

1-1-2013

# International Financial Reforms: Capital Standards, Resolution Regimes and Supervisory Colleges, and their Effect on Emerging Markets

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## Recommended Citation

Duncan Alford, *International Financial Reforms: Capital Standards, Resolution Regimes and Supervisory Colleges, and their Effect on Emerging Markets*, ADBI Working Paper No. 402 (Jan. 17, 2013) Available at SSRN: <http://dx.doi.org/10.2139/ssrn.2202051>.

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**ADB Working Paper Series**

**International Financial Reforms:  
Capital Standards, Resolution  
Regimes and Supervisory  
Colleges, and their Effect on  
Emerging Markets**

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No. 402  
January 2013

**Asian Development Bank Institute**

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The author wishes to thank the attendees at the Asian Development Bank Institute conference entitled *New Paradigms for Financial Regulation and Macro Policies: Emerging Market Perspectives* held in Tokyo on 30 September 2011, for their helpful comments. The author also wishes to thank Rachel Atkinson, Amir Nowroozzadeh, Taylor Smith and Megan Brown for their assistance. All errors or omissions are the author's alone. This article is based on research conducted through 30 December 2011. A working paper containing additional discussion and analysis and more detailed sources is located on SSRN at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2007979](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2007979)

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Suggested citation:

Alford, D. 2013 International Financial Reforms: Capital Standards, Resolution Regimes and Supervisory Colleges, and their Effect on Emerging Markets. ADBI Working Paper 402. Tokyo: Asian Development Bank Institute. Available: <http://www.adbi.org/working-paper/2013/01/16/5430.international.financial.reforms/>

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**Abstract**

This paper focuses on the relevance to emerging economies of three major financial reforms following the global financial crisis of 2007–2009: (1) the improved capital requirements intended to reduce the risk of bank failure (“Basel III”), (2) the improved recovery and resolution regimes for global banks, and (3) the development of supervisory colleges of cross-border financial institutions to improve supervisory cooperation and convergence. The paper also addresses the implications of these regulatory reforms for Asian emerging markets.

**JEL Classification:** G2, G28, O16

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## 1. INTRODUCTION

While the 2007–2008 financial crisis began in the United States, the crisis quickly spread globally causing decreases in gross domestic product and employment levels around the world.<sup>1</sup> The crisis revealed numerous general weaknesses in the supervision and regulation of global banks and financial institutions. National governments and international bodies also recognized these weaknesses in the regulatory and supervisory system of global financial institutions and have begun to take steps to improve the system with the hope of avoiding, or at least mitigating, future financial crises.

1. Since the fall of 2008 when the G-20 met in Washington, DC, at the beginning of the financial crisis, the Heads of State of the G-20 have proposed a flurry of reforms to the international financial system.<sup>2</sup> These proposals cover a wide range of issues and reflect a serious response to the severe financial crisis; however, many portions of the reforms have not yet been fully implemented. The principal proposals<sup>3</sup> include:
2. A significant increase in the amount of the capital requirement for international banks along with a new liquidity ratio intended to strengthen bank resilience during a financial crisis, all part of the Basel III proposal;
3. Intensified supervision of systemically important financial institutions (“SIFIs”). This proposal defines a SIFI and provides for additional loss absorbency capital to be held by the SIFI because of the systemic risk posed if the institution fails. This intensified supervision will also provide for an improved recovery and resolution regime for SIFIs and the use of supervisory colleges to improve supervisory coordination found lacking during the recent financial crisis.
4. Regulation of the shadow banking sector. This proposal will define shadow banking and propose supervision of this sector to respond to the concern that increased regulation and supervision of the traditional financial sectors (banking, insurance, and securities) will drive financial activity to unregulated sectors. These regulations are intended to address the systemic risk posed by the shadow banking sector and any regulatory arbitrage resulting from recent financial reforms.
5. Increased regulation and supervision of over-the counter (“OTC”) and commodity derivatives;
6. Improved macroprudential frameworks and tools. Prior to the financial crisis, policymakers failed to detect (or ignored) systemic risks, particularly macroeconomic risks.
7. Convergence of international accounting standards. The International Accounting Standards Board and the Financial Accounting Standards Board provide two competing sets of standards, making the comparison of the finances of global banks difficult. The G-20 has urged both bodies to converge their standards to create one high-quality global accounting standard.
8. Remuneration practices. This proposal places limits on compensation practices of financial institutions in order to reduce systemic risk.

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<sup>1</sup> Edward Hadas, “Is the Crisis Over?” *New York Times*. 22 April 2009, at B2.

<sup>2</sup> Financial Stability Board, *Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability* (April 10, 2011).

<sup>3</sup> *Id.*

9. Improved adherence to agreed international financial standards through the use of peer reviews of individual G-20 nations, including thematic peer reviews, and the use of supervisory colleges for important cross-border financial institutions.

This paper will focus on three of the above proposed reforms: (1) the improved capital requirements intended to reduce the risk of bank failure (“Basel III”), (2) the improved recovery and resolution regimes for global banks, and (3) the development of supervisory colleges of cross-border financial institutions to improve supervisory cooperation and convergence. In the final section of this article, I will address the implications of these regulatory reforms for Asian emerging markets.

In some ways, these three proposals can be seen as the “book ends” and the “books” of a reformed regulatory and supervisory system. The capital standards are intended to minimize the risk of bank failure—the beginning book end. A recovery and resolution regime is intended to provide an orderly solution in the event of a bank failure—the last book end. Supervisory colleges are the “books” that allow for consistent and effective implementation of these “book end” standards.

Prior to the recent financial crisis, numerous commentators had already concluded that capital levels held by banks were simply too low. The lack of capital intensified the effects of the financial crisis and caused national governments to bail out certain financial institutions in order to preserve financial stability. While supervisors, the financial industry, and academics debate the details of the proposed increase in capital requirements for banks, all such groups, including the financial industry, agree that some increase is necessary.

The recent financial crisis highlighted the ineffective supervisory cooperation among national bank supervisors related to cross-border financial institutions. As a result, several international governmental organizations, national governments and commentators<sup>4</sup> have called for the use of supervisory colleges to supervise global financial institutions, in particular, those SIFIs that have been the recipients of government financial support during the crisis. During the financial crisis, Member States of the European Union (EU) committed aid to banks in the amount of approximately 30% of EU gross domestic product (GDP) and paid out amounts equivalent to 13% of EU GDP.<sup>5</sup> As President Nicholas Sarkozy and Prime Minister Gordon Brown noted in 2009, “Better regulation and supervision are the means by which the risk to the taxpayer can be reduced for the longer term.”<sup>6</sup>

An international regime for the orderly winding up of insolvent banks is a necessary component for truly effective international regulation and supervisory coordination. Without such a regime, policymakers are left with two stark choices: failure of the financial institution with the resulting

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<sup>4</sup> International Monetary Fund, “Initial Lessons of the Crisis for the Global Architecture and the IMF” (February 18, 2009), at <http://www.imf.org/external/np/pp/eng/2009/021809.pdf>; Financial Services Authority, Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), at [http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf); The Group of Thirty, Financial Reform: A Framework for Financial Stability (Jan. 2009), available at <http://www.group30.org>; The Group of Thirty, Working Group on Financial Supervision, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* 48 (2008), available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us\\_fsi\\_banking\\_G30%20Final%20Report%2010-3-08.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf).

<sup>5</sup> Herman van Rompuy, “Reshaping Europe’s Economy—The Role of the Financial Sector,” 3 (9 Feb. 2011), ([http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/119231.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119231.pdf)).

<sup>6</sup> Gordon Brown and Nicolas Sarkozy, “For Global Finance, Global Regulation,” *Wall Street Journal*, 10 December 2009, at A25.

economic disruption or the use of taxpayer funds to recapitalize the financial institution. Several international bodies and commentators have proposed solutions for winding down insolvent financial institutions. This article also explores some of these proposals.

## 2. G-20 SUMMITS AND FINANCIAL REFORMS

The G-20, asserting itself as the pre-eminent forum for international economic cooperation,<sup>7</sup> has addressed the need for reform in the governance, regulation and supervision of the international financial system. The G-20 has called on its members to implement Basel III, contribute to the effectiveness of supervisory colleges, and to adopt a resolution regime for financial institutions.

Beginning with the Washington summit in November 2008 to address the financial crisis, the G-20<sup>8</sup> has recommended the expanded use of colleges of supervisors to supervise SIFIs. Their communiqué from that summit stated that by 31 March 2009:

Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of the efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessments of the risks it faces.<sup>9</sup>

During the London Summit on 2 April 2009, the G-20 leaders established the Financial Stability Board, as successor to the Financial Stability Forum ("FSF"), with the goal of extending "regulation and oversight to all systemically important financial institutions, instruments and markets"<sup>10</sup> and emphasized the use and development of colleges of supervisors in supervising global banks. Furthermore, the Financial Stability Board would expand its membership to include all G-20 countries, FSF members,<sup>11</sup> Spain, and the European Commission,<sup>12</sup> in recognition of the global nature of the financial system and the growing importance of emerging markets in the world economy.

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<sup>7</sup> G-20, "Leaders' Statement, Pittsburgh Summit, Preamble," para. 1–6 (2009) [hereinafter *G20 Pittsburgh*]

<sup>8</sup> The following countries are members of the G-20: Argentina, Australia, Brazil, Canada, the Republic of China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Netherlands, the Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States. G-20, "What is the G-20?" (<http://www.g20.org>). The G-20 represents 89% of global GDP and two-thirds of the world's population. Korea-FSB Financial Reform Conference, "An Emerging Market Perspective" 9 (2010).

<sup>9</sup> G-20, "Declaration Summit on Financial Markets and the World Economy" (2008), *reprinted in Statement from G-20 Summit, New York Times*, 16 November 2008.

<sup>10</sup> G-20, "Declaration on Strengthening the Financial System: London Summit" 1 (2009), available at <http://www.londonsummit.gov.uk> [hereinafter *London Communiqué*].

<sup>11</sup> Finance ministries and central banks from the following nations are members of the Financial Stability Board: Argentina; Australia; Brazil; Canada; the Republic of China; France; Germany; Hong Kong, China; India; Indonesia; Italy; Japan; Mexico; the Netherlands; the Republic of Korea; Russia; Saudi Arabia; Singapore; South Africa; Spain; Switzerland; Turkey; the United Kingdom; and the United States. Financial Stability Board, *Member Institutions*. available at <http://www.financialstabilityboard.org/members/links.htm>.

