-in the subsidiary's creditors, and it would be organized by the host authorities. This approach would probably

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[83] In the US, most holding companies are very well capitalized and equipped with various type of debt, which makes them particularly suited for a SPoE approach. On the contrary, continental European and UK banks have a different structure in which the liabilities are scattered around the group. See, Federal Deposit Insurance Corporation and Bank of England, *supra* n. 69, p. 13; See also, Gordon and Ringe, *supra* n. 3, pp. 19-20.

[84] Goodhart and Avgouleas, *supra* n. 3, p. 37

[85] Ibid.; Gordon and Ringe, *supra* n. 3.

[86] Federal Deposit Insurance Corporation, "Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy", Federal Register Vol. 78, No 243 (December 18, 2013); D. A. Skeel, "The Single Point of Entry and the Bankruptcy Alternative", Faculty Scholarship Paper 949 (2014).

[87] Huertas, *supra* n. 74, p. 20.

work best when the banking group is organized as a group of independent and separately capitalized subsidiaries with their own capital and liabilities.[88] The EU BRRD adopts a similar approach, in which the bank group is resolved on a legal entity basis by the competent national supervisors, albeit based on close coordination through resolution colleges.[89]

From a coordination viewpoint, MPoE is somehow easier, as it treats each part of the banking group as a stand-alone entity with its own liabilities and assets. In this context, the main problem is to ensure that each part of the banking group is bailed-in by the competent authority. This means that besides having recognized statutory power to intervene, the host supervisory authorities must ensure that the host subsidiary has at its disposal a primary loss absorbing capacity (PLAC) of around 17-20 per cent of risk weighted assets.[90] In this regard, the FSB has just initiated a consultation on a harmonized framework on loss-absorbing capacity for systemically important banks that would guarantee a similar level of PLAC across different countries. [91]

4.3 Supervisory Conflicts and the Role of the Law in Enhancing Coordination

Supervisory coordination in cross-border banking resolution has historically been based on constructive ambiguity or improvised cooperation.[92] The rationale was to reduce moral hazard and guarantee freedom of manoeuvre with regard to the recapitalization.[93] A long

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[88] Ibid., p. 28.
[89] It is however important to note that, when the Single Resolution Mechanism will enter into force, the Single Resolution Board will be the only competent authority for the bail-in among Banking Union countries.
[90] This means that the total amount of non-core Tier I capital, Tier II capital and senior debt should range around 7 to 10% of the foreign bank's risk weighted assets. See, Huertas, *supra* n. 74, p. 4; The UK Vickers Report proposed 17-20% in primary loss absorbent capacity.
[91] Financial Stability Board, "Adequacy of Loss-absorbing Capacity of Global Systemically Important Banks in Resolution", Consultative Document (10 November 2014).
[92] Freixas, *supra* n. 21.
[93] X. Freixas,"Optimal Bailout, Conditionality and Creative Ambiguity" , *CEPR Discussion Paper 2238* (1999).

history of coordination failures nonetheless demonstrates that in order to work effectively cross-border banking resolution must be based on what Huertas call "constructive certainty".

Bail-in is no different from other crisis resolution mechanisms, as it would suffer from the same underlying incentive problems that make international bailouts and insolvencies so challenging. In the absence of external factors, regulators would probably adopt a non-cooperative approach to minimize the systemic impact on the local financial system. The problems are particularly acute in the context of a SPoE bail-in.

4.3.1 Supervisory Conflicts in a SPoE Bail-In

The literature on crisis resolution demonstrates that the resolution of a bank experiencing difficulty would probably maximise the value of the firm and reduce negative spillovers if the home authorities take a unitary approach and consider the bank in its consolidated structure.[94] In this regard, the main objectives of a SPoE bail-in are to minimize the risk of forbearance of the home authorities in resolving the subsidiary or walking away from it, and to reduce the host authorities' incentives to initiate an independent resolution procedure without the home authorities' approval.[95]

However, even in the context of a bail-in, the parent and the host authorities might suffer from some coordination problems. A SPoE would work only if there is legal certainty that the parent would intervene to maintain the stability of its subsidiaries. The experience with bailouts nonetheless suggests that, under various circumstances, the parent company and the home authority would be reluctant to bear the entire burden of recapitalizing a foreign entity subject to foreign supervision and regulation, even if they agreed to do so in advance.[96]

[94] This can be seen, for instance in cross-border bank insolvencies and bailouts.
[95] Huertas, *supra* n. 74, p. 21.
[96] Schoenmaker, *supra* n.11. pp. 68-88

