

DRAFT COMMENT LETTER TO THE FSB

EFFECTIVE RESOLUTION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

This letter presents the comments of the Dubai Financial Services Authority (DFSA) on the Consultative Document published on 19 July 2011.

The DFSA is the independent regulator for financial services in the Dubai International Financial Centre. We thus approach this consultation:

- as predominantly a small host regulator, in a region where GSIFs will commonly have operations which are unlikely to pose global risks, but may be systemically important in local terms;
- as an integrated regulator, covering banking, securities and insurance and dealing with both prudential and conduct of business matters;
- as a common law jurisdiction, but located in a region where civil law, and Shari'a, are both important, and where insolvency frameworks tend to be underdeveloped; and
- with direct experience of regulating Islamic finance, including some Islamic activities of potential GSIFs.

We note also that insofar as changes need to be incorporated into jurisdictions' legal regimes, it will not be possible to restrict them to SIFs, whether local or global. Whilst this can certainly be done for supervisory arrangements, and for the exercise of discretion, legal regimes, especially in contentious areas like insolvency, require reasonable certainty in defining their boundaries, and this cannot be delegated to an external organisation like the FSB. Furthermore, once resolution arrangements are established in law, there are bound to be pressures to use them for firms whose failure would cause material damage to counterparties, but which might not be systemic in the true sense. The legal elements of the proposals therefore need to be considered in the context of possible application to a relatively wide range of financial services firms.

One further general point to which the FSB should give attention is the likelihood of regulatory arbitrage. To the extent that any of the proposals may involve cost to firms (for example cost of capital resulting from bail-in provisions), there will be an incentive to avoid this cost through changes to corporate structures, geographical location, etc, where these changes do not impose higher costs of their own. An important part of the FSB's consideration should be to stress-test its proposals against responses of this kind.

Effective Resolution Regimes

In this context we note that thinking about insolvency in the context of Shari'a law is at a relatively rudimentary level. (The Islamic Financial Services Board and the World Bank earlier this year published "Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance", which provides a good guide to the issues.) To give just one example, traditionally creditors are only those with matured debt, which clearly limits the ability of many who would normally be deemed creditors to take part in insolvency proceedings. One important feature of traditional Shari'a thinking is that all unsecured creditors rank *pari passu*, which clearly limits the ability to establish a hierarchy of claims. More work will therefore need to be done to consider how effective resolution regimes can be implemented in countries where Shari'a law is a significant element of the legal system. There may

also be instances in Islamic finance where Shari'a may be held to apply to particular transactions even within a common or civil law system.

If the resolution regime is to be applied to insurers, it will need to take account of the fact that in an insurance failure there may be very material uncertainty on the liability side of the balance sheet. The problems over asbestos liabilities in the 1980s and 1990s are merely an extreme version of a common problem. Some of those who will become creditors may not even know at the point of resolution that they have a claim. In such circumstances, it may be difficult to give firm assurance that all creditors are in a better position than they would have been in an ordinary liquidation.

Creditor hierarchy, depositor preference and depositor protection in resolution

The problems we have already noted above in Shari'a law will in any event be an impediment to a convergence of statutory ranking of creditors across jurisdictions. In addition, the structures used in Islamic finance raise substantial questions about depositor preference and deposit insurance. A common structure in Islamic banking is the Profit Sharing Investment Account (PSIA), which in market terms plays a similar role to a conventional deposit account. It is in principle an investment product, in which both return and principal are at risk, but in practice banks use various smoothing mechanisms to provide a return very similar to a conventional deposit and often mirroring conventional interest rates in the same market. Some regulators therefore follow the underlying principle, and treat PSIAs as investments; others treat them as deposits. Views in this area tend to be strongly held, and the situation is further complicated by the fact that there has been no legal test of this position in an insolvency.

On a different point, the issues around depositor preference are to some extent mirrored in relation to policyholder preference in an insurance resolution. In this case, however, those with active claims may well have at stake a sum much greater than they paid to the company, and they bought insurance precisely to reduce risk. It is much harder to respond to those with a large sum at stake – say, a firm whose factory has burnt down – that they should not have put all their eggs in one basket.

Early termination rights

One issue that will need to be considered here is whether the prospect of suspension of termination rights might, in some circumstances, lead to their being exercised early. If the termination rights are straightforwardly linked to entry into resolution this will not be a problem. But we must assume that if such rights can be over-ridden, lawyers will turn their minds to creating rights which can be exercised during the run-up to resolution. For example, there might be more extensive use of the ratings triggers which are common in reinsurance contracts. In such circumstances, unless entry into resolution is wholly unexpected, the effect will have been merely to bring forward the rush for the exits.