<sup>12</sup> *London Communiqué*, *supra* note 11.



At the end of the G-20 Summit held in Toronto in June 2010, the Heads of State recognized the importance of a resolution regime addressing systemic institutions and committed themselves “to design and implement a system where we have the powers and tools to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden, and adopted principles that will guide implementation.”<sup>13</sup>

The Heads of State stated their clear intention to reduce moral hazard by designing and implementing “a system where we have the powers and tools to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden.”<sup>14</sup> Any resolution regime should provide for:

- Proper allocation of losses to reduce moral hazard and protect taxpayers;
- Continuity of critical financial services, including uninterrupted service for insured depositors;
- Credibility of the resolution regime in the market;
- Minimization of contagion;
- Advanced planning for orderly resolution and transfer of contractual relationships; and,
- Effective cooperation and information exchange domestically and among jurisdictions in the event of a failure of a cross-border institution.<sup>15</sup>

At the Seoul Summit in November 2010, the G-20 Heads of State continued their commitment to the reform of the international financial system. In their Declaration, the leaders promised to deliver the “core elements of a new financial regulatory framework, including bank capital and liquidity standards, as well as measures to better regulate and effectively resolve systemically important financial institutions, complemented by more effective oversight and supervision.”<sup>16</sup> The G-20 leaders “endorsed the policy framework, work processes, and timelines proposed by the FSB to reduce the moral hazard risks posed by systemically important financial institutions and address the too-big-to-fail problem.”<sup>17</sup> In particular, the G-20 agreed that global SIFIs “should be subject to a sustained process of mandatory international recovery and resolution planning,”<sup>18</sup> and that nations should implement the Basel Committee’s cross-border resolution recommendations.

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<sup>13</sup> G-20, “Toronto Summit Declaration” 5 (26 June 2010).

<sup>14</sup> *Id.* at 13.

<sup>15</sup> *Id.*

<sup>16</sup> G-20 Seoul Summit, “Leaders’ Declaration (Seoul)” 2 (11 November 2010) [hereinafter *Seoul Declaration*].

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

### 3. BASEL III CAPITAL STANDARD

During the financial crisis of 2007–2008, the leaders of the G-20 tasked the Basel Committee on Banking Supervision (“Basel Committee”) to improve the capital standards of international banks as the weakness of international capital standards (Basel II) was seen as a major cause of the crisis. In December 2010, the Basel Committee issued this important reform proposal—a new, more stringent capital standard for banks known as Basel III.<sup>19</sup> The Heads of State of the G-20 previously endorsed this proposal at the November 2010 Summit held in Seoul.

#### 3.1 Minimum Capital Standard

The Basel Committee proposed that international banks hold total capital equivalent to 8% of risk-weighted assets as opposed to the current level of 2% of risk-weighted assets. The definition of risk-weighted assets also changed. More stringent criteria were applied to types of assets and the risk-weights applied to certain assets increased. The intent of the revisions of the Basel capital framework was to capture all material risks of a financial institution. During the recent financial crisis, the Basel II framework failed to capture on and off-balance sheet risks and derivative-related exposures of financial institutions. Under the prior standard, Basel II, the definition of risk-weighted assets underestimated risk exposures, the definition of capital did not reflect the institution’s ability to absorb losses, and the required minimum capital ratios were too low.<sup>20</sup> This failure and the resulting lack of capital intensified the financial crisis. Basel III requires more capital both in quality and in amount. The effect of the Basel III revisions to risk coverage is “to increase the capital charges associated with exposure to counterparties to OTC derivatives, repos and stock lending transactions, in each case which are not cleared through central counterparties and thus provide incentives to employ more standardized derivatives to be cleared centrally.”<sup>21</sup>

Capital under Basel III consists of three components: common equity Tier 1 capital, additional Tier 1 capital, and Tier 2 capital. Basel III emphasizes the importance of common equity as capital. The goal of the Basel Committee is to develop a *minimum* standard; national supervisors are free to apply more stringent capital requirements. The minimum level of common equity Tier 1 capital will be 4.5% of risk-weighted assets with total Tier 1 capital being 6% and total capital including Tier 2 capital being 8% after the phase in period. International banks must meet these capital requirements by 1 January 2015 (Table 1).

**Table 1: New capital requirements and Phase-in period under Basel III**

	From 1 Jan. 2013	From 1 Jan. 2014	From 1 Jan. 2015
Common Equity Tier 1 Capital / Risk Weighted Assets (“RWA”)	3.5%	4.0%	4.5%
Tier 1 Capital / RWA	4.5%	5.5%	6.0%
Total Capital /RWA	8.0%	8.0%	8.0%

<sup>19</sup> Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Dec. 2010, revised June 2011), available at <http://www.bis.org/publ/bcbs189.htm>.

<sup>20</sup> Shadow Financial Regulatory Committee, Statement 207, at 1 (February 14, 2011).

<sup>21</sup> Morrison & Foerster, Basel III: The (Nearly) Full Picture 4 (December 23, 2010), available at <http://www.mofo.com/files/Uploads/Images/101223-Basel-III-The-Nearly-Full-Picture.pdf>.

Source: Author.

In addition to this core capital standard, international banks must also meet an additional capital conservation buffer equivalent to 2.5% of risk-weighted assets. Also, at the discretion of national supervisors, banks may be required to hold an additional amount of capital as a countercyclical buffer equivalent to 2.5% of risk-weighted assets. Thus, the total capital required for international banks could potentially increase from 2% of risk-weighted assets under the previous standard to 13% under the new, more stringent Basel III standard.

### 3.2 Leverage Ratio and Liquidity Ratio

The Basel Committee also proposed a leverage ratio for international banks. This ratio is calculated as the amount of capital held by the bank divided by the amount of exposure of the bank. Exposure includes the value of bank assets and the value of derivatives and off-balance sheet items. Again, the intent is to capture all risks, both on and off-balance sheet, for which the bank is liable. The ratio will be tested at a level of 3% from 1 January 2013 to 1 January 2017. The Basel Committee stated that this ratio may change depending on the Committee's evaluation of its effect on bank operations.

The Basel Committee also recommended a liquidity standard for international banks as part of the new Basel III standard—the first time the Basel Committee has addressed liquidity. The liquidity standard will be measured by two separate ratios: a Liquidity Coverage Ratio and a Net Stable Funding Ratio. The Liquidity Coverage Ratio is the value of high quality liquid assets over the total net cash flow of the bank for a thirty-day period. This ratio should be greater than or equal to one and should be reported monthly to the appropriate supervisor.

In contrast to the Liquidity Coverage Ratio, the Net Stable Funding Ratio is intended to promote the resilience of the bank over a longer time period of one year. This ratio is the bank's Available Stable Funding over its Required Stable Funding. The Required Stable Funding is an amount determined by the appropriate supervisor using assumptions regarding the liquidity risk profile of the bank. The Available Stable Funding is the sum of a bank's capital, preferred stock with a maturity over one year, non-maturing deposits, term deposits, and wholesale funding that is expected to remain with the bank in the event of a financial crisis. This Net Stable Funding Ratio should be greater than or equal to one and must be reported quarterly. The supervisor in the home jurisdiction typically enforces this ratio according to the home jurisdiction's standards. With respect to retail and small business deposits, the liquidity standards of the host jurisdiction are applied.

Supervisors must balance the tension between increasing bank capital to promote financial stability against the effect of decreased economic growth caused by a reduction in bank lending necessitated by the higher capital levels. The Quantitative Impact Study conducted by the Basel Committee as part of the development of Basel III showed that €577 billion were needed to meet these new capital standards for a sample of international banks.<sup>22</sup> This same sample earned after-tax profits of €209 billion in 2009. Retained earnings alone may not be sufficient to fund these new capital standards.

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<sup>22</sup> Basel Committee on Banking Supervision, Quantitative Impact Study (16 December 2010), *available at* <http://www.bis.org/publ/bcbs186.htm>.

### 3.3 Additional Capital Required for Global SIFIs

The Basel Committee has also proposed additional, more stringent capital standards for global SIFIs. These banks are a subset of the international banks subject to Basel III generally because they pose systemic risks to the world economy and thus will receive more intense supervision. The Basel proposal is intended to create a framework for identifying these systemically important banks and not to create a fixed list of such institutions. The Basel Committee proposed an “indicator based measurement approach,” consisting of five indicators of equal weight. The five indicators are:

- (1) Cross-Jurisdictional Activity which will be measured by the amount of cross-jurisdictional claims and cross-jurisdictional liabilities with the idea that the greater the cross-jurisdictional activity of the institution the more difficult it will be to resolve the institution.
- (2) Size which will be measured by the total exposures of the bank used in the calculation of the leverage ratio under Basel III. The theory is that the larger the bank, the more likely its failure would damage the global economy.
- (3) Interconnectedness refers to the network of contractual obligations within which the bank operates and is measured by three sub-indicators: intra-financial system assets, intra-financial system liabilities, and the wholesale funding ratio.
- (4) Substitutability refers to whether there are substitutes or alternatives for major lines of business or services of the bank and is measured by the amount of assets under custody, the amount of payments cleared and settled through payment systems, and the value of underwritten transactions in debt and equity markets.
- (5) Complexity is measured by the notional value of OTC derivatives, the amount of Level 3 assets (whose fair value cannot be determined by using observable measures), and the trading book value and “available for sale” value. This criterion recognizes that the systemic impact of the failure of a bank would typically be more severe as the complexity of the bank increases.<sup>23</sup>

In November 2011 the Financial Stability Board designated 29 financial institutions to be systemic and therefore subject to the additional capital requirement.<sup>24</sup> These banks must hold an additional amount of capital ranging from 1% to a potential 3.5% of risk-weighted assets, depending on the bank’s rating. The higher the rating, the more systemically important the bank, and, thus, more capital must be held. This loss absorbency capital is *in addition* to the other forms of capital required by Basel III.