In general, the bail-in of a multinational bank through a SPoE approach would distribute gains and losses unevenly between the parent bank and the foreign subsidiary. In the bail-in game the host authorities are those that gain the most. From the home authority's viewpoint, the bail-in of the subsidiary by the parent bank would amount to a bailout of the subsidiary's creditors at the expense of the parent's creditors. Furthermore, if the subsidiary is big enough, the bail-in could wipe out the equity in a healthy parent bank, thereby destabilizing the entire banking group.[97] This means that the cost of the recapitalization would be borne entirely by the home financial system. Moreover, if the liabilities were subject to foreign law, the home authorities would risk huge legal battles. Finally, if most of the creditors are concentrated in one particular foreign country, bail-in could create international political problems.[98]

From the host authority's perspective, without the utmost legal certainty that the parent bank would recapitalize the subsidiary, the host authority would probably ring fence the assets of the subsidiary or initiate a separate bail-in procedure. Article 86 of the EU BRRD grants European authorities the right to initiate independent resolution procedures against subsidiaries and branches of non-EU financial institutions whenever the home authority does not sufficiently guarantee intervention or when such intervention would jeopardize financial stability in Europe. Furthermore, countries that apply a territorial approach to the bankruptcy might not recognize the home country's control. Indeed, for those jurisdictions that adopt the territorial approach, it would be difficult to accept a foreign authority modifying the balance sheet of the entities located in its jurisdiction. [99]

Uncoordinated unilateral approaches are extremely dangerous in the resolution of a cross-border bank. Firstly they can reduce the value of the firm and force the home authority to put the rest of the bank into resolution. The objective of host authorities is to sell the assets

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[97] Zhou et al. *supra* n.13, p. 15.

[98] Goodhart and Avgouleas argue that foreign creditors will more likely to flee at the first sign of distress, thereby forcing the bank to rely only on local creditors. Goodhart and Avgouleas, *supra* n. 3, p. 26.

[99] Zhou et al. *supra* n.13, p. 17.

as soon as possible, even at a reduced value, to meet local creditors' demand in full. This means that the consolidated value of the firm is less than what it could have been, and the parent bank's creditors are much worse off. Furthermore, if only the branch or subsidiary is in liquidation it can trigger cross-default clauses in derivatives and repo contracts that would also prevent the parent bank from conducting business.

4.3.2 And in a MPoE Bail-In

In a MPoE, coordination would probably be easier, as each part of the group would be resolved independently by the local authority. However, even in this case, supervisors would have different incentives. The home and the host authorities must agree in advance on the conditions that would trigger the bail-in – for instance, only after the host subsidiary reaches the point of non-viability – and to inform the other authority before taking any action.[100] Under the MPoE approach the host supervisor must recognize that the bank is part of a broader group, which is headquartered in a foreign country. At present, coordination is scarce. In the United States, the legislation on cross-border bank resolution does the opposite. The Federal Reserve Board proposal for the resolution of foreign bank organizations does not require the Federal Reserve to consult foreign agencies before initiating the resolution of the foreign subsidiary.[101]

Furthermore, home and (all) host country authorities must agree to eliminate cross-resolution clauses, which entitle any host authority to sell the subsidiary under their jurisdiction whenever a resolution procedure has been initiated in another legal entity of the group. By doing so, the host authority could end up selling a solvent and healthy subsidiary

[100] Huertas, *supra* n. 74, p. 29.

[101] The Federal Reserve's "Final Rule" implementing Section 165 Dodd-Frank Act requires large foreign banks with operations in the US to establish a US holding company through which all the bank's subsidiaries will operate.

for a reduced price, to the detriment of parent's and other subsidiaries' creditors.[102] Finally, Huertas notes that in a MPoE approach it is implicit that the host authorities do not expect the subsidiary to rely on the parent company as a source of strength. This means also that the host authorities must remove the capital requirements that usually apply with regard to the strength of the parent company.[103]

4.3.3 The Need for Binding International Law

Without real cooperation, national bail-ins will lead to lengthy and disorderly resolutions and, ultimately, to a progressive subsidization of the financial system along national lines.[104] In this situation, a role for international law emerges. The literature on law and economics demonstrates that international law has a powerful role to play in addressing the negative externalities of unilateral actions. As pointed out by Sykes and Posner, (binding) international law is well adapted to address externalities, as it forces states to move from a non-cooperative policy equilibrium in which global welfare is reduced to a more efficient equilibrium in which the marginal costs of economic policies will be commensurate with the marginal benefits from a global perspective.[105]