This additional capital for global SIFIs must consist of common equity Tier 1 capital. The Basel Committee considered the inclusion of bail-in capital<sup>25</sup> but decided not to include these instruments. Rather, in its view, bail-in capital could be used to meet other types of capital required to be held by banks. The effect of this proposal is to increase the capital required to be

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<sup>23</sup> Morrison & Foerster, “Defining Global Systemically Important Banks and Additional Loss Absorbency Requirements,” 12 August 2011.

<sup>24</sup> Financial Stability Board, FSB announces policy measures to address systemically important financial institutions (SIFIs) and names initial group of global SIFIs (4 November 2011), *available at* [http://www.financialstabilityboard.org/press/pr\\_111104cc.pdf](http://www.financialstabilityboard.org/press/pr_111104cc.pdf) These 29 financial institutions are listed in Annex C.

<sup>25</sup> Bail-in capital refers to debt that converts to equity upon the triggering of certain events.

held by global systemically important banks from 2% of risk-weighted assets to potentially 16.5% if all types of Basel III capital are imposed in addition to the loss absorbency capital for a global SIFI.

I will address the implications of the reform of capital standards on emerging markets in the conclusion of this chapter.

## 4. SUPERVISORY COLLEGES

One tool used to improve the international legal framework for financial supervision is the college of supervisors or supervisory colleges for cross-border financial institutions. These *ad hoc* groups are intended to improve the exchange of information among supervisors with the goal of ensuring safe and sound banking practices, reducing the possibility of governmental assistance to financial institutions, and building confidence generally in the international financial system. The hope is that these colleges, which meet on a regular basis to discuss the supervision of a particular financial institution, will identify issues or problems early, then address them quickly and thus reduce the risk of a bail out or a bank failure.

The G-20 and the European Union have been particularly active in developing these colleges and codifying best practices for their operation. However, colleges of supervisors are a limited, incomplete response to the inadequate coordination of supervision of global financial institutions. International supervisory coordination is necessarily hindered because each national supervisor will strive to minimize its use of taxpayer resources to cover any losses from bank failures. At times of crisis, national supervisors tend to ring-fence assets and neglect (or ignore) efforts at supervisory coordination.

Convergence of the types and extent of powers of supervisory authorities is needed to improve coordination of supervision of cross-border financial institutions. Currently, the legal powers of supervisors vary widely among nations. When the supervisors participating in a college have similar legal powers and authority, the college can be more effective. Similarly, the skills and capacity of supervisors varies widely, particularly when one compares the typical developed nation to the typical emerging market. Likewise, the supervisory approach can vary among nations; for example, some countries prefer on-site supervision while others rely on off-site surveillance. Past experience with supervisory colleges illustrates that they are not a complete solution to the issue of effective supervision of global banks.

Supervisory colleges were not first created as a result of the 2007–2008 financial crisis. Financial supervisors have previously formed these groups to monitor financial institutions with cross-border operations. For example, in the late 1980s, a college of supervisors, including authorities from the United Kingdom, Luxembourg, and other European nations, supervised the Bank of Credit and Commerce International (“BCCI”), a bank with operations in several dozen countries. However, this college proved ineffective as the bank was ultimately liquidated because of internal fraudulent activities.<sup>26</sup>

To compensate for the weak supervisory resources directed towards BCCI, bank supervisors from the Cayman Islands; France; Hong Kong, China; Luxembourg; Spain; Switzerland; the United Arab Emirates; and the United Kingdom created a college of supervisors in 1987 to coordinate their supervisory efforts. In the end, this scheme proved unworkable and allowed supervisors to shift responsibility for any BCCI transgression among themselves. No single

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<sup>26</sup> See generally Duncan Alford, “1992 Basle Committee Minimum Standards: International Regulatory Response to the Failure of BCCI,” 26 *Geo. Wash. J. Int. L. & Econ.* 241 (1992).

supervisor had any incentive to supervise BCCI properly, and the supervisors did not cooperate adequately among themselves in sharing information on BCCI operations. In a 2004 speech, Callum McCarthy, then Head of the Financial Services Authority in the United Kingdom, concluded that “in some cases the resources [of a supervisor] are simply not up to the task of acting as a home regulator for a large group” and, in the case of BCCI, “the resources then available in Luxembourg,” the home supervisor, were not sufficient.<sup>27</sup>

#### 4.1 The European Union and Colleges of Supervisors

The EU has been particularly active in utilizing colleges to supervise financial institutions operating in multiple Member States. Their experience can be instructive for other financial supervisors, including those from emerging markets despite the differences in development of their respective economies.

The European Banking Authority (“EBA”), and its predecessor, the Committee of European Banking Supervisors (“CEBS”), have the objective “to foster supervisory convergence across the Community.”<sup>28</sup> In furtherance of this objective, CEBS was active in supporting the development of supervisory colleges of cross-border banks within the European Union and has recently stated: “[T]he establishment of supervisory colleges and their functioning is a cornerstone of the new institutional framework.”<sup>29</sup>

The recent financial crisis focused renewed attention on colleges of supervisors as one of several tools to reduce risk within the international financial system. In January 2009, CEBS updated its guidance on supervisory colleges and provided more specific detail on the operations and best practices of the colleges of supervisors. In its *Colleges of Supervisors—10 Common Principles*,<sup>30</sup> CEBS and its sister agency CEIOPS provide that a college of supervisors shall supervise any cross-border insurance group, banking group or financial conglomerate. The colleges—flexible, permanent fora for cooperation and coordination among financial supervisory authorities—shall have agreements in place describing the cooperation between the supervisors and the practical organization of the supervisory activities of the financial institution. For banking groups, the consolidating supervisor as defined in the Capital Requirements Directive shall initiate the cooperation process. The colleges shall also promote harmonization of supervisory approaches, coordinate all major supervisory decisions, plan and coordinate supervisory on-site inspections, and share the findings from such visits with other members of the college.

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<sup>27</sup> Callum McCarthy, “How Should International Financial Service Companies Be Regulated?” para. 13 (22 September 2004), available at <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP196.shtml>.

<sup>28</sup> Commission Decision of 23 January 2009 establishing the Committee of European Bank Supervisors, 2009 O.J. (L 25) 23, para. 12. See generally Duncan E. Alford, “The Lamfalussy Process and EU Bank Regulation: Another Step on the Road to Pan-European Regulation?”, 25 Ann. Rev. Banking & Fin. L. 389 (2006).

<sup>29</sup> CEBS, Annual Report, 6 (2010), available at <http://eba.europa.eu/Publications/Other-Publications/Annual-Report.aspx>

<sup>30</sup> Committee of European Bank Supervisors & Committee of European Insurance and Occupational Pension Supervisors, College of Supervisors—10 Common Principles, CEBS No. 2008 124 (2009), available at <http://www.c-eps.org/getdoc/aeecaf1a-81b5-476a-95dd-599c5e967697/Clean-V3-formatted-CEBS-2008-124-CEIOPS-SEC-08-54-.aspx>.

The EU Regulation creating the European Banking Authority grants the EBA the authority to mediate disputes between the national supervisory authorities.<sup>31</sup> The regulation states that if the national supervisors cannot reach an agreement after a conciliation period, the EBA “may . . . take a decision requiring them to take specific action or to refrain from action in order to settle the matter, with binding effects for the competent authorities concerned, in order to ensure compliance with Union law.”<sup>32</sup> This power is intended to promote convergence of supervisory practice and builds upon the mediation powers previously granted to CEBS.

The EU has taken additional steps to buttress colleges as a supervisory tool. In several directives, the EU institutionalized greater cooperation among supervisors supervising cross-border banks. In the adoption of the Basel II directive dealing with capital requirements of credit institutions,<sup>33</sup> the European Union specifically created rules dealing with cooperation among supervisors of cross-border banks operating in the EU. In this directive, Chapter 4 (Articles 124 through 144) of this directive lays out rules determining which supervisor, also known as the lead supervisor, exercises consolidated supervision over the cross-border bank.<sup>34</sup> Articles 125 and 126 set forth detailed rules identifying the lead supervisor, depending on the structure of the credit institution and its relationship to any parent financial holding company. The membership of the college shall include supervisors from all EU Member States where the credit institution has a subsidiary. Under Article 126(3), the supervisors may waive these rules, appoint a lead supervisor selected among themselves to supervise the credit institution, and notify the Commission of such appointment. In addition, Article 131 of the CRD requires that the supervisors “shall have written coordination, cooperation agreements in place.”<sup>35</sup> Within the EU, these colleges carry out the tasks set forth in the CRD, generally limited to regulating capital requirements of financial institutions. In practice, colleges of supervisors may expand their purview to include other supervisory matters.

Until the enactment of the EBA regulation, one weakness of the college of supervisors within the EU was the lack of a mandatory mediation process if the supervisors could not agree on an action with respect to the supervision of the financial institution. As seen in the recent financial crisis, this lack of mediation allowed supervisors to act on their own and not in coordination with their peers. For example, in the fall 2008 rescue of Fortis, the financial group with operations in Belgium, the Netherlands, and Luxembourg, the national supervisors struggled to coordinate their actions.<sup>36</sup> At first, the Benelux governments purchased 49% of the equity of Fortis. Then a few days later, the Dutch government seized the Dutch operations of Fortis and the Belgian and

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<sup>31</sup> Regulation 1093/2010, O.J. (L 331) 12 (15 December 2010).

<sup>32</sup> *Id.* at art. 20(3).

<sup>33</sup> Directive 2006/49/EC, 2006 O.J. (L 177) 201; Directive 2006/48/EC, 2006 O.J. (L 17) 1. Council Directive 2006/49/EC, 2006 O.J. (L177) 201; Council Directive 2006/48/EC, 2006 O.J. (177) 1.

<sup>34</sup> Council Directive 2006/48/EC, art. 125 – 132, 2006 O.J. (177) 1, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF>, as amended by Directive 2009/111, 2009 O.J. (L 30) 97.

<sup>35</sup> *Id.* at art. 131.

<sup>36</sup> Nikki Tait & Jennifer Hughes, “Trichet Calls for Supervision of All Institutions,” *Financial Times*, 24 February 2008.

Luxembourgian operations were sold to BNP Paribas.<sup>37</sup> These events illustrate a lack of effective supervisory cooperation, particularly during times of crisis. Even among supervisors who have a long practice of cooperation, namely, the Benelux authorities, cooperation can break down in times of crisis as national interests come to the fore. Recognizing the weaknesses in the supervisory system highlighted by the financial crisis, the EU responded with legislative proposals to reform the EU system.

## 4.2 The European Union's Reform of Financial Supervision<sup>38</sup>

On 23 February 2009, a high level group of advisors, chaired by Jacques de Larosière, former Governor of the Banque de France, issued its report on the reform of the EU system of financial supervision, also known as the Larosière Report.<sup>39</sup> Appointed by Jose Barroso, the President of the European Commission, in the fall of 2008, the High-Level Group was charged with a broad mandate "to make proposals to strengthen European supervisory arrangements covering all financial sectors, with the objective to establish a more efficient, integrated and sustainable European system of supervision."<sup>40</sup> While a complete analysis of this report is beyond the scope of this article, this article will focus on the report's recommendations related to supervisory cooperation within the EU. The Larosière Report in Recommendation 18 advised that "colleges of supervisors would be set up for all major cross-border institutions."<sup>41</sup> For cross-border institutions, the colleges of supervisors introduced by the revised Capital Requirements Directive ("CRD") and the Solvency II Directive should take the lead in supervision.<sup>42</sup>

The report also stated that the "relatively restrictive use of supervisory colleges should be expanded immediately."<sup>43</sup> By the end of 2009, supervisory colleges should be established for all major cross-border firms within the EU, estimated to be at least 50 financial institutions.<sup>44</sup> The Level 3 committees<sup>45</sup> would participate in this process by defining the supervisory practices and

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<sup>37</sup> Ulrich Volz, "Europe Needs a United Approach to the Credit Crunch," *Wall Street Journal*, 7 October 2008, at A27.

<sup>38</sup> A timeline of the current effort to reform the European Union legal framework for financial supervision is attached as Annex A.

<sup>39</sup> Jacques De Larosiere et al, "The High-Level Group on Financial Supervision in the EU " (2009), *available at* [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf). [hereinafter *Larosière Report*]. This group held 11 public meetings and consulted widely to develop its 31 recommendations to improve financial services regulation within the EU.

<sup>40</sup> Press Release, High Level Expert Group, High Level Expert Group on EU Financial Supervision to Hold First Meeting on 12 November 1P/08/1679 (11 November 2008), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1679&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>41</sup> *Larosière Report*, *supra* note 40, at 48.

<sup>42</sup> *Larosière Report*, *supra* note 40, at 47.

<sup>43</sup> *Larosière Report*, *supra* note 40, at 51.

<sup>44</sup> *Id.*



arrangements for the functioning of the colleges of supervisors and would themselves participate in supervisory colleges. The clear intent is to expand the mandate of CEBS – to be more inclusive of the supervisory players and to broaden the tasks of colleges beyond those stated in the CRD. The report recommended transforming the Level 3 committees into three supervisory authorities, one for each financial sector: banking, securities and insurance—the European Banking Authority (the “EBA”), the European Securities Markets Authority (the “ESMA”) and the European Insurance and Occupational Pensions Authority (the “EIOPA”).

After over a year of negotiation, the Council and the European Parliament in September 2010 agreed on final versions of legislation reforming the EU financial regulatory system. I will focus on the EBA Regulation which transformed CEBS into a European supervisory authority, the European Banking Authority.<sup>46</sup>

The EBA has the authority to submit both regulatory technical standards and implementing technical standards to the European Commission for approval.<sup>47</sup> Once submitted, the Commission can reject or request amendments to the standard. However, the Commission cannot change the text of the standards without coordinating with the EBA. While this legislation does not provide regulation-making authority equivalent to that of national supervisory agencies, it does provide the EBA with significant influence in creating the standards. The Regulation explicitly provides that the Council or the European Parliament can revoke this delegation of power to issue technical standards.

Member States throughout the negotiations were concerned about the power of the EBA to issue decisions directly applicable to financial institutions. Some Member States and national supervisors, particularly in the United Kingdom, were concerned that the EBA would circumvent the authority of national supervisors. The final regulation does allow, under certain limited conditions, the EBA to issue decisions directly applicable to financial institutions.

The EBA also has the power to settle disagreements between national supervisors of cross-border financial institutions. The regulation requires the EBA to attempt at first to mediate any dispute. If the national supervisors cannot reach an agreement, then the EBA by a majority vote of its Board of Managers issues a decision settling the matter. The EBA decision supersedes any earlier decision issued by the national supervisor. This dispute settlement power coupled with the supremacy of the EBA decision over national supervisors will enable the EBA to create “a sound, effective and consistent level of regulation and supervision” within the EU—one of the goals of this Regulation. However, this power to settle disputes is limited by the safeguard

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<sup>45</sup> The Level 3 committees refer to the Committee of European Banking Supervisors (“CEBS”), the Committee of European Securities Regulators (“CESR”), and the Committee of European Insurance and Occupational Pension Supervisors (“CEIOPS”). These committees were set up under the Lamfalussy process to advise the Commission and its committees on implementing measures need to effectuate financial regulation.

<sup>46</sup> Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Banking Authority), Amending Decision No. 716/2009/EC and repealing Commission Decision 2009/78/EC, 2010 O.J. (L 331) 12, 24–5, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF> [hereinafter EBA Regulation]. Regulation (EU) No. 1092/2010 of the European Parliament and of the Council of 24 November 2010 Establishing a European Systemic Risk Board, 2010 O.J. (L 331) 1; Regulation (EU) No. 1094/2010 of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L 331) 48; Regulation (EU) No. 1095/2010 of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84.

<sup>47</sup> EBA Regulation, *supra* note 47, at 24–25.

provision providing that no such decision “impinges in any way on the fiscal responsibilities of Member States.”<sup>48</sup>

The Regulation provides for the EBA to be closely involved in the operation of colleges of supervisors. The EBA is “able to participate in the activities of colleges of supervisors, including on-site examinations.”<sup>49</sup> The final regulation enumerates specific tasks of the EBA related to colleges of supervisors.<sup>50</sup> For instance, the EBA may develop draft regulatory and implementing technical standards related to the operation of colleges of supervisors. Finally, the EBA shall “have a legally binding mediation role to resolve disputes between competent authorities.”<sup>51</sup>

The EBA’s authority to issue decisions resolving a dispute among national supervisors or in the event of a financial emergency is subject to a broad safeguard. The EBA shall not issue a decision that “impinges in any way on the fiscal responsibilities of the Member State.”<sup>52</sup> If a Member State believes that an EBA decision does impinge on its fiscal responsibilities, it can appeal to the Council of the European Union to review the decision. Depending on the type of decision, the Council by its action or inaction can render the decision ineffective.<sup>53</sup> Additional language was added stating any abuse of the safeguard, particularly where there is no material fiscal impact, “shall be prohibited as incompatible with the internal market.”<sup>54</sup> This broadly worded safeguard provision significantly weakens the EBA’s authority. However, this article does not apply to decisions issued by the EBA and endorsed by the Commission related to the breach of EU law. If the action of a national supervisor breaches EU law, the safeguard provision and its delaying procedure do not apply.

The EBA is not optimally independent for a regulatory agency. National supervisors who are subject to its decisions serve on the EBA board. The grounds for dismissal of the head of the EBA are not specified. A representative of the European Commission serves on the board in a non-voting capacity but nevertheless “raises the issue of potential political interference on the [EBA’s] policy decisions.”<sup>55</sup>

Colleges of supervisors are crucial for harmonized supervision within the EU. Proper supervision is not possible “unless the [national] supervisors responsible for monitoring the

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<sup>48</sup> *Id.* at art. 38.

<sup>49</sup> *Id.* at art. 21(1).

<sup>50</sup> The EBA is expected to collect all relevant information needed for the effective operation of the colleges and to institute EU-wide stress tests of financial institutions. The EBA can request further deliberations by colleges, may require the consolidating supervisor to schedule a meeting of the college, and can add items to the agenda of the college.

<sup>51</sup> *Id.* at art. 21(4).

<sup>52</sup> *Id.* at art. 38(1).

<sup>53</sup> *Id.* at art. 38(2)–(4)

<sup>54</sup> *Id.* at art. 38(5).

<sup>55</sup> Donato Masciandoro, Maria J. Neito & Marc Quintyn, “The European Banking Authority: Are Its Governance Arrangements Consistent with Its Objectives,” *Vox*, 7 February 2011, available at <http://www.voxeu.org/index.php?q=node/6084>

subsidiaries (and even branches) of those groups are fully involved in the supervision exercised by the "home supervisor" over the parent company."<sup>56</sup> There are two potential dangers with colleges: one, inconsistent decisions between colleges and, second, failure to take any action in the event of disagreement within a college. The ESAs will reduce inconsistency by attending the colleges as a coordinator and identifying and communicating best practices among colleges. The EBA's powers to issue regulatory and implementing technical standards regarding the operation of supervisory colleges, to mediate disputes among supervisors in a college, to issue binding decisions to a national supervisor, and to issue a decision directly to a financial institution if the supervisor fails to comply with the decision will strengthen the EBA's ability to develop more uniformity in banking supervision within the EU. However, all such decisions are subject to the broad safeguard provision.

The previous explanation of the developments within the EU illustrates the difficulty in integrating the supervision of cross-border financial institutions. Even within the EU where there is a legal framework to enact reform, harmonizing financial regulation and supervision has been difficult and is still incomplete, after several decades of effort. The EBA is not a true supranational regulatory agency. Member States can appeal its decisions, including those issuing technical standards, to the European Council. The EBA's expanded mediation role is an improvement over past practice, but not a definitive solution. All decisions are subject to the broad safeguard provision which was designed to protect national sovereignty.