Coordination would probably take place on different grounds. With regard to the choice between a SPoE or a MPoE, there is no single template for a perfect bail-in, as it all depends on the business structure adopted by each multinational bank. Hence, unless supervisors require their banks to change their corporate structure to fit a particular bail-in approach,[106]

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[102] Huertas, *supra* n. 74, p. 28.
[103] Ibid., p. 29.
[104] Goodhart and Avgouleas, *supra* n. 3, p. 44.
[105] E. A. Posner and A. O. Sykes, *The Economic Foundations of International Law* (Cambridge, Harvard University Press, 2012), at 17-20.
[105] E. A. Posner and A. O. Sykes, "Efficient Breach of International Law: Optimal Remedies, "Legalized Noncompliance," And Related Issues", 110 *Michigan Law Review* (2011-2012), at 248.
[106] Switzerland has requested its main banks to change their business structure to fit the Single-Point-of-Entry approach. See, FINMA, "Resolution of global systemically important banks", *FINMA Position Paper* (August 7, 2013).

each bank could address the location of the liabilities and the point of entry of the bail-in procedure through living wills. Supervisory authorities could agree to all other legal issues in a bilateral Memoranda of Understanding (MoU). Such a MoU should specify which authority will be competent to initiate the procedure and under which conditions,[107] as well as the provision of liquidity by the central bank.[108]

It is also important to ensure that each authority has legal certainty that its actions will be recognized and supported by the foreign authorities where the banking group operates. This is particularly vital in a SPoE approach, whenever the home authority needs the cooperation of the host in bail-in local branches/subsidiaries, or to authorize the transfer of assets back to the parent bank. In this regard, the recent FSB proposal recommends enacting statutory changes in domestic legislation to empower domestic authorities to recognize automatically certain foreign resolution actions, and to authorize support measures that satisfy pre-determined criteria. Foreign authorities should also be given a right of standing and access to fast judicial procedures.[109]

The most important issue, however, is compliance. The history of financial cooperation in crisis resolution shows that non-binding MoUs are totally ineffective in ensuring compliance.[110] Cross-border banking policies prompt a Prisoner's Dilemma scenario in which the most likely decision is not to cooperate.[111] This tendency is reinforced by the fact that banking resolution must take place in a very short time – usually a weekend. Given the sovereignty costs associated with a bank failure, and without legal certainty that the partner authorities will abide by their commitments, supervisors are incentivized to solve the failing bank along national lines, with little regard for partner countries. If properly designed, MoUs

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[107] Huertas, *supra* n. 74, p. 22.
[108] Ibid., p. 21.
[109] Financial Stability Board, *supra* n. 14, p. 8-10.
[110] Claessens et al., *supra* n. 24, pp. 42-55.
[111] P.H. Verdier, "Transnational Regulatory Networks and Their Limits", 13 Yale Journal of International Law (2009), at 125-126.

could reduce the uncertainty as to the procedures to be followed and the role of each national authority, but they do need to be enforceable.[112] Unfortunately, the EU BRRD seems to be inclined towards non-binding agreement. Article 96 states that any arrangement entered into by the EBA or individual states "shall not impose legal obligations upon Member States". This could be explained by the need to maintain policy space for the use of public funds, should the bail-in be insufficient to resolve the failing bank.[113]

5. CONCLUSION

This article suggests that bail-in can present fundamental regulatory challenges when applied to a failing multinational bank. To work successfully, an international bail-in needs a perfect alignment of legal regimes and resolution policies in order to avoid regulatory arbitrage, costly litigation, and ultimately, a disorderly resolution.

To create a viable and globally Pareto optimal bail-in regime, three issues must be addressed. First, banks need to progressively harmonize their business structures in terms of location of debt and legal structure. This would ease regulatory coordination for regulators. Second, regulatory coordination must rest on hard law and binding arrangements, which would reduce the incentive of regulators to free ride. Third, an international regime needs a critical mass of countries willing to agree on a similar regulatory platform.

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[112] See also Goodhart and Avgouleas, *supra* n. 3, p. 36.

[113] G. H. Garcia and M. J Nieto, "Banking crisis management in the European Union: Multiple regulators and resolution authorities", 6 Journal of Banking Regulation (2005); T. F. Huertas, "A Resolvable Bank", *LSE Financial Markets Group Paper Series Special Paper 230* (March 2014), p.21; Claessens et al., *supra* n. 24, p. 96.