Any international agreement to harmonize the regulation and supervision of financial institutions will be even more difficult to achieve because there is no legal framework on which to rely as exists in the EU. The incentive to maintain national sovereignty is even greater in the international arena without a vehicle similar to the EU treaty structure supporting the economic integration of Europe and an "ever closer union among the peoples of Europe."<sup>57</sup> However, the European supervisory authorities such as the EBA created by the EU "offer important lessons for efforts to create a comparable body outside the European Union."<sup>58</sup>

### 4.3 Basel Committee on Supervisory Colleges

In its October 2010 *Good Practice Principles on Supervisory Colleges*<sup>59</sup> (the "Principles"), the Basel Committee issued eight general principles on the operation of colleges of supervisors. The Basel Committee stated that supervisory colleges are not a substitute for effective national supervision of financial institutions. Furthermore, supervisory colleges are not decision-making bodies but rather "provide a framework to enhance effective supervision of international banking groups."<sup>60</sup> The Basel Committee notes that supervisory colleges provide a useful forum in which to share information regarding the overall risk assessment of a banking group and in which to discuss and plan the supervisory assessment of a financial group. Ultimately, the regular

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<sup>56</sup> *Larosière Report*, *supra* note 55, at 5.

<sup>57</sup> Treaty on European Union, Preamble, 2010 O.J. (C 83) 3, 15 (30 March 2010).

<sup>58</sup> Eric Pan, "Four Challenges to Financial Regulatory Reform," 55 *Villanova L. Rev.* 743, 771 (2010).

<sup>59</sup> Basel Committee on Banking Supervision, *Good Practice Principles on Supervisory Colleges*, (2010) *available at* <http://www.bis.org/publ/bcbs170.pdf>.

<sup>60</sup> *Id.* at 1.

interaction and exchange of information among supervisors within a college should enhance the mutual trust and understanding among the supervisors.

The Principles do not prescribe a particular structure of a supervisory college; rather, the college structure should be flexible and proportionate to the size and complexity of the financial institution. The Principles do recognize that the home supervisor who leads the college should designate members of a core college and a general college. The home supervisor should have regular, continuous communication with members of the core college who represent the jurisdictions in which significant operations of the financial institution exist. Members of the general college represent jurisdictions where the financial institution has less significant operations. The college should hold regular physical meetings among the supervisors and the core college should meet at least once annually. The Basel Committee recognizes that the operation of supervisory colleges and crisis management groups are distinct but complementary activities.

The implications from emerging markets of the development of supervisory colleges will be explored in the conclusion.

## 5. RESOLUTION AND INSOLVENCY REGIMES

At the urging of the G-20, both the FSB and the Basel Committee have proposed the creation of a resolution regime for SIFIs. During the recent financial crisis, the lack of such a regime necessitated the bail out of financial institutions by national governments in order to preserve financial stability and prevent an even more severe economic downturn. The creation of a resolution regime, particularly in a cross-border context, has proven difficult and, despite the urging of the G-20 and considerable effort by various international bodies and academics, few concrete actions have been taken thus far.

In creating a bank resolution regime, the different objectives of a corporate insolvency regime and a bank insolvency regime must be recognized. Corporate insolvency laws attempt to reach “a fair and predictable treatment of creditors and the maximization of assets to satisfy creditors’ claims.”<sup>61</sup> On the other hand, the bank insolvency regime must “ensure the protection of (insured) depositors and the continuity of banking and payment services” and minimize the contagion of a bank failure.<sup>62</sup> As long as these goals are attained, a bank should be allowed to fail in order to avoid moral hazard.

Commentators have presented three theoretical approaches for the resolution of financial institutions: universalism, territoriality, and modified universalism.<sup>63</sup> Under the universalist approach, SIFIs are subject to a single resolution process. The home country laws with respect to bankruptcy and resolution would apply to all assets of the SIFI wherever located. This approach would require some sort of *ex ante* burden sharing agreement among the relevant national authorities. From the supervisor’s point of view, the ideal structure of a SIFI under this

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<sup>61</sup> Basel Committee Cross-Border Resolution Group, Report and Recommendations of the Cross-Border Bank Resolution Group, 9 (2010), available at <http://www.bis.org/publ/bcbs169.pdf>.

<sup>62</sup> *Id.*

<sup>63</sup> Stijn Claessens, Richard J. Herring and Dirk Schoenmaker, “A Safer World Financial System: Improving the Resolution of Systemic Institutions” 2 (Brookings Institute, International Center for Monetary and Banking Studies 2010).

approach would be a single entity. Under this approach, national regulatory authority, particularly the authority of the host supervisor, is not preserved.

Under the territoriality approach, there would be no sharing of assets between supervisors in different countries in the event of a SIFI failure. The ideal SIFI structure for this approach would be stand alone subsidiaries within each country of operation. This approach encourages the ring-fencing of assets during a crisis. In other words, no transfer of assets across jurisdictions is allowed. This approach fails to attain efficient cross-border financial integration as each subsidiary is separately capitalized and intra-group transfers are restricted.

Under the modified universalist approach, the home country addresses the overall resolution of the SIFI while the host country is responsible for the resolution of the local host operation. This approach is similar to the bankruptcy procedure where there is a main proceeding and ancillary proceedings in other jurisdictions. Under this system, the mutual recognition and broad harmonization of supervisory and resolution regimes would be helpful. Under this approach, some national regulatory authority is ceded by the host jurisdiction to the home jurisdiction.

Historically, the territoriality approach has prevailed. Following the territoriality approach ignores international coordination and the realities of globalization. The universal approach is not currently feasible because there is no political consensus or will to create a global financial regulator or resolution authority. Even in the EU where financial integration has progressed significantly and there is an overarching legal framework for financial integration, the creation of a true pan-European regulator or resolution authority has not occurred.

## 5.1 European Union Proposal for a Resolution Framework

In October 2009, the European Commission proposed the creation of a resolution framework for European cross-border banks. Noting that the “recent crisis has exposed the EU’s lack of an effective crisis management [framework] for cross-border financial institutions,”<sup>64</sup> the Commission sought comments on an EU harmonized resolution and insolvency regime for cross-border financial institutions.

Current EU laws regarding the resolution of EU financial institutions are minimal. The Directive on the Reorganization and Winding Up of Credit Institutions (the “Winding Up Directive”)<sup>65</sup> takes a modified universal approach to the resolution of EU cross-border institutions<sup>66</sup> and provides that courts located in the same jurisdiction as the home supervisor govern the resolution of the parent institution and any branches. However, the Winding Up Directive does not apply to financial institutions that operate as subsidiaries in Member States. Many European financial institutions operate as subsidiaries in their cross-border operations and thus national laws, with significant variations, govern the resolution of the subsidiaries of an insolvent parent financial institution. The Winding Up Directive principally focuses on determining which national court has

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<sup>64</sup> “Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank: An EU Framework for Cross-Border Crisis Management in the Banking Sector,” at 2, COM (2009) 561 final, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0561:FIN:EN:PDF>. [hereinafter *2009 Communication*].

<sup>65</sup> Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the Reorganization and Winding Up of Credit Institutions, 2001 O.J. (L125) 15, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:125:0015:0023:EN:PDF>.

<sup>66</sup> “Basel Committee Cross-Border Bank Resolution Group,” *supra* note 62, at 23.

jurisdiction over the proceedings in a particular case and intends to ensure that there is only one set of insolvency proceedings for a distressed financial institution; it does not provide a complete, EU-wide system for resolving in an orderly manner the claims against a failing credit institution. The Directive does not apply to non-EU incorporated institutions and makes no attempt to harmonize national insolvency legislation.<sup>67</sup>

History reveals that, in a financial crisis, national law predominates. Given the variations in national insolvency laws, the resolution of cross-border institutions becomes difficult and inefficient. Without a pan-European resolution regime, Member States tend to ring-fence national assets. For example, the actions taken regarding Fortis in 2008 illustrate the strong incentive to ring-fence assets even among bank supervisors that have a significant history of cooperation.<sup>68</sup> As the Commission notes, “If insolvency law is national, domestic authorities have a legitimate—as well as strong political interest to ring-fence the national assets of an ailing bank in order to protect national deposits and maximize the assets available to the creditors of the national entity.”<sup>69</sup>

After receiving and considering public comments, the European Commission in *An EU Framework for Crisis Management in the Financial Sector*<sup>70</sup> sets forth in general terms the content of legislation related to crisis management within the EU financial sector. The framework intends that financial institutions should be allowed to fail without risk to financial stability and without cost to taxpayers. This crisis management framework is based on the following seven principles: (1) put prevention and preparation first, (2) provide credible resolution tools, (3) enable fast and decisive action, (4) reduce moral hazard, (5) contribute to a smooth resolution of cross-border groups, (6) ensure legal certainty, and (7) limit distortions of competition.<sup>71</sup> The Commission’s framework is comprised of three steps: (1) a legislative proposal for a harmonized regime for crisis prevention and bank recovery and resolution, (2) further harmonization of bank insolvency regimes within the EU, and (3) the creation of an integrated resolution regime that could include a single European resolution authority.<sup>72</sup> To accomplish this objective, the Commission is developing three classes of measures—“preparatory and preventative measures; early supervisory intervention; and resolution tools and powers.”<sup>73</sup> Some Member States possess these tools now; for some Member States, these tools will be new. Each Member State will be required to designate a resolution authority to exercise these powers. The resolution authority should be an administrative body rather than a

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<sup>67</sup> “2009 Communication,” *supra* note 65, at 9.

<sup>68</sup> See footnotes 37–38 and the accompanying text.

<sup>69</sup> *Id.*

<sup>70</sup> “Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank: An EU Framework for Crisis Management in the Financial Sector” 3, COM (2010) 579 final, , available at [http://ec.europa.eu/internal\\_market/bank/docs/crisis-management/framework/com2010\\_579\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf)

<sup>71</sup> *Id.* at 3–4.

<sup>72</sup> DG Internal Market and Services, Technical Details of a Possible EU Framework for Bank Recovery and Resolution (January 2011).

<sup>73</sup> *Id.* at 4.

judicial body. In most cases, an existing authority, such as the central bank, the finance ministry, or a deposit guarantee scheme, can be designated the resolution authority.

To meet its stated goals, the Commission proposes a new type of entity—a resolution college. The resolution college will build upon the existing colleges of supervisors by including the resolution authorities for cross-border groups. The Commission recognized that ideally there would be a single pan-European authority that “would deliver a rapid, decisive and equitable resolution process for European financial groups, and better reflect the pan-EU nature of banking markets.”<sup>74</sup> However, the Commission recognizes that it would be difficult politically to create such an integrated system. The resolution colleges are a more moderate and realistic approach to bank resolution. The EBA would serve as an observer on the resolution colleges much as it does with the colleges of supervisors.

In order for a resolution regime to be credible, there must be resolution funds available. The Commission recognizes that much more work is needed to create a credible funding mechanism and that framework must include a mechanism to finance any resolution with the cost being primarily borne by the shareholders and creditors of the financial institution. The Commission recommends some sort of *ex ante* funding by financial institutions for any resolution regime. The European Commission is currently reviewing comments from a consultation on the creation of a resolution framework for financial institutions within the EU.

## 5.2 Basel Committee Cross-Border Resolution Group

Other international standard setting bodies have also issued guidelines related to crisis management. The Basel Committee on Banking Supervision through its Cross-Border Resolution Group also issued a report that “seeks to complement the work of the FSB by providing practical detailed approaches to implement the FSB’s Principles for Cross-border Cooperation on Crisis Management”<sup>75</sup> related to the resolution of cross-border banks.<sup>76</sup> Similar to the European Commission, the Basel Committee took a middle ground approach, recognizing that the *status quo* was not acceptable and that an international agreement on the resolution of cross-border banks was “both unlikely and unenforceable as the practical implications of burden sharing give rise to considerable challenges.”<sup>77</sup> The report makes ten recommendations related to improving the coordination of the resolution of cross-border financial institutions. The report recommends that national supervisory authorities should have the necessary tools for the orderly resolution of a cross-border institution. Each nation should have a national framework providing for the resolution of financial groups. Over time, supervisory authorities should seek the convergence of these resolution tools to allow for better coordination of resolution and should consider procedures that would “facilitate the mutual recognition of crisis management and resolution proceedings.”<sup>78</sup> Contingency plans of SIFIs should address “a period of financial

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<sup>74</sup> *Id.* at 12.

<sup>75</sup> Financial Stability Forum, FSF Principles for Cross-Border Cooperation on Crisis Management (2009), *available at* [http://www.financialstabilityboard.org/publications/r\\_0904c.pdf](http://www.financialstabilityboard.org/publications/r_0904c.pdf). [hereinafter *FSF Principles*].

<sup>76</sup> Basel Committee Cross-Border Bank Resolution Group, Report and Recommendations of the Cross-Border Bank Resolution Group 8 (2010), *available at* <http://www.bis.org/publ/bcb169.pdf>.

<sup>77</sup> *Id.* at 19.

<sup>78</sup> *Id.* at 1.

distress” and should be a regular part of the supervisory process.<sup>79</sup> Key home and host supervisors of systemic institutions should “agree, consistent with national law and policy, on arrangements that ensure the timely production and sharing of needed information.”<sup>80</sup> The drafters recognize that a territorial approach by supervisors predominates because of “the absence of a multinational framework for sharing fiscal burdens for [financial] crises or insolvencies” and “the fact that legal systems and the fiscal responsibility are national.”<sup>81</sup>

### 5.3 Key Attributes of Effective Resolution Regimes for Financial Institutions

Building on its earlier July 2011 report<sup>82</sup> and in preparation for the G-20 Cannes Summit in November 2011, the Financial Stability Board issued *Key Attributes of Effective Resolution Regimes for Financial Institutions* (“*Key Attributes*”) setting forth its minimum standard for a resolution regime applicable to global SIFIs.<sup>83</sup> The FSB’s objective in issuing this new international standard is “to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss.”<sup>84</sup> The *Key Attributes* delineate twelve essential features for a resolution regime. If a financial institution is systemically significant, it must be subject to a resolution regime. Each nation must designate a resolution authority. If there are several possible authorities, the nation must designate a lead authority. The resolution authority must have operational independence and the ability to enter into agreements with resolution authorities from other jurisdictions. The resolution authority must have a broad range of powers, including the ability to replace senior management of the SIFI, to terminate contracts, to override shareholder rights, to transfer or sell assets, to create bridge banks and to create an asset management vehicle. Any setoff or netting rights must be clear and transparent. The resolution regime must respect the hierarchy of creditors’ claims with some flexibility on the part of the authority in order to contain the systemic impact of the resolution of the financial institution.

Creditors should have “a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm.”<sup>85</sup> However, judicial action should not impede the implementation of the resolution. Creditors should seek compensation, rather than injunctive relief. Resolution should not rely on public ownership or public bailout funds. The

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<sup>79</sup> *Id.* at 2.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* at 4.

<sup>82</sup> Financial Stability Board, *Effective Resolution of Systemically Important Financial Institutions* (19 July 2011), available at [http://www.financialstabilityboard.org/publications/r\\_110719.pdf](http://www.financialstabilityboard.org/publications/r_110719.pdf)

<sup>83</sup> Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011). The Leaders of the G-20 approved the *Key Attributes* at the November 2011 Summit in Cannes, France. G-20 Leaders Summit, Final Communiqué, ¶13 (4 November 2011).

<sup>84</sup> *Id.* at 3.

<sup>85</sup> *Id.* at 11.



resolution authority should have the ability to cooperate with resolution authorities from foreign jurisdictions and the authority's statutory mandate should "strongly encourage the authority wherever possible to achieve a cooperative solution with foreign resolution authorities."<sup>86</sup> National insolvency law should not discriminate against creditors based on their nationality. Home and key host authorities should maintain and participate in crisis management groups for each SIFI. Crisis management groups should enter into institution-specific cross-border cooperation agreements.<sup>87</sup>

The home resolution authority in cooperation with other members of the crisis management group should conduct regular resolvability assessments of the financial institution. "Robust and credible recovery and resolution plans" should be in place<sup>88</sup> with the home resolution authority leading the development of the resolution plan and updating the plan annually. Finally, there should be no legal, administrative or political impediments to exchanging information with foreign resolution authorities. The SIFI must maintain management information systems capable of producing needed financial information to supervisors on a timely basis.

The *Key Attributes* are an international standard for resolution regimes in the event of the failure of a SIFI.<sup>89</sup> This new standard reinforces the role of the home resolution authority and attempts to provide incentives for national authorities to cooperate in planning and conducting the resolution of a SIFI.

## 5.4 Recovery and Resolution Plans—"Living Wills" for Financial Institutions

Supervisors are requiring financial institutions to develop living wills as part of the planning for a financial crisis. In the United States, the Dodd-Frank Act requires systemically significant financial companies to report a plan "for rapid and orderly resolution in the event of material financial distress or failure."<sup>90</sup> U.S. regulators and Congress have thus adopted living wills as a tool to avoid future bank failures. The Federal Reserve and the FDIC recently promulgated regulations stating the details that financial institutions must disclose in these plans.<sup>91</sup>

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<sup>86</sup> *Id.* at 13.

<sup>87</sup> *Key Attributes*, *supra* note 84. Annex I of the *Key Attributes* describes the essential elements of such an agreement.

<sup>88</sup> *Id.* at 16.

<sup>89</sup> Financial Stability Board, Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability 7 (4 November 2011), available at [http://www.financialstabilityboard.org/publications/r\\_111104gg.pdf](http://www.financialstabilityboard.org/publications/r_111104gg.pdf).

<sup>90</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5325(d)(1) (2011). The statute applies to non-bank financial companies supervised by the Federal Reserve and "large, interconnected bank holding companies." See also David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 127 (2010).

<sup>91</sup> "FDIC Adopts 'Living Wills' Regulations," CCH Federal Banking Law Reports, No. 2435 (15 September 2011). Financial regulatory agencies in the United States have recently issued regulations regarding recovery and resolution plans that must be filed by banks operating in the United States. 12 C.F.R. Part 243 (2012); 12 C.F.R. Part 381 (2012).

Financial conglomerates have hundreds – sometimes thousands – of subsidiaries, creating very complex institutions.<sup>92</sup> This complexity is a reflection of regulatory arbitrage, and any orderly wind-down is hampered by the “lack of international agreement on cross-border resolution.”<sup>93</sup> Large financial institutions should have a wind-down plan that will assure its regulators and its college of supervisors that the institution can be wound down without unacceptable contagion effects. Such a plan will “make the primary supervisor and the college of supervisors aware of what they need to do if a SIFI approaches bankruptcy.”<sup>94</sup>

An outstanding issue is whether regulators will require financial institutions to restructure its operations and related corporate entities in advance to allow for a more orderly wind-down proceeding. In any event, regulators must have special resolution authority in order to avoid a last minute government bailout. The resolution authority must support market discipline allowing for “wiping out shareholders, changing management, and paying off creditors (promptly) at estimated recovery cost (not at par).”<sup>95</sup>

A living will is a recovery and resolution plan for a financial institution.<sup>96</sup> Typically the bank will draft the initial plan to be reviewed and challenged by the supervisors.<sup>97</sup> The core supervisory college—the home supervisory and key host supervisors—typically conduct this review. The living will should cover all operations of the bank; therefore, there should be one plan rather than separate national plans. The development of living wills may lead to the simplification of complex legal structures of global financial institutions.

Living wills ideally should include a burden sharing plan among the institution’s supervisors. Each country’s burden will be aligned to the benefit the country would receive in the event of financial distress—the economic value of the “maintenance of financial stability.”<sup>98</sup> The core supervisory college would prepare the burden-sharing agreement. Because each country would have a financial obligation pursuant to the burden-sharing agreement, “it has an incentive to make sure that supervision is properly done to minimize the possibility of failure.”<sup>99</sup> However, living wills will not be as effective as intended without a harmonized insolvency procedure for financial institutions across nations, which does not currently exist.

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<sup>92</sup> For instance, Lehman Brothers had “a presence in some 50 countries and comprised almost 3000 legal entities before the crisis.” Vitor Constancio, A European Solution for Crisis Management and Bank Resolution, 14 November 2011, available at <http://www.bis.org/review/r111117c.pdf>

<sup>93</sup> Morris Goldstein, “Integrating Reform of Financial Regulation with Reform of the International Monetary System,” WP-11, 10 (Peterson Institute for International Economics, 2011), available at <http://www.iie.com/publications/wp/wp11-5.pdf>.

<sup>94</sup> *Id.* at 13.

<sup>95</sup> *Id.* at 14.

<sup>96</sup> Emilion Avgouleas, Charles Goodhart, Dirk Schoenmaker, “Living Wills as a Catalyst for Action 2” (2010) available at <http://fic.wharton.upenn.edu/fic/papers/10/10-09.pdf>.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 6.

<sup>99</sup> *Id.*

In assessing the current status of cross-border resolution recommendations, the Basel Committee, noted that, overall, recent reforms show a “clear trend towards the introduction of special resolution regimes (SRRs) and tools aimed at ‘public interest’ objectives,”<sup>100</sup> though such reforms are being implemented by jurisdictions at a varied pace. These reforms address the gap in national resolution regimes which lack “certain essential powers, including the power to terminate unnecessary contracts, continue needed contracts, sell assets and transfer liabilities.”<sup>101</sup> The lack of these powers risks increasing the cost and difficulty of resolution.

Despite countries having implemented necessary domestic resolution changes, “uncertainty remains as regards the mechanisms and processes to implement and ensure recognition of resolution measures in a cross-border context.”<sup>102</sup> A small number of jurisdictions have “cross-border agreements that specifically deal with cooperation and coordination in managing and resolving a financial crisis.”<sup>103</sup> These agreements generally consist of bilateral or multilateral memoranda of understanding which promote heightened cooperation; however, they are usually non-binding and are not institution-specific.

## 6. CONCLUSION

Before analyzing each of the three reforms discussed, there are limitations on the ability of emerging markets to implement any reform of or change in financial regulation and supervision. Prior to the November 2010 G-20 Summit in Seoul, the Republic of Korea and the FSB held a conference highlighting the concerns of emerging markets with the ongoing financial system reforms.<sup>104</sup> Speakers at this conference noted that emerging markets are particularly vulnerable to external shocks to their economy, are susceptible to changes in capital inflows and outflows during times of crisis, and have few tools to smooth out the flow of capital.<sup>105</sup> Asian markets learned this lesson during the 1997–98 financial crisis.

Emerging markets generally lack the supervisory capacity to implement many of the proposed reforms. Existing supervisors in emerging markets generally are few in number, lack sufficient resources, and lack the supervisory knowledge and experience comparable to that available in developed nations. For any reforms to be effectively implemented, additional training and resources must be devoted to emerging market supervisory capacity.

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<sup>100</sup> Basel Committee on Banking Supervision, “Resolution Policies and Frameworks—Progress so far,” Executive Summary, 1 (July 2011).

<sup>101</sup> *Id.* at 2.

<sup>102</sup> *Id.* at 4.

<sup>103</sup> *Id.*

<sup>104</sup> Republic of Korea-FSB Financial Reform Conference: An Emerging Market Perspective (2–3 September 2010), available at <http://www.g20.org/Documents2010/09/Korea-FSB%20Financial%20Reform%20Conference%20booklet.pdf>

<sup>105</sup> Emerging market financial systems were designed to mobilize domestic savings to foster economic growth and with no conception of a future global, interconnected financial market. Andrew Sheng, “From Asian to Global Financial Crisis: An Asian Regulator’s View of Unfettered Finance in the 1990s and 2000s 360” (2009).

Emerging markets are at different stages of development; this fact is rarely acknowledged in reform proposals. Many potential customers in emerging markets are outside of the formal banking sector. For instance, in Kenya, only 23% of customers participated in the formal banking sector in 2009. The banking sector in emerging markets tends to be a large share of the credit market generally, as opposed to the securities markets which tend to be less important and less sophisticated. Customer behavior and the structure of the banking system can differ significantly from those in the developed countries. Because of the significant differences in the development of emerging markets and industrialized nations, proposed reforms should allow for the exercise of national discretion by emerging markets and for a phase in of these reforms depending on the level of development of the emerging market.

## 6.1 Basel III—Implications for Emerging Markets

A general concern with the Basel Committee has been the dominance of supervisors from the Western developed world in the creation of its standards. Historically, the membership of the Basel Committee has been relatively small and closed, consisting of supervisors from certain OECD member countries.<sup>106</sup> During the development of the Basel III proposal, the membership of the Basel Committee doubled to 27 member nations with the intent to align its membership with that of the G-20, which includes the larger emerging markets.<sup>107</sup> Despite this increase in membership, there is a concern that Basel III represents the interests of banks in the developed world more so than in emerging markets.

Few emerging market banks are global SIFIs and, therefore, few are subject to the additional loss absorbency capital requirement and other reforms focused on SIFIs. In the FSB's recent list of systemically important financial institutions, only one financial institution headquartered in an emerging market was included—the Bank of China. Furthermore, emerging market supervisors have typically required higher levels of capital in the banks they supervise than those required under Basel III. Therefore, the initial effect of Basel III on emerging market banks will likely be moderate.

However, the world economy is dynamic and, in the near future, some emerging market banks will grow and become global SIFIs. According to a recent analysis, emerging markets represent 54% of world GDP, 50% of world trade, and approximately 25% of financial assets.<sup>108</sup> Recent trends indicate that emerging markets will continue to gain an increasing share of all three measures. In addition, global banks have significant operations in emerging markets. For example, the Spanish bank Santander operates in numerous countries in Europe and Central and South America and approximately 44% of its earnings come from emerging markets.<sup>109</sup> Similarly, HSBC operates around the globe with nearly half of its earnings generated in emerging markets.<sup>110</sup> While Basel III may have little immediate effect on banks headquartered in

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<sup>106</sup> The Organization for Economic Cooperation and Development is based in Paris and its membership consists principally of developed nations. Members of OECD are listed at [www.oecd.org](http://www.oecd.org).

<sup>107</sup> Barbara A. Rehm, "Basel III Point Man Answers Critics of the Capital Rules," *American Banker*, vol. 176, no. 170 (1 September 2011). Emerging market members of the Basel Committee include the Republic of China, Turkey, South Africa, Brazil and India.

<sup>108</sup> "Why the Tail Wags the Dog," *The Economist* (6 August 2011).

<sup>109</sup> Santander, "2011 Financial Report First Half."

<sup>110</sup> HSBC, "First Half 2011 Interim Results."

emerging markets, the higher capital requirements will affect global banks that can dominate the banking system of certain emerging markets. In order to fund the higher capital requirement, the parent company may charge higher interest rates for credit in all its operations wherever located. Host jurisdictions, often emerging markets, will benefit little from this higher level of capital held by the parent bank although host operations may have funded a portion of this capital through higher interest rates charged to borrowers.

Emerging markets may suffer the indirect economic effect of decreased capital inflows resulting from Basel III. Under Basel III, SIFIs will hold a higher level of capital and may limit their investments in smaller financial markets, which for now tend to be emerging markets. Thus, emerging market supervisors have focused on and should monitor the implementation of Basel III and the additional loss absorbency capital for global SIFIs. If present economic growth trends continue, some of their supervised banks will relatively soon become global SIFIs and therefore subject to more intense supervision.

## 6.2 Supervisory Colleges—Implications for Emerging Markets

Similar to Basel III, international efforts to establish supervisory colleges have also focused on global SIFIs. Within a supervisory college, the home supervisor generally takes the lead in college activities. The host supervisor within a college has a limited role, particularly where foreign banks operate in their jurisdiction through branches rather than as a subsidiary.

Supervisory colleges as currently envisioned “endorse the leadership of the home-country regulator” and do not address conflicts between the home and host regulator.<sup>111</sup> Home country supervisors are frequently based in developed nations and may have little understanding of emerging markets. Because global bank operations in emerging markets tend to be relatively smaller, supervisors from emerging markets are likely not included in the core college, consisting of the supervisors from the jurisdiction where the SIFIs’ most significant operations are located. Rather, supervisors from emerging markets are typically relegated to the general college.

Home country control is the core principle of international supervisory cooperation.<sup>112</sup> The EU reinforces this principle with the use of the EU passport for banks – allowing a bank licensed in one EU jurisdiction to operate as a branch throughout the EU. This system of home country rule is designed assuming that most financial risk would emerge from a host jurisdiction and be transferred to home jurisdictions. The assumption is that host jurisdictions are typically emerging markets and the home jurisdictions are developed nations. Most of the financial institution’s activities are centered in the home jurisdiction, namely, developed economies. In interconnected, global financial markets, these historical assumptions no longer hold. The 2007–2008 financial crisis illustrated how the risk of contagion can come from any jurisdiction in an interdependent world.

Host countries where foreign-owned banks control the banking system have little leverage over home supervisors supervising those banks. For example, in Eastern Europe, large, foreign-owned banks control a significant share (over 45%) of the banking assets in Slovenia, Poland, and Estonia, among others. The host jurisdiction may represent a small portion of the global

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<sup>111</sup> Erik Berglof & Katharina Pistor, “European Financial Regulation’s Wrong Turn,” *The New Times*, September 29, 2009.

<sup>112</sup> Katharina Pistor, “Host’s Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis,” European Corporate Governance Institute Working Paper 286/2010 (June 2010).

bank's activities, and the home supervisor is less concerned with the host's portion of the global bank's operations because a failure there would likely have a minor effect on the institution as a whole. The home supervisor is focused on the global bank as an entity and encourages diversification within the bank to minimize the risk of failure. The host supervisor is primarily concerned with the stability of the financial system in the host jurisdiction and how the bank licensed in the home jurisdiction could affect that stability.

The host supervisor lacks information on the entire operation of the bank, while the home supervisor lacks information on or understanding of the impact that a failure of the bank will have in the host jurisdiction. The home supervisor has little incentive to change its behavior as it does not bear the costs of failure within the host jurisdiction. In the past, the costs incurred in a host jurisdiction are typically borne by a multilateral financial institution, such as the International Monetary Fund ("IMF"), which places conditions on the host jurisdiction in exchange for financial assistance.

Incentives for supervisors to share information are weak. A key challenge arising in the operation of supervisory colleges is the legal constraint on sharing confidential information about financial institutions among the supervisors.<sup>113</sup> Thus far, statements regarding cooperation among supervisors, including sharing information, during a financial crisis are not enforceable. During a crisis, supervisory cooperation deteriorates quickly because of "the complex distribution of tasks between home and host- country authorities, the lack of *ex ante* burden-sharing agreements, and the limited power of host authorities to protect markets."<sup>114</sup> Full cooperation among supervisors will be hindered because of the absence of a cross-border insolvency procedure for financial institutions. Since an orderly way to resolve claims against a cross-border financial institution does not currently exist, supervisors necessarily focus on protecting their national interests -- the rights of residents within their jurisdiction who may have claims against a failing financial institution.

This effort to create supervisory colleges has not yet extended to regional SIFIs.<sup>115</sup> As regional banks grow in size, regional supervisory colleges should be established similar to those in the EU and for global SIFIs. As financial institutions become more active regionally, colleges should be "developed in a parallel fashion."<sup>116</sup>

Supervisory colleges are strengthened when members have similar legal powers and are independent from political influence. Often, this is not the case. Recognizing both the intensity and effectiveness of supervision during the financial crisis was lacking, the FSB in Fall 2010 recommended strengthening the quality of supervision and revising the Basel Core Principles

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<sup>113</sup> Financial Stability Board, Overview of Progress in the Implementation of the G20 Recommendation for Strengthening Financial Stability 10 (4 November 2011), available at [http://www.financialstabilityboard.org/publications/r\\_111104gg.pdf](http://www.financialstabilityboard.org/publications/r_111104gg.pdf)

<sup>114</sup> *Id.*

<sup>115</sup> Douglas W. Arner and Cyn-Young Park, "Global Financial Regulatory Reforms: Implications for Developing Asia," 57 ADB Working Paper Series on Regional Economic Integration 1, 6 (September 2010), available at [http://aric.adb.org/pdf/workingpaper/Arner\\_Park\\_2010\\_Global\\_Financial\\_Regulatory\\_Reforms.pdf](http://aric.adb.org/pdf/workingpaper/Arner_Park_2010_Global_Financial_Regulatory_Reforms.pdf).

<sup>116</sup> *Id.* at 12.

for Effective Bank Supervision.<sup>117</sup> Supervisors must have adequate resources, an appropriate mandate and true independence. Approximately one-third of the 130 nations reviewed under the IMF-World Bank Financial Sector Assessment Program do not have a truly independent bank supervisor. Similarly, resources devoted to bank supervision vary by country. The number of supervisors assigned to a SIFI varied from 14 government officials per SIFI in one country to over 100 supervisory officials per SIFI in another.

Because host supervisors generally have little influence within a college, supervisors from emerging markets with similar interests may want to combine efforts to influence a supervisory college. Countries at similar stages of economic development and with similar policy interests—such as vulnerability to capital flows—may wish to combine efforts and speak with one voice in a particular college to influence outcomes regarding a financial institution. Of course, this combination is easier said than done as national interests and policies come into play. Home supervisors typically call college meetings and invite attendees so, as a first matter, emerging market supervisors may first need to combine their efforts to ensure they are included in the core college. Once they have secured a presence or representative voice in the core college, emerging market supervisors can then proceed to raising their concerns regarding the effect on financial stability in their jurisdiction by global SIFIs.

### 6.3 Resolution Regimes—Implications for Emerging Markets

Unlike Basel III and the development of supervisory colleges, there has been little discussion of the effect on emerging markets of the third reform discussed -- resolution regime proposals. Such proposals discussing the resolution of cross-border financial institutions typically include two components: recovery of the financial institution and resolution or winding down of the institution. In a recovery plan whose goal is to maintain the bank (or at least a portion of it) as a going concern, the smaller operations of a global bank, typically those in an emerging market, may be wound down first. The bank operations in the emerging market may be significant to that market, but small in comparison to the bank's global operations. In an effort to save the bank as a going concern, smaller operations may be closed first or capital support from the parent company to smaller operations withheld.

The home supervisor and the related college of supervisors typically approve the resolution plan for a global bank, the plan to liquidate the bank's operations in an orderly manner. As seen in the discussion of supervisory colleges, host supervisors tend to have little leverage over the home supervisor or within the college. As a result, the host supervisor, frequently from emerging markets, will likely have little influence on the contents of the resolution plan.

The resolution regime proposals thus far tend to encourage banks to operate as subsidiaries in foreign markets. Because global cooperation is in practice difficult, some nations have insisted on more local self-sufficiency of bank operations within their borders, by requiring the creation of subsidiary structures for national operations. For instance, Malaysia requires foreign banks to operate as subsidiaries within its borders. While the subsidiary structure may have the added benefit of facilitating the resolution of cross-border banks, this structure may be costly for some banks as it will prevent certain business models and may require higher levels of capital and liquidity than an integrated bank would need. While operating as a subsidiary allows for separate

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<sup>117</sup> Financial Stability Board, Intensity and Effectiveness of SIFI Supervision (November 2, 2010), *available at* [http://www.financialstabilityboard.org/publications/r\\_101101.pdf](http://www.financialstabilityboard.org/publications/r_101101.pdf). The Basel Committee issued a revised version of the Core Principles for Effective Banking Supervision for consultation in December 2011. Basel Committee on Banking Supervision, "Core Principles for Effective Banking Supervision: Consultative Document" (December 2011).

capitalization and for ring-fencing of assets in the event of financial distress, the subsidiary structure may not be economically efficient. Over the long term, the subsidiary structure may discourage operations in emerging markets because the parent corporation may not wish to commit this level of capital to emerging markets and hinder the transfer of capital within the parent's global operations.

A new Concordat between home and host countries with respect to crisis management is needed.<sup>118</sup> Supplanting the Basel Concordat that focused on home-host supervisory coordination, this new Concordat would set standards allowing for the resolution of cross-border banks. Under the new Concordat, financial institutions would only be able to enter a market if effective resolution arrangements existed in both the home and host countries. The *Key Attributes* issued by the FSB may be the beginning of this new Concordat.

Until a resolution regime for cross-border financial institutions is effectively implemented, national governments are unlikely to relinquish their sovereignty over the resolution of claims against an insolvent financial institution. As seen in the creation of the European Banking Authority, the United Kingdom insisted on placing a brake on EBA decisions because of the possibility of a Member State expending national government funds to comply with an EU decision counter to the Member State's own public policy choice. While colleges of supervisors may improve the surveillance function over cross-border financial institutions by improving the flow of prudential information, truly full supervisory cooperation will not occur until a credible, international regime for the resolution of financial institutions is designed and implemented.

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<sup>118</sup> Claessens, *supra* note 64, at 99.



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Why the Tail Wags the Dog. *The Economist*. 6 August 2011.

## ANNEX A: EUROPEAN UNION FINANCIAL SUPERVISION LEGAL FRAMEWORK

29 October 2008	Barroso appoints Larosière group	From Financial Crisis to Recovery: A European Framework for Action, COM(08) 114 final.
25 February 2008	Larosière Report issued	The High-Level Group on Financial Supervision in the EU (25 Feb. 2009), at <a href="http://ec.europa.eu/internal_market/finances/docs/de_la_rosiere_report_en.pdf">http://ec.europa.eu/internal_market/finances/docs/de_la_rosiere_report_en.pdf</a> .
4 March 2009	The European Commission issues a COM document based on the Larosière Report	Communication for the Spring European Council: Driving European Recovery, Volume 1, COM(09)114 final.
19 June 2009	The European Council approves the ESFS and the ESRC	<i>Brussels European Council 18/19 June 2009 Presidency Conclusions</i> , European Council Doc. 11225/2/09 REV 2 (10 July 2009), at <a href="http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ec/108622.pdf">http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ec/108622.pdf</a>
16 September 2009	Capital Requirements Directive Amendments published	Council Directive 2009/111/EC, 2009 O.J. (L 302) 97.
23 September 2009	European Commission proposes regulations creating three European Supervisory Authorities	Proposal for a Regulation of the European Parliament and of the Council Establishing a European Banking Authority, COM(09)501 final; Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority, COM(09)502 final; Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority, COM(09)503 final.
November 2010	Regulations creating the three European Supervisory Authorities enacted	Regulation No. 1092/2010 establishing the European Banking Authority Regulation, 2010 O.J. (L 331) 12 (15 Dec. 2010). Regulation establishing the European Insurance and Occupation Pension Supervisory Authority No. 1094/2010, 2010 O.J. (L 331) 48 (15 Dec. 2010). Regulation No. 1095/2010 establishing the European Securities and Markets Authority, 2010 O.J. (L 331) 84 (15 Dec. 2010).
November 2010	Regulation creating a new macroprudential supervisory framework enacted	Regulation No. 1092/2010 on European Union macro-prudential oversight of the financial crisis and establishing a European Systemic Risk Board, 2010 O.J. (L 331) 1 (15 Dec. 2010)
July 2011	Directive and Regulation regarding Capital Requirements (implementing Basel III)	Proposal for a directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM(2011) 453 final (20 July 2011); Proposal for a Regulation on Prudential Requirements for Credit Institutions and Insurance Firms, COM(2011) 452 final (20 July 2011).

## **ANNEX B: RESOLUTION FRAMEWORKS—IMPORTANT DOCUMENTS**

Directive 2001/24/EC on the Reorganization and Winding Up of Credit Institutions	April 2001
FSF Principles for Cross-Border Cooperation on Crisis Management	April 2009
Report and Recommendations of the Cross-Border Bank Resolution Group issued by the Basel Committee	September 2009
An EU Framework for Cross-Border Crisis Management in the Banking Sector	October 2009
An EU Framework for Crisis Management in the Financial Sector	October 2010
Technical Details of a Possible EU Framework for Bank Recovery and Resolution	January 2011
Financial Stability Board, Effective Resolution of Systemically Important Financial Institutions	July 2011
Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions	November 2011

## ANNEX C: SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS SUBJECT TO ADDITIONAL LOSS ABSORBENCY CAPITAL

Bank of America	JP Morgan Chase
Bank of China	Lloyds Banking Group
Bank of New York Mellon	Mitsubishi UFJ FG
Banque Populaire CdE	Mizuho FG
Barclays	Morgan Stanley
BNP Paribas	Nordea
Citigroup	Royal Bank of Scotland
Commerzbank	Santander
Credit Suisse	Société Générale
Deutsche Bank	State Street
Dexia	Sumitomo Mitsui FG
Goldman Sachs	UBS
Group Crédit Agricole	Unicredit Group
HSBC	Wells Fargo
ING Bank	

Source: Financial Stability Board, FSB announces policy measures to address systemically important financial institutions (SIFIs) and names initial group of global SIFIs (4 Nov. 2011), *available* at [http://www.financialstabilityboard.org/press/pr\\_111104cc.pdf](http://www.financialstabilityboard.org/press/pr_111104cc.pdf)